

Exhausted: Courts Reject Restraints On Alienation Of IP

By Jason Russell, Hillary Hamilton and Adam Lloyd

Law360, New York (July 21, 2017, 12:25 PM EDT) -- For centuries, common law has outlawed restraints on the alienation of private property. As Lord Edward Coke wrote nearly 400 years ago, a transaction where a property owner “give[s] or sell[s] his whole interest” in personal property on the condition “that the Donee or Vendee shall not alien[ate] the same” is “voi[d], because his whole interest ... is out of him, so as he hath no possibility of a Reverter, and it is against Trade and Traffi[c], and bargaining and contracting betwee[n] man and man” to permit such a restraint on later sales. 1 E. Coke, *Institutes of the Laws of England* § 360, p. 223 (1628).



Jason Russell

Intellectual property laws provide creators the right to exclude others from the control, use and distribution of their creations. These exclusive rights allow creators to obtain financial reward as an incentive to create intellectual property for the public to use and enjoy. However, courts and Congress balance these exclusive intellectual property rights with the historically enshrined right of free alienation of property by limiting a creator’s right to control distribution only to the initial sale of intellectual property — that is, once a creator sells a product, the creator can no longer use the intellectual property laws to control the subsequent distribution of that item. In patent law, this doctrine is one of common law and is referred to as “patent exhaustion.” In the copyright field, the doctrine has been codified at 17 U.S.C. § 109(a) and is generally referred to as the “first sale doctrine.”



Hillary Hamilton

These doctrines are far from new. In 1908, the U.S. Supreme Court decided *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908), holding that an author could not dictate a minimum resale price for copies of his book. The court observed that federal copyright law was not “intended to create a right which would permit the holder of the copyright to fasten ... a restriction upon the subsequent alienation of the subject-matter of copyright after the owner had parted with the title” because “one who has sold a copyrighted article, without restriction, has parted with all right to control the sale of it.” Thus, a copyright owner’s attempt to set subsequent sale prices of a work impermissibly sought to control distribution of that work, because the copyright holder was seeking “not only the right to sell the copies, but to qualify the title of a future purchaser by the reservation of the right to have the remedies of the statute against an infringer ... unless the purchaser sells at a price



Adam Lloyd

fixed [by the author.]" Instead, the Supreme Court held that a copyright owner's financial rights in the sale of a particular copy of a work are limited to receipt of a "satisfactory price" for an initial transfer.

While these well-settled principles appear indisputable, intellectual property creators still seek to skirt these restraints through increasingly inventive efforts to try to retain their rights and control such property after the initial sale. These efforts have sparked renewed interest and affirmation of the patent exhaustion and first sale doctrines in the Supreme Court and federal courts of appeals in recent years. Indeed, the Supreme Court in particular has emphatically rejected any attempt by creators to control or otherwise interfere with the distribution or use of products embodying intellectual property after the first sale has taken place.

For example, in May 2017, the Supreme Court decided *Impression Products Inc. v. Lexmark International Inc.*, removing all doubt that "a patentee's decision to sell a product exhausts all of its patent rights in that item, regardless of any restrictions the patentee purports to impose or the location of the sale." 137 S. Ct. 1523, 1529 (2017). In *Impression Products*, Lexmark sold laser printer toner cartridges at a discount price as part of its "Return Program," which required a buyer to sign a contract agreeing to use the cartridge only once and to not transfer the empty cartridge to anyone but Lexmark. Lexmark also equipped these cartridges with microchips that prevented reuse of empty cartridges. Nevertheless, *Impression Products* acquired these Return Program cartridges, disabled the microchip blocking reuse, then refilled and resold them at a lower price than Lexmark's new cartridges. *Impression Products* also imported to the United States refilled Lexmark toner cartridges that Lexmark sold abroad. Lexmark sued *Impression Products* for patent infringement. At issue in the case was whether Lexmark exhausted its patent rights (1) when it sold the Return Program cartridges subject to an express restriction on the buyer's right to reuse or resell the cartridge; and (2) when Lexmark sold its cartridges outside the United States. The Federal Circuit en banc ruled in Lexmark's favor and held that (1) if a patented item is sold subject to otherwise lawful restrictions on reuse or resale, the patent exhaustion doctrine does not apply, and thus any downstream user who violates the restriction can be liable for patent infringement; and (2) foreign sales do not exhaust a U.S. patent holder's rights in the item sold.

The Supreme Court disagreed. The court reversed the Federal Circuit on both grounds, effectively ruling that a patent holder's patent rights end absolutely upon the first sale of a patented item, without exception.

First, the court held that Lexmark "exhausted its patent rights in these cartridges the moment it sold them," because "once a patentee sells an item, it has enjoyed all the rights secured by that limited monopoly." The court observed the "inconvenience and annoyance to the public that an opposite conclusion would occasion," and noted that "Congress enacted and has repeatedly revised the Patent Act against the backdrop of the hostility toward restraints on alienation," and "[t]hat enmity is reflected in the exhaustion doctrine. ... The patent laws do not include the right to restrain further alienation after an initial sale; such conditions have been hateful to the law from Lord Coke's day to ours and are obnoxious to the public interest." The court further reasoned that "when an item passes into commerce, it should not be shaded by a legal cloud on title as it moves through the marketplace"; otherwise, patent law could "clog the channels of commerce."

Additionally, although a patent holder can place limits on licensees, if a licensee complies with the terms of the license when selling the item to a purchaser, it is as if the patent holder sold the item itself, and therefore the "[t]he sale exhausts the patentee's rights in that item." Thus, even if the purchaser does not comply with any restrictions imposed by the licensee, the only recourse is through contract law. On this point, the court concluded: "In sum, patent exhaustion is uniform and automatic. Once a patentee decides to sell — whether on its own or through a licensee — that sale exhausts its patent rights, regardless

of any post-sale restrictions the patentee purports to impose, either directly or through a license.”

Second, the court held that patent holders exhaust their patent rights upon first sale, even if the initial sale occurs abroad. The court stated that it was “straightforward” that foreign sales exhaust U.S. patent rights, because the patent exhaustion doctrine “has its roots in the antipathy toward restraints on alienation, and nothing in the text or history of the Patent Act shows that Congress intended to confine that borderless common law principle to domestic sales.” The court reiterated that “exhaustion is triggered by the patentee’s decision to give that item up and receive whatever fee it decides is appropriate for the article and the invention which it embodies,” even though the patent holder “may not be able to command the same amount for its products abroad as it does in the United States.” This is because “the Patent Act does not guarantee a particular price, much less the price from selling to American consumers,” but rather simply “ensures that the patentee receives one reward — of whatever amount the patentee deems to be satisfactory compensation for every item that passes outside the scope of the patent monopoly.”

In sum, the court held that “exhaustion occurs because, in a sale, the patentee elects to give up title to an item in exchange for payment,” and “[a]llowing patent rights to stick remora-like to that item as it flows through the market would violate the principle against restraints on alienation.”

Likewise, the court in *Kirtsaeng v. John Wiley & Sons Inc.*, addressed whether the copyright first sale doctrine applied to copies that were created and sold abroad. 133 S. Ct. 1351, 1355 (2013). John Wiley & Sons Inc., through its wholly owned subsidiary, printed and sold English-language academic textbooks abroad. The textbooks sold abroad contained a limitation that the books were authorized for sale only in Europe, Asia, Africa and the Middle East, and that exportation from or importation of the book to another region was “illegal and ... a violation of the Publisher’s rights.” While Supap Kirtsaeng, a Thai citizen, was attending college in the United States, he asked his friends and family in Thailand to buy Wiley’s English-language textbooks in Thailand, where they sold at lower prices, and send them to him in the United States. Upon receipt in America, Kirtsaeng would sell the books, reimburse his friends and family, and pocket the profit. Wiley sued Kirtsaeng for copyright infringement for unauthorized importation of its books and claimed that Kirtsaeng’s resale of the books violated Wiley’s exclusive distribution right provided by the Copyright Act. *Id.* at 1357.

The Supreme Court rejected Wiley’s arguments, reasoning that the common-law doctrine prohibiting interference with subsequent sales after the first sale, which was codified in 17 U.S.C. § 109(a), “makes no geographical distinctions,” and the court could “find no language, context, purpose, or history that would rebut a straightforward application of that doctrine here.” The court decried as “absurd” the notion that a “copyright owner can exercise downstream control even when it authorized the ... first sale.” The Supreme Court explained that the first sale doctrine has “an impeccable historic pedigree” that “emphasizes the importance of leaving buyers of goods free to compete with each other when reselling or otherwise disposing of those goods,” which “work[s] to the advantage of the consumer.” The doctrine “frees courts from the administrative burden of trying to enforce restrictions upon difficult-to-trace, readily movable goods” and “avoids the selective enforcement inherent in any such effort.”

Federal courts of appeals, taking their cue from the Supreme Court’s emphatic affirmation of the patent exhaustion and first sale doctrines, also are embracing the doctrines’ expansive scope, rebuffing attempts by patent and copyright holders to interfere in subsequent sales after the first sale of their work. For example, the Fifth Circuit recently noted that a “copyright owner will not be heard to complain of his transferee’s transferring the material object [embodying the copyright] in a way that might otherwise foul the exclusive right to distribute.” *Geophysical Serv. Inc. v. TGS-NOPEC Geophysical Co.*, 850

F.3d 785, 794 (5th Cir. 2017). Similarly, the Ninth Circuit repeatedly has affirmed the Supreme Court's expansive interpretation of the doctrines in recent years. For example, in *Omega SA v. Costco Wholesale Corp.*, the Ninth Circuit, following *Kirtsaeng*, held that "the first sale doctrine disposes of Omega's claim, resolves this case in Costco's favor, and conclusively reaffirms that copyright holders cannot use their rights to fix resale prices in the downstream market." 776 F.3d 692, 695 (9th Cir. 2015) (citing *Kirtsaeng*, 133 S. Ct. at 1366); see also *Adobe Sys. Inc. v. Christenson*, 809 F.3d 1071, 1076-77 (9th Cir. 2015) ("The practical effect of [§ 109(a)] is to significantly circumscribe a copyright owner's exclusive distribution right only to the first sale of the copyrighted work because once the copyright owner places a copyrighted item in the stream of commerce by selling it, he has exhausted his exclusive statutory right to control its distribution.") (internal quotation marks omitted). The Supreme Court's hard-line approach to restraints on alienation in the intellectual property context most recently championed in *Impression Products* likely will continue gaining traction in the lower courts.

As the Supreme Court decisions show, the court emphatically has endorsed a sweeping interpretation of the patent exhaustion and first sale doctrines. While some may see these decisions as strong medicine for creators, it is clear that potential negative practical ramifications of the court's understanding of the patent exhaustion and first sale doctrines for creators are not driving the analysis. Rather, the court focuses on the impact on "consumers" — that is, the rights of later purchasers to use or sell what they have acquired, without interference from the creator. The court's spirited explication of the doctrines indicate that any attempt by creators to use the intellectual property laws to control their products after the first sale will be met with harsh resistance by the court. Indeed, the court's use of forceful and colorful language throughout the opinions to deride such restraints as "absurd," "hateful," "hostil[e]" and "obnoxious" suggest that the court would like to put this issue to rest.

The court's robust interpretation of the patent exhaustion and first sale doctrines is likely to have significant effects on commerce. An obvious example is that companies like *Lexmark*, which have tried to restrict subsequent use and resale of their products by coupling discounts with restrictions, will not be able to use intellectual property law to enforce such restrictions. For such companies, *Impression Products* leaves them in the position of potentially suing their own customers for breach of contract or forgoing enforcement of the restrictions. Without a credible enforcement mechanism, such discount programs may vanish. Additionally, creators may think twice about pricing their products lower outside the United States, to the extent they are able, as such products can generally be imported once lawfully acquired abroad without violating intellectual property laws. Similarly, state statutes that attempt to extend intellectual property creators' rights to subsequent sales beyond the first sale are in clear conflict with the Court's expansive understanding of the federal patent exhaustion and copyright first sale doctrines.

Plaintiffs pursuing lawsuits attempting to control, enforce restrictions on, or otherwise interfere with downstream sales of intellectual property should take heed of these decisions; for defendants in such actions, the Supreme Court's recent broad interpretation of the doctrines has heavily fortified already substantial arguments for dismissal. For intellectual property creators, the decisions reiterate an explicit warning: Recover the total financial reward for intellectual property contributions to society upon the first sale, because the court will offer no relief for subsequent sales.

Jason Russell is a partner and leader of the Los Angeles litigation group at Skadden Arps Slate Meagher & Flom LLP. Hillary Hamilton and Adam Lloyd are associates in the firm's Los Angeles office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views

of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2017, Portfolio Media, Inc.