Clients&FriendsMemo

Avoiding Patent Exhaustion: Structuring Agreements in View of the Latest Jurisprudence

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What do the principles of patent exhaustion have to do with the convenience of disposable consumer products such as individual coffee/tea/beverage pods, disposable diagnostic test strips, refillable ink cartridges and the like? Although transparent to consumers, these principles are important to the innovative companies creating these products and protecting them through IP rights. How a company controls the proprietary rights to make and/or market these components can have profound consequences on maintaining its competitive edge in the marketplace.

A patent owner has the right to develop and license its bundle of make/use/sell/etc. rights as it sees fit, but an unqualified sale of a patented device can effect a complete transfer of the entire bundle of ownership rights. Under the principles of patent exhaustion, a patent owner cannot later sue a customer who purchased a patented product without qualification. But whether a patentee can restrict a sale in some manner so as to retain some of its rights in the sold item remains an issue which can be highly fact-sensitive. Here, we explore whether the sale of a larger appliance—coffee-maker, printer, etc.—exhausts patent rights to disposable components or refills sold for use with the appliance. Several recent cases illustrate the circumstances in which patent exhaustion may apply, and suggest ways of possibly avoiding exhaustion through careful approaches in crafting patent claims, thoughtful patent portfolio strategies and use of carefully tailored patent license agreements.

In the recent U.S. Supreme Court decision *Impression Products, Inc. v. Lexmark International Inc.*,[1] the patentee was the designer of ink-toner cartridges for use in laser printers, and owned patents covering both the cartridges and their use in printers. Lexmark sold these cartridges worldwide. But, because the cartridges were refillable, Lexmark had difficulty maintaining control of the cartridges after their sale.[2] In an attempt to prevent unauthorized re-filling of spent cartridges, Lexmark required its customers to sign a contract prohibiting them from returning their empty

1 *Impression Prods., Inc. v. Lexmark Int'l, Inc.*, 137 S. Ct. 1523 (2017).

2 *Id.* at 1529 (third parties named "remanufacturers" obtained used cartridges from Lexmark customers).

cartridges to anyone other than Lexmark. Despite this provision, remanufacturers acquired empty cartridges which they refilled and resold.[3]

Lexmark sued the remanufacturers, alleging patent infringement of the cartridge patents. But the Supreme Court held that any Lexmark patent rights in the cartridge were exhausted when Lexmark sold it to the first purchaser (Lexmark's customer), applying the established principle that when a patentee sells an item under an express, otherwise lawful restriction, the patentee does not retain patent rights in that product.[4] The Court explained that the Patent Laws promote innovation by allowing patentees to "'secure the financial rewards' for their inventions."[5] However, once the patentee sells a patented product it has secured its reward and the Patent Laws provide no further basis for restraining that product's use and enjoyment.[6] Accordingly, Lexmark could not maintain an action in patent infringement against the remanufacturers who were selling the same (but refilled) cartridges previously sold by Lexmark.[7] And whether the sale occurred within the United States or abroad made no difference, "what matters is the patentee's decision to make a sale"[8] without regard to the sale's location.[9] As for the express contractual provisions between Lexmark and its cartridge customers, although lawful, those provisions did nothing to avoid exhaustion of the patent. Once sold, "whatever rights Lexmark retained are a matter of the contracts with its purchasers, not the patent law."[10]

Patent exhaustion put Lexmark in a tough position. On the one hand, it did not want to sue its customers for breach of the contract provision restricting its action with the empty cartridges. On the other hand, it could not sue the remanufacturers for contract violations because the remanufacturers were not a party to that contract and, as it turns out, patent infringement was also not an available cause of action.

While *Lexmark*'s application of patent exhaustion involved a refillable cartridge fully covered by a patent claim, other U.S. Supreme Court and Federal Circuit decisions have applied the doctrine of

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3 *Id.* at 1529-30.

4 *Id.* at 1532-33.

5 *Id.* at 1532 (citation omitted).

6 *Id.* at 1531-32.

7 *Id.* at 1535.

8 *Id.* at 1538.

9 *Id.* at 1537 ("[T]he Patent Act does not guarantee a particular price, much less the price from selling to American consumers. Instead, the right to exclude just ensures that the patentee receives one reward[.]"); *see also id.* at 1532 ("[O]nce a patentee sells an item, it has 'enjoyed all the rights secured[.]'") (citation omitted).

10 *Id.* at 1533; *see also id. at* 1535 ("Once a patentee decides to sell . . . that sale exhausts its patent rights, regardless of any post-sale restrictions the patentee purports to impose"; and "[t]he purchasers might not comply with the restriction, but the only recourse for the licensee is through contract law[.]").

patent exhaustion to patent claims where the commercial product read on only part of the patent claims. In other words, the product is covered by some, but not all, of the elements in the patent claim.

Before *Lexmark*, the Supreme Court in *Quanta Computer, Inc. v. LG Electronics, Inc.*,[11] articulated a standard for determining the potential applicability of patent exhaustion: "[t]he authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights . . .", even when not fully infringed by the sold item, where the product sold "had no reasonable noninfringing use and included all the inventive aspects" of the patented claim.[12] In *Quanta*, the licensed products accused of infringement (*i.e.*, computer chips) read onto a portion of each of the asserted patent claims and had no use other than to be coupled to the system claimed in the remaining claim elements (*i.e.*, the computer) because without the other components the licensed product would not work.[13] Although some of the patents included method claims, it did not change the exhaustion analysis because methods may be "'embodied' in a product, the sale of which exhausts patent rights."[14]

With this test, patentees were on notice that sale of a component used in a larger patented system —despite not embodying the entire patent claim—could nevertheless potentially exhaust any potential patent right the patentee might hope to assert to protect against follow-on sales of the larger system. This created a dilemma for companies who sell two (or more) items as part of a system where the patent claims are directed to the system, but not individual components within the system.

The Federal Circuit case, *LifeScan Scotland, Ltd. v. Shasta Technologies, LLC*[15] provides a post-*Quanta* example of patent exhaustion involving a disposable component used in a larger device. LifeScan Scotland ("LifeScan") sold a glucose metering system having a meter device and disposable test strips. LifeScan obtained patent protection covering the system of using the strips with the meters to determine blood glucose levels but not on the disposable strips alone.[16] Of the seven elements in the asserted claim, three were directed to the meter while four were directed to the strips. Defendant Shasta sold only disposable test strips, not meters.[17] LifeScan sued Shasta

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

[12] *Id.* at 638.

[13] *Id.* at 633 (*e.g.*, "[T]he incomplete article substantially embodies the patent because the only step necessary to practice the patent is the application of common processes or the addition of standard parts.").

[14] *Id.* at 628.

[15] *LifeScan Scot., Ltd. v. Shasta Techs., LLC*, 734 F.3d 1361 (Fed. Cir. 2013).

[16] *Id.* at 1364-65.

[17] *Id.*

alleging its manufacture and distribution of competing disposable test strips indirectly infringed LifeScan's patents.[18]

Using the analysis set forth in Quanta, the Federal Circuit held that LifeScan's sale of its glucose meters exhausted the rights to the asserted patent claims.[19] In applying the *Quanta* test, the Federal Circuit considered whether the strips themselves were inventive. But because LifeScan had originally tried and failed to obtain patent protection for the test strips alone, the court held the meter device embodied the essential inventive elements of the claims.[20] Given that the claimed inventive concept was based on the meters and not the test strips, the Federal Circuit found that the sale of the LifeScan meter exhausted LifeScan's patent rights and it could not obtain any recovery for Shasta's sale of test strips under the principles of *Quanta*.[21]

Another example of exhaustion in the context of disposable components occurred in *Keurig, Inc. v. Sturm Foods, Inc.*[22] Patentee Keurig separately sold coffee brewers and disposable coffee pods for use with these brewers. Sturm Foods ("Sturm") sold disposable coffee pods for use with Keurig's brewers. Keurig sued Sturm for infringing patent claims directed to Keurig's brewer and methods of using the brewer. However, here Keurig admitted that their brewer fully embodied the asserted apparatus claims.[23] This fatal admission resulted in a finding that the sale of the Keurig brewer exhausted the product and method claims, because both required the brewer device.[24]

In contrast, biotechnology is one area where the Supreme Court has provided an exception to the rule of patent exhaustion. As with any other product, products utilizing patented biotechnology (*e.g.*, genetically modified seed) also exhaust all patent rights upon sale of the product.[25] However, unlike products in other technological fields, biotechnology products may, in some cases, self-replicate after purchase. For example, when farmers purchase patent-protected genetically modified seed, they grow the seed and then harvest the newly produced seeds from the resulting plant. This new seed will have the same genetically modified traits as the originally purchased seed, but is not the same item.[26] The Supreme Court in *Bowman v. Monsanto Company* ruled that the

[18] *Id.* at 1365.

[19] *Id.* at 1377.

[20] *Id.* at 1370-71 (patent office rejected claims).

[21] *Id.* at 1377.

[22] *Keurig, Inc. v. Sturm Foods, Inc.*, 732 F.3d 1370 (Fed. Cir. 2013).

[23] *Id.* at 1373-74 ("Keurig . . . does not dispute that its rights in its brewers were exhausted with respect to the apparatus claims of the asserted patents.").

[24] Id. at 1374 ("'Where a person has purchased a patented machine of the patentee or his assignee, this purchase carries with it the right to the use of the machine so long as it is capable of use.'") (quoting *Quanta*, 553 U.S. at 625).

[25] See *Bowman v. Monsanto Co.*, 569 U.S. 278, 284 (2013).

[26] *Id.* at 282.

doctrine of patent exhaustion only applies to the "'particular article' sold [but] leaves untouched the patentee's ability to prevent a buyer from making new copies of the patented item."[27] To the extent that a product is able to self-replicate, copies made from the purchased product are not bound by patent exhaustion, providing at least one exception to this rule.

A recently filed case between Apple Inc. and Qualcomm Inc.[28] in the Southern District of California will take another look at the patent-exhaustion doctrine. There, Apple is defending against allegations of patent infringement by arguing Qualcomm's patent rights are exhausted by sale of its chips and that Qualcomm's separate license royalty fees are not enforceable under *Lexmark* and *Quanta*. However, because—as Apple alleges—Qualcomm uses two separate corporate entities—one to sell its chips and another to license its technology—a new question of whether exhaustion occurs may need to be considered.[29] It will be interesting to see how the court addresses this new situation.

Practitioners should consider these recent patent-exhaustion decisions when advising clients regarding their licensing and sales strategies. First, one must consider whether the patentee wishes to relinquish all patent rights or only some: Is the contemplated transaction a sale or a license? If the transaction is a license, consider what rights will be granted and what corporate entity is transferring those rights. Second, because sales of a product made outside the U.S. also exhaust domestic U.S. patent rights, a company should consider the economics of selling the patented item abroad. It may be useful to negotiate particular sales prices or royalty rates to adjust for a potential imbalance in return between country-specific prices.

Another lesson from these cases relates to obtaining sufficient patent protection for the different components of a system. The *LifeScan* and *Keurig* models are well-known to many companies, i.e., the principal appliance and the disposable refills. In such systems, it will be highly significant to obtain patent protection for each component that could potentially be sold separately. In Keurig, as with LifeScan, the way in which the patent attorneys decided to claim the device affected the outcome of the ruling. Perhaps if a patent claiming the coffee pod itself had been asserted, Keurig would have had recourse against Sturm. With separate patents in hand, a patentee may more clearly define the line between rights transferred and rights retained to avoid a situation where sale of one component exhausts the rights to a second, different, component.

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[27] *Id.* at 284 (emphasis added, citation omitted).

[28] *See Apple Inc. v. Qualcomm Inc.*, No. 3:17-cv-108-GPC-MDD (S.D. Cal. June 20, 2017), ECF No. 83 (First Am. Compl.) ¶¶ 91-93, 582-83.

[29] *Id.*

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