6-24-08

Commentary: Shuba Ghosh

The Quandary of Quanta

In addition to its Working Paper series, the American Antitrust Institute offers to its Senior Fellows and other invitees the opportunity to present their views on important issues facing antitrust policy and antitrust enforcement. Persons interested in responding to these views should contact the Author.

COMMENTARY

AUTHOR: Shubha Ghosh, The University of Wisconsin Law School

CONTACT INFORMATION: ghosh7@wisc.edu

The United States Supreme Court handed down its decision in Quanta v LG Electronics in June, 2008, and the unanimous, relatively short opinion has raised more questions than it perhaps answered. Professor Shubha Ghosh, now of The University of Wisconsin Law School, wrote an amicus brief on behalf of the American Antitrust Institute supporting the side that was ultimately victorious. In the following commentary, he divides his comments into three parts here: (1) what the case is about, (2) what the Supreme Court opinion says, and (3) what the Court's opinion means. This analysis originally appeared as "The Quandary of Quanta: Thoughts on the Supreme Court Decision One Week Later" in the June 17, 2008 Antitrust and Competition Policy Blog, http://lawprofessors.typepad.com/antitrustprof_blog/2008/week25/index.html.

The Road to Quanta

The controversy began in 1992 when the United States Court of Appeals for the Federal Circuit decided Mallinckrodt v. Medpart (download opinion here: Download Mallinckrodt.pdf). At issue in Mallinckrodt was the enforceability of a license restriction that prohibited reuse of a patented device for releasing a therapeutic spray in mist form. The Federal Circuit upheld the restriction, holding that conditions are enforceable if within the terms of the patent grant. Through its decision, the Federal Circuit created the "conditional sale doctrine," which allows a patent owner to impose conditions in a patent license and enforce them through claims for patent infringement.

At issue in Quanta was the relationship between the conditional sale doctrine and the doctrine of patent exhaustion, dating back to the Nineteenth Century. Under the doctrine of patent exhaustion, the sale of a patented item exhausts the patent owner's rights and limits the ability of the patent owner to sue for patent infringement. Patent exhaustion allows users to sell or reuse patented items without being sued for patent infringement. The facts of Quanta illustrate the controversy. LG and Intel settled a patent dispute involving several of LG's patents relating to methods and products relating to computer memory. Under the terms of the settlement, Intel was given a blanket license over the use of LG's patent portfolio and LG had placed several restrictions on the use of its patents, including combination of patented methods and products with unpatented components. These restrictions were to run against computer manufacturers who bought computer chips from Intel that incorporated LG's patents. LG brought suit against several manufacturers for violation of the licensing restrictions, and the manufactures argued that LG's patent rights had been exhausted when the chips were sold. The Federal Circuit held that method patents could not be exhausted as a matter of law and that the product patents had not been exhausted since LG had conditioned the sale of the patents with restrictions on combinations. Last week, the Supreme Court reversed, ruling in favor of Quanta that (1) method patents can be exhausted and (2) LG's patent rights had been exhausted in the transfer of the patents to Intel.

What the Supreme Court Opinion Says

As is often the case, the manner in which the Court stated the issue at the beginning of its opinion frames the issues decided. Justice Thomas' twenty page, unanimous opinion states at the outset the question the Court purports to answer: "In this case, we decide whether patent exhaustion applies to the sale of components of a patented system that must be combined with additional components in order to practice the patented methods." The framing of the question suggests how the Court viewed the facts of the case and the issues to be decided. Two points are striking. The first is the reference to the "patented methods." The Court, unlike many practitioners watching the case, was concerned with the method patent issue. Second, the Court viewed the combination of patented and unpatented components as crucial to this case. The patents could be practiced only if the inventions were combined with other components; this commercial background affected the expectations of the parties when they entered into the transactions that were at issue in the case.

Accordingly, the Court decided the issues consistent with this initial statement. First, the Court held that patent methods could be exhausted, overruling the Federal Circuit and creating precedent in a murky area of patent law. Although lower courts had disagreed on this issue, the Court decided that there is no reason to treat method patents any differently from product patents for the purposes of patent exhaustion. Once the Court had ruled on this new principle of patent exhaustion, the Court moved on to the issue of whether LG's patent rights had been exhausted in this case. Relying on an antitrust case, United States v. Univis Lens Co., 316 U.S. 241 (1942), the Supreme Court held that the rights had been exhausted when the patent owner sold patented items to purchasers who would use the patented item consistent with the manner in which the patent was to be practiced. In Univis Lens, the Court had examined whether the patent owner had exhausted its rights in the distribution of its patented eyeglass lens and thereby had given up any patent defenses to the antitrust claims raised by the government. The Court ruled that the patentee had exhausted its rights because the product sold incorporated essential features of the patented invention. Following the logic of Univis Lens, the Court in Quanta reasoned that the chips purchased by the computer manufacturers incorporated the features of LG's patents and practiced the patents. To quote the Court, "Everything inventive about each patent is embodied in the Intel Products." Hence, the Court concludes, LG had exhausted its patent

rights and could not enforce the limitations against Quanta and the other computer manufacturers as patent infringement claims.

Note the last point. In what I think will become a famous footnote, the Court stated that LG may still have contract claims against the manufactures, but these claims were not before the Court (see footnote 7). Therefore, the Court acknowledges that patent owners may still be able to enforce license limitations through contract claims, but implictly acknowledges that violations of such limitations may not be the basis for claims of patent infringement. Nowhere in its opinion does the Court mention the Mallinckrodt decision, but footnote 7 strongly suggests that Mallinckrodt no longer stands as the prevailing precedent and that there are now limits on the Federal Circuit's conditional sale doctrine.

The Road After Quanta

There are four points I would like to emphasize about the Quanta decision.

First, the Court's decision on the exhaustion of method patents caught many people by surprise because the issue had not been a main focus of the briefing or the oral argument. It is not clear that the ruling was necessary for the Court to find in favor of Quanta or for its second holding about exhaustion under Univis Lens. Nonetheless, the fact that the Court addressed and settled the issue of patent exhaustion for method claims suggests that the Court takes the patent exhaustion doctrine seriously as a bedrock principle of patent law.

Second, the dog that did not bark makes the most noise. The Court does not mention the Mallinckrodt decision, suggesting that the Federal Circuit's 1992 is still good law. But the Court seems to weaken the conditional sale doctrine in many respects. Footnote 7, for example, could be read to mean that the conditional sale doctrine gives rise to contract remedies, rather than patent ones. Furthermore, the broad reading that the Court gives to Univis Lens and to patent exhaustion suggests that licensing restrictions may not survive the scrutiny of the patent exhaustion doctrine. What to make of the silence? An affirmation or a cold dismissal? There are two ways in which Mallinckrodt and

Quanta can be read together consistently. First, the conditional sale doctrine applies to use restrictions placed on the direct purchaser of a patented invention. The Quanta decision applies to attempts by a patent owner to use licensing restrictions to reach through and enjoin subsequent purchasers and users of the patented invention. Second, the Quanta decision applies to situations where patented inventions are integrated with other components in complex inventions. This second interpretation is consistent with the concern that the Supreme Court has expressed for the integration of patented and unpatented components in cases like eBay and KSR. In eBay, for example, Justice Kennedy's influential concurrence admonished the granting of injunctive relief when a patented invention is part of a larger unpatented product. In KSR, the Court was concerned about the combination of patented and unpatented items to satisfy the nonobviousness requirement. The Quanta decision can be read in line with these other two recent precedents.

Third, the Court speaks broadly of the patent exhaustion doctrine but seems to conflate other related doctrines in crafting this new precedent. Intellectual property law deals with three sets of doctrines that govern what users can do with intellectual property that they have obtained. The first doctrine deals with resale by the user and is called, appropriately enough, the first sale doctrine. The second doctrine deals with uses other than sales, such as reuses of the commodity protected by intellectual property law. This second doctrine goes under various names, such as fair use in copyright and trademark, repair in patent law, and the broader category of implied licenses that runs through copyright and especially patent law. The third doctrine is that of exhaustion and governs limitations on the IP owner's ability to enforce its IP rights, once the protected work has been transferred. Copyright law, for the most part, deals with these issues statutorily through Section 109 of the Copyright Act (dealing with the first sale doctrine) and Section 107 (dealing with fair use). In fact, the last time the Supreme Court addressed the question of first sale was in the copyright context, exactly ten years ago in its Quality King v L'Anza decision, a case dealing with the statutory right of importation and the first sale doctrine under the Copyright Act. The Court's decision in Quanta could have been handled as one of implied license: Quanta implicitly had the right to make use of the patentend invention given the context of the transaction and the expectations of the parties. But the Court's appeal to patent exhaustion reflects its precedents from patent and antitrust law (see Univis Lens) on the interpretation and enforcement of patent licenses. More broadly, the Court's decision reflects the common law nature of the patent exhaustion doctrine. Perhaps once the dust of the most recent patent reform venture clears, Congress could focus on an area where patent reform might be

useful: crafting statutory solutions to first sale and exhaustion in patent law, much like it has in copyright law.

Finally, there is the issue of the relationship between contract law and patent law. Footnote 7 of the Quanta opinion leaves open the possibility that licensing restrictions can be enforced, possibly even against downstream purchasers, under contract law. The Court does not address the contract and property law issues raised by this possibility (for example, do covenants run with the chattel and how?), but needless to say contract remedies are not as substantial as patent ones. The conditional sale doctrine allows patent owners to turn violations of patent licensing restrictions into claims for patent infringement, with the attendant benefit of treble damages. Whatever the status of Mallinckrodt, footnote 7 and the Court's decision in Quanta places limitations on the patent owners to bring licensing restrictions under the purview of patent law.

Although the Court did not delve into the policy issues raised by the Quanta case and the conditional sale doctrine, its decision goes a long way in limiting a patent owner's ability to reach past the initial transaction and control downstream users and purchasers of patented products. Such reach through is inconsistent with the principles of contracting as it leads to uncertainty and unpredictability in the use of products and services. The Court seemed alert to these concerns in the oral argument with a number of justices asking questions about the implications of the conditional sale doctrine for contracting and business practice. The Court's decision, despite its problems, attempts to strike the right balance between patent law and contract law by recognizing limits on the patent owner's rights while leaving room for contract principles. More importantly, the silence on Mallinckrodt implies that a modified version of the conditional sale doctrine may survive the Quanta decision.

My assessment on the Quanta decision: it could have been much worse and much room is left for the development of both patent law and commercial law in this area.