

Patent Exhaustion and the Exhausted Defendant: Why Parties Should Not be Able to Contract Around Exhaustion in Settling Patent Litigation

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Abstract

Can parties draft a patent license agreement that precludes or limits application of the exhaustion doctrine? Courts and commentators have noted that the law is currently ambiguous. Although the Supreme Court held in *Quanta Computer, Inc. v. LG Electronics, Inc.* that the license agreement at issue in that case failed to contract around exhaustion, it could be that a properly drafted provision would avoid exhaustion. On the other hand, the case may be read as dismissing the effectiveness of post-sale restrictions altogether, overruling Federal Circuit precedent that post-sale restrictions can defeat patent exhaustion. A third possibility is that clauses purporting to restrict the use of licensed products by downstream purchasers may be enforced as breach of contract claims between the parties to the license, but are ineffective at preserving patent infringement remedies against downstream purchasers.

This ambiguity serves as a practical barrier to settling patent lawsuits. Many patent-holders are reluctant to grant a settlement license that could preclude them from pursuing licenses or infringement litigation against downstream purchasers. This article catalogues and assesses potential licensing solutions that would arguably preserve the ability of the patent-holder to enforce patents, or at least collect royalties, downstream.

But should parties be allowed to contract around exhaustion in settling patent litigation? Although various commentators argue that it is economically efficient to allow patent-holders to license their patents at multiple points along the production chain, the litigation settlement context distorts these efficiencies. The expense and risk of litigation, the threat of injunctions, and the pressure to settle can weigh heavily against the patent infringement defendant in its consideration of the effects of the settlement on downstream purchasers. The license fee that is negotiated may not be sufficiently discounted to account for the reservation of downstream rights preserved by the patent holder. The patent holder will be overcompensated for the rights it cedes and able to achieve a double recovery if allowed to pursue downstream purchasers. If, instead, there is a clear rule against contracting around exhaustion, the parties will set the license fee at a rate that gives the patent holder full compensation up front, and the defendant can simply pass along this extra cost to downstream purchasers. This efficiently avoids the costs of additional licensing negotiations or litigation against downstream purchasers.

A clear prohibition would be more judicially efficient as well. Although it may result in making the settlement of the initial case more difficult, it would preclude the multiplication of lawsuits against downstream purchasers.

Finally, there is scant evidence to suggest that strengthening the exhaustion doctrine discourages innovation. Historically, as the exhaustion doctrine has been strengthened or loosened, it has had no corresponding impact on the number of patent applications, which have continued to rise without relation to the courts' pronouncements on exhaustion.