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High Court Declines to Reassess 'Brulotte'

Seventh Circuit Challenge Rejected, So Post-Expiration Patent Royalty Restrictions Remain

BY DANIEL L. REISNER AND DAVID K. BARR

IN A LANDMARK decision, *Brulotte v. Thys Co.*, 379 U.S. 29, 32 (1965), 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." The Court explained that if this were permitted, "the free market visualized for the post-expiration period would be subject to monopoly influences that have no proper place there." Id. at 32-33. A recent opinion by Judge Richard Posner, *Scheiber v. Dolby Laboratories, Inc.*, 293 F.3d 1014 (7th Cir. June 17, 2002), while acknowledging that *Brulotte* controls, challenged its reasoning and invited the Supreme Court to reconsider.

However, any expectations that the Court would pick up Judge Posner's gauntlet and reassess *Brulotte*'s restriction on the ability of parties to structure the royalty terms of license agreements were dashed when the Court, on Jan. 13, 2003, denied Scheiber's petition for a writ of certiorari. Nevertheless, *Scheiber* should re-focus the attention of patent lawyers and their clients on the *Brulotte* restriction, which impacts the drafting of nearly every patent license. In addition, *Scheiber* may very well encourage future challenges to *Brulotte*.

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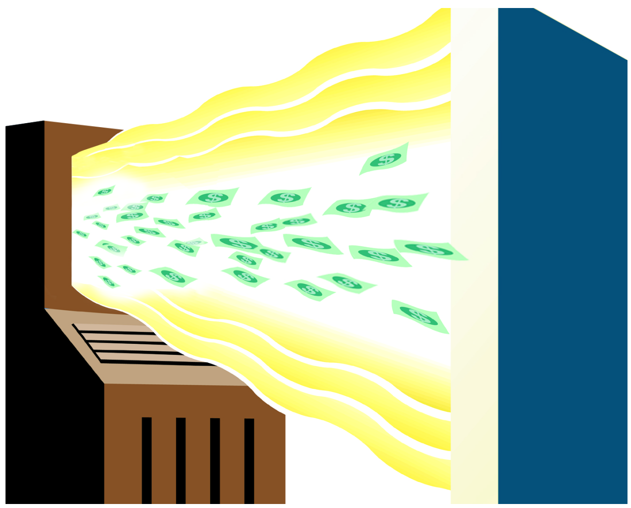

The 'Brulotte' Ruling

Before examining *Scheiber*, it will help to consider *Brulotte*. Thys, the patentee, sold hop-picking machines to its licensees for about $3,000, and provided them with a license for their use at about $3 per 200 pounds of dried hops with an annual $500 minimum. The license "continued for terms beyond" the date the relevant patents expired. *Brulotte*, 379 U.S. at 30.

The Court remarked that "the purchase price in each case was a flat sum, the annual payments not being part of the purchase price but royalties for use of the machine during that year. The royalty payments due for the post-expiration period are by their terms for use during that period, and are not deferred payments for use during the pre-expiration period." Id. at 31. The Court was troubled by the fact that the licenses "draw no line between the term of the patent and the post-expiration period." Adopting a per se rule of law that such terms were illegal, the Court was unwilling to determine "what resultant arrangement might have emerged had the provision for post-expiration royalties been divorced from the patent and nowise subject to its leverage." Id. at 32.

Justice John Harlan penned a blistering dissent. "I think that more discriminating analysis than the Court has seen fit to give this case produces a different result." Id. at 34. The nub of the dissent was that the contracts merely restricted the use of the particular hop-picking machines, not the use of the patented ideas after patent expiration. After patent expiration any farmer, including Thys licensees, could make or buy a machine using the patented ideas. Continuing to charge for use of particular Thys machines was no different from selling "a recording of a song in the public domain to a juke-box owner for an undetermined consideration based on the number of times the record was played." Id. at 34.

Justice Harlan, however did not oppose the general principle that a patentee should not be able to collect post-expiration patent royalties, only its application in this case. "[I]t should be equally clear that if Thys licensed another manufacturer to produce hop-picking machines incorporating any of the Thys patents, royalties could not be exacted beyond the patent term." Id. at 35.

The Federal Circuit has made explicit the long-held view that the *Brulotte* ruling had established a per se form of patent misuse. See, e.g., *Virginia Panel Corp. v. Mac Panel Co.*, 133 F.3d 860, 869 (Fed. Cir. 1998).

'Scheiber v. Dolby'

Although the Seventh Circuit disagreed with the holding of *Brulotte*, its opinion affirmed the district court's grant of summary judgment in favor of defendants' patent misuse defense.

Scheiber, the plaintiff-patentee and inventor of the audio effect, "surround sound," had entered into an agreement with the Dolby defendants to settle his patent infringement suit. During the settlement negotiations Dolby suggested that, in exchange for a lower royalty rate, it would agree to pay royalties "until the Canadian patent expired, including therefore [U.S.] patents that had already expired." *Scheiber*, 293 F.3d at 1016. Scheiber "acceded to the suggestions and the agreement was drafted accordingly, but Dolby later refused to pay royalties on any patent after it expired, precipitating this suit." Id.

Relying on *Brulotte*, Dolby argued that it was entitled to summary judgment denying the patentee's claim for post patent-expiration royalties. The Seventh Circuit reluctantly affirmed. "[W]e have no authority to overrule a Supreme Court decision no matter how dubious its reasoning strikes us." Id. at 1018. Scheiber then sought Supreme Court review, which the High Court denied.

The Seventh Circuit observed that *Brulotte* has been "severely" and "justly, criticized, beginning with Justice Harlan's dissent [in *Brulotte*] and continuing with our opinion in *USM*." Id. at 1017 (citing *USM Corp. v. SPS Technologies, Inc.*, 694 F.2d 505 (7th Cir. 1982) (Posner, J.)) But despite Justice Harlan's dissent and criticism of the application of the ban on post patent-expiration royalties to the particular facts of *Brulotte*, he did agree that in general such royalties should be prohibited. *Brulotte*, 379 U.S. at 35. Thus the only decision cited in *Scheiber* that challenges *Brulotte*'s prohibition of post-expiration royalties is *USM*, another decision by Judge Posner.

In *USM*, the court remarked that if a patentee requires post-expiration royalties he will have to accept a lower royalty rate and that one might question whether "this practice really 'extends' the patent." *USM*, 694 F.2d at 510. The Seventh Circuit completed the thought in *Dolby*. "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." *Scheiber*, 293 F.3d at 1017.

Scheiber bolstered the critique of *Brulotte* by quoting extensively from a law review article by Harold See & Frank M. Caprio, "The Trouble with *Brulotte*: the Patent Royalty Term and Patent Monopoly Extension," 1990 Utah L. Rev. 813, 814, 851. The argument against the *Brulotte* rule is that patent expiration places a limit on the value of the patent that cannot be overcome by extracting an agreement to pay royalties past expiration. A rational party negotiating a license will therefore demand, as Dolby did, a lower royalty knowing that the patent ceases to have value after expiration. Thus, this argument holds that any post patent-expiration payment is a deferred payment for value received during the patent term and not for the value (which must be zero) of the post-expiration period.

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The *Scheiber* decision's argument against *Brulotte* is based on two assumptions. First, it assumes that the value of a patent license to the licensee ends upon the patent's expiration. Second, it assumes that any payment of post-expiration royalties is simply a deferred payment for value obtained during the patent's term.

Patent Value After Expiration

The first assumption raises the question of whether a licensee ever has an advantage over its competition after the licensed patent expires.

There are circumstances where a licensee, particularly an exclusive licensee, may obtain a dominant position in the marketplace, giving it a competitive advantage that could extend for years after the patent's expiration. For example, in some markets an exclusive licensee may be able to build a dominant position through a brand name, establishment of relationships with distributors or large customers, low cost manufacturing of the product or retention of valuable, skilled employees with unique knowledge of the product — all of which may take years for a competitor to match. If post-expiration royalties were legal, such a licensee may be willing to pay for this post-expiration value.

Post-Expiration Royalties

In the absence of *Brulotte*, a patent owner negotiating a license that will give the prospective licensee some competitive advantage extending into the post-expiration period will demand a royalty to compensate it for the patent's benefits in both the pre- and post-expiration periods. Thus, contrary to the second assumption, in some cases where parties seek to avoid *Brulotte*, a post-expiration royalty may represent payment for the value derived from the patent in the post-expiration period.

One response by those who argue for overruling *Brulotte* might be as follows. Even if a post-expiration royalty is sometimes payment for a post-expiration benefit, *Brulotte* only prevents payment of a post-expiration royalty, not payment of value for a post-expiration benefit. Parties to a license agreement can always agree to a higher pre-expiration royalty in order to capture any post-expiration benefit. The *Brulotte* rule merely affects the timing of the payment, not its absolute value, and therefore fails to achieve its stated purpose — preventing any extension of the patent beyond its term.

Stated otherwise, a licensor and licensee could agree to provide the licensor with the same total amount of royalties by providing for a higher pre-expiration rate while avoiding the prohibition of *Brulotte* by not providing for post-expiration royalties at a lower rate. This option is only available to the extent that the parties are able to calculate and agree upon a higher pre-expiration royalty that is sufficient to compensate the patentee for any post-expiration benefits. This, however, overlooks practical difficulties many parties face in calculating a patent's value.

Most royalty agreements are based on an agreed percentage of the licensee's sales, known as the royalty rate. Parties are often better able to evaluate profit margins than sales. This explains why most license agreements employ royalties that are based on an agreed percentage of the licensee's sales. A license based on a royalty rate enables the patentee to obtain a share of the licensee's revenues without subjecting either party to the risk of fixed royalty payments that are not in proportion to the licensee's revenues. Fixed royalty payments that prove to be disproportionately large compared to the licensees' revenue may not be sustainable by the licensee. On the other hand, fixed royalty payments that prove to be small relative to the licensee's revenues may not adequately compensate the licensor for the value obtained by the licensee. A license based on a royalty rate reduces the risk of miscalculating sales, and gives both licensee and licensor a predictable portion of the profits. Thus, in many cases, the most convenient form of royalty payment for value from the post patent-expiration period are payments based on a percentage of sales in the post-expiration time period.

The *Brulotte* rule, therefore, does make it difficult for the patentee to obtain any value from the post-expiration period because it bars the most convenient form of royalty payments by barring post patent-expiration royalties. In theory, a patentee could try to induce a licensee to accept a higher royalty rate pre-expiration and no post-expiration royalty that is equivalent to the desired post-expiration royalty. This would require the licensee to accept a lowered rate of return on pre patent-expiration sales in the hopes of making this up in the post-expiration period.

Computing the tradeoff between different royalty rates over different periods of time, however, requires the parties to predict sales volume beyond the term of the patent, often more than a decade. If the parties cannot accurately estimate the sales volume, they will not be able to determine with any accuracy the value of post-expiration sales and calculate an acceptable pre-expiration royalty rate. Accordingly, the *Brulotte* rule, by barring royalties based on post-expiration sales, bars the most convenient and commonly used form of valuing future use of the licensed patent. Patentees cannot induce licensees to pay higher pre-expiration royalties to reflect any post-expiration value if such value cannot be accurately ascertained during the negotiations, nor can patentees, in view of *Brulotte*, collect post-expiration royalties. Thus, in many circumstances, the *Brulotte* rule may effectively prohibit patentees from obtaining any value for the post-expiration period.

'Scheiber' … maintains that the statutorily mandated patent expiration fixes the patent's value and any post patent-expiration payments simply represent deferred compensation for the value of the license during the patent's term.

Conclusion

The Supreme Court, in *Brulotte*, decided almost 40 years ago that it is unlawful for a patentee to collect royalties on an expired patent. *Scheiber* attacks *Brulotte*'s most basic proposition. It maintains that the statutorily mandated patent expiration fixes the patent's value and any post patent-expiration payments simply represent deferred compensation for the value of the license during the patent's term.

Scheiber, however, may oversimplify two marketplace realities. In some markets a licensee may be able to profit from a dominant position established during a patent's term for years after its expiration. Secondly, often a patentee's only practical way of capturing these post-expiration patent-based profits will be a royalty on post-expiration sales. *Brulotte*, however, prohibits royalties on post-expiration sales. The unpredictability of sales, particularly decades into the future, can make it impossible to calculate the size of a pre-expiration payment (permissible under *Brulotte*) that would compensate the patentee for these post-expiration sales. Therefore, the *Brulotte* rule effectively renders it impossible for many patentees to negotiate a license that compensates them for post-expiration patent-based profits.

Brulotte has been the law now for nearly four decades. *Scheiber* raises interesting issues, including the question of whether some post-expiration royalties should be permissible as deferred payment for enjoyment of pre-expiration rights. The Supreme Court decided not to review *Scheiber*, and therefore the questions raised by the Seventh Circuit are still open.

Given the probability that other patent licenses raising *Brulotte* issues will be litigated in the future, it is likely *Scheiber* will be used as a basis for bringing challenges to *Brulotte*. Any reassessment of *Brulotte* should take into account the potential that, in its absence, some licensing parties may be able to agree to payment of royalties after patent expiration which reflect the residual value of the patent right extending into the post-expiration period.