Fall 2019 www.uclajolt.com Digest 2, Issue 1

UCLA Journal of Law & Technology

JACK AND THE LICENSED BEANSTALK:

IN SEARCH OF A LICENSING TEST FOR PATENTED ARTICLES TRANSFERRED WITH CONTRACTUAL RESTRICTIONS

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Jack and the Licensed Beanstalk: In Search of a Licensing Test for Patented Articles Transferred with Contractual Restrictions

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I. **Introduction**

A United States patent owner's right to exclude others from using, offering for sale, selling, and importing a patented article is subject to the doctrine of patent exhaustion. When ownership of a patented article is transferred by sale, patent exhaustion allows the purchaser of the article to use, sell, offer for sale, and import the article without the patent owner's permission. Patent exhaustion only applies in the event that a patented article has been sold; the doctrine is not triggered when a patent owner merely licenses rights under its patent.

If a patent owner licenses rights under its patent and does not transfer a patented article incident to that license, a sale has not occurred, and patent exhaustion is unambiguously inapplicable. However, this article will argue that current United States patent law presents no tenable distinction between the sale of a patented article with contractual restrictions and the transfer of a patented article incident to a license of patent rights. While some have proposed employing tests used to distinguish between licenses and sales of copyrighted works, this article will illustrate why such copyright tests would prove unworkable under patent law.

II. **Patent Exhaustion**

35 U.S.C. § 154(a)(1) grants patent owners "the right to exclude others from making, using, offering for sale, or selling the [patented] invention throughout the United States or importing the [patented] invention into the United States."[1] A patent owner's right to exclude is subject to the judicial doctrine of patent exhaustion (unlike the corresponding first-sale doctrine of copyright

[1] 35 U.S.C. § 154(a)(1) (2012).

law,[2] patent exhaustion has not been legislatively codified[3]). Patent exhaustion prevents a patent owner from enforcing its right to exclude the use, offering for sale, sale, or importation of an article covered by the patent—a patented article—after ownership of the article is transferred by a sale.[4] The doctrine does not extend to embodiments of the article that were not sold.[5] Furthermore, the doctrine does not prevent a patent owner from exercising its right under 35 U.S.C. § 154(a)(1) to exclude the purchaser of a patented article from making additional embodiments of the article.[6]

Mitchell v. Hawley, decided by the United States Supreme Court in 1872, addressed the applicability of the patent exhaustion doctrine to a patented article that is sold unlawfully. The patent owner granted a license under a patent covering a machine for felting hats.[7] The license allowed the licensee to make machines, use machines, and license the right to use machines to third parties in Massachusetts and New Hampshire during the patent term.[8] The licensee then made and sold machines to defendants.[9] The patent term was subsequently extended for seven years,[10] and the original patent owner assigned the patent rights in Massachusetts and New

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[2] The first-sale doctrine is codified in 17 U.S.C. § 109(a), which states that the "owner of a particular copy or phonorecord" of a copyrighted work "is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord." 17 U.S.C. § 109(a) (2012); *see infra* Part VI. 17 U.S.C. § 109(a) does not specify the method by which ownership of a copy of a copyrighted work must be transferred for the first-sale doctrine to apply. *See* 17 U.S.C. § 109(a) (2012). Unlike the first-sale doctrine, patent exhaustion applies only when ownership of a patented article is transferred via a sale. *See* United States v. Univis Lens Co., 316 U.S. 241, 250 (1942).

[3] Adanna Uwazurike, *Remaking Making: Integrating Self-Replicating Technologies with the Exhaustion Doctrine*, 59 B.C. L. REV. 389, 395 (2018); Herbert Hovenkamp, *Reasonable Patent Exhaustion*, 35 YALE J. ON REG. 513, 516 (2018).

[4] Bloomer v. McQuewan, 55 U.S. 539, 549 (1852) (noting that *when a "machine passes to the hands of the purchaser, it is no longer within the limits of the [patent] monopoly. It passes outside of it, and is no longer under the protection of the [patent] act of Congress"); see also* Univis Lens Co., 316 U.S. at 250 ("[The patentee's] monopoly remains so long as he retains ownership of the patented article. But sale of it exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his patent, control the use or disposition of that article."); Impression Prods. v. Lexmark Int'l, Inc., 137 S. Ct. 1523, 1534–36 (2017) (holding that a patent owner may not exclude the importation of a patented article after that article's sale, even if the sale is outside of the United States).

[5] "[T]he [patent exhaustion] doctrine restricts the patentee's rights only as to the 'particular article' sold." Bowman v. Monsanto Co., 569 U.S. 278, 284 (2013) (citing *Univis Lens Co.*, 316 U.S. at 251).

[6] *Id.* at 280; *see also* American Cotton-Tie Co. v. Simmons, 106 U.S. 89, 94 (1882).

[7] Mitchell v. Hawley, 83 U.S. 544, 545 (1872).

[8] *Id.*

[9] *Id.* at 549.

[10] Under the Patent Act of 1836 in effect at the time of this case, the initial term of a patent could be extended for seven additional years. Patent Act of 1836, ch. 357, § 18, 5 Stat. 117, 125.

Hampshire for the extended term to plaintiff.[11] Plaintiff then sued defendants, alleging that defendants' use of the patented machines constituted patent infringement.[12] Since the purported sale of the machines by the licensee to defendants lay outside the scope of the original license grant, the Supreme Court invalidated the sale, holding that it infringed the underlying patent.[13]

In *Mitchell*, the Supreme Court distinguished between a conveyance of title (used synonymously with ownership) to a patented article via a sale on the one hand, and a conveyance of rights to make, sell, offer for sale, use, and import the patented article on the other. The latter conveyance is a grant of rights under the patent itself.[14] In contrast, conveyance of title to a patented article is a separate grant of rights that, without more, does not grant the purchaser any rights in the underlying patent.[15] In *Mitchell*, the rights granted by the original patent owner during the initial patent term—the right to make, the right to use, and the right to license the right to use to others[16]—were rights granted under the patent. The patent assignee retained the right to exclude the licensee from selling the machine, as the right to sell had not been licensed, and there had not been a lawful sale that exhausted the patent assignee's right to control future sales.[17]

In the 1913 Supreme Court case *Bauer & Cie. v. O'Donnell*, the question of whether there had been a lawful sale of a patented article was less straightforward than in *Mitchell*. Plaintiff entered into an agreement with defendant pertaining to the distribution of plaintiff's patented medicine.[18] The agreement included the following terms: the medicine "is licensed by [plaintiff] for sale and use at a price not less than one dollar ($1). Any sale in violation of this condition, or use when so sold, will constitute an infringement of our patent . . . . All rights revert to

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[11] *Mitchell*, 83 U.S. 544 at 549.

[12] *Id*.

[13] *Id.* at 551 (affirming Hawley v. Mitchell, 11 F. Cas. 883, 885 (D. Mass. 1871) ("The very act of sale was a violation of the [license] contract and an act of infringement.")).

[14] *Id.* at 548 ("Purchasers of the exclusive privilege of making or [selling] the patented machine hold the whole or a portion of the franchise which the patent secures . . . ."). While the Supreme Court mentioned only making and selling, patent owners may also grant rights to use (as was granted in this case), offer for sale, and import. 35 U.S.C. § 154(a)(1) (2012).

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> [T]he purchaser of the . . . machine . . . does not acquire any right to construct another machine either for his own use or to be [sold] to another . . . . Complete title to the . . . machine purchased becomes vested in the vendee by the sale and purchase, but [the vendee] acquires no portion of the [patent] franchise, as the machine, when it rightfully passes from the patentee to the purchaser, ceases to be within the limits of the [patent] monopoly.

Mitchell, 83 U.S. 544 at 548.

[16] *Id.* at 545.

[17] *Id.* at 549–50.

[18] *Bauer & Cie. v. O'Donnell, 229 U.S. 1, 8–9 (1913).*

[plaintiff] in the event of a violation."[19] Plaintiff then sued defendant for patent infringement after defendant sold the medicine for less than one dollar.[20] Plaintiff alleged that the agreement gave defendant the right under the patent to use the patented medicine but did not transfer title of the medicine to defendant.[21] Under plaintiff's interpretation of the agreement, defendant could not avail itself of the patent exhaustion doctrine to avoid the sale restriction. The Supreme Court ruled against plaintiff, holding that the agreement resulted in a sale that transferred title of the medicine to defendant.[22] The Court stated that "the title transferred was full and complete" and that it would be a "perversion of terms to call the transaction in any sense a license [under the patent] to use the invention."[23] In making this conclusion, the Court reasoned that the medicine was purchased at a presumably "satisfactory" price and that "[t]he patentee had no interest in the proceeds of the subsequent sales, no right to any royalty thereon, or to participation in the profits thereof."[24] As a result of the sale, plaintiff's rights to control future sales of the medicine were exhausted, and the sale restriction in the agreement was unenforceable under patent law.[25]

The Supreme Court further clarified the distinction between licensing rights under a patent, as in *Mitchell*, and transferring title to a patented article via a sale, as in *Bauer*, in the 1926 case *United States v. General Electric Co.* The Court held that the licensing of patent rights does not prevent a patentee from restricting the licensee's subsequent sale of patented articles, "provided [that] the conditions of sale are normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly."[26] On the other hand, "a patentee may not attach to the article made by

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[19] *Id*.
[20] *Id.* at 9.
[21] *Id.* at 16.
[22] *Id.*
[23] *Id.* Although the Court found a sale here, it leaves open the possibility of certain transactions being classified as licenses under patents rather than sales. *See id.* at 15 ("[T]here are several substantive [patent] rights, and each is the subject of subdivision, so that one person may be permitted to make, but neither to sell nor use, the patented thing. To another may be conveyed the right to sell, but within a limited area, or for a particular use, while to another the patentee may grant only the right to make and use, or to use only for specific purposes.") (citations omitted).
[24] *Id.* at 16.
[25] *Id.* at 17. In *Henry v. A.B. Dick Co.*, decided one year before *Bauer*, the Supreme Court upheld a sale restriction accompanying a patented mimeograph stating that the mimeograph could only be used with "stencil paper, ink, and other supplies made by [the patent owner]." Henry v. A.B. Dick Co., 224 U.S. 1, 11 (1912). The *Bauer* Court distinguished *Henry*, stating that, "[w]hile the title was transferred, it was a qualified title." *Bauer*, 229 U.S. at 15. *Henry* was subsequently overruled on antitrust grounds. *See* Motion Pictures Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 518 (1917). Nonetheless, the concept of a qualified transfer of title, as distinct from an absolute transfer, is similar to the conditional sale doctrine. This doctrine was pronounced by the United States Court of Appeals for the Federal Circuit in 1992 but was ultimately overruled by the Supreme Court in *Lexmark*. *See infra* Parts III, V.
[26] United States v. Gen. Elec. Co., 272 U.S. 476, 490 (1926).

him . . . a condition running with the article in the hands of purchasers limiting the price at which one who becomes its owner for full consideration shall part with it."[27] *Mitchell*, *Bauer*, and *General Electric Co.* suggest that title to a patented article is conveyed via a sale (thereby triggering patent exhaustion) when: (i) the patent owner (or the patent owner's licensee, in a manner authorized by its license grant) transfers the patented article for a purchase price representing full consideration; and (ii) the patent owner has no financial interest or right to receive royalties from future sales of the article.

III. <u>**The Conditional Sale Doctrine**</u>

The United States Court of Appeals for the Federal Circuit created an exception to the patent exhaustion doctrine known as the conditional sale doctrine in 1992. In *Mallinckrodt, Inc. v. Medipart, Inc.*, plaintiff sold patented medical devices with a "single use only" notice.[28] Defendant purchased these devices and used them more than once, in violation of the notice. Plaintiff then sued for patent infringement.[29] The Federal Circuit reversed the district court's summary judgment ruling of non-infringement, stating that the transfer of title to a patented article via a conditional sale would not exhaust the patent owner's ability to control the further use and sale of the article.[30] The Court defined a conditional sale as one that is "validly conditioned" on a "restriction . . . within the scope of the patent grant or otherwise justified."[31]

The 2008 Supreme Court case *Quanta Computer, Inc. v. LG Electronics, Inc.* appeared to endorse the conditional sale doctrine, although it did not cite to *Mallinckrodt*. Plaintiff LG Electronics (LGE) entered into two agreements with Intel Corporation (Intel).[32] A license agreement granted Intel rights under several LGE method patents to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" Intel products covered by LGE's patents.[33] The license agreement also stated that a license was not granted to any third party to combine Intel products received pursuant to the agreement with any products not manufactured by LGE or Intel.[34] A second master agreement between LGE and Intel required Intel to notify its customers that Intel's license from LGE did not cover products made by "combining an Intel

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[27] *Id.* at 494.
[28] Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 701 (Fed. Cir. 1992) (*overruled by* Impression Prods. v. Lexmark Int'l, Inc., 137 S. Ct. 1523 (2017)).
[29] *Id.* at 702.
[30] *Id.* at 709.
[31] *Id.* The Federal Circuit remanded the case to the district court to determine if there had been a conditional sale. *Id.*
[32] Quanta Comput., Inc. v. LG Elecs., Inc., 553 U.S. 617, 623 (2008).
[33] *Id.*
[34] *Id.*

product with any non-Intel product."[35] The master agreement also included a provision noting that a breach of the master agreement would not result in termination of the license agreement.[36] LGE sued Quanta, an Intel customer, after Quanta combined a non-Intel product with a product purchased from Intel pursuant to Intel's LGE license agreement.[37]

In *Quanta*, the Supreme Court analyzed the effect of the combination restriction in the license agreement and the notification provision in the master agreement on the exhaustion of LGE's method patents.[38] The Court held that patent exhaustion applied to Quanta's purchase from Intel.[39] The license agreement, while containing a provision that a license was not granted to third parties to combine Intel products with non-Intel products, did not restrict (or condition, using *Mallinckrodt*'s terminology) Intel's sales.[40] Intel's sales were similarly not conditioned on providing notice to customers in accordance with the master agreement, as the master agreement stated that a failure to provide notice would not terminate the license agreement.[41] The Supreme Court's analysis suggests that if Intel's sales had been conditioned, patent exhaustion would not apply. Thus, *Quanta* implicitly leaves the conditional sale doctrine intact.

IV. The *McFarling* Trilogy

In *Monsanto Co. v. McFarling*, the Federal Circuit ruled on patent exhaustion in the context of second-generation soybean seeds. This case was heard by the Federal Circuit three times—in 2002,[42] 2004,[43] and 2007.[44]

In the *McFarling* cases, Monsanto obtained utility patents covering genetically modified soybeans that display resistance to specific herbicides, along with the seeds for such plants and the "isolated DNA sequence" for the modified gene itself.[45] Monsanto granted certain seed distribution companies the right to "insert [Monsanto's patented gene] into . . . their own seeds" in order to create genetically modified seeds (for which Monsanto also held the patent, as noted

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[35] *Id.* at 623–24.
[36] *Id.* at 624.
[37] Id.
[38] *Id.* at 636. The Court considered whether patent exhaustion applied to method patents and concluded that a method patent is exhausted when an article that "substantially embodies" the patent is sold. *Id.* at 638. The articles sold in this case were found to meet the substantial embodiment test. *Id.*
[39] *Id*.
[40] *Id.* at 636.
[41] *Id.* at 636–37.
[42] Monsanto Co. v. McFarling (*McFarling I*), 302 F.3d 1291 (Fed. Cir. 2002).
[43] Monsanto Co. v. McFarling (*McFarling II*), 363 F.3d 1336 (Fed. Cir. 2004).
[44] Monsanto Co. v. McFarling (*McFarling III*), 488 F.3d 973 (Fed. Cir. 2007).
[45] *McFarling II*, 363 F.3d at 1338–39.

above).[46] Monsanto granted the seed distribution companies the additional right to distribute these first-generation seeds to farmers.[47] As part of the distributions, the companies were required to have the farmers sign a technology agreement.[48] The technology agreement included a "license fee" that the farmers owed to Monsanto for each bag.[49] The agreement also limited the permitted use of the seeds to "planting a commercial crop only in a single season" and stated that a "licensee" could not "save any crop produced from [the first-generation] seed for replanting, or supply saved seed to anyone for replanting."[50] Defendant McFarling received seeds lawfully from Monsanto via a distributor but then breached the technology agreement he signed by saving soybean crops produced from the first-generation seeds and planting the crops as seeds to grow second-generation plants.[51] Monsanto sued McFarling for patent infringement, but McFarling argued that he was not liable due to patent exhaustion.[52] In 2002, the Federal Circuit held that patent exhaustion did not protect McFarling with respect to the second-generation seeds.[53] Firstly, McFarling did not receive the second-generation seeds via a sale.[54] Additionally, "the original sale of the [first-generation] seeds did not confer a license to construct new seeds."[55]

The *McFarling* cases highlight the lack of a clear distinction between the sale of a patented article and the transfer of a patented article incident to a license of patent rights. In earlier patent exhaustion cases, a grant of rights under a patent, such as the right to make and use a patented article, without the transfer of the article, was classified as a license.[56] On the other hand,

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[46] *Id.*; *McFarling I*, 302 F.3d at 1293.
[47] *McFarling II*, 363 F.3d at 1338–39; *McFarling I*, 302 F.3d at 1293.
[48] *McFarling II*, 363 F.3d at 1338–39; *McFarling I*, 302 F.3d at 1293.
[49] *McFarling I*, 302 F.3d at 1293.
[50] *McFarling II*, 363 F.3d at 1338–39.
[51] *McFarling I*, 302 F.3d at 1293.
[52] *Id.* at 1294, 1298. McFarling also argued that he was entitled to save seeds under Section 2543 of the Plant Variety Protection Act. *McFarling I*, 302 F.3d at 1299. The Court held that this act, which pertains to plant patents, was not applicable because Monsanto's patents covering the genetically modified seeds were utility patents. *Id*; 7 U.S.C. § 2543 (2000). The Patent Act (codified in Title 35 of the United States Code) does not allow for the right to save seeds covered by a utility patent. *McFarling I*, 302 F.3d at 1299.
[53] *Id*.
[54] *Id*.
[55] *Id.* The Federal Circuit and Supreme Court reached the same conclusion with regard to second-generation seeds in the subsequent cases *Monsanto Co. v. Scruggs* and *Bowman v. Monsanto Co.*, respectively. *See* Bowman v. Monsanto Co., 569 U.S. 278, 284–85 (2013); Monsanto Co. v. Scruggs, 459 F.3d 1328, 1336 (Fed. Cir. 2006).
[56] *See, e.g.*, Mitchell v. Hawley, 83 U.S. 544, 545 (1872). As noted in Part II above, the licensee in this case received a license under the patent to make, use, and license the right to use with respect to patented

transfers of patented articles were classified as either conditional or unconditional sales.[57] In *McFarling*, first-generation seeds were transferred from distribution companies to farmers, yet the Federal Circuit refers to the transfer as a sale at some points in its opinions and a license at others. The Federal Circuit characterized the transfers primarily as sales in its 2002 opinion.[58] However, in 2004, the Court referred to the seed transfers as licenses, stating that the "seed companies execute[d] licenses, rather than . . . unconditional sales, [of the first-generation soybean seeds] with their farmer customers."[59] The Federal Circuit does not provide a clear test for determining when the transfer of a patented article with contractual restrictions will be considered a sale and when it will be considered only incident to a patent license.

V. A Transfer Incident to a License, or a Perversion of Terms?

The conditional sale doctrine pronounced in *Mallinckrodt* and implicitly accepted in *Quanta* was overruled in the 2017 Supreme Court case *Impression Products, Inc. v. Lexmark International, Inc.* Plaintiff Lexmark distributed toner cartridges via two different plans.[60] Under the first plan, customers purchased cartridges at full price.[61] Under the second plan, known as the "Return Plan," customers purchased cartridges at a discounted price and were required to sign a contract.[62] The contract provided that Return Plan cartridges could be used only once and could

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machines. *Id.* The machines were not considered sold to the licensee because the machines were not transferred to the licensee; rather, the licensee made them. *Id.* at 549.

[57] *See, e.g.*, *Bauer & Cie. v. O'Donnell, 229 U.S. 1, 8–9 (1913)*; Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 701 (Fed. Cir. 1992) (*overruled by* Impression Prods. v. Lexmark Int'l, Inc., 137 S. Ct. 1523 (2017)); *supra* Part II–III.

[58] *McFarling I*, 302 F.3d at 1293 (explaining that "Monsanto authorizes various companies to manufacture the patented seeds, which are then *sold* to farmers" along with a technology agreement) (emphasis added). The Court in 2002 did refer to the farmers as licensees at certain points in its opinion, however. *See, e.g.*, *id.* at 1293 ("The agreements include the requirement that the seeds are to be used 'for planting a commercial crop only in a single season' and direct the *licensee* not to 'save any crop produced from this seed for replanting, or supply saved seeds to anyone for replanting.'") (emphasis added). The court also referred to the "license fee" that farmers owed Monsanto per each bag of genetically modified seeds, as noted above. *Id.*

[59] *McFarling II*, 363 F.3d at 1339. In *McFarling II*, the Court also referred to the first-generation seeds as "licensed soybeans." *Id.* The Federal Circuit in 2004 did not address the possibility of a conditional sale. *See id.* In McFarling's third and final appeal in 2007, the Federal Circuit reverted to classifying the distribution company's transfer of seeds to farmers as sales. *See McFarling III*, 488 F.3d 973, 976 (Fed. Cir. 2007) (explaining that "Monsanto distributed the patented seeds by authorizing various companies to produce the seed and *sell* them to farmers" along with a technology agreement) (emphasis added).

[60] Impression Prods. v. Lexmark Int'l, Inc., 137 S. Ct. 1523, 1529 (2017).

[61] *Id.*

[62] *Id.* at 1529–30.

not be transferred to third parties.[63] Lexmark attached microchips to Return Plan cartridges to prevent these cartridges from being reused.[64] Lexmark sued Impression Products for patent infringement after Impression Products circumvented the microchip technology and then refilled and resold Return Plan cartridges.[65] The Court found that "express restriction[s]" do not limit patent exhaustion's applicability.[66] Therefore, the conditional sale of a patented article exhausts the patent holder's rights to exclude the use, sale, offering for sale, and importation of the article.[67] Lexmark's Return Plan restrictions "may have been clear and enforceable under contract law, but they do not entitle Lexmark to retain patent rights in an item that it has elected to sell."[68]

The Supreme Court notes in *Lexmark* that a patentee may license individual rights under its patent: "The patentee [may] agree[] not to exclude a licensee from making or selling the patented invention . . . . Because the patentee is exchanging rights, *not goods*, it is free to relinquish only a portion of its bundle of patent protections."[69] The Court distinguishes a license from "an item [that] passes into commerce."[70] However, it is possible for an item to pass into commerce via a license. Since a patentee is free to relinquish only a portion of its patent rights, the patentee must be able to license certain rights to the patented article—for example, the right to use the article—without conveying the right to make the article.[71] To enable such a license, the patentee must transfer the article to the licensee. On its surface, this license transaction, in which the patent licensee has received the right to use, but not to make, a patented article, is economically identical to a sale transaction in which the patented article has been sold to a purchaser—a patented article has been transferred, and money has exchanged hands. Although these transactions are economically identical, patent exhaustion will apply only to the sale, not to the license. Thus, the patent owner will always characterize the transaction as a transfer of an article incident to a license, while the article transferee will always characterize the transaction as a sale. This is, in fact, the issue that arose in *Bauer*—the patentee claimed that it had licensed the rights to use and sell the medicine to defendant, in which case patent exhaustion would not be triggered

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[63] *Id*.
[64] *Id.* at 1530.
[65] *Id*.
[66] *Id.* at 1532–33.
[67] *Id.* at 1534. If a patent owner licenses certain patent rights, including the right to sale, to a licensee, patent exhaustion similarly applies following the licensee's sale of the patented article to the ultimate purchaser. *Id.* at 1535.
[68] *Id.* at 1531.
[69] *Id.* at 1534 (emphasis added); *see supra* note 23.
[70] *Id*.
[71] The patent owner may convey the right to use its patented article for any purpose or for only a limited set of purposes. *See supra* note 23.

and the patentee could place reasonable restrictions on future sales.[72] The Court found, however, that the patentee's use of the word "license" in its contract with defendant was a "perversion of terms" and that the transaction was actually a sale to which patent exhaustion did apply.[73]

As noted above,[74] *Mitchell*, *Bauer*, and *General Electric Co.* suggest a two-part test for determining when a patent owner has conveyed title to a transferred patented article via a sale (as opposed to transferring the patented article incident to a patent license): (i) the patent owner (or the patent owner's licensee, in a manner authorized by its license grant) transfers the patented article for a purchase price representing full consideration; and (ii) the patent owner has no financial interest or right to receive royalties from future sales of the article.

In practice, however, the first part of this test would prove unworkable—as noted above, the transfer of a patented article for full consideration via a sale may look economically identical to a transfer of that article incident to a license of patent rights. In *Lexmark*, for instance, Impression Products purchased the Return Plan cartridges at a discounted price, as compared to the price of Lexmark's cartridges distributed without contractual restrictions.[75] The Return Plan cartridges could be considered sold for full consideration of their title (thereby triggering patent exhaustion), with the price discount simply reflecting the contractual restrictions. Alternatively, the Return Plan cartridges could be considered transferred (but not sold) incident to Lexmark's licensing the limited patent right to use the cartridges. Under this latter interpretation, the price paid would simply reflect the value of the limited use right that was licensed (and patent exhaustion would not apply because there was no sale). Under either interpretation of the transaction, printer cartridges have been transferred in exchange for money. It is not clear whether the transaction is properly characterized as a sale (which the Supreme Court assumed) or a patent license to use.

The second part of the licensing test discussed in earlier exhaustion case law is also problematic. In order to determine whether or not the patent owner is capable of having a future financial interest in a patented article, it first must be determined whether or not the patented article has been sold. If the article has been sold, patent exhaustion will prevent the patent owner from having an enforceable financial interest in the article under patent law. If the article has been licensed instead, the patent owner may have a continued financial interest in the article. The potential financial interest will depend on whether the right to sell the article has been granted to the article transferee, and whether the license agreement specifies that the article transferee owes the patentee a royalty fee for each article sold. Since the enforceability of a patentee's purported financial interest in a transferred patented article requires a prior determination of whether the

[72] *Bauer & Cie. v. O'Donnell, 229 U.S. 1, 8–9 (1913).*
[73] *Id.* at 16; *see supra* Part II.
[74] *See supra* Part II.
[75] *Lexmark*, 137 S. Ct. at 1529–30.

article has been sold, the purported financial interest cannot be used to make this determination in the first place.

The transfer of a patented article with contractual restrictions in exchange for payment may indicate either that (i) the patent owner has sold the article and placed contractual restrictions on it; or (ii) the patent owner has licensed rights under its patent and transferred the article incident to the license. There is no clear distinction between these two alternatives under current United States patent law. The next part of this article will discuss other tests that have been proposed to distinguish patent licenses from sales and show why these tests are unworkable.

VI. Proposed Licensing Tests for Transferred Patented Articles

17 U.S.C. § 106 under the Copyright Act is similar to 35 U.S.C. § 154(a)(1) under the Patent Act. 17 U.S.C. § 106 grants a copyright owner six exclusive rights, including the rights "to distribute copies or phonorecords[76] of the copyrighted work" and "to reproduce the copyrighted work in copies or phonorecords."[77] While 35 U.S.C. § 154(a)(1) grants patent holders the right to exclude others from using their patented articles, 17 U.S.C. § 106 does not grant copyright owners the right to use copies of the copyrighted work.[78] Thus, in copyright law, the right to "use" is not statutory in nature.

Transferred copies of copyrighted works may be considered to have exchanged ownership or to have been simply licensed.[79] In 2010, the United States Court of Appeals for the Ninth Circuit pronounced a three-factor test for distinguishing between owners and licensees of software copies. The Ninth Circuit stated that the user of a copy of a copyrighted software program "is a licensee rather than an owner of a copy where the copyright owner: (1) specifies that the user is granted a license;(2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions."[80]

Jiang Bian suggests that the *Vernor* licensing test can be used to distinguish between licenses and sales in patent law as well as copyright law.[81] Moreover, this author has addressed the

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[76] Phonorecords are "material objects in which sounds . . . are fixed." 17 U.S.C. § 101 (2012).
[77] *Id.* § 106.
[78] *See id*.
[79] The importance of this distinction lies in the fact that, under the first-sale doctrine, a copyright owner loses certain rights in copies of copyrighted works following a transfer of ownership. *See supra* notes 2, 7. For purposes of brevity, this article will refer to copies of copyrighted works as "copies."
[80] Vernor v. Autodesk, 621 F.3d 1102, 1111 (9th Cir. 2010).
[81] Jiang Bian, *The Supreme Court Says Conditional and Foreign Sales Cannot Avoid IP Exhaustion--What Should IP Owners Do?: An Analysis of the Supreme Court's IP-Exhaustion Jurisprudence*, 45 AIPLA Q.J. 671, 716–21 (2017).

shortcomings of the test in copyright law and proposed a new licensing test to overcome these shortcomings.[82] The new test analyzes the contractual terms accompanying an electronic copy and considers: (1) Non-statutory limitations in which the copyright holder preserves title to the copy;(2) Non-statutory limitations in which the copyright holder preserves control over the copy; and (3) Non-statutory limitations that do not directly relate to title or control of the copy and that restrict use of the copy beyond the typical use of such copy by an owner.[83] While the presence of the word "license" could not be considered under copyright law, it may be considered as an additional fourth factor of the licensing test under patent law.[84]

The licensing test proposed above, while overcoming the deficiencies of the *Vernor* test, is not of help in determining whether a patented article transferred with contractual restrictions has been sold. Firstly, contractual use restrictions unrelated to title or control in factor three cannot be considered. As noted above, patent law differs from copyright law in that the right to use a patented article is statutorily based on the patent owner's right to exclude others from using the article under 35 U.S.C. § 154(a)(1). Consequently, the transferee of a patented article may not use the article unless (a) the right has been granted to the transferee; or (b) the patent owner's right to exclude is rendered unenforceable under the patent exhaustion doctrine after the article's sale. If a patent owner transfers (but does not sell) a patented article and grants a license under its patent to use the article for purpose X, the article cannot be used for purposes other than X. Therefore, a contractual provision stating that the article may not be used for purpose Y is redundant. If, on the other hand, the patent owner sells the patented article, a contractual provision stating that the article may not be used for purpose Y is no longer redundant. Without this provision (which, as a result of patent exhaustion, would be enforceable only under contract

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[82] *See* Elliot Horlick, *License Your Cake and Eat it Too: Creating a Uniform Licensing Test for Copyrighted Electronic Works*, 1 UCLA J. L. TECH. DIGEST 1 (2019).

[83] *Id*.

[84] As this author has previously noted, under copyright law, the word "license" can refer to both a copyright and a copy of a copyrighted work: "[T]he word 'license' may refer to the copyright rather than the copy of the copyrighted work. Automatically associating 'license' with the copy presupposes a contractual interpretation that benefits the copyright holder." *Id.* at 10. Thus, the word cannot be used to determine whether a copyrighted work has been licensed. Under patent law, however, the word "license" refers to a licensing of rights under a patent rather than goods. See *Lexmark*, 137 S. Ct. at 1534 ("The patentee [may] agree[] not to exclude a licensee from making or selling the patented invention . . . . Because the patentee is exchanging rights, not goods, it is free to relinquish only a portion of its bundle of patent protections."). The word "license" therefore may be considered in deciding whether a transferred patented article has been licensed or sold.
However, as noted in *Bauer* and below, a patentee's attempt to create a license rather than a sale simply by inserting the word "license" into a contract may be a "perversion of terms." *Bauer & Cie. v. O'Donnell, 229 U.S. 1, 16 (1913).*

law[85]), the purchaser of the article would be able to use the article for Purpose Y. The contractual prohibition, if redundant, is not imposing additional restrictions on the licensee's use of the article. Furthermore, in order to conclude that the prohibition is redundant, it first needs to be determined that the patented article was not sold. Similarly, in order to conclude that the provision is not redundant, it first needs to be determined that the article was sold. Therefore, a contractual use prohibition on a patented article cannot be used to determine whether the article has been sold in the first place. Assuming, as in *Lexmark*, that a use restriction is not enforceable under patent law presupposes that the patented article is sold—that is to say, it puts the cartridge before the horse.

Preservation of control in factor two of the licensing test above also cannot be used to decide whether or not a patented article transferred with contractual restrictions has been sold. A contractual preservation of control over a patented article, such as limiting use of the article to a specified geographic location, raises the same issues as those noted in the preceding paragraph about use restrictions more generally. The preservation of control is either redundant, in which case it is not imposing any additional restrictions on the patented article (and in which case it must have already been determined that the article has not been sold), or enforceable only under contract law, in which case it must have already been determined that the article has been sold.

Lastly, relying solely on the patentee's purported retention of title to the patented article under factor one of the licensing test, or classification of the transaction as a license under factor four of the licensing test, affords too much discretion to the patentee. A patent owner intending to sell a patented article yet wishing to circumvent the effects of patent exhaustion could simply insert the magic word "license" in a contract or claim to retain title to the article. Classifying a transaction as a license solely as a result of these statements by a patentee could be, as the *Bauer* court noted, a "perversion of terms."[86] The word "license" and the patentee's retention of title are therefore insufficient in and of themselves to determine whether or not a patented article has been sold.

VII. <u>Conclusion</u>

There is no clear distinction between (i) the sale of a patented article with accompanying contractual restrictions; and (ii) and the transfer of that article incident to a license of patent rights. Relying on *Lexmark*, courts are likely to conclude that a patented article is sold any time it is transferred, thereby triggering the patent exhaustion doctrine. This conclusion, however, is antithetical to the Supreme Court's assertion that a "patentee . . . exchanging rights [but] not

[85] *See* Impression Prods. v. Lexmark Int'l, Inc., 137 S. Ct. 1523, 1529 (2017) (noting that Lexmark's Return Plan restrictions "may have been clear and enforceable under contract law, but they do not entitle Lexmark to retain patent rights in an item that it has elected to sell"). *See also supra* Part V.
[86] *Bauer, 229 U.S. at 16.*

goods . . . is free to relinquish only a portion of its bundle of patent protections."[87] It seems that a patent owner wishing to relinquish only a portion of rights from its "bundle of patent protections" may lose more rights than it intended.

[87] *Lexmark*, 137 S. Ct. at 1531.