No. ________

In The
Supreme Court of the United States

STEPHEN KIMBLE AND ROBERT MICHAEL GRABB,

Petitioners,

v.

MARVEL ENTERPRISES, INC.,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Petitioners are individuals who assigned a patent and conveyed other intellectual property rights to Respondent. The court of appeals "reluctantly" held that Respondent, a large business concern, was absolved of its remaining financial obligations to Petitioners because of "a technical detail that both parties regarded as insignificant at the time of the agreement." App. 2-3; 23. Specifically, because royalty payments under the parties' contract extended undiminished beyond the expiration date of the assigned patent, Respondent's obligation to pay was excused under *Brulotte v. Thys Co.,* 379 U.S. 29, 32 (1964), which had held that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*."

A product of a bygone era, *Brulotte* is the most widely criticized of this Court's intellectual property and competition law decisions. Three panels of the courts of appeals (including the panel below), the Justice Department, the Federal Trade Commission, and virtually every treatise and article in the field have called on this Court to reconsider *Brulotte*, and to replace its rigid *per se* prohibition on post-expiration patent royalties with a contextualized rule of reason analysis.

The question presented is:

Whether this Court should overrule *Brulotte v. Thys Co*., 379 U.S. 29 (1964).

PARTIES TO THE PROCEEDINGS

There are no parties to the proceedings other than those listed in the caption.

However, it is Petitioners' understanding that Respondent Marvel Enterprises, Inc. has been succeeded by merger by an entity called Marvel Entertainment, LLC, and that the latter is wholly owned by The Walt Disney Company.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Stephen Kimble and Robert Michael Grabb respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1-26) is reported at 727 F.3d 856. The opinion of the United States District Court for the District of Arizona (App. 27-45) is reported at 692 F. Supp. 2d 1156. The report and recommendation of the magistrate judge (App. 46-72) also is reported at 692 F. Supp. 2d 1156 as an attachment to the district court opinion.

JURISDICTION

The Ninth Circuit entered judgment on July 16, 2013. On September 27, 2013, Justice Kennedy granted an extension until December 13, 2013 (No. 13A304) to file a petition for a writ of certiorari in this matter. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

None.

INTRODUCTION

Petitioners respectfully ask this Court to overrule *Brulotte v. Thys Co.,* 379 U.S. 29 (1964), App. 73-85, and to reject its *per se* prohibition on licensing arrangements involving post-expiration patent royalties. Petitioners are in good company. Three panels of the courts of appeals (including the Ninth Circuit panel below), the Justice Department, the Federal Trade Commission, and virtually every treatise and article in the field also have called on this Court to reconsider that decision. *See* Part I.A., *infra.*

The reason for this unanimity is straightforward. *Brulotte*, now approaching its half-century anniversary, has not withstood the test of time. Other competition law decisions from that era have been updated by this Court in light of a keener awareness of economics and real world business circumstances, with rigid *per se* rules, unequal to the realities of the marketplace, supplanted with analysis under the rule of reason. *See* Part III, *infra.* It is now *Brulotte*'s turn – as Judge Posner has observed, "*Brulotte* does not reflect the Supreme Court's current thinking about

competition and monopoly, but . . . will continue to bind the lower courts until the Supreme Court decides to overrule it."[1]

1. In *Brulotte*, this Court held, as a matter of federal common law, that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*." *Brulotte*, 379 U.S. at 32, App. 77. While a "patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly," the Court observed, "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." *Id.*, 379 U.S. at 33, App. 78. Consequently, the Court reasoned, the "exaction of royalties for use of a machine after the patent has expired is an assertion of monopoly power in the post-expiration period when . . . the patent has entered the public domain." *Id.*, 379 U.S. at 33, App. 78-79.

As a consequence of *Brulotte*, "willing parties are prohibited from agreeing to [patent] royalties that accrue based on post-expiration use, even if that royalty structure is mutually agreed (a) without any coercion by the licensor, (b) as the most convenient

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[1] Richard A. Posner, *Transaction Costs and Antitrust Concerns in the Licensing of Intellectual Property*, 4 J. Marshall Rev. Intell. Prop. L. 325, 332 (2005).

method of measuring the value of the licensed rights, and (c) in exchange for a lower royalty rate overall."[2] In other words, *Brulotte* categorically "requires the licensor and licensee to amortize the present value of the license fee over the remaining years of the patent term, rather than over a longer period of years, even if a longer amortization period is optimal for the parties."[3]

Lower court decisions, antitrust enforcement agency analysis, and the academic and professional literature point to three reasons for overturning *Brulotte* and replacing its rigid *per se* prohibition on post-expiration patent royalties with a more nuanced rule of reason analysis.

a. First, there is pervasive agreement that the primary premise of *Brulotte* – that post-expiration patent *royalties* somehow extend the patent *right* into the post-expiration period – is fundamentally in error. *See* Part I.B.1., *infra.* Once a patent has expired, it can no longer be used to prevent anyone from practicing the invention – a fact of which the contracting parties are well aware in advance. License payment terms, consequently, reflect solely the anticipated value of the authorization to use the

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[2] Alfred C. Server et al., *Reach-Through Rights and the Patentability, Enforcement, and Licensing of Patents on Drug Discovery Tools*, 1 Hastings Sci. & Tech. L.J. 21, 98 (2008).

[3] Harold See & Frank M. Caprio, *The Trouble with Brulotte: The Patent Royalty Term and Patent Monopoly Extension*, 1990 Utah L. Rev. 813, 814 (1990).

patented invention prior to patent expiration. Even if certain patent royalty payments nominally are measured by post-expiration use, they nonetheless represent an amortization of the predicted value of the pre-expiration authorization. For example, the parties may agree to defer the start of the payment period, or to lower the royalty rate, in exchange for an extended payment period. Such a trade-off, however, merely calibrates the value of the pre-expiration authorization to the circumstances – it does not entail an extension in time of the patent right to exclude.

b. Second, as the Justice Department and FTC particularly have emphasized, *Brulotte*'s *per se* rule discourages technological innovation and does significant damage to the American economy by categorically proscribing licensing practices that are usually procompetitive and further the goals of the patent system. *See* Part I.B.2., *infra.* Licensing arrangements that permit post-expiration patent royalties can (i) serve as an efficient means of financing development of nascent technologies when the licensor is able to access capital more cheaply than the licensee, (ii) allow parties to balance and allocate the upside and downside risks of developing and commercializing new technology, (iii) lower prices and raise output during the patent term by means of an upfront royalty rate reduction, and (iv) also lower prices and increase competition *after* the end of the patent term by encouraging market entry by new, lower-priced competitors. *See id.* In the closely-related antitrust context, this Court consistently has emphasized that

per se prohibitions are reserved for practices that are "always or almost always" anticompetitive.[4] Against this background, the *Brulotte per se* rule makes little sense – post-expiration patent royalties should, as the Justice Department and the FTC have recommended, instead be reviewed "pursuant to the rule of reason." U.S. Dep't of Justice and FTC, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition* 12 & 122 (Apr. 2007) ("2007 DOJ/FTC Report").[5]

c. Third, *Brulotte* should be revisited because a key assumption underlying that decision has since been abandoned. *See* Part I.B.3., *infra*. *Brulotte* – relying on an analogy to tying cases – irrebuttably presumed that merely having a patent conferred market power and inherently allowed the licensor to exercise improper leverage over the licensee. In recent years, however, both Congress and this Court pointedly have rejected the patent-equals-market-power presumption in the tying context. *See* 35 U.S.C. §271(d)(5); *Ill. Tool Works, Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 42, 45-46 (2006). This change in the law of tying has further undermined *Brulotte*, bolstering instead the view of the Justice Department and FTC that the "starting point for evaluating practices

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[4] *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 886-87 (2007) (internal quotation marks omitted).

[5] The 2007 DOJ/FTC Report is available at http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf.

that extend beyond a patent's expiration [should be] . . . analyzing whether the patent in question confers market power." 2007 DOJ/FTC Report at 12.

2. The doctrine of *stare decisis* does not counsel against overruling *Brulotte*, for three reasons. *See* Part III, *infra*. First, *Brulotte* itself is a judge-made rule, rather than an interpretation of the patent statute, and thus more amenable to reconsideration. Second, in the closely-related antitrust context, this Court consistently has emphasized that reappraisal of *per se* prohibitions particularly is warranted when the relevant government agencies and the academic literature, in light of intervening experience and analysis, urge application of the rule of reason. Finally, reliance interests are not significantly implicated by a reevaluation of *Brulotte*, as the only existing agreements likely to be impacted are either those – like the one at issue in this case – where the parties agreed to post-expiration royalty payments because they were unaware of *Brulotte*, or those where one of the parties purposely entered into such an agreement in the hope of later avoiding its contractual obligations on the basis of *Brulotte*.

STATEMENT

A. Factual background

Petitioner Stephen Kimble invented a toy that allows a child to role play as Spider-Man by mimicking that superhero's web-shooting abilities with foam

string. App. 3. In December 1991, Kimble obtained a patent on his invention. App. 3-4.

Meanwhile, in December 1990, Kimble had a meeting with the president of the predecessor in interest of Respondent Marvel Enterprises, Inc. ("Marvel") to discuss his then-pending patent application and other "ideas and know-how" related to the web-shooting toy. App. 4. The executive verbally agreed to compensate Kimble if the company used any of his ideas. *Id.*

In 1997, Kimble sued Marvel for breach of the verbal agreement and patent infringement, alleging that it had used his ideas in developing a toy called the Web Blaster without compensating him. App. 5. After the district court granted summary judgment of noninfringement, the jury found for Kimble on the contract claim. *Id.* Both parties appealed. *Id.*

In 2001, while the appeals were pending, Kimble, Petitioner Robert M. Grabb[6] and Marvel settled the 1997 litigation. App. 5-6. Pursuant to the 2001 settlement agreement, Petitioners assigned their patent to Marvel, as well as conveying the non-patent intellectual property rights to the toy ideas verbally exchanged between the parties during the December 1990 meeting. App. 9. In return, the agreement provided for a lump-sum payment and an additional

[6] Mr. Grabb had acquired an interest in Kimble's intellectual property rights prior to the 2001 settlement, and became a party to that agreement. App. 3 n.1; App. 29 n.1.

running royalty of 3% of "net product sales." App. 6. The settlement agreement did not provide for any reduction in the royalty rate after the assigned patent expired. *Id.* At the time the agreement was signed, neither party was aware of the *Brulotte* decision. App. 6-7 & n.3.

In 2008, after certain disagreements arose between the parties regarding royalty calculation methodology, Petitioners sued Marvel in state court for breach of the 2001 settlement agreement. App. 8. After removal to federal court, Marvel – which had since become aware of *Brulotte* as a result of sublicensing negotiations with a third party – counterclaimed, seeking a declaration that it would owe no further royalties after the assigned patent expired on May 25, 2010. App. 7-8 & n.3.

B. The district court decision

The district court, adopting the magistrate judge's report and recommendation, granted summary judgment to Marvel on its declaratory counterclaim. App. 37. In the absence of a royalty rate reduction at patent expiration or other indication to the contrary, the district court reasoned, the post-expiration royalty was at least partially attributable to the assigned patent rights, and hence entirely uncollectible under *Brulotte*, as the court was "'unable to conjecture what the bargaining position of the parties might have been and what resultant arrangement might have emerged had the provision for

post-expiration royalties been divorced from the patent and nowise subject to its leverage.' " App. 35 & 37 & 58-60 (quoting *Brulotte*, 379 U.S. at 32, App. 77).

C. The Ninth Circuit decision

The Ninth Circuit "reluctantly" affirmed. App. 2-3. The 2001 settlement agreement, it held, conveyed "inseparable patent and non-patent rights" and contained neither a post-expiration discount "from the patent-protected rate" nor "some other clear indication that the [post-expiration] royalty at issue was in no way subject to patent leverage." App. 3; App. 18. Consequently, the panel was constrained to "presume that the post-expiration royalty payments . . . [were] for the then-current patent use, which is an improper extension of the patent monopoly under *Brulotte*," rendering the obligation to make those royalty payments "unenforceable." App. 18. This was true even though "Kimble's primary leverage in negotiating the [2001] settlement was undoubtedly the jury verdict on the contract claim," as, "at the time of the negotiations, he [also] was [still] challenging the district court's decision and likely derived some amount of leverage from his patent infringement appeal." App. 22-23.

At the same time, the court of appeals noted that application of the *Brulotte per se* rule compelled an unjust result:

> We acknowledge [that] our application of the *Brulotte* rule in this case arguably deprives

> Kimble of part of the benefit of his bargain based upon a technical detail that both parties regarded as insignificant at the time of the agreement. . . . [¶] The patent leverage in this case was vastly overshadowed by what were likely non-patent rights, and Kimble may have been able to obtain a higher royalty rate had the parties understood that the royalty payments would stop when the patent expired.

App. 23-25.

Additionally, the Ninth Circuit observed that *Brulotte* was a "frequently-criticized" decision resting on a "counterintuitive" and "economically unconvincing" rationale:

> 'The Supreme Court's majority opinion [in *Brulotte*] 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 . . . 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.'

App. 24-25 (quoting *Scheiber v. Dolby Labs., Inc.*, 293 F.3d 1014, 1017 (7th Cir. 2002) (Posner, J.)); App. 2; App. 15.

Consequently, while acknowledging that it was "bound by Supreme Court authority," the court of appeals called on this Court to reconsider *Brulotte,* noting that the Seventh Circuit, the Justice Department, the Federal Trade Commission, a previous Ninth Circuit panel, and numerous academic commentators similarly had done so. App. 2; App. 24-25 & n.7; App. 15-16.

REASONS FOR GRANTING THE PETITION

I. The Court Should Grant This Petition To Reconsider *Brulotte* And Reject Its Rigid *Per Se* Prohibition On Post-Expiration Patent Royalties.

A. The Courts Of Appeals, The Justice Department, The Federal Trade Commission, And The Academic And Professional Literature All Have Called On This Court To Overrule *Brulotte*.

Brulotte is the most widely criticized of this Court's intellectual property and competition law

decisions. Virtually every treatise in the field to address the issue, and every article on the subject, denounces *Brulotte* as fundamentally misguided and economically unsound, and calls for it to be overruled and for its rigid *per se* prohibition on post-expiration patent royalties to be replaced with a more nuanced rule of reason analysis. *See, e.g.*, 3 Roger M. Milgrim & Eric E. Bensen, *Milgrim on Licensing* §18.05 (2013) ("Milgrim Treatise") (*Brulotte* "is so illogical from the standpoint of any economic analysis that it inspires awe that legal reasoning can be so removed from the universe in which it occurs"); Jay Dratler, Jr., *Licensing of Intellectual Property* §4.04[5][d] (1994 & Supp. 2013) ("Dratler Treatise") ("[The] rule of *Brulotte* is an anachronism with little or no economic justification[,] . . . a lonely *per se* outpost in a rule-of-reason world."); William M. Landes & Richard A. Posner, *The Economic Structure of Intellectual Property Law* 380 & 418 (Harvard Univ. Press 2003) ("Landes & Posner") (*Brulotte* is "wrong," "dubious," "anomalous," and "one of the all-time economically dumb Supreme Court decisions"); John W. Schlicher, *Patent Law, Legal and Economic Principles* §13:218 (2d ed. 2012) ("Schlicher Patent Treatise") ("[P]ost-expiration royalties should not be a basis for patent misuse," or, at a minimum, "should not be the subject of a *per se* rule."); Ian Ayres & Paul Klemperer, *Limiting Patentees' Market Power without Reducing Innovation Incentives: The Perverse Benefits of Uncertainty and Non-Injunctive Remedies*, 97 Mich. L. Rev. 985, 1027 (1999) ("Our analysis . . . suggests that *Brulotte* should be overruled."); Richard Gilbert & Carl Shapiro, *Antitrust*

Issues in the Licensing of Intellectual Property: The Nine No-No's Meet the Nineties in *Brookings Papers on Economic Activity: Microeconomics* 283, 322 (1997) ("Gilbert & Shapiro")[7] ("Economic theory reveals that [the *Brulotte*] . . . doctrine is flawed. . . . [Its] [l]egal reasoning . . . , based on the notion that extending the royalties in time is to 'enlarge the monopoly of the patent,' although rhetorically appealing, does not seem to reflect commercial reality or basic economics.").[8]

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[7] *Available at* faculty.haas.berkeley.edu/shapiro/ninenono.pdf.

[8] *See also* 10 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* ¶1782c & 555 (3d ed. 2011 & Supp. 2013) (describing in detail "the error in *Brulotte*"); 1 Herbert Hovenkamp, Mark D. Janis, Mark A. Lemley & Christopher R. Leslie, *IP and Antitrust: An Analysis of Antitrust Principles Applied to Intellectual Property Law* §23.2a at 23-5–23-6 & 23-11 (2d ed. 2013) ("Hovenkamp IP & Antitrust Treatise") ("*Brulotte* condemned a post-[expiration] royalty provision under a per se rule that reflected the hostility of that era toward perceived extension of the patent 'monopoly.' . . . [T]hese concerns are misplaced. . . ."); Raymond T. Nimmer & Jeff Dodd, *Modern Licensing Law* §7:10 (2012) ("Nimmer Treatise") ("Per se illegality . . . [pursuant to *Brulotte*] is a bad rule."); See & Caprio, 1990 Utah L. Rev. at 853 ("*Brulotte* . . . is wrongly decided"); Rochelle Cooper Dreyfuss & Lawrence S. Pope, *Dethroning* Lear? *Incentives to Innovate After* MedImmune, 24 Berkeley Tech. L.J. 971, 1006 (2009) (*Brulotte* was "misguided when . . . decided and . . . [is] certainly out of step with current economic understanding and business practices."); Thomas F. Cotter, *Four Questionable Rationales for the Patent Misuse Doctrine*, 12 Minn. J. L. Sci. & Tech. 457, 461 n.18 & 480 (2011) ("*Brulotte* has been widely, and justly, criticized as resting on flawed economic reasoning . . . [and] would be hard to

(Continued on following page)

Three recent decisions of the courts of appeals, including the Ninth Circuit's decision in this case, while reluctantly following *Brulotte*, also have called on this Court to reconsider it:

> [*Brulotte*] has . . . been severely, and as it seems to us, with all due respect, justly, criticized. . . . However, we have no authority to overrule a Supreme Court decision no matter how dubious its reasoning strikes us, or even how out of touch with the Supreme Court's current thinking the decision seems.

Scheiber v. Dolby Labs., Inc., 293 F.3d 1014, 1017-18 (7th Cir. 2002) (Posner, J.); *accord Kimble v. Marvel Enters., Inc.*, App. 2 & 24-25 & n.7 (noting that although the panel was "bound by Supreme Court authority," the "*Brulotte* rule is counterintuitive and its rationale is arguably unconvincing"); *Zila, Inc. v. Tinnell*, 502 F.3d 1014, 1019-20 & n.4 (9th Cir. 2007) ("[We] are bound to apply [*Brulotte*] . . . if it applies to the case before us . . . [and must leave to the Supreme] Court the prerogative of overruling its own decisions.") (internal quotation marks omitted); *see also* Frank H. Easterbrook, *Contract and Copyright*, 42 Hous. L. Rev. 953, 955 n.7 (2005) ("*Brulotte* [is] wrong in principle – but conclusive on the lower federal judiciary until the Justices deliver the R.I.P.").

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defend."); Server et al., 1 Hastings Sci. & Tech. L.J. at 96-68 (criticizing *Brulotte* as "flawed").

The Justice Department and the Federal Trade Commission similarly have expressed disagreement with *Brulotte.* In a recent joint report, the enforcement agencies noted that "[c]ollecting royalties beyond a patent's statutory term can be efficient," and concluded that, notwithstanding *Brulotte*'s *per se* prohibition, the "Agencies [will] review most agreements that have the potential to extend the market power conferred by a valuable patent beyond that patent's expiration pursuant to the rule of reason." 2007 DOJ/FTC Report at 12 & 122; *see also* Rochelle Cooper Dreyfuss & Lawrence S. Pope, *Dethroning* Lear*? Incentives to Innovate After* MedImmune*,* 24 Berkeley Tech. L.J. 971, 996 (2009) (2007 DOJ/FTC Report suggests that *Brulotte* "ought to be reconsidered"); William C. Holmes, *Intellectual Property and Antitrust Law* §24:3 (2013) ("Holmes Treatise") ("[Post-expiration patent royalties] should not be held *per se* illegal, but should instead be governed by the more flexible . . . rule of reason – a position that is now taken by both federal antitrust enforcement agencies. . . .") (citing 2007 DOJ/FTC Report at 122) (internal quotation marks omitted).

B. *Brulotte* Should Be Revisited Because It Incorrectly Conflates Patent Royalties And Patent Rights, Prohibits Procompetitive Licensing Practices, And Relies On Outdated Assumptions.

Why has *Brulotte* met with such pervasive criticism? The lower court decisions, enforcement agency

analysis, and academic and professional literature point to three primary reasons for overturning that decision: *Brulotte* (i) incorrectly assumes that post-expiration patent royalties extend patent rights, (ii) suppresses innovation by proscribing procompetitive licensing practices, and (iii) relies on the outdated irrebuttable presumption that patents confer market power.

1. Post-Expiration Patent Royalties Do Not Temporally Extend Patent Rights.

As an initial matter, the primary premise of *Brulotte* – that post-expiration patent *royalties* somehow extend the patent *right* into the post-expiration period – is fundamentally in error. Once a patent has expired, it can no longer be used to prevent anyone from practicing the invention – a fact of which the contracting parties are well aware in advance. License payment terms, consequently, reflect solely the anticipated value of the authorization to use the patented invention prior to patent expiration. Even if certain patent royalty payments nominally are measured by post-expiration use, they nonetheless represent an amortization of the predicted value of the pre-expiration authorization. For example, the parties may agree to defer the start of the payment period, or to lower the royalty rate, in exchange for an extended payment period. Such a trade-off, however, merely calibrates the value of the pre-expiration authorization to the circumstances – it does not entail an

extension in time of the patent right to exclude. As a leading treatise has explained,

> [w]hen the only payments are for use and such payments are required beyond patent expiration, the patentee may appear to extract an unauthorized fee for post-expiration use. *However, this appearance is an illusion*. The machine is presumably more valuable while the patent prevents copying; hence, the annual fee for using it would be higher during the early years if it were not stretched out over the machine's useful life. . . . [¶] Competing manufacturers [nevertheless] are free to employ the patented technology the instant the patents have expired.

10 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* ¶1782c.3 at 556 (3d ed. 2011 & Supp. 2013) ("Areeda Treatise") (emphasis added).

Judge Posner has made the same point on behalf of the Seventh Circuit:

> 'The *Brulotte* rule incorrectly assumes that a patent license has significance after the patent terminates. When the patent term ends, the exclusive right to make, use or sell the licensed invention also ends. Because the invention is available to the world, the license in fact ceases to have value. Presumably, licensees know this when they enter into a licensing agreement. If the licensing agreement calls for royalty payments beyond the patent term, the parties base those payments

> on the licensees' assessment of the value of the license during the patent period. These payments, therefore, do not represent an extension in time of the patent monopoly.'

Scheiber, 293 F.3d at 1017-18, 1020 (quoting Harold See & Frank M. Caprio, *The Trouble with* Brulotte*: The Patent Royalty Term and Patent Monopoly Extension*, 1990 Utah L. Rev. 813, 814 & 851(1990)).

Virtually every treatise and article on the subject agrees with the Seventh Circuit's analysis, as do the Ninth Circuit, the Justice Department, and the FTC. *See Kimble v. Marvel Enters., Inc.*, App. 24-25 (quoting *Scheiber*); 2007 DOJ/FTC Report at 118 n.18 ("Once a patent expires, a licensee can use the patent for no charge. It is therefore unclear how a licensor could persuade a licensee to pay more than the amount the licensee would be willing to pay to use the patent during its term.") (citing *Scheiber*); Easterbrook, 42 Hous. L. Rev. at 955 (A "license [does] not create a monopoly. . . . *Brulotte* . . . is problematic because it misses this point. Once the patent expires, the power to exclude is gone and all we have is a problem about optimal contract design. If it is lawful to set royalties as '10% during the patent and nothing thereafter,' why is it forbidden to set them at 5% during and after the patent?"); John W. Schlicher, *Licensing Intellectual Property: Legal, Business and Market Dynamics* 195 (John Wiley & Sons, Inc. 1996) ("Schlicher Licensing Treatise") ("If the patent owner asks that royalties be paid over the twenty-five year period, the royalty rate during the term must be

lower. This is so because the value of the patent to the licensee is limited by the difference between the cost and demand during the term. After the term, all others will be able to use the invention freely in competition with those licensees. Unless that license provides them some additional benefit, the rate must be lowered to induce the licensees to agree to pay over the longer period.").[9]

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[9] *See also* 1 Hovenkamp IP & Antitrust Treatise §23.2a at 23-10 ("It is not even clear that the *Brulotte* arrangement served to enlarge the gross amount of royalties payable to the patentee by making them payable for a longer time. The patentee could as easily have charged a higher royalty rate but made the royalty requirement expire with the patents. If adjusted to present value, the licensee would be indifferent among the options."); Nimmer Treatise at §7:10 ("*Brulotte* reflects a fundamental misdescription of the royalty decision to cover uses after expiration of the underlying rights. That choice does not extend the underlying property right but merely reflects a decision about how to compute and pay the price charged for a license."); Dratler Treatise at §5.04[6][a][i] ("[The] contractual obligation . . . at issue [in *Brulotte*] hardly extended the term of the patents. Everyone besides the licensee was free to practice the patents after they expired with no payment whatsoever. For example, competing manufacturers could make the same machines freely and even sell them to licensees of the expired patents."); Server et al., 1 Hastings Sci. & Tech. L.J. at 101 n.231 ("[P]ost-expiration royalties are merely a method of financing the value received by the licensee during the patent term, since upon expiration of the patent, the patentee has nothing of value left to offer in exchange. Following the expiration of the patent, no one can be excluded from exploiting the previously patented invention, and licensees presumably know this fact when they negotiate the royalty terms of their license."); Christina Bohannan, *IP Misuse as Foreclosure*, 96 Iowa L. Rev. 475, 516-17 (2011) ("[T]he Court's reasoning [in *Brulotte*]

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The Court's assumption that "exaction of royalties for use of a machine after the patent has expired is an assertion of monopoly power in the post-expiration period," App. 78, undergirds the entire opinion in *Brulotte.* The consensus among the lower

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is faulty. . . . The patent holder can charge as much as it wants for the use of the invention during the patent term, and the entire amount that the licensee is willing to pay can be allocated to use of the patent during the term. The licensee is indifferent as to how the total payment will be allocated and will not pay another monopoly price for use of the patented invention after the patent has expired."); Vincent Chiappetta, *Living with Patents: Insights from Patent Misuse*, 15 Marq. Intell. Prop. L. Rev. 1, 41-42 & n.186 (2011) ("Post-term royalties are later payment for value already received (the value of access to the patent during its term). . . . The relevant 'extension of the monopoly' post-term royalty inquiry, therefore, is not when payment occurs, but whether the discounted present value of the aggregate royalty payments exceeds the value of accessing the patent during its (remaining) term. [¶] The market ensures that equivalence will always exist regardless of when actual payment is made."); Rochelle Cooper Dreyfuss, *Dethroning* Lear*: Licensee Estoppel and the Incentive to Innovate*, 72 Va. L. Rev. 677, 710 n.120 (1986) ("It is important to note that post-expiration royalty provisions do not entirely circumvent the limited-time provision of the Patent Act or the Constitution. The . . . patent term influences the price that the licensee will pay for the product in two ways. Knowing that the product will eventually be available royalty-free may induce the licensee to pay less for it in the first place. The licensee will also bargain down the royalty rate because it knows that after the patent lapses it will have to compete with rivals who enjoy free use of the invention."); Mark A. Lemley, *The Economic Irrationality of the Patent Misuse Doctrine*, 78 Cal. L. Rev. 1599, 1630 (1990) ("A licensee will pay a fixed amount for a license, and the courts should not care whether the licensee pays that amount up front, in ten years, or in a hundred years.").

courts, the enforcement agencies, and commentators of all stripes that this assumption was mistaken powerfully demonstrates the need to revisit that decision.

2. *Brulotte* Suppresses Innovation By Proscribing Procompetitive Licensing Practices.

Brulotte should be reevaluated for yet another reason. As the Justice Department and FTC have stressed, *Brulotte* discourages technological innovation and does significant damage to the American economy by categorically proscribing licensing practices that are usually procompetitive and further the goals of the patent system.

In the closely-related antitrust context, this Court repeatedly has emphasized that resort "to *per se* rules is confined to restraints . . . that would always or almost always tend to restrict competition and decrease output," i.e., ones that "have manifestly anticompetitive effects," "lack any redeeming virtue," and "would be invalidated in all or almost all instances under the rule of reason." *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 886-87 (2007) (internal quotation marks and ellipses omitted). Yet *Brulotte* did not inquire into the nature or frequency of any anticompetitive effects that might stem from post-expiration patent royalties: it simply assumed the worst. *See* 1 Herbert Hovenkamp, Mark D. Janis, Mark A. Lemley & Christopher R. Leslie, *IP and*

Antitrust: An Analysis of Antitrust Principles Applied to Intellectual Property Law §23.2a. at 23-8 (2d ed. 2013) ("Hovenkamp IP & Antitrust Treatise") (*Brulotte* "created a rule of per se illegality" without requiring "any finding of anticompetitive effects in any market").

As the Justice Department and the FTC have explained, however, *Brulotte*'s unquestioning assumption that post-expiration patent royalties invariably are anticompetitive is erroneous:

> Collecting royalties beyond a patent's statutory term can be efficient. Although [under current law] there are limitations on a patent owner's ability to [do so] . . . , [*see Brulotte*], that practice may permit licensees to pay lower royalty rates over a longer period of time, which reduces the deadweight loss associated with a patent monopoly and allows the patent holder to recover the full value of the patent, thereby preserving innovation incentives.

2007 DOJ/FTC Report at 12; *see also id.* at 118 & 122 (same).

The pernicious consequence of *Brulotte*'s *per se* rule, then, is that it *destroys* rather than protects innovation incentives:

> [*Brulotte*'s] prohibition of post-term royalties causes affirmative social harm. By unnecessarily limiting flexibility in private-ordering regarding timing of payments, it . . . unduly restricts access and exploitation of the

> patented invention . . . [and] needlessly (and ironically) interferes with . . . promotion of innovation policy. . . .

Vincent Chiappetta, *Living with Patents: Insights from Patent Misuse*, 15 Marq. Intell. Prop. L. Rev. 1, 42-43 (2011).[10]

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[10] *See also* Schlicher Licensing Treatise at 196 (post-expiration patent royalties are "[p]rocompetitive" because "extension of the payment period reduces the cost of producing or using the patent or operating under the license, . . . [which in turn] increases the value of the patent and increases innovation"); See & Caprio, 1990 Utah L. Rev. at 846 & n.228 ("*Brulotte* is simply wrong" because it "invalidate[s] a multitude of economically beneficial licensing agreements, thereby discouraging businesses from entering into efficient business arrangements . . . [and suppressing] incentives to exploit an invention."); ABA Section of Antitrust Law, Intellectual Property Misuse: Licensing and Litigation 137 (2000) (an "effort by the patent holder to extract payment from the licensee after the patent has expired . . . is least harmful to society from an economic perspective" and can be "economically neutral or procompetitive"); Gilbert & Shapiro at 322 ("Permitting royalties to be paid over a longer term can, under reasonable conditions, reduce the deadweight loss from a patent monopoly. Thus, allocative efficiency considerations should permit a licensor and licensee to agree to longer royalty terms. . . . [A]lthough the license agreement may appear to extend the duration of the patent license, its effect is to allow that licensor to recover the same present value royalties, but with a lower social cost."); Ayres & Klemperer, 97 Mich. L. Rev. at 1027 ("Negotiating a lower per-unit royalty in return for a longer royalty time period is likely to reduce the deadweight loss of supra-competitive pricing."); Dreyfuss & Pope, 24 Berkeley Tech. L.J. at 995 ("Spreading out the cost of the license over a longer period of time is . . . efficient because it reduces deadweight loss.").

Indeed, there are at least four ways in which post-expiration patent royalty provisions can be procompetitive and reduce the "deadweight" losses identified by the Justice Department and the FTC.

First, post-expiration patent royalty provisions can serve as an efficient means of financing development of nascent technologies when the licensor is able to access capital more cheaply than the licensee:

> [S]preading royalties over a longer period helps the licensee defer costs. It is a device by which the patent owner assists in financing the cost of producing or using the new device. If the patent owner borrows at lower rates than his licensees, he may effectively reduce their borrowing costs by permitting them to spread royalty payment over a longer period. . . . The effect of that capital cost reduction is to permit greater use in the combined pre- and post-[expiration] period and increase the value of the patent to the extent of the cost reduction during the term.

Schlicher Patent Treatise at §11:27.[11]

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[11] *See also* Dreyfuss & Pope, 24 Berkeley Tech. L.J. at 988 & 995 ("[A post-expiration patent royalty] arrangement is in the nature of a loan. It permits a cash-poor licensee to work the patent . . . at lower cost than if the payout term were limited to the life of the patent. . . . [Such] a lower fee is attractive, especially to thinly capitalized entrepreneurs and to startup companies. . . ."); Thomas F. Cotter, *Misuse*, 44 Hous. L. Rev. 901, 939 n.169 & 960 (2007) ("*Brulotte* . . . has been widely criticized for invalidating an efficient method for financing the

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Second, post-expiration patent royalty provisions can allow parties to balance and allocate the risks of developing and commercializing new technology:

> With many new products and processes, neither the licensor nor the licensee knows how commercially valuable the product (or process) will turn out to be. This is one of the main reasons why many licenses provide for royalties to be paid out over a period of time rather than a single lump-sum payment: if the product turns out to be a success, both parties will share in the proceeds, but if it turns out to be a failure, the licensee's cost is limited. . . . [¶] Allowing the parties the flexibility to stretch out payments over a longer period simply gives them another option, one that may be economically preferable to both parties. . . . [The *Brulotte*] rule, which encourages all payments to be made during the life of the patent, can prevent some of these mutually beneficial deals.

ABA Section of Antitrust Law, Intellectual Property Misuse: Licensing and Litigation 138 (2000).[12]

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licensing of patents [because,] . . . depending on the cost of credit, . . . licensees may prefer the option of making smaller payments over a longer term."); Chiappetta, 15 Marq. Intell. Prop. L. Rev. at 42-43 (post-expiration patent royalties can serve "as a financing mechanism").

[12] *See also* 3 Milgrim Treatise at §18.05 ("Both licensor and licensee may be better served by an arrangement in which the royalty rate is low but the term of royalty extended. The low royalty rate might help the licensee in the early investment

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Third, as the Justice Department and the FTC have pointed out, post-expiration patent royalty provisions can lower prices and raise output during the patent term:

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phase and thereby encourage it to take the risks to launch new, and thus inherently risk-prone, technology. The extended life [in turn] might give the licensor the expectation of ultimate reward, if the project thus jointly sponsored takes commercial root. In establishing a royalty arrangement of this character, moreover, both parties would recognize that, at the expiration of the statutory exclusivity period conferred by the patent, others will be free to practice the previously patented invention without any power on the part of the licensor or licensee to prevent it. But astute business people are willing to conclude, in the appropriate situation, that securing a marketing foothold and developing on-line know-how makes sense and that the interests of both licensor and licensee are best served by doing so."); Dreyfuss & Pope, 24 Berkeley Tech. L.J. at 983-984 ("Especially in situations where substantial development of the invention is required before it can be marketed, potential licensees may be unwilling to devote their available funds to paying off licensing fees. Licensees who are just starting out may not even have the money to make the payment. Furthermore, at the time of the negotiation, before the risky business of development and commercialization has been completed successfully, the parties may be unable to accurately determine the benefits that will flow from the invention. In contrast, a running royalty provision insures that the licensee will not have to pay if the invention turns out to be worthless. At the same time, it gives the patent holder the assurance of a fair return on a successful invention."); *Scheiber*, 293 F.3d at 1017 ("If royalties are calculated on post-patent term sales, the calculation is simply a risk-shifting credit arrangement between patentee and licensee.") (internal quotation marks omitted); Easterbrook, 42 Hous. L. Rev. at 955 ("Once the patent has expired, there is no market power; and both sides may gain by longer-term royalties that not only share risk but also link payments to an idea's staying power.").

> The countervailing benefit to society from allowing the licensor greater freedom to contract is the reduction in royalty rate, and hence prices, during the patent period that occurs as the licensor adjusts the license to induce a licensee to accept the longer term.

2007 DOJ/FTC Report at 118 n.20 (internal quotation marks omitted); *see also* Rochelle Cooper Dreyfuss, *Dethroning* Lear*: Licensee Estoppel and the Incentive to Innovate*, 72 Va. L. Rev. 677, 712 n.124 (1986) ("[S]tretching out the computation period decreases royalties during the patent period and may operate to increase output during that time.").

Finally, post-expiration patent royalty provisions also can lower prices and increase competition *after* the end of the patent term despite the fact that the licensee continues to pay royalties, because others need not:

> [I]n the great majority of cases no rival is foreclosed from the market by post-expiration royalties, since the licensee is not restrained from licensing competing technologies either before or after the patents expire. Indeed, to the extent that the user of the machine must pay royalties on expired patents while new entrants into the machine market do not charge such royalties, the practice encourages rather than discourages new entry. . . . As a result, the post-expiration royalties will make the market more, rather than less, attractive to new entrants.

1 Hovenkamp IP & Antitrust Treatise §23.2a. at 23-6; *see also* 10 Areeda Treatise ¶1782c.1. at 552 ("The Supreme Court [in *Brulotte*] failed to see that anti-competitive foreclosure is barely conceivable. . . ."); *cf. Leegin*, 551 U.S. at 906 ("The purpose of antitrust law . . . is the protection of competition, not competitors.") (internal quotation marks and emphasis omitted).[13] These post-expiration market conditions, in turn, will surely have been taken into account by the parties to the license when negotiating the royalty commencement, royalty rate(s), and duration of payment.

In light of the foregoing analyses and criticisms, *Brulotte*'s *per se* prohibition makes little sense: "[t]he

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[13] *See also* Lemley, 78 Cal. L. Rev. at 1630 ("[A]greements that extend royalty terms simply are not anticompetitive."); Bohannan, 96 Iowa L. Rev. at 517 & n.159 (2011) ("[R]oyalty payments that extend beyond the expiration of a patent do not foreclose access to the public domain any more than do other payments on business debts. . . . To the contrary, requiring royalties on unpatented technology might actually encourage new entrants who are not bound by the license and will be able to undercut the former patentee's price."); Schlicher Licensing Treatise at 196 ("[A post-expiration] royalty provision is highly unlikely to limit competition [after patent expiration]. . . . The agreement does not prevent unlicensed companies from entering [the market] in the postexpiration period. . . . If such entry occurs, there will be no loss in postexpiration resource allocation. This device does not provide a profitable mechanism to limit competition in the postexpiration period and separately exploit that limitation."); Cotter, 44 Hous. L. Rev. at 949 & n.199 (little "evidence that the challenged provision [in *Brulotte*] was likely to have any significant impact upon competition or innovation.").

small number of cases suggesting anticompetitive possibilities indicates that post-expiration royalty provisions should be treated under a rule of reason, with proof of anticompetitive effects required," as the Justice Department and the FTC have recommended. 1 Hovenkamp IP & Antitrust Treatise §23.2a. at 23-6; *see also* 2007 DOJ/FTC Report at 122 ("The Agencies [will] review most agreements that have the potential to extend the market power conferred by a valuable patent beyond that patent's expiration pursuant to the rule of reason."); Holmes Treatise at §24:3 ("[Post-expiration patent royalties] should not be held *per se* illegal, but should instead be governed by the more flexible . . . rule of reason – a position that is now taken by both federal antitrust enforcement agencies. . . .") (internal quotation marks omitted).

3. *Brulotte* Relies On The Outdated Irrebuttable Presumption That Patents Confer Market Power.

Finally, *Brulotte* should be revisited because a key assumption underlying that decision has been undercut both by subsequent Congressional action and a later decision of this Court.

Brulotte – relying on an analogy to tying cases – irrebuttably presumed that merely having a patent conferred market power and inherently allowed the licensor to exercise improper leverage over the licensee. *See id.*, 379 U.S. at 33, App. 78-79; *see also* 1 Hovenkamp IP & Antitrust Treatise §23.2a. at 23-8

(*Brulotte* "created a rule of per se illegality that required . . . [a] presumption that a patent created market power for the purpose of tying arrangements or patent misuse" while demanding no "proof of coercion"); Thomas F. Cotter, *Misuse,* 44 Hous. L. Rev. 901, 924-25 (2007) ("[In] *Brulotte*, the proposition that the patent conferred monopoly power upon the patent owner appears to have been assumed, rather than proven.").

One unfortunate but predictable consequence of this conclusive presumption was that the *Brulotte* rule became a trap for the unwary and an instrument of injustice when wielded by large, sophisticated licensees to deny small inventors their contractually-guaranteed royalties under circumstances where the licensors had no actual market power, and had applied no coercion. *See, e.g., Scheiber*, 293 F.3d at 1016 (licensee allowed to avoid payment under *Brulotte* even though licensee itself had suggested post-expiration royalties in exchange for lower overall royalty rate); *Indus. Promotion Co. v. Versa Prods., Inc.,* 467 N.W.2d 168, 172, 173-74 & n.4 (Wis. Ct. App. 1991) (same); *Delaney v. Marchon, Inc.*, 627 N.E.2d 244, 246 (Ill. App. Ct. 1993) (licensee sought to avoid payment on ground that "its own form [license agreement] ... was illegal and unenforceable" under *Brulotte*); *see also* Dratler Treatise at §4.04[5][d] ("[*Brulotte*] conjure[s] up patent 'leverage' where none in fact exists.").

Indeed, the case at bar presents a similar scenario. As the Ninth Circuit explained, *Brulotte* compelled

it to attribute improper leverage to Petitioners, absolving Marvel – a wholly-owned subsidiary of the even-larger Walt Disney Company – of its financial obligations, merely because Petitioners possessed a patent, even though that patent already had been held noninfringed by the district court at the time the agreement was negotiated. App. 22-23 & 25.

The force of *Brulotte*'s patent-equals-market-power presumption, however, has been severely undercut by two subsequent events.

First, in 1988, Congress enacted a new statutory provision, 35 U.S.C. §271(d)(5), that states that tying does not constitute patent misuse "unless, in view of the circumstances, the patent owner has market power in the relevant market." This development made "it clear that Congress did not intend the mere existence of a patent [any longer] to constitute the requisite 'market power.'" *Ill. Tool Works, Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 42 (2006).

Second, in 2006, this Court followed suit in *Illinois Tool Works*, and, overruling four of its prior decisions, held that, in the antitrust tying context, "a patent [also] does not necessarily confer market power upon the patentee." *Id.*, 547 U.S. at 45-46.

This change in the law of tying – to which *Brulotte* had analogized post-expiration patent royalties – delivered yet another blow to that opinion's already crumbling doctrinal foundation:

> [In finding *per se* unenforceability] solely from the face of the agreement without inquiry into the actual negotiations of the parties, . . . [*Brulotte* is now] clearly out of step with modern, more realistic assessments of licensing practices. The better approach would address whether, realistically viewed, any wrongful leveraging actually occurred. . . . [¶] The fact that payments are to be made . . . based on post-expiration uses . . . [does] not reflect patent leverage or coercion in and of [itself]. . . . What is at issue is . . . whether the assessment of value is skewed by the presence of market power, by a set of actions beyond the pale of the rule of reason, or by actual coercion. . . . [M]odern antitrust principles and rule of reason analysis . . . are much better suited [to addressing this issue] than *per se* . . . rules that presume . . . use of leverage that may not in fact be present.

Raymond T. Nimmer & Jeff Dodd, *Modern Licensing Law* §§9:9 & 13:31 (2012).

The Justice Department and FTC have come to the same conclusion, noting that the "starting point for evaluating practices that extend beyond a patent's expiration [should be] . . . analyzing whether the patent in question confers market power," and "collecting royalties beyond the statutory term" should not be condemned if "the patent holder . . . [cannot] profitably maintain prices above, or output below, competitive levels for a significant period of time." 2007 DOJ/FTC Report at 12 (internal quotation

marks omitted); *see also id.* at 122 ("The first step in the Agencies' analysis is to assess whether the patent at issue confers market power upon its holder, and if so, whether the patent holder's conduct unreasonably extends that market power beyond the patent's statutory term. In performing that inquiry, the Agencies consider . . . whether a firm is exercising such market power beyond the patent's statutory term so as to prevent expansion by those already in the market, or deter entry of substitute products or processes.").[14]

Consequently, the fall of the patent-equals-market-power presumption in the tying context

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[14] *See also* Dreyfuss & Pope, 24 Berkeley Tech. L.J. at 987 ("In this new environment, the result in *Brulotte* . . . is highly questionable. Without knowing how much economic power the patent conferred, there is no way to determine whether the contractual promise to continue payments beyond the term of the patent was produced by leverage."); Holmes Treatise at §24:4 ("While patent royalty arrangements are not expressly covered [by §271(d)(5)], they would seem to be subject to the same basic logic. Unless the patentee has market power in the economic sense of an ability to affect market prices or output, the fact that it has selected a particular royalty mechanism seems unlikely to affect, let alone injure, competition within the overall market."); Landes & Posner at 380-81 (enactment of section 271(d)(5) has rendered *Brulotte* rule "particularly anomalous"); A. Douglas Melamed & Ali M. Stoeppelwerth, *The* CSU *Case: Facts, Formalism and the Intersection of Antitrust and Intellectual Property Law*, 10 Geo. Mason L. Rev. 407, 418 n.44 (2002) (*Brulotte* is "wrongly decided from the vantage point of contemporary antitrust analysis because deferring royalty payments probably does not constitute creation of additional market power.").

provides yet another reason for rethinking *Brulotte*'s *per se* rule.

II. This Case Presents A Clean Vehicle For Reconsidering *Brulotte*.

The district court and the court of appeals relied solely on *Brulotte's per se* prohibition to dispose of Petitioners' claim for post-expiration royalties. *See* App. 25-26 ("We are bound to follow *Brulotte* and cannot deny that it applies here."); App. 37 ("[T]he Magistrate Judge correctly applied *Brulotte* in this case to find that the royalty provision is unenforceable after the expiration of the Kimble patent."); App. 60. If *Brulotte*'s *per se* proscription were overturned, the post-expiration royalty payment provision in this case readily would satisfy a more contextualized test, such as the rule of reason, and would thus be enforced, as, *inter alia*, Petitioners obviously never had any market power. This case consequently presents a clean vehicle for this Court to reconsider *Brulotte*'s *per se* rule.

III. *Stare Decisis* Does Not Foreclose Reconsideration Of *Brulotte*.

Finally, the doctrine of *stare decisis* does not counsel against reconsideration of *Brulotte*, for three reasons.

First, *Brulotte* is a judge-made rule, rather than an "interpretation of . . . the patent statute or any other statute." *Scheiber*, 293 F.3d at 1018. The sole

statutory provision mentioned in *Brulotte,* 35 U.S.C. §154, says nothing about royalties, let alone the propriety of contracts providing for post-expiration patent royalties. *See Brulotte*, 379 U.S. at 30, App. 74-75 (quoting statute). In fact, "the language of the Patent Act nowhere condemns such a contract." 1 Hovenkamp IP & Antitrust Treatise §23.2a. at 23-11. Rather, as Judge Posner has explained, *Brulotte* is "a free-floating product of a misplaced fear of monopoly." *Scheiber*, 293 F.3d at 1018. This Court has not, in the past, hesitated to overrule decisions espousing judge-made patent doctrines when they had proven to be misguided. *See, e.g., Lear, Inc. v. Adkins,* 395 U.S. 653, 663-71 (1969) (overruling prior decision and rejecting the common-law doctrine of patent licensee estoppel); *Blonder-Tongue Labs., Inc. v. Univ. of Ill. Found.*, 402 U.S. 313, 321 (1971) (overruling prior decision and rejecting the "judge-made doctrine" of mutuality of estoppel in patent litigation). The Court should do so again here.

Second, in the closely-related antitrust context, this Court consistently has emphasized that reconsideration of *per se* prohibitions particularly is warranted when the relevant government agencies and the academic literature, in light of intervening experience and analysis, come to the conclusion that application of a more nuanced approach such as the rule of reason is appropriate:

> *Stare decisis,* we conclude, does not compel our continued adherence to the *per se* rule [at issue]. As discussed earlier, respected

> authorities in the economics literature suggest the *per se* rule is inappropriate, and there is now widespread agreement that [the challenged practices] . . . can have procompetitive effects. . . . It is also significant that both the Department of Justice and the Federal Trade Commission – the antitrust enforcement agencies with the ability to assess the long-term impacts of . . . [these practices] – have recommended that this Court replace the *per se* rule with the traditional rule of reason.

Leegin, 551 U.S. at 900 & 907 (overruling prior decision to the contrary); *see also Ill. Tool Works*, 547 U.S. at 40 (overruling several prior decisions and rejecting *per se* rule in view of the "extensive scholarly comment and a change in position by the administrative agencies charged with enforcement of the antitrust laws"); *State Oil Co. v. Khan,* 522 U.S. 3, 15, 18, 21 (1997) (overruling prior decision and holding that "there is insufficient economic justification for *per se* [rule at issue]" in light of the "considerable body of scholarship" showing that "the theoretical underpinnings" of that rule have been "called into serious question"). *Brulotte*'s *per se* rule should be reconsidered for the same reason.

Finally, reliance interests do not counsel against reconsideration of *Brulotte.* Overruling *Brulotte* will open the door to desirable, procompetitive licensing practices going forward. At the same time, the only existing agreements likely to be impacted are either those – like the ones at issue in this case – where the

parties agreed to post-expiration royalty payments because they were unaware of *Brulotte*, App. 7 n.3, or those where one of the parties purposely entered into such an agreement in the hope of later avoiding its contractual obligations on the basis of *Brulotte*. In either case, a change in the law that would require parties to live up to their voluntarily-undertaken contractual obligations can hardly be said to upset their reasonable expectations.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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December 13, 2013

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

STEPHEN KIMBLE; ROBERT MICHAEL GRABB, INDIVIDUALS,

Plaintiffs-Appellants,

v.

MARVEL ENTERPRISES INC.,

Defendant-Appellee.

No. 11-15605.

Argued and Submitted Dec. 5, 2012.
Submission vacated Dec. 14, 2012.
Resubmitted May 29, 2013.
Filed July 16, 2013.

Antonio R. Durando (argued), Tucson, AZ; Stephen Kimble, Tucson, AZ; and Robert Grabb, Tucson, AZ, for Plaintiffs-Appellants.

David Fleischer (argued), Haynes and Boone, LLP, New York, NY; Andrew M. Jacobs, Snell & Wilmer L.L.P., Tucson, AZ; and Jason T. Christiansen, Zuniga Christiansen PLLC, Houston, TX, for Defendant-Appellee.

Appeal from the United States District Court for the District of Arizona, David C. Bury, District Judge, Presiding. D.C. No. 4:08-cv-00372-DCB.

Before DIARMUID F. O'SCANNLAIN, SIDNEY R. THOMAS, and CONSUELO M. CALLAHAN, Circuit Judges.

OPINION

CALLAHAN, Circuit Judge:

This appeal calls on us to again construe the Supreme Court's frequently-criticized decision in *Brulotte v. Thys Co.,* 379 U.S. 29, 85 S.Ct. 176, 13 L.Ed.2d 99 (1964). In *Brulotte,* the Court held that a patent licensing agreement requiring a licensee to make royalty payments beyond the expiration date of the underlying patent was unenforceable because it represented an improper attempt to extend the patent monopoly. *Id.* at 30-33, 85 S.Ct. 176. We have previously noted that *Brulotte* has been read to require that any contract requiring royalty payments for an invention either after a patent expires or when it fails to issue cannot be upheld unless the contract provides a discount from the alternative, patent-protected rate. *Zila, Inc. v. Tinnell,* 502 F.3d 1014, 1021 (9th Cir.2007). We acknowledged that the *Brulotte* rule is counterintuitive and its rationale is arguably unconvincing. *Id.* at 1019-20 & n. 4. Nonetheless, recognizing that we are bound by Supreme Court authority and the strong interest in maintaining national uniformity on patent law issues, we have

reluctantly applied the rule. *Id.* at 1020, 1022. We are compelled to do so again. Accordingly, we join our sister circuits in holding that a so-called "hybrid" licensing agreement encompassing inseparable patent and non-patent rights is unenforceable beyond the expiration date of the underlying patent, unless the agreement provides a discounted rate for the non-patent rights or some other clear indication that the royalty at issue was in no way subject to patent leverage. *See Meehan v. PPG Indus., Inc.,* 802 F.2d 881, 884-86 (7th Cir.1986); *Boggild v. Kenner Prods.,* 776 F.2d 1315, 1319-20 & n. 5 (6th Cir.1985); *Pitney Bowes, Inc. v. Mestre,* 701 F.2d 1365, 1371-72 (11th Cir.1983).

I

A

Around 1990, Appellant Stephen Kimble[1] invented a Spider-Man toy that allowed a child or other user to "role play" as Spider-Man by mimicking Spider-Man's web-shooting abilities with foam string. A user would operate the toy by activating a trigger attached to a valve in the palm of a glove. The valve was attached to a flexible line leading to a can of foam strapped to the user's wrist or waist. Kimble

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[1] Kimble is the inventor of the intellectual property at issue, while Appellant Robert Grabb represented Kimble in a prior litigation with Marvel and, at some point, acquired an interest in the property. Accordingly, as most of the references concern Kimble alone, we use "Kimble" in the singular to refer to both Appellants for ease of reference.

patented the idea under U.S. Patent No. 5,072,856 (the "'856 Patent"). The '856 Patent expired on or about May 25, 2010.

In December 1990, Kimble met with Lou Schwartz (the President of Appellee Marvel's predecessor[2]) to discuss the idea covered by then-pending application for the '856 Patent and other "ideas and know-how." Kimble contends that at the meeting, Schwartz verbally agreed that Marvel would compensate him if it used any of his ideas. Marvel subsequently told Kimble that it was not interested in his ideas. Despite its supposed lack of interest, Marvel thereafter began manufacturing a similar Spider-Man role-playing toy called the "Web Blaster." The Web Blaster allowed that toy's user to shoot foam string from a can mounted on the user's wrist by activating a trigger in the user's hand. Like Kimble's toy, the Web Blaster was packaged with a glove, but unlike Kimble's toy, the Web Blaster glove was purely cosmetic—a Web Blaster user did not need the glove in order to shoot foam string.

[2] Marvel Entertainment, LLC is the entity actively litigating the action, and is the successor to Marvel Enterprises, Inc. (the named party), and Toy Biz, Inc. (the entity that Kimble allegedly shared his ideas with and defendant in the 1997 action). We refer to all of these entities as "Marvel."

B

In 1997, Kimble sued Marvel for patent infringement and breach of contract, claiming that it had used his ideas in developing the Web Blaster without compensating him. Kimble alleged that Marvel had breached the verbal agreement because the Web Blaster incorporated "many of the ideas" he disclosed at the meeting and Marvel had not compensated him for its use of those ideas.

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 Web Blaster "net product sales" (excluding sales of foam string refills). Kimble appealed the court's decision on the patent infringement claim, and Marvel appealed the verdict on the contract claim. Throughout all stages of the case, Kimble maintained that the Web Blaster infringed the '856 Patent while Marvel contended that it did not.

C

In 2001, the parties agreed to settle the case while the appeals were still pending. They accordingly executed a written agreement (the "Settlement Agreement") memorializing their agreement to: (a) withdraw their appeals; (b) stipulate to vacating the

district court judgment; and (c) stipulate to dismissing the case with prejudice. Marvel also agreed to purchase the '856 Patent. The relevant section provided that:

> The purchase price for the Patent shall be payable to the Patent Holders as follows:
>
> a. $516,214.62 upon execution and delivery of this Agreement; and
>
> b. 3% of "net product sales" (as such term is used in the Judgment) excluding refill royalties made after December 31, 2000. For purposes of this paragraph 3.b, "net product sales" shall be deemed to include product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers.

The parties also agreed to a release, under which Kimble released Marvel except for Marvel's obligations under the Settlement Agreement itself, "and except for those obligations under the alleged verbal agreement that was the subject of the Action." The agreement has no expiration date and does not include any specific time limit on Marvel's obligation to pay "3% of 'net product sales.'" At the parties' request, the district court entered an order vacating the judgment and dismissing the action with prejudice.

D

Thereafter, the parties coexisted for several years without any significant disagreements. Web Blaster sales—and as a consequence, royalty payments over the life of the Settlement Agreement—were substantial. All together, Marvel paid Kimble more than $6 million in royalties.

But the peace did not last. In 2006, Marvel entered into a licensing agreement with Hasbro giving it the right to produce certain toys related to Marvel characters, including the Web Blaster. A number of disagreements subsequently arose between Marvel and Kimble concerning the royalty payments.[3] These disputes revolved around the calculation of royalties for subsequent iterations of the Web Blaster that included additional functions (in addition to shooting foam string) or Web Blasters that were packaged with other role play items (such as Spider-Man masks). In their discussions, Kimble initially

[3] Marvel intended to have Hasbro assume its responsibilities under the Settlement Agreement by requiring it to execute a sublicense agreement. Hasbro, however, did not execute the sublicense agreement at the same time that it executed the licensing agreement. Marvel, apparently, overlooked this. It later asked Hasbro to execute the agreement, but Hasbro refused. At oral argument, Marvel's counsel acknowledged that when the parties negotiated the Settlement Agreement, they were not aware of *Brulotte.* Consequently, had the Hasbro deal not occurred, it is quite possible that Marvel would have continued to pay Kimble under the Settlement Agreement beyond the expiration date of the patent without dispute.

took the position that royalties were due for these products under the Settlement Agreement because they "would infringe the Patent."

Kimble filed suit in Arizona state court for breach of contract and related claims. Marvel removed based on diversity of citizenship. Marvel then counter-claimed seeking, among other things, a declaration that it was no longer obligated to pay Kimble under the Settlement Agreement "based on the sales of products after the expiration of the '856 patent." In discovery, Marvel reaffirmed its view that the Web Blaster never infringed the '856 Patent.

The parties filed summary judgment motions, which the district court referred to the magistrate judge for a report and recommendation. *Kimble v. Marvel Enters., Inc.,* 692 F.Supp.2d 1156, 1164 (D.Ariz.2010). The magistrate judge found that under *Brulotte,* Kimble could not recover royalties under the Settlement Agreement beyond the expiration date of the '856 Patent. *Id.* at 1167-69 (discussing *Brulotte v. Thys Co.,* 379 U.S. 29, 85 S.Ct. 176, 13 L.Ed.2d 99 (1964)). He reasoned that the Settlement Agreement transferred patent rights, and that it was less clear that it transferred any non-patent rights. *Id.* at 1167-68. He observed that the release clause "more reasonably suggests that Plaintiffs reserved the non-patent rights from the verbal agreement and did not transfer them to Marvel." *Id.* at 1168. Alternatively, he found that *Brulotte* applied because the Settlement Agreement was a "hybrid" agreement transferring inseparable patent and non-patent rights, and because the

patent rights were used as leverage to negotiate the agreement. *Id.* at 1168-69.

Kimble objected, arguing "that the Agreement transferred both patented and non-patented rights and while the royalties for the patent rights end with the patent, they do not end for the non-patented rights which cover the Web Blaster." *Id.* at 1159. The district court nonetheless adopted the recommendation over Kimble's objection. *Id.* at 1159-63. It noted that the Settlement Agreement could be read as transferring both patent rights and "the rights to the toy idea(s) verbally exchanged" between the parties in 1990, but rejected Kimble's argument that it created "separable" patent and non-patent rights because it made "no distinction between the royalties for these two" categories. *Id.* at 1160. Accordingly, the district court agreed that the Settlement Agreement was a "hybrid" and that the royalties had to end when the patent expired. *Id.* at 1159-61. Kimble now appeals, and we have jurisdiction pursuant to 28 U.S.C. § 1291.

II

We review the district court's decision to grant summary judgment de novo. *Michelman v. Lincoln Nat'l Life Ins. Co.,* 685 F.3d 887, 892 (9th Cir.2012). We "must determine, viewing the evidence in the light most favorable to the non-moving party, whether there are any genuine issues of material fact and whether the district court correctly applied the

substantive law." *Id.* (quoting *Cruz v. Int'l Collection Corp.,* 673 F.3d 991, 996 (9th Cir.2012) (internal quotation marks omitted)).

III

A

Before analyzing the parties' arguments, we review *Brulotte* and its progeny. In *Brulotte v. Thys Co.,* 379 U.S. 29, 29, 85 S.Ct. 176, 13 L.Ed.2d 99 (1964), the owner of patents for a hop-picking machine sold machines to two purchasers along with licenses for their use. The purchasers paid a flat sum for the machines, but also had to make seasonal royalty payments. *Id.* The licenses also precluded the purchasers from assigning the licenses or moving the machines outside of the county. *Id.* The purchasers eventually stopped making royalty payments, arguing that the owner had misused the patents by extending the license agreements beyond the expiration dates of the patents. *Id.* at 30. The Supreme Court agreed, concluding "that a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful per se." *Id.* at 32, 85 S.Ct. 176.

The Court explained that Congress had granted inventors "the exclusive right" to make, use, or sell their discoveries "for limited times." *Id.* at 30, 85 S.Ct. 176 (quoting U.S. Const. art. 1, § 8) (internal quotation marks omitted). After the relevant period

expires,[4] however, "these rights become public property." *Id* . at 31, 85 S.Ct. 176. Any attempt to reserve or continue the patent monopoly after expiration "runs counter to the policy and purpose of the patent laws" regardless of what "legal device" is employed. *Id.* (quoting *Scott Paper Co. v. Marcalus Mfg. Co.,* 326 U.S. 249, 256, 66 S.Ct. 101, 90 L.Ed. 47 (1945)).

The Court found that the annual payments were not designed merely to compensate the owner for the use during the patent term because the parties had agreed on a flat sum as the purchase price for the machine and the royalty payments covered the use of the machine for each year. *Id.* Thus, the payments due in "the post-expiration period [we]re by their terms for use during that period, and [we]re not deferred payments for use during the pre-expiration period." *Id.* Similarly, the Court rejected the argument that the license was merely an arrangement for payment based on the amount of use. *Id.* at 31-32, 85 S.Ct. 176. Thus, "[t]he sale or lease of unpatented machines on long-term payments based on a deferred purchase price or on use would present wholly different

[4] When *Brulotte* was decided, the statute provided a seventeen-year period of exclusivity. *Id.* at 30-31, 85 S.Ct. 176 (citing, inter alia, 35 U.S.C. § 154). Congress subsequently revised the statute to provide a term beginning on the date of issuance and ending twenty years from the date of the application, in most cases. 35 U.S.C. § 154(a)(2). The term may be extended where the U.S. Patent and Trademark Office fails to issue the patent within three years of the application's filing date. *Id.* § 154(b)(1)(B).

considerations." *Id.* at 32, 85 S.Ct. 176. The Court also noted that the license agreement precluded assignment or removal of the machines from the county both before and after expiration of the patents. *Id.* at 31-32.

Because the licenses made no distinction "between the term of the patent and the post-expiration period," they were "on their face a bald attempt to exact the same terms and conditions for the period after the patents have expired as they d[id] for the monopoly period." *Id.* at 32, 85 S.Ct. 176. The Court was consequently "unable to conjecture what the bargaining position of the parties might have been and 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.* Thus, the patent owner could not use that leverage to project the patent monopoly beyond the expiration of the patent because, if it was permissible to do so, "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, 85 S.Ct. 176.

In contrast, in *Aronson v. Quick Point Pencil Co.,* 440 U.S. 257, 262-66, 99 S.Ct. 1096, 59 L.Ed.2d 296 (1979), the Supreme Court found that patent law did not preclude the enforcement of an agreement to provide royalty payments indefinitely where no patent had issued. In that case, the petitioner had invented a keyholder and filed a patent application. *Id.* at 259. The design was "ingenious" but also "so

simple that it readily could be copied unless it was protected by patent." *Id.* The respondent had agreed that it would pay the petitioner a five percent royalty for the exclusive right to manufacture and sell the keyholder. *Id.* The parties had also agreed, however, that if the patent application was "not allowed within five (5) years" the respondent "would pay two and one half percent (2½%) of sales so long as [it] continue[d] to sell" the keyholder. *Id.* (original alteration marks omitted). The petitioner did not obtain the patent within five years, and the Board of Patent Appeals subsequently issued a final rejection of her application. *Id.* at 260, 99 S.Ct. 1096. After the keyholder proved successful, but also subject to widespread copying by competitors, the respondent sued, seeking a declaration that the contract was preempted by patent law. *Id.*

The Court found that the agreement was "not inconsistent" with patent law principles, as it did "not withdraw any idea from the public domain." *Id.* at 262-63, 99 S.Ct. 1096. It noted that the petitioner had disclosed the design to the respondent in confidence, and had the respondent "tried to exploit the design in breach of that confidence, it would have risked legal liability." *Id.* at 263, 99 S.Ct. 1096. The agreement would "merely require[the respondent] to pay the consideration which it promised in return for the use of a novel device which enabled it to pre-empt the market." *Id.* at 264, 99 S.Ct. 1096. Nonetheless, it accepted that had the petitioner obtained the patent, "she would have received a 5% royalty only on

keyholders sold during the 17-year life of the patent." *Id.* at 263-64, 99 S.Ct. 1096.

The Court 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." *Id.* at 264-65, 99 S.Ct. 1096 (discussing 379 U.S. at 33, 85 S.Ct. 176). The Court further explained:

> No doubt a pending patent application gives the applicant some additional bargaining power for purposes of negotiating a royalty agreement. The pending application allows the inventor to hold out the hope of an exclusive right to exploit the idea, as well as the threat that the other party will be prevented from using the idea for 17 years. However, the amount of leverage arising from a patent application depends on how likely the parties consider it to be that a valid patent will issue. Here, where no patent ever issued, the record is entirely clear that the parties assigned a substantial likelihood to that contingency, since they specifically provided for a reduced royalty in the event no patent issued within five years.
>
> This case does not require us to draw the line between what constitutes abuse of a pending application and what does not. It is clear that whatever role the pending application played in the negotiation of the 5% royalty,

> it played no part in the contract to pay the 2½% royalty indefinitely.

Id. at 265, 99 S.Ct. 1096. Accordingly, patent law was not a "barrier" to the contract. *Id.* at 266, 99 S.Ct. 1096.

In light of these decisions, several of our sister circuits have applied the *Brulotte* rule to preclude the payment of royalties beyond the expiration date of patents under so-called "hybrid" agreements encompassing inseparable patent and non-patent rights. *Meehan v. PPG Indus., Inc.,* 802 F.2d 881, 884-86 (7th Cir.1986) (discussing *Pitney Bowes* and *Boggild* with approval and applying *Brulotte* where agreement conveyed patent rights in addition to trade secrets); *Boggild v. Kenner Prods.,* 776 F.2d 1315, 1319-20 & n. 5 (6th Cir.1985) (discussing *Pitney Bowes* and *Aronson,* 440 U.S. at 263-64); *Pitney Bowes, Inc. v. Mestre,* 701 F.2d 1365, 1371-72 (11th Cir.1983) (discussing *Brulotte,* 379 U.S. at 32, 85 S.Ct. 176, and *Aronson,* 440 U.S. at 261, 99 S.Ct. 1096).

In *Zila, Inc. v. Tinnell,* 502 F.3d 1014, 1016, 1019-22 (9th Cir.2007), we applied *Brulotte* in a case where the patent owner had relinquished all patent and other rights in a product in exchange for a royalty in perpetuity. In that case, the inventor's patent application was pending when the parties entered into the royalty agreement. *Id.* at 1017. The patent later issued, but the royalty rate was not contingent on issuance, nor was there any discount for the post-expiration period. *See id.*

We initially observed that *Brulotte* "runs counter to the usual task in a contract case—to interpret the terms agreed to by the parties." *Id.* at 1019. Moreover, we acknowledged that *Brulotte* renders some aspects of otherwise valid contracts unenforceable "for a reason that many courts and commentators have found economically unconvincing, namely, that 'the free market visualized for the post-expiration period would be subject to monopoly influences' if 'a royalty agreement was allowed to project beyond the expiration date of the patent.'" *Id.* at 1019-20 (quoting *Brulotte,* 379 U.S. at 32-33, 85 S.Ct. 176) (alteration marks and footnote omitted). Thus, we acknowledged that we were bound to apply *Brulotte*'s holding, but that we need not and should not "expand *Brulotte*'s holding beyond its terms." *Id.* at 1020.

We then went on to discuss the state of the law after the *Aronson* decision. We explained that "[t]he distinction between the contract in *Brulotte* and the one in *Aronson* rested, according to the Court, on the fact that the extended royalty term in *Aronson* was not 'negotiated with the leverage of a patent but rested on the contingency that no patent would issue within five years.'" *Id.* at 1020 (quoting *Aronson,* 440 U.S. at 265, 99 S.Ct. 1096) (alteration marks and internal quotation marks omitted). We noted that other circuits had read *Brulotte* and *Aronson* "to create two bright-line rules: (1) If a patent ever issues on an invention, *Brulotte* applies, and no contract can properly demand royalty payments after the patent expires; and (2) a contract that provides for royalties

either when a patent expires or when it fails to issue cannot be upheld unless it provides a discount from the alternative, patent-protected rate." *Id.* at 1021 (citing *Meehan,* 802 F.2d at 884-85; *Boggild,* 776 F.2d at 1319-20; *Pitney Bowes,* 701 F.2d at 1372-74).

We observed that *Brulotte* and *Aronson* did not necessarily compel these rules. We suggested that *Brulotte* turned on the existence of the onerous use restrictions unrelated to the royalty. *Id.* at 1021 (citing *Brulotte,* 379 U.S. at 29, 31-32, 85 S.Ct. 176). It was those restrictions that showed that the unchanging royalty rate was significant and that the patent owner "was acting *in all respects* as if the patent remained in place." *Id.* (citing *Brulotte,* 379 U.S. at 32, 85 S.Ct. 176). *Aronson,* in contrast, involved a sale of pure intellectual property that had value apart from the patent. *Id.* at 1022 (citing *Aronson,* 440 U.S. at 261-63, 265, 99 S.Ct. 1096). The language in *Aronson* suggesting that the patent owner in that case could not have received the full patent royalty beyond the patent term "was counterfactual dicta, neither supported by any analysis nor necessary for the decision." *Id.* at 1022. Nonetheless, we reluctantly followed the other circuits' "consensus" in light of the "particularly strong national uniformity concerns" present in patent cases. *Id.* Accordingly, we found that *Brulotte* rendered the agreement unenforceable to the extent it required royalty payments beyond the expiration date of the patent, but rejected several other arguments to extend the rule.

Id. at 1022-26 (holding, inter alia, that *Brulotte* did not apply to a foreign patent).

The rule that follows, in relevant part, is that a license for inseparable patent and non-patent rights involving royalty payments that extends beyond a patent term is unenforceable for the post-expiration period unless the agreement provides a discount for the non-patent rights from the patent-protected rate. This is because—in the absence of a discount or other clear indication that the license was in no way subject to patent leverage—we presume that the post-expiration royalty payments are for the then-current patent use, which is an improper extension of the patent monopoly under *Brulotte.*

B

Kimble argues that the Settlement Agreement distinguishes between patent and non-patent rights, that both parties now agree that the Web Blaster did not infringe the '856 Patent, and therefore, that *Brulotte* does not apply to the Web Blaster royalty payments. We cannot agree because the agreement plainly involved one royalty rate for both patent and Web Blaster rights, with no discount or other clear indication that the Web Blaster royalties were not subject to patent leverage.

Kimble's primary contention is that the Settlement Agreement provided two separate royalty rates (which were both 3%) for the patented rights and the non-patented Web Blaster rights. Putting aside for

the moment the fact that there is admittedly no discounted rate for non-patent rights, Kimble's argument is not supported by the language of the Settlement Agreement. *Cf. Meehan,* 802 F.2d at 885-86 (rejecting a similar argument that a royalty merely related to trade secrets based on the terms of the agreement). The Settlement Agreement provided that Marvel would purchase the '856 Patent for a lump sum plus a continuing royalty of "3% of 'net product sales.'" The agreement then defined "net product sales" as including "product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product."

Thus, the Settlement Agreement contemplated one royalty for patent rights and Web Blaster rights. At the time the parties negotiated the agreement, the patent infringement claim was not definitively resolved. The district court had found that the Web Blaster did not infringe the patent, but Kimble was appealing that decision. Because the infringement claim remained disputed, it was necessary for the parties to specifically include "Web Blaster" sales in addition to sales of products that allegedly infringed the patent to resolve their dispute. This, however, did not create a distinct royalty for non-patent rights. To the contrary, the structure of the agreement demonstrates that the rights were intertwined and cannot be separated in any principled manner. Tellingly: (a) the purpose of the entire provision was to set the sale price for *the patent;* (b) *all* rights were encompassed

within the definition of "net product sales" used to calculate a single royalty; and (c) the agreement specifically referred to "Web Blaster" sales, as opposed to sales of products utilizing ideas and know-how covered by the verbal agreement. The agreement was structured this way because, at that time, it was unclear whether Web Blaster sales infringed the patent, violated the verbal agreement, or both. If there were two distinct royalties at issue, the parties could have easily specified as much. Their failure to do so is dispositive.

The Settlement Agreement also did not include a discounted rate for the alleged non-patent rights. Some language in prior opinions suggests that the failure to include a discounted rate is a per se violation of *Brulotte. See Zila,* 502 F.3d at 1021 (discussing cases). Of course, the point of requiring a discount from the patent-protected rate is that it shows that the royalty at issue was not subject to patent leverage. *See Brulotte,* 379 U.S. at 32, 85 S.Ct. 176; *see also Aronson,* 440 U.S. at 265, 99 S.Ct. 1096 (finding that the discounted rate demonstrated that the patent "played no part" in the agreement to pay the lower royalty indefinitely); *Pitney Bowes,* 701 F.2d at 1372 n. 12 ("The implication of this language [in *Brulotte*] is that, if a patent owner can prove that he did not use his patent monopoly leverage to exact reduced post-expiration trade secret payments, then there would be no direct conflict with federal law and the agreement would be enforced."). We do not think that the "discount" requirement should be applied

inflexibly without reference to its purpose. Consequently, even though a discounted rate may not be necessary to avoid *Brulotte* in every case, in the absence of a discounted rate, there must be some other clear indication that the royalty was in no way subject to patent leverage. *See Meehan,* 802 F.2d at 886 ("Although it is true . . . that parties can contract for trade secret payments to extend beyond the life of a patent, there must be some provision that distinguishes between patent royalties and trade secret royalties."). Here, there is no such indications.[5] *See id.*

Kimble also argues that the Settlement Agreement's 3% rate represents a "discount" from the district court judgment's 3 1/2% rate. Kimble is essentially arguing that because the rate in the judgment was higher, there was a "discount" in the final agreement. Kimble's argument misconstrues the significance of a discounted rate in the *Brulotte* analysis. The rates in the agreement at issue are what matters, not the rates in the long-since vacated judgment. In the Settlement Agreement, there was only one rate for all rights, and it was the same for both patent and Web Blaster rights. Moreover, where

[5] We note, for example, that had the parties explicitly indicated, in a separate section of the agreement, that royalty payments for sales of non-patented products, including the Web Blaster, were to be paid in settlement of Kimble's claims that Marvel used the ideas and know-how he verbally disclosed at the 1990 meeting without compensation, it would arguably be immaterial if the rate were the same as the rate for sales of allegedly patent-infringing products.

a first rate is higher and is not subject to patent leverage, that does not show that a second, lower rate encompassing both patent-protected and non-patent protected rights was not subject to patent leverage. The "discount" from the rate in the judgment to the Settlement Agreement reflected the fact that Kimble might not prevail on appeal, not that the rights at issue were not subject to patent leverage.

Kimble further contends that this case is distinguishable because it involved a "hybrid" *agreement,* that coincidentally included both patent and non-patent rights, as opposed to a "hybrid" *product,* consisting of both patented and non-patented ideas. *Cf. Boggild,* 776 F.2d at 1319 (applying *Brulotte* to a "patented item"). The flaw with Kimble's argument is that at the time of the Settlement Agreement, it was uncertain whether the Web Blaster sales infringed the '856 Patent and the Settlement Agreement does not contain any clear indication that the Web Blaster royalties were not subject to patent leverage.

Kimble's primary leverage in negotiating the settlement was undoubtedly the jury verdict on the contract claim. Generally speaking, a party who prevailed before the district court has the better chance of prevailing on appeal. *See, e.g., U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship,* 513 U.S. 18, 26, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994) ("Judicial precedents are presumptively correct. . . ." (internal quotation

marks omitted)).[6] However, contrary to Kimble's recent suggestion that he agrees that the Web Blaster never infringed the '856 Patent, at the time of the negotiations, he was challenging the district court's decision and likely derived some amount of leverage from his patent infringement appeal. Even if this patent leverage was significantly less than the leverage that Kimble derived from the jury verdict on his contract claim, *Brulotte* applies because it is impossible to tell "what the bargaining position of the parties might have been and what resultant arrangement might have emerged had the provision for post-expiration royalties been divorced from the patent and nowise subject to its leverage." *Brulotte,* 379 U.S. at 32, 85 S.Ct. 176. Thus, the patent rights and any non-patent rights were intertwined and *Brulotte*'s presumption must apply.

IV

We acknowledge our application of the *Brulotte* rule in this case arguably deprives Kimble of part of

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[6] The Settlement Agreement was dated September 21, 2001. For the twelve-month period ending September 30, 2002, we affirmed on the merits 968 of 1,244, or 77.8%, of "other private civil" appeals (i .e., civil appeals excluding prisoner petitions, administrative appeals, bankruptcy cases, and cases involving the federal government). Administrative Office of the United States Courts, *2002 Annual Report of the Director: Judicial Business of the United States Courts* 99 (2003), *available at* http://www.uscourts.gov/uscourts/Statistics/JudicialBusiness/2002/appendices/b05sep02.pdf (last visited July 3, 2013).

the benefit of his bargain based upon a technical detail that both parties regarded as insignificant at the time of the agreement. Indeed, as the Seventh Circuit has explained, *Brulotte* has been criticized for exactly that reason:

> 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 . . . 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.

Scheiber v. Dolby Labs., Inc., 293 F.3d 1014, 1017 (7th Cir.2002).[7]

The Seventh Circuit's criticism is particularly apt in this case. The patent leverage in this case was vastly overshadowed by what were likely non-patent rights, and Kimble may have been able to obtain a higher royalty rate had the parties understood that the royalty payments would stop when the patent expired. Nonetheless, *Brulotte* and its progeny are controlling. We are bound to follow *Brulotte* and

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[7] We previously acknowledged these criticisms in *Zila,* 502 F.3d at 1019 n. 4 (collecting authorities). *Accord Brulotte,* 379 U.S. at 34-39, 85 S.Ct. 176 (Harlan, J., dissenting); U.S. Dep't of Justice & FTC, *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition* 12, 116-19, 122-23 (2007) (discussing criticisms of *Brulotte* and concluding that permitting patent holders to enter agreements requiring royalty payments beyond the expiration of the patent "can be efficient" in that it will "reduce[ ] deadweight loss associated with a patent monopoly and allow[ ] the patent holder to recover the full value of the patent, thereby preserving innovation incentives"), *available at* http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetition (last visited July 3, 2013); Richard Gilbert & Carl Shapiro, *Antitrust Issues in the Licensing of Intellectual Property: The Nine No-No's Meet the Nineties,* in *Brookings Papers on Economic Activity: Microeconomics* 233, 322 (1997) (concluding that the "[l]egal reasoning here, based on the notion that extending the royalties in time is to 'enlarge the monopoly of the patent,' although rhetorically appealing, does not seem to reflect commercial reality or basic economics"), *available at* http://www.brookings.edu/~/media/Projects/BPEA/1997%20micro/1997_bpeamicro_gilbert.PDF (last visited July 3, 2013).

cannot deny that it applies here. Accordingly, the district court's judgment is **AFFIRMED.**[8]

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[8] In a related case, Kimble contends that Marvel breached the verbal agreement by failing to compensate him after the expiration of the patent for its use of his ideas. The district court granted summary judgment for Marvel, finding that the Settlement Agreement unambiguously barred the claim. In an unpublished decision, we reversed, finding the agreement ambiguous under New York law. *Marvel Entmt., LLC v. Kimble,* ___ Fed. App'x ___, No. 12-15315, 2013 WL 3648860 (9th Cir. July 16, 2013). Indeed, Kimble's claim under the verbal agreement may be consistent with the Seventh Circuit's suggestion that a patent holder might be able to recover under a quantum meruit theory if the amount of royalties paid was lower than the fair market value of the defendant's use of the license given that illegal contracts are treated as rescinded, placing the parties back in the positions they would have occupied had the contract never been made in the first place. *See Scheiber,* 293 F.3d at 1022-23; *see also Zila,* 502 F.3d at 1023 (indicating that under *Scheiber,* the portion of the licensing agreement that seeks to extend the patent term is void). In that case, much like a quantum meruit plaintiff, Kimble is essentially asking to be placed in the position that he would have occupied had the Settlement Agreement never been made. Like the Seventh Circuit, we do not read *Brulotte* to preclude such a claim.

UNITED STATES DISTRICT COURT
DISTRICT OF ARIZONA

Stephen Kimble, an individual, and Robert Grabb, an individual, Plaintiffs, v. Marvel Enterprises, Inc., Defendant.	CV 08-372-TUC-DCB **ORDER** (Filed Mar. 2, 2010)

On December 2, 2009, Magistrate Judge Ferraro issued a Report and Recommendation (R&R). (Doc. 77.) He recommends granting Defendant's motion on termination of royalties when the patent expires and Plaintiffs' motion on the definition of "net product sales." He recommends denying Plaintiffs' four other motions. After an independent review of the record, the Court adopts the R&R as the opinion of the Court and grants and denies the motions for summary judgment accordingly.

STANDARD OF REVIEW

The duties of the district court in connection with a R&R by a Magistrate Judge are set forth in Rule 72(b) of the Federal Rules of Civil Procedure and 28 U.S.C. § 636(b)(1). The district court may "accept, reject, or modify, in whole or in part, the findings or recommendations made by the magistrate judge."

Fed. R. Civ. P. 72(b), 28 U.S.C. § 636(b)(1). Where the parties object to a R&R, "[a] judge of the [district] court shall make a *de novo* determination of those portions of the [R&R] to which objection is made." 28 U.S.C. § 636(b)(1); *see Thomas v. Arn,* 474 U.S. 140, 149-50 (1985). When no objection is filed, the district court need not review the R&R *de novo.*

This Court's ruling is a *de novo* determination as to those portions of the R&R to which there are objections. 28 U.S.C. § 636(b)(1)(C); *Wang v. Masaitis,* 416 F.3d 992, 1000 n. 13 (9th Cir. 2005); *United States v. Reyna-Tapia,* 328 F.3d 1114, 1121-22 (9th Cir. 2003) (*en banc*). To the extent that no objection has been made, arguments to the contrary have been waived. *See* 28 U.S.C. § 636(b)(1)(A) (objections are waived if they are not filed within ten days of service of the R&R), *McCall v. Andrus,* 628 F.2d 1185, 1187 (9th Cir. 1980) (failure to object to Magistrate's report waives right to do so on appeal); Advisory Committee Notes to Fed. R. Civ. P. 72 (citing *Campbell v. United States Dist. Court for N.D. Calif.,* 501 F.2d 196, 206 (9th Cir. 1974) (when no timely objection is filed, the court need only satisfy itself that there is no clear error on the face of the record in order to accept the recommendation)). Accordingly, the Court reviews only the objections raised in the briefs filed in objection to the R&R and reviews *de novo* the arguments urged before the Magistrate Judge that pertain to such objections. All other objections are waived.

STATEMENT OF THE CASE

In 1997, Plaintiff Kimble[1] sued Toy Biz (now known as Marvel) for patent infringement and breach of contract based on an oral agreement in CV 97-557 TUC RCC. Kimble invented a web shooting toy, patent no. 5,072,856, which expires no later than May 25, 2010. In 1990, he met with Toy Biz to discuss his patent application and related ideas. Toy Biz agreed it would not use the ideas disclosed by Kimble without first negotiating a reasonable royalty payment for their use. Toy Biz subsequently made and sold a toy, "Web Blaster" and refused to pay Kimble any royalty. Kimble sued Toy Biz. The District Court ruled as a matter of law that the Web Blaster did not infringe the Kimble patent, but there were disputed questions of fact as to the verbal agreement between the parties. After a jury trial, the court entered judgment for Kimble finding the Web Blaster was covered by the verbal agreement and awarded damages "to be 3.5% of net product sales, past, present and future excluding refill royalties." Both parties appealed. (R&R at 3.)

While the appeal was pending, the parties entered into a settlement agreement (the Agreement). They withdrew their appeals and agreed to vacate the

[1] Plaintiff Grabb was not a party to the 1997 action. He acted as Kimble's attorney during that proceeding and is a signatory on the Agreement and a Plaintiff in this action.

Judgment. The "key provision" of the Agreement, is as follows:

> 3. Marvel agrees to purchase from the Patent Holders and the Patent Holders agree to sell to Marvel the Patent which will be evidenced by an instrument of assignment in the form of exhibit C hereto. The purchase price for the Patent shall be payable to the Patent Holders as follows:
>
> > a. $516,214.62 upon execution and delivery of this Agreement; and
> >
> > b. 3% of "net product sales" (as such term is used in the Judgment) excluding refill royalties made after December 31, 2000. For purposes of this paragraph 3.b, "net product sales" shall be deemed to include product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers.

Id. at 4 (citing doc. 47: Agreement at 4). The Agreement contains no expiration date.

On January 6, 2006, Marvel entered a licensing agreement with an independent company, Hasbro, effective in 2007, giving Hasbro copyright and trademark rights for Marvel characters in certain toy categories, and Hasbro began making versions of the Web Blaster. *Id.* at 4.

Hasbro refused to sign a sublicense to pay Plaintiffs royalties owed under the Agreement. Since 2007, Hasbro has reported quarterly to Marvel the units sold, and Marvel receives royalties from Hasbro amounting to 10% of net sales of the licensed products. Up until May 2008, Marvel paid Plaintiffs 3% of Hasbro's net sales of various Web Blaster products. On May 23, 2008, Marvel informed Plaintiffs they were not entitled to royalties on Extra Value Items and that it had recalculated the 2007 royalties and determined Marvel had overpaid Plaintiffs by $282,700.00 *Id.* at 4-5.

Plaintiff filed for breach of contract in state court. The action was removed to federal court by Defendant, who answered and counterclaimed for overpayment and declaratory judgment as to its obligations under the Agreement.

The matters have been fully briefed. Plaintiffs filed a Motion for Summary Judgment requesting the Court deny Marvel's counterclaim for the overpayment. (Ps' MSJ) (doc. 47). Plaintiffs/Counterdefendants filed a Motion for Partial Summary Judgment on Marvel's counterclaim of overpayment as to royalties owed on "3% of net product sales" for multifunctional toys, which are those that shoot not only the foam web but shoot additional things like darts, missiles, water, etc. (Ps' MPSJ) (doc. 48). Plaintiffs/Counterdefendants filed a Motion for Summary Judgment seeking declaratory judgment that Marvel continues to be responsible for certain obligations beyond the expiration of the patent, May

25, 2010. (Ps' MSJ) (doc. 49). Plaintiffs/ Counterdefendants filed a Motion for Summary Judgment on Marvel's counterclaim of overpayment as to royalties owed on "3% of net product sales" for "extra value items" of the Web Blaster. (Ps' MSJ) (doc. 50). Plaintiffs filed a Motion for Partial Summary Judgment regarding the definition of "net product sales." (Ps' MPSJ) (doc 51). Defendant, Marvel, filed a Motion for Summary Judgment for a declaratory judgment that any obligation to make payments pursuant to the Agreement terminates on the date the Kimble patent underlying the Agreement expires, May 25, 2010. (MSJ) (doc. 54).

The Magistrate Judge addressed the issues raised in these interrelated summary judgment motions in one R&R, as follows: Section B: whether, as a matter of law, Marvel owes royalties under the Agreement after the patent expires; Section C: whether, as a matter of law, "net product sales" is defined in the Agreement; Section D: whether, as a matter of law, Marvel owes royalties under the Agreement for Hasbro's net product sales, and Section E: whether, as a matter of law, Marvel owes royalties for improved Web Blasters and Extra Value Items.

The Magistrate Judge found that as a matter of law, Marvel is not required to pay royalties under the Agreement after the May 25, 2010, expiration of the Kimble patent. He found there was no genuine issue of material fact regarding the definition of "net product sales" in the Agreement – it means 93% of gross

product sales. He found there are genuine issues of material fact in dispute which preclude summary judgment on the issue of sales by Hasbro for improved Web Blasters and Extra Value Items.

On December 16, 2009, the parties filed Objections to the R&R on the question of law: whether Marvel owes royalties after the expiration of the patent under the terms of the Agreement; whether Marvel owes royalties under the Agreement for Hasbro's "net product sales," and whether "net product sales" is defined as 93% of gross product sales.

PLAINTIFFS/COUNTERDEFENDANTS' OBJECTIONS

Plaintiffs object to Magistrate Judge Ferraro's finding that the royalty Agreement ends when the patent expires. Plaintiffs argue that the Agreement transferred both patented and non-patented rights and while the royalties for the patented rights end with the patent, they do not end for non-patented rights which cover the Web Blaster.

This Court notes that Plaintiffs' position on whether the Web Blaster infringes on the Kimble patent has changed since the 1997 law suit and settlement. On appeal, Kimble argued that the Web Blaster infringed the patent. Kimble had prevailed on his breach of contract claims related to Defendant's oral agreement to not use the ideas he disclosed without negotiating a reasonable royalty payment, but he lost on summary judgment his patent

infringement claim. Defendant appealed the Judgement for Kimble on the breach of contract claim.

The Agreement vacated the Judgment, which had issued in favor of Kimble on the breach of contract claim. The parties agreed for Marvel to purchase the patent at the purchase price of: "$516,214.62 and 3% of "net product sales" (as such term is used in the Judgment) . . . For purposes of this paragraph 3.b, "net product sales" shall be deemed to include product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers." "Net product sales," as such term was used in the Judgment referred to the Web Blaster that had been found to *not* infringe on the Kimble patent. The 3% net product sales was deemed to "include product sales that would infringe the Patent *as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers.*" This language in the Agreement is arguably in keeping with the parties' interpretations of the Agreement "as transferring the patent right and the rights to the toy idea(s) verbally exchanged between Kimble and Toy Biz in 1990." (R&R at 8.)

"Because the parties are in agreement, and the outcome is the same whether the Agreement transferred only patent rights or both patent and non-patent rights, the [Magistrate Judge] also assessed the latter possibility." *Id.* The Magistrate Judge correctly found that the Agreement is a hybrid under

the law. Plaintiffs' argument that the Agreement creates separable rights, "patent rights" and "non-patent rights" fails because there is no distinction between the royalties for these two. (R&R at 8-9) (discussing hybrid concept from *Pitney Bowes, Inc. v. Mestre,* 701 F.2d 1365, 1371-72 (11th Cir. 1983); *Boggild v. Kenner Products,* 776 F.2d 1315, 1319 (6th Cir. 1985)).

Plaintiffs' argument also fails under the seminal case on the issue, *Brulotte v. Thys Co.,* 379 U.S. 29, 32 (1964), in which the Court held that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*." *Id.* at 6. In *Brulotte,* the Court distinguished the situation from ones in which non-patented items are priced based on long-term use or in which different arrangements would apply before and after the expiration of a patent. *Id.* (citing *Brulotte,* 379 U.S. at 31-32). "The Court emphasized that because the terms were the same both before and after expiration of the patent, they were "'unable to conjecture what the bargaining position of the parties might have been and 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., see also Aronson v. Quick Point Pencil Co.,* 440 U.S. 257, 259-262 (1979) (distinguishing a situation with two agreements, one for a 5% royalty for the item in the inventor's pending patent application and the second for a 2 ½% royalty if the patent application was not allowed within five years,

because the 2 ½% royalty did not rely on a patent). As noted by the Magistrate Judge the reduced royalty in *Aronson* was negotiated for the express purpose of compensation in the absence of a patent. The *Aronson* agreement did not offend the principle emphasized in *Brulotte* that it is unlawful to leverage a patent monopoly beyond it expiration.

This Court has read *Zila, Inc. v. Tinnell,* 502 F.3d 1014 (9th Cir. 2007) and agrees with the Magistrate Judge that even though Plaintiffs rely on this case, it does not support them. *Id.* at 7. In *Zila,* the Ninth Circuit considered an Agreement containing a royalty provision for "a five percent (5%) royalty on gross sales of [Zila] of the invention" in perpetuity. *Zila,* 502 F.3d at 1017. It was uncontested that when the parties entered into the Agreement they did not know whether any patent would issue on the invention, and they did not intend the royalties to relate in any way to patents that might or might not be obtained. *Id.* Subsequently, however, patents were obtained. After criticizing *Brulotte* and its progeny, the Ninth Circuit held that for the sake of national uniformity in patent law it would follow the majority view that under *Brulotte* state contract law is preempted "on facts that (1) a patent did *not* issue in [a] case and (2) the underlying agreement provided for a lower royalty if no patent issued than if one did." *Id.* at 1022. The court held that since a patent did issue for the *Zila* invention, *Brulotte* controlled and the royalty provision was unenforceable after the last of the patents covering the invention ended. In *Zila,* the court

applied *Brulotte* to a royalty provision covering "the invention," covering both patent and non-patent rights.

Following *Zila,* the Magistrate Judge correctly applied *Brulotte* in this case to find that the royalty provision is unenforceable after the expiration of the Kimble patent.

DEFENDANT'S OBJECTIONS

Defendant raises two objections: 1) whether Marvel owes royalties for Hasbro's "net product sales" and 2) whether "net product sales" is defined as 93% of gross product sales. (D's Objection at 1.)

First, Defendant objects to what Plaintiffs correctly point out is dicta in the Magistrate Judge's R&R: "'Marvel owes Plaintiffs a 3% royalty for anyone's product sales covered by the Agreement.'" (D's Objection at 2 (quoting R&R at 14)). Specifically, Defendant objects to the following:

> Contrary to Marvel's contention, this would not obligate [Marvel] to pay for sales by an unrelated third-party. A third-party with no relationship to Marvel could not legally manufacture a toy within either of these categories [in paragraph 3.b of the Agreement] because Marvel owns the patent and it owns the right to Spider-Man, and the Web Blaster is a Spider-Man toy. Thus, Marvel has complete control over the sale of any toys within those two categories.

Id. (citing R&R at 13). "Marvel object to the above findings because they misapprehend the facts and overstate Marvel's rights as an intellectual property holder." (D's Objection at 2.)

The issue before the Court has nothing to do with an unrelated third-party. As Defendant recognizes, the "plaintiffs themselves have conceded that the Agreement would not require Marvel to pay royalties on such sales." *Id.* at 3. "Plaintiffs admitted that if a third-party such as Mattel were to independently come out with a toy that infringed the Kimble patent, Marvel would not be obligated to pay Kimble a royalty on Mattel's sales of that product." *Id.* Defendant then argues that because Marvel would not be obligated to pay royalties for a third-party's sales of products covered by the Agreement if the company had no relationship with Marvel, the fact of the licensing relationship between Marvel and Hasbro should not change the result, "given that the [A]greement between Hasbro does not license any of the rights covered by the Agreement." (Objection at 3.)

Whether or not the licensing agreement between Hasbro and Marvel licensed any rights covered by the Marvel-Kimble Agreement is a disputed question of fact to be resolved at trial, and as thoroughly discussed in the R&R the relationship between Hasbro and Marvel does make a difference. "Under the licensing agreement, Marvel receives 10% of Hasbro's net sales for the use of the Spider-Man license and trademark." (R&R at 13.) "Hasbro, which is making

the Web Blaster, is making it as Marvel's assignee and paying Marvel for the rights to do so." (Ps' Reply to D's Objection at 3.) In other words, the 3% royalty provision in the Agreement applies, if a jury finds that Hasbro is manufacturing and selling any product under its licensing agreement with Marvel, covered by the Marvel-Kimble Agreement.

Second, "Marvel objects to the ruling in section III.C of the report and recommendation for the reasons stated in defendant's opposition to plaintiffs' motions for summary judgment section IV.C.4. (dkts. 59 at p. 23-24 and 60.)" (D's Objection at 5.) "In response, Plaintiffs incorporate those relevant portions of their Motion for Summary Judgment." (Ps' Reply at 3.)

Defendant fails to raise a proper objection to the R&R to invoke this Court's *de novo* determination of this portion of the R&R. 28 U.S.C. § 636(b)(1); *see Thomas v. Arn,* 474 U.S. 140, 149-50 (1985) (explaining when no objections are filed, the district court need not review the R&R *de novo*). "The filing of objections to a magistrate's report enables the district judge to focus attention on those issues – factual and legal – that are at the heart of the parties' dispute." *Thomas,* 474 U.S. at 147. Precluding review of any issue not contained in an objection, prevents a litigant from "sandbagging" the district judge by failing to object and then appealing. "Absent such a rule, any issue before the magistrate would be a proper subject for appellate review." Without the rule requiring parties to object, the district court would have to

review every issue in every case, no matter how thorough the magistrate's analysis. The rule promotes the efficient use of judicial resources. *Id.* These principles require a party to do more than simply object, without identifying and explaining the objection. Defendant has done nothing more than the legal equivalent of filing a notice of some nondescript objection.

Nevertheless, the Court has reviewed *de novo* Subsection III.C of the R&R, wherein the Magistrate Judge found that as a matter of law in the Agreement the definition of "net product sales" means 93% of gross product sales. (R&R at 10.) The Court agrees with the Magistrate Judge's conclusion that the Agreement is ambiguous because "net product sales' is not defined, but only refers to the term as used in the Judgment, and the term was not defined in the Judgement. *Id.*

The Magistrate Judge relied on extrinsic evidence of deposition testimony from the 1997 action and the parties' performance under the Agreement through 2006, during the time it was selling toys. The Magistrate Judge found that the Defendant's arguments were conclusory, and Defendant failed to provide any conflicting evidence or any other definition the parties may have intended at the time they adopted the Agreement. The Defendant's unsupported contentions remain unsupported, and as recommended by the Magistrate Judge, this Court finds that the term "net product sales" means 93% of gross product sales.

CONCLUSION

As a matter of law, Defendant is not required to pay royalties under the Agreement after the May 25, 2010 expiration of the patent. As a matter of law, the term "net product sales" in the Agreement means 93% of gross product sales. There are genuine issues of material fact precluding summary judgment on all other issues.

After *de novo* review of the issues raised in the parties' Objections, this Court agrees with the findings of fact and conclusions of law made by the Magistrate Judge in his Report and Recommendation for determining the pending motions.

Accordingly,

IT IS ORDERED that the Report and Recommendation is adopted as the Opinion of the Court.

IT IS FURTHER ORDERED that the Plaintiff's Motion for Summary Judgment (doc. 49) is DENIED; the Defendant's Motion for Summary Judgment (doc. 54) is GRANTED.

IT IS FURTHER ORDERED that Plaintiff's Motion for Partial Summary Judgment (doc. 51) is GRANTED.

IT IS FURTHER ORDERED that all other summary judgment motions (doc. 47,48, 50) are DENIED.

IT IS FURTHER ORDERED WITHDRAWING THE REFERENCE from Magistrate Judge Ferraro.

This matter shall be tried by the Honorable David C. Bury.

IT IS FURTHER ORDERED that the parties shall file a Joint Pretrial Order by March 26, 2010. (*See* attached form of Order.) Subsequently, the Court shall set a pretrial conference and the trial date will be set at the pretrial conference.

DATED this 1st day of March, 2010.

/s/ David C. Bury
David C. Bury
United States District Judge

FORM OF PRETRIAL ORDER

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF ARIZONA

	)	CV TUC DCB
Plaintiff,	)	**PRETRIAL ORDER**
	)	
v.	)	
	)	
	)	
Defendant.	)	

(Although the text of the pretrial order appears in single space, the actual order submitted by the parties must be double spaced and conform in all other respects to the Local Rules.)

The following are pretrial proceedings in this cause pursuant to Rule 16.2 of this Court, and **IT IS ORDERED**:

I. NATURE OF ACTION

This is an action for: (Short concise statement of the case, including the nature of the action and the relief sought.)

II. STATEMENT OF JURISDICTION

Statement of jurisdiction: (state the claims and cite the statutes which give this Court jurisdiction over each claim.)

III. CONTESTED ISSUES OF LAW/FACT

State the ultimate issues of fact and law which must be decided at trial. State only the issues of fact and law necessary and material for a verdict in this case. Each issue must be stated separately and specifically.

IV. LIST OF EXHIBITS

Each party shall list the exhibits it intends to offer at trial.

V. LIST OF WITNESSES

Each party shall list the witnesses it intends to call at trial.

VI. JURY TRIAL or BENCH TRIAL

The parties shall state whether the trial is a jury or bench trial.

For a Jury Trial

At the Pretrial Conference, the Court will direct the parties to file proposed voir dire, objections to exhibits, deposition testimony, stipulated jury instructions, counsel's additional proposed jury instructions, motions in limine, and trial memoranda 20 days prior to trial. Any opposition shall be filed five days thereafter.

For a Bench Trial

At the Pretrial Conference, the Court will direct the parties to file trial briefs, objections to exhibits, motions in limine, and proposed findings of fact and conclusions of law 20 days prior to trial. Any opposition shall be filed five days thereafter.

VII. PROBABLE LENGTH OF TRIAL

Each party shall identify the estimated length of time it will take to present its case.

VIII. CERTIFICATION

The undersigned counsel for each of the parties in this action do hereby approve and certify the form and content of this proposed Joint Pretrial Order.

________________________	________________________
Attorney for Plaintiff	Attorney for Defendant

This Joint Pretrial Order is hereby approved on this ___ day of ___, 2006.

____
David C. Bury
United States District Judge

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA

Stephen Kimble and Robert Grabb,	)	No. CV-08-372-TUC-DCB-DTF
Plaintiffs,	)	**REPORT AND RECOMMENDATION**
vs.	)	
Marvel Enterprises, Inc.,	)	(Filed Dec. 2, 2009)
Defendant.	)	

Pending before the Court are Plaintiffs' five Motions for Summary Judgment and Defendant's Motion for Summary Judgment. (Dkts. 47-51, 54.) Both parties have filed responses and replies. (Dkts. 59, 63, 64, 67.) Pursuant to the Rules of Practice in this Court, the matter was assigned to Magistrate Judge Ferraro for a report and recommendation. The Magistrate Judge recommends the District Court, after its independent review of the record, enter an order granting Defendant's motion on termination of royalties when the patent expires, granting Plaintiffs' motion on the definition of "net product sales," and denying Plaintiffs' four other motions.

I

PROCEDURAL BACKGROUND

In 1997, Plaintiff Kimble filed suit against Toy Biz (the predecessor of Marvel) in this Court, *Kimble v. Toy Biz, et al.*, No. CV97-557-TUC-RCC (the 1997

Action), alleging patent infringement and breach of contract based on an alleged oral agreement. The patent claim was resolved on a motion for summary judgment in favor of Marvel. Thereafter, Kimble obtained a judgment against Toy Biz on the contract claim. Both parties appealed. In 2001, while the appeals were pending, the parties entered a settlement agreement (Agreement). In 2008, Plaintiffs filed this action, alleging breach of the Agreement.[1] (Dkt. 1, 23.) Defendant counterclaimed seeking a declaratory judgment and alleging unjust enrichment. (Dkt. 33.) After completing discovery, the parties filed the instant motions. On November 6, 2009, the Court heard oral argument on the motions.

II

MOTION FOR SUMMARY JUDGMENT STANDARD

Summary judgment is proper if the evidence shows there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986). The moving party must produce evidence and persuade the court there is no genuine issue of material fact. *Nissan Fire & Marine Ins. Co., Ltd. v. Fritz Cos., Inc.*, 210 F.3d 1099,

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[1] Plaintiffs' complaint also alleged bad faith, fraud, and unjust enrichment. The parties stipulated to dismissal of those counts. (Dkt. 29.)

1102 (9th Cir. 2000). A material fact is one that might affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). A factual issue is genuine "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Id.*

To defeat a motion for summary judgment, the nonmoving party must show that there are genuine issues of material fact. *Id.* at 250. When the moving party has carried its burden under Rule 56(c), the nonmoving party must produce evidence to support its claim or defense by more than simply showing "there is some metaphysical doubt as to the material facts." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986). However, the court presumes the nonmoving party's evidence is true and draws all inferences from the evidence in the light most favorable to the nonmoving party. *Eisenberg v. Ins. Co. of North America*, 815 F.2d 1285, 1289 (9th Cir. 1987). Each numbered paragraph of the moving party's separate statement of facts shall be deemed admitted for purposes of the motion for summary judgment if not specifically controverted by a correspondingly numbered paragraph in the opposing party's separate statement of facts. LRCiv 56.1(b).

III

DISCUSSION

Plaintiffs moved for summary judgment on Defendant's Counterclaims 1(a), 2, 3, 4, and the definition

of "net product sales" in the Agreement. Defendant moves for summary judgment on its Counterclaim 1(a).

A. **Relevant Undisputed Facts**[2]

Kimble is the inventor of a web shooting toy described in U.S. Patent No. 5,072,856. (Dkt. 49-3.) The Kimble patent expires no later than May 25, 2010. (Dkt. 33, ¶ 31; Dkt. 44, ¶ 1.) The 1997 Action, *Kimble v. Toy Biz, et al.*, No. CV97-557-TUC-RCC, alleged patent infringement and breach of an oral contract. (Dkt. 49-4.) Kimble alleged that in 1990 he met with Toy Biz president Lou Schwartz to discuss Kimble's patent application and related ideas. At that meeting, Schwartz agreed that Toy Biz would not use the ideas disclosed by Kimble without first negotiating a reasonable royalty payment for their use. (*Id.*, ¶¶ 26, 27.)

Kimble also alleged in the 1997 Action that Toy Biz subsequently made and sold a "Web Blaster" toy based on Kimble's ideas, but refused to pay Kimble any royalty. (*Id.*, ¶ 30.) The Web Blaster is a role play toy whose primary play value is to allow the user to adopt aspects of Marvel's Spider-Man character by shooting foam string. (Dkt. 56-2 at 4.) The District Court ruled as a matter of law that the Web Blaster

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[2] The relevant undisputed facts were taken from the parties' statements of facts, responses, and replies thereto. (Dkts. 47-1, 48-1, 49-1, 50-1, 51-1, 55, 60, 63-1, 66, 67-1.)

did not infringe the Kimble patent, but that the claims concerning the verbal agreement involved disputed issues of fact for a jury to decide. (Dkt. 49-5.)

After a jury trial on the breach of contract claim, the District Court entered judgment in favor of Kimble and against Toy Biz, finding that the Web Blaster was covered by the verbal agreement and awarding "the full damages to be 3.5% of net product sales, past, present and future excluding refill royalties." (Dkt. 49-6.) Both parties appealed the judgment.

While appeal was pending, on September 21, 2001, Plaintiffs Kimble and Grabb (the "Patent Holders")[3] entered the Agreement with Defendant Marvel to end the pending litigation. (Dkt. 47-3.) Thereafter, the appeals were withdrawn and the judgment vacated. (*Id.* at 3.) The key provision of the Agreement relevant to the instant matter provides:

> 3. Marvel agrees to purchase from the Patent Holders and the Patent Holders agree to sell to Marvel the Patent which will be evidenced by an instrument of assignment in the form of exhibit C hereto. The purchase price for the Patent shall be payable to the Patent Holders as follows:

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[3] Robert Grabb is not on the patent application nor was he a party to the 1997 Action, rather, he acted as Kimble's attorney during that proceeding. He is a signatory of the Agreement and a party to the instant case.

> a. $516,214.62 upon execution and delivery of this Agreement; and
>
> b. 3% of "net product sales" (as such term is used in the Judgment) excluding refill royalties made after December 31, 2000. For purposes of this paragraph 3.b, "net product sales" shall be deemed to include product sales that would infringe the Patent but for the purchase and sale thereof pursuant to this Agreement as well as sales of the Web Blaster product that was the subject of the Action and to which the Judgment refers.

(*Id.* at 4.) The Agreement contains no expiration date.

David Fremed, Toy Biz CFO, testified in the 1997 Action that "net sales" in the industry meant "gross sales of certain products less some reserve associated with deductions, discounts, returns, allowances." Marvel used a fixed 7% as that reserve, a "P&L allowance." (Dkt. 51-4 at 3-5; Dkt. 62-8 at 7; Dkt. 62-2 at 4.) During 2001-2006, Marvel paid 3% royalties on 93% of the invoiced sale of Web Blasters, taking 7% off as a "P&L allowance." (Dkt. 61, ¶ 4; Dkt. 51-4 at 5-6.)

On January 6, 2006, Marvel entered a licensing agreement with Hasbro. (Dkt. 73 (sealed).) The licensing agreement gave Hasbro copyright and trademark rights for Marvel characters in certain toy categories, including role-play toys. (Dkt. 50-6 at 3.) Hasbro began making versions of the Web Blaster pursuant to the licensing agreement in 2007. (*Id.* at 5.) While negotiating the Agreement, the parties never discussed

what would happen if Marvel stopped making Web Blasters and entered into a licensing agreement. (Dkt. 62-1 at 9)[4]

Between August 2006 and May 2007, Marvel negotiated with Hasbro to sign a Toy Technology Sublicense Agreement, which would have obligated Hasbro to pay Plaintiffs the royalties owed under the Agreement; Hasbro declined to sign the sublicense. (Dkt. 50-6 at 13-14; Dkts. 50-8, 50-9.) Since 2007, Hasbro has sold several versions of the Web Blaster, some of which are packaged in kits with "Extra Value Items." (Dkt. 62-10 at 6-15.) Hasbro also has been selling the Ultimate Web Blaster, which rotates through five shooting functions. (Dkt. 62-10 at 7-15; Dkt. 62-11.) Since 2007, Hasbro has reported quarterly to Marvel the units sold (Dkt. 62-8 at 6) and has paid Marvel royalties amounting to 10% of net sales of the licensed products (Dkt. 50-6 at 10-11).

Up until May 2008 (which included payments for all of 2007), after the resolution of some disputes, Marvel paid Plaintiffs 3% of Hasbro's net sales of various Web Blaster products. (Dkt. 67-35; Dkt. 50-4, ¶ 6; Dkt. 50-5, ¶ 6; Dkt. 60 at 10, ¶ 7; Dkt. 61, ¶ 8.) These royalties included payments for Web Blaster kits with Extra Value items. (Dkt. 50-4, ¶ 6; Dkt. 50-5, ¶ 6; Dkt. 50-2 at 2, ¶ 7; Dkt. 60 at 10, ¶ 7; Dkt. 61,

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[4] Marvel has not manufactured or directly marketed any Web Blasters since prior to 2007. (Dkt. 60 at 20, ¶ 21; Dkt. 67-1 at 17, ¶ 21.)

¶ 7.) Plaintiffs exercised their right to audit Marvel's financial records with respect to the 2007 net product sales. (Dkt. 23, ¶ 12; Dkt. 33, ¶ 12.) On May 23, 2008, Marvel informed Plaintiffs they were not entitled to royalties on Extra Value Items and Marvel had recalculated 2007 royalties and determined Marvel had overpaid Plaintiffs by $282,700. (Dkt. 62-4.)

B. Whether, as a Matter of Law, Marvel Owes Royalties Under the Agreement After the Patent Expires

Both Plaintiffs and the Defendant seek summary judgment on the issue of whether royalty payments extend beyond the patent's expiration, May 25, 2010 (Counterclaim 1(a)). Plaintiffs contend royalties are due under the Agreement for as long as Marvel receives revenue for Web Blaster sales. Defendant argues the royalty provision in the Agreement is unenforceable after the patent expires. The opposing motions demonstrate that both parties agree there is no issue of material fact and summary judgment is appropriate. The Court agrees that this is purely a legal question.

The seminal case on this issue is *Brulotte v. Thys Co.*, 379 U.S. 29, 32 (1965), which held that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful per se." In *Brulotte*, a patent-owner sold a hop-picking machine for a flat fee and issued a license, which made payable an annual royalty and also precluded

assignment of the license or removal of the machine from the county. 379 U.S. at 29. The Court found the licensing agreement unenforceable after expiration of the patent because to conclude otherwise would allow assertion of the monopoly power of the patent beyond its term. *Id.* at 33. The Court distinguished the situation from ones in which non-patented items are priced based on long-term use or in which different arrangements would apply before and after the expiration of a patent. *Id.* at 31-32. The Court emphasized that because the terms were the same both before and after expiration of the patent, they were "unable to conjecture what the bargaining position of the parties might have been and 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.

The Court subsequently distinguished a situation in which an inventor and a manufacturer entered two agreements, one for a 5% royalty for the item in the inventor's pending patent application, and the second for a 2 ½% royalty if the patent application was not allowed within five years. *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257, 259 (1979). The Court distinguished *Brulotte* because the contract for a 2 ½% royalty did not rely on a patent. *Id.* at 262 (finding that federal law did not preempt state contract law in this situation). The reduced royalty was negotiated for the express purpose of compensation in the absence of a patent. Hence, the *Aronson* agreement did not offend the principle emphasized in *Brulotte* – it is

unlawful to leverage a patent monopoly beyond its expiration. *Id.* at 265. The Court noted that "[n]o doubt a pending patent application gives the applicant some additional bargaining power for purposes of negotiating a royalty agreement," which cannot extend beyond a patent term; however, because the lower royalty rate was negotiated for the express contingency of no patent, it was enforceable. *Id.*

Plaintiffs rely on *Zila, Inc. v. Tinnell*, 502 F.3d 1014 (9th Cir. 2007), to support their argument that this Court should give effect to the parties' intent that the royalty continue as long as the toys are sold. *Zila* is the leading Ninth Circuit case on this issue and it involved a contract intended by the parties to, and drafted to, grant a 5% royalty in perpetuity on sales of a herpes treatment in exchange for all rights to the treatment, including any future patents (four of which were eventually obtained). 502 F.3d at 1016. Contrary to Plaintiffs' argument, the Ninth Circuit was unable to enforce the parties' intent because it found that "*Brulotte* preempts state law with regard to a contract for payment of royalties on the sale of an invention that may be patented, if a patent indeed issues." *Id.* at 1020, 1022. Thus, *Zila* illustrates that *Brulotte* may override the parties' intent regarding the length of a royalty provision.

Here, the parties are in accord that the Agreement provided for the sale of a patent right.[5] Whether the Agreement also transferred non-patent rights is less clear. The plain language of paragraph three of the Agreement provides that the only right Plaintiffs transferred to Marvel was the patent. "The purchase price for the Patent shall be" royalty payments for two categories of toys (infringing and the Web Blaster previously litigated). (Dkt. 47-3, ¶ 3.) Although royalties are due for sales of the Web Blaster, there is no release or transfer relating to the Web Blaster. In fact, paragraph 9 of the Agreement provides: "Except for the obligations undertaken by Marvel in this Agreement and except for those obligations under the alleged verbal agreement that was the subject of the Action, the Patent Holders hereby release and discharge Marvel. . . ." (Dkt. 47-3, ¶ 9.) Plaintiffs contend this language demonstrates the Agreement provided obligations separable from the patent. Although Plaintiffs may have reserved non-patent rights, the Agreement does not clearly transfer any of these non-patent rights. Paragraph nine more reasonably suggests that Plaintiffs reserved the non-patent rights from the verbal agreement and did not transfer them to Marvel.

The plain language of the Agreement clearly relies on a patent and does not have separate provisions for non-patent rights, the distinction made by

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[5] Plaintiffs' attorney reaffirmed the Agreement provided for the sale of Plaintiff's patent at oral argument.

Aronson. Because the Agreement is premised on a patent, *Brulotte* controls and the royalty cannot extend beyond the life of the patent.

Despite the plain language of the Agreement, both parties interpret the Agreement as transferring the patent right *and* the rights to the toy idea(s) verbally exchanged between Kimble and Toy Biz in 1990. At oral argument, Defendant could not identify any language in the Agreement that transferred a non-patent right. Nevertheless, Defendant asserted the transfer of non-patent rights was implicit in the Agreement. Because the parties are in agreement, and the outcome is the same whether the Agreement transferred only patent rights or both patent and non-patent rights, the Court will also assess the latter possibility.

Plaintiffs contend that, pursuant to the royalty provision of the Agreement there are separable rights, "patent rights" and "non-patent rights." Under their interpretation, in consideration for non-patent rights there is a 3% royalty on the non-infringing toys, which is distinct from the 3% royalty for infringing toys. They agree that no royalties would be due for infringing products after the expiration of the patent, but argue for the continuation of royalty payments for toys not tied to the patent. Defendant contends there is no distinction between royalties for patent rights and those for non-patent rights. Therefore, they conclude the Agreement is a hybrid under the law. To the extent the Agreement can be

interpreted as transferring non-patent rights, the Court agrees with Defendant.

In *Pitney Bowes, Inc. v. Mestre*, 701 F.2d 1365, 1371-72 (11th Cir. 1983), the circuit court emphasized that a "hybrid" agreement providing royalties for patent rights and trade secrets was no different than *Brulotte* which licensed both patent rights and "use." Because restrictions and royalties applied the same before and after the expiration of the patent, which indicates the projection of the patent monopoly beyond its period, the agreement was unenforceable beyond the patent expiration. *Id.* at 1373. The Sixth Circuit followed the Eleventh, holding, "enforcement of royalty provisions for other rights which conflict with and are indistinguishable from royalties for patent rights, is precluded." *Boggild v. Kenner Products*, 776 F.2d 1315, 1319 (6th Cir. 1985). Here, the Agreement does not distinguish royalties for the patent from those paid for non-patent rights, or royalties before and after the patent expires.

The inseparability of the rights transferred is illustrated by the history of the Agreement. When the Agreement was executed, Plaintiffs believed Marvel was infringing their patent and were pursuing an appeal to vindicate this belief. Thus, patent rights and infringement were still in dispute and the parties entered into the Agreement to settle all issues, patent and contract, in order "to avoid the further expense and distraction of litigation." (Dkt. 47-3 at 2, ¶ E.) To that end, the Agreement included a royalty for certain toys, infringing or not. Since the signing of the

Agreement, the parties have continued to take various positions on whether any toys sold would have infringed the patent. (Dkt. 48-7 at 10-11; Dkt. 56-2 at 5-7; Dkt. 67-36 at 3-4; Dkt. 67-37 at 6.) The Agreement created no distinction, nor has one been made by the parties, for royalty payments for infringing versus non-infringing toys.

Although conceding the patent was part of the bargain at oral argument, Plaintiffs contended that their leverage in negotiating the Agreement was the judgment not the patent. As noted above, the issue of patent rights and infringement were actively in dispute and the Agreement was negotiated to settle those issues. The Sixth Circuit held in *Boggild* that when anticipated patents are used as leverage to negotiate a royalty agreement, regardless of the fact that the application has not been filed, *Brulotte* invalidates the agreement to the extent it extends beyond expiration of the eventually-issued patent. 776 F.2d at 1319. The Seventh Circuit has similarly held that a contract transferring an "invention" and the right to seek a patent for the invention, triggers *Brulotte* once a patent issues because the patent possibility put the inventor in a stronger bargaining position. *Meehan v. PPG Indust., Inc.*, 802 F.2d 881, 885 (7th Cir. 1986). Here, because a patent was used as leverage to negotiate the Agreement, which transferred the patent rights, it fits squarely within the parameters of *Brulotte. See Aronson*, 440 U.S. at 265.

Accordingly, the Court finds the Agreement is governed by *Brulotte* and the royalty provision is unenforceable after expiration of the patent. This is true if the Agreement is interpreted as transferring only a patent right, in which case the royalty provision is clearly premised on a patent, or if the Agreement is a hybrid and transfers patent and non-patent rights for royalties that are inseparable between the two rights.

C. Whether, as a Matter of Law, "Net Product Sales" is Defined

Plaintiffs seek summary judgment on the definition of the term "net product sales" in the Agreement. Plaintiffs contend that "net product sales" means 93% of gross product sales.

The Agreement is governed by New York law. (Dkt. 47-3 at 7, ¶ 14.) When interpreting a contract, the goal is to give effect to the parties' intent. *Hartford Accident & Indem. Co. v. Wesolowski*, 305 N.E.2d 907, 909 (N.Y. 1973). "Whether an agreement is ambiguous is a question of law for the courts." *Kass v. Kass*, 696 N.E.2d 174, 181 (N.Y. 1998). Here, the Agreement is ambiguous because "net product sales" is not defined. The Agreement only provides that the term is used as it "is used in the Judgment," (Dkt. 47-3, ¶ 3.b) but that term is not defined in the judgment. If a contract is ambiguous, courts may consider

extrinsic evidence to interpret it.[6] *Hartford Accident & Indem.*, 305 N.E.2d at 909.

The available extrinsic evidence includes testimony in the 1997 Action defining "net product sales" and the parties' course of performance. The CFO for Toy Biz, David Fremed, testified in a deposition for the 1997 Action that in the industry "net sales" is "gross sales of certain products less some reserve associated with deductions, discounts, returns, allowances." (Dkt. 51-4 at 3-5.) Marvel used a fixed 7% for that reserve, referred to as a "P&L allowance." (*Id.*) Plaintiffs believed, at the time they entered the Agreement, that "net product sales" meant 93% of gross product sales. (Dkt. 51-5, ¶1; Dkt. 51-6, ¶1.) The same definition for net sales provided by Fremed was reiterated by other Marvel executives in depositions for this case. (Dkt. 62-8 at 7; Dkt. 62-2 at 4.)

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[6] Relying primarily on New York law, Defendant suggests that if the Court has to look to extrinsic evidence, disputed issues of fact are necessarily implicated and summary judgment is precluded. (Dkt. 59 at 19, 20.) First, although New York law governs the substantive contract issues before the Court, such as which facts are material, the ultimate question, whether there is a genuine dispute of fact, is assessed under federal standards. *See Anderson*, 477 U.S. at 248-49 (the court determines if there is a factual issue that a jury could reasonably resolve in favor of either party). Second, New York law does not require such a rule. *See Federal Ins. Co. v. Americas Ins. Co.*, 258 A.D.2d 39, 44-45 (N.Y. App. Div. 1999) (when the moving party sets forth extrinsic evidence of the parties' intent and the responding party does not provide any conflicting evidence, summary judgment is properly granted).

From 2001 to 2006, Marvel paid Plaintiffs 3% royalties on 93% of the invoiced sales of Web Blasters, taking 7% off as a "P&L allowance." (Dkt. 61, ¶ 4; Dkt. 51-4 at 5-6.) "The parties' course of performance under the contract is considered to be the 'most persuasive evidence of the agreed intention of the parties.'" *Federal Ins. Co. v. Americas Ins. Co.*, 258 A.D.2d 39, 44 (N.Y. App. Div. 1999) (the parties' interpretation for "any considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence.").

Marvel argues that, with respect to a particular agreement, the term "net sales" to which Fremed testified might be a "completely different term" from "net product sales." While "net sales" and "net product sales" might not have the same meaning in varying contexts, Marvel's contention that they did not mean the same thing as to the Agreement between the parties is unsupported. Testimony by Marvel executives does not establish any distinction between net sales and net product sales, at least with respect to this Agreement. (Dkt. 62-2 at 4.) To the contrary, Marvel confirms that it paid royalties on 93% of invoiced sales through 2006 when it was selling toys. Marvel does not contend that these payments were erroneous or that was not the intended definition. Rather, it makes the conclusory argument that "this does not establish that 93% of the 'invoiced sales' is the definition of 'net product sales' as an undisputed fact." (Dkt. 59 at 28.) Defendant does not provide any conflicting evidence or any other definition the

parties may have intended. An unsupported assertion is insufficient to create a "genuine issue for trial." *Matsushita*, 475 U.S. at 586-87.

Marvel further argues that 93% is no longer the appropriate number because, since 2007, Hasbro has been the decision-maker regarding the packaging and selling of the toys. Up until Hasbro began selling the Web Blaster there was no dispute that "net product sales" meant 93% of gross product sales. Marvel provides no explanation or evidentiary support for how their licensing agreement with Hasbro, effective in 2007, alters what the parties intended the term "net product sales" to mean in their 2001 Agreement.[7]

In sum, Plaintiffs set forth undisputed facts regarding what the parties understood "net product sales" to mean at the time they entered the 2001 Agreement, and how it was used in royalty payments up through 2006. It was consistently interpreted to mean 93% of gross product sales. Marvel has not produced any conflicting evidence to alter that definition. Thus, summary judgment for Plaintiffs is appropriate.

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[7] Defendant points to Plaintiffs' assertion that, since 2007, Marvel has paid royalties on 87.2% of Hasbro's gross sales of Web Blasters, not on 93% (Dkt. 62-9 at 4). In addition to the fact that this unproven, it is not material to resolving the parties' intention as to the definition of "net product sales" in the 2001 Agreement.

D. Whether, as a Matter of Law, Marvel Owes Royalties Under the Agreement For Hasbro's Net Product Sales

Counterclaim 2 alleges that Marvel mistakenly paid Plaintiffs for Hasbro's sales in 2007, unjustly enriching Plaintiffs, when the Agreement did not require payments for sales by Hasbro.[8] Plaintiffs seek summary judgment on their entitlement to royalties for Hasbro's sales of toys. As discussed in more detail below, the Court finds there are triable issues of fact regarding whether the toys manufactured by Hasbro are within the scope of the Agreement.

The plain language of the Agreement obligated Marvel to pay a 3% royalty to Plaintiffs for any products within the two categories specified by the Agreement – products that would infringe the patent and the Web Blaster litigated in the prior Action. The Agreement has no limitations based on who is manufacturing and/or marketing the products. Contrary to Marvel's contention, this would not obligate it to pay for sales by an unrelated third-party. A third-party with no relationship to Marvel could not legally manufacture a toy within either of these categories

[8] In relation to this claim, Plaintiffs contends the Hasbro license amounts to an assignment of Marvel's rights under the Agreement; Defendant disagrees. Whether any rights were legally assigned to Hasbro, the parties agree that no duties relative to the Agreement were assigned. (Dkt. 47 at 5; Dkt. 59 at 14; Dkt. 67 at 9.) Resolution of whether there was an assignment of rights to Hasbro is irrelevant because any duty remains with Marvel.

because Marvel owns the patent and it owns the right to Spider-Man, and the Web Blaster is a Spider-Man toy. Thus, Marvel has complete control over the sale of any toys within those two categories.

Under the licensing agreement, Marvel receives 10% of Hasbro's net sales for the use of the Spider-Man license and trademark. (Dkt. 50-6 at 3, 10.) Marvel argues that continuing its 3% royalty obligation to Kimble would lead to an absurd result requiring Marvel to pay 30% of the royalties they received from Hasbro to Plaintiffs. If this is an absurd result, it was created by Marvel with full knowledge of its obligations under the Agreement.[9] Additionally, the 30% figure on which Marvel relies has little meaning in the abstract. There is no evidence in the record regarding Marvel's profit when it manufactured the Web Blaster, and the percentage of that paid to Plaintiffs, versus its profit as a licensor, and what percentage of that the 3% royalty constitutes.

Marvel's remaining arguments based on the plain language of the Agreement, in support of their position that no royalty is due for Hasbro's sales, are unpersuasive. Marvel argues that it would not be able to provide the information required by the Agreement for a third-party's sales – quarterly reports of net

[9] Marvel apparently attempted to avoid this result by obligating Hasbro to pay Plaintiffs the royalties owed under the Agreement through a Toy Technology Sublicense Agreement. (Dkt. 50-6 at 13-14; Dkts. 50-8, 50-9.)

product sales, number of units sold, and price – nor would it have obligated itself to late payment provisions that could be impacted by a third-party. Marvel could control its ability to meet these obligations by including them in the terms of any subsequent licensing agreement, which it did in its agreement with Hasbro. Similarly, Marvel argues that if it owed Plaintiffs for *any* third-party sales, Plaintiffs' right under the Agreement to examine Marvel's financial records as to net product sales would be rendered meaningless, as those records would contain no relevant information. Because all sales within the Agreement are controlled by Marvel, and Marvel profits from Hasbro's sales, Marvel's records would, and do, provide the relevant financial information. These provisions of the Agreement do not make the existence or nonexistence of an obligation to pay Plaintiffs royalties on Hasbro's net product sales more or less probable. The Court concludes that, under the plain language of the Agreement, Marvel owes Plaintiffs a 3% royalty for anyone's product sales covered by the Agreement.

Notwithstanding this finding, there remains an ambiguity precluding summary judgment – whether any toys sold by Hasbro come within the toy categories covered by the royalty provision of the Agreement. Whether Hasbro sold any toys that would infringe the patent is a legal issue not before the Court. Also, there are genuine issues of fact regarding whether any toys sold by Hasbro are properly categorized as the "Web Blaster product that was the

subject of the Action and to which the Judgment refers." Although the toy that was litigated during the 1997 Action was one specific version of the Web Blaster, Marvel has made royalty payments to Plaintiffs for many later-developed versions of the Web Blaster. Thus, determining what toys the parties intended to be covered by the Agreement will require examining the course of performance and the specific toys for which royalties are in dispute. In particular, as discussed below, the parties dispute whether Hasbro' s Ultimate Web Blaster is entirely within the terms of the Agreement. Additionally, Marvel made payments to Plaintiffs for sales by Hasbro in 2007 (Dkt. 67-35), which it asserts were made in error, and Marvel negotiated, without completing a contract, for Hasbro to take over royalty payments to Plaintiffs (Dkt. 50-6 at 13-14; Dkts. 50-8, 50-9). The relevance of these facts is a matter for the trier of fact.

Accordingly, Plaintiffs are not entitled to summary judgement on Counterclaim 2.

E. Whether, as a Matter of Law, Marvel Owes Royalties for Improved Web Blasters and Extra Value Items

Marvel alleges Plaintiffs were overpaid in 2007 for "kits," which included a Web Blaster and Extra Value Items (Counterclaim 3) and improved Web Blasters (Counterclaim 4). Plaintiffs move for summary judgment on both these claims.

Plaintiffs interpret the Agreement broadly and argue the plain language does not allow for a reduction in royalty payments based on improved Web Blaster functions nor does it distinguish between a product that includes Extra Value Items and one that does not. The Court agrees with Defendant that the plain language of the Agreement does not address this situation. Rather, it is ambiguous regarding whether royalties are due for Extra Value Items packaged with a Web Blaster or for Web Blaster versions developed after the 1997 Action. Thus, the Court must assess whether the parties' intent can be discerned from undisputed extrinsic evidence.

With respect to Extra Value Items, Plaintiffs rely on the parties' course of performance from 2001 through May 2008 – Marvel paid royalties on the entirety of kits (Dkt. 50-4, ¶ 6; Dkt. 50-5, ¶ 6; Dkt. 50-2 at 2, ¶ 7; Dkt. 60 at 10, ¶ 7; Dkt. 61, ¶ 7) – as proof that there is no genuine issue of fact.[10] Marvel agrees such payments were made, but asserts they were made in error. Marvel provided a declaration from Kenneth West, Marvel's Chief Financial Officer, who attested that Marvel's payments for Extra Value Items without any deduction or allocation were a mistake, which it did not realize until it entered the licensing agreement with Hasbro. (Dkt. 61, ¶¶ 7, 10.) Marvel's assertion that its payments for Extra Value

[10] Web Blasters packaged with Extra Value items were sold with a single SKU number. (Dkts. 50-4, ¶ 3; Dkt. 50-5, ¶ 3; Dkt. 60 at 10, ¶ 4.)

Items were made in error raises a credibility issue and a question of fact. Whether the course of performance evidences the parties' intent under the Agreement as to sales of Extra Value Items by Hasbro is a factual dispute for the trier or fact precluding summary judgment on Counterclaim 3.

With respect to "improved" Web Blasters, Defendant argues Plaintiffs are only entitled to a partial royalty for the Ultimate Web Blaster sold by Hasbro, which it categorizes as the first "multi-function" Web Blaster. Plaintiffs counter that Marvel has always paid full royalties on Web Blasters with multiple functions, such as the Dual Action and Triple Action Web Blasters and the Mega Blast Web Shooter that shot silly string, water, and darts. (Dkts. 67-14 to -17.) Defendant does not dispute that it sold toys with those functions, but claims the Ultimate Web Blaster incorporates all the functions into a single unit and does not require the user to change out canisters to use different functions. The Court cannot resolve on summary judgment whether the Ultimate Web Blaster is factually and functionally distinct from the original Web Blaster or the other products previously sold by Marvel, such that the parties' course of performance is not persuasive evidence of the parties' intent regarding royalty payments for the Ultimate Web Blaster. *See Federal Ins. Co.*, 258 A.D.2d at 44 (the parties' interpretation for "any considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence.").

Additionally, Marvel contends the attachments for the prior improved versions of the Web Blaster, sold by Marvel, were properly categorized as Extra Value Items for which Marvel should not have made full payment. Because the factual dispute regarding Extra Value Items cannot be resolved on summary judgment, as discussed above, that is another issue of material fact precluding summary judgment regarding the Ultimate Web Blaster. Whether the Ultimate Web Blaster is a product within the scope of the Agreement is a question of fact precluding summary judgment on Counterclaim 4.

Plaintiffs' alternative legal theory of accord and satisfaction with respect to the Ultimate Web Blaster is unpersuasive. According to Plaintiffs, their acceptance of a check from Marvel, after a dispute over royalties for the Ultimate Web Blaster, acted as an accord and satisfaction.[11] *See Patel v. Orma*, 593 N.Y.S.2d 851, 853 (App. 1993) (acceptance of a check in full settlement of a disputed claim amounts to an accord and satisfaction). Acceptance of a check only operates a release if the parties are on notice of such a consequence, *see Sorrye v. Kennedy*, 699 N.Y.S.2d 214, 215-16 (App. Div. 1999), and there is no evidence

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[11] On December 13, 2007, Plaintiffs inquired with Marvel's CFO, Ken West, why the Ultimate Web Blaster was not included in the 2007 third quarter report. (Dkt. 48-7 at 2.) After partial payment and further debate (*see* Dkts. 48-7, 48-8), on January 28, 2008, Marvel agreed to pay full royalties for the Ultimate Web Blaster. (*Id.* at 17; Dkt. 48-10.)

the parties reached such an understanding regarding the Ultimate Web Blaster. (*See* Dkt. 48-7.) Further, accord and satisfaction requires new consideration and a meeting of the minds. *Id.* at 216 (citing *Komp v. Raymond*, 67 N.E. 113 (1903)). The items Plaintiffs cite as consideration, foregoing interest payments and their right to sue, were never mentioned during the email exchanges. (Dkt. 48-7.) Further, the parties December 2007 to January 2008 email exchanges, which is the only evidence on which the parties' rely, do not establish a meeting of the minds and the execution of a new contract. (*Id.*) Plaintiffs are not entitled to summary judgment on their defense of accord and satisfaction.

IV

RECOMMENDATION

Defendant Marvel is entitled to summary judgment as a matter of law on Counterclaim 1(a) – Marvel is not required to pay royalties under the Agreement after the May 25, 2010 expiration of the patent. Therefore, the Magistrate Judge recommends the District Court, after its independent review of the record, deny Plaintiffs' Motion for Summary Judgment (Dkt. 49) on this issue and grant Defendant's motion (Dkt. 54). Plaintiffs have demonstrated there is no genuine issue of material fact regarding the definition of "net" product sales in the agreement – it means 93% of gross product sales. Thus, the Magistrate Judge recommends the District Court, after its

independent review of the record, grant Plaintiffs' motion for summary judgment on this issue (Dkt. 51.) There are genuine issues of material fact precluding summary judgment on the issue of sales by Hasbro, improved Web Blasters and Extra Value Items. Therefore, the Magistrate Judge recommends the District Court, after its independent review of the record, deny summary judgment on Counterclaims 2, 3 and 4 (Dkts. 47, 48, 50).

Pursuant to Federal Rule of Civil Procedure 72(b)(2), any party may serve and file written objections within 14 days of being served with a copy of this Report and Recommendation. If objections are not timely filed, they may be deemed waived. If objections are filed, the parties should use the following case number: **CV-08-372-TUC-DCB**.

DATED this 2nd day of December, 2009.

/s/ D. Thomas Ferraro
D. Thomas Ferraro
United States Magistrate Judge

379 U.S. 29

Walter C. BRULOTTE et al., Petitioner

v.

THYS COMPANY.

No. 20.

Argued Oct. 20, 1964.
Decided Nov. 16, 1964.

Rehearing Denied Jan. 18, 1965.
See 379 U.S. 985, 85 S.Ct. 638.

Edward S. Irons, Washington, D.C., for petitioners.

Elwood Hutcheson, Yakima, Wash., for respondent.

Mr. Justice DOUGLAS delivered the opinion of the Court.

Respondent, owner of various patents for hop-picking, sold a machine to each of the petitioners for a flat sum[1] and issued a license for its use. Under that license there is payable a minimum royalty of $500 for each hop-picking season or $3.33 1/3 per 200 pounds of dried hops harvested by the machine, whichever is greater. The licenses by their terms may not be assigned nor may the machines be removed from Yakima County. The licenses issued to petitioners

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[1] One petitioner paid $3,125 for "title" to a machine, the other petitioner, $3,300.

listed 12 patents relating to hop-picking machines;[2] but only seven were incorporated into the machines sold to and licensed for use by petitioners. Of those seven all expired on or before 1957. But the licenses issued by respondent to them[3] continued for terms beyond that date.

Petitioners refused to make royalty payments accruing both before and after the expiration of the patents. This suit followed. One defense was misuse of the patents through extension of the license agreements beyond the expiration date of the patents. The trial court rendered judgment for respondent and the Supreme Court of Washington affirmed. 62 Wash. 2d 284, 382 P. 2d 271. The case is here on a writ of certiorari. 376 U.S. 905, 84 S.Ct. 666, 11 L.E.2d 605.

We conclude that the judgment below must be reversed insofar as it allows royalties to be collected which accrued after the last of the patents incorporated into the machines had expired.

The Constitution by Art. I, § 8 authorizes Congress to secure "for limited times" to inventors "the exclusive right" to their discoveries. Congress exercised

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[2] All but one of the 12 expired prior to the expiration of the license agreements. The exception was a patent whose mechanism was not incorporated in these machines.

[3] Petitioners purchased their machines from prior purchasers under transfer agreements to which respondent was a party.

that power by 35 U.S.C. § 154 which provides in part as follows:

> "Every patent shall contain a short title of the invention and a grant to the patentee, his heirs or assigns, for the term of seventeen years, of the right to exclude others from making, using, or selling the invention throughout the United States, referring to the specification for the particulars thereof. . . ."

The right to make, the right to sell, and the right to use "may be granted or conferred separately by the patentee." *Adams v. Burke*, 17 Wall. 453, 456, 21 L.Ed. 700. But these rights become public property once the 17-year period expires. *See Singer Mfg. Co. v. June Mfg. Co.*, 163 U.S. 169, 185, 16 S.Ct. 1002, 1008, 41 L.Ed. 118; *Kellogg Co. v. National Biscuit Co.*, 305 U.S. 111, 118, 59 S.Ct. 109, 113, 83 L.Ed. 73. As stated by Chief Justice Stone, speaking for the Court in *Scott Paper Co. v. Marcalus Co.*, 326 U.S. 249, 256, 66 S.Ct. 101, 104, 90 L.Ed. 47:

> " . . . any attempted reservation or continuation in the patentee or those claiming under him of the patent monopoly, after the patent expires, whatever the legal device employed, runs counter to the policy and purpose of the patent laws."

The Supreme Court of Washington held that in the present case the period during which royalties were required was only "a reasonable amount of time over which to spread the payments for the use of the

patent." 62 Wash. 2d, at 291, 382 P. 2d, at 275. But there is intrinsic evidence that the agreements were not designed with that limited view. As we have seen,[4] 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. Nor is the case like the hypothetical ones put to us where non-patented articles are marketed at prices based on use. The machines in issue here were patented articles and the royalties exacted were the same for the post-expiration period as they were for the period of the patent. That is peculiarly significant in this case in view of other provisions of the license agreements. The license agreements prevent assignment of the machines or their removal from Yakima County *after*, as well as before, the expiration of the patents.

Those restrictions are apt and pertinent to protection of the patent monopoly; and their applicability to the post-expiration period is a telltale sign that the licensor was using the licenses to project its monopoly beyond the patent period. They forcefully negate the suggestion that we have here a bare arrangement for a sale or a lease at an undetermined price based on use. The sale or lease of *unpatented* machines on

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[4] Note 1, *supra*.

long-term payments based on a deferred purchase price or on use would present wholly different considerations. Those arrangements seldom rise to the level of a federal question. But patents are in the federal domain; and "whatever the legal device employed" (*Scott Paper Co. v. Marcalus Mfg. Co., supra*, 326 U.S., at 256, 66 S.Ct., at 104) a projection of the patent monopoly after the patent expires is not enforceable. The present licenses draw no line between the term of the patent and the post-expiration period. The same provisions as respects both use and royalties are applicable to each. The contracts are, therefore, on their face a bald attempt to exact the same terms and conditions for the period after the patents have expired as they do for the monopoly period. We are, therefore, unable to conjecture what the bargaining position of the parties might have been and what resultant arrangement might have emerged had the provision for post-expiration royalties been divorced from the patent and nowise subject to its leverage.

In light of those considerations, we conclude that a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*. If that device were available to patentees, the free market visualized for the post-expiration period would be subject to monopoly influences that have no proper place there.

Automatic Radio Co. v. Hazeltine, 339 U.S. 827, 70 S.Ct. 894, 94 L.Ed. 1312, is not in point. While some of the patents under that license apparently

had expired, the royalties claimed were not for a period when all of them had expired.[5] That license covered several hundred patents and the royalty was based on the licensee's sales, even when no patents were used. The Court held that the computation of royalty payments by that formula was a convenient and reasonable device. We decline the invitation to extend it so as to project the patent monopoly beyond the 17-year period.

A patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly. But 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 tieing the sale or use of the patented article to the purchase or use of unpatented ones. *See Ethyl Gasoline Corp. v. United States*, 309 U.S. 436, 60 S.Ct. 618; *Mercoid Corp. v. Mid-Continent Inv. Co.*, 320 U.S. 661, 664-665, 64 S.Ct. 268, 270, 88 L.Ed. 376, and cases cited. The exaction of royalties for use of a machine after the patent has expired is an assertion of monopoly power in the post-expiration period when, as we have seen, the patent has entered the

[5] The petition for certiorari did not in the questions presented raise the question of the effect of the expiration of any of the patents on the royalty agreement. Also, the Hazeltine license, which covered many patents, exacted royalties for patents never used. But that aspect of the case is likewise not apposite here for the present licensees are farmers using the machines, not manufacturers buying the right to incorporate patents into their manufactured products.

public domain. We share the views of the Court of Appeals in *Ar-Tik Systems, Inc. v. Dairy Queen, Inc.*, 3 Cir. 302 F.2d 496, 510, that after expiration of the last of the patents incorporated in the machines "the grant of patent monopoly was spent" and that an attempt to project it into another term by continuation of the licensing agreement is unenforceable.

Reversed.

Mr. Justice HARLAN, dissenting.

The Court holds that the Thys Company unlawfully misused its patent monopoly by contracting with purchasers of its patented machines for royalty payments based on use beyond the patent term. I think that more discriminating analysis than the Court has seen fit to give this case produces a different result.

The patent laws prohibit post-expiration restrictions on the use of patented ideas; they have no bearing on use restrictions upon nonpatented, tangible machines. We have before us a mixed case involving the sale of a tangible machine which incorporates an intangible, patented idea. My effort in what follows is to separate out these two notions, to show that

there is no substantial restriction on the use of the Thys *idea*, and to demonstrate that what slight restriction there may be is less objectionable than other post-expiration use restrictions which are clearly acceptable.

I.

It surely cannot be questioned that Thys could have lawfully set a fixed price for its machine and extended credit terms beyond the patent period. It is equally unquestionable, I take it, that if Thys had had no patent or if its patent had expired, it could have sold its machines at a flexible, undetermined price based on use; for example, a phonograph record manufacturer could sell 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.

Conversely it 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. Such royalties would restrict the manufacturer's exploitation of the *idea* after it falls into the public domain, and no such restriction should be valid. To give another example unconnected with a tangible machine, a song writer could charge a royalty every time his song—his idea—was sung for profit during the period of copyright. But once the song falls into the public domain each and every member of the public should be free to sing it.

In fact Thys sells both a machine and the use of an idea. The company should be free to restrict the use of its machine, as in the first two examples given above. It may not restrict the use of its patented idea once it has fallen into the public domain. Whether it has done so must be the point of inquiry.

Consider the situation as of the day the patent monopoly ends. Any manufacturer is completely free to produce Thys-type hop-pickers. The farmer who has previously purchased a Thys machine is free to buy and use any other kind of machine whether or not it incorporates the Thys idea, or make one himself if he is able. Of course, he is not entitled as against Thys to the *free* use of any Thys machine. The Court's opinion must therefore ultimately rest on the proposition that the purchasing farmer is restricted in using his particular machine, embodying as it does an application of the patented idea, by the fact that royalties are tied directly to use.

To test this proposition I again put a hypothetical. Assume that a Thys contract called for neither an initial flat-sum payment nor any annual minimum royalties; Thys' sole recompense for giving up ownership of its machine was a royalty payment extending beyond the patent term based on use, without any requirement either to use the machine or not to use a competitor's. A moment's thought reveals that, despite the clear restriction on use both before and after the expiration of the patent term, the arrangement

would involve no misuse of patent leverage.[1] Unless the Court's opinion rests on technicalities of contract draftsmanship and not on the economic substance of the transaction, the distinction between the hypothetical and the actual case lies only in the cumulative investment consisting of the initial and minimum payments independent of use, which the purchaser obligated himself to make to Thys. I fail to see why this distinguishing feature should be critical. If anything the investment will encourage the purchaser to use his machine in order to amortize the machine's fixed cost over as large a production base as possible. Yet the gravamen of the majority opinion is restriction, not encouragement, of use.

II.

The essence of the majority opinion may lie in some notion that "patent leverage" being used by Thys to exact use payments extending beyond the patent term somehow allows Thys to extract more onerous payments from the farmers than would otherwise be obtainable. If this be the case, the Court must in some way distinguish long-term use payments from long-term installment payments of a flat-sum purchase price. For the danger which it seems to fear would appear to inhere equally in both, and as I

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[1] Installment of a patented, coin-operated washing machine in the basement of an apartment building without charge except that the landlord and his tenants must deposit 25 cents for every use, should not constitute patent misuse.

read the Court's opinion, the latter type of arrangement is lawful despite the fact that failure to pay an installment under a conditional sales contract would permit the seller to recapture the machine, thus terminating—not merely restricting—the farmer's use of it. Furthermore, since the judgments against petitioners were based almost entirely on defaults in paying the $500 minimums and not on failures to pay for above-minimum use,[2] any such distinction of extended use payments and extended installments, even if accepted, would not justify eradicating all petitioners' obligations beyond the patent term, but only those based on use above the stated minimums; for the minimums by themselves, being payable whether or not a machine has been used, are precisely identical in substantive economic effect to flat installments.

In fact a distinction should not be accepted based on the assumption that Thys, which exploits its patents by selling its patented machines rather than licensing others to manufacture them, can use its patent leverage to exact more onerous payments from farmers by gearing price to use instead of charging a flat sum. Four possible situations must be considered. The purchasing farmer could overestimate, exactly estimate, underestimate, or have no firm

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[2] Petitioner Charvet was indebted to Thys only to the extent of the minimums; petitioner Brulotte was in default approximately $4,500 of which $3,120 was attributable to minimums.

estimate of his use requirements for a Thys machine. If he overestimates or exactly estimates, the farmer will be fully aware of what the machine will cost him in the long run, and it is unrealistic to suppose that in such circumstances he would be willing to pay more to have the machine on use than on straight terms. If the farmer underestimates, the thought may be that Thys will take advantage of him; but surely the farmer is in a better position than Thys or anyone else to estimate his own requirements and is hardly in need of the Court's protection in this respect. If the farmer has no fixed estimate of his use requirements he may have good business reasons entirely unconnected with "patent leverage" for wanting payments tied to use, and may indeed be willing to pay more in the long run to obtain such an arrangement. One final example should illustrate my point:

At the time when the Thys patent term still has a few years to run, a farmer who has been picking his hops by hand comes into the Thys retail outlet to inquire about the mechanical pickers. The salesman concludes his description of the advantages of the Thys machine with the price tag—$20,000. Value to the farmer depends completely on the use he will derive from the machine; he is willing to obligate himself on long credit terms to pay $10,000, but unless the machine can substantially outpick his old hand-picking methods, it is worth no more to him. He therefore offers to pay $2,000 down, $400 annually for 20 years, and an additional payment during the contract term for any production he can derive from

the machine over and above the minimum amount he could pick by hand. Thys accepts, and by doing so, according to the majority, commits a *per se* misuse of its patent. I cannot believe that this is good law.[3]

III.

The possibility remains that the Court is basing its decision on the technical framing of the contract and would have treated the case differently if title had been declared to pass at the termination instead of the outset of the contract term, or if the use payments had been verbally disassociated from the patent licenses and described as a convenient means of spreading out payments for the machine. If indeed the impact of the opinion is that Thys must redraft its contracts to achieve the same economic results, the decision is not only wrong, but conspicuously ineffectual.

I would affirm.

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[3] The Court also adverts to the provisions in the license agreements prohibiting "assignment of the machines or their removal from Yakima County" (*ante*, p. 179) during the terms of the agreements. Such provisions, however, are surely appropriate to secure performance of what are in effect conditional sales agreements and they do not advance the argument for patent misuse.

Furthermore, it should not be overlooked that we are dealing here with a patent, not an antitrust, case, there being no basis in the record for concluding that Thys' arrangements with its licensees were such as to run afoul of the antitrust laws.