High Court Sets Patent Exhaustion Law Back On Track

- IP Law360, July 10, 2008

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Tuesday, Jun 10, 2008 — For the first time in over fifty years, and certainly since the U.S. Court of Appeals for the Federal Circuit was formed, the Supreme Court has directly addressed the law of patent exhaustion this week in Quanta Computers Inc. v. LG Electronics Inc., Slip Op. (Sup. Ct. Jun. 9, 2008).

In Quanta, the Supreme Court has confirmed that "[t]he longstanding doctrine of patent exhaustion provides that the initial authorized sale of a patented item terminates all patent rights to that item." (Slip op. at 5).

he Supreme Court has also confirmed that "the exhaustion doctrine applies to method patents" (Slip op. at 1, 9-11) and when a "license authorizes the sale of components that substantially embody the patents in suit, the sale exhaust[s] the patents." (Slip op. at 1, 11-16).

Over the past 15 years, since the Federal Circuit's decision in Mallinckrodt Inc. v. Medipart Inc., 976 F.2d 700 (Fed. Cir. 1992), the law of patent exhaustion has been limited in various ways. The Federal Circuit endorsed that a patentee could contract around the patent exhaustion doctrine, that method claims were not subject to the patent exhaustion doctrine, and that sales made outside the U.S. would not be exhausted (even when the same sales could be subject to charges of infringement).

This week's Supreme Court decision has addressed (and rejected) two of these departures from long-standing Supreme Court precedent, and promises to provide customers of a patent licensee with greater certainty as to the rights they receive incident to their purchases of patented items.

In Part I, we review the fundamental law of patent exhaustion as previously stated in Supreme Court precedent, and identify the areas where the Federal Circuit has departed from those principles over the past 15 years.

In Part II, we briefly discuss the procedural history of Quanta. (A more fulsome discussion of the Quanta case, the briefing to the Supreme Court, and the arguments made at oral argument can be found in our prior Guest Columns and article on this case, which are available at our firm's website (www.arelaw.com/articles).)

In Part III, we review the Supreme Court's decision in Quanta.

In Part IV, we identify issues in the law of patent exhaustion that remain open after Quanta.

Part I: Prior Supreme Court Precedent On Patent Exhaustion And How The Federal Circuit Deviated From It

Patent exhaustion is a fundamental doctrine of patent law that was 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 a license to 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 and to allow downstream customers to be free from claims that they are infringing a patent when their supplier was authorized by the patentee to make sales under the patent.

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).

The Supreme Court's most recent precedent on the subject was United States v. Univis Lens Co., 316 U.S. 241 (1942). This case provides one of the best examples of the application of the exhaustion doctrine. In Univis, the patentee, Univis Corp., held a patent having claims directed to an eyeglass lens and the method for making the lens by producing, grinding, and polishing lens blanks. 316 U.S. at 243. Univis Corp. licensed its related company, Univis Lens, to manufacture lens blanks.

Univis Lens sold those licensed blanks to wholesalers and retailers. 316 U.S. at 244 45. After purchasing the Univis Lens blanks, the wholesalers and retailers would finish the grinding and polishing of the lens blanks through practice of Univis Corp.'s 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 resale price. Id.

Before the Supreme Court was the issue (among others) of whether a patent owner could exclude a purchaser from practicing the claimed inventions necessary to finish and use the product. 316 U.S. at 248. In addressing the patent owner's post-sale rights, the Court held:

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 with the patent, he has sold his invention so far as it is or may be embodied in that particular article.

Univis Lens, 316 U.S. at 250 51. Accordingly, since the unfinished lens blanks were sold under license from Univis Corp., and since they had no realistic use except to practice the method of

Univis Corp.'s patent, the patent rights with respect to the lens blanks and the finished lenses were exhausted when the lens blanks were sold:

"[T]he 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." Univis Lens, 316 U.S. at 249.

Thus, the Univis Court summarized the relevant governing principles as follows:

"The first vending of any article manufactured under a patent puts the article beyond the reach of the monopoly which that patent confers. Whether the licensee sells the patented article in its complete form or sell it before the completion for the purpose of enabling the buyer to finish and sell it, he has equally parted with the article, and made it the vehicle for transferring to the buyer ownership of the invention with respect to that article."

"To that extent he has parted with his patent monopoly in either case, and has received in the purchase price every benefit of that monopoly which the patent law secures to him. If he were permitted to control the price at which it could be sold by others he would extend his monopoly quite as much as in the one case as in the other, and he would extend it beyond the fair meaning of the patent statutes and the construction which has hither to been given to them." 316 U.S. at 252.

The Federal Circuit's precedent over the past 15 years had deviated from the Supreme Court's precedent in three significant ways:

First, in seeming contradiction of Supreme Court precedent, the Federal Circuit had allowed 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. 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, also in seeming contradiction of Supreme Court precedent, the Federal Circuit had 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 had severely weakened its usefulness.

Third, the Federal Circuit had held that sales outside the United States could not "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. Consequently, a patent owner was not precluded from also seeking patent royalties from the end-product manufacturer.

Part II: Procedural History In Quanta

LG Electronics ("LGE") sued Quanta and other Taiwanese computer manufacturers for infringement of certain LGE Patents, which were licensed to Intel. Quanta and the other defendants purchased microprocessors and chipsets from Intel, and combined them with non-Intel components in manufacturing their computers.

Prior to trial, Quanta and the other defendants moved for summary judgment on the grounds that the patents-insuit were exhausted by virtue of the license to Intel. The district court granted summary judgment in favor of the defendants as to the apparatus claims of the patents-in-suit, but not their method claims. LG Electronics Inc. v. Asustek Computer Inc., 65 USPQ 2d 1589 (N.D. Cal. 2002); LG Electronics Inc. v. Asustek Computer Inc., 248 F. Supp. 2d 912 (N.D. Cal. 2003).

The Federal Circuit reversed the district court as to the apparatus claims. LG Electronics Inc. v. Bizcom Electronics Inc., 453 F. 3d 1364 (Fed. Cir. 2006). The Supreme Court granted certiorari. Quanta Computer Inc. v. LG Elecs. Inc., 551 U.S. ___ (2007).

Part III: The Supreme Court's Decision

In Quanta, a unanimous Supreme Court recognized that "[f]or over 150 years this Court has applied the doctrine of patent exhaustion to limit the patent rights that survive the initial authorized sale of a patented item." (Slip op. at 1).

The Court disagreed with the Federal Circuit on both issues raised on certiorari and found, "[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 exhausts the patents." (Sip op. at 1).

In Part I of the Opinion, the Court reviewed the patents in suit and the license agreement at issue. The patents at issue are owned by LGE and relate to microprocessors. (Slip op at 2-3). LGE entered into a series of agreements with Intel, which authorized Intel to sell microprocessors and chipsets that use LGE Patents. In this regard, the Court summarized the agreements as follows:

The cross-licensing agreement (License Agreement) permits Intel to manufacture and sell microprocessors and chipsets that use the LGE Patents (the Intel Products). The License Agreement authorizes Intel to "'make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of'" its own products practicing the LGE Patents.

Notwithstanding this broad language, the License Agreement contains some limitations. Relevant here, it stipulates that no license

"'is granted by either party hereto ... 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.'"

The License Agreement purports not to alter the usual rules of patent exhaustion, however, providing that, "'[n]otwithstanding anything to the contrary contained in this Agreement, the parties agree that nothing herein shall in any way limit or alter the effect of patent exhaustion that would otherwise apply when a party hereto sells any of its Licensed Products.'"

In a separate agreement (Master Agreement), Intel agreed to give written notice to its own customers informing them that, while it had obtained a broad license "'ensur[ing] that any Intel product that you purchase is licensed by LGE and thus does not infringe any patent held by LGE,'" 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.'"

The Master Agreement also provides that "'a breach of this Agreement shall have no effect on and shall not be grounds for termination of the Patent License.'"

(Slip op. at 3-4 (citations omitted)).

Quanta, in turn, purchased the microprocessors and chipsets in question from Intel and incorporated them into the accused products. With respect to Quanta's transactions with Intel, the Court explains:

"Quanta purchased microprocessors and chipsets from Intel and received the notice required by the Master Agreement. Nonetheless, Quanta manufactured computers using Intel parts in combination with non-Intel memory and buses in ways that practice the LGE Patents. Quanta does not modify the Intel components and follows Intel's specifications to incorporate the parts into its own systems."

(Slip op at 4).

In Part II of its Opinion, the Court reviewed "[t]he longstanding doctrine of patent exhaustion" which "provides that the initial authorized sale of a patented item terminates all patent rights to that item." (Slip op. at 5-8).

In this overview, the Court discussed the historical roots of this doctrine, and how previous decisions by the Court to permit post-sale restrictions on the use of patented items had been explicitly overruled. (Slip op at 6-7, discussing Motion Pictures Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 518 (1917), explicitly overruling Henry v. A.B. Dick Co., 224 U.S. 1 (1912)).

The Court then discussed its prior decision in Univis, 316 U.S. 241, which it found dispositive of the present case.

In Part III of the Opinion, the Court addressed each of LGE's arguments in turn, and rejected them in favor of Quanta's arguments.

First, in Part III.A of the Opinion, the Court found that "[n]othing in this Court's approach to patent exhaustion supports LGE's argument that method patents cannot be exhausted. It is true 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." (Slip op. at 9).

The Court emphasized, "this Court has repeatedly held that method patents were exhausted by the sale of an item that embodied that method." (Id.). The Court also recognized that "[e]liminating exhaustion for method patents would seriously undermine the exhaustion doctrine." (Slip op. at 10).

Thus, the Court concluded, "[w]e reject LGE's argument that method claims, as a category, are never exhaustible." (Slip op. at 11).

Next, in Part III.B of its Opinion, the Court considered "the extent to which a product must embody a patent in order to trigger exhaustion." (Slip op. at 11). Here, the Court relied heavily upon its prior decision in Univis as governing. "As the Court there explained, exhaustion was triggered by the sale of 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.'" 316 U.S., at 249-251.

Each of those attributes is shared by the microprocessors and chipsets Intel sold to Quanta under the License Agreement." (Slip op. at 12).

The Court first relied upon the holding in Univis 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." (Slip op. at 12, quoting Univis, 316 U.S. at 249).

Like Univis, the Quanta Court found that "LGE has suggested no reasonable use for the Intel Products other than incorporating them into computer systems that practice the LGE Patents." (Slip op. at 12-13, emphasis added).

The Quanta Court specifically rejected LGE's arguments that "Intel Products would not infringe its patents if they were sold overseas, used as replacements parts, or engineered so that use with non-Intel Products would disable their patented features" as misplaced. "Univis teaches that the question is whether the product is 'capable of use only in practicing the patent,' not whether those uses are infringing." (Slip op. at 13, n. 6, quoting Univis, 316 U.S. at 249 (emphasis supplied by Quanta Court).

The Court also found that “disabled features would have no real use”. (Id. (emphasis in original)).

Next, the Court relied upon the holding in Univis that the lens blanks “embodie[d] essential features of [the] patented invention”. (Slip op. at 13, quoting Univis, 316 U.S. at 250-51).

The Court looked to the “uniqueness” of the finishing process, that it “was not central to the patents,” and that it was a “standard process” not included in the details of the patent, as guiding principles coming from Univis.

In Quanta, the Court found, “[h]ere, as in Univis, the incomplete article substantially embodies the patent because the only step necessary to practice the patent is the application of common processes or the addition of standard parts.” (Slip op. at 14).

The Quanta Court found it significant that “[t]he Intel Products were specifically designed to function only when memory or buses are attached; Quanta was not required to make any creative or inventive decision when it added those parts,” and “[i]ndeed, Quanta had no alternative ....” (Slip op. at 14-15).

The Court rejected LGE’s attempt to distinguish Univis. “First, there is no reason to distinguish the two cases on the ground that the articles in Univis required the removal of material to practice the patent while the Intel Products required the addition of components to practice the patent.” (Slip op. at 15 (emphasis in original)).

Rather, the more dispositive inquiry to the Quanta Court was the “nature of the final step” as to whether it was “common and noninventive.” (Id.).

The Court also made short shrift of LGE’s argument that exhaustion did not apply across patents. In particular, the Quanta Court explained:

The sale of a device that practices patent A does not, by virtue of practicing patent A, exhaust patent B. But if the device practices patent A while substantially embodying patent B, its relationship to patent A does not prevent exhaustion of patent B.

(Slip op. at 15 (emphasis in original)). Thus, the Court explained:

The relevant consideration is whether the Intel Products that partially practice a patent—by, for example, embodying its essential features—exhaust that patent.

(Slip op. at 16 (emphasis in original)).

Finally, the Court rejected LGE’s attempt to rely upon the Court’s prior statement in Aro Mfg. Co. v. Convertible Top Replacement Co., 365 U. S. 336, 344–345 (1961), that it is impermissible to “ascrib[e] to one element of the patented combination the status of the

patented invention in itself" as "misplaced." (Slip op. at 16).

The Court confirmed that "Aro described combination patents as 'cover[ing] only the totality of the elements in the claim [so] that no element, separately viewed, is within the grant.'" 365 U. S., at 344. (Id.).

The Court cautioned, however, that "Aro's warning that no element can be viewed as central to or equivalent to the invention is specific to the context in which the combination itself is the only inventive aspect of the patent." (Slip op. at 16).

In Part III.C of the Opinion, the Court addressed the final issue: "Having concluded that the Intel Products embodied the patents, we next consider whether their sale to Quanta exhausted LGE's patent rights." (Slip op. at 16). In this regard, the Court recognized, "Exhaustion is triggered only by a sale authorized by the patent holder." (Id.). The Court rejected LGE's arguments that Intel's sale to Quanta was not authorized. The Court confirmed, "Nothing in the License Agreement restricts Intel's right to sell its microprocessors and chip-sets to purchasers who intend to combine them with non-Intel parts." (Slip op. at 17).

The Court found it significant that "Intel's authority to sell its products embodying the LGE Patents was not conditioned on the notice or on Quanta's decision to abide by LGE's directions in that notice." (Slip op. at 17–18).

The Court rejected LGE's argument that the explicit disclaimer of licenses to third parties in the License Agreement somehow precluded the patent exhaustion doctrine from applying "because Quanta asserts its right to practice the patents based not on implied license but on exhaustion. And exhaustion turns only on Intel's own license to sell products practicing the LGE Patents." (Slip op. at 18).

In sum, on this issue the Court found:

The License Agreement authorized Intel to sell products that practiced the LGE Patents. No conditions limited Intel's authority to sell products substantially embodying the patents. Because Intel was authorized to sell its products to Quanta, the doctrine of patent exhaustion prevents LGE from further asserting its patent rights with respect to the patents substantially embodied by those products.

(Slip op. at 18).

In the final footnote of the Opinion, the Court left open the issue of "whether contract damages might be available even though exhaustion operates to eliminate patent damages." (Slip op. at 18, fn.7). This passing thought may lead to a host of new theories of litigation.

The Court concluded its Opinion as follows:

"The authorized sale of an article that substantially embodies a patent exhausts the patent

holder's rights and prevents the patent holder from invoking patent law to control post sale use of the article."

"Here, LGE licensed Intel to practice any of its patents and to sell products practicing those patents. Intel's microprocessors and chipsets substantially embodied the LGE Patents because they had no reasonable noninfringing use and included all the inventive aspects of the patented methods. Nothing in the License Agreement limited Intel's ability to sell its products practicing the LGE Patents.

"Intel's authorized sale to Quanta thus took its products outside the scope of the patent monopoly, and as a result, LGE can no longer assert its patent rights against Quanta. Accordingly, the judgment of the Court of Appeals is reversed."

(Slip op. at 19).

Part IV: Remaining Questions

While it is useful that the Supreme Court has reaffirmed its prior holdings on the first two areas where the Federal Circuit has departed from the proper application of the patent exhaustion doctrine (i.e., reaffirming that the doctrine cannot be contracted around, and that patent exhaustion applies to method claims), Quanta did not provide the Supreme Court the opportunity to address the questions raised in Jazz Photo.

Thus, the Federal Circuit's precedent that the sale of patented components outside the U.S. by a patentee or its licensee does not exhaust a U.S. patent still remains an open issue. Although this issue was not specifically addressed in Quanta, perhaps the lower courts will take Quanta as an indication that time has come to reject as well this departure from the proper application of the patent exhaustion doctrine.

In Footnote 7, the Supreme Court raised a new issue for consideration, viz., whether a patentee has any available remedies under contract law if patent exhaustion precludes damages under patent law. This issue may lead to a host of new theories of contract law.

Whether the patent exhaustion doctrine is an issue of patent law or contract law was heavily discussed during oral argument. The Supreme Court's Opinion has addressed patent exhaustion as a question of patent law, but has left open a suggestion that other bodies of law might give rise to potential causes of action to a patentee.

The Court's discussion as to what constitutes a "reasonable use" of a patented product and what are the "essential features" of a patent claim is helpful. However, it is likely that these standards will need to be further fleshed out by the lower courts in the future.

Finally, the Court's analysis in Quanta has left open the possibility that, under a different contractual scheme, such as where a conditional license is granted and the condition is not fulfilled, the exhaustion doctrine may not come into play.

Conclusion

This week the Supreme Court took a big step to put the patent exhaustion doctrine back on track with its priorprecedent. It has reaffirmed that an authorized sale or disposition of a patented article exhausts a patentee's rightswith respect to that article.

It has also reaffirmed that the patent exhaustion doctrine applies with equal vigor to method claims as it does to
apparatus claims.

It has further reaffirmed that the patent exhaustion doctrine applies not only to articles that fully embody a patent, but equally to articles that substantially embody the patent.

However, the Supreme Court has not addressed all of the departures from the patent exhaustion doctrine by the Federal Circuit. The patent bar will have to wait for the next case to resolve these remaining issues.

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