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WILL THE HIGH COURT CLARIFY THE EXHAUSTION DOCTRINE?

Jan 16, 2008 — Today, for the first time in half a century, the Supreme Court heard oral argument on the extent to which a patentee can license its patents to different members of the same sales chain for the same product.

In *Quanta v. LG Electronics*, the High Court heard arguments on whether a patentee can grant patent rights and at the same time contract around the exhaustion doctrine. Further, the issue of whether patent exhaustion applies to method claims was also before the Court.

Charley Macedo attended the oral arguments to get a first hand impression of how the Supreme Court might deal with the issues related to patent exhaustion.

Last week, in a guest column, we provided background on the issues that *Quanta* raised, and the problems raised by the manner in which the Federal Circuit created carveouts to the exhaustion doctrine. See also Michael J. Kasdan, *Quanta Computer v. LG Electronics: Will The Supreme Court Revive The Exhaustion Doctrine?* (available at <http://www.arelaw.com/articles/index.html>).

In this guest column, we address the details of the arguments being made to the Supreme Court. In Part I, we provide a summary of the briefing before the Supreme Court. In Part II, we provide a summary of highlights from today's arguments. In Part III, we propose how to set the exhaustion doctrine back on track.

Part I: The Supreme Court Briefing

In their Petition for Certiorari, the computer-maker Petitioners assert that LG Electronics' (LGE) patent suit against them constitutes impermissible double-dipping under principles of patent exhaustion. This is because the Supreme Court "has consistently held for more than a century that no patent owner is entitled to more than one royalty on the sale of a patented article, and that an authorized first sale fully exhausts the patent owner's rights with respect to that article during its ordinary useful life." (Petition for Certiorari at 6, *Quanta Computers, Inc. v. LG Elecs., Inc.*, 128 S. Ct. 28 (2007) (No. 06-937).)

Petitioners contend that LGE's attempt to "contract around" the patent exhaustion doctrine, by including third-party conditions of use in its license agreement with Intel Corporation (Intel), is ineffective under Supreme Court exhaustion precedent.

Specifically, LGE licensed some of its patents to Intel and required Intel to send a letter to its customers that the license did not extend to their incorporation of the Intel microprocessors into their products.

The Federal Circuit held that such a letter created a valid restriction on the rights of Intel's customers even though LGE had authorized Intel to sell microprocessors.

In opposition, Respondent LGE contends that "patentees can restrict their licensees to preclude passing on any authority to practice their patents [to downstream customers]," and that in such circumstances the operative sales are "conditional" and outside the scope of the patent exhaustion doctrine. (Response at 12, *Quanta*.)

In other words, LGE argues that “exhaustion does not override a patentee’s freedom to restrict its licensee’s ability to convey patent-practicing authority to the licensee’s customers.” (Id. 13.) Respondent argues that this proposition is fully consistent with both Federal Circuit and Supreme Court law.

Several amici, including the United States (at the request of the Supreme Court) and a group of computer-makers consisting of Dell, Hewlett-Packard, and Gateway, filed briefs in support of the Petitioners.

All of the amici briefs contend that the Federal Circuit’s decision was in direct conflict with Supreme Court precedent on patent exhaustion. They argue that, whereas under Supreme Court precedent the patent exhaustion doctrine defines the exclusive rights granted by patent law, under the Federal Circuit’s view the patent exhaustion doctrine is subject to express modification.

This has created a situation where, under Federal Circuit law, patentees can avoid the effect of the exhaustion doctrine simply by agreement or unilateral notice. As stated in the Dell/Hewlett-Packard/Gateway brief:

The Federal Circuit has abandoned the doctrine of patent exhaustion, as it has been defined by this Court for over a century, and replaced it with a regime that serves no useful purpose but to multiply the recovery for clever patent-owners.

The doctrine of patent exhaustion, once a definitional constraint on patent rights, has been reduced to a mere default rule of contract interpretation that is easily avoided...(Brief Dell/Hewlett-Packard/Gateway at 2, Quanta.)

Each certiorari brief points to the Federal Circuit’s decision in *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (1992) as the point at which Federal Circuit law departed from that of the Supreme Court by effectively allowing parties to contract around the patent exhaustion doctrine.

The United States brief also criticizes the Federal Circuit approach, as a matter of policy, arguing that it permits patentees to “employ the patent law to extract royalties on articles embodying their invention at multiple downstream points in the channels of commerce, even after they have parted (or a licensee has parted in an authorized sale) with title to the article.” (Brief of United States at 17-18, Quanta.)

The amici also criticize the Federal Circuit’s holding that the patent exhaustion doctrine does not apply to method claims, particularly since certain Supreme Court cases finding patent exhaustion (such as *Univis*) themselves involved method claims.

Part II: The Supreme Court Arguments

An interesting aspect of oral argument at the Supreme Court was the focus of the Justices on whether patent exhaustion is an issue of patent law or contract/antitrust law.

Justice Breyer’s questions appeared to suggest that, under contract law theories, a patentee should not be able to put a post customer restriction in a license because it would impose improper “equitable servitudes on chattel.”

He also suggested that placing such a restriction could violate antitrust law doctrines. By contrast, Justice Roberts focused on whether exhaustion is a patent law or contract law doctrine.

In fact, the theory of patent exhaustion probably implicates both patent law and contract law. It implicates patent law because, once an authorized sale is made, the patentee should have no further right to limit the sale of that item in commerce. It implicates contract and antitrust law to the extent the patentee tries to impose an improper restriction

in its license agreement. Either way, the Supreme Court should preclude a patentee from contracting around the exhaustion doctrine.

The Justices were also interested in knowing why the exhaustion doctrine was codified in the Copyright Act but not in the 1952 Patent Act. In this regard the Amici were unable to cite to any useful discussion.

During argument LGE also argued that the notices Intel sent to its customers were valid techniques of avoiding a defense of implied license. LGE objected to the use of the exhaustion doctrine as an end-around to the defense of implied license.

Part III: Setting the Exhaustion Doctrine Back On Track

Over the past fifteen years, the Federal Circuit has eviscerated the exhaustion doctrine. Under the Federal Circuit's view of exhaustion, patentees are encouraged to seek royalties at multiple points in the channel of commerce as a patented product progresses downstream. This strains relations between manufacturers and customers since even if manufactures take a license, their customers still can be at risk.

The Supreme Court should return to its simple rule: a patented product that is sold with the authority of the patentee should not be subject to further restriction. This will curtail transaction costs associated with licensing a product under a patented invention by forcing the patentee to pick its target for its licensing program.

The Supreme Court now has the opportunity to set the law straight by stating that:

Parties should not be able to contract around the exhaustion doctrine.

The exhaustion doctrine should apply to method claims in the same manner as it is applied for apparatus and other types of claims.

In sum, once a patentee has authorized someone to use a patented product through a sale or license of that product, the patentee should not be entitled to receive a second royalty for that same product under the same patent.

Conclusion

The role of patent protection in the U.S. economy continues to remain important and should not be undermined. However, once a patentee has authorized goods or services to be sold under its patent, it should not be entitled to obtain a second payment for the same patent. The Supreme Court has a chance to reestablish this fundamental principle of U.S. Patent Law. We will have to wait and see if the Court takes advantage of this opportunity.

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