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Patent Law

ALERT

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Federal Circuit Rules That an Unconditional Covenant Not To Sue Authorizes Sales For Purposes of Patent Exhaustion

On April 8, the U.S. Court of Appeals for the Federal Circuit ruled that sales under an unconditional covenant not to sue are “authorized” for purposes of the patent exhaustion doctrine. *TransCore, LP, et al. v. Electronic Transaction Consultants Corp.*, No. 2008-1430. The court reasoned that the difference between an unconditional covenant not to sue and a license “is only one of form, not of substance – both are properly viewed as ‘authorizations.’” *Id.* at 7.

The TransCore opinion follows the U.S. Supreme Court address of patent exhaustion last term in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 128 S.Ct. 2109, 2115 (2008). There, the Supreme Court held that in the context of patent rights, the exhaustion doctrine, sometimes also referred to as the “first sale doctrine,” dictates that an initial authorized sale of a patented item terminates, or “exhausts,” all patent right to that item.

Exhaustion of rights is a concept generally applicable to all areas of intellectual property, including patent, trademark and copyright law, whereby an intellectual property owner will “exhaust” certain rights in a work or product after the first authorized copying, use or sale of the subject work or product. For example, in the context of trademarks, once a trademark owner has authorized the sale of a product bearing the trademark owner’s mark, the trademark owner’s right to control or restrict subsequent sales of that trademarked product is “exhausted” following the initial authorized sale of that product. Similarly, in the context of copyrighted works, while the proper owner of a copy of a third party’s work may not make copies of the work, the third party author may not control or restrict the owner of

the copy from subsequently selling the copy of which he is the authorized owner (e.g., second-hand bookstores).

TransCore’s patents at issue were directed to automated toll collection systems (e.g., E-ZPass). In 2000, TransCore sued a competitor, Mark IV Industries, for patent infringement. That suit was settled pursuant to a settlement agreement in which TransCore, in exchange for payment, “agrees and covenants not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement of any of [a list of patents] ... for the entire remainder of the terms of the respective United States Patents and their foreign counterparts.” *Id.* at 2. A release of claims existing as of the agreement date was also granted, however no “express or implied license or future release whatsoever is granted to MARK IV or to any third party by this Release.” *Id.* at 2-3.

Several years later, the defendant, ETC, won a bid and agreed to set up and test toll-collection systems purchased by the Illinois State Toll Highway Authority (ISTHA) from Mark IV. TransCore sued ETC for infringement of several of its toll collection system patents.

The district court granted summary judgment to ETC finding that ETC’s activities were permitted by the TransCore-Mark IV settlement agreement, and dismissed TransCore’s claims. The Federal Circuit affirmed.

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On appeal, the Federal Circuit stated the question for the court was “whether an unconditional covenant not to sue authorizes sales by the covenantee for purposes of patent exhaustion. We hold that it does.” *Id.* at 4.

TransCore argued that sales under a covenant not to sue are not “authorized” sales that would result in exhaustion of patent rights. The Federal Circuit answered that since “one cannot convey what one does not own[,] ... the grant of a patent does not provide the patentee with an affirmative right to practice the patent but merely the right to exclude It follows, therefore, that a patentee, by license or otherwise, cannot convey an affirmative right to practice a patented invention ...; the patentee can only convey a freedom from suit.” *TransCore*, pp. 5-6.

The court pointed out that the Federal Circuit and its predecessors have on numerous occasions found that a non-exclusive patent license is equivalent to a covenant not to sue. Thus, the ultimate question for the court was not *whether* the TransCore-Mark IV settlement agreement authorized any conduct, but *what* the agreement authorized. The court concluded that the unrestricted covenant set forth in the settlement agreement did, in fact, authorize **sales**, and thus TransCore’s patent rights are exhausted.

In view of the *TransCore* opinion, patent owners will now need to more carefully craft covenants not to sue, where possible, to include appropriate restrictions to try to avoid

a similar outcome. For instance, perhaps TransCore could have agreed “not to bring any demand, claim, lawsuit, or action against Mark IV for future infringement of any of [the subject patents] ... for the entire remainder of the terms of the respective United States Patents and their foreign counterparts. This Covenant Not To Sue shall not apply to **any products or services that have been sold by or on behalf of Mark IV**” under specifically negotiated terms and conditions.

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