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QUANTA COMPUTER V. LG ELECTRONICS: THE U.S. SUPREME COURT BREATHES NEW LIFE INTO THE PATENT EXHAUSTION DEFENSE

On June 9, 2008, the U.S. Supreme Court issued its decision in *Quanta Computer v. LG Electronics*, the most recent in a string of patent cases decided by the Court over the past several years. The case specifically concerned application of the "patent exhaustion" doctrine as a defense to patent infringement. At issue were: (1) whether the sale of a product can exhaust the patent holder's rights in a patented method; (2) whether the sale of a product that substantially embodies but does not contain all of the elements of a patented system or method can exhaust the patent holder's rights in that system or method; and (3) whether the sales at issue triggered exhaustion despite an attempt by the patentee to condition the sales (*i.e.*, whether the sales were authorized).

In reversing the Federal Circuit, the Supreme Court held that the patent exhaustion defense applies to patented method claims, as well as when an authorized/licensed sale of a product substantially embodies a patented invention. In addition, the Court found the sales at issue triggered exhaustion despite the patentee's attempt to limit downstream use of the products.

The *Quanta* ruling continues the Supreme Court's trend of reversing the Federal Circuit in patent cases and readjusting the balance between patent owners and accused infringers by potentially precluding a patentee's ability to succeed in an infringement action against downstream users of a component that substantially embodies a larger patented invention. Moreover, *Quanta* will almost certainly result in patent owners paying more attention to the structure of patent-licensing transactions, especially the explicit scope of the license granted.

What follows is a brief introduction to the patent exhaustion doctrine, followed by an explanation of the *Quanta* case as it developed in the lower courts and Supreme Court, and finally, a discussion of how the

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Supreme Court's decision in *Quanta* may affect patent litigation and patent-licensing transactions.

THE PATENT EXHAUSTION DOCTRINE

The patent exhaustion doctrine (also known as the "first sale doctrine") is a judicially created defense to patent infringement, first articulated by the Supreme Court more than a century ago. The doctrine follows from the premise that a patent owner is entitled to a single royalty for each patented device. That is, by selling or authorizing sales of the patented device, the patent owner has bargained for and received an amount equal to the value of the patent rights that attach to the device. Thus, while the rights conveyed by a patent enable its owner to exclude others from using the patented device, once a patent owner engages in or authorizes an unrestricted sale of the patented device, such exclusionary rights are terminated with respect to that device. Put simply, the patent owner's rights are "exhausted" and cannot be asserted against any downstream purchasers, sellers, or users of the device.

The Federal Circuit and district courts established a number of exceptions to the exhaustion doctrine in the years prior to *Quanta*. For example, patent exhaustion did not occur where the patent owner imposed by contract at the time of sale, certain conditions on the downstream use of the patented product. Such contractual conditions generally were permitted unless they violated some law or policy, such as antitrust law, contract law, or patent misuse, because courts assumed that the parties negotiated a price that reflects only the value of the use contemplated with the conditions. Courts also previously held that the exhaustion doctrine did not apply to the practice of method claims. In addition to these exceptions, courts were faced with the issue of whether the patent exhaustion doctrine applied when the article sold was an unfinished part or component of a patented system or product (*e.g.,* an unfinished eyeglass lens or a part to a computer), and even more so when such an unfinished part or component had no reasonable use other than incorporation into the larger patented system or product. These two exceptions, and additional issue, took center stage in *Quanta*.

QUANTA'S FACTUAL AND PROCEDURAL BACKGROUND

The facts in *Quanta* were as follows. LG Electronics ("LGE") granted Intel a license to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" its microprocessors and chipsets that would otherwise infringe a number of LGE's patents, several of which included method claims. The LGE-Intel license transaction involved a License Agreement and a separate Master Agreement. The License Agreement expressly disclaimed any license directly to third parties (*e.g.*, Intel's customers) to combine licensed Intel microprocessors or chipsets with any non-Intel or non-Quanta components or products (*i.e.*, to make a computer).

Under the Master Agreement, Intel was required to send notice to its customers advising them of the license disclaimer discussed above. Intel sent such notice to those who purchased its licensed microprocessors and chipsets, including Quanta and other computer manufacturers. Notably, though, the Master Agreement also provided that "a breach of this Agreement shall have no effect on and shall not be grounds for termination of the Patent License."

Despite receiving the license disclaimer notice from Intel, Quanta and other computer manufacturers used the licensed Intel microprocessors and chipsets in combination with other non-Intel components to make computer systems that were then sold to major computer sellers such as Dell, Gateway, and Hewlett-Packard. LGE subsequently sued Quanta and these computer manufacturers for infringement of LGE's patents concerning computer systems.

In May 2002, several defendants, including Quanta, moved for summary judgment of noninfringement on five of the six LGE patents-in-suit based on the patent exhaustion doctrine. Specifically, those defendants argued that LGE exhausted its patent rights based on LGE's license to Intel and/or Intel's sale of its licensed microprocessors and chipsets to the defendants. LGE argued that the licensed products sold by Intel did not read on/infringe any of the patents at issue (directed to combinations or systems incorporating such

products), and therefore, the patent exhaustion doctrine did not apply. The district court ruled in favor of the defendants, holding that the license or authorized sale of an essential element of a patented device may exhaust the patentee's statutory right to exclude others from making, using, or selling that device. In so holding, the court found that the defendants successfully showed that the microprocessors and chipsets had no reasonable noninfringing use, since the only reasonable use was to incorporate them into computers, such as those made and sold by the defendants.

Following the district court's grant of summary judgment, the remaining defendants moved for summary judgment on the same grounds. The district court treated LGE's opposition to this motion as a request for reconsideration of the first ruling based in part on LGE's new arguments that: (1) Intel's sale of microprocessors and chipsets did not exhaust LGE's patent rights because the sale was conditional; and (2) there could be no exhaustion as to any of the method claims. The district court found that the notice from Intel to the defendants was insufficient to create a conditional sale. Accordingly, the exhaustion doctrine applied to the patented product claims. The district court, however, agreed with LGE that the exhaustion doctrine did not apply to the method claims.

On appeal, the Federal Circuit agreed with the district court that the patent exhaustion doctrine did not apply to method claims. The Federal Circuit, however, reversed the district court's ruling that the patent exhaustion doctrine applied to LGE's product claims, finding that Intel's sale of the licensed component microprocessors and chipsets was conditional based on provisions within the LGE-Intel agreements, and since Intel's customers were expressly put on notice that they were prohibited from combining the licensed microprocessors with non-Intel components. Quanta, and several other defendants, subsequently appealed to the Supreme Court, arguing that the Federal Circuit's decision was directly in conflict with prior Supreme Court precedent concerning the patent exhaustion doctrine. Certiorari was granted on September 25, 2007, and oral argument was heard by the Court on January 16, 2008.

Quanta presented the Supreme Court with three primary questions: (1) whether the sale of a product can exhaust the patent holder's rights in a patented method; (2) whether the sale of a product that substantially embodies but does not contain all of the elements of a patented system or method can exhaust the patent holder's rights in that system or method; and (3) whether Intel's sale of its licensed components to Quanta and others was authorized, such that the patent exhaustion doctrine applied.

In a unanimous opinion authored by Justice Thomas, the Supreme Court answered "yes" to all three of these questions. Accordingly, the Supreme Court reversed the Federal Circuit's decision below, and held that LGE's patent rights were exhausted as against Quanta and the other defendants.

THE SUPREME COURT DECISION

Within its decision, the Supreme Court provided a brief history of the patent exhaustion doctrine. The Court began with its first-ever discussion of the defense, which occurred in a set of 19th-century patent cases involving a wood-planing machine. It ended by discussing its most recent application of the patent exhaustion doctrine in the 1942 decision of *United States v. Univis Lens Co.*, a case involving unfinished eyeglass lenses. The Court found *Univis* particularly applicable to the facts here. With this historical background in mind, the Court then turned to the three main issues raised in *Quanta*.

First, the Court addressed whether the patent exhaustion doctrine applies to method claims. The Court observed that it "has repeatedly held that method patents were exhausted by the sale of an item that embodied the method." It also acknowledged a concern that exempting method claims from the patent exhaustion defense would "seriously undermine the exhaustion doctrine," because patentees could "simply draft their patent claims to describe a method rather than an apparatus," and thereby "shield practically any patented item from exhaustion." Thus, the Court rejected the Federal Circuit's categorical exclusion of method claims from the scope of the patent exhaustion doctrine, holding that method claims can be exhausted by the sale of products.

Second, the Court addressed the issue of when patent exhaustion applies to situations involving the sale of a component that does not contain all of the elements of the patented invention. Relying on its previous decision in *Univis*, the Court stated that the sale of such components can trigger patent exhaustion of combination claims when the component "substantially embodies the patent." This occurs when two conditions exist: (1) "when [the component's] only reasonable and intended use [is] to practice the patent"; and (2) when the component "constitute[s] a material part of the patented invention and all but completely practice[s] the patent."

Using the facts of *Univis* as a guide, the Court found that Intel's licensed microprocessors and chipsets—even though they were components of the patent claims at issue—had no reasonable use other than for incorporation within the accused computer systems that practiced LGE's patents. While LGE argued that Intel's licensed components could be used in non-infringing ways (*e.g.*, by being sold overseas, where the U.S. patent laws have no force, or by being used as replacement parts), the Supreme Court rejected LGE's arguments, stating that the proper question is "whether the product is 'capable of use only in *practicing* the patent,' not whether those uses are infringing." In other words, "[w]hether outside the country or functioning as replacement parts, the Intel Products would still be *practicing* the patent, even if not infringing it."

The Court went on to conclude that the licensed Intel products "constitute a material part of the patented invention and all but completely practice the invention." As such, the microprocessors and chipsets sold by Intel substantially embody the LGE patents, because the only step necessary to practice LGE's patents is the "application of common processes or the addition of standard parts" (*i.e.*, combining the licensed microprocessors and chipsets with memory and buses, standard components in a computer system that enable the microprocessor and chipset to properly function). Accordingly, since Intel's products' only reasonable use was to practice the patent and the products substantially embodied the patent claims at issue, the Court held that the patent exhaustion doctrine could apply.

Finally, the Court examined whether Intel's sale of its microprocessors and chipsets to Quanta and others actually exhausted LGE's patent rights. Because exhaustion is triggered only by a sale authorized by the patentee, this issue depended on whether LGE authorized Intel's sale of its licensed microprocessors and chipsets to the defendants. LGE argued that there was no authorized sale, because the License Agreement did not permit Intel to sell its licensed products for use in combination with non-Intel products. The Court disagreed with LGE, finding that the Intel-LGE License Agreement "broadly permitted Intel to 'make, use, [or] sell' products free of LGE's patent claims." The Court found nothing in the License Agreement restricting Intel's right to sell its licensed products to companies with plans to combine them with non-Intel products. The only arguable condition appeared in the Master Agreement, and it required Intel to provide notice to its customers that LGE had not licensed those customers any rights to combinations of licensed Intel products with non-Intel products. However, Intel provided such notice, thereby satisfying its contractual obligations regardless of what Quanta and the other defendants did with Intel's products. Moreover, because the notice requirement appeared only in the Master Agreement, which also provided that a breach of the Master Agreement would not affect Intel's license, the Court concluded that Intel's authority to sell was not conditioned on such notice. As the Court succinctly stated, "Intel's authority to sell its products embodying the LGE Patents was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice." Accordingly, the Court found that because Intel was authorized to sell the products and no conditions limited that authority, LGE's patent rights were exhausted by Intel's sale to Quanta and the other defendants.

In finding for the defendants, the Court also dismissed LGE's reliance on the fact that the License Agreement disclaimed any license to third parties. The Court explained that whether any third parties received an implied license was irrelevant to patent exhaustion. Instead, "exhaustion turn[ed] only on Intel's own license to sell products practicing the LGE Patents." Because Intel's sale was authorized, exhaustion applied.

THE PRACTICAL EFFECTS OF, AND QUESTIONS RAISED BY, *QUANTA*

The implications of *Quanta* are likely to be significant in the context of both patent litigation and patent-licensing transactions.

From a litigation perspective, *Quanta* may affect a patent owner's success when bringing an infringement action against downstream users of a licensed product or component that is incorporated into a larger patented system or involved in a patented method. Even so, patent owners may still have forceful arguments against claims of exhaustion. For example, the patentee may argue that the licensed component has some reasonable use that does not practice the patent, or that the component is not a material part of the inventive part of the patented system or method and therefore does not substantially embody the patent claim (a patentee, however, must be cautious when making such arguments to ensure that they do not undermine any contributory-infringement claims the patentee may have raised). Where the patentee has granted a license, the patentee may also argue that the sale was outside the scope of the license grant or in violation of a condition therein and therefore unauthorized. Moreover, even if patent exhaustion were to apply, the patent owner may, where the license allows, still seek redress through a breach-of-contract claim, an option explicitly recognized in the Court's opinion.

While *Quanta* will likely have some impact in the context of patent litigation, the effects of *Quanta* may reverberate even more so in the context of patent licenses. Despite the outcome in *Quanta*, it is important to understand that the Supreme Court did not eliminate a patentee's ability to create restrictions or conditions within a license agreement that might avoid later application of the patent exhaustion defense. In fact, the Supreme Court indicated that Intel's sale might not have been authorized—and thus, the patent exhaustion doctrine might not have applied—if the license grant to Intel had explicitly excluded Intel's right to sell products to customers who would combine the licensed Intel products with non-Intel products downstream. Patent owners can learn from *Quanta* when structuring licenses to ensure that the license grant offered is as narrow and circumscribed as possible, such as through field-of-use and market limitations. Put simply, unlike what was done in *Quanta,* the patent owner must be careful to explicitly limit the scope of the license itself in a way that ensures the patent owner will receive the compensation it expects from the sale of each licensed product.

From either perspective—litigation or transactional—*Quanta* leaves a number of open questions. Most notably, what will constitute a "substantial embodiment" of the patent to trigger the exhaustion doctrine? From the Court's discussion of its prior *Univis* decision, we know that supplying optical lens "blanks" that "partially practiced a patent" exhausted method patents, even though infringement of those method patents did not occur until the buyer ground those blanks into actual, finished lenses. That, of course, was a "substantial embodiment" of a patent claim. Similarly, we know that the Intel microprocessors and chipsets in *Quanta* "substantially embodied the LGE Patents because they had no reasonable noninfringing use and included all the inventive aspects of the patented methods." But it is not clear that those two conditions (no reasonable noninfringing use and including all "inventive" aspects of the patent) are going to be *necessary* conditions for a "substantial" embodiment finding. Only case-by-case development by the Federal Circuit and lower federal courts will definitively answer these questions.

CONCLUSION

The *Quanta* decision marks yet another Supreme Court reversal of a Federal Circuit patent decision—the last 12 patent decisions reviewed by the Supreme Court have been reversed, vacated, or otherwise disturbed. Once again, the Supreme Court appears to be rebalancing the patent laws in a way different from the balance the Federal Circuit has struck over the years. Nonetheless, as with every Supreme Court decision, it will be important to see how the Federal Circuit and district courts interpret *Quanta* and, most importantly, under what circumstances they will uphold conditional sales and licenses and refuse to apply the patent exhaustion doctrine.

N.B.: Jones Day filed an amicus curiae brief on behalf of IBM in the Quanta *case.*

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