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Lexmark May Fundamentally Change Patent Licensing

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Law360, New York (December 13, 2016, 12:45 PM EST) -- Once again, the U.S. Supreme Court revisits the issue of patent exhaustion in reviewing the Federal Circuit's en banc decision in Lexmark[1] and may provide additional guidance since its 2008 Quanta[2] decision. Quanta, although finding patent exhaustion based on the facts presented, confirmed the long-standing practice that allowed patent owners to obtain royalty-revenue from downstream points in the supply chain by continuing to allow patentees to subject sales of patented products to post-sale restrictions in appropriate circumstances. In Quanta, the court found that LG had exhausted its patent rights when its component licensee, Intel, sold microprocessors to Quanta. LG had granted Intel an *unrestricted* license to its patents,[3] and, thus, LG had exhausted its patent rights. Accordingly, the Supreme Court concluded that LG could not obtain royalties from downstream system manufacturers (e.g., Quanta) that produced computers using the licensed microprocessors purchased from Intel. Quanta has been widely understood to follow the Supreme Court's earlier 1938 General Talking Pictures[4] decision, where the court held that product sales by a licensee — subject to a restrictive field-of-use license — avoided patent exhaustion outside that restricted field.

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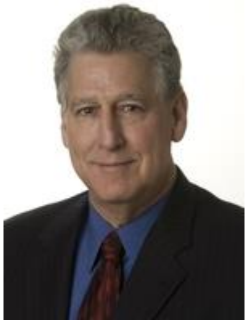

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On Dec. 2, 2016, the Supreme Court granted Impression Products' petition for writ of certiorari appealing the Federal Circuit's Lexmark decision. In its Lexmark decision, the Federal Circuit held that: (1) the sale of an article under clearly communicated and lawful post-sale restrictions on use and resale/reuse avoids patent exhaustion and preserves the patentee's infringement rights against both licensees and downstream buyers *with knowledge* of the restrictions; and (2) a patentee's or licensee's overseas sales of a patented article *do not* exhaust the U.S. patent rights in the article sold, even if no reservation of those rights accompanies the sale. Lexmark follows Quanta, as well as General Talking Pictures, and stands for the long-standing proposition that patent owners can avoid patent exhaustion and obtain license revenue from downstream points in the supply chain through use of post-sale restrictions on product sales.

This case will raise serious concerns for patent owners seeking to obtain fair value for their intellectual property through licensing or contracting restrictions on future use, should the Supreme Court overrule Lexmark and follow the approach advocated by Impression Products, as well as several amici, including the United States government. Then, not only may patent licensing in the United States fundamentally change, but patent owners may not be able to obtain fair value for their patents.

Federal Circuit's Lexmark Case

Critical Facts

Lexmark sold printer-cartridges covered by multiple patents in the U.S. and foreign markets under two programs: a "regular cartridge" program, where cartridges were sold at full price without restrictions on resale or reuse; and a "return program cartridge" program, where cartridges were sold at a discount, but subject to no-resale and no-reuse restrictions. The parties stipulated that "Lexmark ha[d] an express and enforceable contractual agreement with each of its end-user customers," and it was undisputed that end-users and resellers of "return program cartridges" received notice that cartridges could only be used once.[5]

Impression Products acquired expended Lexmark cartridges from third parties for refilling/sale in the U.S. These cartridges included the restricted-use contract language "return program cartridges" that Lexmark originally sold subject to no-resale and no-reuse restrictions. Thus, Impression obtained the used cartridges with notice of such restriction. Lexmark sued Impression for patent infringement over Impression's refurbishment and sale of the same. Lexmark also alleged that Impression's importation of foreign-sold cartridges — both under the "regular" and "return" programs — constituted infringement.

Impression argued Quanta (where an authorized, unrestricted sale exhausted patent rights) overruled the Federal Circuit's Mallinckrodt[6] decision, which held that a sale that is "validly conditioned under the applicable law such as the law governing sales and licenses" avoids exhaustion "if the restriction on reuse was within the scope of the patent grant or otherwise justified," which "may be remedied by action for patent infringement."[7] Trying to fit within the Quanta and General Talking Pictures factual framework, Impression argued that the result is different when the *patent owner* — as opposed to a licensee — sells the patented articles. According to Impression, post-sale restrictions in a patentee's *own* sales cannot avoid patent exhaustion as such sales are "authorized," whereas post-sale restrictions in a *licensee's* sales are only valid if clearly communicated and not otherwise unlawful, hence non-exhaustive as to patented items sold by licensees but used outside such restrictions, i.e. an "unauthorized" sale.[8]

On a motion to dismiss, the district court agreed with Impression that the resale of cartridges originally sold in the U.S. was permissible despite Lexmark's no-reuse and no-resale restrictions. The district court accepted that both the first purchaser of the cartridges and Impression had notice of the no-resale and no-reuse restrictions before they made their purchases, but relied on Quanta to hold that exhaustion applied because the initial sales were authorized.

Majority's En Banc Decision

The Federal Circuit concluded that exhaustion had not occurred, disagreeing with Impression and reversing the district court's holding which would have permitted resale of the originally sold domestic products. The court reaffirmed Mallinckrodt based on two premises: (1) exhaustion as a conferral of "authority" under § 271(a) of the Patent Act; and (2) the distinction without a difference between a patentee's own sales and a licensee's sales for purposes of exhaustive effect.

Judge Richard Taranto wrote the 10-2 decision, finding that no reason existed to treat patentees and licensees differently: “We conclude that a patentee may preserve its § 271 rights when itself selling a patented article, through clearly communicated, otherwise-lawful restrictions, as it may do when contracting out the manufacturing and sale,” as long as downstream users have adequate notice.[9] The court explained that the “exhaustion doctrine … must be understood as an interpretation of § 271(a)’s ‘without authority’ language.” It further explained that because “authority” refers to a grant of permission by the patentee, the patentee may limit its grant by imposing conditions or restrictions.[10] The court saw no reason why a patentee-seller should have less of an ability to restrict downstream uses of its own products than a patentee-licensor who licenses the right to make and sell the product to others.

Contrasting Lexmark with General Talking Pictures reflects the significance of the patentee-/licensee-seller’s awareness. In General Talking Pictures, a buyer purchased a patented sound amplifier from a non-exclusive licensee that had a restricted license to sell/manufacture the patented article within a particular field of use (i.e., private, non-commercial use). The licensee, however, *knowingly sold* the amplifiers to a commercial theater, which also *knew* that the sale was outside the license-scope and that the licensee lacked authority to make such sale. Since both licensee and buyer knew that the licensee had no license to convey the right to use the article in this particular field, the court held that the licensee infringed the patent by selling the article *outside* the particular “field of use,” and that the buyer had no exhaustion defense based on an *unauthorized* sale.[11]

As discussed in Section II.C.3, the court also rejected Impression’s other defense, namely that Lexmark’s foreign sales exhausted Lexmark’s U.S. patent rights (affirming Jazz Photo Corp. v. International Trade Commission, 264 F.3d 1094 (Fed. Cir. 2001)). The court found that Impression infringed the Lexmark patents and remanded the case to the trial court.[12]

U.S. Government’s Position of Reversing Lexmark

The U.S. government has joined Impression and urged the Supreme Court to overturn the Federal Circuit’s holdings in Lexmark as to: (i) the viability of post-sale use restrictions after an initial authorized sale; as well as (ii) foreign-sale exhaustion. On Dec. 2, 2016, the Supreme Court granted certiorari.[13]

"Authorized" Sales: Lexmark’s First Elephant in the Room

First, in the solicitor general’s amicus brief[14], the government contends that “[u]nder the exhaustion doctrine, also known as the 'first sale' doctrine, 'the initial authorized sale of a patented item terminates all patent rights to that item.'” Quanta, 553 U.S. 617, 625 (2008).[15] It goes on to argue that the Supremes have long held that when a patentee sells, or authorizes the sale by a licensee of, a patented product in the U.S., patent law does not restrict subsequent sales of the product, *regardless of whether the patentee puts limitations on the post-sale use or resale of the product as part of the transaction*.[16] Thus, a patentee that authorizes a sale of a patented article cannot enforce ongoing restrictions on the use/resale of that item against downstream purchasers.

Instead, according to the government, enforceability of downstream restrictions after an authorized sale only arises “as a question of contract, and not as one under the inherent meaning and effect of the patent laws.” Keeler v. Standard Folding Bed Co., 157 U.S. 659, 666 (1895); Quanta, 553 U.S. at 637 n.7.[17] Anything to the contrary “would substantially erode the exhaustion doctrine.”[18] Further, according to the government, it does not matter who makes the sale — whether patentee or licensee —

as long as it was "authorized." See, e.g., Quanta, 553 U.S. at 636-637 (finding exhaustion where licensee sold product with restrictions mandated by the patentee); Univis, 316 U.S. at 249 (observing that a sale "by the patentee or by his licensee" constitutes "a complete transfer of ownership" that exhausts the patentee's patent rights, notwithstanding use restrictions).

The government reconciled General Talking Pictures with its position by noting that, in that case, the licensee *knowingly* sold patented products to the seller in violation of the "non-commercial use only" requirement in the license agreement. Such sales were not authorized and, thus, the patents were not exhausted.

The government raised several other arguments based on the decision in General Talking Pictures. First, the government argues that General Talking Pictures would be on point in Lexmark if the patentee had instructed the licensee to impose a contractual single-use/no-resale restriction with buyers, and the licensee instead *knowingly* violated that requirement and sold the cartridges under agreements that allowed resale or multiple uses.[19] In that case, the licensee's sales would not exhaust the patentee's patents; the licensee would be liable under 271(a) for sales "without authority," and the buyer could also be liable for infringement if it resold/reused the cartridges.[20]

Second, the government argues that General Talking Pictures does not suggest that, if a licensee obeys the patentee's directive and places the single-use/no-resale restriction in its sales contracts, a downstream buyer (or subsequent repurchaser) that knowingly violates that restriction could be liable for patent infringement.[21] To the contrary, the government contends that precedent establishes that the patentee's rights here would be exhausted as this latter scenario involves an "initial authorized sale" between the patentee and licensee.[22]

Finally, the government raises a public policy argument — whether patentees should be able to avoid exhaustion by agreement or notice.[23] It reminds the Supreme Court that the court has long recognized that "[t]he inconvenience and annoyance to the public" if patent rights are not exhausted by the first authorized sale are "too obvious to require illustration."[24] Yet under the Federal Circuit's reasoning in Lexmark, a patentee could demand royalties for the use or resale of articles embodying its invention at multiple downstream points in the channels of commerce, long after the first authorized sale in the U.S.[25] That result would threaten the viability of aftermarket sales of patented goods at a substantial cost to the public interest, without regard to the purposes of the Patent Clause.[26] Indeed, this argument echoes Judge Timothy Dyk's dissenting concern from Lexmark, namely that "impos[ing] conditions on the sale of a patented item would" not "promote free competition in the resale market and certainty in commercial transactions … largely eviscerat[ing] the exhaustion doctrine".[27]

Colossal Potential Impact of SCOTUS' Decision

The positions taken by the government, as well as by the dissent in Lexmark, challenge the fundamentals of patent licensing and commercializing patents in the United States.[28] According to the government, any initial sale authorized by the patentee — either through a direct sale by the patentee or a sale made by a licensee subject to a restrictive field-of-use license — to a buyer results in exhaustion. According to the government, a patentee's relief from violations of post-sale restrictions lies under breach of contract, not patent infringement.

If the Supreme Court moves in the direction urged by the government (and the Lexmark dissenters), then the licensing of U.S. patents could fundamentally alter, and the effectiveness of thousands of existing license agreements placed in doubt.[29] The viability of seeking remedies via breach of contract is also unclear. First, to sue for damages resulting from a breach of contract may be cost prohibitive, whereas in an infringement suit, patentees have the potential to obtain injunctive relief. Second, the available relief in a contract action may raise anti-trust issues (such as patent misuse).[30] Third, contractual options may not be viable because the patentee may not have standing to sue downstream buyers because of lack of priority.[31] What's more, the government's view seems to shift the focus from the buyer's *actions* to the seller's *intent* when assessing whether or not a sale is authorized. And the government's approach has severe practical implications. Should the justices adopt the government's approach, parties and courts would be compelled to seek fact-intensive discovery into challenging and subjective evidentiary issues, particularly where, for instance, patentees raise allegations of collusion between licensee and buyer as a counter-defense to exhaustion.

Importation: Lexmark's Second Elephant in the Room

Lexmark also raises the question of whether extraterritorial sales of Lexmark's cartridges exhausted Lexmark's patent rights. In the solicitor general's amicus brief, the government asserts that the Federal Circuit was wrong to hold that an overseas sale never exhausts U.S. patent rights in the patented product.[32] But, the government also contends that Impression's argument that an authorized overseas sale always exhausts U.S. patent rights is equally erroneous.[33] According to the government, the correct rule should be that U.S. patent rights are *presumptively exhausted* unless the terms of the foreign sale specifically provide otherwise.[34]

In the district court, Impression argued that Lexmark's patent rights had been exhausted by Lexmark's first sale of certain cartridges abroad and later imported. Impression argued the Federal Circuit's ruling in Jazz Photo[35] was wrong, which held that U.S. patent rights are exhausted only by a first sale in the U.S. The district court, on a motion to dismiss, rejected Impression's argument that Lexmark's patent rights had been exhausted given the Supreme Court's Kirtsaeng[36] decision. Under Kirtsaeng, the copyright owner's right to restrict the sale or distribution of a particular copy of a *copyrighted work* in the U.S. is exhausted if the copy was lawfully made, whether in the U.S. or overseas. The district court determined Kirtsaeng to be rooted in a statutory provision of the Copyright Act that does not exist in the Patent Act. Following Jazz Photo, the district court held that foreign sales do not exhaust U.S. patent rights.

The en banc Federal Circuit, in addressing the issue of foreign-sold printer cartridges, affirmed and held that the foreign sales did *not* exhaust Lexmark's right to prevent subsequent resales, imports or use in the U.S. The court stated that the domestic exhaustion principle "does not preclude an accused infringer from establishing that the U.S. patentee actually gave it a license, expressly or by implication," to make or sell the patented invention abroad.[37] The majority however found that Impression did not preserve this argument because it did not advance an implied-license defense.

The U.S. government in its brief advanced a midway position between the Federal Circuit's Lexmark holding and Impression's position: it argued that though the Federal Circuit was partially correct given that "Kirtsaeng's reasoning does not carry over to the patent context,"[38] since the two areas are governed by different statutes, the Federal Circuit still wrongly held that such extraterritorial sales never exhaust U.S. rights in the patented product.[39]

The government's position echoes the Kirtsaeng dissent, arguing that Mallinckrodt was wrong when decided and is irreconcilable with Quanta, positing that an unrestricted "foreign sale [should] result in exhaustion," but that an authorized seller could avoid such exhaustion by *explicitly reserving* its U.S. patent rights.[40] It reasoned that "[b]ecause a foreign sale by a U.S. patentee does not implicate or require any authority under the U.S. patent, such a sale should not automatically exhaust U.S. patent rights in that article … [i]nstead, a rule of presumptive exhaustion should apply, permitting a patentee to reserve his U.S. rights as part of a foreign sale if he does so expressly."[41] Although Lexmark asserts that it "did reserve those rights,"[42] the en banc decision rested on "the premise that Lexmark made the foreign sales without communicating a reservation of U.S. patent rights."[43]

Concluding Remarks

Lexmark marks the fourth patent case the Supreme Court has taken up on its docket this term. Currently as the law stands, patentees can avoid patent exhaustion by imposing post-sale restrictions on the sales of patent products. Accordingly, by thoughtfully tailoring grant and covenant-not-to-sue provisions in license agreements, patentees can establish a licensing program where license royalties are obtained from multiple points in the stream of commerce. This approach enables patentees to better obtain fair value for their patents while not unduly burdening any single licensee. Post-Lexmark, to achieve this result, it appears necessary (or at least prudent) to inform downstream purchasers of the limited nature of their purchases in order to avoid patent exhaustion.

Under the Lexmark decision, businesses are better able to reap the rewards of both their investment in technological research and development, as well as monetization of their intellectual property. They have the flexibility to develop business strategies that involve multiple points in the stream of commerce, rather than having to rely on just the players in the next tier over.

On the other hand, as the district court and en banc Federal Circuit dissenters cautioned, the Federal Circuit's Lexmark holding has the potential to "create significant uncertainty for downstream purchasers and end users who may continue to be liable for infringement even after an authorized sale to the consumer has occurred."[44] These would include businesses that regularly purchase patented products or components in the global marketplace. But this concern is not new, and is already routinely addressed using indemnification provisions vis-à-vis patentee-sellers, licensees and end-users. And this concern might be further addressed by imposing a notice requirement on patent owners as a condition to avoid patent exhaustion, as was the case in the Lexmark holding. In fact, this is exactly the approach advanced by the U.S. government, albeit for foreign sales.

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[1] Lexmark Int'l v. Impression Prods., 816 F.3d 721 (Fed. Cir. 2016) cert. granted, No. 15-1189, 2016 WL 1117396 (U.S. Dec. 2, 2016).

[2] Quanta Computer, Inc. v. LG Electronics, Inc., 553 U.S. 617 (2008).

[3] The license agreement between LG and Intel gave Intel the right to “make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of” Intel microprocessors under LG’s patents. For practical purposes, this license grant was unrestricted. Accordingly, Intel’s sales of microprocessors "exhausted" the patents, thereby preventing LG from using the patents to obtain royalties from downstream system-level producers such as Quanta.

[4] See General Talking Pictures Corp. v. Western Electric Co., 304 U.S. 175 (1938) (emphasis added).

[5] Lexmark, 816 F.3d at 728.

[6] Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 709 (Fed. Cir. 1992) (authorized sales of devices sold with clearly communicated “single use” notices—marked on devices and instructions—did not exhaust patents for multi-use applications).

[7] Id.

[8] Lexmark, 816 F.3d at 738.

[9] Id. at 750.

[10] Id. at 735.

[11] The Court explained that patentees may restrict their licensees to certain uses of licensed technology as long as the restrictions do not “extend the scope of the monopoly.” General Talking Pictures, 304 U.S. at 181. The “controlling facts” were “[t]he patent owner did not [directly] sell to [the downstream purchaser] the amplifiers in question or authorize [the licensee] to sell them or any amplifiers for use in theaters or any other commercial use.” Id. at 180. There had been no authorized first sale, for the licensee “could not convey to [the ultimate purchaser] what both knew it was not authorized to sell”. Id. at 181–82.

[12] Lexmark at 774.

[13] Though non-dispositive, studies show that the Justices generally give the government’s advice significant weight. See, e.g., B. D. Harper, The Effectiveness of State-Filed Amicus Briefs at the U.S. Supreme Court, University of Pennsylvania Journal of Constitutional Law (May 2014, Vol. 16:5) (available at: http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1540&context=jcl); R. C. Black and R. J. Owens, Solicitor General Influence and the U.S. Supreme Court (available at: http://www.vanderbilt.edu/csdi/archived/working%20papers/Ryan%20Owens.pdf); see also M. M. Cordray & R. Cordray, The Solicitor General’s Changing Role in Supreme Court Litigation, 51 B.C. L. REV. 1323, 1324, 1353–55 (2010) (arguing that the Solicitor General is both filing more briefs and finding greater success than other institutional briefers).

[14] Brief for the U.S. as Amicus Curiae Supporting Petitioner In Part, Impression Prods, Inc. v. Lexmark Int’l (filed Oct. 12, 2016, No. 15-1189) ("Solicitor General Amicus Brief").

[15] Solicitor General Amicus Brief at 2.

[16] Id., at 2, 7-8 (citing Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 514-516 (1917)).

[17] Id. at 9.

[18] Id. at 5.

[19] Id. at 13.

[20] Id. at 12, note 2.

[21] Id. at 13.

[22] Id. at 11-13.

[23] Id. at 14.

[24] Keeler, 157 U.S. at 667.

[25] Id.

[26] Id. (citing See U.S. Const. Art. I, § 8, Cl. 8.)

[27] Lexmark, 816 F.3d at 780.

[28] Id.

[29] This is particularly true given the facts of Lexmark. Lexmark sells its cartridges for a very specific use directly to end-users (there are no licensees making sales). It receives a price that one assumes is fair for that single use, and to clarify its intent, it states in the contract the one-time use restriction, and Lexmark re-states that refurbished use and resale is prohibited on the cartridges. Indeed, Lexmark obtains no benefit from non-parties to its original sales that later refurbish the cartridges and re-use/re-sell the patented objects without payment of a reasonable royalty.

[30] Patentees should be cautious of field-of-use restrictions being encumbering for “patent misuse” or anti-trust liability, i.e., ensure the restrictive scope of the field-of-use relates to subject matter within the scope of the patent claims. Princo Corporation v. International Trade Commission (Fed. Cir. 2010) (considering patent misuse in the context of upholding package licenses containing field-of-use restrictions for rewritable CDs, allowing intervenor to enforce patents as there was a lack of price-fixing conditions and tying restraints).

[31] Additionally, the Federal Circuit appeared to limit infringement claims against subsequent downstream buyers to only those “having knowledge of the restrictions.” Lexmark, 816 F.3d at 774. The Court did not elaborate on what defenses a subsequent bona fide downstream purchaser without actual knowledge may have, assuming no-exhaustion. The Court only mentioned, in dicta, that “we do not have before us the questions that would arise, whether under principles governing bona fide purchasers [for value without notice] or otherwise, if a downstream re-purchaser acquired a patented article with less than actual knowledge of such a restriction.” Id. at 729. Thus, such downstream buyers at present

may have a legitimate defense if later sued for infringement or under an equitable cause of action.

[32] Solicitor General Amicus Brief at 15-23.

[33] Id.

[34] Id. at 17-20.

[35] Jazz Photo Corp. v. International Trade Comm’n, 264 F.3d 1094 (Fed. Cir. 2001).

[36] Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351 (2013).

[37] Lexmark, 816 F. 3d at 763

[38] Solicitor General Amicus Brief at 21.

[39] Id. at 20-23.

[40] Id.

[41] Id. at 16-17; see also id. at note 3 ("[i]n light of this Court’s domestic-exhaustion decisions, however, a patentee can only reserve his U.S. rights in full; he cannot divide the U.S. rights and retain some but not all.")

[42] Lexmark Supp. Br. 12.

[43] Pet. App. 63a.

[44] Lexmark Int'l, Inc. v. Ink Techs. Printer Supplies, LLC, No. 1:10-CV-564, 2014 WL 1276133, at *7 (S.D. Ohio Mar. 27, 2014), rev'd and remanded sub nom. Lexmark, 816 F.3d at 779, citing Tessera, Inc. v. Int’l Trade Comm’n, 646 F. 3d 1357, 1370 (Fed. Cir. 2011).
