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PATENTS

A landmark 2008 Supreme Court decision and a recent ruling by the Federal Circuit have revitalized the doctrine of patent exhaustion. In the wake of these developments, patent holders drafting license agreements and convenants not to sue must take care to include language limiting the rights of third parties to use the patented invention.

Patent Exhaustion After *Quanta* and *TransCore*: Protecting Your Right to Sue Third Parties

BY JAMES R. KLAIBER AND JEFFREY W. LESOVITZ

Recently, the U.S. Court of Appeals for the Federal Circuit ruled in *TransCore LP v. Electronic Transaction Consultants Corp.* that an "unconditional covenant not to sue authorizes sales by the covenantee for purposes of patent exhaustion."[1] This ruling comes less than a year after the Supreme Court revitalized the patent exhaustion (or first-sale) doctrine in *Quanta Computer v. LG Electronics* by extending the doctrine's reach to both apparatus and method claims.[2]

Both cases represent a renewal of the traditional doctrine that an authorized sale of a patented item terminates, or exhausts, all patent rights with respect to that item. The patent exhaustion doctrine may even terminate the patentee's right to prevent downstream customers from practicing the patented invention. To avoid this outcome, patent owners should exercise caution when drafting license agreements and covenants not to sue by including appropriate restrictions limiting the rights of third parties to use the patented invention.

The Patent Exhaustion Doctrine

The patent exhaustion doctrine represents the longstanding principle that the first unrestricted sale of a patented item "exhausts" the patentee's control over

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[1] 563 F.3d 1271, 1274, 90 USPQ2d 1372 (Fed. Cir. 2009) (77 PTCJ 664, 4/17/09).

[2] 128 S. Ct. 2109, 86 USPQ2d 1673 (2008) (76 PTCJ 205, 6/13/08).

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that item. In other words, after the first authorized sale, the patentee loses all rights to the patent and subsequently has no recourse if a downstream customer practices the patent. Thus, the doctrine has typically been raised as an affirmative defense to charges of patent infringement.

Originally formulated in the early part of the 20th century, the patent exhaustion doctrine arose as a response to post-sale restrictions on patents that enabled patentees to exercise control and receive additional royalties from downstream customers long after the initial sale of a patented item. At that time, the Supreme Court had approved certain post-sale restrictions on the use of patented items. In particular, in *Henry v. A.B. Dick Co.*, the court permitted restrictions on a patent that required the purchaser to use only products made by the patentee when practicing the patent.[3]

By 1917, the court definitively rejected post-sale restrictions on patents and held ''the right to vend is exhausted by a single, unconditional sale, the article sold . . . rendered free of every restriction which the vendor may attempt to put upon it.''[4] In reaching its conclusion, the court was concerned that numerous patent holders were using licenses to limit the permissible uses of their products which, in turn, secured market control of related, unpatented items. After noting ''the primary purpose of our patent laws is not the creation of private fortunes for the owners of patents but is 'to promote the progress of science and useful arts,' '' the court concluded that the patentee's power ''must be limited to the invention described in the claims of his patent.''[5]

In 1942, the court provided more insight into the patent exhaustion doctrine when it invalidated post-sale restrictions on a patented hardboard.[6] The court's ruling, though grounded in a violation of the Sherman Antitrust Act of 1890, reaffirmed the doctrine by striking restrictions on a patent license that included fixed selling prices and sale terms. In doing so, the court noted that a patentee should be entitled only to a single royalty arising through the first authorized sale of the product. And it is presumed, after the first sale, the patentee has received the value of the patent right. Thus, the court said, application of the patent exhaustion doctrine depends on ''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 the same year, the court also extended the patent exhaustion doctrine to method patents. In *United States v. Univis Lens Co.*, the patentee owned a patent for an eyeglass lens and the method for making lenses by producing, grinding, and polishing lens blanks.[7] The patentee sold lens blanks to certain wholesalers and retailers, who in turn would finish the grinding and polishing of the blanks according to the patented method. Licenses to the wholesalers and retailers contained explicit limitations as to whom the lens blanks could be sold and at what price. Even though the wholesalers and retailers were not practicing all elements of the patent's claims, the court noted that ''[w]hether the licensee sells the patented article in its complete form or sells it before completion for the purpose of enabling the buyer to finish and sell it, he has equally parted with the article . . . .'' As a result, the court found the patent exhaustion doctrine applicable and the restrictions invalid.

Following *Univis*, several Federal Circuit decisions refined the patent exhaustion doctrine by permitting patentees to place certain post-sale restrictions and limitations on their patents. For instance, in *Mallinckrodt Inc. v. Medipart Inc.*, the court permitted patentees to condition the sale of patented goods with a restrictive notice so long as the restrictions did not violate antitrust law or ''some other law or policy.''[8] Subsequent Federal Circuit decisions followed this same approach.[9] In fact, the Federal Circuit went so far as to hold that only apparatus claims, not method claims, were subject to the patent exhaustion doctrine.[10]

Quanta and License Agreements

In its 2008 landmark decision *Quanta Computer Inc. v. LG Electronics Inc.*, the Supreme Court reaffirmed the patent exhaustion doctrine and conclusively held that it applies to method claims as well as apparatus claims.[11] LG Electronics held rights to several computer technology method patents. Pursuant to a license agreement, Intel Corp. was authorized to manufacture and sell microprocessors and chipsets that incorporated LG's patents. Additionally, both parties had a separate, ''Master Agreement,'' requiring Intel to notify its customers that the license did not extend to products constructed by combining Intel products with non-Intel products.

After purchasing microprocessors and chips from Intel, Quanta manufactured computers using both Intel and non-Intel products. Subsequently, LG sued Quanta claiming that this combination constituted patent infringement. In response, Quanta argued that the patent exhaustion doctrine precluded LG from asserting the patents-at-issue.

The Supreme Court, relying heavily upon its prior ruling in *Univis*, confirmed that the patent exhaustion doctrine applies to method claims. Although a patented method may not be sold in the same way as an article or item, the court noted that ''methods nonetheless may be 'embodied' in a product, the sales of which exhausts patent rights.'' In fact, any other result would ''seriously undermine the exhaustion doctrine'' by permitting patentees to ''simply draft their patent claims to describe a method rather than an apparatus.''

After confirming that method patents are covered by the patent exhaustion doctrine, the court next discussed

[3] 224 U.S. 1 (1912).

[4] *Motion Pictures Patents Co. v. Universal Film Manufacturing Co.*, 243 U.S. 502, 516 (1917).

[5] *Id.* at 516-17 (quoting U.S. Const. art. I, § 8, cl. 8).

[6] *United States v. Masonite Corp.*, 316 U.S. 265, 268, 53 USPQ 396 (1942).

[7] 316 U.S. 241, 53 USPQ 404 (1942).

[8] 976 F.2d 700, 708, 24 USPQ2d 1173 (Fed. Cir. 1992) (44 PTCJ 577, 10/1/92).

[9] *See, e.g.*, *U.S. Philips Corp. v. International Trade Commission*, 424 F.3d 1179, 1185, 76 USPQ2d 1545 (Fed. Cir. 2005) (70 PTCJ 596, 9/30/05) (''If the particular licensing arrangement in question is not one of those specific practices that has been held to constitute per se misuse, it will be analyzed under the rule of reason. We have held that under the rule of reason, a practice is impermissible only if its effect is to restrain competition in a relevant market.'').

[10] *Glass Equipment Development Inc. v. Besten Inc.*, 174 F.3d 1337, 1341 n.1, 50 USPQ2d 1300 (Fed. Cir. 1999) (57 PTCJ 479, 4/8/99).

[11] 128 S. Ct. 2109, 86 USPQ2d 1673 (2008) (76 PTCJ 205, 6/13/08).

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"the extent to which a product must embody a patent in order to trigger exhaustion." The court noted that when a product can only be used to practice the patented method, the patent exhaustion doctrine applies. Citing *Univis*, the court said that 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.

Following the Supreme Court's ruling in *Quanta*, it has become more difficult for parties to contract around the exhaustion doctrine. At a minimum, *Quanta* revitalized the doctrine and stymied limitations to its application that the federal courts had permitted since *Univis*.

TransCore and Covenants Not to Sue

In *TransCore LP v. Electronic Transaction Consultants Corp.*, the Federal Circuit was again asked to decide the scope of the patent exhaustion doctrine. Specifically, the court decided "whether an unconditional covenant not to sue authorizes sales by the covenantee for purposes of patent exhaustion."[12]

In 2000, TransCore sued a competitor, Mark IV Industries, for infringement of several TransCore patents involving automated toll collection systems such as E-ZPass. Pursuant to a settlement agreement, TransCore made an unconditional covenant not to sue and released all existing claims against Mark IV Industries. Several years later, Electronic Transaction Consultants Corp. agreed to install and test a new toll collection system purchased by the Illinois State Toll Highway Authority from Mark IV.

TransCore sued Electronic Transaction for infringement of several patents relating to the toll collection systems. The lawsuit alleged infringement of three patents subject to TransCore's covenant not to sue Mark IV, plus a related patent that was pending but not issued at the time of the covenant. Electronic Transaction responded to the suit by arguing that the use of the patents was permitted by the TransCore-Mark IV settlement agreement under several related theories including patent exhaustion. TransCore argued that sales under a covenant not to sue are not "authorized" for purposes of the patent exhaustion doctrine. Finding that Mark IV's sales of the toll collection systems installed by Electronic Transaction were, in fact, authorized by the settlement agreement, the district court granted Electronic Transaction's motion for summary judgment and dismissed the claim.

On appeal, the Federal Circuit affirmed the ruling of the district court finding that Mark IV's sales to the highway authority were authorized and that TransCore's patent rights were exhausted. The court first noted that, with respect to downstream customers, the intention of the parties to the settlement agreement is irrelevant. Instead, the court reiterated that a patent license "does not provide the patentee with an affirmative right to practice the patent but merely the right to exclude." *Id.* at 1275. In other words, a patentee cannot convey a right to practice the patent but can only convey freedom from suit. Thus, a patent license has been described as a " 'mere waiver of the right to sue by the patentee.' "[13]

[12] *TransCore*, 563 F.3d at 1274.

[13] *Id.* at 1275 (quoting *De Forest Radio Telephone & Telegraph Co. v. U.S.*, 273 U.S. 236, 242 (1927)).

As a result, the court noted that the real question was "not whether an agreement is framed in terms of a 'covenant not to sue' or a license." In fact, any distinction between a covenant not to sue and a license "is only one of form, not substance—both are properly viewed as 'authorizations.' " Thus, the court focused on *what* the TransCore-Mark IV settlement agreement authorized. Specifically, the court was interested in whether the settlement agreement authorized "sales."

The settlement agreement stated that TransCore "agrees and covenants not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement . . . ." This clause, according to the court, unambiguously authorized all acts that would otherwise constitute infringement including "making, using offering for sale, selling, or importing" the patents. Accordingly, the language of the settlement did not include a restriction on sales, a fact TransCore conceded at oral argument. Because there were no restrictions on sales, the court concluded the settlement agreement authorized Mark IV's sales to third parties, which consequently exhausted TransCore's right to sue Electronic Transaction.

The court also held that a covenant not to sue conveys an implied license by estoppel to a patent issued after the covenant was executed if it is necessary to practice the covenanted (or licensed) patent. Such a holding is true, in the Federal Circuit's view, even where the covenant expressly states that it does not extend to later-issued patents.

Practice Tips on Drafting License and Settlement Agreements

After *Quanta* and *TransCore*, patent owners must exercise caution when drafting licenses, settlement agreements, and covenants not to sue. These decisions make clear that imprecise drafting may create the risk that a license or covenant not to sue will be interpreted broadly without restricting the sale or use of patented products by third parties. Attorneys drafting such agreements should carefully consider the rights and covenants they intend to include in the agreements and use language clearly reflecting those intentions.

Parties drafting licenses could avoid the outcome in *Quanta* by licensing the end users directly rather than licensing suppliers of patented components. If a component manufacturer is licensed, the agreement should include express language that the license fee is not for the entire patent right. Licensors may also consider expressly stating that the patent right is not exhausted in sales of the components to end users. A license may include only rights to make (or have made), and not include rights to sell or use, so that the patentee may control sales to unauthorized end users. Another route would be to incorporate field-of-use restrictions into the license to prevent unauthorized sales by a licensee outside an agreed-upon class of end users.

Similarly, to avoid the outcome in *TransCore*, settlement agreements should limit covenants not to sue to the "making" or "using" of the product. They should contain explicit language addressing future sales of patented products and specifically excluding actual products or services sold by or on behalf of the covenantee. Also, a patentee who wishes to exclude a particular patent from the scope of a covenant not to sue (or license) should make that intent express by referring to the patent or application number in the agreement it-

self. The agreement should not include the patent at least to the extent it is unnecessary to practice the covenanted (or licensed) patent.

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