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IpQ

ENHANCING YOUR IP IQ

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KEY IDEAS:

ANALYZING PATENT EXHAUSTION – TIRED YET?

The U.S. Supreme Court has long championed the doctrine of patent exhaustion.[1] Under this doctrine—also known as the "first-sale doctrine"—a patentee who sells a product embodying the invention (either directly or through an authorized licensee) cannot bring an action against purchasers for reselling that product.[2] Because the patentee's rights are considered "exhausted" by virtue of the first authorized sale, the patentee cannot seek royalties from secondary buyers in the supply chain.[3]

This sure sounds simple. In fact, until last year, the U.S. Supreme Court had not interpreted the doctrine of patent exhaustion since 1942.[4] But that status has changed. Recently, both the U.S. Supreme Court and the Federal Circuit Court of Appeals (CAFC) have revisited patent exhaustion, and an awareness of those decisions and some open questions ought to be a part of your IP IQ.

A. Quanta and Three Rules of Patent Exhaustion

Quanta Computer, Inc. v. LG Electronics, Inc.[5] involved a patent infringement dispute between LG Electronics, Inc. (LGE) and a group of computer manufacturers, including Quanta Computer, Inc.[6]

LGE owned three patents related to personal computers.[7] In September 2000, LGE and Intel Corp. entered into (1) a cross-licensing agreement, and (2) a Master Agreement relating to LGE's three patents.[8] The license agreement: (1) allowed Intel to make, use and sell products, including microprocessors and chipsets that used LGE's patents;[9] (2)

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1 *Quanta Computer, Inc. v. LG Elecs., Inc.*, ___ U.S. ___, 128 S. Ct. 2109, 2113 (2008) ("For over 150 years this Court has applied the doctrine of patent exhaustion to limit the patent rights that survive the initial authorized sale of a patented item.").

2 *See, e.g., Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 516 (1917) ("[T]he right to vend is exhausted by a single, unconditional sale, the article sold being thereby carried outside the monopoly of the patent law and rendered free of every restriction which the vendor may attempt to put upon it.").

3 *See id.*

4 *See United States v. Univis Lens Co.*, 316 U.S. 241 (1942).

5 ___ U.S. ___, 128 S. Ct. 2109 (2008).

6 *Id.* at 2114 ("Petitioners, including Quanta Computer (collectively Quanta), are a group of computer manufacturers.").

7 *See id.* at 2113-14.

8 *Id.* at 2114 ("LGE licensed a patent portfolio, including the LGE Patents, to Intel Corporation (Intel)").

9 *Id.* ("The License Agreement authorizes Intel to "'make, use, sell (directly or indirectly), offer to sell, import or

stipulated that no license was granted to any third party to combine licensed products with components from sources other than Intel;[10] and (3) affirmed that, "the parties agree that nothing herein shall in any way limit or alter the effect of patent exhaustion that would otherwise apply when a party hereto sells any of its Licensed Products."[11] The Master Agreement required Intel to notify prospective purchasers, like Quanta, that buying Intel chips did not authorize the combination of those chips with non-Intel components in a manner that infringes LGE's patents.[12]

LGE's patents did not cover the products licensed to Intel or the products sold by Intel to others. The patents did, however, cover products manufactured by Intel when combined with other components in personal computers.[13]

Quanta purchased microprocessors and chipsets from Intel and received the notice required by the Master Agreement.[14] Quanta then incorporated the Intel products into computers using non-Intel parts, practicing the LGE Patents in ways not authorized by the Intel-LGE license agreement or the Master Agreement.[15] LGE subsequently sued Quanta alleging infringement.[16]

The Federal Circuit reversed the district court's decision that LGE's patents were exhausted by Intel's secondary sale to Quanta. In doing so, the Federal Circuit said patent

otherwise dispose of'" its own products practicing the LGE Patents."). *See also LG Elecs., Inc. v. Asustek Computer, Inc.*, 248 F. Supp. 2d 912, 914 (N.D. Cal., 2003), *rev'd in part*, 453 F.3d 1364 (Fed. Cir. 2006), *rev'd*, ___ U.S. ___, 128 S. Ct. 2109 (2008) ("The license gives Intel the right to manufacture products that would otherwise infringe any of the patents owned by LGE, including the patents at issue here.").

10 *Id.* at 2114 ("Notwithstanding this broad language, the License Agreement contains some limitations. Relevant here, it stipulates that no license '"is granted by either party hereto . . . to any third party for the combination by a third party of Licensed Products of either party with items, components, or the like acquired . . . from sources other than a party hereto, or for the use, import, offer for sale or sale of such combination."') (citation to record omitted).

11 *Id.* (citation to record omitted).

12 *Id.* ("In a separate agreement (Master Agreement), Intel agreed to give written notice to its own customers informing them that, while it had obtained a broad license '"ensur[ing] that any Intel product that you purchase is licensed by LGE and thus does not infringe any patent held by LGE,"' the license '"does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product."') (citation to record omitted).

13 *LG Elecs., Inc. v. Bizcom Elecs., Inc.*, 453 F.3d 1364, 1369 (Fed. Cir. 2006) ("The patents asserted by LGE do not cover the products licensed to or sold by Intel; they cover those products when combined with additional components.").

14 *Quanta Computer*, 128 S. Ct. at 2114, *LG Elecs., Inc.*, 453 F.3d at 1368 ("Defendants purchase microprocessors and chipsets from Intel or its authorized distributors and install them in computers. Intel is authorized to sell these products to defendants under an agreement with LGE. However, pursuant to this agreement, Intel notified defendants that, although it was licensed to sell the products to them, they were not authorized under that agreement to combine the products with non-Intel products.").

15 *Quanta Computer,* 128 S. Ct. at 2114 ("Quanta purchased microprocessors and chipsets from Intel and received the notice required by the Master Agreement. Nonetheless, Quanta manufactured computers using Intel parts in combination with non-Intel memory and buses in ways that practice the LGE Patents. Quanta does not modify the Intel components and follows Intel's specifications to incorporate the parts into its own systems.")

16 *See id.* at 2114 ("LGE filed a complaint against Quanta, asserting that the combination of the Intel Products with non-Intel memory and buses infringed the LGE Patents."). *See LG Elecs., Inc.*, 453 F.3d at 1368 ("LGE brought suit against defendants, asserting that the *combination* of microprocessors or chipsets with other computer components infringes LGE's patents covering those combinations. LGE did not assert patent rights in the microprocessors or chipsets themselves."). *See also LG Elecs., Inc.*, 248 F. Supp. 2d at 914 ("LGE alleges that the computers that incorporate these microprocessors and chipsets infringe its patents.").

exhaustion applies only to "unconditional" sales, and Quanta's sales were "conditional" because LGE did not intend to convey any "license" to purchasers such as Quanta.[17] The CAFC then affirmed the district court, holding that method claims are not subject to the patent exhaustion doctrine.[18]

Reversing the CAFC, the U.S. Supreme Court summarized the Federal Circuit's opinion and the Court's response:

> The Court of Appeals for the Federal Circuit held that the doctrine does not apply to method patents at all and, in the alternative, that it does not apply here because the sales were not authorized by the license agreement. We disagree on both scores. Because the exhaustion doctrine applies to method patents, and because the license authorizes the sale of components that substantially embody the patents in suit, the sale exhausted the patents.[19]

The Court's opinion in *Quanta* sets out three key rules of patent exhaustion:

Rule 1: Unconditional sales exhaust patent rights. Importantly, nothing in the license agreement restricted Intel's right to sell its microprocessors and chipsets to purchasers who intended to combine them with non-Intel parts.[20] Rather, it broadly permitted Intel to make, use or sell its products free of LGE's patent claims.[21] Because Intel was authorized to sell its products to Quanta, the Court ruled in Quanta's favor, concluding that "the doctrine of patent exhaustion prevents LGE from further asserting its patent rights with respect to the patents substantially embodied by those products."[22]

Rule 2: Both apparatus and method patent rights are subject to patent exhaustion.[23] Rejecting arguments that method patents are not subject to exhaustion, the Court explained that eliminating "exhaustion for method patents would seriously undermine the exhaustion doctrine"[24] because patentees "seeking to avoid patent exhaustion could simply draft their patent claims to describe a method rather than an apparatus."[25] Noting the danger of allowing such an obvious end run around exhaustion, the Court held that method patents can, indeed, be exhausted, saying "Nothing in this Court's approach to patent exhaustion supports LGE's argument that method patents cannot be exhausted."[26]

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17 *LG Elecs., Inc.*, 453 F.3d at 1369-70.

18 *Id.* at 1369 ("We reverse the trial court's holding with respect to the system claims and affirm with respect to the method claims."). *See Quanta Computer,* 128 S. Ct. at 2115 ("The Court of Appeals for the Federal Circuit affirmed in part and reversed in part. It agreed that the doctrine of patent exhaustion does not apply to method claims. In the alternative, it concluded that exhaustion did not apply because LGE did not license Intel to sell the Intel Products to Quanta for use in combination with non-Intel products.").

19 *Quanta Computer,* 128 S. Ct. at 2113 (2008).

20 *Id.* at 2121 ("LGE overlooks important aspects of the structure of the Intel-LGE transaction. Nothing in the License Agreement restricts Intel's right to sell its microprocessors and chipsets to purchasers who intend to combine them with non-Intel parts."). *See also id.* at 2122 ("Hence, Intel's authority to sell its products embodying the LGE Patents was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice.").

21 *Id.* at 2122.

22 *Id.*

23 *Quanta Computer,* 128 S. Ct. at 2118.

24 *Id.* at 2117 ("Quanta has the better of this argument.").

25 *Id.* at 2117 *See also id.*. at 2118 ("By characterizing their claims as method instead of apparatus claims, or including a method claim for the machine's patented method of performing its task, a patent drafter could shield practically any patented item from exhaustion.")

26 *Id.* at 2117 ("Nothing in this Court's approach to patent exhaustion supports LGE's argument that method

Rule 3: A sale involving substantially all the patent rights will exhaust the patent.[27] Relying on its decision in *United States v. Univis Lens Co.*,[28] the Court reasoned that "although sales of an incomplete article do not necessarily exhaust the patent in that article, the sale of the microprocessors and chipsets exhausted LGE's patents in the same way the sale of the lens blanks exhausted the patents in *Univis*."[29] The Court noted that, in *Univis*, exhaustion was triggered by "the sale of the lens blanks because their only reasonable and intended use was to practice the patent and because they 'embodie[d] essential features of [the] patented invention.'"[30]

B. *TransCore* Adds Covenants Not to Sue to "Authorized Sales"

In *TransCore, LP v. Electronic Transaction Consultants Corp.,* the CAFC held that an unconditional covenant not to sue is an authorized sale by the covenantee for purposes of patent exhaustion."[31]

TransCore manufactured and sold automated toll collection systems (e.g., E-ZPass).[32] TransCore sued Mark IV for patent infringement. The parties ultimately settled the case with a payment by the alleged infringer in exchange for a release of all existing claims and an unconditional covenant not to sue which provided that, "In exchange for the payment set forth in paragraph 1, TCI hereby agrees and covenants not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement of any of United States Patents."[33]

Later, when defendant Electronic Transaction Consultants Corp. (ETC) won a contract to install a toll system using a system purchased from Mark IV, TransCore sued ETC for infringement.[34] Granting summary judgment, the district court held that, "TransCore's patent infringement claims against Electronic Transaction Consultants Corp. ('ETC') were barred by patent exhaustion, implied license and legal estoppel, in view of a settlement agreement between TransCore and the supplier of the products ETC installed, Mark IV."[35]

Affirming the district court, the CAFC first relied on *Quanta* to confirm that the "doctrine of patent exhaustion provides that the initial authorized sale of a patented item termi-

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patents cannot be exhausted. . . . To the contrary, this Court has repeatedly held that method patents were exhausted by the sale of an item that embodied the method.").

27 *Id.* at 2122 ("As explained above, making a product that substantially embodies a patent is, for exhaustion purposes, no different from making the patented article itself. In other words, no further 'making' results from the addition of standard parts—here, the buses and memory—to a product that already substantially embodies the patent.")

28 316 U.S. 241 (1942).

29 *Quanta Computer,* 128 S. Ct. at 2118 ("Quanta argues that, although sales of an incomplete article do not necessarily exhaust the patent in that article, the sale of the microprocessors and chipsets exhausted LGE's patents in the same way the sale of the lens blanks exhausted the patents in *Univis*.").

30 *Id.* at 2119 ("[E]xhaustion was triggered by the sale of the lens blanks because their only reasonable and intended use was to practice the patent and because they "embodie[d] essential features of [the] patented invention.").

31 563 F.3d 1271, 1274 (Fed. Cir. 2009).

32 *Id.* at 1273.

33 *Id.*

34 *Id.*

35 *Id.*

nates all patent rights to that item," and that "exhaustion is triggered only by a sale authorized by the patent holder."[36]

The Federal Circuit then said, "[O]ur analysis begins with the premise that one cannot convey what one does not own."[37] The court observed, "This principle is particularly important in patent licensing, as the grant of a patent does not provide the patentee with an affirmative right to practice the patent but merely the right to exclude."[38] Based on this premise, the court concluded, "It follows, therefore, that a patentee, by license or otherwise, cannot convey an affirmative right to practice a patented invention by way of making, using, selling, etc.; the patentee can only convey a freedom from suit."[39]

The court then reaffirmed, "[T]his court and its predecessors have on numerous occasions explained that a non-exclusive patent license is equivalent to a covenant not to sue,"[40] concluding that, "The real question, then, is not whether an agreement is framed in terms of a 'covenant not to sue' or a 'license.' That difference is only one of form, not substance—both are properly viewed as 'authorizations.'"[41]

Having equated non-exclusive patent licenses and covenants not to sue, the Court then asked what the settlement agreement authorized and, "More specifically, does the TransCore-Mark IV settlement agreement authorize *sales*? We conclude that it does."[42] Turning its attention to the settlement agreement, the CAFC concluded that the agreement authorized **all** acts that would otherwise be infringing, including: making, using, selling, offering for sale, or importing.[43] Slamming the door, the court said, "[A]t oral argument, TransCore conceded that the TransCore-Mark IV settlement agreement does not include a restriction on sales."[44] Based on this analysis, the court agreed with the district court's finding that Mark IV's sales were authorized and that TransCore's patent rights were exhausted.[45]

C. Key Questions

Two issues the U.S. Supreme Court did not address in *Quanta*—implied license and contract-based conditions of sale—may have importance in future cases.

36 *Id.* at 1274 ("Recently, in *Quanta Computer, Inc. v. LG Electronics, Inc.*, ___ U.S. ___, 128 S. Ct. 2109, 170 L. Ed. 2d 996 (2008), the Supreme Court reiterated unequivocally that '[t]he longstanding doctrine of patent exhaustion provides that the initial authorized sale of a patented item terminates all patent rights to that item,' *id.* at 2115, and that '[e]xhaustion is triggered only by a sale authorized by the patent holder,' *id.* at 2121.").
37 *Id.* at 1275.
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.* at 1276.
42 *Id.*
43 *Id.* ("The language of the TransCore-Mark IV settlement agreement is unambiguous: '[TransCore] agrees and covenants not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement…' This term, without apparent restriction or limitation, thus authorizes all acts that would otherwise be infringements: making, using, offering for sale, selling, or importing.").
44 *Id.*
45 *Id.* at 1277.

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1. **Implied License.** In reaching its conclusions, the Court expressly determined that the issue of implied license was not relevant.[46] The CAFC addressed implied license in *TransCore* in the narrow context of legal estoppel.[47] The CAFC affirmed the district court's finding that, by virtue of legal estoppel, Mark IV had an implied license to practice a patent which had not issued as of the date of the parties' settlement agreement.[48] Specifically, the later-issued patent was necessary to practice one of the patents covered by the settlement agreement.[49] Therefore, under the doctrine of legal estoppel, TransCore was estopped from asserting the later-issued patent in derogation of the right granted in the agreement.[50]

2. **Contract-Based Conditions of Sale.** The U.S. Supreme Court did not consider the effect of contract law when reaching its decision.[51] Thus, contract rights may exist even where the patent is exhausted.[52] But contract conditions are subject to other non-patent legal constraints such as antitrust law.[53] These issues remain to be determined by the courts as cases arise to test contractual obligations that may seem to contradict patent exhaustion.

46 *Quanta Computer,* 128 S. Ct. at 2122 ("But the question whether third parties received implied licenses is irrelevant because Quanta asserts its right to practice the patents based not on implied license but on exhaustion. And exhaustion turns only on Intel's own license to *sell* products practicing the LGE Patents.").
47 *TransCore, LP,* 563 F.3d at 1278-79.
48 *Id.* at 1279 ("The district court further found that TransCore's rights to the '946 patent—which had not yet issued and was thus not identified in the TransCore-Mark IV settlement agreement—were exhausted by Mark IV's authorized sales under an implied license to practice that patent by virtue of legal estoppel. Again, we agree with the district court.").
49 *Id.* at 1279.
50 *Id.* at 1279 ("The basic principle is, therefore, quite simple: 'Legal estoppel refers to a narrow[ ] category of conduct encompassing scenarios where a patentee has licensed or assigned a right, received consideration, and then sought to derogate from the right granted.' *Wang Labs., Inc. v. Mitsubishi Elecs. Am., Inc.,* 103 F.3d 1571, 1581 (Fed.Cir.1997).").
51 *Id.* at 2122 n.7 ("LGE's complaint does not include a breach-of-contract claim, and we express no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages.").
52 *See Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 701,708 (Fed. Cir. 1992) ("Unless the condition violates some other law or policy (in the patent field, notably the misuse or antitrust law, *e.g.,* *United States v. Univis Lens Co.,* 316 U.S. 241, 62 S. Ct. 1088, 86 L.Ed. 1408 (1942)), private parties retain the freedom to contract concerning conditions of sale.").
53 *Boston Store of Chicago. v. Am. Graphophone Co.,* 246 U.S. 8, 25 (1918) ("Applying the cases thus reviewed there can be no doubt that the alleged price-fixing contract disclosed in the certificate was contrary to the general law and void. There can be equally no doubt that the power to make it in derogation of the general law was not within the monopoly conferred by the patent law and that the attempt to enforce its apparent obligations under the guise of a patent infringement was not embraced within the remedies given for the protection of the rights which the patent law conferred."); *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 509 (1917) ("'License Notice' as we have here, and whatever validity it has must be derived from the general, and not from the patent, law."); *id.* ("The extent to which the use of the patented machine may validly be restricted to specific supplies or otherwise by special contract between the owner of a patent and the purchaser or licensee is a question outside the patent law, and with it we are not here concerned. "); *id.* at 513 ("Whatever the right of the owner may be to control by restriction the materials to be used in operating the machine, it must be a right derived through the general law from the ownership of the property in the machine, and it cannot be derived from or protected by the patent law, which allows a grant only of the right to an exclusive use of the new and useful discovery which has been made,—this and nothing more.").