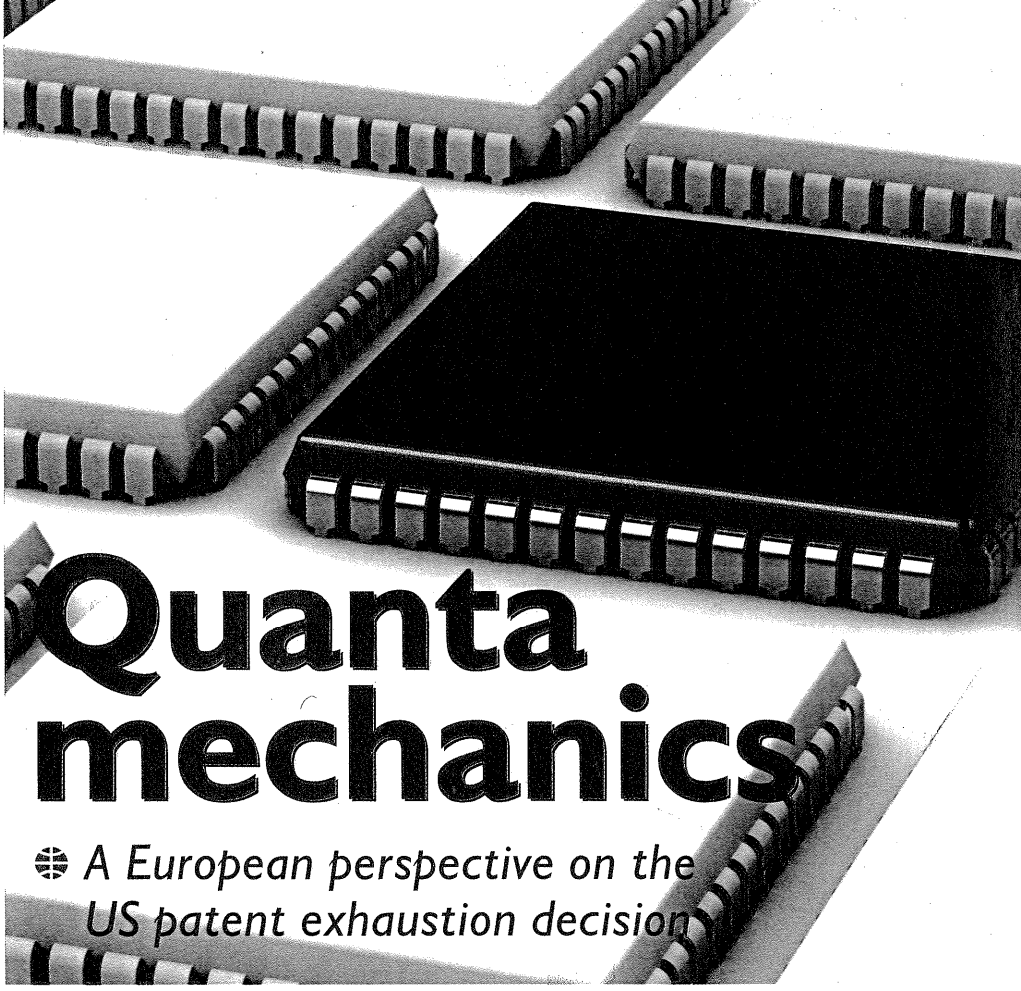
THE CASE

– *Quanta Computer v. LG Electronics*

– US Supreme Court

– 9 June 2008



Quanta mechanics

A European perspective on the US patent exhaustion decision

Johann Pitz of Vossius & Partner comments on the Federal Supreme Court's judgment from the European perspective and tries to forecast how courts in Europe would have decided on this case

While the general principles of the exhaustion doctrine are well accepted in the US and in Europe, significant disputes exist as to its specific application. The precise contours of the patent exhaustion doctrine are of critical importance in commercial transactions involving patented products.

Facts

The Quanta case concerns product and method patents which relate to microprocessors and chipsets used in combination with other computer components. Here LG licensed Intel to practice any of its patents and to sell products practicing those patents. Intel then sold the licensed products to Quanta and other purchasers who then combined them with other devices to produce operational computing systems for resale.

In a separate agreement with Intel, LG required Intel to notify its prospective purchasers, like Quanta, that they were not authorised by LG to use the products purchased from Intel in combination with non-Intel products. Quanta purchased an ongoing stream of these products from Intel and combined them with non-Intel products for resale. LG sued Quanta for patent infringement.

The US District Court for the Northern District of California granted a summary judgment of non-infringement to Quanta. The District Court held that Intel's sale to Quanta had exhausted LG's system patent claims but not LG's method claims. On appeal to the US Court of Appeals for the Federal Circuit, the first instance judgment was partly reversed. The Federal Circuit held that the notice provided by Intel to Quanta constituted a conditional sale and that the exhaustion doctrine therefore did not apply. The Federal Circuit upheld the District Court's judgment that the sale of a device does not exhaust a patentee's rights in its method claims. The Federal Supreme Court (FSC) disagreed on both scores. Because the exhaustion doctrine in principle applied to method patents and because the license authorised the sale of components that substantially embody the patents in suit, the sale had exhausted the method patents.

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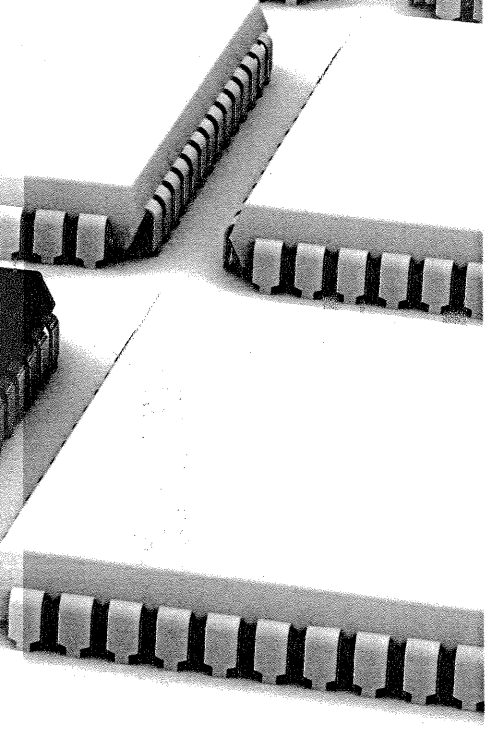

Method and process claims

LG argued that method claims can never be exhausted through the sale of products because method claims are linked to a process and not to a tangible article. Even if the method/process was practiced by a reasonable use of the product sold, exhaustion was limited to the product as such because the economic value of the method patent did not reside in the product as such but in the use of the process/method.

Quanta, in turn, argued that method claims should be subject to exhaustion if the product embodied the essential features of the method claim. Quanta contended that all patented functions defined by the method claims were realised by a reasonable use of the microprocessors and chip-sets purchased from Intel. In addition, Quanta pointed out that to preclude exhaustion of method claims would allow patent holders to avoid exhaustion entirely by inserting method claims in their patent specifications.

In contrast to the Federal Circuit's view, the FSC made it clear that the doctrine of patent exhaustion also applies to method claims. Using a detailed reference to the history of the patent exhaustion doctrine and US case law, the FSC pointed out that method patents are in principle exhaustible by sale of products embodying the patents.

In its decision, the FSC defined the extent to which a product must embody a patent in order to trigger exhaustion. In this context, the FSC pointed out that the only reasonable and intended use of the microprocessors and chipset Intel sold to Quanta was to practice LG's method claims. There is no reasonable use for the Intel products other than incorporating them into computer systems by connecting them to buses and memories. The FSC underlined that the Intel products were specifically designed to function only when they are integrated with standard components of computer systems.

The FSC also took into account that eliminating exhaustion for method patents would seriously undermine the exhaustion doctrine and would allow LG to control the sale of computers that are complete with the exception of minor standard steps and extend their rights through each downstream-purchaser down to the end-user. To avoid such far-reaching patent rights, the sale of products leads to an exhaustion of method claims in cases where the products substantially embody the essential features of the patented process.

With regard to the exhaustion of method claims, there is no uniform case law in Europe. According to the judgment "Fullplastverfahren"[1] of the German Federal Supreme Court (BGH), the market placement of a product does not lead to the exhaustion of a process claim even if the holder of the process patent itself is selling the product.

This judgment has been confirmed by the BGH decision "Bodenwaschanlage"[2]. According to the BGH, there is no market placement of the patent-protected method even if the use of the product necessarily makes use of the method/process. In the BGH's view, market placement of the product cannot be considered as authorised use of the patent protected method/process.

In an obiter dictum in the decision "Handhabungsgerät"[3], the BGH held, however, that if both method and component are patent-protected, exhaustion of the method patent may be given.

Based on the aforementioned case law, German courts could come to the result that there was exhaustion of the component patents in the Quanta case but not of the method patents because Intel's sale did not involve the methods and the use of the patent-protected process.

If – from this perspective – exhaustion principles would not be applied, the remaining question would be whether Intel and its customers had been authorised by LG to use the patent-protected methods. Such consent could be granted on a contractual basis not requiring, however, the written form. In cases where the use of products is limited to the implementation of the patent-protected method, such consent is usually given by way of an implied license.

In the case under discussion, LG licensed a patent portfolio, including the LG patents to Intel. The license agreement permits Intel to manufacture and sell microprocessors and chipsets that use the LG patents. The license agreement authorises Intel to "make, use, sell (directly or indirectly), offer to sell, import or otherwise dispose" its own products practicing the LG patents. The license agreement clarified that no license was given to any third party to combine the licensed products with non-Intel components. In addition, Intel agreed to give written notice to its own customers that the license does not extend to combinations of Intel products with non-Intel products.

From this backdrop, Intel was authorised on a contractual basis to use LG's method patents. Intel's customers including Quanta were, however, not authorised to use Intel's products with non-Intel components. This applied because no license was granted to Intel's customers and what is more, in view of the notification there was no room for an implied license.

Purpose and legal nature of exhaustion

Quanta pleaded – in accordance with the prevailing view in Europe – in favour of a broad scope of exhaustion where the right in a patent is limited by the public interest in the free marketability of goods which have been placed on the market by the right holder himself or with his consent. LG pleaded in favour of strong patent rights allowing the control of distribution channels even after market placement.

With regards to the legal nature of exhaustion, it is LG's position that patent holders should have the right to negotiate around patent exhaustion and to impose conditions on patented articles which have to be respected by third parties.

In contrast, it is Quanta's position – close to the European perspective – that exhaustion is not a contractual issue but an inherent boundary of the IP right itself serving the purpose to limit post-sale control under the patent laws of downstream use in the public interest of free marketability of goods[4].

The latter seems to be the view also of the FSC. In its decision, the court did not explicitly define the nature of exhaustion but made a clear distinction between contractual obligations on

the one hand and exhaustion as an inherent effect of the patent laws on the other.

Market placement

Having stated that the exhaustion principles apply to method patents and having concluded that the Intel products embodied the patent claims, the FSC considered whether their sale to Quanta exhausted LG's patent rights. The Court pointed out that exhaustion is triggered only by a sale authorised by the patent holder. The FSC held that this requirement was fulfilled in the present case because nothing in the license agreement restricted Intel's right to sell microprocessors and chipsets to purchasers who intended to combine them with non-Intel parts. In contrast to the Federal Circuit's ruling the FSC stated that the notice provided by Intel to Quanta did not constitute a condition for sale and that therefore the exhaustion doctrine applies.

The FSC's judgment is in accordance with the current European view. After the product has been placed on the market, distribution and sale of the product are allowed without limitations imposed by the patent. The use of the product is patent free. With regard to the requirements of exhaustion, market placement is an essential requirement of exhaustion of patent rights in Europe, which is clearly derived from the existing European Court of Justice (ECJ) case law.

In German literature it is stated that for deciding the question of whether or not market placement has taken place, a property right transfer is not absolutely necessary. According to recent case law of the BGH[5], every action resulting in a third party's gaining effective ability to dispose of certain products results in market placement. The decisive criterion for market placement is therefore whether the right holder deliberately gave up its right of disposal within the European market[6]. In such a case an EU-wide – not a worldwide – exhaustion takes place.[7]

Contractual Conditions

Marketing by the patent owner is not different from marketing by a third party with the patent owner's explicit consent. Such consent is generally given by a distribution or license agreement – even if only agreed on verbally. It is up to the patent holder to grant and limit licenses within the framework of antitrust and competition law. From this backdrop the legal limitations of licenses may define the limits of exhaustion.

The crucial question is whether and to what extent the patentee can limit or preclude the effect of exhaustion by imposing limitations on the licensee. The patent owner can restrict licenses territorially, temporally, quantitatively and personally and stipulate that the licensee is only permitted to exercise the patent within the contractual restrictions.

From the European perspective, LG's allegation is correct that a patentee can define the conditions under which exhaustion of patent rights takes place. In case of disregarding such contractual limitations, no exhaustion arises. The free movement rules of Articles 28 and 30 of the EC Treaty and Articles 11 and 13 of EEA Agreement prohibit, however, any limitations on patent exhaustion which are extending beyond the scope or in other words "the specific subject matter" of patent rights.[8]

Trade restrictions beyond the scope of patents, such as competition clauses, price restrictions and trade limitations for downstream customers, are only enforceable on a contractual basis. A breach of such trade restrictions does therefore not hinder the effect of exhaustion.

Unfortunately the FSC did not provide general guidelines on the issue of whether explicit contractual provisions can prevent an authorised sale and, thus, define the reach of the exhaustion doctrine in the US. In the present case it had no reason to do so.

The FSC focused very tightly upon the language used by the contracting parties in their agreements and made it clear that Intel's obligation to notify was not a condition of the license from LG. In addition, the FSC pointed out that Intel had respected its obligation to notify its customers and therefore there had been an authorised market placement rather than a conditional sale. Under these circumstances, patent exhaustion may not be precluded by notice restrictions to licensee's customers regardless of whether the latter respect the notice or restriction.

Insofar the FSC's judgment is in accordance with the prevailing European perspective. Under the assumption that the authorised sale of Intel products had exhausted not only LG's product patents but also the method patents, Intel's obligation to notify its customers would be considered as a mere contractual obligation which cannot hinder the effect of exhaustion. Nothing 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.

In accordance with the case law of the ECJ, the FSC made a clear distinction between patent exhaustion as an inherent boundary of patent rights on the one hand and implied licenses on the other hand. As a consequence, the question of whether or not Intel's customers had been granted implied licenses (they had not because of the notification) was considered to be irrelevant in the FSC's view because Quanta asserted its right to practice the patents not on an implied license but on exhaustion as a consequence of an authorised sale.

Conclusion

The crucial question of whether and to what extent the exhaustion doctrine is applicable to method and process claims has not yet been answered sufficiently clearly by courts in Europe. The same is true with regard to the question whether and to what extent the patentee can limit the effects of exhaustion on a contractual basis.

The courts may come to the result that there was exhaustion of LG's component claims, but not of the method claims, because Intel's sale did not involve the method and the entire system. Exhaustion might, however, be acknowledged in view of the fact that the use of Intel products was limited to the patent protected implementation of LG's method claims.

If courts in Europe would, under these circumstances, apply the exhaustion doctrine to method claims they certainly would not accept the Federal Circuit's view that the notice provided by Intel to Quanta constituted a conditional sale which did not exhaust patent rights. The courts would share the FSC's view and confirm the ruling that contractual agreements or disclaimer do not overrule the effect of exhaustion in cases where the right holder already intentionally transferred its right of disposal to the purchaser.

Notes

1. BGH GRUR 1980, 38.
2. BGH GRUR 2001, 223.
3. BGH GRUR 1998, 130.
4. ECJ ECR 1985, 2281 – Pharmon B.V./Hoechst AG; ECJ GRUR Int. 1974, 454 – Centrapharm/Sterling Drug; ECJ GRUR Int. 1976, 402 - Terrapin/Terranova.
5. GRUR 2006, 863 – ex works; BGH GRUR 2007, 882 - Parfümtester.
6. ECJ case C-16/03, *Peak Holding v. Axolin-Elinor*, 2004 ECR I-11313.
7. Federal Supreme Court GRUR 1968, 129 ff., 130 – forwards; GRUR 1975, 598, 600 – lumber elevator; BGH GRUR 1976, 579 ff. 582 – Tylosin; BGH judgment of December 14, 1999, GRUR 2000, 635, 637 – karate).
8. ECJ, GRUR Int. 1978, 291 – Roche/Centraform; EJC, GRUR Int. 1996, 144 – Bristol Myers Squibb.