The Supreme Court Decides *Quanta v. LGE* / U.S. and European Perspectives

By Michael Hurley, Paul Devinsky and Justin Hill

In 2008, in a highly anticipated decision, the Supreme Court of the United States issued its unanimous opinion in Quanta Computer, Inc. v. LG Electronics, Inc. The Supreme Court, continuing a string of reversals for the U.S. Court of Appeals for the Federal Circuit (as well as a trend towards limiting the rights of patent holders) held that the doctrine of patent exhaustion applies to method patents (as well as apparatus patents) and that exhaustion occurs where there is a sale of a component that "substantially embodies" or "essentially embodies" the patent(s) in question and that is made under license. Throughout the opinion, the Supreme Court cited its 1942 Univis decision, especially in differentiation between the doctrines of implied license and exhaustion. Justice Thomas wrote for the Supreme Court.

Background

Quanta was one of several defendants in the courts below. The case arose after these defendants had purchased microprocessors and chipsets from Intel for installation in their computers. Intel held a license from the plaintiff LG Electronics (LGE) covering LGE's portfolio of patents on computer systems and system components. Under the license, Intel was authorized to sell components to the defendants. However, pursuant to a separate agreement with LGE, Intel was also obligated to notify defendants that they were not authorized to combine the components with non-Intel products. Intel provided the required notice. LGE subsequently brought suit against the defendants asserting that the combination of Intel's microprocessors and chipsets with other computer components (such as memory and data buses) infringed LGE's patents covering the combination and its method of use. LGE did not assert its patents covering the chipsets themselves.

The district court, relying on the 1942 Supreme Court case *U.S. v. Univis*, found on summary judgment that LGE's rights in its computer system patent claims were exhausted by the license to Intel. On appeal, the Federal Circuit reversed, finding no implied license in view of Intel's express disclaimer and no exhaustion because there was no unconditional sale.

The Supreme Court granted *certiorari* on the following issue:

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 the product under the license to petitioners.

The Supreme Court Decision

Tellingly, Justice Thomas started his analysis with a less than patent friendly quote from the Supreme Court's 1917 decision in *Motion Picture Patents*: ". . . the primary purpose of our patent laws is not the creation of private fortunes for the owners of patents but is to 'promote the progress of science and useful arts.' . . . Accordingly, [the *Motion Picture Patents* Court] reiterated the rule that the right to vend is exhausted by a single, unconditional sale, the article sold being thereby carried outside the monopoly of the patent law and rendered free of every restriction which the vendor may attempt to put upon it."

Exhaustion Is Governed by Whether the Product Embodies "Essential Features" of the Patent

Echoing the district court's analysis, Justice Thomas explained that the exhaustion analysis is grounded in whether the thing licensed and subsequently sold embodies "essential features" of the patented device, and was without utility until it became a part of a finished product. In other words, exhaustion can occur even where the thing sold does not practice the entire claimed combination. Quoting *Univis*, the Supreme Court observed:

[W]here 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.

The Supreme Court then expanded the test for exhaustion from "essential features" to "sufficiently embodies," stating "the [*Univis*] Court concluded 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."

Analogizing the Intel chipsets to the lens blanks at issue in *Univis*, the Supreme Court found no "reasonable use" for the Intel products other than incorporating them into a computer, *i.e.*, a system including data buses and memory (as per the LGE patent claims). The Supreme Court also found the Intel chipsets embodied the "essential features" of the patented invention.

As explained in a footnote, the issue is *not* (as argued by LGE) whether a purchaser (such as Quanta) could have avoided creating a direct infringement by only selling computers outside the United States or disabling the inventive features of the Intel chipsets. Rather the issue is whether the Intel chip sets are capable of use only by practicing the patent—regardless of whether that use is infringing. As explained by Justice Thomas, disabling a feature is irrelevant to the analysis as a disabled feature would have no use.

Here, the Supreme Court found that the separately patented article (the chipset) substantially embodies the LGE system patents because the only step necessary to practice the patents by the *Quanta* defendants is the application

of common processes or the addition of standard parts. The Supreme Court noted that "everything inventive about each patent is embodied in the Intel products." Justice Thomas then concluded that exhaustion had occurred, pointing out that "[t]he 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" (emphasis in original).

Method Claims Can Be Exhausted

While recognizing that a patented method is not sold in the same way as an article or device, Justice Thomas explained a patented method "nonetheless may be 'embodied' in a product, the sale of which exhausts patent rights. Our precedents do not differentiate transactions involving embodiments of patented methods or processes from those involving patented apparatuses or materials."

Disagreeing with the Federal Circuit, the Supreme Court stated that "eliminating exhaustion for method patents would seriously undermine the exhaustion doctrine. Patentees seeking to avoid patent exhaustion could simply draft their patent claims to describe a method rather than an apparatus," noting "the danger of allowing such an end-run around exhaustion."

Exhaustion vs. Implied License

Rejecting 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," Justice Thomas looked to other aspects of the Intel-LGE transaction (primarily the broad granting clause in the license) and concluded that Intel's authority to sell its products was not conditioned by the patent license on whether Intel's customers abided by the notice given to them. The Supreme Court explained that LGE's notice argument confused exhaustion and implied license, the former turning only on Intel's own license to sell products under its license, which was not restricted. Thus, Quanta's right to practice the patent was based on exhaustion of LGE's patent rights, not on implied license rights. Justice Thomas also made short work of LGE's "post sale restrictions" argument, essentially finding that once exhaustion occurred under the "substantially embodies" test, the patent owner has no right to impose further restrictions.

Authorized Use or Sale

Because the LGE/Intel license contained no restrictions on Intel's right to sell the products at issue, the Court rejected LGE's reliance on the Supreme Court's 1938 *General Talking Pictures* case where the manufacturer sold patented amplifiers for commercial use despite a license which only extended to sales for private and home use. The Court in *General Talking Pictures* found that exhaustion did not apply because sales for commercial use were not authorized by the license at issue. Justice Thomas distinguished the case by pointing out that "[n]othing in the License Agreement restricts Intel's right to sell its microprocessors and chipsets to purchasers who intend to combine them with non-Intel parts."

U.S. Perspective

Quanta plainly restricts the ability of U.S. patent holders to extract royalties from downstream users across industries. The effect of this restriction is likely to vary depending on the size and strength of the bargaining parties to a license agreement. Where the prospective licensor and licensee are substantial entities with relatively equal bargaining power, the issue can likely be addressed by the inclusion of field of use restrictions, or alternatively by larger up-front royalty payments. Where the innovating entity is a small start-up or individual inventor, the ability to negotiate balanced agreements with the knowledge that downstream royalties will be largely unavailable will present greater challenges.

Problems of initial valuation are also implicated by the decision. In a mature market, the value of innovations generally takes the form of improvements with patent rights covering those improvements. There, product life cycles and anticipated revenue streams will be better understood during a license negotiation. In emerging industries, where the market for patented products is not well established, appropriate licensing terms that account for an unclear supply chain regarding downstream users will be more problematic.

European Perspective

In general, a patent owner in an EC member state may impose restrictions on sales by a licensee outside the country in which the licensee is licensed to manufacture, including bans on exporting to other parts of the Community. In Europe, however, principles of free movement of goods are considered fundamental to the creation, operation and development of the European Economic Area's (EEA) internal market. Accordingly, the rights of patent owners must be balanced with the competing interests of the internal market and in certain circumstances exhaustion applies across the EEA rather than within national boundaries.

For example, once a patent right holder has placed goods protected by patents in one country within the European market, its rights will be exhausted and the right holder cannot then object to parallel importation from that country into other countries without legitimate reason. Third parties will therefore be entitled to import and resell the goods within the EEA, in accordance with the fundamental principle of free movement of goods. When managed correctly this does not affect the entitlement to grant licenses by territory (eg, by country) but it is a relatively complex and constantly evolving theme and oftentimes companies overlook the provisions and practical controls required to effectively retain the ability to grant exclusive rights by individual European state.

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