CLEARY GOTTLIEB

ALERT MEMORANDUM

The Top Intellectual Property Decisions Of 2017: Their Practical Impact And Strategies For Addressing Them

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The Supreme Court issued several important intellectual property decisions over the course of last year, but for the most part its opinions notably lacked any real weighing of policy considerations or practical consequences. In the patent field in particular, the Supreme Court repeatedly rejected the Federal Circuit's efforts to fashion patent-specific jurisprudence based on concerns perceived as unique to patent law. Instead, in reversing the Federal Circuit in six of seven cases, the Court hewed to simple (if not simplistic) principles of law, with little regard for their market impact. Here, we recap the most important decisions and their practical implications, and offer suggestions for pragmatic, strategic responses to these new developments.

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Patents

1. The Supreme Court Eliminates Laches As A Defense In Patent Suits

In *SCA Hygiene Products Aktiebolag v. First Quality Baby Products, LLC*, the Supreme Court ruled that laches can no longer serve to bar pre-suit damages based on a patent owner's unreasonable and prejudicial delay in filing suit.[1] The Court reasoned that, because the Patent Act limits the period of recoverable damages to six years prior to suit, further limiting damages based on laches would be inappropriate.[2] The ruling extends to patent suits the holding in *Petrella v. Metro-Goldwyn-Mayer, Inc.*, which similarly eliminated laches from copyright suits.[3]

As a practical matter, eliminating laches gives patent holders the tactical option to defer suing while an alleged infringer develops the market for an infringing product and engages in years of sales, thus maximizing the claimed damages and correspondingly increasing the potential risk alleged infringers will face. In partial response to these concerns, the Supreme Court noted that equitable estoppel remains available as a defense,[4] but estoppel requires proof that a patentee affirmatively misled a defendant into believing it would not be sued. Thus, it does not protect innocent infringers who are unaware of the patent at issue. Apart from the reference to equitable estoppel, the majority observed that policy concerns are a matter for Congress.

Some may argue that eliminating laches will have little impact because laches rarely succeeded as a defense in practice. But the mere existence of laches as a potential defense may have deterred patentees from intentionally delaying suit. Now, nothing prevents patentees from using delay as a tactical tool, with confidence that they can always seek damages going back at least six years before suit is filed. Companies that practice their patented inventions will have an incentive not to delay, but rather to move quickly against infringing competitors in the hope of protecting market share by winning an injunction against them. But non-practicing entities – colloquially referred to as "trolls" – may now treat tactical delay as another weapon in their arsenal.

There are a number of strategies for responding to the elimination of the laches defense. To guard against the enhanced risks of delayed infringement suits, companies launching new products should give even more attention to "freedom to operate" assessments for identifying relevant patents and ensuring that their products do not infringe. When faced with long-delayed infringement claims, defendants should explore a "non-infringing alternative" argument – contending that, with earlier notice, they could have switched to a non-infringing design, and accordingly, damages should be limited to the cost of such a redesign. Further, defendants should consider the availability of a potential patent "marking" defense – that the plaintiff failed to mark its products (or those of its licensees) with the asserted patent number, barring the recovery of damages for the period before the plaintiff sued or gave notice of its claim.

2. The Supreme Court Extends The Reach Of Patent Exhaustion

The Supreme Court's June 2017 ruling in *Impression Products, Inc. v. Lexmark Int'l, Inc.*[5] dramatically extends the reach of patent exhaustion – the principle that a patentee's sale of a product "exhausts" its patent rights, leaving the purchaser and subsequent owners

[1] 137 S. Ct. 954, 959 (2017).
[2] *Id.*
[3] 134 S. Ct. 1962, 1977 (2014).
[4] *SCA Hygiene*, 137 S. Ct. at 967.
[5] 137 S. Ct. 1523 (2017).

free to use or resell the product free from infringement claims. *Lexmark* addressed two questions: (1) whether a patentee that sells an item under an express restriction on the purchaser's right to reuse or resell the product may enforce that restriction through an infringement lawsuit; and (2) whether a patentee exhausts its U.S. patent rights by selling its product outside the United States.

On both questions, the Supreme Court reversed the Federal Circuit and ruled in favor of exhaustion, holding that "a patentee's decision to sell a product exhausts all of its patent rights in that item, regardless of any restrictions the patentee purports to impose or the location of the sale."[6] The key driver of the Court's opinion is simple: the common law rule against restraints on alienation. Writing for the Court, Chief Justice Roberts traced this principle of "impeccable historic pedigree" as far back as Lord Coke's observation in the 17th century that "if an owner restricts the resale or use of an item after selling it, that restriction 'is voide, because . . . it is against Trade and Traffique, and bargaining and contracting betweene man and man.'"[7] While this guiding principle may be simple, the market consequences of the Court's ruling – which the *Lexmark* opinion barely mentions – are more complex.

The Supreme Court's ruling will have the greatest impact in two areas. First, those patent owners whose products can be resold have lost the ability to use patent infringement claims to ward off competition in the secondary market. The *Lexmark* facts illustrate the point. In its contracts with consumers, Lexmark offered a lower price in exchange for the purchaser's agreement not to reuse or sell the cartridges to others. Lexmark brought an infringement suit against Impression Products, a remanufacturer of printer cartridges that refurbished and resold Lexmark printer cartridges that it bought from consumers. The key question addressed by the Court was whether Lexmark's initial sale to consumers exhausted its patent rights, or whether the restrictions Lexmark sought to impose on the initial purchaser's reuse or resale of the cartridges could effectively avoid exhaustion. The Court's ruling in favor of exhaustion effectively barred Lexmark's infringement suit against Impression Products. As a result, Lexmark can no longer use its patents on its toner cartridges to avoid competition by preventing companies such as Impression Products from refilling and refurbishing cartridges. Unsurprisingly, the biggest manufacturers of printers and copiers – including Canon, Epson, Hewlett-Packard and Xerox – aligned with Lexmark and weighed in with an amicus brief in support of Lexmark's no-exhaustion argument.[8]

Second, companies that sell their products in overseas markets at prices below their U.S. market prices will now face the prospect that these foreign-sold products will be re-distributed back into the U.S. market. This is a critical concern, for example, for pharmaceutical companies that sell their products in countries around the world at prices guided by local market conditions and, in some instances, dictated by local governments. Here too, the major players – Pfizer, Johnson & Johnson, Bayer, Merck and others – submitted an amicus brief arguing against patent exhaustion for overseas sales and presenting extensive economic analyses in support of that position.[9]

[6] *Id.* at 1529.
[7] *Id.* at 1532.
[8] Br. Imaging Supplies Coalition Amicus Curiae Supp. Resp't, *Lexmark*, 137 S. Ct. 1523 (2017).
[9] Br. Pharmaceutical Research Manufacturers America Amicus Curiae Supp. Resp't, *Lexmark*, 137 S. Ct. 1523 (2017).

In its ruling in favor of patent exhaustion, the Court did not grapple with these consequences or the policy considerations they raise, except to suggest in very general terms that the prospect of a product facing an infringement claim after its initial lawful sale could raise problems in the marketplace.

Going forward, patent owners seeking to restrict the resale of their products may seek to use contractual provisions, instead of infringement claims, to impose post-sale restrictions. The *Lexmark* Court did not expressly endorse this course, but it seemed to acknowledge the possible resort to such restrictions in circumstances where patent rights are exhausted.[10] Relying on contractual restrictions, however, has its limitations. In most cases, enforcement of contractual restrictions against the *initial* purchasers of the product (who could be parties to a contract with the patent owner or the patent owner's licensee) would be commercially undesirable, given that these purchasers are the patentee's or its licensee's direct customers. And such restrictions ordinarily could not be enforced against a *subsequent* purchaser of a patented item, who would not be party to the contract with the patent owner.

In addition, the remedies for breach of contract tend to be less favorable than the remedies for patent infringement; while prevailing plaintiffs in patent actions are entitled to seek treble damages, enhanced damages are generally not awarded in contract cases. Further, contractual disputes are more often adjudicated in state court, which may be less desirable than the federal forum in which patent suits are litigated. Finally, while a patentee's legitimate exercise of its patent rights generally does not raise antitrust issues, because the patent confers a lawful monopoly, an attempt to impose contractual restrictions in restraint of competition when patent rights have been exhausted could give rise to antitrust concerns.

The *Lexmark* ruling will also have a profound impact on patent owners' licensing arrangements with their distributors and other licensees, both in the United States and abroad. Licensees are viewed as an extension of the patent owner, and hence an authorized sale by a licensee will exhaust the patent owner's rights in a patented item.[11] On the other hand, as the Court recognized, "if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee's rights."[12] Thus, patent owners may be able to avoid exhaustion by restricting their licensees' rights to sell patented items.

However, it is not entirely clear whether a licensee's customers must have been given notice that products have been sold to them in violation of a license before those customers can be deemed liable for patent infringement. Some doubt arises from the Court's reference to *General Talking Pictures Corp. v. Western Elec. Co.*, which held that a customer who purchased from a licensee with knowledge that the sale violated the terms of the license participated in the licensee's infringement,[13] implying that the customer's knowledge may be important. But the Court's discussion of the general principles indicates that exhaustion should not apply if the licensee's sale was not itself authorized.[14]

Patent owners that rely on contractual resale restrictions on their licensees may consider adding provisions to their license agreements that require licensees to enter into

[10] *See Lexmark*, 137 S. Ct. at 1534–35.
[11] *Id.* at 1535.
[12] *Id.*
[13] 305 U.S. 124, 126–27 (1938).
[14] *Lexmark*, 137 S. Ct. at 1535 ("*General Talking Pictures*, then, stands for the modest principle that, if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee's rights.").

formal sale agreements with customers that designate the patent owners as third-party beneficiaries. Doing so would seek to preserve the chain of privity from the patentee to the ultimate purchaser, possibly enabling breach of contract claims for violations by the purchaser. Patentees may also consider providing in their (and their licensees') sale and license agreements that the agreements are governed by U.S. law and that any breach of those agreements (or the agreements entered by licensees) would be subject to exclusive U.S. jurisdiction.

Patent owners may also seek to avoid exhaustion by structuring the transfer of patented items as leases or licenses, not sales. For example, the printer cartridges at issue in *Lexmark* could have been provided under license agreements that obligated consumers to return the (leased) cartridges when the license was terminated, such that title to the cartridges never passed to the customer and no "sale" was effected. While the Court made clear that a sale transfers all rights in a patented product, a license simply "chang[es] the contours of the patentee's monopoly."[15] However, there is some risk that courts would construe such licenses as sales, and the patent owner's rights would be exhausted in any case.

Lexmark's expansion of patent exhaustion also should lead companies to focus on obtaining and asserting patents that are not exhausted by the sale of a particular product or component. In *Quanta Computer, Inc. v. LG Elecs., Inc.*, the Supreme Court held that "[t]he authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control postsale use of the article."[16] But if the asserted patent is not "substantially embodied" in the sold article – for example, because the patent claims inventive features beyond those of the sold article, such as those relating to the complete product – then the sale of the article does not exhaust that particular patent. In the wake of *Lexmark*, such patents will become even more valuable.

Further, while patent owners that sell products overseas may no longer be able to bring patent infringement claims against companies that purchase patented products overseas and then import them into the United States, they may still be able to stop those sales by bringing trademark and unfair competition claims either in U.S. federal courts or before the U.S. International Trade Commission. In *Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc.*, for example, the First Circuit held that any material difference between the trademark holder's domestic product and the versions of its products sold overseas creates a presumption of consumer confusion and harm if a third party acquires the overseas products and imports them into the United States without permission.[17] A patent owner might consider introducing variations into products that are sold abroad and then seek to use trademark law to police imports.

3. <u>The Supreme Court Limits Where Patent Infringement Lawsuits May Be Filed</u>

The Supreme Court's decision last year in *TC Heartland LLC v. Kraft Foods Group Brands LLC*[18] upended more than 25 years of patent litigation practice by significantly narrowing where patent infringement lawsuits can be filed against domestic corporations. For decades, courts have allowed such lawsuits to be brought wherever a corporate defendant is subject to personal jurisdiction, which often equates to wherever the defendant is alleged to

[15] *Id.* at 1534.
[16] 553 U.S. 617, 638 (2008).
[17] 982 F.2d 633, 641 (1st Cir. 1992); *see also Bose Corp. v. Ejaz*, 732 F.3d 17, 27 (1st Cir. 2013).
[18] 137 S. Ct. 1514.

have produced infringing items or made infringing sales. But in *TC Heartland*, the Court ruled that the proper venue for a patent infringement lawsuit against a domestic corporate defendant is limited to either (1) the state where the defendant is incorporated; or (2) any state in which the defendant has committed acts of infringement and has a regular and established place of business.[19]

As a practical matter, the decision curbs the ability of patentees to file infringement lawsuits in forums perceived as patentee-friendly and with which defendants have limited contacts. As expected, the number of cases filed in the Eastern District of Texas has decreased substantially in the wake of *TC Heartland*, with a corresponding rise in filings in the District of Delaware, where many corporations are incorporated. The Northern and Central Districts of California also have seen an upswing in patent suits due to the presence of a great number of technology companies in those areas.

An early decision by the Eastern District of Texas applying *TC Heartland* might have curbed its impact by broadly construing what it means to have a "regular and established place of business."[20] But in September 2017, the Federal Circuit reversed, emphasizing that for venue to be proper under 28 U.S.C. § 1400(b), there must be (1) "a physical place in the district," that is (2) "a regular and established place of business," and (3) is a "place of the defendant."[21] The Federal Circuit made clear that sporadic or transient activities are not sufficient; nor can the presence of an employee alone establish the location of the corporation.[22]

The Federal Circuit also ruled in November of last year that *TC Heartland* represented a change in the law, which means that alleged infringers that had previously relied on Federal Circuit precedent and had not challenged venue could attempt to do so following the *TC Heartland* ruling.[23]

Finally, *TC Heartland* leaves open the question of venue over non-U.S. defendants, an issue the Court expressly said it was not deciding.[24] 28 U.S.C. § 1391 provides that foreign defendants "may be sued in any judicial district,"[25] and courts have generally held that a lawsuit against a foreign defendant can be filed under this statute anywhere the defendant is subject to personal jurisdiction. Foreign defendants therefore are unlikely to benefit from *TC Heartland*'s narrowing of the scope of venue. One interesting variation on this venue question arises when a foreign parent and its U.S. subsidiary are sued in a single action. The answer provided by the recent district court decision in *3G Licensing, S.A. v. HTC Corp.* is that the foreign parent can be sued anywhere it is subject to personal jurisdiction (in this case, the District of Delaware), but the U.S. subsidiary can be sued only where it is incorporated or does regular business.[26] In so ruling, the court rejected policy arguments that foreign parents should share the same venue as their U.S. subsidiaries, and left a result with practical consequences that would not be ideal for any of the parties: suits with venues in different places, even though they involve the same products and corporate affiliates responsible for those products.

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[19] *Id.* at 1521; 28 U.S.C. § 1400(b).
[20] *See Raytheon Co. v. Cray, Inc.*, 258 F. Supp. 3d 781 (E.D. Tex. 2017).
[21] *In re Cray*, 871 F.3d 1355, 1362–63 (Fed. Cir. 2017).
[22] *Id.*
[23] *In re Micron Technology, Inc.*, 875 F.3d 1091, 1094 (Fed. Cir. 2017).
[24] *TC Heartland*, 137 S. Ct. at 1520 n.2.
[25] 28 U.S.C. § 1391(c)(3).
[26] No. CV 17-83-LPS-CJB, 2017 WL 6442101, at *1 (D. Del. Dec. 18, 2017).

4. The Supreme Court Limits U.S. Patent Infringement Liability For Goods Sold Overseas

Under the Patent Act, infringement occurs when someone "supplies . . . in or from the United States all or a *substantial portion* of the components of a patented invention . . . in such manner as to actively induce the combination of such components outside of the United States."[27] In February 2017, the Court decided *Life Technologies Corp. v. Promega Corp.*, which adopted a quantitative interpretation of "substantial portion" and ruled that a *single* component of a multi-component product could never be deemed a "substantial portion" of a patented invention.[28] This reasoning applies even if the component in question is important or crucial to the patented invention. While the ruling was framed as a matter of statutory interpretation, it also is consistent with the Court's reluctance to apply U.S. laws extraterritorially.

The Court declined to determine how many components are necessary to constitute a "substantial portion" of an invention,[29] leaving that question for the lower courts to address in future cases.

5. A District Court Imposes A FRAND Royalty Rate

In a groundbreaking decision, the District Court for the Central District of California imposed a court-ordered fair, reasonable and non-discriminatory ("FRAND") royalty rate on a portfolio of standard-essential patents. The decision in *TCL Communication Technology Holdings, Ltd. v. Telefonaktiebolaget Ericsson* addressed FRAND rates for Ericsson patents that are essential to implementing the 2G, 3G and 4G cellular communication standards.[30] Ericsson and other wireless innovators committed to the European Telecommunications Standards Institute that they would license their patents on FRAND terms in exchange for being part of the standard.

After a bench trial, the court held that Ericsson's prior offers were not compliant with FRAND requirements, though it declined to find that Ericsson violated FRAND obligations merely by proposing higher rates than were ultimately awarded.[31] The court imposed a global five-year license agreement upon both parties and set the royalty rates not just for the United States, but also for Europe and the rest of the world, at rates lower than Ericsson had sought.[32] The court also rejected Ericsson's attempt to impose a "floor" for the royalty rate at a particular dollar level and instead held that the FRAND rates would be based on a percentage rate without any absolute floor.[33] Ericsson has appealed the ruling.

Copyright

1. The Supreme Court Establishes A New Test For Determining The Copyright Eligibility Of Design Elements

In March 2017, the Supreme Court addressed the circumstances under which a "useful" article, such as the design of a cheerleading outfit, would be entitled to copyright protection. In *Star Athletica, L.L.C. v. Varsity Brands, Inc.*,[34] the Court established a two-part test under which a design for a useful article will be eligible for copyright protection only if it "(1) can be perceived as a two- or

[27] 35 U.S.C. § 271(f)(1) (emphasis added).
[28] 137 S. Ct. 734, 741 (2017).
[29] *Id.* at 742.
[30] No. CV 15-2370 JVS(DFMX), 2017 WL 6611635 (C.D. Cal. Dec. 21, 2017).
[31] *See id.* at *2.
[32] *See id.* at *58.
[33] *See id.* at *37–38.
[34] 137 S. Ct. 1002 (2017).

three-dimensional work of art separate from the useful article and (2) would qualify as a protectable pictorial, graphic, or sculptural work . . . if it were imagined separately from the useful article into which it is incorporated."[35]

While *Star Athletica* was closely watched by the fashion industry, the Court's ruling does little to support intellectual property protection for the designs of clothing and accessories. The structural shape and design of articles such as dresses and handbags will remain non-copyrightable. Instead, copyright protection is available only when a pictorial or graphic image is essentially imprinted on an article of clothing or other object.

But in other fields, such as appliances and electronics, courts have applied *Star Athletica* to uphold copyright protection. For example, in *Jetmax Ltd. v. Big Lots, Inc.*, the district court found tear drop-shaped light bulbs eligible for copyright protection because the shape of the bulbs possessed sculptural quality separate from the utilitarian aspects of the light set.[36] In such circumstances, companies may be able to use copyright claims to ward off look-alike products – provided, of course, they can show that the defendant copied the design, rather than independently developing it.

Trademark

1. The Supreme Court Holds "Disparaging" Trademarks Are Protected By The First Amendment

Last June, the Supreme Court deemed unconstitutional a clause in Section 2(a) of the Lanham Act that allowed the Patent and Trademark Office ("PTO") to reject registrations that disparage individuals, groups or institutions.[37] In *Matal v. Tam* (formerly *Lee v. Tam*), the PTO rejected an application to register the band name, "The Slants," because it is known as a derogatory term used to describe Asians.[38] Had the name portrayed Asians in a positive light, however, registration might have been permitted by the PTO. Given this dichotomy, the Court held that the "anti-disparagement" clause violated the bedrock principle of the First Amendment – that speech cannot be banned merely because it offends.[39]

Following *Tam*, the constitutionality of another clause in Section 2(a), which prevents registration of "scandalous" or "immoral" matter, has also been called into question. Erik Brunetti, an artist and street designer, was denied registration of his clothing line mark "Fuct" because it could be considered scandalous and immoral.[40] In December 2017, the Federal Circuit held that, like the disparagement clause, the scandalous or immoral portion of Section 2(a) is an unconstitutional content-based restriction under the First Amendment.[41]

Trade Secrets

1. Courts Begin To Flesh Out The Defend Trade Secrets Act

In the period since Congress created a federal civil claim for trade secret misappropriation with the Defend Trade Secrets Act ("DTSA") in 2016,[42] the contours of this new federal remedy – which was not intended to displace state law trade secret claims – has begun to take shape. When enacted, the DTSA's most controversial

[35] *Id.* at 1007.

[36] No. 15-CV-9597 (KBF), 2017 WL 3726756, at *6 (S.D.N.Y. Aug. 28, 2017); *see also Design Ideas, Ltd. v. Meijer, Inc.*, No. 15-CV-03093, 2017 WL 2662473, at *1 (C.D. Ill. June 20, 2017) (applying the *Star Athletica* test to sparrow-shaped clothespins).

[37] *Matal v. Tam*, 137 S. Ct. 1744 (2017).

[38] *Id.* at 1754.

[39] *Id.* at 1751.

[40] *In re Brunetti*, 877 F.3d 1330, 1335 (Fed. Cir. 2017).

[41] *Id.*

[42] Defend Trade Secrets Act, S. 1890, 114th Congress (2016).

provision was its allowance of *ex parte* applications for "the seizure of property necessary to prevent the propagation or dissemination of . . . trade secret[s]."[43] Critics expressed concern that this provision was too broad, ripe for abuse and could violate a defendant's due process protections. To date, temporary restraining orders and expedited discovery have been the most common forms of pre-trial relief.[44] And it appears that courts are granting the more extreme relief of *ex parte* seizures only in extraordinary circumstances, as the statute directs. In *Mission Capital Advisors LLC v. Romaka*, for example, the U.S. District Court for the Southern District of New York ordered U.S. marshals to seize files on the computer of a former Mission Capital employee who had stopped responding to Mission Capital's requests and had failed to appear for a hearing.[45]

Some courts also have clarified that, to state a claim under the DTSA, misappropriation must have occurred after May 11, 2016, the law's effective date.[46] However, other courts have found pre-enactment misappropriation compensable under the DTSA if it continues past May 11, 2016.[47]

Going forward, given the familiarity of federal judges with intellectual property protections, the broad jurisdictional reach of federal courts and the remedies federal courts can provide, federal claims under the DTSA likely will provide an attractive means of seeking relief in high stakes cases involving alleged trade secret misappropriation.

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[43] *Id*. § 2(b)(2)(A)(i).
[44] *See, e.g.*, *Earthbound Corp. v. MiTek USA, Inc.*, No. C16-1150-RSM, 2016 WL 4418013 (W.D. Wa. Aug. 19, 2016).
[45] Seizure Order, No. 1:16-cv-05878-LLS (S.D.N.Y. July 29, 2016).
[46] *See, e.g.*, *Adams Arms, LLC v. Unified Weapon Sys., Inc.*, No. 8:16-CV-1503-T-33AEP, 2016 WL 5391394, at *6–7 (M.D. Fla. Sept. 27, 2016).
[47] *See, e.g.*, *Brand Energy & Infrastructure Servs., Inc. v. Irex Contracting Grp.*, No. 16-2499, 2017 WL 1105648, at *8 (E.D. Pa. Mar. 24, 2017).