



Intellectual Property Advisory

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Federal Circuit Equates "Covenant not to Sue" with "Patent License," Expanding Avenues for Exhausting Patent Rights

On Friday, April 10, the Federal Circuit rewrote a basic principle of patent licensing law, by eliminating a significant distinction between a "license" and a "covenant not to sue."

TransCore LP vs. Electronic Transaction Consultants Corporation ("ETC"), No. 20081430 (Federal Circuit), involved a lawsuit by TransCore, the owner of a portfolio of patents for automated toll collection systems (such as E-ZPass) against ETC, a firm engaged in consulting and systems integration related to highway toll systems. ETC defended against the infringement allegations on the grounds that it was installing toll collection systems supplied by a company named Mark IV, to which TransCore had supplied a covenant not to sue several years earlier. Notably, this covenant not to sue, on its face, was provided to Mark IV and its affiliates. The covenant did not profess to extend to Mark IV's vendors or customers, such as ETC. ETC argued, however, that this covenant was the equivalent to a patent license, as a result of which Mark IV's sale of the alleged infringing toll collection systems "exhausted" TransCore's rights under the covenanted patents.

This decision is an extension of the U.S. Supreme Court's June 9, 2008 decision in *Quanta Computer Corp. vs. LG Electronics*. In *Quanta*, the Supreme Court issued a decision that significantly expanded application of the patent exhaustion doctrine, ruling that the patent holder's rights are exhausted once usage of a patented item has been "authorized by the patent holder." Prior to the *Quanta* ruling, patent owners had been permitted to "condition" a downstream user's rights, so long as the user was notified of the limitation (e.g., a field of use restriction). If the downstream user exceeded that field of use, it was subject to a suit for patent infringement. In *Quanta*, however, the Supreme Court ruled that conditional licenses are not enforceable. Instead, if the patented item was made and sold under "authority" from the patent owner, the patent owner's rights against downstream customers are exhausted, notwithstanding any limitations on use imposed by the manufacturer or patent owner. Post *Quanta*, a significant question remained -- is activity under an unconditional covenant not to sue "authorized by the patent holder," for purposes of finding exhaustion of the covenanted patent rights?

This was a question of significant importance, because a "covenant not to sue" was traditionally viewed as a contractual commitment not to sue. This is contrasted with a "patent license," which was viewed interchangeably as either an authorization under the patent or a freedom from suit under the patent. And because the former was considered a personal commitment, rather than an authorization under the patent, the benefits of a covenant not to sue were not believed to extend to third parties.

Given this distinction, a covenant not to sue was often used in lieu of a patent license, particularly where a patent owner wished to secure peace with one party while limiting the benefits afforded to that party's customers or vendors. A common example is the covenant not to sue granted to eliminate standing in a declaratory judgment action for invalidity or non-infringement of the covenanted patent. Another example is in the licensing context, where the patentee provides a license for one field of activity while providing a limited covenant in another field. In both cases, the patent owner uses a covenant not to sue, rather than a license, in order to reserve its patent infringement remedies against unlicensed use by third parties, while securing peace with others.

In *TransCore*, however, the Federal Circuit has taken the next step in the expansion of the exhaustion doctrine. Addressing ETC's defense, the Federal Circuit concluded that activity under an unconditional covenant not to sue is activity "authorized by the patent holder." As a result, Mark IV's sales of the toll collection system exhausts TransCore's related patent rights, to the same extent as if Mark IV had manufactured and sold the system under a patent license, rather than a covenant not to sue.

Furthermore, the Federal Circuit reached this ruling irrespective of the intentions of TransCore and Mark IV. Although TransCore provided evidence of the intent to limit rights to downstream customers, the Federal Circuit opined that "the

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parties' intent with respect to downstream customers is of no moment in a patent exhaustion analysis." *TransCore* at 5 (citations omitted). Instead, "[t]he only issue relevant to patent exhaustion is whether Mark IV's sales were authorized, not whether TransCore and Mark IV intended, expressly or impliedly, for the covenant to extend to Mark IV's customers." *Id.* at 9 (citations omitted).

This decision is a watershed in the law of patent licensing, guaranteed to dramatically change existing patent license agreements, covenants granted to secure settlement of litigations, and the future relations between licensors and licensees.

How this Ruling Affects You

You should be aware of the potential impacts this ruling will have on your company's existing and future patent license agreements. There are potential adverse effects to licensors and licensees. In evaluating the impact of this ruling upon your patent interests, consider:

- Do you have agreements to provide or receive rights under patents?
- Do those agreements include covenants not to sue?
- Have you ever settled a patent infringement action, whether as patent holder or defendant, by entering into a covenant not to sue?
- Do you purchase patented components? Are those components subject to field of use, market, or other limitations on how you may dispose of (or use) the products?

We recommend that everyone, patentee and licensee alike, revisit and consider the continuing validity of existing patent licenses and supply relationships.

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