

Will High Court Take On Patent Exhaustion?

Law360, New York (October 13, 2016, 11:36 AM EDT) --

The U.S. Supreme Court's 2008 Quanta decision made it more difficult for patent owners to obtain license revenue from downstream points of the supply chain. *Quanta Computer Inc. v. LG Electronics Inc.*, 553 U.S. 617 (2008). Eight years later, the Supreme Court may revisit Quanta, given the petition for certiorari that requests review of the Federal Circuit's recent *Lexmark* decision. *Lexmark Int'l v. Impression Prods.*, 816 F.3d 721 (Fed. Cir. 2016). The dissent in *Lexmark*, as well as the positions taken by the U.S. government in its amicus brief, challenges some of the key holdings of Quanta. A reversal could fundamentally change the patent exhaustion doctrine, and scale back the ability of patent owners to obtain the full value of their patents.



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Quanta: Where Were We?

The Effects of Quanta

In its 2008 Quanta decision, the Supreme Court held there was no infringement because the LG Electronics ("LGE") patents were exhausted. The doctrine of patent exhaustion provides that the initial authorized sale of a patented item terminates all patent rights as to that item. Quanta, 553 U.S. at 625. LGE had licensed microprocessor patents to Intel. The license grant was broad, authorizing Intel to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" Intel products that practiced the LGE patents. Under its license with LGE, Intel sold microprocessors and chipsets to Quanta. Quanta made and sold computers using the components purchased from Intel. Thereafter, LGE sued Quanta for infringement of its patents.



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The Supreme Court found that the LGE patents were exhausted when Intel sold the microprocessors and chipsets to Quanta because the license grant provided to Intel was so broad — essentially unrestricted — and authorized Intel to sell to Quanta such products "substantially embodying" the LGE patents. *Id.*

Quanta had two interesting twists. First was the notice requirement that required Intel to give written notice to its customers informing them that its license with LGE "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product." Quanta, 553 U.S. at 617, Brief for Respondent at 9 (quoting App. 198). Quanta did exactly that. It made and sold computers using the Intel microprocessors combined with non-Intel parts. The issue was, then, whether or not this notice requirement restricted Intel's sales to Quanta (and hence Intel's license to the LGE patents), such that LGE's patents were not exhausted as to Quanta's computers made from Intel

and non-Intel parts.

Certainly, under current law, properly communicated restrictive notices are effective to negate patent exhaustion. This is clear from *Mallinckrodt*, for example, where the Federal Circuit held that authorized sales of medical devices sold with clearly communicated “single use” notices (the notice being both marked on the medical devices and stated in the product instructions) did not exhaust *Mallinckrodt*’s patents for multi-use applications. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992). But in *Quanta*, the Supreme Court reached a different conclusion even after finding that Intel had provided the “no combination” notice to all its customers. Why then, did the Supreme Court find that the “no combination” notice in *Quanta* was not a post-sale restriction that failed to prevent exhaustion of LGE’s patent rights for *Quanta*’s computers made from both Intel and non-Intel parts?

The controlling fact here was not that the “no combination” notice requirement was in a separate agreement (the master agreement) rather than the license agreement; nor was the controlling fact a possible contractual interpretation that the notice requirement was a mere requirement that Intel provide notice to its customers rather than a restriction on the license grant. Instead, what controlled were: (1) the broad, unrestricted license grant; and (2) an additional clause in the master agreement that stated “a breach of [the master agreement] shall have no effect on and shall not be grounds for termination of the Patent License.” *Quanta*, 553 U.S. at 624. Thus, the Supreme Court held that “Intel’s authority to sell its products ... was not conditioned on the notice or on *Quanta*’s decision to abide by LGE’s directions in that notice.” *Id.* at 624-625. For this reason, the court found that Intel’s rights to the LG patents were not restricted by the notice provision.

The second twist was the following disclaimer-restriction in the license agreement: “[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.” The Supreme Court paid little attention to this clause because *Quanta* based its defense on patent exhaustion, rather than an implied license. *Id.* at 625. But, this clause may not have helped LGE in any case because *Quanta* did not need a license from LGE to make its Intel/non-Intel computers. LGE’s patents had already been exhausted as a result of Intel’s first sale to *Quanta*.

The Patent Owner Road Map to Avoid Patent Exhaustion and Obtain Downstream License Revenue

Although the Supreme Court found that LGE’s patents had been exhausted (given LGE’s unrestricted license to Intel to sell its products practicing the LGE patents) and, thus, was not able to obtain downstream license revenue, its *Quanta* decision, like the earlier Supreme Court *General Talking Pictures* decision, provides patent owners with a road map on how to prevent patent exhaustion and obtain greater value for their patents by distributing licensing cost over multiple players in the stream of commerce. *General Talking Pictures Corp. v. Western Electric Co.*, 304 U.S. 175, 181-82 (1938) (holding that since licensee and buyer both knew that the licensee lacked authority to make sales of amplifiers to a commercial theater, in violation of a field-of-use restriction, the licensee infringed the patent and did not have an exhaustion defense). Specifically, through use of post-sale restrictions that are clearly communicated and otherwise lawful (i.e., do not constitute patent misuse), patentees can avoid patent exhaustion and obtain license revenue from entities throughout the commercial stream.

The question now, eight years later, is how the Federal Circuit’s *Lexmark* decision affects our post-*Quanta* analysis and these licensing strategies.

Lexmark: Where Are We?

The Critical Facts

Lexmark made and sold printers and toner cartridges covered by multiple Lexmark patents. Lexmark sold toner cartridges in the U.S. and foreign markets under two programs: a “Regular Cartridge” program, where cartridges were sold at full price and without restriction on resale or reuse; and a “Return Program Cartridge” program, where cartridges were sold at a 20 percent discount, but subject to no-resale and no-reuse restrictions. The parties stipulated that “Lexmark ha[d] an express and enforceable contractual agreement with each of its end-user customers,” and it was undisputed that end users and resellers of “Return Program Cartridges” received adequate notice that cartridges could not be used more than once. Lexmark, 816 F.3d at 728.

Impression Products acquired spent Lexmark cartridges for refilling and sale in the U.S. These refilled cartridges included restricted “Return Program Cartridges” that Lexmark originally sold subject to no-resale and no-reuse restrictions.

Lexmark sued Impression for patent infringement, alleging that Impression’s refurbishment and sale of “Return Program Cartridges” infringed Lexmark’s patents. Lexmark also alleged that Impression’s importation of foreign-sold cartridges — both under the “Regular” and “Return” Programs — constituted patent infringement.

Impression argued *Quanta* overruled *Mallinckrodt*. Its defense was based on the theory that, with regard to patent exhaustion, the result is different when a patentee sells the patented articles, versus when a licensee sells the patent articles. According to Impression, post-sale restrictions in a patentee’s own sales cannot avoid patent exhaustion, whereas post-sale restrictions in licensee sales are valid if clearly communicated and not otherwise unlawful. Lexmark, 816 F.3d at 738.

Impression’s theory rested on dicta in *Quanta*: “The longstanding doctrine of patent exhaustion provides that the initial authorized sale of a patented item terminates all patent rights to that item.” *Id.* at 739. Impression argued that any sale by the patentee, even when the sale is expressly restricted, is an “authorized sale” that results in the patents being fully exhausted as to the items sold.

To reconcile its position with *Quanta* and *General Talking Pictures*, Impression distinguished sales by licensees versus sales by patentees. According to Impression, sales by licensees outside restrictions in the license grant are not authorized. Thus, patent exhaustion is not invoked. The patentee’s patents are not exhausted as to patented items sold by licensees and used outside those restrictions.

The Majority's En Banc Decision

The en banc Federal Circuit, in holding there to be no exhaustion, disagreed with Impression and held *Quanta* did not overrule *Mallinckrodt*. Judge Richard Taranto wrote the 10-2 decision, finding that there was no reason to treat patentees and licensees differently: “We conclude that a patentee may preserve its § 271 rights when itself selling a patented article, through clearly communicated, otherwise-lawful restrictions, as it may do when contracting out the manufacturing and sale.” The court explained that the “exhaustion doctrine ... must be understood as an interpretation of § 271(a)’s ‘without authority’ language.” The court further explained that because “authority” refers to a grant of permission by the patent owner, the patent owner may limit its grant by imposing conditions or restrictions. *Id.* at 735. The Federal Circuit saw no reason why a patentee-seller should have less of an ability to restrict downstream

uses of its own products than a patentee-licensor who licenses the right to make and sell the product to others. The court reaffirmed *Mallinckrodt*, emphasizing that a “patentee may preserve its patent rights by otherwise-proper restrictions when it makes and sells patented articles itself and not only when it contracts out manufacturing and sales.” *Id.* at 750.

The court also rejected Impression’s other defense, namely that Lexmark’s foreign sales exhausted Lexmark’s U.S. patent rights. In doing so, the court affirmed its decision in *Jazz Photo*. *Jazz Photo Corp. v. U.S. International Trade Commission*, 264 F.3d 1094 (Fed. Cir. 2001). Notably, the court stated that the domestic exhaustion principle “does not preclude an accused infringer from establishing that the U.S. patentee actually gave it a license, expressly or by implication.” *Lexmark*, 816 F. 3d at 763. The majority found that Impression had not preserved this argument because it did not advance an implied-license defense (similar to the situation in *Quanta*). Ultimately, the court found that Impression infringed the Lexmark patents and remanded the case to the district court for an entry of judgment for Lexmark. *Id.* at 774.

The Dissent

The dissent by Judge Timothy Dyk (joined by Judge Todd Hughes) argued that, historically, “the Supreme Court repeatedly held that the authorized sale of a patented article exhausted all of the patentee’s patent rights” and that “[p]ost-sale restrictions were enforceable only as a matter of state contract law.” *Id.* at 775-776. Because sales by the patentee constitute “authorized sales” as they “transfer[] title to the purchaser,” the dissent found that this principle is consistent with *Quanta* where the Supreme Court found that the “authorized sale of an article that substantially embodies a patent exhausts the patent holder’s rights and prevents the patent holder from invoking patent law to control post-sale use of the article.” *Id.* at 778. Judge Dyk agreed with Impression and the U.S. government (in its amicus brief) that the Federal Circuit’s three-judge panel decision in “*Mallinckrodt* was wrong when decided, and in any event cannot be reconciled with the Supreme Court’s [*Quanta* decision].” *Id.* at 774.

As to Impression’s second defense, Judge Dyk stated “the government argues, and I agree, that [a] foreign sale should result in exhaustion if the authorized seller does not explicitly reserve its United States patent rights.” According to Judge Dyk, the “majority’s rule would require a manufacturer to ‘trace the patent rights of every component it purchases and then negotiate appropriate license arrangements ...,’ and ultimately ‘it is consumers who suffer most directly through higher prices.’” *Id.* at 787.

Lexmark and Quanta: Where Are We Going?

In sum, Lexmark followed *Quanta* (as well as the earlier Supreme Court *General Talking Pictures* decision) and, thus, it remains possible for patent owners to avoid patent exhaustion and obtain downstream license revenue by using post-sale or field-of-use restrictions in its license agreements.

The Road to the Supreme Court

Patent owners currently face a significant threat to the value of their patent portfolios and rights. Impression filed a petition for certiorari in *Lexmark* on March 21, 2016. The Supreme Court is scheduled to consider the petition later this year and have invited the solicitor general to file a brief expressing the views of the U.S. government. The case is being carefully watched.[1] If the Supreme Court decides to hear the case and moves toward the dissent and the U.S. government’s position, then the ability of patent owners to obtain full value of their patents could be scaled back. According to the *Lexmark*

dissent, this would be a good result because, under the majority's decision, businesses that purchase patented products in the global market-place face "a cloud of uncertainty over every sale" given the possible existence of post-sale restraints that avoid patent exhaustion. *Lexmark*, 816 F. 3d at 779, citing *Tessera Inc. v. ITC*, 646 F. 3d 1357, 1370 (Fed. Cir. 2011).

Lexmark left open the issue of whether the patentee's licensee must provide notice of the post-sale restriction to the downstream buyer to avoid patent exhaustion against that buyer. Certainly such notice must be clearly communicated by a patentee to the licensee and to buyers who purchase directly from the patentee. But is notice required for a licensee's or downstream owner's subsequent sales to avoid patent exhaustion as to those sales? *General Talking Pictures* and *Quanta* do not explicitly address this issue. Some argue the cases require actual notice for subsequent sales to avoid patent infringement, and in fact such notice may help address the *Lexmark* dissent's concern of "a cloud of uncertainty over every sale." *Lexmark* at 779. Others argue actual notice for subsequent sales is not practical and, in any case, downstream sellers that sell patented products to downstream buyers cannot convey rights they do not have; so, lawful post-sale restrictions originally imposed by the patentee are effective against those downstream buyers, irrespective of notice. *Lexmark's* mention of the buyer's knowledge, even if dicta, adds to the "cloud of uncertainty" surrounding the issue of patent exhaustion and downstream licensing efforts. This will be another topic to watch if the Supreme Court grants certiorari in *Lexmark*.

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[1] Docket available here: <https://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/15-1189.htm>.