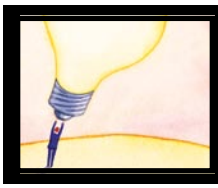
Legal Times
WEEK OF JULY 7, 2008 • VOL. XXXI, NO. 27
ALM



A Practice Focus
Intellectual Property

High Court Sees a Lot More Exhaustion

After *Quanta Computers*, prudent patentees ought to re-evaluate their licensing arrangements.

By David L. Cavanaugh and Owen K. Allen

On June 9, the Supreme Court made its latest pronouncement on patent law. In *Quanta Computers v. LG Electronics,* the Court interpreted anew the doctrine of patent exhaustion. Now prudent patentees who wish to control the post-sale use or resale price of their products should re-evaluate their licensing arrangements.

This marks the first time in 66 years that the Court has addressed patent exhaustion, but the decision fits within the Court's recent pattern of greater attention to patent law. Just last year, in *KSR v. Teleflex*, the Court arguably created a higher standard of nonobviousness, and two years ago, in *eBay v. MercExchange*, the Court held that a finding of patent infringement does not automatically require an injunction against the infringer.

The Court continued its newfound interest in patent law in *Quanta*. Although the exact ramifications of the decision are unclear, and probably will remain unclear for some time, it appears that patent law now provides less certain protection for patentees' efforts to control products after they are sold. Care should be taken during negotiation of licensing agreements so that downstream rights are preserved to the fullest extent.

The Exhaustion Story

The roots of this longstanding doctrine of patent exhaustion, also known as the "first sale" doctrine, date from the mid-19th century. The doctrine states that the authorized first sale of a patented article exhausts the patentee's patent rights in that article. Accordingly, if a patentee sells a patented item, it cannot exclude the purchaser from using or selling that particular item. The patentee also cannot exclude any downstream purchasers from using or further reselling that item.

Patent exhaustion is relatively straightforward for sales of a patented apparatus—i.e., if the patentee makes and sells a patented apparatus, a purchaser can use and resell that apparatus without any recourse by the patentee.

Application of the exhaustion doctrine is not as clear for patents on methods, or for sales of articles that nearly, but don't completely, embody an apparatus patent. For example, if a patentee sells a patented component to a purchaser, but the patentee also owns a separate apparatus patent that covers combinations of that sold component with other components, is the apparatus patent exhausted with the sale of the component? Likewise, if a patentee sells a patented apparatus to a purchaser, but also owns a separate method patent that covers the use of that apparatus in a particular method, is the method patent exhausted with the sale of the apparatus? These are questions that the Supreme Court attempted to settle in *Quanta*.

Three Players

Quanta involved three players—a patentee, a microchip manufacturer, and a computer manufacturer. LG Electronics (LGE), the patentee, owned an extensive portfolio of patents that covered numerous aspects of computer design. Quanta Computers manufactured computers and sold them to various computer retailers.

Under a broad cross-license agreement with LGE, Intel Corp. manufactured computer chips and chipsets and sold them to Quanta. The license agreement between LGE and Intel authorized Intel to "make, use, [or] sell" any products covered under LGE's patents. It also required Intel to notify its customers that the license agreement did not extend to them and to inform those customers that they did not have any license, express or implied, to combine Intel products with non-Intel products. Intel complied with this requirement. LGE's apparent intent was to reserve

the right to collect additional downstream royalties, i.e., royalties from purchasers and users of LGE's patented products at any point in the chain of commerce after the initial sale.

Quanta purchased microchips and chipsets from Intel and, despite the explicit warning from Intel, subsequently combined them with non-Intel computer components to make computers. LGE sued Quanta for patent infringement, alleging that Quanta's combination of the purchased chips and chipsets with other computer components infringed LGE's apparatus and method patents. Quanta argued that LGE's apparatus and method patents were exhausted with the authorized sale by Intel to Quanta.

The U.S. Court of Appeals for the Federal Circuit held that LGE's patents had not been exhausted. Specifically, the court held that method patents could never be exhausted and that because Intel's sale to Quanta was a conditional sale, LGE's apparatus patents had also not been exhausted.

The Supreme Court reversed the Federal Circuit's holding on whether method patents can be exhausted, and it further held that Intel's sale to Quanta exhausted LGE's patents.

The Court first held that method patents could be exhausted, just like apparatus patents. The Court reasoned that although "a patented method may not be sold in the same way as an article or device, … methods nonetheless may be 'embodied' in a product, the sale of which exhausts patent rights."

The Court then set forth a two-part test to determine if a patent is exhausted by the sale of a component product.

First, the "only reasonable and intended use" of the sold product must be to practice the patent. The Court found that the chips and chipsets sold by Intel to Quanta had only one reasonable and intended use—to be combined with other computer components as claimed by LGE's apparatus and method patents.

Second, the product sold must "substantially embody" the patent. If the final steps in practicing a patent are "common and noninventive" and involve the "application of common processes or the addition of standard parts," then the patent is exhausted by the sale of the component product. The Court found that the chips and chipsets sold by Intel to Quanta "substantially embodied" LGE's apparatus and method patents because everything inventive in the patents was already present in the chips and chipsets being sold; the combination of the chips and chipsets with non-Intel components did not constitute an inventive step.

Finally, the Court reaffirmed that a sale must be authorized to trigger the exhaustion doctrine. The Court found that Intel's sale of chips and chipsets to Quanta was fully authorized because Intel's license agreement with LGE "authorized Intel to sell products that practiced the LGE patents" and "[n]o conditions limited Intel's authority to sell products substantially embodying the patents." The Court held that LGE's patents had therefore exhausted.

The Court noted, however, that even though LGE's patent rights had been exhausted, LGE might still be able to enforce its contractual rights, if any. The Court declined to comment on whether LGE had any contractual rights or which rights would be enforceable.

Patentee Beware

Although *Quanta*'s importance is still being debated, it appears that there is much to be aware of when negotiating complex licensing agreements.

The Court's newly articulated interpretation of the patent exhaustion doctrine leaves patentees to be more mindful of downstream uses of the device, if such uses are of significant value. An authorized sale of a patentee's products will not only exhaust the product patent, but may also exhaust related patents, including method and apparatus patents.

Although a patentee's options following *Quanta* are not entirely clear, several options may protect downstream rights. For one, patentees may try entering into licensing agreements with product manufacturers that carefully define the authority of the manufacturers to sell the patented products. For example, a patentee may contractually require a manufacturing licensee to confirm that a potential customer has obtained a separate license from the patentee before selling the product. A sale without such confirmation would amount to an unauthorized sale. Because *Quanta* clearly emphasized the necessity of an authorized sale for the exhaustion doctrine to apply, any unauthorized sale would appear to preserve patent rights.

Patentees may also attempt to rely on contractual remedies. For example, a patentee may enter into a contract with its customer in which the customer agrees to use the purchased products only for certain purposes. Although *Quanta* reserved judgment on whether patentees may control the downstream use of a sold product under contract law, the Court's exhaustion precedents (including *Motion Picture Patents Co. v. Universal Film Manufacturing Co.* (1917)) appear to suggest that such restrictions may be enforceable.

Purchaser Beware

A strong patent exhaustion doctrine may benefit purchasers of patented products by shielding them from some patent infringement lawsuits. In particular, purchasers may now be able to combine the patented products with other products or use the products in various methods without fearing an infringement lawsuit, so long as the patented products meets the criteria in *Quanta*.

Purchasers of patented products, however, should still remain alert. Because patentees may now be looking for new ways to protect their patent rights, buyers may be exposed to infringement liability in ways they have not seen in the past. In particular, more than ever before, patentees may attempt to limit the authority of their manufacturing licensees to sell patented products. An unauthorized sale exposes both the manufacturing licensee and the purchaser to potential infringement liability. Purchasers may need to exercise greater diligence when purchasing patented products from a manufacturer.

By deciding *Quanta*, the Supreme Court changed the patent exhaustion landscape. The Court seemed to indicate that the downstream control of a patented product by the patentee should be limited. The implications of the decision, especially for contractual relationships, will take years to become apparent, but patentees should re-examine their technology transfer and licensing practices in light of this decision.

David L. Cavanaugh is a partner and Owen K. Allen is an associate in the D.C. office of Wilmer Cutler Pickering Hale and Dorr. They may be contacted at david.cavanaugh@wilmerhale.com and owen.allen@wilmerhale.com.