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Memorandum

Supreme Court Clarifies That Even Conditional or Foreign Sales Result in Patent Exhaustion

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On May 30, 2017, in *Impression Products, Inc. v. Lexmark International, Inc.*, No. 15-1189, the Supreme Court held that the initial authorized sale of a patented item exhausts all downstream rights, even if the sale is expressly conditional or takes place outside of the United States. In doing so, the Supreme Court overruled two longstanding Federal Circuit decisions that had reached a contrary result, *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (1992) (conditional domestic sales), and *Jazz Photo Corp. v. International Trade Commission*, 264 F.3d 1094 (2001) (extraterritorial sales). The key holdings in the Court's opinion are summarized below, followed by a more detailed discussion of the decision and its potentially far-reaching implications:

Conditional Sales Result in Exhaustion of Patent Rights

- Extending the Supreme Court's decision in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617.(2008), the Court concluded that a patentee's initial authorized sale exhausts all patent rights in the item, regardless of even express conditions imposed on its resale or reuse;
- While a patentee may enforce post-sale conditions through *contractual* remedies, such relief is now outside the scope of patent law;
- Exhaustion is a judicially imposed doctrine that strikes a balance between: (i) the right to exclude under the Patent Act and (ii) the common law policy against restraints on alienation.

Extraterritorial Sales Likewise Result in Domestic Exhaustion

- Applying its recent copyright decision finding extraterritorial exhaustion in *Kirtsaeng v. John Wiley & Sons, Inc.*, 568 U.S. 519 (2013), the Court found that foreign sales exhaust U.S. patent rights, based on the same common law policy against downstream restraints on alienation;

- The extraterritorial limits of U.S. patent law do not compel a different result, because exhaustion is a separate limit on the patent right once the patentee makes an authorized sale, regardless of where that sale may occur.

Background

From the time of the Federal Circuit's 25-year-old decision in *Mallinckrodt*, the settled rule had been that a patentee could place otherwise proper, clearly communicated restrictions on the post-sale use of a patented item. The Federal Circuit in that case found that, as long as a restriction did not run afoul of the antitrust laws or other prohibitions, "private parties retain the freedom to contract concerning conditions of sale."[1] In its more recent decision in *Quanta*, however, the Supreme Court appeared to walk this principle back somewhat, holding flatly in that case that an initial authorized sale "terminates all patent rights to that item,"[2] leading some commentators to conclude that *Quanta* had implicitly overruled *Mallinckrodt*.

A similar sequence of events occurred with respect to the question of extraterritorial exhaustion. Under the Federal Circuit's more than 15-year-old holding in *Jazz Photo*, the sale abroad of a patented item *never* resulted in U.S. patent exhaustion, because "the authorized first sale must have occurred under the United States patent."[3] Here again, however, recent Supreme Court jurisprudence had called the Federal Circuit's reasoning into question, as the Court held just a few years ago in *Kirtsaeng* that the first sale doctrine in copyright law results in exhaustion for foreign sales, while noting exhaustion's "impeccable historic pedigree," based on the common law refusal to allow restraints on alienation.[4]

The case at bar then presented both of these related questions squarely in the patent law context. Lexmark sells printer cartridges under two models: (i) at full price for unlimited use (including any resale or reuse), or (ii) at a significant discount for a "single use," which does not permit any resale or reuse. Lexmark implemented technology designed to prevent unauthorized reuse of the cartridge for single-use customers, but downstream users had found a technical way to circumvent this restriction.

In 2010, Lexmark sued a number of "remanufacturers" of its cartridges for unauthorized reuses and resales. The litigation ultimately narrowed to only Lexmark and Impression, and to only the two legal questions of: (i) whether conditional sales in the U.S. precluded the application of exhaustion, and (ii) whether international sales exhausted U.S. patent rights. The district court granted Impression's motion to dismiss with respect to domestic sales, but sided with Lexmark on the extraterritorial sales issue.

[1] *Mallinckrodt*, 976 F.2d at 708.

[2] *Quanta*, 553 U.S. at 625.

[3] *Jazz Photo*, 264 F.3d at 1105.

[4] *Kirtsaeng*, 568 U.S. at 538.

In a rare procedural move, the Federal Circuit heard the appeals *en banc*, issuing a lengthy opinion in favor of Lexmark and rejecting the application of exhaustion for both conditional domestic sales and all foreign sales. On the domestic front, the Federal Circuit followed *Mallinckrodt*, focusing on the language of the Patent Act that permits a patentee to exclude certain acts from occurring "without authority." Based on this language, the court found that, where a patentee withholds authority for resales or reuses, any unauthorized act cannot be immunized from infringement under the statute. The court also declined to draw what it viewed as an artificial distinction between restrictions placed on the sale of a patented item and restrictions placed on a licensee, which are indisputably permitted.

Finally, with respect to foreign sales, the Federal Circuit held that U.S. patent law offers patentees a separate reward for infringement occurring in this context, noting that foreign sales may very well occur in countries with limited or no patent protection and where a patentee cannot command the same market price. Two Federal Circuit judges dissented on both points.

Summary of the Supreme Court's Decision

The Supreme Court then reversed the Federal Circuit's decision in its entirety. Chief Justice Roberts delivered an opinion joined by all justices except for Justice Ginsberg (who joined the court on the domestic sale issue, but dissented on the extraterritoriality question), and Justice Gorsuch, who took no part in the consideration or decision of this case.

Conditional Domestic Sales Exhaust Patent Rights

On the first question, the Court followed *Quanta*'s broad holding that an initial authorized sale terminates any further *patent* rights in the item, finding that "[t]his well-established exhaustion rule marks the point where patent rights yield to the common law principle against restraints on alienation."[5] The Court focused heavily on the common law policy against restraints on the alienation of chattels, citing a favored 17th-century passage from Lord Coke (on which the Court also relied in *Kirtsaeng*) to conclude that, once a sale occurs, common law principles prevent the patent laws from imposing restraints on alienation, though, importantly, limitations on post-sale use may still be enforced through ordinary contract remedies.[6]

The Court then immediately moved to a public policy illustration of why, in its view, a contrary rule would permit "'obnoxious'" patent law restraints on downstream use that would be harmful to commerce.[7] Citing

[5] *Slip op.* at 6.

[6] *Id.* at 9. *Lexmark* is thus yet another in a long line of reminders that "patent law is governed by the same common-law principles, methods of statutory interpretation, and procedural rules as other areas of civil litigation." *SCA Hygiene Products Aktiebolag v. First Quality Baby Products, LLC*, No. 15-927, *Slip op*. at 9; *eBay Inc. v. MercExchange, LLC*, 126 S. Ct. 1837 (2006); *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749 (2014); *Halo Electronics, Inc. v. Pulse Electronics Inc.*, 136 S. Ct. 1923 (2016).

[7] *Id.* at 7 (quoting *Straus* v. *Victor Talking Machine Co.*, 243 U. S. 490, 501 (1917)).

an example similar to one proffered by many of the *amici* who supported this view, the Court suggested that a repair shop restoring or reselling used cars might face patent suits over any number of patented components that comprise a vehicle, "clog[ging] the channels of commerce" with little benefit to the patentee—even though the patentee had already received his or her reward for the initial authorized sale.[8] The Court further noted the even more complex supply chains that go into technologically advanced devices like smartphones, which could leave downstream entities (or even end customers) exposed to at least theoretical infringement liability on many thousands of patents.[9]

Finally, the Court rejected the Federal Circuit's reliance on the "without authority" language of the Patent Act, as well as its analysis of sales versus licenses. With respect to the statutory language, Justice Roberts noted that exhaustion arises not by statute, but rather as a *judicial limitation* on the patentee's rights to secure more than one benefit from a single sale.[10] Likewise, the Court found the Federal Circuit's concern about a sale-license distinction "misplaced," because sales and licenses are fundamentally different: exhaustion seeks to avoid muddying the chain of commerce once an item has changed ownership, while a license only grants certain rights under a patent, not a change in title.[11]

Extraterritorial Sales Exhaust Patent Rights

In its related decision to extend exhaustion to foreign sales, the Court applied similar principles to find that, just as in the copyright context in *Kirtsaeng*, the common law's opposition to "restraints on alienation" precludes a patentee from recovering multiple rewards for sales of the same item both internationally and in the U.S.[12] The Court noted that the relevant statutory provisions do not prevent the application of exhaustion to foreign sales, and that distinguishing between patent and copyright law makes little sense since "[t]he two [areas] share a 'strong similarity . . . and identity of purpose.'"[13]

Lastly, the Court rejected the notion that limits on the extraterritorial application of patent law preclude the application of exhaustion, holding that a patentee's rights are exhausted by an initial authorized sale wherever it occurs, and that even an express reservation of rights at the time of sale is ineffective because "[m]ore is at stake . . . than simply the dealings between the parties, which can be addressed through

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[8] *Id.* at 7-8.

[9] *Id.* at 8.

[10] *Id.* at 10.

[11] *Id.* at 11.

[12] *Id.* at 14.

[13] *Id.* (quoting *Bauer & Cie v. O'Donnell*, 229 U.S. 1, 13 (1913)).

contract law."[14] Justice Roberts explained that the animating purpose behind applying exhaustion to international sales is, again, to prevent restraints on alienation rather than to give the patentee any specific market reward, and that, "[a]s a result, restrictions and location are irrelevant; what matters is the patentee's decision to make a sale."[15]

Implications

Unlike many of the Court's recent patent decisions, the implications in this case are not entirely clear. Indeed, the parties and *amici* posited a variety of potential competing "horribles," and some of the pro-exhaustion hypotheticals were ultimately central to the Court's decision, as set forth above. *Amicus Brief of Intel Corp., et al.*, at *17 and n.5 (Jan. 24, 2017) ("As in *Kirtsaeng*, a consumer who purchases a phone, a new pair of golf shoes, or even a package of diapers while on a trip abroad could find herself liable for patent infringement upon her return to the United States."); *Amicus Brief of Costco Wholesale Corp., et al.*, at *6 (Apr. 21, 2016) ("Goods of all kinds . . . incorporate innumerable components made throughout the world . . . . If the decision below stands, each product developer and manufacturer would be required to trace to origin the patent rights of every single component it purchases.").

On the other hand, while this decision undoubtedly furthers the quite legitimate policy goals of protecting the flow of commerce and downstream purchasers, the Court appeared to pay little heed to potentially countervailing interests raised by other *amici*. We will now briefly address certain of those other potential implications below.

Implications of Applying Exhaustion to Conditional Sales

As many of the *amici* pointed out, the first and most obvious implication of this week's decision is that applying exhaustion to expressly conditional sales will likely throw significant existing business practices into chaos. Differential pricing such as that employed by Lexmark in this case is commonplace and, indeed, at least arguably beneficial, permitting smaller customers to purchase goods that might not otherwise make commercial sense. The Court's decision potentially invalidates an unknown number of carefully negotiated agreements and unsettles decades-old commercial expectations, perhaps causing the very "sputter[ing]" of commerce that its decision seeks to avoid.[16] More broadly, *Lexmark* will of course make it harder for patentees to enforce their rights against downstream users and provide an important new defense to alleged infringers, likely changing the nature of at least some downstream infringement suits to focus on contractual or related tort claims, such as interference with contract.

[14] *Id.* at 15-18.

[15] *Id.* at 18.

[16] *Slip op.* at 7.

The Court's decision also likely invalidates agreements that may very well serve the legitimate interests of the patentee in protecting its reputation, or even the safety of end consumers (as in the case of certain medical devices or pharmaceutical products). Prohibiting restrictions on reuse could allow practices that harm the patentee by, for example, permitting lower-quality resales or reuses of the product, or practices that are actually dangerous to customers if the product can only be safely used in the specified manner. The patentee may thus need to turn to other types of contract,[17] tort, or regulatory avenues to try to constrain this conduct.

Finally, and perhaps most importantly, the *Lexmark* decision could fundamentally change the way that patentee manufacturers sell and license their products. Because the Court reaffirmed the distinction between a sale and license, companies such as Lexmark may now be motivated to adopt the curious (and entirely arbitrary) practice of simply "licensing" a product, or rights to use a product, to some customers instead of selling it, while using the exact same differential pricing model.[18] This approach could dramatically increase transaction costs[19] and the complexity of supply chains—because every step of the chain may require an express license in order for the patentee to retain privity against downstream users—as well as raise tricky questions as to what constitutes a "sale" or "license" when conveying rights to use a physical product. And this, in turn, will likely spur even more disputes about whether and how state law provisions or the Uniform Commercial Code should govern these transactions, as well as a greater emphasis on contract drafting to avoid making a "sale" that exhausts all patent rights. Likewise, what might happen as a real-world commercial matter if many customers balked at taking only a limited "license" to a product—or at entering into complex licensing arrangements that increase the price of doing business—is completely unknown.

Implications of Applying Exhaustion to Foreign Sales

The same balancing act applies to the competing policy interests raised in the extraterritoriality context. On the one hand, the Court was clearly concerned about purchasers of products abroad having to trace back thousands of components to every patent holder—a very real problem. On the other hand, the Court's decision could also have major policy consequences in the opposite direction.

First, as above, the Court has unsettled more than a decade of expectations that patentees who sell abroad would be permitted to restrict resales into the U.S., potentially disrupting large numbers of existing, complex

[17] As the Supreme Court noted in *Lexmark*, *see Slip Op.* at 9, certain contractual limitations may of course still run afoul of the antitrust laws, potentially complicating attempts to use more extensive contractual restraints as a replacement for patent remedies.

[18] Patentee manufacturers may also be motivated to develop more effective technology for tracking and limiting use of their products, though, as Lexmark learned here, there may always be creative ways to circumvent such efforts.

[19] Ironically, the same concern about increasing transaction costs may very well animate public policy positions on both ends of the spectrum. *See, e.g.*, *Brief of Intel Corp.*, *et al.*, at *4 ("*Jazz Photo* has imposed unwarranted transaction costs on high technology . . . . [A] rule that requires duplicative licensing imposes massive transaction costs with no corresponding benefit, aside from wealth to the patentee.").

international agreements and chains of commerce involving numerous players and countries. The decision may cause patent holders to simply cease selling certain products overseas altogether or, alternatively, to switch to a licensing regime that, as in the domestic context, may arbitrarily change the form of many deals and increase both transaction and enforcement costs.

Second, the Court did not appear interested in one policy issue raised repeatedly by *amici*: the likely effect on pharmaceutical suppliers who currently provide drugs at minimal cost in poorer countries—or, for that matter, who engage in territorial pricing at all—while retaining the ability to sell these products at higher prices in the U.S. *Amicus Brief of Pharm. Research and Mfgs. of Am.*, at *2 (Feb. 23, 2017) (noting importance of previous no-exhaustion rule to "the pharmaceutical industry's ability to continue to develop innovative, life-saving medicines and treatments for patients"); *Amicus Brief of Biotech. Innovation Org.*, at *13-*14 (Feb. 23, 2017) ("The territorial limitation on patent exhaustion allows patent owners to establish regional prices based on local conditions and reach customers who could not or would not purchase the products at a higher price.").

Extraterritorial exhaustion could limit drugmakers' ability to sell life-saving products more cheaply to indigent customers and regional pricing more broadly, as parties would seemingly be free (at least as a matter of patent law) to resell in the U.S. at higher prices. This type of arbitrage may make it harder for pharmaceutical companies to recoup the high research and development costs necessary to bring a product to market, as well as raising complex problems where a product can only be sold at wildly varying prices under different governmental regimes. On the other hand, there is reason to think that U.S. regulatory barriers to importation, such as testing requirements, approval processes, and the like, could play a more prominent role in the absence of patent restrictions, and political factors may also close the price gap as subsidizing drug costs in other wealthy nations grows increasingly unpalatable.

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