Quanta-fying Patent Exhaustion: Impact on Patent Litigation and Licensing Strategies

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Licensing Executives Society Joint Luncheon
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What Commentators Are Saying

- "*Quanta Computer v. LG Electronics*: The U.S. Supreme Court Breathes New Life Into the Patent Exhaustion Doctrine"
- "Supreme Court Strengthens Patent Exhaustion"
- "Supreme Court's Quanta Decision Answers Some Questions about Patent Licenses, Raises Others"
- "Supreme Court Decision in *Quanta* Case Clarifies Patent Exhaustion"
- "U.S. Supreme Court ruling sets limits on patent royalties"
- "Supreme Court Reaffirms Principles of Patent Exhaustion in Quanta Computer v. LG Electronics"

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Overview

- How did we get here? Background of patent exhaustion.
- Where are we now? Summary of the *Quanta* decision.
- Where do we go from here? Future licensing and litigation implications of *Quanta*.

Background of Patent Exhaustion

Origins of Patent Exhaustion

Adams v. Burke, 84 U.S. (17 Wall) 453, 456 (1873):

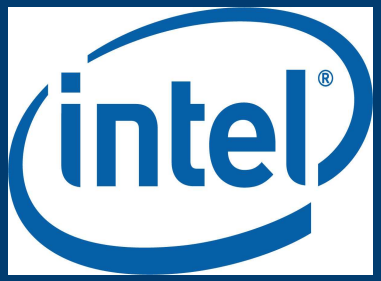
> In the essential nature of things, when the patentee, or the person having his rights, sells a machine or instrument whose sole value is in its use, he receives the consideration for its use and he parts with the right to restrict that use. The article, in the language of the court, passes without the limit of the monopoly. That is to say, the patentee or his assignee having in the act of sale received all the royalty or consideration which he claims for the use of his invention in that particular machine or instrument, it is open to the use of the purchaser without further restriction on account of the monopoly of the patentees. (citations omitted).

Patent Exhaustion—Traditional Concepts

- Basic concept: Authorized, unrestricted sale of patented product bars patentee from precluding subsequent use or resale of that product.
- Limitation: Only claims fully practiced by the product sold are "exhausted."
- Must address on claim-by-claim basis.

Easy Case—"First Sale"

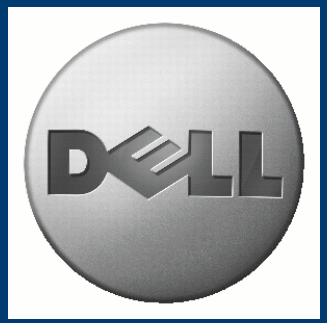
(hypothetical)



We claim:
1. A processor comprising:
* * *

Patentee

Unconditional sale of microprocessor that fully embodies patent claim; patent claim is exhausted



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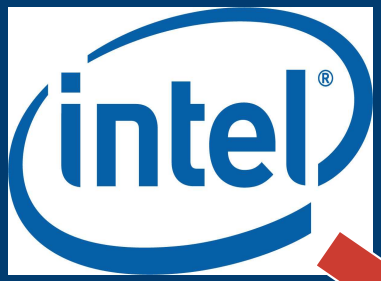

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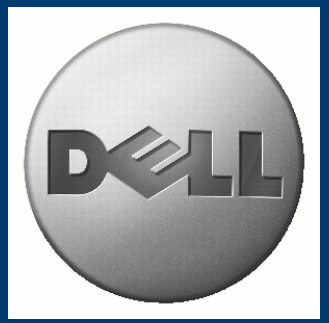
Patentee

Patentee cannot collect additional royalties under exhausted claim for use or resale of microprocessor

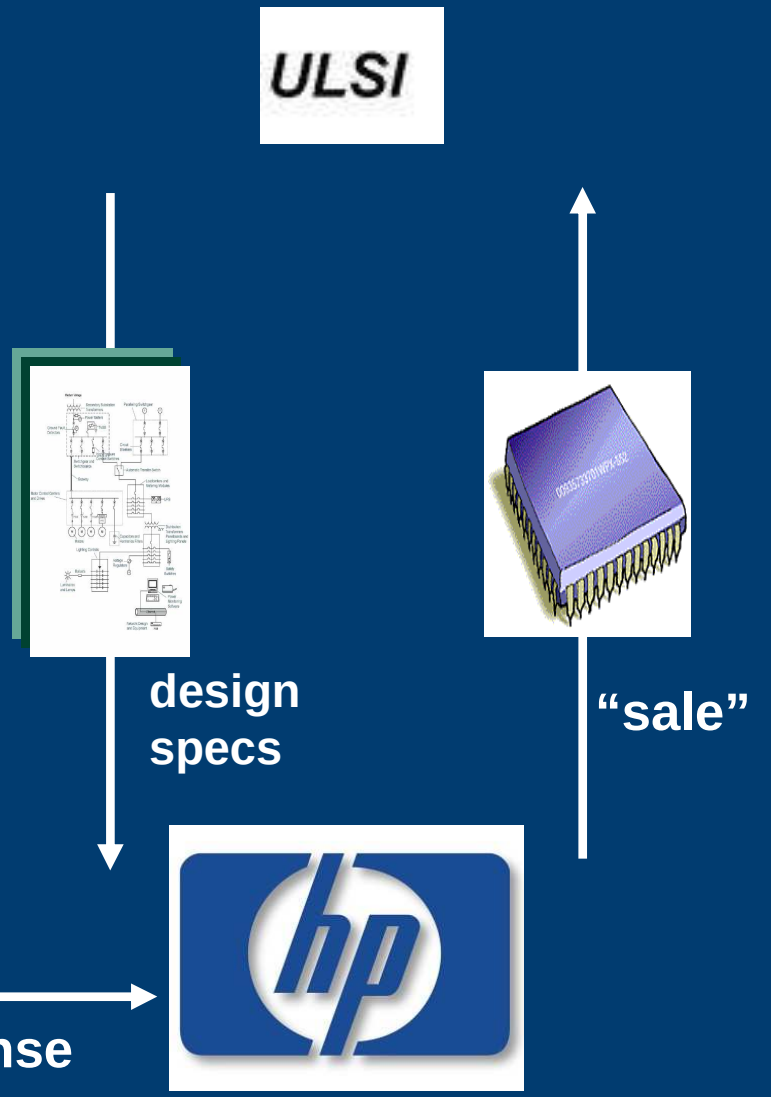


Questions Presented by Exhaustion Defense

- What if the product is not sold by the patentee but by its licensee?
  - Exhaustion still applies as long as the licensee acted within the scope of its authority.
- What if the product is designed by an unlicensed third party and made according to its specifications by a licensed foundry?
- What if the patentee imposes conditions on the sale?
- What if the product sold does not fully practice the patent claim at issue?
- Can the patentee limit the rights passed along to the licensee's customers?

Foundry Sales

- A licensee's producing "Licensed Products" for a third party according to the third-party's designs and specifications is an "authorized sale" of the products from the licensee to the third party.
  (*E.g.*, *Intel Corp. v. ULSI Sys. Tech.*, 995 F.2d 1566 (Fed. Cir. 1993))



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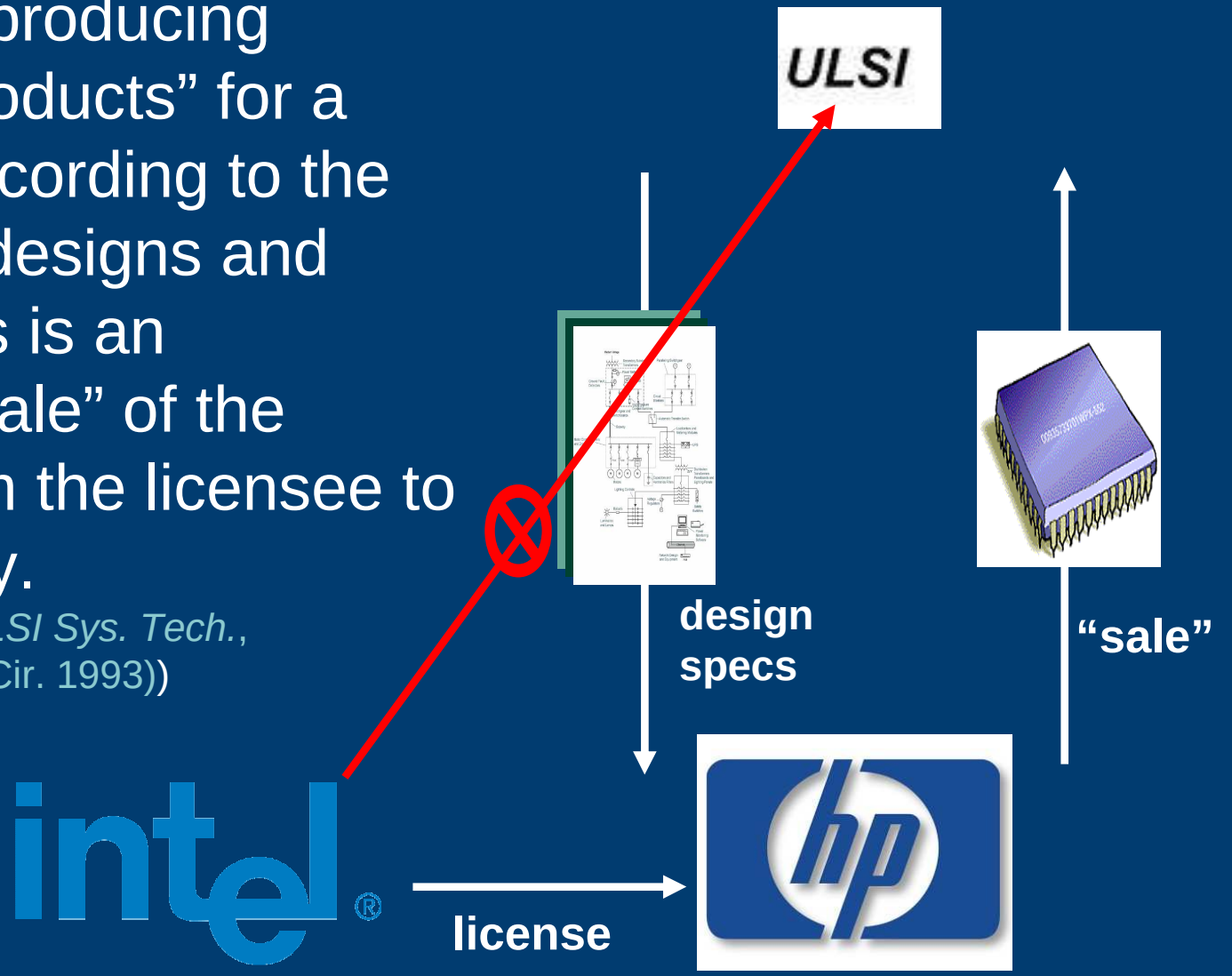


Conditional Sales

- In *Mallinckrodt* (1992), the Federal Circuit recognized that a single-use-only restriction imposed by the patentee could preclude exhaustion: "The principle of exhaustion of the patent right did not turn a conditional sale into an unconditional one."
- Suit against the recycler for contributory infringement was not barred by exhaustion. Remanded for consideration of antitrust issues.

  (*Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992))

MALLINCKRODT

Mallinckrodt → Hospital "For Single Use Only"

medipart
Precision Parts for the Medical Device Industry

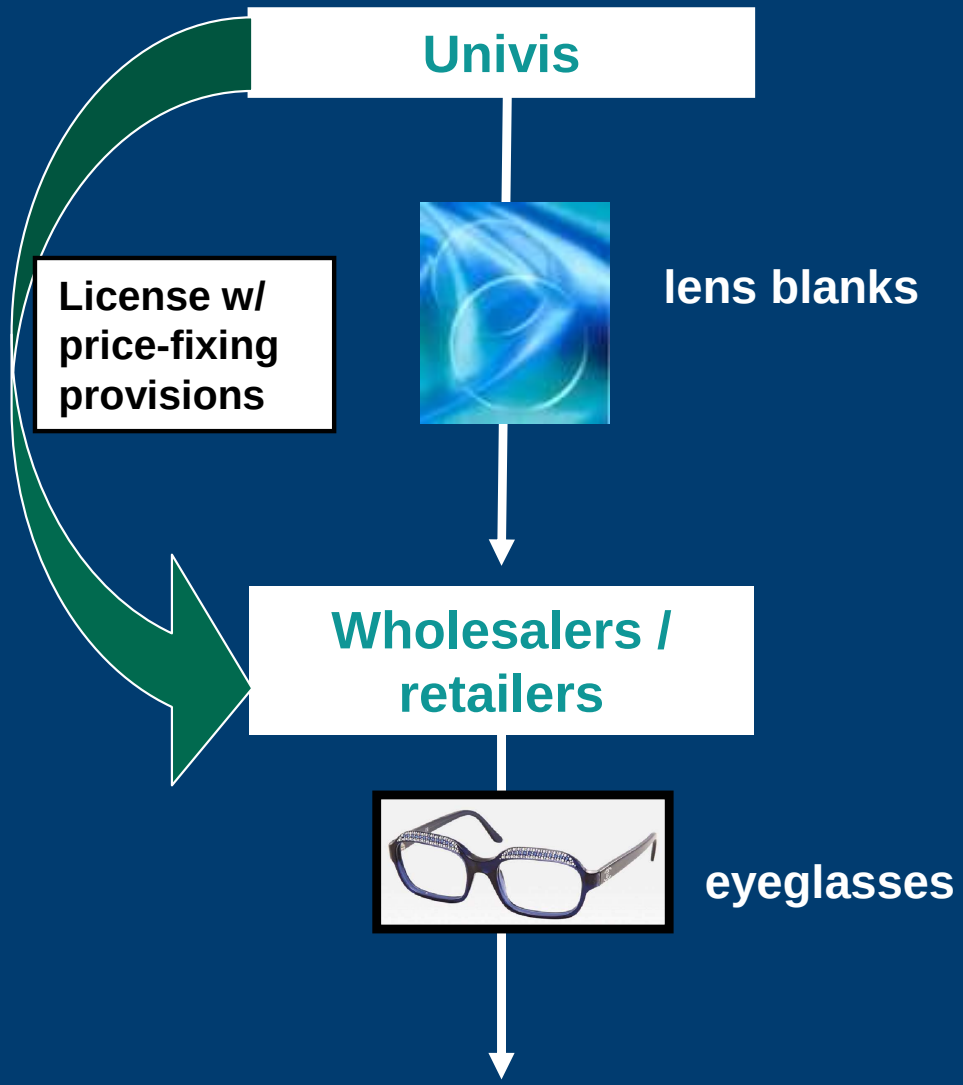
Recycled and sold back to Hospital.

Claims Not Fully Practiced

- Combination claims: Patent rights that are not fully practiced by an article as sold may still be exhausted according to the "unfinished products" exception.
  - *United States v. Univis Lens Co.*, 316 U.S. 241, 249 (1942)
  - *Cyrix Corp. v. Intel Corp.,* 846 F. Supp. 522 (E.D. Tex. 1994), *aff'd without op.,* 42 F.3d 1411 (Fed. Cir. 1994)

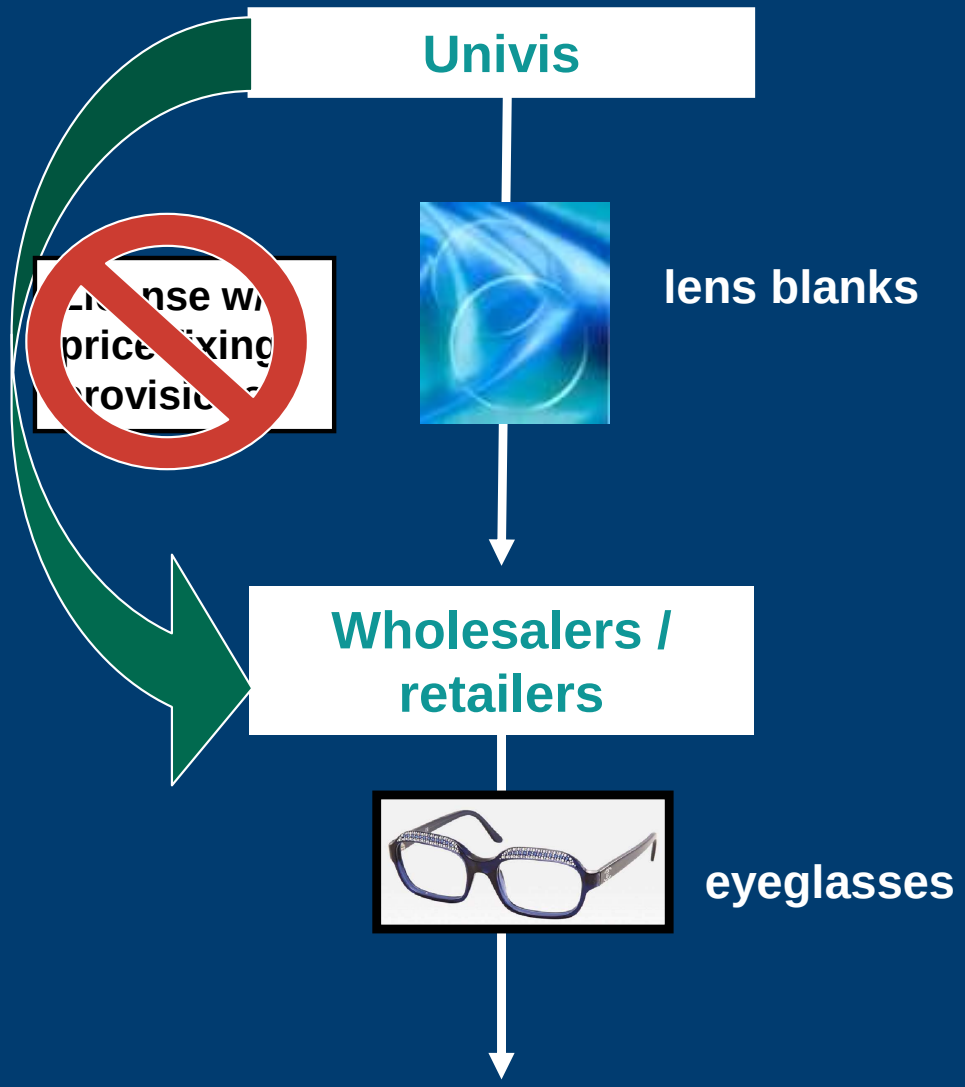
"Unfinished Products" Exception (*Univis Lens*)

- Patentee (Univis) sold lens blanks for eyeglasses to wholesalers and retailers.
- Wholesalers/retailers ground the blanks into prescription eyeglasses.
- Univis licensed certain wholesalers/retailers to practice patent claims necessary for finishing, but on condition of sales at fixed prices.



"Unfinished Products" Exception (*Univis Lens*)

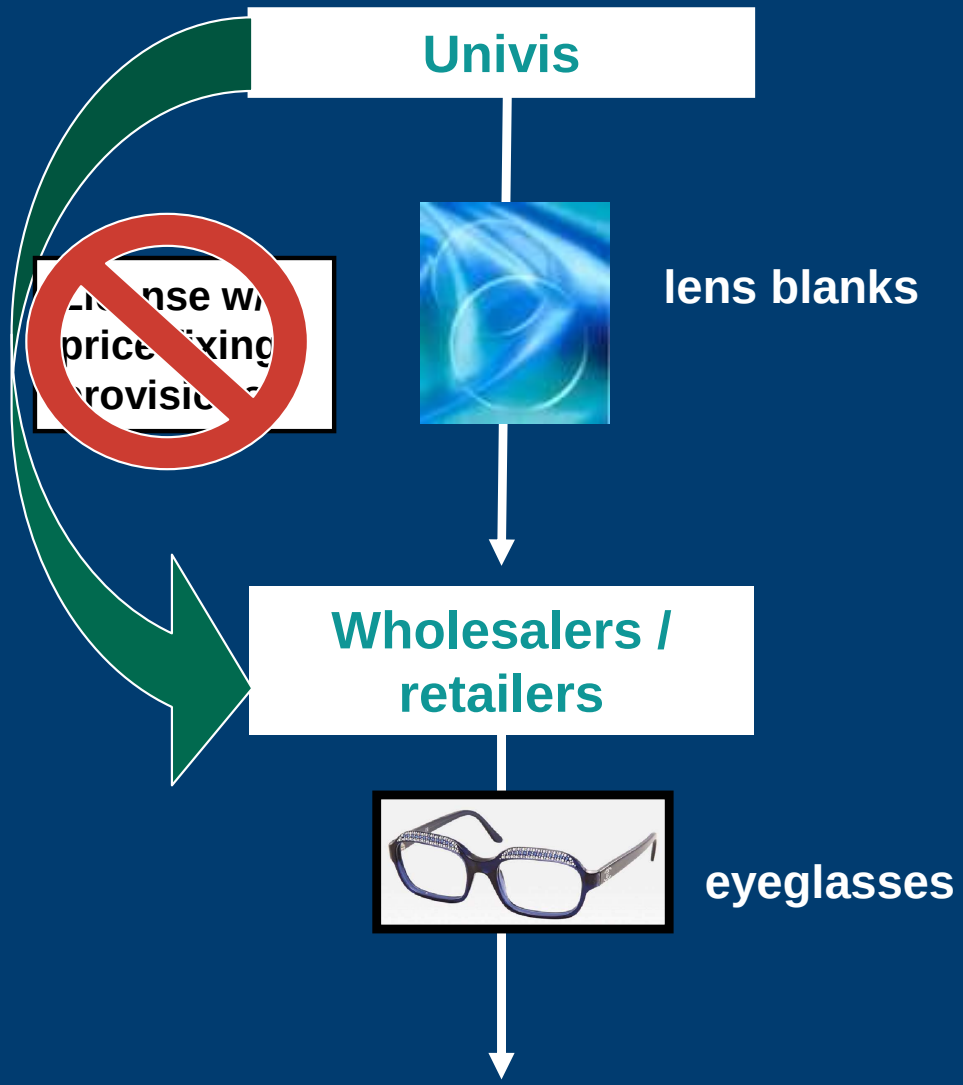
- Question presented: Did Univis's licensing scheme violate antitrust laws?
- Answer: Yes. Univis could not justify its price-fixing scheme under the guise of its patent licenses. Wholesalers/retailers did not need the licenses because they did not infringe by finishing the lenses.



"Unfinished Products" Exception (*Univis Lens*)

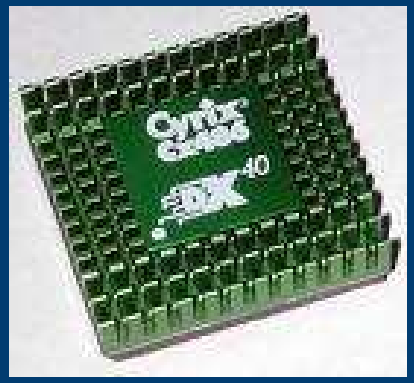
S. Ct.:

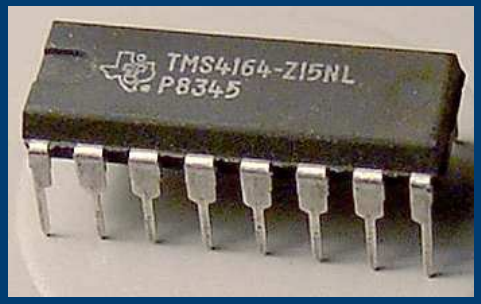
- "[E]ach blank … embodies essential features of the patented device and is without utility until it is ground and polished as the finished lens of the patent."
- "Sale of a lens blank by the patentee or by his licensee is thus in itself both a complete transfer of ownership of the blank, which is with the protection of the patent law, and a license to practice the final stage of the patent procedure."



"Unfinished Products" Exception (*Cyrix*)

- Intel's patent claim required a microprocessor plus memory.
- D. Ct.: "Cyrix's microprocessors, although complete in and of themselves, are unfinished in the sense that they need to be combined with external memory to be used."





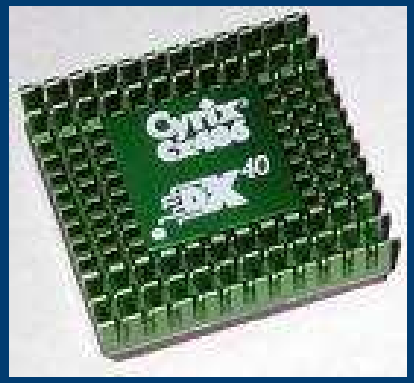
"unfinished"

"finished"

"Unfinished Products" Exception (*Cyrix*)

- D. Ct. "The patent exhaustion doctrine is so strong that it applies even to an incomplete product that has no substantial use other than to be further manufactured into a completed patented and allegedly infringing article."

∴ The sale of the microprocessor by the licensee exhausted the combination claim, and the customers were free to make the connection to memory.



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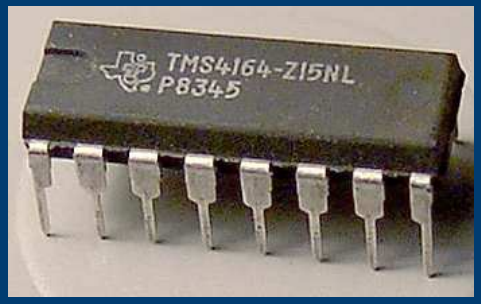

"finished"

Trivia Question #1

- What happened to Cyrix Corporation?

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- Answer: Merged into National Semiconductor in 1997.

Claims Not Fully Practiced by Product Sale– Method Claims

- **CAFC**: Method claims cannot be exhausted because a product cannot fully practice a method claim as sold, nor are method claims subject to the "unfinished products" exception.
  - *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*,750 F.2d 903 (Fed. Cir. 1984)
  - *Glass Equip. Dev., Inc. v. Besten, Inc.*, 174 F.3d 1337 (Fed. Cir. 1997)
- Product-based infringement immunities for method claims limited to the implied license doctrine.

Limiting Rights Passed Along to Licensee's Customers

- "No combinations" clause: "[N]o release or license is granted … to third parties acquiring products from either party … for the combination of separate products licensed hereunder with each other or with any other product."
  - *Cyrix*: This clause was deemed ineffective against exhaustion.
    (➔CAFC: affirmed without opinion)

Limiting Rights Passed Along to Licensee's Customers

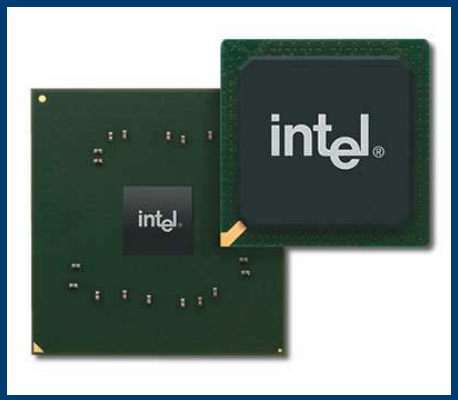
- Monsanto "Seed Cases"—Patented seeds are sold by licensees with **restrictive legend** on the bags:

  "These seeds are covered under U.S. Patents … . The purchase of these seeds conveys no license under said patents to use these seeds. A license must first be obtained from Monsanto Company before these seeds can be used in any way."

- Monsanto restricts licensees' rights to sell only to licensed growers.
- Sale held to be conditional; infringement claims upheld against growers who violate license restricting use of seeds for single growing season only. (*E.g. Monsanto v. Trantham*, 156 F. Supp. 2d 855 (W.D. Tenn. 2002))

Summary of the *Quanta* Decision

Technology



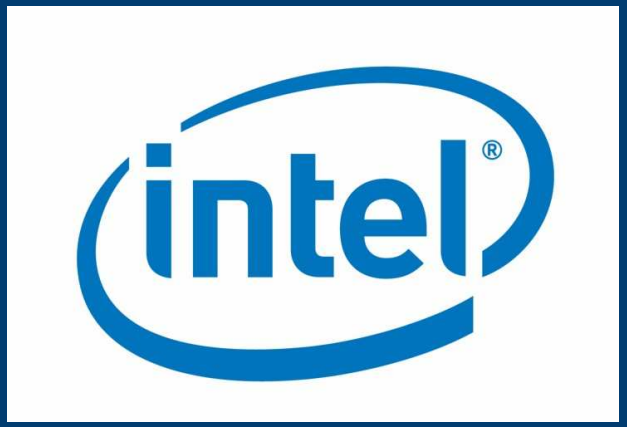
LG's Patents-in-Suit—Microprocessor-based systems and methods

- '733: Method that controls device access to shared bus (manages data traffic on the bus)
- '641: System to ensure outdated data not retrieved from memory
- '379: Method of coordinating read / write requests from and to memory

Parties and Relationships

Infringement Allegations

Patent License



Chip Sales

System Sales

Trivia Question #2

- What does “LG” stand for?

Trivia Question #2

- What does “LG” stand for?

- Answer: Lucky Goldstar. Renamed “LG” in 1995.

Key Contractual Provisions

- "No combinations" clause: 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."

Key Contractual Provisions

- No limit on exhaustion: "Notwithstanding anything to the contrary contained in this Agreement, 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."

Key Contractual Provisions

- Notice required to customers: Master Agreement required Intel to give notice to its customers that Intel's license with LG "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product."

Key Contractual Provisions

- Breach not grounds for termination: Master Agreement provided that "a breach of this Agreement shall have no effect on and shall not be grounds for termination of the Patent License."

Procedural Posture

N.D. Cal. (Wilken)

MSJ Noninfringement Granted (2002)

No implied license

System claims exhausted

Method claims exhausted

Motion for Reconsideration Granted in part (2003)

System claims exhausted

Method claims ***not exhausted***

Procedural Posture

CAFC (Michel, Newman, *Mayer*)

Affirmed in-part, reversed in-part

No implied license

*System claims **not exhausted***

*Method claims **not exhausted***

Rehearing *En Banc* Denied

Patent Exhaustion—System Claims

CAFC

"It is axiomatic that the patent exhaustion doctrine, commonly referred to as the first sale doctrine, is triggered by an unconditional sale." 453 F.3d at 1369.

Exhaustion does not apply "'to an expressly conditional sale or license. In such a transaction, it is more reasonable to infer that the parties negotiated a price that reflects only the value of the 'use' rights conferred by the patentee." 453 F.3d at 1369-70.

Patent Exhaustion—System Claims

CAFC

"Although Intel was free to sell its microprocessors and chipsets, those sales were conditional, and Intel's customers were expressly prohibited from infringing LGE's combination patents [under the LGE-Intel license]. *Cf.* N.Y. U.C.C. Law § 2-202 (allowing contracts to be supplemented by consistent additional terms unless the writing is intended to be complete and exclusive)." 453 F.3d at 1370.

Patent Exhaustion—Method Claims

CAFC

"[T]he sale of a device does not exhaust a patentee's rights in its method claims." 453 F.3d at 1369 (citing *Glass Equip. Dev., Inc. v. Besten, Inc.*, 174 F.3d 1337, 1341 n.1 (Fed. Cir. 1999)).

"[E]ven if the exhaustion doctrine were applicable to method claims, it would not apply here because there was no unconditional sale." 453 F.3d at 1369.

Question Presented to the Supreme Court

"Whether the Federal Circuit erred by holding, in conflict with decisions of this Court and other courts of appeals, that respondent's patent rights were not exhausted by its license agreement with Intel Corporation, and Intel's subsequent sale of product under the license to petitioners."

Parties' Arguments

- Quanta: Focus on whether sale is authorized; authorized sale of component exhausts combination and method claims, per *Univis Lens.*
- LG: Exhaustion should apply only if the product sold completely embodies the patent claim at issue. Otherwise, should analyze under implied license.
- *Amicus* briefing: Roughly balanced between the parties.

Trivia Question #3

- What year was the case originally filed?

Trivia Question #3

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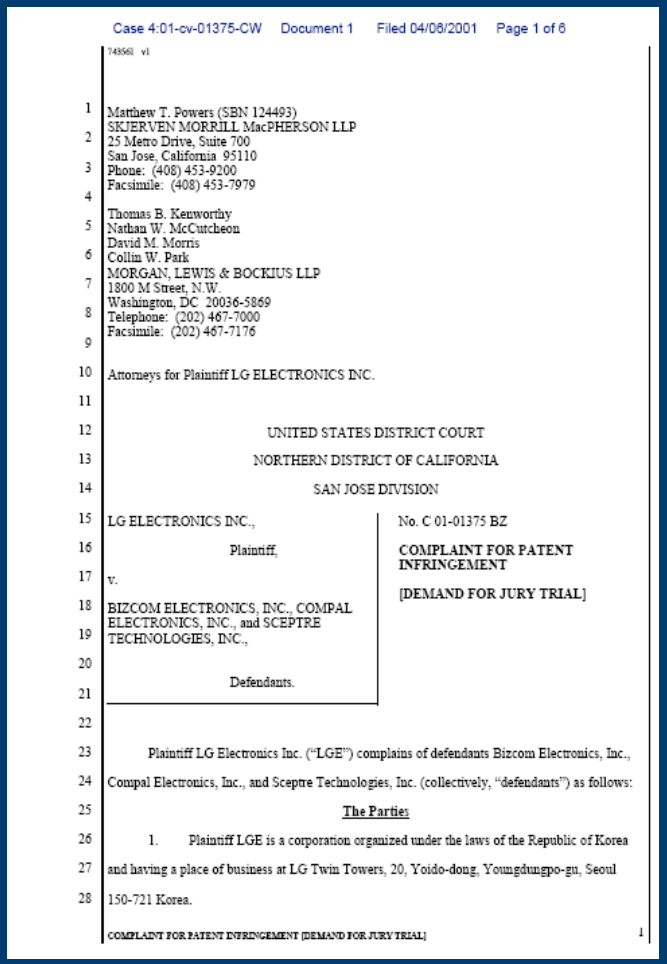
- Answer: 2000-2001.

  (series of cases consolidated)



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748561 v1

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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

LG ELECTRONICS INC.,

Plaintiff,

v.

BIZCOM ELECTRONICS, INC., COMPAL ELECTRONICS, INC., and SCEPTRE TECHNOLOGIES, INC.,

Defendants.

No. C 01-01375 BZ

COMPLAINT FOR PATENT INFRINGEMENT

[DEMAND FOR JURY TRIAL]

Plaintiff LG Electronics Inc. ("LGE") complains of defendants Bizcom Electronics, Inc., Compal Electronics, Inc., and Sceptre Technologies, Inc. (collectively, "defendants") as follows:

The Parties

1. Plaintiff LGE is a corporation organized under the laws of the Republic of Korea and having a place of business at LG Twin Towers, 20, Yoido-dong, Youngdungpo-gu, Seoul 150-721 Korea.

COMPLAINT FOR PATENT INFRINGEMENT [DEMAND FOR JURY TRIAL] 1

Issue as Framed in the Court's Opinion

"[W]hether patent exhaustion applies to the sale of components of a patented system that must be combined with additional components in order to practice the patented methods."

Supreme Court's Decision in a Nutshell

- Continuing a string of reversals of Federal Circuit decisions, the Supreme Court held that:
  - The doctrine of patent exhaustion applies to method claims; and
  - An authorized sale of a component that substantially embodies a claimed invention exhausts the patent owner's rights in that invention.

Summary of Take-Home Points

- Exhaustion applies with equal force to method claims as to combination or system claims.
  - Overruled over 20 years of Federal Circuit precedent.
  - Previously, product-based immunities for method claims were analyzed principally under implied license, which is easier to defeat contractually.

Summary of Take-Home Points

- Exhaustion does not necessarily apply to all of patentee's patents, but can apply to more than one. But, should address claim-by-claim.
- Two-part test: A component "substantially embodies" an invention and its authorized sale triggers exhaustion if (1) the component's only "reasonable and intended use" is to practice the invention; and (2) the component "embodies essential features" of the patented invention.

Summary of Take-Home Points

- "Reasonable and intended use" prong: Focus on specific patented feature at issue, not the product as a whole. [fn. 6] If the only "reasonable and intended use" of the specific feature is to practice the patent, then this prong is met, even if the product as a whole has many other nonpatented uses.
- Existence of legally noninfringing uses (*e.g.*, sales overseas) does not defeat this prong.

Summary of Take-Home Points

- "Essential elements" prong: What about *Aro*? The Court in *Aro* held that there is no legally recognizable or protected "essential" element, "gist" or "heart" of the invention in a list of elements making up a patent claim.
  Aro Mfg. Co. v. Convertible Top Replacement Co., Inc., 365 U.S. 336, 344 (1961).
- The *Quanta* Court held that these statements in *Aro* were limited to "the context in which the combination itself is the only inventive aspect of the patent."

Summary of Take-Home Points

- Patentee may still have claim against licensee for breach of contract even if exhaustion precludes infringement claims against licensee's customers. [fn 7]
- Conditional sales … ? Question of allowable restrictions not reached here because LG did not impose conditions on Intel's authority to sell products substantially embodying the patents.

Future Implications

Practical Implications of Quanta Uncertain

"While it is clear that the Supreme Court revived the U.S. patent exhaustion doctrine as a viable defense to infringement, many questions still arise as to its real-world effect in both a litigation and transactional context."

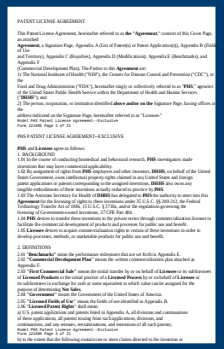
Potential Impact on Licensing – What Commentators Are Saying

- "Although the defendant won this case, the Supreme Court gave some glimmer of hope to those hoping to limit the scope of patent exhaustion through specific licensing terms."

- "The practical impact is that the patentee has direct power through only the first level of the production / marketing process and forces the patentee to rely on the contract rather than patent rules."

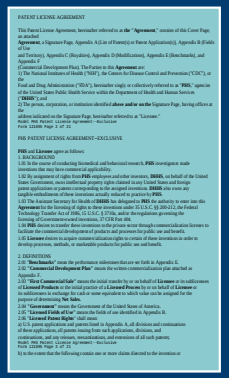
Practical Licensing Impact—What Doesn't Work

License Agreement



- Broad cross license agreement authorizing Licensee to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" Licensee Products practicing Patentee's patents
- Standard "no combinations language"
- Disclaimer of any attempt to alter default patent exhaustion rules

"Master Agreement"



- Requirement for Licensee to notify its customers that the patentee didn't license the customers for combinations with non-licensed product
- Failure to notify does not constitute breach of the License Agreement

Conditional Sales—Reconciling S. Ct. Precedent

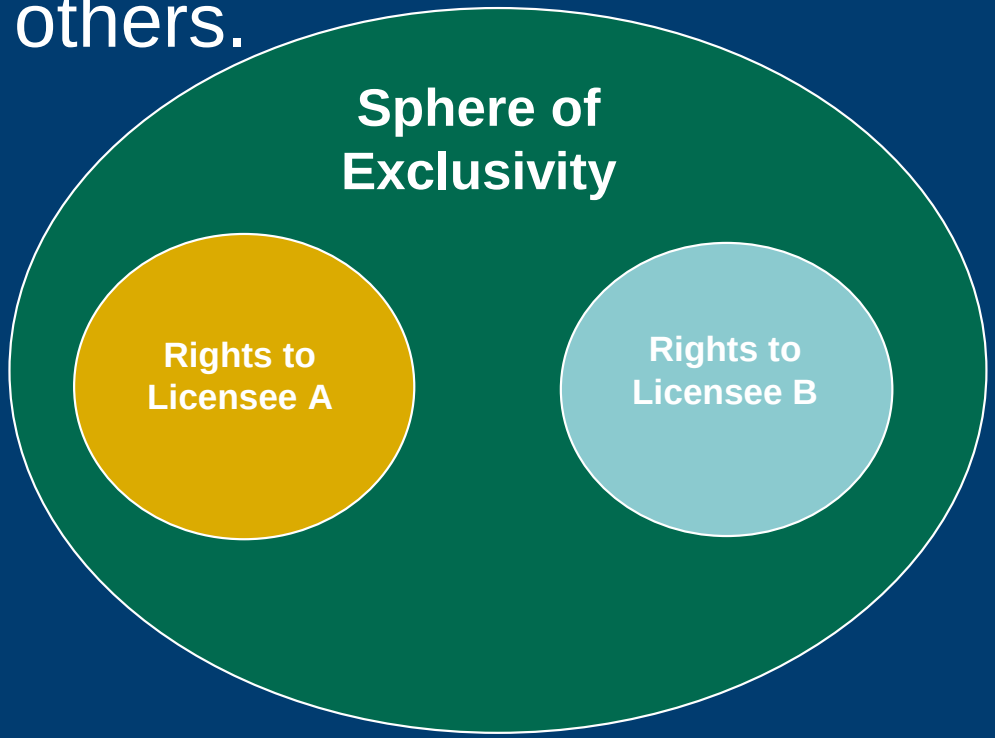
- *Motion Picture Patents* (1917): Cannot limit use of patented products to use with unpatented components (tying). Conditions imposed after the sale.
- *Univis Lens* (1942): Cannot require price-fixing. Conditions imposed after the sale.

BUT:

- *General Talking Pictures* (1938): Can impose field-of-use restrictions as a condition of the license/sale: "Unquestionably, the owner of a patent may grant licenses to manufacture, use or sell upon conditions not inconsistent with the scope of the monopoly."

Conditional Sales—Reconciling S. Ct. Precedent

- *Distinction?*
  - Patentee can choose to part with only some of the "exclusive right" granted by a patent, by conditioning sale/license on use in some fields but not others.



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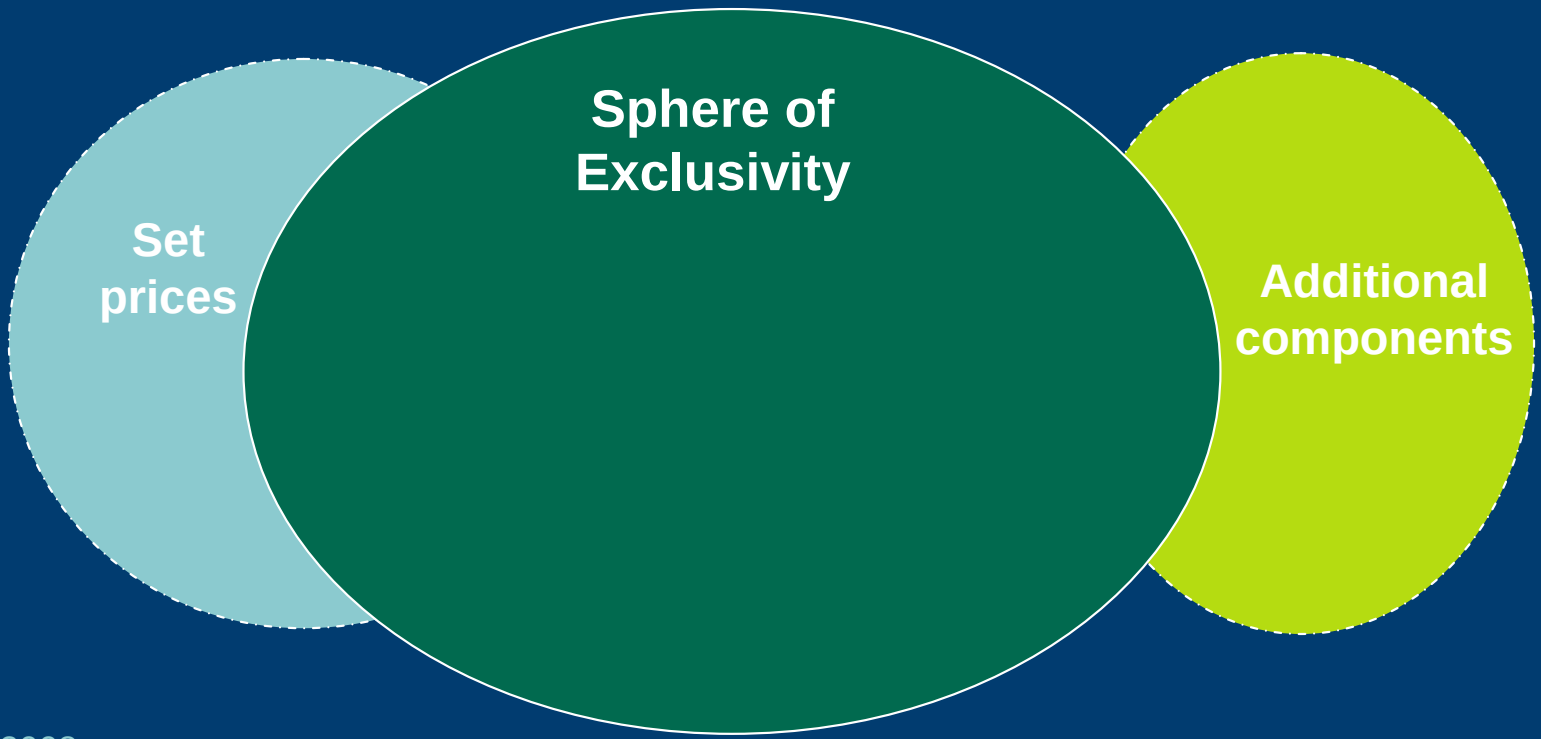

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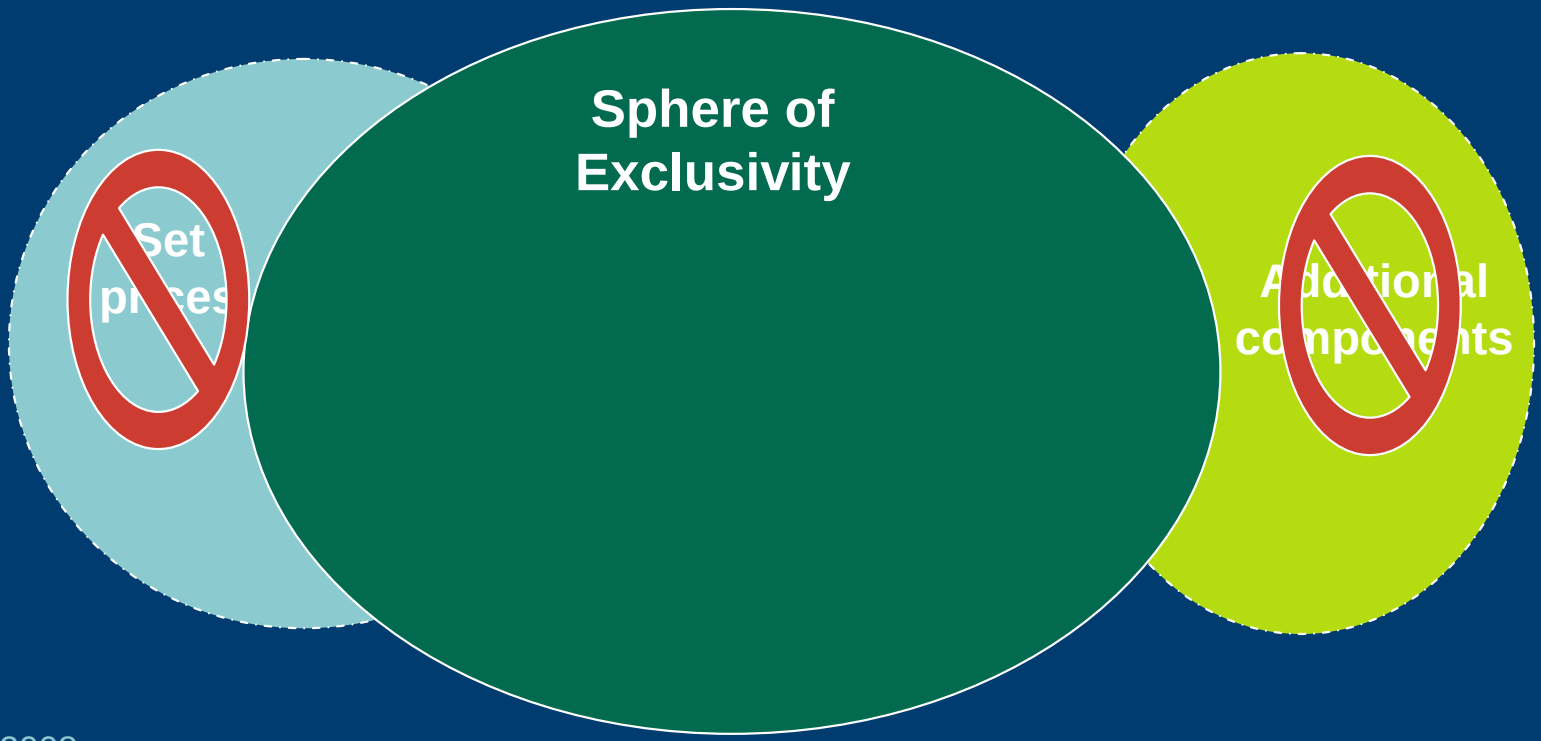

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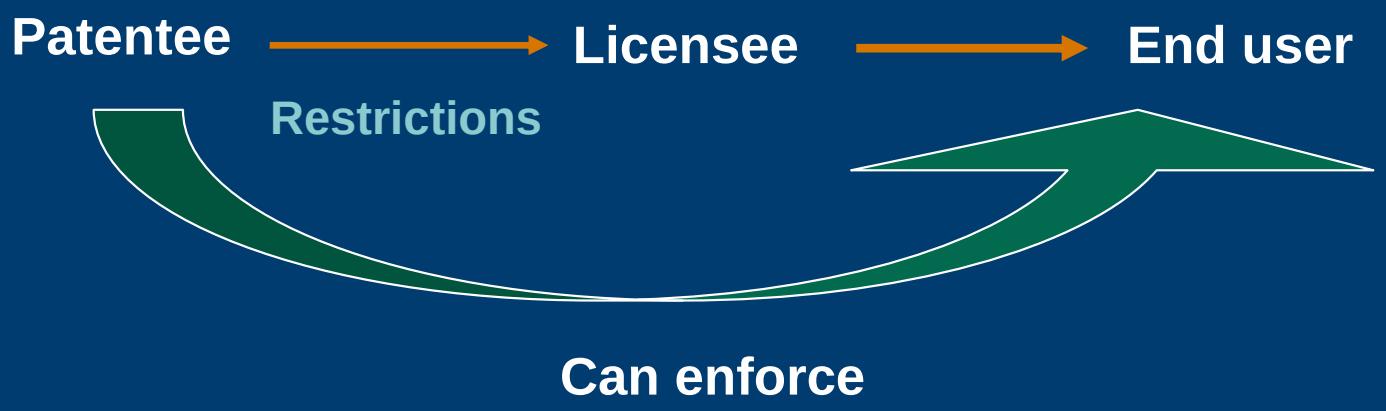

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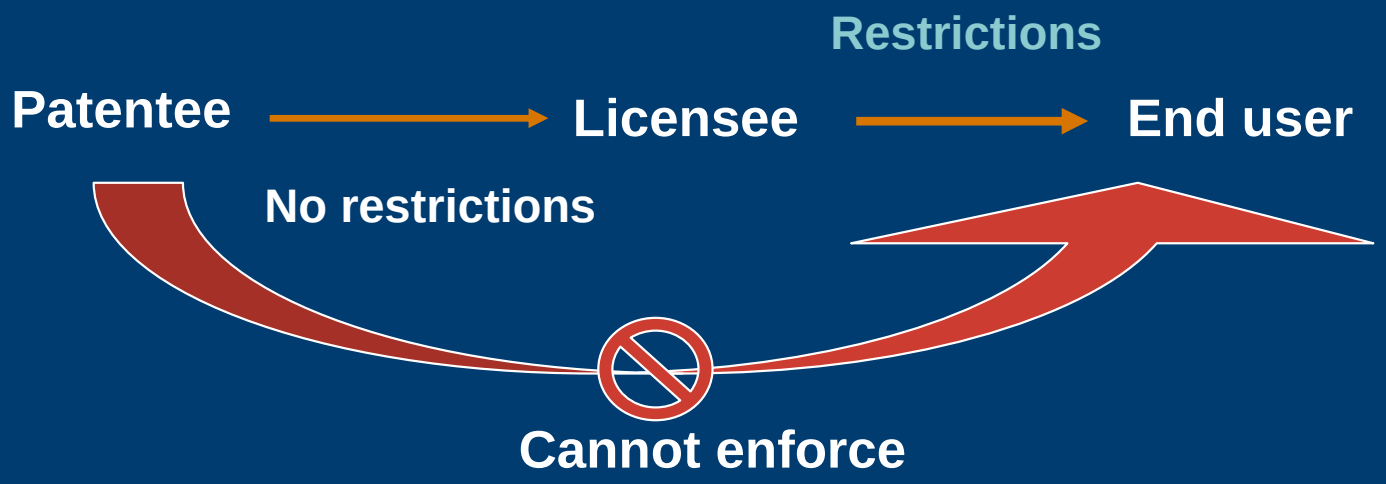
- *Distinction?*
  - Another key appears to be whether the patentee has conditioned the initial transaction (sale/license) on a transfer of only a portion of its exclusive rights.



Conditional Sales—Application of Principle

- *Mallinckrodt*: The patentee's sale of the products was conditioned on the purchaser agreeing to the "single-use only" restriction.
- Monsanto seed cases: The patentee grants licenses to seed companies to make the patented seeds; the license restricts the right of the seed companies to sell seeds to only growers who execute a "Technology License" with Monsanto. (*E.g.*, *Monsanto v. Scruggs,* 459 F.3d 1328, (Fed. Cir. 2006))

Standard "Combination Exclusion" Disclaimer:
Not a "Conditional Sale"

- *Quanta* case—"No Combinations" Clause:
  - *"[N]o license 'is granted by either party hereto . . . to any third party for the combination by any 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.'"*
- The Court found that this clause did not create a conditional sale:
  - "[N]othing 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."
  - The Court distinguished *General Talking Pictures Corp.*: The Licensee breached the license agreement by selling patented amplifiers for commercial use contrary to provisions limiting the sale to home use.

Disclaiming Limitations on Default Exhaustion Rules—NOT HELPFUL

- "Notwithstanding anything to the contrary contained in this Agreement, 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."

Simplified *Quanta* Licensing "Formula"

Scope of "Authorization" and effectiveness of "Conditions" (or Restrictions) are Key:

Broad Authorization + No "Conditions" Limiting Authorization = EXHAUSTION

Broad Authorization + "Conditions" = ? ?

Narrow Authorization + No "Conditions" = ? ?

No Authorization = NO EXHAUSTION
(sale in viol. of cond.)

Practical Licensing Impact – Implied Solution

- The Court implied that a patent owner may possibly be able to sue downstream manufacturers, users and sellers of combinations:

1. If the License Agreement restricts the Licensee's right to sell Licensed Products, precluding sales to purchasers "who intend to combine them with" unlicensed components, and breach of such restriction/condition would constitute a breach of the License Agreement, OR

2. If the License Agreement conditions the Licensee's authority to sell products embodying the Licensed Patents on the notice or on the Licensee's decision to abide by the notice.

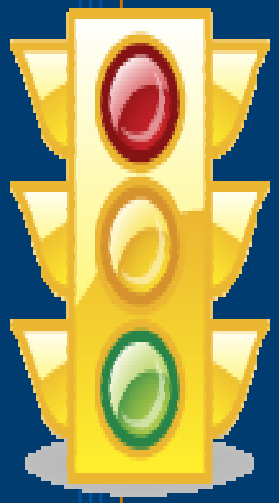
Possible Practical Licensing Solutions

- Patentees should be able to craft a license agreement that may avoid application of patent exhaustion to downstream combinations by:
  - Imposing field of use restrictions or other market limitations.
  - Structuring licenses to ensure the grant is as narrow as possible or otherwise explicitly limiting the scope of the license to ensure that the patentee receives compensation for the sale of each licensed product.
  - Restricting sale of products to customers for certain applications or precluding sale to unlicensed customers who intend to combine licensed products with unlicensed products downstream (where breach of the restrictions constitutes a breach of the license thus removing authorization).

Licensing Take Away Points

1. ***Authorization is Key***

2. ***Licensors seeking to impose "conditions" on licensees and end users should consider structuring restrictions on license grants themselves and seeking potential contractual remedies for sales they wish to restrict***



Broad Authorization + No "Conditions"
Limiting Authorization = EXHAUSTION

Broad Authorization + "Conditions" = ? ?
Narrow Authorization + No "Conditions" = ? ?

No Authorization = NO EXHAUSTION
(no grant or sale in violation of condition)

Potential Impact on Litigation

- Method claims—Exhaustion may now apply where only implied license was thought to apply.
- Attempted conditions—"No combinations" clauses may be of no benefit to patentee in exhaustion analysis.
- Whom to sue—Customer (patent infringement in federal court) or Licensee (breach of contract in state court)?

Potential Impact on Litigation

- Application of the two-part test:
  - What are the "essential elements" of the asserted claims? (Decide in claim construction?)
  - Do reasonable and intended, but noninfringing, uses exist? (Note that the patentee will be arguing for the existence of noninfringing uses.)

Trivia Question #4

- Who is the most senior judge on the Court, and what was the year of the appointment?

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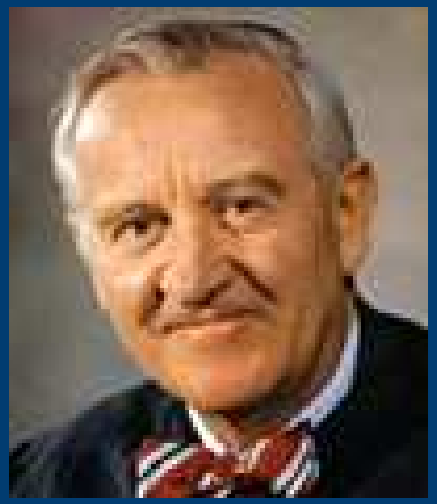

- Answer: Justice John Paul Stevens, appointed by President Ford in 1975.

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Quanta-fying Patent Exhaustion: Impact on Patent Litigation and Licensing Strategies

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Licensing Executives Society Joint Luncheon
August 12, 2008