OVERVIEW OF THE IMPLICATIONS OF THE *QUANTA COMPUTER, INC. v. LG ELECTRONICS, INC.* DECISION ON THE DRAFTING OF LICENSE AGREEMENTS FROM A CANADIAN PERSPECTIVE.

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I- The Quanta decision

On June 9, 2008, the U.S. Supreme Court rendered a much awaited decision (the "Quanta decision" [1]) which clarified the uncertainty surrounding the application of the doctrine of patent exhaustion in the United States (which essentially provides that "a patented item's initial authorized sale terminates all patent rights to that item"[2]) by essentially removing the ability of patent owners to limit the authorized sales of products embodying their inventions. In order to reach such a conclusion, the Court reaffirmed the 150 year old longstanding exhaustion doctrine and its essential role in maintaining competition in the market place. Despite the Federal Circuit's recent precedent limiting the scope of the exhaustion doctrine and extending the patent owner's power to control the use of the product after the first sale[3], the Supreme Court – evoking the risk that patent drafters try to evade exhaustion by drafting method claims – also ruled that exhaustion extended to method patents by the sale of an article that embodied the method.

In this case, LG Electronics ("LGE"), through a License Agreement, licensed Intel Corporation ("Intel") to manufacture and sell microprocessors and chipsets using three of its computer technology patents. LGE did not limit the downstream sale of Intel products in its License Agreement, but in a separate agreement (the "Master Agreement"), it required Intel to notify its customers that the License Agreement did not extend to combinations of Intel products with non-Intel products. Through said requirements, LGE was apparently planning on collecting downstream royalties from computer manufacturer's who would combine the patented technology with other components. Despite receiving such notice, Quanta Computers ("Quanta") purchased microprocessors and chipsets from Intel and manufactured computers

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1 *Quanta Computer, Inc. v. LG Electronics, Inc., no. 06-937, 2008 U.S. LEXIS 4702 (U.S. June 9, 2008;* 86 USPQ2d 1673 (June 9, 2008)*)*.
2 *Id*. Thomas J., p.5
3 See *Mallinckrodt, Inc*. v. *Medipart, Inc*., 976 F. 2d 700 (Fed Cir. 1992)

using the Intel products in combination with non-Intel products. Once aware of this, LGE initiated proceedings against Quanta for infringement of its patents and breach of the terms of the License Agreement. In trying to determine if patent holders could seek damages from downstream users, both the District Court and the Federal Circuit Court found that the exhaustion doctrine was not applicable to patent methods. The Federal Circuit Court further concluded that LGE had not licensed Intel to sell its products to a customer who was to combine them with non-Intel products and that the exhaustion doctrine could only be triggered by an unconditional sale, which was not the case here.

The Supreme Court granted certiorari to Quanta and, after hearing both parties' arguments, unanimously ruled (i) that the patent exhaustion doctrine did apply to method patents, (ii) that the Intel products embodied the LGE patents and (iii) that Intel, which provided Quanta with the notice stipulating that the license would not extend to the combination of Intel parts with non-Intel parts, was authorized to sell its products to Quanta because nothing in the License agreement between LGE and Intel forbade or restricted the sale of products that practiced the patents. According to the Court, a licensee's authorized sale of components which substantially embody a patented apparatus or method and which have no reasonable use other than to practice the patent, exhausts the patent holder's rights[4]. The Court therefore determined that LGE was not in a position to assert patent rights against downstream purchasers of the Intel products. This means that, in such a situation, a patent holder/licensor cannot rely on patent law to demand royalties from downstream customers of authorised purchasers of components that include all the essential features of the patents, nor can he sue wholesalers or retailers for selling the products or end-users for using them.

II- Widespread implications

From a patent licensor's perspective this strict application of the exhaustion doctrine limits the ability to control the patented goods pursuant to the first authorised sale of the product and therefore limits the possibility to optimize profits from the sale of the patented technology.

An additional result deriving from this decision is that a mere notification from a patent licensor to its customers, customers that they are not licensed to use the product, will not allow such patent licensor to avoid exhaustion of his rights. If LGE's license agreement had limited or conditioned Intel's right to sell the products, the

[4] "The authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control post-sale use of the article" (86 USPQ 2d at 1682)

outcome of the decision would most likely have been different as the sale to Quanta would probably have been considered as unauthorised.

There is no doubt to the fact that this unanimous decision shall have consequences on the ways licensors impose limitations on and/or restrict downstream use of patented products.

While the Court did not proceed to an analysis of a patent licensor's contractual rights and expressed no opinion with regard to contract damages or to contractual rights in general, it appears that despite an authorised sale, a patentee is not precluded from imposing contractual restrictions to a licensee's right to use or sell the patented product (and accordingly avoid the application of the exhaustion doctrine)[5]. Accordingly and because the patentee's direct control is limited to the first sale, post Quanta patentees will have no choice but to rely on contractual damages and on contractual restrictions in their patent licenses for downstream control, even if patent law may result in stronger relief which, as opposed to contract law, is binding on everyone.

Although it is too early to set out all the concrete impacts of the high court's ruling, this decision, and its potential implications on patent owners and licensors, has already been analysed quite thoroughly by quantity of observers and concern has already risen in the field of technology transfer and intellectual property licensing. It is clear that in a fast growing technological market where various elements of patented inventions are manufactured and sold by different parties, patentees will want to know how to draft an efficient restrictive/not-too-broad license agreement in order to reverse the contractual equilibrium that the Quanta decision seems to have established in favour of licensees.

III- The Canadian Perspective

Because the U.S represents the largest licensing market worldwide, the Quanta decision will clearly have widespread implications for businesses worldwide on both existing and future license agreements.

From a Canadian perspective, the doctrine of Patent exhaustion – which is common to many legal systems – does exist but is not as developed[6] and has not benefited from the same court analysis or judicial developments as it has in the United States.

[5] In footnote 7 of the decision, Justice Thomas simply mentioned the following: "We note that the authorized nature of the sale to Quanta does not necessarily limit LGE's other contract rights. LGE's complain does not include a breach-of-contract claim and we express no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages".

[6] Roger HUGHES and Martin KRATZ, *Licensing Commercial Transactions*, vol 1, LexisNexis, 2007, Markham, p.1-6

Essentially, the application of the exhaustion doctrine in Canada was confirmed in 1998, in an important decision rendered by the Supreme Court of Canada which ruled that unless clearly and unambiguously stipulated in the license agreement, the sale of a patented article to a licensee entitles the licensee to "pass to purchasers the right to use or resell the article without fear of infringing the patent"[7].

Because the United States Supreme Court has now reaffirmed the doctrine of patent exhaustion and because patent infringement suits are not the right remedy for the unlicensed subsequent sale or use of a patented product in the U.S., post-Quanta Canadian patent licensors doing business in the United States –which is eighty percent of all Canadian exports– shall clearly suffer the same consequences as American patent licensors, and accordingly may not be able to derive as much downstream additional revenue as hoped from their patented products which an American licensee or a licensee selling in the U.S. is entitled to sell or use. That is why such Canadian patent licensors may well need to re-evaluate their patent licensing strategies and make sure that they cover every issue that need to be addressed while drafting the license agreement, which is the cornerstone of the relationship between the licensor and the licensee.

IV- The potential impacts of the Quanta decision in Canada from a licensing point of view

Through a license, the patent licensor grants rights in a patent to the licensee. This transfer of rights does not necessarily give the licensee all the rights of the patentee. As Harold G. Fox wrote some time ago, in Canadian law, a license is "a consent by an owner of a right that another person should commit an act which, but for that licence, would be an infringement of the right of the person who gives the licence. A licence gives no more than the right to do the thing actually licensed to be done." To that effect, it is interesting to note that for years, the interpretation of license agreements (well-known and well-established common law institutions) in Quebec suffered much ambiguity, as license agreements had no determined judicial qualification under Quebec Civil law. However, after some years of uncertainty and discussions as to the "status" of such agreements, the authors as well as the courts ended up recognizing the *sui generis* nature of licenses under Quebec Civil law[8] and its definition is now aligned with the Canadian common law definition.

Although the patent licensor is in the position of granting rights to the licensee, the power to insert restrictions in a license is not unlimited. Inserting restrictive clauses in a license shall require careful drafting as some restrictions may be found abusive,

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[7] *Eli Lilly & Co*. v. *Novopharm Ltd*. [1998] 2 S.C.R. 129, 187

[8] For additional information on the state of the law with regard to License Agreements in the province of Québec, we refer you to François Painchaud's article: *Les Transferts de Technologie et leurs clauses principales dans le cadre d'un contrat de licence*, 2002; available on Leger Robic Richard's website at the following link: http://www.robic.ca/publications/Pdf/291-FP.pdf

and accordingly illegal, by the courts under either of the two legal systems applicable to contracts on the Canadian territory or under the Federal Competition law (Canada enjoys duality of systems under the Constitution[9] which is “common law” based in nine provinces and the territories and “civil law” based in the Province of Quebec). From a Quebec perspective, the clause of an adhesion contract which is unreasonably or excessively detrimental to the licensee is an abusive clause. Of course not all license agreements are adhesion contracts, but for those which fall within that category (i.e. of which the essential clauses were drawn up by the licensor and were not negotiable[10]), a more rigorous review of the provisions and their court interpretation must be made. Although the concept of adhesion contracts is not as developed in Common Law provinces as it is in Quebec, a similar concept does exist under the Common Law legal system where courts may not enforce unreasonable or unconscionable terms [11] even in extreme cases the license agreement itself.

That is why, while negotiating a license agreement, not only will patent licensors have to make sure that they preserve total control over their intellectual property, as required in the Quanta case, they will also need to make sure that they are negotiating efficiently and proposing clear and undisputable clauses under the Canadian law applicable to the contract.

The aim of a restrictive license with regard to intellectual property rights is to limit the use of the patented product by clearly establishing what the licensee is entitled to do and what it is expressly not entitled to do. From the point of view of a licensor, royalties constitute one of the most important elements that derive from a license agreement and a well drafted agreement will enable a licensor to accumulate substantial financial returns on the initial investment (research and development, drafting of the patent, etc).

However, the possibility of drafting a very restrictive agreement is subject to the difficulty inherent to contract laws which require the agreement of the other party. While licensors will likely try to narrow their licensee’s rights to exploit the product, licensees will most probably see the imposing of various and strict restrictions as an impediment to the realization of full benefits from the use of the licensed product. Except in specific cases, licensees will most probably not easily accept (unless at a drastically reduced rate) to enter into a license agreement that considerably limit their use of the licensed products and any financial gain that could derive from such use. Thus, considering that both licensors and licensees need one another to develop the patented invention and benefit from the revenues it shall create, it is

[9] To that effect Section 92 of the *Constitution Act, 1867*, 30 & 31 Victoria c.3 (U.K.), lays out the powers of the provinces in Canada.
[10] Section 1370 of the *Civil code of Québec*, S.Q, 1991, c-64
[11] Roger HUGHES and Martin KRATZ, *Licensing Commercial Transactions*, vol1, LexisNexis, 2007, Markham, p.1-26

very important that each party finds a common ground in determining what may be permitted under the license agreement.

Further, in order for licensors to maintain a broad control over their intellectual property, it is essential that the contractual restrictions that are established between the parties may be enforced directly against the licensee and not exclusively with downstream users as LGE tried to do. That is why a patent owner who wishes to license a patent might want to seriously consider to whom in the supply chain the initial license shall be issued. Of course, as previously mentioned, one of the main criteria shall be a licensee who can best pay royalties – and who, in view of the Quanta decision, shall accept to pay higher royalties – however this criteria should be evaluated from a more global perspective and other options may be considered such as: narrowing down the scope of "permitted use" of the patented article to certain customers, to specific combinations with other products, or to a specific market; signing a license which will allow the broadest array of uses and the largest control possible; or licensing the downstream end consumers of the product.

If the licensor chooses to allow licensees to assign or sublicense some of the rights conferred under the license, it might want to make sure that any such assignment is subject to the licensor's written consent in order to maintain a veto and avoid that its interests be transferred to a competitor or to a party who does not have sufficient assets[12].

It is worth distinguishing between existing licenses and future licenses as the implications and difficulties to be considered in each case are not the same. While drafting a new license agreement implies making sure that every issue decided in the Quanta case is addressed and that the licensor is not deprived of any remedies; modifying an existing license agreement may be slightly more complicated. Indeed, if the license agreement as drafted is too broad and does not offer the licensor as much contractual control as would be necessary in the post-Quanta era, the licensor might encounter difficulties to obtain the licensee's acceptance to amendments to the agreement. Furthermore, it results from the Quanta case, that once a licensor has agreed to an authorized sale, it can no longer try to impose restrictions to the downstream users as the rights are exhausted. Therefore, if the existing license agreement has authorised a sale, the licensor will not only be unable to rely on patent law but will also have no foundation to file a suit for breach of contract law.

Finally, in addition to the obligations set out under contract law, it is important that, when seeking to impose or extend restrictions, the licensor be very careful not to encounter competition issues that might result in the invalidation of the license agreement. To that effect and as discussed hereafter, competition law provisions should not be underestimated when drafting a license agreement.

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[12] Roger HUGHES and Martin KRATZ, *Licensing Commercial Transactions*, vol1, LexisNexis, 2007, Markham, p.1-14

V- The limits of contractual law (or how competition law may limit the possibility to draft restrictive licenses /clauses)

The necessity to determine on a case-by-case basis that the abuse of intellectual property rights does not unduly restrain trade is internationally recognised and is reflected through the WTO Trade Related Aspects of International Property Rights Agreement ("TRIP") which entitles members to specify "in their legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market"[13]. To that effect, Canada, as a Member state, has adopted measures to prevent or control such anticompetitive practices, which, under TRIP'S, may include for example "exclusive grant back conditions, conditions preventing challenges to validity and coercive package licensing, in the light of the relevant laws and regulations of that Member"[14].

In Canada, section 32 of the *Competition Act*[15] (the "Act"), stipulates that the Federal court may declare void (in whole or in part) any agreement, arrangement or license relating to the use of a patent, or restrain any person from carrying out or exercising any or all of the terms or provisions of the agreement, arrangement or license (amongst others) in any case where use has been made of the exclusive rights and privileges conferred by patents that, amongst others, restrain or injure unduly, trade or commerce in relation to any such article or prevent or lessen, unduly, competition in the production, manufacture, purchase, barter, sale, transportation or supply of any such article or commodity.

It appears that the Competition Bureau of Canada (the "Bureau") and the Attorney general will seek the intervention of the Federal court if they have proof of restraint of trade or lessened competition[16]. Unfortunately, the "restraint of trade or lessened competition" concept has not enjoyed much discussion in Canadian courts, it is difficult to determine how this section may be applied to the holder of a patent right.

The Patent rights holder at least enjoys *prima fasciae* presumptions offered by section 79(5) of the Act, which, as an exception to the principle that a tribunal may make an order prohibiting a person from engaging into an anti-competitive practice, stipulates that "an act engaged in pursuant <u>only</u> to the exercise of any right or enjoyment of any interest derived under the *Copyright Act*, *Industrial Design Act*, *Integrated Circuit Topography Act*, *Patent Act*, *Trade-marks Act* or any other Act of

[13] Section 40 of the TRIP Agreement available online at http://www.wto.org/english/docs_e/legal_e/27-trips_04d_e.htm
[14] *Id.*
[15] R.S., 1985, c. C-34
[16] Competition Bureau – Intellectual Property Enforcement Guidelines (2000) http://strategis.ic.gc.ca/pics/ct/ipege.pdf

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Parliament pertaining to intellectual or industrial property is not an anti-competitive act".

The policy adopted by the Bureau is also of help: "licensing in the vast majority of cases is pro-competitive because it facilitates the broader use of a valuable intellectual property right by additional parties"[17]. Yet, despite the fact that the Bureau insists on the fact that intellectual property and competition laws are both necessary for the efficient operation of the market place, an abuse of intellectual property rights may always result in violation of section 79 of the act (abuse of a dominant position)[18] and such rights are not exempt from the application of the Act.

The only certainty that can be retrieved from various guidelines and principles set out by the Bureau[19] with regard to the drafting of license agreements, is that the Bureau in its assessment of a situation is guided by the necessity of protecting proprietary rights and intellectual property to the largest extent possible in order to encourage innovation, promote economy, maintain a competitive market place, obtain widespread economical benefits, and allow the owners of such rights to benefit from their innovations and inventions. Although the defence of proprietary rights may sometimes lead to abuse and monopolies, such defence also constitutes the basis of sound competition. To that effect, the Bureau does not consider a license of intellectual property rights to be anticompetitive unless such an agreement limits competition to an inferior level than the one that would have existed in the absence of a license agreement[20]. That is why the Bureau emphasizes the necessity of a balance between the rights that are granted by various intellectual property laws and a sound competition policy[21].

In order to determine if a license agreement raises a competition issue in the market place, the Bureau will determine if the clauses of the agreement "serve to create, enhance or maintain the market power of either the licensor or the licensee"[22] (i.e. lessen or prevent competition). The Bureau will not consider licensing agreements involving intellectual property to be anti-competitive unless they reduce competition substantially or unduly relatively to the market place which would have existed in the absence of the license. If it has established that the license agreement as drafted entices more than the mere exercise of an intellectual property right, the Bureau may intervene under the appropriate sections of the Act.

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[17] *Id.*

[18] Richard F.D. Corley, Navin Joneja, Prakash Narayanan, *The Competition/Intellectual Property Interface Present Concerns and Future Challenges*, March 2006, http://www.competitionbureau.gc.ca/epic/site/cb-bc.nsf/en/02285e.html

[19] See http://strategis.ic.gc.ca/pics/ct/ipege.pdf, http://www.competitionbureau.gc.ca/epic/site/cb-bc.nsf/en/01807e.html, http://www.bureaudelaconcurrence.gc.ca/epic/site/cb-bc.nsf/fr/01808f.html and http://www.competitionbureau.gc.ca/epic/site/cb-bc.nsf/en/02285e.html#4A3

[20] http://www.competitionbureau.gc.ca/epic/site/cb-bc.nsf/en/02285e.html#4A3

[21] *Id.*

[22] *Id.*

While it appears that the exhaustion doctrine and its potential impacts on Canadian competition law have not been discussed or analyzed by the Bureau, it is clear – in view of decisions rendered by the Competition Tribunal - that a licensor must be very careful not to engage in anti-competitive acts and in business practices which create civil offences under the Act such as creating a situation of abuse of dominant position. To that effect, in the early nineties, the Competition Bureau rendered a landmark decision[23] ruling that NutraSweet had engaged into anti-competitive acts that were preventing or lessening competition substantially. The acts in which NutraSweet had engaged in order to extend its monopoly beyond the life of the aspartame patent, included requiring that its licensees display the NutraSweet name and registered trade-mark on all products containing the sweetener in question and offering discounts to those who accepted to display said trade-mark on their products. After the expiration of the patent, only those purchasing the product with NutraSweet were authorized to display the NutraSweet trade-mark which had become well-known and strongly associated with the sweetener. The Tribunal ruled that contract terms that impeded competitors to enter into the aspartame market (such as clauses requiring that purchasers use only the NutraSweet brand, or price discounts for displaying the NutraSweet trade-mark and name), were to be prohibited because contrary to sections 77 and 79 of the Act. The principles established in said ruling have since been affirmed by the Federal Court of Appeal, namely in the Canada Pipe case[24] where the definition of anti-competitive as established in the NutraSweet case (being “an intended negative effect on a competitor that is exclusionary, disciplinary or predatory”[25]) was sustained.

In view of the state of the law in Canada, and in order to avoid any “bad surprises” such as the license agreement being declared anti-competitive, a licensor should use caution in drafting restrictive license terms and should not unnecessarily extend the applicability of the license agreement beyond what is provided for by the applicable intellectual property, contractual and competition legislation. Whilst a patent holder is entitled to draft a license agreement that facilitates the development of a vast and interesting market for the patented article, any restrictions aiming downstream purchasers should remain legitimate. To that effect, in the same way that a licensor must make sure that the provisions of its license agreement respect applicable laws, said licensor may not attempt to adapt the interpretation of longstanding doctrines or rules, such as the patent exhaustion doctrine, in a way that favours its interests. Clearly, relying on an ambiguity pertaining to the application of a given doctrine may end up being a risky business.

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[23] *Canada (Director of Investigation and Research)* v. *NutraSweet Co.* (1990), 32 C.P.R. 3d 1 (Comp. Trib.)
[24] *Canada (Commissioner of Competition)* v. *Canada Pipe Corporation Ltd*., 2006 FCA 233
[25] *Id*., para. 77

Conclusion

As of today, there is certainty in defining the extent of the consequences that will result from the Quanta case even when dealing from the outside of the U.S. That is why the scope of the agreement that parties are about to enter into as well as any restriction in the agreement, must be clearly and carefully defined and described[26]. Drafting an agreement, while keeping this longstanding and undisputed principle in mind, is probably the best way to limit any misinterpretation of the contract that could lead to disagreements relating to the scope of the license.

To that effect, it is worth reading a recent British decision of the High Court of Justice, Chancery Division, in which Justice Peter Prescott was to adjudicate between two conflicting interpretations of a poorly drafted license agreement and determine to which extent the licensor was entitled to the payment of royalties[27]. Although the facts of the case and the judicial issues at stake are very different than those of the Quanta decision, Justice Prescott provides us with very wise suggestions, universally applicable when it comes to drafting patent licence agreements, that may help avoid business uncertainty and long and expensive litigation[28]:

- Be familiar with patent terminology;
- Do not let your word processor do the thinking for you;
- Do not rely exclusively on precedents;
- Use precise and clear terminology; and
- Do not leave any room to ambiguous terms.

Although this advice does not preclude any of us from the consequences of the Quanta decision, it is worth referring to as a useful reminder of the fact that a license agreement must always be drafted with caution, knowing that it is in the licensor's best interest to draw terms that are clear, straightforward, not too large or too restrictive, of which the scope and the applicability cannot be contested in view of any applicable contractual or competition law.

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[26] Roger HUGHES and Martin KRATZ, *Licensing Commercial Transactions*, vol1, LexisNexis, 2007, Markham, p.1-7
[27] *Oxonica Energy Limited* v. *Neuftec Limited*, [2008] EWHC 2127 (*Pat*)
[28] *Id.*

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