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## U.S. Supreme Court's Decision Limits Patent Owners from Claiming Infringement by Downstream Customers

### Introduction

On June 9, 2008, in *Quanta Computer, Inc., v. LG Electronics, Inc.*, No. 06-937, 553 U.S. \_\_\_, the U.S. Supreme Court limited the ability of a patent owner to collect royalties from customers downstream of the patent owner's licensee. In a unanimous opinion delivered by Justice Thomas, the Court reaffirmed the patent exhaustion doctrine, explaining that "the initial authorized sale of a patented item terminates all patent rights to that item." Rejecting arguments to the contrary, the Court specifically held that the patent exhaustion doctrine may apply to (1) method (process) claims and (2) authorized sales of components that "substantially embody" a patented system even though they must be combined with additional components to practice the patent.

The Court's decision substantially limits the ability of patent owners to claim infringement by downstream customers of their licensees and may offer downstream users a strong potential defense to infringement claims. The decision also highlights the importance of contract drafting and enforcement for patent owners.

### Background of the Decision

The case concerns three LG Electronics, Inc. (LGE) patents for computer chip technology and LGE's efforts to collect royalties from computer makers in addition to chip makers.<sup>1</sup> LGE licensed the patents to Intel, authorizing Intel to manufacture and, most importantly, to sell microprocessors and chipsets that use the patented technology. The license agreement, however, also provided that no license was granted to any third party for combining the licensed products with other components or items from sources other than the parties to the license, even though the patented technology must be combined with additional components in order to practice the LGE patents. In a separate agreement, Intel agreed to provide notice to its customers that the LGE license did not extend to any product combining the Intel products with other non-Intel components. Finally, the license agreement specifically provided that the parties did not intend to limit or alter the effect of the patent exhaustion doctrine.

Intel sold the licensed microprocessor and chipset products for the express purpose of being incorporated into computers and provided the requisite notice. A group of computer manufacturers including Quanta Computer (collectively, Quanta), purchased LGE-licensed microprocessors and chipsets from Intel, and used them in combination with other non-licensed components to manufacture computers that practiced the patented technology.

LGE sued Quanta in 2001, alleging that Quanta's combination of the licensed Intel products with other components infringed its patents. Quanta asserted as a defense the doctrine of patent exhaustion, under which the initial authorized sale of a patented item terminates all patent rights in that item. The doctrine arises out of a series of 19th century cases prohibiting restrictions on the post-sale use of a patented article. Early in the 20th century,

the Court explained 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.”<sup>2</sup>

Relying on the patent exhaustion doctrine, in 2002 the District Court (N.D.Cal.) granted summary judgment to Quanta. On appeal, in 2006 the Court of Appeals for the Federal Circuit, which handles all patent appeals from the district courts, ruled in favor of LGE. The Federal Circuit held that the patent exhaustion doctrine did not apply to LGE’s method (as distinct from apparatus) claims, and alternatively, that patent exhaustion did not apply because the LGE-Intel license agreement did not authorize Intel to sell its products for use in combination with non-Intel components. In 2007, the Supreme Court granted certiorari, and with over thirty amicus briefs filed, the case generated considerable attention and varying positions.

### **The Supreme Court’s decision confirms the availability of the patent exhaustion doctrine as defense to patent infringement claims**

The Court’s decision clarifies three specific points regarding application of the doctrine of patent exhaustion.

First, the doctrine applies not only to apparatus patents, but also to method patents. LGE had argued that because a method is not a tangible article, the related patent rights can be exhausted only through an assignment of rights, not through the sale of a product. The Court rejected that argument, reasoning that (i) patented methods can be embodied in a product, the sale of which will exhaust the patent rights of the method patents; (ii) there is no basis in law to distinguish between method and apparatus claims; and (iii) to hold otherwise would allow an “end-run” around the doctrine of patent exhaustion, as skilled patent drafters “could shield practically any patented item from exhaustion” by characterizing an invention as a method instead of or in addition to an apparatus.<sup>3</sup>

Second, the Court concluded that exhaustion is triggered by the sale of products that do not fully embody a patent if the product’s only reasonable and intended use is to practice the patent and the product embodies the essential features of the patented invention. Under

the first prong of this test, the Court noted that LGE had “suggested no reasonable use for the Intel products other than incorporating them into computer systems that practice the LGE Patents.” Under the latter prong of this test, the Court found persuasive the facts that everything inventive about each LGE patent was embodied in the Intel microprocessors and chipsets because the only other steps required to practice the patents were “common and noninventive,” namely, “the application of common processes or the addition of standard parts.”<sup>4</sup>

Finally, the Court emphasized that “[e]xhaustion is triggered only by a sale authorized by the patent holder.” Here, nothing in the LGE-Intel license agreement restricted Intel’s right to sell its microprocessors and chipsets utilizing the LGE patented methods to purchasers who intended to combine them with non-Intel parts. LGE argued that the license agreement specifically disclaimed any license to third parties to practice the patent by combining the licensed products with non-Intel components. However, the Court held that, since the Intel sale itself was authorized under the license agreement, no such implied license was necessary if the patent rights were exhausted after Intel’s sale of the licensed product to Quanta. Therefore, LG could not assert any of its patent rights against Quanta.

### **Broader implications of the case and recommendations for clients - contracts are important, pick your targets**

First, the case provides some lessons in contract drafting. The LGE-Intel agreements were central to the litigation, and the result likely would have been more favorable to LGE had the license expressly limited or conditioned Intel’s authority to sell the products such that the sales to Quanta could have been found to be unauthorized. Of course, that likely was an issue LGE had to concede in its negotiations with Intel, and LGE’s creative attempt to preserve control over use of its intellectual property is now clearly foreclosed. Not all parties, however, will be in a position in which they have to cede that control, but care is required to maintain that control within the confines of this decision. Note too that the Court specifically stated (in footnote 7) that it expressed no opinion whether contract damages might be available even though the patent exhaustion doctrine eliminated the claim for

patent damages. In this case, the litigation defendants were not parties to an agreement with the patent holder. Therefore, nothing in the decision should limit contractual restrictions in a patent license from being enforced against a party to the contract.

If you are patent owner, you either need to collect your patent royalties from one place in the manufacture - distribution chain, or rely on contractual restrictions that you can enforce directly against your contract partner.

Second, the Court's decision means that careful thought is required when considering an overall licensing program. As a result, patent owners faced with an array of licensing options in a supply chain must realize that a license anywhere in the chain may limit options further down the chain. Accordingly, care should be taken to select licensees who can best pay royalties, are most likely to comply with contractual restrictions, and are most likely to encompass the broadest array of uses. If you want to restrict downstream uses of your patents, expect to put those restrictions in a contract and to enforce the restrictions with the contractual party, not downstream users. Likewise, the pricing of any license must take into account the potential limits on enforcing the patent against other downstream users.

In non-royalty situations, such as cross-licensing, companies may be able to use non-assertion clauses, or covenants not to sue, that explicitly do not include downstream parties. However, if the patent non-assertion provisions essentially are just a disguised license for value, there is no guarantee that the patent

exhaustion doctrine would not be deemed to apply in those circumstances. Additionally, patent owners might try to follow the example of the software industry and, when possible, license the use of any patented products, instead of simply "selling" them, as only authorized sales trigger patent exhaustion. Licensing instead of an outright sale, however, will not be practical in many situations.

Third, accused infringers now need to consider whether they can benefit from upstream licenses. If you are downstream user and are asked to take a patent license, or are sued for infringement, find out if your supplier (or your supplier's supplier) was licensed. Downstream customers who are not licensees now may have a much stronger defense to patent infringement claims for technology that has been licensed to an intermediate party, even if that license is limited.

Fourth, the decision may have some impact on the issue of how the somewhat parallel "first sale" provisions of copyright law interrelate with software license restrictions such as prohibitions on the resale of used software.

Finally, the decision continues a line of recent Supreme Court decisions narrowing the rights of patent holders versus the rights of those selling or using patented technology and overturning Federal Circuit decisions in favor of patent holders. Patent litigation of late appears to be a rare instance in which the Court is setting a steady and (sometimes) unanimous course.

- 1 U.S. Patent Nos. 4,939,641 ('641), 5,379,379 ('379) and 5,077,733 ('733). The '641 patent addresses the problem of coordinating data stored in both random access memory and cache memory, by disclosing a system for monitoring data requests and updating the main memory from the cache memory so that consistent data versions are maintained in both the main and cache memories. The '379 patent provides a method to coordinate requests to read from, and write to, the main memory in a speedy and accurate way. The '733 patent describes a method to manage data traffic on a "bus" (a set of wires that transfers data between the microprocessor and devices such as the keyboard, mouse, and disk drives) by using a system of rotating priority access to the bus for each device.
- 2 *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 516 (1917).
- 3 The Court cited *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436, 446, 457 (1940), where the sale of a patented motor fuel also exhausted the rights of a related patent for the method to use the fuel in combustion motors.
- 4 On this point, the Court discussed at some length *United States v. Univis Lens Co.*, 316 U.S. 241 (1942). *Univis* held 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 to the patent, he has sold his invention as far as it is or may be embodied in that particular article." *Id.* at 250-251.

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