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Patent Exhaustion – The Limits to Post-Sale Restrictions Following *Quanta*

The longstanding "patent exhaustion doctrine" provides that the initial authorized first sale of a patented item terminates all patent rights to that item. Thus, the buyer and any subsequent or downstream buyers may use or resell that article without incurring liability for patent infringement. This doctrine is grounded in the common sense view that the purpose of buying a patented article is to use it as claimed by the patent. Patentees benefit from this default rule because they can sell their products at their highest value (*i.e.*, with all of the rights to use the product) without needing to provide express waivers to assure customers that they will not risk liability for infringement. At the same time, the doctrine does not prevent patentees from making a restricted sale, offering terms and conditions that limit the use or resale of a patented article. *See Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 705 (Fed. Cir. 1992) ("The practice of granting licenses for restricted use is an old one . . . . So far as it appears, its legality has never been questioned."). The permissible scope of such restrictions is generally subject to limitations with regard to potential anticompetitive effects or equitable considerations. *Id.* at 703 ("[The] right to exclude may be waived in whole or in part. The conditions of such waiver are subject to patent, contract, antitrust, and any other applicable law, as well as equitable considerations such as are reflected in the law of patent misuse." Quoting *E. Bement & Sons v. National Harrow Co.*, 186 U.S. 70, 91 (1902)).

The Supreme Court, in *Quanta Computer, Inc. v. LG Electronics, Inc.*, __ U.S. __, 128 S. Ct. 2109 (2008), recently addressed the doctrine of patent exhaustion and "whether it applied to the sale of components of a patented system that must be combined with additional components in order to practice the patented methods." *Id.* at 2113. A method patent claim, unlike an apparatus or product claim, is not limited to a particular article or device, but rather is defined by a series of procedures or steps. Method claims are not "sold in the same way as an article or device, but methods nonetheless may be 'embodied' in a product." *Id.* at 2117. *Quanta* also addressed whether the license agreement that authorized sales under the patent included restrictions sufficient to preclude the application of the doctrine. *Id.* at 2113. The Supreme Court reversed the Federal Circuit, stating, "[b]ecause the exhaustion doctrine applies to method patents, and because the license authorizes the sale of components that substantially embody the patents in suit, the sale exhausted the patents." *Id.*

Quanta continues a recent trend of cases in which the Supreme Court has taken a dim view of patent doctrines that generally favored patentees. *See KSR International Co. v. Teleflex, Inc.*, __ U.S. __, 127 S. Ct. 1727 (2007) (restraining the Federal Circuit's obviousness test in favor of "common sense"); *Microsoft Corp. v. AT&T Corp.*, __ U.S. __, 127 S. Ct. 1746 (2007) (limiting extraterritorial application of patent infringement claims); *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118, 127 S. Ct. 764 (2007) (permitting declaratory judgment challenges by licensees in good standing); *eBay v. MercExchange, L.L.C.*, 547 U.S. 388, 126 S. Ct. 1837 (2006) (limiting the availability of injunctive relief). In *eBay*, Justice Kennedy in a concurring opinion, expressly raised concerns regarding "firms [that] use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees." 547 U.S. at 396. Such firms, often referred to as patent trolls, have generated a substantial amount of criticism of patent rights in recent years.

In an exception to this trend, the Court held that the courts could no longer presume that a patent confers the market power necessary to establish that a tying arrangement is unlawful under the antitrust laws. *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 126 S. Ct. 1281 (2006).

In *Quanta*, LG Electronics ("LGE") licensed a portfolio of patents to Intel Corporation ("Intel") for use in Intel microchips and microprocessors. 128 S. Ct. at 2114. The license included three LGE patents for the processing of information in a computer system. *Id*. at 2113-2114. The license agreement authorized Intel to market, use and sell products that practiced the LGE patents. *Id*. at 2114. The agreements, however, did not extend 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." *Id*. (internal quotations omitted). Under a separate Master Agreement between LGE and Intel, Intel also agreed to notify purchasers that its license "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product." *Id*. (internal quotations omitted).

Quanta Computer, Inc. and a group of other computer manufacturers (collectively "Quanta") purchased microprocessors and chip sets from Intel and used the Intel parts in combination with non-Intel products that practiced the LGE patents. *Id*. LGE sued Quanta for infringement and the District Court first granted summary judgment for Quanta holding that the license LGE granted to Intel exhausted any patent infringement claims against legitimate users of the Intel products. *Id.* at 2114-2115 (citing *LG Elects., Inc. v. Asustek Computer, Inc.*, 65 U.S.P.Q. 2d 1589, 1593, 1600 (N.D. Cal. 2002)). In a subsequent ruling the District Court held that patent exhaustion did not apply to method patents such as the LGE patents. 128 S. Ct. at 2115 (citing *LG Elects., Inc. v. Asustek Computer, Inc.*, 248 F. Supp. 2d 912, 918 (N.D. Cal. 2003)). On appeal, the Federal Circuit agreed that the patent exhaustion did not apply to method patent claims and, alternatively, exhaustion did not apply because LGE did not license Intel to sell its products to Quanta for use with non-Intel products. 128 S. Ct. at 2115

In *Quanta*, the Supreme Court first rejected LGE's argument that method patents, as a category, can never be exhausted. *Id*. at 2118. LGE had argued that method patents are linked not to a tangible article but to a process and, therefore, they can never be exhausted through a sale. *Id*. at 2117. The Court agreed that a patented method may not be sold in the same way as an article or device, "but methods nonetheless may be 'embodied' in a product, the sale of which exhausts patent rights." *Id*. The Court also expressed concern that eliminating exhaustion for method patents would undermine the exhaustion doctrine because drafters could do an "end run" around exhaustion by simply characterizing their claims as method claims instead of apparatus claims. *Id*. at 2118.

The *Quanta* court next considered the extent to which a product must embody a patent in order to trigger exhaustion. *Id*. It relied on its decision in *United States v. Univis Lens Co.*, 316 U.S. 241 (1942), where the Court concluded that "exhaustion was triggered by the sale of eye glass lens blanks because their only reasonable and intended use was to practice the patent and because they 'embodie[d] essential features of [the] patented invention.'" *Quanta*, 128 S. Ct. at 2119 (quoting *Univis*, 316 U.S. at 249-251). *See also* 128 S. Ct. at 2116 (explaining that Univis had licensed, and therefore purported to extend its patent rights, to downstream retailers that ground and polished lens blanks into the finished lens of the patent). The Court explained that *Univis* held that "'the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold.'" *Id*. It further noted that LGE failed to suggest a use for the Intel products other than incorporating the computer systems that practice the LGE patents. *Id*. The Court concluded that, "[l]ike the Univis lens blanks, the Intel Products constitute a material part of the patented invention and all but completely practice the patent." *Id*. at 2120. Accordingly, the Court concluded that the Intel products "embodied" the LGE patents. *Id*. at 2120-2121.

The *Quanta* court then considered whether, under the license agreement, the sale to Quanta exhausted LGE's patent rights through a sale authorized by the patent holder, LGE. LGE contended that there was no authorized sale because the license agreement did not permit Intel to sell its products for use or in combination with non-Intel products to practice the LGE patents. The Court, however, found that the license agreement

broadly allows Intel to "make, use [or] sell" products free of LGE's patent claims, and that nothing in the agreement restricts Intel from selling its microprocessors and chipsets to purchasers who intend to combine them with non-Intel parts. *Id*. at 2121. Although the agreement disclaimed any license to third parties to practice the patents by combining them with other components, the Court found this restriction irrelevant because Intel was not contractually restricted from doing so, and the question of exhaustion turned only on Intel's license to sell products practicing the LGE patents. *Id*. at 2122. Accordingly, the Court concluded that the license agreement did not restrict Intel's right to sell products substantially embodying the patents and, therefore, the doctrine of patent exhaustion prevented LGE from asserting patent rights against Quanta.

The actual impact of the *Quanta* decision remains to be seen. The analysis provided by the Court leaves open a broad range of possibilities. For instance, apparently left unresolved is whether the exhaustion doctrine applies to all method patents, or only to method patents that are "embodied" in a product. Indeed, there are method or process claims that do not relate to the sale of a patented article or product. Patentees may arguably still restrict the use of methods or processes for such claims because there is no "first sale" of a patented article. In such cases, it is only the method or process itself that is licensed. It seems unlikely that the decision applies to situations such as this because there is no "unrestricted sale" of an article.

The *Quanta* Court's decision is arguably more limited to situations where the products sold substantially embodied the claims at issue, whether or not there were method claims that also applied to such sales. In other words, the existence of a separate method claim alone does not provide a basis for overcoming an otherwise applicable first sale exhaustion of patent rights. Accordingly, exhaustion still might not apply to a method claim where the article sold practices the method but does not "embody" the method claim (*e.g.*, where the method is but one novel way to use the patented article).

The *Quanta* decision also creates uncertainty with respect to attempted restrictions on patent licenses. The agreements at issue in *Quanta* sought to prevent the use of the LGE patents with non-Intel products. The Court, however, refused to recognize the contractual limitations at issue because the Court did not view them as restrictions on the licensee's rights in the patent. 128 S. Ct. at 2121. Nevertheless, the Court acknowledged that the separate Master Agreement did require Intel to give notice to customers that the patentee had not licensed those customers, but noted that LGE had not alleged that Intel breached this aspect of this separate agreement. *Id.* This rationale suggests that the patentee might have a claim for breach of contract against its licensee, Intel. *See Id.* at 2122, n. 7. But what would such a claim accomplish? If Intel had breached the notice requirement, there are no apparent damages because under the Court's holding, the patentee already had lost all its rights in the patent.

If the Court is merely holding that the language in this agreement was deficient, it is a potentially very narrow decision. For example, the patentee might have succeeded had it required its licensee to state, at the time of the sale, that the rights in the patented article are limited to use by the buyer with Intel parts only, and there is no right to re-sell the product. Although the apparent intent of the notice requirement was to ensure that buyers understood a similar condition, the Supreme Court may merely be signaling that the courts should only enforce clearly defined limitations. Otherwise, the absence of express limitations in a license could lead to exhaustion.

Quanta is also noteworthy in that it disparaged its earlier precedent, permitting post-sale restrictions, as a decision that was short lived. 128 S. Ct. at 2115-2116 (discussing *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912) and citing *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 518 (1917), the case that overruled *A.B. Dick* after less than five years). In *A.B. Dick*, the Court upheld post sale restrictions on the use of a patented product over a dissent arguing that the restrictions constituted unlawful tying and an anti-competitive extension of patent rights. *Illinois Tool Works*, 547 U.S. at 33 (2006). The *Quanta* Court's criticism of *A.B. Dick* is at least surprising in view of the Court's holding and reasoning in *Illinois Tool Works*. Extensive commentary, and *Illinois Tool Works* itself, recognize the potential efficiencies that may justify restrictive terms or tie-ins generally. *See, e.g.*, Richard A. Posner, *Antitrust Law*, 198-199 (University of Chicago Press) (2d ed. 2001). There is, thus, little support for finding such arrangements automatically unenforceable where the tying product is a patent. Posner at 203. *Illinois Tool Works*, clearly criticized the

economic foundation underlying the *Motion Picture Patents*, and concluded that the "view that tying arrangements may well be procompetitive prevailed." 547 U.S. at 33-36.

Though *Quanta* cites several decisions founded on antitrust or patent misuse principles, it provides no analysis of the competitive impact or legality of the arrangement at issue. Of course, the Court did not need to address competition, because that is not a necessary consideration in a patent exhaustion case (unless the enforceability of the restriction itself is at issue). As such, the Court's analysis and reliance on these cases is arguably dicta and should not impact the enforceability of post sale restrictions in any way.

In conclusion, the *Quanta* decision appears to represent yet another recent ruling from the Supreme Court that limits a patent holder's monopoly rights and rejects attempts to retain those rights. *Quanta* may be limited to the particular circumstances involved in the case, and to avoid its result, patentees may merely need to draft clearer affirmative restrictions in agreements with licensees. *See Quanta*, 128 S. Ct. at 2121 (discussing *General Talking Pictures Corp. v. Western Elec. Co.*, 304 U.S. 175, 181 (1938)). The decision may, however, have a substantially broader impact if courts apply it to hold that restrictions in license agreements generally do not apply to downstream third party buyers and users of an invention.

About the Author

Michael C. Bruck is a partner at *Williams Montgomery & John, Ltd.* focusing in litigation and dispute resolution. He has defended numerous multi-million dollar lawsuits involving complex commercial disputes, professional and financial malpractice, intellectual property, franchise law, employment issues, personal injury, toxic torts and insurance coverage. An experienced trial lawyer, Mr. Bruck has successfully litigated cases across the nation and argued appeals in the Illinois and 7th Circuit appellate courts.