



QUANTA COMPUTER V. LG ELECTRONICS: WILL THE SUPREME COURT REVIVE THE EXHAUSTION DOCTRINE?

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INTRODUCTION

The doctrine of patent exhaustion has long acted as a measure to prevent patent owners from “double-dipping” by collecting patent licensing royalties from multiple entities in a supply chain for use of the same patented invention. For example, assume that a patent owner has a patent that covers a computer processing chip. The patent exhaustion doctrine is the rule that prevents that patent owner from collecting a first license payment from the chipmaker, and then collecting additional licensing payments from computer makers that make end-products that incorporate the licensed chipmaker’s chip. In such a circumstance the patent is said to be “exhausted,” by the authorized first sale of the patented article. Once the patent owner licenses the chipmaker, and thus authorizes the chipmaker to sell the patented article, the patent owner cannot collect a second time from downstream users who purchase the chip from the licensed chipmaker.

A good illustration of how the patent exhaustion doctrine should operate to prevent double-dipping is found in the District Court’s opinion in *Cyrix Corp. v. Intel Corp.*, 846 F. Supp. 522, 540 (E.D. Tex.), *aff’d*, 42 F.3d 1411 (Fed. Cir. 1994). There, the patent owner, Intel, had entered into a broad cross-license agreement with Texas Instruments (“TI”) under which TI was licensed to manufacture microprocessors under Intel’s patents. TI sold these microprocessors to its customer Cyrix, who combined these microprocessors with an external memory to form a combination that was alleged by Intel to infringe the asserted claims of the patent at issue. The *Cyrix* Court held that the Intel’s patent claims were exhausted when TI sold the licensed microprocessors to Cyrix, and that therefore Intel could not assert its infringement claims against Cyrix, who was simply using the microprocessors for their intended purpose.

But over the past fifteen years, this fundamental doctrine has been eroded in a number of significant ways by the U.S. Court of Appeals for the Federal Circuit. As a result, the doctrine of patent exhaustion has become a less effective tool for preventing double-dipping, and downstream purchasers of products from licensed manufacturers have found themselves subject to paying a second royalty to patent owners who have already collected a first royalty from the upstream manufacturer. Here are some significant ways that the patent exhaustion doctrine has been eroded by the Federal Circuit:

- First, in seeming contradiction to Supreme Court precedent, the Federal Circuit now allows parties to “contract around” exhaustion. See *LG Electronics, Inc. v. Bizcom Electronics, Inc.*, 453 F.3d 1364 (Fed. Cir. 2006); *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed.

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Cir. 1992); *cf. United States v. Univis Lens Co.*, 316 U.S. 241 (1942) (finding that once an authorized first sale occurs, exhaustion applies in spite of any attempt to contract around it). Savvy patent owners have been taking advantage of this by drafting license agreements that the Federal Circuit has interpreted as preserving their rights to pursue infringement claims against downstream users who purchase and use the licensed product.

- Second, and also in seeming contradiction to Supreme Court precedent, the Federal Circuit also has held that method claims are not subject to patent exhaustion. See *LG Electronics*, 453 F.3d 1364; *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*, 750 F.2d 903 (Fed. Cir. 1984); *cf. Univis*, 316 U.S. 241 (applying exhaustion doctrine to method claims). By limiting the patent exhaustion doctrine to only apparatus claims, the Federal Circuit has severely weakened its usefulness.
- Third, the Federal Circuit has held that sales outside of the United States cannot “exhaust” a U.S. Patent. See *Fuji Photo Film Co., Ltd. v. Jazz Photo Corp.*, 394 F.3d 1368 (Fed. Cir. 2005); *Jazz Photo Corp. v. U.S. ITC*, 264 F.3d 1094 (Fed. Cir. 2001). Therefore, in the common situation where components (such as chipsets) are sold abroad for incorporation into end-products (such as personal computers) that are then sold in the United States, sales by a licensed component-maker will not trigger the exhaustion doctrine, and a patent owner will not be precluded from also seeking patent royalties from the end-product maker.

Having considered a host of important patent law issues over the past two years (reversing the Federal Circuit on each such occasion), the Supreme Court has now indicated its intent to revisit the patent exhaustion doctrine and to address the first two of the three above issues. On September 25, 2007, the Supreme Court granted certiorari in *Quanta Computer, Inc. v. LG Electronics, Inc.*, 128 S. Ct. 28. Since then, the parties and a host of interested parties have submitted their briefs. See *Quanta* Docket, available at <http://www.supremecourtus.gov/docket/06-937.htm> (including amicus briefs submitted by the United States, Dell/HP/Gateway, IBM, Nokia, Qualcomm, the AIPLA, and others) In *Quanta*, the Supreme Court will decide:

Whether the Federal Circuit erred by holding, in conflict with decisions of this Court and other courts of appeals, that respondent's patent rights were not exhausted by its license agreement with Intel Corporation, and Intel's subsequent sale of product under the license to petitioners.

Quanta Computer, Inc., v. LG Elecs., Inc., No. 06-937 (U.S. Sept. 25, 2007) (order granting certiorari).

This Article examines the patent exhaustion doctrine, summarizes the issues framed in the pending *Quanta* case, and discusses how the Supreme Court might revive the patent exhaustion doctrine. Part I reviews the doctrine of patent exhaustion as developed by the Supreme Court, as well as more recent developments by the Federal Circuit. Part II discusses the background of and issues raised in the pending *Quanta* case. Part III analyzes how the Supreme Court may rule in *Quanta* in light of its prior exhaustion precedents. Finally, Part IV discusses other important patent exhaustion issues that will remain even after the Supreme Court has ruled in *Quanta*.

I. Patent Exhaustion: The Evolution of the Doctrine

Patent exhaustion is a fundamental doctrine of patent law first expressly enunciated by the Supreme Court in *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 456 (1873). The doctrine derives from the statutory grant of exclusivity to the patentee and holds that once a patentee abandons its right to exclusivity through the sale of a patented product or the license of the patent itself, there is no statutory basis for the patentee to impose restrictions or secure royalties on the subsequent use of the invention. See *Bloomer v. McQuewan*, 55 U.S. (14 How.) 539, 549 (1852). The doctrine is intended to prevent a patentee from receiving a double royalty on a single patented invention. As the Supreme Court has explained, the touchstone of the patent exhaustion doctrine is “whether or not there has been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article.” *United States v. Masonite Corp.*, 316 U.S. 265, 277-78 (1942).

Under the doctrine of patent exhaustion, “[a]n authorized sale of a patented product exhausts the patent monopoly as to that product. Thus, a purchaser of such product from the patent owner or one licensed by the patent owner may use or resell the product free of control or conditions imposed by the patent owner.” 5 DONALD S. CHISUM, CHISUM ON PATENTS § 16.03[2][a] (2002); see also *Adams*, 84 U.S. at 456; *United States v. Univis Lens Co.*, 316 U.S. 241 (1942); *Intel Corp. v. ULSI Sys. Tech., Inc.*, 995 F.2d 1566, 1568 (Fed. Cir. 1993) (“The law is well settled that an authorized sale of a patented product places that product beyond the reach of the patent. The patent owner’s rights with respect to the product end with its sale.”). It is well settled that the patent exhaustion doctrine applies as well to the disposition of a product under a license as it does to an outright sale. See generally *Masonite Corp.*, 316 U.S. at 278 (“The test has been whether or not there has been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article”). In order to trigger patent exhaustion, the sale must have been an “authorized” sale. See *Gen. Talking Pictures Corp. v. W. Elec. Co.*, 304 U.S. 175 (1938) (finding that customer who purchased goods from a licensee, knowing that licensee lacked authority to make the sale, could be sued for infringement). After an “authorized” sale, the Supreme Court has held that enforcing restrictions by asserting infringement against downstream customers is improper; the patent is said to be exhausted. See *Adams*, 84 U.S. at 456 (finding that a downstream customer is not bound to the territorial restriction placed on licensee of patent at issue).²

It is well established that the exhaustion doctrine extends not only to the authorized sale of a patented product, but also may be extended to cover the authorized sale of “essential” components of a patented product that do not contain all elements of the patented invention. See, e.g., *Univis*, 316 U.S. at 249-51 (“We think that . . . where 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.”); *Cyrix*, 846 F. Supp. at 522, 538-40 (E.D. Tex.) (noting further that “[t]he patent exhaustion doctrine is so strong that it applies even to an incomplete product that has no substantial use other than to be further manufactured into a completed patented and allegedly infringing article.”), *aff’d*, 42 F.3d 1411 (Fed. Cir. 1994).

² Unfortunately, the doctrine of patent exhaustion is often analytically confused with the distinct (and far narrower) doctrine of implied license that may be raised based upon similar factual circumstances. For the sake of clarity, patent exhaustion refers to the principle of patent law that the patentee’s rights to pursue infringement claims against downstream users of a patented article are extinguished by the first authorized sale. Pursuant to exhaustion principles, a patented item, once sold in an authorized sale, becomes the property of the purchasers, and is no longer specifically protected by the patent laws. The patentee retains no right to control further sale or use of the item via enforcement of the patent. The doctrine of implied license may also provide a defense to a claim of infringement against users of a licensed product or component. In contrast to patent exhaustion, which is automatically triggered based upon an “authorized sale,” in order to prove an implied license, the accused infringer must show that the circumstances plainly indicate that the grant of a license should be inferred. Accordingly, it is clear that claims of implied license can be negated by simply stating in the license agreement that no implied licenses are granted (or reserving the right to sue third parties) and by providing notice to the purchaser that there is no implied license.

THE CLASSIC SUPREME COURT PATENT EXHAUSTION CASES

Univis - The Supreme Court's Last Pronouncement On Patent Exhaustion

One of the leading Supreme Court cases addressing the exhaustion doctrine is the Court's decision in *United States v. Univis Lens Co.*, 316 U.S. 241 (1942). In *Univis*, the patentee, Univis Corp., held a set of patents with claims directed to an eyeglass lens and to methods for making the lens by producing, grinding and polishing the lens blanks. 316 U.S. at 243. Univis Corp. licensed its related company, Univis Lens, to manufacture lens blanks. Univis Lens then sold those licensed blanks to a set of wholesalers and retailers, who were also licensed by Univis Corp. 316 U.S. at 244-45. After purchasing the Univis Lens blanks, these wholesalers and retailers would finish the grinding and polishing of the lens blanks through practice of the Univis Corp. patented method. *Id.* The licenses to the wholesalers and retailers contained strict limitations on the parties to whom the lens blanks purchased from Univis Lens could be resold and the price of resale. *Id.*

Before the U.S. Supreme Court was the issue (among others) of whether, after the sale of the licensed lens blanks, the patent owner could impose any further control over the further downstream use of finished lenses or unfinished lens blanks. 316 U.S. at 248. In addressing the patent owner's post-sale rights, the Court held that since the unfinished lens blanks embodying essential features of the patented invention were sold under license from Univis Corp., the patent rights with respect to the lens blanks and the finished lenses were exhausted when the lens blanks were sold:

The first vending of any article manufactured under a patent puts the article beyond the reach of the monopoly which that patent confers Accordingly, neither the Lens Company nor the Corporation, by virtue of the patents, could after the sales of the lens blank exercise any further control over the article sold.

Id. at 252 (“with the sale of the lens blanks for use in manufacturing lenses, the patent-owner conferred on the buyer the right to practice the patent with respect to the blanks and parted with the right to assert its patent monopoly with respect to them”). As to the fact that the lenses were components that still had to be finished, the Court stated that “where 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. . . . He has thus parted with his right to assert the patent monopoly with respect to it No one would doubt that if the patentee's licensee had sold the blanks to a wholesaler or finishing retailer, without more, the purchaser would not infringe by grinding and selling them.” *Id.* at 250-5.

Univis appears to be the high-water mark of the reach of the patent exhaustion doctrine. In *Univis*, even though all of the licensees were on notice of and in fact specifically agreed to the particular limitations at issue, the Court nonetheless found that the sale to the first licensee exhausted the patent, and that the limitations placed on the other licensees were without effect. Interestingly, Univis Lens' stated reason for setting up the licensing structure as it did was to “protect the public interest and their own good will by the selection as licensees of those who are specially skilled and competent to render the service which they undertake.” *Id.* at 254. In other words, Univis contended, this was not a classic double-dipping scenario where it was trying to recover twice against different entities for the same invention. The Supreme Court, nonetheless, found Univis' patent rights were exhausted by the authorized first sale.

However, it should be noted that the particular facts of *Univis*, and in particular the significant anti-trust and price-fixing aspects to the decision, have made understanding the precise boundaries of its holding more difficult to discern. In particular, *Univis* involved a price-fixing scheme that, under Supreme Court law at that time, was *per se* illegal. As the Supreme Court indicated in response to *Univis*' above arguments:

[Even] if we assume that such restrictions might otherwise be valid, these features are so interwoven with and identified with the price restrictions which are the core of the licensing system that the case is an appropriate one for the suppression of the entire licensing scheme

Id.

Adams v. Burke - The Supreme Court Holds That An Authorized Sale Leads To Patent Exhaustion Irrespective Of Purported Post-Sale Conditions

Seventy years before *Univis*, in the seminal case of *Adams v. Burke*, the Supreme Court held that under the patent exhaustion doctrine, an authorized first sale extinguishes the patentee's rights to pursue downstream customers for infringement. *Adams* held that customers that purchased a licensed product in an authorized sale could not be pursued for patent infringement, and that restrictions included in license agreements purporting to limit the purchaser's post-sale use of the product were without effect. *Adams v. Burke*, 84 U.S. (17 Wall.) at 456-57.

In *Adams*, the patent owner had granted a license to Lockhart & Steele to sell coffin lids under the patent with a specific limitation that the sale be within ten miles from Boston. Lockhart & Steele sold a patented coffin lid to Burke, an undertaker, within the ten mile limit, but Burke subsequently sold the coffin lids he purchased outside the ten mile radius. *Id.* The Supreme Court held that Burke could not infringe the patent since it was exhausted after the first authorized sale: "a purchaser from them of a single coffin acquired the right to use that coffin for the purpose for which all coffins are used. . . . It would be to engraft a limitation upon the right of use not contemplated by the statute nor within the reason of the contract to say that it could only be used within the ten-miles circle." *Adams*, 84 U.S. at 456. In support of this holding, the *Adams* Court quoted its earlier *Bloomer v. McQuewan* case: "when a machine passes to the hands of the purchaser, it is no longer within the limits of the [patent] monopoly. It passes outside of it, and is no longer under the protection of the act of Congress." *Id.* at 460 (quoting *Bloomer*, 55 U.S. at 549). Thus in *Adams* (and in *Univis* seventy years later), the Supreme Court consistently maintained that once the authorized first sale has occurred, any conditions that the patentee purports to attach to post-sale uses are without effect, because the patentee's rights are exhausted and end with the first sale.

General Talking Pictures - The Supreme Court Holds That Sales Made In Violation Of A License Condition Are Unauthorized Sales And Do Not Trigger Patent Exhaustion

The Supreme Court has also separately addressed the very different effect of a breach of a manufacturing restriction in a license on the exhaustion analysis. In *General Talking Pictures Corp. v. Western Electric*, 304 U.S. 175 (1938), the patentee that held a patent on amplifiers licensed a subsidiary to make and sell equipment using the patented amplifiers for commercial theaters only and licensed third-parties to sell equipment using the patented amplifier for the private home. The defendant purchaser, which had actual notice of the field-of-use restriction on the license, purchased theater equipment from a licensee that was only authorized to make equipment for the private home. The Supreme Court upheld the field-of-use restriction, and held both the third-party licensee and the purchaser liable for infringement.

This holding is not inconsistent with the Supreme Court's other pronouncements on patent exhaustion. *General Talking Pictures* is factually and legally distinguishable from *Adams* and *Univis*. Both *Adams* and *Univis* involved authorized first sales, and found that once there is an authorized first sale, exhaustion applies notwithstanding any purported restrictions as to downstream use. By contrast, in *General Talking Pictures*, because there was a restriction on the licensee's authority to make and sell the patented product and that restriction was breached by the licensee making and selling equipment that it was not authorized to make (i.e., theater equipment), the Court found that the sale at issue was not an "authorized" sale under the patent in the first instance. Accordingly, patent exhaustion was not triggered.

Interestingly, in addressing a subsequent petition for rehearing, 305 U.S. 124, 126 (1938) the Supreme Court specifically declined to answer whether "the owner of a patent, by means thereof, [can] restrict the use made of a device manufactured under the patent, after the device has passed into the hands of a purchaser in the ordinary channels of trade, and full consideration paid therefor?" or whether "a patent owner, merely by a 'license notice' attached to a device made under the patent, and sold in the ordinary channels of trade, [can] place an enforceable restriction on the purchaser thereof as to the use to which the purchaser may put the device?" The Court declined to address these questions, finding them to be irrelevant to the case at hand, since the Court had already found that the devices which were purchased "were not manufactured or sold 'under the patent(s)' and did not 'pass into the hands of a purchaser in the ordinary channels of trade,'" because they were not "authorized." *Id.* at 128. These are the very questions that are now at issue in *Quanta*. Notably, the Supreme Court had already commented on such issues in *Adams*, and, it appears, answered these questions in the negative a mere four years later in *Univis*.

THE FEDERAL CIRCUIT DEPARTURES FROM CLASSIC PATENT EXHAUSTION LAW

The foregoing Supreme Court cases make clear that under the patent exhaustion doctrine, an authorized first sale of a patented product extinguishes any right to pursue infringement claims against downstream users of the product, despite any purported limitations on that use that are set by the patentee. As stated by one District Court:

[T]he consistency with which the Supreme Court has asserted for over half a century that the patent laws afford no authority for a patentee to control the use to which a patented article may be put after the patentee has sold it, and the failure of the Supreme Court to qualify in any way the reach of this principle make me disinclined to write exceptions into the principle at odds with its inherent comprehensiveness.

Baldwin Lima Hamilton Corp. v. Tatnall Measuring Sys. Co., 169 F. Supp. 1, 29-30 (E.D. Pa. 1958), *aff'd*, 268 F.2d 395 (3d. Cir. 1959). Nevertheless, in the past fifteen years, the Federal Circuit has written a number of exceptions into the patent exhaustion doctrine. Two of these exceptions, which are described in the following sections, will be subject to review in *Quanta*.

Mallinckrodt - The Federal Circuit Carves Out An Exception To Exhaustion; Patent Owner's Can Contract Around The Patent Exhaustion Doctrine By Including Post-Sale Conditions

In *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992), the Federal Circuit was confronted with a scenario in which a patent owner, Mallinckrodt, sold its patented nebulizer products to hospitals, with a notice that the devices were limited to "single use only." The hospitals shipped used nebulizers to Medipart, which reconditioned them so they could be re-used and shipped them back to the

hospitals. Mallinckrodt sued Medipart for infringement, arguing that the restriction to single patient use was valid and enforceable under the patent law. Medipart argued that such a restriction was unenforceable, arguing based upon patent exhaustion principles, no restriction is enforceable under patent law upon a purchaser of a sold article. The District Court found in favor of Medipart.

In its decision reversing the District Court's ruling, the Federal Circuit noted that the district court had cited a number of patent exhaustion cases, including *Adams v. Burke*. After reviewing these Supreme Court cases, the Federal Circuit reasoned that those cases simply stood for the proposition that the “*unconditional* sale of a patented device exhausts the patentee's right to control the purchaser's use of the device; and that the sale of patented goods, like other goods, can be conditioned.” *Mallinckrodt*, 976 F.2d at 706. The Federal Circuit held that “*Adams v. Burke* and its kindred cases do not stand for the proposition that no restriction or condition may be placed upon the sale of a patented article” and that if such a condition is made and violated, “violation of the restriction may be remedied by action for patent infringement.” *Id.* at 708-09. Instead, the Federal Circuit relied heavily on *General Talking Pictures* for the proposition that the sale was validly conditioned and therefore was not subject to the patent exhaustion doctrine. In so doing, the Federal Circuit gave short shrift to the *Univis* decision, characterizing it as a misuse and antitrust case that stood for an exception, rather than the rule. *Id.* at 708 (In the only citation to *Univis* in its opinion, the Federal Circuit stated that “[u]nless the condition violates some other law or policy (in the field of patent law), notably the misuse or antitrust, private parties retain the freedom to contract concerning conditions of sale.”). Accordingly, the Federal Circuit found that “[t]he principle of exhaustion of the patent right [does] not turn a conditional sale into an unconditional one.” *Id.* at 706. Thus, the Federal Circuit held, an exception to the general exhaustion rule occurs where the first sale of the product is expressly conditioned.

This exception to patent exhaustion has been relied upon by the Federal Circuit in subsequent cases. See *B. Braun Med., Inc. v. Abbott Lab.*, 124 F.3d 1419, 1426 (Fed. Cir. 1997) (Whereas patent exhaustion doctrine applies to an unconditional authorized sale or license, it “does not apply to an expressly conditional sale or license.”). As explained above, *Mallinckrodt* was also expressly relied upon by the Federal Circuit in *Quanta*. Applying the rule of *Mallinckrodt* to the facts at hand, the Federal Circuit ruled that because the license grant to Intel was “conditional,” LGE could sue Quanta for patent infringement, even though Quanta engaged in the authorized use of a licensed Intel component that it purchased and used for its intended purpose.

Bandag Inc. - The Federal Circuit Limits The Application of Exhaustion To Apparatus Claims

Also, beginning in the early 1980s, the Federal Circuit has repeatedly held that patent exhaustion is inapplicable to method claims. In *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*, 750 F.2d 903 (Fed. Cir. 1984), the plaintiff patentee Bandag claimed that the defendant infringed its patented method for retreading tires. The defendant had bought the recapping equipment it was using for tire retreading from a third party, which had originally purchased the equipment from Bandag itself. The defendant used this recapping equipment for its intended purpose, and, in so doing, allegedly practiced the patented method. The defendant asserted a defense based on patent exhaustion. In addressing the patent exhaustion defense, the Federal Circuit summarily concluded, that the exhaustion doctrine “is inapplicable here, because the claims of the . . . patent are directed to a method of retreading, and cannot read on the equipment [the defendant] used in its cold process recapping.” 750 F.2d at 924. (It then turned to the separate defense of implied license, which was also rejected. *Id.* at 925.)

The court provided no support for this seemingly new, and rather broad, exception. Ironically, the court cited *Univis* for the general rule of exhaustion. Notably, however, in *Univis*, the Supreme Court

actually applied the exhaustion doctrine to method claims.

The Federal Circuit reapplied this same analysis fifteen years later in *Glass Equipment Development, Inc. v. Besten, Inc.*, 174 F.3d 1337 (Fed. Cir. 1999). In *Glass Equipment*, the Federal Circuit, citing *Bandag*, again held the exhaustion doctrine inapplicable to method claims. 174 F.3d at 1342 at n.1. As explained above, in holding exhaustion inapplicable to method claims, the Federal Circuit in *Quanta* followed this same line of reasoning.

II. BACKGROUND OF QUANTA CASE TO BE DECIDED BY SUPREME COURT

District Court Proceedings

Quanta is an appeal by a number of Taiwanese computer-makers who are defendants in a patent infringement dispute with LG Electronics Inc. Prior to the underlying lawsuit, LG Electronics had licensed the patents at issue to Intel, a large manufacturer of specialized microprocessor and chipset products. Under the Intel License, Intel agreed to pay LG Electronics a lump sum payment in exchange for the right to make, use, sell, offer to sell, import or otherwise dispose of its own Intel microprocessor and chipset products. Intel and LG Electronics also entered into a side-agreement under which Intel agreed to send a “notice” to its own customers, informing them that they did not receive any “license” from LG Electronics to combine the products purchased from Intel with any non-Intel product. The computer-maker Petitioners purchased the licensed Intel chips for use in their computer products. Pursuant to its side-agreement, Intel sent the agreed-upon notices to the computer-makers. LG Electronics then sued the computer makers, seeking to extract another royalty payment from the computer makers for use of the same products for which Intel had paid a first royalty.

Prior to trial, the Defendants moved for summary judgment on patent exhaustion grounds. The District Court granted the defendants’ motion in part, finding that the apparatus claims of the patents at issue were exhausted (but that the method claims were not). The District Court’s exhaustion decision was based on the seminal patent exhaustion decision, *United States v. Univis Lens Co.*, 316 U.S. 241 (1942). LG Electronics had argued that because Intel “expressly informed [the computer-makers] that their purchase of components from Intel did not grant them a license to infringe LG Electronics’ patents” by combining those components with other standard components, the sale was conditional and not subject to exhaustion. The District Court, however, rejected LG Electronics’ argument that the patent exhaustion doctrine did not apply because Intel’s sales to the computer-makers were “not unconditional.” Instead, the District Court reasoned that having “licensed to Intel the right to practice [its] patents,” LG Electronics could not assert an infringement claim “against those who legitimately purchase and use the Intel microprocessor and chipset.” As to the method claims however, the District Court based its holding that they were not subject to the patent exhaustion doctrine on a series of Federal Circuit cases, which held that the patent exhaustion doctrine was not applicable where the first sale was of an apparatus and the patent claim at issue was a method claim. See *Glass Equip. Dev., Inc. v. Besten, Inc.*, 174 F.3d 1337, 1341 n.1 (Fed. Cir. 1999); *Bandag, Inc. v. Al Bolser’s Tire Stores, Inc.*, 750 F.2d 903, 924 (Fed. Cir. 1984).

The Federal Circuit Decision

On appeal, the Federal Circuit reversed the District Court's holding on patent exhaustion. In so doing, the Federal Circuit explained that "[i]t is axiomatic that the patent exhaustion doctrine, commonly referred to as the first sale doctrine, is triggered by an unconditional sale" but found that the Intel-LG Electronics License was conditional and therefore Intel's sales were outside the boundaries of the patent exhaustion doctrine: "Although Intel was free to sell its microprocessors and chipsets, those sales were conditional, and Intel's customers were expressly prohibited from infringing LGE's combination patents," and "LGE's rights in asserting infringement of its system claims were not exhausted." The Federal Circuit concluded that exhaustion did not apply to the method claims based on the same reasoning: "even if the exhaustion doctrine were applicable to method claims, it would not apply here because there was no unconditional sale." The Federal Circuit also noted that in any event "the sale of a device does not exhaust a patentee's rights in its method claims."

Supreme Court Proceedings

In their Petition for Certiorari, the computer-maker Petitioners assert that LG Electronics' patent suit against them constitutes impermissible double-dipping under principles of patent exhaustion, arguing that the Supreme Court "has consistently held for more than a century that no patent owner is entitled to more than one royalty on the sale of a patented article, and that an authorized first sale fully exhausts the patent owner's rights with respect to that article during its ordinary useful life." (Petition for Certiorari at 6, *Quanta Computers, Inc. v. LG Elecs., Inc.*, 128 S. Ct. 28 (2007) (No. 06-937.)) Petitioners contend that LGE's attempt to "contract around" the patent exhaustion doctrine, by including third-party conditions of use in its license agreement with Intel, is ineffective under Supreme Court exhaustion precedent.

In opposition, Respondent LG Electronics contends that "patentees *can* restrict their licensees to preclude passing on any authority to practice their patents [to downstream customers]," and that in such circumstances the operative sales are "conditional" and outside the scope of the patent exhaustion doctrine. (Response at 12, *Quanta*) In other words, LG Electronics argues that "exhaustion does not override a patentee's freedom to restrict its licensee's ability to convey patent-practicing authority to the licensee's customers." (*Id.* 13.) Respondent argues that this proposition is fully consistent with both Federal Circuit and Supreme Court law.

Several amicie, including the United States (at the request of the Supreme Court) and a group of computer-makers consisting of Dell, Hewlett-Packard, and Gateway, filed briefs in support of the Petitioners. All of the amicie briefs contend that the Federal Circuit's decision was in direct conflict with Supreme Court precedent on patent exhaustion. They argue that whereas under Supreme Court precedent the patent exhaustion doctrine delimits the exclusive rights granted by patent law, under the Federal Circuit's view, the patent exhaustion doctrine is subject to express modification. This has created a situation where, under Federal Circuit law, patentees can avoid the effect of the exhaustion doctrine simply by agreement or unilateral notice. As stated in the Dell/Hewlett Packard/Gateway brief:

The Federal Circuit has abandoned the doctrine of patent exhaustion, as it has been defined by this Court for over a century, and replaced it with a regime that serves no useful purpose but to multiply the recovery for clever patent-owners. The doctrine of patent exhaustion, once a definitional constraint on patent rights, has been reduced to a mere default rule of contract interpretation that is easily avoided

(Brief Dell/Hewlett-Packard, Gateway at 2, *Quanta*.) Each certiorari brief points to the Federal Circuit's decision in *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (1992) as the point at which Federal Circuit law departed from that of the Supreme Court by effectively allowing parties to contract around the patent exhaustion doctrine. The United States brief also criticizes the Federal Circuit approach, as a matter of policy, arguing that it permits patentees to "employ the patent law to extract royalties on articles embodying their invention at multiple downstream points in the channels of commerce, even after they have parted (or a licensee has parted in an authorized sale) with title to the article." (Brief of United States at 17-18, *Quanta*.)

The amicie also criticize the Federal Circuit's holding that the patent exhaustion doctrine does not apply to method claims, particularly since certain Supreme Court cases finding patent exhaustion (such as *Univis*) themselves involved method claims.

As noted above, the Supreme Court granted Certiorari on September 25, 2007. Oral argument will be held in January of 2008. In reaching its decision in *Quanta*, the Court will address whether a patentee may avoid the patent exhaustion doctrine by attaching restrictions to the license on products embodying the patented invention, and then bring patent infringement actions against downstream purchasers of the licensed products. The Court may also reach the issue of whether the patent exhaustion doctrine applies to method claims.

III. HOW THE SUPREME COURT IN QUANTA MIGHT REVIVE THE EXHAUSTION DOCTRINE

Contracting Around The Patent Exhaustion Doctrine?

The central question that the Supreme Court will now address in *Quanta* is whether, by attaching conditions to the license and notifying downstream purchasers of these conditions, a patent-owner may preserve infringement claims against downstream users of licensed products or components. How the Supreme Court resolves this issue will determine whether the patent exhaustion is simply a default rule that a patent-owner can contract around and therefore avoid, or whether the patent exhaustion is an iron-clad rule of patent law that may not be avoided.

The Briefs arguing in favor of the Petitioner all contend that the Federal Circuit's decision in *Mallinckrodt* (and now *Quanta*) is in direct conflict with the Supreme Court's exhaustion precedent, focusing particularly on *Univis*. They argue that under the Supreme Court's patent exhaustion precedent, the doctrine should delimit the patent rights granted to the patent owner under patent law, but that the Federal Circuit's conflicting precedent has converted the doctrine into an optional default rule that can be expressly modified by the patent owner and thus easily avoided. A thorough reading of *Adams*, *General Talking Pictures*, *Univis*, and *Mallinckrodt*, bears out the Petitioner's and amicie's criticism that the Federal Circuit erred by allowing patent owners to avoid the patent exhaustion doctrine by attaching post-sale conditions to licenses, and that *Mallinckrodt* and *Quanta* should be reversed. *Quanta* presents the Supreme Court with the opportunity to so rule.

In order to determine whether the rule of *Mallinckrodt* is indeed inconsistent with Supreme Court precedent, it is necessary to understand how the Supreme Court's holdings in *Adams* and *Univis*, on the one hand, can be harmonized with *General Talking Pictures*, on the other.³

³ Unfortunately, this issue has been complicated by the fact that the Supreme Court's exhaustion cases, often made in the context of antitrust, are notoriously confusing. The issue has been further confused by the distinction between sales and licenses, and the distinction between the exhaustion doctrine and the implied license defense.

As explained above, in *Univis*, the Supreme Court specifically held that the authorized sale of an article manufactured “under the patent” exhausts all patent claims in the article regardless of any purported limitation or condition on the subsequent use or sale of the article. In fact, the *Univis* Court characterized the patentee’s attempt to enforce such conditions on the use of the article after an authorized sale as an improper effort to “extend [the patent monopoly] beyond the fair meaning of the patent statutes” 316 U.S. at 252. Under *Univis* an authorized first sale of a patented article exhausts the patentee’s rights in that article and nullifies any “conditions” that the patent owner has tried to attach to its use or resale. *Adams* similarly rejects enforcing any purported post-sale conditions in an infringement suit against the purchaser of the patented article. By contrast, just as a patent owner may control who a patented product is sold to, a patent owner may control what sales are “authorized” by placing (and enforcing) valid restrictions on manufacturing licensees. A sale made in violation of such a license restriction is not an “authorized” sale, and therefore does not trigger exhaustion. See, e.g. *Gen. Talking Pictures*, 304 U.S. at 181. However, a patentee may not authorize a licensee to make sales that are subject to downstream conditions on the purchaser’s use or resale of the product, and then sue the purchaser for infringement if it violates those conditions. In other words, once the licensee is authorized to sell the patented article, this authorized first sale should trigger the exhaustion doctrine and nullify any post-sale conditions. See, e.g., *Adams*, 84 U.S. at 456.

Despite this, in *Mallinckrodt* and again in *Quanta*, the Federal Circuit found that by attaching conditions on the subsequent use of the article, the patentee could avoid the exhaustion doctrine. In effect, the *Mallinckrodt* Court analytically treated the patent exhaustion doctrine in the same manner as the defense of implied license. While the defense of implied license may be negated by disclaiming it in an agreement, the same is not true for the patent exhaustion doctrine under Supreme Court precedent.

It appears *Mallinckrodt* went wrong by relying on a misunderstanding of the holding of *General Talking Pictures* and also by failing to follow *Univis*.⁴ While the Federal Circuit concluded that the sales in *Quanta* were “conditional” and therefore outside the scope of the exhaustion doctrine, the Supreme Court (in *Univis* and *Adams*) has held that such “conditions,” which purport to limit a purchaser’s use of the goods after they purchased them in an authorized sale, do not make the first sale “conditional.” Rather, such “conditions” are precisely the types of conditions that are nullified by law under the exhaustion doctrine.⁵

⁴ As explained by the United States brief, as seen in *Mallinckrodt* and *Quanta*, “the Federal Circuit [mis-]understands the Court’s first-sale decisions as drawing a distinction between ‘unconditional’ and ‘conditional’ sales, with the latter category encompassing any sales subject to restrictions on the right to use or to resell the purchased article.” However, this understanding is not supported by Supreme Court caselaw, which holds that the patent exhaustion doctrine is triggered when a patented item is “lawfully made and sold” (*Adams*, 84 U.S. at 457), or “passes to the hands of the purchaser” after an authorized first sale (*McQuewan*, 55 U.S. at 549). See *Univis*, 316 U.S. at 249-251 (“authorized sale” triggered patent exhaustion doctrine despite license agreement limiting resale prices). Rather, *General Talking Pictures* stands for the narrower proposition that when the licensee itself breaches a manufacturing condition of the license, the resulting sale is not “authorized” and therefore does not trigger the patent exhaustion doctrine. By contrast, purporting to place conditions on a downstream purchaser’s use of a purchased product does not convert an authorized first sale that would otherwise trigger the exhaustion doctrine into an “unconditional” sale that does not trigger the exhaustion doctrine. The Joint Dell/Hewlett Packard/Gateway amicus brief similarly explains that “the Federal Circuit’s error rests on its confusion of two lines of [Supreme Court exhaustion] decisions - those dealing with limitations on a license to *manufacture* a patented device, and those dealing with limitations on the *downstream use* of a patented device.” The former limitations are generally enforceable under the patent laws; a patented device manufactured in violation of that limitation is not “authorized” and therefore does not trigger the exhaustion doctrine. See, e.g., *Gen. Talking Pictures*, 304 U.S. at 181. The latter limitations, however, such as those at issue in *Mallinckrodt* and *Quanta*, are not enforceable against those that purchased the patented device.

⁵ As to *Univis* in particular, some have questioned whether the Supreme Court went as far as it did in finding patent exhaustion, because of the then per se illegal price-fixing scheme that was at issue in that case. In *Univis* there was an agreed-upon licensing scheme, and each licensee was put on notice of and in fact agreed to the restrictions at issue. Some have questioned whether, with the price-fixing aspects removed, the Supreme Court might consider such a license-splitting scheme to be permissible. Others have argued that, as an economic point, the apportionment of royalties between different members of the supply chain could in some cases be appropriate. Cf. *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 502-03 (1964) (allowing for the apportionment between different members of supply chain in the context of release for past damages but not for apportionment of future damages by license). In considering whether there is any room for contracting around the exhaustion doctrine, a more nuanced approach is possible. The Supreme Court might attempt to find a principled distinction between situations where the patentee is impermissibly double-dipping by seeking to extract royalties for the same technology from different members of the supply chain (to which exhaustion should apply) and situations where the patentee is seeking to license different entities in the supply chain with full notice and disclosure in order to divide the licensing fees among different user groups or for the purpose of more tightly controlling use of the patented invention in order to maintain good will and control quality (to which exhaustion should not apply). But such a holding seems unlikely and would be a departure from the Supreme Court precedent on patent exhaustion.

Based on the foregoing discussion, it would be consistent with its prior precedent for the Supreme Court to overrule *Mallinckrodt* and hold that the application of the patent exhaustion doctrine after an authorized first sale cannot be limited by private agreement. While the patent owner can set limits on the authority of its licensee to make or sell the patented product, see, e.g. *General Talking Pictures*, once an authorized sale is made, patent claims on that product should be exhausted as a matter of patent law.

The Exhaustion Of Method Claims

In making its ruling in *Quanta*, the Supreme Court may also determine whether the Federal Circuit's holdings in *Bandag* and *Glass Equipment* that method claims are not subject to the exhaustion doctrine is consistent with Supreme Court precedent. This issue was fully briefed during the briefing on Certiorari.

As noted above, while the Federal Circuit has concluded that method claims are not subject to the exhaustion doctrine because there is technically no "article" that is "sold," the *Univis* case itself (in which exhaustion was found) involved method claims. Accordingly, the Federal Circuit rule appears to be inconsistent with the Supreme Court rule.

Furthermore, a rule excepting method claims from the scope of the patent exhaustion doctrine results in absurd results such as double-dipping on method patents. For instance, a patent owner with a patented method claim whose steps are necessarily performed in the ordinary operation of a particular apparatus could first license the method claim to the product manufacturer and collect a first royalty. If method claims are exempt from the exhaustion doctrine, that patent owner could then collect additional royalty payments from downstream purchasers for use of the already licensed product. But if a patent owner or authorized licensee sells a particular product, which by virtue of its normal operation practices a patented method, why should the principle of exhaustion not be a viable defense to downstream purchasers of that product that are accused of infringing the method claim? Cf. *Static Control Components, Inc. v. Lexmark Intl, Inc.*, 487 F. Supp. 2d 830, 856 (E.D. Ky., 2007) ("To hold that method claims are always exempt from the first sale/exhaustion doctrine would be the promulgation of an ipse dixit rule void of rationale, and accordingly, the Federal Circuit case law . . . ought not be construed to hold such.").

Because certain of the claims at issue in *Quanta* are method claims that arguably must be practiced in order to use the patented product that was purchased, it seems likely that the Supreme Court will provide clarification or guidance as to the applicability of the patent exhaustion doctrine against method claims.

IV. OTHER EXHAUSTION PROBLEMS OUTSIDE THE SCOPE OF QUANTA

Stepping away from the issues of whether it is permissible to contract around exhaustion and whether exhaustion should be applicable to method claims, which will be addressed in *Quanta*, other problems remain that still make the application of the exhaustion doctrine difficult. These problems are briefly discussed below.

The Problem Of Foreign Sales

As noted above, in recent years, the patent exhaustion doctrine has been further limited by the Federal Circuit, through its holdings that foreign "first sales" cannot trigger patent exhaustion. Although this particular issue is not before the Supreme Court in *Quanta*, it bears mention since it is another significant way that the usefulness of the patent exhaustion doctrine has been eroded.

Specifically, the Federal Circuit has held that in order “[t]o invoke the protection of the [patent exhaustion] doctrine, the authorized first sale must have occurred *under the United States patent.*” *Jazz Photo Corp. v. U.S. ITC*, 264 F.3d 1094, 1105 (Fed. Cir. 2001) (emphasis added); *see also Fuji Photo Film Co., Ltd. v. Jazz Photo Corp.*, 394 F.3d 1368, 1376 (Fed. Cir. 2005) (“the patentee’s authorization of an international first sale does not affect exhaustion of that patentee’s rights in the United States”).

At least one district court has interpreted these decisions as holding that foreign sales, even if authorized, cannot exhaust U.S. Patents as a matter of law, even when foreign purchased components are combined with other components to form the accused infringing product in the United States. *See Minebea Co. Ltd. v. Papst*, 374 F. Supp. 2d. 202, 216-17 (D.D.C. 2005) (rejecting argument that the authorized sale of a component of a patented combination outside the U.S. with knowledge and intent that it will be imported into the U.S. and used to form the infringing combination is a component sold “under” the United States patent.)

As with the rule concerning method claims, this rule also seems incongruous. Specifically, if foreign sales can give rise to U.S. patent infringement under 35 U.S.C. § 271, why should the fact that a product is purchased abroad and later imported into the United States nullify the defense of patent exhaustion? Although the Supreme Court will not address this particular issue in *Quanta*, the development of the law in this area will be important to monitor.

The Issue of Proving That A Component Should Exhaust A Patent

The practical usefulness of the patent exhaustion doctrine has also been further limited by a lack of clarity as to how to apply the exhaustion doctrine to the most common case - that of components. As discussed above, the Supreme Court has addressed the circumstances under which the sale of a component triggers the exhaustion doctrine as to a completed product. The Supreme Court test for whether exhaustion applies is whether the component embodies “the essential features” of the patented invention. This test was set forth in *Univis*. There, the Court found that the sale of unfinished components triggered the patent exhaustion doctrine, because the “uncompleted article . . . embodie[d the] **essential features** of his patented invention.” *Univis*, 316 U.S. at 250-51 (emphasis added). Thus, since the unfinished lens blanks were sold under license from Univis Corp. and since they embodied essential features of the patented invention, the patent rights with respect to the lens blanks and the finished lenses were exhausted when the lens blanks were sold.

What must be shown to demonstrate that the component embodies the “essential features of [the] patented invention” has been the subject of varying application by the Courts. For example, in *Cyrrix*, the District Court held that the patented microprocessors had to be combined with external memory in order to be useful in the sense of being commercially viable and that the essential features of the asserted claims were the same (i.e., nothing in the memory itself added anything of patentable significance to the invention embodied in the microprocessor). Accordingly, exhaustion applied based on the sale of the microprocessor components, even though the downstream customer ultimately combined that component with another component, memory, to create the patented article:

Cyrrix’s microprocessors, although complete in and of themselves, are unfinished in the sense that they need to be combined with external memory to be used. Cyrrix’s microprocessors thus are like the lens blanks in *United States v. Univis Lens Co.*, 316 U.S. 241, 252, 86 L. Ed. 1408, 62 S. Ct. 1088 (1942) which, although completed lens blanks, had no use other than to be ground into finished lenses in accordance with patents owned by the Lens Company.

Cyrix Corp. v. Intel Corp., 846 F. Supp. 532, 538-40 (E.D. Tex. 1994). Thus, the *Cyrix* Court reasoned that the combination of licensed components with non-licensed components will not negate patent exhaustion, so long as the licensed components are sufficiently unique that they have no other “commercially viable use” that is non-infringing. *Id.* at 541 (“Since *Cyrix*’s claim 1 microprocessors cannot be used without infringing claims 2 and 6 of the ‘338 Patent, there are no commercially viable non-infringing uses for the microprocessors.”).

However, in recent years, patentees have been able to avoid summary judgment of patent exhaustion on the basis that there are factual issues as to whether the components embody “the essential features” of the patented invention. Some Courts, like *Cyrix* above, have reduced the inquiry to whether there is a “commercially viable use” for the component. But others have require the accused infringer to prove that there are “no non-infringing uses” for the component. See, e.g., *Elkay Mfg. Co. v. Ebco Mfg. Co.*, No. 94-1424, 1996 U.S. App. LEXIS 28092, at *5-6 (Fed. Cir. Oct. 29, 1996) (finding that in order to have an implied license for use in a combination there must be “no non-infringing uses,” i.e., “that there is no other use for the article than in the claimed invention.”).⁶ This is a much tougher standard to meet.

Proving that the component embodies the essential features of a patented product is a significant aspect of proving a patent exhaustion defense in the case of components. While a more workable articulation of this particular standard is not likely to emerge from *Quanta*, perhaps more clarity will emerge as the exhaustion case law develops further.

CONCLUSION

The *Quanta* case presents the Supreme Court with an opportunity to strengthen the patent exhaustion doctrine on multiple grounds. In so doing, it is likely that the Supreme Court will overrule the Federal Circuit’s decisions in *Mallinckrodt*, as to contracting around exhaustion, and *Bandag*, as to the inapplicability of the exhaustion doctrine to method claims.

With respect to the central issue in *Quanta* of whether it is possible to contract around the exhaustion doctrine, the most consistent approach that the Supreme Court should take is to reverse *Mallinckrodt* and set a bright-line rule, in line with *Univis*, that strictly holds that the patent exhaustion doctrine may not be contracted around by setting restrictions in a license agreement that purport to restrict the post-sale use of the products at issue. A detailed review of the Supreme Court exhaustion indicates that the application of the exhaustion doctrine should turn solely on whether there was an “authorized sale.” Once there is an authorized sale, any purported post-sale restrictions or conditions intended to preserve the patent-owner’s right to claim infringement against downstream purchasers (even where they are notified of that purported restriction, as in *Quanta*) should be held to be without effect.

Such a holding would prevent the double-dipping scenario of *Quanta*: patent owners would not be able to extract multiple royalties for the use of the same patented invention from different members of a supply chain.

Patent owners will have to be extremely mindful of the exhaustion doctrine in setting up licensing programs and in determining from what member of a given supply chain (e.g., component maker, product maker, or further downstream user) to seek royalties. Where appropriate, patent owners should continue to be able to license distinct inventions (i.e., patent claims with distinct essential features) to different members

⁶ While *Elkay* is an implied license case, as noted earlier, many courts analytically confuse the two.

of a supply chain without triggering the exhaustion doctrine. In such cases, there is no issue of double-dipping or patent exhaustion. However, once a patented invention is licensed to one member of the supply chain, the exhaustion doctrine will prevent further recovery under that patent from those downstream from that licensee.⁷

Even after the issues presently before the Supreme Court in *Quanta* are resolved, other unresolved issues will continue to impede the defensive use of the exhaustion doctrine in certain circumstances. These include the Federal Circuit's holding that the patent exhaustion doctrine is inapplicable to foreign sales and the lack of clarity in how to apply the "essential features standard" to determine when to apply the exhaustion doctrine to a sale of a component of the patented invention. For now, it is important that these limitations under the present law be well understood both patentees and accused infringers alike.

⁷ Of course, under *General Talking Pictures*, it will still be possible for a patentee to attempt to limit the authority of the licensee to make and sell licensed products and to pursue infringement claims against downstream customers of products that were not "authorized" sales. Practically speaking, however, this may prove difficult, since a licensee paying a royalty will often want full freedom to make and sell product.