

## The U.S. Supreme Court Clarifies Patent Exhaustion

By John C. Paul, Kia L. Freeman, Bart A. Gerstenblish and Jessica R. Underwood

### I. Introduction

In the United States, the doctrine of patent exhaustion cuts off a patent owner's rights to enjoin, control or extract royalties from a patented product after an initial authorized sale of that product in the U.S. While the basic policy of preventing a patent owner from repeatedly extracting compensation for the same product seems straightforward, the law developed by the courts over the past two centuries in response to efforts by patent owners to preserve and control their rights is more complex. For example, patent owners have tried to avoid exhausting their rights in a patented product by characterizing their disposition of the patented product as a license rather than a sale, only to see that courts have uniformly concluded that patent rights are exhausted in such instances. Patent owners have also sold or licensed patented products with various restrictions on their subsequent use by companies at various levels in the supply chain. It is in those situations where the courts have most frequently discussed the exhaustion doctrine.

Patent owners who license a component manufacturer often desire to retain their rights to obtain all or a large portion of their compensation from their licensee's customers who produce higher-value finished products by processing the component further or combining the component with other components to produce finished goods. While it would appear to be simple to accomplish this objective and avoid patent exhaustion by allowing a licensee to sell its components only to customers who were licensed by the patent owner at the time of sale, it is easier said than done. A component manufacturer would likely object to such a restriction because it creates a significant hurdle to making sales—limiting the component manufacturer's ability to sell only to customers who are already licensed or who are willing to take a license prior to the sale. Therefore, only licensors with significant negotiating power may be able to obtain such conditions in their agreements.

As a result, during the negotiation process, licensors and licensees often reach a compromised resolution which allows the licensee to sell its components to all customers, regardless of whether they are licensed, and to agree to a lesser obligation that attempts to address the issue of patent exhaustion. The nature of such lesser obligations usually hinges

on the relative negotiation power of the licensors and licensees and can include, for example: (1) conditioning the sale to its customer on the customer taking a license from the patent owner before processing the component further or combining the component with other parts to produce finished goods, (2) providing notice to the customer that the customer must take a license from the patent owner before processing the component further or combining the component with other parts to produce finished goods, (3) providing notice to the customer that the customer is not licensed to process the component further or to combine the component with other parts to produce finished goods, or (4) simply including in the license agreement between the licensor and licensee a provision that the licensee's customers are not licensed to process the subcomponent further or combine the component with other parts to produce finished goods.

Part of the calculus for the licensor during the negotiation process is evaluating the likelihood that a court would find that the negotiated obligation allowed the patent owner to retain its rights to obtain some or all of its compensation from its licensee's customers, and whether the licensee's customers would be convinced that the patent owner retained such rights such that they would agree to take a license and pay the compensation desired by the patent owner. The U.S. Supreme Court recently provided further clarity and guidance on this point in *Quanta Computer, Inc. v. LG Electronics, Inc.*, No. 06-937, 2008 U.S. LEXIS 4702 (U.S. June 9, 2008).

Prior to *Quanta*, the last United States Supreme Court decision involving the patent exhaustion

■ John C. Paul, Partner, Finnegan, Henderson, Farabow, Garrett & Dunner, LLP, Washington, D.C., USA  
E-mail: [john.paul@finnegan.com](mailto:john.paul@finnegan.com)

■ Kia L. Freeman, Attorney, Finnegan, Henderson, Farabow, Garrett & Dunner, LLP, Cambridge, MA, USA  
E-mail: [kia.freeman@finnegan.com](mailto:kia.freeman@finnegan.com)

■ Bart A. Gerstenblish, Attorney, Finnegan, Henderson, Farabow, Garrett & Dunner, LLP, Washington, D.C., USA  
E-mail: [bart.gerstenblish@finnegan.com](mailto:bart.gerstenblish@finnegan.com)

■ Jessica R. Underwood, Attorney, Finnegan, Henderson, Farabow, Garrett & Dunner, LLP, Washington, D.C., USA  
E-mail: [jessica.underwood@finnegan.com](mailto:jessica.underwood@finnegan.com)

doctrine occurred more than 60 years ago in *United States v. Univis Lens Co.* Since that time, U.S. case law has been developed by the United States Court of Appeals for the Federal Circuit, which has exclusive jurisdiction over patent appeals.

This article discusses the history of the exhaustion doctrine and concludes with a discussion of the arguments and issues raised and addressed in *Quanta* and some practical implications of the Court's decision.

## II. Establishing the Exhaustion Doctrine

In creating the patent exhaustion doctrine, the Supreme Court started with the Constitutional limitation that patents must serve “[t]o promote the progress of science and useful arts,”<sup>1</sup> and recognized that the reward of inventors is merely a means to promote progress.<sup>2</sup> Thus, it found that patent rights should be recognized only to the extent that they serve the larger purpose of the patent system—to promote progress. It concluded that patent rights in a patented article are exhausted whenever “there has been...a disposition of [a patented] article [such] that it may fairly be said that the patentee has received his reward for the use of the article.”<sup>3</sup>

The exhaustion doctrine thus operates to allow patentees to extract full consideration for a patented article, but no more. Accordingly, once a patent has been exhausted with respect to an article, the patentee has no further patent rights that can be exercised with respect to that article.<sup>4</sup> The form of a transaction does not determine whether exhaustion applies,<sup>5</sup> and thus the doctrine has been applied even though a transaction is not characterized as a conventional sale.

### A. Exhaustion Requires an Authorized Sale or Other Disposition of the Patented Article

In determining whether patentees had received their just reward under their patents, the Supreme Court has looked to see whether an authorized sale or other disposition of a patented article had occurred. Purchasers of patented articles are generally subject to the terms of the sales or license agreement through which they acquired the articles. But a purchaser who acquires a patented article through an authorized sale takes it free from any patent rights.

This principle is illustrated by comparing two cases involving the sale of a patented article under a lim-

ited license. In each, the Supreme Court focused on whether the sale of the patented article was within the scope of the license, and therefore authorized. If the sale was authorized, the doctrine applies, and the patent rights are exhausted in the licensed product. Otherwise, the doctrine does not apply, and the patent rights are not exhausted.

In *Adams v. Burke*, the Supreme Court considered a sale by a licensee who was authorized to make, use, and sell patented coffin lids within a designated geographical area of the United States.<sup>6</sup> Although an undertaker purchased the lids from the licensee within the designated area of the licensee, he used them outside the designated area.<sup>7</sup> The patentee objected to the undertaker's use of the patented lids, presumably because the undertaker was competing with the patentee in an area reserved for the patentee. The Court recognized that, since the value of the patented article was in its use, the patentee should have received full consideration from the sale of the lids whether they were used within the designated area or elsewhere.<sup>8</sup> The Court therefore concluded that the licensee's sale of the lids to the undertaker was authorized and exhausted the patent rights in those lids.<sup>9</sup> Thus, the patentee could not enforce the patent against the undertaker with respect to the lids purchased from the licensee, even though the lids were used outside the area in which the licensee was authorized to use them.

In *General Talking Pictures v. Western Electric*, the Supreme Court considered a sale by a licensee who was authorized to make and sell patented amplifiers within a designated, private use market in the United States.<sup>10</sup> The licensee admitted to selling the amplifiers to a customer knowing that the customer planned to use the amplifiers for commercial use in the motion picture industry, rather than in the private use market for which the license was granted.<sup>11</sup> The patentee had licensed the use of his patent in the commercial market to different licensees, who sought to preserve the patent's separate value in that market by attempting to prevent the private use licensee from encroaching on the commercial use market in which they were licensed.<sup>12</sup> The Court found that movie theaters were outside the private

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1. U.S. Const. Art. I, § 8, ¶ 7.  
2. See *United States v. Masonite Corporation*, 316 U.S. 265, 278 (1942).  
3. *Id.* at 278.  
4. See *id.*  
5. See, e.g., *id.*

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6. See *Adams v. Burke*, 84 U.S. 453, 456 (1873).  
7. See *id.* at 457.  
8. See *id.* at 456.  
9. See *id.*  
10. See 304 U.S. 175, 179-80 (1938).  
11. See *id.* at 180.  
12. See *id.* at 179.

use market, and that the private use licensee's sale of the patented amplifiers for use in movie theatres violated the terms of his license and was therefore an unauthorized sale.<sup>13</sup> As a result, the rights of the patentee in the amplifier were not exhausted.<sup>14</sup> The purchaser, having bought the amplifier subject to the terms of the private use license, was therefore only authorized to use the amplifier in the private use market<sup>15</sup>—and consequently, the patent could be asserted against use of that amplifier in the commercial market.

## B. Conditional Sales and Questionable Enforcement Under Patent Law

Before articulating the exhaustion test in *Masonite*, the Supreme Court allowed for the possibility of an authorized, but conditional sale<sup>16</sup> while suggesting that conditions imposed by the authorized seller at the time of sale might be enforceable under contract law, but not patent law.<sup>17</sup> This limitation to enforcement under contract law may suggest that a patentee could only enforce license or sales conditions against original and subsequent purchasers who had notice of the conditions or who agreed to the conditions, making it more difficult or problematic for the patentee to enforce the conditions against all downstream purchasers in the distribution chain. According to the Court, the “inconvenience and annoyance to the public that an opposite conclusion would occasion are too obvious to require illustration.”<sup>18</sup>

## C. Univis: the Supreme Court's Last Word for Over 60 Years

In *United States v. Univis Lens Co.*, the Supreme Court recited and relied on most of the boundaries of its exhaustion doctrine.<sup>19</sup> The patents at issue in *Univis* related to multifocal eyeglass lenses. Univis acquired a group of eight patents directed to features of pieces of glass fused into multifocal lens blanks, as well as a group of five patents directed to methods of producing finished lenses.<sup>20</sup> The method patents involved the use of the patented blanks.<sup>21</sup> Univis licensed a lens company to manufacture lens blanks and sell them to other licensees at a fixed price.<sup>22</sup> The Court considered whether Univis' patents allowed

it to control the downstream use of the lens blanks after their authorized sale by the lens company to its other licensees.

In addition to the lens company, Univis licensed three other classes of licensees: wholesalers, finishing retailers, and prescription retailers.<sup>23</sup> Wholesalers and finishing retailers were licensed to purchase blanks, finish them by grinding and polishing, and sell the finished lenses at fixed prices.<sup>24</sup> Wholesalers were licensed to sell the finished lenses to licensed prescription retailers, while finishing retailers were licensed to sell the lenses directly to consumers.<sup>25</sup> The United States government challenged Univis' downstream licensing scheme and resultant price-fixing, alleging that Univis improperly sought to extend the scope of its patent rights.

According to Univis, the lens blanks made by the lens company were covered by Univis' lens blank patents and had no use other than the production of finished multifocal lenses.<sup>26</sup> Univis also claimed that, in manufacturing a lens blank, the lens company practiced certain steps in one of its finishing method patents, and that unlicensed finishing of the lens blank necessarily infringed that method patent.<sup>27</sup>

The Court held that the authorized sale of a lens blank by the lens company exhausted Univis' right to control the further use of the blank.<sup>28</sup> Noting that the blanks had no non-infringing use,<sup>29</sup> the Court explained that a sale of an article that embodied essential features of the patented methods for use in the patented methods exhausted the finishing method patents:

[W]here one has sold an uncompleted article which, because it embodies essential features of his patented invention, is within the protection of his patent, and has destined the article to be finished by the purchaser in conformity to the patent, he has sold his invention so far as it is or may be embodied in that particular article.<sup>30</sup>

13. See *id.* at 180.

14. See *id.* (citations omitted).

15. *Id.*

16. See *Keeler v. Standard Folding-Bed Co.*, 157 U.S. 659 (1895).

17. See *id.* at 667.

18. *Id.*

19. 316 U.S. 241 (1942).

20. See *id.* at 246-47.

21. See *id.* at 249.

22. See *id.* at 244.

23. See *id.*

24. See *id.*

25. See *id.* at 244.

26. See *id.* at 248 (“[E]ach blank . . . embodies essential features of the patented device and is without utility until it is ground and polished as the finished lens of the [method] patent.”).

27. See *id.*

28. See *id.* at 252 (“[A] patentee who manufactures the product protected by the patent and fails to retain his ownership in it can not control the price at which it is sold by his distributors.”) (citing *U.S. v. General Electric Co.*, 272 U.S. 476 (1926)).

29. See *id.* at 249.

30. *Id.* at 250-51.

Accordingly, although the lens company only practiced preliminary steps in the finishing method patents, the Court found that, like the lens blank patents, the finishing method patents were exhausted.

Nonetheless, the Court also stated that the lens company's authorized sale of the lens blanks "is...a license to practice the final stages of the patent procedure."<sup>31</sup> While this statement may appear out of place because implied licenses are generally not created by transactions involving express patent licenses, the Supreme Court determined that Univis could not enforce its method patents against those who purchased blanks from the lens company.

The Court found that its test in the *Masonite* case was satisfied because Univis received full compensation for its patent rights in the form of royalties paid by the lens company based on its sales of the lens blanks.<sup>32</sup> Once Univis received full compensation, patent law provided no public policy justification for Univis' further control of those products pursuant to its patent rights. Accordingly, the Court held that Univis' agreements with its other licensees were not supported by patent law:

[T]he purpose of the patent law is fulfilled with respect to any particular article when the patentee has received his reward for the use of his inventions by the sale of the article, and that once that purpose is realized the patent law affords no basis for restraining the use and enjoyment of the thing sold.<sup>33</sup>

Thus, the Court recognized that a patentee's right to contract around exhaustion is limited and concluded that the patentee's price-fixing licensing scheme violated the antitrust laws.<sup>34</sup>

### III. The Federal Circuit's Development and Interpretation of the Exhaustion Doctrine

Since *Univis*, the Federal Circuit has repeatedly applied the doctrine of patent exhaustion, often using its analysis from *Mallinckrodt, Inc. v. Medipart, Inc.* as a framework for considering the Doctrine in the context of use restrictions.<sup>35</sup> Starting with *Mallinckrodt*, the Federal Circuit's decisions have

developed the doctrine beyond the core principles established in the Supreme Court precedent, authorizing licensing arrangements that allow patentees to accomplish their business objectives in more complex transactions without exhausting their patent rights. And apparently because Supreme Court decisions describing the boundaries of the patent exhaustion doctrine discussed whether the sales in question were unconditional, the Federal Circuit has construed those decisions as implicitly requiring that an authorized sale be unconditional before the patent exhaustion doctrine is triggered.

These developments may reflect the Federal Circuit's recognition that patentees do not receive the full reward for a patented article when they agree to a conditional sale or license. In any event, Federal Circuit precedent has enabled patentees to exercise more control, under patent law, over the downstream use of patented articles following their sale.

#### A. Applying the Exhaustion Doctrine to Conditional Sales

In *Mallinckrodt*, the patentee sought to impose a single use restriction on his patented nebulizer by placing a notice on each product and package insert that the product could only be used once.<sup>36</sup> Rather than follow the notice, hospitals that purchased the patented nebulizers sent them to Medipart for reconditioning after each use and Medipart then returned the reconditioned nebulizers to the hospitals for further use.<sup>37</sup>

The Federal Circuit viewed *Mallinckrodt* as presenting the issue of whether patent law permitted a patent owner, such as *Mallinckrodt*, to validly impose restrictions on the purchasers of a patented item.<sup>38</sup> The Court did not interpret *Adams v. Burke* or other Supreme Court precedent as barring all restrictions on patented articles at the time of sale.<sup>39</sup> Rather, "[u]nless the condition violates some other law or policy..., private parties retain the freedom to contract concerning conditions of sale."<sup>40</sup> The Court noted that "[i]f the sale of the [patented device] was validly conditioned under the applicable law such as the law governing sales and licenses, and if the restriction on reuse was within the scope of the patent grant or otherwise justified, then violation

31. *Id.* at 249.

32. See *id.* at 251.

33. *Id.*

34. See *id.* at 252.

35. See 976 F.2d 700, 702 (Fed. Cir. 1992); see also Amber Hatfield Rovner, *Practical Guide to Application of (or Defense Against) Product-Based Infringement Immunities Under the Doctrines of Patent Exhaustion and Implied License*, 12 *Tex. Intell. Prop. L.J.* 227, 238 (2004) (noting the foundational importance of *Mallinckrodt*).

36. See *Mallinckrodt*, 976 F.2d at 702.

37. See *id.*

38. See *id.* at 701.

39. See *id.* at 708.

40. *Id.* (citing *Univis*, 316 U.S. 241 (1942)).

of the restriction may be remedied by action for patent infringement.”<sup>41</sup> Thus, the Federal Circuit found that the exhaustion doctrine did not preclude *Mallinckrodt* from enforcing its “Single Use Only” condition in a patent infringement action. Notably, *Mallinckrodt* endorsed the practice of patentees enforcing use restrictions, imposed at the time of sale, against downstream purchasers and licensees in a patent infringement action.<sup>42</sup>

## B. Limitations on the Exhaustion Doctrine Related to Method Claims and to Sales Outside of the United States

In addition to the exception provided by *Mallinckrodt* and its progeny, the Federal Circuit also recognized two limitations on the exhaustion doctrine.

First, it has held that the exhaustion doctrine does not apply to method claims, saying in *Bandag, Inc. v. Al Bolser’s Tire Stores, Inc.*:

The doctrine that the first sale by a patentee of an article embodying his invention exhausts his patent rights in that article...is inapplicable here, because the claims...are directed to a ‘method of retreading’ and cannot read on the equipment Bolser used in its cold process recapping.<sup>43</sup>

Second, the Federal Circuit has held that, for a U.S. patent to be exhausted, an authorized first sale must have occurred in the United States.<sup>44</sup> “[W]hen a patented device has been lawfully sold in the United States, subsequent purchasers inherit the same immunity under the doctrine of patent exhaustion.”<sup>45</sup> A later Federal Circuit decision, considering the case on appeal for a second time, reiterated: “[A] patentee’s authorization of an international first sale [outside the United States] does not affect exhaus-

tion of that patentee’s rights in the United States.”<sup>46</sup> Foreign sales “can never occur under a United States patent because the United States patent system does not provide for extraterritorial effect.”<sup>47</sup>

## C. Implied License: A Distinct Doctrine Often Entwined with Exhaustion

The Federal Circuit has also interpreted *Univis* as suggesting that an implied license stems from the exhaustion of a patent right.<sup>48</sup> Under a number of theories, including acquiescence, conduct, equitable estoppel and legal estoppel, a patentee’s conduct may lead to an implied license.<sup>49</sup> For example, where a patentee sells a product without an express disclaimer and the use of that product necessarily involves a patented method, the patentee may have unintentionally granted the purchaser an implied license to practice the patented method.

The Federal Circuit has set forth a two-part test for determining whether an implied license results from the sale of an unpatented article used in a patented process.<sup>50</sup> First, no license can be implied where the article involved has other non-infringing uses, “even if only as replacement parts.”<sup>51</sup> Second, “[a] mere sale does not import a license except where the circumstances plainly indicate that the grant of a license should be inferred.”<sup>52</sup> In considering the second prong of the test, the circumstances of the sale, the Federal Circuit has focused on the time of the sale itself.

In particular, in the context of indirect infringement, defendants have raised the argument that the alleged direct infringer was acting under an implied license and thus its actions cannot constitute the direct infringement upon which the indirect infringement allegations are based. For example, in *Met-Coil Systems Corp. v. Korners Unlimited, Inc.*, Met-Coil was the assignee of a patent claiming an apparatus and method for connecting sections of metal ducts used in heating and air conditioning systems.<sup>53</sup> According to the patent, the ends of the metal duct sections are bent to form flanges, specially shaped corner pieces are snapped in place, and the sections

41. *Id.* at 709; cf. *Hewlett-Packard Co. v. Repeat-O-Type Stencil Manufacturing Corp.*, 123 F.3d 1445, 1453-54 (Fed. Cir. 1997) (rejecting H-P’s attempt to enforce a use restriction contained in the instructions accompanying the product as sold because the restriction was not contractually significant, but rather was “simply a seller’s hope or wish”).

42. See *B. Braun Medical v. Abbott Laboratories*, 124 F.3d 1419, 1426 (Fed. Cir. 1997) (under *Mallinckrodt*, violations of valid conditions entitle the patentee to a remedy for either patent infringement or breach of contract).

43. 750 F.2d 903, 924 (Fed. Cir. 1984); see also *Glass Equipment Development, Inc. v. Besten, Inc.*, 174 F.3d 1337 (Fed. Cir. 1999) (reiterating that the exhaustion doctrine is inapplicable to method claims in the context of sales of unpatented articles); As discussed *infra*, *Quanta* directly overrules this position, finding that method claims are subject to exhaustion.

44. See *Jazz Photo Corp. v. International Trade Commission*, 264 F.3d 1094, 1105 (Fed. Cir. 2001).

45. *Id.*

46. *Fuji Photo Film Co., Ltd. v. Jazz Photo Corp.*, 394 F.3d 1368, 1376 (Fed. Cir. 2005).

47. *Id.*

48. See *Anton/Bauer, Inc. v. PAG, Ltd.*, 329 F.3d 1343, 1349-50 (Fed. Cir. 2003).

49. See Rovner, *supra* note 39, at 246.

50. See *Bandag, Inc. v. Al Bolser’s Tire Stores, Inc.*, 750 F.2d 903 (Fed. Cir. 1984).

51. *Id.* at 924-25.

52. *Id.* at 925 (citation omitted).

53. See 803 F.2d 684, 685 (Fed. Cir. 1986).

are bolted together.<sup>54</sup> Met-Coil made and sold machines that its customers used to bend the ends of metal ducts into flanges so as to practice the claimed inventions and also sold the specially-shaped corner pieces for use with the flanges.<sup>55</sup> Korners made corner pieces for use with Met-Coil's integral flanges and sold them to purchasers of Met-Coil's machines.<sup>56</sup>

Met-Coil sued Korners for inducing infringement of its apparatus and method claims based on the underlying direct infringement of Met-Coil's customers.<sup>57</sup> Korners argued in defense that Met-Coil, by selling the roll-forming machine, granted an implied license under the patent to its customers and thus Korners neither induced nor contributed to infringement of the patent.<sup>58</sup>

The Federal Circuit first found that Met-Coil's machines had no non-infringing use, and then focused on the circumstances of the sale based on the second prong of the *Bandag* test.<sup>59</sup> The court concluded that because Met-Coil's notices, containing restrictions it sought to impose on its customers, were sent to its customers after they had purchased the machines, the notices were "not a part of the circumstances at the time of the sale, when the implied license would have arisen."<sup>60</sup> Thus, the circumstances of the sale plainly indicated that the grant of a license should be inferred because Met-Coil's sales were unrestricted.<sup>61</sup>

*Anton/Bauer, Inc. v PAG, Ltd.*, demonstrates the potential pitfalls of a patentee selling only part of its patented combination.<sup>62</sup> Anton/Bauer alleged that PAG's sales of the PAG battery pack induced or contributed to infringement of Anton/Bauer's combination patent,<sup>63</sup> arguing that its own customers were directly infringing its combination patent when they combined PAG's battery pack and other non-patented Anton/Bauer parts.<sup>64</sup> Anton/Bauer did not sell its patented combination as one product; rather, it sold various unpatented components of that combination and allowed its customers to assemble the components themselves.<sup>65</sup> PAG argued that it was

not liable for indirect infringement because Anton/Bauer's customers had an implied license to practice the claimed combination by virtue of Anton/Bauer's unrestricted sales of components which had no non-infringing use.<sup>66</sup>

As in *Met-Coil*, the circumstances of the sales by Anton/Bauer to its customers indicated that the sales were authorized and made without any express restrictions on the use of the components.<sup>67</sup> Thus, "by the unrestricted sale of the [component], Anton/Bauer grant[ed] an implied license to its customers to employ the combination claimed in the...patent."<sup>68</sup> The Federal Circuit clarified, however, that the determination of an implied license in this case does not obviate the applicability of contributory infringement in every case; rather, "it limits a patentee's ability to assert contributory infringement where the patentee has chosen to sell a part, but not all, of its patented combination."<sup>69</sup>

## IV. Quanta: a Clarification of the Exhaustion Doctrine

In *Quanta*, recently decided by the Supreme Court, LG's patent portfolio encompassed patents directed to components used in personal computers, such as semiconductor chips, and patents directed to methods and systems for combining components into an operational computer system.<sup>70</sup> To avoid litigation between the two companies, LG and Intel entered into a License Agreement where LG licensed its patent portfolio to Intel.<sup>71</sup>

Intel makes and sells products at multiple levels in the computer system supply chain. While it makes and sells semiconductor chips to third parties, it also sells computer systems that it makes by combining its chips with other Intel components. The License Agreement authorized Intel to make and sell products that would otherwise infringe LG's patents.<sup>72</sup> Nonetheless, LG sought to avoid granting third parties, who acquired patented chips from Intel, an implied license to make patented computers

54. See *id.*

55. See *id.*

56. See *id.*

57. See *id.*

58. See *id.*

59. See *id.* at 686-87.

60. *Id.* at 687.

61. See *id.*

62. See 329 F.3d 1343, 1353 (Fed. Cir. 2003).

63. See *id.* at 1347.

64. See *id.*

65. See *id.*

66. See *id.* at 1350-53.

67. See *id.* at 1347.

68. *Id.*

69. See *id.* at 1353.

70. See *Quanta Computer, Inc. v. LG Electronics, Inc.*, Brief of Respondent, No. 06-937, 2007 WL 4244683, at \*1 (U.S. Dec. 3, 2007).

71. See *id.* at \*2.

72. See *id.*; *LG Elecs., Inc. v. Asustek Computer, Inc.*, Nos. C 01-00326, -01375, -01594, -02187, -01552, 2002 US Dist. LEXIS 25956, at \*6 (N.D. Cal. Aug. 20, 2002).

by combining Intel chips with other components.<sup>73</sup> Thus, the License Agreement prohibited Intel from conveying a license to third parties to combine Intel products with non-Intel products.<sup>74</sup> Additionally, the License Agreement purported not to alter the usual rules of patent exhaustion.<sup>75</sup> In a separate Master Agreement, Intel agreed to give written notice to its chip purchasers that the license did not extend “expressly, or by implication, to any product that [its chip purchasers] make by combining an Intel product with any non-Intel product.”<sup>76</sup> Before the License Agreement became effective, Intel notified its customers by letter of license disclaimer.<sup>77</sup>

Thereafter, Quanta bought patented microprocessor chips from Intel, and assembled the chips and other non-Intel components into operating computers systems.<sup>78</sup> LG sued Quanta and other similarly situated computer manufacturers for patent infringement.<sup>79</sup> LG asserted that the computers Quanta manufactured infringed its patents directed to methods and systems for combining components into an operational computer system.<sup>80</sup>

## A. The Trial Court’s Decision

The trial court found that Intel’s chips were “destined...to be finished by the purchaser in conformity with the [system] patent,” and had no other reasonable non-infringing use.<sup>81</sup> Relying on *Univis*, the trial court held that the system claims in the asserted patents were exhausted.<sup>82</sup> LG was therefore precluded from enforcing its system patents against later purchasers who used the chips for their sole intended purpose of being assembled into a computer system.<sup>83</sup> The trial court also held, however, that the method claims in the asserted patents were not exhausted because, under Federal Circuit precedent, the sale of a device does not exhaust a patentee’s

rights to enforce method claims.<sup>84</sup> The court found that Quanta’s purchase of the chips was not conditioned on an agreement by Quanta to restrict the use of the chips to Intel products.<sup>85</sup> Finally, the notice sent by Intel disclaiming the existence of a license to combine the chips with non-Intel components, while not a condition of the sale, was sufficient to indicate that a license was not implied.<sup>86</sup>

## B. The Federal Circuit’s View

On appeal, the Federal Circuit affirmed in part and reversed in part. The Federal Circuit agreed that the sale of a device does not exhaust a patentee’s rights in its method claims, affirming that portion of the court’s decision.<sup>87</sup> The Federal Circuit, however, reversed a portion of the district court decision, and found that the system claims of the asserted patents were not exhausted.<sup>88</sup> The court reasoned that there was no exhaustion because the sale of chips to Quanta was conditional and the LG-Intel License Agreement expressly disclaimed granting a license to allow computer manufacturers to combine Intel’s licensed semiconductor chips with non-Intel components.<sup>89</sup> The Federal Circuit noted that LG required Intel to notify its customers of the limited scope of Intel’s license, which Intel did.<sup>90</sup>

## C. Arguments Raised to the Supreme Court

On appeal to the Supreme Court, LG argued that the patent exhaustion doctrine should be narrowly interpreted and contended that the Court should affirm the Federal Circuit’s holding that sales to Intel’s customers did not trigger exhaustion.<sup>91</sup> LG distinguished the asserted patents, which are directed to methods and systems for combining components into an operational computer system, from the patents that were embodied by Intel’s semiconductor chips.<sup>92</sup> LG argued that Intel’s sale of articles, that embodied LG’s component patents but did not fully embody LG’s computer system patents, could not exhaust LG’s computer system patents, and that the doctrine of exhaustion has never been applied in that way.<sup>93</sup> LG claimed that the asserted patents were infringed, not by the semiconductor chips alone, but by the

73. See Brief of Respondent, 2007 WL 4244683, at \*2.

74. See *id.*

75. *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937, 2008 U.S. LEXIS 4702, at \*11 (U.S. June 9, 2008).

76. *Id.*, 2008 LEXIS 4702.

77. See *Asustek*, 2002 US Dist. LEXIS 25956 at \*6.

78. See *id.* at \*6-7.

79. See *id.*

80. See *LG Elecs. v. Bizcom Elecs., Inc.*, 453 F.3d 1364, 1369 (Fed. Cir. 2006). The Intel-produced chips included some elements from LG’s patents, but these components needed to be combined with other technology to read on LG’s patents. See *Asustek*, 2002 US Dist. LEXIS at \*12.

81. See *LG Elecs., Inc. v. Asustek Computer, Inc.*, 248 F. Supp. 2d 912, 915 (N.D. Cal. 2003).

82. See *id.*

83. See *Asustek*, 2002 US Dist. LEXIS 25956 at \*41.

84. See *LG Elecs.*, 248 F. Supp. 2d at 918.

85. See *id.* at 917.

86. See *id.* at 918.

87. *Bizcom*, 453 F.3d at 1370.

88. See *id.* at 1369-70.

89. See *id.*

90. See *id.*

91. See Brief of Respondent, 2007 WL 4244683, at \*27-38; *Bizcom*, 453 F.3d at 1369-70.

92. See Brief of Respondent, 2007 WL 4244683, at \*2.

93. See *id.* at \*13.

computer systems that Quanta made when it elected to combine the chips with other components.<sup>94</sup> LG distinguished *Univis* by explaining that exhaustion applied in *Univis* because the lens blanks sold by the lens company and the subsequent acts by the lens blank purchasers both implicated *the same patent*.<sup>95</sup> Since LG asserted different patents, it argued that the exhaustion doctrine did not apply.<sup>96</sup> LG further asserted that its method claims were not exhausted because the exhaustion doctrine does not apply to method claims.<sup>97</sup> Finally, LG contended that, as both the trial court and Federal Circuit found, Quanta could not have an implied license to practice the invention because Intel sent Quanta notice that no such license was being conveyed.<sup>98</sup>

Quanta argued that it need not pay royalties to LG because Intel's authorized sale of semiconductor chips that embody essential features of LG's patents and have no reasonable non-infringing use exhausted LG's patents.<sup>99</sup> Quanta contended that the Intel chips had no non-infringing use and that the only reasonable use the manufacturers could make of the chips was to make combination products that would infringe LG's patents.<sup>100</sup> Finally, Quanta argued that *Univis* required a finding that Intel's authorized sale of the chips, having no reasonable use other than the practice of LG's asserted patents, exhausted LG's rights<sup>101</sup> and that patent exhaustion applies to method claims under such circumstances.<sup>102</sup>

## D. The Supreme Court Clarifies Exhaustion

The Court ultimately addressed several issues pertaining to patent exhaustion, including: (1) whether the exhaustion doctrine applies to method claims; (2) the extent to which a product must embody a patent in order to trigger exhaustion; and (3) whether an authorized sale of a product can result in exhaustion despite attempts to control the use of the product.

### 1. Patent Exhaustion Applies to Method Claims

The Supreme Court found that the exhaustion doctrine applies to method claims, noting that "nothing in this Court's approach to patent exhaustion supports [LG's] argument that method patents

cannot be exhausted."<sup>103</sup> It reiterated that its precedent demonstrated that patented methods may be "embodied in a product," the sale of which triggers exhaustion of that patent.<sup>104</sup> The Court did not see any justification for departing from this rule which would only undercut the exhaustion doctrine by allowing patentees to draft around the rule by using method rather than apparatus claims.<sup>105</sup> In so ruling, the Supreme Court reversed years of recent Federal Circuit precedent, most notably *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*, 750 F.2d 903, 924 (Fed. Cir. 1984), which held that exhaustion did not apply to method patents.

### 2. Patent Exhaustion is Triggered by the Authorized Sale of Products that Embody the Essential Features of the Patented Invention and Whose Only Reasonable and Intended Use is to Practice the Patent.

The Court then determined that the products Intel sold to Quanta did indeed embody the patents at issue. Applying its most recent discussion of patent exhaustion from *Univis*,<sup>106</sup> the Court found that exhaustion was triggered by Intel's sale to Quanta under the License Agreement because the "only reasonable and intended use [of the microprocessors and chipsets] was to practice the patent[s] and because they 'embodie[d] essential features of [the] patented invention[s].'"<sup>107</sup> Just as in *Univis*, there was no reasonable use for the microprocessors or chipsets sold by Intel other than incorporating them into computer systems that practiced the LG patents.<sup>108</sup> In addition, even though the microprocessors and chipsets sold by Intel to Quanta only partially practiced the LG patents, they embodied everything inventive about the LG patents because "the only step necessary to practice the patent[s] [was] the application of common processes or the addition of standard parts."<sup>109</sup>

### 3. An Authorized Sale of a Product Can Result in Exhaustion Despite Attempts to Control the Use of the Product

If a licensee is authorized to make a sale, that sale can exhaust the licensor's patent rights even though the license agreement attempts to control

94. See *id.* at \*18.

95. See *id.* at \*26-28.

96. See *id.*

97. See *id.* at \*51.

98. See *id.* at \*13.

99. See *Quanta Computer, Inc. v. LG Elecs., Inc.*, Brief for Petitioners, No. 06-937, 2007 WL 3276505, at \*15-38 (U.S. Nov. 5, 2007).

100. See *id.* at \*15.

101. *LG Elecs.*, 248 F. Supp. 2d at 912-915; *Asustek*, 2002 US Dist. LEXIS 25956 at \*41.

102. See Brief for Petitioners, 2007 WL 3276505, at \*34.

103. *Quanta Computer, Inc. v. LG Elecs., Inc.*, No. 06-937, 2008 U.S. LEXIS 4702, at \*19 (U.S. June 9, 2008).

104. *Id.*

105. *Id.*

106. *United States v. Univis Lens Co.*, 316 U.S. 241 (1942).

107. *Quanta*, 2008 U.S. LEXIS 4702, at \*24-25 (quoting *Univis*, 316 U.S. at 249-51.)

108. *Id.* at \*25.

109. *Id.* at \*28.

the use of the product by the licensee's customers. The Master Agreement in *Quanta* required Intel to notify its customers (e.g., Quanta) of a limitation in the scope of Intel's license, which Intel did. The Court, however, rejected LG's argument that the notice requirement somehow resulted in Intel's sales being unauthorized.<sup>110</sup> Unlike the license restrictions in *General Talking Pictures Corp. v. Western Electric*,<sup>111</sup> which specifically limited the types of sales permitted by the licensee—sales for private and home use were authorized, but sales for commercial use were not—nothing in the License Agreement with Intel impaired its authority to sell products that embodied LG's patents.<sup>112</sup> Rather, the License Agreement broadly permitted Intel to “make, use, [or] sell” products free of LG's patent claims.<sup>113</sup>

Further, even though Intel was required to provide notice of its license limitation to its customers, neither party contended that (a) Intel breached the notice requirement or (b) that a breach of the Master Agreement (the only agreement containing the notice requirement) would constitute a breach of the License Agreement.<sup>114</sup> Thus, patent exhaustion was triggered because “no conditions limited Intel's authority to sell products [the microprocessors and chipsets] substantially embodying the patents.”<sup>115</sup> Thus, the doctrine of patent exhaustion prevented LG from further asserting its patent rights with respect to those products that substantially embodied the patents.<sup>116</sup>

In its final footnote, the Supreme Court stated that although the sale here exhausted LG's *patent* rights, an authorized sale “does not necessarily limit [LG's] other contract rights[,]” such as pursuing a breach-of-contract claim.<sup>117</sup> In this case, however, because LG's complaint did not include such a claim, the Court “express[ed] no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages.”<sup>118</sup>

110. *Id.* at \*35.

111. 304 U.S. 175, 181 (1938).

112. *Quanta*, 2008 U.S. LEXIS 4702, at \*35.

113. *Id.* at \*33.

114. *Id.* The Master Agreement, on its face, precluded the likelihood that its breach would constitute a breach of the License Agreement by stating: “a breach of this Agreement shall have no effect on and shall not be ground for termination of the Patent License.” *Quanta*, 2008 U.S. LEXIS 4702, at \*11.

115. *Id.* at \*35.

116. *Id.*

117. *Id.* at \*35 n.7.

118. *Id.*

119. See *Fuji Photo Film Co., Ltd. v. Jazz Photo Corp.*, 394 F.3d 1368, 1376 (Fed. Cir. 2005).

## V. Conclusion

For those interested in issues involving international exhaustion, it is useful to note that this decision does not purport to alter the Federal Circuit's current position that in order to invoke the U.S. patent exhaustion doctrine, an authorized first sale must occur in the United States under a U.S. patent.<sup>119</sup>

For those interested in how license agreements should be structured to avoid exhaustion, Quanta provides more clarity on the effect of a number of common provisions in transactions involving fragmented manufacturing markets, where IC chips, subassemblies, and the final value-added product are sequentially made by different parties in the supply chain.

Patent licensors can no longer rely on method claims to save them from exhausting their rights in a patent in which product claims were exhausted. In addition, patent licensors now know that if they follow the LG scenario of authorizing their licensees to sell products covered by the licensed patents, they cannot avoid exhausting their rights in the patents simply by requiring the licensee to provide notice to its customers that they are not licensed under the patents.

To be able to assert rights against a licensee's customer, the patent licensor may now need to have its licensee agree to less attractive business conditions up front, either to avoid exhaustion or by attempting to create contractual rights that are enforceable regardless of whether the patents rights are exhausted. For example, in the first instance, the licensor can limit sales of components only to customers who are licensed by the licensor, and in the second instance can require the licensee to condition the sale of its components to its customers on those customers taking a license before assembling the components or combining them with non-licensed components.

Going forward, it will be interesting to see how licensors and licensees will structure agreements to navigate the exhaustion issue, and how the courts will interpret and apply the exhaustion doctrine and evaluate the enforceability of contractual restrictions. ■

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