
Paul E. Jahn, Rufus Pichler, and Lincoln C. Lo

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Technology Transactions

Client Alert

Introduction

In *Lexmark International, Inc. v. Impression Products, Inc.*, the en banc Federal Circuit held that (1) the sale of an article under clearly communicated and otherwise lawful restrictions on use and resale avoids patent exhaustion and preserves the patentee's rights to pursue infringement remedies both against the buyer and downstream buyers with knowledge of the restrictions, and (2) a patentee's or licensee's foreign 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. The 10-2 decision comes as a surprise to many observers, at least as to its restricted sales holding, as it creates some tension with recent Supreme Court authority on intellectual property exhaustion.

Background

Lexmark International, Inc. manufactures and sells printers and toner cartridges covered by multiple Lexmark patents. Lexmark sells toner cartridges in the United States and foreign markets under two programs: a "Regular Cartridge" program, under which cartridges are sold at full price and without restriction on resale or reuse of the cartridge; and a "Return Program Cartridge" program, under which cartridges are sold at a 20% 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 adequate notice that cartridges may not be used more than once and may be transferred only to Lexmark. Lexmark also seeks to enforce these restrictions through a microchip in the cartridge.

Impression Products, Inc. is a small West Virginia-based business that acquires spent cartridges for refilling and sale in the United States. These refilled cartridges included restricted "Return Program Cartridges" that had been altered by microchip replacement to circumvent Lexmark enforcement.

Lexmark sued Impression for patent infringement, alleging that Impression's refurbishment and sale of domestically sold "Return Program Cartridges" infringed Lexmark's patents. Lexmark also alleged infringement by all imported foreign-sold cartridges—both under the "Regular" and "Return" Programs. Impression argued that Lexmark's patent rights had been exhausted by Lexmark's first sale of the cartridges domestically and abroad.

Impression's argument that Lexmark had exhausted its patent rights challenged a pair of Federal Circuit cases: *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992) and *Jazz Photo Corp. v. International Trade Comm'n*, 264 F.3d 1094 (Fed. Cir. 2001). In *Mallinckrodt*, the Federal Circuit held that a sale that is "validly conditioned under the applicable law governing sales and licenses" avoids exhaustion and "may be remedied by action for patent infringement."
In *Jazz Photo*, the appellate court held that U.S. patent rights are exhausted only by a first sale in the United States, not abroad.

On motion to dismiss, the District Court for the Southern District of Ohio agreed with Impression that the re-sale of cartridges originally sold in the United States was permissible despite Lexmark's no-reuse and no-resale restrictions. The court adopted as a premise that both the first purchaser of the cartridges and Impression had adequate notice of the no-resale and no-reuse restrictions before they made their purchases. Nonetheless, relying on the Supreme Court's decision in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617 (2008), the district court held that the exhaustion defense applied because the initial sales were still authorized. The district court viewed *Quanta*, which held that an authorized and unrestricted initial sale exhausts patent rights, as implicitly overruling *Mallinckrodt*.

As for the cartridges originally sold overseas and then imported, the district court rejected Impression's argument that Lexmark's patent rights had been exhausted in light of the Supreme Court's holding in *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013). Under *Kirtsaeng*, the copyright owner's right to restrict the sale or distribution of a particular copy of a copyrighted work in the United States is exhausted if the copy was lawfully made, whether in the United States or abroad. The district court distinguished *Kirtsaeng* as rooted in a statutory provision of copyright law that does not exist in patent law. Following *Jazz Photo*, the district court held that foreign sales do not exhaust U.S. patent rights.

On appeal, the Federal Circuit *sua sponte* ordered *en banc* hearing of the case.

**The Federal Circuit's Holding**

In a 10-2 decision authored by Judge Taranto, the *en banc* Federal Circuit disagreed with the district court that *Quanta* had overruled *Mallinckrodt*. Deeming *Mallinckrodt* still good law, the appellate court reversed the district court's holding that the exhaustion doctrine permitted re-sale of the originally domestic sold products. But it affirmed the trial court's ruling that *Kirtsaeng* did not overrule *Jazz Photo*, such that the foreign sales do not exhaust the right to prevent subsequent resales in the United States.

In discussing Lexmark's restricted sales, the majority emphasized that the sale in *Quanta* had been made by a licensee rather than the patentee and that the licensee's authorizations were unrestricted. The appellate court therefore distinguished *Quanta* on the basis that there were "no patentee sales" and "no restrictions on the sales made by the licensee."

The Federal Circuit then re-affirmed *Mallinckrodt* based on two main arguments: (1) its understanding of patent exhaustion as a conferral of "authority" under Section 271(a) of the Patent Act, and (2) it would be odd for a licensee's sales not to be exhausted under the Supreme Court's decision in *General Talking Pictures Corp. v. Western Electric Co.*, 304 U.S. 175 (1938), but for the patentee's own sales to be exhausted.

The Federal Circuit began by noting that, under Section 271(a) of the Patent Act, any making, using, or selling of a patented article "without authority" constitutes infringement. With this background, the appellate court explained that the "exhaustion doctrine … must be understood as an interpretation of § 271(a)'s 'without authority' language." "Authority," to the court, refers to a grant of permission by the patent owner, and the patent owner may limit this grant by imposing conditions or restrictions. Thus, the appellate court concluded that "[a] sale made under a clearly communicated, otherwise lawful restriction as to post-sale use or resale does not confer on the buyer and a subsequent purchaser the 'authority' to engage in the use or resale that the restriction precludes" and does not exhaust the patentee's rights as to such conduct.
Also, the Federal Circuit said it did not believe that exhaustion should turn on whether the patentee or a licensee had sold the patented articles. In *General Talking Pictures*, a buyer had purchased a patented article from a licensee who had a restricted license to sell the article within a particular field of use. Both the licensee and the buyer knew that the licensee had no license to convey the right to use the article in this particular field. The Supreme Court held that the licensee had infringed the patent by selling the article for use outside of the particular field of use, and that the buyer had no exhaustion defense based on this unauthorized sale. In *Lexmark*, the Federal Circuit saw no reason why a practicing-entity patentee should have less of an ability to restrict the downstream use of its products than a patentee who licensed the right to make and sell the product to others. Re-affirming *Mallinckrodt*, the appellate court emphasized that a "patentee may preserve its patent rights by otherwise-proper restrictions when it makes and sells patented articles itself and not only when it contracts out manufacturing and sales," provided that downstream users have adequate notice.

Addressing the foreign-sold printer cartridges, the Federal Circuit affirmed the district court's holding that *Jazz Photo* remains good law despite *Kirtsaeng*. The Federal Circuit reiterated that *Kirtsaeng* was a copyright case rooted in a statutory provision with no Patent Act analogue. Additionally, the appellate court noted that *Kirtsaeng* did not address "whether a foreign sale is properly treated as conferring authority to engage in otherwise-infringing domestic acts." As a result, Lexmark's foreign sales did not exhaust Lexmark's U.S. patent rights, and foreign buyers were not authorized to import the cartridge for sale or use in the United States. Notably, the court emphasized throughout the opinion 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." The majority said Impression did not preserve such an argument because it had agreed to forego an implied-license defense.

Judge Dyk, joined by Judge Hughes, dissented from the *Lexmark* majority and echoed the government's positions in its amicus brief. In their view, *Mallinckrodt* was wrong when decided and is irreconcilable with *Quanta*. According to the dissent, the majority's focus on whether a patentee-seller had "authorized" the use or resale of the articles it sold was "simply irrelevant." Rather, the dissent viewed the doctrine of patent exhaustion as an inherent limit on the scope of the patentee's exclusive rights-one that does not depend on whether the buyer's use has been expressly or impliedly authorized. The dissent also posited 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.

**Tension With Quanta**

There seems to be a reasonable possibility of Supreme Court review of *Lexmark* for several reasons. Chief among these are the business community's and the government's strong interest in the case, the decision's *en banc* nature, and its tension with *Quanta* and re-affirmation of *Mallinckrodt*.

*Quanta* expressly distinguished implied licenses and exhaustion, holding that disclaimers of license rights are "irrelevant" where "the right to practice the patents is based not on implied license but on exhaustion." While *Quanta* did not directly address *Mallinckrodt*, the two decisions have significant tension with respect to their approach to exhaustion. By characterizing exhaustion as a grant of "authority" that a patentee-seller can grant or deny, the Federal Circuit appears to treat exhaustion like an implied license-one that the patentee can disclaim by "clearly communicate[d]" restrictions. The Supreme Court in *Quanta*, by contrast, recognized that "[t]he longstanding doctrine of patent exhaustion provides that the initial authorized sale of a patented item terminates all patent rights to that item."

In *Quanta*, sales by the licensee included a notice that disclaimed rights with respect to the combination of licensed products with other components. The Federal Circuit's holding in *Lexmark* raises the question of whether that mere
disclaimer notice might avoid exhaustion under the patentee-seller's own patents, even though the Supreme Court held it to be insufficient to avoid exhaustion under the patents licensed to the seller. Moreover, the Federal Circuit's approval of patent remedies against downstream users after initial restricted sales may create the very danger "of allowing . . . an end-run around exhaustion" where "any downstream purchasers . . . could nonetheless be liable for patent infringement" that the Supreme Court frowned upon in *Quanta*. The Supreme Court may well seize the opportunity to clarify these tensions and the patent exhaustion doctrine generally.

**Lexmark's Significance for Businesses**

Pending Immersion's decision to seek (and the Supreme Court's decision to grant) review of *Lexmark*, the decision requires that patentees and licensees be mindful of the tension between the decision and *Quanta* and exercise caution in relying on former. If *Lexmark* stands, it will benefit businesses that depend on patent monetization and that have a strong interest in differentiated downstream licensing models. Businesses that regularly purchase patented products or components in the worldwide market, on the other hand, may face "a cloud of uncertainty over every sale," as the dissent forewarned.

Besides the tension with *Quanta*, the *Lexmark* decision leaves other important questions unanswered.

One question is what arrangement between a seller and buyer is sufficient to deny "authority." It was undisputed in *Lexmark* that there was "an express and enforceable contractual agreement" between Lexmark and each end-user, and that the no-resale and no-reuse restrictions were binding on end users. Yet throughout the *Lexmark* opinion, the majority suggests that restrictions may be sufficient if "clearly communicated"—even if well short of a contractual meeting of the minds.

The indication that "clear communication" is sufficient to avoid exhaustion may go even beyond *Mallinckrodt*. In *Mallinckrodt*, the Federal Circuit had explained a patentee may pursue a patent infringement action where the purchase has violated licensing terms "[i]f the sale . . . was validly conditioned under the applicable law such as the law governing sales and licenses." This suggests that any restriction must be part of a contract, not a mere notice, between the patentee and the initial buyer. The Federal Circuit reiterated this point in *Jazz Photo*, noting that the "package instructions [were] not in the form of a contractual agreement by the purchaser to limit reuse of the cameras." As a result, "[t]here was no showing of a 'meeting of the minds' whereby the purchaser, and those obtaining the purchaser's discarded camera, may be deemed to have breached a contract or violated a license limited to a single use of the camera." *Jazz Photo*, at 1108. It is unclear if the Federal Circuit intended an expansion of the patentee-seller's ability to avoid exhaustion.

Another question is what "clear communication" requires. The Federal Circuit appears to limit infringement claims against subsequent downstream buyers to those "having knowledge of the restrictions." The appellate court did not elaborate on what defenses a subsequent downstream purchaser without knowledge may have, assuming no exhaustion. The court only mentions in passing that "we do not have before us the questions that would arise, whether under principles governing bona fide purchasers or otherwise, if a downstream re-purchaser acquired a patented article with less than actual knowledge of the restriction."

Finally, *Lexmark* highlights the question of whether the focus on "clear communication" is a two-way street for patentees seeking to limit downstream rights. The Federal Circuit suggested repeatedly that buyers' knowledge of the licensee's field of use limitation may be required for a licensee's sale to be non-exhaustive. While *General Talking Pictures* did not clearly resolve this question, many licensors have assumed that sales by a licensee outside of its licensed field are unauthorized altogether and are therefore non-exhaustive regardless of the purchaser's knowledge of the field of use limitation. *Lexmark*'s emphasis on the buyer's knowledge, even if *dicta*, adds to the uncertainty concerning this issue.