published: IP LAW360

REVIVING THE EXHAUSTION DOCTRINE

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Thursday, Jan 10, 2008 — On Jan. 16, 2008, the Supreme Court will be hearing oral argument in yet another patent case. This time, the Supreme Court is reviewing the latest precedent from the U.S. Court of Appeals for the Federal Circuit on the law of patent exhaustion.

In Quanta Computer v. LG Electronics, the Supreme Court will have its first opportunity since the formation of the Federal Circuit to weigh in on the important issue of whether and to what extent one may "contract around" the patent exhaustion. The Supreme Court may also provide guidance on the applicability of the exhaustion doctrine to method claims.

Part I of this article reviews the traditional law of patent exhaustion. Part II identifies the areas in which the Federal Circuit precedent has deviated from the traditional law of patent exhaustion. Finally, Part III offers our guidance on how the Supreme Court will likely address the important, but complex, issues in the Quanta case.

Part I: Traditional Law of Patent Exhaustion

Patent exhaustion is a fundamental doctrine of patent law first expressly enunciated by the Supreme Court in Adams v. Burke, 84 U.S. (17 Wall.) 453, 456 (1873).

The doctrine derives from the statutory grant of exclusivity to the patentee and holds that once a patentee abandons its right to exclusivity through the sale of a patented product or the license of the patent itself, there is no statutory basis for the patentee to impose restrictions or secure royalties on the subsequent use of the invention. See also Bloomer v. McQuewan, 55 U.S. (14 How.) 539, 549 (1852).

The doctrine is intended to prevent a patentee from receiving a double royalty on a single patented invention.

As the Supreme Court has explained, the touchstone of the patent exhaustion doctrine is "whether or not there has been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article." United States v. Masonite Corp., 316 U.S. 265, 277-78 (1942).

Under the doctrine of patent exhaustion, "[a]n authorized sale of a patented product exhausts the patent monopoly as to that product. Thus, a purchaser of such product from the patent owner or one licensed by the patent owner may use or resell the product free of control or conditions imposed by the patent owner." 5 Donald S. Chisum, Chisum on Patents § 16.03[2][a] (2002); see also Adams, 84 U.S. at 456; United States v. Univis Lens Co., 316 U.S. 241 (1942); Intel Corp. v. ULSI Sys. Tech., Inc., 995 F.2d 1566, 1568 (Fed. Cir. 1993) ("The law is well settled that an authorized sale of a patented product places that product beyond the reach of the patent. The patent owner's rights with respect to the product end with its sale.").

It is well-settled that the patent exhaustion doctrine applies as well to the disposition of a product under a license as it does to an outright sale. See generally Masonite Corp., 316 U.S. at 278 ("The test has been whether or not there has

been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article").

In order to trigger patent exhaustion, the sale must have been an "authorized" sale. See Gen. Talking Pictures Corp. v. W. Elec. Co., 304 U.S. 175 (1938) (finding that customer who purchased goods from a licensee, knowing that licensee lacked authority to make the sale, could be sued for infringement).

After an "authorized" sale, the Supreme Court has held that enforcing restrictions by asserting infringement against downstream customers is improper; the patent is said to be exhausted. See Adams, 84 U.S. at 456 (finding that a downstream customer is not bound to the territorial restriction placed on licensee of patent at issue).

It is well-established that the exhaustion doctrine extends not only to the authorized sale of a patented product but also may be extended to cover the authorized sale of "essential" components of a patented product that do not contain all elements of the patented invention. See, e.g., Univis, 316 U.S. at 249-51 ("We think that...where one has sold an uncompleted article which, because it embodies essential features of his patented invention, is within the protection of his patent, and has destined the article to be finished by the purchaser in conformity to the patent, he has sold his invention so far as it is or may be embodied in that particular article.");

Cyrix Corp. v. Intel Corp., 846 F. Supp. 522, 538-40 (E.D. Tex.) (noting further that "[t]he 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."), aff'd, 42 F.3d 1411 (Fed. Cir. 1994).

Part II: The Federal Circuit's Departure From Traditional Principles

The doctrine of patent exhaustion has long acted as a measure to prevent patent owners from "double-dipping" by collecting patent licensing royalties from multiple entities in a supply chain for use of the same patented invention.

For example, assume that a patent owner has a patent that covers a computer processing chip. The patent exhaustion doctrine is the rule that prevents that patent owner from collecting a first license payment from the chipmaker and then collecting additional licensing payments from computer makers that make end-products that incorporate the licensed chipmaker's chip.

In such a circumstance the patent is said to be "exhausted" by the authorized first sale of the patented article. Once the patent owner licenses the chipmaker, and thus authorizes the chipmaker to sell the patented article, the patent owner cannot collect a second time from downstream users who purchase the chip from the licensed chipmaker.

A good illustration of how the patent exhaustion doctrine should operate to prevent double-dipping is found in the district court's opinion in Cyrix Corp. v. Intel Corp., 846 F. Supp. 522, 540 (E.D. Tex.), aff'd, 42 F.3d 1411 (Fed. Cir. 1994).

There, the patent owner, Intel, had entered into a broad cross-license agreement with Texas Instruments ("TI") under which TI was licensed to manufacture microprocessors under Intel's patents.

TI sold these microprocessors to its customer Cyrix, who combined these microprocessors with an external memory to form a combination that was alleged by Intel to infringe the asserted claims of the patent at issue.

The Cyrix court held that the Intel's patent claims were exhausted when TI sold the licensed microprocessors to Cyrix and that therefore Intel could not assert its infringement claims against Cyrix, who was simply using the microprocessors for their intended purpose.

But over the past 15 years, this fundamental doctrine has been eroded in a number of significant ways by the U.S. Court of Appeals for the Federal Circuit.

As a result, the doctrine of patent exhaustion has become a less effective tool for preventing double-dipping, and downstream purchasers of products from licensed manufacturers have found themselves subject to paying a second royalty to patent owners who have already collected a first royalty from the upstream manufacturer.

Here are some significant ways that the patent exhaustion doctrine has been eroded by the Federal Circuit:

First, in seeming contradiction to Supreme Court precedent, the Federal Circuit now allows parties to "contract around" exhaustion. See LG Electronics, Inc. v. Bizcom Electronics, Inc., 453 F.3d 1364 (Fed. Cir. 2006); Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700 (Fed. Cir. 1992); cf. United States v. Univis Lens Co., 316 U.S. 241 (1942) (finding that once an authorized first sale occurs, exhaustion applies in spite of any attempt to contract around it).

Savvy patent owners have been taking advantage of this by drafting license agreements that the Federal Circuit has interpreted as preserving their rights to pursue infringement claims against downstream users who purchase and use the licensed product.

Second, and also in seeming contradiction to Supreme Court precedent, the Federal Circuit also has held that method claims are not subject to patent exhaustion. See LG Electronics, 453 F.3d 1364; Bandag, Inc. v. Al Bolser's Tire Stores, Inc., 750 F.2d 903 (Fed. Cir. 1984); cf. Univis, 316 U.S. 241 (applying exhaustion doctrine to method claims).

By limiting the patent exhaustion doctrine to only apparatus claims, the Federal Circuit has severely weakened its usefulness.

Third, the Federal Circuit has held that sales outside of the United States cannot "exhaust" a U.S. Patent. See Fuji Photo Film Co. v. Jazz Photo Corp.,394 F.3d 1368 (Fed. Cir. 2005); Jazz Photo Corp. v. U.S. ITC, 264 F.3d 1094 (Fed. Cir. 2001).

Therefore, in the common situation where components (such as chipsets) are sold abroad for incorporation into end-products (such as personal computers) that are then sold in the United States, sales by a licensed component-maker will not trigger the exhaustion doctrine, and a patent owner will not be precluded from also seeking patent royalties from the end-product maker.

Part III: The Supreme Court's Challenge

Having considered a host of important patent law issues over the past two years (reversing the Federal Circuit on each such occasion), the Supreme Court has now indicated its intent to revisit the patent exhaustion doctrine and to address the first two of the three above issues.

On Sept. 25, 2007, the Supreme Court granted certiorari in Quanta Computer Inc. v. LG Electronics Inc., 128 S. Ct. 28 (2007). Since then, the parties and a host of interested parties have submitted their briefs. (including amicus briefs submitted by the United States, Dell/HP/Gateway, IBM, Nokia, Qualcomm, the AIPLA, and others)

In Quanta, the Supreme Court will decide:

"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." Quanta Computer Inc., v. LG Elecs. Inc., No. 06-937 (U.S. Sept. 25, 2007) (order granting certiorari).

The Quanta case presents the Supreme Court with an opportunity to strengthen the patent exhaustion doctrine on multiple grounds.

In so doing, it is likely that the Supreme Court will overrule the Federal Circuit's decisions in Mallinckrodt, as to contracting around exhaustion, and Bandag, as to the inapplicability of the exhaustion doctrine to method claims.

With respect to the central issue in Quanta of whether it is possible to contract around the exhaustion doctrine, the most consistent approach that the Supreme Court should take is to reverse Mallinckrodt and set a bright-line rule in line with Univis, that strictly holds that the patent exhaustion doctrine may not be contracted around by setting restrictions in a license agreement that purport to restrict the post-sale use of the products at issue.

A detailed review of the Supreme Court exhaustion indicates that the application of the exhaustion doctrine should turn solely on whether there was an "authorized sale." See 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).

Once there is an authorized sale, any purported post-sale restrictions or conditions intended to preserve the patent-owner's right to claim infringement against downstream purchasers (even where they are notified of that purported restriction, as in Quanta) should be held to be without effect.

Such a holding would prevent the double-dipping scenario of Quanta: patent owners would not be able to extract multiple royalties for the use of the same patented invention from different members of a supply chain.

Patent owners will have to be extremely mindful of the exhaustion doctrine in setting up licensing programs and in determining from what member of a given supply chain (e.g., component-maker, product maker or further downstream user) to seek royalties.

Where appropriate, patent owners should continue to be able to license distinct inventions (i.e., patent claims with distinct essential features) to different members of a supply chain without triggering the exhaustion doctrine. In such cases, there is no issue of double-dipping or patent exhaustion.

However, once a patented invention is licensed to one member of the supply chain, the exhaustion doctrine will prevent further recovery under that patent from those downstream from that licensee.

Even after the issues presently before the Supreme Court in Quanta are resolved, other unresolved issues will continue to impede the defensive use of the exhaustion doctrine in certain circumstances.

These include the Federal Circuit's holding that the patent exhaustion doctrine is inapplicable to foreign sales and the lack of clarity in how to apply the "essential features standard" to determine when to apply the exhaustion doctrine to a sale of a component of the patented invention.

For now, it is important that these limitations under the present law be well-understood both patentees and accused infringers alike.

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