November – December 2015 Intellectual Property Roundtable – *After Lexmark, Is International Patent Exhaustion on the Horizon?*

By Matthew K. Blackburn, Locke Lord LLP
44 Montgomery Street, Suite 4100
San Francisco, CA 94104-4815
mblackburn@lockelord.com

Like it or not, the United States is moving towards "international" patent exhaustion. The U.S. has long operated under a national patent exhaustion system, where a domestic sale of a patented item authorized by the patent holder or their privy exhausts or ends U.S. patent rights. The U.S. Supreme Court has never held that a sale abroad of a patented item exhausts U.S. patent rights and the Federal Circuit has repeatedly rejected such arguments since 2001.

This legal framework could soon change. On April 14, 2015, the Federal Circuit granted en banc rehearing, on its own accord, in *Lexmark International Inc. v. Impression Prods. Inc*.[1] The *en banc* court will address whether it should overrule existing precedent (*Jazz Photo Corp. v. International Trade Commission*[2]) and find the sale of a patented item abroad exhausts U.S. patent rights.

By choosing to hear *Lexmark en banc*, the Federal Circuit clearly signaled the holding in *Jazz Photo* is in serious jeopardy. No matter how the Federal Circuit decides *Lexmark*, the parties are likely to seek review by the U.S. Supreme Court, which is not bound by *Jazz Photo*.

To address the impact of this potential shift in the law, patent owners should understand these important issues and consider proactive steps to protect their businesses.

Legal Framework of Patent Exhaustion

Patent exhaustion has a long history in U.S. common law. Under this non-statutory doctrine, the first authorized sale of a patented item ends the U.S. patent monopoly over that item. More than 160 years ago, the Supreme Court explained in *Bloomer v. McQuewan*[3] that after patented technology "passes to the hands of the purchaser, it is no longer within the limits of the [patent] monopoly."[4] This is consistent with the more general common law principle disfavoring restraints on the alienation of personal property.

Patent exhaustion limits patent holders to a single reward for their U.S. patent monopoly.[5] The patentee has bargained for and received the full value of the patented item and therefore the patentee's right to control the purchaser's use of that item ends.[6]

Patent exhaustion has become more complicated in the context of international commerce. When a product is made and assembled abroad, courts have been mindful of the legal presumption against extraterritorial reach of U.S. patents. At the same time, not applying patent exhaustion could allow patent holders to receive excessive double recoveries for their patent rights and reduce access to valuable technology. Some leading cases addressing patent exhaustion when commercial activity occurs at least partially outside the U.S. are discussed below.

The Supreme Court — *Boesch v. Graff* (1890)

The U.S. Supreme Court long ago recognized it should focus on the sales transaction itself, and not its location, when deciding whether U.S. patent rights were exhausted. If the U.S. patent owner authorized an unrestricted sale of a patented item (either directly by the patent owner or by an authorized privy), then that item is free of the patent monopoly, is in the public domain, and can be bought, sold, imported, or used without concern for the U.S. patent rights. However,

patent exhaustion does not apply to an unauthorized sale. These general principles apply no matter where the sale occurs.

For example, in *Boesch v. Graff*,[7] the Supreme Court considered whether sale of a patented item in Germany had exhausted U.S. patent rights. The seller (Mr. Hecht) did not hold the U.S. patent right and was only authorized to make the patented burners within Germany.[8] The Court explained the seller could not convey U.S. patent rights that he did not have:

"The right which Hecht had to make and sell the burners in Germany was allowed him under the laws of that country, and purchasers from him could not be thereby authorized to sell the articles in the United States in defiance of the rights of patentees under a United States patent."[9]

Boesch stands for the proposition that a sale not authorized by the U.S. patent holder does not exhaust U.S. patent rights. Boesch does not address a foreign sales authorized by the U.S. patent holder.

Early Second Circuit Court Rulings — *Dickerson* (1893), *Daimler* (1909) and *Curtiss Aeroplane* (1920).

Three early Second Circuit decisions after *Boesch* continued to focus on the sales transaction, rather than its location, when deciding whether a patent had been exhausted.

For example, overseas sales did not exhaust U.S. patents in *Dickerson v. Matheson*[10] and *Daimler Mfg. Co. v. Conklin*.[11] In *Dickerson*, the seller held both the U.S. and foreign patent rights, but the overseas purchaser accepted conditions of sale that specifically prohibited importation into the U.S. Because those conditions excluded use in the U.S., the sale did not exhaust the U.S. patent.[12] In *Daimler*, the overseas seller did not hold any U.S. patent rights and therefore could not exhaust those rights by selling the patented item.[13]

However, an overseas sale did exhaust U.S. patent rights in *Curtiss Aeroplane & Motor Corp. v. United Aircraft Engineering Corp*.[14] In *Curtiss*, the U.S. patent holder sold the patented item (airplanes) in Canada. The sale was unrestricted and the purchaser was free to use the airplanes in the U.S. Therefore, the U.S. patent rights were exhausted by the first Canadian sale.[15]

These Second Circuit decisions generally establish that an authorized and unrestricted sale of a patented item by the U.S. patent holder exhausts those rights, regardless of the geographic location of the sale.

Jazz Photo Corp. v. International Trade Commission (Fed. Cir. 2001)

The Federal Circuit drew a bright line limiting the geographic scope of patent exhaustion in *Jazz Photo Corp. v. International Trade Commission*. The Federal Circuit asserted, "United States patent rights are not exhausted by products of foreign provenance."[16] According to the court, Boesch established that patent exhaustion requires an "authorized first sale … under the United States patent," and a foreign sale is not under the U.S. patent.[17]

Kirtsaeng v. John Wiley & Sons, Inc. (2013)

The Supreme Court's recent *Kirtsaeng*[18] decision interprets the statutory copyright exhaustion doctrine (17 U.S.C. § 109(a)). Like *Boesch* and the trilogy of Second Circuit patent decisions, the *Kirtsaeng* majority focuses on whether the U.S. copyright holder authorized an unrestricted sale of intellectual property (IP), rather than the geographic location of the sale.

John Wiley & Sons, Inc. ("Wiley") published English-language textbooks for distribution abroad through a wholly owned subsidiary. Kirtsaeng obtained in Thailand authorized copies of those textbooks at significantly lower prices and then shipped them into the U.S. for resale. Wiley filed suit claiming Kirtsaeng's actions violated its U.S. copyrights.

Kirtsaeng countered that Wiley's copyrights had been exhausted by the first sale, even though it occurred abroad. Specifically, Section 109(a) grants "the owner of a particular copy … lawfully made under this title "the right to "dispose" of that copy without the copyright owner's permission. Wiley countered that the language of Section 109, "lawfully made under this title," requires that the textbooks be made within the U.S.[19]

In a 6-3 decision, the Supreme Court found that Section 109(a) allowed Kirtsaeng to import and resell textbooks that had been lawfully made and sold by the copyright holder abroad.[20] Section 109(a) contains no express geographic limitations.[21] The Court presumed Congress intended to retain the substance of the common law, which also lacked any express geographic limitation.[22] The common law embraces the general policy against restraints on the alienation of personal property.[23]

Justices Ginsburg, Kennedy, and Scalia "dissent[ed] from the Court's embrace of 'international exhaustion.'"[24]

Although Kirtsaeng relates to statutory copyright exhaustion, its reasoning is at least relevant to the analysis of common law patent exhaustion.[25]

Planning Ahead

Patent owners should consider adapting their businesses to address the potential ramifications if the Federal Circuit or the Supreme Court overrules *Jazz Photo* or otherwise adopts a doctrine of international patent exhaustion. Sale of a patented item domestically already exhausts the U.S. patent rights. That is unlikely to change. However, the overruling of *Jazz Photo* potentially would allow importation into the U.S. of "gray market" goods that were originally sold by the patent owner abroad.

First, make your overseas sales and licensing contracts conditional upon the purchaser accepting conditions that exclude importation into the U.S., as discussed in the Second Circuit's *Dickerson* decision. The Federal Circuit has upheld similar conditions on reuse or resale, even if patent exhaustion would otherwise apply.[26]

However, the Federal Circuit's recent en banc grant in Lexmark also extends to the whether contractual conditions can negate patent exhaustion. Despite that uncertainty, patent holders should consider this approach.

Second, patent owners should carefully structure the rights held by the entity selling the patented goods. "A sale authorized by the patent holder" is what triggers patent exhaustion.[27] This includes sales not just by patent owners, but also by licensees and even recipients of covenants not to sue.[28] Even sales by a subsidiary have been found to exhaust the IP rights of its corporate parent.[29]

Make sure that entities selling abroad (and their parent companies) do not hold the U.S. patent rights. At least one district court has endorsed this approach. In *Griffin v. Keystone Mushroom Farm, Inc*.,[30] the patent owner exclusively licensed one company (Longwood Manufacturing Corporation) under the U.S. patent and it licensed another company (Celeste Carminati) under the corresponding Italian patent.[31] Critically, Carminati was not authorized to sell the articles in the U.S., and lacked any U.S. patent rights. Therefore, the court rejected the accused infringer's argument that the U.S. patent rights had been exhausted by its purchase from Carminati (the Italian licensee).[32] This is consistent with the Supreme Court's Boesch decision and the Second Circuit's Daimler decision, which suggest that U.S. patent rights will not be exhausted if the selling entity does not hold or control U.S. patent rights.

Third, patent owners should consider modifying pricing strategies to reduce reselling opportunities. In *Kirtsaeng* and *Jazz Photo*, resellers took advantage of significant price differences inside and outside the U.S. The price within the U.S. was significantly higher than the price for the same goods sold abroad. Textbooks in *Kirtsaeng* could be purchased for relatively small amounts in Thailand, shipped to the U.S., and then sold for a large profit. Reducing geographic price differences will minimize the incentive for reselling.

Fourth, given that some foreign countries already have international patent exhaustion, begin now to draft your sales and licensing contracts to avoid unintended exhaustion in those countries. Countries that already have international patent exhaustion include China, Japan, and Brazil. An unconditional sale of your patented item in the U.S. may exhaust your foreign patent rights in those countries. A purchaser of your goods in the U.S. may then resell those goods (perhaps after repairing or refurbishing them) in those foreign countries. Consider adding provisions in any U.S. sales or license agreements to prohibit export to those foreign countries. This may protect against your foreign patent rights from being exhausted by U.S.-based transactions.

Conclusion

The Federal Circuit's recent decision to rehear *Lexmark en banc* could significantly alter international commerce in patented goods. The Federal Circuit or Supreme Court could soon determine that authorized overseas sales of patented goods exhaust U.S. patent rights. Given that very real possibility, patent holders should take the time now to understand international patent exhaustion and conduct their affairs to minimize any adverse impact.

* Article first appeared in June 2015 on https://bol.bna.com/after-lexmark-is-international-patent-exhaustion-on-the-horizon

[1] *Lexmark Int'l Inc. v. Impression Prods. Inc*., Nos. 14–1617, –1619, 2015 U.S. App. LEXIS 6049 (Fed. Cir. Apr. 14, 2015).

[2] *Jazz Photo Corp. v. Int'l Trade Comm'n*, 264 F.3d 1094 (Fed. Cir. 2001).

[3] 55 U.S. (14 How.) 539 (1852).

[4] *Id*. at 549.

[5] *See United States v. Univis Lens Co*., 316 U.S. 241 (1942); and *Motion Picture Patents Co. v. Universal Film Mfg.*, 243 U.S. 502, 516 (1917) (finding that "the right to vend is exhausted by a single, unconditional sale, the article sold being thereby carried outside the monopoly of the patent law and rendered free of every restriction which the vendor may attempt to put upon it.")

[6] *Princo Corp. v. Int'l Trade Comm'n*, 616 F.3d 1318, 1328 (Fed. Cir. 2010) (*en banc*).

[7] 133 U.S. 697 (1890).

[8] *Id*. at 701.

[9] *Id*. at 703.

[10] 57 F. 524 (2d Cir. 1893).

[11] 170 F. 70 (2d Cir. 1909).

[12] *Dickerson*, 57 F. at 527 (*citing Boesch*, 133 U.S. 697).

[13] *Daimler*, 170 F. at 72.

[14] 266 F. 71 (2d Cir. 1920).

[15] *Id*. at 78.

[16] *Jazz Photo*, 264 F.3d at 1105.

[17] *Id*.; *see also Fuji Photo Film Co. Ltd. v. Jazz Photo Corp*., 394 F.3d 1368, 1376 (Fed. Cir. 2005) ("patentee's authorization of an international first sale does not affect exhaustion of that patentee's rights in the United States."); *Fujifilm Corp. v. Benun*, 605 F.3d 1366, 1371 (Fed. Cir. 2010) (*per curiam*) (same); and *Ninestar Tech. Co., Ltd. v. Int'l Trade Comm'n*, 667 F.3d 1373, 1378 (Fed. Cir. 2012) (same).

[18] 568 U.S. ____, 133 S.Ct. 1351 (2013).

[19] *Id*. at 1357–58.

[20] *Id*. at 1371.

[21] *Id*. at 1358–60.

[22] *Id*. at 1363–64.
[23] *Id*. at 1363.

[24] *Id*. at 1374.

[25] *See, e.g., Lifescan Scotland, Ltd. v. Shasta Techs., LLC*, 734 F.3d 1361, 1375 n.9 (Fed. Cir. 2013)("[t]he Supreme Court has frequently explained that copyright cases inform similar cases under patent law.")

[26] *See Jazz Photo*, 264 F.3d at 1102; *Mallinckrodt, Inc. v. Medipart, Inc*., 976 F.2d 700 (Fed. Cir. 1992) (upholding a "single use only" condition); *B. Braun Medical, Inc. v. Abbott Labs*., 124 F.3d 1419, 1426–27 (Fed. Cir. 1997) ("express conditions accompanying the sale or license of a patented product are generally upheld").

[27] *Quanta Computer, Inc. v. LG Elecs., Inc*., 553 U.S. 617, 636 (2008).

[28] *Id*. (licensee); *LG Elecs., Inc. v. Hitachi Ltd*., 655 F.Supp.2d 1036, 1044–45 (N.D. Cal. 2009) (same); *Multimedia Patent Trust v. Apple, Inc*., 2012 WL 6863471 (S.D. Cal. Nov. 9, 2012) (same); *San Disk Corp. v. Round Rock Research LLC*, 2014 WL 2700583 (N.D. Cal. Jun. 13, 2014) (same); *TransCore, LP v. Electronic Transaction Consultants Corp*., 563 F.3d 1271, 1276–77 (Fed. Cir. 2009) (covenant not to sue).

[29] *See Kirtsaeng*, 133 S.Ct. at 1356, 1371 (copyright exhaustion); and *Sanofi, S.A. v. Med-Tech Veterinarian Prods.*, Inc., 565 F.Supp. 931, 938 (D. N.J. 1983) (patent exhaustion).

[30] 453 F. Supp. 1283 (E.D. Pa. 1978).

[31] *Id*. at 1284.

[32] *Id*. at 1284–85.