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Justices' Expired-Patent Royalties Ban To Spur Clever Deals

By Ryan Davis

Law360, New York (June 22, 2015, 7:59 PM ET) -- The U.S. Supreme Court's decision Monday to leave intact a 50-year-old rule barring royalty agreements that continue after a patent expires means that companies interested in striking long-running licensing deals will have to find creative ways to structure them to get around the rule, attorneys say.

In a 6-3 decision in a case involving an expired Spider-Man toy patent, the justices ruled that they were bound by stare decisis not to overturn the ban, which was established in 1964 in *Brulotte v. Thys Co.*

Justice Elena Kagan wrote for the majority that inventor Stephen Kimble, who challenged the rule in a dispute with Spider-Man rights holder Marvel Enterprises Inc., had not shown a compelling reason to end the ban. However, she noted that "parties can often find ways around *Brulotte*," allowing them to achieve the same goal of crafting licenses that last longer than the patent.

Those techniques, including spreading payments over a longer period of time or licensing other intellectual property along with a patent, have been used for years but will now be front and center in licensing negotiations, attorneys say.

"The decision explains that the *Brulotte* rule really is as narrow as we thought it was," said Jordan Sigale of Dunlap Codding. "If you make it clear there are no royalties for the patent after it expires, you can do anything you want."

While it may seem counterintuitive that any licensee would agree to keep paying for a patent after it expires when the Supreme Court has said it is not necessary, it often makes sense from a business perspective, attorneys say.

"There may certainly be times where both parties want to agree to a license for some technology beyond the life of the patent, but with the affirmance of the *Brulotte* rule, you can't simply enter into an agreement to do that," said Jeremiah Frueauf of Sterne Kessler Goldstein & Fox PLLC.

However, Justice Kagan suggested that a comparatively minor rephrasing can make a contract pass muster under *Brulotte*. Rather than agreeing to keep paying royalties after the patent expires, she said, a licensee can "defer payments for pre-expiration use of a patent into the post-expiration period."

"A licensee could agree, for example, to pay the licensor a sum equal to 10 percent of sales during the 20-year patent term, but to amortize that amount over 40 years," bringing down early

payments by spreading them over a longer period of time, she said.

Although that does not provide the wide freedom to contract that Kimble was seeking by asking the court to overturn the Brulotte rule, it is a viable workaround in most cases, attorneys say.

"That's easy. It's strictly a wording change," said Robert Kidwell of Mintz Levin Cohn Ferris Glovsky & Popeo PC.

Spreading out the payments that way is what attorneys have long done to account for Brulotte, and there aren't many situations where that wouldn't be an effective strategy, he said.

For licensing attorneys, "this is the water they swim in. It's not a problem to get around it if you need to get around it," he said.

Sigale said it was helpful that the court expressly gave its blessing to later payments of royalties accrued during the life of the patent. "Before today, people were a little nervous that the court would say that's just putting form over substance," he said.

In addition, Justice Kagan noted that post-expiration royalties are allowable under Brulotte as long as they are tied to a nonpatent right like trademarks or trade secrets, even when they are closely related to the patent.

"That means, for example, that a license involving both a patent and a trade secret can set a 5 percent royalty during the patent period (as compensation for the two combined) and a 4 percent royalty afterward (as payment for the trade secret alone)," she wrote.

Since trade secrets and trademarks do not expire like patents do, agreements that include those types of intellectual property with a "step down" in the royalty rate after the patent expires have long been a popular way to deal with Brulotte.

"If you pick up 100 license agreements that have a post-patent-term royalty in it, 95 percent would have a step down," said Basam Nabulsi of McCarter & English LLP. "That's the most common way to do it, and it will continue to be the most common way to do it."

Those alternatives, as well as nonroyalty joint ventures and other agreements the high court said are also permissible, will allow parties that want to agree to a license that extends beyond the life of a patent to do so in most instances. However, the deals need to be carefully drafted, said Melanie Mayer of Fenwick & West LLP.

The alternatives the court outlined "will work to the extent the parties are explicit about what they're doing in the contract," she said.

If the parties have an oral agreement on how to structure the deal but don't spell out in the contract that they are using one of the Supreme Court's preferred methods, there is a chance that the agreement could still be found unenforceable by a court under Brulotte, she said.

If Brulotte had been overturned, parties would have had much greater leeway to structure licensing agreements in ways that might make business sense for them but didn't fall within the categories the Supreme Court said were allowed under the rule, Nabulsi said.

"There are creative ways to work around it, but changing the rule would have made it easier and would have been more in keeping with commercial realities," he said.

The high court agreed that "a broad scholarly consensus supports Kimble's view" that allowing post-expiration royalties would foster competition. However, it said that it was not the right branch of government to address that concern, and that "critics of our ruling can take their objections across the street, and Congress can correct any mistake it sees."

The opinion noted that Congress has had decades to rewrite patent laws to end the Brulotte rule but has never done so, which Justice Kagan said bolstered the case for leaving it intact.

However, attorneys pointed out that Congress is now deep into consideration of a wide-ranging patent bill, and it would be relatively easy to insert language overruling Brulotte if lawmakers were so inclined.

"Congress has shown a lot of interest in patent issues in recent years, so I don't think it's inconceivable that Congress can be persuaded that this is worth their time, especially since the majority and the dissent both say that the economic analysis presented by Kimble is viable," Nabulsi said.

For now, the Brulotte rule is the law of the land, just as it has been for over 50 years, and most attorneys involved in licensing negotiations likely keep it in mind when structuring agreements, attorneys say.

The Kimble case arose because neither party knew about the rule when Marvel agreed to license Kimble's patent for use in a Spider-Man Web Blaster toy in perpetuity. Marvel then learned about the rule and got a court to declare that the company did not have to pay Kimble once the patent expired because of Brulotte.

That scenario highlights the pitfalls of not knowing the nuances of licensing law, but ignorance of the Brulotte rule no doubt sharply declined after Monday's ruling, attorneys say.

"The big problem with Brulotte is that it's such an old decision from the early 1960s that a lot of sophisticated parties weren't aware of it," Mayer said. "In a way, Kimble is acting as PR for the Brulotte rule, to make people more aware of it."

--Editing by Kat Laskowski and Brian Baresch.

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