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INTELLECTUAL PROPERTY

Patent exhaustion revitalized?

Supreme Court's 'Quanta' ruling continues recent trend of narrowing rights of patentees.

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ON JUNE 9, the U.S. Supreme Court ruled unanimously in *Quanta v. LG Electronics*, 128 S. Ct. 2109 (2008), to extend the patent exhaustion doctrine to authorized sales of items that substantially embody the essential features of a patented method or combination. Specifically, the court ruled that LG Electronics Inc. could not enforce its patented method claims against Quanta Computer Inc.

Quanta had purchased microprocessors and chip sets from Intel Corp., LG's authorized licensee, and combined those microprocessors and chip sets with other non-Intel components in a manner that practiced LG's patents. Despite the fact that Intel had notified Quanta that it had no license from LG to combine the microprocessors and chip sets with other non-Intel products, the Supreme Court found that the sale itself to Quanta was authorized and unconditional, and therefore exhausted all patent rights LG had as applied to those items. The decision reversed the U.S. Court of Appeals for the Federal Circuit's holding that the exhaustion doctrine did not apply to method claims.

The *Quanta* decision continues a trend in recent years of Supreme Court rulings that narrow the rights and protections afforded patent owners, and is itself significant because it will make it more difficult for patent owners to control downstream use of an item covered by a patent, or to exact a royalty at multiple points in the supply chain.

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However, the Supreme Court expressed no opinion on whether LG could have recovered on a breach-of-contract claim. And the court reiterated that the exhaustion doctrine does not apply to conditional sales. In theory, therefore, patent owners can still avoid exhausting their patent rights through carefully crafted language in licensing or purchase agreements.

PATENT

Patent exhaustion explained

The patent exhaustion or "first-sale" doctrine is intended to prevent excessive restraints on free trade by limiting a patentee's exercise of its monopoly rights to authorized first sales of a patented item. Under the exhaustion doctrine, once such a sale has occurred, a patentee can no longer control or demand additional royalties from the subsequent use or sale of that item.

While the exhaustion doctrine is simply stated, its practical application posed two questions the court had to answer in the *Quanta* case: First, what constitutes an "authorized" first sale sufficient to trigger exhaustion? Second, how closely must the item sold match the patent claims to trigger exhaustion? In particular, if the patented technology is not a single tangible item, but instead an intangible method, how, if at all, should exhaustion apply?

Once a sale occurs, patentee can't ask for more royalties.

Prior to *Quanta*, the Federal Circuit—the appellate court with exclusive jurisdiction over patent appeals—had answered those questions largely in favor of patentees. Under Federal Circuit precedent, only the unconditional first sale of a patented item would trigger exhaustion. Patentees were able to avoid exhaustion of their patent rights by attaching conditions to sales of patented items, provided that those conditions did not rise to the level of antitrust violations or patent misuse. Examples of conditions that have been upheld include field-of-use restrictions and single-use restrictions. *Monsanto Co. v. Scruggs*, 459 F.3d 1328 (Fed. Cir. 2006); *Mallinckrodt Inc. v. Medipart Inc.*, 976 F.2d 700 (Fed. Cir. 1992).

Further, the Federal Circuit had ruled that exhaustion could not apply to patents that claim a method as opposed to a tangible apparatus. *Bandag Inc. v. Al Bolser's Tire Stores Inc.*, 750 F.2d 903, 924 (Fed. Cir. 1984).

Background and arguments

LG is the owner of a portfolio of patents concerning personal computers. Under a cross-licensing agreement, LG authorized Intel to sell microprocessors and chip sets that use LG's patents. The license agreement expressly disclaimed any implied license to Intel's customers to combine those microprocessors and chip sets with other non-Intel components. Further, a separate master agreement between LG and Intel required Intel to give notice to its customers that its license from LG did not permit them to combine Intel components with non-Intel products.

Quanta purchased microprocessors and chip sets from Intel and received the notice required by the master agreement, but combined the items with other non-Intel products anyway. In 2001, LG sued Quanta and asserted that Quanta's combination of Intel components with non-Intel components infringed certain method and systems claims in LG's patents covering the combination. Quanta denied infringement on the grounds that the sale of the microprocessors and chip sets had exhausted all of LG's patent rights.

The U.S. District Court for the Northern District of California, relying on Federal Circuit precedent, found the exhaustion doctrine applicable to the system claims, but not the method claims. *LG Electronics Inc. v. Asustek Computer Inc.*, 65 U.S.P.Q. 2d 1589, 1593, 1600 (N.D. Calif. 2002); *LG Electronics Inc. v. Asustek Computer Inc.*, 248 F. Supp. 2d 912, 918 (N.D. Calif. 2003).

On appeal, the Federal Circuit found the exhaustion doctrine inapplicable to either the system claims or the method claims. *LG Electronics Inc. v. Bizcom Electronics Inc.*, 453 F.3d 1364, 1370 (Fed. Cir. 2006). The Federal Circuit found that Intel's sale to Quanta was conditional, that Quanta had purchased Intel components subject to that condition and that the exhaustion doctrine therefore was inapplicable to any of LG's patent claims. The Federal Circuit also held that the sale of a device could not, in any case, exhaust LG's rights in the method claims.

Supreme Court held exhaustion applies to method claims, too.

Quanta then appealed to the Supreme Court and advanced three main arguments:

- Notwithstanding the notice requirement in the master agreement between Intel and LG, Intel's sales were authorized and unconditional, and the exhaustion doctrine therefore should apply.
- The exhaustion doctrine should be triggered by the authorized sale of components and incomplete articles that embody the essential features of a patented combination invention.
- The exhaustion doctrine should apply to method claims because otherwise patentees could avoid exhaustion simply by including method claims in all patents.

LG countered principally with the following arguments:

- The notice required by the master agreement, and provided to Quanta, imposed a valid condition on Intel's customers not to create a separately patented system using Intel components. Accordingly, Intel's sales were conditional, and thus insufficient to trigger exhaustion.
- Exhaustion, as a matter of law, cannot apply to method claims. As opposed to an apparatus, which is a tangible article whose economic value derives solely from its manufacture, a method's value lies in its use, and therefore cannot be exhausted by sale.
- Although the sale of a component may exhaust a patentee's rights to the component itself, it does not exhaust the right to make anew a separately patented system incorporating the component.

On June 9, the Supreme Court ruled unanimously in Quanta's favor in a decision written by Justice Clarence Thomas.

Methods claims were exhausted

First, the Supreme Court rejected the argument that method claims, as a matter of law, cannot be exhausted. Instead, Thomas' opinion asserted that "[o]ur precedents do not differentiate transactions involving embodiments of patented methods or processes from those involving patented apparatuses or materials," and that method claims indeed can be exhausted by the sale of an item embodying the patented method. *Quanta Computer Inc. v. LG Elecs. Inc.*, 128 S. Ct. at 2117.

To hold otherwise, Thomas wrote, would enable patentees to evade the exhaustion doctrine "[b]y characterizing their claims as method instead of apparatus claims, or including a method claim for the machine's patented method of performing its task." Id. at 2118.

The court held that patent rights, whether to a method or apparatus, are exhausted by the first sale of an item, provided that the item sold "substantially embodies" the claimed invention and that the sale is authorized. As to the first prong, Thomas noted that the microprocessors sold by Intel to Quanta had no reasonable use other than in practicing the invention defined by the claims of LG's patents. Moreover, the microprocessors themselves included all inventive aspects of the asserted patent claims, and required only combination with common processes or standard parts to practice the invention.

As to the second prong, the Supreme Court held that nothing in the agreement between LG and Intel "restricts Intel's right to sell its microprocessors and chip sets to purchasers who intend to combine them with non-Intel parts." Id. at 2121. Although Intel was obligated under its agreement with LG to notify its customers that its license did not permit them to combine Intel components with non-Intel components, LG did not contend that the notice requirement was ever breached, and Intel's right to sell licensed components was not conditioned upon the compliance of Intel, or its customers, with the terms of the notice. Id. at. 2121-22.

Court acknowledged conditional sale won't trigger exhaustion.

The most obvious implication of the *Quanta* decision is that it puts method and apparatus claims on equal footing as concerns the exhaustive effect of the first sale of an item that "substantially embodies" a patent claim. Accordingly, the sale of an item that embodies a patented method will exhaust those patent rights. A patentee who wishes to control the post-sale use of an apparatus, or secure an additional royalty for a particular post-sale use, can no longer rely on a method claim to do so.

Unanswered questions

The decision did, however, leave unanswered some questions as to the reach of the exhaustion doctrine in the future. For example, it remains an open question whether the requirement that the item sold "substantially embody" the claimed invention will be met if the item incorporates only some of the inventive aspects of the patented invention, but has no reasonable noninfringing use. (e.g., a single specialized engine part that requires other specialized parts to complete a functioning engine comprising the patented system). Conversely, *Quanta* did not address the case in which the item sold embodies the inventive aspects of the patented invention (a specialized engine, to be used in the patented method of propelling a car) but nevertheless is capable of a reasonable noninfringing use (the same engine, to be used in propelling a boat).

Perhaps more importantly, the Supreme Court acknowledged that a conditional sale will still not trigger exhaustion. Further, the court expressly declined to consider whether LG Electronics could have recovered under a breach-of-contract theory. The *Quanta* decision simply held that the notice requirement in the master agreement and the disclaimer in the license agreement itself did not amount to a condition on the sale from Intel to Quanta. Presumably, a more explicit condition would have avoided exhaustion.

For example, LG could have required Intel to take steps to ensure that its customers did not violate the restriction on non-Intel combinations. LG could have insisted that all Intel sales include in the purchase agreement a commitment by the customer to abide by the restriction on non-Intel combinations. LG could further have provided that any failure in the operative agreement to meet these or other obligations would result in the express termination of the license, rendering the sales unauthorized under LG patents and thus insufficient to trigger exhaustion.

Whether these or other measures would be acceptable to licensees, distributors and customers is, of course, another question. As a practical matter, patentees may have to respond to *Quanta* by negotiating larger up-front royalties for their method and system patents from the first purchaser or licensee in the supply chain. NLJ