

REPORT

**SUPREME COURT HOLDS THAT EXHAUSTION DOCTRINE
APPLIES TO METHOD PATENTS AND
THAT AUTHORIZED SALE OF PRODUCT "EMBODYING PATENT"
EXHAUSTS PATENT HOLDER'S RIGHTS**

June 24, 2008

I. Summary

On June 9, in *Quanta Computer, Inc. v. LG Electronics, Inc.*,¹ the U.S. Supreme Court applied its holding in *United States v. Unisys Lens Co.*, 316 U.S. 241 (1942) (relating to exhaustion of patents on eyeglass lenses), to method and system patents on computer technology. The Court's unanimous decision, written by Justice Thomas, addresses "the extent to which a product must *embody a patent* in order to trigger exhaustion" (emphasis added). The decision holds that "[t]he 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 postsale use of the article."

In a footnote, however, the Court notes that its decision applies only to exhaustion and does not "necessarily limit" the patent holder's "contract right" or address "whether contract damages might be available even though exhaustion operates to eliminate patent damages." In addition, under the Court's holding, neither an unauthorized sale, e.g., a sale made in violation of a restriction in the license agreement between the patent holder and its licensee, nor an authorized sale of an article not "substantially embodying" the patented invention, will exhaust the patent holder's rights in the article sold.

II. Background

LG Electronics ("LGE") sued Quanta in the U.S. District Court for the Northern District of California, asserting that Quanta's computers using components

(microchips and chipsets) purchased from Intel infringed three LGE patents relating to systems incorporating the components and methods using the components.² LGE had licensed all of the patents to Intel under a License Agreement authorizing Intel to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" its own products practicing the inventions of the LGE patents. The License Agreement stipulated 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." In a separate agreement ("Master Agreement"), Intel agreed to give written notice to its own customers, such as Quanta, informing them that Intel's license from LGE "does not extend, expressly or by implication, to any product that you make by combining an Intel product with any non-Intel product." However, the Master Agreement also provided that "a breach of this Agreement shall have no effect on and shall not be grounds for termination of the Patent License."

On these facts, the District Court first ruled that, although the Intel components themselves do not fully "practice any of the patents" at issue, they have no reasonable noninfringing use and therefore their authorized sale to Quanta by Intel exhausted LGE's patent rights as to

² One asserted patent relates to a system for ensuring that most current data are retrieved from main memory, one relates to coordination of requests to read from and write to main memory, and one addresses the problem of managing data traffic on a set of wires, or "bus," connecting computer components.

¹ 2008 WL 2329719.

June 24, 2008

Quanta's accused computers under *Univis*. However, in a subsequent ruling, the District Court held that exhaustion did not apply to the method claims of LGE's patents, because in the District Court's opinion the doctrine of patent exhaustion applies only to apparatus or composition-of-matter claims that describe a physical object, and not to method claims that describe operations to make or use a product.

The U.S. Court of Appeals for the Federal Circuit affirmed in part and reversed in part. The Federal Circuit first confirmed that the patents at issue "do not cover the products licensed to or sold by Intel." It agreed that the doctrine of patent exhaustion does not apply to method claims. The Federal Circuit also determined that exhaustion does not apply even to the system patents, because LGE did not license Intel to sell the Intel components to Quanta for use in systems in which the Intel components are combined with non-Intel components, and thus the sales to Quanta were unauthorized sales falling outside the doctrine of patent exhaustion.

III. The Supreme Court's *Quanta* Decision

The Supreme Court reversed. After reviewing the history of the doctrine of patent exhaustion, the Court rejected LGE's argument that method claims, as a category, are never exhaustible. Next, the Court considered the parties' arguments regarding the extent to which a product must "embody a patent" in order to trigger exhaustion and concluded, applying *Univis*, that the Intel components "embodied LGE's patents." Finally, the Supreme Court concluded that the sale of the Intel components to Quanta was authorized, and thus exhausted LGE's patent rights, because nothing in the License Agreement restricted Intel's right to sell the Intel components to purchasers that intended to combine them with non-Intel components.

A. Method Claims

Agreeing with Quanta that the *Univis* holding is applicable to method claims, the Supreme Court stated that "[n]othing in this Court's approach to patent exhaustion supports LGE's argument that method patents cannot be exhausted," and that "methods ... may be 'embodied' in a product the sale of which exhausts patent rights." Citing *Ethyl Gasoline Corp. v. United States*³ and *Univis*, the

³ 309 U.S. 436, 446, 457 (1940) (holding that motor fuel produced under one patent also exhausted another patent for a method comprising using the fuel in combustion motors).

Quanta Court further observed that "this Court has repeatedly held that method patents were exhausted by the sale of the item that embodied the method."

While following its precedent, the Court also stated its rationale that "[e]liminating exhaustion for method patents would seriously undermine the exhaustion doctrine" because "[p]atentees seeking to avoid patent exhaustion could simply draft their patent claims to describe a method rather than an apparatus." The Court saw LGE's position in this light, and rejected it. "On LGE's theory," the Court stated, "although Intel is authorized to sell a completed computer system that practices the LGE Patents, any downstream purchasers of the system could nonetheless be liable for patent infringement." In the Court's view, such potential liability would violate the "longstanding principle that, when a patented item is 'once lawfully made and sold, there is no restriction on [its] use to be implied for the benefit of the patentee,'" quoting *Adams v. Burke*, 17 Wall. 453, 457 (1873).

B. The Extent To Which A Product Must "Embody A Patent"

"The longstanding doctrine of patent exhaustion," as restated by the *Quanta* Court, "provides that the initial authorized sale of a patented item terminates all patent rights to that item." In its prior *Univis* case, the Supreme Court applied this doctrine to the sale of *unfinished* lens blanks and held that the sale exhausted patents on the *finished* lenses, reasoning 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*, 316 U.S. at 250-251. In *Quanta*, the Supreme Court distilled the *Univis* holding to the following:

In sum, the Court concluded [*in Univis*] that the traditional bar on patent restrictions following the sale of an item applies when the item sufficiently embodies the patent -- even if it does not completely practice the patent -- such that its only and intended use is to be finished under the terms of the patent.

The Supreme Court applied the holding in *Univis* to determine whether the Intel components sufficiently "embodied the LGE patents" to trigger exhaustion. In *Univis*, one factor triggering exhaustion was the fact that

June 24, 2008

the "only reasonable and intended use" of the lens blanks was to practice the patented invention. With respect to this first factor, 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."

A second factor triggering exhaustion in *Univis* was the fact that the lens blanks "embodied essential features" of the patented invention. The Court appeared to apply a "point-of-novelty" approach to this analysis. The Court explained that "[t]he essential, or inventive, feature of the Univis lens patents was the fusing together of different lens segments to create bi- and tri-focal lenses" and that "[t]he finishing process performed by the finishing and prescription retailers after the fusing was not unique." Characterizing the grinding process as "standard," the Court further explained that the grinding process "was not included in detail in any of the patents" at issue in *Univis*, "was not referred to at all in two of the patents," and was "treated ... as incidental to the invention" in the patents that did mention it (quoting the patent where it stated "[t]he blank is then ground in the usual manner"). The *Quanta* Court found as to this second factor that, "[l]ike the Univis lens blanks, the Intel Products constitute a material part of the patented invention and all but completely practice the patent." The Court further found that "[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" and "[e]verything inventive about each patent is embodied in the Intel Products." "In each case, the final step to practice the patent is common and noninventive: grinding a lens to the customer's prescription, or connecting a microprocessor or chipset to buses or memory." "The Intel Products embody the essential features of the LGE Patents because they carry out all the inventive processes when combined, according to their design, with standard components."

The Court was not persuaded by LGE's argument that, in *Univis*, there was no "patentable distinction" between the lens blanks and the patented finished lenses. LGE had characterized the Intel components as "independent and distinct products" from the systems using LGE's patents and subject to "independent patents." In rejecting this argument, the Court stated:

While each Intel microprocessor and chipset practices thousands of individual patents, including some LGE patents not at issue in this

case, the exhaustion analysis is not altered by the fact that more than one patent is practiced by the same product. The relevant consideration is whether the Intel Products that partially practice a patent -- by, for example, embodying its essential features -- exhaust *that* patent.

The Court distinguished *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 365 U.S. 336, 344-45 (1961). LGE had argued that *Univis* does not apply because the Intel components are analogous to individual elements of a combination patent, and allowing sale of those elements to exhaust the patent would impermissibly "ascrib[e] to one element of the patented combination the status of the patented invention itself." *Aro*, 365 U.S. at 344-45. However, the Supreme Court rejected this argument. It stated that *Aro* "dealt only with the question whether replacement of one part of a patented combination infringes the patent," a question not at issue in *Quanta*. The Court further stated 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." In this context, the Court cited *Mercoird Corp. v. Mid-Continent Investment Co.*, 320 U.S. 661, 667-68 (1944), for the proposition that in a combination patent "the combination is the invention and it is distinct from any of its elements." The Court distinguished *Aro* on the basis that, "[i]n this case, the inventive part of the patent is not the fact that memory and buses are combined with a microprocessor or chipset; rather, it is included in the design of the Intel Products themselves and the way these products access the memory or bus."

C. Authorized Sales

In finally concluding that the sale of the Intel components to Quanta exhausted LGE's patent rights, the Court addressed the prerequisite to application of the doctrine that the initial sale must be an "authorized" sale. The Court carefully analyzed the Intel-LGE transaction and concluded that "[n]othing in the License Agreement restricts Intel's right to sell its microprocessors and chipsets to purchasers who intended to combine them with non-Intel parts." Rather, the License Agreement "broadly permits Intel to 'make, use, [or] sell' products free of LGE's patent claims. In reaching this result, the Court found that Intel's authority under the License Agreement to sell products embodying the LGE patents was not subject to any limitations or conditions imposed on Intel contractually by the separate Master Agreement.

June 24, 2008

As interpreted by the Supreme Court, Intel's contractual obligation under the Master Agreement to give notice to its customers, including Quanta, that LGE had not licensed those customers to practice its patents, was separate from the License Agreement. The Court noted that "LGE does not suggest that a breach of that agreement would constitute a breach of the License Agreement."

Thus, based on its analysis of the Intel-LGE transaction, the Supreme Court rejected LGE's argument that "Intel could not convey to Quanta what both knew it was not authorized to sell, *i.e.*, the right to practice the patents with non-Intel parts." The Court stated that this argument was "irrelevant," "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." The Court concluded:

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.

IV. Analysis

A. Method Claims

In *Quanta*, the Supreme Court overruled the Federal Circuit's holding that the patent exhaustion doctrine does not apply to method patents. This represents a significant change in the law as interpreted by the Federal Circuit, because it closes a loophole by which patent applicants were able to avoid application of the doctrine simply by drafting their patent claims to define a method rather than a product or an apparatus. As the law now stands, whether the exhaustion doctrine applies to a licensing transaction involving a method or system patent will depend on whether the product sold by the licensee "substantially embodies" the patented invention and on whether the license agreement contains exhaustion-negating restrictions on the licensee's rights under the patent, as discussed below.

The Supreme Court's *Quanta* decision holds that all method patents, including both method-of-making and method-of-use patents, are subject to the exhaustion

doctrine. The Court did not explicitly address, however, whether the authorized sale of a manufactured article can exhaust a patent on the method of making (manufacturing) that article. We believe that in most situations the authorized sale of such a manufactured article, as distinct from a machine or system used to make the article, would not exhaust the method-of-making patent, because it would not "embody" the claimed steps of the method required to make the article. In contrast, the authorized sale of a machine that is used in manufacturing the article could embody those steps, and therefore could exhaust the method-of-making patent under *Quanta*.⁴

B. The Extent To Which A Product Must "Embody A Patent"

Under *Quanta*, in order to "substantially embody" a method or system patent, a product must be reasonably capable of use only in practicing the patented method or system and must embody the essential, unique, or inventive features of that method or system. If a product includes all of the claimed features, except processing or operating method steps or additional system features that may be characterized as "standard," "common," "noninventive," "incidental," or "usual," it will almost certainly "substantially embody" the patent under *Quanta*. While this is the same two-factor test that the Supreme Court applied in *Univis*, the *Quanta* decision significantly clarifies this test, particularly as applied to method patents.

From the standpoint of a patent applicant wishing to avoid, insofar as possible, application of the exhaustion doctrine to its invention after issuance of a patent, and in light of *Quanta*, the patent application should be drafted so as to describe the claimed features in neutral terms and to avoid characterizing any of them as "standard," "common," "noninventive," "incidental," "usual," etc. The application should also discuss any alternative uses of the product that is the subject of the application. If the claimed use of the product, but not the product itself, is novel, the application should also spell out any noninfringing uses. By such careful drafting, the patent applicant can make it more

⁴ There may be cases, for example, in the biotechnical arts, in which the manufactured article is self-replicating -- *i.e.*, could be argued to embody the method of making. Application of the "embody the patent" test to such products and method-of-making patents will be complex. Thus clear terms in agreements relating to such products will be very important to avoid or ensure exhaustion.

June 24, 2008

difficult for a court to find that a component substantially embodies a claimed system or method of use.

The Court's holding in *Quanta* focuses on exhaustion of a "patent," rather than on exhaustion of a "claim" of a patent. In addition, it appears to focus on analysis of one patent at a time as to a given product. Accordingly, it may also be advantageous, in the case of a system or method patent, to file separate applications covering, for example, a patentable product and at least two mutually exclusive systems and methods of using the product. Thus there would be a reasonable, non-infringing use of the product as to each of (but not necessarily both of) the system patents or method patents.

In view of this potential strategy, it may sometimes be better for a patent applicant to file divisional applications rather than traverse restriction requirements or election of species requirements for important inventions. However, as always, the cost of such additional applications and resulting patents must also be considered.

In the case of a system comprising patentable part A and patentable part B, the patent applicant might obtain separate patents on parts A and B as well as on the system as a whole. In this example, the sale of part A pursuant to a license of the patent on part A would clearly not exhaust any rights under the patent on part B, because part A would not substantially embody part B under the second prong of the *Univis* test applied in *Quanta*. It is not clear, however, whether, in this example, the sale of part A would exhaust the patent on the system as a whole under *Quanta*. Like the Intel components in *Quanta*, part A in this example is unquestionably essential, unique and inventive, and thus for this reason part A *arguably substantially embodies* the system patent; however, part B is also unquestionably essential, unique and inventive in this example (rather than merely "standard," "common," "noninventive," "incidental," or "usual" like the buses and memory in *Quanta*), and for this reason part A *arguably does not substantially embody* the system patent.⁵

A potential licensee negotiating a license with a patent holder should analyze the offered terms in light of *Quanta*, especially if the patent holder refuses to authorize some or

all of the licensee's customers' contemplated downstream activities. Of course, from the perspective of a company accused of infringing a system or method patent, the defense of patent exhaustion (as well as implied license) should be considered if the company purchased an essential component used in its system or method from the patent holder or a licensee of the patent holder.

C. Authorized Sales

Under *Quanta*, only "authorized" sales result in the exhaustion of patent rights. This aspect of the Supreme Court's decision does not represent a significant change in the law. However, it is very important nonetheless, because patent holders (e.g., LGE) that sell or authorize their direct licensee to sell products that can be combined or used in ways that practice their system or method patents, *without any restriction*, may not be able to demand royalty fees from or otherwise control downstream purchasers or users of the technology on the basis of the system or method patents. In the absence of appropriate restrictions, such a patent holder must seek to obtain all its licensing revenue from the first sale of a licensed product. Existing licenses and licensing practices should be reviewed in light of the *Quanta* decision.

The Court did not provide explicit guidance on the types of restrictions that would avoid exhaustion. However, we believe that properly drafting a license agreement with restrictions whose violation breaches the agreement, including restrictions on the class of purchasers, types of permissible uses, and/or types of permissible combinations, should prevent exhaustion by any sale in violation of the restriction, because the sale would not be authorized.⁶ Such restrictions on manufacture, use and sale should be defined in the sale/license agreement, and violation of any such restriction should expressly constitute a material breach of the agreement. For example, the LGE/Intel license agreement at issue in *Quanta* might have been drafted (assuming Intel would have agreed) so as: (1) to authorize Intel to manufacture, use and sell the Intel components (microchips and chipsets) *only* for use, combination and resale by Intel with parts and systems manufactured by Intel; and (2) to provide that any Intel customer's use,

⁵ In other circumstances, however, the authorized sale of a component that practices the claims of a first patent could exhaust the patent holder's rights under a second patent, if the component "substantially embodies" the invention of the second patent.

⁶ The Supreme Court found that the LGE/Intel license provisions at issue in *Quanta* did not impose any effective restrictions at all on Intel. Intel's separate notice obligation was not drafted in the form of a restriction or even included in the license agreement, and its violation did not constitute a breach of the license agreement.

June 24, 2008

combination or resale of the Intel components with non-Intel parts would constitute a material breach of the LGE/Intel license agreement unless the customer was separately licensed by LGE. Such an agreement would likely have avoided application of the exhaustion doctrine.

Further, we believe that patent holders should be free under *Quanta* to impose similar breach-enforceable restrictions on geographical area or field of use, and that sales subject to such restrictions should not exhaust the patent holders' rights to enforce their patents in the non-licensed geographical areas or fields of use. Thus, for example, an authorized sale of a product restricted to manufacture, sale and resale in one geographical area should not exhaust the patent holder's right to demand a royalty for its resale by a downstream purchaser in another geographical area.

Aside from the patent exhaustion doctrine, however, the patent holder would still need to avoid the creation of an implied license, *e.g.*, by requiring a licensee to give notice to downstream purchasers of the license restrictions.

V. Recommendations

A. Patent Applicants

To avoid the exhaustion doctrine insofar as possible, a patent applicant should draft his or her application for a system or method patent with an eye to establishing that the essential components or steps of the claimed invention do not, by themselves, "substantially embody" the claimed invention. Some suggestions are the following:

- Describe the claimed features in neutral terms and avoid characterizing any of them as "standard," "common," "noninventive," "incidental," "usual," etc.
- Describe alternative uses of the product that is the subject of the application.
- If the claimed *use* of the product is novel, but not the product itself, describe any non-infringing uses.
- Consider the cost and benefit of filing separate applications covering each patentable product and mutually exclusive systems and methods involving the product, possibly by filing divisional applications rather than traversing restriction or election of species requirements.

B. Patent Holders

A patent holder wishing to demand royalties from downstream purchasers and users should:

- If possible, avoid licensing component manufacturers under system or method patents.
- Draft license agreements with restrictions on the class of purchasers, types of permissible uses, and/or types of permissible combinations, and specify that violation of those restrictions by the licensee or its customers constitutes a material breach of the agreement.
- Draft sales agreements for components in a manner that similarly restricts any license under system and method patents.
- Avoid the creation of an implied license, *e.g.*, by requiring the licensee to give notice to downstream purchasers of the license restrictions.
- For self-replicating articles, such as some plant and other biotechnology products, be especially vigilant to explicitly restrict use and sale licenses to make unauthorized production a defined material breach.

C. Potential Licensees

In negotiating a patent license, a potential licensee should carefully analyze the license terms in light of *Quanta*, especially if the patent holder refuses to authorize some or all of the licensee's customers' contemplated downstream activities. To protect itself and avoid restrictions on its potential customers, the potential licensee should seek to establish in the agreement that its customers' activities will not result in a breach of the license.

D. Accused Infringers

A company accused of infringing a system or method patent should separately consider the defenses of patent exhaustion and implied license if it purchased any component used in its system or method from either the patent holder or a purchaser from, or licensee of, the patent holder.

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June 24, 2008

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