Quanta Computer, Inc. v. LG Electronics, Inc.: **The Supreme Court Revisits The Patent Exhaustion Doctrine – Is It Time To Re-Think Your Sales And Licensing Strategies?**

By:

Proprietary Rights Committee
Information Technology Law Section
State Bar of Michigan

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Brooks Kushman P.C.
Southfield, Michigan

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Introduction

In the *Quanta* case[1], on June 9, 2008, a unanimous Supreme Court clarified the "patent exhaustion doctrine" by holding that the doctrine applies 1) to the method and not just the apparatus claims of patents and 2) to sales "authorized" by the patent holder of incomplete products that "substantially embody" essential features of a patented invention. Consequently, the patentee's attempt in *Quanta* to contract around the doctrine and collect royalties from multiple points in a chain of users incorporating devices covered by its patents was ineffective.[2]

As described by the Court, for more than 150 years the patent exhaustion doctrine "exhausts" a patentee's rights following the first authorized sale of a patented item. Once a patented article is unconditionally sold by the patent owner or its licensee without restriction, that article passes beyond the exclusive rights of the patent. In this way, the first authorized sale of a patented article "exhausts" the patent to the extent that an "unconditional" sale frees the purchaser from patent liability to use and resale the article.[3]

While the patent exhaustion doctrine is relatively easy to state, it is not so easy to fully understand so as to be avoided as exemplified by the *Quanta* case.[4] The history of *Quanta* reveals a misunderstanding of the doctrine wherein the Court reversed the Federal Circuit which, in turn, had earlier disagreed with a district court's patent exhaustion ruling[5] by holding that sales of microprocessors and chipsets made by Intel under license from LG Electronics (*i.e.*, LGE) were conditional and, consequently, did not exhaust LGE's combination patent rights.[6] Apparently, LGE was willing to allow Intel's customers to combine the licensed microprocessor products with non-Intel products but only upon payment of a further royalty to LGE for the right to do so.

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[1] 128 S.Ct. 2109 (2008).

[2] *Id*. at 2118.

[3] *Bloomer v. McQuewan*, 14 How. 539 (1853); Adams *v. Burke*, 84 U.S. 453 (1873).

[4] In another case, as reported at 77 BNA's PTCJ 664, on April 8, 2009, the U.S. Court of Appeals for the Federal Circuit held that an unconditional covenant not to sue in a settlement agreement is authorization to sell under *Quanta*, thereby frustrating the intent of the parties to the agreement. *Transcore LP v. Electronic Transaction Consultants Corp.*

[5] *LG Electronics, Inc. v. Asustek Computer, Inc.*, 65 USPQ2d 1589 (N.D. Cal. 2002) (sales held to be "authorized."

[6] *LG Electronics, Inc. v. Bizcom Electronics, Inc.*, 453 F.3d 1364 (Fed. Cir. 2006).

The decision will most certainly affect the viability of certain patent and perhaps other intellectual property licensing strategies such as copyright licensing strategies.[7] Because of the importance of intellectual property licensing to the domestic and foreign economy,[8] it is important for intellectual property (IP) owners to not only fully understand the patent exhaustion doctrine as clarified by *Quanta* but also carefully consider the relatively recent sales and licensing strategies of others in other industries including the software industry if appropriate.

Part I of this paper takes a look at the history of the *Quanta* case. Part II of this paper looks at "field of use" licensing as a way to avoid the patent exhaustion doctrine. Part III of this paper looks at standard form agreements and the evolution of sales and licensing strategies employed over the last 20 years for software and digitized data. Part IV of the paper looks at the more recent printer cartridge business models of Hewlett-Packard and Lexmark. Part V of the paper concludes with some practice pointers when using standard form contracts to market products which "substantially embody" a patent under *Quanta*.

I. The *Quanta* Case

A. Facts

In 1999, LG Electronics (*i.e.*, LGE) purchased a patent portfolio that included the patents at issue.[9] These patents contained apparatus claims and claims for methods of managing the data flow inside a computer.[10] LGE licensed the patent portfolio to Intel[11] under a License Agreement, under which Intel was entitled to "make, use, sell (directly or indirectly) computer components that used the patented methods." Such a clause typically appears in patent license agreements and is called the "grant clause." The terms of the grant clause describe the legal

[7] More broadly, the doctrine is often called the "exhaustion doctrine" and is a rule that some or all of the exclusive rights belong to the owner of intellectual property are terminated as to a particular item upon the first authorized sale of that item by the owner of the intellectual property or the owner's licensee. In the Copyright Act this rule is codified at 17 U.S.C. § 109(a) and is known as the First Sale Doctrine.

[8] "A Market for Ideas," October 20, 2005, THE ECONOMIST. ("In America alone, technology licensing revenues account for an estimated $45 billion annually; worldwide, the figure is around $100 billion and growing fast." IBM alone earns over $1 billion annually from its intellectual property portfolio. HP's revenue from licensing has quadrupled in less than three years, to over $200 million this year [2005].").

[9] *Quanta Computer*, 128 S.Ct. at 2113.

[10] *Id.* at 2113-14.

[11] *Id.* at 2114.

character of the license being extended and are the essence of any license agreement. The *Quanta* Court characterized this language as "broad."[12]

The License Agreement, however, also stated that no license "is granted . . . to any third party for the combination by a third party of Licensed Products of either party with items, components, or the like acquired . . . from sources other than a party hereto . . . ."[13] The License Agreement further provided, however, "Notwithstanding 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." Consequently, clearly the parties to the Agreement knew of the patent exhaustion doctrine but, as described further below, did not fully understand the scope or significance of the doctrine as articulated by the *Quanta* Court.

A separate agreement (a Master Agreement) required Intel to notify its customers in writing that Intel's license did not "extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product." In other words, in the Master Agreement, LGE required Intel to give Intel's customers notice that the patent license did not extend to any product made by combining a licensed Intel microprocessor product with any non-Intel products. The Master Agreement also provided that a breach of the Master Agreement would have no effect on the License Agreement and would not be grounds for its termination.

Quanta Computer, Inc., Bizcom Electronics, Inc., First International Computer Inc., and others purchased microprocessors and chipsets from Intel Corp. or other authorized LGE licensees and installed them in computers. Intel notified the purchasers by letter that although it had been licensed to sell the components, the purchasers were not authorized to combine the products with non-Intel products.[14] This notice was sent prior to execution of the License Agreement by the parties. Notwithstanding this notice, Quanta combined the Intel products with various non-Intel components to make computer systems.[15]

B. <u>District Court Ruling</u>

LGE sued Bizcom Electronics, Inc. and several other Taiwanese computer assemblers — who manufacture hardware for companies such as Hewlett-Packard Co., Gateway Inc., and Dell Inc. — claiming that the combination of microprocessors or chipsets with other components infringed its combination patents. The district court granted summary judgment to Quanta, holding that the

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[12] *Id.*

[13] *Id.* (quoting License Agreement).

[14] *Id.*

[15] *Id.*

patents were exhausted because Intel had a license to make and sell the components, which did not have any substantial non-infringing use.[16] Also, no conditions were imposed on the sale of the components. Rather, the purchase of the components was unconditional. The letter notice by Intel to its customers was not sufficient to transform an unconditional sale of the components to a conditional sale. The district court later clarified its ruling, holding that while the apparatus claims were exhausted, the exhaustion doctrine did not apply to the method claims.[17]

C. <u>Federal Circuit Ruling</u>

The Federal Circuit affirmed in part and reversed in part.[18] It reaffirmed that the doctrine of patent exhaustion does not apply to method claims. In the alternative, it held that LGE's patents were not exhausted because LGE did not license Intel to sell the Intel products to Quanta for use in combination with non-Intel products.[19] The court found that although Intel was free to sell its microprocessors and chipsets, the terms of those sales had expressly prohibited Intel's customers from infringing LGE's combination patents, and thus the exhaustion doctrine did not apply. The court stated that Intel's notification to its customers made its sales conditional sales. Quanta successfully petitioned for U.S. Supreme Court review.

D. <u>Supreme Court Ruling</u>

The U.S. Supreme Court's opinion contained two holdings as noted earlier: (1) a patent's method claims may be exhausted by the sale of a product that embodies the patented method; and (2) a patent is exhausted by the unconditional sale of a product, whether complete or not, that substantially embodies the claimed invention. Of equal, if not greater, interest (at least with respect to this paper) is the Court's analysis of the different agreements between LGE and Intel and their impact on the patent exhaustion doctrine.

1. <u>Method Claims Of A Patent May Be Exhausted</u>

In prior cases, the Federal Circuit had held that method claims are not subject to the patent exhaustion doctrine.[20] The U.S. Supreme Court reversed this categorical rule by relying on a

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[16] *LG Electronics, Inc. v. Asustek Computer, Inc.*, 65 USPQ2d 1589, 1593, 1600 (N.D. Cal. 2002).

[17] *LG Electronics, Inc. v. Asustek Computer, Inc.*, 248 F.Supp.2d 912, 918 (N.D. Cal. 2003).

[18] *LG Electronics, Inc. v. Bizcom Electronics, Inc.*, 453 F.3d 1364, 1377 (Fed. Cir. 2006).

[19] *Id.* at 1370.

[20] *See, e.g., Glass Equip. Dev., Inc. v. Besten, Inc.*, 174 F.3d 1337, 1341 n.1 (Fed. Cir. 1999) (citing *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*, 750 F.2d 903, 924 (Fed. Cir. 1984)).

pair of its earlier decisions[21] and held that method claims may be exhausted by the sale of a device that embodies the claimed method.[22] In rejecting the Federal Circuit's contrary decisions, the Court expressly recognized that Federal Circuit rule provided an incentive for parties to convert apparatus claims to method claims during patent prosecution and thus provide "an end-run around exhaustion."[23] "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.'"[24]

2. Two-Part Test For Determining Whether The Sale Of A Product Exhausts A Patent

As previously stated, a patent is exhausted by the first authorized sale of a product that embodies the patent. The Court again relied on the *Univis* case[25] in stating that sales of an incomplete product, embodying the patent, may exhaust the patent. The Court provided a two-part test for determining whether the sale of an incomplete product exhausts the patent rights in that product.

First, the incomplete product must have no reasonable use other than practicing the patents. In reaching this decision, the Court pointed to whether the product embodied "essential features" of the patented invention or the inventive aspects of the patented methods.[26] The Court also distinguished between practicing the patent and infringing the patent. Thus, the exhaustion doctrine is not defeated by the possibility of overseas sales that would use the patented technology without infringing the patent.[27]

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[21] *United States v. Univis Lens Co.*, 316 U.S. 241 (1942); *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436 (1940) (The *Univis* and *Ethyl* cases both involved price restrictions implemented subsequent to the first sale of the patented products for compensation. The Supreme Court held that the resale price restrictions in these cases were not protected by the patent laws and thus violated the antitrust laws).

[22] *Quanta Computer*, 128 S.Ct. at 2117-18.

[23] *Id.* at 2118.

[24] *Id.*

[25] (Patent exhaustion triggered by the sale of a lens blank which subsequent processing turned it into a patented finished lens since such blanks had no use but to be further processed into a finished lens.)

[26] *Quanta Computer*, 128 S.Ct. at 2119.

[27] *Id.* at 2119 n.6.

Second, the incomplete product must "substantially embod[y] the patent" and "all but completely practice the patent."[28] Thus, sale of an incomplete product exhausts the patent if the only "step[s] necessary to practice the patent is the application of "common processes" or the addition of "standard parts."[29] In reaching this conclusion, the Court distinguished the patents at issue from so-called combination patents, where the only inventive aspect of the patent is the particular combination of known elements that are claimed."[30]

3. Analysis Of The Agreements Between LGE And Intel

LGE contended that the patent exhaustion doctrine was not applicable because Intel did not have the right to convey an unrestricted license to Quanta, citing the two decisions by the Supreme Court in *General Talking Pictures Corp. v. Western Elec. Co.*[31] The Court, however, distinguished *General Talking Pictures* based on the language of the granting clause in LGE's License Agreement with Intel:

> The Court [in *General Talking Pictures*] 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." . . . 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 chipsets 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 . . . . 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 . . . . 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

[28] *Id.* at 2120.

[29] *Id.*

[30] *Id.* at 2121.

[31] 304 U.S. 175 and 305 U.S. 124 (1938).

> Patents was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice.[32]

In summary, the *Quanta* Court concluded that patent exhaustion did not apply in *General Talking Pictures* because "the manufacturer 'could not convey to petitioner what both knew it was not authorized to sell.'"[33] By contrast, exhaustion applied in *Quanta* because "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."[34] Rather, "[E]xhaustion turns only on Intel's own license to sell products practicing the LGE Patents."[35] That sentence and the Court's implicit adoption of *General Talking Pictures* demonstrate the limited holding in *Quanta*: if the scope of the rights conveyed is broad and not restricted or limited (*i.e.*, the agreement language (the granting clause)) authorized all acts that would otherwise be an infringement), then the patent exhaustion doctrine governs.

In other words, the Court is saying that LGE broadly licensed Intel to make, use, and sell microprocessor products without restrictions or conditions in the license grant clause of the License Agreement. LGE did not license Intel "to make, use, and sell microprocessor products only in the field of microprocessor products combined with other LGE-licensed products" (so-called Intel products). There was no explicit field-of-use limitation on Intel's manufacturing, using, and selling rights — no restrictions or limitations on sales in the license grant clause. Even though LGE said it was not licensing third parties to combine licensed product with other products, and it required Intel to notify customers of that — LGE failed to include this or similar language in the license grant clause of the License Agreement to expressly deny Intel any license to make microprocessor products that would be combined with other, non-Intel, products.

II. <u>Avoiding The Patent Exhaustion Doctrine Through "Field Of Use" Licensing</u>

A. <u>Background</u>

Licenses that carve out a particular field of customer class for the licensee are commonly referred to by the courts as "field of use" licenses, thereby lumping product and customer restraints together under a common label. Like territorial licenses, and unlike resale price maintenance of the *Univis* and *Ethyl* cases noted in the *Quanta* case, these arrangements have long been considered presumably lawful exercises of the patentee's exclusionary rights (*i.e.*, making, using, offering for sale or importing) under its patent, notwithstanding their obvious competitive

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[32] *Quanta*, 128 S.Ct. at 2121-22 (citations omitted).

[33] *Quanta*, 128 S.Ct. at 2121.

[34] *Id.* at 2122.

[35] *Id.*

ramifications. The leading case upholding the basic legality of field of use licenses is the Supreme Court's decision in *General Talking Pictures Corp. v. Western Electric Co.*[36] which, while distinguished, was implicitly adopted by the *Quanta* Court.

B. *General Talking Pictures* Case

In *General Talking Pictures*, the patent owner had granted Transformer Company a non-exclusive license to sell the patented product solely for home use. The license agreement required Transformer Company to mark each product with a label describing the limited field license.[37] Transformer Company sold the product to General Talking Pictures with knowledge that the latter intended to use it for commercial purposes, and General Talking Pictures knew Transformer Company had no right to sell outside the home use field. The Court held that the patent owner could sue General Talking Pictures for patent infringement because:

> The sales made by the Transformer Company to [General Talking Pictures] were outside the scope of its license and not under the patent. Both parties knew that fact at the time of the transactions. There is no ground for the assumption that [General Talking Pictures] was "a purchaser in the ordinary channels of trade."[38]

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[36] *General Talking Pictures Corporation v. Western Electric Co.,* 305 U.S. 124, 59 S.Ct. 116, 83 L.Ed. 81, 39 USPQ (BNA) 329 (1938). (The Court, discussing restrictions on use, summarized the state of the law as follows:

> That a restrictive license is legal seems clear. *Mitchell v. Hawley* [83 U.S.], 16 Wall. 544 [21 L.Ed. 322 (1873)]. As was said in *United States v. General Electric Co.*, 272 U.S. 476, 489 [47 S.Ct. 192, 196, 71 L.Ed. 362 (1926)], the patentee may grant a license "upon any condition the performance of which is reasonably within the reward which the patentee by the grant of the patent is entitled to secure" . . . .
>
> The practice of granting licenses for restricted use is an old one, see *Rubber Company v. Goodyear* [76 U.S.] 9 Wall. 788, 799, 800 [19 L.Ed. 566 (1870)]; *Gamewell Fire-Alarm Telegraph Co. v. Brooklyn*, 14 F. 255 [C.C.N.Y. (1882)]. So far as it appears, its legality has never been questioned.

305 U.S. at 127, 59 S.Ct. at 117, 39 USPQ at 330.)

[37] *General Talking Pictures*, 305 U.S. at 182.

[38] *Id.* at 180-81.

C. **Tension Between *General Talking Pictures* And *Quanta***

Even after Quanta, the *General Talking Pictures* doctrine remains valid law, subject to possible antitrust exceptions (*see* 1995 Federal Antitrust Guidelines noted below). Tension exists between the two doctrines — particularly when the granting clause of a patent license agreement is not as broad as it might be. As illustrated by the *Quanta* case, when a court interprets a license or other contract as broadly granting the right to make, use and sell, the *exhaustion doctrine* governs and not the *General Talking Pictures* doctrine. A use restriction in the granting clause of a license must be explicit to bind a seller. Otherwise, the license is unlimited, *i.e.*, it covers all possible fields or acts that would otherwise be infringement.

The Court in *Quanta* applied the *exhaustion doctrine* rather than the *General Talking Pictures* doctrine because of the broad language of the granting clause in the License Agreement. Therefore, purchasers of the patented product were free to use them without restrictions that the patentee sought but failed to impose on them.

D. ***Mallinckrodt* Case**

1. Facts

The plaintiff Mallinckrodt owned a patent on a device for dispensing a radioactive mist used in taking diagnostic lung X-rays, and for trapping the mist after use. Mallinckrodt sold the device to hospitals. Hospital personnel would load the device with a suitable radioactive fluid to perform a diagnostic procedure on a patient, use the device, and then discard it. Mallinckrodt sold the devices with a notice "Single use only." For a recycling fee, Medipart would clean one of the devices for a hospital, replace some parts, subject the device to gamma radiation to kill germs, and return it to the hospital for reuse.

2. Federal Circuit Ruling

In the *Mallinckrodt* case,[39] the Federal Circuit held that a patentee's "Single Use Only" restriction, applied to its patented radioactive mist manifold and nebulizer combination, was not "as a matter of law, unenforceable under the patent law" and that a patent infringement remedy would be available against purchasers who used an item purchased from the patentee in violation of a restriction "validity conditioned under the applicable law such as the law governing sales and licenses and if the restriction on reuse was within the scope of the patent grant or otherwise justified."[40] The Federal Circuit did not decide whether the terms of the restriction met the legal

[39] *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992).

[40] *Id.* at 709.

requirements of notice or sufficed as a "label license" under state contract law.[41] The device bore the inscription "Single use only" and a package insert provided with each device stated "For Single Patient Use Only."

Mallinckrodt described the restriction on reuse as a label license for a specified field of use, where the field is a single (*i.e.*, disposable) use.

The plaintiff also stated that such a field of use was within the scope of the patent grant and did not enlarge the patent grant. That is, the patent grant from the Government is a right to exclude as described in 35 U.S.C. § 154: "Every patent shall contain . . . a grant . . . for the term of seventeen years . . . of the right to exclude others from making, using, or selling the invention throughout the United States . . . ." This right to exclude may be waived in whole or in part. The conditions of such waiver are subject to patent, contract, antitrust, and any other applicable law, as well as equitable considerations such as are reflected in the law of patent misuse. As in other areas of commerce, private parties may contract as they choose, provided that no law is violated thereby:

> [T]he rule is, with few exceptions, that any conditions which are not in their very nature illegal with regard to this kind of property, imposed by the patentee and agreed to by the licensee for the right to manufacture or use or sell the [patented] article, will be upheld by the courts.
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> *E. Bement & Sons v. National Harrow Co.*, 186 U.S. 70, 91, 22 S.Ct. 747, 755, 46 L.Ed. 1058 (1902).

In the *Braun* case,[42] the Federal Circuit, in commenting on the *Mallinckrodt* case, stated:

> In that case, we canvassed precedent concerning the legality of restrictions placed upon the post-sale use of patented goods. As a general matter, we explained that an unconditional sale of a patented device exhausts the patentee's right to control the purchaser's use of the device thereafter . . . . The theory behind this rule is that in such a transaction, the patentee has bargained for, and received, an amount equal to the full value of the goods . . . . This exhaustion doctrine, however, does not apply to an expressly conditional sale or license. In such a transaction, it is more reasonable to infer that the parties

[41] In accordance with the Uniform Commercial Code, a license notice may become a term of sale, even if not part of the original transaction, if not objected to within a reasonable time. U.C.C. § 1-207(2)(c).

[42] *B. Braun Medical, Inc. v. Abbott Laboratories*, 124 F.3d 1419 (Fed. Cir. 1997).

> negotiated a price that reflects only the value of the "use" rights conferred by the patentee. As a result, express conditions accompanying the sale or license of a patented product are generally upheld. *See Mallinckrodt* . . . .; *cf. General Talking Pictures Corp. v. Western Elec. Co.*, 305 U.S. 124, 127, 39 USPQ 329, 330 (1938) ("That a restrictive license is legal seems clear."). Such express conditions, however, are contractual in nature and are subject to antitrust, patent, contract, and any other applicable law, as well as equitable considerations such as patent misuse . . . . Accordingly, conditions that violate some law or equitable consideration are unenforceable. On the other hand, violation of valid conditions entitles the patentee to a remedy for either patent infringement or breach of contract . . . . This, then, is the general framework.

E. Patent Misuse And Antitrust Guidelines On The Use Of <u>Restrictions Placed Upon Post-Sale Use Of Licensed Goods</u>

The use of restrictions placed upon post-sale use of licensed goods as in the *General Talking Pictures* and *Mallinckrodt* cases is generally permissible since such restrictions are based on the patent right to exclude others from making, using or selling. However, such restrictions must be evaluated to ensure their legality.

1. <u>Patent Misuse</u>

In the *Braun* case noted above, the Federal Circuit further commented on the "patent misuse doctrine" as limiting the use of restrictions placed upon post-sale use of goods:

> In *Mallinckrodt*, we . . . outlined the framework for evaluating whether an express condition on the post-sale use of a patented product constitutes patent misuse. The patent misuse doctrine, born from the equitable doctrine of unclean hands, is a method of limiting abuse of patent rights separate from the antitrust laws. The key inquiry under this fact-intensive doctrine is whether, by imposing the condition, the patentee has 'impermissibly broadened the "physical or temporal scope" of the patent grant with anticompetitive effect. Two common examples of such impermissible broadening are using a patent which enjoys market power in the relevant market, *see* 35 U.S.C. § 271(d)(5) (1994), to restrain competition in an unpatented product or employing the patent beyond its 17-year term. In contrast, field of use restrictions (such as those at issue in the present case) are generally upheld, *see General Talking Pictures*, . . . and any

> anticompetitive effects they may cause are reviewed in accordance with the rule of reason.[43]

2. Federal Antitrust Guidelines

Unlike resale price maintenance of the *Univis* and *Ethyl* cases discussed in *Quanta*, express conditions on the post-sale use of product contained within intellectual property licenses are generally viewed as being pro-competitive by the U.S. Department of Justice and the Federal Trade Commission as long as the licensed rights are less than the rights that the licensor holds:

> Field of use, territorial, and other limitations on intellectual property licenses may serve procompetitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible. These various forms of exclusivity can be used to give a licensee an incentive to invest in the commercialization and distribution of products embodying the licensed intellectual property and to develop additional applications for the licensed property. The restrictions may do so, for example, by protecting the licensee against free-riding on the licensee's investments by other licensees or by the licensor. They may also increase the licensor's incentive to license, for example, by protecting the licensor from competition in the licensor's own technology in a market niche that it prefers to keep to itself. These benefits of licensing restrictions apply to patent, copyright, and trade secret licenses, and to know-how agreements.
>
> **Example 1**
>
> *Situation:* ComputerCo develops a new, copyrighted software program for inventory management. The program has wide application in the health field. ComputerCo licenses the program in an arrangement that imposes both field of use and territorial limitations. Some of ComputerCo's licenses permit use only in hospitals; others permit use only in group medical practices. ComputerCo charges different royalties for the different uses. All of ComputerCo's licenses permit use only in specified portions of the United States and in specified foreign countries. The licenses contain no provisions that would prevent or discourage licensees from developing, using, or selling any other program, or from competing in any other good or service other than in the use of the licensed program. None of the licensees are actual or likely potential

[43] *Id.* at 1426.

competitors of ComputerCo in the sale of inventory management programs.[44]

III. Standard Form Agreements Such As Shrink-Wrap Agreements And Their Online Analogues

A. Background

Sellers of many types of products would like to control the use or disposition of their products after the products have been delivered to customers. For example, control over resale may be necessary to make a price discrimination scheme work as allowed by the antitrust laws described above. Another reason is that a vendor may simply not be willing to sell to a particular class of purchasers at all, such as to actual or potential competitors.

Price discrimination is possible only if the seller has some means to prevent arbitrage. If low-cost buyers could resell their products to high-cost buyers, such as over the Internet, they would swiftly undermine any such scheme for price discrimination. If the vendor can control resale, either by precluding it entirely or by limiting the class of purchasers to whom a buyer can resell, the vendor may be able to make a price discrimination scheme work.

To avoid the patent exhaustion doctrine as clarified by the Court in *Quanta*, conditional or restricted sales or licenses such as field of use licenses can be used. While many

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[44] U.S. Department of Justice and Federal Trade Commission, *Antitrust Guidelines for the Licensing of Intellectual Property*, Sec. 2.3 (April 6, 1995). (A discussion following the Situation of Example 1 stated: "The key competitive issue raised by the licensing arrangement is whether it harms competition among entities that would have been actual or likely potential competitors in the absence of the arrangement. Such harm could occur if, for example, the licenses anticompetitively foreclose access to competing technologies (in this case, most likely competing computer programs), prevent licensees from developing their own competing technologies (again, in this case, most likely computer programs), or facilitate market allocation or price-fixing for any product or service supplied by the licensees. (*See* section 3.1.) If the license agreements contained such provisions, the Agency evaluating the arrangement would analyze its likely competitive effects as described in parts 3-5 of these Guidelines. In this hypothetical, there are no such provisions and thus the arrangement is merely a subdivision of the licensor's intellectual property among different fields of use and territories. The licensing arrangement does not appear likely to harm competition among entities that would have been actual or likely potential competitors if ComputerCo had chosen not to license the software program. The Agency therefore would be unlikely to object to this arrangement. Based on these facts, the result of the antitrust analysis would be the same whether the technology was protected by patent, copyright, or trade secret. The Agency's conclusion as to likely competitive effects could differ if, for example, the license barred licensees from using any other inventory management program.")

commercial contracts still conform to the classical model of contract formation wherein negotiation takes place, the vast majority of current contracts consist of standard forms.

Standard form contracts are necessary in a modern economy, and are important for efficiency and control purposes where an enterprise enters into many transactions of a similar kind. The drafter of the standard contract clearly benefits from the contract's terms, which are written to serve its interests. However, the impact on the other party or on society need not be negative. If the form's terms are generally fair and not unduly one-sided they can create a sensible basis for contracting and could save on transaction costs and, consequently, keep prices down.

As mass markets for software emerged, software developers widely used standard form contracts in distributing their products not only to individual consumers but also to small and medium-sized businesses. In the mass market, software licenses could not practically be individually negotiated, so developers of software which is copyrightable began to use standard form licenses, a type of end user license. Also, such mass market end user license agreements were purported to avoid the copyright counterpart to the patent exhaustion doctrine, that is, the "First Sale Doctrine."[45] The uniform terms of standard form agreements which accompany the software facilitate high-volume distribution without the cost of individually negotiating individual licenses. The terms and conditions of use in the license agreement normally state that the customer/licensee can use the licensed copy only if it abides by the terms of such a license agreement. If the customer violates the agreement, the license normally requires that the licensed copy of software be returned.

A license agreement usually prohibits the customer/licensee from engaging in certain activities that it could otherwise engage in if it owned a copy of the software product. For example, typically a software license requires the customer/licensee to treat the software as a trade secret, prohibits reverse engineering of the software by the licensee, forbids the licensee from transferring the licensed copy by loan or sale to another party, requires that the software be used at a particular site or on a particular computer, and forbids use of the software on a computer network.[46] Because

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[45] This doctrine is an exception to the exclusive right of a copyright owner to distribute copies or phonorecords of the copyrighted work. Under this exception, after the first sale of a lawfully made copy or phonorecord of the copyrighted work, anyone who is the owner of that copy can sell or dispose of that copy in any way without copyright infringement liability. This rule is codified in 17 U.S.C. § 109(a). However, if the copyright owner transfers only possession of a copy or phonorecord, without conveying title in the object, then there is no ownership and the first sale doctrine is not triggered. For example, if the owner of copyright in a computer program licenses copies of the program to users, a user would infringe the copyright if it resold that copy to another. This rule is codified in 17 U.S.C. § 109(d).

[46] Footnote 2 of the case *Vault v. Quaid Software Ltd.*, 847 F.2d 255 (5th Cir. 1988), shows the kind of "shrink-wrap" standard form license agreement terms that software makers typically enclose with their software as follows:

IMPORTANT! VAULT IS PROVIDING THE ENCLOSED of the additional control licensing can provide, most companies prefer to license rather than sell copies of their software.

B. Shrink-Wrap And Click-Through Agreements

Most early standard form end user license agreements for software were of the "shrink-wrap" type.

The term "shrink-wrap" license usually refers to a license agreement, governing a purchaser's use of software or digitized data, that is presented to the purchaser only *after* payment of the purchase price. The term takes its name from the clear plastic wrapping that typically surrounds boxes of software that are offered for sale at retail stores. The license agreement is enclosed within

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MATERIALS TO YOU ON THE EXPRESS CONDITION THAT YOU ASSENT TO THIS SOFTWARE LICENSE. BY USING ANY OF THE ENCLOSED DISKETTE(S), YOU AGREE TO THE FOLLOWING PROVISIONS. IF YOU DO NOT AGREE WITH THESE LICENSE PROVISIONS, RETURN THESE MATERIALS TO YOUR DEALER, IN ORIGINAL PACKAGING WITHIN 3 DAYS FROM RECEIPT, FOR A REFUND.

1. This copy of the PROLOK Software Protection System and this PROLOK Software Protection Diskette (the "Licensed Software") are licensed to you, the end-user, for your own internal use. Title to the Licensed Software and all copyrights and proprietary rights in the Licensed Software shall remain with VAULT. You may not transfer, sublicense, rent, lease, convey, copy, modify, translate, convert to another programming language, decompile or disassemble the Licensed Software for any purpose without VAULT's prior written consent.

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the box, and the shrink-wrap prevents the purchaser from reading its terms until after she pays for the software and is entitled to break the seal. There may or may not be a notice visible on the outside of the box, informing the prospective purchaser that additional terms are enclosed.

1. *Step-Saver* Case

Initially, courts were hesitant to enforce shrink-wrap licenses. In the *Step-Saver* case,[47] once the leading case on shrink-wrap agreements, the court refused to enforce an end user license interjected by a software distributor in a dispute between the distributor and a value added reseller. This case involved a value added retailer, Step-Saver, who put together hardware and software packages to satisfy the word processing, data management, and communications needs for physicians and lawyers offices. Step-Saver selected software developed by The Software Link (TSL) as part of its package. This software developed chronic problems. Step-Saver sued TSL for breach of warranty.

The Third Circuit, applying UCC 2-207's battle of the forms provisions, found that the end user agreement accompanying TSL's software did not become part of the distribution contract between Step-Saver and TSL because TSL's label notice of the condition at the time of purchase was only seen after paying for the product. Another way of looking at the *Step-Saver* case is that the court simply applied traditional offer and acceptance rules: The offer and acceptance occurred at the time of buying the goods. Terms not divulged to the offeree at that time are not part of the contract because the offeror cannot unilaterally impose terms on the offeree after the contract was formed.[48]

2. *ProCD* Case

The first case to clearly address the enforceability issue in a dispute between an end user and a software publisher was *ProCD, Inc. v. Zeidenberg*[49]. Defendant, Zeidenberg, purchased a copy of plaintiff's software, a program that was comprised of a database of information from over 3,000 nationwide phonebooks. Every box containing the software came with a notice on the outside of the box that the software comes with restrictions stated in an enclosed license. The software was sold for two prices, one for businesses, and the other for personal use, the latter being discounted.

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[47] *Step-Saver Data Systems, Inc. v. Wyse Technology*, 979 F.2d 91 (3rd Cir. 1991).

[48] Another case which follows this view is *Klocek v. Gateway, Inc.*, 104 F.Supp.2d 1332 (D. Kan. 2000). However, even that court stated in footnote 14 of the opinion that "it is not unreasonable for a vendor to clearly communicate to a buyer—at the time of sale—either the complete terms of the sale or the fact that the vendor will propose additional terms as a condition of sale, if that be the case."

[49] 86 F.3d 1447 (7th Cir. 1996).

The personal use software contained a purchase agreement in the form of a "click-through" license[50] with provisions against commercial use. Zeidenberg ignored the license and formed his own company, making the contents of the software available on his Web site for a fee.

In determining whether defendant had breached the terms of his end user purchase agreement, the court held that the click-through license was enforceable under common law of contract and the UCC. The court stated:

> Under Uniform Commercial Code §2-204(1): A contract for sale of goods may be made in *any manner* sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract. A vendor, as master of the offer, may invite acceptance by conduct, and may propose limitations on the kind of conduct that constitutes acceptance. A buyer may accept by performing the acts the vendor proposes to treat as acceptance.

The court held that Zeidenberg did accept the offer by "clicking through." The court noted, "He had no choice, because the software splashed the license on the screen and would not let him proceed without indicating acceptance." The court also stated that Zeidenberg could have rejected the terms of the contract and returned the software.

ProCD emphasized the importance of standard form contracting and its benefits in streamlining contract formation in a modern economy. Furthermore, the court noted that it would be very cumbersome to insist that standard terms are made apparent when goods or services are ordered, so the law has to accommodate the practice of disseminating standard form contracts. *ProCD* stands for the proposition that it is neither procedurally nor substantively unconscionable for a party to provide standard terms that are not revealed to the other party at the time the transaction is entered provided that the terms are accessible, they are not outside the reasonable expectations of the marketplace, and they are not unduly harsh or one sided.

Another way of looking at *ProCD* is that the court adjusted the view of when a traditional offer and acceptance occurred: there was no offer and acceptance at the time of buying the software. Rather, the delivery of the standard terms (which occurs upon delivery of the box of goods that contain notice of the terms) is an offer. The buyer accepts the offer if he does not reject it

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[50] Similar to shrink-wrap licenses, a click-through license is used by manufacturers of computer software when distributing software through the Internet, or before installation of the software on the end-user's computer. The click-through license typically pops up on a computer display either before the user can initiate the download, or install the software. Although some of the same objections raised for shrink-wrap licenses can be raised for click-through licenses, *i.e.*, that they are unenforceable adhesion contracts, the prevailing notion is that click-through licenses are enforceable since they present the user with the opportunity to read the contract and agree to the terms of its use.

within a reasonable time by returning or declining the benefit of the contract. This provides an opportunity to read the forms at the time of delivery and gives the buyer the opportunity to refuse to contract on the offeror's standard terms by returning the product.

C. Boot Screen, Click-Wrap And Browse-Wrap Agreements

1. Background

More common today than shrink-wrap agreements are so-called boot screen, click-wrap, or browse-wrap agreements. In a boot screen license, the license appears on the computer screen the first time the software runs (or "boots"). The user agrees to the license by clicking on "I agree" button or icon or typing in the user's name. This license is similar to the click-through agreement of the *ProCD* case noted above. If the user does not agree to the license, the software stops running.

A click-wrap license agreement accompanies software that is downloaded, usually from a server. Prior to download or installation, the license agreement is displayed. Like a boot screen license, the user manifests assent to the terms of the license agreement by clicking the "I agree" button or typing the user's name. If the user does not agree, the software cannot be downloaded or installed.

A browse-wrap license is like a click-wrap license except that it is part of a website and the user assents to the contract when the user visits the website.

Click-wrap licenses are similar to shrink-wrap licenses except that they are viewed online and the software is usually downloaded over the Internet. Click-wrap licenses are generally held to be enforceable when the license terms are viewed prior to the software's purchase or installation.[51]

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[51] *i.Lan Sys., Inc. v. NetScout Serv. Level Corp.*, 183 F.Supp.2d 328, 338 (D. Mass. 2002) ("If *ProCD* was correct to enforce a shrink-wrap license agreement, where any assent is implicit, then it must also be correct to enforce a click-wrap license agreement, where the assent is explicit. To be sure, shrink-wrap and click-wrap license agreements share the defect of any standardized contract – they are susceptible to the inclusion of terms that border on the unconscionable – but that is not the issue in this case. The only issue before the Court is whether click-wrap license agreements are an appropriate way to form contracts, and the Court holds they are.").

2. *Specht* Case[52]

a. Facts

The defendant in this case, Netscape Communications, offered software which allows users to access the Internet. The company has a software application called "Smart Download" which helps users download files from the Internet. It has the capability to pause downloads or to resume downloading if the Internet connection is broken.

Users who want to download Smart Download can go to Netscape's Web site to download the application. On the Web site, there is a download button, which, when clicked, downloads the "Smart Download" software. The reference to a License Agreement can be found only if a user scrolls down to the bottom of the page where the following text is displayed:

> Please review and agree to the terms of the Netscape Smart Download software license agreement before downloading and using the software.

If the user then clicks on the link in the text, they will be taken to a Web page titled "License & Support Agreements," which contains the following text:

> The use of each Netscape software product is governed by a license agreement. You must read and agree to the license agreement terms BEFORE acquiring a product. Please click on the appropriate link below to review the current license agreement for the product of interest to you before acquisition. For products available for download, you must read and agree to the license agreement terms BEFORE you install the software. If you do not agree to the license terms, do not download, install or use the software.

This page also contains a link to the full text of the Smart Download software license. This license agreement indicates that by using or installing the Smart Download software, the user agrees to be bound by the terms of the license agreement:

> BY CLICKING THE ACCEPTANCE BUTTON OR INSTALLING OR USING NETSCAPE COMMUNICATOR, NETSCAPE NAVIGATOR, OR NETSCAPE SMART DOWNLOAD SOFTWARE (THE "PRODUCT"), THE INDIVIDUAL OR ENTITY LICENSING THE PRODUCT ("LICENSEE") IS CONSENTING TO BE BOUND BY AND IS BECOMING A PARTY TO THIS

[52] *Specht v. Netscape Communications Corp.*, 150 F.Supp.2d 585 (S.D.N.Y. 2001), *aff'd* 306 F.3d 17 (2d Cir. 2002).

> AGREEMENT. IF LICENSEE DOES NOT AGREE TO ALL OF THE TERMS OF THIS AGREEMENT, THE BUTTON INDICATING NON-ACCEPTANCE MUST BE SELECTED, AND LICENSEE MUST NOT INSTALL OR USE THE SOFTWARE.

However, a user can download and use the software without taking any action explicitly indicating consent to the License Agreement.

b. District Court Ruling

The court applied California law and ruled that no contract was formed with respect to the license agreement for the Smart Download software. The Smart Download license agreement was not binding because: 1) the user did not have to click on an icon or link to unambiguously express assent to the terms of the associated license as a precondition to downloading and using the software; and 2) the text near where the user can download the application merely indicated an invitation to view the license agreement not a precondition that the user must agree to before using the software.

3. *Jacobsen* Case[53]

a. Background

The key element in open-source licensing is providing source code under a license with broad rights to modify and redistribute. Open-source is not about simply giving the code away. The license agreement gives one control over what people do with the code so that the licensor can rely on intellectual property rights to enforce the license. However, by making the source code publicly available it is no longer confidential. So, although one is relying on copyright rights, you are giving up trade secret protection for the code.

Some of the elements typically found in an open-source license, or in open-source code, include the following:

(1) You may be required to post or disclose your "diffs," the changes that you made to the open-source code. Some licenses require that you identify, post, or disclose what you changed from the original program. Thus, if I download your version, I would know what was different and what changes you made.

(2) The license may contain restrictions on your ability to charge for distribution either in binary and/or source code form.

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[53] *Jacobsen v. Katzer*, 535 F.2d 1373 (Fed. Cir. 2008).

(3) Open-source licenses usually include limitation of liability provisions, disclaimers of warranties (and, potentially, attribution or flow-through requirements), protecting you and all the upstream contributors to that code.

b. Facts

The case involves certain software code made available by Robert Jacobsen, a physics professor at the University of California, on behalf of an open-source software group called the Java Model Railroad Interface (JMRI). Jacobsen offered the software free of charge under a type of open-source license called an Artistic License, which required only that subsequent distributors of the code include attribution, credit, and modification information. The Artistic License stated on its face that the document creates conditions: "The intent of this document is to state the *conditions* under which a Package may be copied." (Emphasis added.) The Artistic License also uses the traditional language of conditions by noting that the rights to copy, modify, and distribute are granted "*provided that*" the conditions are met.

Matthew Katzer and his business, KAM Industries, incorporated the JMRI code into a commercial product that they called Decoder Commander. The program was used to program decoder chips in model trains. After Katzer failed to comply with the requirements of the Artistic License, Jacobsen filed a lawsuit claiming copyright infringement and seeking a preliminary injunction halting Katzer's distribution of the JMRI code.

c. District Court Ruling

The district court had held that the Artistic License was "unlimited in scope" and did not provide a basis for copyright infringement. In particular, the court stated that the attribution and modification tracking requirements were covenants and not conditions in the Artistic License and that failure to comply with such covenants did not support enjoining use of the code. The district court also held that, although Jacobsen had a cause of action for breach of the license agreement, he did not have a cause of action for copyright infringement.

d. Federal Circuit Ruling

The Federal Circuit applied the copyright law of the Ninth Circuit, primarily relying on the analysis and holding in *Sun Microsystems, Inc. v. Microsoft Corp.*[54] in holding that a licensor providing free open-source software can enforce a restriction or condition on further distribution of the software through terms in an open-source software license requiring attribution credits to the author and modification tracking. The court looked to California contract law wherein the language "provided that" typically denotes a condition. The defendant failed to meet those requirements, breaching the license agreement by violating a condition of the license, and thereby infringed the plaintiff's copyright.

[54] 188 F.3d 1715 (9th Cir. 1999).

Under *Sun Microsystems*, a breach of a covenant in a license gives rise only to a claim for breach of contract, whereas breach of a license condition takes the licensee's conduct outside the scope of the license and so constitutes copyright infringement with a presumption of irreparable harm. The court said "Open source licensing has become a widely used method of creative collaboration that serves to advance the arts and sciences in a manner and at a pace that few could have imagined just a few decades ago," and cited as examples "the GNU/Linux operating system, the Perl programming language, the Apache web server programs, the Firefox web browser, and the collaborative web-based encyclopedia called Wikipedia."

IV. Printer Cartridge Business Models And Cases

A. Background

Over the lifetime of modern computer printers, the cost of the ink cartridges can in typical usage be much more than the printer itself. Consumers have a motivation to refill their own cartridges either themselves or through third-parties. Large printer manufacturers like Lexmark, Hewlett-Packard and Epson have been waging an ongoing battle with third-party ink sellers. The manufacturers have sought to employ standard form contracts and the intellectual property laws in their battle to control the use of their products after "first sale" with greater or lesser success as noted in the following *Hewlett-Packard* and *Lexmark* cases.

B. *Hewlett-Packard* Case[55]

1. Facts

HP manufactures and sells ink jet printers and disposable ink jet cartridges for its printers. Before running out of ink, the cartridges can print approximately 200 to 2000 pages, depending on the cartridge used and the nature of the printing being performed. Once the ink in a cartridge has been depleted, HP expects the cartridge to be discarded and replaced by a new one. Instructions accompanying the cartridges disclaim liability for printer damage caused by refilling and advise the user to "discard old print cartridge immediately."

The HP cartridges were designed to be non-refillable. HP stated because "refilled cartridges present significant problems of resistor lifetime, nozzle clogging and air bubble formation, the cartridges are not intended to be refilled. Accordingly, the user instructions in the HP cartridges advise the user to 'Discard old print cartridge immediately.'" Defendant, Repeat-O-Type Stencil ("ROT"), has chosen to disregard HP's advice. ROT purchases HP cartridges, modifies them so that they will be refillable, and then resells them as refillable ink jet cartridges. As HP concedes, ROT starts with brand-new and unused HP cartridges. It does not modify "spent" cartridges.

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[55] *Hewlett-Packard Co. v. Repeat-O-Type Stencil Mfg. Corp., Inc.*, 123 F.3d 1445 (Fed. Cir. 1997).

HP filed suit against ROT after learning that ROT was selling refillable ink jet cartridges. HP asserted that ROT's modification and resale of the cartridges infringed HP patents.

2. Federal Circuit Ruling

The Federal Circuit determined that despite what HP labeled as a single-use condition, it actually sold its printer cartridges unconditionally.[56] More specifically, HP owned numerous patents on a toner cartridge compatible with its HP brand printers.[57] HP's instruction manual advised consumers to "discard old print cartridge immediately."[58] Defendant ROT, however, obtained the used cartridges and refurbished and resold them. In finding that ROT had not infringed HP's patent rights, the court noted that HP had not placed any restrictions on the sale of the cartridges. "A non-contractual intention is simply the seller's hope or wish, rather than an enforceable restriction."[59] To create a conditional sale, HP had to do more than place the words "discard old print cartridge immediately" in the instruction manual.

C. The *Lexmark* Cases

1. The Lexmark Business Model

The plaintiff, Lexmark (a spinoff from IBM), manufactures and markets laser and inkjet printers, along with printer toner cartridges. Lexmark designed and implemented a business strategy that enabled owners of certain Lexmark printers to buy either an ink cartridge at the regular price or a "Prebate" ink cartridge at a discounted price. A Prebate is similar to a rebate, but with a Prebate there is no need to send in a receipt to acquire a refund. Instead, the consumer accepts a shrink-wrap license agreement (that appeared on the outside of the packaging) and is offered an on-the-spot discount. For instance, in *Lexmark*, by opening Prebate cartridge packaging, consumers accepted the following agreement that required them to return their spent Prebate cartridge to Lexmark after the initial use and prohibited them from refilling the spent cartridge:

> RETURN EMPTY CARTRIDGE TO LEXMARK FOR REMANUFACTURING AND RECYCLING. Please read before opening. Opening this package or using the patented cartridge inside confirms your acceptance of the following license/agreement. This all-new cartridge is sold at a special price subject to a restriction that

[56] 123 F.3d at 1447.

[57] *Id.*

[58] *Id.*

[59] *Id.* at 1453.

> it may be used only once. Following this initial use, you agree to return the empty cartridge only to Lexmark for remanufacturing and recycling. If you don't accept these terms, return the unopened package to your point of purchase. A regular price cartridge without these terms is available.

To ensure customer compliance with the shrink-wrap agreement, Lexmark manufactured the Prebate cartridges with a microchip that prevented their compatibility with a Lexmark printer if the cartridges had been refilled. Lexmark placed the microchip on each Prebate cartridge, and employed an authentication sequence whereby certain Lexmark printers exchanged a "secret handshake" with each microchip.

Two computer programs allegedly were protected by the secret handshake. A Toner Loading Program (*i.e.*, TLP) was located on each microchip, and downloaded by the printer to calculate the quantity of toner left within the cartridge. One version of the TLP contained 33 instructions and occupied 37 bytes of memory. Another version of the TLP contained 45 commands and occupied 55 bytes of memory.

A Printer Engine Program (*i.e.*, PEP) resided within the printer, and controlled certain printer functions. The programs were protected by the secret handshake in the sense that the printer would return an error message and fail to operate upon the insertion of a toner cartridge incapable of satisfying the secret handshake. However, neither program was encrypted nor required a password to be read from memory.

The secret handshake was initiated whenever a Lexmark printer was powered up, opened or closed, or when a toner cartridge was inserted therein. When any of these events occurred, both the microchip and the printer calculated an authentication code, the results of which were then compared. The printer would function only when the authentication codes matched.

2. <u>Case Against Static Control</u>

a. <u>Facts</u>

The defendant, Static Control Components (SCC), manufactures, among other items, component parts for refurbished toner cartridges. By October of 2002, SCC had developed its Smartek microchip for use with remanufactured Prebate cartridges. This microchip mimicked the authentication sequence to allow interoperability between Lexmark printers and Prebate cartridges refurbished by unauthorized parties. Although SCC had independently reverse-engineered a means for bypassing the authentication sequence, it programmed wholesale copies of the TLP onto its Smartek chips.

b. District Court Ruling

On December 30, 2002, Lexmark brought suit and moved for a preliminary injunction against SCC. Lexmark claimed that SCC's Smartek chips infringed its copyright in the TLP, and that distribution of the chips violated the § 1201(a)(2) anti-trafficking provision of the DMCA[60] The district court first concluded that Lexmark's claims of copyright infringement was likely to prevail on the merits. The court stated that the plain meaning of the statutory language was clear and therefore any appeal to legislative history of the DMCA would be inappropriate. Consequently, the court granted the preliminary injunction.

c. Sixth Circuit Ruling[61]

SCC appealed the district court's ruling to the Sixth Circuit Court of Appeals. As is usual for federal appeals in the United States, three judges — Gilbert S. Merritt, Jeffrey S. Sutton, and John Feikens (a district court judge temporarily assisting the appeals court) — considered the case. On October 26, 2004, the judges issued their ruling. Somewhat unusually, all three judges wrote opinions.

(1) Majority Opinion

In the majority opinion, Judge Sutton (with Judge Merritt agreeing) reversed the lower court's ruling and vacated the temporary injunction, holding that Lexmark was unlikely to succeed in its case.

The court found that the TLP was not copyrightable because of the merger and *scenes a faire* doctrines of the copyright law, and even if it were copyrightable SCC's use of the program in this case appears to fall under the fair use exception of the copyright law. Its purpose, though commercial in nature, was only to sell cartridges that could be used by Lexmark printers rather than to profit by infringing any Lexmark copyright.

The court stated that the fact that the Toner Loading Program was not copyrightable defeated both Lexmark's direct claim to copyright infringement and its DMCA claim based on the Toner Loading Program (because the DMCA only prevents the circumvention of measures that protect copyright-protected works). Also, Lexmark's DMCA claim based on the clearly copyrightable Printer Engine Program failed because the authentication sequence does not, and is not intended to, "effectively control[] access" to the Printer Engine Program. Rather, the purchase of the printer itself allowed access to the program. "Anyone who buys a Lexmark printer may read the

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[60] *Lexmark International, Inc. v. Static Control Components, Inc.*, 253 F.Supp.2d 944 (E.D. Ky. 2003).

[61] *Lexmark International, Inc. v. Static Control Components, Inc.*, 387 F.3d 522 (6th Cir. 2004).

literal code of the Printer Engine Program directly from the printer memory, with or without the benefit of the authentication sequence[...]No security device, in other words, protects access to the Printer Engine Program[...]"

(2) Concurring Opinion

In a concurring opinion, Judge Merritt agreed with Judge Sutton on the outcome of this particular case, but also expressly rejected the suggestion that any device that intentionally circumvents a technological access control measure violates the DMCA, regardless of the purpose of the circumvention. Were that the case, Judge Merritt noted, "Manufacturers could potentially create monopolies for replacement parts simply by using similar, but more creative, lock-out codes. Automobile manufacturers, for example, could control the entire market of replacement parts for their vehicles by including lock-out chips. Congress did not intend to allow the DMCA to be used offensively in this manner, but rather only sought to reach those who circumvented protective measures 'for the purpose' of pirating works protected by the copyright statute."

(3) Concurring/Dissenting Opinion

Judge John Feikens also jointed in the majority opinion by agreeing that the DMCA was not intended by Congress to be used to create a monopoly in the secondary markets for parts or components of products that consumers have already purchased. He also agreed on the outcome of the second count, although he came to that conclusion for different reasons. Judge Feikens authored a separate opinion that concurred with respect to Lexmark's DMCA claims. In particular, he stated his view that a customer's purchase of a Lexmark printer entitles the customer to use the Printer Engine Program for the life of the printer. Judge Feikens dissented as to the majority's decision on the first count, regarding the copyrightability and infringement of the Toner Loading Program (TLP).

Footnote 10 of Judge Feikens' opinion is particularly instructive with respect to this paper:

> SCC contends that such shrinkwrap agreements are not enforceable. In support of this, at least one amicus brief cites a 2001 Federal Circuit court decision that held there must be a "meeting of the minds" in order for restrictions in the agreement to be enforceable. *Jazz Phot Corp. v. Int'l Trade Comm.*, 264 F.3d 1094, 1108 (Fed. Cir. 2001), *cert. denied*, 536 U.S. 950 (2002). Other circuits have upheld the validity of shrinkwrap agreements. *See, e.g., ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996) (holding that terms inside a box of software bind consumers who use the software after an opportunity to read the terms and to reject them by returning the product). Here, the shrinkwrap agreement was clear and the district court could find that it supports the conclusion that there was a meeting of the minds and the agreement is enforceable. To wit:

"This all-new cartridge is sold at a special price subject to a restriction that it may be used only once. Following this initial use, you agree to return the empty cartridge only to Lexmark for remanufacturing and recycling. If you don't accept these terms, return the unopened package to your point of purchase. A regular price cartridge without these terms is available." Finally, I note this case is factually different from *Hewlett-Packard Co. v. Repeat-O-Type Stencil Mfg. Corp. Inc.*, 123 F.3d 1445 (Fed. Cir. 1997), in which the shrinkwrap agreement contained only a warning against refilling, and did not condition the sale on a promise not to refill.

d. District Court 2009 Ruling

After the 2004 Sixth Circuit ruling described above, SCC filed a declaratory judgment action, seeking a declaration that its new line of re-engineered toner chips did not infringe Lexmark's copyrights or violate the DMCA. The cases were consolidated by the U.S. District Court for the Eastern District of Kentucky. In April 2007, the court ruled that the Toner Loading Program was not sufficiently original to be afforded copyright protection.[62]

Lexmark's counterclaims included claims of infringement of nine patents.[63] Static Control asserted exhaustion and invalidity as defenses and moved for summary judgment. Regarding the exhaustion argument, the court ruled that the restrictions were legitimate and could be enforced against a consumer.[64]

Recently, however, as reported at 77 BNA's PTCJ 634, on March 31, 2009, the U.S. District Court for the Eastern District of Kentucky relied on the *Quanta* case to reverse its earlier ruling that Lexmark's shrink-wrap license terms were enforceable. The court stated that the *Quanta* ruling preventing LGE from using its patents to restrict the actions of downstream users prompts a "renewed" understanding of the first-sale doctrine that requires reversal of a decision that allowed Lexmark to use its patents to enforce restrictions on reuse of the cartridges by end users. Due to the prior dealings between the parties, this decision will most likely be appealed, but this time to the Federal Circuit since the Federal Circuit hears all patent appeals.

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[62] *Static Control Components Inc. v. Lexmark International Inc.*, No. 02-571 (E.D. Ky. April 18, 2007) (79 PTCJ, 04/25/07).

[63] *Static Control Components Inc. v. Lexmark International Inc.*, No. 04-00084 (E.D. Ky. Nov. 22, 2006).

[64] *Static Control Components Inc. v. Lexmark International Inc.*, No. 5:02-571 (E.D. Ky. April 24, 2007).

3. Case Against Arizona Cartridge

a. Facts

Arizona Cartridge Remanufacturers Association (*i.e.*, ACRA) is an association of remanufacturers who obtain, refill, refurbish or remanufacture used toner cartridges for laser printers. ACRA filed an action against Lexmark for false and misleading advertising and unfair competition under Cal. Bus. & Prof. Code §§ 17500 and 17200, and for conspiracy to violate those statutes.

The heart of ACRA's complaint for misleading statements and unfair business practices arise out of three programs that Lexmark has initiated: the Prebate program, Lexmark's threats of litigation, and Lexmark's implementation of a lock-out chip.

b. District Court Ruling[65]

Initially, the district court was not convinced that this was truly a false and misleading advertising case:

> This is not a patent case. At least, that is what ACRA would have this Court believe. This is a case about deceptive advertising; about how Lexmark has deceived customers into believing that they are subject to a post-sale condition that, as a matter of law, is unenforceable. Whether or not it is, however, hinges on whether or not it falls within Lexmark's patent rights. This may not be a patent case, but to determine whether or not Lexmark has engaged in deceptive and unfair business practices the Court must analyze this case under the rubric of patent law.

The court stated that:

> Unlike the sale in *Hewlett-Packard*,[66] here Lexmark does not obscure its single-use condition in its instruction manual. It places the Prebate label on the outside of its cartridge boxes. A purchaser picking up the Lexmark box will readily note the words, "Opening this package or using the patented cartridge inside confirms your acceptance of the following license/agreement." Thus, ... whether it buys directly from Lexmark or indirectly through an intermediary distributor, the Lexmark purchaser is on notice that Lexmark has

[65] *Arizona Cartridge Remanufacturers Ass'n, Inc. v. Lexmark Int'l, Inc.*, 290 F.Supp. 2d 1034 (N.D. Cal. 2003).

[66] *Supra*, n.__.

> imposed a single-use condition on the cartridge. ... [T]he Lexmark purchaser can reject the condition. The Prebate package states, "[i]f you don't accept these terms, return the unopened package to your point of purchase." If the purchaser returns the Prebate cartridge, it can obtain a non-Prebate cartridge. If the purchaser does not return the Prebate cartridge, then . . . the Lexmark purchaser has accepted the single-use restriction.
>
> Moreover, the Lexmark purchaser has accepted the single-use condition in exchange for a lower price. "This patented cartridge is sold at a special price ..." [Citation omitted.] If the purchaser wishes to obtain a Lexmark cartridge without conditions, it may do so at a price that reflects Lexmark's exhaustion of rights.
>
> In short, the circumstances of the sale indicate: (1) purchasers, including end-users, are on notice of the single-use condition; (2) purchasers have an opportunity to reject the condition; and (3) the Prebate is offered at a special price that reflects an exchange for a single-use condition. Based on these circumstances, the Court concludes that Lexmark has not exhausted its rights. The Prebate is a conditional sale and the single-use condition is enforceable.

c. Ninth Circuit Ruling[67]

The court affirmed the district court by holding: (1) restriction on reuse of cartridges did not violate California unfair competition and false advertising statutes, and (2) placement of a special chip in cartridges that prevent reuse did not violate California unfair competition statute.

Moreover, the ruling also states that such shrink-wrap contracts are binding on consumers who "indicate their agreement" by performing a physical action, as long as that contract was available to consumers before purchase: "Lexmark has presented sufficient unrebutted evidence to show that it has a facially valid contract with the consumers who buy and open its cartridges. Specifically, the language on the outside of the cartridge package specifies the terms under which a consumer may use the purchased item. The consumer can read the terms and conditions on the box before deciding whether to accept them or whether to opt for the non-Prebate cartridges that are sold without any restrictions. The district court found that the ultimate purchasers of the cartridge — consumers — had notice of the restrictions on use and had a chance to reject the condition before opening the clearly marked cartridge container."[68]

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[67] *Arizona Cartridge v. Lexmark Intern., Inc.*, 421 F.3d 981 (9th Cir. 2005).

[68] *Id.* at p. 987.

The court distinguished the *Step-Saver* case by stating in footnote 6 that:

> This case is different from those instances in which a consumer lacks notice of the condition at the time of purchase. *See, e.g., Step-Saver Data Sys. v. Wyse Tech., Inc.*, 939 F.2d 91, 105 (3d Cir. 1991) (treating box-top license as an additional term not incorporated into the parties' contract where the term's addition to the contract would materially alter the agreement and the consumer did not see license until after paying for product). Another variant involves "shrinkwrap licenses" on software, which impose restrictions that a consumer may discover only *after* opening and installing the software. *See, e.g., ProCD v. Zeidenberg*, 86 F.3d 1447, 1452-53 (7th Cir. 1996) (holding that contract between the parties included license agreement terms that appeared on screen even though they came after user had purchased, opened and installed software).

V. Conclusion And Practice Pointers For Creating Standard Form Agreements To Avoid Patent Exhaustion

In view of the above, patentees should consider drafting the license grant clause in negotiated and non-negotiated standard form agreements narrowly through field of use limitations. Doing so may allow the patentee to extract a royalty or other consideration from each downstream conditional or restricted sale when it is prudent to do so from a business perspective. Patentees should consider such narrow license grants where the product includes software. Many purchasers are now conditioned to accept such a license when software is involved with a 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 grant clause 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, as the *Quanta* court clearly said, authorized sales are a prerequisite for patent exhaustion.

A grant clause limited to sales in a field defined by customers who are licensed could read as follows:

> LICENSOR hereby grants to LICENSEE a nonexclusive license to make or import LICENSED COMPONENTS and to offer for sale and

> sell such LICENSED COMPONENTS solely to entities who are licensed by LICENSOR at the time of such sale or offer for sale [or] to entities who agree as a condition of such sale not to use the LICENSED COMPONENTS without a license from LICENSOR.

Such a grant clause would deprive the licensee of authority to sell to unlicensed entities and thus any such sale would not be "authorized" and would not exhaust the patent owner's rights.

A licensee may be authorized to sell products only with a standard form license agreement, such as a shrink-wrap agreement or a click-wrap agreement. Sales without the shrink-wrap agreement would be outside the license and an infringement. Of course, sales with the standard form agreement would be authorized with respect to such end-user license agreements. To meet the contractual expectations of the end user, such agreements should:

- Clearly alert potential end users that use of the product is subject to a license agreement, preferably prior to payment but certainly before or with first use.
- Make it clear that the product is only offered for use under the agreement's terms.
- Give the user a meaningful opportunity to review the terms of the agreement at the time of sale.
- Given the medium, make the agreement as user friendly to review as possible.
- Provide a meaningful mechanism for the user to manifest assent to the agreement.
- Provide a means for the user to keep or get a copy of the agreement.
- Provide an opportunity for the user to decline the terms of the agreement, such as, by providing a refund, or by allowing return of the product.