

# Patent Exhaustion, Implied License and Contributory Infringement

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On March 22, 2017, the Beijing IP Court (the "trial court") issued a decision on a high-profile case *Iwncomm v. Sony* concerning infringement of a standard essential patent (SEP). This case has drawn extensive attention in China's IP community because it is the first SEP-based injunction granted by a Chinese court, and it involves quite a few issues lack of clarifications in the patent practice, such as patent exhaustion, implied license, contributory infringement, and divided infringement on multi-step claims. This article provides a brief discussion on the case and these issues. We will discuss the latest development of SEP in China in a separate blog.

## 1. Background

WLAN Authentication and Privacy Infrastructure (WAPI) is a Chinese national standard for wireless local area network (WLAN). It is the Chinese counterpart to WiFi and is officially supported by the Chinese government. The WAPI standard is a mandatory testing criteria for all mobile devices sold in China.

Iwncomm (also known by its Chinese name Xidian Jietong) owned a WAPI-related SEP ("WAPI Patent") on a method for the secure access of mobile terminal to WLAN and for secure communication via wireless link, which is achieved with the participation of a mobile terminal (MT), an access point (AP) and an authentication server (AS).

Iwncomm entered into a contract with Qualcomm, authorizing Qualcomm to make and sell chipsets using Iwncomm's copyrights and technical secrets for implementing the WAPI standard. The contract did not expressly authorize Qualcomm to use Iwncomm's WAPI Patent.

Sony purchased chipsets from Qualcomm and proceeded to manufacture mobile phones with WAPI module containing the chipsets. Sony was sued by Iwncomm for direct infringement of the WAPI Patent for testing the WAPI functionality of its handset products during R&D, manufacture process and pre-delivery inspection; and sued for contributory infringement for manufacturing and selling MT (the WAPI module of handsets), which jointly infringes the WAPI Patent together with AP and AS, and assists infringement by providing an indispensable device for others to practice the WAPI Patent.

The trial court found that Sony willfully infringed Iwncomm's WAPI Patent because Sony intentionally delayed to reach a FRAND license with Iwncomm by raising unreasonable requirements during negotiations, and awarded a permanent injunction and about RMB 9 million (USD 1.3 million) in damages (3 times of royalty rate Sony granted to third party licensees).

Sony will highly likely file an appeal. We will follow up with the appeal status and may provide updates when appropriate.

## 2. Patent Exhaustion Does Not Apply to Method-of-Use Claims?

Sony made a defense of patent exhaustion. Sony argued that the asserted patent was exhausted because (1) the testing device it used in pre-delivery testings was sold by Iwncomm, and (2) the chips it purchased from Qualcomm for making the WAPI module were destined to be used in conformity with the WAPI Patent and had no other reasonable non-infringing use.

The trial court found that the exhaustion doctrine does not apply to method-of-use claims because the Chinese Patent Law only explicitly provides exhaustion for product claims and product-by-process claims (products directly obtained through a patented process). The trial court held that the Article 69 of the Chinese Patent Law is the legal basis for patent rights exhaustion in which only product-by-process claims are literally provided, and that the silence on whether exhaustion applies to method-of-use claims indicated that the legislators never intended to exhaust method-of-use claims. The trial court, therefore, dismissed Sony's exhaustion defense.

We have not identified any written rules excluding the application of exhaustion doctrine on method-of-use claims, or any case precedent discussing whether method-of-use claims are covered by the exhaustion defense. The trial court's position is a bit cursory, without a sufficient and persuasive reasoning. We also noted that such position seems contradictory to existing regulations. Article 131 of the *Guideline for Patent Infringement Determination* (2017) ("Guideline") issued by the Beijing High Court provides that "after the patentee of a patented method or its licensee sells an equipment specially used for exploiting the patented method, anyone using the equipment to exploit this patented methods shall not be deemed as infringement of the patent rights", indicating that the exhaustion doctrine applies to patented methods regardless whether it is a method-of-use claim or a product-by-process claim.

In addition, before reaching a negative conclusion, the court need to consider the legislative purpose and the policy rationale underlying the exhaustion doctrine, instead of narrowly interpreting the statute from its literal meaning. Our understanding of the rationale for patent exhaustion is that once the patentee has received all the royalty or consideration from the sale of a patented item, the patentee relinquishes its monopoly with respect to the item sold and may not impose further restrictions on the purchaser. Following this understanding, we think patent exhaustion should apply to method-of-use claims as long as the patentee has received full consideration for the value of its patent by selling a device specially designed for the patented method or authorizing a third party to manufacture and sell chipsets especially used for implementing the patented method. Considering from a different perspective, the exhaustion doctrine, if not applicable to method-of-use claims, could easily be evaded by drafting an apparatus claim in the method format.

In particular, a method-of-use claim is exhausted by the authorized sale of an item if: (i) the only reasonable and intended use of the item is to practice the patented method; and (ii) the item covers all the inventive aspects of the patented method. If both factors are satisfied, the full value of the patented method is embodied by the item and the patent is exhausted through the sale of the item. Such an analysis approach is similar to the U.S. Supreme Court's reasoning in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617 (2008).

To investigate the second element, a court should first identify all the inventive features which distinguished the patent from the prior art, based on a review of the claim's language, specification and prosecution history. If the court determines that all inventive features are included in an accused product, then exhaustion shall be triggered by the patentee's direct or authorized sale of the accused product. The two-prong test has never been tried by any Chinese courts, including the Beijing IP Court in the present case, where the first element has been obviously met. Neither party contended that the only reasonable and intended use of the testing device and the chipsets was to practice the WAPI Patent. Nevertheless, the first element is concluded in the Beijing High Court's Guideline. It will be interesting to see how the appellate court, the Beijing High Court, will deal with the question in this regard.

## 3. Implied License May be A Viable Defense?

It is worth noting that neither Sony nor the trial court raised the implied license theory during the first instance proceeding, but we think implied license may be a better alternative to deal with the patent exhaustion issue.

The implied license defense is typically presented where a patentee sells a product without an express disclaimer and the use of that product necessarily involves a patented method. The patentee may have unintentionally granted the purchaser an implied license to practice the patented method. Precedents show that, Chinese courts have set forth two requirements for the grant of an implied license. First, the product involved must have no non-infringing uses. *Jiansu Microorganism Institute Co., Ltd. v. Fuzhou Haiwang Fuyao Pharmaceutical Co., Ltd.*, the Supreme People's Court (2011). "If the sole reasonable commercial use of the product is for use in implementing the patent, the sale of the product by the patentee or licensee means an implied license for practicing the patent by the purchaser." Id. Second, the patentee or licensee places no express restriction on the purchaser's use or sale of the product. *Founder v. P&G*, the Beijing No.11 Intermediate Court (2011). The two-prong test was included in the *Guide of Determining Patent Infringement* published by the State Intellectual Property Office (SIPO) in 2016.

In the present case, Sony may argue that Iwncomm's sale of the testing device especially for practicing the WAPI Patent constitutes an implied license for the purchaser to use such device in practicing the WAPI Patent. Sony may also argue that, under the authorization of Iwncomm, Qualcomm's sale of the chipsets that are undisputed to have no non-infringing use, also amounts to an implied license. However, because relevant facts were not clarified in the case, there are uncertainties in the second argument. The trial court identified that Qualcomm has Iwncomm's authorization to use its copyrights and technical secrets to manufacture and sell the WAPI chipsets, but received no express license to use or otherwise dispose the chipsets free of Iwncomm's patented method. It is also unclear whether the contract between Iwncomm and Qualcomm contains any provision requiring Qualcomm to acquire a license to the WAPI Patent for its own use or give written notices to its downstream purchasers that Iwncomm had not licensed those purchasers to practice the patent at issue.

## 4. Contributory Infringement v. Divided Infringement

Iwncomm maintained that Sony engaged in contributory infringement by supplying MT (mobile phones) and facilitating its customers' use of the WAPI function. Under the Chinese law, to establish contributory infringement, a patentee must show that (1) a component is specially designed for a patented product or method and has no substantial non-infringing use, and (2) the accused contributory infringer knowingly provides the component to a third party for the purpose of making infringing products or practicing the patented method.

Before evaluating the two requirements, a commonly accepted practice is that, there must be a direct infringement in order to establish contributory infringement. In this regard, the trial court's position is a bit novel and vague, reasoning that a finding of indirect infringement is predicated upon first finding that certain entity has practiced the patent but is not necessarily responsible for direct infringement. For example, the end user of mobile phones could be such an entity, who himself is not liable for infringement because his use is deemed non-commercial and exempted from infringement liability under the Chinese Patent Law. The trial court then found that the WAPI module of Sony's mobile phones had no substantial use except to implement the disputed patent, and that Sony had knowledge of the patent's existence. As a result, the trial court held that Sony's provision of such mobile phones to end users constituted contributory infringement.

The trial court's opinion on direct infringement is questionable. The trial court did not make it clear on whether the WAPI Patent was practiced by one single entity or collectively performed by multi-actors. Our understanding is that, no any single entity, neither the end user nor the provider of MT, AP and AS has performed all the steps of the WAPI Patent. If this understanding is correct, the pre-condition for finding contributory infringement is missing in the present case, and the court shall determine infringement liability of each entity based on the so-called divided infringement.

Divided infringement refers to a situation where multiple actors collectively practice all steps of a patented method, but no single person or entity has performed all the steps in the claim. In that case, no direct infringement occurred and therefore there is no indirect infringement. According to the Chinese Tort Liability Law, the entities collectively performing the patent shall be at joint fault (with joint actual or constructive knowledge) of infringement. In the present case, however, all involved parties, the end user and the providers of MT, AP and AS, are doing their own part without any communication or liaison of intention.

If we consider the agency theory, the end user might be viewed as the single party who has performed the entire steps of the WAPI Patent. Under the agency theory, if a party controls or directs the entire process, and

every step could be attributable to the controlling party, then the controlling party should be liable for direct infringement even if it does not itself perform all of a patent's steps.

#### 5. Comments

Though the above court judgment leaves a few question marks, it is an interesting decision worthy of further follow-ups. Over the past five years, especially since the establishment of the three IP-specialized Courts, China has been aggressively advancing its own intellectual property system. China is now becoming a top patent litigation forum for patent owners from western countries, and Beijing is to China what the Eastern District of Texas is to the U.S. The Beijing IP Court deals with the most complicated and hottest patent law issues from China and other parts of the world. While some of the Beijing IP Court's finding may be debatable, they show China's strong determination in patent enforcement. We look forward to learning how the appellate court would clarify these issues in this case.