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 REMBRANDT IP MANAGEMENT, LLC AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF *AMICUS CURIAE*[1]

Rembrandt IP Management, LLC is in the business of "making a market" in patents, providing liquidity to inventors and patent owners. To do so, Rembrandt must enforce the patents it acquires against infringers, including through the negotiation of license agreements. Rembrandt's principals have dozens of years of experience with patent litigation, patent licensing, and technology, and have a strong interest in the development of clear rules that facilitate, rather than frustrate, voluntary arrangements governing patent rights. Patent law benefits from rules that respect parties' private ordering without imposition of inflexible restrictions on conveyance of intellectual property rights. There is no evidence that the rule of *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992), has, over the past 15 years, produced confusion or given rise to abuse. By upholding freedom of contract, the Court will contribute to efficiency and clarity in the patent system.

[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that it authored this brief in its entirety and that none of the parties or their counsel, nor any other person or entity other than *amicus* or its counsel, made a monetary contribution intended to fund the preparation or submission of this brief. All parties have consented to the filing of this brief, and letters reflecting their blanket consent to the filing of *amicus* briefs in this case are on file with the Clerk.

STATEMENT

Respondent granted *to Intel* a license under its patents to "make, use, [and] sell" certain products. *See* Pet'rs Br. 8. The parties' arrangement made clear that the license granted *to Intel* was not intended to grant *to Intel's customers* a right to combine Intel and non-Intel parts to practice Respondent's patents. Petitioners had actual notice of Intel's license and Respondent's intent to deny Intel the right to grant to Intel's customers a license.

The legal validity of such licensing arrangements is a matter of pressing concern to Rembrandt and other patent owners that support invention and innovation by helping to obtain fair value for intellectual property. Patent owners often encounter situations, as Rembrandt has, in which a manufacturer is infringing a patent – directly or indirectly – and selling a product at a price that does not reflect the value of the intellectual property. Purchasers of the product may likewise infringe, reaping large profits by exploiting intellectual property not paid for. The patent owner is entitled to seek a reasonable royalty from the purchasers; however, an effort to obtain it may prompt the manufacturer – perhaps under pressure as a result of indemnification obligations – to file a declaratory judgment action asserting its willingness to pay a reasonable royalty on the sales of the articles.

In such circumstances, the manufacturer should be able to obtain a license at a cost that reflects the rights granted. A license may authorize the manufacture and sale of the patented invention, but not the purchaser's use; or the license may authorize both the manufacture and sale of the patented invention and the invention's use by the purchaser.

In many cases, the revenues derived from the purchaser's use of the invention far exceed the cost of the manufactured item. That difference will be reflected in the price of the license. Failure to recognize this distinction would substantially impair the value of the patented invention and grant a windfall to downstream infringers. It must be possible for the patentee to license the manufacturer to make and to sell, without necessarily granting a right for purchasers to use.

In instances where a potential infringer (whether a prospective manufacturer or user) seeks a license in advance, the parties should be permitted to fashion any agreement that is suited to the economic circumstances. (Indeed, there is broad agreement that legal enforcement of restrictions on use of patented articles is critical to economic efficiency, innovation, and growth. *See*, *e.g.*, IBM Br. 32-34; ASTA Br. 4 (consequences of refusal to enforce restrictions after sale "would be devastating"); BIO Br. 10, 21-34.) In some instances, the most efficient arrangement will include a royalty based on the value to downstream users. In other cases, it will make sense to agree that the manufacturer is licensed to make and sell only to customers that have entered into their own licenses with the patentee – an arrangement that Petitioners concede would be lawful. *See* Pet'rs Br. 51. And in still other instances it may make sense to authorize the manufacturer to sell but without conveying any license to downstream purchasers to practice the patent, leaving it to purchasers and the patent holder to negotiate separately. These are just three alternatives among the many that will be fashioned by those with the best information – the parties to the negotiation.

SUMMARY OF ARGUMENT

I. A. Sale of a patented article is conceptually distinct from the grant of a license to practice the patent by using the article sold, as this Court has recognized. It is fully *consistent* with the characteristics of the rights granted by Congress that a patent holder may sell (or authorize sale of) a patented article while retaining rights to exclude certain uses. The claim that the exhaustion doctrine reflects "inherent limits" on the patent grant is wrong. *Absent legal restrictions*, patent rights are freely divisible.

B. This Court's precedents recognize that a patentee (or its licensee) may make an authorized sale while retaining the right to exclude one or more uses of the patented article. *See Mitchell v. Hawley*, 83 U.S. (16 Wall.) 544, 547 (1873); *see also Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).

The cases upon which Petitioners and supporting *amici* rely establish two propositions, both of which are fully consistent with the continued vitality of *Mitchell*. *First*, when a patentee makes (or authorizes) a sale without explicit restrictions on use, no such restriction will be implied. *See Keeler v. Standard Folding-Bed Co.*, 157 U.S. 659 (1895); *Hobbie v. Jennison*, 149 U.S. 355 (1893); *Adams v. Burke*, 84 U.S. (17 Wall.) 453 (1873). *Second*, when a patentee imposes a restriction that seeks unlawfully to extend the scope of the patent grant, that restriction will be disregarded. *See United States v. Univis Lens Co.*, 316 U.S. 241, 251 (1942); *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917). The Federal Circuit's decision follows both principles.

As Respondent shows, an expansion of exhaustion doctrine would be needed to find exhaustion here, and that makes no sense: both Congress and this

Court have eliminated legal restrictions on efficient contractual arrangements under both patent and antitrust law, reflecting the recognition that arrangements that were previously thought harmful are, in fact, often efficient or benign. *See* 35 U.S.C. § 271(d)(5); *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007); *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006). Those developments directly undermine the very decisions on which Petitioners principally rely, *Univis* and *Motion Picture Patents*, to restrict contracting freedom.

II. A. As a matter of policy, a prohibition on otherwise lawful restrictions on use after authorized sales would be misguided. Because invention and innovation are critical to economic growth, Congress, to stimulate inventive and innovative activity, has granted inventors a right to exclude others from using an invention for a period of time. The economic value of a patent is measured by the marketplace's choice of the patented invention over available alternatives. Economic analysis demonstrates that vertical arrangements dividing permissible uses of the invention do not generally allow a patentee to earn more than the economic value of the patent; such arrangements do not *extend* the scope of the patent, but do help to secure to inventors the full value of their inventions. *See* Ward S. Bowman, Jr., *Patent and Antitrust Law: A Legal and Economic Appraisal* (1973).

Exhaustion doctrine reflects a presumption that an authorized sale of a patented article conveys an unrestricted license to use the article. But allowing private parties to contract around such presumptions respects individual liberty and autonomy and promotes efficient allocation of resources. *See id.*; Frank H. Easterbrook, *Contract and Copyright*, 42 Hous. L. Rev. 953 (2005); Richard A. Epstein, "*ProCD v. Zeidenberg*: Do Doctrine and Function Mix?," *in Contract Stories* 94 (D. Baird ed., 2007). Prohibiting (or complicating) such contracting-around leads to inefficiency and increased transaction costs.

B. The claim that an exhaustion *rule* – rather than an exhaustion *presumption* – is required to protect against abuses is empirically unsupported and unpersuasive. Many of these arguments are based on hostility to patent rights. Such hostility is not only contrary to the will of Congress but also offers no principled basis for adopting Petitioners' exhaustion rule, which would create arbitrary distinctions involving the role of the patent in a particular industry, the structure of the industry, or the organization of particular firms.

ARGUMENT

I. THE PATENT STATUTE AND THIS COURT'S PRECEDENTS PERMIT AUTHORIZED SALES SUBJECT TO CONDITIONS ON USE

Petitioners and supporting *amici* argue that patent law maintains a sharp distinction between conditions that a patentee may attempt to place on a title-transferring sale of a patented article – which are invalid – and conditions placed on a mere license to use – which are enforceable through the patent law. *See* Pet'rs Br. 28; U.S. Br. 15. This purely formalistic distinction makes no sense in any relevant policy terms and misreads this Court's precedents.

A. Because Patent Rights Are Distinct from "Patented Articles," Claims that Patent Exhaustion Reflects "Inherent Limits" on the Patent Grant Are Confused and Circular

1. The statute defines a patent as a right to exclude others from practicing a patented invention. *See* 35 U.S.C. § 154(a)(1). The patent is thus a right to prevent others from engaging in enumerated activities, not a claim to ownership of any thing. Furthermore, the patented "invention" itself is not a *tangible* thing but a "new and useful process, machine, manufacture, or composition of matter," *id.* § 101 – that is, a conception or idea (of a particular kind) that exists apart from any particular exemplification or embodiment.

The sale of an *article* thus does not, as a definitional matter, convey or otherwise surrender any patent rights except as such license is included, implicitly or explicitly, in the sale of the article. *See* U.S. Br. 9 (acknowledging that exhaustion depends on a theory of implied license). It is thus an error to conflate the purchase of an *article* with the purchase of *rights to practice a patent*. One of Petitioners' *amici* argues that, when one "*buys* [a] patented invention," the "invention that he purchased 'becomes his private individual property.'" Gen-Probe Br. 13. This is wrong. The "patented invention" is the idea or conception, and it is not (and cannot be) sold. The sale of an article conveys title to the article. It is an analytically separate question whether the seller conveys a license to practice any particular patent.

As Thomas Reed Powell explained "with characteristic lucidity"[2] 90 years ago:

> When the patentee sells a patented machine, he does not sell his right to exclude others from the use of the invention. The purchaser . . . acquires title to the machine. This title passes by the law which governs the sale of chattels, the law of the state. This law permits one who by purchase becomes owner of a machine to use it in any way not forbidden by that law. But such right of use[] is in conflict with the right of the patentee to exclude others from all use of the invention.

Thomas Reed Powell, *The Nature of a Patent Right*, 17 Colum. L. Rev. 663, 666 (1917).

This does not mean that there is no patent exhaustion doctrine: when a patentee sells a patented machine without any conditions, "he must be assumed to consent that the right to use the machine shall be governed by the law of the state." *Id.* That is a sound *presumption*, reflecting the reality that, in

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[2] William F. Baxter, *Legal Restrictions on Exploitation of the Patent Monopoly: An Economic Analysis*, 76 Yale L.J. 267, 276 (1966).

a typical case, "[t]he reward [the patentee] has demanded and received is for the article and the invention which it embodies and which his vendee is to practice upon it." *Univis*, 316 U.S. at 251. But, absent legal constraints, there is no reason that a patentee cannot sell an article – convey title – while retaining patent rights to exclude practice of the patent, by the purchaser or by anyone else, with the price reflecting any such conditions. *See* Powell, 17 Colum. L. Rev. at 666.

This Court has recognized "the distinction between the property right in the materials composing a patented machine, and the right to use for the purpose and in the manner pointed out by the patent." *A.B. Dick*, 224 U.S. at 24.[3] "The latter may be and often is the greater element of value, and the buyer may desire it only to apply to some or all of the uses included in the invention. *But the two things are separable rights*." *Id.* (emphasis added).[4]

2. Petitioners argue that, "when a patented invention 'passes to the hands of the purchaser,' it 'passes outside' the scope of the patentee's rights,"

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[3] As noted below, *see infra* p. 15, while *A.B. Dick*'s approval of a tying condition was overruled, its conceptual underpinnings have not been.

[4] For this reason, the suggestion that Petitioners' exhaustion rule gains support from the common-law distrust of servitudes on personal property, *see*, *e.g.*, Pet'rs Br. 46-47, is likewise incorrect. Such a servitude would arise if the owner of personal property sold it while purporting to retain some interest based on prior ownership. *See generally* Glen O. Robinson, *Personal Property Servitudes*, 71 U. Chi. L. Rev. 1449 (2004). The issue presented here is quite different, because the general power of a patentee to retain certain rights under a patent while surrendering others – for example, by granting restricted licenses – is unquestioned.

Pet'rs Br. 16 (quoting *Bloomer v. McQuewan*, 55 U.S. (14 How.) 539, 549 (1853)), a rule that supposedly "stems from *inherent limits* on the grant of the patent right," *id.* at 26 (internal quotation marks omitted, emphasis added). But any limitations on a patentee's ability to retain patent rights on sale of a patented article would reflect judicially imposed limitations on private arrangements regarding patent rights, *not* any restriction "inherent" in the statutory grant.

To the contrary, it is *consistent* with the nature of patent rights that they can be retained (in whole or in part) upon the sale of a patented article. The rights granted by Congress are protected as *property*, *see* 35 U.S.C. § 261; the defining characteristic of property rights is that they are subject to free-market exchange and parceling out. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1092 (1972). Petitioners seek to create, instead, a rule of inalienability – to assign a right to purchase a patented article free of conditions on use that *cannot be modified by agreement*. *See id.* at 1092-93. There is no justification for doing so.

B. This Court's Precedents Are Inconsistent with an Inflexible Rule of Patent Exhaustion on Authorized Sale

The primary argument of Petitioners and the government is that this Court's prior decisions mandate an inflexible exhaustion rule. That is incorrect.

1. This Court has recognized that a licensee may make an authorized sale of a patented article without "exhausting" the right to exclude the purchaser from some uses of the article, thus recognizing that sale of a patented article is both distinct and divisible from the granting of an exhaustive patent license. *See also* IBM Br. 14 ("[T]he Court has . . . recognized, for over a century, an exception to exhaustion where there is an express agreement limiting the licensee's or purchaser's rights under a patent.").

In *Mitchell v. Hawley*, the patentee (Taylor) conveyed to a licensee (Bayley) the right, during the original patent term, to make and to use, and to license others to make and to use, a hat-making machine, the use of which was covered by Taylor's patent. The licensee "sold the machines," and also executed to the purchasers a license to use the machines, *limited to the original patent term*. 83 U.S. at 549. After the patent was extended and use continued after expiration of the original term, the patent owner sued the current owners of the machines for infringement. The defendants argued that "they are by law authorized to continue to use the four machines just the same under the extended letters-patent as they had the right to do under the original patent, when the purchase was made." *Id.* at 549-50.

The Court rejected that defense, holding that the original purchasers "never acquired the right to sell the machines and give their purchasers the right to use the same . . . beyond the term of the original patent." *Id.* at 550. There was no lack of authorization to sell the items, but only lack of authorization to give the extended-use right. *See id.* at 551 (original purchasers had no "power to sell a machine *so as to withdraw it indefinitely from the operation of the franchise secured by the patent*") (emphasis added). *Mitchell* thus makes clear that, so long as the terms of the conveyance are clear, a sale of an article need not lead to surrender of all rights to exclude use of the article. *See also* Bowman at 143.

This understanding was confirmed by the Court in *A.B. Dick*, which reaffirmed the underlying principles:

> The question argued . . . was there, as here, that by a sale of the machines "they were taken out of the reach of the patent law altogether, and that as long as the machines themselves lasted, the owner could use them." For the patentee it was urged that "the right to make and use and to license others to use was expressly limited by apt words, showing clearly an intent that it should not survive the original term of the patent." This latter was the argument that prevailed.

224 U.S. at 22.

Petitioners now argue that *Mitchell* dealt with a "conditional sale," that is, where the seller does not part with title until the buyer performed a condition precedent. Pet'rs Br. 19. That assertion is unsupported and incorrect, contradicting not only the language of *Mitchell* but also Petitioners' own statements. *See*, *e.g.*, Cert. Pet. 10-11 (acknowledging that "defendants had *bought* patented machines" but that, "because the licensee had no title or authority *to grant any right to use the patent* beyond the original term, *purchasers* from him could not have acquired such a right") (emphases added); *see also A.B. Dick*, 224 U.S. at 21 ("The force and bearing of [*Mitchell*] cannot be escaped by suggesting that the court was referring to mere common-law contractual conditions, for the suit was to restrain infringement by the use of four machines which had been sold, *not leased*."); 2 William C. Robinson, *The Law of Patents for Useful Inventions* § 824, at 617-24 (1890) (recognizing that, under *Mitchell*, a condition can prevent loss of patent rights on sale).[5] Moreover, if there were no authorized sale in *Mitchell*, the dissent in *A.B. Dick* surely would have mentioned that fact.

The attempt to distinguish *Mitchell* as limited to conditional sales also runs headlong into *Straus v. Victor Talking Machine Co.*, 243 U.S. 490 (1917), and Justice Holmes' dissent in *Motion Picture Patents*. *Straus did* involve a conditional sale, *see* 243 U.S. at 495, as Justice Holmes expressly noted, *see* 243 U.S. at 520-21, yet that did not save the license restrictions or prevent the court from concluding, given the absence of any *valid* restriction on the right to use, that the case "falls within the principles of Adams v. Burke." *Straus*, 243 U.S. at 501.

2. The cases on which Petitioners rely stand for two propositions. *First*, where a patentee sells an article free of explicit restrictions on use, or where a licensee is authorized to make a sale and no restriction is placed on the licensee's conveyance of patent rights, the patentee thereafter surrenders the right to exclude others from use or resale of the article – courts will not *imply* any restrictions on use or resale of a patented article after an authorized sale. *Second*, a patentee may not improperly expand the scope of patent rights by placing restrictions on use that are substantively unlawful, for example, because they would impose an unlawful restraint of trade.

a. *Adams v. Burke* involved the sale of a coffin lid by a licensee in the Boston area; the purchaser

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[5] The government claims that *Mitchell* involved an unauthorized sale, *see* U.S. Br. 16-17, but it has no evidence for that characterization. There was no restriction on sale of the patented article; the restriction was on the nature of the license that could be granted to the purchaser.

transported the lid to Natick, and the assignee sued the purchaser for infringement. The license authorized manufacture, sale, and use of the lids only in the Boston area (not in Natick); the Court held that, because the *sale* had been made within the authorized territory, there was "no restriction on . . . *use* to be *implied* for the benefit of the patentee" where such a "limitation upon the right of use [was] not contemplated by the statute nor within the reason of the contract." 84 U.S. at 456-57 (second emphasis added). The case thus establishes the principle that an authorized sale conveys an unrestricted right to use *in the absence of any contrary agreement*.

This principle was applied in *Hobbie* and *Keeler*. In *Hobbie*, a licensee made a sale within its assigned territory, knowing the material would be used outside of that territory; the Court held that there was no infringement because "the defendant . . . had a right, under the patent, to make, use, and vend the patented article in the state of Michigan, and the article was lawfully made and sold there." 149 U.S. at 363. The Court noted, however, that a patentee has the power to "impos[e] conditions which will prevent any other licensee or assignee from being interfered with" but that "[t]here is no condition or restriction in the present case in the title of the defendant." *Id.* at 363-64. In *Keeler*, the facts were comparable; again, the Court had no occasion to consider "[w]hether a patentee may protect himself and his assignees by special contracts brought home to the purchasers." 157 U.S. at 666.[6]

[6] The Court did not limit its qualification to contracts *with* the purchasers but included contracts "brought home to" the purchasers – *i.e.*, of which purchasers are made aware. *Cf.*, *e.g.*, *Clune v. United States*, 159 U.S. 590, 592 (1895) (noting that

b. As noted above, a patentee's ability to reserve rights to exclude upon authorized sale of articles was affirmed by the Court in *A.B. Dick*. That case was, of course, held to be overruled in *Motion Picture Patents*, *see* 243 U.S. at 518, but the basis for the overruling was narrow – leaving untouched the principle that a patentee may continue to enforce use restrictions that are otherwise permissible. Instead, *Motion Picture Patents* rested on the holding that the license restriction – which required use of unpatented materials (films) acquired from the patentee – unlawfully expanded the scope of the patentee's rights beyond the specific patented mechanism. *See id.* at 512-13, 516. The Court derived additional support for its conclusion from the terms of the recently passed Clayton Act, which prohibits tying arrangements "where the effect of such [arrangement] . . . may be to substantially lessen competition or tend to create a monopoly in any line of commerce." *Id.* at 517 (internal quotation marks omitted).

As discussed below, the rationale of *Motion Picture Patents* has been disapproved by Congress and this Court. But the critical point is that its elaborate discussion of the scope of the patented invention – its supposed inapplicability to unpatented materials used with the patented machine – would have been unnecessary if, as Petitioners urge, *any* restriction on use after sale were prohibited. *Motion Picture Patents* stood for the proposition (now disapproved) that a tying restriction unlawfully expands the scope of a patent, but it did not even discuss *Mitchell* or the broader analysis in *A.B. Dick*, because it did not con-

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"telegrams of this character, if identified and *brought home to* the defendants, were obviously circumstances tending to show [a] conspiracy") (emphasis added).

sider any restriction that would (as the Court understood the concept) fall within the patent grant.[7] *See United States v. General Elec. Co.*, 272 U.S. 476, 493 (1926) ("The overruling of the Dick Case was based on the ground that the grant of the patent was of the exclusive right to use the mechanism and produce the result with any appropriate material and that the materials or pictures upon which the machine was operated were no part of the patented machine, or of the combination which produced the patented result."); Powell, 17 Colum. L. Rev. at 685-86 ("It seems clear that . . . the reversal of the Dick case does not impugn the authority of the earlier decisions sustaining the validity of restrictions on time, place and purpose of use.") (footnote omitted).[8]

c. The best case for Petitioners is *Univis*, which employs broad language in holding that a restriction on resale prices charged by licensees was not made enforceable under the patent law if unlawful under the antitrust laws. *See* 316 U.S. at 249-52. But the case should not be read to resolve the question presented here because (1) it does not address *Mitchell*; (2) the Court was faced with a vertical price-fixing

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[7] Likewise, *Straus* disapproved an arrangement that sought to condition a license on compliance with the patentee's resale price maintenance scheme. Finding that "th[e] plan of marketing . . . is, in substance, the one dealt with by this court in Dr. Miles Medical Co. v. John D. Park & Sons Co. 220 U.S. 373 [(1911)]," 243 U.S. at 498, the Court refused to give effect to the condition, bringing the case within the rule of *Adams*, *see id.* at 501.

[8] Powell's detailed discussion of *Motion Picture Patents* did not even perceive the case to articulate any exhaustion principle and (correctly) read the case as concerning solely the question whether a patentee could permissibly grant a license subject to a tying arrangement.

agreement that had already been held unlawful in *Straus* and other cases; and (3) the Court found that "the *entire consideration and compensation* for *both* [the articles sold and the license to practice the patent] is the purchase price paid by the finishing licensee to the Lens Company." *Id.* at 249-50 (emphases added). The Court understood that any restriction on retail prices was unrelated to securing additional reward to the patentee. The Court therefore did not consider a case in which a patentee agreed to accept reduced payment from a manufacturing licensee in exchange for a limited license after sale. In short, the result in *Univis* is fully consistent with the principle that patent exhaustion is simply an implied license that is subject to modification by *otherwise lawful* contracts.

3. The reliance on *Motion Picture Patents* and *Univis* – to achieve the *extension* of exhaustion doctrine needed to embrace this case – is all the more misplaced because the legal foundation on which those cases rest has been swept away by subsequent congressional enactments and decisions of this Court. *Motion Picture Patents* and *Univis* reflect hostility to vertical arrangements that were perceived to "extend" the exclusionary power of a patent. But modern patent and antitrust rules reflect the recognition that vertical agreements generally do not "extend" a monopoly and frequently promote efficiency.

First, the hostility to tying arrangements that underlay *Motion Picture Patents* has given way to the rule that tying is subject to judicial scrutiny only where the defendant has actual market power. Congress specifically established this rule in the patent context by enacting 35 U.S.C. § 271(d)(5), which provides that tying will not constitute patent misuse unless "the patent owner has market power in the relevant market for the patent or patented product." As this Court recognized in *Illinois Tool*, that provision overruled the line of patent misuse cases that stemmed from *Motion Picture Patents*. *See* 547 U.S. at 38 ("[a]lthough *Motion Picture Patents Co.* simply narrowed the scope of possible patent infringement claims, it formed the basis for the Court's subsequent decisions creating a patent misuse defense"). And *Illinois Tool* ruled, in the antitrust context, that tying of unpatented products to patented articles generally raises no competitive concerns.

Second, the Court held in *Leegin* that resale price maintenance agreements are to be judged under the antitrust rule of reason. This means, as a practical matter, that such agreements are usually legal in cases where the relevant market actor lacks market power. *See Leegin*, 127 S. Ct. at 2720. That recognition eviscerates the policy rationale undergirding *Univis* and *Straus*.

Third, and more broadly, there has been a sea-change in judicial approaches to vertical agreements, which has led to substantial reform of patent misuse law and antitrust law. For more than half a century, courts viewed vertical integration and vertical contracts with deep suspicion. As Ward Bowman commented in 1973: "The courts, and particularly the Supreme Court, . . . have with increasing strictness contracted the scope of permissible patent use and expanded the definition of patent misuse. And this has paralleled increasingly stringent antitrust law relating to vertical contracts." Bowman at 240. In both areas, however – misuse and vertical restraints – Congress and the Court have eliminated limitations on potentially beneficial vertical agreements.

See, *e.g.*, Act of Nov. 19, 1988, Pub. L. No. 100-703, § 201, 102 Stat. 4674, 4676; Antitrust Modernization Commission, *Report and Recommendations* 36-37 (Apr. 2007) ("During much of the twentieth century, the courts, antitrust enforcers, and antitrust practitioners viewed intellectual property with deep skepticism. . . . The influence of economic learning about the competitive benefits of intellectual property and the potential efficiencies of intellectual property licensing and other conduct reversed this trend."); U.S. Dep't of Justice & Federal Trade Comm'n, *Antitrust Guidelines for the Licensing of Intellectual Property* § 2.0, at 2 (Apr. 1995) ("1995 IP Licensing Guidelines") ("intellectual property licensing . . . is generally procompetitive"); *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977); *cf.* 6 Donald S. Chisum, *Chisum on Patents* § 19.04[3], at 19-453 (2005) ("[W]hat acts will be viewed as constituting misuse will shift with corresponding shifts in antitrust policy.").

The same considerations should lead the Court to cabin the over-broad dicta in *Univis*. The exhaustion rule that Petitioners advocate is a *per se* rule of unenforceability for vertical agreements to allocate patent rights when those agreements accompany an authorized sale. But, as this Court has recognized, *per se* prohibitions must be adopted with caution. *See Leegin*, 127 S. Ct. at 2713; U.S. Dep't of Justice & Federal Trade Comm'n, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition* 88 (Apr. 2007) ("2007 Report") (noting, with regard to patent licensing practices, that "applying simple rules to broad classes of behavior can risk great inefficiency"). Because Petitioners' rule would deny legal effect to parties' preferred allocation of patent rights, it could be justified only if there were no legitimate reason for such arrangements and if they almost always produced harmful results. That is not the case.

II. ALLOWING PARTIES TO CONTRACT AROUND THE PRESUMPTION OF EXHAUSTION IS GOOD POLICY

As even its proponents acknowledge, Petitioners' exhaustion rule would make the enforceability of private agreements to allocate patent rights depend on whether a particular restriction could be effected through a conditional license (presumptively permitted) or a conditional sale (prohibited). This makes no policy sense.

A. Like Other License Restrictions, License Restrictions Accompanying Sales of Articles May Promote Efficient Exploitation of the Patented Invention

1. Both *Univis* and *Motion Picture Patents* are products of a past attitude of judicial hostility to patent rights grounded in the perception that "patents are privileges *restrictive of a free economy*." *United States v. Masonite Corp.*, 316 U.S. 265, 280 (1942) (emphasis added).[9] That understanding of patent law was dismantled first by economists and legal scholars and then by government policymakers and the courts. As Yale Law Professor and economist Ward Bowman observed, patent law, like antitrust law, has as its "central economic goal . . . *to maximize wealth by producing what consumers want at the lowest cost*." Bowman at 1. Bowman's analysis – which has been praised as "so good and so definitive"

[9] This is a theme that is resuscitated by many of Petitioners' *amici*. *See*, *e.g.*, Dell Br. 3-4.

that it leaves "nothing more to say"[10] and which provided the intellectual underpinnings for the government's patent-related antitrust policy[11] – begins from the premise that the congressional decision to grant patent rights reflects its judgment that allowing patentees to reap the value of their invention will encourage an appropriate level of investment in innovation. *Id.* at 53. Investors will not provide the capital needed for testing, manufacturing, marketing, and distribution of new inventions unless they know that they have adequate patent protection.

The value of the right to exclude others from practicing the patent is measured by the competitive superiority of the patented invention over available substitutes. An arrangement involving patent rights is thus within a patent's scope when "the reward to the patentee comes from advantage ascribable to the patent rather than from another source not deserving of monopoly protection." *Id.* at 54.

Bowman concluded that "vertical contracts – which patentees make with licensees for the purpose of 'restricting' the use licensees may make of the patent under the terms of the license . . . [–] are not monopoly-extending." *Id.* at 55. Rather, such arrangements help the patent owner to realize the full value of the patent right granted by Congress. *Id.* at 55-56. His analysis shows that licensing restrictions

> can lead to resource allocation in which both the patentee and the community can be expected to

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[10] Robert H. Bork, *The Antitrust Paradox* x (1978).

[11] *See* Willard K. Tom & Joshua A. Newberg, *Antitrust and Intellectual Property: From Separate Spheres to Unified Field*, 66 Antitrust L.J. 167, 173 (1997) (crediting Bowman with "profoundly influenc[ing] the perspective of the 1995 [IP Licensing] Guidelines").

> be richer, not poorer, than if these practices were proscribed. Imposing conditions on licensees, in the absence of collusion with competitors, predictably leads to results which compel a conclusion that the public interest would *not* be fostered by repressing rather than supporting a patentee's freedom to exploit by noncollusive means, in his self-interest.

Id. at 61-62.

This insight underlies the 1995 IP Licensing Guidelines, which note that "[f]ield-of-use, territorial, and other limitations on intellectual property licenses may serve *procompetitive* ends by allowing the licensor to exploit its property as efficiently and effectively as possible." § 2.3, at 5 (emphasis added); *see also* 2007 Report at 87 ("[t]he vast majority of licensing restraints can be expected to contribute to an efficiency-enhancing integration of economic activity") (internal quotation marks omitted).

2. The considerations that have led antitrust enforcement authorities to conclude that licensing restrictions are "generally procompetitive," 2007 Report at 87, likewise favor giving effect to licensing restrictions that accompany sales of patented articles. Like any other license restriction, a license restriction on sale is simply "an explicit refusal of a patentee to permit particular use in time or place" that is presumptively efficiency-enhancing. Bowman at 146. There is "no convincing economic rationale for denying such rights to patentees." *Id.*

To the contrary, the *A.B. Dick* case provides a good illustration for why use restrictions accompanying a sale can be economically useful.[12] The defendant manufactured patented mimeograph machines; the value of the patented invention to individual purchasers would naturally depend in part on how intensively the purchaser used the machine. By conditioning a license to use the machine on purchase of ink from the patentee, the patentee was able to make the machine available at a low price to a broad spectrum of users (including to those who would use it only a little), while earning the value of the patent from sales of ink and other supplies (thus recovering more from those using the machine more). Without the ability to price discriminate in this way, not only would the patentee be worse off, but society (and many consumers) would be worse off as well, because, at a higher (uniform) price, fewer mimeograph

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[12] By contrast, *Motion Picture Patents* is unpersuasive. The Court's main concern seemed to be that the patentee had already reaped enough reward:

> Assuming that the plaintiff has been paid an average royalty of $5 on each machine sold, . . . it has already received over $200,000 for the use of its patented improvement, which relates only to the method of using the films which another had invented, and yet it seeks by this device to collect . . . what would doubtless aggregate many times this amount . . . .
>
> A restriction which would give to the plaintiff such a potential power for evil over an industry which must be recognized as an important element in the amusement life of the nation . . . is plainly void . . . .

243 U.S. at 518-19. Such an *ipse dixit* judicial declaration of what reward to a particular patentee is fair is inconsistent with the principle that the patent system is a *market*-based system, in which the value of a patented invention is measured by what users are willing to pay for it. *See* Bowman at 54. It is no surprise that *Motion Picture Patents* has been effectively overruled legislatively and by this Court.

machines would be produced and many consumers that would otherwise be able to purchase them would have to do without.

The suggestion that "the first purchaser will be willing and able to pay an amount sufficient" to reward the patentee full value of the patented invention, Dell Br. 9, reflects not economic principle but wishful thinking combined with lack of imagination. To cite one example, recovery from the first purchaser may be totally impractical where there is an established market based on infringement, with prices that do not reflect the value of a patentee's intellectual property. More generally: markets, but not courts, can be relied on to identify efficient arrangements.[13]

A similar analysis applies to the single-use-only restriction in *Mallinckrodt*. The value to a hospital-purchaser of the patented invention is likely to be related to the intensity of use of the patented article (a medical device known as a nebulizer). If a hospital were able to re-use the device, the patentee might well have to increase the price of the device to recover the value of the invention. As even critics of *Mallinckrodt* acknowledge, it is possible that recycling of the devices was *inefficient* – more costly than producing a new one – but that a recycler could still undersell the patentee because its price did not include the value of the intellectual property. *See* Richard H. Stern, *Post-Sale Patent Restrictions After* Mallinckrodt – *An Idea in Search of Definition*, 5 Alb.

[13] Petitioners argue that "patentees are not entitled to more powerful price discrimination tools than are available to ordinary sellers." Pet'rs Br. 50. But of course they are: they are given a right to exclude and to grant restricted licenses to practice the patent.

L.J. Sci. & Tech. 1, 11 (1994). This sort of "Robin Hood-ism," *id.* – rules set up to transfer wealth, in this case from inventors to those who wish to exploit their inventions – is highly suspect. *See* Easterbrook, 42 Hous. L. Rev. at 969 ("As long as price terms remain open, judicial adjustment of contracts' terms will make consumers worse off. Judges cannot redistribute income from producers to consumers[.]"); Epstein, *ProCD*, at 106 ("At this point, the contract analysis has a different form of urgency, which is to make sure that efficient contractual provisions are not routinely left on the cutting room floor.").[14]

3. It is no answer to these points to argue, as Petitioners and the government do, that many efficient restrictions may be imposed in other ways, either by altering the form of the restrictions included in contracts with manufacturing licensees or by erecting elaborate systems of contracts. *See* Pet'rs Br. 28-29, 48; U.S. Br. 29. If the substance of the restrictions is benign, Petitioners bear a heavy burden of explaining why patentees and their licensees should not be able to achieve them in the way that is clearest and most straightforward. Petitioners' exhaustion rule would increase the costs of achieving desired allocation of property rights. Such costs are "pure deadweight losses, for there are no analogous costs generated under the freedom of contract alternative." Richard A. Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. Cal. L. Rev. 1353, 1361 (1982).

Moreover, Petitioners' exhaustion rule would create arbitrary distinctions among patents and patent-

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[14] The same analysis applies to *Static Control Components, Inc. v. Lexmark International, Inc.*, 487 F. Supp. 2d 830 (E.D. Ky. 2007).

ees depending on the nature of the patent and the organization of the relevant firm. In the *Univis* case, for example, the patentee presumably chose a distribution structure that reflected its belief that certain steps in the process of producing prescription lenses (and finished eyeglasses) could best be performed by unaffiliated businesses with the arrangements between them governed by contract. *See generally* Ronald H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937). But resale price maintenance was also sufficiently important to the patentee that it licensed *all* downstream distributors of its lenses, at the wholesale and retail level, to ensure that its pricing scheme would be maintained. *See* 316 U.S. at 244-45. If the refusal to enforce the license restriction was sufficiently costly to Univis, it could be induced to integrate downstream into wholesale grinding and even retail distribution, in which case there would be no issue as to its ability to set the price for the patented article.

More generally, the value of a patent should not depend on whether it is licensed to an integrated manufacturer/user rather than to a manufacturer that sells the article to a downstream user. Yet, as a practical matter, Petitioners' exhaustion doctrine would treat the two situations as fundamentally different by allowing licensing restrictions in the first situation that are categorically prohibited in the second. Thus, refusal to respect parties' private ordering not only prevents business arrangements that are in themselves efficient, but may induce patentees to create inefficient structures to avoid the arbitrary impact of an inflexible doctrine. *See Leegin*, 127 S. Ct. at 2722-23.

In sum, while Petitioners would claim "that they want to simplify market transactions, not destroy market choices, . . . they provide no practical or principled basis for distinguishing between the two." Robinson, 71 U. Chi. L. Rev. at 1488.

4. All of this discussion supports a more general point, which is that it serves the interests of both economic efficiency and respect for individual autonomy to give effect to private agreements allocating property rights. What Judge Easterbrook has written with respect to copyright applies, as he notes, to all forms of intellectual property:

> Does anyone really believe that one single allocation of rights to produce and use works best for movies, records, books, architectural plans, photographs, software, and so on? The domain of copyright is vast. The most anyone can hope for in a law is to create a framework – that is, to endow authors with a set of property rights – and let people work out the details for themselves. This is of course the fundamental point in Ronald Coase's essay The Problem of Social Cost, nicely amplified by Calabresi and Melamed in Liability Rules and Property Rules.

Easterbrook, 42 Hous. L. Rev. at 961. To be sure, any system of intellectual property must create an initial system of entitlements – for example, the judicially created entitlement on the part of a purchaser of a patented article to use it without infringing the patent is a sensible one. But

> [w]e must bear in mind *the high possibility of error in the original specification of entitlements* . . . . The risk of error should lead to initial assignments *that are easy to reverse, so that*

people may find their own way with the least interference.

Id. at 971 (emphases added).

The award of patent rights strikes a balance between "the need to encourage innovation and the avoidance of monopolies which stifle competition," *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989), but "the key function of property rights is to create the baseline from which voluntary transactions can take place. It is not . . . to block further voluntary transactions." Epstein, *ProCD*, at 121. "[O]ne traditional argument for both freedom of contract and private property is that they define domains in which individuals may establish both the means and the ends for themselves, to pursue as they see fit (so long as they do not infringe upon the rights of third parties)." Epstein, 55 S. Cal. L. Rev. at 1359. An agreement to purchase a patented article subject to limitations on patent rights should be enforced unless "some very strong reason [is] advanced" for outlawing that arrangement. *Id.*

B. No Legitimate Policy Rationale Supports Petitioners' Exhaustion Rule

The policy rationales offered by Petitioners and supporting *amici* are either unpersuasive or inapposite. *Mallinckrodt* has been the law for 15 years, yet Petitioners and supporting *amici* provide no empirical evidence – or even any examples to show – that the contractual freedom that *Mallinckrodt* upholds has produced any untoward result in the real world. Indeed, in the FTC's comprehensive 2003 analysis of patent-law issues, it made no mention of any exhaustion-doctrine problem, though *Mallinckrodt* had by then been governing law for more than a decade. *See* Federal Trade Comm'n, *To Promote*

Innovation: The Proper Balance of Competition and Patent Law and Policy (Oct. 2003).

1. *Transaction Costs*: Petitioners and the government argue that their exhaustion rule will reduce transaction costs, because patentees will be encouraged to obtain full royalty from the first purchaser of a patented article, thus avoiding the need to negotiate licenses with subsequent purchasers. *See* Pet'rs Br. 49; U.S. Br. 27. This makes no sense. Patentees and first-level licensees are well motivated to establish full royalties at that level, *i.e.*, by including no restriction on use rights accompanying a sale, where it is efficient to do so. The Court's *presumption* that patent rights are exhausted on first sale makes perfect sense: it would be foolish to require parties affirmatively to negotiate a separate license upon sale of patented articles. But where the parties *do* affirmatively alter this presumption through private agreement, they have done so because it would have been *more* costly or difficult to attempt to negotiate a single license. The case of an established market built on a pattern of infringement is one example: where existing prices do not reflect the value of a patented invention, it may be more onerous to restructure the established pricing pattern than to negotiate licenses at more than one level.[15]

[15] There are many more reasons why an upstream manufacturer may be unable or unwilling either to determine the value of the patented invention to the downstream purchaser or to structure transactions in a way that effectively distinguishes between the value of the patent to different users. In this case, for example, Intel may have lacked information concerning the value of the invention to computer manufacturers or it may have been unwilling to gamble on uncertainty about arguments concerning validity and infringement. From the limited information that is available publicly, it appears that the transaction

The government suggests that a patentee might attempt to negotiate restricted licenses "down the chain of distribution, with no obvious stopping point," but, almost in the same breath, it acknowledges the implausibility of this suggestion. *See* U.S. Br. 27-28 & n.10. To negotiate a license agreement with an entity with which the patentee otherwise has no business relationship is costly; the expense of enforcing patent rights is likely much higher. An exhaustion rule is not required to give patentees an incentive to reduce transaction costs – that incentive is automatic.

2. *Antitrust Concerns*: Petitioners and the government suggest that allowing parties to contract around the exhaustion presumption will give rise to antitrust problems or "immunize" antitrust violations. *See* Pet'rs Br. 50-51; U.S. Br. 28-29. It is no accident that no illustration is offered. Though an agreement to allocate patent rights could violate the antitrust laws, the antitrust laws are available to address that possibility, as the government itself has affirmed. *See* 2007 Report at 6. But there is no explanation of how an allocation that is attendant on a sale of a patented article is any more likely to produce anti-competitive effects than any other type of patent-related agreement – to the contrary, such agreements are perhaps uniquely *un*likely to produce any such effects because they are invariably vertical arrangements. Consistent with the learning

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between Intel and Respondent was a complicated one that involved many patents (and perhaps other issues). There is no reason offered to explain why Intel and Respondent should be prevented from establishing patent peace *inter se* unless they also went the additional step of calculating the value of the patents to the downstream computer manufacturers that practiced them.

reflected in the last three decades of antitrust decisions, there is no basis for a blanket bar on vertical restrictions as a substitute for targeted analysis of particular restrictions.

3. *Consumer Protection*: Various *amici* suggest that, without a rigid exhaustion rule, consumers will either acquire products without the right to use them or lose other valuable entitlements such as the right to resell or the right to repair. *See* Consumers Union Br. 7, 9; AERA Br. 13-15. These arguments reflect a profound distrust of markets. If a patentee grants a license to manufacture and sell while retaining the right to exclude purchasers from use, the royalty will reflect the value of the rights granted, not others. If a patentee sells an article while retaining the right to exclude certain uses (or with limitations on use that limit the purchasers right to repair), the price of the article will reflect the limitation on the rights granted. *See* Epstein, 55 S. Cal. L. Rev. at 1360.

If there is any unfairness, it comes from awarding to the purchaser a right to practice a patent for which the purchaser did not pay. This case is illustrative: from all that appears, Intel did not pay for, and thus did not charge its customers for, any right to license its customers to practice Respondent's patents, leaving it to Petitioners and Respondent to resolve that issue. Petitioners were notified, and Intel presumably suffered loss of goodwill. That all of these costs were willingly incurred by both Respondent and Intel illustrates just how daunting the problem of contracting at a single level for the full value of the patents must have been.

4. *Information Costs*: Related to the transaction-cost argument is the claim that Petitioners' rule will lower information costs. *See*, *e.g.*, CCIA Br. 9. This is unfounded. In the case where a patentee sells a patented article, the default exhaustion presumption will ensure that, unless the customer is informed of any restriction on the license granted, the ordinary presumption of unfettered use applies. In the case of sales by licensees, an inflexible rule saves no information costs. There would be no presumption that the seller of an article would be granting a license to a patent that it did not own; the only way for the purchaser to determine whether the seller has a license is if the information is separately disclosed. Any such disclosure, however, could equally disclose any limitations. And, of course, that is precisely what happened here.[16] *See also* Robinson, 71 U. Chi. L. Rev. at 1486-87.

5. Petitioners' *amici* criticize the patent system and the Federal Circuit for their supposed overprotection of patent rights. *See*, *e.g.*, CCIA Br. 11-14; Dell Br. 20-22. The simple answer to these arguments is that they have nothing to do with this case. If there are problems with validity or infringement standards, they should be directly addressed. There is no principled reason to single out for condemnation limited licenses granted upon the sale of a patented article.

Dell argues that the exhaustion rule is justified because "the only situation in which respondent's strat-

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[16] Some suggest that, in the absence of an inflexible exhaustion rule, idiosyncratic restrictions will proliferate. *See* AAI Br. 22. Not so. *See* Robinson, 71 U. Chi. L. Rev. at 1486 ("[I]f the law allowed the creation of time-share interests in watches, it would have no more effect on the market for watches than releasing a sterile liger [a cross between a lion and a tiger] from the zoo into the wild would have on the gene pool of feline predators.").

egy makes sense . . . is when the patent owner asserts its claim *after* the target has made a significant investment in the alleged infringing technology." Dell Br. 14. This argument is shrewd, first, because it suggests that nothing legitimate is lost by adopting a rigid exhaustion rule and, second, because it taps into a sense that patent owners may profit unduly where their invention has already been commercialized. But the argument is wrong on both counts. *First*, as *A.B. Dick* and *Mallinckrodt* illustrate, restrictions on use may be imposed by a patentee or its licensee at the outset for pro-competitive reasons. *Second*, granting for the sake of argument that "lock-in" may occur, an exhaustion rule would do nothing to address it; it would simply place a premium on careful contract drafting and timing.

CONCLUSION

The court of appeals' judgment should be affirmed.

Respectfully submitted,

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