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Supreme Court Breathes New Life Into Patent Exhaustion Defense

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On June 9, 2008, the U.S. Supreme Court issued its decision in *Quanta Computer v. LG Electronics*, a case concerning 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.

Continuing its trend of reversing the Federal Circuit in patent cases, 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.

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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 over a century ago. The doctrine follows from the premise that, 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, once such a sale has occurred, 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 and at the time of sale, certain conditions on the downstream use of the patented product. 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 larger patented system or product (*e.g.*, an unfinished eyeglass lens or a part to a computer). These issues took center stage in *Quanta* .

Quanta's Factual and Procedural Background

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 to combine licensed Intel microprocessors or chipsets with any non-Intel or non-Quanta components or products.

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

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licensed Intel microprocessors and chipsets in combination with other non-Intel components to make computer systems that they then sold to major computer sellers such as Dell, Gateway and Hewlett-Packard. LGE subsequently sued Quanta and other computer manufacturers for infringement of LGE's patents covering computer systems.

At the district court, defendants moved for summary judgment of non-infringement, arguing that LGE exhausted its patent rights based on its license to Intel and/or Intel's sale of its licensed microprocessors and chipsets. The district court ruled in favor of defendants, finding that Intel's licensed microprocessors and chipsets were essential components of LGE's patented computer systems, and had no reasonable non-infringing use other than to be incorporated into computers. Moreover, since Intel's sale to defendants of these components was unconditional, patent exhaustion applied with respect to some of LGE's patent rights. The district court also found, however, that the patent exhaustion doctrine did not apply to any of LGE's 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 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.

The Supreme Court's Decision

In a unanimous opinion authored by Justice Thomas, the Supreme Court reversed the Federal Circuit, holding that (1) patent exhaustion can apply to method claims; (2) patent exhaustion applies where the sale of a product "substantially embodies" a patented system or method; and (3) in this case, patent exhaustion applied since Intel's sale of its licensed microprocessors and chipsets to defendants was authorized.

Concerning patent method claims, the Court recognized that such claims could not fairly be exempted from patent exhaustion. To allow otherwise would let patentees "simply draft their patent claims to describe a method rather than an apparatus," thereby "shield[ing] practically any patented item from exhaustion."

Next, the Court relied on its 1942 decision in *United States v. Univis Lens* to find that the sale of a component that does not contain all of the elements of a patented invention can trigger patent exhaustion when such component "substantially embodies the patent." Specifically, 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." Here, since Intel's microprocessors and chipsets met both conditions, patent exhaustion could apply.

Finally, the Court found that Intel's sales were authorized since the Intel-LGE License Agreement "broadly permitted Intel to 'make, use, [or] sell' products free of LGE's patent claims." The explicit scope of the license granted did not preclude Intel from selling its products to companies with plans to combine those products with non-Intel products. Indeed, the only "condition" appeared in the Master Agreement, requiring Intel to provide notice to its customers that LGE had not licensed to those customers any rights to combinations of licensed Intel products with non-Intel products. By sending such notice Intel complied with this condition, regardless of what 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.

The Practical Effects Of, And Questions Raised By, *Quanta*

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 argue that patent exhaustion does *not* apply since the licensed component has some reasonable use that does not practice the patent, or 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). Moreover, where the patentee has granted a license, the patentee may argue that the sale was outside the scope of the license grant or in violation of a condition therein and therefore unauthorized.

In the transactional context, it is important to understand that *Quanta* 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 patent exhaustion may *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? While 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," it is not clear that these two conditions 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.