



Supreme Court to hear semiconductor chip patent “exhaustion” case

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.....The Supreme Court has decided, for the first time in many years, to hear arguments in a patent licensing case. The dispute involves whether the “exhaustion doctrine”—the rule that a patentee’s or licensee’s sale of a product “exhausts” patent rights over the sold product—is still alive and kicking.

The doctrine seemed a settled principle of patent law until the early 1990s, when the US Court of Appeals for the Federal Circuit in the *Mallinckrodt* decision decided that what the Supreme Court had been saying all these years about patent exhaustion was just irrelevant *dicta*. It turned out that what the Federal Circuit meant by calling what the Supreme Court said “*dicta*” was a convoluted way of saying that the Federal Circuit didn’t like what the Supreme Court had said. Since, at that time, the Supreme Court followed a hands-off policy about reviewing Federal Circuit patent decisions, that meant that 90 or 100 years of precedent went into the dustbin of history. But a counter-current at the Court now may turn things back around.

The underlying dispute

LG Electronics bought a patent portfolio from Wang Labs and began trying to enforce it. LG negotiated a license with Intel that, by its terms, gave Intel the right to make, use, and sell microprocessors and chipsets embodying the patented technology, but purported to

withhold the right of purchasers of Intel microprocessors and chipsets to practice that technology. The LG-Intel agreement required Intel to send notices to its customers warning them that Intel’s patent license did not apply to them.

Presently, LG and Quanta Computer, an original equipment manufacturer (OEM), got into an argument over Quanta’s use of microprocessors and chipsets that Quanta bought from Intel and incorporated into Quanta’s personal computers and servers. Intel, at LG’s insistence, sent the required notice to Quanta, and Quanta simply ignored it. LG sued Quanta for patent infringement. The patents that LG asserted against Quanta were not on the microprocessors or chipsets that Intel sold. They were on such things as combinations of microprocessors with memories or buses, so that Intel was not selling an infringing product as such. Intel was selling an important component of the product. Evidently (the LG-Intel license is confidential) the reason that Intel agreed to take a license and pay royalties must be that Intel’s specifications and data sheets on how to use its microprocessors and chipsets instruct users how to incorporate the semiconductors into buses and other devices that, when used, infringe the LG patents. That is, Intel was paying LG because Intel was concerned about its potential liability for “inducing” or “con-

tributing to” infringement by customers for Intel semiconductors, in violation of sections 271(b) and 271(c) of the patent law. (Induced or contributory infringement can occur only if someone else, as a result of the alleged inducer’s or contributor’s knowing conduct, commits direct or actual infringement of the relevant patent. When that happens, the inducer or contributor becomes liable. Intel’s license from LG thus expressly contemplated that Intel’s customers would be infringing the patents. Otherwise, Intel would not have needed any license.)

The district court and Federal Circuit rulings

The district court ruled that the only reasonable utility of the Intel semiconductor chips that Quanta bought was as parts of personal computers and servers that, when used, practiced the patented technology. (The court said that “such use is the sole contemplated use for the devices.”) The district court therefore held that Quanta’s use of the semiconductors was not infringement, because of the exhaustion doctrine. The court limited this ruling, however, to the device or system claims. It held that exhaustion did not occur as to the method claims of LG’s patents, on the ground that the Federal Circuit had held that the exhaustion doctrine did not apply to method claims.

Dicta

In legal parlance, *dicta* or *obiter dicta* refers to statements in a Court's opinion that are in the nature of a *BTW* remark, an unnecessary digression, something thrown out for purposes of general illumination or explanation, but not part of the logical train of propositions that the court needs in order to be able to say "Q.E.D."

The opposite concept is *ratio decidendi*, which refers to the line of reasoning that the court used to get from A to B or from facts of the case to the final result of who wins. In principle, *dicta* are not binding precedents, but they may be persuasive if they come from an authoritative source. A *ratio decidendi*, however, is considered binding precedent. It is what the decision "held."

In its *Mallinckrodt* decision [*Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, (Fed. Cir. 1992)], the Federal Circuit said that the Supreme Court's statements about patent exhaustion in many prior cases were mere *dicta* because the Court could have decided those cases on a different rationale (antitrust violation) from the one (exhaustion) that it had actually used. That is a very peculiar way to analyze precedents and a peculiar concept of the difference between a *dictum* and a *ratio decidendi*.

To be sure, one way to define a *dictum* is to say it is anything in a judicial opinion that is not necessary to support the result (that is, who wins), and one might say that a line of reasoning is not necessary to the result if an alternative route to reach the same judgment could instead have been taken. But that is not ordinarily what "necessary to support the result" means in this context. Ordinarily it means, necessary to support the result if you follow the same general path but just ignore lateral digressions. For example, you can determine that "Isaac Newton discovered America" is false by showing that Newton never came within a thousand miles of America. You might also show the same proposition false by establishing that Columbus (or someone else) actually discovered America. If a court uses the first way to get to the result and never even mentions the second way, as in the Supreme Court's exhaustion cases, the existence of the second way does not make the first one *dictum*. What the Federal Circuit did in the *Mallinckrodt* decision amounted to a lower court deciding to overrule a higher court, because it did not like what the higher court had said—perhaps not unheard of, but nonetheless peculiar.

The Federal Circuit reversed the ruling that the exhaustion doctrine shielded Quanta from liability under the device or system claims, and upheld the ruling that the doctrine did not apply to method claims. The exhaustion doctrine did not apply, the court said, because the sales were conditional rather than unconditional. That is, Intel's notice that it sent Quanta imposed a condition on the sales of the semiconductors. Although Quanta simply ignored the notice and did not make any statement to Intel that it would obey it, the Federal Circuit said that under New York's version of the Uniform Commercial Code (applicable for unexplained reasons) Quanta's failure to make an express objection to the condition or notice amounted to an agreement to accept it: Silence was consent.

The Federal Circuit explained why it considers the exhaustion doctrine in-

applicable when the patentee causes notice to be given that exhaustion shall not occur. "The theory behind" the patent exhaustion doctrine, according to the Federal Circuit, is that when "an unconditional sale" occurs, "the patentee has bargained for, and received, an amount equal to the full value of the goods." But when the patentee requires that the sale be conditional, "it is more reasonable to infer that the parties negotiated a price that reflects only the [lower] value of the [lesser] 'use' rights conferred by the patentee."

Thus, the Federal Circuit considers exhaustion a matter of the parties' intent—a default rule that courts use when the parties fail to make their intentions explicit. The contrary approach, apparently followed in prior Supreme Court decisions, is that exhaustion occurs as a matter of law,

something that flows automatically from the nature of the property rights that buyers acquire by virtue of sales of goods to them. In this view, post-sale restrictions on customer use of patented goods are contrary to considerations of public policy—like putting sand between the gears of commerce instead of greasing them.

The competing interests

Quanta is Intel's downstream customer. But as an OEM, Quanta has its own downstream customers, such as Dell and Gateway. They, too, have their own farther-downstream customers. Quanta, Dell, and Gateway argue that LG is unfairly mulcting users of the patented technology with multiple layers of royalties—double- or triple-dipping, or two bites at the apple, whichever metaphor you prefer. These stakeholders say, "One patent, one royalty!" (Dell and Gateway see themselves as being next on LG's hit list if it succeeds against Quanta.)

The Federal Circuit's opinion embodies the premise that there exists a single, definite royalty that the patent licensor can extract for a given scope of the license—"one monopoly rent." Say it is \$100 for a complete license that exhausts all rights—"the full value of the goods," as the Federal Circuit puts it. On this theory, if Intel decides that it wants to buy only a license for itself and not one for downstream customers too, it can negotiate a cheaper license from LG—say, one for \$60. In that case, LG must look to Quanta and other downstream customers of Intel for the other \$40. The traffic will bear only \$100, and whether it is all paid by Intel or divided up between Intel and Quanta, or spread out among Intel, Quanta, and Dell, makes no difference. It still will be the same \$100. The complaint by Quanta and its downstream customers about double-dipping is therefore misguided. LG should be allowed to negotiate with Intel and other layers of the distribution chain, in a free market, for whatever allocation of the \$100 most suits the

needs and desires of all concerned. Moreover, this will lead to the most efficient allocation of resources and an optimum transfer of wealth among the parties.

Dell and Gateway argue that this is a pipe dream, a fantasy. They say that there would be no \$40 limit on what Quanta could exact from them after it gets its \$60 from Intel. Instead, the LG-Intel deal simply enhances LG's bargaining power against them. If Intel enters into a license with LG, instead of choosing to try to design around the patents, Dell and Gateway will not be able to turn to a vast army of other microprocessor sellers. They don't exist. To the extent that maybe they can find suitable microprocessors from an AMD or other Intel substitute, they may run up against Intel's patents on the technology that they have already designed into their computers. They do not believe that LG would be satisfied with the notional \$40 bite that this theory postulates and think they will more likely end up paying the same \$60 that Intel paid, or more.

The real problem with the Federal Circuit's concept of a fair partition of patent-right payments along vertically disposed horizontal planes is that computers and other complex products (such as cell phones, automobiles, airplanes, TVs) have many components of varying complexity and value, networked inside the product in no simple hierarchy of layers, differently present in different models of the same product, with the models constantly changing and replacing old models. Keeping track of patent usage, much less negotiating the "fair value" for the use at the relevant level of distribution, is hardly feasible, and the transaction cost is absurd. Such a situation cries out for Alexander's solution for the Gordian Knot: in this case, the traditional version of the exhaustion doctrine, which requires patentees to pick a distribution level and levy their royalties there—under the principle of

one patent, one royalty. The alternative, the Federal Circuit's doctrine, just throws sand into the gears of commerce.

Still another view

That's one way of looking at it. But it's not the whole story. The notion of vertical partition of patent rights to negotiate and realize "fair value" may be just so much hogwash most of the time, but in some circumstances there is something to it. Moreover, the courts have recognized its reasonableness in certain special fact patterns. About 50 years ago, there was a series of cases in the textile industry involving multitier licenses. Typically, there would be one royalty arrangement for manufacturers of textile machines—say, yarn-spinning machinery. These licenses tended to be at a flat rate or a rate based on machine size. Then there would be another royalty arrangement for those companies that used the machines to make thread or yarn. Here, the rate would be a running royalty of so much per 1,000 feet of product manufactured per year.

The reason for the separate arrangements was that the patented technology had a value that depended on how it was used. The value of the invention to a machinery manufacturer was proportional to how much he could sell the machine for, which ordinarily would be a known, fixed amount. The value of the patented technology to a spinner of yarn depended on how much yarn the machine manufactured over a given time. Thus, there are two kinds of technology-embodied goods: the end product sold to downstream users and the tool (machine) used to make the end product. Their respective utilities have different measures. (Conceivably, one might obliterate the distinction by leasing the machinery or selling it for a metered price instead of a fixed price, so that the machinery's price would better conform

to the value of the benefit conferred, but those expedients may be impracticable.)

The courts considered these special cases to be exceptions to the exhaustion doctrine because of their special fact pattern. A comparable ruling occurred in a case involving steel mills, where the manufacturer of the mill paid one royalty (a fixed sum) and the user of the mill paid a running royalty of so much per ton of steel produced. These cases show that in some circumstances the Federal Circuit's "fair-value" theory makes sense. It just doesn't make sense for microprocessors.

Or does it? It is known that you can charge more for a microprocessor than runs at 2 GHz than for one that runs at 200 MHz. Is that an argument for the Federal Circuit's approach? Actually, it isn't. We are not talking here about microprocessors and machines for making them. We are talking about microprocessors and microprocessors. Cases like that are easily taken care of by the fact that a 3 percent royalty on \$100 for a 2-GHz microprocessor is twice the amount of a 3 percent royalty on \$50 for a 200-MHz microprocessor. Net sales royalties automatically account for differences in value. But is that too coarse a mesh? Perhaps the value of the technology is somehow not linearly proportional to the price. Hard to believe, but possible. Maybe this should be a case-specific fact question turning on the administrative costs of making things more complicated: "Fair-value" partitioning like that which LG wants is permissible if it's not too complicated, but it's impermissible when it gets too hairy. But the value of having simple legal rules far outbalances the value of superbly nuanced decisions, even if a methodology could be devised to fit the situation.

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