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Does the Patent Exhaustion Doctrine Apply when the Patentee Placed Express Conditions on the Subsequent Sale or License of a Patented Article?

by Kali Murray

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ISSUE

Has a patentee exhausted its patent rights, if upon entering into a license agreement, the patentee places conditions on the licensee's subsequent sale of the licensed item to duly notified third-party purchasers?

FACTS

Respondent LG Electronics, Inc., (LGE) owns a portfolio of patents, among them the three patents in dispute in this case (U.S. Patent Nos. 4,939,641, 5,077,733, and 5,379,379). These patents aid in conducting two common computing tasks: (1) establishing memory coherency between the main memory of the computer and the cache memory (the high-speed memory associated with the computer's microprocessor); and (2) establishing a rotating priority system that allows different components of the computer to communicate with the "system bus," a memory device that operates as the hub of the computer and connects the microprocessor

and chipset to the other parts of the computer, such as a keyboard or printer. The relevant patents had a variety of claims that were directed to the components of the patented invention (such claims are typically referred to as "systems" claims) and the methods of undertaking functions associated with each invention (such claims are typically referred to as "methods" claims). Roughly speaking, a system claim is addressed to a specific component or apparatus and a method claim is directed towards a process that allows an actor to complete a task.

LGE entered into a license agreement with Intel Corporation that allowed Intel to "make, use, sell (directly or indirectly), offer to sell, import and otherwise dispose of all Intel licensed parties." In addition to the basic agreement between Intel and LGE, the license agreement (which constituted the license itself and an accompanying master agreement) also sought to limit the use of the licensed Intel components with non-Intel components. A number of third parties, including petitioner

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QUANTA COMPUTER V.
LG ELECTRONICS
DOCKET No. 06-937

ARGUMENT DATE:
JANUARY 16, 2008
FROM: THE FEDERAL CIRCUIT

Case at a Glance

The patent exhaustion doctrine ensures that after the initial sale or license to sell a patented item, the patentee cannot dispose or profit from any subsequent resale of the same patented item. This case asks the Supreme Court to analyze whether this doctrine applies when a patentee places express conditions on a patented item that will exist after the initial sale or license to sell that patented item.

Quanta Computer, Inc., typically purchase and then install Intel microprocessors and chipsets into their computers. The license sought to impose two limits on the ability of companies such as Quanta to use the licensed Intel products in this manner. First, the license stated that no express or implied license existed when third parties such as Quanta combined the licensed Intel products with their separate products. Second, the accompanying master agreement required that a notice be sent to third parties such as Quanta. The notice stated that while that patent license granted by LGE to Intel covered Intel's products, "it does not extend, expressly or by implication to any product that you make by combining an Intel product with any non-Intel product." In due course, Intel notified (although when and to what extent is disputed) customers, such as Quanta, of this particular limitation.

LGE then sued Quanta and a number of other manufacturers for patent infringement, contending that combining the Intel microprocessors and chipset with non-Intel products infringed the relevant patents. In *LGE Electronics, Inc. v. Asutek Computer, Inc.*, 248 F. Supp. 2d 912 (N.D. Cal. 2003), the U.S. District Court for the Northern District of California held that the patent exhaustion doctrine applied to the systems claims of the relevant patents. The patent exhaustion also referred to as the "first sale doctrine"), holds that a patentee or an authorized licensee cannot assert patent rights after the first sale or license to sell of an article that embodies the patented invention.

The district court, however, recognized that an expressly *conditional* sale or license would not trigger the patent exhaustion doctrine, and held that the patent exhaustion doctrine did not apply to Intel's sale to

customers such as Quanta. In particular, the notification letter from Intel was not clear enough to become an express condition on the sale between Intel and its customers. By contrast, the district court held that the patent exhaustion doctrine did not apply to all the "method claims" of the disputed patents. Relevant precedent indicated that the patentee's sale of a device did not exhaust his or her rights under a separate patent that teaches a method of accomplishing a function.

The Federal Circuit, in *LGE Electronics, Inc. v. Bizcom Electronics, Inc.*, 453 F.3d 1364 (Fed. Cir. 2006), upheld the district court's holding as to the method claims, but overturned its holding as to the systems components. In doing so, the Federal Circuit stressed that two sales were at issue in this case: the initial license agreement between LGE and Intel and the subsequent sale of the components from Intel to its customers. The Federal Circuit contended that LGE's actions did place express conditions on Intel's subsequent customers. Two conditions, in particular, appeared to persuade the Federal Circuit that LGE had appropriately conditioned Intel's sale to its customers. First, LGE had included an express disclaimer in the license that prevented Intel's customers from combining the licensed parts with other non-Intel components. Second, Intel's notification to its customers of the terms of the license clearly conditioned its subsequent sale. The Federal Circuit's decision, in *LGE Electronics*, is remarkable in that it concluded that Intel's brief disclosure to its customers could constitute an express condition on the subsequent sale of an item. The Supreme Court granted Quanta's petition for a writ of certiorari on September 25, 2007.

CASE ANALYSIS

The dispute between the parties in *Quanta Computer* masks a deep conflict over the scope of the patent exhaustion doctrine. The relevance of the patent exhaustion doctrine has been unclear since the Federal Circuit's holding in *Mallinckrodt Inc. v. Medipart Inc.*, 976 F.2d 700 (Fed. Cir. 1992). In *Mallinckrodt*, the Federal Circuit held that the patent exhaustion doctrine will not apply when a patentee places express conditions upon the sale or license to sell of an article that embodies the essential features of the relevant patent. This holding in *Mallinckrodt* limits the use of the patent exhaustion doctrine to those circumstances in which the sale or license to sell the patented article is unconditional. The Federal Circuit's holding in *Mallinckrodt* has been particularly controversial since it may conflict with older Supreme Court precedent such as *United States v. Univis Lens Co.*, 316 U.S. 241 (1941). In *Univis Lens*, the Supreme Court held that the patent exhaustion doctrine was triggered when a patentee attempted to place conditions on the prices that retailers could charge for patented eyeglass lenses that had been purchased from a separate manufacturer. In *Univis Lens*, the Supreme Court stated that the patent exhaustion doctrine is triggered when the patentee sells any "uncompleted article, which, because it embodies essential features of his patented invention, is within the protection of his patent [and is] destined ... to be finished by the purchaser in conformity to the patent." *Univis Lens*, 316 U.S. at 250-51. Resolving the conflict between the relevant Supreme Court precedent and Federal Circuit precedent will drive the outcome of *Quanta Computer*.

The petitioner, Quanta, asserts two primary claims. First, Quanta argues that LGE exhausted its patent rights

upon Intel's authorized sale to Quanta because Intel sold it a product that embodied the essential features of the disputed patents and had no other reasonable non-infringing uses. This initial claim rests on a number of key themes. The first theme is that the patent exhaustion doctrine is an independent statutory limit on the scope of a patentee's rights that cannot be contracted away by any relevant party. Quanta attempts to underscore this first theme in various ways. First, Quanta surveys a number of older cases, beginning with *Adams v. Burke*, 84 U.S. (17 Wall) 453 (1873), which stress that the patent exhaustion doctrine is a statutory limit that cannot be eliminated by a contractual arrangement between the relevant parties. Second, Quanta attempts to distinguish the doctrine of patent exhaustion from the doctrine of implied license. The doctrine of implied license states that if a patentee does not place conditions on the sale of a product, then the patentee effectively promises not to interfere with the purchaser's reasonable enjoyment of the patented product. Quanta contends these two doctrines are different from each other because the doctrine of implied license is a quasi-contractual right that can be repudiated while the patent exhaustion doctrine, by contrast, is a statutory limit placed on the patent owner and thus can never be repudiated by contract. Quanta asserts that *Mallinckrodt* improperly conflates these two theories of recovery. Third, Quanta stresses that the patent exhaustion doctrine differs from those rights enjoyed by the patentee under a manufacturing license because under such a license, the patentee continues to exert ongoing influence over the patent. Quanta argues that once Intel sold its components to its customers, it no longer exerted ongoing influence over the patent.

Quanta's next theme is linked to the first—the patent exhaustion doctrine should not be conflated with antitrust or patent misuse principles. Again, Quanta explicitly rejects *Mallinckrodt*, arguing that the Federal Circuit's view that the only issue as to patent exhaustion is whether an express condition is “reasonably within the patent grant or whether the patentee has ventured beyond the patent grant into behavior having an anti-competitive act not justifiable under the ‘rule of law’ ” is “incorrect and unworkable.” Once again, Quanta relies on older precedent, which it contends demonstrates that that patent exhaustion doctrine should be interpreted in light of general property principles, not antitrust principles. Second, Quanta also attacks the Federal Circuit's decision in *Mallinckrodt* because it relied on antitrust principles rather than property principles and, therefore, is “circular and imposes no meaningful limits in practice.” In particular, Quanta critiques *Mallinckrodt*'s reliance on articulating the proper scope of the express conditions. Quanta contends that under traditional patent exhaustion doctrine, “no restrictions after an authorized sale are ‘within the patent grant’ because the patentee's monopoly is exhausted.”

Quanta's final theme in support of its first claim is that an authorized sale occurs when an unfinished article embodies the essential features of the patent and no other reasonable use exists for an invention other than to “practice a patent” (in other words, to use the patent for the purpose for which it was intended) or to be finished in another device. Quanta contends that each of these elements is suggested by the Supreme Court's holding in *Univis Lens*. Quanta argues the exhaustion doctrine would be “dead letter” if not “triggered by the sale

of components that embody essential features of the invention and are within the protection of the patent.” Quanta extends this insight to its final key point—that the patent exhaustion doctrine applies to method patents as well. Again, relying on older precedent, Quanta contends that method claims are subject to exhaustion claims if the method to be practiced is the only reasonable use of the article. If method claims are not covered by the patent exhaustion doctrine, Quanta asserts, the patentees will simply include method claims in their patents so as to avoid application of the doctrine.

Quanta's second primary claim is based on policy grounds. Initially, Quanta maintains that Congress is the appropriate party to limit the scope of patent exhaustion. Quanta then insists that policy and economic reasons support the continued use of the patent exhaustion doctrine. According to Quanta, the patent exhaustion doctrine: (1) reflects the continuing importance of property principles in outlining the scope of a patent grant; (2) reduces transaction costs without reducing the patentee's reward since the patentee, by negotiating for the highest price for one potential customer, does not have to engage in multiple transactions with subsequent purchasers; and (3) prevents potential antitrust abuse by the patent owner. Conversely, the Federal Circuit's policy—in its extension of the patent exhaustion doctrine and its refusal to apply the patent exhaustion doctrine to method claims—distorted the commercial relationships between patentees and purchasers.

The respondent, LGE, counters with three basic claims. Initially, LGE argues that the sale of one component could not exhaust a patent claim when the component is part

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of a separately patented system. According to LGE, “the components which petitioners purchased from Intel are independent and distinct products from the patented systems that petitioners now claim ‘authority’ to practice.” In support of this claim, LGE raises four arguments. First, it contends that the fact that the Patent and Trademark Office issued more than one patent in this case demonstrates that the sale of one article does not exhaust rights in *multiple* patents. Second, LGE argues that while the patent exhaustion doctrine may be triggered once the patent has been sold, that doctrine does not limit the patentee’s ability to control other rights listed in 35 U.S.C. § 154, such as the right to make or sell the product. Third, LGE argues that the doctrine of implied license is the doctrine most appropriately directed to the sale of an article when patents exist in both the article and accompanying systems. According to LGE, the doctrine of implied license is more suited to the circumstances at stake in *Quanta* because the doctrine “focuses on the conduct and intent of the parties, to determine whether they could reasonably anticipate that the purchaser would receive a license to practice the separate patented system or process.” Finally, LGE attempts to counter Quanta’s claim that the Supreme Court’s holding in *Univis Lens* applies to this case. LGE argues that unlike the patented eyeglass lens that was in dispute in *Univis Lens*, Quanta fundamentally altered the microprocessors and chipsets licensed to it by Intel when it combined them with non-Intel components to make a new product.

Next, LGE contends that a patentee could restrict the ability of licensors to allow their customers to fully practice the patent. Such a position, argues LGE, is fully consistent with

precedent, such as *Gen. Talking Pictures Corp., v. Western Electric Co.*, 305 U.S. 124 (1938), which states patentees can enforce any number of conditions on manufacturing licenses so long as such restrictions are enacted before the sale of a given product. Moreover, LGE claims that a patentee could continue to place conditions on the “making” of an item even after such an item was sold or used. Thus, the patent exhaustion doctrine would not be triggered if Quanta continued to “make” the relevant patented article after Intel’s initial “sale” of the article to Quanta. This position allows LGE to minimize the importance of *Mallinckrodt* as relevant precedent since, in that case, the “issue involved not the validity of a restriction on ‘making’ the article, but instead, the enforceability of a restriction on the ‘use’ of the article.”

Finally, LGE argues that even if the rights in the component patent were exhausted, the claims in the methods still were actionable. LGE argues the patent exhaustion doctrine should not be applied to process patents because they differed significantly from other types of patents. In support of its claims, LGE states that “[r]ights in a process patent are not linked to a tangible article, but, rather represent the means by which a particular task is accomplished or item is produced.” Therefore, the patent exhaustion doctrine could not address the unique issues raised by method claims.

SIGNIFICANCE

Quanta Computer has significant practical interest for the manufacturing community. Manufacturing today is often characterized by complex licensing arrangements that may involve many purchasers. The ability of patentees to “pass-through” the conditions on a license

to third-party purchasers may decrease the ability of manufacturers to conduct flexible business transactions. In particular, manufacturers may be harmed when many different components are included in one product and the manufacturer would have to negotiate a separate licensing price for each component. For many patentees, however, the ability to fully exploit their patents may be harmed by an overly harsh patent exhaustion doctrine that could potentially prevent patentees from exploiting the product through “downstream” licensing agreements. Thus, both sides have a significant interest in the ultimate outcome of *Quanta*.

Quanta Computer has also generated a significant amount of interest in the patent community of lawyers and scholars. The Federal Circuit’s decision in *Mallinckrodt* has been the cause of significant controversy. Scholars, in particular, have focused on its seeming inconsistency with previous Supreme Court precedent such as *Univis Lens*. *Univis Lens*, however, was decided within the context of a much different antitrust regime than the present one (as seen in the Court’s decision in *Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006)). Thus, *Quanta Computer* offers a unique opportunity for the Supreme Court to assess the impact of its own precedent on the Federal Circuit.

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