

The Patent Is Dead; Long Live The Royalties!

An upcoming Supreme Court ruling could extend product royalties beyond the life of a patent, and thus have a major impact on pharma and medtech deal structures and bottom lines. What companies need to do now to prepare.

BY BASAM NABULSI AND ERIK PAUL BELT

- **Kimble v. Marvel Enterprises**, a case currently pending in the Supreme Court, may change the long-standing rule that patent royalties may not extend beyond the life of a patent.
- A new rule allowing licensors to continue to receive royalty income after a patent expires could cause an important shift in the economics of licensing.
- Such a ruling could give companies increased flexibility in structuring licensing terms to more effectively share risk and address cash flow and capitalization issues. Conversely, it could lengthen royalty obligations.
- Regardless of the Supreme Court's decision in *Kimble*, there are important options for companies to consider in structuring licenses that can benefit their interests during the patent term and beyond.

You are in charge of technology licensing at an R&D company and are in the process of negotiating a license to the company's breakthrough patented technology. You offer to license the technology for a royalty equal to 5% of annual net sales. The potential licensee, a larger company with established manufacturing and marketing capabilities, wants to structure the deal such that the bulk of royalties will be due after five years, reasoning that for the first five years, it will need to make significant capital investments to bring the product to market. In exchange for a lower rate of 2% for the first five years, it will pay a higher running royalty of 8% after five years, when sales are expected to increase, and then past the patent's expiration for the next 25 years.

You finish negotiating the license and are proud of the deal because it makes economic sense for both parties. Just one step remains – to have the lawyers bless it. Your lawyer, a savvy patent attorney, says that the license is unenforceable under a decades-old US Supreme Court case known as *Brulotte v. Thys Co.*

The reason for this rule, your lawyer explains, is that a technology license that seeks to require patent royalties beyond the life of the patent is analogous to an antitrust violation and is thus per se unlawful. There are some exceptions to this strict rule, but even in those cases, the license will often receive heightened scrutiny should it be challenged in court – for example, when the licensee stops paying royalties and the licensor sues.

But a case currently pending in the Supreme Court may change this long-standing rule and could have major ramifications for the technology licensing programs and bottom lines of pharmaceutical and medical technology companies big and small. The case, *Kimble v. Marvel Enterprises*, asks the question whether the Supreme Court should allow royalties to continue after a patent expires.

The impact of such a rule could be enormous for your business. Given the potential that the longstanding rule may change in the near future, careful planning now regarding licensing programs and negotiations will avoid surprises later and help companies plan their

royalty obligations and royalty income long into the future. This article will discuss the economic impact of technology licensing, the current legal framework regarding the structuring of royalties beyond the life of a patent, and what you can do to take advantage of, or plan for, a new licensing scheme if the Supreme Court changes the rule.

THE ECONOMIC IMPACT OF PATENT LICENSING

As a preliminary matter, patent licensing likely affects the majority of medtech companies. In the pharmaceutical, biotech, and medical device industries, patent licensing is often a significant component of a company’s business, whether the company licenses patented technology from, or licenses technology to, others. For example, a *survey of members of the Biotechnology Industry Organization* found that the majority of respondents had license agreements with universities or other biotech and pharmaceutical companies. The survey also noted some other statistics demonstrating how important technology licensing is to the industry:

- Half of the companies were founded on the basis of obtaining a license to technology.

- 45% of the companies obtained a license in the preclinical stage of drug development, with an additional 15% obtaining a license in Phase I of clinical trials.

- More than 65% of respondents said that an exclusive license was extremely or very important to their ability to bring a product to market.

- 73% of respondents said that more than half of their in-license agreements included running royalties.

- 66% said that more than half of their in-license agreements included milestone payments.

While data on the total value of patent licenses in the medtech industry are hard to come by, *one study* estimated that academic licensing alone (including technology developed at universities, hospitals, and research institutes) over a 15-year period contributed from \$86 billion to \$338 billion to this country’s gross domestic product.

Certainly, licensing income can be a significant portion of a company’s bottom line profit. Or royalty obligations can be a significant contributor to a company’s expenses and deductions from revenue. In the biotech and pharmaceutical industry, for example, one survey of patent licensing

rates showed a median rate of 5.1% and a maximum rate of 40% (Gregory J. Battersby and Charles W. Grimes, *Licensing Royalty Rates, 2012 Edition*, at 265).

Another study of licensing terms by economist Thomas Varner concluded that typical royalty rates in the medical and pharmaceutical industries was roughly 3% to 5% of net sales of products and that these royalties are “running,” meaning they continue year after year during the term of the license. (*See Exhibits 1 and 2.*)

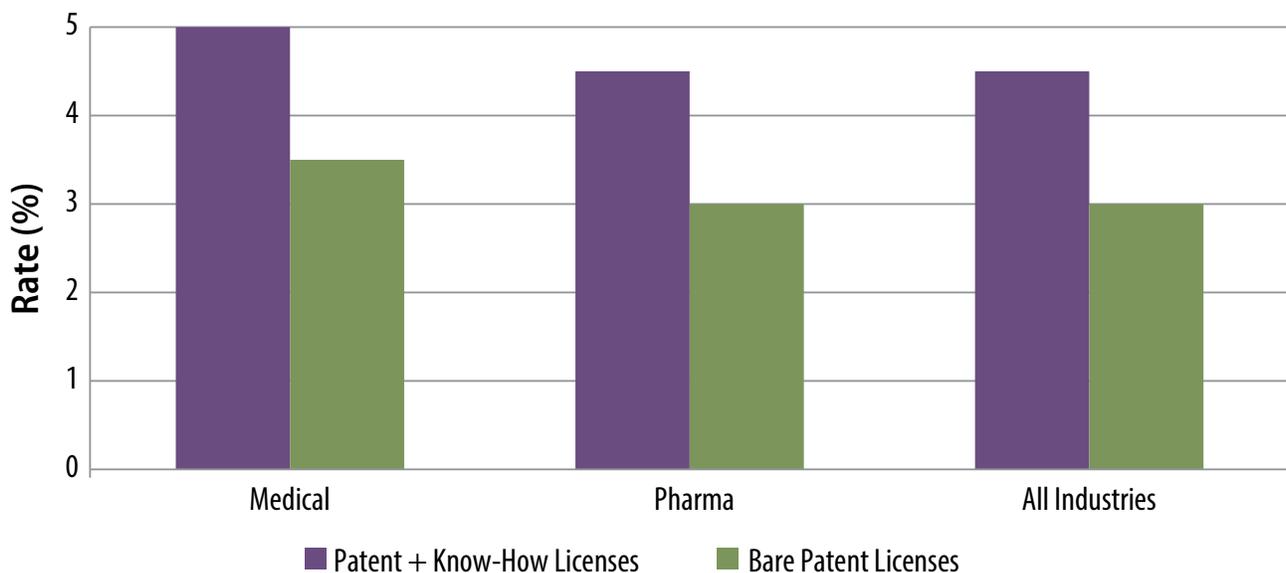
Accordingly, a new rule that would allow licensors to continue to receive royalty income after a patent expires could cause an important shift in the economics of licensing. Companies will be pleased with the increased flexibility in structuring licensing terms to more effectively share risk and address cash flow and capitalization issues. By the same token, a new rule could lengthen royalty obligations and impact long-term market conditions.

CURRENT LEGAL FRAMEWORK FOR PATENT ROYALTIES

A patent has a limited life. The owner may not enforce the patent against infringers before the patent issues or after it expires.

Exhibit 1

Average Running Rates



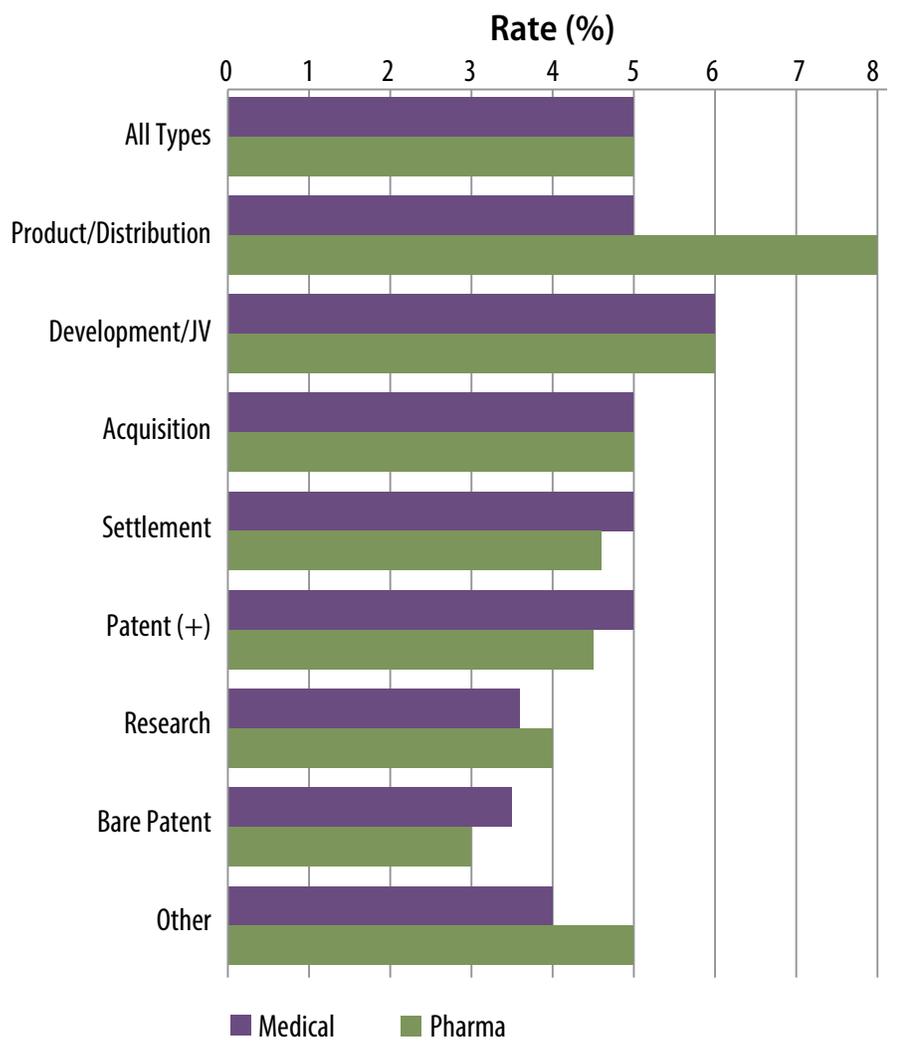
Note: Medical includes medical, surgical, dental, ophthalmic, and orthopedic apparatus firms. Pharma includes medicinal chemical, pharmaceutical preparation, diagnostic substances, biological products, medical laboratories, and biological research firms.

SOURCE: McCarter & English LLP, citing statistics and analysis in Thomas R. Varner, “Technology Royalty Rates in SEC Filings,” 45 *les Nouvelles* 120 (September 2010)

INTELLECTUAL PROPERTY

Exhibit 2

Running Rates By Agreement Type And Industry



+ Patent Plus Know-How

SOURCE: McCarter & English LLP, citing statistics and analysis in Thomas R. Varner, "Technology Royalty Rates in SEC Filings," 45 *les Nouvelles* 120 (September 2010)

That means that anyone may use the technology claimed in the patent, without license or permission, starting the day the patent expires or after it is declared invalid in a litigation. A patent begins life on the date that the US Patent and Trademark Office issues it and expires 20 years from the date the application for that patent was first filed. The average pendency of a patent application from filing until allowance is about 30 months. Thus, as a practical matter, the actual life of a patent is usually about 17 years.

In the 1964 case of *Brulotte v. Thys Co.*, the Supreme Court reasoned that, because

a patent has a limited life, any obligation to pay royalties that extends beyond the life of the patent is per se unlawful. To the Court, a post-expiration royalty is like an improper attempt to extend patent rights beyond the limited, government-approved monopoly of the patent's term. In other words, collecting royalties past the patent's expiration is comparable to an antitrust violation. This per se rule holds true *even if* the parties to the license had equal bargaining power, *even if* they voluntarily agreed to extend royalty payments beyond patent expiration, and *even if* circumstances made

it more desirable economically to defer royalties until patent expiration.

There are some exceptions to the per se rule, however. For example, if the license is for a large portfolio of patents, the royalties may continue until the last patent in the portfolio expires. In other words, even if one patent in the licensed portfolio expires several years before the others, the royalty obligation does not need to end prematurely when the first patent expires.

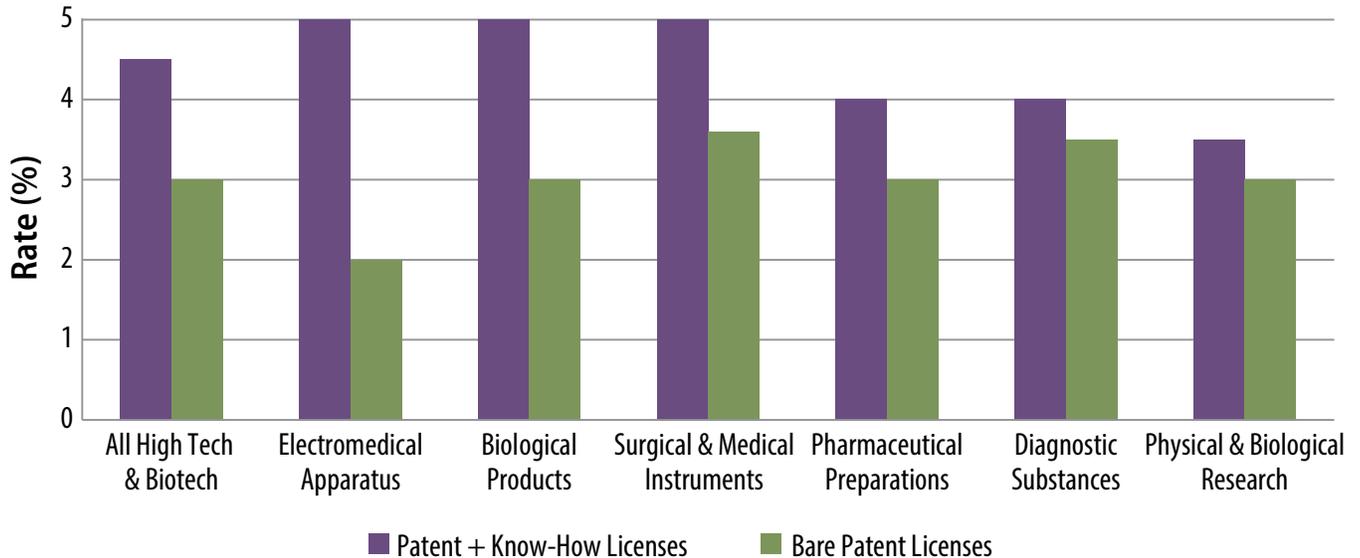
Another possible exception is when the license agreement includes both a right to use the patent and "know-how." In other words, the licensor provides technical support to the licensee throughout the term of the license. These license agreements typically include two royalty rates, one for the life of the licensed patent and a lower one for the remaining term of the license after the patent expires. For example, the running royalty rate may be 5% during the life of the patent and then drop to 2% after the patent expires to reflect that the patent is no longer of value (but that the continuing technical assistance is). Exhibit 3 illustrates that licenses that include both know-how and a patent typically have higher royalty rates than bare patent licenses alone, reflecting the contribution of both the patent and the know-how.

Over time, however, a number of lower courts, legal and business scholars, and economists have questioned the 1964 *Brulotte* rule as outdated and based on unsound economic reasoning. From the perspective of these individuals, the *Brulotte* rule that post-patent royalties are per se unlawful does not square with economic and business realities, such as barriers to market entry, access to capital, sales cycles, and other factors that may make it preferable to defer or amortize the economic value of a patent beyond its life.

Take, for example, a typical case in which the licensee needs to invest substantial time and money to bring the product to market. For example, there may be FDA clinical trials or other regulatory hurdles to overcome. *A recent study by Tufts University* estimated the cost of developing and gaining FDA approval for a prescription drug at \$2.6 billion. In such cases, both the licensor and the licensee may want to defer royalties until later in or even after the patent

Exhibit 3

Running Rates By Industry And License Type



SOURCE: McCarter & English LLP, citing statistics and analysis in Thomas R. Varner, "Technology Royalty Rates in SEC Filings," 45 *les Nouvelles* 120 (September 2010)

term to allow the licensee to develop the product unhindered by royalty obligations. In exchange, the licensor may see benefits in collecting a higher royalty rate after the product is released and gains market share.

Against this backdrop, the Supreme Court has agreed to revisit the *Brulotte* rule more than 50 years after its adoption. In *Kimble v. Marvel Enterprises*, the patent owner, inventor Stephen Kimble, asked the Supreme Court to overturn the *Brulotte* rule so that royalties on his Spider-Man toy could extend past the patent term. Kimble's argument is, in part, that post-patent royalties do not necessarily represent an improper attempt to extend the life of the patent, but rather only an attempt to amortize royalties or to defer payment until later,

when it may, under the circumstances of a particular case, make more economic sense for the parties. Indeed, Kimble argued that allowing parties to postpone royalties may actually encourage innovation (which is the purpose of the patent system) by allowing, for example, a licensee to pay a lower royalty rate but over a longer period of time. That structure may free up profits to be used for other company initiatives and may also reduce the price of the product, thus having a pro-competitive effect.

STRATEGIES FOR STRUCTURING ROYALTIES AFTER KIMBLE

The Supreme Court will likely decide the *Kimble* case by the end of June. Based on the questions the justices asked at oral argu-

ment, we cannot predict whether the Court will overturn the old rule or leave it in place. If the Court overturns the old rule, doing so may allow more creativity and freedom in structuring patent royalties to the economic benefit of both licensor and licensee. But even if the Court keeps the old rule, or adopts some new rule that still scrutinizes post-patent royalties, there are still strategies companies can employ to allow for at least some deferral or amortization of royalties if doing so would make business sense for the parties to the license. Thus, here are some factors to keep in mind when you are negotiating the next big license agreement.

- First, in the past, licenses that have distinguished between use of the technology before and after the patent expires have

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more often survived court scrutiny. These licenses have generally required different (usually lower) royalty rates or payment structures for the period after the patent expires. For instance, during the patent term, the royalty may be 5% of net sales, but that rate drops to 3% after the patent expires. The point is to show that the royalties are not compensating for use of the patent beyond its life, but rather are compensating for some other aspect of the bargain. The license should make clear what the post-patent consideration is and should also emphasize that the lower rate reflects the fact that the expired patent no longer has value.

- Second, licenses that have withstood court scrutiny typically have provided for the transfer of know-how or technical support in addition to the grant of a patent license. These are so-called hybrid licenses in which the licensor provides more than just the patent itself. For instance, the license may be part of a joint venture agreement in which the licensor maintains an active role in helping with marketing, manufacturing, product development, and the like.

- Third, the license may grant rights to a portfolio of patents that expire at different times. The license may also grant rights to other kinds of intellectual property, such as trademarks, that continue long past the expiration of the patent. Any such license should distinguish those portions of the

royalty that compensate for the other rights and should reduce the royalty rate accordingly after the patent expires.

- Finally, the license may provide for milestone payments or changes to the royalty rate triggered by real-world events related to the commercialization of the patented technology. For example, a license agreement for a pharmaceutical compound could tie a lump-sum payment to FDA approval. Or a licensing agreement for a genetic engineering tool could require a higher royalty rate once the tool has been used to successfully introduce a trait into a genetically modified crop. These types of provisions can allow licensors and licensees to align their interests and tie the benefits and burdens of a license agreement to real-world commercial events, even if *Brulotte's* bright-line rule survives.

CONCLUSION

It is unusual for the Supreme Court to agree to revisit a prior decision only to leave it in place, unchanged in any respect. Thus, the Supreme Court's agreement to hear the *Kimble* case understandably raised expectations in the licensing community that a change was in the offing. The oral argument dampened those expectations to some degree – the questions posed by the justices suggested a level of comfort with the current *Brulotte* rule. However, reading tea leaves based on oral argument banter

is at best a risky proposition. Regardless of the Supreme Court's decision in the *Kimble* case there are important options to consider in structuring licenses that can benefit the interests of the parties during the patent term and beyond. And if the *Brulotte* rule is overturned, an understanding of the new "*Kimble* rule" will be important for licensors and licensees alike as the increased flexibility is brought to bear in new license negotiations.

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