# PATENT ROYALTIES EXTENDING BEYOND EXPIRATION: AN ILLOGICAL BAN FROM *BRULOTTE* TO *SCHEIBER*

*A recent decision by the Seventh Circuit Court of Appeals,* Scheiber v. Dolby Laboratories, Inc.,[1] *called into question, yet dutifully applied, the somewhat disfavored Supreme Court patent case of* Brulotte v. Thys Co.[2] *For thirty-eight years,* Brulotte *has served as an absolute prohibition on the collection of any patent royalties extending beyond the expiration date of the patent. As Justice Douglas stated in writing for the eight-Justice majority, "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful* per se*."*[3] *Ostensibly, this concise and easily-applied exposition of the law seems sensible enough. But, the devil is in the details. This iBrief highlights the flawed reasoning underlying* Brulotte *as evidenced by its application in* Scheiber*, but ultimately concludes that overruling the case may be of little help to Mr. Scheiber in his suit against Dolby.*

## Introduction

The basic tenet underlying patent law is a very simple quid pro quo: in exchange for public disclosure of the nuts and bolts of an invention, Congress is constitutionally empowered to grant to the inventor an exclusive right to the invention disclosed for a limited time.[4] While the basic idea is simple enough, an interesting situation arises when private parties intentionally contract beyond the twenty-year grant[5] in order to optimize the mutual economic benefits of their agreement. Absent any foul play, one might think notions of freedom of contract make such agreements allowable, and indeed desirable. But alas, one would be wrong - at least according to the teachings of Brulotte, where a nearly unanimous Supreme Court held such agreements "unlawful per se."[6] That this precedent, nearly four decades old, remains good law was reiterated at the unfortunate expense of musician-turned-inventor Peter Scheiber[7] in his dealings with Dolby Laboratories.[8]

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[1] Scheiber v. Dolby Labs., Inc., 293 F.3d 1014 (7th Cir. 2002), *cert. denied*, 71 U.S.L.W. 3471 (2003).
[2] Brulotte v. Thys Co., 379 U.S. 29 (1964).
[3] *Id.* at 32.
[4] *See* U.S. Const. art. I, § 8, cl. 8.
[5] 35 U.S.C. § 154(a)(2) (1994).
[6] *Brulotte*, 379 U.S. at 32.
[7] *Scheiber*, 293 F.3d at 1016.
[8] *See id.* at 1018.

### *Scheiber* Meets *Brulotte*

Peter Scheiber, inventor of the "surround sound" audio system, held several patents on this technology both in the United States and in Canada.[9] Scheiber's last United States patent was scheduled to expire in 1993, while his last Canadian patent was scheduled to expire in 1995.[10] In 1983, Scheiber sued Dolby for infringement.[11] Rather than undertaking the expense of litigation, the parties agreed to settle on a licensing contract.[12] During negotiations Dolby proposed to Scheiber that in exchange for lower royalty payments (and hence, increased sales), it would continue paying beyond the expiration of the United States patents until 1995, when the last Canadian patent expired.[13] Scheiber agreed to these terms.[14] However, upon expiration of the United States patents in 1993, Dolby discontinued its royalty payments and Scheiber filed suit.[15]

Dolby rationalized its actions based on the *Brulotte* rule:[16] "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*."[17] In *Brulotte*, the Thys Company sold hop-picking machines incorporating several of its patents.[18] In addition to the flat sum for the physical machines, Thys also licensed the machines based on the machines' incorporation of the patents.[19] Under this license, the purchasers paid royalties to Thys in various amounts depending upon their use of the machines.[20] Since the license extracted royalties extending beyond the term of the patent grants, the purchasers discontinued payment when the patents expired.[21]

Over the dissent of Justice Harlan, Justice Douglas' majority opinion invalidated the license agreement as "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."[22] While recognizing the legitimacy of using the patent as leverage to exact royalties as high as possible during the life of the patent, the Court deemed it improper to use that same leverage to exact lower royalties for a term

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[9] *Id.* at 1016.
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Scheiber*, 293 F.3d at 1016.
[14] *Id.*
[15] *Id.*
[16] *Id.* at 1017.
[17] *Brulotte*, 379 U.S. at 32.
[18] *Id.* at 29.
[19] *Id.*
[20] *Id.*
[21] *Id.* at 30.
[22] *Id.* at 32.

extending beyond the life of the patent.[23] The Court analogized post-expiration royalty agreements to tying arrangements, whereby a monopolist uses its power in one market to leverage itself into another market.[24] In other words, since the patentee has a monopoly in the pre-expiration market for his product, a patentee cannot use that monopoly as leverage into the post-expiration market.[25] Although the Court seemed to acknowledge that equality of bargaining power could exist between a patentee and licensee in entering into this type of agreement,[26] it nevertheless erected an insurmountable barrier by creating a *per se* rule of invalidity.[27]

Thus, under the *Brulotte* rule, Dolby had a virtual slam-dunk because Chief Judge Posner's opinion for the court found the two cases to be "indistinguishable."[28] To be sure, the court gave Scheiber's arguments every chance.[29] In fact, the court made its distaste for the rule abundantly clear, characterizing it as "dubious" in reasoning,[30] "out of touch with the Supreme Court's current thinking,"[31] and even "silly."[32] But neither Scheiber's arguments nor the court's fundamental disagreement with the rule allowed disregard of such a strong *per se* rule of invalidity.[33]

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[23] *Brulotte*, 379 U.S. at 33.
[24] *Id.*
[25] *See* Note, *An Economic Analysis of Royalty Terms in Patent Licenses*, 67 MINN. L. REV. 1198, 1217-22 (1983), for an extended discussion of tying pre-expiration royalties to post-expiration royalties.
[26] *See Brulotte*, 379 U.S. at 32. The Court stated that since the "present licenses draw no line between the term of the patent and the post-expiration period," it 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."
[27] *Id.*
[28] *Scheiber*, 293 F.3d at 1017. This assertion is not technically correct because in *Brulotte* the license was limited to use of the particular machines sold by Thys. 379 U.S. at 29-30. The license in *Scheiber* applied to equipment manufactured by Dolby that incorporated the Scheiber's patents. 293 F.3d at 1017. However, this distinction is to Scheiber's detriment because even Justice Harlan's *Brulotte* dissent found post-expiration royalty agreements of this sort to be impermissible. 379 U.S. at 35 (Harlan, J., dissenting).
[29] *See Scheiber*, 293 F.3d at 1019 (although the reasoning of *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979), seems to support Mr. Scheiber's argument against Dolby, the case is inapposite because the *Aronson* Court explicitly distinguished and reaffirmed *Brulotte*). *See also Scheiber*, 293 F.3d at 1019-21 (the 1988 amendment to 35 U.S.C. § 271(d)(5) is limited to infringement suits in which tying is alleged between two products); *id.* at 1021-23 (the doctrine of "unclean hands" is limited to equitable relief).
[30] *Scheiber*, 293 F.3d at 1018.
[31] *Id.*
[32] Audio recording: *Scheiber* oral argument, *available at* http://www.ca7.uscourts.gov/farg/arg.fwx?submit=showar&caseno=01-2466_001.mpg (Dec. 3, 2001).
[33] *Scheiber*, 293 F.3d at 1018.

## The Fusion of Precedent

The legal basis for the rule set forth in *Brulotte* is essentially a fusion of two distinct lines of Supreme Court precedent, neither being clearly on-point. The first is derived from *Scott Paper Co. v. Marcalus Manufacturing. Co.*[34] In that case, Marcalus was the patentee of a packaging machine which it assigned to Scott Paper for valuable consideration.[35] However, upon discovering a pre-existing expired patent thought to invalidate the assigned patent, Marcalus began to manufacture the packaging machine itself without first obtaining a license from Scott Paper as assignee.[36] In its ensuing suit for infringement, Scott Paper asserted that Marcalus was estopped to defend its infringement of the patent on the basis of prior art anticipation because Marcalus was the assignor of Scott Paper's patent.[37] In other words, it was Scott Paper's position that a party such as Marcalus cannot sell a patent, only to turn around and attack it on grounds of validity.

Despite Scott Paper's seemingly reasonable reliance on precedent to support this contention,[38] the Court found that such a rule would undermine the very *quid pro quo* underlying the patent laws enacted by Congress.[39] Since the public had already paid the price for disclosure of the expired patent's technology, it had a vested interest in ensuring its free use.[40] According to Chief Justice Stone's majority opinion, it was irrelevant that only Marcalus would be affected by the rule, leaving the disclosed technology open to the general public for exploitation. The opinion reasoned that "[i]f a manufacturer or user could restrict himself, by express contract, or by any action which would give rise to an 'estoppel,' from using the invention of an expired patent, he would deprive himself *and the consuming public* of the advantage to be derived from his free use of the disclosures."[41] Thus, the Court said "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."[42]

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[34] Scott Paper Co. v. Marcalus Mfg. Co., 326 U.S. 249 (1945).
[35] *Id.* at 251.
[36] *Id.*
[37] *Id.*
[38] *Id.* at 251-52. Scott Paper relied on *Westinghouse Co. v. Formica Co.*, which stated "an assignor of a patent right is estopped to attack the utility, novelty or validity of a patented invention which he has assigned or granted as against any one claiming the right under his assignment or grant. As to the rest of the world, the patent may have no efficacy and create no right of monopoly; but the assignor can not be heard to question the right of his assignee to exclude him from its use." 266 U.S. 342, 349 (1924).
[39] *Id.* at 255-56.
[40] *Scott Paper*, 326 U.S. at 256.
[41] *Id.* at 255-56 (emphasis added).
[42] *Id.* at 256.

Because *Scott Paper* placed so much emphasis on ensuring unfettered access to the technology disclosed by an expired patent, the *Brulotte* Court latched onto this case as the main basis for its holding.[43] But there is a crucial difference between the two cases. *Scott Paper* was an action for patent infringement in which the plaintiff sought to enjoin the defendant on an estoppel theory.[44] *Brulotte* was an action for royalties owed under contract in which the defendant sought to defend his actions on a patent misuse theory.[45] This is significant because *Scott Paper* did not enunciate patent misuse as the reason for its holding, and not one case in the interim between *Scott Paper* and *Brulotte* cited it for such a purpose.[46] In fact, the factual background of *Scott Paper* would not have allowed the case to be based on patent misuse since that doctrine only limits action by the holder of the patent in question,[47] and the expired patent in *Scott Paper* was held by a party unrelated to the litigation.[48] Thus, the *Brulotte* Court needed a doctrinal hook upon which to hang its new *per se* rule.

The Court found that hook by simply analogizing the projection of royalty payments beyond the life of the patent to "an effort to enlarge the monopoly of the patent by tieing [sic.] the sale or use of the patented article to the purchase or use of unpatented ones."[49] Through this analogy—stated as though self-evident—the Court effectively fused the *Scott Paper* line of cases with a second line of cases invalidating tying arrangements[50] to form this new version of patent misuse. Whereas the concern in *Scott Paper* was protection of the public's vested interest in free access to the disclosed technology,[51] the concern in the tying cases was protection of the public from overreaching by the patentee beyond the scope of the patent grant.[52] At the inception of this anti-tying doctrine in *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*, the Court viewed such arrangements as the "perfect instrument of favoritism and oppression."[53] While

[43] *See Brulotte*, 379 U.S. at 31-32.
[44] *Scott Paper*, 326 U.S. at 250.
[45] *Brulotte*, 379 U.S. at 30.
[46] *See* United States v. Singer Mfg. Co., 374 U.S. 174, 200 (1963); United States v. United States Gypsum Co., 340 U.S. 76, 94 (1950); MacGregor v. Westinghouse Electric & Mfg. Co., 329 U.S. 402, 407 (1947); Edward Katzinger Co. v. Chicago Metallic Mfg. Co., 329 U.S. 394, 400-01 (1947*)*. *But see* Automatic Radio Mfg. Co. v. Hazeltine Research, Inc., 339 U.S. 827, 838-40 (1950) (Douglas, J. dissenting, arguing that *Scott Paper* could support a finding of patent misuse).
[47] *See* Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2, 38 (1984) (O'Connor, J. concurring).
[48] *See Scott Paper*, 326 U.S. at 251.
[49] *Brulotte*, 379 U.S. at 33.
[50] *Id.* (citing *Mercoid Corp. v. Mid-Continental Inv. Co.*, 320 U.S. 661 (1944), and *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436 (1940), as invalidating monopolistic tying arrangements).
[51] *Scott Paper*, 326 U.S. at 256.
[52] *See, e.g.,* Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 492 (1942).
[53] Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 515 (1917).

*Universal Film* was purportedly based on the statutory language of the patent grant by Congress,[54] the cases to follow relied more and more on policy considerations.[55] Over time, several cases arose involving monopolists already violating antitrust laws and attempting to use patents to legitimize their tying arrangements.[56] This progression eventually led the Court, speaking through Justice Douglas, to state in very broad terms: "[w]here the sale of an unpatented product is tied to a patented article, that is a *per se* violation since it is a bald effort to enlarge the monopoly of the patent beyond its terms."[57]

Although *Brulotte* involved no allegations of antitrust violations,[58] the Court swept that fact aside without comment and effortlessly categorized the hop-picking licenses at issue as *per se* illegal because they did in fact extract royalties in the post-expiration term.[59] Hence, a new form of patent misuse was born.

## A Nonsensical Rule

Regardless of whether traditional tying arrangements actually produce deleterious effects on competition,[60] fear of the type of tying proscribed in *Brulotte* is unfounded because it is based on two faulty presumptions. First, as in traditional tying cases, in order to use a patent as leverage into the post-expiration market, the patentee must have pre-expiration market power. Without this power in the pre-expiration market, the patentee would be unable to coerce licensees into promising their business in the post-expiration market. While pre-expiration market power could exist in a given case, as the Court recognized in *Northern Pacific Railway v. United States*, it is definitely not the rule.[61] Despite the label of "monopoly" given to patents, a patentee has no more market power by virtue of his patent than does the holder of a closely-guarded trade secret.

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[54] *Id.* at 514-15.
[55] *See, e.g., Morton Salt*, 314 U.S. at 492 ("But the public policy which includes inventions within the granted monopoly excludes from it all that is not embraced in the invention. It equally forbids the use of the patent to secure an exclusive right or limited monopoly not granted by the Patent Office and which it is contrary to public policy to grant.").
[56] *See, e.g.,* Int'l Salt Co. v. United States, 332 U.S. 392, 395-96 (1947); Ethyl Gasoline Corp. v. United States, 309 U.S. 436, 456 (1940).
[57] White Motor Co. v. United States, 372 U.S. 253, 259 (1963) (Douglas, J.).
[58] *Brulotte*, 379 U.S. at 38 n.3 (Harlan, J., dissenting).
[59] *Id.* at 32.
[60] There is insufficient space in this iBrief to rehash the traditional tying debate. For more on this topic, *see Scheiber,* 293 F.3d at 1020 (Posner, C.J., giving a concise explanation of the argument in favor of tying arrangements).
[61] N. Pac. Ry. v. United States, 356 U.S. 1, 10 n.8 (1958).

Yet, the Court has consistently ignored competition among patentees in its tying cases,[62] which amounts to a constructive presumption of market power conferred by the patent.

Certainly, in *Scheiber* it is difficult to imagine that a musician-turned-inventor would have sufficient market power such that he could coerce Dolby into unwilling acceptance of a license extending beyond the term of his patents. But even if such power existed, coercion was not present because Dolby approached Scheiber with the idea of an extended license agreement.[63] Without coercion as a factor, the *Brulotte* Court's analogy between traditional tying and post-expiration royalty agreements is undermined to a considerable degree.

Second, for an extended-term patent license to have a deleterious effect on competition in the post-expiration market, the patent must enable the patentee to use power in the pre-expiration market to drive competition out of the post-expiration market. In traditional tying arrangements, the theory is that a patentee is able to attain market power in the market for the unpatented article if he has power in the market for the patented article. For example, if a salt manufacturer conditioned licenses for its patented salt canning machines upon the purchase of its unpatented salt, then the salt manufacturer could obtain market power in the unpatented salt market by using its power in the salt canning machine market to drive out competition.[64]

Although the *Brulotte* Court implicitly presumes it is possible to use pre-expiration market power to drive out competition from the post-expiration market, *Scheiber* is certainly evidence that this is an erroneous presumption. The fallacy lies in the fact that, unlike traditional tying arrangements, there is no third party for Scheiber to drive out. In other words, this type of tying arrangement does not reduce the ability of others besides Dolby to compete in the post-expiration market. But Dolby, by agreeing to the longer royalty agreement, made reduced payments in the pre-expiration period and thus received an advantage during that time which it must pay for in the post-expiration period.[65] So again, the analogy to traditional tying cases is undermined because these types of arrangements are not susceptible to being used to restrain competition.

In addition to these two faulty presumptions underlying *Brulotte*, the *per se* rule of invalidity has perverse effects. Since the various flavors of patent misuse are grounded on the premise that the patent grant conveys to patentees a power which may not be used contrary to the

[62] *Id.*
[63] *Scheiber*, 293 F.3d at 1016.
[64] *See Morton Salt*, 314 U.S. at 491-94.
[65] *See Scheiber*, 293 F.3d at 1018 ("The parties could have agreed that Dolby would pay royalties for the next 100 years, but obviously the royalty rate would be minuscule...").

public interest,[66] it seems logical to assume the *Brulotte* rule would act to further those interests. Yet, this is not the case.

First, the *Brulotte* rule is detrimental to the *quid pro quo* underlying the entire patent system. For example, say a person invents a revolutionary cure for baldness. The formula is clearly worthy of a patent, but it is costly to manufacture and it is only effective on a small percentage of the balding population. The inventor does an economic analysis and concludes that it will require thirty years to sell enough of his formula to this select demographic in order to show a profit. Having consulted with his attorney, who is familiar with *Brulotte*, the inventor finds out that his formula cannot be patented and then licensed for a thirty–year block of time. Thus, the inventor's only choice is to guard the formula as a trade secret and deprive the public of a valuable tool in the fight against baldness generally. Such a situation is undesirable from a public policy point of view, but under *Brulotte*, the inventor has no other choice.

Second, the *Brulotte* rule undermines the policy favoring self-help over litigation. Taking Mr. Scheiber's case as an example, when he originally sued Dolby for patent infringement the parties had two options: either (1) pursue lengthy and costly litigation, or (2) pursue a mutually beneficial licensing agreement that happens to extend beyond the patent term.[67] They clearly chose the latter because it was the most economically efficient solution. For this choice, the parties should be applauded. Instead, the *Brulotte* rule acts as a roadblock standing in the way of such efficient and favorable arrangements.

Given the economic and logical nonsense of *Brulotte*, and more importantly, the perversity of its effect on public policy, it is clearly an undesirable rule.

## Congress is the Answer

Because the *Brulotte* decision was based on policy considerations rather than on statutory interpretation,[68] its lack of economic or logical sense is irrelevant if the granting clause of the patent statutes[69] does not itself permit the arrangement struck down in *Scheiber*. Indeed, it appears as though that is precisely the case. According to the text of the clause, for a period of

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[66] *See, e.g., Morton Salt*, 314 U.S. at 494.
[67] *Scheiber*, 293 F.3d at 1016.
[68] *Scheiber*, 293 F.3d at 1018. Although *Brulotte* does cite the granting clause of the patent stautes, 379 U.S. at 30, the clear basis for the holding is policy rather than statutory interpretation.
[69] The relevant statutes are: 35 U.S.C. § 154(a)(1) ("Every patent shall contain…a grant to the patentee, his heirs or assigns, of the right to exclude others from making, using, offering for sale, or selling the invention…"); and 35 U.S.C. § 154(a)(2) ("…such grant shall be for a term beginning on the date on which the patent issues and ending 20 years from the date on which the application for the patent was filed…").

twenty years a patentee is granted "the right to *exclude* others…."[70] Once that term has passed, the right to exclude disappears. In *Scheiber*, enforcement of the licensing agreement would plainly be just this sort of exclusion on Dolby's ability to use the expired patent's technology. Admittedly, this is rather simple-minded observation is one to which Chief Judge Posner would surely object. In fact, he indirectly did just that in *Scheiber*. Criticizing *Brulotte*, he said:

> The Supreme Court's majority opinion reasoned that by extracting a promise to continue paying royalties after expiration of the patent, the patentee extends the patent beyond the term fixed in the patent statute and therefore in violation of the law. That is not true. After the patent expires, anyone can make the patented process or product without being guilty of patent infringement. The patent can no longer be used to exclude anybody from such production. Expiration thus accomplishes what it is supposed to accomplish. For a licensee in accordance with a provision in the license agreement to go on paying royalties after the patent expires does not extend the duration of the patent either technically or practically, because, as this case demonstrates, if the licensee agrees to continue paying royalties after the patent expires the royalty rate will be lower. The duration of the patent fixes the limit of the patentee's power to extract royalties; it is a detail whether he extracts them at a higher rate over a shorter period of time or a lower rate over a longer period of time.[71]

While this is a sound argument from an economic perspective, it does nothing to address the very real restrictions imposed by the granting clause. Customizing the clear import of statutory language cannot be justified merely because the legislation fails to produce optimal results.[72] Had Congress meant to allow this type of agreement, different statutory language would be appropriate. For instance, the granting clause could be modified to read:

> Every patent shall contain…a grant to the patentee, his heirs or assigns, of the right to exclude others from making, using, offering for sale, or selling the invention…and of *the exclusive right to enter contracts* providing for the manufacture, use, offers to sell, or sales of the invention…

Certainly, if the granting clause proceeded in this manner, Scheiber would have an excellent statutory interpretation argument. Of course, this particular wording may allow for some unforeseen pitfalls, but the idea is clear. So long as the contract providing for the manufacture, use, etc. is entered into during the twenty-year period, the length of the agreement is

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[70] 35 U.S.C. § 154(a)(1) (emphasis added).
[71] *Scheiber*, 293 F.3d at 1017.
[72] Somewhat ironically, Chief Judge Posner recognized this principle while addressing another issue in *Scheiber*: "Congress isn't constrained, as courts like to think *they* are, to rule logically.

immaterial. While a party such as Scheiber seeking to enforce his agreement would still need to confront *Brulotte*, at least the statutory language of the granting clause would support his argument. In short, without modification of the granting clause by Congress, it is difficult to see how the Court could overrule the *Brulotte* rule of *per se* invalidity and remain consistent with the statutory language.[73]

## Conclusion

Overall, it is a bad rule that patent licensing agreements cannot be used to collect royalties after the patent has expired. As has been explained, the rationale behind this rule is fatally flawed and it has a perverse effect on public policy. Unfortunately, it seems unlikely that overruling the case would be sufficient to remedy the situation since the statutory language of the granting clause is quite clear. Therefore, unless Congress acts to change the statute's wording, the world of patent law will be stuck with the *Brulotte* rule for quite some time.

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Most statutes are the product of compromise, and compromises need not cut at the logical joints of a controversy." 293 F.3d at 1021.

[73] In a late-breaking development, the Supreme Court unanimously denied certiorari. Scheiber v. Dolby Labs., 71 U.S.L.W. 3471 (2003). While the denial contains no commentary, it seems likely that Chief Judge Posner's criticism of the *Brulotte* rule did not escape the Court's attention. Yet, because of the statutory language, it is not surprising that certiorari was denied.