

## Supreme Court Expands Exhaustion Doctrine

by *Jason M. Honeyman*

Earlier this month, the U.S. Supreme Court issued its decision in *Quanta Computer Inc. v. LG Electronics Inc.*, thereby limiting the ability of patent owners to demand downstream royalties from customers of licensees. Although *Quanta* involved manufacturers in the laptop computer industry, the ruling has implications for medical device manufacturers, many of whom routinely incorporate components purchased from outside vendors into their final products.

### The Quanta Case

At the heart of *Quanta* were two general issues: the exhaustion doctrine and conditional sales agreements. Also referred to as the first-sale rule, the exhaustion doctrine maintains that the initial unconditional sale of a patented article by a patent owner (or its licensee) terminates, or exhausts, all patent rights to that item. In other words, the purchaser of the patented article can use or resell the article as it pleases.

On the other hand, under a conditional sale agreement, a patent owner can attach restrictions on the use or resale of its patented article. Thus, a conditional sale enables a patent owner to sue a downstream purchaser of its patented item if the conditions of sale are breached.

In its ruling on *Quanta*, the Supreme Court expanded the applications of the exhaustion doctrine, yet left questions hanging with regard to the legitimacy of conditional sales agreements designed to negate the exhaustion doctrine.

In *Quanta*, LG Electronics (LGE) granted a license to Intel to make and sell microprocessors and chipsets that, when combined with other components, would enable a computer to provide LGE's patented technology. The contract between LGE and Intel stated that the patent license would not extend to combinations of Intel's components with parts purchased from other companies. In

addition, a separate agreement required Intel to notify its customers in writing that the LGE license did not extend to any computer made by "combining an Intel product with any non-Intel product."

*Quanta* built computer systems by combining computer parts with Intel's specialized components. LGE then sued *Quanta* for patent infringement, alleging that the licensed Intel products, when combined with other components, infringe its patents.

In its ruling, the Supreme Court unanimously ruled that LGE had exhausted its patent rights and could not control *Quanta*'s use of the licensed microprocessors and chipsets. The Court viewed the LGE-Intel license as providing for unconditional sale of the patented components, so that Intel's sale of microprocessors and chipsets to *Quanta* exhausted LGE's patent rights.

The *Quanta* decision also implies that exhaustion is not limited simply to the licensed patent covering the component, but that the doctrine also will apply to any patent that is "substantially embodied" by the purchased item.

### Quanta's Implications and Questions

Although *Quanta* involved manufacturers in the computer industry, the implications of the Supreme Court decision on patent exhaustion and conditional sales extend to the medical device, biotechnology, and research communities. For example, medical device companies may purchase components from vendors that have licensed patents from third parties for the purposes of building their components. Depending on the agreement between the original patent holders and the components vendors, LGE's argument would suggest that device manufacturers may also have to purchase rights to the original patents embodied in

the components. The Supreme Court's ruling rejected this notion.

Prior to the ruling, more than two dozen amicus curiae—or friend of the court—briefs were filed by organizations and companies concerned about the broader impact of the Supreme Court's decision. Some original equipment manufacturers wanted the Supreme Court to reject the use of postsale restrictions on patented products, thereby protecting manufacturers from being sued as downstream purchasers. On the other side of the argument, some companies that label-license their products as 'disposable' or 'single-use only'—device manufacturers included—hoped the court would uphold the legitimacy of such conditional sales. Meanwhile, the biotech and research communities feared that a sweeping patent exhaustion rule could jeopardize their industry practice of dual-tier licensing. Others voiced concern that field-of-use licenses might be voided or diluted.

Many organizations that submitted amicus curiae briefs to the Court urged the



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justices to consider the viability of postsale restrictions. However, the Quanta decision was silent on the propriety of patent owner-imposed downstream limitations. For now, a purchaser of components will be insulated from liability under Quanta, so long as the license agreement between its vendor and the patent owner is unconditional. However, in many commercial settings, a medical device company will not have access to the details of such patent license agreements.

Quanta does not preclude a patent owner from extracting royalties from multiple parties in the distribution chain, so long as appropriate restrictions on the licensee's right to sell are spelled out in the license

agreement. It is expected that patent holders with sufficient market power will avoid patent exhaustion by expressly limiting resale or use of licensed products in their contractual arrangements. Patent owners unable to restrict the resale of licensed products may attempt to seek higher royalties at the outset, in which case their licensees will likely seek to recover the increased costs from its downstream customers.

In the end, all is not lost for the patent owner if exhaustion is found; as the Quanta Court alluded, despite losing its infringement claim, a patent owner may still have contract remedies against the licensee and, perhaps, the licensee's customers.