U.S. Supreme Court to Review Whether Post-Patent Term Royalty Schemes Lawful

On Friday, December 12, 2014, the U.S. Supreme Court granted certiorari on *Kimble v. Marvel Enterprises, Inc.*, No. 13-720, opening the possibility that the Supreme Court will overturn *Brulotte v. Thys Co.*, 379 U.S. 29 (1964), the widely criticized case holding that patent royalties beyond a patent's expiration date are "unlawful *per se*." Consequently, the Court will be considering whether to replace its rigid *per se* prohibition with a more flexible antitrust test called the rule of reason, which would carry significant implications for licensing agreements in the future. The *Kimble* case comes to the Supreme Court from the U.S. Court of Appeals for the Ninth Circuit. In that decision, 727 F.3d 856 (9th Cir. 2013), the Ninth Circuit refused to enforce royalty obligations payable under a "hybrid" intellectual property agreement – that is, an agreement involving a bundle of patent, trade secret, and other intellectual property rights – because the agreement called for a single royalty rate that did not step down following expiration of the patent included in that bundle of rights.

Under the 50-year-old *Brulotte* rule, royalty payments extending beyond the expiration of a patent are *per se* unlawful, because such royalties extend the duration of a patent monopoly beyond the lawful time period. In *Brulotte*, the Supreme Court refused to treat post-expiration royalties as merely deferred payments for use of a patent during the pre-expiration period, since the Court was hesitant to guess what parties' bargaining position would have been had post-expiration royalties been separated from the patent. This rule was further developed in*Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979). In that case, the Supreme Court clarified that patent law allows indefinite royalty payments where no patent is ultimately issued. The facts of the *Aronson* case involved a 5% royalty that decreased to 2.5% if a patent was not issued within five years. Such a decrease in the royalty rate, whether to account for non-patent intellectual property rights or the failure of a patent to issue, is commonly known as a "step-down."

The recent *Kimble* controversy arose over the Web Blaster, a gloved Spider-Man toy that could shoot foam string. Kimble shared such a concept with Marvel's predecessor, Toy Biz, on the condition that he would receive compensation if the company used the idea. Part of Kimble's idea was allegedly covered by a then-pending patent application filed by Kimble. However, after Marvel created a competing product without compensating Kimble, a patent infringement and breach of contract lawsuit ensued. Under a settlement, Marvel agreed to purchase the patent for approximately $500,000, plus 3% of net product sales (including sales of infringing products and the Web Blaster). However, the agreement provided no end date for the royalties. Marvel's counsel conceded at oral arguments that the parties were not then aware of *Brulotte*. In the ensuing lawsuit, Marvel sought summary judgment and a declaration that it was no longer obliged to pay royalties to Kimble as the patent had expired.

The Ninth Circuit affirmed the district court's judgment for Marvel, but it did so only reluctantly. The court joined other circuits in interpreting *Brulotte* and *Aronson* as prohibiting indefinite royalties under hybrid agreements, unless such agreements either 1) provide a discount from the patent-protected rate to cover the non-patent rights, or 2) provide some other clear indication that the royalty was not subject to patent leverage. In addition, the court found the patent and non-patent rights under the hybrid agreement to be inseparable. Because the parties could have easily included a discounted royalty rate, the court found the failure to do so dispositive.

Even though the Ninth Circuit applied *Brulotte*, it still criticized the Supreme Court's decision, observing that a patent holder can extract a higher royalty rate over a shorter period of time, instead of a lower rate over a longer period of time. The court also conceded that the non-patent rights vastly overshadowed the patent leverage in Kimble's case, and the court sympathetically acknowledged that *Brulotte* would rob Kimble of the benefit of his bargain based on a seemingly insignificant technical detail at the time of licensing negotiations. However, the Ninth Circuit cited the binding nature of *Brulotte* as a key reason for extending its holding to hybrid agreements. The Ninth Circuit is not the only federal circuit that has applied *Brulotte* while critiquing that decision. In *Scheiber v. Dolby Laboratories, Inc.*, 293 F.3d 1014 (7th Cir. 2002), Judge Posner argued that post-expiration royalties should not be *per se*unlawful, since they are not an extension of a patent monopoly due to the inventor's inability to exclude others from making, using, selling, or importing the patented invention after the patent's expiration.

In their petition for certiorari, the *Kimble* petitioners make a number of arguments for revisiting*Brulotte*'s *per se* prohibition on post-expiration patent royalties. The petition argues that*Brulotte* "has not withstood the test of time" in light of subsequent case law, and post-expiration royalties do not entail an extension of a patent monopoly. The petition also mentions that both the Justice Department and Federal Trade Commission have taken the position that *Brulotte* discourages technological innovation by categorically limiting certain licensing practices that typically encourage competition. For example, post-expiration royalties can be an efficient means of financing nascent technologies, since they allow parties to allocate risks and raise output by lowering prices. In addition, the cert petition points out that a key assumption underlying *Brulotte* has since been abandoned – that is, the irrebuttable presumption that a patent automatically confers market power enabling improper leverage over licensees.

Of course, until the Supreme Court renders a decision, the bright-line rule of *Brulotte* will continue to apply, and licensors would be well-advised to continue to step down royalty rates upon patent expiration to avoid patent misuse claims until the rule is changed. To discuss this development and strategies relating to royalties in hybrid intellectual property license agreements, please contact Ed Black, Mark Bellomy, Jim DeGraw, Geoffrey Lin, David McIntosh, Harry Rubin, or any other member of our intellectual property transactions team.

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