Reach Through Royalties and the Patent Misuse Defense:
Can a Tool Company Still Hit the Jackpot?

Biotech tools may include cell lines, monoclonal antibodies, reagents, animal models, growth factors, combinatorial chemistry and DNA libraries, clones and cloning tools (such as PCR), methods, laboratory equipment, and machines.¹ Many tool companies attempt to negotiate licensing agreements that will allow them to capitalize on the market for products that have been created by using their tool. The big money is made from the sale of medicines, treatments, and medical tests to consumers. Tool companies want a slice of that pie, but getting it may cause them indigestion.

Most tool companies’ direct customers are either venture capital funded start-up companies that try to develop products to sell to pharmaceutical companies or basic research institutions.² Tool company customers don’t know whether they will find anything with the tool that they are purchasing, so they don’t want to pay much for it. Moreover, they typically have little capital and are interested in conserving cash. The tool company naturally wants a lot of money for its product. How can it convince its customers to pay it a lot of money?

One solution has been “reach through” royalties based upon a percentage of downstream consumer product sales. The tool company only asks for a little money at the time of licensing or initial sale but asks for big bucks down the line if the customer hits the jackpot using the tool. These royalty arrangements are being challenged as patent misuse.

I. What Happens If Patent Misuse Is Found?

Patent misuse is an affirmative defense raised by a defendant in a patent infringement case. The patent misuse doctrine is designed to protect the public interest, rather than to benefit the alleged infringer. A defendant need not have been harmed by the practice to raise patent misuse as a defense. No damages are awarded if it is found. Nevertheless, patent misuse may have severe consequences.

A finding of patent misuse renders the patent unenforceable until the misuse has been cured by cessation of the abusive practices and the passage of sufficient time for any harmful consequences to dissipate. While the patent is temporarily unenforceable, competitors may enter the tool company’s market and practice the invention. The loss of one patent misuse suit often leads to subsequent losses of related cases. The first patent misuse loss sets a precedent, paving the way for other licensees to challenge the license provisions. The ensuing litigation and license renegotiations may disrupt customer relations and diminish anticipated revenues. Accounting standards may then require the company to restate its balance sheet, as the previously disclosed value of the patent has been diminished. The financial restatement may then hamper the company’s ability to obtain further venture capital. In sum, patent misuse can trigger a cascade of horribles that is best avoided.

II. What is Patent Misuse?

Patent misuse is defined as an impermissible attempt to extend the time or scope of a patent. A patent provides the owner with the right to control who makes, uses, or sells its

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3 B. Braun Med. Inc. v. Abbott Lab., 124 F.3d 1419, 1428 (Fed.Cir.1997). The patent is not invalidated and can be enforced again once the misuse has been purged. C.R. Bard, Inc. v. M3 Systems, Inc., 157 F.3d 1340, 1372 (Fed. Cir.1998).

invention for a period of twenty years. If the patent owner tries to get something larger or longer than those rights, it may be guilty of patent misuse.

“Reach through” royalties are paid on the sales of commercial products that do not contain the patented technology. Since the patented invention is the tool itself, and payments are made based on something else, the tool company is getting a return on a product other than its patented invention. Is it therefore impermissibly extending the scope of its patent and committing patent misuse? Not necessarily.

Where a number of patents are bundled together in a license, a licensing structure which provides for a flat royalty rate to be charged for the patent pool and does not permit licensing the patents separately, presumably at a lower rate, may be permissible. It is not per se patent misuse to assess royalties on a patent bundle based on a percentage of sales revenues where an undetermined number of the products sold do not embody a licensed patent. However, where a total sales royalty is imposed by the patent owner as a condition of the patent license, the coercive use of the patent power constitutes patent misuse.

III. Can You Get Royalties On Your Tool Customer’s Invention?

Modern courts have tested “reach through” royalty licenses for patent misuse by applying antitrust rules and examining voluntariness. The customer may willingly trade the possibility of paying an astronomical future return if it develops a blockbuster drug using the tool, for a miniscule payment for its present use. But there is no guarantee that, once it has a successful consumer product, the customer will remember that the royalty scheme was uncoerced. It may then resist paying the royalty, on the grounds of patent misuse.

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Documenting elements of voluntariness in the licensing negotiations may prevent a finding of patent misuse, providing evidence that the power of the patent monopoly was not being coercively applied. However, if your tool customer objected to “reach through” royalties and instead wanted something narrower and more specific, the risk that patent misuse will be found increases significantly.

Judges are not fools. The license should not say that the royalty payment is based on know-how or on trade secrets that are not worth very much, if it doesn’t pass the laugh test. A royalty that is structured as a fixed payment, to be paid out of a future net sales income stream and to be forgiven in the event that there is no future net income, may pass muster so long as the royalty amount is fixed and the arrangement appears to schedule of deferred payments. But if it is really an attempt to be paid for someone else’s invention, it may not provide protection.

IV. How Long Can You Collect Reach Through Royalties?

In the biotech field, the product development cycle is extremely long. Major sales of a consumer drug or test, which would not have been developed but for use of the patented tool, may occur only after the tool’s patent term has expired. What happens if the product, on which the royalties are calculated, is sold after the patent term expires?

A license agreement that includes provisions to collect a royalty based upon a patent, after its expiration date, is per se patent misuse. One must be careful to structure the license so that royalties are not assessed on expired patents. The license should define a product on which

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9 Evidence that the tool company had entered into licenses with other companies using different royalty arrangements, such as a lump sum payment based on the licensee’s research and development budget, may protect against a finding of misuse. See, e.g., Bayer A.G. v. Housey Pharmaceuticals, Inc. 228 F. Supp. 2d 467 (DC Del. 2002).

10 See Brulotte v. Thys Co., 379 U.S. 29 (1964) (royalties cannot be collected that accrue after the last of the patents incorporated into the licensed machines have expired). For a criticism of Brulotte, see Scheiber v. Dolby Laboratories, Inc., 293 F.3d 1014 (7th Cir. 2002). Nevertheless, the 7th Circuit refused to enforce the licensing agreement for post expiration royalties, holding that only an express overruling would relieve it as an inferior court from the duty to follow Supreme Court precedent. Scheiber appealed and the Supreme Court denied certiorari. Therefore Brulotte remains good law today.
royalties are calculated as one which is covered by a valid claim of an unexpired patent. Although one can maintain the same royalty rate throughout the life of a multiple patent license, if it can be economically justified, a conservative approach is to have royalties decrease as licensed patents expire. Before commencing a patent infringement action, the tool company should review all its outstanding licenses for the patents in suit to be sure that their licenses do not contain an impermissible extension of the royalty payment time. Companies charged with infringement of tool patents may seek discovery of the patent’s licenses and check them for impermissible time extensions.

V. What’s a Tool Company To Do?

One solution is to avoid restrictive “reach through” royalty arrangements altogether, and instead create a licensing program that broadly distributes the tool. Stanford University employs a low fee, non-exclusive licensing structure, which makes its licenses attractive. Its Office of Technology Licensing has developed Ready-to-Sign Agreements with standard terms and conditions that can be conveniently downloaded from its website. These licenses generally contain a noncreditable, nonrefundable issue royalty in a fixed dollar amount and an annual maintenance fee in a fixed dollar amount. No attempt is made to derive income from a product that is not covered by a valid claim in a pending patent application or in an issued and unexpired patent. The simple forms and favorable terms encourage licensing agreements. Stanford’s licensing program has been hugely profitable.

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Patent pooling is another successful approach. Patent pools have a proven synergistic effect that accelerates technology adoption, increasing the size of the product market. The bundling allows the participants to respond rapidly and flexibly to commercial opportunities that arise. No time or resources need be wasted negotiating licensing contracts between the pool participants. The creation of tool patent stacks that can be easily licensed will create additional revenue for tools that might not otherwise be licensed or sold.13 Tool companies may apply for FTC and antitrust clearance for their patent pools.14 Such approval should insulate the tool company from a patent misuse attack.

If you are a tool company, make sure that your patents claimed enough and try to structure the deal to maximize their benefits. Do not impose royalties on products not covered by your patents or require royalty payments beyond the patents’ lives. Enjoy the fruits of your patented invention and don’t overreach to capture the benefits of your customers’ future innovations.

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14 Business practices reviews are performed by the Anti-Trust Division of the Justice Department pursuant to 28 C.F.R. § 50.6, and by the FTC pursuant to 16 C.F.R. §§1.1-1.4. The agencies’ enforcement policies are set forth in Antitrust Guidelines for the Licensing of Intellectual Property (“IP Guidelines”), at: http://www.usdoj.gov/atr/public/guidelines/0558.htm.