

## Will the Supreme Court Remove *Brulotte's* Shadow Over Patent Licensing?

### Part Two of a Two-Part Article

By Sean Gates and Jeny Maier

*Part One, last month, set the stage for a possible overruling by the U.S. Supreme Court of its 1964 ruling in Brulotte v. Thys Co. that the collection of royalties after a patent's expiration constitutes per se patent misuse by looking at the case's critics and its impact on licensing over the last 50 years. In Part Two, the authors continue that discussion and look at the arguments made to the Supreme Court for and against overruling the case.*

#### Hybrid Licenses

Courts have also struggled in dealing with post-expiration royalty provisions in so-called "hybrid" licenses — package licenses for issued patent rights and non-patent rights, such as trade secrets and know-how. The Eleventh Circuit, for instance, has held that a hybrid license constitutes misuse under *Brulotte* where: 1) the rights granted under the license agreement applied equally before and after the patents' expiration; and 2) the agreement required the licensee to pay royalties at the same rate and on the same basis both before and after the patents' expiration. See, *Pitney Bowes, Inc. v. Mestre*, 701 F.2d 1365, 1373 (11th Cir. 1983).

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The court, however, left open the question of whether a license agreement that allocates royalty payments between the patent rights and the trade secret rights would be enforceable. *Id.* at 1372 n.12 ("In light of our conclusion that the [agreement] violates federal patent law, and the fact that there is no allocation in the agreement, we need not decide whether allocation — of some similar provision — would have rendered it enforceable.") If a patent owner could prove that it did not use the patent monopoly to leverage payments after the patent expiration, then the agreement providing for continuing trade secret royalties could be enforced. *Id.* Other courts have applied this reasoning to hold that provisions in hybrid licenses that do not have a step-down in royalty rate after the patent expires are unenforceable. See, e.g., *Baladevon, Inc. v. Abbott Labs., Inc.*, 871 F. Supp. 89, 97 (D. Mass. 1994) (citing cases but noting that some compensation for non-patent rights may be appropriate to avoid unjust enrichment); *Sanford Redmond, Inc. v. Mid-America Dairymen, Inc.*, 29 U.S.P.Q. 2d (BNA) 1222, 1226 (S.D.N.Y. 1992) (citing *Pitney Bowes*); *Veltman v. Norton Simon, Inc.*, 425 F. Supp. 774, 776 (S.D.N.Y. 1977) (license agreement invalid where it failed to allocate royalties between patent and non-patent rights, and had no distinction between the pre- and post-expiration terms); see also, *Nordion Int'l, Inc. v. Medi-Physics, Inc.*, No. 95 C 1323, 1995 U.S. Dist. LEXIS 12639 (N.D. Ill. Aug. 29, 1995), where a license agreement for the use of the licensor's patent and technology called for royalty payments to be paid over a

five-year period. After the licensee made the third royalty payment, the patent was declared invalid and the licensee refused to pay any further royalties, contending it was illegal for the licensor to exact royalty payments after the patent was declared invalid. The district court agreed and held that a holder of an expired or invalid patent is prohibited from collecting royalties due after the patent was declared invalid. *Id.* at 14. The court explained that because the royalty was for both the patent and know-how, it should be considered a hybrid royalty, but because the agreement failed to attribute a specific portion of the royalty to the know-how rather than the patent, the court held that the entire provision was unenforceable. *Id.* (citing *Pitney Bowes*). Nevertheless, the court noted that the licensor may be entitled to compensation for the value of the know-how. *Id.* at 15.

#### Patent Applications

*Brulotte* also casts its shadow over licenses of pending patent applications. In *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979), the Supreme Court upheld an agreement that provided for perpetual royalties on sales of a product, then the subject of a pending patent application, at a specified rate if the patent issued and a lower royalty rate if the patent did not issue. The Court explained that the principle underlying the holding in *Brulotte* was "simply that the monopoly granted under a patent cannot lawfully be used to 'negotiate with the leverage of that monopoly,'" but, in this case, "the reduced royalty, which is challenged, far from being negotiated 'with the leverage' of a patent, rested on the contingency that

no patent would issue within five years.” *Id.* at 265 (emphasis in original) (quoting *Brulotte*, 379 U.S. at 33).

In cases concerning license agreements covering patent applications where the patent actually issues, however, courts have applied the *Brulotte* rule to conclude that agreements providing for post-expiration royalties are unenforceable. As the Sixth Circuit explained: “Once the pending patent issues, enforcement of royalty provisions for other rights which conflict with and are indistinguishable from royalties for patent rights, is precluded.” *Boggild v. Kenner Prods.*, 776 F.2d 1315, 1319 (6th Cir. 1985). The court thus held that the terms of a license agreement for patent applications calling for royalty payments after the expiration of the later-issued patent were unenforceable under *Brulotte* where the parties enter the agreement “with clear expectations that a valid patent will issue.” *Id.* at 1316. According to the Sixth Circuit, patent applications give the applicant bargaining power (or, in the language of *Brulotte*, “leverage”) just like issued patents but to a lesser extent. *Id.* at 1320-21 (“In our view, the same violations of patent law arising from abuse of the leverage attached to a pending or issued patent can arise from abuse of the leverage afforded by an expressly anticipated application for a patent. ... The terms of the licensing agreement compel the conclusion that, at the time the parties executed the license, the plaintiffs exerted considerable leverage from the anticipated patents”).

The Seventh Circuit similarly reasoned, “It is the issuance of the patent that triggers *Brulotte*’s application.” *Meehan v. PPG Indus., Inc.*, 802 F.2d 881, 885 (7th Cir. 1986). The court focused on the *ex ante* bargaining positions of the parties to the agreement:

Even when an inventor has not yet applied for a patent, the right to apply for and obtain those protections is valuable. Such a right places the inventor in a strong bargaining position. It is abuse of that leverage over which the Supreme Court expressed concern in *Brulotte*. *Id.*

The courts have thus treated licenses to patent applications in which a patent issues similarly to hybrid licenses. *Brulotte* may thus invalidate license agreements for patent applications providing for post-

expiration royalties if the agreement does not provide for a step-down for the post-expiration period or for the failure of the patents to issue. *See, Boggild*, 776 F.2d at 1321 (“As in *Brulotte*, the agreement contains neither provisions for reduction of royalties in the event valid patents never issued nor terms for reduction of post-expiration royalties. ... Therefore, under *Brulotte*, the agreement is unlawful *per se.*”); *Meehan*, 802 F.2d at 886 (“Under *Brulotte* when royalty payments extend unchanged beyond the life of a patent, patent leverage has been abused and is unlawful *per se.*”); *Pitney Bowes*, 701 F.2d at 1373. The necessity of coercion in such cases may depend on the circuit in which the case is brought. A license to a package of patent applications, however, may extend royalties out to the expiration of the last patent, even though the date of expiration is uncertain because the patent has not yet been issued. Similarly, a license that includes future improvements to an invention may also extend the royalty term to the expiration of any subsequently issued improvement patent, even if no application was filed for the improvement at the time of the license. *Zila, Inc. v. Tinnell*, 502 F.3d 1014, 1027 (9th Cir. 2007).

#### THE CASE BEFORE THE SUPREME COURT

The criticisms of *Brulotte* have now been placed before the Supreme Court in *Kimble v. Marvel Enterprises, Inc.* Recognizing these criticisms as “particularly apt,” the Ninth Circuit in *Kimble* nevertheless held that it was bound to follow *Brulotte*. The court therefore issued a halfhearted decision, which created the opportunity for the Supreme Court to consider whether *Brulotte* should finally be overruled.

*Kimble* concerns a long-running dispute between Stephen Kimble, the inventor of a patented toy that allows users to shoot foam string out of a glove, and Marvel Enterprises, the owner of the Spider-Man comic book franchise. In 1997, Kimble sued Marvel for patent infringement and breach of an oral contract, claiming that Marvel had developed a toy — the Web Blaster — that incorporated his patented idea and other ideas that Kimble had disclosed to Marvel. As part of a settlement agreement, Marvel agreed to purchase Kimble’s patent for a cash payment

plus 3% of net sales of: 1) products that would be deemed to infringe the patent; and 2) Web Blaster products.

A number of years later, the parties found themselves in litigation over the amount of royalties due to Kimble under the settlement. The district court granted summary judgment for Marvel, holding that the settlement was a “hybrid” license and, because it did not specify different royalty rates for the patent and non-patent rights, the royalties had to end when the patent expired.

On appeal, the Ninth Circuit first summarized the rule of *Brulotte* and its progeny: “[A] license for inseparable patent and non-patent rights involving royalty payments that extends beyond a patent term is unenforceable for the post-expiration period unless the agreement provides a discount for the non-patent rights from the patent-protected rate.” *Kimble v. Marvel Enters., Inc.*, 727 F.3d 856, 863 (9th Cir. 2013). While acknowledging that its “application of the *Brulotte* rule in this case arguably deprives Kimble of part of the benefit of his bargain based upon a technical detail that both parties regarded as insignificant at the time of the agreement,” the Ninth Circuit nevertheless held it was bound by *Brulotte* to affirm the judgment in favor of Marvel. *Id.* at 866-67.

#### THE DIFFERING VIEWS OF BRULOTTE

Kimble’s petition for certiorari brought out a number of amici, nearly all supporting Kimble’s argument that *Brulotte* is ripe for reconsideration because: 1) it prevents efficient and procompetitive licensing transactions; and 2) it is inconsistent with the Supreme Court’s current jurisprudence regarding the market power conferred by ownership of a patent. The Solicitor General’s amicus brief, however, argued that certiorari was not warranted because: 1) principles of *stare decisis* support leaving *Brulotte* undisturbed; and 2) criticisms of *Brulotte* based on antitrust principles are inapposite because the decision was based on other concerns. The government argued that *Brulotte* reflects “the policies of the federal patent laws, which the Court has repeatedly viewed as precluding enforcement of legal or contractual provisions that would impair the public’s access to formerly patented

inventions after the relevant patents expire.” United States as Amicus Br. at 12.

The amicus briefs from academic and research organizations contend that *Brulotte* emphasizes form over function, discouraging “flexible licensing agreements needed for commercialization of inventions.” Center for Intellectual Prop. Research Amicus Br. at 3. The Supreme Court has long recognized that a patent holder may license its patent for a fixed sum. These amici contend that there are a number of ways to structure the payment of such a fixed sum, but *Brulotte* condones some of these structures while forbidding others — without any economic justification. *Id.* at 3-5.

According to some amici, *Brulotte* has had an acute negative impact on licensing in the pharmaceutical and biologic areas. See, Memorial Sloan-Kettering Cancer Ctr. Amicus Br. at 5-7. Many academic research institutions conduct early-stage research to discover new compounds or treatments for serious diseases and patent their discoveries. Because these institutions lack the expertise and resources needed for commercial development of a drug, they typically grant a license to companies with the financial resources and business expertise to undertake development, seek regulatory approval, and commercialize the drug. In this context, licensees prefer to delay payments as long as possible because of the difficulty and uncertainty of bringing a product to market, and therefore prefer to base the license payments on the sale of the commercialized, approved drug. This arrangement accommodates the licensee’s desire to conserve its current financial resources and to shift some of the risk of failure to the licensor. According to these amici, the licensor is generally willing to delay receipt of its royalties because it lacks the ability to commercialize the drug. These amici thus argue that this arrangement is economically efficient for both licensor and licensee, and that it benefits society by facilitating the introduction of new treatments to the market. *Id.*

Legal and academic scholars have also criticized *Brulotte* as being inconsistent with the Supreme Court’s modern jurisprudence on issues at the intersection of intellectual property and antitrust. Center for Intellectual Prop. Research Amicus Br.; Intellectual Prop. Law Ass’n of Chi.

Amicus Br. Most notably, *Brulotte*’s critics point to the Court’s decision in *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006), as calling into question the theoretical underpinnings of *Brulotte* — namely, that a patent confers market power on a patent holder. *Brulotte*’s *per se* rule is premised on the view that post-expiration royalties are, by definition, an improper (coercive) extension of the patent-holder’s monopoly power into the post-expiration period. After *Illinois Tool Works*, patents are no longer presumed to create monopoly power, and most licensing arrangements are instead evaluated under the rule of reason. Not only do many treatises in the fields of intellectual property and antitrust denounce the *Brulotte per se* rule as being misguided, the antitrust agencies have twice set forward guidelines that reject *per se* treatment for patent licenses with post-expiration royalties. See, Pet. for Cert. at 13 (citing publications). See also, U.S. Dep’t of Justice & Federal Trade Comm’n, “Antitrust Guidelines for the Licensing of Intellectual Property” (1995); U.S. Dep’t of Justice & Federal Trade Comm’n, “Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition,” 12 (2007) Instead, the agencies recognize that licensing often has significant efficiency benefits, and collecting royalties beyond a patent’s statutory term can be efficient. *Id.*

Despite the agencies’ guidelines and a history of scholarship criticizing *Brulotte*, the Solicitor General’s amicus brief in *Kimble* recommended that the Supreme Court deny certiorari, arguing instead that principles of *stare decisis* should apply. United States Amicus Br. at 8-11. The government argues that *Brulotte* should be left undisturbed because it reflects the policies of the federal patent laws — not the antitrust laws. According to the government, even though “some aspects of *Brulotte*’s analysis reflect antitrust-type reasoning,” it “does not rest solely, or even predominantly, on assumptions about market power. Rather, it reflects an affirmative vision of the scope and purposes of the patent laws ....” *Id.* at 15-16. The patent laws, according to the government’s brief, “reflect an affirmative congressional policy judgment that the patented invention should thereafter be freely available for exploitation by others

and for enjoyment by the general public.” *Id.* at 17. In the government’s view, the economic critique of *Brulotte* does not justify overturning “that settled rule of patent policy.” *Id.* at 19. Echoing an argument made by Marvel, the government contends that *Brulotte*’s rule is narrow, and that “private parties enjoy significant leeway in structuring license agreements to spread payments over a period longer than the patent term, and to contract for non-patent royalties.” *Id.* at 20.

### THE POTENTIAL IMPACT OF THE COURT’S DECISION

The Court’s decision in *Kimble* may have a significant impact on licensing practices. There are at least three possible outcomes. First, the Court could, as the Solicitor General urges, leave *Brulotte* undisturbed and leave in place its shadow over patent licensing. Second, the Court could overrule *Brulotte* and hold that an agreement to pay post-expiration royalties is lawful. Third, the Court could hold that whether an agreement that includes post-expiration royalties constitutes misuse should be analyzed under the rule of reason as are other types of conduct. These latter two outcomes would have ripple effects that would significantly change the analysis not only for agreements involving a single patent, but also for agreements involving patent applications, packages of patents, and packages of patents and other intellectual property rights.

Those involved in patent licensing need to keep a close eye on *Kimble*. We may see another old Supreme Court precedent overruled or significantly altered.



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