

The growing global impact of the US patent exhaustion doctrine

While the patent exhaustion doctrine can help patent owners control the further use of their products, there is disagreement over how far downstream it applies. Post-*Quanta* uncertainty still lingers over whether foreign sales exhaust patent rights.

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Patent exhaustion is a fundamental doctrine of US patent law, first enunciated by the Supreme Court more than 130 years ago in *Adams v Burke* (84 US (17 Wall) 453 (1873)). According to this doctrine, a patent's monopoly ends with the first sale or disposition of an article embodying the claimed invention by the patentee, or by a licensee of the patentee acting within the scope of the licence. As the court later noted in *US v Unis Lens Co* (316 US 241, 250 (1942)): "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 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 the article."

This doctrine has important implications for patent licensing transactions, since the sale of a patented invention by a licensee to a third party can place any resale beyond the reach of US patent laws as a result of the third party's "authority to resell the product" derived from the licensee (See *United States v Masonite Corp* (316 US 265, 278 (1942)); *Unidisco, Inc v Schattner* (824 F 2d 965, 968 (Fed Cir 1987), cert denied, 484 US 1042 (1988))).

Quanta v LG – applying the patent exhaustion doctrine to licensing transactions

The US Supreme Court recently unanimously reaffirmed the patent exhaustion doctrine in *Quanta Computer, Inc v LG Electronics, Inc* (128 S Ct 2109 (2008)). In *Quanta*, the court held that once a patent holder has authorised the sale of a patented product, it is no longer entitled to control a purchaser's subsequent disposition or use of that product. Although the *Quanta* opinion does not explicitly address the topic, as in earlier Supreme Court cases, the underlying principle of the *Quanta* decision is that the patentee had already been compensated by the licensee for the use of the patented invention. Following this rationale, some US courts have interpreted *Quanta* as broadly prohibiting a patentee that authorises the sale of patented products from collecting a second payment from a downstream purchaser or user for the subsequent sale or use of such products.

One such case is a patent infringement lawsuit brought by LG (the plaintiff in the *Quanta* litigation) against Hitachi, *LG Electronics Inc v Hitachi, Ltd* (No 07-6511 CW, ND Cal 13th March 2009). In this litigation, the court granted summary judgment to Hitachi, ruling that LG's patent rights were exhausted by the first authorised sale overseas. In its opinion, the court rejected LG's argument that the exhaustion doctrine articulated in *Quanta* applies only when the first authorised sale of a patented product occurs in the United States. The *Hitachi* court also declined to follow the Federal Circuit's precedent in *Jazz Photo Corp v International Trade Comm'n* (264 F 3d 1094 (Fed Cir 2001)) and *Fuji Photo Film Co, Ltd v Jazz Photo Corp* (394 F 3d 1368 (Fed Cir 2005)), which held that Jazz Photo's importation into the United States

of refurbished single-use cameras (known as lens-fitted film packages (LFFPs)) did not infringe Fuji Photo Film Co's patents.

Quanta v Hitachi – will the Jazz Photo decision still be followed?

The core issue in the Federal Circuit's 2001 *Jazz Photo* opinion was whether the refurbishment of the Jazz LFFPs constituted repair or reconstruction. If considered to be repair, exhaustion would be applicable, since once a product is legitimately sold, the purchaser has the right to repair it, as do all subsequent purchasers. Reconstruction, on the other hand, is a 'second creation,' which prevents the initial purchaser and those that follow from invoking exhaustion to defend against an infringement claim.

Some of the imported LFFP cameras in dispute in *Jazz Photo* originated overseas and were sold outside the United States. The Federal Circuit held that "United States patent rights are not exhausted by products of foreign provenance", and that imported LFFPs of solely foreign origin were not immune from infringement of Fuji's US patents simply because Jazz Photo had refurbished them. Four years later, in *Fuji Photo Film v Jazz Photo Corp*, the Federal Circuit revisited these issues. The court decided that foreign sales could not occur under a US patent because there is no extraterritorial effect in the US patent system, and that Jazz Photo did not avoid liability for infringement because Fuji and its licensees had permitted overseas sales of the cameras, stating that the "patentee's authorization of an international first sale does not affect exhaustion of that patentee's rights in the United States".

The Quanta legacy – licensed foreign sales may exhaust US patent rights

Several US patents owned by LG, covering technology relating to computer systems and operations using microprocessors and chipsets with memory chips, were asserted in both *Quanta v LG* and *Hitachi*. In September 2000, LG licensed the patents to Intel, authorising it to manufacture and sell microprocessors and chipsets that practised the LG system and method patents. In exchange for a licensing fee and reciprocal licence to use Intel patents, LG granted Intel a "fully paid-up, worldwide license" to the technology in LG's patent portfolio, including the patents in dispute.

The LG-Intel licence stated that Intel's customers were not authorised to combine licensed Intel microprocessors and chipsets with non-Intel components. It also stated that "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". In a separate master agreement, Intel agreed to provide notice to its customers that they were not authorised to combine licensed Intel microprocessors and chipsets with non-Intel components. Some of those customers, including Quanta and Hitachi, purchased microprocessors and chipsets from Intel. Both companies received the notice required by the LG-Intel master agreement, but nevertheless manufactured computers using Intel components in combination with non-Intel components in ways that practised LG's system and method patents. LG then brought suit for infringement, claiming that combining Intel components with those of other manufacturers violated its patents.

In the *Quanta v LG* litigation, the district court had ruled against LG, applying the exhaustion doctrine. The Federal Circuit reversed, concluding that the doctrine did not apply to the arrangement between LG and Intel because the agreement expressly disclaimed granting any licence to computer system manufacturers purchasing components from Intel to combine the licensed parts with non-Intel products. In addition, Intel had notified its customers of the limited scope of the licence LG had granted. On review, the Supreme Court reversed the Federal Circuit, finding 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".

The court also found that Intel's microprocessors and chipsets did substantially embody the LG patents because they had no reasonable non-infringing use.

In its litigation against *Hitachi*, LG tried to distinguish the Supreme Court's *Quanta v LG* ruling by arguing that the Intel components in dispute did not "substantially embody" LG's patents, and that even if those parts did, the exhaustion doctrine articulated in *Quanta* applies only when the first authorised sale of patented products occurs in the United States. However, the Northern District of California court held that although the Intel components in *Hitachi* were different from those under scrutiny in *Quanta*, the fact that the Hitachi products contained Intel components in combination with other elements was sufficient to demonstrate infringement.

While LG did not dispute that sales in

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the United States of products substantially embodying a patent claim exhaust the patent holder’s rights, it argued that foreign sales do not result in such exhaustion, particularly because the Supreme Court did not specifically apply its ruling in *Quanta* to foreign sales. Unconvinced, the court in *Hitachi* stated that the Supreme Court was unequivocal in its decision. The court noted that the licence granted by LG authorised Intel to sell LG products to Hitachi, and that those sales fell within the Supreme Court’s holding in *Quanta* because “authorised sales” include authorised foreign sales.

The *Hitachi* district court also noted that the Supreme Court in *Quanta* was fully aware that at least some sales under the LG-Intel licence agreement were made overseas, and the court concluded that “the question is whether the product is ‘capable of use only in practicing the patent,’ not whether those uses are infringing. Whether outside the country or functioning as replacement parts, the Intel Products would still be practicing the patent, even if not infringing it.”

Ultimately, the court in *Hitachi* decided that “the fact that the Court was aware of foreign sales of the Intel parts, yet declined to limit its holding to sales in the United States, suggests that interpreting these *Quanta* so as to impose such a limitation would be incorrect”. The court in *Hitachi* also found the Federal Circuit rulings in the *Fuji Photo Case* inconsistent with the Supreme Court’s *Quanta* decision and declined to follow that precedent. It noted that distinguishing between authorised foreign and domestic sales would contradict the Supreme Court’s intention of eliminating the possibility of a

patent holder avoiding the implications of the exhaustion doctrine by authorising a sale and enjoying the benefit of its patent monopoly, then suing a subsequent purchaser for infringement.

The applicability of the patent exhaustion doctrine to first sales outside the United States was first raised as an issue when the Supreme Court ruled in *Boesch v Graff* (133 US 697, 10 S Ct 378 (1890)) that a lawful foreign purchase does not eliminate the need for a licence from the US patentee prior to importation and sale of the patented product in the United States. Although the Federal Circuit relied on *Boesch* in *Jazz Photo*, the court in *Hitachi* found that *Boesch* was distinguishable, noting that the plaintiffs in that case held patents for the same product in both the United States and Germany. The court also noted that the defendants had purchased the patented product in Germany from a source that had the right to sell under German law, but did not have a licence or consent from the US patent owner to sell those products in the United States.

The facts in *Hitachi* are different from those in *Boesch* because LG authorised the sale of patented products pursuant to a licence under a US patent, rather than a foreign patent. In considering these differences, the court in *Hitachi* noted that ‘extraterritorial effect’ refers to holding an entity liable for a violation of US law for actions it took outside the nation’s borders. The *Hitachi* court ultimately concluded that *Quanta* is controlling, and that the exhaustion doctrine applies to authorised foreign sales as well as to authorised domestic sales: “The present case, in

contrast, involves an authorized sale made pursuant to a license under a United States patent. *Boesch* does not speak to this issue.”

The court in *Hitachi* also decided that signing the licence agreement was also an authorised sale, which by itself exhausted LG’s patent rights, citing the Supreme Court’s 1942 decision in *United States v Masonite Corp.* In that case, the court emphasised that exhaustion depends on whether the patent holder has received compensation for licensing the patented product. The court in *Hitachi* ruled that since LG received both a payment from Intel and a licence to Intel’s patented products, the first sale took place at the time LG granted the licence to practise its patents.

Post-Quanta licensing issues

While *Quanta* has the potential to limit a patent owner’s control of the downstream use of patented products through the patent laws, it also recognises that a patentee can impose enforceable restrictions on use through contract law: “We note that the authorized nature of the sale to *Quanta* does not necessarily limit LGE’s other contract rights. LGE’s complaint does not include a breach-of-contract claim, and we express no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages (See *Keeler v Standard Folding Bed Co*, 157 US 659, 666, 15 SCt 738, 39 LEd 848 (1895) (“Whether a patentee may protect himself and his assignees by special contracts brought home to the purchasers is not a question before us, and upon which we express no opinion. It is, however, obvious that such a question would arise as a question of contract, and not as one under the inherent meaning and effect of the patent laws”)).”

This would appear consistent with the court’s opinion in *General Talking Pictures Corp v Western Electric Co* (304 US 175, adhered to, 305 US 124 (1938)), reh’g denied,

305 US 675 (1939)), which states, in summarising the law on use restrictions, that “a restrictive license is legal seems clear ... As was said in *United States v General Electric Co.*, 272 U.S. 476, 489 (1926), the patentee may grant a license ‘upon any condition the performance of which is reasonably within the reward which the patentee by the grant of the patent is entitled to secure’”.

The Federal Circuit’s ruling in *Mallinckrodt, Inc v Medipart, Inc* (976 F 2d 700, 703 (Fed Cir 1992)) also recognises this exception. “As in other areas of commerce, private parties may contract as they choose, provided that no law is violated thereby: [T]he rule is, with few exceptions, that any conditions which are not in their very nature illegal with regard to this kind of property, imposed by the patentee and agreed to by the licensee for the right to manufacture or use or sell the [patented] article, will be upheld by the courts. *E. Bement & Sons v National Harrow Co.*, 186 U.S. 70, 91, 22 S.Ct. 747, 755, 46 L.Ed. 1058 (1902).”

Post-*Quanta*, patent holders interested in limiting the potential effect of the US patent exhaustion doctrine on their licensing transactions should consider contractual options as restrictions. For example, the Supreme Court’s opinion in *Quanta* noted that the licence agreement between Intel and LG did not expressly restrict Intel’s right to sell its products to purchasers that intended to combine them with non-Intel parts. Even though Intel was required to give its customers notice that LG had not licensed those customers to practice its patents, neither LG nor *Quanta* argued that Intel had breached the licence agreement. The court also noted that the customer notice provision was part of the Intel master agreement, and that LG did not even suggest that a breach of that agreement would constitute a licence agreement breach. **iam**

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