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Supreme Court takes a second look at patent exhaustion, but is it *déjà vu* again?
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Supreme Court takes a second look at patent exhaustion, but is it *déjà vu* again?

In its much-anticipated decision in *Quanta Computer, Inc v LG Electronics, Inc* (128 S Ct 2109 (2008)), the US Supreme Court – addressing the patent exhaustion doctrine after a 60-year hiatus – repeated its earlier *Univis* rule that “the initial authorized sale of a patented item terminates all patent rights to that item”. Because *Quanta* may generate renewed interest in the exhaustion doctrine, it is important that patent portfolio managers and practitioners understand the origins of this doctrine and the specific analysis in *Quanta*, to help them deal with potential patent exhaustion issues that might surface when drafting licence agreements, and in planning patent enforcement and settlement strategies.

History

Under the US patent statute, a patent holder has the “right to exclude others from making, using, offering for sale, or selling... or importing the invention” (Title 35 USC §154(a)). However, under the judicial doctrine of patent exhaustion, first articulated 150 years ago, a patent owner may lose its ability to control post-sale activities through the unconditional sale of an article that embodies the patented invention (*Bloomer v McQuewan*, 55 US 539 (1853)). In *Bloomer* the Supreme Court held that purchasers of patented Woodworth planing machines – purchased without any time-use restriction – could continue to use the machines despite a later extension of the patent term, explaining that “when the machine passes to the hands of the purchaser, it is no longer within the limits of the monopoly...[it] becomes [the purchaser’s] private, individual property” (*id* at 549).

Twenty years later, the Supreme Court applied the patent exhaustion doctrine for the benefit of downstream customers. In *Adams v Burke* (84 US 453 (1873)) a patent licensee was authorised to make, use and sell patented coffin lids within a 10-mile radius of Boston. The licensee sold the patented lids to an undertaker within the 10-mile geographical limit, but the undertaker subsequently used them outside the

restricted territory. Ruling that the downstream purchaser/undertaker was not subject to patent infringement liability, the Supreme Court explained that “the sale by a person who has the full right to make, sell, and use such a machine carries with it the right to the use of that machine to the full extent to which it can be used” (*id* at 455).

In addition, the Supreme Court refused to permit a patent owner to restrict use of its patented film projectors to display only films made under another of its patents. According to the court, “the 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” (*Motion Picture Patents Co v Universal Film Mfg*, 243 US 502, 516 (1917)).

The Supreme Court also recognised that a past damages award in patent litigation could subject the patentee to patent exhaustion because having received “full compensation for the wrongful use of [the] invention [the patentee] adopts the sales as though made by himself, and therefore necessarily licenses the use of the devices, and frees them from the monopoly of the patent” (*Union Tool Co v Wilson*, 259 US 107 (1922)).

Finally, in *United States v Univis Lens Co* (316 US 241 (1942)) – an antitrust enforcement case – Univis owned a number of patents related to multifocal lenses including methods for finishing, grinding and polishing lens blanks (*id* at 243). It licensed a related company to manufacture and sell lens blanks to wholesalers and retailers at agreed-upon rates; they, in turn, were licensed to grind and finish the blanks into patented finished lenses to be sold under fixed resale prices and customer restrictions (*id* at 244-45).

The Supreme Court ruled that the authorised sales of the lens blanks exhausted Univis’ ability to restrict the finished lenses. As a result, Univis’ resale price-maintenance programme was found to violate US antitrust law. The court reasoned that although the item sold by the licensed manufacturer was incomplete (ie,

only a lens blank), it had no reasonable use or purpose other than to practise the patented finishing methods. Therefore, all patent rights concerning the lens blanks and finished lenses were exhausted for those particular authorised sales (*id* at 250-51). As the court summarised, “the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold” (*id* at 249).

Enforceable patent restrictions

While the Supreme Court has applied the doctrine of patent exhaustion to limit patent owners’ post-sale control over articles sold, it has also consistently recognised that patentees may properly restrict their licensees (eg, grant less than the full panoply of patent rights), and thereby limit a purchaser’s or licensee’s authorisation to practise the patent, such that the sale or other use outside the scope of the restricted grant would subject a licensee, as well as downstream users, to patent infringement liability (eg, *Mitchell v Hawley*, 83 US 544 (1873), where the purchaser of a patented machine “does not acquire any right to construct another machine either for his own use or to be vended to another for any use” and enforcing a provision precluding licensees from disposing, selling or granting any license to the patented machines beyond the expiration of the original term of the patent; also *United States v Gen Elec Co*, 272 US 476, 490 (1926): “The patentee may make and grant a license to another to make and use the patented articles, but withhold his right to sell them. The licensee in such a case acquires an interest in the articles made. He owns the material of them and may use them. But if he sells them, he infringes the right of the patentee, and may be held for damages and enjoined”). Similarly, “[t]he owner of a patent may assign it to another and convey, (1) the exclusive right to make, use and vend the invention throughout the United States, or, (2) an undivided part or share of that exclusive right, or (3) the exclusive right under the patent within and through a specific part of the United States” (*Gen Elec Co*, 272 US at 489).

Accordingly, the Supreme Court has sustained express restrictions on licensees and downstream users – thereby circumscribing, among other things, the scope of what constitutes authorised sales or uses, provided that such restrictions do not violate other laws (see *Gen Talking Pictures Corp v W Elec Co*, 305 US 124, 125-26 (1938): “If where a patented invention is applicable to different uses, the owner of the patent may legally restrict a licensee to a particular field and exclude him from others”).

Federal Circuit patent exhaustion jurisprudence

Before *Quanta* the Federal Circuit issued a number of decisions tending to confine the application of patent exhaustion. For example, it enforced contractual prohibitions on the reuse of patented medical devices – that is, to one use only (*Mallinckrodt, Inc v Medipart, Inc*, 976 F 2d 700 (Fed Cir 1992)). It also ruled that method patent claims are not subject to exhaustion (*Bandag Inc v Al Bolster’s Tire Stores Inc*, 750 F 2d 903 (Fed Cir 1984)), and that sales of patented products outside the United States do not exhaust a patent owner’s rights over those products (*Fuji Photo Film Co, Ltd v Jazz Photo Corp*, 394 F 3d 1368 (Fed Cir 2005)).

The Federal Circuit also enforced a patentee’s restriction on replanting new generations of its patented seeds because “the new seeds grown from the original batch had never been sold” (*Monstanto Co v Scruggs*, 459 F 3d 1328, 1336 (Fed Cir 2006)). In *Quanta* itself, the Federal Circuit reiterated the exemption of method claims from patent exhaustion and ruled that patent exhaustion did not apply because it did not find an unconditional sale (*LG Electronics, Inc v Bizcom Electronics, Inc*, 453 F 3d 1364 (Fed Cir 2006)).

Supreme Court’s decision in *Quanta*

In *Quanta* LG Electronics licensed Intel broadly to “make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of” microprocessors and chipsets covered by LG’s patents, including apparatus and method patents (*Quanta Computer, Inc v LG Electronics, Inc*, 128 S Ct 2109, 2114 (2008)). The agreement also purported to disclaim any licence to Intel’s customers to combine products covered by the LG-Intel licence with non-Intel products, but acknowledged that this provision (as well as the rest of the licence agreement) was not intended to avoid or limit application of the exhaustion doctrine. By a separate side agreement, Intel was obligated to notify its customers of this disclaimer. Despite receiving the disclaimer, Intel’s customers, including *Quanta*, combined the licensed Intel microprocessors and chipsets with non-Intel components so as to infringe LG’s patents. LG then sued *Quanta* for infringement.

In ruling that LG’s patents were exhausted, the Supreme Court rejected the Federal Circuit’s categorical rule that method claims cannot be exhausted, reasoning that “methods nonetheless may be embodied in a product, the sale of which exhausts patent rights” (*id* at 2117). Quoting from its *Univis* decision, the Supreme Court reiterated that “the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to

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the article sold” (*id* at 2119). The court then noted that “the only apparent object of Intel’s sales to Quanta was to permit Quanta to incorporate the Intel Products into computers that would practice the [LG] patents” (*id*).

On the question of how much a product must embody a patent to trigger exhaustion, the court explained, again referring to *Univis*, that: “[l]ike the *Univis* lens blanks, the Intel Products constitute a material part of the patented invention and all but completely practice the patent. Here, as in *Univis*, the 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. Everything inventive about each patent is embodied in the Intel Products.” (*Id* at 2120.)

The Supreme Court then analysed whether the sale of Intel products to Quanta exhausted LG’s patent rights, noting that “[e]xhaustion is triggered only by a sale authorized by the patent holder” (*id* at 2121). The court found that nothing in the LG-Intel agreement limited or restricted Intel’s rights to make, use, sell or import licensed products to purchasers which intended to combine them with non-Intel components; and that “Intel’s authority to sell its products embodying the LG Patents was not conditioned on the notice [disclaiming any license to downstream purchasers to combine Intel products with non-Intel components] or on Quanta’s decision to abide by LGE’s directions in that notice” (*id* at 2121-22).

Nor was the Supreme Court influenced by the purported disclaimer in the LG-Intel licence, deeming that fact relevant only to the question – not before the court – of whether Quanta had obtained an implied licence to practise LG’s patents (*id* at 2122). The court concluded that “[b]ecause Intel was authorized to sell

its products to Quanta, the doctrine of patent exhaustion prevent[ed] LGE from further asserting its patent rights with respect to the patents substantially embodied by those products” (*id*). While the court held that exhaustion operated to prevent LG from asserting its patent rights, it expressed no opinion on “whether contract damages might be available” (*id* at n 7).

Patent exhaustion post-*Quanta*

The Supreme Court’s *Quanta* decision may spur renewed interest in assertions of patent exhaustion. As a result, courts may revisit a number of scenarios that were previously decided by lower courts and the Federal Circuit. The *Quanta* decision, contrary to some expectations, did not promulgate a revolutionary or ‘bright-line’ test for patent exhaustion. For example, because the holding was necessarily fact specific, the court did not articulate a definitive test or standard by which to determine whether a product “substantially embodies” a patent. In addition, because the court acknowledged the continued viability that a patentee may place restrictions or conditions on the sale or licence of its patented technology, it did not explain the bounds of what might constitute an authorised or unconditional sale for the purposes of triggering exhaustion. These still remain among the significant issues that persist for any exhaustion analysis.

In its first post-*Quanta* decision, the Federal Circuit held that exhaustion prevented a patent infringement claim against an installer of certain patented automated toll collection systems based on a settlement agreement between the patentee and the supplier of those systems which granted the supplier an unconditional release and covenant not to sue (*Transcore, LP v Electronic Transaction Consultants Corp*, 563 F 3d 1271 (Fed Cir 2009); compare

this to a similar proposition in *Union Tool Co v Wilson*, 259 US 107 (1922)). The Federal Circuit rejected any distinction between the covenant not to sue and a non-exclusive patent licence, finding that by covenanting without restriction or limitation “not to bring any demand, claim, lawsuit, or action against [the supplier] for future infringement”, the patentee effectively authorised “all acts that would otherwise be infringements: making, using, offering for sale, selling or importing” and “did not, as it could have, limit this authorization to, for example, ‘making’ or ‘using’” (*id* at 1276).

Similarly the *Quanta* decision may generate interesting questions in areas such as biotechnology, where a patentee’s ability to control self-replicating inventions and a purchaser’s right to manufacture and commercialise new copies of patented materials will likely collide (eg, *Monsanto Co v Scruggs*, 459 F 3d 1328 (Fed Cir 2006)). In addition, as demonstrated by at least one recent district court decision, the viability of the Federal Circuit’s *Mallinckrodt* decision – permitting patentees to impose single-use restrictions – may be revisited (*Static Control Components, Inc v Lexmark Int’l, Inc*, 615 F Supp 2d 575 (DKy 2009), refusing to follow the Federal Circuit’s *Mallinckrodt* decision and applying patent exhaustion to post-sale re-use of printer cartridges).

Other issues may re-surface, such as whether authorised foreign sales qualify. One district court has

said that they do (*LG Electronics, Inc v Hitachi, Ltd*, 2009 US Dist LEXIS 20457, at *18 (ND Cal 2009), while another disagrees, holding that “the controlling rule of law, as set forth in *Jazz Photo Corp v International Trade Commission*, 264 F3d 1094, 1110 (Fed Cir 2001) remains that US Patent rights are only exhausted when the patentee (or a licensee) sells the patented article in the United States, deriving a benefit from their US patent rights” (*Fujifilm Corp v Benun*, 2009 US Dist LEXIS 64465, at *9 (DNJ 2009)). Yet another district court ruled that “[t]he requirement [for patent exhaustion] that the sale be in the United States can be satisfied when the contracting and performance occur in the United States, even where some parts of the transaction occur abroad” (*Cornell University v Hewlett-Packard Co*, 2008 US Dist LEXIS 60209, at *2 (NDNY 2008)).

Viewed in historical context, the *Quanta* decision may not necessarily represent a remarkable, if any, departure from earlier Supreme Court precedent. Nevertheless, because renewed interest in the exhaustion principle may follow from the decision, patent portfolio managers and practitioners should keep monitoring post-*Quanta* developments in the law to factor potential patent exhaustion considerations into licensing, enforcement and settlement strategies.

The views expressed in this chapter are not those of Cadwalader Wickersham & Taft LLP or its clients.



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