

# U.S. Supreme Court Unanimously Reverses Federal Circuit In *LG Electronics* Case And Limits A Patent Holder's Ability To Demand Downstream Royalties On The Use Of A Product

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On June 9, 2008, the United States Supreme Court reversed a decision by the U.S. Court of Appeals for the Federal Circuit in the closely watched battle between LG Electronics, Inc. ("LGE") and Quanta Computer, Inc. The decision restricts LGE's ability to demand royalties from Quanta, which had purchased chipsets and microprocessors from LGE's licensee, Intel Corporation, and used them to manufacture computers.<sup>1</sup>

The Supreme Court ruled that the doctrine of patent exhaustion applies to method patents and that patent holders cannot demand royalties from downstream customers of authorized purchasers of components that substantially embody the patents in question.

## Background

The doctrine of patent exhaustion was developed over 150 years ago to prevent patent rights from extending beyond the first authorized sale of a patented instrument. First set forth by the Supreme Court in *Adams v. Burke*, the rationale behind patent exhaustion is that "where a person ha[s] purchased a patented machine of the patentee or his assignee, this purchase carri[es] with it the right to the use of that machine so long as it [is] capable of use."<sup>2</sup> After a patent holder has already received consideration from the sale of a patented device, the doctrine prevents the patent holder from demanding subsequent royalties or restricting the use of the device.

LGE and Intel entered into a license agreement in 2000 that authorizes Intel to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose of" products that practice LGE patents.<sup>3</sup> The license agreement states that it does not "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."<sup>4</sup> LGE and Intel entered into a separate master agreement requiring Intel to give written notice to its customers that although Intel had a license to manufacture and sell the patented technology, the license "does not extend, expressly or by implication, to any product that [the purchaser] make[s] by combining an Intel product with any non-Intel product."<sup>5</sup>

Intel manufactured licensed chipsets and microprocessors and sold them to computer manufacturers. Quanta purchased chipsets and microprocessors from Intel and, despite receiving the notice provided by Intel, Quanta manufactured computers using the Intel products in combination with non-Intel products in a way that practiced the LGE patents. LGE accused Quanta of patent infringement. Because Intel provided the required notice to Quanta, LGE did not contend that Intel had breached the license or the master agreement.

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The U.S. District Court for the Northern District of California granted summary judgment in favor of Quanta and held that Intel's sales exhausted LGE's patent rights in its system claims. The district court held, however, that patent exhaustion did not apply to LGE's method patent claims.

The Federal Circuit reversed the district court's decision on the license issue. The Federal Circuit found that because "[t]he LGE-Intel license expressly disclaims granting a license allowing computer system manufacturers to combine Intel's licensed parts with other non-Intel components . . . [the] sales were conditional, and Intel's customers were expressly prohibited from infringing LGE's combination patents."<sup>6</sup> Because the sales were conditional, they did not trigger patent exhaustion. Additionally, the Federal Circuit agreed with the district court that "the sale of a device does not exhaust a patentee's rights in its method claims."<sup>7</sup>

## U.S. Supreme Court Decision

The Supreme Court reversed the Federal Circuit, holding that (1) the doctrine of patent exhaustion applies to method claims, (2) patent rights can be exhausted by the sale of an incomplete item that substantially embodies the patents, and (3) patent exhaustion is triggered only by an authorized sale by the patent holder. Because LGE licensed Intel to practice its patents and to sell products embodying those patents, LGE's patent rights were exhausted and LGE was prohibited from asserting those rights against downstream purchasers of the products.

The Court relied heavily on its 1942 decision in *United States v. Unisys Lens Co.*<sup>8</sup> Unisys owned patents on eyeglass lenses and issued a chain of licenses to (1) manufacturers of the lens blanks, (2) wholesalers that ground the blanks into the patented finished lenses, and (3) prescription retailers that sold the finished lenses to consumers. Unisys fixed the price rate at each level of the chain. The United States sued Unisys under the Sherman Act for unlawful restraints on trade, and Unisys claimed a defense under its patent rights. The Court held that Unisys' patent rights did not survive the sale of the lens blanks, because although the lens blanks did not completely practice the patent, the lens blanks "embodie[d] essential features of the patented device and [were] without utility until . . . ground and polished as the finished lens of the patent."<sup>9</sup>

The Court applied the logic of *Unisys* to hold that patented methods are subject to patent exhaustion if they are "embodied" in a product.<sup>10</sup> The Court explained that carving method claims out of the doctrine would permit an "end-run" around patent exhaustion, by allowing patentees to craft their claims as methods and then assert their patent rights against downstream users of the patented methods.<sup>11</sup>

In considering the extent to which a product must embody a patent in order to trigger exhaustion, the Court found that, similar to lens blanks, there is only one reasonable and intended use for the Intel products, which is to practice the LGE patents by incorporating the products into computer systems. The Intel products "all but completely practice" LGE's patents, lacking only "the application of common processes or the addition of standard parts."<sup>12</sup> The Court found that, as in *Unisys*, "the final step to practice the patent is common and non-inventive" because the products "carry out all the inventive processes when combined, according to their design, with standard

components."<sup>13</sup> The Intel chipsets and microprocessors thus embody the LGE patents to a sufficient extent to trigger exhaustion.

Finally, under *Univis*, "[e]xhaustion is triggered only by a sale authorized by the patent holder."<sup>14</sup> The LGE-Intel license agreement did not condition Intel's authority to sell "on the notice or on Quanta's decision to abide by LGE's directions in that notice."<sup>15</sup> The Court accordingly found that Intel's sales to Quanta were authorized by the license agreement and triggered patent exhaustion.

In conclusion, the Court held that 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."<sup>16</sup>

## Conditional Sales

The Court's *Quanta* decision did not address previous Federal Circuit decisions concerning post-sale restrictions on the use of a patented product, such as *Mallinckrodt, Inc. v. Medipart, Inc.*<sup>17</sup> and *B. Braun Medical v. Abbott Labs.*<sup>18</sup> The Federal Circuit has acknowledged that "an unconditional sale of a patented device exhausts the patentee's right to control the purchaser's use of the device thereafter," but exhaustion "does not apply to an expressly conditional sale or license."<sup>19</sup> The theory underlying this distinction is that, in an unconditional sale, the patentee presumably has bargained for and received a price that represents the full value of the goods sold; in a conditional sale the parties presumably have negotiated a price that represents only the value of the "use" rights.<sup>20</sup>

For example, in *Mallinckrodt*, the patent holder sold its patented medical device to hospitals with a "single use only" restriction.<sup>21</sup> Hospitals that purchased and used the device sent it to Medipart for servicing that enabled them to use the device again.<sup>22</sup> The patent holder then sued Medipart for patent infringement and inducement of infringement.<sup>23</sup> The Federal Circuit ruled in favor of the patent holder, holding that a post-sale restriction with adequate notice did not trigger patent exhaustion and could be enforced (provided that no other legal doctrine – such as antitrust law or the patent misuse doctrine – prevented enforcement of the patent).<sup>24</sup>

In *Quanta*, the Federal Circuit followed *Mallinckrodt* and *B. Braun*, finding that Intel's sales of chipsets also were conditional sales that did not exhaust LGE's patent rights.<sup>25</sup> According to the Federal Circuit, the license agreement between LGE and Intel (1) "expressly disclaims granting a license allowing computer system manufacturers to combine Intel's licensed parts with other non-Intel components," and (2) "required Intel to notify its customers of the limited scope of the license, which it did."<sup>26</sup> Thus, 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.<sup>27</sup>

As discussed above, the Supreme Court reached a different conclusion, holding that the LGE-Intel license agreement did not condition Intel's authority to sell on the notice given to customers or on Quanta's decision to abide by LGE's directions in that notice. The Court accordingly found that because Intel's sales to Quanta were authorized by the license agreement, those sales triggered patent exhaustion.

## Implications Of The Supreme Court's Decision

The *Quanta* decision has at least two important implications.

First, the *Quanta* decision continues a string of recent cases in which the Supreme Court has overruled the Federal Circuit and restricted patent rights. In *eBay Inc. v. MercExchange, L.L.C.*, the Court held that the decision to grant or deny injunctive relief in patent cases must be "exercised consistent with traditional principles of equity" rather than a patent-specific rule developed by the Federal Circuit that made permanent injunctions automatic.<sup>28</sup> In *MedImmune, Inc. v. Genentech, Inc.*, the Court ruled that a licensee in good standing can seek a declaratory judgment that the licensed patent is invalid, unenforceable, or not infringed and overruled the Federal Circuit's "reasonable apprehension of suit" test for declaratory judgment jurisdiction.<sup>29</sup> In *KSR Int'l Co. v. Teleflex Inc.*, the Court made it easier to attack patents on obviousness grounds by rejecting the Federal Circuit's rigid application of the teaching-suggestion-motivation test.<sup>30</sup> In *Microsoft Corp. v. AT&T Corp.*, the Court limited the ability of patent holders to bring infringement claims against companies that export patented software, copy the software abroad, and install the software on foreign-manufactured computers.<sup>31</sup>

Second, it appears that LGE could have avoided this result by negotiating a more specific license agreement. The Court distinguished this case from prior Supreme Court decisions that allow patent holders to impose field-of-use restrictions.<sup>32</sup> LGE, for example, could have negotiated a provision that limited Intel's license to sell products only to companies that LGE had licensed to make and use computers under LGE's patents. An Intel sale to an unlicensed customer in that situation would not have been an "authorized sale," which is a predicate for patent exhaustion.

<sup>1</sup> See *Quanta Computer, Inc. v. LG Elecs., Inc.*, 128 S. Ct. 2109, 170 L. Ed. 2d 996 (June 9, 2008).

<sup>2</sup> 84 U.S. 453, 455 (1873).

<sup>3</sup> *Quanta*, 170 L. Ed. 2d at 1001.

<sup>4</sup> *Id.* at 1002 (citations omitted).

<sup>5</sup> *Id.* (citations omitted).

<sup>6</sup> *LG Elecs., Inc. v. Quanta Computer, Inc.*, 453 F.3d 1364, 1370 (Fed. Cir. 2006).

<sup>7</sup> *Id.*

<sup>8</sup> 316 U.S. 241 (1942).

<sup>9</sup> *Id.* at 249.

<sup>10</sup> *Quanta*, 170 L. Ed. 2d at 1005.

<sup>11</sup> *Id.* at 1006.

<sup>12</sup> *Id.* at 1008.

<sup>13</sup> *Id.* at 1008-09.

<sup>14</sup> *Id.* at 1009.

<sup>15</sup> *Id.* at 1010.

<sup>16</sup> *Id.* at 1011.

<sup>17</sup> 976 F.2d 700 (Fed. Cir. 1992).

<sup>18</sup> 124 F.3d 1419, 1426 (Fed. Cir. 1997) (summarizing and applying *Mallinckrodt*).

<sup>19</sup> *Id.* at 1426 (emphasis added).

<sup>20</sup> *Id.*

<sup>21</sup> 976 F.2d at 701. The notice was placed on the device itself and in the package insert that accompanied the device. The adequacy of the notice was not at issue in the Federal Circuit decision. *Id.* at 701-02.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *LG Elecs., Inc. v. Bizcom Elecs., Inc.*, 453 F.3d 1364, 1370 (Fed. Cir. 2006).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> 547 U.S. 388, 394 (2006).

<sup>33</sup> 549 U.S. 118, 127 S. Ct. 764, 774 n.11 & 777 (2007).

<sup>34</sup> 127 S.Ct. 1727, 1741 (2007).

<sup>35</sup> 127 S. Ct. 1746, 1751 (2007).

<sup>36</sup> *Quanta*, 170 L. Ed. 2d at 1009-10 (discussing General Talking Pictures Corp. v. Western Elec. Co., 304 U.S. 175 (1938), and 305 U.S. 124 (1938)).