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1

STRATEGIES FOR THE NEW PATENT LAW FRONTIER

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Chapter 17

Strategies for the New Patent Law Frontier

§ 17:1 Strategies Are Needed to Address Changes in the Law

Recent court decisions have greatly altered several established tenets in patent law—tenets that had endured for years and were widely relied upon in drafting patent license agreements. In some cases, the issuance of one opinion has had drastic consequences to the everyday business practices of patent licensing.

Transactional attorneys face a challenge in drafting provisions in patent license agreements that limit—or attempt to limit—the application of case law adverse to their client's interests. As with many groundbreaking decisions, the opinions discussed below often introduce more questions than they answer. Until the lower courts have had an opportunity to apply and interpret these recent appellate holdings, licensing attorneys face a daunting challenge.

This chapter looks at some of the approaches which can be considered in maneuvering through this new landscape.[1]

§ 17:2 Declaratory Judgments: The New Frontier

§ 17:2.1 MedImmune

The Supreme Court in *MedImmune, Inc. v. Genentech, Inc.*[2] altered the law governing the challenge of patents by allowing a licensee to continue to perform its obligations under the license agreement (for example, pay royalties) while bringing a declaratory

1. Throughout this book, strategies applicable to various provisions and legal considerations are discussed separately in the relevant sections. In this chapter, we address strategies that apply as a general rule to the negotiation and drafting of patent licenses.
2. MedImmune, Inc. v. Genentech, Inc., 127 S. Ct. 764 (2007).

judgment action challenging the validity and enforceability of the licensed patents. In other words, under *MedImmune*, a patent licensee is not required to breach the license agreement as a prerequisite to filing a declaratory judgment action to declare the patent invalid, unenforceable, or not infringed.

[A] Facts

As stated in the syllabus of the Supreme Court's opinion, the following were the basic facts in *MedImmune*:

> After the parties entered into a patent license agreement covering, *inter alia*, [Genentech's] then-pending patent application, the application matured into the "Cabilly II" patent. [Genentech] sent [MedImmune] a letter stating that Synagis, a drug [MedImmune] manufactured, was covered by the Cabilly II patent and that [MedImmune] owed royalties under the agreement. Although [MedImmune] believed no royalties were due because the patent was invalid and unenforceable and because Synagis did not infringe the patent's claims, [MedImmune] considered the letter a clear threat to enforce the patent, terminate the license agreement, and bring a patent infringement action if [MedImmune] did not pay. Because such an action could have resulted in [MedImmune's] being ordered to pay treble damages and attorney's fees and enjoined from selling Synagis, which accounts for more than 80 percent of its sales revenue, [MedImmune] paid the royalties under protest and filed this action for declaratory and other relief. The District Court dismissed the declaratory-judgment claims for lack of subject-matter jurisdiction because, under Federal Circuit precedent, a patent licensee in good standing cannot establish an Article III case or controversy with regard to the patent's validity, enforceability, or scope. The Federal Circuit affirmed.[3]

[B] Holding

As stated in the syllabus of its opinion, the Supreme Court held that:

1. Contrary to [Genentech's] assertion that only a freestanding patent-invalidity claim is at issue, the record establishes that [MedImmune] has raised and preserved the contract claim that, because of patent invalidity, unenforceability, and noninfringement, no royalties are owing.
2. The Federal Circuit erred in affirming the dismissal of the action for lack of subject-matter jurisdiction. The standards for determining whether a particular declaratory-judgment action satisfies the case-or-controversy requirement—*i.e.*,

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3. *Id*. at 766.

> "whether the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant" relief—are satisfied here even though [MedImmune] did not refuse to make royalty payments under the license agreement. Where threatened *government* action is concerned, a plaintiff is not required to expose himself to liability before bringing suit to challenge the basis for the threat. His own action (or inaction) in failing to violate the law eliminates the imminent threat of prosecution, but nonetheless does not eliminate Article III jurisdiction because the threat-eliminating behavior was effectively coerced. Similarly, where the plaintiff's self-avoidance of imminent injury is coerced by the threatened enforcement action of *a private party* rather than the government, lower federal and state courts have long accepted jurisdiction. In its only decision in point, this Court held that a licensee's failure to cease its royalty payments did not render nonjusticiable a dispute over the patent's validity. *Altvater v. Freeman*, 319 U.S. 359, 364. Though *Altvater* involved an injunction, it acknowledged that the licensees had the option of stopping payments in defiance of the injunction, but that the *consequence* of doing so would be to risk "actual [and] treble damages in infringement suits" by the patentees, a consequence also threatened in this case. *Id.*, at 365.[4]

The Court rejected Genentech's assertion that "the parties in effect settled this dispute when they entered into their license agreement," and also Genentech's appeal to "the common-law rule that a party to a contract cannot both challenge its validity and continue to reap its benefits."[5] Lastly, because it was raised for the first time in the Supreme Court, the Court did not decide Genentech's request to affirm the dismissal of the declaratory judgment claims on discretionary grounds. That question and any merits-based arguments for denial of declaratory relief were left for the lower courts on remand.[6]

§ 17:2.2 SanDisk: *Federal Circuit Construes* MedImmune

This book does not usually dwell at length on the facts of a particular case as most practitioners prefer a condensed rendition along with the holding and the court's rationale. However, close

4. *Id.* (citation omitted).
5. *Id.*
6. *Id.*

attention to the facts and circumstances recited by the court may prove useful in the context of drafting letters to potential licensees, because what was once considered "safe" to say and write to a potential licensee has changed. In its first opportunity to construe *MedImmune,* the Federal Circuit in *SanDisk Corp. v. STMicroelectronics, Inc.,*[7] discussed at great length the letters, emails, and conversations between the parties.

The facts of the case are significant in trying to determine what behavior, if any, can provide a "safe harbor" in avoiding a declaratory judgment action. What used to be accepted as nonthreatening has been altered dramatically by *SanDisk*. Before discussing possible strategies, an analysis of the *SanDisk* opinion is in order.

[A] Facts

The court explained the parties' initial contacts as follows:

> SanDisk is in the flash memory storage market and owns several patents related to flash memory storage products. ST, traditionally in the market of semiconductor integrated circuits, more recently entered the flash memory market and has a sizeable portfolio of patents related to flash memory storage products. On April 16, 2004, ST's vice president of intellectual property and licensing . . . sent a letter to SanDisk's CEO requesting a meeting to discuss a cross-license agreement. The letter listed eight patents owned by ST that [the vice president] believed "may be of interest" to SanDisk. . . . SanDisk "responded that it would need time to review the listed patents and would be in touch in several weeks to discuss the possibility of meeting in June."[8]

Having received no response, ST sent a letter to SanDisk reiterating its request to meet to discuss a cross-license agreement and listing four additional ST patents that "may also be of interest" to SanDisk. SanDisk responded by informing ST of its "understanding that both sides wish to continue . . . friendly discussions."[9] The reference was to earlier discussions among managers and vice presidents from both companies to explore the possibility of ST's selling flash memory products to SanDisk.[10]

As the court noted, "[t]he business meetings were unrelated to any patents."[11] SanDisk also requested that ST's vice president of licensing join the next business meeting. ST's vice president of licensing replied, "again urging a meeting with [SanDisk's chief intellectual

7. SanDisk Corp. v. STMicroelectronics, Inc., 480 F.3d 1372 (Fed. Cir. 2007).
8. *Id*. at 1374 (citations omitted).
9. *Id*.
10. *Id*.
11. *Id*.

property counsel], noting that it was 'best to separate the business discussions from the patent license discussions.'"[12]

> [W]hen the business representatives next met, SanDisk presented an analysis of three of its patents and orally offered ST a license. ST declined to present an analysis of any of its patents, stating instead that any patent and licensing issues should be discussed in a separate meeting with [ST's vice president of licensing]. Later that same day, [SanDisk] wrote a letter to [ST] objecting to separating business and intellectual property issues and stating that "[i]t has been SanDisk's hope and desire to enter into a mutually beneficial discussion without the rattling of sabers."[13]

ST replied, stating that its understanding that the parties were going to have a licensing and intellectual property meeting later that month "to discuss the possibility for a patent cross-license."[14] ST suggested that SanDisk should come prepared to present an analysis of the three SanDisk patents it identified earlier, as well as "any infringement analyses of an ST device or need for ST to have a license to these patents."[15] For its part, ST would be prepared to discuss the twelve patents identified in ST's prior letters, and it was looking forward to "open and frank discussions with SanDisk concerning fair and reasonable terms for a broad cross-license agreement."[16]

The licensing meeting was attended by ST's vice president for licensing, two of its licensing attorneys, and three technical experts retained by it to perform the infringement analyses of SanDisk's products; SanDisk's chief intellectual property counsel and an engineer attended on behalf of SanDisk. At the meeting, ST

> requested that the parties' discussions be treated as "settlement discussions" under Federal Rule of Evidence 408. ST then presented a slide show which compared statistics regarding SanDisk's and ST's patent portfolios, revenue, and research and development expenses, and listed SanDisk's various "unlicensed activities." This slide show was followed by a four- to five-hour presentation by ST's technical experts, during which they identified and discussed the specific claims of each patent and alleged that they were infringed by SanDisk. According to [SanDisk's chief intellectual property counsel], the presentation by ST's technical experts included "mapp[ing] the elements of each of the allegedly

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12. *Id.*
13. *Id.*
14. *Id.* at 1375.
15. *Id.*
16. *Id.*

> infringed claims to the aspects of the accused SanDisk products alleged to practice the elements."[17]

According to SanDisk, at the meeting "the experts liberally referred to SanDisk's (alleged) infringement of [ST's] products."[18] In turn, SanDisk's engineer "made a presentation, describing several of SanDisk's patents and analyzing how a semiconductor chip product sold by ST infringes."[19]

At the end of the meeting, ST provided SanDisk "a packet of materials containing, for each of ST's fourteen patents under discussion, a copy of the patent, reverse engineering reports for certain of SanDisk's products, and diagrams showing how elements of ST's patent claims cover SanDisk's products."[20] According to SanDisk, ST's vice president of licensing said something like this:

> I know that this is material that would allow SanDisk to DJ [ST] on. We have had some internal discussions on whether I should be giving you a copy of these materials in light of that fact. But I have decided that I will go ahead and give you these materials.[21]

ST further told SanDisk that "ST has absolutely no plan whatsoever to sue SanDisk." SanDisk responded that "SanDisk is not going to sue you on Monday" and suggested another meeting.[22]

Subsequently, ST wrote to SanDisk, "enclosing copies of ST's general slide presentation from the . . . meeting and also enclosing a hard copy booklet containing each of the engineering reports 'for each claim on all products where ST demonstrated coverage by the 14 ST patents to-date [sic].' [ST] requested that SanDisk provide ST with a copy of SanDisk's presentation and information about the three SanDisk patents presented."[23] SanDisk's chief intellectual property counsel replied, attaching a copy of SanDisk's presentation, indicating it was his "personal feeling . . . that we have got to trust one another during these negotiations," and seeking a nondisclosure agreement. He also wrote, "I still owe you the rates quoted."[24]

In a subsequent letter, SanDisk's chief intellectual property counsel enclosed a confidential version of SanDisk's cross-licensing offer, which noted that the offer would expire in twelve days. ST destroyed this confidential offer and did not retain a copy, and, the next day,

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17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at 1376.
23. *Id.*
24. *Id.*

sent SanDisk an e-mail requesting that a nonconfidential version be sent.[25]

SanDisk refused to send a nonconfidential version. Instead, on the offer's expiration date, SanDisk offered to send another confidential version, or to communicate the offer orally. SanDisk also indicated that it did not need additional information regarding ST's patents because SanDisk was "quite comfortable with its position" and that it was "time to let our business people talk and see if a peaceful resolution is possible."[26] On the day after the SanDisk offer expired, ST repeated its request for a written, nonconfidential version of SanDisk's licensing offer. The following day, SanDisk e-mailed another confidential version of SanDisk's offer.[27]

Two weeks later, after further communication between the business representatives trying to establish another meeting, SanDisk filed suit, alleging infringement of one of its patents and seeking a declaratory judgment of noninfringement and invalidity of the fourteen ST patents that had been discussed during the cross-licensing negotiations.

> ST filed a motion to dismiss SanDisk's declaratory judgment claims for lack of subject matter jurisdiction, maintaining that there was no actual controversy at the time SanDisk filed its complaint.
>
> The district court granted ST's motion to dismiss, holding that no actual controversy existed for purposes of the Declaratory Judgment Act because SanDisk did not have an objectively reasonable apprehension of suit, even though it may have subjectively believed that ST would bring an infringement suit. The district court reasoned that "SanDisk has presented no evidence that ST threatened it with litigation at any time during the parties' negotiations, nor has SanDisk shown other conduct by ST rising to a level sufficient to indicate an intent on the part of ST to initiate an infringement action." The district court found that the studied and determined infringement analyses that ST presented to SanDisk did not constitute the requisite "express charges [of infringement] carrying with them the threat of enforcement." The district court also found that the totality of the circumstances did not evince an actual controversy because ST told SanDisk that it did not intend to sue SanDisk for infringement. In a footnote, the court indicated that, as an alternative basis for its ruling, even if it did have jurisdiction, it would exercise its discretion and decline to hear the case.[28]

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25. *Id*.
26. *Id*.
27. *Id*.
28. *Id.* at 1376–77 (citations omitted).

[B] Holding

In reversing, the Federal Circuit determined that the Supreme Court's *MedImmune*[29] decision represented a rejection of the "reasonable apprehension of suit" test and devised a new test in light of *MedImmune*:

> In the context of conduct prior to the existence of a license, declaratory judgment jurisdiction generally will not arise merely on the basis that a party learns of the existence of a patent owned by another or even perceives such a patent to pose a risk of infringement, without some affirmative act by the patentee. But Article III jurisdiction may be met where the patentee takes a position that puts the declaratory judgment plaintiff in the position of either pursuing arguably illegal behavior or abandoning that which he claims a right to do. . . . *We hold* only that where [1] a patentee *asserts rights* under a patent based on [2] *certain identified* ongoing or planned *activity* of another party, and [3] where that party *contends* that it *has the right to engage in the accused activity without license*, an Article III case or controversy will arise and the party need not risk a suit for infringement by engaging in the identified activity before seeking a declaration of its legal rights.[30]

In applying this new test, the court made note of certain facts in its determination that a case and controversy existed.

> ST sought a right to a royalty under its patents based on *specific, identified* activity by SanDisk. For example, at the August 27, 2004 licensing meeting, ST presented, as part of the "license negotiations," a *thorough infringement analysis* presented by seasoned *litigation* experts, detailing that one or more claims of its patents *read on* one or more of SanDisk's identified products. At that meeting, ST presented SanDisk with a *detailed* presentation which identified, on an *element-by-element* basis, the manner in which ST believed each of SanDisk's products *infringed the specific claims* of each of ST's patents. During discussions, the experts *liberally referred* to SanDisk's present, ongoing infringement of ST's patents and the need for SanDisk to license those patents. ST also gave SanDisk a packet of materials, over 300 pages in length, containing, for each of ST's fourteen patents under discussion, a copy of the patent, reverse engineering reports for certain of SanDisk's products, and diagrams showing a detailed infringement analysis of SanDisk's products. ST communicated to SanDisk that it had made a studied and determined infringement determination and asserted the right to a royalty based on

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29. MedImmune, Inc. v. Genentech, Inc., 127 S. Ct. 764 (2007).
30. *Sandisk*, 480 F.3d at 1380–81 (emphasis and bracketed numbering added).

this determination. SanDisk, on the other hand, maintained that it could proceed in its conduct without the payment of royalties to ST.[31]

[C] Promise Not to Sue: Actions Speak Louder Than Words

As noted earlier, during the negotiations, ST made a "direct and unequivocal" statement that "ST has absolutely no plan whatsoever to sue SanDisk." Not unexpectedly, ST argued that this statement eliminated any actual controversy and rendered SanDisk's declaratory judgment claims moot.

The Federal Circuit declined to hold that the statement eliminated the justiciable controversy created by ST's actions. The court instead was influenced by ST's course of conduct, which

> show[ed] a preparedness and willingness to enforce its patent rights despite [ST's] statement. Having *approached* SanDisk, having made a *studied and considered* determination of infringement by SanDisk, having *communicated that determination* to SanDisk, and *then saying that it does not intend to sue*, ST is engaging in the kinds of 'extra-judicial patent enforcement with scare-the-customer-and-run tactics' that the Declaratory Judgment Act was intended to obviate. ST's statement that it does not intend to sue does not moot the actual controversy created by its acts.[32]

From this reasoning, it is apparent that the Federal Circuit wants courts to analyze the patentee's actions rather than its words. The iron-fist-in-a-velvet-glove approach has become more dangerous and may very well be abandoned. As discussed below, *SanDisk* may result in patentees' filing suit first and negotiating later.

[D] What's a Patentee to Do? The Federal Circuit Offers Advice

In an unusual departure for a court, the Federal Circuit provided advice in a footnote on how to avoid the predicament that its *SanDisk* decision inevitably imposes on patent owners attempting to license their patents:

> To avoid the risk of a declaratory judgment action, ST could have sought SanDisk's agreement to the terms of a *suitable confidentiality agreement*. The record before us reflects that the parties did not enter into such an agreement. Rather, ST sought to condition its open licensing discussions and the infringement study on

31. *Id*. at 1382 (emphasis added).
32. *Id*. at 1383 (emphasis added; citation omitted).

> adherence to Federal Rule of Evidence 408. That rule expressly relates to evidence of efforts toward compromising or attempting to compromise a claim in litigation and does not prevent SanDisk from relying on the licensing discussions and infringement study to support its claims. See Fed. R. Evid. 408. Furthermore, ST's presentation was made outside the context of litigation, and there is nothing on the record to indicate that it could be properly considered an "offer" to settle a claim which was then in dispute. *See, e.g.*, *Deere & Co. v. Int'l Harvester Co.*, 710 F.2d 1551, 1556–57 (Fed. Cir. 1983).[33]

> As noted by Judge Bryson in his concurring opinion,

> [t]he problem with [the] suggestion is that it would normally *work only when it was not needed*—only a party that was not interested in bringing a declaratory judgment action would enter into such an agreement. A party that contemplates bringing a declaratory judgment action or at least keeping that option open would have no incentive to enter into such an agreement.[34]

Further, what does the patentee do if the potential licensee simply refuses to enter into such a confidentiality agreement? Is that an indication that the potential licensee is considering bringing a declaratory judgment action? Or simply that the potential licensee sees no benefit in entering into such an agreement? Perhaps the potential licensee feels that if it declines to enter into such an agreement, the patentee may be scared off by the uncertainty of whether the potential licensee would bring suit.

[E] What Is a "Suitable" Confidentiality Agreement?

Unfortunately, in advising the use of a "suitable confidentiality agreement," the Federal Circuit did not offer specifics as to what it meant by the word "suitable." A few comments are offered below.

[E][1] Confidentiality

Presumably, such an agreement would include the basic terms of a confidentiality agreement, such as that anything said or written as part of the negotiations would not be disclosed to third parties.

Arguably, a confidentiality agreement alone may suffice. It may be unlikely that a potential licensee could file pleadings sufficient to establish a declaratory judgment without disclosing the confidential information.

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33. *Id.* at 1375 n.1 (emphasis added).
34. *Id.* at 1385 n.1 (emphasis added).

One conceivable way to plead a case for declaratory judgment relief without disclosing the confidential information would be to file the complaint under seal and request the court to hold closed hearings as well as issue a "gag order" preventing the parties, witnesses, and counsel from discussing the case. It is doubtful a federal court would be amenable, as First Amendment considerations and policy considerations favoring public trials might override a party's desire to conduct a secret civil proceeding.

[E][2] Nonuse

In using the adjective "suitable," the court may have meant that such an agreement should include something more than a simple confidentiality provision. The court may have envisioned the inclusion of a "nonuse" provision. A nonuse provision could provide that any communications related to the patent license negotiations would not be used for any purpose other than in furtherance of the negotiations.

While such a provision would seem to preclude any use other than the permitted use (that is, furtherance of the negotiations), a patentee may wish to consider further language such as a provision that the confidential information not be used for any purpose other than the negotiation of a license of the patents, including any litigation or arbitration.

[E][3] Nonlitigation Provision

In addition to relying on a nonuse prohibition, a patentee may seek further protection by using a specific nonlitigation provision. Such a provision would prohibit the potential licensee from initiating or participating in any action to challenge the patents.

The potential licensee may want to consider a limitation on the period of time during which its hands are tied by the nonlitigation provision. The potential licensee may also want to consider making the obligation mutual by seeking a reciprocal promise from the patentee that it would not file an infringement action during the standstill period.

To encourage compliance, the patentee may consider a provision whereby the prevailing party in any action to enforce the nonlitigation provision would be reimbursed its attorneys' fees and costs.

§ 17:3 Tactics and Strategies After *MedImmune* and *SanDisk*

In this section, we will look at some of the tactics and strategies that licensees and patent owners may adopt in light of *MedImmune* and *SanDisk*. Because these tactics have not (as far as the author is aware) been ruled upon as of the date of writing (fall 2007), it is uncertain as to what extent, if any, they are valid.

§ 17:3.1 Licensee Tactics

The *MedImmune* and *SanDisk* decisions favor licensees. Licensees are now permitted to bring declaratory judgment actions against their licensors without having to first breach the patent license agreement. Pre-*MedImmune*, the risks to a licensee arising from breaching the patent license agreement could be formidable: if sued by the licensor for patent infringement, the licensee faced the risk of an injunction,[35] treble damages, and attorneys' fees.

[A] Limiting Infringement Damages Under the Guise of a License Agreement

MedImmune and *SanDisk* offer one tactic of great potential advantage to patent infringers.

The tactic an infringer could use is to enter into a patent license with the owner of the infringed patent. The former patent infringer—now patent licensee—would then file suit against the licensor seeking a declaratory judgment that the infringed patent is invalid. In doing so, the former infringer—now licensee—would no longer be concerned about being enjoined from use of the patent or about the financial risk of paying treble damages and attorneys' fees or reasonable royalties as determined by a court. Because it is continuing to pay royalties under the license agreement, it is not an infringer.

[B] Attempting to Renegotiate License Terms

A licensee unhappy with the terms of the license agreement (for example, minimum royalties, royalty rates, etc.) could challenge or threaten to challenge the validity of the licensed patents in hopes of bringing the patentee back to the bargaining table.

The success of such a tactic will depend upon the strength of the challenge (for example, the strength of the prior art cited by the licensee in attempting to invalidate the patent).

§ 17:3.2 Licensor Tactics

While *MedImmune* and *SanDisk* favor licensees, licensors are not without some means of countering the effects of both decisions. In this section, we will look at some of the possible tactics available to licensors.

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35. Perhaps less likely since the Supreme Court decision in *eBay*. *See* eBay, Inc. v. MercExchange, L.L.C., 126 S. Ct. 1837 (2006).

The extent to which the Supreme Court's decision in *Lear v. Adkins*[36] would prohibit any attempt to restrict a licensee from challenging a licensed patent is unclear.

[A] Severability and Blue Line Provisions

The uncertainty as to the enforceability of any of the tactics discussed herein highlights the need to consider inclusion of a severability provision. If a tactic is struck or determined by a court to be unenforceable, it may be desirable to preserve the balance of the agreement and even the other parts of the section that includes the unenforceable tactic.

Severability is discussed elsewhere in this book (see section 15:3).

[B] Prohibition on Challenges

One of the contractual means of discouraging a licensee from challenging the patent is to prohibit it from bringing such an action. Is such a prohibition enforceable?

Interestingly, in the *MedImmune* opinion, the Supreme Court noted the absence of a contractual prohibition against challenges. The Court could not find a "prohibition against challenging the validity of the patents" in the patent license agreement, and the Court found that a prohibition against challenges could not be "implied from the mere promise to pay royalties on patents" not found to be invalid.[37] MedImmune asserted that "the contract, properly interpreted, does not prevent it from challenging the patents . . . ."[38]

Does this mean that if there had been a contractual prohibition, the Court would have ruled differently? We will probably have to await lower court interpretations for the answer.

[C] Termination Upon Challenge

Another approach would be to provide contractually that any challenge by the licensee of the validity of the licensed patents constitutes a material breach of the license agreement and is grounds for termination of the license.

Unlike an absolute prohibition, this provision allows the licensee to challenge the validity of the licensed patents, but the licensor in turn may terminate the license agreement.

One aspect to consider is whether the termination would be more likely to be held enforceable if it occurred automatically upon the filing of the declaratory action or if it was discretionary at the option of the licensor.

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36. Lear v. Adkins, 395 U.S. 653 (1969).
37. MedImmune, Inc. v. Genentech, Inc., 127 S. Ct. 764, 776 (2007).
38. *Id.*

[D] Prepaid and Signing Royalties

It is not uncommon, especially with exclusive grants, for license agreements to include a signing royalty. There are several arguments used by licensors in negotiating up-front royalties: they say they must recapture R&D costs, patent maintenance fees, legal costs in drafting and negotiating the license agreement, etc.

The patentee may wish to increase the amount of the up-front royalty as a disincentive for the licensee to challenge the patent. If the licensee has already paid the royalties in advance, there may be little for the licensee to gain from challenging the patent in an effort to end the running royalties.

The patentee may also try to have all the royalties paid up front. However, this may be an uphill battle as the licensee may not have the cash or inclination to pay all royalties up front (even on a discounted present value basis). Also, the licensee who pays in advance is taking a risk in assuming that the patent will not subsequently be invalidated by a third party on the basis of prior art that neither the patentee nor the licensee was aware of.

[E] Royalty Payments Continue During Declaratory Judgment Action

As a further means of discouraging the licensee from bringing a validity challenge, the patent owner may include a provision in the license agreement that the licensee shall continue to make royalty payments during the period of such challenge.

[E][1] Royalty Payments Not Escrowed

Also, the licensor may wish to provide in its agreement that the licensee may not pay the royalties into an escrow account, but rather must pay them directly to the licensor, and without deduction or offset.

[E][2] Must the Licensee Repudiate the License Agreement?

Whether a licensee who does not repudiate the license (that is, continues to pay royalties) but challenges the licensed patent can recover the royalties it paid during the pendency of the action was specifically left unanswered by the Supreme Court in *MedImmune*:

> True, the license requires petitioner to pay royalties *until* a patent claim has been held invalid by a competent body, and the Cabilly II patent has not. But the license at issue in Lear, Inc. v. Adkins, 395 U.S. 653, 673 (1969), similarly provided that "royalties are to be paid until such time as the 'patent . . . is held invalid,'" and we rejected the argument that a repudiating licensee must comply with its contract and pay royalties until its claim is vindicated in

> court. We express no opinion on whether a *nonrepudiating licensee* is similarly relieved of its contract obligation during a successful challenge to a patent's validity—that is, on the applicability of licensee estoppel under these circumstances.[39]

It is unclear to the author whether this language counsels licensees to discontinue paying royalties during the patent challenge where the license contractually obligates the licensee to continue making payments, and whether those royalties may be recovered (presumably from the date of filing of the complaint) if the patent is eventually held invalid.

[F] Increased Royalties Upon Bringing a Declaratory Judgment Action

If the licensee will not agree to a prepaid royalty, a tactic available to the patentee is to increase the royalty rate should the licensee bring a declaratory judgment action.

Application of the provision would not be contingent upon the success or failure of the declaratory judgment action; the filing of the action alone would trigger the immediate increase in the amount of royalties, for example, by 150%, by 200%, by 250%, or by some other significant amount.

The clause could further provide that the increased rate would remain in effect during the pendency of the action and any appeals therefrom.

[G] Increased Royalties Upon Losing Declaratory Judgment Action

A further disincentive to discourage licensees from bringing declaratory judgment actions is a royalty escalation triggered by a finding that the patent is valid and infringed.

Under such a provision, if the trial court finds *any* claim (i.e., even just one claim) of the licensed patents is valid as well as infringed by a licensed product or service, then the royalty rate would be increased over the life of the patent license agreement. The increase could be substantial—200%, 250%, 300%, 350%, etc.

Note that the royalty increase described in the previous paragraph is triggered by a finding of validity and infringement of a *single claim*. This may create a greater danger than the licensee may suspect, especially if the quantity of licensed products sold over the life of a license is anticipated to be significant; those products may incur a higher royalty rate, thus increasing the licensee's costs and its ability to compete in the market.

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39. *Id.* at 769–70 (emphasis in original).

The question arises, Would the degree of increased royalty affect a court's willingness to enforce the provision? That is, would a large increase (doubling or tripling) be looked upon by a court as punitive, or as an acceptable contractual discouragement?

[H] Signing Royalties Nonrefundable

It is not uncommon for licensors to include language providing that signing royalties are nonrefundable. Licensors may also provide that signing royalties are not creditable against future royalties. In other words, the signing royalty is not treated as a prepayment of or an advanced payment against running royalties. The principle is that once paid, the signing royalty can never be returned, reduced, or recouped.

[I] Licensee Pays Patentee's Attorneys' Fees

There are at least two possible approaches in using attorneys' fees to discourage licensee challenges to the validity of licensed patents:

(1) requiring licensee to pay attorneys' fees if the challenge is brought, or

(2) requiring licensee to pay attorneys' fees if the challenge is unsuccessful.

[I][1] Attorneys' Fees If Challenge Is Brought

This may prove to be the more effective strategy in discouraging a challenge. Under such a provision, the licensee pays the licensor's attorneys' fees if a declaratory judgment challenging the licensed patents is brought. The outcome has no bearing on the licensee's obligation to pay.

The licensor may consider also providing that the attorneys' fees become due as incurred by the licensor, rather than at the end of the litigation.

[I][2] Attorneys' Fees If Challenge Is Unsuccessful

Providing that the licensee will pay the licensor's attorneys' fees only if the licensor prevails will likely not be as potent a deterrent as providing that the licensee pays the licensor's attorneys' fees regardless of the outcome.

If anything, this may be an incentive for the licensee to fight harder in its attempts to kill the licensed patents.

[J] Choice of Venue

Another deterrent available to licensors is to contractually provide for venue selection in the event of any litigation. The licensor may wish to include specific language stating that the venue selection provision includes any declaratory judgment filed by the licensee.

This tactic is intended to avoid any inconvenient or hostile forum. A licensee may be less likely to bring a declaratory judgment action if it must do so in the hometown of the licensor. Of course, to the extent the law provides for decisions to be made by judges, hostility or bias may not be a realistic consideration.

[K] File First, Negotiate Later

One approach a patentee may take against an infringer is to file a patent infringement suit against the infringer in the patentee's hometown or a preferred venue. Since the patentee need not serve the complaint for 120 days, this gives the patentee four months to negotiate a license before alerting the infringer to the lawsuit.

This strategy is particularly effective against infringers who are known to be hard-nosed or litigious. Faced with a lawsuit in a distant or unfriendly forum, the infringer may take the negotiation more seriously.

[L] Licensee Admissions

If a patentee and licensee enter into a license agreement resulting out of litigation, the patentee may wish to consider inserting in *both* the judgment dismissing the lawsuit *and* the resulting license agreement an admission by the licensee that the patents are valid and enforceable. This may prove helpful to the patentee in any subsequent challenge to the validity of the patents brought by the licensee.

Here is an example of an admission of validity and enforceability:

> Licensee hereby <u>admits</u> that the Patent and claims issuing from the Reexamination are <u>valid and enforceable</u> in the Territory and agrees not to challenge the validity or enforceability of the Patent in the Territory on any grounds in the future.

The licensee may consider qualifying the admission to preserve its opportunity to defend itself in other proceedings less related to the specific patents in the underlying matter:

> <u>Notwithstanding</u> the above, nothing in this Agreement shall (a) be construed or cited as an admission of validity or enforceability of any <u>foreign</u> patent or currently pending patent applications or (b) prohibit Licensee from asserting that a <u>non</u>-Licensed Product does not infringe the Patent or claims issuing from the Reexamination on the grounds that such non-Licensed Product is identical to prior art not currently known to Licensee and/or its counsel. Prior art currently known to Licensee <u>and/or its counsel</u> includes, but is not limited to, all prior art cited: (i) in the Lawsuit, (ii) in the Patent, (iii) in the Reexamination, (iv) in U.S. Patent No. ___________ and (v) in any divisional, continuation, or continuation in part of U.S. Application No. ______________

that is currently publicly available, or any other prior art that is currently in the possession of Licensee or its counsel.

[M] Definition of "Patent Challenge"

Filing a declaratory action is not the only means of challenging a patent. If a patentee seeks a wide prohibition, he may consider using a broad definition of "patent challenge." For instance, in addition to declaratory actions, a patentee may want to prevent:

- interferences
- oppositions
- oppositions to extensions or supplementary protection certificates

An example of a broad definition is:

> "Patent Challenge" means any interference or opposition proceeding, challenge to the validity or enforceability of, or opposition to any extension of or the grant of a supplementary protection certificate with respect to, any Patent.

[N] Controlling Sublicensees

The patentee may wish to consider preventing its sublicensees from challenging the sublicensed patents. Since patentees often do not exert much control absent contractual rights (as discussed elsewhere in this book), patentees may consider providing language in their licenses that binds their licensees to terminate sublicensees who challenge the licensed patents.

In the following provision, the patentee reserves the right to terminate sublicensees whom the licensee fails to terminate. Note that the provision includes affiliates of sublicensees. Licensees may want to consider obligating the patentee to notify the licensee, to avoid questions over whether the licensee knew of the sublicensee's challenge, assuming the licensee would not be named in any such challenge. Some licensees prefer to be contractually forced to terminate the sublicensee under the license agreement to avoid upsetting the sublicensee, with whom the licensee may have other business dealings and a relationship worth trying to preserve: "We are sorry to terminate the sublicense with you, but as you can see under our agreement with the patent owner, we have no choice."

> X.3 **Sublicensees**. LICENSEE shall include provisions in all agreements granting sublicenses of LICENSEE's rights hereunder providing that if the sublicensee or its Affiliates undertake a Patent Challenge with respect to any Patent under which the sublicensee is sublicensed, LICENSEE shall be permitted to terminate such

> sublicense agreement. If a sublicensee of LICENSEE (or an Affiliate of such sublicensee) undertakes a Patent Challenge of any such Patent under which such sublicensee is sublicensed, then LICENSEE [upon receipt of notice from OWNER of such Patent Challenge] shall terminate the applicable sublicense agreement. If LICENSEE fails to so terminate such sublicense agreement, OWNER may terminate this Agreement.

[O] No Termination for Challenge As Defense Outside Scope of License

The licensee may wish to consider carving out an exception to a no-challenge provision allowing the licensee to challenge the licensed patents as part of its defense arising out of the licensee's activities unrelated to the license agreement or outside the scope of the license agreement.

An example of such a provision is:

> OWNER may terminate this Agreement in the event that Licensee or its Affiliates take any action, direct or indirect: (a) to challenge the validity, scope, or enforceability of the Patents licensed to Licensee hereunder; or (b) to oppose, object to, provoke an interference toward or initiate or support any re-examination proceedings challenging the Patents; <u>provided that it shall not be grounds for terminating this Agreement</u> if Licensee challenges the validity, scope, or enforceability of the Patents licensed to Licensee hereunder <u>in defense of an action for infringement of the Patents brought by OWNER</u> arising from Licensee's activities <u>outside of the scope</u> of this Agreement.

[P] Drop Dead; No Opportunity to Cure

Some patentees take challenges so seriously that they will not contractually permit a licensee the opportunity to cure (for example, withdraw or dismiss the action). Some patentees feel that a licensee may file a challenge with the goal of disclosing or making public the grounds of their case for invalidity. They know they have the option to cure their breach by terminating the challenge. They also know that another person or entity may use the evidence made public in the complaint to challenge the licensed patent.

To avoid such a tactic, a patentee may consider a clause providing for immediate termination without the possibility of cure. Here is an example:

> During the Term of this Agreement, should Licensee, either directly or indirectly, contest the validity of any claim of any of the Licensed Patents, then in such case, OWNER shall have the right to terminate the Agreement for cause with <u>immediate effect</u>

> and no right to cure. In such case, with regard to the Licensed Patents, OWNER shall retain all rights and remedies available to it under this Agreement and all applicable laws and regulations.

[Q] No Future Challenges

What if the licensee has initiated a challenge and agrees to terminate it? A patent owner may consider contractually prohibiting the licensee from any future challenges. Otherwise, there may not be much to stop the licensee from bringing further challenges, especially if the licensee is motivated to terminate the license by killing the patent to avoid minimum royalty payments or other obligations. Such motives become stronger as net sales weaken and the licensee is paying minimum royalties for inventions the market no longer wants.

An example of such a provision is:

> Licensee agrees not to take any action, direct or indirect, in connection with any patent opposition proceedings related to the Patents, shall withdraw its participation in such proceedings, and shall not initiate any additional opposition proceedings for the Patents currently in opposition proceedings in the U.S. Patent Office. Licensee agrees to take any actions reasonably requested by OWNER in connection with its withdrawal from opposition proceedings, shall not directly or indirectly oppose, object to, provoke an interference toward or initiate or support any re-examination proceedings challenging the Patents and agrees to withdraw any challenge to the Patents, other than in defense of an action for infringement of the Patents.

[R] "Show Me Your Cards"

One way to discourage licensee challenges is to require the licensee to disclose to the licensor its strategy in advance. Doing so removes the licensee's advantage of surprise. It also allows the licensor the ability to preemptively file against the licensee or offer to settle, e.g., alter the terms of the license to appease the licensee.

The notification should include:

- sufficient advance notice, e.g., sixty or ninety days; and
- details of any claims of invalidity, reduction in scope, enforceability, or noninfringement.

The licensor may also wish to consider contractually limiting the licensee's action to the claims disclosed beforehand. There may be uncertainty if, and to what extent, a court would enforce a licensor's contractual limitations of the licensee's claims to what it has disclosed.

It may be against public policy in some jurisdictions to limit the licensee's counterclaims, as the licensee would not know the licensor's counterclaims (or claims in a preemptive action). It may be perceived by a court as contractually binding the licensee to fighting with one hand tied behind its back.

[S] Solicitation Letters

Prior to *MedImmune* and *SanDisk*, it was common practice for patent owners to write infringers a mildly phrased, nonthreatening letter ostensibly bringing to the infringer's attention an opportunity to license the infringed patent. Sometimes the letter would be accompanied by a recitation of the features of the infringer's products or services that the patent owner deemed "relevant" in light of the patent's claims. The letter might even have suggested a "need" for the infringer to take a license in light of the particular features of the infringing product or service.

A bold patent owner might even have included a claims chart or included an invitation for the infringer to ask for a claims chart.

The process could often be a bit of a charade during which the patent owner refrained from using the "I" word—infringement—and the infringer responded with feigned innocence and claims of ignorance as to why it had received the patentee's letter. The infringer often requested "clarifications" about the patentee's intentions and the relevancy of the infringer's products to the cited patents.

After *MedImmune* and *SanDisk*, the question remains whether a letter which does not mention the need for a license or reference a particular product or service of the infringer would expose the patent owner to a declaratory judgment action. If the patent owner merely recites the economic or technological advantages offered by its patent, will that alone establish declaratory judgment jurisdiction?

For the answer, we will have to wait to see how the trial courts and Federal Circuit construe *MedImmune*.

[T] Advantages of Arbitration

One of the advantages of arbitration is the absence of establishing an unfavorable precedent. If a court finds the licensed patent to be invalid or unenforceable, other licensees may avail themselves of the decision, especially if the judgment is affirmed on appeal.

Arbitration, on the other hand, may be binding only on the parties and have "no force or effect on any other person."[40]

40. 35 U.S.C. § 294(c).

As to whether patent invalidity may be determined by arbitration, a district court has held that it may.[41]

§ 17:3.3 Conclusion

These are trying times for licensing patents. Patent license agreements are long-term contracts. The life of an agreement may be for the life of the patents being licensed. Much can happen over the term of a license. Just a few years ago, who could have predicted the *eBay*, *SanDisk,* or *MedImmune* decisions? As the courts interpret and apply *SanDisk* and *MedImmune*, the usefulness of the tactics discussed above will become more clear.

§ 17:4 *Quanta Computer:* Rebirth of Patent Exhaustion?

On June 9, 2008, the Supreme Court unanimously held in *Quanta Computer, Inc. v. LG Electronics, Inc.*,[42] that the doctrine of patent exhaustion:

(1) applies to the sale of an article where
  - the sale was authorized by the patentee, and
  - the article "substantially embodies" the patent;

(2) prevents patentees from using patent law to restrict downstream use of the article; and

(3) applies equally to method claims.

Quanta Computer is one of the first Supreme Court pronouncements on the doctrine of patent exhaustion in years. To better understand the opinion, some background on the doctrine of patent exhaustion may be helpful.

§ 17:4.1 Doctrine of Patent Exhaustion (or "First Sale" Doctrine)

The doctrine of patent exhaustion, while uncomplicated in theory, is not always easy to apply. Under the doctrine, an authorized

41. INVISTA N. Am., S.a.r.l. v. Rhodia Polyamide Intermediates S.A.S., No. 06-2180, 2007 WL 2230273 (D.D.C. Aug. 6, 2007) ("without express direction from Congress prohibiting the arbitration of Section 256 inventorship disputes, the federal presumption in favor of arbitration prevails").
42. Quanta Computer, Inc. v. LG Elecs., Inc., 128 S. Ct. 2109 (2008).

sale of a patented product *exhausts the patent monopoly* as to *that product*.[43]

In simplest terms, it is meant to prevent patent owners from double-dipping or getting two bites at the royalty apple. The underlying premise is that a patent owner should receive a royalty on only one sale of the patented invention.

Under the doctrine—also known as the "first sale" doctrine—the first *unrestricted or unconditional* sale of a patented item exhausts the patentee's control over that particular item, and the patentee has no further right to limit the sale of that item in commerce. The operative fact comes down to whether the first sale was unrestricted or unconditional.

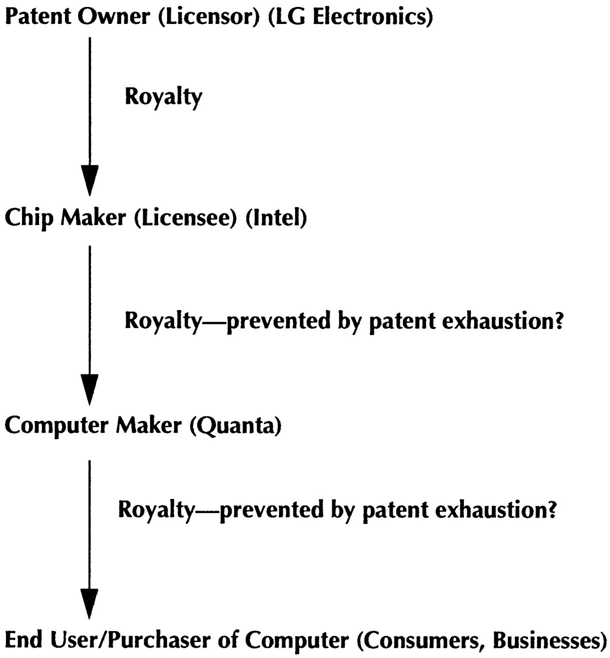
By way of example, consider a licensed invention that is a component or part of an end product. If the patented invention passes through several hands as part of a supply chain in the creation of the end product, under the theory of patent exhaustion the patentee is entitled to only one royalty, not a royalty every time the patented invention passes through each hand.

The application—or attempted application—of patent exhaustion arises frequently or at least prominently in the computer industry related to semiconductor chips. Assume a patent owner holds a patent covering a semiconductor (computer processing) chip. Patent exhaustion in theory could prevent the patent owner from collecting multiple royalties throughout the chain of manufacture and supply, e.g., a royalty on its first license (to the chipmaker) and then from the computer maker that assembles the computer (the end product) that incorporates the licensed chipmaker's chip.

Figure 17-1 shows the relation of the various entities affected in the *Quanta Computer* case. In the diagram, the chip patent could be said to be "exhausted" by the authorized (or licensed) first sale of the patented article (the chip). Once the patent owner has licensed the chip maker and thus "authorized" the chipmaker to sell the patented article to the computer assembler, the patent owner should not be able to collect further royalties from downstream users of the chip.

43. Intel Corp. v. ULSI Corp., 995 F.2d 1566, 1568 (Fed. Cir. 1993) ("The law is well settled that an authorized sale of a patented product places that product beyond the reach of the patent . . . ."), *cert. denied*, 510 U.S. 1092 (1994).

Figure 17-1



In addition to not being able to extract a royalty from the computer manufacturer, the patentee in the above example would not be able to bring a patent infringement claim against a third-party end-user/ purchaser of the computer (consumers, businesses).

"The test has been 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."[43.1]

§ 17:4.2 *Facts in* Quanta Computer

As summarized in the syllabus of the Supreme Court's opinion, the basic facts of *Quanta Computer* are as follows:

> Respondent (LGE) purchased, *inter alia*, the computer technology patents at issue (LGE Patents): One discloses a system for ensuring that most current data are retrieved from main memory, one relates to the coordination of requests to read from and write to main memory, and one addresses the problem of managing data traffic on a set of wires, or "bus," connecting two computer components. LGE licensed the patents to Intel Corporation (Intel), in an agreement (License Agreement) that authorizes Intel to

43.1. United States v. Masonite Corp., 316 U.S. 265, 277–78 (1942).

> manufacture and sell microprocessors and chipsets using the LGE Patents (Intel Products) and that does not purport to alter patent exhaustion rules. A separate agreement (Master Agreement) required Intel to give its customers written notice that the license does not extend to a product made by combining an Intel Product with a non-Intel product, and provided that a breach of the agreement would not affect the License Agreement. Petitioner computer manufacturers (Quanta) purchased microprocessors and chipsets from Intel. Quanta then manufactured computers using Intel parts in combination with non-Intel parts, but did not modify the Intel components. LGE sued, asserting that this combination infringed the LGE Patents. The District Court granted Quanta summary judgment, but on reconsideration, denied summary judgment as to the LGE Patents because they contained method claims. The Federal Circuit affirmed in part and reversed in part, agreeing with the District Court that the patent exhaustion doctrine does not apply to method patents, which describe operations to make or use a product; and concluding, in the alternative, that exhaustion did not apply because LGE did not license Intel to sell the Intel Products to Quanta to combine with non-Intel products.[43.2]

§ 17:4.3 *Reliance on* Univis Lens *Case*

The *Quanta* Court relied heavily on its earlier decision in *United States v. Univis Lens Co.*,[44] where the government challenged a patentee's licensing program on patents covering multifocal eyeglasses. Univis Lens (parent) owned "a number of patents . . . relating to multifocal lenses." It created a subsidiary, Univis Corporation (subsidiary), to which it transferred the patents. The subsidiary in turn "license[d] the [parent] to manufacture lens blanks and to sell them to designated licensees of the [subsidiary]" in exchange for a royalty. The blank lenses were covered by the "claims of some one of the [subsidiary's] patents." In addition to licensing its parent, the subsidiary created three classes of licensees who could purchase the lens blanks.

The subsidiary admitted that "the invention of only a single patent is utilized in making each blank and finishing it as a lens." Accordingly, the *Univis* Court

> put to one side questions which might arise if the finisher of a particular lens blank utilized the invention of some patent other than the patent which was practiced in part by the manufacture of the blank. And we assume . . . without deciding, that the patent is

43.2. *Quanta Computer*, 128 S. Ct. at 2110–11.
44. United States v. Univis Lens Co., 316 U.S. 241 (1942).

> not fully practiced until the finishing licensee has ground and polished the blank so that it will serve its purpose as a lens.[45]

The Court "assume[d] . . . that sale of the blanks by an unlicensed manufacturer to an unlicensed finisher for their completion would constitute contributory infringement by the seller."[46] The Court further noted that upon "sale of the blank . . . to a finisher, the *only use* to which it could be put and the only object of the sale is to enable the latter to grind and polish it for use as a lens by a prospective wearer."[47]

The *Univis* Court defined the first sale doctrine as follows:

> [U]pon familiar principles the authorized sale of an article which is capable of use *only in practicing the patent* is a relinquishment of the patent monopoly with respect to the article sold. Sale of a lens blank by the patentee or by his licensee is thus in itself both a complete transfer of ownership of the blank, which is within the protection of the patent law, and a license to practice the final stage of the patent procedure. In the present case the entire consideration and compensation for both is the purchase price paid by the finishing licensee to the Lens Company.[48]

According to *Univis*,

> [t]he 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*.[49]

§ 17:4.4 Patent Exhaustion Applies to Method Claims

On the issue of whether patent exhaustion can be applied to method claims, the Supreme Court in *Quanta Computer* reversed the Federal Circuit and held that patent exhaustion applies to method patents as well as product patents. "[T]his Court has repeatedly held that method patents were exhausted by the sale of an item that embodied the method."[50] The Court agreed with Quanta that if method claims were exempt from patent exhaustion, patentees could easily protect their inventions from patent exhaustion by inserting method claims in their patents. The Court explained:

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45. *Id.* at 248–49.
46. *Id.* at 249.
47. *Id*. (emphasis added).
48. *Id*. at 249–50 (citation omitted; emphasis added).
49. *Id*. at 250 (emphasis added).
50. *Quanta Computer*, 128 S. Ct. at 2111 (citing Ethyl Gasoline Corp. v. United States, 309 U.S. 436, 446, 457 (1940) and *Univis Lens Co.*, 316 U.S. at 250–51).

> By characterizing their claims as method instead of apparatus claims, or including a method claim for the machine's patented method of performing its task, a patent drafter could shield practically any patented item from exhaustion. This case illustrates the danger of allowing such an end-run around exhaustion. On LGE's theory, although Intel is authorized to sell a completed computer system that practices the LGE patents, any downstream purchasers of the system could nonetheless be liable for patent infringement. Such a result would violate the longstanding principle that, when a patented item is "once lawfully made and sold, there is no restriction on [its] use to be implied for the benefit of the patentee." *Adams*, 17 Wall., at 457, 21 L.Ed. 700. We therefore reject LGE's argument that method claims, as a category, are never exhaustible.[51]

The Court then considered the extent to which a product must embody a patent before the patent exhaustion doctrine applies. The Court found that LGE's products were like the unfinished lenses in the *Univis* case. In *Univis*, the Court found patent exhaustion to apply to a sale of an incomplete product where (1) its *only reasonable and intended use was to practice the patent* and (2) it embodied essential features of the patented invention.[52]

In *Quanta*, the Court found that there was only one intended use for Intel's products, and that the Intel products constituted a material part of the LGE patented invention and all but completely practiced the patent:

> Here, LGE has suggested no reasonable use for the Intel products other than incorporating them into computer systems that practice the LGE Patents. Nor can we can discern one: A microprocessor or chipset cannot function until it is connected to buses and memory. And here, as in *Univis*, the only apparent object of Intel's sales to Quanta was to permit Quanta to incorporate the Intel products into computers that would practice the patents. . . . [T]he Intel products constitute a material part of the patented invention and all but completely practice the patent. Here, as in *Univis*, the incomplete article substantially embodies the patent because the only step necessary to practice the patent is the application of common processes or the addition of standard parts. . . . The Intel products embody the essential features of the LGE patents because they carry out all the inventive processes when combined, according to their design, with standard components.[53]

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51. *Id*. at 2118.
52. *Univis Lens Co*., 316 U.S. at 250–51.
53. *Quanta Computer*, 128 S. Ct. at 2119-20.

§ 17:4.5 *A Product Must Embody a Patent to Trigger Exhaustion*

The Court next considered "the extent to which a product must embody a patent in order to trigger exhaustion."[54] The Court rejected Quanta's argument that "although sales of an incomplete article do not necessarily exhaust the patent in that article, the sale of the microprocessors and chipsets exhausted LGE's patents in the same way the sale of the lens blanks exhausted the patents in *Univis*."[55] The Court reasoned that

> [j]ust as the lens blanks in *Univis* did not fully practice the patents at issue because they had not been ground into finished lenses, . . . the Intel Products cannot practice the LGE Patents—or indeed, function at all—until they are combined with memory and buses in a computer system. If . . . patent rights are exhausted by the sale of the *incomplete* item, then LGE has no postsale right to require that the patents be practiced using only Intel parts.[56]

The Court rejected Quanta's argument that

> the exhaustion doctrine will be a dead letter unless it is triggered by the sale of components that *essentially*, even if not completely, *embody* an invention. Otherwise, patent holders could authorize the sale of computers that are complete with the exception of one *minor step*—say, inserting the microprocessor into a socket—and extend their rights through each downstream purchaser all the way to the end user.[57]

Finding the case similar to *Univis*, where exhaustion was triggered by the sale of the lens blanks "because their only reasonable and intended use was to practice the patent and because they 'embodie[d] essential features of [the] patented invention,'" the Court found that "[e]ach of those attributes is shared by the microprocessors and chipsets Intel sold to Quanta under the License Agreement."[58]

Harking back to *Univis*'s holding that "the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold," the Court noted that

> [t]he lens blanks in *Univis* met this standard because they were "without utility until [they were] ground and polished as the

54. *Id*. at 2118.
55. *Id.*
56. *Id*. (emphasis added).
57. *Id*. (emphasis added).
58. *Id.* at 2119.

> finished lens of the patent." Accordingly, "the only object of the sale [was] to enable the [finishing retailer] to grind and polish it for use as a lens by the prospective wearer."[59]

Applying this reasoning, the Court observed that LGE had suggested

> no reasonable use for the Intel Products other than incorporating them into computer systems that practice the LGE Patents. . . . A microprocessor or chipset cannot function until it is connected to buses and memory. And here, as in *Univis*, the only apparent object of Intel's sales to Quanta was to permit Quanta to incorporate the Intel Products into computers that would practice the patents.[60]

The Court further noted that the lens blanks in *Univis* "embodie[d] essential features of [the] patented invention,"[61] and that the "*essential, or inventive*, feature of the Univis lens patents was the fusing together of different lens segments to create bi- and tri-focal lenses. The finishing process performed by the finishing and prescription retailers after the fusing was not unique."[62]

The Court compared Intel's chips to Univis's blank lens:

> Like the Univis lens blanks, the Intel Products constitute a material part of the patented invention and *all but completely practice the patent*. Here, as in *Univis*, the incomplete article *substantially embodies* the patent *because the only step necessary to practice the patent is the application of common processes or the addition of standard parts*. *Everything inventive* about each patent is embodied in the Intel Products.[63]

The Court gave short shrift to LGE's attempts to distinguish *Univis*, finding that

> the nature of the final step, rather than whether it consists of adding or deleting material, is the relevant characteristic. In each case, the final step to practice the patent is *common and non-inventive*: grinding a lens to the customer's prescription, or connecting a microprocessor or chipset to buses or memory. The Intel Products embody the *essential features* of the LGE Patents because they *carry out all the inventive processes when combined, according to their design, with standard components*.[64]

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59. *Id*. (citations omitted).
60. *Id.*
61. *Id*. (quoting *Univis Lens Co.*, 316 U.S. at 250–51).
62. *Id*. (emphasis added).
63. *Id*. at 2120 (emphasis added).
64. *Id*. (emphasis added).

§ 17:4.6 Patent Exhaustion Can Be Applied Across Patents

The Court rejected LGE's argument that patent exhaustion does not apply across patents, holding that sales of products that *partially practice* a method patent can still trigger patent exhaustion when the products include essential features of the patent and the reasonable and intended use of the product is to practice the patent:

> With regard to LGE's argument that exhaustion does not apply across patents, we agree on the general principle: The sale of a device that practices patent A does not, by virtue of practicing patent A, exhaust patent B. *But if the device practices patent A while substantially embodying patent B, its relationship to patent A does not prevent exhaustion of patent B* . . . . While each Intel microprocessor and chipset practices thousands of individual patents, including some LGE patents not at issue in this case, the exhaustion analysis is not altered by the fact that more than one patent is practiced by the same product. *The relevant consideration is whether the Intel Products that partially practice a patent by, for example, embodying its essential features exhaust that patent*.[65]

§ 17:4.7 Exhaustion Is Triggered Only by a Sale Authorized by the Patent Holder

The Court then considered whether Intel had the authority to sell to Quanta: "Exhaustion is triggered only by a sale authorized by the patent holder."[66] The Court rejected LGE's argument that no authorized sale occurred because the license agreement "does not permit Intel to sell its products for use in combination with non-Intel products."[67]

The Court distinguished cases such as *General Talking Pictures Corp. v. Western Elec. Co.*,[68] in which the manufacturer sold patented amplifiers for commercial use, thereby breaching a license that limited the buyer to selling the amplifiers for private and home use. The licensee "could not convey to petitioner what both knew it was not authorized to sell."[69] In *Quanta Computer*, the Court noted, "neither party contends that Intel breached the agreement"[70] to provide notice

65. *Id*. at 2120–21 (emphasis added).
66. *Id*. at 2121.
67. *Id*.
68. Gen. Talking Pictures Corp. v. W. Elec. Co., 304 U.S. 175 (1938); Gen. Talking Pictures Corp. v. W. Elec. Co., 305 U.S. 124 (1938).
69. *Gen. Talking Pictures Corp.*, 304 U.S. at 181.
70. *Quanta Computer*, 128 S. Ct. at 2121.

to its customers of the all-Intel restrictions. Further, "Intel's authority to sell its products . . . was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice."[71] The language "disclaim[ing] any license to third parties" was dismissed as "irrelevant because Quanta asserts its right to practice the patents based not on implied license but on exhaustion. And exhaustion turns only on Intel's license to sell products practicing the LGE patents."[72]

§ 17:4.8 Authorized Sale Exhausts the Patent Rights

After finding that the products sold by Intel to Quanta "effectively embodied" LGE's patents, the Court turned its attention to whether LGE's patent rights were exhausted by Intel's sale to Quanta. The Court noted that patent exhaustion "is triggered only by a sale authorized by the patent holder."[73]

LGE argued that Intel's sale to Quanta was not authorized because the license agreement did not permit Intel to sell its products for use in combination with non-Intel products. LGE argued that under the master agreement between LGE and Intel, Intel was obligated to give notice to its customers (including Quanta) that LGE had not licensed those customers to practice its patent. No such obligation appeared in the license agreement between LGE and Intel.

The Court rejected the argument, instead emphasizing that nothing in the license agreement restricted Intel's right to sell products to purchasers who, as LGE well knew, intended to combine them with non-Intel products, i.e., the computers.

The Court found that the notice provision required Intel to give notice to its customers, including Quanta, that LGE had not licensed those customers to practice its patents. But that was not at issue, since neither party contended that Intel breached that obligation.

The notice was not considered important because it was in the master agreement, not the license agreement:

> In any event, the provision requiring notice to Quanta appeared only in the Master Agreement, and LGE does not suggest that a breach of that agreement would constitute a breach of the license agreement. Hence, *Intel's authority* to sell its products embodying the LGE Patents was *not conditioned on the notice* or on Quanta's decision to abide by LGE's directions in that notice.[74]

71. *Id.* at 2122.
72. *Id.*
73. *Id.* at 2121.
74. *Id.* at 2121–22 (emphasis added).

The Supreme Court thus found that

> [t]he License Agreement authorized Intel to sell products that practiced the LGE patents. *No conditions limited Intel's authority* to sell products substantially embodying the patents. Because Intel was authorized to sell its products to Quanta, the doctrine of patent exhaustion prevents LGE from further asserting its patent rights with respect to the patents *substantially embodied by those products*.[75]

§ 17:4.9 *What* Quanta *Means to Practitioners*

[A] The Contracts and Conditions in *Quanta*

In determining whether restrictions are still allowed after *Quanta*, it is helpful to consider the particular circumstances of the case.

The facts of *Quanta* are a bit unusual in that two agreements were involved: a Master Agreement and a License Agreement. Performance under the License Agreement was independent of the Master Agreement. The Master Agreement provided that a breach of the Master Agreement would not constitute a breach of the License Agreement:

> [A] breach of this [Master] Agreement shall have no effect on and shall not be grounds for termination of the Patent License.[76]

The Court noted that there was nothing in the license agreement that restricted Intel's rights to sell the chips to third parties who wished to combine them with non-Intel parts.

Intel was only required to provide notice to its customers "ensur[ing] that any Intel product that [Intel's customers] purchase is licensed by LGE and thus does not infringe any patent held by LGE." The notice provision was in the Master Agreement, not the License Agreement.

Neither LGE nor Quanta alleged that Intel did not give the required notice to its customers.

The Court found that Intel's sales to Quanta were not conditioned on the notice given pursuant to the Master Agreement. The Court also found that Intel's sales to Quanta were not conditioned on Quanta's decision to comply with the requirements of the notice.

Without any conditions limiting Intel's authority to sell the chips in the license, the doctrine of patent exhaustion was held to apply and prevented LGE from asserting its patent rights against Quanta.

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75. *Id*. at 2122.
76. *Id*. at 2114 (internal quotation marks omitted; emphasis added).

[B] Restrictions or Conditions Should Be in the License Agreement

In considering whether Intel's sales to Quanta exhausted LGE's patent rights because they were authorized sales, the Court made note of the fact that the purported restrictions were not in the license agreement but rather in the master agreement.

> The License Agreement purports not to alter the *usual rules of patent exhaustion*, however, providing that, "[n]otwithstanding 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."
>
> In *a separate agreement* (Master Agreement), Intel agreed to give written notice to its own customers informing them that, while it had obtained a broad license "ensur[ing] that any Intel product that you purchase is licensed by LGE and thus does not infringe any patent held by LGE," the license "'does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product."[77]

The Court also noted that a breach of the master agreement was by contract irrelevant to the license agreement.

> The Master Agreement also provides that "a breach of this Agreement shall have no effect on and shall not be grounds for termination of the Patent License."[78]

The lesson is that licensors should consider placing any restrictions or conditions in the license agreement, not in any ancillary or master agreement.

[C] Are Restrictions and Conditions Still Allowed?

While it discussed the license in *General Talking Pictures*, which contained restrictions on the licensee's ability to sell, the Court distinguished the license there from the LGE-Intel license, but did not limit or overrule *General Talking Pictures*:

> LGE argues that there was no authorized sale here because the License Agreement does not permit Intel to sell its products for use in combination with non-Intel products to practice the LGE Patents. It cites *General Talking Pictures Corp. v. Western Elec. Co.*, 304 U.S. 175 (1938), and *General Talking Pictures Corp. v.*

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77. *Id*. (some internal quotation marks omitted; citations omitted; emphasis added).

78. *Id.* (some internal quotation marks omitted; emphasis added).

> *Western Elec. Co.*, 305 U.S. 124 (1938), in which the manufacturer sold patented amplifiers for commercial use, thereby breaching *a license* that *limited the buyer to selling the amplifiers for private and home use*. The Court held that exhaustion did *not apply* because the *manufacturer had no authority to sell the amplifiers for commercial use*, and the manufacturer "could not convey to petitioner what both knew it was not authorized to sell." *General Talking Pictures, supra*, at 181. LGE argues that the same principle applies here: Intel could not convey to Quanta what both knew it was not authorized to sell, *i.e.*, the right to practice the patents with non-Intel parts.
>
> LGE overlooks important aspects of the structure of the Intel-LGE transaction. Nothing *in the License Agreement* restricts Intel's right to sell its microprocessors and chip-sets to purchasers who intend to combine them with non-Intel parts. It broadly permits Intel to "'make, use, [or] sell'" products free of LGE's patent claims. Brief for Petitioners 8 (quoting App. 154). To be sure, LGE did require Intel to give notice to its customers, including Quanta, that LGE had not licensed those customers to practice its patents. But neither party contends that Intel breached the agreement in that respect. In any event, the provision requiring notice to Quanta appeared only in the Master Agreement, and LGE does not suggest that a breach of that agreement would constitute a breach of the License Agreement. Hence, Intel's authority to sell its products embodying the LGE Patents was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice.[79]

The Court did not hold that a patent holder can place no conditions or restrictions on post-sale uses of a patented article. It held only that under the terms of the LGE-Intel license agreement and master agreement, Intel had an unconditional right to sell products which embodied the "inventive features" of the licensed patents, thus triggering patent exhaustion.

It thus appears licensors may continue to place limitations on a licensee's sales of licensed products. However, the holding offers little guidance, because, having found that the LGE-Intel license agreement broadly permitted Intel to sell its products without limitation, there was no opportunity for the Court to address whether other conditions—not present in the LGE-Intel agreement—would be permissible.

[D] What Conditions or Restrictions Are Available?

If indeed *Quanta* did not prohibit a licensor's ability to place restrictions on a licensee's sale of licensed products, then restrictions such as field-of-use and geographical limitations should still be

79. *Id*. at 2121–22 (emphasis added).

available. Support is found in the Supreme Court's noting that Intel's sale might not have been authorized—and patent exhaustion would not have applied—if the license grant had prohibited Intel from selling patented products to customers who would *combine* them with *non-Intel* products downstream.

Patentees should consider drafting the license grant narrowly through field-of-use limitations and geographical and market limitations. Doing so may allow the patentee to extract a royalty from the sale of each licensed product.

In light of the Court's examination of the language in the Master Agreement and License Agreement in *Quanta*, the 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 included in its license agreement 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 "authorized sale," and authorized sales are a prerequisite for patent exhaustion.

But LGE failed to limit Intel's ability to sell the patented chips. When downstream entities like Quanta purchased the Intel chips and installed them in computers that used the patented method, patent exhaustion prevented LGE from obtaining license royalties from the PC makers or the end users. Had LGE's license agreement (not the master agreement) to Intel included field-of-use restrictions or other limitations that restricted sales to third parties, then Intel's sales may not have exhausted LGE's patent rights with respect to those downstream entities.

[E] Reasons for Restricted Licenses

There are reasons for licensors to restrict the use and sales of their patented inventions beyond "double dipping."

For instance, a university that owns a patented compound or gene may wish to license other academic institutions for nonprofit research and separately license commercial applications to for-profit entities. The license to other academic institutions may be royalty-free or under a nominal royalty rate, whereas the license to for-profit entities may be at market rates.

The university may want to protect itself from transfers of royalty-free products to market-rate products, e.g., loss of a commercial market for its patented compound through transfer of royalty-free compounds to commercial users. The university has a legitimate interest in preventing unauthorized use of the patented chemical.

There are also health and tort liability concerns that may permit restricted use licenses such as the "one use" restriction in *Mallinckrodt, Inc. v. Medipart, Inc.*[80]

The Supreme Court did not address *Mallinckrodt* in its *Quanta* decision. Therefore the opportunity arguably still exists for a licensor to divide up the market by licensing higher-value uses to some and licensing low-value uses to others via field-of-use restrictions.

As long as the low-value licensees have not been granted the right to sell but only the right to use, there may be less risk that the public will be able to purchase from the low-value licensee products for use in the higher value fields of use.

Note that neither the lower-royalty licensee nor the higher-royalty licensee is granted the right to sell, only the right to use. Without being granted the right to sell, there can be no authorized sale.

[F] Restrictions in Practice

If lower courts do not interpret and apply *Quanta* as banning a patentee's right to restrict and condition its license grants, patentees may be able to avoid patent exhaustion by

1. restricting the licensee to *selling only* to purchasers who have been *separately licensed* by the patentee to practice the patent, and

2. selling only to purchasers who agree as *a condition of such sale not to use* the *components* to practice the licensed patents without a license from the *patentee*.

Any restrictions should be in the license agreement and explicit.

Subject to patent misuse review (i.e., antitrust and anticompetition considerations), patentees should consider expressly stating both the restriction and the parties restricted. For example the license agreement could state that:

Licensee is granted the right:

1. only to practice [licensed applications],

2. only under the following situations [adapt language from the licensed patents],

3. Licensee is not licensed to do the following [list applications included in the licensed patents but not within the license grant],

4. nor any other activity not enumerated in Section 1 but falling within the licensed patents.

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80. Mallinckrodt, Inc. v. Medipart, Inc., 976 F.2d 700, 708 (Fed. Cir. 1992).

What could LGE have done to avoid patent exhaustion? While it is difficult to predict how the Supreme Court would have ruled under different facts, one cannot help but wonder how the outcome might have differed if the LGE-Quanta license grant had included language to the effect of:

Quanta is licensed:

(1) to <u>use</u> and <u>combine</u> Licensed Products <u>only</u> as <u>part of</u> Intel products, and

(2) to <u>sell</u> Licensed Products <u>only</u> for <u>use with</u> Intel products;

(3) no other rights to use or sell are granted hereunder.

[G] Separately Licensing Consumers

Any strategy that includes separate licenses to consumers may prove unwieldy both in the logistics (collecting royalties, monitoring compliance, etc.) and consumer acceptance.

The sheer volume of licenses may also be so difficult to manage as to be proportionally too expensive compared to the potential revenue to be generated.

[H] Digital Rights Management

When Apple first proposed selling music online, skeptics and studios alike decried the proposed venture as a pirate's dream, declaring that there was no manageable means to monitor or control compliance. There were simply too many copyright licenses involved.

It may be that a patentee someday adopts a licensing strategy similar to the digital rights management programs prevalent online.

[I] License but Do Not Sell (Software Model)

Patentees could also follow the business model of the software industry and license the use of patented products rather than selling them. Theoretically, because the licensed products are licensed and not sold, patent exhaustion may be avoided.

Just as with some applications of digital rights management, licensing inventions instead of selling them may prove more trouble than trying to obtain a higher royalty in the initial license.

[J] Higher Up-Front Royalties

It is difficult to predict the extent to which *Quanta* has diminished a patentees' ability to contract for market rate royalties. It may come to pass that patentees will attempt to sidestep the issue by extracting larger royalties from one point in the product supply chain rather than collecting from multiple points.

Companies in the position of Intel under the *Quanta* facts arguably no longer have as strong an argument to tell licensees like LGE to accept a smaller royalty from Intel and seek further compensation downstream from companies like Quanta.

Of course, the economic effect of *Quanta* may be to raise royalty rates, as patentees avoid the risk of complex contractual language and licensing deals and prefer to take their pound of flesh from whom they are certain to get it—the first to be licensed, e.g., the Intels of the world.

This may not be an easy sell, as the Intels of the world may fear that the chips may not be purchased by companies like Quanta. Intel could pay only on the chips actually sold (agreeing to destroy the unsold chips).

[K] Confirmation That Purchaser Is Separately Licensed

The Supreme Court in *Quanta* did not prohibit conditional sales. The Court did stress the prerequisite of an authorized sale for patent exhaustion to apply. Consequently patent owners should consider contractually requiring licensees to sell only to those who have been licensed by the patent owner.

To assure compliance by licensees, patent owners may wish to consider requiring their licensees to confirm in writing that purchasers are indeed separately licensed by the patent owner before they sell licensed products to such purchasers.

Patent owners can also consider requiring licensees to secure permission from the patent owner before such sale.

In subsequent patent infringement litigation, patent owners would then be able to argue that any unconfirmed sales were unauthorized sales and therefore patent exhaustion should not apply.

[L] Termination of License Grant for Breach

A further consideration for patent owners is to provide for termination of the patent license for breach of any restrictions on downstream use or sale of the licensed products. In other words, if there is a breach of the restrictions, the license terminates and patent infringement remedies become available.

This creates a grave consequence for breach and may indeed heighten awareness and compliance. It may be perceived as draconian and consequently may be difficult to negotiate.

[M] When Does a Sale Exhaust the Patent?

The Court in *Quanta* adopted a two-part test for determining when the sale of an incomplete product or component exhausts the patent rights in that product or component.

Analyzing the facts before it, the Court found that the licensed microprocessors embodied *both* system and method claims because:

(1) There was "*no reasonable use*" for the Intel products other than incorporating them into computer systems that practiced the licensed patents, and

(2) "the *final step* [of assembling the PC's] to practice the patent is *common and noninventive*."[81]

Several questions remain after *Quanta*:

- Would the result had been different in *Quanta* if the component had "other reasonable uses," i.e., other than as incorporated into a licensed patent?
- Would there be exhaustion if one of the two above elements were missing?
- Or is exhaustion limited to sales of components capable of use only in *practicing* the patent, e.g., components that embody a patent?

In its analysis of determining what is sufficient to "substantially embod[y] the patent," the Court examined the "final step." The licensed chip sold by Intel included "all the essential features" or "everything inventive" under the patent, with nothing more required to practice the invention than combine it with standard PC components (the final "step necessary to practice the patent is the application of common processes or the addition of standard parts").[82]

Part of the test is that the incomplete article or product must "substantially embod[y] the patent" and "all but completely practice the patent."[83] If the only "step[s] necessary to practice the patent [are] the application of common processes or the addition of standard parts," then the patent is exhausted.[84]

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81. *Quanta Computer*, 128 S. Ct. at 2120. The Court said:

> [T]he final step to practice the patent is common and noninventive: grinding a lens to the customer's prescription, or connecting a microprocessor or chipset to buses or memory. The Intel Products embody the essential features of the LGE Patents because they carry out all the inventive processes when combined, according to their design, with standard components.

Id.

82. *Id.*
83. *Id.*
84. *Id.*

The Court distinguished the LGE patents from "combination patents," which are patents whose inventive quality is the combination of known elements.[85]

It may prove difficult for practitioners—and ultimately courts—to distinguish between a product that "substantially embodies" the invention and a "combination patent" that falls outside the two-part test.

[N] Is It Helpful to State Whether Licensed Products "Substantially Embody" the Licensed Patent?

Because the *Quanta* Court directed much of its discussion to substantial embodiment, patent owners may want to consider stating in their patent license agreements that the licensed products "substantially embody" the patented methods.

The big question is whether a court would look upon this as window dressing or an accurate statement of the facts. The answer may turn on whether the provision was negotiated freely or was foisted or strong-armed upon the licensee.

[O] Implied License Distinguished from Patent Exhaustion

Implied license is an equitable doctrine that may arise "by acquiescence, by conduct, by equitable estoppel (estoppel in pais) or by legal estoppel."[86]

In *Quanta*, the patent owner argued that the license agreement specifically disclaimed any license to third parties to practice the

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85. Finally, LGE's reliance on *Aro* is misplaced because that case dealt only with the question *whether replacement of one part of a patented combination infringes the patent*. First, the replacement question is not at issue here. Second, and more importantly, *Aro* is not squarely applicable to the exhaustion of patents like *the LGE Patents that do not disclose a new combination of existing parts*. *Aro* described *combination patents* as "cover[ing] *only the totality of the elements* in the claim [so] that no element, separately viewed, is within the grant." 365 U.S., at 344; see also *Mercoid Corp. v. Mid-Continent Investment Co.*, 320 U.S. 661, 667–68 (1944) (noting that, in a combination patent, "*the combination is the invention* and it is distinct from any" of its elements). *Aro*'s warning that no element can be viewed as central to or equivalent to the invention is specific to the context in which the combination itself is the only inventive aspect of the patent. In this case, *the inventive part of the patent* is not the fact that memory and buses are combined with a microprocessor or chipset; rather, it *is included in the design* of the Intel Products *themselves* and the way these products access the memory or bus."
Id. at 2121 (emphasis added).

86. Wang Labs., Inc. v. Mitsubishi Elecs. Am., Inc., 103 F.3d 1571, 1580, 41 U.S.P.Q.2d 1263, 1271 (Fed. Cir. 1997).

patents by combining licensed products with other components. Unlike patent exhaustion, a patentee can disclaim an implied license in the license agreement. However, the Court held that whether third parties received implied licenses was irrelevant because Quanta asserted its right to practice the patents based not on implied license but on exhaustion. And exhaustion turns only on Intel's own license to sell products practicing the LGE Patents.

Patent owners should consider continuing the practice of disclaiming implied licenses in their patent license agreements.

[P] Effect on Downstream "Infringers"

One practical effect of *Quanta* may be to provide downstream infringers a defense to claims of infringement. If the upstream supplier (or anyone else higher in the supply chain) has a license with the patent owner, the accused infringer may benefit under such license just as Quanta benefited from the LGE-Intel license.

[Q] Contract Remedies

[Q][1] Patentee May Enforce Additional Restrictions by Contract

The Court may have allowed patent owners the greatest flexibility from its language in footnote 7 in *Quanta*:

> 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 U.S. 659, 666 (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*").[87]

This leaves open the opportunity for patent owners to provide in their license agreements restrictions on downstream sales and uses that are not available under the patent law.

Patent owners may attempt to do under contract law what they no longer can under patent law. This may result in a substitution of state contract law for what was once allowed under federal patent law.

87. *Quanta Computer*, 128 S. Ct. at 2122 n.7 (emphasis added).

Such restrictions may include liquidated damages and the granting of injunctions by arbitration.[88]

One of the challenges in substituting state contract law for federal patent law is whether the applicable state law prohibits the remedy. This may affect which law the patent owner selects to govern its patent license agreement.

Another consideration is the absence of semi-immunity to antitrust constraints granted patentees under federal patent laws (i.e., the patent monopoly and ability of patent owners to enjoy it), which would not be available to patent owners under state contract law.

This may frustrate patent owners attempting to mimic the remedies available under federal patent law via state contract law.

[Q][2] Privity of Contract

Substituting contractual remedies for patent law remedies may prove unwieldy in practice. State contract law may require contractual privity between litigants, thus making it unlikely that a court or arbitrator would find grounds to enforce contractual rights against parties not privy to the contract.

For example, trying to use state contract law to limit the rights of downstream buyers would invariably require privity of contract. In *Quanta*, LG could not sue Quanta for breach of contract since there was no contract between LG and Quanta.

Imagine the burden of trying to obtain privity of contract with numerous downstream buyers. Would the patent owner be able to use something akin to a shrink wrap software license or an Internet click-through?

[R] Importance of Selecting Licensees

Another effect of *Quanta* is the consequence to patent owners of selecting which party in the supply chain to license. Because the Court in footnote 7 is inviting the use of contractual remedies as opposed to patent remedies, patent owners need to consider selecting parties who are most likely to perform and most likely to have pockets sufficiently deep to pay monetary contractual damages as well as royalties.

Patent owners may also want to select parties in the supply chain that are unlikely to seek bankruptcy protection. Of course, this is a challenge with all long-term agreements, including patent license agreements.

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88. Arbitrators have the authority to grant injunctions, Anderman/Smith Operating Co. v. Tenn. Gas Pipeline Co., 918 F.2d 1215, 1219 (5th Cir. 1990), which can be confirmed through the courts. Swan Magnetics, Inc. v. Superior Ct., 66 Cal. Rptr. 2d 541 (Cal. App. 1997).

[S] How Can a Purchaser Protect Itself?

Purchasers of articles marked as patented may demand to review the patent license agreement between the patent owner and the manufacturer to confirm that the sale to the purchaser by the manufacturer is authorized under the license agreement.

A purchaser could further protect itself by demanding indemnification from the manufacturer with respect to the purchased items being covered by the license agreement between the patent owner and the manufacturer.

[T] Restrictions in Biopharma Industry

While *Quanta* involved semiconductors, its holding is instructive for other industries such as biopharma, where restricted sales are not uncommon.

Post *Quanta*, licensors may still be able to prohibit purchasers from replicating new generations of plant seed or strands of DNA from purchased seeds or DNA.

However, if the Court's analysis in *Quanta* is applied to biopharma, the results may be drastic and unintended.

LGE argued that patent exhaustion does not apply to postsale restrictions on "making" an article. The Court dismissed this as simply a rephrasing of its argument that combining the Intel products with other components adds more than standard finishing to complete a patented article. The Court found that "*making a product* that *substantially embodies a patent* is, for exhaustion purposes, *no different* from making the patented article itself."[89]

If the use of the purchased plant seed or DNA is the use of its "essential feature," then patent exhaustion may apply. The question remains whether companies may continue to condition their sales on limited use (e.g., research purposes only; one planting season only) as well as prohibitions against replication.

[U] Conclusion: *Quanta* in a (Very Small) Nutshell

The patent exhaustion doctrine is not always easy to understand or to apply. It may be helpful to consider the following in trying to determine *Quanta's* application under your particular facts.

1. If a patent license authorizes a manufacturer to make or assemble an article that

    - has "no reasonable use" other than as the patented invention *and*

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89. *Quanta Computer*, 128 S. Ct. at 2122 (emphasis added).

- requires only the addition of "common processes" or "standard parts" to complete the article,[90]

then that license should also *protect the purchaser of the article* from claims for patent infringement.

2. A patent owner who wishes to *exclude* certain *purchasers from using* the patent must clearly set forth in the *manufacturer's* patent license that the manufacturer is *not* authorized to *sell* to such excluded *purchasers*.

90. "[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." *Id*. at 2116–17 (quoting *Univis Lens Co.*, 316 U.S. at 250–51).

Strategies for the New Patent Law Frontier

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The World Has Changed

Where We Are Today

- In the last few years patents have been under attack in the Supreme Court
- Why is the Court doing so?
  - Educated guesses
  - “Garbage” patents issued
  - Reaction to NPE’s (“patent trolls”)?
- Effect on the value of patents
- Effect on the value of licensing

How We Got Here

- 1982: Court of Appeals for the Federal Circuit
- Jurisdiction over patent appeals
- Uniformity and predictability to patent law
  - End forum (circuits) shopping
- CAFC perceived as pro patent rights
- Supreme Court hands-off approach
  - Benign neglect?
  - Starting in 2006 overturned <u>five</u> decisions

MedImmune, Inc. v. Genentech, Inc

127 S. Ct. 764 (2007)

- Licensees in good standing may bring declaratory judgment action challenging validity and enforceability of the licensed patents
- No need to breach agreement
  - Risk infringement liability

SanDisk Corp. v. STMicroelectronics, Inc.

480 F.3d 1372 (Fed. Cir. 2007)

- Prior to *SanDisk* customary to bring to infringer's attention relevancy of the patent to its products
  - No "actual controversy" under Declaratory Judgment Act when invitee did not have "objectively reasonable apprehension" of suit
  - Kabuki dance
- Post *SanDisk*: Invitation to take a license gives invitee grounds for DJ
  - Threat no longer required
  - Effect on small inventors unaware of *SanDisk*?

SanDisk Corp. v. STMicroelectronics, Inc. (cont.)

- “I won’t sue you”
  - Inconsistent actions in *SanDisk*
  - Iron fist in the velvet glove?
- Settlement discussions under Federal Rule of Evidence 408
  - Rule 408 “expressly relates to evidence of efforts toward compromising . . . a claim in litigation.”

Cases post *SanDisk Corp*

- *Teva Pharmaceuticals USA, Inc. v. Novartis Pharmaceuticals Corp*., 482 F.3d 1330 (Fed. Cir. 2007) ("[R]elated litigation involving the same technology and the same parties is relevant in determining whether a justiciable declaratory judgment controversy exists on <u>other related</u> patents.")

- *Cingular Wireless v. Freedom Wireless*, 2007 WL 1876377 (D. Ariz. 2007) (allowing DJ where infringement allegation in <u>press release</u>)

Cases post *SanDisk Corp*

- *Judkinds v. HT Window Fashions Corp.*, 2007 U.S. Dist. LEXIS 42468 (W.D. Penn. 2007) (allowing DJ where letters mailed to third parties alleging defendant's product infringes)

What’s a Patentee to Do?

It’s a Brave New World

What's a Patentee to Do?

The Federal Circuit Offers Advice

- "To avoid the risk of declaratory judgment action, ST could have sought SanDisk's agreement to the terms of a <u>suitable confidentiality agreement</u>."
- Judge Bryson concurring opinion:

  "The problem with [the] suggestion is that it would normally *work only when it was not needed*—only a party that was not interested in bringing a declaratory judgment action would enter into such an agreement. A party that contemplates bringing a declaratory judgment action or at least <u>keeping that option open</u> would have no incentive to enter into such an agreement."

What Is a “Suitable” Confidentiality Agreement?

- Includes basic terms such as that anything said or written as part of the negotiations would not be disclosed to third parties
- Could a potential licensee file pleadings sufficient to establish a declaratory judgment without disclosing the confidential information?
- One approach:
  - File complaint under seal
  - Request court hold closed hearings
  - Request court issue “gag order” preventing the parties, witnesses, and counsel from discussing the case.

“Suitable” Confidentiality Agreement (Cont.)

- Would a federal court – consistent with First Amendment considerations favoring public trials – allow secret civil proceeding?
  - Would press intervene?
- Inclusion of a “nonuse” provision
  - Provide that communications related to the negotiations would not be used for any purpose other than in furtherance of the negotiations

“Suitable” Confidentiality Agreement (Cont.)

- Patentee’s response to infringer’s request for non-litigation provision
  - Limit period of time
  - Infringer may want obligation mutual … a reciprocal promise patentee will not file infringement action during standstill period
  - Prevailing party receive attorneys’ fees in enforcing

Infringer Opportunities

- Become Licensee and Sue
  - Infringer enters into patent license with patentee
  - Infringer files suit against licensor seeking DJ that infringed patent is invalid
  - Benefits:
    - Infringer - now licensee - no longer concerned about:
    - Being enjoined
    - Treble damages
    - Attorneys’ fees
    - “Reasonable royalties” as determined by a court

Licensee Opportunities

Renegotiate License Terms

- Licensee unhappy with the terms of license (e.g., minimum royalties, royalty rates, etc.) could challenge or threaten to challenge validity of licensed patents to bring patentee back to bargaining table
- Success may depend on strength of challenge (e.g., strength of prior art cited by licensee in to invalidate the patent)

Licensor Opportunities

Prohibition of Challenges

- Contractually prohibiting licensee from bringing action challenging patent
- Enforceable?
  - Would Supreme Court's *Lear v. Adkins*, 395 U.S. 653 (1969), decision prohibit attempt to restrict licensee from challenging licensed patent?

Licensor Opportunities

•In *MedImmune* Supreme Court noted absence of contractual prohibition against challenges:

– Court could not find a “prohibition against challenging the validity of the patents” in the patent license agreement <u>and</u>

– Court found that a prohibition against challenges could not be “implied from the mere promise to pay royalties on patents” not found to be invalid.

– At trial, MedImmune asserted that “the contract, properly interpreted, does not prevent it from challenging the patents . . . .”

Licensor Opportunities

•Does this mean that if there had been a contractual prohibition, the Court would have ruled differently?

•Reading tea leaves?

Licensor Opportunities

Termination For Challenge

- Provide contractually that any challenge by licensee of validity of licensed patents constitutes material breach and is grounds for termination

•Unlike an absolute prohibition, this provision allows the licensee to challenge the validity of the licensed patents, but the licensor in turn may terminate the license agreement.

Licensor Opportunities

Termination For Challenge (Cont.)

- Consider if termination more likely to be enforceable if triggered automatically upon licensee’s filing of DJ or if discretionary to licensor

Licensor Opportunities

Prepaid Royalties

- Royalties paid up-front may act as disincentive to licensee challenges
  - If licensee has already paid all royalties … little for licensee to gain from challenging the patent
  - No running royalties to end from successful challenge
  - Prepaid royalties "non-refundable"
  - Prepaid royalties not a credit for future royalties

Licensor Opportunities

Prepaid Royalties (Cont.)

- Push back to all royalties paid up front
- Licensee may not have the cash (even on a discounted present value basis)
- Licensee who pays in advance takes risk that patent will not subsequently be invalidated by a third party on the basis of prior art that neither the patentee nor the licensee was aware of

Licensor Opportunities

Royalties Continue During DJ Action

•Include provision that licensee will continue to make royalty payments during period of DJ challenge

Royalty Payments Not Escrowed

•Licensee may not pay the royalties into escrow … must pay directly to licensor … without deduction or offset

Licensor Opportunities

Must Licensee Repudiate License?

- Whether licensee who does not repudiate license (e.g., continues to pay royalties) but challenges licensed patent can recover royalties paid during pendency of DJ action was specifically left unanswered by Supreme Court in *MedImmune*:

Licensor Opportunities

Must Licensee Repudiate License? (Cont.)

- "We express no opinion on whether a *nonrepudiating licensee* is similarly relieved of its contract obligation during a successful challenge to a patent's validity—that is, on the applicability of licensee estoppel under these circumstances."
- Does this language counsel licensees to stop paying royalties during DJ challenge where the license contractually obligates the licensee to do so
- Are those royalties recoverable if patent held invalid?

Licensor Opportunities

Increase Royalties If DJ Brought

- Increase royalty rate if licensee brings DJ action
- Provision not contingent on success or failure of DJ action … filing alone triggers increase
- Increases of 150% … 200% … 250%, etc.
- Further provide that increased rate would remain in effect during pendency of the action and any appeals

Licensor Opportunities

Increased Royalties If DJ Lost

- Royalty escalation triggered by finding patent valid and infringed
- If *any* claim -- just one claim -- held valid and infringed … then royalty rate increases
- Increase could be substantial—200%, 250%, 300%, 350%, etc.
- Perceived by court as punitive?
- Acceptable contractual discouragement?

Licensor Opportunities

Licensee Pays Patentee's Attorneys' Fees

- Two approaches:
  - Requiring licensee to pay attorneys' fees if DJ brought OR
  - Requiring licensee to pay attorneys' fees if DJ unsuccessful

Choice of Venue

- Home court advantage

Licensor Opportunities

File First, Negotiate Later

•Patentee files patent infringement suit against infringer in patentee's hometown or a preferred venue

•Patentee need not serve complaint for 120 days giving patentee four months to negotiate a license before alerting the infringer to lawsuit

Licensor Opportunities

File First, Negotiate Later (Cont.)

•Strategy is particularly effective against infringers who are known to be hard-nosed or litigious

•Faced with lawsuit in distant or unfriendly forum, infringer may take the negotiation more seriously

Quanta Computer, Inc. v. LG Electronics, Inc.

(Supreme Court 2008)

Doctrine of Patent Exhaustion (or "First Sale" Doctrine)

What is patent exhaustion?

- First <u>unrestricted or unconditional</u> sale of a patented item exhausts patentee's control over that particular item, and the patentee has no further right to limit the sale of that item in commerce
- May only collect a royalty on the first unrestricted sale of the patented product
- "Unrestricted" is the big question

Doctrine of Patent Exhaustion (or "First Sale" Doctrine)

- Rationale: Prevent patent owners from double-dipping or getting two bites at the royalty apple.
- Underlying premise is that a patent owner should receive a royalty on only one sale of the patented invention.

Doctrine of Patent Exhaustion (cont)

Inventor (Licensor) (e.g., LG Electronics)

↓ $ Royalty to Licensor.

Chip Maker (Licensee) (e.g., Intel)

↓ $ Royalty to Licensor. Prevented by Patent Exhaustion?

Computer Maker (e.g., Dell, HP)

↓ $ Royalty to Licensor. Prevented by Patent Exhaustion?

End User/Purchaser of Computer (Consumers, Businesses)

Doctrine of Patent Exhaustion (cont)

Quanta v. LG (S.Ct. 2008)

Unanimously held that doctrine of patent exhaustion:

(1) applies to the sale of an article where:

- (a) the sale was authorized by the patentee,
- (b) the article "substantially embodies" the patent

(2) prevents patentees from using patent law to restrict downstream use of the article, and

(3) applies equally to method claims

Doctrine of Patent Exhaustion (cont)

Quanta v. LG (S.Ct. 2008)

- The operative fact comes down to whether the first sale was unrestricted or unconditional
- Restriction must be in patent license agreement
  - Effect on past M&A deal structures?

Doctrine of Patent Exhaustion (cont)

Quanta v. LG (S.Ct. 2008)

- The operative fact comes down to whether the first sale was unrestricted or unconditional
- Restriction must be in patent license agreement
    - Effect on past M&A deal structures?

City of Hope National Medical Center v. Genentech Inc. (California Supreme Court 2008)

- Dispute over royalty payments
- Patentee claimed licensee owed it a fiduciary duty
- "[W]e conclude that the trial court erred here in instructing the jury that a fiduciary relationship is <u>necessarily created</u> when a party, in return for royalties, entrusts a <u>secret idea</u> to another to develop, patent, and commercially develop. "
- Consider including a disclaimer of fiduciary relationship

Examining Various Licensing Terms In Preparation for This Afternoon's Analysis Segment

Field of Use Restrictions

- Licensor goal: Maximize revenues by limiting each licensee's use
- Cherry picking the best player by application/industry
- Consider specificity required
  - Challenge may be in articulating the limitations
- Restricted by application
  - Example: Licensing a Laser Device
    - Medical Treatment Of Specific Applications (Laser Dermatology)
    - For Specific Diseases, e.g., Cosmetic vs. Insurance-covered Mole removal

Fields of Use (cont.)

- Further examples
  - Restricted Markets/Industries: Aerospace and Automotive, but not Maritime
  - “treat lung cancer”
  - “online residential real estate listings”
  - “non-commercial university research”

Fields of Use (cont.)

- Careful language to avoid overlap
  - Internet applications (TM: *Apple Corps (Beatles record label) v. Apple Computer* Dispute over iPods & iTunes)
- Enforceable on the street?
  - How can you police?
  - Different prices for devices with same potential use

Indemnification

- Infringing 3rd party IP rights
- Risk of injunctions (eBay v. MercExchange)
- Patent infringement litigation very expensive
- Controlling defense costs
  - Attorneys' fees only (no secretaries, etc.)
  - Expenses (airfare & travel, experts, etc.)
- Insurance (high premiums, high deductibles)

Indemnification (cont.)

- Too many patents (many of questionable validity) resulting in higher risk
- Unpublished patent applications
- Licensing foreign patents? Foreign risks
- Product Liability
- Licensor may increase costs/royalties for expanded indemnification (or obtain insurance)
- "It's all negotiable"

Indemnification (cont)

- Limitations of liability by dollar cap:
  - Total license fees paid
  - License fees paid over limited period, e.g., past 6 months
  - Specified dollar amount
  - Cannot be so low as to be unconscionable (assumed conscionable in commercial contracts)

Best Efforts

- Exclusive licenses
  – Concern over shelving patents
- Vague burden
- Steep burden?
  – State law
- “Commercially reasonable” efforts
  – Variations
- Consider stated $ expenditures to avoid lack of meeting of minds/unmet expectations

Negotiation

- Consider long term life of patent licenses
- Long term relationship
- Life of last to expire patent
- Scorched Earth tactic
- You may need a favor or accommodation during the license life
- Not like an M&A

Thank you!

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