

May 31, 2017

## Supreme Court Sets New Rules for Patent Exhaustion Doctrine

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**In a Highly Anticipated Decision, the Supreme Court Reverses Federal Circuit and Holds That Patent Exhaustion Is “Uniform and Automatic” — a First Sale, Whether Domestic or Foreign, Exhausts U.S. Patent Rights and Such Rights Cannot Be Employed to Impose Post-Sale Restrictions on the Buyer**

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### SUMMARY

In *Impression Products, Inc. v. Lexmark International Inc.*,<sup>1</sup> the U.S. Supreme Court ruled that the sale of a patented product authorized by the patentee exhausts all patent rights to the product, regardless of any restrictions on the product's use or resale that the patentee seeks to impose, either directly or through a license in connection with the sale. The Supreme Court also held that an authorized sale outside the United States, just as one within the United States, exhausts all U.S. patent rights. The Supreme Court's ruling clarifies the scope of its 2008 decision in *Quanta Computer, Inc. v. LG Electronics, Inc.*<sup>2</sup> and overturns longstanding Federal Circuit precedent that (i) had permitted patentees to reserve rights through otherwise lawful post-sale restrictions, and (ii) had held that sales abroad do not exhaust U.S. patent rights.

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### BACKGROUND

The Patent Act, 35 U.S.C. § 154(a), grants a patentee a time-limited right to “exclude others from making, using, offering for sale, or selling [its] invention throughout the United States or importing the invention into the United States.” The doctrine of patent exhaustion has long limited these rights by providing that the first “authorized sale” of a patented product exhausts all rights to control the product under the patent laws. Previously, the Federal Circuit had held that violation of patent rights explicitly withheld at the time of sale (e.g., the right to sell only in a particular territory) meant the sale was not “authorized” and,

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therefore, the patentee could enforce such explicit restrictions post-sale through an action for infringement.

Plaintiff Lexmark International, Inc. (“Lexmark”) makes and sells laser printers and associated toner cartridges that are protected by a number of patents. Once the toner in the cartridges has been depleted, spent cartridges can be reused by refilling them with toner. Lexmark sold cartridges at two prices: one without restriction on refilling, the other at a lower price with rights restricted to a single use and requiring the return of the spent cartridge to Lexmark for refilling. Defendant Impression Products, Inc. (“Impression”) is a remanufacturer that buys spent cartridges, refills them, and resells them to customers at a price lower than new Lexmark cartridges.<sup>3</sup> In 2010, Lexmark filed a patent infringement action against Impression and a number of other remanufacturers based on the refilling of (i) single use cartridges sold in the U.S. and (ii) cartridges that Lexmark had sold abroad and that Impression imported into the U.S.<sup>4</sup> Impression moved to dismiss the case as to both types of cartridges on exhaustion grounds. The District Court granted the motion with respect to cartridges Lexmark sold in the U.S. but denied the motion for cartridges sold abroad. On appeal, the en banc Federal Circuit reversed the portion of the lower court ruling that found Lexmark’s patent rights exhausted, concluding that exhaustion did not apply to the domestic cartridges in light of the express post-sale reuse and resale restrictions.<sup>5</sup> The Federal Circuit also re-affirmed its holding in *Jazz Photo Corp. v. International Trade Commission*<sup>6</sup> that the sale of a patented product abroad does not exhaust a patentee’s U.S. patent rights.<sup>7</sup> The Supreme Court reversed on both issues.

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### THE SUPREME COURT’S DECISION

In a decision from the eight participating Justices authored by Chief Justice Roberts, the Supreme Court held that “patent exhaustion is uniform and automatic” upon the sale of a patented good.<sup>8</sup> (Justice Ginsberg dissented only on international exhaustion.) Thus, “[o]nce a patentee decides to sell—whether on its own or through a licensee—that sale exhausts its patent rights, regardless of any post-sale restrictions the patentee purports to impose, either directly or through a license” at the time of sale.<sup>9</sup> Likewise, “[a]n authorized sale outside the United States, just as one within the United States, exhausts all rights under the Patent Act.”<sup>10</sup> As noted below, the Court explicitly ruled that a license to a patented device may impose restrictions enforceable under the patent laws if there is no sale or if the sale is made by the licensee in violation of the license restriction.

The Court began by emphasizing that exhaustion is a limit on the patentee’s right to exclude—a limit that “functions automatically” whenever “a patentee chooses to sell an item.”<sup>11</sup> Quoting the writings of Lord Coke from the 17<sup>th</sup> century, the Court explained that, like the first sale doctrine in copyright law, the patent exhaustion doctrine is rooted in the common law’s presumption against restraints on alienation.<sup>12</sup> Allowing patent rights to extend “beyond the first sale would clog the channels of commerce, with little benefit from the extra control that the patentees retain,” especially in light of modern technology and the

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existence of complex supply chains wherein a single product can embody hundreds of thousands of patents.<sup>13</sup> The fact that Lexmark decided to sell and indeed sold its patented cartridges meant that the sale of those cartridges exhausted all of Lexmark's patent rights to the product.<sup>14</sup>

The Court also rejected the Federal Circuit's view that exhaustion is premised on the "without authority" clause of the infringement statute. Rather, the Court explained that "the exhaustion doctrine is not a presumption about the authority that comes along with a sale; it is instead a limit on 'the scope of the patentee's rights.'"<sup>15</sup> The majority further disagreed with the Federal Circuit that preventing patentees from expressly reserving post-sale reuse or resale rights "would create an artificial distinction" between sales by patentees and sales by licensees.<sup>16</sup> The Court explained that patentees may place restrictions on licenses to make or sell a product because such restrictions relate to the exchange of rights and thus "do[] not implicate the same concerns about restraints on alienation as a sale."<sup>17</sup> Thus, while a patentee may impose restrictions on a license that is enforceable under the patent laws, if the licensee duly complies with that restriction, upon sale, the patentee's rights to the item are exhausted.<sup>18</sup> If the purchaser from the complying licensee fails to abide by the restriction, however, "the only recourse" to enforce the license restriction "is through contract law, just as if the patentee itself sold the item with a restriction."<sup>19</sup> Here, the Court explained that its prior decision in *General Talking Pictures Corp. v. Western Electric Co.*,<sup>20</sup> which Lexmark had relied upon, applied only to the limited situation where the licensee's sale was unauthorized because it was "'outside the scope of [the] license.'"<sup>21</sup>

Turning to the question of international exhaustion, the Court started by noting that in *Kirtsaeng v. John Wiley & Sons, Inc.*,<sup>22</sup> the Court held that a foreign sale exhausted U.S. copyright protections based in large part on the common law's aversion to restraints on alienation.<sup>23</sup> Similarly, "[a]pplying patent exhaustion to foreign sales is just as straightforward," because patent exhaustion is also rooted in the common law's presumption against restraints on alienation.<sup>24</sup> The fact that U.S. patent rights are inherently territorial does not dictate a different outcome because "[e]xhaustion is a separate limit on the patent grant, and does not depend on the patentee receiving some undefined premium for selling the right to access the American market."<sup>25</sup> All that the patent law ensures is that "the patentee receives one reward—of whatever amount the patentee deems to be 'satisfactory compensation,' . . . for every item that passes outside the scope of the patent monopoly."<sup>26</sup>

The Court also rejected the position of the United States, as *amicus curiae*, on international exhaustion, that a foreign sale should presumptively "exhaust[] U.S. patent rights unless those rights are expressly reserved."<sup>27</sup> The Court stated that the government's position was "largely based on policy rather than principle," unsupported by recent precedent, and incorrectly focused on the expectations of patentees and consumers, rather than the principle behind patent exhaustion—namely, the principle against restraints on alienation.<sup>28</sup> In the end, "what matters [for purposes of triggering patent exhaustion] is the patentee's decision to make a sale."<sup>29</sup>

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Justice Ginsburg concurred in the judgment regarding domestic exhaustion, but dissented in part on the issue of international exhaustion. Justice Ginsburg noted that “[b]ecause a sale abroad operates independently of the U.S. patent system, it makes little sense to say that such a sale exhausts an inventor’s U.S. patent rights.”<sup>30</sup> She also noted that *Kirtsaeng*’s reasoning in the copyright context “should bear little weight in the patent context,” because while there is a kinship between copyright law and patent law, “the two ‘are not identical twins.’”<sup>31</sup>

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### IMPLICATIONS

The Court’s rulings in *Lexmark*—whether on domestic exhaustion or international exhaustion—represent a significant change in the scope of the patent exhaustion doctrine. The Court’s decision can be seen as drawing a categorical, bright-line rule that any authorized *sale* of a patented product by a patentee or licensee, domestic or abroad, exhausts all U.S. patent rights to the product. The decision makes clear that once an authorized sale has occurred, patentees or licensees can seek recourse only under contract law for any improper post-sale uses of a patented product. As a result, patentees that had relied on Federal Circuit precedent to withhold certain patent rights as “not authorized” will likely need to re-write licenses, and there will be fewer possibilities for restricting post-sale activities under the patent laws. Like *Lexmark*, the “not authorized” justification has been used by patentees to efficiently price both licenses and goods. The underlying rationale for those restrictions was that the patentee should be able to divide its government-granted patent monopoly, seeking remuneration from more than one actor based on the value of the patents to the particular licensee or customer. For example, the right to sell a patented good may be far more valuable to a customer whose license is nationwide than to a customer who only seeks rights to sell in a particular state. Such distinctions in pricing and granting only part of the patent monopoly in any single sale transaction becomes more difficult after *Lexmark*.

Nevertheless, the Court’s broad pronouncements on the scope of patent exhaustion still allow for certain *license* restrictions that likely will remain enforceable. Because the Court’s rationale was closely tied to alienation of chattels and the *sale* of a patented product, the ruling re-affirms that “[a] patentee can impose restrictions on licensees because a license does not implicate the same concerns about restraints on alienation as a sale.”<sup>32</sup> As a result, licensing agreements may be able to accomplish post-sale restrictions that seek to grant less than all patent rights. The licensing structures that may not exhaust all patent rights include restrictions on sales to only another licensee (thereby allowing the patentee to efficiently price its license for different uses or at different points in the distribution chain), or granting a license that forbids sales but allows only the grant of a sublicense to customers in the distribution chain (the model regularly used to license software). Because the Court did not restrict the ability to enforce post-sale restrictions under contract law, patentees may also consider requiring that they become third-party beneficiaries of their licensee’s sales contracts reflecting such restrictions, and/or requiring that damages for breach of the contractual restriction mirror those available under patent law. While any such license limitations that seek to address the Court’s decision may be the subject of difficult negotiations,

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unless the patentee seeks the full value of all patent rights in a single transaction, license provisions of this kind may be necessary to avoid exhaustion and avoid limiting remedies for breach of post-sale restrictions to those that may be available under contract law.

In addition to requiring a review of current licenses, the decision calls for additional care in assessing the value of patent rights in corporate transactions. Under *Lexmark*, patent rights that may have explicitly been retained may nevertheless be exhausted.

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ENDNOTES

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- 1 581 U.S. \_\_\_, No. 15-1189 (May 30, 2017) (slip op.).
- 2 553 U.S. 617 (2008).
- 3 Slip op. at 2.
- 4 *Id.* at 3.
- 5 *Id.* at 4. This portion of the Court's decision relied on the Federal Circuit's decision in *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992).
- 6 264 F.3d 1094 (2001).
- 7 Slip op. at 4.
- 8 *Id.* at 13.
- 9 *Id.*
- 10 *Id.*
- 11 *Id.* at 6.
- 12 *Id.* at 6-7.
- 13 *Id.* at 8.
- 14 *Id.* at 9.
- 15 *Id.* at 10 (quoting *United States v. Gen. Elec. Co.*, 272 U.S. 476, 489 (1926)) (emphasis in original).
- 16 Slip op. at 10.
- 17 *Id.* at 11.
- 18 *Id.* at 12.
- 19 *Id.*
- 20 304 U.S. 175, *aff'd on reh'g*, 305 U.S. 124 (1938).
- 21 Slip op. at 12 (quoting *Gen. Talking Pictures*, 304 U.S. at 181-82).
- 22 568 U.S. 519, 525 (2013).
- 23 Slip op. at 14.
- 24 *Id.*
- 25 *Id.* at 15.
- 26 *Id.* at 16 (internal citation omitted).
- 27 *Id.* at 17 (quoting Brief for United States 7-8).
- 28 *Id.*
- 29 *Id.* at 18.
- 30 581 U.S. \_\_\_, No. 15-1189, slip op. at 2 (May 30, 2017) (Ginsburg, J., dissenting in part).
- 31 *Id.* (quoting *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 439 (1984)).
- 32 Slip op. at 11.

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