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Strategies Regarding Patent Exhaustion After *Quanta*

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Introduction

On June 9, 2008, the U.S. Supreme Court issued its decision in *Quanta Computer, Inc. v. LG Electronics, Inc*. In reversing the Federal Circuit, the Supreme Court held that patent exhaustion (1) can apply to method patents and (2) can apply to the sale of components of a patented system that must be combined with additional components in order to practice the patented methods.

The LGE Patents

Respondent LG Electronics, Inc. (LGE) purchased a portfolio of computer technology patents. One patent discloses a system for ensuring that current data is retrieved from main memory by monitoring data requests and updating main memory from cache when stale data is requested. Another patent discloses an efficient method of organizing read and write requests while maintaining accuracy by allowing the computer to execute only read requests until it needs data for which there is an outstanding write request. The last patent describes methods that establish a rotating priority system under which devices alternatively have access to a computer bus for varying periods of cycles, depending on whether the user is a "heavy user."

The License Agreement and Master Agreement

LGE licensed a patent portfolio, including the LGE Patents, to Intel Corporation (Intel). The License Agreement permitted Intel to manufacture and sell microprocessors and chipsets that use the LGE Patents. The License Agreement authorized Intel to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" its own products practicing the LGE Patents. Notwithstanding this broad language, the License Agreement stated that no license "is granted by either party hereto . . . to any third party for the combination by a third party of Licensed Products of either party with items, components, or the like acquired . . . from sources other than a party hereto, or for the use, import, offer for sale or sale of such combination." The License Agreement purported not to alter the usual rules of patent exhaustion, providing that, "[n]otwithstanding anything to the contrary contained in this Agreement, the parties agree that nothing herein shall in any way limit or alter the effect of patent exhaustion that would otherwise apply when a party hereto sells any of its Licensed Products."

In a separate agreement (*i.e*., the Master Agreement), Intel agreed to give written notice to its own customers informing them that, while it had obtained a broad license "ensur[ing] that any Intel product that you purchase is licensed by LGE and thus does not infringe any patent held by LGE," 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." 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."

The District Court and Federal Circuit Proceedings

Petitioners Quanta Computer, Inc. et al. (collectively Quanta), are a group of computer manufacturers who purchased microprocessors and chipsets from Intel and received the notice required by the Master Agreement. Nonetheless, Quanta manufactured computers using Intel parts in combination with non-Intel memory and buses in ways that practiced the LGE Patents. LGE sued Quanta for patent infringement. As an affirmative defense, Quanta argued patent exhaustion (i.e., the longstanding doctrine that the initial authorized sale of a patented item terminates all patent rights to that item).

The District Court granted summary judgment to Quanta, holding that, for purposes of the patent exhaustion doctrine, the license LGE granted to Intel resulted in forfeiture of any potential infringement actions against legitimate purchasers of the Intel Products. The District Court found that, although the Intel Products did not fully practice any of the patents at issue, they had no reasonable noninfringing use and therefore their authorized sale exhausted patent rights in the completed computers under *United States v. Univis Lens Co*., 316 U. S. 241 (1942). The District Court further held that patent exhaustion applied only to apparatus or composition-of-matter claims that describe a physical object, and did not apply to process or method claims that describe operations to make or use a product. Because each of the LGE Patents included method claims, the District Court held that exhaustion did not apply.

The Federal Circuit agreed that the doctrine of patent exhaustion does not apply to method claims. Additionally, it concluded that exhaustion does not apply because LGE did not license Intel to sell the Intel Products to Quanta for use in combination with non-Intel products.

The Supreme Court Holds That Method Patents Can Be Exhausted

LGE argued that the exhaustion doctrine is inapplicable because it does not apply to method claims. LGE reasoned that, because method patents are linked not to a tangible article but to a process, they can never be exhausted through a sale. Rather, practicing the patent—which occurs upon each use of an article embodying a method patent—is permissible only to the extent rights are transferred in an assignment contract.

The Supreme Court expressed a concern that eliminating exhaustion for method patents would seriously undermine the exhaustion doctrine, because patentees seeking to avoid patent exhaustion could simply draft their patent claims to describe a method rather than an apparatus. Consequently, the Court rejected LGE's argument that method claims, as a category, are never exhaustible.

An Authorized Sale of an Article That Substantially Embodies a Patent Exhausts the Patent Holder's Rights

The Supreme Court next considered the extent to which a product must embody a patented method in order to trigger exhaustion. The Court decided that its prior decision in *Univis* governed this case. The Court explained that exhaustion is triggered by a sale of a product if the only reasonable and intended use was to practice the patent and because the product embodied essential features of the patented invention. Accordingly, for a variety of reasons, the Court held that exhaustion applied in this case.

First, LGE suggested no reasonable use for the Intel Products other than incorporating them into computer systems that practice the LGE Patents. The Court reasoned that the only apparent object of Intel's sales to Quanta was to permit Quanta to incorporate the Intel Products into computers that would practice the patents.

Second, the Court explained that the Intel Products constituted a material part of the patented invention and all but completely practiced the patent. This Court reasoned that the incomplete article substantially embodied the patent, because the only step necessary to practice the patent was application of common processes or the addition of standard parts. Everything inventive about each patent was embodied in the Intel Products.

The Court further explained that while each Intel microprocessor and chipset practiced thousands of individual patents, including some LGE patents not at issue in this case, the exhaustion analysis was not altered by the fact that more than one patent was practiced by the same product. Rather, the relevant consideration was whether the Intel Products that partially practice a patent—by, for example, embodying its essential features—exhaust that patent.

Having concluded that the Intel Products embodied the patents, the Supreme Court next considered whether the sale to Quanta exhausted LGE's patent rights. In its analysis, the Court explained that the License Agreement authorized Intel to sell products that practiced the LGE Patents and that no conditions limited Intel's authority to sell products substantially embodying the patents. Because Intel was authorized to sell its products to Quanta, the doctrine of patent exhaustion prevented LGE from further asserting its patent rights with respect to the patents substantially embodied by those products.

The Court further explained that exhaustion turned only on Intel's own license to sell products practicing the LGE Patents. Because nothing in the License Agreement limited Intel's ability to sell its products practicing the LGE Patents, Intel's authorized sale to Quanta thus took its products outside the scope of the patent monopoly, and as a result, LGE could no longer assert its patent rights against Quanta.

Author's Opinion

In this author's opinion, the Supreme Court's decision makes clear that method claims can be exhausted by the sale of a product. Whether patent exhaustion is triggered

depends on the extent to which the product embodies the claimed method. Exhaustion likely will be found if (1) the only reasonable and intended use is to practice a patented method and the product embodies essential features of the patented invention; (2) the only apparent object of the product sales is to permit the products to practice the patents; and (3) the products constitute a material part of the patented invention and all but completely practiced the patented method.

However, I do not believe and respectfully submit that the limited holding in *Quanta* does not affect current Federal Circuit law that—by virtue of an appropriately worded restricted license and notice—a patent owner can reserve patent rights that would otherwise be exhausted by an unrestricted sale. *See, e.g., Mallinckrodt, Inc. v. Medipart, Inc*., 976 F.2d 700 (Fed. Cir. 1992).

Strategies After Quanta

The bottom line is that the Court's decision in *Quanta* reinforces the importance of careful drafting by an experienced attorney of language included in patent licenses, especially in limited licenses that attempt to reserve patent rights that would otherwise be exhausted by an unrestricted sale. Consequently, prior to litigation, it is critical for patent owners to focus their attention on the precise language of their patent licenses.

Accused Infringer Strategies in Litigation

Although I do not agree with these points, some accused infringers have made the following types of arguments regarding exhaustion post-*Quanta*.

First, accused infringers likely will argue that *Quanta* overruled *Mallinckrodt*. Consequently, they will contend that patent owners no longer have the ability to issue limited licenses. Further, accused infringers will argue that any such license agreement that is "limited" in some fashion is invalid and unenforceable under the patent laws in view of *Quanta.*

Second, alleged infringers likely will argue that if an initial sale is authorized, then the patent rights are exhausted in the article sold. Thus, for example, under this argument, any sale by a patent owner to someone else would be "authorized." Therefore, exhaustion would apply.

Third, accused infringers may point to *Quanta* and argue that use of a patented product that exceeds the scope of the limited license does not lead to a claim for patent infringement. Instead, the appropriate remedy would be for breach of contract.

Lastly, alleged infringers may argue that *Quanta* rejected the policy rationale that a patent owner can exact additional compensation for its patent rights based on post-sale conditions.

Patent Owner Strategies in Litigation

If presented in litigation with arguments from an accused infringer regarding *Quanta*, a patent owner likely would want to make the following types of arguments.

First, *Quanta* did not overrule *Mallinckrodt* and was not even mentioned in the opinion, despite having been addressed at oral argument. All *Quanta* did was reaffirm the rule of law that an unconditional sale of an article that substantially embodies a patented invention results in patent exhaustion. *Quanta* does not invalidate all post-sale restrictions, and limited licenses remain viable post-*Quanta*.

In *Quanta*, the Supreme Court analyzed whether the license agreement at issue placed any conditions on Intel's authorization to sell patented articles. Based on the structure of that particular license agreement, the Supreme Court found that no such conditions existed in the agreement, and thus, found that LG's patent rights were exhausted.

Second, patent exhaustion applies only where a sale is both authorized and unconditional. Thus, for example, sale of a product that is subject to a valid limited license (*e.g.*, a single use license), does not result in exhaustion.

Third, *Quanta* did not alter the policy underlying patent exhaustion that exhaustion depends on whether the patent holder receives full reward for the use of the patented article.

Finally, the prior Supreme Court precedent on which *Mallinckrodt* was based was not overruled. In particular, *General Talking Pictures* held that

- "Unquestionably, the owner of a patent may grant licenses to manufacture, use, or sell upon conditions not inconsistent with the scope of the monopoly."
- "That a restrictive license is legal seems clear."
- Defendant "could not convey … what [it] … knew it was not authorized to sell. By knowingly making the sales … outside the scope of its license, [Defendant] … infringed the patents embodied in the amplifiers."

See, e.g., General Talking Pictures Corporation v. Western Electric Co., 304 U.S. 175, 181-82 (1938).

The Future

The debate over *Quanta*, *Mallinckrodt*, limited licenses, and exhaustion likely will continue until at least the matter is addressed by the Federal Circuit.