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In Impression Products, Inc. v. Lexmark International, No. 15–1189, 137 S. Ct. ___, 2017 WL 2322830 (May 30, 2017), the U.S. Supreme Court held that a patentee's sale of a product exhausts all of its U.S. patent rights in that item, regardless of any contractual restrictions the patentee may have imposed on subsequent use or sale of the product and regardless of whether the sale occurs within the U.S. or abroad. This update discusses the ramifications of that decision for patentees and patent licensing arrangements, as well as for buyers of patented products.

The Supreme Court's Ruling

The facts of the case were simple and largely undisputed. Lexmark adopted a “Return Program” under which it sold patented printer toner cartridges to U.S. customers at a favorable price, but subject to the condition that the customer would use the cartridge only once and then transfer it only to Lexmark. Customers who wanted the freedom to refill or sell their cartridges to others had to pay more. Lexmark also sold toner cartridges in other countries without the restrictions of the Return Program. Impression Products purchased used Lexmark cartridges from both U.S. Return Program customers and foreign customers, refurbished and refilled the cartridges, and then resold the cartridges in the U.S.

Lexmark sued Impression for patent infringement. Impression's main defense was that Lexmark’s sales to U.S. and foreign customers had exhausted Lexmark’s U.S. patent rights. As to the Return Program cartridges, Lexmark argued that its patent rights were not exhausted because it had imposed valid restrictions on reuse and resale of the cartridges, and that customers had violated those restrictions. In support of that argument, Lexmark relied on Mallinckrodt, Inc. v. Medi-Part, Inc., 976 F.2d 700 (Fed. Cir. 1992), where the U.S. Court of Appeals for the Federal Circuit held that violation of a contractual single-use restriction prevented exhaustion of a patent on a medical device. As to the foreign-sourced cartridges, Lexmark contended that foreign sales cannot exhaust U.S. patent rights because patent rights are territorial. In support, Lexmark relied on a line of cases beginning with Jazz Photo Corp. v. USITC, 264 F.3d 1094 (Fed. Cir. 2001). Impression countered that both Mallinckrodt and Jazz Photo were inconsistent with intervening Supreme Court decisions.

After a mixed ruling in the district court, the Federal Circuit took the case en banc, reaffirmed both Mallinckrodt and Jazz Photo, and ruled for Lexmark on both key issues. In particular, it held, by a wide 10–2 margin, that a patentee may retain the right to sue for patent infringement when it imposes conditions on downstream sales and use, and customers violate those conditions. It further held, by the same wide margin, that only authorized sales within the United States can exhaust U.S. patent rights.

The Supreme Court, however, reversed on both points, holding that Lexmark’s initial sales of the Return Program cartridges in the United States and unrestricted sales of cartridges abroad both exhausted all of its U.S. patent rights in those products. As to the Return Program cartridges, the Court invoked the common-law hostility toward restraints on alienation and held that once a patentee sells an item, it has taken its reward and cannot invoke patent law to restrain downstream use and sale of that item. As to the foreign sales, the Court held that an authorized sale outside the United States exhausts U.S. patent rights just as much as an authorized sale within the United States. In so holding, the Court again invoked the common-law antipathy toward restraints on alienation and followed its similar copyright holding in Kirtsaeng v. John Wiley & Sons, Inc., 568 U.S. 519 (2013). The Court’s ruling was emphatic and nearly unanimous: only Justice Ginsburg dissented, and only on the foreign sales issue.

Implications for Patentees and Licensors

Impression raises important questions about how patentees and licensors can prevent exhaustion of their patent rights, or at least control when it occurs, and how the new rules of patent exhaustion will affect relationships in today’s worldwide supply chains. (Pharmaceutical and some medical devices are subject to a variety of additional legal and regulatory constraints that are beyond the scope of this update.)

To begin with, Mallinckrodt and Jazz Photo are no longer good law, and strategies such as Lexmark’s that were built around those precedents will need to be revisited. Lexmark, for example, can no longer rely on patent law to enforce contractual restrictions on downstream sales and use, and its Return Program will likely need to be retooled. Likewise, patentees that used to sell at lower prices in foreign countries and higher prices in the United States will be hard pressed to maintain that price discrimination because “grey market” imports of products lawfully purchased abroad may undermine the higher U.S. pricing.
More generally, the decision characterizes the exhaustion doctrine as imposing an absolute limit on the scope of patentees' rights: once a patentee sells an item (or an authorized licensee sells an item within the scope of its license), the patentee cannot use patent law to control how the new owner or anyone downstream uses or disposes of that product. The corollary is that a patentee must take its statutory reward when it first sells or authorizes others to sell a product; it may not take a second “bite” later because once the product is sold, it is “outside the scope of the patent monopoly.”

On the other hand, the Court did not do away with patentees’ freedom to restrict the scope of licenses. The decision specifically recognized that “a license does not implicate the same concerns as a sale” because “a license is not about passing title to a product, it is about changing the contours of the patentee’s monopoly [and] expanding the club of authorized producers and sellers.” Accordingly, when a patentee grants a license, “it is free to relinquish only a portion of its bundle of patent protections.” As discussed below, this distinction has important ramifications for patentees, licensees and their customers.

After *Impression*, patentees and licensors may pursue a variety of strategies, some more likely to be legally valid and practically effective than others.

**Extract Value Up Front and Charge Everyone the Same Price.** The most straightforward response to *Impression* would be acquisitiveness. Instead of restricting downstream sale or use and instead of charging different customers different prices, a patentee that makes and sells patented items could charge everyone a uniform, presumably higher price for those products. Lexmark, for example, could abandon its Return Program, allow everyone to refill and sell their toner cartridges, and charge the same price everywhere in the world.

But although that may be the result the Supreme Court envisioned, it is not ideal for patentees and may often be unworkable. To take just one example, differential pricing may be important to a business that sells products in both developed countries and less developed countries where operating costs and customer disposable income differ significantly. Most patentees and licensors will look for other options.

**Rely on Contract and Tort Law.** Despite invoking the common law’s antipathy toward restraints on alienation, the Supreme Court suggested that patentees and licensors may enforce restrictions on downstream sales and uses using contract law. That approach might work reasonably well for patentees that sell large volumes to a few large customers. But it may be impractical to enforce contractual limitations against large numbers of individual customers, and impossible to sue downstream customers and users that are not in contractual privity with the patentee.

In some cases, a patentee may be able to sue a third party to a contract for tortious interference with contract. Lexmark, for example, might be able to sue *Impression* for tortious interference with contract if *Impression* was aware of the restrictions of Lexmark’s Return Program and induced customers who were in contractual privity with Lexmark to breach contracts with Lexmark. But that strategy would not work if, for example, the users who sold or refilled their cartridges were not in contractual privity with Lexmark.

**Limit the Scope of Authorized Sales by Licensees.** *Impression* reiterated that an authorized sale by an authorized licensee exhausts the patent owner’s rights just like a direct sale by the patent owner itself: “So long as a licensee complies with the license when selling an item, the patentee has, in effect, authorized the sale,” with the result that “[t]he sale exhausts the patentee’s rights in the item.” But the Court also reaffirmed the inverse proposition: an unauthorized sale by a licensee (a sale outside the scope of its license) does not exhaust the patentee’s rights in the products sold. Thus, for example, if a license permits a distributor to sell patented products only to customers east of the Mississippi River, sales to customers west of the Mississippi would be unauthorized, and if such sales occur, the patentee may sue both the distributor and downstream customers and users for patent infringement. Likewise, a patentee may impose field-of-use restrictions and retain the right to sue for patent infringement if the licensee sells outside its authorized field of use.

To the extent possible, then, patentees should frame restrictions as conditions on initial sales by licensors, rather than as conditions on subsequent use or sale by purchasers. How easy and practical it is to do so will depend on the facts of individual cases.

**Avoid Transfer of Title.** *Impression* confirms that an authorized sale of a product that substantially embodies a patented invention exhausts the patentee’s U.S. patent rights in that invention. The Federal Circuit has held that giving a product away for free can also trigger patent exhaustion because the patentee had the opportunity to exact its compensation. But both sales and gifts involve transfer of ownership, and patentees may try to avoid immediate exhaustion by recasting transactions as leases or consignments rather than transfers of title.

Whether this will work is unclear. Many courts have upheld shrink-wrap contracts in which software companies retain rights to control use and distribution of the software by characterizing transactions as licenses rather than sales of individual copies. But jurisdictions vary in how they treat leased and consigned goods for various purposes such as creditors’ rights, implied warranties to downstream users and bankruptcies. Moreover, patent exhaustion is ultimately a matter of federal patent law, not state commercial law.
The *Impression* opinion focuses on “passing title” and avoiding “a legal cloud on title” as a product moves through the marketplace. Nevertheless, given the Supreme Court’s antipathy to restraints on alienation and use, we cannot be sure that retaining formal title to goods will entitle patentees and licensors to continue to restrict downstream use and transfer of products that have long passed to others’ hands. Notably, exhaustion law is not entirely formalistic: under *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617 (2008), authorized sale of a product that *substantially* embodies a patented invention exhausts the patent rights even though the product itself does not fully practice the patent claims.

In any event, a licensing or consignment model would be transactionally complex, may affect tax and other legal issues, and would require careful retooling of distribution and licensing agreements and related internal business processes.

**Separate the Patent-Holding Entity from the Product-Selling Entity.** Some have suggested that a patent owner that desires to enforce licensing restrictions on products downstream should create two separate entities: one dedicated to holding the patents, and another dedicated to selling patented products. Under this approach, the product-selling entity would have no formal license from the patent-holding entity, so its sales would not be licensed. The patent-holding entity would then police activities of downstream customers but refrain from suing the product-distribution entity.

But such an approach may be too clever, especially where both entities are controlled by the same corporate parent or shareholders. In that case, courts may conclude that the patent-holding entity has effectively authorized the sales by its sister company even though it has not formally licensed those sales. Such an implied license would exhaust the patent-holder’s patent rights.

Cases with less than complete overlap in ownership between the patent-holding and product-sales entities may present closer calls. If the owners of the patent-holding entity do not legally or actually control the product-sales entity, sales by the latter might not exhaust the patent rights of the former. On the other hand, substantial overlap in ownership might lead courts to treat the patent-holder’s forbearance from suing the product-sales company as an implied license and authorization, resulting in exhaustion.

Companies may try similar approaches to avoid *Impression’s* international exhaustion holding. For example, a parent company might assign its foreign patents to a foreign affiliate that makes foreign sales and its U.S. patents to a U.S. affiliate that makes U.S. sales. If the foreign affiliate’s products were resold and imported into the United States, the U.S. affiliate would contend that it did not authorize any foreign sales by the foreign affiliate and thus could still sue an unauthorized importer under its U.S. patent rights. Again, however, the courts might pierce corporate veils in such circumstances and find exhaustion—especially if the U.S. and foreign entities share common ownership.

**License Some Patent Rights But Not Others.** In recent years, some patent owners have adopted licensing programs in which they try to maintain some downstream control by granting only partial patent rights. For example, a patentee might collect a royalty or other consideration from a component manufacturer in exchange for the right to make certain products, but the license would authorize the component manufacturer to *sell* those products only to a list of approved system manufacturers. The patent owner would then require system manufacturers to pay an additional royalty to be on the approved-purchaser list. The premise of this approach is that no authorized sale and exhaustion occurs unless both seller and buyer are licensed.

*Impression* observes that when a patentee is acting as a licensor, “it is exchanging rights, not goods, [and] it is free to relinquish only a portion of its bundle of patent protections.” In the same discussion, the Court cited an earlier case (*General Elec. Co. v. United States*, 272 U.S. 476 (1926)), that stated, in dictum, that a patentee may grant the right to make and use patent products while withholding the right to sell them. Moreover, the Court reaffirmed that “if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee’s rights.” Those statements suggest that patentees remain free to license some patent rights but not others.

On the other hand, neither *Impression* nor *General Electric* actually involved licensing some patent rights and not others. Moreover, *Impression* made clear that the right to impose constraints on licensees “does not mean that patentees can use licenses to impose post-sale restraints on purchasers.” Again, patent holders will need to draft their licenses carefully to place restrictions on the licensee’s initial authorization to sell, rather than what purchasers may do with products after an authorized sale. The principal concern of the Court’s decision was that “[a]llowing patent rights to stick remora-like to that item as it flows through the market would violate the principle against restraints on alienation.”

**License Some Patents But Not Others.** Partial portfolio licenses authorize sales of products under some patents held by a licensor but not others. Such licenses are common. For example, companies selling patents often receive a license to continue practicing those patents when making their own products, but not a license to practice other patents owned by the buyer. Likewise, settlement agreements often cover the patents-in-suit but not any other patents that the plaintiff may also hold or later acquire. (Courts sometimes presume that licenses covering certain products extend to all patents that apply to those products, but parties remain free to specify that a licensor is not licensing certain patents and retains the right to sue the licensee and downstream customers for infringement of the unlicensed patents.)

Whether this will remain true after *Impression* is unclear. *Impression* does not directly address partial portfolio licenses. As discussed above, it does reaffirm that licenses are different from sales and that a licensing patentee is “free to relinquish only a portion of its bundle of patent protections.” On the other hand, the Court also held that a patentee's own authorized sale abroad will exhaust its U.S. patent rights even if it purports to reserve its U.S. patent rights at the time of the foreign sale. Moreover, the logic
of the decision is that an authorized sale frees products sold from any lingering control by the patentee, even when, as in Impression, the buyer has paid less in exchange for fewer rights. Courts will need to decide whether sales authorized under some U.S. patents should be deemed authorized under all of the patentee’s U.S. patents, effectively resulting in full-portfolio licenses. In the meantime, patentees may want to review both their patent ownership structures and the terms of their license agreements to mitigate the impact of a broad application of Impression.

Opportunities for Buyers and Licensees

The new troubles of patentees and licensors under Impression correspond to new opportunities for those who buy products and license patents. Buyers of components and larger products should carefully examine the terms of their supply agreements and any related license agreements. They may conclude that they are now overpaying for license rights or that they no longer need such rights—especially if a supplier is obliged to license its patents on FRAND terms. In some cases, buyers may want to terminate or stop paying under license agreements. Many issues remain unclear after Impression, however, so buyers should take care and consult expert counsel rather than assuming they are home free.

Customers of suppliers that have enforced differentiated pricing regimes should also carefully examine any existing or proposed agreements with those suppliers in light of the Impression decision. Again, however, caution is warranted, and clients should consider implications under contract, tort, and antitrust and other statutory law as well as patent law.

Finally, companies interested in exploiting international price arbitrage strategies that may arise after Impression should also proceed with caution, as suppliers may have remedies in contract, tort, trade secret and other sources of law. Additionally, national regulations beyond the scope of this update may limit such activities, especially for pharmaceuticals and medical devices.

Conclusion

The Supreme Court’s decision in Impression went further than most observers predicted. Patentees with business and IP strategies based on the legal principles rejected in Impression need to re-think those strategies in close consultation with legal counsel. Customers and licensees should, too. Impression will also spawn new strategies that will raise new legal questions in a complex area of law, leading to new disputes and further evolution in the law.

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