Ninth Circuit Holds Hybrid IP Agreement With Flat Royalty Rate Unenforceable Post Patent Expiration

The Ninth Circuit U.S. Court of Appeals recently reluctantly refused to enforce a hybrid intellectual property agreement – that is, an agreement involving a bundle of patent, trade secret, and other intellectual property rights – with a single royalty rate beyond the expiration date of the patent included in that bundle of rights. The court in the case, *Kimble v. Marvel Enterprises Inc.*, No. 11-15605 (9th Cir. July 16, 2013), found itself bound by the Supreme Court's holding in *Brullote v. Thys Co.*, 379 U.S. 29 (1964), that charging patent royalties beyond a patent's expiration date is "unlawful per se." The Ninth Circuit, like others, extensively criticized *Brulotte*, noting that applying the *Brulotte* rule to the hybrid agreement before it likely resulted in the agreement having less actual value than the parties likely understood when they entered into the agreement. Yet absent "a discounted rate for the non-patent rights [a "step-down"] or some other clear indication that the royalty at issue was in no way subject to patent leverage" in the agreement, even though the "patent leverage in this case was vastly overshadowed" by non-patent rights, the Ninth Circuit felt compelled to cut off the ability to collect royalties beyond the life of the patent.

The Supreme Court in *Brullote* held royalty payments beyond the expiration date of a patent unlawful per se, viewing such royalties as impermissibly extending the duration of a patent monopoly. The Supreme Court there rejected arguments that post-expiration royalties were merely deferred payments for use of a patent during the pre-expiration period. In addition, the Court refused to conjecture what the parties' bargaining position would have been and what agreement might have resulted had post-expiration royalties been separated from the patent. Later in *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979), the Supreme Court clarified that patent law permits indefinite royalty payments where no patent is ultimately issued. The*Aronson* decision largely turned on the fact that the parties had agreed to a 5% royalty, but if a patent application was not allowed within five years, the royalty stepped-down to 2.5%.

The *Kimble* controversy arose over a Spider-Man Web Blaster toy. Kimble contended he had met with a representative of Marvel Entertainment's predecessor, Toy Biz, and shared ideas Kimble had about a gloved toy that could shoot foam string. Some of those ideas were allegedly covered by a then-pending patent application of Kimble. Kimble further contended that the company's representative promised to compensate him if it used any of his ideas.

Some time after the meeting, Marvel launched their foam-string-shooting Spider-Man Web Blaster, and Kimble sued for patent infringement and breach of contract. The trial court proceeded to grant Marvel's motion for summary judgment of non-infringement of the patent, and sent the contract claim to a jury. The jury found breach of contract, and awarded Mr. Kimble 3.5% of the past, present and future net product sales of the Web Blaster.

Everyone appealed, and a settlement was eventually reached. Under the settlement, Marvel bought the patent for about $500,000, plus 3% of "net product sales" as the term was used in the judgment (which had no time limit). The settlement agreement also stated that "new product sales" "shall be deemed to include product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers." Marvel's counsel conceded at oral argument that the parties were not then aware of *Brulotte*.

Royalty payment disputes eventually erupted among the parties, and a new lawsuit emerged. In it, Marvel reaffirmed its view that the Web Blaster never infringed the patent, but also sought a declaration that it was no longer obliged to pay royalties as the patent had expired. The district court found the settlement agreement to be a "hybrid" rights agreement and that royalty payments therefore had to stop upon the patent's expiration.

In affirming, the Ninth Circuit joined other circuits in interpreting *Brullote* and *Aronson* as prohibiting indefinite royalties under hybrid agreements encompassing inseparable patent and non-patent rights. Therefore, to be enforceable under *Brullote*, an agreement with a royalty running post-patent expiration either needs to include a discount for the non-patent rights from the patent-protected rate (often termed a "step-down") or, in the absence of a discount, "some other clear indication that the royalty was in no way subject to patent leverage." Applying these principles to the facts before it, the Ninth Circuit deemed the rights in the settlement agreement to be an intertwined hybrid and so applied the *Brullote* rule to affirm the judgment that royalties were no longer payable under the settlement agreement.

The Ninth Circuit did so reluctantly. It noted that the case arguably deprived Kimble of part of his bargain based on a technical detail the parties at the time deemed insignificant. It criticized the logic behind *Brullote*, quoting extensively from similar criticisms of the case from the Seventh Circuit. Observing that any patent leverage in the case before it was "vastly overshadowed" by non-patent rights and that Kimball probably would have sought a higher royalty had the parties understood the effect of the *Brullote* rule, the court cited the binding nature of *Brullote* as the key reason for applying it to the settlement agreement

The *Kimble* decision illustrates the ongoing challenges involved with the negotiation and drafting of royalty provisions in intellectual property agreements. Parties often want to create simple, easy to manage payment arrangements that do not necessarily require them to try to negotiate allocations of future value to particular kinds of intellectual property or create complicated payment structures. The *Brullote* rule can spin an evil valuation web for those seeking simplicity without keeping in mind the potential impact the rule can have. And as*Kimble* shows, this web becomes even stickier when structuring license and other agreements with royalty and other future payment schemes connected to bundles of patent and non-patent rights. To discuss strategies and other concerns for protecting your intellectual property rights, please contact Ed Black, Mark Bellomy, Jim DeGraw, David McIntosh, Harry Rubin, Geoffrey Lin or any other member of our leading IP team.