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Why Patentees Conveying Covenants Not to Sue Should Take Another Look at the Fine Print

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INTRODUCTION

Patentees concerned with downstream use may want to take a closer look at the terms on which they license and covenant not to sue. Very recently, on April 8, the U.S. Court of Appeals for the Federal Circuit ruled in *TransCore, Inc. v. ETC Corp.* that an unconditional covenant not to sue authorizes the sale of a patented article, thereby exhausting patent rights in the article.^[FOOTNOTE 1] Although the *TransCore* ruling represents a logical extension of existing patent exhaustion jurisprudence, it should be carefully considered when drafting patent licenses and covenants not to sue.

LEGAL LANDSCAPE

In exchange for disclosure of an invention, 35 U.S.C. §154 grants inventors a limited monopoly including the "right to exclude others from making, using, offering for sale, or selling the invention throughout the United States" The doctrine of patent exhaustion plays a limiting function with respect to a patentee's ability to control use of a patented invention.^[FOOTNOTE 2] The patent exhaustion doctrine, also known as the "first sale" doctrine, provides that the first authorized sale of a patented article exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his or her patent, control the use or disposition of the article.^[FOOTNOTE 3] In other words, once a patented article is lawfully sold, it can be resold or used at will because the patent monopoly ends upon authorized sale.^[FOOTNOTE 4]

In recent years, the Supreme Court has actively clarified and redefined how patent exhaustion is triggered. In June 2008, the Supreme Court held in *Quanta Computer, Inc. v. LG Electronics, Inc.*, that patent exhaustion is triggered by the sale of an item that does not completely practice the patented invention if the item sold substantially embodies the patented article and is sold under circumstances indicating that the only and intended use is that the item be finished under the patent's terms.^[FOOTNOTE 5] The Court

in *Quanta* considered language in a Master Agreement between LG and Intel, which required Intel to give notice to Intel's customers (including Quanta) that LG had not licensed those customers to practice its patented invention. The court held that, while such language evidenced the parties' intent with respect to downstream customers, it was irrelevant to the question of exhaustion because Intel's authority to sell products embodying the LG patents was not conditioned on the requirement of notice or on Quanta's decision to abide by the directives in LG's notice to customers.^[FOOTNOTE 6] The Court further found that, while the License Agreement itself expressly disclaimed any implied third party license to practice the patents, Quanta asserted its right to practice the patents on the basis of exhaustion, not on implied license.^[FOOTNOTE 7] In the wake of *Quanta*, patent practitioners have continued to debate how to most effectively exert control over downstream use of patented articles.



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THE FACTS OF 'TRANSCORE V. ETC'

TransCore, LP, is a company that manufactures, sells and installs automated toll collection systems, and is the assignee of several patents to related technologies.^[FOOTNOTE 8] In 2000, TransCore sued Mark IV Industries, a competitor, for infringement of several patents. The suit was resolved by a settlement agreement under which Mark IV paid \$4.5 million in exchange for a covenant not to sue and a release of all existing claims.^[FOOTNOTE 9] The settlement agreement, in relevant part, read:

"[TransCore] agrees and covenants not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement"

Several years later, ETC, a company providing consulting and systems integration services related to toll collection, won a bid with the Illinois State Toll Highway Authority to install and test a new open-road tolling system. As part of the contract, ETC agreed to set up and test toll collection systems purchased by the ISTHA from Mark IV. TransCore sued ETC for infringement of three patents previously asserted in the suit against Mark IV, as well as one related

patent that was pending before the Patent and Trademark Office, but had not issued at the time of the TransCore-Mark IV settlement. After the district court granted summary judgment, asserting that ETC's activities were permitted by the TransCore-Mark IV settlement agreement under the related doctrines of patent exhaustion, implied license and legal estoppel, TransCore appealed to the Federal Circuit.

PATENT EXHAUSTION RELATED RULINGS

The Federal Circuit opinion in *TransCore* explained that an unconditional covenant not to sue "authorizes" sales by the covenantee for purposes of patent exhaustion. The court reasoned that because patent rights are exclusionary in nature (i.e., rights to exclude others from making, using or selling the patented article), patentees cannot convey -- whether by license, covenant or otherwise -- an affirmative right to practice the patent in question. As a result, the court found there to be no difference between the rights conveyed by a covenant to sue and those conveyed by a patent license.

As for restricting downstream use, the Federal Circuit followed the logic of the *Quanta* opinion, explaining that the "parties' intent with respect to downstream customers is of no moment in a patent exhaustion analysis."[\[FOOTNOTE 10\]](#) The court explained that the "only issue relevant to patent exhaustion is whether Mark IV's sales were authorized, not whether TransCore and Mark IV intended, expressly or impliedly, for the covenant to extend to Mark IV's customers."[\[FOOTNOTE 11\]](#) TransCore sought to introduce parol evidence that the parties did not intend to include customers or other downstream users of the toll products within the license conveyed.[\[FOOTNOTE 12\]](#) The court found this evidence of the parties' intent irrelevant.

The Federal Circuit found that the operative provision, a covenant not to sue "for future infringement," was "without apparent restriction or limitation, [and] thus authorizes all acts that would otherwise be infringements: making, using, offering for sale, selling or importing."[\[FOOTNOTE 13\]](#) As a result, it affirmed the district court finding that Mark IV's sales to ISTHA were authorized and that TransCore's patent rights were correspondingly exhausted.

IMPLIED LICENSE RULINGS

The fourth patent asserted by TransCore (the '946 patent) had not issued at the time of the TransCore-Mark IV settlement and was thus not covered by the covenant not to sue. Moreover, the covenant not to sue expressly provided that "[t]his Covenant Not To Sue shall not apply to any other patents issued as of the effective date of this Agreement or to be issued in the future."[\[FOOTNOTE 14\]](#) Notwithstanding this language, the Federal Circuit affirmed the district court finding that TransCore's rights in the '946 patent were exhausted by Mark IV's authorized sales under an implied license to practice that patent by virtue of legal estoppel.[\[FOOTNOTE 15\]](#) The Federal Circuit found that the '946 patent was broader than, and thus necessary to practice, at least one of the three patents included in the covenant not to sue. The court therefore reasoned that TransCore should be legally estopped from asserting the '946 patent in derogation of the authorization it had granted to Mark IV with respect to the patents expressly included in the covenant not to sue.[\[FOOTNOTE 16\]](#)

DRAFTING TO AVOID PATENT EXHAUSTION AFTER TRANSCORE

The basic principle set forth by the Federal Circuit in *TransCore*, that a broad covenant not to sue authorizes sales in the same manner as a license to sell, is a new one. It is, however, a natural extension of a long line of cases holding licenses and covenants to be equivalent for various purposes.[\[FOOTNOTE 17\]](#) The result in *TransCore* should serve to focus attention where it belongs: on careful drafting of the substantive provisions of licenses and covenants to avoid inadvertently triggering patent exhaustion or to appropriately provide for continued control over use in the event of patent exhaustion.

After *TransCore*, there remain substantive questions regarding different contractual approaches to controlling downstream use. For instance, in discussing steps that could have been taken to avoid exhaustion, the Federal Circuit remarked that TransCore "did not, as it could have, limit this authorization [meaning the scope of rights it effectively gave to Mark IV] to, for example, 'making' or 'using.'"[\[FOOTNOTE 18\]](#) In this fashion, the Federal Circuit telegraphed one obvious solution, that a patentee or licensee avoid exhaustion by excluding the right to sell from the rights conveyed. Thus, the patentee could grant rights of "use" while expressly prohibiting the "sale" of the patented articles under the terms of the license or covenant not to sue.[\[FOOTNOTE 19\]](#)

On the closer (and more pertinent) issue of how parties can "contract around" patent exhaustion, the Federal Circuit provided little additional guidance. Sales made in violation of a license to sell remain "unauthorized" for purposes of exhaustion.[\[FOOTNOTE 20\]](#) Since *Quanta*, however, practitioners have been concerned with how to draft license conditions of sale to avoid patent exhaustion. The *TransCore* decision does little to address this concern because it does not consider contractual restrictions that would have rendered the relevant sales unauthorized for purposes of patent exhaustion.

TransCore does not resolve the question of what contractual mechanisms may be most effective to control downstream use. Considering the *TransCore* opinion in the context of recent Supreme Court decisions, however, a few drafting lessons can be drawn. First, while debate continues in some legal circles, after *Quanta*, a cautious business person would be well advised to proceed on the assumption that restrictions enforceable only against downstream purchasers will not be enforceable. Restrictions on the licensee's authority to sell, on the other hand, should be enforceable, if such restrictions are drafted with sufficiently clarity. Put in concrete terms, a license giving a manufacturer authority to sell only within the State of Virginia will be effective, and a sale outside of Virginia will subject both the manufacturer and the purchaser to a potential infringement suit. A license giving the manufacturer the right to sell nationwide "with the condition that purchasers are only authorized to use the product in Virginia" raises far more difficult issues and the restriction may not be enforceable against anyone.[\[FOOTNOTE 21\]](#) Post-sale restrictions on purchasers have long been disfavored,[\[FOOTNOTE 22\]](#) and *TransCore*'s disregard for proffered evidence of the parties' intent with respect to third parties reinforces the importance of party-specific restrictions.

Whatever their form, sale related restrictions should be expressly included in the license grant or in the operative provision of the covenant not to sue. The holdings in *Quanta* and *TransCore* make clear

that only sales in violation of an express and enforceable condition are likely to avoid exhaustion. Clarifying language indicating that the grantee understands and agrees to such express conditions as a fundamental part of the license agreement, without which the patentee or licensor would be unwilling to enter the agreement or covenant not to sue, should help to strengthen the enforceability of such language.

There are, of course, many potential approaches to drafting the language of conditions restricting sale. These depend, in part, on whether a patentee wishes to take a negative approach (e.g., prohibiting sale of items to certain customers or for certain uses) or an affirmative approach (e.g., identifying acceptable customers and uses). Sales in violation of enforceable restrictions of either kind would presumably be deemed unauthorized, enabling suit for infringing downstream use.

Perhaps a more efficient mechanism for controlling downstream use would be a license grant authorizing sale only to purchasers who have already signed a related contract with the patentee. A sale by the licensee under such a license grant would likely exhaust patent rights under *TransCore*, but the patentee would have contractual remedies against the downstream purchaser, yielding the patentee substantial control over use.

DRAFTING TO AVOID IMPLIED LICENSE ISSUES

The Federal Circuit's grant of implied license rights to the '946 patent in this case should be cautionary to counsel drafting licenses and covenants not to sue. The court declined to uphold express language disclaiming license rights to patents such as the '946 patent in order to give effect to license rights it deemed express.^[FOOTNOTE 23] The scope of a license grant is generally negotiated in earnest and at length. Thus, in *TransCore* the court acted in equity to override language most observers would consider an unambiguous expression of the parties' intent.

After *TransCore*, practitioners may want to include language defining the scope of what is not included in the bargain or business deal between the parties. It may be best to draft express language excluding a patent from the scope of a covenant not to sue or a non-exclusive license, including reference to the relevant patent or application number. To the extent that certain uses of the licensed patents will be precluded by the excluded patent, these uses, along with permissible uses should likely be made express.

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FOOTNOTES

FN1 *TransCore, LP v. ETC Corp.*, 563 F.3d 1271, 1277 (Fed. Cir. 2009).

FN2 The patent exhaustion doctrine is derived from the first sale doctrine of copyright, both copyright and patent rights having a common origin in Article I of the U.S. Constitution.

FN3 *United States v. Univis Lens Co.*, 316 U.S. 241, 250-51 (1942) (indicating that the sale may be by the patentee or by a licensee acting within the scope of a license that does not otherwise restrict the licensee's activities). The principle guiding patent exhaustion is that once a patentee receives valuable

consideration for an item embodying a patent, the patentee should lose the ability to restrict downstream use of the item. *Adams v. Burke*, 84 U.S. 453, 456 (1873).

FN4 *Quanta Computer, Inc. v. LG Electronics, Inc.*, 128 S.Ct. 2109, 2118 (2008) quoting *Adams v. Burke*, 84 U.S. 453, 457.

FN5 *Quanta*, 128 S.Ct. at 2111-12 (affirming its view in *Univis* that the sale of unfinished products may trigger exhaustion).

FN6 *Id.* at 2121-22.

FN7 *Id.*

FN8 *TransCore*, 563 F.3d 1271, 1273.

FN9 *Id.*

FN10 *Id.* at 1275.

FN11 *Id.* at 1277.

FN12 *Id.* at 1277.

FN13 *Id.* at 1276

FN14 *Id.* at 1273.

FN15 *Id.* at 1279-80.

FN16 *Id.* at 1279.

FN17 See *Id.* at 1276 (citing a long line of precedent demonstrating equivalence of covenants not to sue and licenses in various contexts).

FN18 *Id.* at 1276.

FN19 *Mitchell v. Hawley*, 83 U.S. 544, 550 (1872) (seminal case enforcing patent rights where conveyance did not authorize sales of any kind).

FN20 In *Intel Corp.* the Federal Circuit held that patent exhaustion was not triggered by acts of a purchaser that were in violation of an enforceable condition of sale. *Intel Corp. v. United States Int'l Trade Comm'n*, 946 F.2d 821, 827-28 (Fed. Cir. 1991) accord *General Talking Pictures Corp. v. Western Elec. Co.*, 304 U.S. 175 (1938) (holding exhaustion inapplicable because sale was in violation of limitations on the licensee's authority to sell).

FN21 The question of whether or not courts will, under certain circumstances, enforce restrictions on downstream use under the doctrine of *Mallinckrodt Inc. v. Medipart, Inc.* has not been finally resolved. 976 F.2d 821 (Fed. Cir. 1992). The reasoning of *TransCore* and *Quanta*, under which the licensing parties' intent to restrict downstream use is irrelevant, appears to be at odds with the holding in *Mallinckrodt*, even if that holding has not been substantively overruled.

FN22 See *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917) (refusing to enforce post-sale restrictions on the use of a patented film projector); see also *United States v. General Electric Co.*, 272 U.S. 476 (1926) (distinguishing between impermissible post-sale restrictions and permissible license restrictions).

FN23 *TransCore*, 563 F.3d at 1279.