

## Patent Exhaustion Post-Tessera

*Law360, New York (September 21, 2011, 1:49 PM ET)* -- You execute a worldwide patent license that authorizes your company, on a worldwide basis without any restrictions, to make use, sell, offer for sale and/or import products anywhere in the world under a patent portfolio that includes United States patents as well as related and unrelated foreign patents. You manufacture and sell your products outside of the United States to various customers, some of whom you know import your products into the United States. You pay royalties on every licensed product, regardless of where the product is sold or imported.

Despite your payment of royalties, you learn that the patent owner has sued your customers in the United States for patent infringement on the United States patents in the licensed portfolio. Your customers, angry because they now face potential monetary damages and an injunction for products, look to you to resolve the threat and cover costs. You agree to help your customers by helping them prove your product is licensed and should be immune from an infringement suit. Will you and your customers succeed?

Patent exhaustion, also known as the “first sale” doctrine, holds that the first authorized sale of a patented product terminates the patent owner’s rights in that product.[1] Broadly applied to licensed products, patent exhaustion should shield licensed products and customers’ use of those products from infringement claims concerning the licensed patents. Until recently, however, two competing theories of patent exhaustion seemed to imply different outcomes in the above scenario. The Federal Circuit in its *Jazz Photo* cases decided not to apply patent exhaustion where the first unlicensed sale occurred outside of the United States.[2]

The Federal Circuit reasoned that a bare sale made in a foreign country, even if made by the patent owner, could not be inferred to have occurred under a United States patent — and exhaust a patent owner’s United States patent rights — because the United States patent system does not apply abroad. The United States Supreme Court in *Quanta*, by contrast, adopted an authorization-based inquiry, looking at the first authorized sale regardless of the location of the initial sale.[3]

While not explicitly discussed, the *Quanta* court implied that territorial restrictions on the first sale were immaterial for determining patent exhaustion. Two years later, in *Fujifilm v. Benun*, the Federal Circuit explicitly rejected the argument that *Quanta* eliminated the requirement of a United States sale for patent exhaustion in the context of a bare sale abroad by the patent owner.[4]

The Federal Circuit's decision in *Tessera*, reconciles the *Jazz Photo* cases with *Quanta*.<sup>[5]</sup> Relying on *Quanta*, the Federal Circuit focused on the nature of the authorization under the worldwide license grant. The Federal Circuit in *Tessera* held that the "proper focus" in deciding to apply patent exhaustion is whether the initial sale of the patented product was authorized, implying that the *Jazz Photo*'s territorial-based inquiry is not applicable to analysis of similar unrestricted worldwide licenses. Thus, a correct application of the holding in *Tessera* to the above scenario should result in you and your customers defeating a patent infringement suit directed at your licensed products.

## **Worldwide Licenses**

Patent licenses that grant unrestricted rights to fully practice the licensed United States patents on a worldwide basis offer clear circumstances that give rise to patent exhaustion. A worldwide license, like any other contract, represents a bargained-for agreement between two parties — patent owner and licensee — who exchange consideration. The patent owner authorizes the licensee to manufacture, use, sell, offer for sale, or import licensed products anywhere in the world. The licensee, in exchange, agrees to pay, either royalties or a lump sum payment, on all licensed products, no matter where a licensed product is manufactured, used, sold, offered for sale or imported.

A number of issues arise, however, when a worldwide license is considered in the context of the United States patent system. Foremost, the United States patent system does not apply outside the United States. Practicing a patent outside of the United States does not constitute patent infringement and does not entitle the patent owner to a royalty on patent products that never make it to the United States.

Thus, under normal circumstances, a patent owner would not be able to enforce its patents against foreign activity. A worldwide license gives the patent owner something it is otherwise not entitled under a United States patent — i.e., a royalty on products that may never enter the United States and enforcement rights in the form of breach of contract actions. Presumably, a worldwide license that includes United States patents provides downstream immunity from patent liability in the United States, else the benefit of the bargain is not delivered. In addition to obtaining freedom to operate for itself and its customers, a licensee may find it advantageous to pay a royalty on worldwide sales because it can obtain a lower royalty rate. It may also provide more efficient means of accounting for, paying and collecting royalties and/or offer lower transaction costs for both the patent owner and licensee.

As mentioned, a worldwide license raises yet another set of issues regarding post-grant enforcement of patent rights. When a license is involved, a patent owner must typically choose between pursuing breach of contract claims or patent infringement claims. What options are available to a patent owner ultimately may depend on provisions in the agreement, location of the parties, ability to execute a judgment, the remedies available under contract and patent law, etc. Without terminating the license, the patentee is likely limited to solely breach of contract remedies against the licensee.

Underlying the applicability of patent exhaustion to worldwide patent licenses like the one outlined here is the question of potential double-recovery on the same patented product. A double-recovery may arise when a patent owner, having already received royalties from a licensee on its worldwide sale of the patent products might attempt to collect royalties on a downstream product made, used, sold or imported into the United States. Patent exhaustion is intended, among other things, to prevent double-recovery by limiting a patent owner's ability to collect more than a single reward from a patented product.<sup>[6]</sup>

As *Jazz Photo* and *Quanta* demonstrate, whether patent exhaustion applies to extraterritorial activity and actually prevents or promotes a double recovery depends on whether there is a broad patent license at issue and the details of that license.

## The Competing Patent Exhaustion Analyses in Jazz Photo and Quanta

Until the Federal Circuit's decision in *Tessera*, there was some debate as to what version of patent exhaustion applied. Although the Supreme Court's decision in *Quanta* is binding law, the lack of an explicit rejection of the Federal Circuit's *Jazz Photo* cases left some courts doubting *Quanta*'s application to worldwide licenses.

Thus, courts were left to decide between the Federal Circuit's territorial-based analysis asserted in the *Jazz Photo* cases that held that a first authorized sale to occur in the United States before applying patent exhaustion and the Supreme Court's authorization-based analysis in *Quanta*. The Federal Circuit's decision in *Tessera* reconciles this issue.

### *The Federal Circuit's Territorial-Based Analysis under Jazz Photo*

The Federal Circuit in *Jazz Photo I* held that patent exhaustion did not apply to products that originated and were sold only overseas by the patentee before being imported into the United States by someone else because the first sale did not occur inside the United States.[7]

In that case, *Fuji Photo* filed an investigation with the International Trade Commission alleging that several overseas remanufacturers had purchased, refurbished and imported used *Fuji Photo* single-use cameras that infringed its patents.[8] The remanufacturers obtained the used *Fuji Photo* single-use cameras from both United States and foreign companies.[9] As that case developed, *Jazz Photo* could not show that *Fuji Photo* had collected a royalty for use of the United States patents in relation to the foreign use/sales of the cameras that *Jazz Photo* was repairing and selling in the United States, and of course, *Fuji Photo* insisted that it had not collected such a royalty.

The Federal Circuit thus had to consider whether patent exhaustion would apply to the used *Fuji* cameras imported into the United States that the refurbishing entities had purchased outside the United States.[10] The Federal Circuit held patent exhaustion would not apply to the foreign-sourced cameras because the first sale — i.e., *Fuji Photo*'s original sale of the camera to a foreign purchaser — did not occur inside the United States.[11] Underlying that analysis was the fact that there was no evidence to show that *Fuji Photo* had been compensated for the use of the United States patents when the first sales abroad took place.

The Federal Circuit thus reasoned that “products of foreign provenance” did not exhaust United States patent rights but generally failed to stress the point that the sale had been made by the patent holder or to distinguish the case of licensed sale of products.[12] Without considering the effect of licensed sales or other fact patterns that would support finding a foreign sale to be an authorized sale that could give rise to exhaustion, on the facts presented the *Jazz Photo I* court appeared to categorically hold that a first sale for patent exhaustion purposes had to occur under the United States patent and, therefore, inside the United States.[13]

The Federal Circuit reiterated the territorial-based analysis for patent exhaustion without consideration of licensed-based authorization in *Jazz Photo II*, the companion district court patent infringement lawsuit to the *Jazz Photo I* ITC investigation. It considered in *Jazz Photo II* whether the district court had properly applied its holding in *Jazz Photo I*. [14] The Federal Circuit decided that the district court had properly applied *Jazz Photo I*, explaining that a foreign sale could not exhaust rights under United States patent because a foreign sale does not “occur under a United States patent.” [15]

The Jazz Photo II court concluded that applying patent exhaustion to a foreign sale would require the impressive application of United State patent law abroad.[16] The Federal Circuit concluded that a patentee's conduct of making the foreign sale under the facts in the case would not trigger patent exhaustion.[17] A year later, the Federal Circuit reaffirmed its territorial restriction on patent exhaustion in Jazz Photo III.[18]

### *Quanta's Authorization-Based Analysis*

The Supreme Court's decision in *Quanta* suggests that the proper inquiry for patent exhaustion is whether an authorized sale occurred regardless of its location. The court in *Quanta* considered whether LG Electronics had authorized certain sales of products embodying the asserted patent.[19] LG entered a worldwide license with Intel that gave Intel the unrestricted right to sell Intel products that practice the patented technology.[20] The license, however, did not give Intel the right to practice LG's patents in conjunction with any non-Intel products.[21] *Quanta* purchased licensed products from Intel and combined them with other non-Intel parts.[22] When combined, the products practiced embodied the patented technology.[23] LG sued *Quanta* for patent infringement.[24]

The *Quanta* court held that Intel's authorized sale to *Quanta* under the LG-Intel license exhausted LG's patent rights:

The authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights.[25]

In so holding, the court focused on Intel's authority to sell the patented products as granted in the license rather than where the sales occurred.[26] Acknowledging that the LG-Intel license had "no conditions" that limited Intel's authority to sell patented products, the court held that Intel was authorized to sell patented products to *Quanta*. [27] Patent exhaustion prevented LG from asserting any patent rights against *Quanta*.

While the Supreme Court's decision in *Quanta* did not expressly overturn the Federal Circuit's *Jazz Photo* line of cases, it implied that a sale inside the United States was unnecessary for patent exhaustion where the foreign sale was authorized — i.e., where the patent owner had been compensated for the United States patent rights that allegedly covered the licensed accused product. LG suggested that Intel's products alone would not infringe and patent exhaustion would not apply to products Intel sold overseas.[28] The court rejected LG's argument, stating that the relevant question is whether the product is "capable of practicing the invention."

In doing so, the court recognized that a product capable of practicing a patent regardless of its location: "Univis teaches that the question is whether the product is "capable of practicing the patent," not whether those uses are infringing. [citations] Whether outside the country or functioning as a replacement parts, the Intel Products would still be practicing the patent, even if not infringing it." [29]

The *Quanta* court, therefore, seemed to eliminate the absolute requirement for a United States sale to trigger patent exhaustion, shifting the analysis instead to the terms of the license at issue or context of the foreign activity.[30]

Even so, *Quanta's* focus on whether an authorized sale exhausts did not conclusively resolve the question of whether a United States sale is always required to trigger patent exhaustion.[31]

The district court in *LG Electronics Inc. v. Hitachi Ltd.*, for example, reasoned that the Federal Circuit's *Jazz Photo* distinction between United States and foreign sales was inconsistent with *Quanta* as it would allow a patentee to negate the patent exhaustion defenses of an authorized downstream purchaser.[32] In that case, the court applied *Quanta's* authorization-based analysis to hold Intel's authorized foreign sale of products to Hitachi pursuant to the LG-Intel worldwide license exhausted LG's patent rights.[33]

By contrast, the district court in *Fujifilm Corp. v. Benun*, held that Jazz Photo and its progeny remained good law even in light of *Quanta*.<sup>[34]</sup> The Benun court reasoned that *Quanta* failed to address whether a foreign sale by the patentee would exhaust the patentee's United States patent rights, leaving the Jazz Photo cases intact.<sup>[35]</sup> In so ruling, the logic of the Benun Court seems implicitly limited by its limited focus on the bare or naked nature of the foreign sales at issue in that case — i.e., nothing about the extraterritorial sales by patentee in that case gave indication that exhaustion of U.S. patents should apply.

Nonetheless, the Federal Circuit later affirmed the district court's territorial-based analysis of patent exhaustion, holding that *Quanta* "did not eliminate the first sale rule's territoriality requirement."<sup>[36]</sup> The Federal Circuit attempted to distinguish *Quanta*, holding that it did not involve a foreign sale.<sup>[37]</sup> Critically, the Federal Circuit explained that patent exhaustion required an infringing use and that an infringing use could only occur inside the United States.<sup>[38]</sup> In that context, the Federal Circuit read the *Quanta* Court's statement that "[w]hether outside the country" as referring only to "practicing" the patent and not infringement.<sup>[39]</sup> The Federal Circuit read *Quanta* as supporting a territorial requirement rather than eliminating it.<sup>[40]</sup> Thus, even after *Quanta*, a question remained as to the necessity of a United States sale for patent exhaustion.

### **Tessera Adopts *Quanta*'s Authorization-Based Inquiry**

The Federal Circuit's decision in *Tessera* adopts the Supreme Court's authorization-based inquiry in *Quanta* in the context of licensed sales. *Tessera*, unlike *Jazz Photo*, involved an authorized foreign sale by a licensee of patented products that were later imported into the United States. The dispute in *Tessera* concerned semiconductor packaging technology.<sup>[41]</sup> *Tessera* had granted licenses to several domestic and foreign companies to its TCC portfolio of patents and authorized them to "sell ... and/or offer for sale" products that practiced the patented technology:

Subject to the terms and conditions [of this agreement] Tessera hereby grants License a ... license to Tessera's Patents ... and to sell ... and/or offer for sale such TCC Licensed Products.<sup>[42]</sup>

The licenses also included an "exclusion from license" provision, stating that licensees were only licensed for products that either the licensee or a third party had paid a royalty: "Licensee is licensed only Licensed Products for which Licensee or a third party has satisfied a royalty obligation of Tessera."<sup>[43]</sup>

*Tessera* requested an ITC investigation, alleging that 18 companies had impermissibly imported patented products.<sup>[44]</sup> Of the 18 companies named in the investigation, *Tessera* alleged that only Elpida Memory Inc. and Elpida Memory (USA) Inc. (collectively "Elpida") had imported a certain type of accused product — the  $\mu$ BGA products.<sup>[45]</sup> The ITC determined that while the  $\mu$ BGA products embodied patented technology, patent exhaustion applied to immunize Elpida from any infringement.<sup>[46]</sup>

*Tessera* argued on appeal that patent exhaustion should not apply because not all of the sales of  $\mu$ BGA products were authorized. Relying on the "exclusion from license" provision in its licenses, *Tessera* argued that failure by some of its licensees to pay royalties meant that some of the sales by its licensees of the patented  $\mu$ BGA products to Elpida were not authorized.<sup>[47]</sup>

The Federal Circuit rejected *Tessera*'s argument and relying on the TCC License itself, found patent exhaustion. Relying on *Quanta*, the Federal Circuit held that the proper inquiry was whether the sales were authorized under the license — not the effect of the "exclusion from license" provision: "[*Tessera*'s] arguments add unnecessary complexity to a rather straightforward analysis. The proper focus is on whether the sales were authorized."<sup>[48]</sup>

Notably absent is any consideration as to where the authorized sales occurred. Also absent is any discussion of its Jazz Photo line of cases. The Federal Circuit, instead, focused on the unconditional grant of Tessera's license "to sell ... and/or offer for sale" the patented product.[49] Recognizing that the licenses authorized the licensees to sell patented products and "pay later," the Federal Circuit concluded that the sales were authorized.[50]

Unlike the Jazz Photo cases, the Federal Circuit in Tessera did not consider the foreign nature of the first sale when deciding whether patent exhaustion applied. The facts in the Jazz Photo line of cases are arguably distinguishable from Tessera, as the alleged "authorized sale" was an actual sale outside of the United States directly by the patent holder and not a sale made pursuant to a license. This distinction is crucial to square the holding of these cases. The lack of any consideration as to where the authorized sale occurred in Tessera is a strong indication that the absolute territorial requirement established in the Jazz Photo line of cases is no longer absolute, especially when a worldwide license that includes a license to United States patents is at issue.

### **The Changing Landscape for Patent Owners, Licensees and Downstream Customers**

In applying the Quanta court's authorization-based analysis as the proper framework for determining patent exhaustion, the Federal Circuit's Tessera opinion also advances the single reward principle that underlies the patent exhaustion doctrine. Moreover, the opinion offers some additional clarity for patent owners, licensees and downstream customers in managing their relationships.

Focusing on the authorization of the sale preserves the single-reward principle by limiting the recovery beyond any authorized sale. In a worldwide license context where the parties bargained for the licensee to have worldwide freedom to operate and the licensor to collect royalties on all products made under the license, an authorized sale could occur anywhere.

To apply exhaustion only when the authorized sale technically occurred inside the United States would give a patent owner an opportunity for double recovery — once upon licensing and another at the time of importation. The territorial-based patent exhaustion analysis in the Jazz Photo cases ostensibly allowed Fuji to receive two recoveries on same patented product — the camera price when it was originally sold and the price of the camera when resold into the United States. While the result in Jazz Photo I could perhaps be sustained on the basis of a repair-reconstruction analysis, if the point is avoiding double recovery then Fuji appears to have obtained one.

As Tessera demonstrates, in the case of a licensee granted an unrestricted, worldwide license who promises to pay a royalty on each product that falls under the license regardless of where it is sold or made, the patent owner already has authorized the sale and has received its single-reward for that product. Allowing a patent owner any further reward on the licensed products would add a post-sale restriction on the later use of that product and negate the bargain of the parties. Thus, the application of the authorization-based analysis advances the principle goal of patent exhaustion of limiting a patent owner's ability to obtain double recovery, yet allowing the patent owner the freedom to control and monetize its patent rights as it sees fit.

By shifting the focus to the language of the license grant to determine the scope of authorization, the Tessera court reinforces the need for patent owners to draft their licenses with more care as the reach of Quanta is significant. Even so, a patent owner may be unlikely to place onerous conditions on the license granted as such conditions might require lowering the royalty charged or lead to a refusal to license.

Tessera also highlights how under a worldwide licensing scenario, there are real limitations on a patent owner's enforcement options. Critically, having found patent exhaustion applied to immunize the licensees' customers from infringement claims, the Tessera court stated that Tessera's dispute for the alleged unpaid royalties was with its licensees not their customers.[51] Thus, where a patent owner grants unconditioned authorization to a licensee, a patent owner's recovery for nonpayment of royalties is limited to contract damages. The Tessera opinion follows Quanta — the parties decide their own fate, at least as far as patent exhaustion is concerned, by structuring the license grant as they see fit.

## Conclusion

The Federal Circuit's decision in Tessera confirms that the authorization-based patent exhaustion analysis explained in Quanta analysis is applicable to extraterritorial activities. The territorial requirement may still apply under unique facts like those in the Jazz Photo cases, but the claim that there is an absolute requirement for a United States-based use or sale before patent exhaustion can apply can no longer stand. It is a change that advances the single-recovery principle in patent law and adds clarity to discussion of patent exhaustion in general.

--By Michael Heafey, Matthew Hult, Hopkins Guy and Jacob Heath, Orrick Herrington & Sutcliffe LLP

*Michael Heafey and Hopkins Guy are partners in Orrick's Silicon Valley, Calif., office. Matthew Hult is a partner in the firm's San Francisco office. Jacob Heath is a managing associate in the firm's Silicon Valley office.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] Quanta Computer Inc. v. LG Elecs. Inc., 553 U.S. 617 (2008).

[2] Jazz Photo Corp. v. Int'l Trade Comm'n, 264 F.3d 1094, 1105 (Fed. Cir. 2001) (Jazz Photo I); Fuji Photo Film Co. Ltd. v. Jazz Photo Corp., 394 F.3d 1368, 1376 (Fed. Cir. 2005) (Jazz Photo II); Jazz Photo Corp. v. United States, 439 F.3d 1344, 1351 (Fed. Cir. 2006) (Jazz Photo III).

[3] Quanta Computer Inc. v. LG Elecs. Inc., 553 U.S. 617 (2008).

[4] Fujifilm Corp., 605 F.3d 1366, 1371 (Fed. Cir. 2010). Benun is latest version of the entity that used to Jazz Photo, and thus Benun may be considered part of the Jazz Photo line of cases.

[5] Tessera Inc. v. Int'l Trade Comm'n, No. 2010-1176. 2011 U.S. App. (Fed. Cir. May 23, 2011).

[6] See Adams v. Burke, 84 U.S. 453, 456 (1873); Keeler v. Standard Folding-Bed Co., 157 U.S. 659, 663 (1895); United States v. Univis Lens Co. Inc., 316 U.S. 241, 251 (1942).

[7] Jazz Photo I, 264 F.3d at 1105.

[8] Id. at 1098.

[9] Id. at 1105

[10] Ibid.

[11] Ibid.

[12] Ibid.

[13] Ibid.

[14] Jazz Photo II, 394 F.3d at 1376.

[15] Ibid.

[16] Ibid.

[17] Ibid.

[18] Jazz Photo III, 439 F.3d at 1351.

[19] Quanta, 553 U.S. at 636.

[20] Id. at 623.

[21] Id. at 623-24.

[22] Ibid.

[23] Ibid

[24] Id. at 624.

[25] Id. at 638.

[26] Id. at 637.

[27] Id.

[28] Quanta, 553 U.S. at 631. Patent exhaustion operates as a defense to patent infringement that immunizes the alleged infringer from infringement.

[29] Id. at 633 n. 6.

[30] Id. at 631-32.

[31] Compare LG Electronics Inc. v. Hitachi Ltd., 655 F. Supp. 2d 1036 (N.D. Cal. 2009) (Hitachi) with Fujifilm Corp. v. Benun, No.05-cv-1863, 2009 U.S. Dist., \*1 (D. N.J. July 24, 2009), aff'd Fujifilm, 605 F.3d 1366.

[32] Hitachi, 655 F. Supp. 2d at 1046.

[33] Hitachi, 633 F. Supp. at 1044.

[34] Fujifilm, 2009 U.S. Dist at \*9.

[35] Fujifilm, 2009 U.S. Dist.at \*9.

[36] Fujifilm, 605 F.3d at 1371.

[37] Fujifilm, 605 F.3d at 1371.

[38] Id. at 1371-72.

[39] Fujifilm, 605 F.3d at 1371-72.

[40] Id. at 1372.

[41] Tessera, 2011 U.S. App. at \*6.

[42] Tessera, 2011 U.S. App. at \*8.

[43] Ibid.

[44] Ibid.

[45] Id. at \*6-7.

[46] Id. at \*9.

[47] Id. at \*30.

[48] Id. at \*30-31.

[49] Id at \*30.

[50] Id. at \*31.

[51] Tessera, 2011 U.S. App. at \*31.

All Content © 2003-2011, Portfolio Media, Inc.