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Patent Law

Patent Exhaustion

Implications of *Quanta* on Seed Licenses and Downstream Purchasers

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The U.S. Supreme Court in *Quanta Computer, Inc. v. LG Electronics*[2] dusted off the century-old doctrine of patent exhaustion. Finding the patentee's downstream patent rights were exhausted with the first licensed sale to another party, the Court significantly raised the profile of this often-overlooked area of patent law.

Initially, the *Quanta* decision, which involved licensing and sale of patented electronic component parts, would seem to have little to do with seeds. But the Court's finding in this case does indeed have implications not just for seed patent owners, but for any patent owner whose licensing strategies involve multiple downstream users.

In view of *Quanta*, seed companies may want to take a fresh look at their existing licensing strategies for protecting proprietary seeds.

Patent Exhaustion Doctrine

Patent exhaustion (sometimes referred to as "first sale") is a century-old, judge-created doctrine. Under this doctrine, once a patentee has sold a patented product, the patentee can no longer use the patent to prevent downstream purchasers from using or reselling the products. In other words, the patentee's rights to restrict the use or further sale are "exhausted."

But courts have established a number of exceptions to this doctrine. For example, a patent right is not exhausted if the patentee imposes, at the time of sale, certain conditions on the downstream use of the patented product. These conditions, however, should not violate other laws or policies such as antitrust or patent misuse laws.

Summary of Quanta Case

LG Electronics (LGE) entered into a licensing agreement with Intel that provided Intel complete and unrestricted rights to make, use, and sell LGE's patented products. The agreement expressly disclaimed any implied licenses to third parties for the purpose of combining Intel products with non-Intel components, *e.g.*, downstream purchasers of Intel.

Under a separate agreement (the "Master Agreement") between the parties, Intel agreed to send written notice to its customers informing them that Intel's license "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product." Intel's authority to sell its products to others, however, was not expressly limited in the LGE-Intel agreement nor was Intel's sale to others conditioned on Intel's customers' acceptance of the limitation in Intel's notice.

Quanta Computer purchased microprocessors and chipsets from Intel and received Intel's notice about licensing rights for these products. Despite the notice, Quanta combined Intel components with non-Intel products, and produced and sold computers without a license from LGE. LGE sued Quanta for patent infringement.

LGE "Authorized" Intel's Sale; Notice Provision Did Not Impose Conditions of Sale

Quanta argued that LGE's patents were exhausted because LGE authorized Intel's sale to Quanta, or in the alternative, that LGE's license to Intel was unconditional, thereby resulting in exhaustion of LGE's patent rights with the first sale of the components to Intel under Intel's unconditional license.

The Court held that LGE's "authorized sale of an article that substantially embodied a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control post-sale use of the article."[3] The Court found that LGE's broad license to Intel to make, use, and sell products "authorized" Intel's sale of the LGE components to downstream users such as Quanta.

Patent exhaustion may be limited by express restrictions in a license agreement, but the Court found the required notice provision, appearing only in the ancillary Master Agreement, did not expressly limit the rights transferred in the license to Intel.[4] Moreover, Intel's sale to Quanta was not conditioned on compliance with the notice.

Products Substantially Embodied Patents

Citing a 1942 Supreme Court case, *United States v. Univis Lens Co. Inc.*,[5] the Court found that patent exhaustion applies even when an article, such as a component part, does not completely embody the invention. *Univis* concerned licensing of a patent for finished eyeglass lenses.

Univis, the patent owner, issued three classes of licenses to wholesalers, finishing retailers, and prescription retailers. In each case, the patentee did not sell the patented, finished eyeglass lenses. Rather, the patentee sold unpatented lens blanks and licensed the purchaser to manufacture lens blanks by fusing together lens segments. These unpatented lens blanks were then sold to other Univis licensees at agreed-upon rates to produce finished lenses.

Even though the patents covered only finished eyeglass lenses, the *Univis* Court held that the patents were exhausted when the patentee sold the lens blanks to its licensees because the lens blanks sufficiently embodied the patent—the only use for the lens blank was to grind and finish them into patented eyeglass lenses.

Applying *Univis*, the Court held that Intel's microprocessors and chipsets substantially embodied LGE's patents because the articles had "no reasonable non-infringing use," and the articles "included all the inventive aspects of the patents." Intel's products had no reasonable non-infringing use because the microprocessors and chipsets included all the inventive aspects of the patents and could not function unless connected to other standard components.

License Restrictions Can Avoid Patent Exhaustion; Sales Restrictions Impose Contract Liability

At issue in *Quanta* was a microchip, a component of a larger system. The *Quanta* Court held that because the chip embodied the invention and all but practiced the patent, the patent rights were exhausted by LGE's first and unconditional sale to Intel. "Everything inventive about each patent is embodied in Intel's Products," and could function only when attached to standard components, memory and buses.[6]

But patent exhaustion can be circumvented with proper license restrictions. For example, the license from LGE to Intel might have expressly prohibited Intel from selling microprocessors and chipsets to manufacturers who combined them with non-Intel parts. A violation of that restriction would have breached the license. If LGE's license to Intel had required Intel to sell only to buyers who agreed to comply with the notice, the affirmative license restriction would have avoided patent exhaustion. Further, a sale conditioned on acceptance of a restriction would create contract liability.

The *Quanta* Court alluded that in addition to patent laws patent owners can resort to contract law when patent rights are exhausted: "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."[7]

Quanta and Seed Sales

Like electronic component parts, proprietary seed has multiple downstream purchasers, including seed companies, seed distributors, seed purchaser growers, and the like.

Bag Tag Licenses Previously Considered Binding

It is common industry practice for seed companies to sell patent-protected seeds with bag tag licenses that restrict the ultimate purchaser (farmer) to growing only a single commercial crop from the purchased proprietary seed. The license affirmatively restricts the farmer from producing a next-generation crop. Bag tag licenses are akin to shrink-wrap licenses and have been upheld as binding on licensees because of the affirmative notice they provide.[8]

The question of whether a bag tag license affirmatively restricts downstream use of the product or merely provides notice has not yet been addressed in view of *Quanta.*

Seeds Are Different from Microchips

Unlike the circumstances in *Quanta*, the ultimate downstream seed purchaser receives the product unchanged from its original condition. Purchasers of seed take the product with the same restrictions of sale imposed on the first purchaser in the chain. The single crop restriction made to the first purchaser is carried along the chain to the ultimate purchaser as a limitation in the rights available for transfer.

Seeds are unique. Unlike the component parts in *Quanta*, seeds can self-replicate, *i.e.*, they can be used to create new seeds that embody the entire potential of a patented invention. This fact in itself, some have argued, makes seeds very different from microchips.

Agricultural products company Monsanto has made this point:

> "Monsanto sells seeds to farmers and allows them to plant and sell the harvest as a commodity. We don't allow them to save and use or sell the *offspring* of those seeds for planting. This would be the same as buying a book from a bookstore, *photocopying* it numerous times, and then selling the *copies* on Ebay. The *patent exhaustion doctrine* simply does not pertain to copies of products."[9]

Squarely addressing this issue, the U.S. Court of Appeals for the Federal Circuit held that patent exhaustion does not apply to second generation seed:

> "The first sale doctrine of exhaustion of the patent right is not implicated as the new seed grown from the original batch had never been sold."[10]

And the likelihood that the Supreme Court will resolve seed patent owner rights anytime soon is slim.[11]

Recently, in light of *Quanta*, Mitchell Scruggs, a farmer accused of saving Monsanto seeds, appealed to the district judge in *Scruggs v. Monsanto* to reconsider a summary judgment ruling of patent infringement, but the Court refused: "After careful reading of the Supreme Court's opinion, the Court concludes that defendants read *Quanta* too broadly."[12] The district court noted that Scruggs' purchase of the seed was unauthorized as he purchased seed without the required license. Besides, as the district court pointed out, the Federal Circuit has held that patent exhaustion does not apply to second generation seed.

Thus, the courts acknowledge a patentee's option to place limits on patent licenses. As stated in *Quanta*, however, such limits, must be expressed in the license and must bind all in the downstream chain.

Steps for Seed Patent Owners

After *Quanta*, does the originally purchased seed exhaust a patentee's rights in the next generation seed? Answers may be license-specific, generally influenced by language used in the license, recognition of affirmative limitations on downstream users and purchasers, specific license provisions that limit the original transfer of patent rights, and downstream sales contracts.

Expressly and Affirmatively State License Restrictions

Given the *Quanta* Court's views that the patent license affirmatively describes what rights are conveyed, patent holders wishing to avoid exhaustion should go a step beyond merely implying restrictions or conditions. Restrictions should be expressly and affirmatively stated in the patent license, together with an express description of what rights are actually being sold with the seed.

For example, as some seed companies already have in place, the license and sales agreement should clearly and affirmatively grant the right to grow only a single crop with no right to sell or use the resulting next-generation progeny. Since this right is not conveyed with the first sale, any violation down the distribution chain would amount to patent infringement. Unlike *Univis*, the patented seed is available to the grower for its intended purpose—production of crops. Any use outside the licensed rights, such as use of non-licensed next-generation sale, would not be exhausted.

List Additional Restricted Uses

Where practical, licenses should describe alternative reasonable uses for a patented item such that it avoids exhaustion. In the case of patented seed, seed companies typically sell the patented seed for growing a single commercial crop and not for replicating the crop for resale or for research. As such, an argument may be made that such alternative uses are precluded and not exhausted.

Including restrictive language may serve to defeat a litigant's attempts at arguing that the patented articles substantially embody the patents, thereby exhausting a patentee's rights in its patents.

Require All Parties to Obtain License Before Using or Selling

Quanta further counsels in favor of requiring all parties in the supply and distribution chain—such as seed producers, seed retailers, and farmers—to obtain a license or contractually comply with licensing restrictions before selling or using the patented seed. This license agreement should expressly restrict the rights of each member in the distribution chain from using or selling seed to purchasers who intend to save seed or replicate it for the next-generation seeds.

If any member fails to abide by the restrictions, such an unauthorized sale would result in patent infringement or a breach of contract claim.

Conclusion

In conclusion, the *Quanta* decision invites patent owners whose patented products travel along a chain of distribution to review their licensing strategies for potential patent exhaustion issues. For seed companies, an affirmative approach to forestall any suggestion of exhaustion—such as express limitations in the first sale and license as well as express agreements down the chain—may be useful.

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[2] *Quanta Computer, Inc., v. LG Electronics, Inc.*, 128 S. Ct. 2109 (2008).

[3] *Quanta*, 128 S. Ct. at 2122.

[4] *Id.* at 2121-22.

[5] 316 U.S. 241 (1942).

[6] *Quanta*, 128 S. Ct. at 2120.

[7] *Quanta*, 128 S. Ct. at 2122 n.7.

[8] *Pioneer Hi-Bred Int'l Inc. v. Ottawa Plant Food Inc.*, 283 F. Supp. 2d 1018, 1035-49 (N.D. Iowa 2003); *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996).

[9] http://www.monsanto.com/monsanto_today/for_the_record/lg_quanta_ruling.asp.

[10] *Monsanto Co. v. McFarling*, 302 F. 3d 1291, 1299 (Fed. Cir. 2002); *see also Monsanto Co. v. Scruggs*, 459 F.3d 1328, 1336 (Fed. Cir. 2006).

[11] *See Monsanto Co. v. Scruggs*, 459 F.3d 1328, 1336 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1342 (2007); *McFarling v. Monsanto Co.*, 537 U.S. 1232 (2003) (cert. denied), 545 U.S. 1139 (2005) (cert. denied), 128 S. Ct. 871 (2008) (cert. denied); *Monsanto Co. v. David*, 516 F.3d 1009 (Fed. Cir. 2008), *cert. denied*, 129 S. Ct. 309 (U.S. 2008).

[12] *Monsanto Co. v. Scruggs,* No. 00-CV-00161, 2009 BL 44663 (N.D. Miss. Mar. 3, 2009).

Reasonable Royalties

$358 Million Damages Award Against Microsoft Vacated in Dispute with Lucent Technologies

Lucent Technologies, Inc. v. Gateway, Inc., Nos. 08-01485, -01487, -01495, 2009 BL 193956 (Fed. Cir. Sept. 11, 2009)

The U.S. Court of Appeals for the Federal Circuit, while upholding a jury verdict that Microsoft Corp. infringed a patent