

Quanta, LG Case Will Have Huge Impact On Licensing

Wednesday, Nov 14, 2007 --- What do Supreme Court cases from the 19th to mid-20th centuries dealing with patents on coffin lids, felting machines, vacuum tube amplifiers, and bifocal eyeglass lenses, the last of which was decided in 1942, have to do with contemporary patent licenses and lawsuits for infringement?

The answer is that these cases establish a doctrine called patent exhaustion, which limits the ability of a patent holder to control a patented article once it has been sold, whether through use restrictions or royalty payments.

The Supreme Court will hear a case concerning the scope of the doctrine in its next term; the decision may have far-reaching consequences on a patentee's ability to enter and enforce licenses.

The case is *Quanta Computer Inc. v. LG Electronics Inc.*, in which the parties dispute the propriety of LGE's attempt to obtain royalties on its patents on computer chips and computer systems from multiple points in the supply chain for computer manufacture.

LGE claims that it can license its patent portfolio to chipmaker Intel, and yet retain the right to collect additional royalties from computer manufacturers who purchase the licensed chips and combine them into circuit boards and computer systems.

LGE contends that these systems, despite the Intel license, are unlicensed combinations on which they can collect additional royalties.

Quanta and its co-defendants contend that once LGE permitted Intel to sell to any purchaser, LGE's patent rights were exhausted and it can neither receive additional royalties from them nor sue them for patent infringement.

When LGE sued Quanta and a number of other manufacturers of computers and computer circuit boards for patent infringements, Quanta asserted LGE's license to Intel as a defense.

LGE had licensed its entire patent portfolio to Intel; under the license Intel could practice any of LGE's patents, and could sell licensed chips to others. The license to sell came with conditions, however.

Although Intel could sell to anyone, it was required to announce to its customers that its license with LGE only covered combinations of all-Intel components, and did not cover the purchasers if they combined licensed Intel components with components from suppliers other than Intel.

Quanta contended that LGE's rights in its patents were exhausted by Intel's sale, thereby barring LGE from enforcing its patents on downstream purchasers, because the license did not bar Intel from selling the licensed chips.

The required announcement, argued Quanta, could not restrict its rights to use where LGE's license did not restrict Intel's right to sell.

The district court sided with Quanta and dismissed the case. In doing so, it relied heavily on a 1942 Supreme Court case concerning a two-tiered licensing arrangement on lenses for multifocal eyeglasses, *United States v. Unis Lens*.

In that case, an owner of patents covering both the lens blanks and the process of finished lenses entered separate licenses with wholesalers, who made the lens blanks, and finishers, who turned the lens blanks into finished lenses.

The Supreme Court held that, since the lens blank was a necessary component of the finishing process, the patentee relinquished his patent rights upon sale of the blank and could not impose additional restrictions upon those who finished the blank into a lens.

According to the district court, the *Univis Lens* case meant that LGE could not impose further restrictions on Intel's customers because the computer chips had no meaningful use other than to be combined into a computer system, just as the lens blanks had no meaningful use other than to be turned into finished lenses.

The Court of Appeals for the Federal Circuit held otherwise. The Federal Circuit, established in 1982 with the purpose of creating a more unified treatment of patent cases, hears all appeals of cases arising under the patent laws.

The Federal Circuit relied on one of its own cases, *Mallinckrodt, Inc. v. Medipart, Inc.*, in ruling for LGE. According to the 1992 *Mallinckrodt* decision and subsequent Federal Circuit cases, the old Supreme Court precedents simply establish that unconditional sales result in patent exhaustion. Parties to a transaction may freely transact around patent exhaustion and enforce any breaches with a suit for patent infringement.

In *Mallinckrodt*, the Federal Circuit held that a medical device maker's notice that its product was sold subject to a single-use condition was enforceable by a patent infringement suit.

In the present case, the Federal Circuit held that Intel's announcement to its customers validly reserved LGE's right to bring an infringement action against combinations of Intel and non-Intel products.

Quanta petitioned the Supreme Court to hear the case, contending that the Federal Circuit's decision conflicts with a series of earlier Supreme Court decisions.

In opposing the petition, LGE argued that the same precedent justified upholding its license to Intel and lawsuits against Intel's customers.

The cases cited by Quanta and LGE reflect both the increasing the country's growing technical sophistication as well as the Supreme Court's ongoing efforts to strike the proper balance between the rights of a patent holder and a commitment to an economy marked by free competition.

Adams v. Burke, decided in 1873, concerned a patent on coffin lids. The patent owner granted a license to make and sell coffins with the patented lid within a 10-mile radius of Boston. A purchaser of one of the coffins who used it beyond the 10-mile limit was not liable for infringement. The majority of the Court held that once an article was "lawfully made and sold, there is no restriction on their use to be implied for benefit of the patentee."

Opening an ongoing debate, three justices in dissent questioned how a licensee with a geographic restriction "can [] confer upon their vendees a right which they cannot exercise themselves?"

Mitchell v. Hawley, decided that same year, upheld restrictive conditions in a license on both the licensee and his sub-licensee.

This time the patent concerned a machine for making felt hats, and the patentee imposed a time limitation, not a geographical limitation, on his licensee. The patent owner granted a license to practice the patent for only the first 14 of a patent term that was subsequently extended by the patent office to 21 years.

The Supreme Court held that a sub-licensee was liable for infringement by using the machine past the expiration of the 14-year grant. Notice was not required to the sub-licensee; he bore the risk that his licensor could not validly convey the right to operate the hat-felting machine for the full 21-year term.

In 1938, the Supreme Court addressed a case concerning a license containing field-of-use restrictions in General Talking Pictures Corp. v. Western Electric Co. In this case, a patent licensee was restricted to use the patented vacuum-tube amplifiers for home radios. It violated the license by using the amplifiers in commercial equipment. The licensee's customer was liable for infringement.

The Court held that the licensee was "in no better position than if it had manufactured the amplifiers itself without a license."

The most recent Supreme Court case on the issue is United States v. Unis Lens Co., the eyeglass lens case from 1942. Although the Court, at the

outset of the opinion, claimed to address only the issue of whether the patentee's resale price restrictions, contained in the license agreements, conflicted with the Sherman Antitrust Act, the opinion contains strong language that appears to limit a patentee from obtaining only a single license from a product used in a multi-level supply chain and which has no substantial use other than as used by the downstream users.

Once the patentee gave up the power to exclude others granted by the patent, he gave up his power to control the downstream conditions of sale. "The patentee may surrender his monopoly in whole by the sale of his patent or in part by the sale of an article embodying the invention." "But the sale of it exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his patent, control the use or disposition of that article."

This loss of right applied even where the patentee sold only a component of a complete invention. "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 with the patent, he has sold his invention so far as it is or may be embodied in that particular article."

In addition to the parties' briefing, the Supreme Court invited the Solicitor General to provide the views of the United States government on the issues raised by the case.

The Solicitor General's office performs all of the litigation on behalf of the United States in the Supreme Court; its views carry significant weight with the Court in deciding whether to hear a case. Reviewing the same precedent as Quanta and LGE, the Solicitor General concluded that that the Supreme Court had established a distinction between permissible restrictions on a licensee of a patent, who could be validly limited to particular locales, times, or fields of use, and restrictions purportedly placed on the use of a tangible item itself.

Under the SG's reading of the Court's cases, patent exhaustion bars enforcement of such restricted use via a suit for patent infringement. Enforcement can be had, if at all, by a suit to enforce a contract that commits each party to the restrictions.

The SG both recommended that the Court hear the case and subtly suggested the recommended outcome, a position which it will undoubtedly develop at greater length when the case is briefed yet again prior to oral argument.

Although it is impossible to predict how the case will be resolved, recent trends are instructive. The case reflects the Court's renewed interest in patent law. In recent terms, the Court has issued several opinions in the area of patent law; this represents very active involvement by a Court that now issues fewer than 100 opinions per year.

The case is likely to continue the trend of imposing greater Supreme Court supervision of the Federal Circuit. In its early years, the specialized court of appeals was rarely reviewed by the Supreme Court, leading some commentators to even refer to it as the Supreme Court of Patent Law.

The Federal Circuit largely relied on its own precedents developed since its founding in 1982 and rarely turned to the old Supreme Court cases for guidance.

The recent Supreme Court cases on patent law generally indicate that it regards its own precedent as highly instructive. The Supreme Court's opinion in *Quanta* will very likely rely on and reconcile the same precedent cited by all of the briefing in the petitions and give much less weight to recent Federal Circuit opinions.

The outcome suggested by the SG, if adopted, could have very far-reaching consequences for patent licensing. A patent that could be enforced only on its key components or on the entire patented combination, but not both, would be much less valuable than a patent that could be enforced at multiple points in the supply chain.

A patentee who could only sue in contract, and not under the patent laws, would face greater scrutiny of the license arrangement and more limited remedies than would be available in a patent infringement suit.

For example, contracts involving patents that are characterized by the court as extending the patent's technical or temporal limits are struck down as a "misuse" of the patent.

Even if a contract passes this threshold, a contract limiting use of an article whose patent rights had been exhausted would be subject to antitrust scrutiny, an outcome that the SG suggested with approval in its brief.

While the *Quanta* decision will determine whether LGE can enforce its announced license restrictions, the full effects of the case, should it overturn the Federal Circuit's case, will take some time to be determined.

While the Federal Circuit will be bound by the outcome of the case, it will then have to apply the reasoning of the decision to the wide variety of license restrictions imposed in technical fields that differ widely from the electronics industry, such as biotechnology.

The *Quanta* case may usher in a new era for patentees in which their license arrangements are closely scrutinized under patent, contract, and antitrust laws, with a corresponding uncertainty as to the enforceability, and thus the value, of many patent licenses.

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