ALERT MEMORANDUM

The Supreme Court's *Lexmark* Ruling On Patent Exhaustion: The Strategic Implications For Patentees

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The Supreme Court's ruling last week in *Impression Products, Inc. v. Lexmark Int'l, Inc.*[1] 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 free to use or resell the product free from infringement claims. *Lexmark* addresses two questions: First, 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 second, whether a patentee exhausts its U.S. patent rights by selling its product outside the United States.

On both questions, the Federal Circuit had ruled in *Lexmark* and in earlier decisions against exhaustion, enabling patentees to enforce post-sale restrictions through patent infringement suits and to avoid exhaustion when selling their products overseas. The Supreme Court reversed on both points, 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."[2]

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

Lawrence B. Friedman
+1 212 225 2840
lfriedman@cgsh.com

David H. Herrington
+1 212 225 2266
dherrington@cgsh.com

Daniel Ilan
+1 212 225 2415
dilan@cgsh.com

Arminda B. Bepko
+1 212 225 2517
abepko@cgsh.com

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

The key driver of the Supreme Court's opinion is simple: the common law rule against restraints on alienation. Less simple are the market consequences of the Court's ruling, which the *Lexmark* opinion barely mentions. We focus here on some of those consequences, as well as strategies for patent owners going forward.

[1] No. 15-1189, 2017 WL 2322830 (U.S. May 30, 2017).
[2] *Id.* at *5.

Background

Lexmark sells patented printer cartridges in the U.S. and abroad. In contracts with consumers, Lexmark offered a lower price in exchange for the purchaser's agreement not to reuse or sell the cartridges. Impression Products, a remanufacturer of printer cartridges, refurbished and resold Lexmark printer cartridges that it bought from consumers in the U.S., and also imported cartridges purchased from Lexmark overseas. When Lexmark sued Impression Products for patent infringement, Impression argued that Lexmark's sales, both in the U.S. and abroad, exhausted its patent rights, leaving Impression Products free to refurbish and resell them, and to import them if acquired overseas.

As to post-sale restrictions, the District Court ruled that Lexmark's restrictions were impermissible and that a contrary ruling would "create significant uncertainty for downstream purchasers and end users."[3] However, as to cartridges imported from overseas, it held that Lexmark's patent rights were not exhausted by sale of its printer cartridges outside the U.S. In so ruling, the District Court distinguished the Supreme Court's decision in *Kirtsaeng v. John Wiley & Sons, Inc.*, which held that foreign sales exhaust a copyright owner's rights under copyright law's "first sale" doctrine.[4]

On appeal, the Federal Circuit reversed the ruling on post-sale restrictions, holding that "a patentee may preserve its…rights when itself selling a patented article, through clearly communicated, otherwise-lawful restrictions."[5] The Federal Circuit also held that foreign sales did not exhaust Lexmark's patent rights, reasoning that, because of differences in the development and history of copyright and patent laws, it would be inappropriate to apply the ruling in *Kirtsaeng* in the patent setting.[6]

The Supreme Court's Ruling

As noted, the Supreme Court reversed on both points – unanimously as to post-sale restrictions, and with only Justice Ginsburg in dissent as to whether overseas sales exhaust patent rights. In so ruling, the Court relied principally on the common law rule against restraints on alienation.[7] Writing for the Court, 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.'"[8]

In ruling that overseas sales exhaust U.S. patent rights, the Court also was guided by its decision in *Kirtsaeng*, which reached the same result in the copyright context. Finding no material difference between the copyright first sale doctrine and patent exhaustion, the Court reasoned that "[a] purchaser buys an item, not patent rights. And exhaustion is triggered by the patentee's decision to give up that item and receive whatever fee it decides is appropriate."[9] In dissenting on this issue, Justice Ginsburg pointed to differences between copyright and patent law – including the fact that the "Patent Act contains no analogue to 17 U.S.C. § 109(a), the Copyright Act first-sale provision analyzed in *Kirtsaeng*,"[10] and that the Berne Convention, an international copyright treaty, provides relatively uniform copyright protection for authors who sell copyrighted works in one of the 174 member countries, while patent rights vary significantly by country.[11]

[3] *Lexmark Int'l, Inc. v. Ink Techs. Printer Supplies, LLC*, 2014 WL 1276133, at *7 (S.D. Ohio Mar. 27, 2014).
[4] *Lexmark Int'l, Inc. v. Ink Techs. Printer Supplies, LLC*, 9 F. Supp. 3d 830, 834-37 (S.D. Ohio 2014) (citing *Kirtsaeng v. John Wiley*, 568 U.S. 519 (2013)).
[5] *Lexmark Int'l, Inc. v. Impression Prods., Inc.*, 816 F.3d 721, 742 (Fed Cir 2016).
[6] *Id.* at 756–60.
[7] *Lexmark*, 2017 WL 2322830 at *6, *14.
[8] *Id.* at *8 (quoting 1 E. Coke, Institutes of the Laws of England § 360, p. 223 (1628)).
[9] *Id*. at *15 (citing *United States v. Univis Lens Co.*, 316 U.S. 241, 251 (1942)).
[10] *Id.* at *17 (Ginsburg, J., dissenting).
[11] *Id.*

Key Impacts

The Supreme Court's ruling will have the greatest impact in two areas. First, those patent owners whose products can be resold (including, where necessary for resale, after being refurbished) have lost the ability to use patent infringement claims to ward off competition in the secondary market. The facts of *Lexmark* illustrate the point: Lexmark sought to use its patents on its toner cartridges to avoid or reduce competition from alternative suppliers, enabling it to charge premium prices over the cost of the toner itself. Unsurprisingly, the biggest players in the field of printers and copiers – including Canon, Epson, Hewlett-Packard and Xerox – weighed in with an amicus brief in support of Lexmark's no-exhaustion argument.[12]

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 analysis in support.[13]

In its ruling in favor of patent exhaustion, the Supreme 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.

Strategies Going Forward

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. Of course, 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) could be commercially undesirable, given that these purchasers are the patentee's or its licensees' direct customers. And such restrictions could not be enforced against a *subsequent* purchaser of a patented item to prevent that purchaser from reusing or reselling the item in a way the patent owner finds objectionable. 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 favorable 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 concerns, 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.

This ruling will also have a profound impact on the licensing arrangements that patent owners have with their distributors, both in the U.S. and abroad, given that licensees are viewed as an extension of the patent owner and that authorized sales by

[12] Brief for Imaging Supplies Coalition as Amicus Curiae in Support of Respondent, *Impression Products, Inc. v. Lexmark Int'l, Inc.*, No. 15-1189, 2017 WL 2322830 (U.S. May 30, 2017).

[13] Brief for Pharmaceutical Research and Manufacturers of America as Amicus Curiae in Support of Respondent, *Impression Products, Inc. v. Lexmark Int'l, Inc.*, No. 15-1189, 2017 WL 2322830 (U.S. May 30, 2017).

licensees also exhaust the patent owner's rights in a patented item.[14] However, the Court also recognized that "if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee's rights."[15]

In light of these considerations, going forward patent owners concerned about the risk of exhaustion of their patent rights will undoubtedly develop contractual and other strategies to reduce this risk. While the usefulness of some of these tactics will need to be assessed by the courts, patent owners may consider the following:

1. Restrictions On Licensees' Right to Sell

Patent owners may be able to avoid exhaustion by restricting their licensees' right to sell patented items. For example, patent holders may wish to revisit existing agreements with licensees that purport to require the licensees to restrict post-sale use or resale *by their customers*. Under *Lexmark*, the effect of sales by these licensees is exhaustion of the patent owner's rights. Instead, patent owners could seek to limit the scope of the license by prohibiting the sale of patented items *by the licensees* in certain geographic areas or to certain classes of customers. As the Court noted, a purchaser of products sold without the patentee's authority (outside the scope of the license) will still face liability for patent infringement (together with the licensee) "as if no license whatsoever had been granted."[16]

However, license limitations that are *de facto* post-sale restrictions are not likely to prevent exhaustion. Moreover, it is not entirely clear whether 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. While a licensee that completes an unauthorized sale would be liable for patent infringement, *Lexmark* does not clearly state that the licensee's customer would be exposed to an infringement claim even if it had no knowledge that the licensee's sale was unauthorized. While the answer to this question should be that the customer is liable, 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. But the Court's discussion of the general principles indicates that exhaustion should not apply if the licensee's sale was not itself authorized.[17]

2. Use of Licenses vs. Sales

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 whereby consumers were obligated 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…."[18] 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.

3. Strategic Enforcement (and Development) of Rights

Patent owners who sell or license for sale incomplete articles may wish to strategically select which patents they assert against third parties using such articles in (or in conjunction with) the complete product. In *Quanta Computer, Inc. v. LG*

[14] *Lexmark*, 2017 WL 2322830 at *12.
[15] *Id.*
[16] *Id.* (quoting *General Talking Pictures Corp. v. Western Elec. Co.*, 305 U.S. 124, 127 (1938)).
[17] *Id.* ("*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.").
[18] *Id.* at *11.

Elecs., Inc.,[19] 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."[20] 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. Patentees who sell (or license others to sell) components or incomplete products can seek to enforce (or develop patent portfolios that include) patents that are not exhausted by their products but are nevertheless infringed by downstream users.

4. <u>Restrictions on Law and Forum</u>

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

5. <u>Assertion of Trademark Rights</u>

While patent owners who sell products overseas may no longer be able to bring patent infringement claims against distributors who purchase patented products overseas and then import them into the U.S., 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.*,[21] for example, the First Circuit held that any material difference between the trademark holder's domestic product and an unauthorized imported version creates a presumption of consumer confusion and harm to the local trademark holder's goodwill that supports a Lanham Act claim to prevent importation.[22] Because the materiality standard may differ depending on the jurisdiction,[23] a patent owner might consider introducing variations into products that are sold abroad and then seek to use trademark law to police imports.

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[19] 553 U.S. 617 (2008).
[20] *Id.* at 638.
[21] 982 F.2d 633 (1st Cir. 1992).
[22] *Id.* at 641.
[23] *Id.*; but *cf. John Paul Mitchell Sys. v. Pete-N-Larry's Inc.*, 862 F. Supp. 1020, 1023–24 (W.D.N.Y. 1994).