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Reestablishing the Doctrine of Patent Exhaustion

Quanta Computer, Inc. v. LG Electronics, Inc.[1], presents facts at the intersection of two legal rules. On the one hand, patentees are free to impose restrictions, such as field-of-use restrictions, when they license others to manufacture their patented products.[2] Such restrictions can be permissible even if they would be antitrust violations outside the patent context.[3] On the other hand, a patentee cannot restrict the use of its patented products once they are sold, whether the sale is by the patentee itself or by a licensee.[4] This is the exhaustion, or first-sale, doctrine.

The Federal Circuit has caused the first of these rules to swallow the second, by allowing a patentee to convert any sale into a license by imposing some sort of restriction in the transfer. The restriction makes the transfer a "conditional sale," and the Federal Circuit has held that the exhaustion doctrine applies only to "unconditional sales."[5] It has applied this rule, moreover, despite the Supreme Court's application of the exhaustion doctrine to conditional sales.[6]

The Federal Circuit's approach allows patentees to transform a wide range of otherwise permissible conduct into patent infringement. All the patentee needs to do is forbid that conduct in its "conditional sale" arrangement. The Federal Circuit itself suggested in *Mallinckrodt* that this could allow patentees to eliminate the right of repair, and indeed other courts have applied the approach to allow patentees to

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1 Supreme Court Docket No. 06-937. Oral arguments are scheduled for Wednesday, January 16, 2008. http://www.supremecourtus.gov. For background on the particular issues, see, Dennis Crouch, *Supreme Court to Decide Patent Exhaustion Case*, Patently-O (Sept. 25, 2007) at http://www.patentlyo.com/patent/2007/09/supreme-court-t.html.

2 *General Talking Pictures Corp. v. Western Electric Co.*, 304 U.S. 175 (1938).

3 *United States v. General Electric Co.*, 272 U.S. 476 (1926).

4 *Adams v. Burke*, 84 U.S. 453 (1873); *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*, 243 U.S. 502 (1917), *United States v. Univis Lens Co.*, 316 U.S. 241 (1942).

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

6 *Motion Picture Patents* 243 U.S. 502; *Univis Lens*. 316 U.S. 241.

eliminate not only the right of reuse/repair,[7] but also the right to resell patented products.[8] More generally, as the American Antitrust Institute argues in its *amicus* brief, the elimination of the exhaustion doctrine leads to considerable uncertainty, as downstream purchasers cannot know whether their use of the product is permissible unless they ensure that upstream sellers were in compliance with any license restrictions.[9]

It seems probable that the Supreme Court will reverse or at least vacate the Federal Circuit's *Quanta* decision. It is likely to hold that sales of patented products exhaust the patentee's patent rights, as the Solicitor General and other *amici* argue that it should. The patentee could still impose limitations on buyers' uses of the products, but those limitations would be solely matters of contract. They could not be enforced through patent infringement actions, and they would be subject to antitrust law limitations.

But this raises two questions. First, will the Court define the difference between a sale and a license for this purpose? Quanta and the Solicitor General appear to take the position that the distinction should turn on the transfer of title. A problem with that approach is that it would give patentees considerable opportunity to use formal differences in the transaction to alter what should be substantive rules. (The Solicitor General may be unconcerned about this. It discusses with apparent approval *Mitchell v. Hawley*, 83 U.S. 544 (1872), where the patentee arguably forbad its manufacturing licensee from selling the patented inventions, granting only the right "to license to others the right to use the said machines." The Court in *Mitchell* allowed an infringement suit against the downstream users, though the case is somewhat peculiar because the infringement arose after the original patent term had been extended, when the license terms extended only to the end of the original patent term.)

An alternative sale-license distinction might focus on what is being transferred by the patentee. As the district court argued in *Mallinckrodt*, one can read the Supreme Court's decisions to allow restrictions on manufacturing licensees but not on ultimate purchasers. This echoes a distinction drawn in Europe, where the EC's technology transfer block exemption applies to exempt from antitrust scrutiny certain "technology transfer agreements entered into between two undertakings permitting the production of contract products."[10] Sales of the products *after* they are produced

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[7] *Arizona Cartridge Remanufacturers Association, Inc. v. Lexmark International, Inc.*, 290 F. Supp. 2d 1034 (N.D. Cal. 2003), *aff'd*, 421 F.3d 981 (9th Cir. 2005).

[8] *Pioneer Hi-Bred International, Inc. v. Ottawa Plant Food, Inc.*, 283 F. Supp. 2d 1018 (D. Iowa 2003).

[9] AAI brief available at http://patent.googlepages.com/Quanta.Amicus.AAI.pdf.

[10] Commission Regulation 772/2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements, O.J. L 123/11, art. 2 (2004), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004R0772:EN:NOT.

are governed by another block exemption.[11] Under this view, it is in the manufacture of the product that the patentee's technology is first used, and its rights exhausted.

One effect of the exhaustion doctrine is to make price-discrimination more difficult for the patentee. For example, if the patentee would prefer to sell at different prices to different users, an inability to enforce its patent rights downstream would make it more difficult for the patentee to prevent arbitrage. But the Supreme Court has not hesitated to place other practical limits on price-discrimination by patentees, as in disallowing tying arrangements, which prevents metering through sales of the tied products (though only for patentees with market power). Moreover, even when its patent rights are exhausted, a patentee can enter into contracts forbidding resale for arbitrage, but it can only enforce those contracts through breach-of-contract actions, not through patent infringement suits.

The second question is whether the exhaustion rule applies if, as in *Quanta v. LG*, the product sold is only a component of the patented invention, in that it does not itself satisfy all the claim elements. The Supreme Court has said yes, at least in some circumstances: "[W]here 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."[12] This rule recalls, though is perhaps somewhat broader than, the contributory infringement doctrine. That is, if this were the rule, the exhaustion doctrine would apply where there has been an authorized sale of a product that would contributorily infringe if its sale were unauthorized.

But the *Univis* Court followed the statement quoted above with another: "The reward [the patentee] has demanded and received is for the article and the invention which it embodies and which his vendee is to practice upon it." *Id.* at 251. The question in *Quanta v. LG* can be viewed as turning on whether this second statement from *Univis* is one of law or of fact. If it is interpreted as one of law, then the Court is saying that the patentee *must* get its returns in the sale of the component invention. If the statement is one of fact, then the Court may just be relying on a view that the defendant in *Univis* had in fact gotten the return to which it was entitled in that first sale. In other cases with different facts, the patentee might be able to use patent law to enforce downstream restrictions despite the upstream sale of a component of the patented invention.

For example, one can imagine cases in which the maker of the component at issue, like Intel in *Quanta v. LG*, would have concerns about contributory infringement claims and therefore would seek a license from the patentee. That seems particularly plausible if the component at issue could be resold, so that even if its maker (Intel) ensured that its customers had licenses from the patentee, others to whom they might

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[11] Commission Regulation 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, O.J. L 336/21 (1999), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31999R2790:EN:NOT.

[12] *Univis Lens*, 316 U.S. at 250–51.

resell the component might not. It could make sense for the patentee to grant a license to the component maker in this situation, and make the license apply to downstream purchasers, rather than to enter into licenses with each of those downstream purchasers. But perhaps there could be circumstances in which the patentee would like to price-discriminate by use among the downstream purchasers, so that licenses at each level would be desirable.

It will be interesting to see how, or if, the Supreme Court will resolve this issue. As noted above, it could simply say that the patentee must get its profits from the component maker. This would promote certainty in the downstream product markets and be conceptually consistent with contributory infringement law. On the other hand, it would be somewhat odd to require that patentees deal with contributory infringers rather than direct infringers. Moreover, it would place limits on the ability of patentees to price-discriminate, though, as noted above, the Court might not view that as an obstacle. But one could also take the view that where the downstream applications are significantly different, so as to make separate downstream licenses desirable, there should be separate downstream patents, and that the upstream product then would not be "especially made or especially adapted for use in an infringement of [any one of] such patent[s]."[13]

The Court might simply choose not to address this issue. It could, for example, just correct the Federal Circuit's approach to the exhaustion doctrine and then direct the Federal Circuit to address it.[14] That approach might look particularly attractive in that the LG-Intel license itself includes a provision that calls for application of the exhaustion doctrine: "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."

A final issue is that of LG's method claims. The Federal Circuit held that "the sale of a device does not exhaust a patentee's rights in its method claims." As Quanta's brief describes, this holding is inconsistent with Supreme Court decisions and even with other decisions by the Federal Circuit. Generally speaking, method claims that would be contributorily infringed by an unauthorized sale of a product should be exhausted by an authorized sale of the product. But if the method at issue goes beyond the normal use of the product at issue, so that the product arguably does not contributorily infringe the method patent, as suggested above for downstream product patents, it seems that exhaustion should not occur.

The Federal Circuit's cases beginning with *Mallinckrodt* and continuing through *Quanta* have allowed patentees to use contract, or even simply unilateral notice, to eliminate the application of the exhaustion doctrine. By simply prohibiting certain conduct in their "license" agreements, patentees can under current Federal Circuit law transform what would be permissible conduct into patent infringement. The Supreme Court,

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[13] 35 U.S.C. § 271(c).

[14] *Cf. KSR Int'l Co. v. Teleflex Inc.*, 127 S. Ct. 1727 (2007); *eBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837 (2006).

however, said in *Univis* that "sale of [a patented article] exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his patent, control the use or disposition of the article." The Court's forthcoming decision will likely reestablish that rule.

Notes:

James B. Kobak, Jr., *Contracting Around Exhaustion: Some Thoughts About the CAFC's Mallinckrodt Decision*, 75 J. Pat. & Trademark Off. Soc'y 550 (1993).

Mark R. Patterson, *Contractual Expansion of the Scope of Patent Infringement Through Field-of-Use Licensing*, 49 Wm. & Mary L. Rev. 157 (2007).

Richard H. Stern, *The Unobserved Demise of the Exhaustion Doctrine in U.S. Patent Law: Mallinckrodt v. Medipart*, 15 Eur. Intell. Prop. Rev. 460 (1993).