

HIGH COURT CONTINUES PATENT LAW EXAMINATION WITH *QUANTA COMPUTER* CASE

by

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On January 16, 2008, the U.S. Supreme Court heard oral argument in *Quanta Computer, Inc. v. LG Electronics, Inc.*, No. 06-937. *Quanta Computer* is an important patent law case pertaining to the scope of the patent-exhaustion doctrine for patent licensing arrangements. In particular, it addresses whether that doctrine limits the ability of a patent holder to grant conditional licenses allowing it to enforce its patents and collect royalties for downstream uses of licensed products. The case is the fourth major patent law case the Court has heard over the past two years, reflecting the Court's heightened interest in patent issues. The question presented (as framed by the Petitioner, Quanta Computer, Inc.) is "whether the Federal Circuit erred by holding, in conflict with decisions of this Court and other courts of appeals, that respondent's patent rights were not exhausted by its license agreement with Intel Corporation, and Intel's subsequent sale of product under the license to petitioners."

More specifically, the issue presented is whether the patentee, LG Electronics, was permitted to condition its license to Intel in such a way that Intel's customers (with notice of the restriction) could be precluded from using the licensed Intel product in combination with non-Intel components. The case may result in new legal guidelines for negotiating and structuring licensing arrangements for complex technology. Therefore, this case is likely to have important consequences for patentees, particularly in areas such as biotechnology and complex electrical and computer inventions. In these industries, patented technology is often integrated with other components, or where the patented inventions may have multiple uses, only some of which the patentee may wish to license at a particular time or to a particular licensee.

Patent Licensing Law, and the "First Sale" or "Exhaustion" Doctrine. Under patent law, as well as in copyright and trademark, the law generally permits the patentee to retain ownership of the patent while licensing to others the right to use the patent in some way. Public policy recognizes that economic efficiencies can result from such licensing, for example, when the patent holder may not be the most efficient person or entity to commercially exploit the patent. See *eBay, Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837, 1840 (2006) ("some patent holders, such as university researchers or self-made inventors, might reasonably prefer to license their patents, rather than undertake efforts to secure the financing necessary to bring their works to market themselves."); Federal Trade Comm'n, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy*, ch. 2, 4-7 (2003) (noting that patent rights assist small entities in securing financing needed to successfully commercialize their inventions, thereby enhancing competition by facilitating entry of small entities into marketplace).

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Another principle of intellectual property licensing is that the patentee may choose to license some or all of its exclusionary rights under the patent statute. For example, a U.S. patent generally gives the patentee the right to exclude others from making, using, selling, offering to sell, or importing into the United States the claimed invention. *See generally* 35 U.S.C. § 271(a) (“whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefore, infringes the patent.”). Absent some form of unlawful conduct such as antitrust violations in connection with the grant of a license, the patentee may choose to license none, some, or all of these rights. It might do so on an exclusive or nonexclusive basis. It might choose to limit the fields of use of the license, for example, permitting the use of the patented invention in connection with some types of products but not others. It might grant one license for consumer uses and a different (and likely more expensive) license for commercial uses. It might limit the license to products for which only a single use is permitted, and prohibit any attempt to refurbish or reuse the product. And it might choose to place geographic or temporal restrictions on the license grant. Such limitations upon the scope of a license have been accepted as generally permissible.

The “first sale” or “exhaustion” doctrine, however, places a fundamental limit on the scope of the patentees’ rights. Under this doctrine, once an authorized, unrestricted first sale of the patented invention in the United States has been made, the patentee’s exclusive right is said to be exhausted, and the patentee no longer has the right to prevent the further use or sale of the patented article. *Jazz Photo Corp. v. Int’l Trade Commission*, 264 F.3d 1094, 1105 (Fed. Cir. 2001). As stated by the Supreme Court, “when the patentee, or the person having his rights, sells a machine or instrument whose sole value is in its use, he receives the consideration for its use and he parts with the right to restrict that use.” *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 456 (1873); *see also United States v. Masonite Corp.*, 316 U.S. 265, 278 (1942) (exhaustion of patent right 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.”).

The most common example of this doctrine readily understandable by laypersons is that involving consumer goods. A consumer good might utilize one or more patented inventions, for which the manufacturer has obtained licenses from various patentees. Those licenses may typically require that the manufacturer pay the patentee a royalty for any sales of the product that it makes to consumers. Once that sale to the consumer is made, however, the patent right is exhausted and the consumer may choose to resell the product to anyone else without interference from the patentee. In the analogous copyright context, for example, once a consumer buys a compact disc or DVD through an authorized sale, the consumer generally has the right to resell that item on a second-hand basis without violating the copyright of the rights-holder.

Factual Background and Lower Court Rulings. Pursuant to a settlement agreement, Intel entered into a license agreement with the patentee, LG Electronics, with respect to LG’s entire patent portfolio. The license agreement gave Intel the complete rights to make, use, and sell products covered by LG’s patents, except that with respect to microprocessors and chipsets the license provided only a covenant not to sue Intel and did not provide a license to combine those items with non-Intel components. Under the license, Intel was required to inform its customers that Intel’s license from LG covered only articles comprised entirely of Intel components, and did not, for example, cover articles comprised of a combination of licensed Intel components with components of other suppliers. Quanta thereafter purchased microprocessors and chipsets from Intel and installed them into Quanta computers. Accordingly, although Intel was licensed to sell these products under its license with LG, the license did not by its terms authorize Quanta to combine the licensed Intel products with non-Intel products. Intel informed Quanta of this limitation on its license.

LG sued Quanta for infringement. In summary, LG contends that it has the right as a patentee to license its patents in such a way that it can collect royalties at multiple points in the supply chain (in this case, for the manufacture of computers) before the products reach the end consumer. Thus, although it had licensed its patents to Intel, LG contends that it was nonetheless an infringement for Quanta to purchase the licensed chips and combine them into circuit boards and computer systems. Quanta contends that once LG permitted Intel under its license to sell the patented inventions, this constituted a first sale that exhausted the patent right, and accordingly LG could not collect any additional downstream royalties or sue downstream purchasers or resellers for infringement.

A federal district court granted summary judgment of non-infringement, holding that LG could not impose restrictions on Intel's customers when the licensed computer chips had no meaningful use other than in connection with a computer system. *LG Electronics, Inc. v. Asustek Computer, Inc., et al.*, 248 F. Supp. 2d 912 (N.D. Cal. 2003); *LG Electronics, Inc. v. Asustek Computer, Inc., et al.*, 2002 WL 31996860 (N.D. Cal. Aug. 20, 2002). The District Court relied on a 1942 antitrust case, *United States v. Univis Lens Co.*, 316 U.S. 241 (1942), which involved a two-tiered license arrangement on lenses. In that case, the patentee held patents on both lens blanks and the process for finishing lenses, and it entered into separate licenses with different entities to (i) make the lens blanks and (ii) turn the lens blanks into finished lenses. The Supreme Court held that the patentee exhausted his patent rights with the licensed sale of a lens blank, and it could not obtain a further royalty on the process for finishing the lens because the lens blanks had no meaningful use other than for turning into finished lenses. "The patent exhaustion doctrine is therefore implicated not only by an authorized sale of a patented article, but also by the authorized sale of an 'uncompleted article which, because it embodies essential features of his patented invention, is within the protection of his patent [and is] destined . . . to be finished by the purchaser in conformity to the patent.'" *Id.* at 250-51.

On appeal to the Federal Circuit, the appellate court reversed, holding that patent law permits parties to a license to bargain around the patent exhaustion doctrine, and that Intel's announcement to its customers informing them of the limits of its license was a valid means by which to reserve LG's rights against combination products that include non-Intel components. *LG Electronics, Inc. v. Bizcom Electronics, Inc., et al.*, 453 F.3d 1364 (Fed. Cir. 2006). The Federal Circuit stated that patent exhaustion is triggered only by an unconditional sale, which was not the case here. When a license contains restrictions such as those involved in this case, "it is more reasonable to infer that the parties negotiated a price that reflects only the value of the 'use' rights conferred by the patentee." *Id.* at 1369-70 (citation omitted). In other words, because Intel bargained for a license that did not cover its customers' use of patented components when combined with non-Intel components, Intel presumably paid a lower price for its license.

The Federal Circuit stated that in this case there were two possible sales that might create an exhaustion of patent rights. First, because LG had granted Intel a license for its entire portfolio of patents on computer systems and components, a transaction involving the sale of such computer systems would constitute a first sale for purposes of the exhaustion doctrine. *Id.* at 1370. Second, Intel's license also permitted the sale of microprocessors and chipsets (as distinct from the entire patented system), but in this instance the appellate court found that those sales were conditional and the license prohibited their resale in combination with non-Intel components. *Id.*

The Arguments Before the Court. At stake before the Supreme Court are the ground rules for structuring and negotiating complex intellectual property licensing agreements. On the one hand it is argued that the law should permit sophisticated parties to structure the license in the most economically efficient way, which may mean dividing and limiting the license grants such that they are conditional. The contrary argument is that a rule that is unduly deferential to the patentees' rights could permit the patentee to engage in a form of "double-dipping," by collecting a royalty from a licensee only to preclude the licensee's customers from using the licensed articles. Nearly thirty *amici* have filed briefs, and although these briefs have varied in terms of the tests that they recommend the Court adopt, they have argued that there is confusion in the case law and that commercial parties would benefit from additional legal guidance as to the extent to which a patentee may grant conditional licenses.

The ability to structure and limit a license at multiple stages of product development, for example, are particularly important for research-intensive areas of complex technology such as biotechnology. The arguments set forth in the *amicus* brief of the Biotechnology Industry Organization ("BIO") (which was filed on behalf of neither party) are exemplary, and show how patentees may desire the freedom to grant conditional licenses at various stages of product development:

Bringing biotechnological advancements to market for use by doctors, patients, scientists, and farmers, often requires extensive and long-term collaboration between large and small biotechnology companies and research universities. For example, a university scientist might discover a new protein linked to certain cancers. After patenting the relevant technology, the university might then license a biotech business or university spin-off company to begin the time-intensive process of developing

standardized tools for further research, as well as diagnostic methods, therapeutic treatments, and other real-world applications for the discovery.

Such licensing arrangements are mutually beneficial. They provide the licensee the exclusive rights needed to attract capital for research and development, while providing the university with revenue to support further academic research. Due to the speculative nature of early-stage biotechnology, such licensing fees are generally low. Over time, however, research and development can add significant value to the patented technology. ... As the technology becomes more widely adopted and scientifically validated, specialized biotechnology companies might join the research and development process, subject to bargained-for conditions that reflect the value of the licensed technology for the specific use (research or diagnostic) to which they will put the product. Should useful applications be further identified, larger companies with greater resources would enter the process to shoulder, at staggering cost, the burden of developing a new therapeutic product.

That symbiotic relationship ... is crucial both to ensuring the continued viability of small and publicly funded biotechnology research entities, which cannot afford expensive licensing fees or sale prices, and to making it possible for inventors to navigate successfully the long and resource-intensive road to the commercial use of their products.

Brief of the Biotechnology Industry Organization as *Amicus Curiae* in Support of Neither Party, Case No. 06-397, 5-6 (Nov. 13, 2007).

The Intellectual Property Owners Association (“IPO”) raised a related example involving genetically modified crop seeds that are designed to increase the yield-per-acre of valuable crops. Brief of the Intellectual Property Owners Association in Support of the Respondents, Case No. 06-397, 9 (Dec. 10, 2007). The IPO contends, “[i]n an economically rational system, an owner of a patent for such seeds will be allowed to condition a sale so that the purchaser can use the patented seeds only to create harvestable food products and cannot create a new crop of genetically modified seeds to be replanted.” *Id.* Otherwise, the patent owner would feel compelled to recoup its entire investment in the first season of sales. *Id.*

Companies engaged in the manufacture of products utilizing complex technology are concerned that an unduly narrow interpretation of the exhaustion requirement could result in a proliferation of conditional license agreements that force the payment of royalties at multiple stages of a chain of production. From this point of view, the argument is made that even if conditional licenses are restricted the patentee could still collect the full value of the patented invention and compensate for the full range of potentially downstream uses by charging a higher royalty to its licensee, i.e., to the “first purchaser” of the patented invention. The licensee or “first purchaser” could then pass on the cost of this higher royalty to its customers.

The trend of decisions by the Supreme Court has been markedly unfriendly toward patent-holders over the past two years, what with the Court deciding to (i) expand the rights of licensees in good standing to sue patentees for declaratory judgment (*MedImmune, Inc. v. Genentech, Inc.*, 127 S. Ct. 764 (2007)); (ii) limit the extraterritorial reach of U.S. patent law under 35 U.S.C. § 271(f) (*Microsoft Corp. v. AT&T Corp.*, 127 S. Ct. 1746 (2007)), (iii) ease the requirements for showing obviousness-type invalidity of a patent (*KSR Int’l v. Teleflex, Inc.*, 127 S. Ct. 1727 (2007)); and (iv) emphasize that a patentee must satisfy the four-factor test in order to obtain permanent injunctive relief following a finding of infringement (*eBay, Inc.*, 126 S. Ct. at 1839-40). In addition, substantial revisions to the patent laws remain under consideration before the Congress and the Patent and Trademark Office itself. Some patent law practitioners have noted that the Court’s decisions in these recent cases did not ultimately provide much in the way of concrete legal guidance for lower courts and litigants. It will be interesting to see whether the Court’s opinion in this case reflects suspicion about the conduct of patentees in the licensing process, and whether the Court can set forth a new standard of patent exhaustion that provides licensing parties with useful legal guidance.