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Strategies for Coping with Patent Exhaustion and Post-Sale Restrictions

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Legal Update

Industries employing goods that require reprocessing often face a quandary when attempting to enforce patents on goods that have been produced by the patent holder and are now in the marketplace: the patent exhaustion doctrine. The patent exhaustion doctrine is an old but developing body of law that, as stated by the Supreme Court in *Quanta Computer, Inc. v. LG Electronics, Inc.*, generally expounds that "[t]he authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control post-sale use of the article." In practice, this general prohibition takes on new challenges as patent holders become creative in enforcing their patent rights against those that reprocess, remanufacture, or refurbish their products. This creativity has particularly materialized in one industry – printer cartridges.

Printer cartridge manufactures have long been at odds with reprocessors, or refillers, of used cartridges. Companies such as Lexmark and Epson have fought public patent infringement suits against companies that refill cartridges. The reprocessing often takes the shape of collecting used cartridges from consumers, repairing and refilling the cartridge with ink, and reselling the reprocessed cartridge to consumers, either directly or indirectly through retailers. The reprocessors have relied upon patent exhaustion as a defense of their practices, considering their work as permissible repair and not as reconstruction.

Last month, the Federal Circuit took up print cartridge refilling with an eye toward patent exhaustion. In *Ninestar Technology Co. v. International Trade Commission*, the alleged infringer, Ninestar Technology Co., argued that its importation of reprocessed printer cartridges did not infringe the asserted patents (held by Seiko Epson Corp., Epson America, Inc., and Epson Portland Inc. - collectively "Epson") because Epson's initial sale of the cartridges exhausted Epson's patent rights as to those products under the patent exhaustion doctrine. In so doing, Ninestar relied on the recent Supreme Court decision in *Quanta* and argued that for exhaustion to apply, the initial sale can occur anywhere in the world. The Federal Circuit disagreed, and, referencing its 2001 ruling in *Jazz Photo Corp. v. ITC*, held that exhaustion requires that a sale take place in the United States to eviscerate rights to that product. This territorial component ensures that U.S. patent holders can enjoin a reprocessor that takes a device used or sold in a non-U.S. territory and imports that reprocessed device into the U.S. This result is surely not limited to print cartridge reprocessors and all industries facing reprocessing issues, such as the medical device industry, can utilize the territorial component to restrict their competitors to the U.S. used device market.

So, you are exhausted. What can you do now?

As the Supreme Court alluded in *Quanta*, the patent exhaustion doctrine does not reach contract issues and the Court states that "the authorized nature of the sale to [a third party] does not necessarily limit [the patent owner]'s other contract rights." This opens the door for a clever patent owner to establish contractual relationships with its customers that limit or prohibit the resale of the covered product.

Again, the printer cartridge industry holds an example of attempts to implement post-sale restrictions. Lexmark Inc. recently implemented a "prebate" program where they offer a discounted upfront price in exchange for a contractual agreement to return the spent cartridges to Lexmark for remanufacturing.[1] This prebate program has drawn competing decisions and highlights the essential contract issues arising pre and post-*Quanta*.

Under this Lexmark strategy and prior to the Supreme Court's *Quanta* decision, in *Arizona Cartridge Remanufacturers Association Inc.("ACRA") v. Lexmark International Inc.* the Ninth Circuit Court of Appeals upheld a district court decision that found that the contract terms on the packaging of the printer cartridge were sufficiently clear to act as a "box-wrap" or shrink-wrap license, such that when the user opens the box, he or she is accepting the terms thus forming a contract. Because the printer cartridge was patented, it was held that Lexmark could impose post-sale conditions on purchasers, for instance prohibitions preventing refilling of the cartridge, through contract provisions governed by state law. Here, the shrink-wrap contract employed by Lexmark was deemed to be a valid contract and enforceable against a reprocessor. Notably, the *ACRA* case was decided before *Quanta*, but the Supreme Court in *Quanta* did not expressly overrule the Ninth Circuit and gave dicta indicating that contract provisions of this type may be appropriate.

Post-*Quanta*, in *Static Control Components, Inc. v. Lexmark Int'l, Inc.*, the Eastern District of Kentucky court analyzed the exact same prebate program and determined that Lexmark's prebate program was not a proper contract and was not a valid restriction on the sale of the cartridge and was instead an improper restriction on the consumer's use of the cartridge – thus running afoul of the patent exhaustion doctrine. In direct contrast to the earlier *ACRA* opinion, the court noted that Lexmark failed to enter into any contractual relationship with their consumers, despite a clear statement on the packaging that it was only to be returned to Lexmark. This was determined by the court to be an improper contract and thus not an appropriate post-sale restriction. Commentators have debated this pre and post-*Quanta* decision process, but no decisive conclusions have been drawn. Patent holders can be assured that the relevant analysis likely lands in familiar contract principles.

Patent exhaustion may also affect vertical licensing schemes, in which the same patents are licensed to multiple parties at different levels in the supply chain. Following *Quanta*, patentees will need to take greater care as to whom they license, and to the impact of each license. Further, licensing agreements and the nature of the agreement, i.e., is it a sale or a license to produce or use, will have to be examined carefully, both for the nature and terms of the contract (and to whom the contract applies) and for the legal bounds of what can be contracted for in the agreement.

Turning briefly to antitrust concerns over limiting a consumer's use of a purchased good, assuming that a patent owner has a good faith basis to believe in the validity of its patents, a court's antitrust analysis of a restriction involving contract language would likely end on the fact that the patent owner has stayed within the scope of its patent, even if it implicated other product markets, because it has only restricted the use of that patented product. As with many antitrust issues, the analysis may include a market power determination, which necessarily includes defining what the market is for the products. In cases where there are reasonable substitutes for a patent owner's product in the marketplace, the patent owner can be more confident that an antitrust analysis will not invalidate contractual restrictions on the use of the patent owner's products. In addition, there does not appear to be any indication that the restrictions implicate the types of practices that typically receive antitrust scrutiny -- notwithstanding a valid patent -- in the licensing context, for example, a horizontal conspiracy, tying, or fraudulent patent acquisition.

Finally, an issue with contractually protecting the product is that you may end-up in the less-than-desirable position of having to sue a customer for breach of contract. A clever license draftsman, however, may be able to structure the exchange of goods so that title remains with the patent holder, much like cable companies do with cable boxes and remote controls. In this setting there is no first-sale, because title is not transferred, and thus the exhaustion doctrine does not apply. Because the doctrine does not apply, when the reprocessor provides the remanufactured good back to the original licensee, they will have infringed the patent holder's right to exclusively sell the device. This allows the patent holder to avoid suing the consumer, and instead allows the patent holder to only sue the reprocessor who is selling the infringing reprocessed article.

In sum, the patent exhaustion doctrine is a powerful limitation placed upon producers of durable goods. But, in global industries where reprocessing is common, such as printer cartridges and medical devices, patent owners can protect against international reselling of reprocessed goods through the Federal Circuit's recent decision in *Ninestar* and the creative patent owner may find contractual language to protect their goods – using the patent as a potential justification and defense against antitrust claims.

[1] *Static Control Components, Inc. v. Lexmark Int'l, Inc.,* 615 F. Supp. 2d 575, 576 (E.D. KY 2009).

This advisory was prepared by Nutter's Intellectual Property practice. For more information, please contact your Nutter attorney at 617-439-2000.

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