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IP FRONTIERS

Freedom to contract vs. patent misuse: an analysis of post-expiration patent royalties

Inherent within American contract law is the freedom to contract — i.e., the ability to negotiate and agree to any terms that the parties see fit for any given contract. Contract terms will only be deemed void under special circumstances, such as unconscionability, unenforceability or, in some cases, due to statutory restrictions. This freedom extends to all contracts, including patent licensing agreements. However, the Supreme Court has judicially restricted one key aspect of patent licenses: royalties.

In the 1964 case of *Brulotte v. Thys Co.,* 379 U.S. 29, the Supreme Court held that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful per se." In general, this doctrine makes sense. The United States Constitution provides that inventors may secure the exclusive right to their discoveries for a *limited time.* A patent registration creates a temporary monopoly over a certain invention, after which the public is free to use and enjoy the invention without restriction. The *Brulotte* court reasoned that, by allowing post-expiration patent royalties, the royalty agreement is unlawfully extending the patentee's monopoly period with respect to that invention and restricting the licensee's use of a public domain invention. The court feared that post-expiration patent royalties would open the door to patent misuse.

In the decades following *Brulotte*, nearly every court that has come across this rule has determined that *Brulotte* was wrongfully decided as an improper judicially-created

By THOMAS L. SICA
Daily Record Columnist

restriction of the freedom to contract. For instance, the 9th Circuit found that *Brulotte* "runs counter to the usual task in a contract case — to interpret the terms agreed to by the parties." *Zila, Inc. v. Tinnell,* 502 F.3d 1014, 1019 (9th Cir. 2007). The 7th Circuit held that the *Brulotte* rule does not have the effect of extending the life of a patent, but rather serves to encourage higher royalty rates over a short period of time at the expense of the licensee. *See, Scheiber v. Dolby Labs., Inc.,* 293 F.3d 1014, 1017 (7th Cir. 2002).

Despite this, these courts, often begrudgingly, follow this rule because they cannot overturn Supreme Court precedent. *See, Zila, Inc.,* 502 F.3d at 1020 ("No matter how unconvincing *Brulotte's* foundation may be, however, we are bound to apply its holding if it applies to the case before us."). Even the Supreme Court itself has criticized the *Brulotte* rule in *Kimble v. Marvel Entm't, LLC,* 135 S. Ct. 2401 (2015), but refused to overrule the decision due to the doctrine of *stare decisis:* "Respecting *stare decisis* means sticking to some wrong decisions." The *Kimble* court's majority could not find a "special justification" for overruling the *Brulotte* case, so they upheld it. The court further justified this decision by explaining that the *Brulotte* rule, while controversial, has proved workable and is easier to apply than the case-by-case analysis found in antitrust cases that the plaintiff in *Kimble* sought to impose.

Due to the widespread criticism of the bright-line post-expiration patent royalty restriction, most courts allow, and even encourage, a variety of exceptions and workarounds to the restriction. One such exception occurs when the royalty payments are not dependent upon the existence of the patent registration, such as when the license agreement expressly contemplates a lower royalty payment in the absence of a registration. *See, Aronson v. Quick Point Pencil Co.,* 440 U.S. 257 (1979).

For example, a patentee and a licensee enter into a license agreement whereby the patentee will receive a royalty from the licensee on any sales of the patentee's product. The royalty agreement states that the royalty rate is 20% for the length of the patent but lowers the rate to 15% if the patent either fails to issue or expires. Courts will generally allow this agreement, because the parties have explicitly acknowledged that the royalty is not based solely on the patent, but on the product itself. Going further, a contract may tie the royalty payments to non-patent rights, such as to that of a specific product, so long as the royalties are not expressed to be made for any patent rights. As the Supreme Court has found, "post-expiration royalties are allowable so long as tied to a non-patent right — even when closely related to a patent." *Kimble*, 135 S.

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Ct. at 2408.

One of the major criticisms of the *Brulotte* rule is that a restriction of post-expiration patent royalties leads to higher royalty rates due to the shortened period in which the royalties are imposed. To counter this concern, most courts will allow patent royalty payments to be made after the expiration date of the patent so long as the payments are for pre-expiration use. *See, Scheiber,* 293 F.3d at 1018 (7th Cir. 2002) ("charging royalties beyond the term of the patent does not lengthen the patentee's monopoly; it merely alters the timing of royalty payments.") This gives some flexibility to parties entering into license agreements.

The parties may delay royalty payments partially or entirely past the expiration date of the patent. Alternatively, this gives the opportunity for an amortized arrangement. For example, the licensing parties may agree to a 20% royalty rate covering the 20-year period that the patent is enforceable, but the payments may be made over a 40-year period, thus lowering by half the amount of each payment made.

There are still many other alternatives and workarounds that courts have implicitly or explicitly endorsed. For example, the Supreme Court has found that "parties have still more options when a licensing agreement covers either multiple patents or additional non-patent rights. Under *Brulotte*, royalties may run until the latest-running patent covered in the parties' agreement expires." *Kimble*, 135 S. Ct. at 2408. Or, the license agreement may require a lump sum, rather than royalty payments. Or, the parties may enter into a joint venture rather than a royalty arrangement so that they may fairly share the risks and rewards of the sale of the patented product.

In conclusion, while the general consensus is that the *Brulotte* rule regarding the restriction of post-expiration patent royalties is misguided, there are several ways to get around the rule. There are still a variety of options for patentees and licensees in entering into license agreements so long as the license agreement does not require *patent-specific* royalties to be paid after the patent has expired.

Thomas Sica is an associate with the law firm of Heslin Rothenberg Farley & Mesiti P.C. His experience includes litigation work, trademark prosecution, and general IP counseling. He can be reached at (518) 452-5600 or thomas.sica@hrfmlaw.com.

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