NEW RULES FOR PATENT ROYALTY ARRANGEMENTS MAY BE COMING

Royalty arrangements within patent licenses have long been constrained by an almost 50 year old Supreme Court decision in Brulotte v. Thys Co that prevents collection of royalties after a patent has expired. The Justices have now agreed to revisit the precedent set by that often-criticized ruling in a current case, Kimble v. Marvel Enterprises, Inc.

In the Brulotte matter, a patent owner required licensees to agree to continue to pay royalties after the patent expired. The Supreme Court found this unlawful per se, calling it an attempt to exact the benefits of the monopoly period beyond the expiration date of the patent and a violation of the basic principle that patented technology should be free to public use upon patent expiration.

The key criticism of the ruling is based in economic principles. When negotiating the license agreement, the two parties must come to an acceptable compensation arrangement. In order to optimize their respective economic benefit, the two parties could reasonably come to an agreement to pay a lower rate but over a longer period. Such royalties paid after the expiration would represent delayed compensation for allowed use during the term.

The soundness of the criticism has been recognized in the lower courts, although they have been required to follow Brulotte. A notable example is Scheiber v. Dolby Laboratories, Inc. Dolby, negotiating settlement in the role of licensee, offered that in exchange for paying a lower royalty rate it would be willing to pay royalties beyond the US patent expiration. Scheiber agreed to accept those terms and the agreement was drawn and signed accordingly. In what could be easily be called a "bait and switch" tactic, Dolby later notified Scheiber that it would not honor the agreement terms and would cease payments upon patent expiration in compliance with the applicable law. When Scheiber sued, the Court was obliged to follow the Supreme Court's decision in Brulotte and Dolby prevailed. However, the Court made it clear it was following the ruling with its hands tied and "no matter how dubious its reasoning strikes us". Judge Posner articulated the economically counter intuitive nature of the ruling:

> *"The Supreme Court's majority opinion reasoned that by extracting a promise to continue paying royalties after expiration of the patent, the patentee extends the patent beyond the term fixed in the patent statute and therefore in violation of the law. That is not true. After the patent expires, anyone can make the patented process or product without being guilty of patent infringement. The patent can no longer be used to exclude anybody from such production. Expiration thus accomplishes what it is supposed to accomplish.* ***For a licensee in accordance with a provision in the license agreement to go on paying royalties after the patent expires does not extend the duration of the patent either technically or practically, because, as this case demonstrates, if the licensee agrees to continue paying royalties after the patent expires the royalty rate will be lower. The duration of the patent fixes the limit of the patentee's power to extract royalties; it is a detail whether he extracts them at a higher rate over a shorter period of time or a lower rate over a longer period of time****"* [emphasis added]

The Brulotte, Dolby and Mattel cases have many parallels. In the current Mattel case, Kimble owns the patent for a Spider-Man glove that shoots a foam web string from the palm. A patent infringement suit over Marvel's "Web Blaster" resulted in a settlement agreement whereby Marvel agreed to pay $500,000 and a 3% royalty. Marvel later disputed that it should not pay any royalties upon the patent's expiration. Once again, the courts agreed with the defendant's legal argument while grumbling about the unavoidable result, with the Ninth Circuit describing the rule as "*counterintuitive, and its rationale is arguably unconvincing*".

However, Kimble was not to be deterred. Kimble requested that the Supreme Court consider whether Brulotte should be overruled, as it prevents pro-competitive agreements that are beneficial to all. The US Department of Justice, the Federal Trade Commission, academics and industry players have argued similarly. The Supreme Court has now agreed to do so and the matter should ultimately be decided by mid-2015.

The amount and basis upon which royalties are calculated is often the subject of dispute. This can be caused by ambiguous language in the agreement, poor internal controls that result in unintentional omissions or other types of informational errors, or even purposeful misstatements. However, when a good faith negotiation results in a royalty agreement that clearly represents the intent of the parties exists, it should not be undermined by this type of bright line test that does not serve the interests of the common good, justice or fair dealing.

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