

# Report from Washington

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## The Supreme Court Considers Whether to Apply Rule of Reason Standard to the Enforcement of Patent Royalties Post Patent Expiration

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### Introduction

The Supreme Court heard arguments last week in *Kimble v. Marvel Enterprises*, No. 13-720, where the Court has been asked to decide if *Brulotte v. Thys Co.*, 379 U.S. 29 (1964), a case which deems royalty agreements that involve accruals beyond the expiration of the underlying patent *per se* unlawful, should be overturned and replaced by a holding permitting analysis of such agreements under the antitrust rule of reason standard.

*Brulotte* and its progeny generally stand for the proposition that the courts will usually not enforce agreements that provide for patent royalty accruals on post-expiration use, as any such agreement would represent an improper attempt to extend the patent monopoly beyond its statutory term.

Though the *Brulotte* rule has been narrowly construed over the intervening 50 years, it is one of the Court's most controversial competition and patent law decisions, and is frequently criticized for its counterintuitive holding and arguably unconvincing rationale. In addition to the Ninth Circuit's openly critical opinion that gave rise to the instant case, two other circuit courts, dozens of district courts, the Justice Department, the Federal Trade Commission, and a litany of treatises and articles in the antitrust and patent fields have questioned the viability of *Brulotte*. The Court's decision in *Kimble v. Marvel Enterprises* is expected to clarify the scope and applicability of the *Brulotte* rule.

### Background

In *Brulotte*, the Court reasoned that while a "patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly, to use that leverage to project

those royalty payments beyond the life of the patent is analogous to an effort to enlarge the monopoly of the patent by t[y]ing the sale or use of the patented article to the purchase or use of unpatented ones.” If permitted, the Court held that the “the free market visualized for the post-expiration period would be subject to monopoly influences that have no proper place there.”

In contrast, in *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979), the Court found that neither competition nor patent law precluded the enforcement of an agreement to provide royalty payments indefinitely where no patent had issued. In that case, the respondent and petitioner negotiated a 5% royalty for the exclusive right to manufacture and sell a product if a pending patent was issued, but the parties had also agreed that if the patent application was not granted, the royalty rate would be cut in half. The Court found that the agreement was “not inconsistent” with patent law principles and distinguished *Brulotte*, indicating that “the reduced royalty which is challenged, far from being negotiated ‘with the leverage’ of a patent, rested on the contingency that no patent would issue within five years.”

Based on these two cases, circuit courts have adopted the rule that licenses for inseparable patent and non-patent rights involving royalty payments that accrue beyond a patent term are unenforceable in the post-expiration period, unless the agreement provides a discount for the non-patent rights.

In the case before the Supreme Court last week, the petitioner, Kimble, invented a Spider-Man toy that allowed children to mimic the hero’s web-shooting ability with cans of foam attached to their wrists. At a meeting with representatives of respondent, Marvel, to discuss the idea as covered by a then pending patent, Kimble was told that he would be compensated for any of his ideas that Marvel used. After the meeting, however, Kimble was informed that Marvel was not interested in his idea. Despite the denial, Marvel began producing and selling a similar toy soon thereafter.

Kimble brought suit against Marvel in 1997, alleging that Marvel had infringed his patent and breached the parties’ verbal agreement. The district court granted Marvel’s motion for summary judgment on the patent infringement claim, but found that there were genuine issues of material fact precluding summary judgment on the contract claim. A jury later found for Kimble on the contract claim, and the court entered a judgment awarding him 3.5% of past, present, and future net product sales.

After several years of additional litigation, the parties settled, and Kimble conveyed the patent to Marvel in return for royalties amounting to 3% of product sales. According to both parties, neither was aware of *Brulotte* at the time of settlement. Eventually, the parties again

fell into dispute when Marvel licensed the toy to another company without also transferring the obligation to pay royalties. By this time, Marvel had become aware of *Brulotte* and argued that *Brulotte* terminated its responsibility to pay royalties to Kimble after the patent expired in 2010.

The parties filed cross summary judgment motions, which the district court referred to a magistrate judge. The magistrate judge found that under *Brulotte*, Kimble could not recover royalties under the settlement agreement beyond the expiration date of the relevant patent because the settlement agreement constituted a “hybrid” agreement transferring inseparable patent and non-patent rights, and the patent rights were used as leverage to negotiate the agreement.

Kimble appealed, and the Ninth Circuit “reluctantly” applied the *Brulotte* rule and upheld the district court’s ruling, even though it potentially meant “depriv[ing] Kimble of part of the benefit of his bargain based upon a technical detail that both parties regarded as insignificant at the time of agreement.”

The Supreme Court granted Kimble’s petition for writ of certiorari. Kimble argued that *Brulotte* should be overturned and that the *per se* rule should instead be replaced with rule of reason analysis.

Kimble identified three premises that, in his view, were essential to the decision in *Brulotte*, and portrayed each as flawed in light of current competition policy. The three premises Kimble took issue with were that post-expiration royalties improperly extend a patent monopoly beyond the statutory term, that post-expiration royalties are invariably anticompetitive, and that possessing a patent inherently confers market power. Kimble argued that because parties negotiate contracts with knowledge that a patent’s expiration terminates its enforceability, contracts that call for deferred accruals merely allow innovators to shift the bulk of royalties to a later date, allowing the parties to better manage cash flow during long periods of pre-revenue development.

Marvel’s arguments, on the other hand, centered on the fact that Congress has amended the Patent Act 33 times since 1952 and has even held hearings on *Brulotte* directly, all without ever taking any corrective action on this issue.

### Summary of the Argument

At oral argument, counsel for Kimble opened by asserting that *Brulotte* is an outdated and misguided decision that has prohibited socially beneficial royalty arrangements for over 50

*“[E]conomists frequently don't take account [the] administrative cost of administering by judges a complex rule . . . [a]nd the virtues of a simple rule are obvious.”*

— Justice Breyer

years. Justice Sotomayor immediately challenged this point, asking for examples of actual harm that *Brulotte* has caused. Kimble's counsel pointed to amicus briefs from universities and research hospitals that stressed the depressed value of their research and innovations as a consequence of *Brulotte*. In response, Justice Ginsburg commented that she could not understand why the parties claiming harm would not just amortize the pre-expiration payments over a longer term to achieve the same effect as post-expiration accruals. Kimble's counsel explained that allowing parties to choose to pay for pre-expiration use via post-expiration accrual allows parties to shift the risk of commercialization failure and innovation failure from the licensee to the licensor.

Justices Breyer and Sotomayor appeared critical of the suggestion that the Court adopt the antitrust rule of reason in this context. Justice Breyer asked when something would be “lawful or unlawful? Does it depend upon how many people you license? Does it depend upon the height of entry barriers, something that is notoriously difficult to estimate?” Justice Sotomayor punctuated the same set of concerns throughout, asking “why are we importing antitrust principles, which already have their own set of problems? [E]verybody complains about the expense related to the rule of reason.”

Counsel for Marvel began by stating that this case should “begin and end with *stare decisis*,” arguing that, among other reasons, *Brulotte* should be affirmed so as to not disregard the reliance interest that may affect many parties who have not written an expiration term into their licensing agreements. Justice Scalia was skeptical that there would actually be a large class of people who would be harmed if *Brulotte* were overruled, stating that “the only person I think we could be disappointing is the person who knows of this exotic law and enters a contract which provides for post-termination payments knowing that will be invalid.” Justice Sotomayor pointed out that the reliance Marvel described did not exist in the instant case, as both parties conceded they did not know of *Brulotte* at the time they entered into the licensing agreement.

Chief Justice Roberts appeared open to overturning *Brulotte*. When counsel for Marvel attempted to downplay the academic concerns about the decision, the Chief Justice was quick to point out that “the economists are almost unanimous that this is a very bad rule.” Counsel for Marvel tried to deflect this point by citing an article that defended the rule authored by William Baxter, a former head of the Department of Justice's Antitrust Division, only to have the Chief Justice ask pointedly for the date that article was written. Counsel's answer: “1966.” “We overruled . . . *Lowe's*, *Albrecht*, *Arnold*, [and] *Schwinn* . . . all cases from the mid 1960's, just like this one was,” Chief Justice Roberts noted. “It's a problem with the '60s.”

*“The only person I think we could be disappointing [by overturning *Brulotte*] is the person who knows of this exotic law and enters a contract which provides for post-termination payments knowing that that will be invalid. Now, him we would disappoint, wouldn't we?”*

— Justice Scalia

The United States also participated in oral argument in support of Marvel's position, but did so by taking a fundamentally different approach. Rather than focusing on *stare decisis* or economic arguments, the government argued that the Court's decision in *Brulotte* should not be viewed as an antitrust decision, but rather as a patent case most analogous to cases where the Court examined state laws that would have provided patent-like protection after expiration and invalidated the laws on preemption grounds. The government argued that “during the period when the patent is in force, you can basically charge whatever royalties the market will bear; after the patent expires, the invention is supposed to be available for free, unrestricted use for the public, and you can't trade one for the other” without interfering with the balance set up by the U.S. government.

Justice Sotomayor appeared to be the most conflicted of the Justices during argument. On one hand, Justice Sotomayor appeared willing to overturn *Brulotte* as bad law for economic reasons. On the other hand, she seemed unconvinced that replacing *Brulotte's per se* rule with the rule of reason analysis would solve the problem. Justice Sotomayor questioned counsel for both parties about alternatives to the *per se* and rule of reason approaches. She also asked about the viability of overturning *Brulotte* and allowing patent misuse to continue to be governed by the rule of reason under the doctrines of coercion and fraud while allowing existing antitrust laws to govern any competition concerns that would not be covered.

## Implications

In deciding this case, the Supreme Court is expected either to overturn *Brulotte* or to reaffirm the 50-year-old rule prohibiting patent royalties based on post-expiration uses. If *Brulotte* were to be overturned, the decision would perhaps be most noteworthy as a demonstration of the Court's willingness to overturn precedent because it is based on “bad” economics. This would be a continuation of the Court's approach in antitrust cases during Chief Justice Roberts' tenure. For example, in *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006), the Court rejected as economically unsound the notion that a patent necessarily confers market power upon the patentee. And in *Leegin Creative Leather Products v. PSKS, Inc.*, 551 U.S. 877 (2007), the Court held that vertical minimum resale price maintenance should be analyzed under the rule of reason standard and not treated as *per se* unlawful. The direct impact of any abandonment of the *Brulotte* rule, however, would likely prove to be limited. As Justices Ginsburg, Kagan, and Scalia each suggested during argument, parties aware of the *Brulotte* rule are already able to structure licensing and other agreements in ways that largely circumvent the *per se* prohibition.

*“[T]he economists are almost unanimous that this is a very bad rule . . . .”*

— Chief Justice Roberts

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For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

**Kevin Arquit**  
+1-212-455-7680  
[karquit@stblaw.com](mailto:karquit@stblaw.com)

**Harrison Frahn**  
+1-650-251-5065  
[hfrahn@stblaw.com](mailto:hfrahn@stblaw.com)

**Peter Guryan**  
+1-212-455-2750  
[peter.guryan@stblaw.com](mailto:peter.guryan@stblaw.com)

**Andrew Lacy**  
+1-202-636-5505  
[alacy@stblaw.com](mailto:alacy@stblaw.com)

**Noah Leibowitz**  
+1-212-455-3098  
[nleibowitz@stblaw.com](mailto:nleibowitz@stblaw.com)

**Lori Lesser**  
+1-212-455-3393  
[llesser@stblaw.com](mailto:llesser@stblaw.com)

**Jeffrey Ostrow**  
+1-650-251-5030  
[jostrow@stblaw.com](mailto:jostrow@stblaw.com)

**Sara Razi**  
+1-202-636-5582  
[sara.razi@stblaw.com](mailto:sara.razi@stblaw.com)

**Matthew Reilly**  
+1-202-636-5566  
[matt.reilly@stblaw.com](mailto:matt.reilly@stblaw.com)

**Patrick Ryan**  
+1-212-455-3463  
[pryan@stblaw.com](mailto:pryan@stblaw.com)

**Peter Thomas**  
+1-202-636-5535  
[pthomas@stblaw.com](mailto:pthomas@stblaw.com)

**Joseph Tringali**  
+1-212-455-3840  
[jtringali@stblaw.com](mailto:jtringali@stblaw.com)

**David Vann**  
+44-(0)20-7275-6550  
[dvann@stblaw.com](mailto:dvann@stblaw.com)

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Simpson  
Thacher  
Worldwide



#### UNITED STATES

New York  
425 Lexington Avenue  
New York, NY 10017  
+1 212-455-2000

Houston  
2 Houston Center  
909 Fannin Street  
Houston, TX 77010  
+1 713-821-5650

Los Angeles  
1999 Avenue of the Stars  
Los Angeles, CA 90067  
+1 310-407-7500

Palo Alto  
2475 Hanover Street  
Palo Alto, CA 94304  
+1 650-251-5000

Washington, D.C.  
1155 F Street, N.W.  
Washington, D.C. 20004  
+1 202-636-5500

#### EUROPE

London  
City Point  
One Ropemaker Street  
London EC2Y 9HU  
England  
+44 (0)20-7275-6500

#### ASIA

Beijing  
3919 China World Tower  
1 Jian Guo Men Wai Avenue  
Beijing 100004  
China  
+86 10-5965-2999

Hong Kong  
ICBC Tower  
3 Garden Road, Central  
Hong Kong  
+852 2514-7600

Seoul  
West Tower, Mirae Asset Center 1  
26 Eulji-ro 5-gil, Jung-gu  
Seoul 100-210  
Korea  
+82 2-6030-3800

Tokyo  
Ark Hills Sengokuyama Mori  
Tower  
9-10, Roppongi 1-Chome  
Minato-Ku, Tokyo 106-0032  
Japan  
+81 3-5562-6200

#### SOUTH AMERICA

São Paulo  
Av. Presidente Juscelino  
Kubitschek, 1455  
São Paulo, SP 04543-011  
Brazil  
+55 11-3546-1000