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Supreme Court Issues Ruling on Patent Exhaustion in *Quanta v. LG Electronics*

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On June 9, 2008, the U.S. Supreme Court issued its eagerly awaited decision in *Quanta Computer, Inc. v. L.G. Electronics, Inc.*, U.S. Supreme Court No. 06-937 (June 9, 2008). In a unanimous decision delivered by Justice Thomas, the Court reversed the Federal Circuit's decision below and held that an authorized sale of components that are later combined with other components to form a patented system and to practice patented methods results in exhaustion of all patents, including system and method patents, that are substantially embodied in those components. The Court also clarified that a mere notice to customers regarding limited rights as to patents is not effective to avoid patent exhaustion that otherwise results from authorized sales to those customers.

The Supreme Court's ruling clarifies important questions in an area of law marred by uncertainty. The decision provides clearer guidelines to system vendors and other downstream users trying to assess the risk of patent infringement when purchased products are put to their intended use, as well as to sellers of products (and their licensors) seeking clarity as to what extent a sale may result in patent immunity for downstream users. However, the decision leaves some important questions unanswered and does not remove the need for suppliers and purchasers to analyze carefully remaining infringement risks. The decision will also leave patent holders and licensees considering possibilities for limiting or avoiding the effect of patent exhaustion.

Background

At the heart of the *Quanta* case lie fundamental questions concerning the patent exhaustion doctrine, the "conditional sale" principle, and the implied license doctrine. In recent years, a growing number of decisions by both the Federal Circuit and district courts have inconsistently applied and occasionally conflated these legal principles, resulting in significant legal uncertainty. In particular, the courts have failed to provide clear guidance as to how the doctrines should be applied in cases where a purchased product (whether itself patented or not) is used by the buyer in practicing a method or incorporating the product into a system and the seller (or the seller's licensor) owns patents covering such method or system.

Generally speaking, the patent exhaustion or "first sale" doctrine states that once a patentee has sold a product covered by a patent, the patentee cannot use the patent to prevent the purchaser from using or reselling that product. The patentee's rights to restrict use and further sale are said to be "exhausted."[1] Courts have further held that the "longstanding principle [of patent exhaustion] applies similarly to a sale of a patented product manufactured by a licensee acting within the scope of its license."[2] Consequently, for exhaustion purposes, the "first sale" may be a sale by the patentee or by a third party authorized to sell by the patentee.

Often with the goal of creating additional revenue streams, whether from downstream customers or with respect to different uses of a product, patentees in many industries have tried to limit the effect of the patent exhaustion doctrine by imposing limitations or conditions on purchasers. In its

controversial decision in *Mallinckrodt, Inc. v. Medipart, Inc.*,[3] a case involving a "single use" restriction on a patented medical device, the Federal Circuit established the so called "conditional sale" principle, holding that a seller may limit the applicability of the exhaustion doctrine by placing conditions on the sale of patented products. Remanding the case, the Federal Circuit instructed the district court that, if the sale of the devices was "validly conditioned under applicable law such as the law governing sales and licenses," there is no exhaustion as to uses restricted by the condition and a violation of the condition may be remedied by an action for patent infringement.[4] It remained unclear, however, when exactly a sale could be said to be "validly conditioned."

Absent a valid condition, the exhaustion doctrine clearly applies to apparatus patents covering the product sold. In other cases, however, the law has been less clear, especially where products or components are sold that are not themselves covered by the patents at issue, but are subsequently used by the purchaser in practicing a process covered by a patent of the seller, or where the purchaser combines the product or component with other elements in a system, and the system is covered by a patent of the seller. While some courts have relied on the implied license doctrine to analyze such cases, others, mostly relying on *United States v. Univis Lens Co.*,[5] have applied the patent exhaustion doctrine where the component sold "embodie[d] essential features of [the] patented invention."[6]

Technological developments, changing patent prosecution strategies, and evolving licensing practices have resulted in increasing uncertainty regarding the scope of the exhaustion and implied license doctrines and their relationship to each other. However, the distinction has important consequences, particularly with respect to the requirement of the absence of non-infringing uses[7] and the patentee's ability to avoid the consequences of exhaustion or an implied license.

The Underlying Agreements and the Decisions Below

LG Electronics ("LGE"), the plaintiff in the *Quanta* case, owned several patents claiming various aspects of data processing systems and methods performed therein. LGE had licensed Intel to make and sell microprocessors and chipsets that use LGE's patents. The LGE-Intel license expressly stipulated that no license was granted "to any third party for the combination by a third party of Licensed Products…with [non-Intel components]." A separate master agreement required Intel to notify its customers that the license "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product," which Intel did by sending a letter to that effect to its customers. Breach of the master agreement, however, was not grounds for termination of the license agreement. Quanta and the other defendants, that had received the letter, subsequently purchased microprocessors and chipsets from Intel and used them in computer systems by combining them with non-Intel memory and buses. LGE brought suit against the defendants, alleging that the combination of the Intel products with other components in the defendants' computer systems and the operation of such systems infringed LGE patents. LGE did not allege infringement with respect to the microprocessors or chipsets themselves.

The district court held that LGE's rights under its system patents were exhausted as a result of Intel's authorized sale of the microprocessors and chipsets. The court acknowledged that LGE could have avoided exhaustion if the microprocessor and chipset sales had been "conditional sales," but found that the defendants' purchase "was unconditional, in that [their] purchase of microprocessors and chipsets from Intel was in no way conditioned on their agreement not to combine the Intel microprocessors and chipsets with other non-Intel parts . . . ."[8] Specifically, the letter sent by Intel to its customers could not, according to the court, "transform what would otherwise be the unconditional sale of the microprocessors and chipsets into a conditional one."[9]

The Federal Circuit, like the district court, analyzed the issue of infringement of LGE's system patents under the patent exhaustion doctrine (and not the implied license doctrine). The Federal Circuit, however, reversed the district court's holding that LGE's patent rights were exhausted as a result of Intel's sale of the microprocessors and chipsets. Specifically, the Federal Circuit rejected the district court's conclusion that the purchase of the microprocessors and chipsets from Intel was unconditional. The court found that while "Intel [under the LGE-Intel license] was free to sell its microprocessors and chipsets, those sales were conditional, and Intel's customers were *expressly* prohibited from infringing LGE's combination patents."[10]

The Federal Circuit's holding amounted to a significant erosion of the concept of a "conditional sale" as articulated in *Mallinckrodt*. In *Mallinckrod*, the Federal Circuit held that patent exhaustion may be avoided "[i]f the sale . . . was validly conditioned under the applicable law such as the law governing sales and licenses." As recently as 2001, in *Jazz Photo*, the Federal Circuit stated that a conditional sale requires a contractual agreement between the parties to that effect, explaining that instructions

and warnings on the covers of patented cameras were "not in the form of a contractual agreement by the purchaser to limit reuse of the cameras" and that there "was no showing of a 'meeting of the minds' whereby the purchaser . . . may be deemed to have breached a contract . . . to a single use of the camera."[11]

In *LG Electronics*, however, the Federal Circuit failed to explain how Intel's letter to customers, which merely stated that Intel's license with LGE "does not extend, expressly or by implication to any product that you may make by combining an Intel product with any non-Intel product," could amount to a "meeting of the minds" whereby such customers *contractually agreed* not to combine chipsets purchased from Intel with non-Intel products. The decision could hardly be reconciled with *Mallinckrodt*. Rather, it appeared that the Federal Circuit had abandoned the requirement of a conditional sale altogether and was moving towards permitting patentees (and their licensees) to avoid exhaustion based on mere notices or other circumstances of the sale.

With respect to LGE's method patents, the Federal Circuit upheld the district court's finding that the patent exhaustion doctrine was inapplicable and that Intel's notice to its customers defeated the implication of a license.

The Supreme Court's Decision

While the main argument of the parties before the Federal Circuit concerned whether exhaustion with respect to system patents was avoided as a result of a conditional sale, LGE relied on a very different argument in its brief to the Supreme Court and in oral argument. There, LGE primarily asserted that this case is not a patent exhaustion case at all, but should be analyzed under the implied license doctrine with respect to both LGE's system patents and its method patents. In short, LGE argued that exhaustion applies only to patents covering the article sold, here the microprocessor or chipset itself, not to patents covering systems that may be made using the article sold. In other words, LGE presented the case to the Supreme Court as an *implied license case* and not as an exhaustion and conditional sales case, perhaps because LGE itself was struggling to explain the Federal Circuit's extreme stretch of the conditional sale principle. The Supreme Court was not persuaded by LGE's arguments and applied the patent exhaustion doctrine.

The Patent Exhaustion Doctrine Applies to Method Patents

Reversing the Federal Circuit's holding that the patent exhaustion doctrine is inapplicable to method patents, the Supreme Court held that "[n]othing in this Court's approach to patent exhaustion supports LGE's argument that method patents cannot be exhausted." The Court specifically noted the risk that to hold otherwise would seriously undermine the exhaustion doctrine as patentees could simply draft claims as method claims rather than apparatus claims and thus practically shield any product from exhaustion. The Court emphasized the "danger of allowing such an end-run around exhaustion" for downstream purchasers. Thus, while patented methods may not be sold like articles or devices, the exhaustion doctrine, generally, is still applicable where a product sold embodies the patented method.

The Sale of Products Embodying Essential Features of a Patented Invention Generally Results in Exhaustion

Relying on its *Univis Lens* decision, the Supreme Court confirmed that the sale of components results in exhaustion of a patent covering the combination of such components with other elements if the components "substantially embod[y]" the patent. The Court relied on two criteria to find that the components "substantially embod[y]" the patent and that exhaustion occurs. First, the component's only reasonable use must practice the patent at issue. The court emphasizes that the inquiry is whether possible alternative uses would *not practice* the patent, not whether such uses would *not infringe* the patent. Hence, the Court expressly rejects use outside the country or use as a replacement part as relevant alternative uses because, even though such uses may not infringe the patent, they would still practice it. The Court also notes that disabling the patented features does not constitute a relevant alternative use because it does not constitute a real *use* at all. Second, the components sold must embody the "essential, or inventive, feature[s]" of the patent at issue. The Court finds this to be the case with respect to the Intel microprocessors and chipsets because "the only step necessary to practice the patent is the application of common processes or the addition of standard parts." While the Intel microprocessors and chipsets did not practice LGE's patents unless attached to memory and buses, such attachments were not "inventive" and only involved standard components with which the microprocessors and chipsets were specifically designed to function. The Court contrasts this situation with the situation in *Aro Mfg. Co. v. Convertible Top Replacement Co.*,[12] where the combination itself was the only inventive aspect of the patent and no individual element could be viewed as central to or equivalent to the invention. With respect to LGE's patents, by contrast, the Court states that "the inventive part of the patent is not the fact that memory and

buses are combined with a microprocessor or chipset; rather, it is included in the design of the Intel Products themselves and the way these products access the memory or bus."

Disclaimers and Intel's Obligation to Notify Customers did not Affect Intel's Authorization to Sell

The Supreme Court also confirmed that the focus in determining whether exhaustion occurs is on whether the sale is authorized by the patent holder. In this case, the Court found that Intel's sales were authorized by LGE. Specifically, the Court notes that "[n]othing in the License Agreement restricts Intel's right to sell its microprocessors and chipsets to purchasers who intend to combine them with non-Intel parts." A failure of the requirement in the master agreement that Intel provide notice to its customers regarding combination of Intel products with non-Intel components would not result in a breach of the license agreement and, in any event, Intel's rights to make, use, and sell products was not conditioned on Intel providing such notice. In addition, the Court found the specific disclaimer in the license agreement of any license to third parties to practice combination patents to be irrelevant because Quanta's defense is based on patent exhaustion, not on an implied license.

It is Unclear if Patent Exhaustion Can Still be Avoided by Making Conditional Sales

The Supreme Court never reaches the questions of whether LGE could have avoided patent exhaustion by limiting Intel's authority to sell or requiring Intel to place conditions on its customers' use of its products and, if so, what would be required for a sale to be validly conditioned. While the Federal Circuit found not one, but two conditional sales, LGE, in its Supreme Court argument, seemed to acknowledge that, in this case, there was no conditional sale, focusing instead on the characterization of the case as an implied license case. Not surprisingly, the Court saw no basis for a conditional sale in this case and did not address the issue. Thus, the decision does not provide guidance on the viability of the concept of conditional sales to avoid exhaustion as sanctioned by the Federal Circuit in *Mallinckrodt*.

Significance of the Decision and Open Issues

The *Quanta* decision will have a significant impact on the computer industry as well as other industries heavily relying on patent protection and enforcement in downstream markets. The application of the patent exhaustion doctrine to method patents and the sale of components embodying essential features of a patented system will make it more difficult for patent holders to license component manufacturers while still seeking to enforce their patents against downstream purchasers and users. As a result of the decision, patent holders may refocus their licensing efforts downstream or attempt to require component supplier licensees to impose contractual restrictions on buyers, possibly through multiple levels of distribution. This may result in more disputes concerning appropriate royalties in licensing discussions as well as questions of contract formation and enforceability with respect to such restrictions. In addition, patent holders may increasingly seek to limit their licensees' authority to sell products, *e.g.*, by permitting them only to sell to separately licensed users, by excluding certain patents (*e.g.*, those applicable to systems or methods) from the scope of licensed patents, or by conditioning the licensee's right to sell on imposing (contractual) conditions on purchasers.

Another question unresolved by the decision is what the effect of a conditional sale is—that is, whether the patent holder has a right to sue for patent infringement or merely breach of contract if a condition is validly imposed but the downstream user does not comply with the condition. The Court did not need to address this issue because it did not find a conditional sale.

Also unsettled remains the question whether a "covenant not to sue" amounts to an authorization to sell. The Supreme Court's decision might suggest so when it emphasizes that Intel was authorized to sell as long as its sales did not amount to a breach of its license agreement, but it does not squarely address the issue.

While purchasers have more certainty regarding exhaustion of method and combination patents as a result of the Court's decision, there are still risks and unanswered questions. For example, exhaustion still does not apply if the product purchased is not an essential element of the patented invention or if the seller's authority to sell was limited (which the purchaser may have no way of knowing). Thus, purchasers still need to conduct diligence on third party patents and their sellers' rights and may want to consider requesting broader indemnification rights. The Court's decision is also not entirely clear on whether the sale of products embodying essential features of a patent can trigger exhaustion even where the product sold has reasonable uses other than practicing such patent. In relying on *Univis* in formulating its test, the Supreme Court does not discuss the fact that *Univis* itself appears to mix elements of the exhaustion doctrine with elements of the traditional implied license inquiry. Finally, for all parties involved there remains uncertainty with respect to the

effect of, and requirements for, conditional sales.

Note: Morrison & Foerster represented *amicus curiae* Gen-Probe Incorporated in the *Quanta* case, which filed a brief in support of petitioners Quanta Computer, Inc., *et al.*

Footnotes

[1] The purchaser does not, however, acquire a right to make the product.

[2] *Intel Corp. v. ULSI Sys. Tech., Inc.*, 995 F.2d 1566, 1568 (Fed. Cir. 1993).

[3] *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 708 (Fed. Cir. 1992).

[4] *Id.* at 709.

[5] 316 U.S. 241 (1942).

[6] *Id*. at 250-251.

[7] To find an implied license, the Federal Circuit has formulated a two-prong test requiring that (1) the product sold has no reasonable non-infringing uses, and (2) the circumstances of the sale plainly indicate that the grant of a license should be inferred. However, courts have implied patent licenses under different circumstances, sometimes relying on different legal theories, and recent Federal Circuit decisions also indicate a departure from the strict two-prong test.

[8] *LG Elecs., Inc. v. Asustek, Inc.*, 248 F. Supp. 2d 912, 917 (N.D. Cal. 2003).

[9] *Id.*

[10] *LG Elecs., Inc. v. Bizcom Elecs., Inc.,* 453 F.3d at 1370.

[11] *Jazz Photo Corp. v. Int'l Trade Comm'n*, 264 F.3d 1094, 1108 (Fed. Cir. 2001)

[12] 365 U.S. 336 (1961).