

The Supreme Court Says Conditional And Foreign Sales Cannot Avoid IP Exhaustion And What Should IP Owners Do?

An Analysis Of The Supreme Court's IP-Exhaustion Jurisprudence

By Jiang Bian

I. *Impression Products* Decision and Issues Decided

On May 30, 2017, the United States Supreme Court handed down its long-awaited decision of *Impression Products, Inc. v. Lexmark International, Inc.*,¹ which carries profound implications for intellectual property (IP) owners, manufacturers, sellers, retailers, resellers, and consumers across the globe.

In keeping with its precedents supporting exhaustion of IP rights after the initial sale of products embodying the IP, the Supreme Court effectively overruled the Court of Appeals for the Federal Circuit's patent-exhaustion jurisprudence (or what many commentators referred to as "patent non-exhaustion doctrine"). This doctrine, enumerated in two prior rulings — *Mallinckrodt, Inc. v. Medipart, Inc.* in 1992² and *Jazz Photo Corp. v. International Trade Commission* in 2001³ — as well as its decision for which the Supreme Court granted writ in *Lexmark International v. Impression Products*. In all three cases the Federal Circuit answered "Yes" to each of the following questions:

- (1) whether accompanying product sales with clearly communicated restrictions could avoid patent exhaustion within such declared limits; and
- (2) whether foreign sales authorized by a patent owner could not be relied upon to exhaust the owner's domestic patent rights when patented products are shipped back to the United States.⁴

The Supreme Court, however, squarely answered "No" to both questions, holding that the patent holder exhausted its U.S. patent rights in the patented products the moment it sold them, irrespective of where the sale took place (*i.e.*, in the United States or abroad).⁵ While its impact on different industries may

vary, which is to be seen in the years to come, the *Impression Products* decision will likely prompt many companies to reconsider the way they conduct their IP-related business. By examining this decision against prior Supreme Court decisions involving the IP exhaustion doctrine, this

Article intends to find the contours of the Supreme Court's holding in *Impression Products* and explore its practical implications in: structuring IP transactions; enforcing IP rights and licenses; and drafting distribution, sales, or similar agreements involving IP rights to achieve the intended business goals.

II. *Impression Products* Decision Analysis and Commentary

After the Federal Circuit in its en banc decision in *Lexmark Int'l, Inc. v. Impression Products, Inc.* refused to overrule *Mallinckrodt* and *Jazz Photo* in light of the Supreme Court's *Quanta Computer* and *Kirtsaeng* decisions,⁶ the Supreme Court decided to speak on the exhaustion doctrine again as part of its own *Impression Products* decision.⁷ By overruling the Federal Circuit's holding, the Supreme Court clarified that patent exhaustion upon the first sale should be automatic, unconditional, and international.⁸

A. Summary of Facts

The patentee in *Impression Products* sold patented toner cartridges for its printers, domestically and abroad, and offered its customers two choices: (1) a "regular cartridge" at full price, or (2) a "return program cartridge" at a discount. In exchange for the lower price, customers who bought return-program cartridges agreed not to reuse the cartridges after the toner ran out, as well as not to transfer them to anybody else, under a license wrapped on the cartridges — a legal agree-

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1. *Impression Prods., Inc. v. Lexmark Int'l, Inc.*, No. 15-1189, 2017 WL 2322830 (U.S. May 20, 2017).

2. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992).

3. *Jazz Photo Corp. v. International Trade Commission*, 264 F.3d 1094 (Fed. Cir. 2001).

4. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 702 (Fed. Cir. 1992).

5. *Impression Products, Inc. v. Lexmark Int'l, Inc.*, 581 U.S. ___, 5 and 13 (2017).

6. *Lexmark Int'l, Inc. v. Impression Products, Inc.*, 816 F.3d 721, 726–727 and 734–735 (Fed. Cir. 2016).

7. *Impression Prods., Inc. v. Lexmark Int'l, Inc.*, No. 15-1189, slip op. at 2 (U.S. May 20, 2017).

8. *Id.*

ment deemed to be accepted by customers opening the cartridge packaging.⁹ The license read:

Return Empty Cartridge to Lexmark for Recycling

*Please read before opening. Opening this package or using the patented cartridge inside confirms your acceptance of the following license agreement. The patented Return Program cartridge is sold at a special price subject to a restriction that it may be used only once. Following this initial use, you agree to return the empty cartridge only to Lexmark for recycling. If you don't accept these terms, return the unopened package to your point of purchase. A regular price cartridge without these terms is available.*¹⁰

The defendant purchased used return-program cartridges from the customers, refilled the cartridges with toner, and resold the remanufactured cartridges for use with the patentee's printers.¹¹

B. Supreme Court Holding

Relying on the common-law principle against restraints on alienation and citing its 19th- and 20th-century precedents, the Supreme Court affirmed that an authorized sale of a patented item anywhere in the world terminates all U.S. patent rights to that item, and the patentee cannot sue for infringement with respect to any further use or sale of that item in the United States.¹² The Supreme Court reasoned that even though, unlike the Copyright Act, the Patent Act has not codified the exhaustion doctrine, nothing shows that Congress intended the Patent Act to abrogate that longstanding common-law principle, which therefore should have its full effect as the Supreme Court first utilized it almost 160 years ago.¹³ By holding that post-sale restrictions as a whole, instead of only unreasonable ones, are not enforceable under patent law, the Supreme Court rendered the Federal Circuit's *Mallinckrodt* decision of little precedential value.¹⁴ Similarly, by noting that it does not make sense to apply the exhaustion doctrine internationally for copyrights but only domestically for patents, the Supreme Court overruled the part of the Federal Circuit's *Jazz Photo* decision that limited the application of the patent exhaustion to only U.S. sales.¹⁵

C. Commentary

The Supreme Court seemed to largely base this decision on its view of common-law tradition and pub-

lic policy, instead of solely focusing on statutory construction. Central to the Supreme Court's holding was that IP rights must yield to the common-law principle against restraints on alienation of personal properties.¹⁶

1. Statutory Interpretation and Legislative Intent

The Supreme Court appeared to suggest that because Congress enacted and revised the Patent Act several times against the backdrop of this common-law principle and has not specifically addressed it, Congress must have intended this principle to remain unchanged.¹⁷ Pursuant to the Supreme Court, where a common-law principle is well-established, it is safe to say that Congress has legislated with an expectation that the principle will continue to apply except when a statutory purpose to the contrary is evident.¹⁸ The original Patent Act, however, was first enacted in 1790, almost 50 years before the Supreme Court started to develop its IP-exhaustion jurisprudence.¹⁹ While one can only surmise what Congress had in mind when it passed the Patent Act of 1790, the grant section of the current Patent Act²⁰ on its face provides that each patent grants to the patentee the right to exclude *others* from making, using, offering for sale, selling, or importing a patented invention during the patent term.²¹ Similarly, the infringement section of the Patent Act states that whoever *without authority* makes, uses, offers to sell, sells, or imports the invention during the patent term infringes the patent.²² By the word "others," Congress did not seem to distinguish between those that bought patented items via authorized sales and those that did not.²³ In addition, if the "authority" to use or sell a patented item must come from the patentee in order to avoid infringement,²⁴ the patentee should have the right to negate such authority; for example, in notices to or contracts with purchasers of the patented item. One may also notice that a purchaser's right to resell a patented item is not the same as the right to use it; a distinction seemed to be recognized by the Supreme Court in *Bauer*.²⁵ While the former is not exclusively granted to the patentee on the face of the Patent Act, the latter is.²⁶ Based on that distinction, one could argue that while a purchaser may resell a patented item, such item may only be used as prescribed by the patentee.

16. *Id.*, at 6.

17. *Id.*, at 7.

18. *Id.*, at 14.

19. 1 Stat. 109, which enacted on April 10, 1790 and was the first patent statute passed by the federal government.

20. See 35 U.S. Code § 154(a).

21. *Id.*

22. See 35 U.S. Code § 271(a).

23. See 35 U.S. Code § 154(a).

24. See 35 U.S. Code § 271(a).

25. *Bauer & Cie. v. O'Donnell*, 229 U.S. 1, 17-18 (1913).

26. 35 U.S. Code § 154(a).

9. *Id.*, at 2-3.

10. *Lexmark Intern., Inc. v. Static Control Components, Inc.*, 253 F. Supp. 2d 943, footnote 1 (E.D. Ky. 2003).

11. *Impression Prods.*, 581 U.S. ____ (2017) No. 15-1189, slip op. at 2-3.

12. *Id.*, at 6-9 and 13-17.

13. *Id.*, at 7.

14. *Id.*, at 4.

15. *Id.*, at 17.

Furthermore, by comparing the Patent Act with the Copyright Act,²⁷ it seems fair in the author's opinion to say that Congress gives a patentee a greater exclusivity than that of a copyright owner; a patent includes the exclusive right to use the patented invention, but the same protection is not enjoyed by a copyright owner. While giving a copyright owner the exclusive right to distribute copies of a copyrighted work by sale, the Copyright Act explicitly allows the lawful owner of a particular copy to sell that copy without the authority of the copyright owner.²⁸ The Patent Act does not so provide. One could therefore argue that if Congress intended the common-law principle against restraints on alienation to remain in effect when granting a legal monopoly (whether a patent or a copyright), which monopoly seems to be absolute on its face, Congress would have provided an exception to such monopoly. As Congress has provided such an exception in the Copyright Act but not in the Patent Act,²⁹ it is at least conceivable that Congress could intend that exception to apply to copyrights only, leaving the more powerful patent monopoly unaffected by the exhaustion doctrine. This would best incentivize innovations and compensate for the shorter period of patent monopoly when compared to the duration of copyright exclusivity.

The Supreme Court did not seem to believe this was Congress's intention. The Supreme Court reasoned that, as it held in *Crown Die & Tool*, the right to use, sell, or import a patented item exists independently of the Patent Act, which only confers on a patentee the right to exclude others from doing so.³⁰ According to the Supreme Court, since the exclusionary right conferred by the Patent Act is only incidental to the ownership of a patented item, once such ownership is transferred out, there is nothing left for the patentee to enforce.³¹ One could argue, however, that even if the right to exclude is an incident of an inventor's common-law right, such common-law right, as identified in *Crown Die & Tool*, does not seem to be limited to a particular copy of the invention, but rather is the right to make and sell as many copies as the inventor desires. Therefore, by selling such a copy instead of assigning his entire title in the invention, the inventor transferred the ownership of the sold copy without relinquishing his common-law right to the underlying invention; thus, the inventor did not also give away the exclusionary right incidental to his common-law right.

2. Public Policy

In addition, as the main public policy supporting its

holding, the Supreme Court seemed to believe that if a patentee is allowed to extend the patent rights beyond the first sale of a patented item and stick "remora-like" to that item as it flows through the market, this would clog the channels of commerce.³² This is especially true when nowadays an end product assembled from various components, such as a smartphone, could potentially implicate hundreds of thousands of patents held by different owners.³³ This is a powerful argument. While a licensee authorized to distribute a patented item may be able to negotiate terms with the patent owner, it is hard to imagine that an individual consumer possesses the same bargaining power. This leaves the consumer with only the choices of either accepting whatever conditions are imposed by the patentee, or not using the product at all. One may argue that this is only true during the patent term. The author believes, by continuing to improve upon an invention, however, a patentee can seek endless follow-up patents to prolong the patent monopoly and thus always be in a position to demand restrictions. Another counterargument in the author's opinion could be: even if the Patent Act grants to a patentee a complete monopoly against the world (including purchasers) to use and sell the patented invention during a limited period, it does not exempt the patentee from violating other laws; so if a patentee's restrictions unreasonably constrain commerce, antitrust and unfair competition laws will come into play and keep the patentee's practices checked. Therefore, it is arguably not necessary to categorically deny a patent owner's ability to impose sale conditions under patent law, as this may potentially deprive the patentee of the opportunities to devise marketing strategies to recover what was spent in developing and commercializing the patented invention in today's complex business environment.

Some of such strategies may count for environmental, humanitarian, or similar reasons. For example, the return program in *Impression Products* seemed to be at least partially designed to encourage recycling of the used cartridges.³⁴ Going-forward, the author believes the patentee may only offer cartridges at the regular price. Would a society as a whole benefit from such a less environment-friendly practice? Similarly, should a pharmaceutical company that sells patented drugs in underdeveloped countries at a considerable discount or for a nominal amount be discouraged by arbitrageurs that buy the drugs from locals in such countries and then sell them in the United States at a price lower than what the drug maker normally charg-

27. See 35 U.S. Code § 154(a); Cf. 17 U.S. Code § 106.

28. See 17 U.S. Code § 109(a).

29. *Id.*; cf. 17 U.S. Code § 109(a).

30. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 10.

31. *Id.*, at 6 and 10.

32. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 8 and 18.

33. *Id.*

34. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 10.

es? Even if a patentee's motive is solely to maximize profits by selling the same products to different market segments at different prices, it seems to be well within the patentee's prerogative. But now because of *Impression Products*, the author believes it will likely be more difficult, if not entirely impossible, for a patentee to charge differently situated consumers around the globe different prices for the same products, as the patentee can no longer rely on its U.S. patents to prevent purchasers who bought the products cheaper from reselling them and thus equalizing the price difference.

What tipped the scales for global exhaustion in the Supreme Court's deliberation seemed to be that the common-law exhaustion doctrine by its nature does not make geographical distinctions.³⁵ According to the Supreme Court, a straightforward application of that doctrine requires it to apply internationally, and nothing in the Patent Act shows that Congress intended to confine the common-law principle to domestic sales.³⁶ The Supreme Court distinguished *Boesch* on the basis that the patentee in *Boesch* had nothing to do with the first sale, and therefore, it was not an authorized sale.³⁷ As the Supreme Court noted, it probably makes little sense to differentiate the exhaustion doctrine in the patent and copyright contexts, because many modern products are subject to both protections.³⁸ This holding, however, may lead to diminish the values of U.S. patents in the international commerce. For example, the World Trade Organization's Agreement on Trade Related Aspects of Intellectual Property Rights explicitly leaves to each member state to decide whether and when national IP rights should be exhausted.³⁹ Therefore, post-*Impression Products*, products bought in the United States with exportation restrictions might not be able to move freely into countries that only recognize exhaustion of IP rights on domestic sales, while products sold abroad could find their way to the United States without facing the threat of IP liabilities.

III. Impression Products Decision Implications

By analyzing the scope and impact of the *Impression Products* decision, the author hopes to provide guidance on how to differentiate permissible license conditions from prohibited post-sale restrictions.

35. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 14.

36. *Id.*

37. *Id.*, at 16.

38. *Id.*, at 8.

39. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, The Legal Texts: The Results Of The Uruguay Round Of Multilateral Trade Negotiations 320 (1999), 1869 U.N.T.S. 299, 33 I.L.M.1197 (1994), at Art. 6.

A. Scope

To appreciate the implications of the *Impression Products* decision, it is important to first understand its scope. The Supreme Court made clear that it did not address whether the patentee in *Impression Products* could enforce the restrictions under contract law,⁴⁰ leaving open the possibilities for a patentee to put a contract in place to restrict a purchaser's right to use or resell the patented item.⁴¹ Furthermore, in order to exhaust IP rights, the sale must be authorized by the IP owner.⁴² For example, if a patentee has not granted a licensee the authority to make a sale, any sale by such licensee cannot exhaust the patentee's rights. In addition, since the Supreme Court did not overrule *General Talking Pictures*, it arguably preserved the validity of field-of-use license limitations. Finally, if the *Impression Products* decision leads to undesired results, such as disadvantages to U.S. IP owners, Congress may step in and introduce new legislations to change or qualify the Supreme Court's IP exhaustion jurisprudence.

According to the Supreme Court, the correct application of the exhaustion doctrine seems to be that even if a patentee sold an item under an express restriction (as the patentee did in *Boston Store of Chicago*)⁴³ the patentee could not retain any patent rights in that item.⁴⁴ To reconcile *Impression Products* with *General Talking Pictures*, the Supreme Court explained that while a licensee's sale that was knowingly made outside the scope of its license should essentially be treated as an unauthorized sale and entitle the patentee to sue for infringement, a patentee cannot use licenses to impose post-sale restrictions on downstream purchasers and then enforce such restrictions through patent law.⁴⁵ As long as a licensee complies with the license terms when selling the item, that sale is considered authorized; as a result, the exhaustion doctrine should apply.⁴⁶ Post-*Impression Products*, a patentee may continue to require a licensee to impose a restriction on purchasers, but even if the licensee does so, including having each purchaser sign a contract promising to follow such requirement, the sale nonetheless exhausts all patent rights in the item sold.⁴⁷ If a purchaser fails to comply with the restriction, the only recourse seems to enforce such restriction through contract law which, however, requires the patentee to establish privity of contract with the purchaser.⁴⁸

40. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 8-14.

41. *Id.*

42. *Id.*, at 10.

43. *Boston Store of Chicago v. American Graphophone Co.*, 246 U.S. 8 (1918).

44. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 8-14.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

B. Impact

The impact of the *Impression Products* decision is profound in several aspects. First of all, enhanced damages that are quite typical in IP-infringement suits but rarely awarded in contract cases, in the Author's opinion, could no longer serve as a deterrence to purchasers for violating IP owners' various restrictions. Second, IP owners may need to develop more complex contracting practices or carefully withhold certain rights in order to avoid IP exhaustion. Third, IP owners likely will have to reconsider their global pricing strategies, including whether to narrow the price difference for products sold in different countries. Finally, by reviewing *Impression Products* and its progenitors against the Supreme Court's other decisions such as *E. Bement & Sons* and *General Electric* (which remain good law after *Impression Products*),⁴⁹ this Article opines that the focus of future disputes revolving restrictions imposed based on IP rights could potentially shift from assessing whether the restrictions are reasonable, to deciding whether the particular transaction in question is an outright sale or a license.

If the transaction is held to be a sale, any restrictions the IP owner purports to impose, either directly or through a licensee, can only be enforced under contract law, if at all. In contrast, if the transaction is treated as a license, the IP owner may sue for IP infringement and thus has a better chance to obtain enhanced damages. It is worth noting that the patentee's license in *Impression Products* clearly stated the cartridge was "sold," subject to a restriction.⁵⁰ So what if the license agreement in *Impression Products* made it clear that the cartridge was only licensed for a limited period on the condition that, after the license expires (e.g., when the toner runs out), the customer, who is a licensee instead of a purchaser, shall return the empty cartridge to the patentee? Could such condition then be enforced through patent law against a third party that purchased the used cartridges from consumers?

C. Permissible License Conditions v. Prohibited Post-Sale Restrictions

As the Supreme Court noted in *Bauer*, a mere play upon words to call the transaction in question a license instead of a sale does not transform an outright sale to a license.⁵¹ Appellant-level-case-law on distinguishing selling and licensing patented items seems to be meager. This is likely because before the Supreme Court stepped in via *Impression Products*, the Federal Circuit recognized the effect of conditional sales to impose

post-sale restrictions through the patent law and thus rendered this distinction of little practicable value.

A similar distinction in the copyright context with respect to § 117(a) of the Copyright Act, which allows the owner of a copy of a computer program to copy or modify the program for limited purposes without incurring liability for infringement, however, has been addressed by appellate courts. For example, in *DSC Communications Corp. v. Pulse Communications, Inc.*, the Federal Circuit held that the defendants were not the owners of downloaded copies of software.⁵² The Federal Circuit so held not only because the relevant licensing agreements characterized them as non-owners, but also because such agreements prohibited the defendants from using the software on any hardware other than that provided by the copyright owner and from transferring the copies of software to third parties.⁵³ The Federal Circuit deemed such prohibitions to be inconsistent with the rights normally enjoyed by owners of software copies.⁵⁴

Another appellate court, also dealing with the § 117(a) issue, rejected the mere characterization of a transaction as a "license" instead of a "sale" as binding on the parties.⁵⁵ In *Krause v. Titleserv, Inc.*, where a programmer sued his former employer for modifying his software, the Second Circuit held that the formal title is not decisive and the central question should instead be whether the employer exercises sufficient incidents of ownership to be sensibly considered the owner.⁵⁶ The Second Circuit determined the former employer to be the owner of the copies of software in its possession on the basis that such employer paid the programmer to develop and customize the software for its operations, with resulting copies of the software being stored on its server.⁵⁷ The programmer, without reserving any right to repossess such copies, agreed that the employer may use the software for an unlimited period of time.⁵⁸

In *Vernor v. Autodesk, Inc.*, an online software reseller purchased used copies of software and put said copies up for sale on eBay, despite the developer's protests.⁵⁹ Relying on the Supreme Court's remark in *Quality King Distributors*,⁶⁰ the Ninth Circuit held that a user is considered a licensee rather than an owner of a software copy where the copyright own-

49. See *E. Bement & Sons v. National Harrow Co.*, 186 U.S. 70, 72 (1902) and *United States v. General Electric Co.* 272 U.S. 476, 477-480 (1926).

50. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 8.

51. *Bauer & Cie. v. O'Donnell*, 229 U.S. 1, 17-18 (1913).

52. *DSC Communications Corp. v. Pulse Communications, Inc.*, 170 F.3d 1354 (Fed. Cir. 1999).

53. *Id.*

54. *Id.*, at 1363.

55. *Krause v. Titleserv, Inc.*, 402 F.3d 119, 124 (2d Cir. 2005).

56. *Id.*, at 120-122.

57. *Id.*

58. *Id.*, at 124.

59. *Vernor v. Autodesk, Inc.*, 621 F.3d 1102, 1103 (9th Cir. 2010).

60. *Id.*

er: (1) specifies that the user is granted a license; (2) significantly restricts the user's ability to transfer the copy; and (3) imposes notable use restrictions.⁶¹ The Ninth Circuit noted that, among other things, the developer expressly retained title to the copy, prohibited further transfers or leases of the copy without its consent, and provided for the termination of the license for unauthorized copying.⁶² In October 2011, the Supreme Court denied the reseller's petition for certiorari.⁶³

The author believes the Vernor decision appears favorable to IP owners, as it seems to be fairly easy to have a product accompanied by a license agreement stating the product is "licensed, not sold" to the user. This article advocates that in light of the Supreme Court's long line of pro-exhaustion decisions, it will likely continue to be challenging for IP owners to establish that a bona fide purchaser is a mere licensee in order to impose downstream restrictions. Two other Ninth Circuit cases may also help to shed some light on this issue.

In *MDY Indus., LLC v. Blizzard Entm't, Inc.* and *Vivendi Games, Inc.*, customers used an application developed by the defendant to automatically play the copyright owner's online game.⁶⁴ The Ninth Circuit, applying Vernor's three-prong test, held that the customers were not owners of copies of the game-software downloaded by them for the purposes of § 117(a) because the copyright owner: (1) reserved title in the software by granting customers a limited license; (2) permitted transfer of the software only under certain circumstances; and (3) imposed a variety of use restrictions, including that the software could be used only for non-commercial entertainment purposes, could not be used in computer gaming centers, and could not be run with any unauthorized third-party applications.⁶⁵

In *UMG Recordings, Inc. v. Augusto*, however, the Ninth Circuit held that the exhaustion doctrine applies not only when a copy is sold, but also when a copy is given away or the title is otherwise transferred.⁶⁶ UMG Recordings, Inc., the copyright owner, for marketing purposes, shipped to music critics, radio programmers and others unsolicited promotional CDs bearing a label stating that they are licensed to the intended recipient for personal use only and not for resale or further transfer, and the defendant who obtained the CDs from various sources sold them on eBay.⁶⁷ The Ninth Circuit

determined that, by giving away unlimited possession and failing to retain sufficient incidents of ownership, the copyright owner transferred title of the CDs to the recipients.⁶⁸ The Ninth Circuit also noted that the copyright owner permitted the retention of the CDs by the recipients without accepting the license because it had virtually no control over the distributed CDs, put in place no arrangement to assure that the recipients have assented or will assent to the license limitations, and did not require the return of the CDs if the license was not accepted.⁶⁹

IV. The Current State of Law and Takeaways

By summarizing the *post-Impression Products* state of law on IP exhaustion, the author hopes to offer some practical advice on how to protect and preserve one's IP rights while trying to maximize their commercial value.

A. Dos and Don'ts

Post-Impression Products, upon a sale of a patented or copyrighted article anywhere in the world, the purchaser or a subsequent transferee has the right under the IP-exhaustion doctrine to perform the following actions in the United States with respect to the article sold, provided that such sale was authorized by the IP owner:

- (1) use the article anywhere for any purpose,⁷⁰ including combining it, or using it together, with any other articles that themselves are not patented;⁷¹
- (2) repair it to prolong its usable,⁷² including replacing components that themselves are not patented;⁷³ and
- (3) sell it to anyone anywhere,⁷⁴ at whatever prices,⁷⁵ which logically includes giving it away to anyone.

The purchaser or transferee, however, may not rely on the IP-exhaustion doctrine to:

- (1) make a different article, even if it is identical to the purchased article;⁷⁶

68. *Id.*, at 1178.

69. *Id.*, at 1178–1183.

70. See *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 457 (1873) (where the purchaser was allowed to use the patented product both inside and outside the state where the patent was granted).

71. See *Quanta Computer, Inc.*, 533 U.S. at 625 (where purchaser was allowed to combine the patent component with other components).

72. See *Wilson*, 50 U.S. at 110 (where the purchaser was permitted to repair the patented product).

73. See *Aro Manufacturing Co.*, 365 U.S. at 346 (where the purchaser was permitted to replace parts of the patented machine).

74. See *Keeler*, 157 U.S. at 667 (where the purchaser was permitted to sell the patented product inside and outside the state where the patent was granted).

75. See *Bauer & Cie.*, 229 U.S. at 17-18 (where the purchaser was allowed to resell the patented product cheaper than what the patentee required).

76. See *Bowman*, 569 U.S. ___ No. 11–796, slip op. at 4–7 (where the purchaser was not allowed to reproduce the patented beans).

61. *Id.*, at 1104-1106.

62. *Id.*

63. *Vernor v. Autodesk, Inc.*, 132 S. Ct. 105 (2011).

64. *MDY Indus., LLC v. Blizzard Entm't, Inc. and Vivendi Games, Inc.*, 629 F.3d 928, 931-935 (9th Cir. 2010).

65. *Id.*, at 954.

66. *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175, 1178 (9th Cir. 2011)

67. *Id.*, at 1175-1176.

- (2) remake the purchased article, after it reached the end of its usable life or have performed its intended function;⁷⁷ and
- (3) exercise any of the IP owner's exclusionary rights, including suing anyone, even someone in unlawful possession of the article, for IP infringement.⁷⁸

In addition, as illustrated in *Ethyl Gasoline*, *Univis Lens*, and *Aro Manufacturing*, the application of the exhaustion doctrine does not seem to depend on the type of patents involved, whether it be product, method or combination patents, but rather on whether the product or component sold embodies the underlying invention of the patent involved.⁷⁹ This principle could similarly apply to copyrighted works.

B. How About Improvements?

A question arises as to whether the purchaser or transferee may rely on the exhaustion doctrine to improve the patented article sold. Although not specifically addressed by the Supreme Court in its decisions so far, as the basic principle of the exhaustion doctrine is akin to dealing with one's own personal property as if it is not subject to any IP,⁸⁰ this article opines that the purchaser or transferee may improve the patented article sold or transferred in the absence of any patent on the improvement owned by a third party. This is true even if a patent with respect to the improvement is subsequently granted to the owner of the original patent, because it is the patent owner who puts the article into the stream of commerce. That action should exhaust not just the patent rights the owner has now, but also exhaust future patent rights the owner may possess in the article sold. But in the latter situation, in light of the patentee's exclusive right to practice the invention as-improved, which is derived from his exclusive right to use and make, the purchaser or transferee may only improve that particular article, and not articles purchased by or transferred to others.

As for copyrighted articles, however, § 106(2) of the Copyright Act grants to copyright owners the exclusive right to prepare derivative works based upon the copyrighted work.⁸¹ Because the copyright exhaustion doctrine as codified in § 109(a) of the Copyright Act only seems to serve as an exception to copyright owners' exclusive right to distribute under § 106(3)

of the Copyright Act,⁸² one could argue that this exception does not seem to apply to other exclusionary rights of copyright owners under § 106(3), including the right to create derivative works.⁸³ If this is how Congress intended the exhaustion doctrine to apply in the copyright context, the purchaser or transferee, as a result, may only use the purchased or received copy as-is, and any revision to such copy is prohibited. A counterargument could be that the Supreme Court in *Impression Products*, did not seem to believe that Congress intended its IP statutes to abrogate the common-law-exhaustion doctrine, and therefore, the purchaser or transferee should be allowed to edit the purchased copy as if it is not subject to any copyright.

C. Must be Bought from Authority Without Conditional Precedents

For the IP exhaustion doctrine to apply, however, the purchaser must establish that the patented or copyrighted article was bought from someone with the authority to sell.⁸⁴ If an article is bought from a seller that has never been granted the right to sell or who acted beyond the authority granted by the IP owner, the purchaser, even acting in good faith, might not be shielded from an infringement action.⁸⁵ The exchange must also be a completed transaction: if the transfer of the article to the buyer is subject to an unsatisfied conditional precedent, it may be not ripe for the IP exhaustion doctrine to apply.⁸⁶ In other words, the transaction in question must be an outright sale with the seller retaining no ownership interest.⁸⁷

D. While Contracts Cannot Negate Exhaustion, They Are Still Important

The fact that the purchaser has entered into an agreement with the IP owner, or assented to IP owner's terms and conditions, could not negate the application of the IP-exhaustion doctrine nor be relied on by the owner to sue for infringement. Then one may ask, when trying to commercialize IP rights, why would IP owners be interested in spending resources in contract negotiations anymore? This article advo-

77. See *Cotton-Tie Co.*, 106 U.S. at 94 (where the purchaser was not permitted to reconstruct the patented products after they had performed their intended function).

78. See *Mitchell*, 83 U.S. at 548 (where the purchaser of patented machines did not acquire the patentee's monopoly).

79. *Ethyl Gasoline Corp.*, 309 U.S. at 437-438; *Univis Lens Co.*, 316 U.S. at 243-244; and *Aro Manufacturing Co.*, 365 U.S. at 338-341.

80. *Id.*

81. 17 U.S. Code § 106.

82. 17 U.S. Code § 106 and 17 U.S. Code § 106

83. 17 U.S. Code § 106.

84. See *Boesch*, 133 U.S. at 700-703 (where because the purchaser bought the patented products from someone who was not the owner of the U.S. patent and not authorized by the owner to sell, the purchaser was not allowed to import and sell the products in the United States).

85. See *Mitchell*, 83 U.S. (16 Wall.) at 548 (where, because the purchaser bought the patented machines from a seller whose authority was limited to the initial patent term cannot use the machines after such period).

86. See *Mitchell*, 83 U.S. (16 Wall.) at 548 (for the product sold to become the property of the purchaser, the sale must be absolute without conditions).

87. *Id.*

cates that quite to the contrary, *Impression Products* may actually prompt, rather than discourage, IP owners to protect their interests via contracts.

First of all, a contract that is otherwise valid between the IP owner and a purchaser may continue to be enforced despite application of the IP-exhaustion doctrine. So after selling an article embodying the IP, the IP owner may still sue the purchaser for breach of contract, even when an infringement action is no longer a viable option.⁸⁸ In addition, the IP owner may seek injunctive relief to enjoin the violation of imposed restrictions not only through IP rights, but also based on contractual rights (similar to enforcing a confidentiality agreement).⁸⁹ Moreover, the IP owner may want to use the contract language to establish that the transaction-in-question is not a sale but rather a license and, therefore, pairing it with certain restrictions is a legitimate exercise of the IP owner's legal monopoly.⁹⁰

E. What Patent Owners and Licensors Should do Post-*Impression Products*

1. Establish a Valid and Effective Licensing Program

One could argue that *Impression Products* is not applicable to a situation where a valid license is established because its facts only dealt with conditions accompanying a sale, not those imposed on a licensee; with careful planning, it seems at least conceivable to establish a licensing program for any recyclable product. For example, instead of offering cartridges at a discount, the patentee in *Impression Products* could have potentially retained the title of its cartridges and licensed them for use with its printers, on the condition that the cartridges should be returned when the toner runs out, and provided in the license agreement that, once returned, the user is entitled to a refund of a portion of the license fee.

In addition to explicitly providing that the transferee is a licensee, not the owner, of the transferred item, the IP owner may want to include provisions that limit any further transfer of the patented or copyrighted product beyond the original transferee and impose notable use restrictions in an effort to meet the three-part test set forth in the *Vernor* decision.⁹¹ The IP owner may

88. See *Keeler*, 157 U.S. at 667 (suggesting that if the patentee had a valid contract restricting the purchaser's right to use or resell the articles sold, he may be able to enforce such restriction as a matter of contract law).

89. Cf. 35 U.S. Code § 283.

90. See *E. Bement & Sons*, 186 U.S. at 72 (where license restrictions were enforced); and *General Electric Co.*, 272 U.S. at 488 (holding that reasonable limitations that a patentee might impose on a licensee were permissible).

91. See *Vernor*, 621 F.3d at 1104-1106.

also consider explicitly requiring return or destruction of the transferred item upon the termination of the license grant and reserving the right to repossess such item to boost the claim that the owner retains sufficient incidents of ownership of that item.⁹² One factor that seems to be considered by courts is whether the article is exchanged for a gross consideration.⁹³ By requiring users to pay periodic fees through the usable life of the article instead of a lump-sum amount, it may help to convince judges that the transaction is not an outright sale.

When accompanying products with licenses that do not require signatures,⁹⁴ the IP owner should require the recipients to return the articles if they decide not to accept the license terms and put in place an arrangement to monitor the recipients' acceptance and the whereabouts of articles shipped.⁹⁵ If technically possible, it also may be wise for the IP owner to only allow consumers to access or use the patented or copyrighted technologies, instead of letting them possess copies of the product embodying such technology. This strategy may be easier for software companies — especially those offering copyrighted software as a service — to implement, and could prove to be more difficult for patent owners (such as manufacturing, hardware, and biopharmaceutical companies) whose customers typically purchase tangible products first before starting to consume or use them.

2. Impose Appropriate Restrictions on Licensees

For companies that rely on patent protection, it is important to include appropriate restrictions in license agreements with manufactures or exclusive licensees,⁹⁶ as they may be able to enforce such agreements against downstream purchasers based on the theory of contributory patent infringement, at least against those that are aware of such restrictions.⁹⁷

92. See *MDY Indus.*, 629 F.3d at 954 (where because copyright owner reserved title in, limited transfer of, and imposed use restrictions on the downloaded software copies, customers were not treated as owners of such copies).

93. See *Boston Store of Chicago*, 246 U.S. at 26-27 (holding that once a patented machine was sold for a gross consideration, it was placed beyond the confines of patent law).

94. Such as shrink-wrap licenses.

95. See *UMG Recordings, Inc.*, 628 F.3d at 1178 (where the copyright owner permitted the retention of the CDs by the recipients without accepting the license showed that the owner had no control over the distributed CDs).

96. See *E. Bement & Sons*, 186 U.S. at 72 (where a variety of license restrictions were upheld).

97. See *General Talking Pictures Corp.*, 304 U.S. at 182 (where the license limitations were held to be enforceable against the licensee and those acting in concert with it, including downstream purchasers that knew the products were sold outside the scope of the license).

For example, if a U.S. company that owns worldwide patent rights to a drug product grants a license to a European company to make and sell the drug within the European Union (EU) but not anywhere else, and if the European company sells the drug in the United States to a competitor of the patent owner (who is on notice of the restriction for resale in the United States), *Impression Products* does not seem to prevent the licensor from suing both the European licensee and the U.S. competitor for patent infringement on the basis that the initial sale is made outside the authority granted by the licensor.⁹⁸ In this example, the U.S. company may require the licensee to sell the drug at a certain price,⁹⁹ and may also impose field-of-use limitations.¹⁰⁰ It may also require the licensee to only make and sell the drug for treating certain indications and reserve the right to grant licenses with respect to other indications. If the licensee knowingly sells the drug for use in treating such other indications, such licensee and purchasers acting in concert with it could infringe the patentee's patent rights.¹⁰¹

The patentee's restrictions, however, have to pass antitrust- and unfair-competition-law muster.¹⁰² Therefore, it is advisable to seek counsel's opinion before imposing restrictions that may result in fixing prices, tying other goods to the IP-protected product, or other anti-competitive effects. In addition, the IP owner should condition the license grant on the licensee's strict compliance with such restrictions and preserve the ability to terminate the license in case of violation.¹⁰³ The IP owner may also want to explicitly disclaim any implied licenses.¹⁰⁴ For example, if the IP owner only desires to have the licensee manufacture

and/or sell the product but not to practice it, it may be worth specifically withholding the right to use from the license grant as reserved to the patentee, and vice versa. Moreover, while the permissible repair under the exhaustion doctrine seems to be rather expansive,¹⁰⁵ the IP owner could potentially use contracts to require purchasers to replace no more than a certain percentage of the purchased article's components or to prescribe such article's usable life.

3. *Require Appropriate Restrictions on Downstream Users*

In addition to imposing restrictions on licensees, the IP owner should consider requiring its licensees to include appropriate restrictions in their agreements with distributors, retailers, and even end-users in an attempt to enforce such restrictions under contract law. To enforce a contract to which it is not party (thus lacking privity of contract),¹⁰⁶ the IP owner may consider establishing that it is the intended third-party beneficiary of the restrictions.

In addition, as illustrated in *Quanta Computer*,¹⁰⁷ the patent owner may want to specifically condition the license grant on the licensee's imposition of restrictions on downstream purchasers and list the patent owner as a third-party beneficiary, thus explicitly providing itself with the ability to terminate the license in case of non-compliance. The U.S. company in the example above may impose on the European licensee a condition that it may only sell the drug to someone who has agreed to use the drug only within the EU and not to ship it to anywhere else; but if the U.S. competitor came to the EU and purchased the drug there, that sale seemed to take place within the declared geographic limits and thus exhaust the U.S. company's U.S. patent rights therein, which would potentially allow the competitor to ship the drug to the U.S. without fear of infringement actions.¹⁰⁸

This is different from the situation in *Boesch*, because the licensee here was granted by the IP owner the right to sell the drug in Europe and Europe is where the sale took place, while the buyer in *Boesch* bought from someone unrelated to the IP owner.¹⁰⁹ Similarly, if the licensee initially sold a large amount of the drug to patients on the conditions prescribed in the license

98. *Impression Prods.*, 581 U.S. ___ No. 15-1189, slip op. at 16.

99. See *E. Bement & Sons*, 186 U.S. at 72 (where the licensor/patentee was allowed to require licensees not to sell the licensed products at a lower price than what was set forth in the license).

100. See *General Talking Pictures Corp.*, 304 U.S. at 182 (where field-of-use limitations were upheld).

101. See 35 U.S. Code § 271. See *General Talking Pictures Corp.*, 304 U.S. at 182 (where the license limitations were held to be enforceable against downstream purchasers acting in concert with the licensee).

102. See *Standard Sanitary Mfg. Co.*, 226 U.S. at 49 (patent rights do not immunize the owner from the antitrust law prohibiting unreasonable restraint of trade).

103. See *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617, 625 (2008) (where no license restriction was recognized, partially because any violation thereof was not a basis for terminating the license agreement).

104. See *De Forest Radio Tel. Co.*, 273 U.S. at 242 (an implied license may be inferred from words and actions that indicate the consent).

105. See *Wilbur-Ellis Co.*, 377 U.S. at 425 (repair encompasses fairly extensive refurbishment).

106. See *Victor Talking Machine Co.*, 243 U.S. at 499 (where the patentee cannot sue defendants' department store under contract law because it was not in contract privity with the patentee).

107. *Quanta Computer, Inc.*, 553 U.S. at 625.

108. See *Hobbie*, 149 U.S. at 362 (once the patented articles were purchased from someone with the authority to make and sell the patented articles within his authorized territory, such articles may be used outside such territory).

109. *Boesch*, 133 U.S. at 700-703.

agreement, and some patients then sold the surplus amount without the conditions, it seems difficult to argue that *General Talking Pictures* supports finding infringement for such action as such conditions are conditions of sale but not license conditions.¹¹⁰ Therefore, in such a situation, it seems that the IP owner could only resort to contract law for recourse.

V. Conclusion

In summary, IP owners should appreciate the default IP exhaustion rules as set forth in the Supreme Court's decisions spanning almost 160 years, and should consider using suitable agreements in achieving their objectives. In light of *Impression Products*, to maintain the desired control over their products, it is important for IP owners to: (1) vigilantly avoid IP exhaustion; (2) carefully draft corresponding agreements; (3) clearly delineate the imposed restrictions; and (4) explicitly subject any license grant to the strict compliance with, and the diligent enforcement of, such restrictions. ■

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110. *General Talking Pictures Corp.*, 304 U.S. at 182.