

United States

The future of patent exhaustion after *Quanta*

It has been several months since the US Supreme Court issued its unanimous opinion in *Quanta Computer, Inc v LG Electronics, Inc* (June 9 2008) and the implications for patent holders continue to reverberate. In *Quanta*, the court reiterated the principle that once a patentee has authorised the sale of goods or services, it is not entitled to obtain a second payment for the same patented items.

Understanding the history of the case and the Supreme Court's holding will help those licensing intellectual property to manage future transactions more effectively, particularly in a climate that is likely to be more difficult for patent holders to claim infringement downstream.

Background

LG Electronics, Inc owns various patents for technology relating to systems and methods that combine, for example, microprocessors and chipsets with memory chips. LG licensed those patents to Intel Corporation to manufacture and sell microprocessors and chipsets that use the LG system and method patents.

The licensing agreement between LG and Intel prohibited Intel's customers from combining the licensed Intel microprocessors and chipsets with non-Intel components. In a separate master agreement, Intel agreed to provide notice of this prohibition to its customers.

Those customers – Quanta Computer, Inc and other companies – purchased microprocessors and chipsets from Intel. They received the notice required by the master agreement, but manufactured computers using Intel parts in combination with non-Intel components in ways that practise LG's system and method patents.

Northern District of California decision

LG sued Quanta in the US District Court for the Northern District of California claiming that Quanta violated its patents when it combined Intel components with those of

other manufacturers. The court applied the doctrine of patent exhaustion, also called the first sale doctrine, which mandates that an IP owner can charge a licence fee only once per object and therefore controls only the first sale of a protected object. It granted summary judgment to Quanta, holding that LG's system patent claims were exhausted, but later held that its decision did not apply to the three method patents at issue.

Federal Circuit decision

The Court of Appeals for the Federal Circuit reversed.

It concluded that the exhaustion doctrine did not apply to the conditional licence between LG and Intel because:

- the licence expressly disclaimed granting any licence to computer system manufacturers purchasing from Intel to combine the licensed parts with non-Intel products; and
- Intel notified its customers of the limited scope of the licence.

Therefore, the court concluded that while Intel could sell the licensed products, those sales were conditional and Intel's customers were barred from using LG's patents.

It also affirmed the district court's holding that LG's method claims were not exhausted on the same grounds, holding that "the sale of a device does not exhaust a patentee's rights in its method claims".

The Supreme Court

Quanta's arguments

Quanta sought reversal of the Federal Circuit's opinion on two grounds.

First, it argued that an authorised sale of a product that embodies essential features of the patent and has no reasonable non-infringing use exhausts the patent rights. Quanta highlighted that those customers who purchased

Intel's microprocessors and chipsets were likely to combine them with generic memory and other products. Since they had no other reasonable use, LG's rights must be exhausted.

Second, Quanta argued that method claims are subject to the same exhaustion principle if the method is to be practised by the only reasonable use of the sold item.

Numerous third parties filed briefs in support of Quanta, including the solicitor general of the United States, Dell, IBM and Motorola.

Quanta stressed that since the Supreme Court's 1942 decision in a case involving the production of eyeglass lenses, it is well established that the authorised sale of an item manufactured under patent protection exhausts all patent claims, regardless of limitations placed on the subsequent use and enjoyment of the article.

LG's arguments

LG countered with four principal arguments:

- The patents at issue were independently patentable inventions relative to the components that were sold.
- A sale of the patented components did not constitute a sale of the patented systems. In fact, LG argued that the exhaustion doctrine has never been "held to state that the sale of a patented article exhausts a patent holder's rights in independently issued patents, beyond the one that claims the invention embodied by the article sold". It claimed that the result would not change if the patented article's sole use were in a separate system.
- The effect of a sale of an article on separate patents is determined by an implied licence that "focuses on the conduct and intent of the parties". However, in this case an implied licence did not exist.
- The exhaustion doctrine does not apply to method patent claims because "rights in a process patent are not linked to a tangible article but, rather, represent the means by which a particular task is accomplished or item is produced".

Oral argument

During oral argument on January 16 2008 there was discussion of whether the issue of patent exhaustion is a patent, contract or antitrust concern. In its precedent-setting 1942 decision, the court raised the issue of antitrust concerns associated with limiting subsequent use of an item sold by a patent holder. Both Chief Justice Roberts and Justice Breyer questioned the contractual elements inherent in exhaustion. Breyer actually used the analogy of selling patented bicycle pedals during a discussion of implied licences. Roberts seemed

persuaded by the idea that a patentee could restrict later use by an appropriate condition in the licence.

Decision

In its June 9 2008 decision the Supreme Court reversed the Federal Circuit.

First, the court held that the exhaustion doctrine applies to method patents because "methods nonetheless may be 'embodied' in a product, the sale of which exhausts patent rights". The court cautioned that if it eliminated exhaustion for method patents, patent prosecutors would simply submit applications that described a method, rather than an apparatus.

Second, it held that "[t]he 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 postsale use of the article". Here, Intel's microprocessors and chipsets substantially embodied the LG patents because they had no reasonable non-infringing use and merely required common processes or the addition of standard parts.

In general terms, the court explained that: "The sale of a device that practices patent A does not, by virtue of practicing patent A, exhaust patent B. But if the device practices patent A *while substantially embodying* patent B, its relationship to patent A does not prevent exhaustion of patent B."

Third, it held that Intel's sale to Quanta was within the scope of the licence agreement between Intel and LG. Intel's authority to sell its products embodying the LG patents was not conditioned on the notice to Intel's customers or on that customer's decision to abide by LG's restrictions. The court stated that "exhaustion turns only on Intel's own license to sell products practicing the LGE patents".

Moving forward

In its *amicus* brief supporting Quanta, the Office of the Solicitor General argued that after an authorised sale of an article embodying the invention, a patentee cannot enforce restrictions on use or resale by means of patent law. The brief concluded that whether the patentee can place enforceable downstream restrictions "turns on contract, not patent, law".

While the court alluded to this issue, it expressed no opinion as to whether LG was entitled to damages for breach of contract. However, the discussion does raise the possibility that patent holders interested in limiting the potential for exhaustion might explore contractual options.

Although the court found that the licence agreement between Intel and LG did not adequately limit what Intel sold, it did not suggest alternative language. That

language may be difficult to craft because contract law requires a direct relationship between the parties, which generally does not exist with downstream users.

Accordingly, patent licensors and licensees will likely pay closer scrutiny to early stage documents and agreements to avoid any later stage confusion.

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