Aftermarket Controls Through Single-Use License Restrictions

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Patent license restrictions can be used to control profits from the aftermarket for refillable or reusable products such as printers or medical devices to substantially increase the value of those products. These license restrictions can also spur the public's adoption of a product by permitting the introductory price to be minimal, with the profit coming from sales of the consumable portion of the product. However, placing enforceable license restrictions on patented goods can raise challenging issues. Poorly crafted license restraints can violate antitrust laws or constitute patent misuse. Nevertheless, recent decisions by the U.S. Court of Appeals for the Federal Circuit provide road maps that help show companies how to increase the likelihood that the restrictions will be enforceable and not violate the antitrust laws.

A Cutting-edge Hypothetical

By way of example, assume Replace Co. brings you its newest patented invention, a combination blade holder and blade that is stronger and easier to use than anything else on the market, due to the special way the blade and holder interact. Replace Co.'s CEO explains that the blade holder can be modified for use with a wide variety of cutting blades and that the invention has applications from razor blades, to carpet cutters to harvesting equipment.

Replace Co. has an ambitious marketing plan. Although the blade holder is very strong, it can be made cheaply and the blades are very easily replaced. Replace Co.'s intention is to sell the blade holder with three replacement blades or perhaps give the holders away and only sell the blades, depending on the particular market. Replace Co. hopes to profit from what they expect to be a huge market for replacement blades. One key will be preventing its customers from buying replacement blades from anyone else.

Various antitrust and repair/reconstruction issues spring to mind. See, e.g., *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992) (addressing whether single use restrictions are unenforceable) and *Fuji Photo Film Co. v. Jazz Photo Corp.*, 394 F.3d 1368 (Fed. Cir. 2005) (addressing whether certain refurbished single use cameras were permissibly repaired or impermissibly reconstructed). For example, if a user violates a use restriction, does Replace Co. really need to find them or can Replace Co. sue the replacement blade suppliers? Can Replace Co. sue the replacement blade suppliers for patent infringement, or must they sue for interference with contract? How is this different than the situation with printer cartridges? They can't be protected, can they?

Single-use Restrictions Can Be Enforced

Single-use restrictions are not necessarily improperly anticompetitive. A patentee's ability to restrict its customer to a single-use of a patented product, rather than transferring the entire bundle of patent rights during the sale of the product, was addressed in *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992). Mallinckrodt sold hospitals a patented nebulizer device for entrapping harmful mists generated during the imaging of lungs in connection with the treatment of pulmonary diseases. Each device bore the statement "for single patient use only." Some hospital customers sent used units to a third party refurbisher for cleaning and repackaging so that they could be used again. Mallinckrodt sued the third party refurbisher for patent infringement and inducement to infringe, based on the violation of the single-use "restriction" (*Id.* at 702). The refurbisher alleged that single use restrictions are inherently anticompetitive and therefore unenforceable (*Id.* at 705).

The Federal Circuit held that not all single-use restrictions violated anti-competition laws. Thus, valid single-use license restrictions would prevent all the patentee's patent rights from being exhausted during the original sale. Moreover, if the single-use restriction were binding, the patentee could assert a patent infringement claim against the non-customer refurbisher (*Id.* at 709). Thus, even if there is no contractual relationship between the patentee and the refurbisher, the violation of the single-use license restriction on the sale of patented goods gives rise to a cause of action for indirect patent infringement: causing or contributing to a customer's patent infringing use or sale in violation the single-use violation. See, e.g., *Mallinckrodt*, 976 F.2d 700; and *Arizona Cartridge Remanufacturers Association, Inc. v. Lexmark International,*

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Inc., 290 F.Supp.2d 1034, 1046 and 1049 (N.D. Cal. 2003).

In *Mallinckrodt*, the Federal Circuit explained that a restriction on reuse would not be illegal if:

(1) "the restriction on reuse was within the scope of the patent grant" and;

(2) the sale was "validly conditioned under the applicable law, such as the law governing sales and licenses" (*Id*. at 709). The first consideration refers to whether the "patentee has ventured beyond the patent grant and into behavior having an anticompetitive effect not justifiable under the rule of reason" (*Id*. at 708). The second consideration concerns the circumstances surrounding a sale in the marketplace—in particular, whether there was sufficient evidence of a bargained-for exchange to support enforceable contractual obligations between the patentee and the purchasers. Unfortunately, while the Federal Circuit's opinion confirmed that the patentee can pursue a cause of action for patent infringement under an enforceable single-use license restriction, the Court did not address the specific single-use restriction language at issue in that case. Rather, it left the application of the two-step test to subsequent cases.

Overcoming Antitrust Concerns

Poorly crafted post-sale restraints can violate antitrust rules or constitute patent misuse where the patentee abuses the patent monopoly to unlawfully restrain competition in a relevant market (*See Id*. at 705, discussing decisions holding restraints as antitrust violation). However, courts have cleared certain single-use license restrictions from antitrust and patent misuse challenges. Thus, the goal of Replace Co. in our hypothetical will be to maximize aftermarket profits by adapting one of the court sanctioned licensing programs to its business plans.

Recently, the courts have cleared an analogous licensing program in a series of cases filed by the seed company Monsanto against farmers who, in violation of a "single planting season" license restriction, saved seeds or planted seeds obtained from planting and then harvesting Monsanto's patented genetically modified seeds.

The seed cases share similar facts: Monsanto sells genetically engineered seeds to farmers in bags containing a contract printed on the outside of the bag. The contract prohibits the farmers from using the seeds without first paying for a technology license from Monsanto. See e.g., *Monsanto Co., v. McFarling*, 302 F.3d 1291 (Fed. Cir. 2002); *Monsanto Co., v. Good*, 2004 WL 1664013 (D.N.J 2004); *Monsanto v. Scruggs*, 2004 WL 1598848 (N.D.Miss 2004); *Monsanto Co., v. Swann*, 308 F.Supp.2d 937 (E.D.Mo. 2003). The technology license allows farmers to plant and harvest the seed for one planting season, but otherwise prohibits seed saving, replanting, or resale.

In *Monsanto v. McFarling*, one farmer argued that the single season license constituted unfair competition. He argued that the license tied the market of saved seeds to the purchase of new seeds. 302 F.3d at 1297-99. However, the Court of Appeals for the Federal Circuit found no anticompetitive tying because the purchase of single-use seeds did not prevent the farmers from choosing other seeds in the future, and seeds of different types are readily available in the marketplace (*Id*. at 1298). Also, the saved or harvested seeds were patent infringements. Thus, their use during subsequent seasons was patent infringement and could be licensed (*Id*. at 1299). Accordingly, the prohibition of subsequent use was not outside the patent grant and therefore, not problematic. (*Id).*

Evidencing The Single-Use Contractual Obligation

A valid single-use restriction can be enforceable if it constitutes a genuine condition of an enforceable agreement (express or implied) and is not merely a baseless recommendation or expectation of the seller. For example, Monsanto provided notice by pasting the contract on the outside of the seed package and it publicized the restriction in journals and meetings. In addition, it required the farmers to sign a technology license that conferred a one-time planting right before the farmers could use any seed (*Id*. at 1293). However, not every transaction is amenable to obtaining a signed contract from the customer.

The circumstances of a sale can eliminate the need for a signed contract. For example, in *Arizona Cartridge Remanufacturers Association, Inc. v. Lexmark International, Inc.*, the printer maker Lexmark packaged some of its ink cartridges with a "shrink-wrap" type license that subjected those who opened the package to a single-use restriction. 290 F. Supp.2d 1034 (N.D. Cal. 2003). Lexmark offered these single-use licensed cartridges in a pre-bate program to their customers at a price lower than the unrestricted cartridges. An association of ink cartridge refurbishers challenged the single-use license restriction under unfair competition law, alleging that the single-use agreement was not enforceable.

The District Court for the Northern District of California upheld Lexmark's single-use restrictions. The Court noted that Lexmark printed the single-use restriction on the outside of the printer cartridges to provide adequate notice (*Id*. at 1037). Lexmark's license stated that "opening this package or using the patented cartridge inside confirms your acceptance of the single-use license/agreement" (*Id*. at 1038). The Court held that this affirmative act helped create a contractual obligation, especially because it was coupled with the act of using the cartridge (*Id*. at 1045). In addition, Lexmark's pre-bate system priced different use rights differently, and consumers who purchased the cheaper cartridges presumably agreed to the more limited bundle of rights (*Id).*

In contrast, courts have refused to enforce mere words of single-use expectation. See, e.g., *Hewlett-Packard v. Repeat-O-Type Stencil Mfg.*, 123 F.3d 1445 (Fed. Cir. 1997). In Hewlett-Packard, the Federal Circuit

found that the ink cartridge recycler did not infringe HP's cartridge patent, even though HP's manual instructed users to "discard old print cartridge immediately" (*Id*. at 1448). The Federal Circuit held that the mere request to dispose of empty cartridges failed to create an enforceable restriction because consumers would not have been aware of the instruction in the manual until after they had purchased and opened the patented cartridges (*Id)*.

Thus, to help assure an enforceable single-use agreement, patentees can provide notice to consumers by printing explicit contractual language on the packaging. It also helps if the buyers must perform some act to indicate that they accept the restrictions. A signature on the technology agreement evidenced buyers' acknowledgement for Monsanto. McFarling, 302 F.3d at 1293-95. Acceptance by the act of opening the package and using the product was helpful in Lexmark. 290 F.Supp. 2d at 1044-45. The choice to purchase the cheaper cartridge in the context of the pre-bate program and the contractual language on the packaging was also evidence of a voluntary acceptance of the single-use term (*Id)*.

As seen above, the acceptance of a use restriction can be express or implied. As noted by one court, "[t]o determine whether a patent holder exhausted its rights with an unconditional sale or retained them with a conditional one (which some courts define as a license), a court looks to the circumstances of the sale" *Lexmark* at 1043 *(citing Anton/Bauer, Inc. v. PAG.*, 329 F.3d 1343, 1350 (Fed. Cir. 2003); *cf Carborundum Co. v. Molten Metal Equip. Innov., Inc.* 72 F.3d 872, 877-78 (Fed. Cir. 1995).

Patent Infringement Remedies Are Available

The violation of a single-use patent license restriction can give rise to an action for patent infringement. *Monsanto v. McFarling (McFarling II)*, 363 F.3d 1336 (2004) and *Monsanto v. Ralph*, 382 F.3d 1374 (2004). Therefore, a more flexible range of remedies is available, compared to a straight breach of contract action. In *Monsanto v. Ralph*, a jury returned a three million dollar reasonable royalty judgment against a farmer who saved seed, replanted seed, and resold seed over a three-year period (*Id*. at 1377-79). On appeal, the Federal Circuit affirmed the reasonable royalty award, even though it exceeded what Monsanto would have received for its breach of contract claim under a liquidated damage clause. The court held that the infringement award was an acceptable alternate damages amount (*Id)*.

Conclusion

It is evident that courts recognize the enforceability of license restrictions on a product's use and patentees have recovered significant compensation for the violation of such restrictions. The enforceability of a particular contractual arrangement can depend on the commercial details of the marketplace, including the nature of the product, the transactional setting, the volition of the purchaser, and the potential mode of infringement. Therefore, if Replace Co. wants to increase the odds that the license restrictions it imposes will be enforced in court, it can structure the sales environment to most clearly evidence a meeting of minds under the particular circumstances of the various markets for its blade and holder combination. Even in an off-the-shelf retail setting where sophisticated arrangements are impossible, Replace Co. should still be able to impose enforceable single-use restrictions. Thus, an appropriate program designed and tailored to the circumstances of the various transactions can help Replace Co. implement its business plan of flooding the market with its inexpensive blade holders and profiting from the sale of the replacement blades through appropriate control of its aftermarket patent rights.