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Licensing Considerations After *Impression Products v. Lexmark*




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The Supreme Court's decision in *Impression Products, Inc. v. Lexmark International, Inc.*, 137 S. Ct. 1523, 1529 , 122 U.S.P.Q.2d 1605 (2017), fundamentally impacted post-sale restrictions often used by patent owners to police the use of their products and to extend the value of their intellectual property. The Supreme Court in *Lexmark* also held that foreign sales exhaust U.S. patents. *Id. at* 1538. However, this article focuses on the Court's ruling as to post-sale restrictions rather than international patent exhaustion.

Patent owners have long used post-sale restrictions as one approach for better obtaining full value for their intellectual property. The post-sale restrictions in *Lexmark* are a classic example. In that case, Lexmark sought to capture the value of its printer cartridges through the life of the cartridge through the Lexmark Resale Program. This program provided consumers with reduced pricing on cartridges in exchange for a restriction on the re-sale of the cartridges to third-parties, who would otherwise purchase the used cartridges, refurbish and refill the cartridges, and then re-sell the refurbished cartridges to consumers. *See id.* at 2-3. This post-sale restriction allowed Lexmark to capture both the value of the initial market as well as the secondary market for used cartridges.

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The Supreme Court concluded that such restrictions may not be enforced through patent infringement actions but left open the possibility that contract remedies may still exist. *See id.* at 1533 ((''Once sold, the Return Program cartridges passed outside of the patent monopoly, and whatever rights Lexmark retained are a matter of the contracts with its purchasers, not the patent law.); *id.* at 1535 (''The purchasers might not comply with the restriction, but the only recourse for the licensee is through contract law, just as if the patentee itself sold the item with a restriction.''); *id.* at 1538 (''[T]he dealings between the parties . . . can be addressed through contract law.'')).

This article outlines some takeaways for practitioners interested in developing alternative structures for maximizing intellectual property value in view of the challenges presented by the newly-broadened patent exhaustion doctrine.

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A. A Sale Is a Sale—But What About the Contract Recourse?

The *Lexmark* decision places an even greater emphasis on using contract law to achieve the desired economic outcomes for patent owners. While this may be viable for certain industries, there are practical concerns as to how effective contract law may be for enforcing field-of-use in the supply and use of products/components down the stream of commerce.

1. The Privity Problem

Contract remedies are only effective as between parties who are in privity with respect to the contract. 18 Samuel Williston & Richard A. Lord, A Treatise on the Law of Contracts § 52:38 (4th ed. 2017) (hereinafter Williston & Lord). In the case of *Lexmark*, no privity existed as between it and the refurbished cartridge reseller. While Lexmark could have brought contract actions against each individual consumer who breached the terms of the Return Program, it would have had no contract action directly against the cartridge refurbisher. (An innovator like Lexmark could also have non-contract remedies available against a third-party who induces Lexmark's customers to breach the terms of the Return Program. But such claims may also be difficult to provide because of the need to show the requisite level of scienter for such tort-based claims.). But an innovator who seeks to use contract remedies as a substitute for the now-unavailable patent remedies faces significant challenges with respect to privity.

First, an innovator would likely face significant transaction costs to maintain privity throughout the supply chain to the ultimate downstream user. Except for those innovators who sell directly to the ultimate user, the supply chain can often consist of multiple parties all of whom would need to be contractually bound to the innovator. While this could potentially be accomplished through mandatory third-party beneficiary clauses, not all innovators will have the bargaining power to demand fealty throughout the supply chain. Restatement (Second) of Contracts § 302 (1981); *see also* 18 Williston & Lord§ 52:38.

Second, an innovator could also shift enforcement burden to others in the supply chain. This would relieve the innovator of some of the burden of policing post-sale violations by downstream consumers. However, any shift in enforcement costs may be offset by the price a distributor may be willing to pay. In other words, shifting the cost to licensees may reduce the value of the licenses in the eyes of those licensees.

Given these issues, contract remedies may prove a difficult path for innovators whose intellectual property relates to relatively inexpensive products, such as consumer goods. In the specific case of printer cartridges, it is difficult to imagine any scenario where it would be economically advantageous to sue an end-user for breach of contract relating to the sale of a $25 ink cartridge. As a consequence, the more likely scenario is that consumer goods companies will move away from pricing structures that depend upon maintaining control of a secondary re-sale/re-fill market. This also may increase upfront costs for consumers in the original market but lower costs in a more competitive re-sale market.

Another possible approach is for a manufacturer to contractually restrict downstream buyers from reselling those goods to others by using, for example, liquidated damages provisions to deter a breach. But as noted above this approach has high transaction costs, and not all manufacturers have the bargaining power to demand such fealty throughout the supply chain.

2. Other Issues With the Contract Approach

Contract enforceability presents additional potential hurdles for companies seeking to control the use of their products through private agreements.

First, a breach of contract action requires, among other things, proof of damages. 23 Williston & Lord§ 63:5. In addition, a defendant has a variety of legal and equitable defenses available to it, including unenforceability and unconscionability. Restatement (Second) of Contracts § 208 (1981); *see also* 8 Williston & Lord§ 18:1. In addition, there are limits on what an innovator may be able to do under contract law when it comes to imposing post-sale restrictions on their products. In particular, an innovator should be careful about potential liability under state and federal anti-trust laws to the extent such post-sale restrictions could be viewed as unlawfully anti-competitive. 6 Williston & Lord§ 13:23.

Second, contract actions are often brought in state court—as opposed to federal court for a patent suit (and consequently, licensors should pay closer attention to choice of law and venue provisions in its license agreements)—and the available remedies can fall short of what is available under patent law. For instance, patent damages provide for no less than a reasonable royalty and can include lost profits. Contract damages, on the other hand, are only compensatory in nature and will likely be far less than what could be recovered in a patent case. In addition, enhanced damages and attorneys' fee recovery are statutorily available in patent cases whereas the availability of such additional damages in contract actions depends upon the contract terms. Further, a patent plaintiff can seek injunctive relief whereas obtaining such equitable relief in a contract case can prove more difficult.

Third, there are prudential reasons that would likely deter an innovator from using contract claims to enforce post-sale field-of-use restrictions. For one, innovators would likely not want to be in the position of suing customers for breach of contract. For another, using contract law to enforce would likely be cost prohibitive in many circumstances because it would require suit against individual customers as opposed to a single infringing third-party.

In the end, however, we expect to see a renewed focus on the commercial terms of agreements between innovators and their downstream business partners as the innovators seek to mitigate against the loss of patent remedies against competitors in secondary resale markets.

B. License Rather Than Sell

Because enforcing post-sale field-of-use restrictions through contract law is fraught with challenges, companies whose business models depend upon such restrictions will need to look for alternative strategies to lawfully protect their markets.

One such option would be to structure their transactions with consumers as a license, rather than an outright sale. Licensing products that embody intellectual property—as opposed to selling—is a common ap-

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proach in the software industry and it may be a viable approach for other industries as well.

The software industry's licensing model provides a mechanism to avoid a problem that copyright owners face when entering into transactions to monetize their intellectual property. Under the ''first sale'' doctrine, the purchaser of a copyrighted work is entitled to do what he pleases with that copy. *See* 17 U.S.C. § 109; *see also Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1363, 106 U.S.P.Q.2d 1001 (2013). This effectively prevents a copyright owner from imposing post-sale restrictions on the use and disposition of a copyrighted work.

To avoid application of this doctrine, as well as to maintain control of the software product (to limit copying, prevent reverse engineering, and limit installations, for example) copyright owners often instead will license the use of their copyrighted work rather than make an outright sale. *See, e.g.*, *Vernor v. Autodesk, Inc.*, 621 F.3d 1102, 1116, 96 U.S.P.Q.2d 1201 (9th Cir. 2010); *Int'l Equip. Trading v. AB Sciex LLC*, 2013 BL 231502 at 6 (N.D. Ill. Aug. 29, 2013). Whether a transaction involving a copyright work is a sale or a license depends on whether or not there is a transfer of title (and the right to use, sell, import, etc.) in consideration for a monetary payment, as well as sometimes the terms of the agreement, including, but not limited to, whether it limits the customer's ability to transfer the materials and imposes notable restrictions of use on the licensee. *See, e.g., Vernor*, 621 F.3d at 1116; *Int'l Equip. Trading*, 2013 BL 231502 at 6. Given the Supreme Court's reliance on the copyright ''first sale'' doctrine to support their conclusion on the scope of patent exhaustion, the licensing approach may also prove to be a viable work-around for patent owners just like it is for copyright owners. *See Impression Prods.*, 137 S. Ct. at 1536 (''Differentiating between the patent exhaustion and copyright first sale doctrines would make little theoretical or practical sense . . . .'')

1. No ''Authorized Sale''—No Patent Exhaustion: How Licensing Agreements May Be the Solution

Because the software industry's licensing strategy described above has proven to be an effective means of protecting an owner's rights to a copyright, why not apply this strategy to patented products as well? If patent owners enter into carefully drafted licensing agreements that do not involve a transfer of ownership, then an authorized sale has not occurred and the doctrine of patent exhaustion should not apply. The Supreme Court emphasized this principle in its recent *Lexmark* decision when it held that a patentee may not control downstream use or disposition of a product ''after *ownership* passes to the purchaser.'' *Impression Prods., Inc.*, 137 S. Ct. at 1531 (emphasis added).

The issue then becomes whether courts will permit patent owners to use licensing strategies to avoid the effects of patent exhaustion. The Federal Circuit's reasoning in *TransCore, LP v. Electronic Transaction Consultants Corp.* may guide how courts approach the issue. 563 F.3d 1271, 1272, 90 U.S.P.Q.2d 1372 (Fed. Cir. 2009). In *TransCore*, the court found that calling an agreement a covenant-not-to-sue rather than a license did not preclude the application of the doctrine of patent exhaustion. *Id.* at 1276 (explaining that the difference between a license and a covenant-not-to-sue ''is only one of form, not substance—both are properly viewed as 'authorizations.' ''). Thus, *TransCore* suggests that merely characterizing an agreement as a license (as opposed to a sale) may be insufficient to avoid patent exhaustion. *TransCore* left open the possibility that the patentee could have structured the covenant-not-to-sue in such a manner to effect post-sale restrictions. *Id.* at 1276-77 (''TransCore did not, as it could have, limit this authorization to, for example, 'making' or 'using'. . . . As a result, the district court correctly found . . . that TransCore's patent rights were exhausted.''). But, after *Lexmark*, it is likely such covenant-not-to-sue restrictions would be enforced via breach of contract rather than patent infringement.

Thus, while licensing instead of selling theoretically avoids patent exhaustion, the approach will no doubt be tested. As the Supreme Court explained in *Lexmark*, the Patent Act grants inventors a limited monopoly that allows them to secure a financial reward for their inventions. *Impression Prods.*, 137 S. Ct. at 1527. It does not, however, allow inventors to misuse their patents by attempting to expand their limited monopoly to restrain the use or sale of unpatented materials. *Motion Picture Patents Co. v. Universal Film Mfg.*, 243 U.S. 502 (1917). *See also Int'l Salt Co. v. United States*, 332 U.S. 392, 398 (1947) (''The appellant's patents confer a limited monopoly of the invention they reward. From the appellant derives a right to restrain others from making, vending or using the patented machines. But the patents confer no right to restrain use of, or trade in, unpatented [products].'').

For example, in *Motion Picture Patents*, a patent owner demanded that only films provided by the patentee could be viewed on the patented movie projectors. 243 U.S. at 506. The Supreme Court rejected the patent owner's tie-in restriction as illegal under antitrust law because it attempted to extend the scope of the patentee's limited monopoly to materials that were not covered by the patent. *Id.* at 516. For this reason, applying the software industry's licensing strategy to avoid patent exhaustion cannot be applied to impose post-licensing restrictions that attempt to regulate unpatented products or materials. Accordingly, this strategy may only be beneficial with respect to certain patented products. *See, e.g.*, *Bowman v. Monsanto Co.*, 133 S. Ct. 1761, 1765, 106 U.S.P.Q.2d 1593 (2013) (A patent owner sold patented herbicide resistant soy beans with a licensing agreement that kept customers from replanting the seeds that the original beans produced. The Supreme Court upheld the agreement's restriction when a customer violated it, reasoning that patent exhaustion does not apply to newly created infringing articles.).

In summary, there may be ways to limit the effects of patent exhaustion through adopting a similar licensing strategy as the software industry has done so well. If attempted, however, this strategy must be applied prudently to avoid raising other legal issues, including potential antitrust or patent misuse concerns.

2. Policy Considerations

Whether the courts will uphold licensing patented products as a way to avoid patent exhaustion remains to be seen. There are compelling arguments that cut both ways. A court—and ultimately the Supreme Court, given the breadth of its *Lexmark* decision—may reject this approach based on the rationale that it merely disguises authorized sales with post-sale restrictions as licensing agreements. If a court determines that these licensing agreements really are just camouflaged sales with post-sale restrictions, it will likely re-emphasize its position in *Lexmark* that if patent rights were permitted to stick to a product as that product flows through the market it would violate the principle against restraints on alienation. *Impression Prods.*, 137 S. Ct. at 1538.

On the other hand, a court has persuasive precedent leaning in favor of upholding this approach—namely the fact that software companies have consistently relied upon the same licensing strategy to retain power over their copyrighted works. Accordingly, unless the Supreme Court can carefully distinguish the method presented here from software licensing agreements, a decision rejecting this method may have adverse effects on the software industry (as well as other industries, such as automobile leasing). Additionally, a court would easily be able to reconcile such a ruling with its *Lexmark* decision by reiterating its position that ''a license does not implicate the same concerns about restraints on alienation as a sale.'' *Id.* at 1534.

In conclusion, although persuasive precedent seems to lean in favor of upholding properly structured licensing agreements as a means of avoiding patent exhaustion, the Supreme Court has set itself up for an opinion cutting either way. Avoiding patent exhaustion through the use of licensing agreements is only one of various creative methods of avoiding the consequences of *Lexmark*.

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