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June 18, 2008

Patent Exhaustion - The U.S. Supreme Court's Decision in *Quanta Computer v. LG Electronics*

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On June 9, 2008, the U.S. Supreme Court issued its eagerly awaited decision in *Quanta Computer, Inc. v. L.G. Electronics, Inc.*, U.S. Supreme Court No. 06-937 (June 9, 2008). In a unanimous decision delivered by Justice Thomas, the Court reversed the Federal Circuit's decision below and held that an authorized sale of components that are later combined with other components to form a patented system and to practice patented methods results in exhaustion of all patents, including system and method patents, that are substantially embodied in those components.

BACKGROUND

Generally speaking, the patent exhaustion or "first sale" doctrine states that once a patentee has sold a product covered by a patent, the patentee cannot use the patent to prevent the purchaser from using or reselling that product. The patentee's rights to restrict use and further sale are said to be "exhausted." For exhaustion purposes, the "first sale" may be a sale by the patentee or by a third party authorized to sell by the patentee. The law has been unclear in some areas, however, especially where products or components are sold that are not themselves covered by the patents at issue, but are subsequently used by the purchaser in practicing a process covered by a patent of the seller, or where the purchaser combines the product or component with other elements in a system, and the system is covered by a patent of the seller.

THE FACTS OF THE QUANTA CASE

LG Electronics ("LGE"), the plaintiff in the *Quanta* case, owned several patents claiming various aspects of data processing systems and methods performed therein. LGE had licensed Intel to make and sell microprocessors and chipsets that use LGE's patents. The LGE-Intel license expressly stipulated that no license was granted "to any third party for the combination by a third party of Licensed Products...with [non-Intel components]." A separate master agreement required Intel to notify its customers that the license "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product," which Intel did by sending a letter to that effect to its customers. Breach of the master agreement, however, was not grounds for termination of the license agreement. *Quanta* and the other defendants, that had received the letter, subsequently purchased microprocessors and chipsets from Intel and used them in computer systems by combining them with non-Intel memory and buses. LGE brought suit against the defendants, alleging that the combination of the Intel products with other components in the defendants' computer systems and the operation of such systems infringed LGE patents. LGE did not allege infringement with respect to the microprocessors or chipsets themselves.

THE SUPREME COURT'S DECISION

Before the Supreme Court LGE argued that the patent exhaustion doctrine should not be applied to system and method patents. The Supreme Court was not persuaded by LGE's arguments and applied the patent exhaustion doctrine.

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The Patent Exhaustion Doctrine Applies to Method Patents

Reversing the Federal Circuit's holding that the patent exhaustion doctrine is inapplicable to method patents, the Supreme Court held that "[n]othing in this Court's approach to patent exhaustion supports LGE's argument that method patents cannot be exhausted." The Court specifically noted the risk that to hold otherwise would seriously undermine the exhaustion doctrine as patentees could simply draft claims as method claims rather than apparatus claims and thus practically shield any product from exhaustion.

The Sale of Products Embodying Essential Features of a Patented Invention Generally Results in Exhaustion

The Supreme Court also held that the sale of components results in exhaustion of a patent covering the combination of such components with other elements if the components "substantially embod[y]" the patent. The Court relied on two criteria to find that the components "substantially embod[y]" the patent and that exhaustion occurs. First, the component's only reasonable use must practice the patent at issue. Second, the components sold must embody the "essential, or inventive, feature[s]" of the patent at issue.

Disclaimers and Intel's Obligation to Notify Customers did not Affect Intel's Authorization to Sell

The Supreme Court also confirmed that the focus in determining whether exhaustion occurs is on whether the sale is authorized by the patent holder. In this case, the Court found that Intel's sales were authorized by LGE because Intel's rights to make, use, and sell products were not conditioned in any way.

It is Unclear if Patent Exhaustion Can Still be Avoided by Making Conditional Sales

The Supreme Court never reaches the questions of whether LGE could have avoided patent exhaustion by limiting Intel's authority to sell or requiring Intel to place conditions on its customers' use of its products and, if so, what would be required for a sale to be validly conditioned. Thus, the decision does not provide guidance on the viability of the concept of conditional sales to avoid exhaustion.

SIGNIFICANCE OF THE DECISION AND OPEN ISSUES

The *Quanta* decision will have a significant impact on the computer industry as well as other industries heavily relying on patent protection and enforcement in downstream markets. The application of the patent exhaustion doctrine to method patents and the sale of components embodying essential features of a patented system will make it more difficult for patent holders to license component manufacturers while still seeking to enforce their patents against downstream purchasers and users. However, patent holders may now increasingly seek to limit their licensees' authority to sell products, e.g., by permitting them only to sell to separately licensed users, by excluding certain patents (e.g., those applicable to systems or methods) from the scope of licensed patents, or by conditioning the licensee's right to sell on imposing (contractual) conditions on purchasers.

While purchasers have more certainty regarding exhaustion of method and combination patents as a result of the Court's decision, there are still risks and unanswered questions. For example, exhaustion still does not apply if the product purchased is not an essential element of the patented invention or if the seller's authority to sell was limited (which the purchaser may have no way of knowing). Thus, purchasers still need to conduct diligence on third party patents and their sellers' rights and may want to consider requesting broader indemnification rights.

Note: Morrison & Foerster represented *amicus curiae* Gen-Probe Incorporated in the *Quanta* case, which filed a brief in support of petitioners Quanta Computer, Inc., *et al.*

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