

# Client Alert

December 16, 2014

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

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Fifty years ago, in *Brulotte v. Thys Co.*,<sup>1</sup> the U.S. Supreme Court held that the collection of royalties after a patent's expiration constitutes *per se* patent misuse. Although criticized by scholars, antitrust agencies, and the lower courts as economically irrational, *Brulotte* has not only endured, it has impacted licensing practices in a number of contexts. *Brulotte* looms large over the licensing of a single patent, packages of patents, patents combined with trade secrets, and patent applications. It has bedeviled licensing negotiations, voided freely negotiated contracts, and been used to reopen what were considered long-settled agreements. All that may change, however, because the Court—contrary to the suggestion of the Solicitor General—granted certiorari in *Kimble v. Marvel Enterprises, Inc.* to decide whether to overrule *Brulotte*.

The Court's decision in *Kimble* could significantly impact licensing practices. Unless the Court leaves *Brulotte* undisturbed, the decision will certainly affect the licensing 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. The outcome could allow for more flexible licensing structures, potentially ushering in an era of innovative licensing. Such a change may, however, come with more uncertainty about what practices constitute misuse. *Kimble* may therefore be a harbinger of significant change in the world of patent licensing.

### THE LONG LINE OF *BRULOTTE*'S CRITICS

In *Brulotte*, the Court reasoned that obtaining royalties for the use of patents post-expiration would expand the scope of the patentee's rights:

A patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly. But to use that leverage to project those royalty payments beyond the life of the patent is analogous to an effort to enlarge the monopoly of the patent by tying the sale or use of the patented article to the purchase or use of unpatented ones. The exaction of royalties for use of a machine after the patent has expired is an assertion of monopoly power in the post-expiration period when, as we have seen, the patent has entered the public domain.<sup>2</sup>

The Court therefore held that “a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*.”<sup>3</sup>

This reasoning has been the subject of unending criticism. Commentators have pointed out that “post-expiration royalties merely amortize the price of using patented technology”<sup>4</sup> and “thus do not represent an extension in time

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of the patent monopoly.”<sup>5</sup> Economists have called *Brulotte*’s rule “flawed” and shown that “allocative efficiency considerations should permit a licensor and licensee to agree to longer royalty terms.”<sup>6</sup> Contrary to the premises of *Brulotte*, the U.S. antitrust enforcement agencies have noted that it is “possible that collecting royalties over a longer period of time than the patent grant will reduce the deadweight loss associated with a patent monopoly and allow the patent holder to recover the full value of the patent, thereby preserving innovation incentives.”<sup>7</sup>

The courts too have criticized *Brulotte*. Dissenting from the opinion itself, Justice Harlan believed that the majority had failed to understand the “substantive economic effect” of the provisions.<sup>8</sup> The Seventh Circuit has questioned whether obtaining post-expiration royalties “really ‘extends’ the patent,”<sup>9</sup> and noted that *Brulotte* has been “severely, and as it seems to us, with all due respect, justly, criticized.”<sup>10</sup> The circuit court reasoned that “paying royalties after the patent expires does not extend the duration of the patent either technically or practically, because . . . if the licensee agrees to continue paying royalties after the patent expires the royalty rate will be lower.”<sup>11</sup> Such licenses are therefore nothing more than “a risk-shifting credit arrangement between patentee and licensee.”<sup>12</sup> The Ninth Circuit similarly noted that “many courts and commentators have found” the reasoning of *Brulotte* “economically unconvincing,” but nevertheless conceded that “[n]o matter how unconvincing *Brulotte*’s foundation may be, . . . we are bound to apply its holding if it applies to the case before us.”<sup>13</sup>

## BRULOTTE’S BROAD IMPACT

The effect of *Brulotte*’s economically irrational reasoning would be limited if the holding were applied only to cases in which all of the licensed patents have expired. But *Brulotte* has been applied in other licensing contexts, which has led to a morass of differing, fact-dependent rules that complicate negotiations and create traps for the unwary.

### Package Licenses

Package licenses are a prime example. Patents with varying expiration dates are commonly licensed in packages. The courts are split on whether a package license royalty that remains uniform throughout the term of the last issued patent runs afoul of *Brulotte* by effectively extending the monopoly of the patents that expire during the term. Some courts require a step-down in the license fee when patents in the package expire. Others require a step-down only if the uniform royalty rate was “coerced.”

Relying on *Brulotte*, the Sixth Circuit has held that a package license that “contains no diminution of license fee at the expiration of the most important patent and contains no termination clause at the will of the licensee” is unenforceable.<sup>14</sup> In other words, the court held that a package license that does not contain a step-down provision is *per se* misuse.

Other courts, however, have concluded that a step-down in royalties is required only if the package license is coerced. The Tenth Circuit, for instance, respectfully disagreed with the Sixth Circuit’s conclusion, reasoning that “[f]reedom of choice is the controlling question.”<sup>15</sup> The court held that there is no misuse so long as a “licensee is given the choice to take a patent alone or in combination on reasonable terms”;<sup>16</sup> thus, the “question is whether the licensee was forced to enter into a package agreement.”<sup>17</sup> The Seventh Circuit has similarly held that “a package license agreement, voluntarily entered into, which requires the payment of royalties beyond the expiration of some, but not all, of the licensed patents is valid.”<sup>18</sup>

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Exactly what constitutes “coercion” sufficient to invoke *Brulotte* is a fact-intensive inquiry that has eluded any bright line rule. Courts have looked at a number of factors, such as “whether the provision was bargained for or imposed or whether the licensee made ‘protestations’ which were overridden.”<sup>19</sup> As a general matter, where the licensor and the prospective licensee engage in extensive negotiations, where both sides ask for and receive modifications to the original proposal, courts have not found coercion. To show conditioning, a licensee must show that the licensor did not give it a choice to take a license to the desired patents alone or in combination with other patents on reasonable terms. Courts are reluctant to find coercion even in situations where the patent holder is firm but proposes an alternative arrangement within the scope of its patent rights. Although unclear, a finding of coercion, and thus misuse, may also require a showing that the patent holder has market power in the market for the technology covered by its patent. The question of whether a license is coerced thus creates uncertainty regarding the application of *Brulotte*.

Moreover, when a licensor packages both U.S. and foreign patents in a license, the impact of *Brulotte* may be different. The Ninth Circuit, for instance, has held that *Brulotte* does not “extend its royalty-cancelling powers to contracts for foreign patents.”<sup>20</sup> In a case involving a package of expired U.S. patents and an unexpired foreign patent, the Ninth Circuit reasoned that “*Brulotte* has no self-executing international effect,” and “[e]ven if the principle announced in *Brulotte* were to obviate [the licensee’s] obligation to pay royalties on the [U.S.] patent once it expired . . . it neither renders the entire [license agreement] unenforceable nor displaces [the] obligation to pay royalties on that valid [foreign] patent.”<sup>21</sup> Thus, package licenses need not have a step-down provision if the last expiring issued patent is foreign. It is not clear, however, whether a step-down provision is required if the last expiring issued patent is domestic.

## 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.<sup>22</sup>

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. 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. 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.

## Patent Applications

*Brulotte* also casts its shadow over licenses of pending patent applications. In *Aronson v. Quick Point Pencil Co.*,<sup>23</sup> 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

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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.”<sup>24</sup>

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.”<sup>25</sup> 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.”<sup>26</sup> 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.<sup>27</sup>

The Seventh Circuit similarly reasoned, “It is the issuance of the patent that triggers *Brulotte*’s application.”<sup>28</sup> 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*.<sup>29</sup>

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. 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.

### 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 (i) products that would be deemed to infringe the patent and (ii) Web Blaster products.

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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.”<sup>30</sup> 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.<sup>31</sup>

### 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 (i) it prevents efficient and procompetitive licensing transactions and (ii) 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 (i) principles of *stare decisis* support leaving *Brulotte* undisturbed and (ii) 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.”<sup>32</sup>

The amicus briefs from academic and research organizations contend that *Brulotte* emphasizes form over function, discouraging “flexible licensing agreements needed for commercialization of inventions.”<sup>33</sup> 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.

According to some amici, *Brulotte* has had an acute negative impact on licensing in the pharmaceutical and biologic areas. 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.

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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. Most notably, *Brulotte*'s critics point to the Court's decision in *Illinois Tool Works Inc. v. Independent Ink, Inc.*<sup>34</sup> 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. Instead, the agencies recognize that licensing often has significant efficiency benefits, and collecting royalties beyond a patent's statutory term can be efficient.

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. 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 . . . .”<sup>35</sup> 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.”<sup>36</sup> In the government's view, the economic critique of *Brulotte* does not justify overturning “that settled rule of patent policy.”<sup>37</sup> 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.”<sup>38</sup>

## 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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<sup>1</sup> 379 U.S. 29 (1964).

<sup>2</sup> *Id.* at 33 (citations omitted).

<sup>3</sup> *Id.* at 32.

<sup>4</sup> 10 Phillip E. Areeda, Einer Elhauge & Herbert Hovenkamp, *Antitrust Law: An Application of Antitrust Principles and Their Application* § 1782c, at 492 (2004); see also Michael Koenig, *Patent Royalties Extending Beyond Expiration: An Illogical Ban from Brulotte to Scheiber*, 2003 Duke L. & Tech. Rev. 5 (2003).

<sup>5</sup> Harold See & Frank M. Caprio, *The Trouble with Brulotte: The Patent Royalty Term and Patent Monopoly Extension*, 1990 Utah L. Rev. 813, 814, 851 (1990).

<sup>6</sup> Richard Gilbert & Carl Shapiro, *Antitrust Issues in the Licensing of Intellectual Property: The Nine No-No's Meet the Nineties*, 1997 Brookings Papers on Econ. Activity, Microeconomics 283, 322 (1997).

<sup>7</sup> U.S. Dep't of Justice & Federal Trade Comm'n, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition* 122 (2007).

<sup>8</sup> 379 U.S. at 37.

<sup>9</sup> *USM Corp. v. SPS Techs., Inc.*, 694 F.2d 505, 510-11 (7th Cir. 1982).

<sup>10</sup> *Scheiber v. Dolby Labs., Inc.*, 293 F.3d 1014, 1017 (7th Cir. 2002).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Zila, Inc. v. Tinnell*, 502 F.3d 1014, 1020 (9th Cir. 2007).

<sup>14</sup> *Rocform Corp. v. Acitelli-Standard Concrete Wall*, 367 F.2d 678, 681 (6th Cir. 1966).

<sup>15</sup> *Well Surveys, Inc. v. Perfo-Log, Inc.*, 396 F.2d 15, 18 (10th Cir. 1968).

<sup>16</sup> *Id.* (citing *Hazeltine Research, Inc. v. Zenith Radio Corp.*, 388 F.2d 25 (7th Cir. 1967)).

<sup>17</sup> *Id.* at 17; see also *Sunrise Med. HHG, Inc. v. AirSep Corp.*, 95 F. Supp. 2d 348, 458 (W.D. Pa. 2000) (“the royalty rate need not diminish as patents included in a package license expire, as long as the licensee is not coerced”); *A.C. Aukerman Co. v. R.L. Chaides Const. Co.*, 29 U.S.P.Q.2d (BNA) 1054, 1058 (N.D. Cal. 1993) (“*Brulotte* has been held inapplicable to package licensing agreements containing expired patents if the licensee was not coerced to enter the arrangement. Whether the agreement was the product of unfair patent leverage exerted by the patentee rather than mutual convenience of the parties is a question of fact.”) (internal citations omitted); *Cardinal of Adrian, Inc., v. Keystone Consol. Indus., Inc.*, 195 U.S.P.Q. (BNA) 26, 29 (E.D. Mich. 1977) (“in order to constitute a misuse, there must be an element of coercion, such as where there has been a request by a prospective licensee for a license under less than all of the patents and a refusal by the licensor to grant such a license”).

<sup>18</sup> *Beckman Instruments, Inc. v. Technical Dev. Corp.*, 433 F.2d 55, 61 (7th Cir. 1970).

<sup>19</sup> *Glen Mfg. Inc. v. Perfect Fit Indus., Inc.*, 420 F. 2d 319, 321 (2d Cir. 1970).

<sup>20</sup> *Zila, Inc. v. Tinnell*, 502 F.3d 1014, 1023 (9th Cir. 2007).

<sup>21</sup> *Id.* at 1024; see also *Alvarado Orthopedic Research, L.P. v. Linvatec Corp.*, No. 11-CV-246-IEG RBB, 2013 WL 2351814, at \*7 (S.D. Cal.

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May 24, 2013).

<sup>22</sup> *Pitney Bowes, Inc. v. Mestre*, 701 F.2d 1365, 1373 (11th Cir. 1983).

<sup>23</sup> 440 U.S. 257 (1979).

<sup>24</sup> *Id.* at 265 (emphasis in original) (quoting *Brulotte*, 379 U.S. at 33).

<sup>25</sup> *Boggild v. Kenner Prods.*, 776 F.2d 1315, 1319 (6th Cir. 1985).

<sup>26</sup> *Id.* at 1316.

<sup>27</sup> *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”).

<sup>28</sup> *Meehan v. PPG Indus., Inc.*, 802 F.2d 881, 885 (7th Cir. 1986).

<sup>29</sup> *Id.*

<sup>30</sup> *Kimble v. Marvel Enters., Inc.*, 727 F.3d 856, 863 (9th Cir. 2013).

<sup>31</sup> *Id.* at 866-67.

<sup>32</sup> United States as Amicus Br. at 12.

<sup>33</sup> Center for Intellectual Prop. Research Amicus Br. at 3.

<sup>34</sup> 547 U.S. 28 (2006).

<sup>35</sup> United States Amicus Br. at 15-16.

<sup>36</sup> *Id.* at 17.

<sup>37</sup> *Id.* at 19.

<sup>38</sup> *Id.* at 20.