How to sell and license post-*Quanta*

John Rondini and **David Syrowik** examine how patent owners are adapting their business practices more than one year after the Supreme Court clarified US law on the doctrine of patent exhaustion

The patent exhaustion doctrine operates to exhaust a patentee's rights following the first authorised sale of a patented item. Once a patented article is unconditionally sold by the patent owner or its licensee without restriction, that article passes beyond the exclusive rights of the patent. In this way, the first authorised sale of a patented article exhausts the patent to the extent that an unconditional sale frees the purchaser from patent liability to use and resale the article.

While the patent exhaustion doctrine is relatively easy to state, courts tend to hold that many sales and licensing strategies fall victim to the doctrine. On June 9 2008, the Supreme Court attempted to clarify the patent exhaustion doctrine in *Quanta Computer Inc v LG Electronics Inc* by holding that the doctrine applies 1) to the method and not just the apparatus claims of patents and 2) to sales "authorised" by the patent holder of incomplete products that "substantially embody" essential features of a patented invention.

One-minute read

In *Quanta Computer Inc v LG Electronics Inc*, the Supreme Court addressed the patent exhaustion doctrine after a 66-year hiatus. The decision will most certainly affect the viability of certain patent and perhaps other intellectual property licensing strategies such as copyright licensing strategies. Because of the importance of intellectual property licensing to the domestic and foreign economy, it is important for IP owners not only to fully understand the patent exhaustion doctrine as clarified by *Quanta* but also to consider relatively recent sales and licensing strategies. In particular, so-called field of use and single use licensing has been used in the printer cartridge business model as a way to avoid the patent exhaustion doctrine. This article concludes with some practical pointers when using standard form contracts to market products which "substantially embody" a patent as set out in *Quanta*.

Avoiding exhaustion

Field of use licensing

Licences that carve out a particular field of customer class for the licensee are commonly referred to as field of use licences. Like territorial licences, these arrangements have long been considered presumably lawful exercises of the patentee's exclusionary rights (such as making, using, offering for sale or importing) under its patent, notwithstanding their obvious competitive ramifications. The leading case upholding the basic legality of field of use licences is the Supreme Court's decision in *General Talking Pictures Corp v Western Electric Co,* which, while distinguished, was implicitly adopted by the *Quanta* Court.

In *General Talking Pictures*, the patent owner had granted Transformer Company a non-exclusive licence to sell the patented product solely for home use. The licence agreement required Transformer Company to mark each product with a label describing the limited field licence. Transformer Company sold the product to General Talking Pictures with knowledge that the latter intended to use it for commercial purposes. In addition, General Talking Pictures knew Transformer Company had no right to sell outside the home use field. The Court held that the patent owner could sue General Talking Pictures for patent infringement because "[t]he sales made by the Transformer Company ... were outside the scope of its license and not under the patent." The Court further reasoned that both parties knew this fact at the time of the transactions.

Even after *Quanta*, the holding of *General Talking Pictures* remains valid law. Tension exists between the two holdings, particularly when the granting clause of a patent licence agreement is not as broad as it might be. As illustrated by the *Quanta* case, when a court interprets a licence or other contract as broadly granting the right to make, use and sell, the *exhaustion doctrine* governs and not the *General Talking Pictures* doctrine. A use restriction in the granting clause of a licence must be explicit to bind a seller. Otherwise, the licence is unlimited, *i.e.*, it covers all possible fields or acts that would otherwise be infringement.

The Court in *Quanta* applied the *exhaustion doctrine* rather than the holding of *General Talking Pictures* because of the broad language of the granting clause in the Licence Agreement. Therefore, purchasers of the patented product were free to use them without restrictions even though the patentee sought, but failed, to impose restrictions upon them.

Single-use licensing

While expressly addressing field of use licensing restrictions, the Court in *Quanta*

The printer cartridge example

Over the lifetime of modern computer printers, the cost of the ink cartridges can be much more than the printer itself. Consumers have a financial motivation to refill their cartridges themselves or through a third-party. However, large printer manufacturers like Hewlett-Packard (HP) and Lexmark have been waging an ongoing battle with third-party ink sellers. The manufacturers have sought to employ standard form contracts and the intellectual property laws in their battle to control the use of their products after a "first sale".

Case study 1: Hewlett-Packard

HP manufactures and sells ink jet printers and disposable ink jet cartridges for its printers. Once the ink in a cartridge has been depleted, HP stipulates that the cartridge should be discarded and replaced by a new one. Instructions accompanying the cartridges disclaim liability for printer damage caused by refilling. Accordingly, the user instructions in the HP cartridges advise the user to "discard old print cartridge immediately".

Defendant, Repeat-O-Type Stencil (ROT), chose to disregard HP's attempted restrictions. ROT purchased HP cartridges, modified them so that they will be refillable, and then resold them as refillable ink jet cartridges. HP filed suit against ROT after learning that ROT was selling refillable ink jet cartridges. HP asserted that ROT's modification and resale of the cartridges infringed HP patents.

The Federal Circuit determined that despite what HP labelled as a single-use condition, it actually sold its printer cartridges unconditionally. More specifically, HP owned numerous patents on a toner cartridge compatible with its HP brand printers. In finding that ROT had not infringed HP's patent rights, the court noted that HP had not placed any restrictions on the sale of the cartridges. As was noted by the court, "[a] non-contractual intention is simply the seller's hope or wish, rather than an enforceable restriction". To create a conditional sale, HP had to do more than place the words "discard old print cartridge immediately" in the instruction manual.

Case study 2: Lexmark

Lexmark designed and implemented a business strategy that enabled owners of certain Lexmark printers to buy either an ink cartridge at the regular price or a "Prebate" ink cartridge at a discounted price. If the consumer accepted the Prebate ink cartridge (by opening the packaging), Lexmark did not require the consumer send in a receipt to acquire a refund, but instead offered an on-the-spot discount. Furthermore, by opening the Prebate cartridge packaging, Lexmark consumers were restricted from refilling the spent cartridge and agreed to return their spent Prebate cartridge to Lexmark after the initial use.

To ensure customer compliance with the shrink-wrap agreement, Lexmark manufactured the Prebate cartridges with a microchip that prevented their compatibility with a Lexmark printer if the cartridges had been refilled. Lexmark placed the microchip on each Prebate cartridge, and employed an authentication sequence whereby certain Lexmark printers exchanged a "secret handshake" with each microchip.

The secret handshake was initiated whenever a Lexmark printer was powered up, opened or closed, or when a toner cartridge was inserted therein. When any of these events occurred, both the microchip and the printer calculated an authentication code, the results of which were then compared. The printer would function only when the authentication codes matched.

Lexmark filed suit against Static Control Components (SCC), which manufactures, among other items, component parts for refurbished toner cartridges. By October of 2002, SCC had developed its Smartek microchip for use with remanufactured Prebate cartridges. This microchip mimicked the authentication sequence to allow interoperability between Lexmark printers and Prebate cartridges refurbished by unauthorised parties. Although SCC had independently reverse-engineered a means for bypassing the authentication sequence, it programmed wholesale copies of the TLP onto its Smartek chips.

Sixth circuit holding

After the district court granted a preliminary injunction in favour of Lexmark, SCC appealed to the Sixth Circuit Court of Appeals. The majority opinion, as set forth by Judge Sutton, reversed the lower court's ruling and vacated the temporary injunction, holding that Lexmark was unlikely to succeed in its case.

The appellate court found that the TLP was not copyrightable because of the merger and so-called *scenes a faire* doctrines of the copyright law. The majority opinion further held that even if it were copyrightable, SCC's use of the program in this case appears to fall under the fair use exception of the copyright law. SCC's program, though commercial in nature, was only to sell cartridges that could be used by Lexmark printers rather than to profit by infringing any Lexmark copyright.

By holding that the Toner Loading Program was not copyrightable, the appellate court defeated both Lexmark's direct claim to copyright infringement and its claim that distribution of the Toner Loading Program violated the anti-trafficking provision of the Digital Millennium Copyright Act (DMCA). Also, Lexmark's DMCA claim based on the clearly copyrightable Printer Engine Program failed because the authentication sequence does not, and is not intended to, "effectively control access" to the Printer Engine Program. Rather, the purchase of the printer itself allowed access to the program.

Reversed by Quanta

After the Sixth Circuit's holding, SCC filed a declaratory judgment action in 2009, seeking a declaration that its new line of re-engineered toner chips did not infringe Lexmark's copyrights or violate the DMCA. In April 2009, the US District Court for the Eastern District of Kentucky ruled that the Toner Loading Program was not sufficiently original to be afforded copyright protection. Furthermore, although SCC asserted exhaustion and invalidity as defences, the court ruled that the restrictions were legitimate and could be enforced against a consumer.

However, on March 31 2009, the court, in relying on *Quanta*, reversed its earlier ruling that Lexmark's shrink-wrap licence terms were enforceable. The court stated that the *Quanta* ruling preventing LGE from using its patents to restrict the actions of downstream users prompts a "renewed" understanding of the first-sale doctrine. The court also stated that this renewed understanding required a reversal of the decision that allowed Lexmark to use its patents to enforce restrictions on reuse of the cartridges by end users.

failed to overrule the single use restrictions which arose out of the Federal Circuits decision in *Mallinckrodt Inc v Medipart, Inc* In *Mallinckrodt*, the Federal Circuit held that a patentee's "Single Use Only" restriction was not "as a matter of law, unenforceable under the patent law". The Court further held that a patent infringement remedy would be available against purchasers who used an item purchased from the patentee in violation of a restriction that is "validly conditioned under the applicable law … governing sales and licenses and if the restriction on reuse was within the scope of the patent grant or otherwise justified".

Misuse and antitrust

The restrictions placed upon post-sale use of licensed goods as in the *General Talking Pictures* and *Mallinckrodt* cases is generally permissible since such restrictions are based on the patent right to exclude others from making, using or selling. However, such restrictions must be evaluated to ensure their legality with respect to patent misuse and federal antitrust laws.

Patent misuse

In *B Braun Medical Inc v Abbott Laboratories*, the Federal Circuit commented on the "patent misuse doctrine" as limiting the use of restrictions placed upon post-sale use of goods. The Court held that:

> The key inquiry under [the patent misuse] doctrine is whether, by imposing the condition, the patentee has 'impermissibly broadened the "physical or temporal scope" of the patent grant with anticompetitive effect. Two common examples of such impermissible broadening are using a patent which enjoys market power in the relevant market ... to restrain competition in an unpatented product or employing the patent beyond its 17-year term. In contrast, field of use restrictions ... and any anticompetitive effects they may cause are reviewed in accordance with the rule of reason.

Federal antitrust guidelines

Express conditions on the post-sale use of products contained within intellectual property licences are generally viewed as being pro-competitive and in violation of federal antitrust laws if the licensed rights are less than the rights that the licensor holds.

Field of use, territorial, and other limitations on intellectual property licences may serve pro-competitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible. These various forms of exclusivity can be used to give a licensee an incentive to invest in the commercialisation and distribution of products embodying the licensed intellectual property and to develop additional applications for the licensed property. The restrictions may do so, by protecting the licensee against free-riding on the licensee's investments by other licensees or by the licensor. They may also increase the licensor's incentive to licence, by protecting the licensor from competition in the licensor's own technology in a market niche that it prefers to keep to itself. These benefits of licensing restrictions apply to patent, copyright, and trade secret licences, and to know-how agreements.

Take the case of a company (ComputerCo) that develops a new, copyrighted software program for inventory management in the health field. ComputerCo continues to license the program in an arrangement that imposes both field of use and territorial limitations. Some of ComputerCo's licences permit use only in hospitals; others permit use only in group medical practices. ComputerCo charges different royalties for the different uses. All of ComputerCo's licences permit use only in specified portions of the United States and in specified foreign countries. The licences contain no provisions that would prevent or discourage licensees from developing, using, or selling any other program, or from competing in any other good or service other than in the use of the licensed program. None of the licensees are actual or likely potential competitors of ComputerCo in the sale of inventory management programs.

Practice pointers

Patentees should consider drafting the licence grant clause in negotiated and non-negotiated standard form agreements narrowly through field of use limitations. Doing so may allow the patentee to extract a royalty or other consideration from each downstream conditional or restricted sale when it is prudent to do so from a business perspective. Moreover, patentees should consider such narrow licence grants where the product includes software. Many purchasers are now conditioned to accept such a licence when software is involved with a product.

In light of the Supreme Court's holding in *Quanta*, any restrictions should be explicit and unequivocal in describing the nature of future sales of licensed products. Patentees should also consider explicit restrictions on the types of downstream products that may be combined with the licensee's products.

For instance, LGE may have been successful had it included in its licence grant clause a provision restricting Intel to selling products only to entities that LGE had licensed to make and use computers under LGE's patents. If Intel sold to an unlicensed customer, the sale would not have been contractually an "authorised sale", and, as the *Quanta* Court clearly said, authorised sales are a prerequisite for patent exhaustion.

In a practical example, a grant clause limited to sales in a field defined by customers who are licensed could read as follows:

> LICENSOR hereby grants to LICENSEE a nonexclusive licence to make or import LICENSED COMPONENTS and to offer for sale and sell such LICENSED COMPONENTS solely to entities who are licensed by LICENSOR at the time of such sale or offer for sale [or] to entities who agree as a condition of such sale not to use the LICENSED COMPONENTS without a licence from LICENSOR.

Such a grant clause would deprive the licensee of authority to sell to unlicensed entities and thus any such sale would not be "authorised" and would not exhaust the patent owner's rights.

A licensee may be authorised to sell products only with a standard form licence agreement, such as a shrink-wrap agreement or a click-wrap agreement. Sales without the shrink-wrap agreement would be outside the licence and an infringement. Of course, sales with the standard form agreement would be authorised with respect to such end-user licence agreements. To meet the contractual expectations of the end user, such agreements should:

- Clearly alert potential end users that use of the product is subject to a licence agreement, preferably prior to payment but certainly before or with first use.
- Make it clear that the product is only offered for use under the agreement's terms.
- Give the user a meaningful opportunity to review the terms of the agreement at the time of sale.
- Given the medium, make the agreement as user friendly to review as possible.
- Provide a meaningful mechanism for the user to manifest assent to the agreement.
- Provide a means for the user to keep or get a copy of the agreement.
- Provide an opportunity for the user to decline the terms of the agreement, such as, by providing a refund, or by allowing return of the product.

On managingip.com

Broadcom invokes Quanta in suit against Qualcomm, October 2008

How Quanta will change licensing, July 2008

Litigation planning for licensors, July 2008

Cornell wins $184 million jury award against HP, June 2008

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