No. 06-937

In the Supreme Court of the United States

QUANTA COMPUTER, INC., *ET AL.*
Petitioners,
v.

LG ELECTRONICS, INC.
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF OF *AMICUS CURIAE* YAHOO! INC. IN SUPPORT OF AFFIRMANCE OF THE FEDERAL CIRCUIT

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INTEREST OF *AMICUS CURIAE*[1]

Yahoo! Inc. ("Yahoo!") provides services to almost 500 million individuals each month worldwide and operates one of the most trafficked Internet destinations worldwide. The company is a leading innovator in the Internet, computer, and communications sectors, having developed a wide variety of patented technologies. Yahoo! owns a broad portfolio of patents relating to Internet products and services, and also licenses technology patents both to and from third parties both as standalone agreements and as parallel transactions to other negotiations. Accordingly, Yahoo!'s interest is in an efficient patent system that provides fair rewards for innovation.

This Court granted certiorari in this case to clarify the application of the patent exhaustion doctrine. In the Federal Circuit, that doctrine has evolved into a default rule, which allows sophisticated parties to choose whether a patentee will obtain its entire reward for the value of a patented article in the first sale of that article or whether it will be permitted to seek a portion of that reward from downstream parties with better information about the value of the specific rights involved. As explained below, the Federal Circuit's rule should be affirmed because the flexibility it provides is desirable both legally and economically.

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae* or its counsel made a monetary contribution to its preparation or submission.

To the extent that the parties disagree about the application of that rule to the facts of this case, Yahoo! takes no position.

Regardless of the rule adopted on that narrow issue, however, Yahoo! urges the Court to take care to maintain the undisputed, and critical, distinction between sales and licenses—only an authorized sale implicates the patent exhaustion doctrine. Additionally, the Court should ensure that, whatever its holding it does not cast doubt on the unquestioned rule that patentees may prohibit others to make unauthorized copies of patented articles, which is crucial to the legal regime governing software. As both a patentee and a licensee, Yahoo! has an interest in maintaining the stability and predictability of these established aspects of patent law.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case arises from tension among some of this Court's nineteenth- and twentieth-century decisions adopting and developing the patent exhaustion doctrine. Although petitioners now contend that those cases adopt a strict rule of patent exhaustion that parties cannot modify by agreement, the petition for a writ of certiorari more accurately stated: "Unfortunately, this Court's early exhaustion cases are notoriously confusing, and this Court has not spoken to the issues for more than half a century." Pet. 7. The Federal Circuit—including in the decision on review—has interpreted this Court's cases to permit parties to modify the patent exhaustion doctrine by express agreement. This appeal poses the questions whether that rule is better-suited to today's business environment than a strict patent exhaustion rule and whether it is a permissible reading of this Court's precedents.

Whatever result the Court reaches on those issues, Yahoo! urges a narrow focus that avoids creating uncertainty in other, settled areas of patent law. Specifically, the Court should preserve the distinction between sales and licenses. The patent exhaustion rule is triggered only by an *authorized sale*, as all parties recognize, and it is conceptually distinct from the doctrine of implied license. The patent exhaustion doctrine also has no bearing on another question of significant interest to Yahoo!: the ability of patentees to prevent *anyone*—whether purchaser or licensee—from making additional copies of a patented article. That right, established by statute, is critical for the protection of patented software technology. All agree that patent holders should be able to prohibit others from making additional copies of their patented invention except as specifically authorized, regardless of whether the patent exhaustion doctrine is applied strictly or flexibly.

On the specific issues before the Court, Yahoo! primarily desires a clear rule. So long as the rule is clear, Yahoo! and other parties will be able to enter agreements effectuating their business aims because they will know what rights they are conveying in any given negotiation. On balance, however, Yahoo! believes that the decision below should be affirmed. Absent compelling public policy considerations, sophisticated parties should be permitted wide latitude in negotiating the terms of rights transfers. There is no public policy basis on which to prohibit bargaining around patent exhaustion in circumstances like those present here. Indeed, the fact that *both sides of this dispute and the government all agree that the result LG seeks here could lawfully be reached through licensing or contract law* unambiguously confirms that point: A strict rule of patent exhaustion serves no purpose, but functions only as a trap for the unwary and makes it more difficult for companies to negotiate the terms that they desire.

Petitioners make little effort to explain why strict patent exhaustion makes sense. Instead, they make much of the tension between the Federal Circuit's recent cases and statements in some of this Court's early patent exhaustion cases. That tension, as further discussed below, is not as great as petitioners would have the Court believe. In fact, the Federal Circuit's recent rulings are substantially reconcilable with this Court's decisions.

Finally, while Quanta and LG dispute various factual and interpretive issues relating to the parties' course of dealings, Yahoo! expresses no view on those matters or on whether the lower court's construction of the agreements in this case was correct. Rather, Yahoo!'s views are limited to cautioning that the decision in this case should be crafted to avoid confusing settled areas of law and explaining how best to resolve the specific tension that brought this case before the Court. The Court should affirm the decision below.

ARGUMENT

I. THE COURT SHOULD ADOPT A CLEAR RULE ON THE NARROW ISSUE IT GRANTED CERTIORARI TO RESOLVE.

A. The issue presented is an important but narrow one, and clarity will assist businesses in negotiating the complex licensing arrangements they require.

The issue presented by this case is an important but quite narrow one. In today's commercial environment, businesses commonly negotiate complex arrangements concerning the licensing and/or sale of intellectual property. The parties need to know the rules with certainty to be able to reach mutually beneficial agreements.[2]

If a patentee knows that his patent may lawfully be enforced against a downstream purchaser, he can charge a lower price to his immediate customer and collect an additional fee from the downstream customer or customers. Or he may choose to negotiate away his right to recover from the downstream user and attempt to recover the full

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[2] *Amicus* Biotechnology Industry Organization explains at length the importance of such complex negotiated arrangements to that industry in its brief in support of neither party. While the self-replicating nature of DNA makes that industry's concerns somewhat distinctive, the thrust of their argument applies more broadly: the progress of science in the modern era depends greatly on collaboration among public, not-for-profit, and profit-seeking entities. Complex licensing arrangements facilitate that progress by freeing inventors to widely license their inventions, confident they will be able to recover the reward the patent law intends for them.

value of the patent from his immediate customer. *See, e.g.,* Mark D. Janis, *Supplemental Forms of Intellectual Property Protection for Plants*, 6 Minn. J. of L., Sci. & Tech 305, 327 (2004) (where a patentee places conditions on a sale of a patented product, the purchaser pays less); Pet. Br. 53 (the value of a license depends on whether the license includes the right to sell the product free and clear). In contrast, if the patentee knows that patent exhaustion insulates the downstream purchaser, he has no choice about how to structure his price—he *must* recover the entire value of his invention from his immediate customer.

At the certiorari stage, the Solicitor General correctly pointed out that there is some uncertainty as to which rule currently prevails. Under Federal Circuit cases since *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992), "the patent-exhaustion doctrine is subject to express modification." SG Cert. Br. 14-17. In contrast, an aggressive reading of this Court's decision in *United States v. Univis Lens Co.*, 316 U.S. 241 (1942), might suggest that the patent exhaustion rule "delimits the scope of the patent right in a manner that cannot be extended or altered by the parties." SG Cert. Br. 11.[3]

The Court granted certiorari in this case to provide clarity on that specific issue. As set forth below, Yahoo! urges this Court to take care that its decision on that issue not have broader, unintended consequences.

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[3] The extent of this apparent conflict is further discussed in Part IV, *infra*.

B. The Court should craft the rule in this case narrowly to address the precise question that led it to grant certiorari.

Yahoo! recognizes that the issue that led this Court to grant certiorari is both discrete and narrow, and Yahoo! encourages the Court to adopt a clear rule to facilitate parties' negotiations. At the same time, however, Yahoo! urges the Court to focus its decision precisely, avoiding broad language that could call into doubt well-settled doctrines that are relied on by patentees, licensees, and purchasers throughout the Nation.

1. Yahoo! urges the Court to preserve the distinction—not questioned by any party before the Court—between a sale, which implicates the patent exhaustion doctrine (however that doctrine may be clarified in this case), and a license agreement, which does not.

Petitioners themselves emphasize the distinction between a sale and a license. *See* Pet. Br. 25-29 (distinguishing the doctrines of implied license and patent exhaustion; also distinguishing between restrictions placed on *purchasers*, which implicate patent exhaustion, and restrictions placed on manufacturing *licensees*, which do not); *see also, e.g.*, Resp. Br. 22-23 (noting that the exhaustion doctrine is "conceptually distinct" from the doctrine of implied license). Indeed, the distinction between a sale and a license is critical to petitioners' argument. While this Court granted certiorari in this case to dispel uncertainty as to whether the patent exhaustion rule should be applied strictly or flexibly in the context of an authorized sale, the doctrine of implied license contains no such uncertainty. There is no dispute that parties can agree that no implied license will be granted. *See* Pet. Br. 26. A broad holding from this Court that could be interpreted to the contrary would sow confusion and undermine the negotiation of complex license agreements.

As petitioners also recognize, this Court should also take care not to upend more than a century of precedents by casting doubt on the right of a patentee to grant restricted rights to a manufacturing licensee, including the right to limit to whom the licensee may sell. *See* Pet. Br. 28-29, 51; *see also General Talking Pictures Corp. v. Western Electric Co.*, 305 U.S. 124, 127 (1938); *United States v. General Electric Co.*, 272 U.S. 476, 490 (1926). That question, too, is well settled and appropriately so: any change to that rule would cause enormous economic disruption in myriad manufacturing and sales licensing contexts.

2. The Court should also take care to craft a rule in this case that does not cast doubt on the undisputed right of patentees to prohibit others from making additional copies of the patented invention, a right of critical importance in the context of computer software. *See* 35 U.S.C. § 271(a) ("[W]hoever without authority makes … any patented invention … infringes the patent."). The parties agree that there is no dispute in this case about that right; even where patent exhaustion applies, a purchaser gains no right to make copies, unless he has a license to do so. *See* Pet. Br. 42-43 n.13; Pet. 8; Resp. Br. 20.

3. Finally, Yahoo! endorses a limit on the scope of this Court's decision already suggested by the Solicitor General. Specifically, one of respondent's

arguments here is that regardless of whether the Court adopts a strict or a flexible patent exhaustion rule, the only patents that could be "exhausted" on the facts of this case were the patents covering the *components* sold by Intel, *not* "LGE's systems patents" that are infringed "only when components … are *combined* with other devices … to create personal computer systems." Resp. Br. 17-35 (emphasis added). As the Solicitor General noted, however, because the Federal Circuit applied the flexible patent exhaustion rule, it did not address this argument—in other words, if there was no patent exhaustion, there was no need to decide what patent rights were or were not exhausted. SG Br. 30-31. Accordingly, the Solicitor General suggests that even if the Court reverses the Federal Circuit on the question of whether the patent exhaustion rule can be negotiated around, it should *remand* to the Federal Circuit to consider LG's argument in the first instance. *Id*. The issue, in other words, does not fall within the question presented on which certiorari was granted, and this Court should not pre-empt the Federal Circuit's consideration of the issue in the first instance.

If the Court should nonetheless reach this issue, Yahoo! urges it to endorse a narrow rule. In particular, consistent with the fact that the patent exhaustion doctrine applies only to authorized *sales*, the Court should not permit the doctrine to be extended to apply beyond the *actual things sold*. Thus, for example, when only a patented component is sold, the exhaustion doctrine should not be extended to exhaust a patentee's right to a combination of the patented component with other components, which could be covered by separate patent claims.

II. PETITIONERS OFFER NO CONVINCING JUSTIFICATION FOR PROHIBITING PARTIES FROM MODIFYING PATENT EXHAUSTION BY AGREEMENT.

On the narrow issue before the Court, petitioners' limited efforts to justify a strict patent exhaustion doctrine as a sensible rule fall short of the mark.

First, petitioners appear at times to suggest that strict patent exhaustion is necessary to protect purchasers' reasonable expectations. *See, e.g.,* Pet. Br. 1 (arguing that patent exhaustion is "in the essential nature of things"). But that argument lacks substance: whether parties *expect* the first sale to terminate patent rights depends on the legal rule in place. Petitioners' reliance on hoary references to the common law fails to supply the missing substance. *See, e.g.,* Pet. Br. 19 ("[R]estraints upon … alienation … have been hateful to the law from Lord Coke's day to ours.") On this point, this Court's recent statement in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2714 (2007), applies equally here:

> [The rule against] restraint[s] on alienation [at common law] … tended to evoke policy concerns extraneous to the question … here. Usually associated with land, not chattels, the rule arose from restrictions removing real property from the stream of commerce for generations. The Court should be cautious about putting dispositive weight on doctrines from antiquity but of slight relevance.

In short, while expectation and tradition may explain patent exhaustion as a *default* rule, they cannot justify it as an immutable requirement.[4] It is true that, in the abstract, when one party purchases something from another he reasonably expects to be buying the right to do with the thing as he pleases. But if the parties expressly make some *other* agreement, as sophisticated businesses frequently do when negotiating license agreements, then *that* reasonable expectation should control.

Indeed, in the real world, the strict patent exhaustion rule that petitioners advocate necessarily acts *contrary* to parties' expectations. That is, the strict rule would apply when parties negotiate certain limitations on the scope of a transfer of intellectual property rights, unaware that the strict rule prohibits them from doing so. In such circumstances, the rule would nullify the limitations, defeating the parties' expectations. In contrast, the Federal Circuit's flexible rule would uphold such limitations, exactly as the parties expected. In all other situations, when the parties have not negotiated such limitations, there would be no difference between a strict and a flexible rule. Accordingly, the rule advocated by petitioners differs from the Federal Circuit's approach *only* when it

[4] *See also* Glen O. Robinson, *Personal Property Servitudes*, 71 U. Chi. L. Rev. 1449, 1480 (2004) ("In its formative role—as a reaction to feudal lords restricting the free alienation of property—the [free alienation] rule scarcely required explanation. But with the feudal system out of the way one might expect some explanation for refusing to allow ordinary property owners to dispose of their property on such terms as they choose.").

specifically operates to thwart the parties' expectations. While the law certainly does that from time to time, it does so only for compelling public policy reasons. *See, e.g., Shelly v. Kraemer*, 334 U.S. 1 (1948) (forbidding state courts to enforce racially restrictive covenants). No such compelling reasons have been shown here.

Petitioners also attempt to justify strict patent exhaustion on the ground that "[i]f a property owner were permitted to divvy up his [property rights] in any manner he saw fit, the property regime would become too complex and inefficient to promote the free transfer of property to its greatest use." Pet. Br. 47. In other words, petitioners claim that the patent exhaustion rule limits transaction costs in the market for property interests in patents generally. This is a variation on an argument set out in detail in an academic article cited by petitioners, *see* Thomas Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 Yale L.J. 1 (2000). But the argument is not persuasive. Merrill and Smith use a "timeshare" in a wristwatch as an example of a property interest that the law should forbid notwithstanding the parties' desire to transfer such an interest. According to the authors, such idiosyncratic interests increase "the information processing costs of all persons who have existing or potential interests in this type of property." *Id.* at 27. In other words, an externality is created because market actors incur information costs to ensure that they are receiving the full property rights they expect.

What Merrill & Smith's argument actually demonstrates, however, is that the market is generally self-regulating. In reality, watchmakers could not sell timeshares in a watch because nobody would want one. *See* Robinson, 71 U. Chi. L. Rev. at 1486. There is thus no need for a legal prohibition. But even if such an idiosyncratic interest were to encounter demand, "what [Merrill & Smith] overlook is that if every buyer must be given specific notice of any deviation for the baseline of full title transfer, the information cost problem is solved; there is no externality." *Id.* at 1486-87. "A legally required notice has the same effect of internalizing information costs as a legal guarantee of formal title." *Id.* at 1487. That is precisely what takes place under the Federal Circuit rule at issue here: sophisticated parties negotiate *express* "notice" of the property interest to be transferred in derogation of the flexible patent exhaustion default rule. Accordingly, there is no transaction costs problem.

Furthermore, it is difficult to see how the regime that petitioners advocate does a better job of limiting transaction costs than the Federal Circuit's approach. After all, petitioners, respondents, and the Solicitor General all agree that there are alternate ways, under either patent or contract law, to achieve the result that LG sought here. For example, it is undisputed that LG could have *licensed* Intel to make, but not to sell, technology embodying its technology: "Among the restrictions on licensees that the Court has allowed to be enforced through an infringement action is a restriction on a licensee's ability to make an authorized sale." SG Cert. Br. 13 (citing *Mitchell v. Hawley*, 83 U.S. (16 Wall.) 544 (1873)); *see also* Pet. Br. 51. It is similarly undisputed that LG could have achieved its desired result here through a "complex … web of contractual obligations." Pet. Br. 51. Accordingly, the strict patent rule advocated by petitioners is little more than a trap for the unwary—since the same result may lawfully be reached in different ways, the rule serves no social purpose. *See* Robinson, 71 U. Chi. L. Rev. at 1468. Petitioners' rule, which would force parties to find the right "magic words" to negotiate around this trap and effectuate their intent, imposes, rather than saves, transaction costs. That trap becomes even more costly to those who try, but fail, to avoid it.

Petitioners' *amicus* Dell argued at the certiorari stage that the Federal Circuit rule lets patent owners "multiply" their recovery by "extracting a new, duplicative royalty at each stage of ownership." Dell Cert. Br. 13-15. As petitioners note, however, "[t]here is only one monopoly profit to be obtained in any vertical distribution chain." Pet. Br. 49; *see also* Dell Br. 13 n.7 (agreeing with the same); 3A Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 756b2 (2d ed. 2002); Robert H. Bork, *The Antitrust Paradox* 229 (1978). There is no reason to think that patent owners can "multiply" that profit by dividing it up. If a smaller portion of the bundle of rights is to be conveyed in the first sale, the market will naturally assign a lower price.

Dell suggests that a patentee can nevertheless act strategically to reap excessive (*i.e.*, inefficiently large) royalties by waiting to assert its claim until after those in a supply chain have designed their products incorporating the patented technology. *See* Dell Br. 15-16. While Yahoo! agrees that the law should not promote that sort of opportunistic behavior, no rule adopted in this case could prevent it. It is undisputed that a patentee, whether or not it is acting strategically, need not provide an unrestricted license to sell to anyone in the supply chain. *See supra* at 13-14; Pet. Br. 51. If a patentee opts not to do so, any sale to an unlicensed entity would be unauthorized, and the patent exhaustion rule—strict or flexible—would simply not apply. *See supra* at 13-14; *General Talking Pictures Corp.*, 305 U.S. at 127. In that situation, the patentee could enforce his patent rights against all downstream entities in supply chain, all of whom would be infringers. The rule adopted in this case has no bearing on whether such conduct would be profitable.

Dell also posits an additional source of transaction costs, suggesting that a flexible rule creates an information problem: downstream users might not be able to learn what upstream users paid. *See* Dell Cert. Br. 12. As an economic matter, however, downstream users do not need to know what upstream users paid. They only need to know for certain what rights *they* are being offered to determine what those rights are worth to them. That is simply how markets work: a consumer need not know what Walmart paid Dell for a computer to know whether he wishes to purchase the computer at Walmart's asking price. The same is true for more sophisticated buyers.

Indeed, what Dell offers as a selling point for a strict patent exhaustion rule is its primary flaw—it "forces the patent owner to extract the entire royalty that is due for its invention at a single point." *Id.* That is not an economically sensible regime. LG and

Intel are unlikely to have as good information about the value of those rights to downstream users as the downstream users do. This is particularly true with new technologies, which, in some cases, can be difficult to value accurately. The Federal Circuit's approach allows those with the best information about value to be the ones to negotiate prices for the intellectual property rights they need.

Of course, under the Federal Circuit's rule, if LG and Intel *want* to include in the price LG charges Intel the value that others will derive downstream from combining Intel offerings (containing LG technology) into their own products, they can. But LG should not be *required* to estimate the total downstream value of its patents and collect the entire royalty from Intel. Likewise, Intel should be free to pay only its portion of the royalties and not act as an agent of LG by attempting to estimate the downstream value of its products. Where it would be inefficient for multiple negotiations to take place—in situations, for example, involving numerous parties, little variation in use, and predictable value—one might expect parties to negotiate a full royalty at the first level. But it makes sense to leave that up to them.

Finally, petitioners make the surprising claim that "the Federal Circuit's holding threatens to immunize patent owners for conduct that violates the antitrust law." Pet. Br. 50. That is simply wrong. As discussed *supra* at 14, there is only one monopoly profit to be made on the sale of an invention, and the whole point of patent law is to entitle the patent holder to that profit. Antitrust law is indifferent as to whether the patent holder must collect that entire monopoly profit from the first sale *or* may seek it in a series of transactions—which is the real question presented here.

On the other hand, patent law does *not* entitle the patent holder to anything *more* than the lone monopoly profit to be made on the sale of his invention. And antitrust law is *not* indifferent to a patentee's attempts to multiply that profit. So, for example, it is impermissible to exploit market power in the market for one product (the "tying" product) by conditioning sales of that product on the purchase of a second product (the "tied" product), and the fact that the seller has a lawful monopoly under the patent law in the tying market provides him no shield. *See Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 38-43 (2006) (plaintiff must show that the patentee has market power in the tying product to establish a Sherman Act violation; the same requirement applies to show patent misuse). That fact will not change regardless of the rule adopted in this case. Nor may a patentee somehow invoke a patent to insulate from liability a "cartel," Pet. Br. 51, engaged in horizontal price fixing. A patentee *may*, of course, engage in *vertical* resale price maintenance consistent with the "rule of reason," but so may any manufacturer. Under this Court's recent decision in *Leegin*, 127 S. Ct. 2705, that is simply the law.[5]

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[5] Similarly, the antitrust laws do not prohibit "exclusive territories restrictions." Pet. Br. 51; *see Hobbie v. Jennison*, 149 U.S. 355, 363 (1893) (noting that patentees may lawfully "bind every licensee or assignee" to such restrictions); *Continental T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (holding that non-price restrictions on distribution, including territorial

In sum, the rule advanced by petitioners is deficient because it would limit the ability of sophisticated business entities, such as patent holders and their assigns, from entering into mutually beneficial business arrangements.

III. THE FEDERAL CIRCUIT HAS ADOPTED AN ECONOMICALLY EFFICIENT RULE THAT ENCOURAGES INNOVATION.

While the absence of any compelling justification for the restrictive rule that petitioners advocate is a sufficient basis on which to reject it, there are important benefits to the Federal Circuit's approach. While most of those benefits are implicit in the discussion above, they bear brief express mention.

First, permitting parties to bargain around patent exhaustion would obviously respect the parties' preferences. As noted *supra* at 10-12, while petitioners suggest that a strict rule is necessary to protect parties' expectations, that is flatly incorrect. The strict rule applies *only* to thwart the parties' expectations. *Supra* at 11-12.

Second, the Federal Circuit's rule is economically efficient because it allows parties with the best information about value to be the ones to negotiate prices for the intellectual property rights they need. Dell argues that strict patent exhaustion is a good rule because it "forces the patent owner to extract the entire royalty that is due for its invention at a single point." Dell Cert. Br. 12. But "forcing" parties

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restrictions, are governed by the rule of reason). For purposes of antitrust law, it is thus neither here nor there whether such restrictions are imposed as a matter of patent or contract law.

to do things is rarely economically efficient. Efficiency is advanced by allowing parties to determine for themselves who is best situated to value specific property rights. In general, a downstream user will, of course, have a better idea of what specific rights are worth *to him* than will some other user upstream.

Finally, the Federal Circuit's rule is economically efficient for a reason not yet discussed. Specifically, allowing parties to bargain around patent exhaustion facilitates socially valuable price discrimination. For example, LG might sell at a different price to Quanta than it does to Company X, which intends to use the technology for a different (lower value) use. Company X thereby benefits, because it otherwise would not be able to buy at all since its use is not valuable enough to justify licensing the invention at the market-wide monopoly price. Consumers benefit in turn because they can buy Company X's product. And finally, patentee LG benefits because it is able to make additional sales.

The Department of Justice acknowledges that using license restrictions for price discrimination promotes innovation. *See* Dep't of Justice & Fed. Trade Comm'n, *Antitrust Guidelines for the Licensing of Intellectual Property* (Apr. 6, 1995), http://www.usdoj.gov/atr/public/guidelines/0558.pdf. Specifically, the Guidelines indicate that use restrictions on intellectual property "may serve procompetitive ends by allowing the licensor to exploit its property as efficiently and effectively as possible," including giving "licensee[s] an incentive to invest in the commercialization and distribution of products embodying the licensed intellectual property and to develop additional applications for the licensed property." *Id.* § 2.3. Price discrimination also, of course, increases potential rewards to patentees, which encourages further innovation.

IV. THE FEDERAL CIRCUIT'S APPROACH REASONABLY RECONCILES THIS COURT'S DECISIONS.

The United States is correct, to a point, in identifying "dissonance" between language in some early Supreme Court patent cases and the development of the patent exhaustion doctrine in the Federal Circuit. SG Cert. Br. 18. But the degree of that tension should not be overstated. In fact, the Federal Circuit's approach is largely consistent with the principles animating this Court's patent exhaustion decisions, even if it is inconsistent with the language in some cases.

A. The Federal Circuit's rule is consistent with patent law principles declared by this Court.

The monopoly provided to a patentee, as this Court has repeatedly confirmed, is designed to reward an inventor for his invention. *Univis*, 316 U.S. at 250; *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 511 (1917) (citing cases). This reward is not provided because the nation is proud of its inventors but rather out of the recognition that allowing inventors to reap the benefits of their inventions "promote[s] the Progress of Science and useful Arts." U.S. Const. Art. I § 8. Thus, the Court has said that a patentee's restrictions upon a licensee's sales are valid "provided the conditions of sale are normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly." *General Electric*, 272 U.S. at 490. Put another way, "'the rule is, with few exceptions, that any conditions which are not in their very nature illegal with regard to this kind of property, imposed by the patentee and agreed to by the licensee for the right to manufacture or use or sell the article, will be upheld.'" *Id.* at 491 (quoting *E. Bement & Sons v. Nat'l Harrow Co.*, 186 U.S. 70, 91 (1902)).

Consistent with these general principles, the Court has allowed patentees flexibility in how they choose to structure their license agreements to deliver the monopolist's reward to the patentee. For example, a patentee might choose to license to others the right to sell his invention without restriction to all comers. Alternatively, he may grant a less valuable license, such as a license to sell only in a certain area, or to a certain kind of customer, or to sell the invention with the caveat that the license to use it under the patent expires on a date certain. *See Hobbie v. Jennison*, 149 U.S. 355 (1893) (territorial restrictions on licensee's right to sell); *General Talking Pictures*, 305 U.S. 124 (licenses divided between those who could sell for commercial purposes and those who could sell for home purposes); *Mitchell*, 83 U.S. 544 (purchaser from a licensee infringes if he continues to use the purchased invention after the date the licensee's right to license use expired).

The Federal Circuit's development of the patent exhaustion doctrine reflects these principles. In the Federal Circuit's view, patent exhaustion operates as a default rule. Thus, "an unconditional sale of a patented device exhausts the patentee's right to control the purchaser's use of the device thereafter." *B. Braun Medical, Inc. v. Abbott Labs.*, 124 F.3d 1419, 1426 (1997) (citing *Mallinckrodt*, 976 F.2d at 706). "The theory behind this rule is that in such a transaction, the patentee has bargained for, and received, an amount equal to the full value of the goods." *Braun Medical*, 124 F.3d at 1426 (citations omitted). But where a patentee has expressly limited a licensee's rights, "it is more reasonable to infer that the parties negotiated a price that reflects only the value of the 'use' rights conferred by the patentee." *Id.* (citations omitted). The patentee, under the Federal Circuit's approach, is entitled to take full advantage of the monopoly rights secured by the patent grant, and both he and his licensee should be entitled to enter into whatever licensing agreement they see fit. *Mallinckrodt*, 976 F.2d at 708 (noting that there are exceptions for agreements that constitute misuse or violate the antitrust laws). Thus, the restrictions the parties negotiate are generally upheld. *Braun Medical*, 124 F.3d at 1426 (citing, *inter alia*, *General Talking Pictures*, 305 U.S. at 127).

B. The categorical language the Court has used in describing the patent exhaustion doctrine should not be over-read.

In contrast to the Federal Circuit's approach, this Court has not described the patent exhaustion rule as a default rule. Instead, the Court's language in describing patent exhaustion has tended to be categorical. For example, in *Univis*, the Court said: "The full extent of the [patent] monopoly is the patentee's 'exclusive right to make, use, and vend the invention or discovery' .... [S]ale of [a patented article] exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his patent, control the use or disposition of the article." 316 U.S. at 250. In a similar vein, the Court in *Motion Picture Patents* stated 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." *Motion Picture Patents*, 243 U.S. at 516 (citing *Bauer v. O'Donnell*, 229 U.S. 1 (1913)).

Although such broad language is at odds with the Federal Circuit's rule that the patent exhaustion doctrine operates as a default rule that can be modified by agreement of the parties, it should not be over-read. "It is a maxim not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used." *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 399 (1821). That admonition is especially applicable here, in an area of law awash in broad statements that cannot be easily reconciled.

Thus *Motion Picture Patents*, notwithstanding its broad language, was not thought to present an obstacle when the Court upheld the restriction at issue in *General Talking Pictures*. In that case, the patentee granted some companies licenses to sell its amplifiers in the consumer market for home use and other companies licenses to sell for the commercial market. *General Talking Pictures*, 305 U.S. at 125-26. A commercial buyer, knowing of the license restrictions, bought from a company that was entitled only to sell in the home market. The Court held that the buyer acquired no license at all when it purchased the amplifier; instead, it was an infringer. *Id*. at 127. What made the sale unauthorized, and thus made the buyer an infringer, was precisely the fact that the buyer did not intend to conform his use to the use permitted by the seller's license.

This holding, as the dissent pointed out, was inconsistent with the discussion in the *Motion Picture Patents* case, which seemed to forbid a patentee from imposing *any* restrictions on a purchaser's use. *Id*. at 128-29 & n.3 (Black, J., dissenting). But *Motion Picture Patents* is better understood as a case about patent misuse and product tying rather than a case about restraints under the patent law generally. *See Illinois Tool Works*, 547 U.S. at 33-34 & n.2 (identifying *Motion Picture Patents* as a case condemning product tying as patent misuse). *See also, e.g.*, 9 Areeda & Hovenkamp, *Antitrust Law*, ¶¶ 1701b, 1720; *Mallinckrodt*, 976 F.2d at 708; *Motion Picture Patents*, 243 U.S. at 517 (the fact that the patentee makes its profit from the sale of supplies rather than the sale of the invention "is the clearest possible condemnation" of the scheme because it has the effect of extending the scope of the patent monopoly); *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 n.13 (tracing the antitrust rule of tying to *Motion Picture Patents*).

Indeed, that is why the Court in *Motion Picture Patents* overruled *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912), in which the Court had upheld a tying restriction, but did not so much as criticize or distinguish any of the other cases upholding other sorts of restrictions. Since there was no tie involved in *General Talking Pictures*, *Motion Picture Patents* was simply not applicable. Rather, other cases, such as *Mitchell* and *General Electric*, which had permitted other kinds of restraints using equally broad language, controlled. That is also why the Court's opinion in *General Talking Pictures* was remarkably short—a single paragraph disposed of the legal issue, which was "clear," as the practice at issue was "an old one" whose "legality has never been questioned." 305 U.S. at 127.[6]

Like the broad language in *Motion Picture Patents*, the broad language of *Univis* should be read cautiously. It is far from clear that *Univis* in fact condemns the kind of licensing practices approved by the Federal Circuit's recent cases.

In *Univis*, the patentee imposed a resale price maintenance scheme through its licensing practices. The company held several patents relating to multifocal lenses. The patentee's subsidiary manufactured lens blanks, which it sold to two kinds of customers, wholesalers and "finishing retailers." *Univis*, 316 U.S. at 244. Finishing retailers would grind the lens blanks and then sell the lenses to consumers. So-called prescription retailers, lacking the capability to finish the lenses, would purchase

[6] The United States argued at the certiorari stage that the holding in *General Talking Pictures* creates an "anomaly" that a use restriction can be imposed upon a patented article through a license while no restrictions at all can be placed on an article sold to a purchaser. SG Cert. Br. 14. It is, of course, only an anomaly if one believes that this Court's broad statements in cases like *Motion Picture Patents* should control, instead of equally broad statements made in other cases, such as *General Electric*, that would suggest such restrictions may be imposed.

lenses from wholesalers who would grind the lenses for them. The lens company licensed all three types of entities—wholesalers, finishing retailers, and prescription retailers. *Id.* As part of their licenses, all agreed to maintain certain resale prices set by the patentee. *Id.* at 244-45. But no matter whether the manufacturer sold a lens blank to a finishing retailer or to a wholesaler (later to be sold to a prescription retailer), the patentee was paid the same amount—50 cents, payable from the proceeds of that initial sale by the manufacturer. *Id.* at 245.

In *Univis*, it was important that the licensing scheme purported to restrict prices even *after* the point where the patentee received its part of the proceeds of the sale. As the Court put it, "the *entire* consideration and compensation" paid to the manufacturer was the purchase price of the finishing licensee, from which the manufacturer paid the patentee's royalty. *Id.* at 249 (emphasis added). The Court pointed out that "[w]e have no question here of what other stipulations, *for royalties or otherwise*, might have been exacted as a part of the entire transaction." *Id.* at 250 (emphasis added). The Court rejected the price restrictions, explaining that "the purpose of the patent law is fulfilled … when the patentee *has received his reward for the use of his invention* … and that *once that purpose is realized* the patent law affords no basis for restraining the use and enjoyment of the thing sold." *Id.* at 251 (emphasis added). In the Court's view, the patentee could legitimately dictate only the price of the transaction from which it took its cut; because the subsequent transactions did not provide further compensation to the patentee, the restriction on them was not within the patent grant. *See also*

Bauer, 229 U.S. at 16-17 (emphasizing, in striking down a resale price maintenance system, that the patentee did not receive any payments out of the proceeds of the price-restricted subsequent sales).

In contrast to *Univis*, the Federal Circuit's rule does not concern efforts to control prices unrelated to the patentee's reward. Rather, it is directed to situations where a patentee who grants less than full rights to his manufacturing licensee (expecting to then grant further licenses to those who incorporate that invention into other products) has *not* gotten "the entire consideration and compensation" that he intends to get from the invention. *Compare Univis*, 316 U.S. at 249 *with Braun Medical*, 124 F.3d at 1426. A further license issued to a downstream manufacturer like Quanta would—unlike the situation in *Univis*—provide a reward to the patent holder; the Court's reasoning in *Univis* is thus not directly applicable.[7]

All of this is not, of course, to say that there is perfect harmony between all statements in this Court's cases and those of the Federal Circuit. Rather, the important point is that there is considerable tension in the Court's *own* precedents.

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[7] The Court has also changed its view of resale price maintenance since *Univis*. *See Leegin*, 127 S. Ct. 2705. Today, resale price maintenance is permitted because it encourages non-price competition among retailers as they attempt to sell more of the goods (such as encouraging them to provide more knowledgeable salespeople or to otherwise highlight the desirability of the manufacturer's products). This in turn can lead both to higher profits for the manufacturer and to higher consumer welfare. Thus, resale price maintenance can be one way in which a patentee maximizes the value of his patent.

No case has overruled *General Talking Pictures* or *Mitchell*, both of which upheld under patent law restrictions against purchasers who knew of them when they bought the patented articles.[8] Even *Univis*—arguably petitioner's best case—expressly declined the Government's invitation to reconsider *General Electric*. *Univis*, 316 U.S. at 252. Moreover, no case from this Court has even hinted at disapproving the broad language of *General Electric*—quoted approvingly in *General Talking Pictures*—that a "patentee may grant a license 'upon *any* condition the performance of which is reasonably within the reward which the patentee by the grant of the patent is entitled to secure.'" *General Talking Pictures*, 305 U.S. at 127 (quoting *General Electric*, 272 U.S. at 489) (emphasis added).

This tension in the Court's cases, *cf. Mallinckrodt*, 976 F.2d at 705 (noting that the district court had believed *General Talking Pictures* to be in tension with cases like *Motion Picture Patents*), may be reconciled in either of two ways. One could read the precedents as establishing a purely formalistic distinction between patent exhaustion cases on the one hand and restricted-license cases on the other. *See* SG Cert. Br. at 14. Such a reading creates the "anomaly" of allowing a patentee to achieve indirectly through license restrictions what it cannot achieve directly. *Id.* Alternatively, one could reject "formalistic

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[8] Petitioners make much of the fact that *Dick* was overruled but, as discussed above, *Dick* was a tying case and so was the case (*Motion Picture Patents*) overruling it. *See Illinois Tool Works*, 547 U.S. at 34 & n.2; 9 Areeda & Hovenkamp, *Antitrust Law*, ¶¶ 1701b, 1720.

distinctions of no economic consequence" and read the broad language in cases like *Motion Picture Patents* more narrowly, as applying to the kinds of restrictions at issue in those cases. *See Mallinckrodt*, 976 F.2d at 705, 708 & n.8.[9] The Federal Circuit chose the latter path. *See id.* at 703-08.

In these circumstances, the tension between isolated statements in this Court's cases and the Federal Circuit's patent exhaustion cases should not be overstated. The Federal Circuit was well aware of this Court's patent exhaustion cases when it decided *Mallinckrodt*. *See id.* In that case, the court reasonably applied this Court's precedents to new circumstances. As discussed above, that evolution is not only largely consistent with the principles this Court has declared but is also the more economically sensible approach. This Court should endorse the Federal Circuit's approach notwithstanding its inconsistency with the language in some of this Court's cases.[10]

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[9] Justice Holmes in *Motion Picture Patents* foresaw this issue, arguing that a patentee should be free to impose restrictions on the use of his patented invention except where the public interest forbids them. 243 U.S. at 519-20 (Holmes, J., dissenting). Justice Holmes thus understood that the real question is whether a restriction should be condemned on its own merits. The fact that *Motion Picture Patents* is now seen as a tying case confirms that Justice Holmes was correct.

[10] Petitioners also suggest that when this Court in *Mitchell* discussed the right of patentees to place conditions on sales, it understood the term "condition" only to refer to conditions precedent to the passing of title. *See* Pet. Br. 18-20 & n.7. This Court considered and rejected that argument almost a century ago. *See Dick*, 224 U.S. at 17-24 (overruled on other grounds by *Motion Picture Patents*, 243 U.S. at 518). When the *Dick* case

C. Congress has not endorsed a strict patent exhaustion doctrine.

Petitioners argue that the Federal Circuit's approach should be rejected because Congress, despite having reenacted the patent laws, did not see fit to modify this Court's patent exhaustion doctrine. Pet. Br. 45. While re-using language in a reenacted statute frequently indicates an intent to incorporate prior judicial interpretations of that language, *see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 85 (2006), that rule is of course merely a guide to the interpretation of a statute. There are several reasons to believe that the rule should not apply to this case.

First, as all parties agree, it has always been the case that patentees and their licensees could get around the effects of the strict patent exhaustion doctrine through artful drafting of their license agreements and contracts. *See supra* at 13-14. In this sense, the patent exhaustion doctrine has, in truth, always been a mere default rule. Congress, to the extent it approved of the patent exhaustion doctrine, likewise should be understood to have approved that the rule could be drafted around.

Second, as discussed in Part IV.B above, there is tension in this Court's own cases dealing with patent exhaustion and license restrictions. In light of that tension, it is at least an open question whether Congress specifically approved petitioners' view of

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was overruled, the issue was whether tying conditions could lawfully be imposed or whether they expanded the scope of the patent monopoly, not the meaning of the word "conditions." *See Motion Picture Patents*, 243 U.S. at 509-13.

how to reconcile the cases, rather than the more practical approach taken by the Federal Circuit in *Mallinckrodt*.

Third, despite different outcomes in specific cases, this Court has always interpreted the patent law as a mechanism to encourage the advancement of science by allowing a patentee to benefit from the monopoly in his invention. *See, e.g.*, *Univis*, 316 U.S. at 250. Over time, the Court's understanding of the economics of that mechanism has, of course, evolved. There is no reason to think that Congress endorsed this Court's early twentieth-century pronouncements at the cost of keeping that evolution from improving the patent law. Rather, Congress more plausibly expected that courts would continue to interpret the patent law, including the patent exhaustion doctrine, to permit patentees to negotiate a fair reward for their inventions. This Court should interpret its precedents accordingly.

V. Affirming the Federal Circuit Does Not Present a Danger of Windfalls to Patent Owners.

Petitioners argue that LG—although it inarguably could have imposed its desired conditions through other means—is attempting to take advantage of confusion in the law "to extract a one-time windfall" in this case. Pet. Br. at 52-53. Others go further, conjuring images of thousands of patents involved in countless lawsuits with scarcely imaginable amounts of liability on the line if the Federal Circuit's rule is affirmed. *See* Dell Cert. Br. at 13-14. Such concerns about windfalls to patent owners resulting from affirmance in this case are grossly overstated.

While Yahoo! takes no position on the Federal Circuit's interpretation of the facts in this case, as a logical matter it would appear that whether LG could receive an undeserved "windfall" depends on LG's and Intel's understanding of the background rule in place when they negotiated their licensing agreement. That is, if the parties believed that LG would *not* be able to recover from downstream entities like Quanta, the parties would have negotiated a price conferring on Intel the valuable right to sell LG's invention to others who could incorporate that invention into their products. If that is what they did and LG is nonetheless allowed to recover from downstream users, it will indeed receive a "one-time windfall" in this case. If, on the other hand, the parties believed that the patent exhaustion doctrine was merely a default rule and that LG could impose restrictions on downstream entities like Quanta, then the right Intel obtained was less valuable and Intel would have paid less for it—as Quanta understands. *See* Pet. Br. 49-50, 53. In that case, it is Quanta that could receive an undeserved windfall at LG's expense if this Court endorses the strict patent exhaustion rule.[11]

Yahoo! does not know the parties' understanding of the state of the law at the time of their negotiations. As a general matter, however, sophisticated parties negotiating such agreements

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[11] The potential for a windfall for downstream entities if the Court adopts a strict rule is perhaps even greater. Downstream entities that obtained licenses under the belief that the flexible rule applied might argue that they were free to disregard those agreements, claiming that they had no need of a license, thus obtaining windfalls at the expense of their licensors.

could reasonably have believed that *Mallinckdrodt* established the flexible patent exhaustion as the background rule. Petitioners implicitly acknowledge that fact, because their arguments attack *Mallinckrodt*. *See, e.g.*, Pet. Br. 12-13 (criticizing the *Mallinckrodt* rule and citing journal analyses critical of the *Mallinckrodt* decision); *see also* SG Cert. Br. 14 (identifying *Mallinckrodt* as the "foundation" of the Federal Circuit's approach). Indeed, the Federal Circuit decision below indicates that it certainly thought *Mallinckdrodt* settled this issue. *See* Pet. App. 4a-5a. In short, sophisticated parties negotiating licenses at the time this case arose may well have believed that *Mallinckrodt* stated the applicable law, notwithstanding language in cases from a half-century earlier that is arguably inconsistent with *Mallinckrodt*.

At the same time, we cannot rule out that parties may have held the contrary view. In these circumstances, however, the "windfall" point should not prevent the Court from upholding the Federal Circuit's development of a flexible patent exhaustion doctrine because it is both legally and economically desirable. After this Court makes clear that the patent exhaustion rule is a default rule, so that parties may agree to restrictions on the rights transferred by a license, neither patentees nor licensees should be able to obtain windfalls.

CONCLUSION

This Court should endorse a flexible patent exhaustion rule. However, if this Court announces a strict rule, it should limit its decision carefully. The Court should not reach issues on which the parties agree, such as the distinction between a sale and a license, or the right of a patentee to prohibit the making of unauthorized copies of his invention. In addition, the Court should not extend the reach of the patent exhaustion rule. In particular, the Court should not extend the patent exhaustion rule to apply to any patent claims other than those covering only the actual article sold—not to combinations or to other components that might be used in combination with it. Such an extension of the patent exhaustion rule, even if it were desirable, should be first considered by the Federal Circuit.

The judgment of the Federal Circuit should be affirmed.

Respectfully submitted.

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December 10, 2007