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The Federal Common Law of Patent Licensing

by Stuart H. Nissim

The Constitution and Congressional legislation grant certain exclusive rights to inventors of new and useful articles. This collection of rights is known as a United States patent. For a limited time these inventors can use their rights to seek a return for the sweat and money that they invested in the invention by excluding all others from making, using or selling their invention.

There are several profit making options available to the owner of a patent:

1. The patent owner may manufacture and market the invention himself, excluding competition and accumulating the profits as a result of the lack of competition; or
2. The patent owner may sell the patent, and the rights that go with it outright, eliminating the risk and work involved in the marketing of the product; or
3. The patent owner can contractually authorize others to use all or part of the patent in exchange for the payment of royalties. These licensing and payment arrangements may assume any number of configurations. The patent owner may authorize the use of the patent to a number of licensees, which is called a non-exclusive license, or may limit the use to one sole licensee, which is called an exclusive license. The patent owner may license just one or any combination of the rights which the patent grants. The licensor may also restrict the extent of the use by the licensee.

Such licenses are contracts. Because contracts are generally governed by state law, one could conclude that patent licenses are governed by state law. Absent express federal statutes on point, this is generally the case. At times, however, a patent owner’s freedom of contract may be preempted by policy considerations of the federal patent system.

There is a growing collection of federal cases addressing patent licensing contracts which do not apply the substantive law of the forum state, but instead apply federal common law.

Section I of this article discusses the substantive law to be applied in patent licensing cases and the principles and sources of federal common law. Section II presents the development of the federal policy upon which the federal common law of patent licensing relies for its authority. The next two sections present an analysis of some of the Supreme Court and Federal Circuit cases which establish the federal common law of patent licensing. The fifth section briefly discusses the proposed federal legislation which would codify some of the principles of the federal common law of patent licensing.

I

COMMON LAW OF CONTRACTS—FEDERAL OR STATE?

When Mr. Tompkins bumped into a train in Pennsylvania and sued the train company in a New York court, the Supreme Court of the United States held that: (a) unless the matter is governed by the U.S. Constitution or federal statutes, federal courts must apply the applicable state law; (b) neither Congress nor the federal courts have the power to declare substantive rules of common law applicable to a state; and (c) there is no general federal common law. Thus, when exercising jurisdiction based upon diversity of citizenship, federal courts must apply state substantive law. This means that state law, whether legislative or judicial in origin, is to be applied to issues concerning the validity, revocability and enforceability of contracts. The states are free to regulate the use of intellectual property in any manner not inconsistent with federal law on the subject; state law is not displaced merely because the contract relates to intellectual property. Where a federal court acquires jurisdiction of a dispute involving a patent license based upon a diversity of citizenship, the federal court must look to the law of the state in which the court sits. Federal patent law is not applicable in actions for the breach of a patent license.

While Erie told us that there is no general federal common law - no national common law in the United States distinct from the common law which each state has adopted for itself - it did not say that there is no common law in force generally throughout the United States. There still exists the need and authority in limited areas for federal courts to develop what has come to be known as “federal common law.” Federal common law exists in those areas where Congress has given the courts the power to develop substantive law or where the rights, obligations or interests of the United States are intimately involved. When there is an overriding
federal interest in the need for a uniform rule of decision, the federal courts will fashion federal common law.\textsuperscript{12}

The Constitution and the federal statutes dealing with a general subject are the prime sources of federal policy on the subject and may also be viewed as a starting point for ascertaining the federal common law.\textsuperscript{13} Article I, section 8, clause 8 of the Constitution and the Federal Patent Act\textsuperscript{14} foster the federal patent policy.

II

FEDERAL PATENT POLICY

The federal patent system was set up to "promote the progress of ... the useful arts by securing for limited times to ... inventors the exclusive right to their ... discoveries;"\textsuperscript{15} requiring the full and free competition in the use of ideas which are a part of the public domain, while allowing limited rights of exclusion for subject matter of United States patents.\textsuperscript{16} The purpose of the system is: (1) to foster and reward invention; (2) to promote the disclosure of inventions to stimulate further innovations and to permit the public to practice the invention once the patent expires; and (3) to delineate the stringent requirements for patent protection to assure that ideas in the public domain remain there for the free use of the public.

The requirements for obtaining a patent are strictly observed, and when the patent has been issued the limitation on its exercise are equally strictly enforced.\textsuperscript{17}

The federal courts will not hesitate to completely override established state law as it applies to the licensing of U.S. patents when the judiciary believes that such laws inhibit or conflict with the public policy of the patent system.\textsuperscript{18} The courts have gone so far as to hold the Erie Doctrine\textsuperscript{19} inapplicable to those areas of judicial decision in which the policy of the law is so dominated by the sweep of federal statutes that legal relations in those areas must be deemed as governed by federal law.\textsuperscript{20} The Seventh Circuit in UNARCO Industries, Inc. v. Kelly Company,\textsuperscript{21} held that:

[a] patent monopoly conferred by federal statute as well as the policy perpetuating this monopoly, so effects the licensing of patents, and the policy behind such licensing is so intertwined with the sweep of federal statutes, that any question with respect [to a patent license] must be governed by federal law.\textsuperscript{22}

In intellectual property, as in other fields, the question of whether state law is preempted by federal law "involves a consideration of whether [the state] law stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress."\textsuperscript{23} If it does not, the state law governs.

III

FEDERAL COMMON LAW OF LICENSING

A. LEAR, INC. v. ADKINS

The landmark decision of Lear, Inc. v. Adkins\textsuperscript{24} held that private patent licensing contracts between individuals, with or without the approval of the State, cannot be allowed to frustrate "federal patent policy."\textsuperscript{25} In section III of its opinion, the Court disregarded the Erie Doctrine and reviewed the "competing demands" of common law contracts and federal patent law and ruled in favor of federal law,\textsuperscript{26} burying the "general rule" of licensee estoppel that had been a vital doctrine for over ninety years,\textsuperscript{27} and preempting the common law of contracts.

In Lear, an engineer named John Adkins was hired by Lear in January, 1952 to help them invent a better gyroscope. Mr. Adkins succeeded and filed a patent application in February, 1954. In September, 1955, Lear and Akins executed a formal licensing agreement for the use of Adkins' gyroscopes. In 1957, Adkins had yet to receive a patent on his invention and so Lear stopped royalty payments to Adkins on the large number of gyroscopes being produced in its plant in Michigan. Lear's action was based upon research which revealed that the Adkins' invention had been fully anticipated. Two years later, in April, 1959,\textsuperscript{28} Lear terminated royalty payments on the smaller number of gyroscopes it was producing in its California plant.\textsuperscript{29} In January, 1960, Adkins was issued a patent on a narrowed claim. Adkins immediately brought a lawsuit in the California Superior Court for breach of contract. Lear tried to raise patent invalidity as a defense but the court held that the company was estopped from bringing an invalidity defense because of its position as a licensee. This decision was affirmed by the holding of the California Supreme Court\textsuperscript{30} and reversed by the United States Supreme Court.

This far reaching and potentially controversial decision of the Supreme Court held that: (a) a licensee is not estopped to contest the validity of a licensed patent; (b) the licensor can not enforce the royalty provision of the contract; and, (c) upon proving invalidity of the licensed patent, a licensee is released from its royalty obligations retroactively from the date that the patent was issued.\textsuperscript{31} The rationale for this decision is based upon federal patent policy.

1. LICENSEE ESTOPPEL

Before the Lear decision, the doctrine of licensee estoppel had been valid law for more than one hundred years.\textsuperscript{32} The doctrine states that a licensee was prevented from challenging the validity of the patents under which he was licensed. Two Supreme Court decisions established licensee estoppel as the general rule. In United States v. Harvey Steel,\textsuperscript{33} there was a provision in a licensing document with the government that provided for the termination of royalties if the licensed patent was invalidated. The Court rejected the government's defense of patent invalidity in a suit by the patent owner to collect royalty payments, stating:

[T]he United States [cannot] set up the invalidity of the patent in this suit. ... The [royalty termination] proviso was inserted, no doubt, on the assumption that licensee, when sued for royalties, is estopped to deny the validity of the patent which he has been using, and to give him the benefit of litigation by or against third persons, notwithstanding that rule.\textsuperscript{34}

Again in Automatic Radio Mfg. Co. v. Hazeltine Research Inc.,\textsuperscript{35} the Court stated the "general rule is that the licensee under a patent license agreement may not challenge the validity of the licensed patent in a suit for royalties due under the contract."\textsuperscript{36}

The Court in Lear held that the doctrine of licensee estoppel was "so eroded" that it could no longer be the general rule. The Court ruled that the doctrine should only be invoked in a narrow set of circumstances.\textsuperscript{37} The Court weighed the competing demands of the common law of contracts, which would forbid the repudiation of a subsequently unsatisfactory bargain,\textsuperscript{38} against the federal law of patents, which requires that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent.\textsuperscript{39} Finding a true balance impos-
sible, the Court shifted the scales towards the side of the licensee and “federal patent policy”: “Surely the equities of the licensor do not weigh heavily when they are balanced against the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain.”

Common law contract was overwhelmed by “federal patent policy” and licensee estoppel was dead and properly buried. 41

2. ROYALTIES

The Lear Court then proceeded to decide whether federal patent policy would be frustrated if the licensee was required to make royalty payments pendente lite. That was a question which the Court had not been asked to answer.

Section 6 of the 1955 agreement between Lear and Adkins provided for the payment of royalties until such time as the “patent . . . is held invalid.” 42 When weighed against the overriding federal policies, the Court held that this section of the parties’ contract had no authority and was unenforceable. The Court stated that enforcing the contract and requiring the payment of royalties during the time the validity of the patent was being challenged in the courts would be inconsistent with the aims of federal patent policy. 43 The Court went on to hold that a licensor is prohibited from judicially recovering all royalties accruing after the issuance of the patent if the licensee proves the license is invalid.

Ruling the other way would have “[g]iven the licensor an additional economic incentive to devise every conceivable dilatory tactic in an effort to postpone the day of final judicial reckoning.” 44 The effect of the alternative rule would have been to replace the “muzzle,” discouraging the licensee to challenge the validity of the patent, which the Court had just removed when it eliminated the doctrine of licensee estoppel. 45

The Court’s ruling gave the licensee the right to cease royalty payments at the time it challenged the licensor’s patent; and, it deprived the licensor’s right to enforce the licensing agreement and recover the unpaid royalties if the patent was ultimately declared invalid. The Court refused to rule on the situation of royalties paid before the patent issued.

IV

NEW DEVELOPMENTS IN THE COMMON LAW OF LICENSING

A. WHAT TO DO WITH ROYALTIES? - Cordis Corporation v. Medtronic, Inc. 46

The Federal Circuit recently answered several of the questions left unanswered by Lear. 47 In Cordis Corp. v. Medtronic, Inc., 48 Cordis filed suit in district court asking for a declaratory judgment that the two patents it licensed from Medtronic were invalid. 49 Cordis also moved for the court to order the establishment of an escrow account into which Cordis would deposit royalty payments due Medtronic pendente lite and sought a preliminary injunction to enjoin Medtronic from terminating the licensing agreement for failure to make royalty payments during the pendency of the patent invalidity suit. 50 The district court granted the injunction and ordered the establishment of an escrow account. The Federal Circuit vacated and remanded the district court’s decision.

“the court intimates that it might allow an escrow account . . .”

The Federal Circuit found “no authority in Lear” 51 for establishing an escrow account for royalties due pendente lite or preliminarily enjoining a licensor from cancelling the license agreement and, thus, from counterclaiming for patent infringement when [a] material breach of the license occurs.” 52 Cordis and a number of district court decisions argued that with such a decision:

[the] speed and efficiency gained by permitting the licensee to suspend royalty payments would surely be lost if nonpayment meant termination of a license. [T]he threat of termination would discourage the withholding of royalties because . . . termination would lay the licensee open to possibly substantial liability for damages for infringement and an injunction against future use of the product whose patentability had been successfully established. Since few licensees will run the risk, to permit the licensor to terminate the license agreement because of nonpayment would enable it to achieve indirectly what it quite obviously cannot obtain directly - specific performance of the provision requiring payment. 53

The Cordis court, citing the Second Circuit in Warner-Jenkinson Co. v. Allied Chemical Corp., 54 and the Eighth Circuit in Nebraska Engineering Corp. v. Stivers, 55 held that the federal patent policy encouraging prompt adjudication of patent validity permits a licensee to cease royalty payments during the patent invalidity suit but does not permit the licensee to avoid the consequences of such a breach. A licensee cannot enjoy the security of a licensing agreement 56 without making payments required under the agreement. If the challenging licensee does not want to risk forfeiture of the royalties paid while litigating the validity of the patent(s), the consequences of nonpayment, termination of the agreement, and exposure to a potential patent infringement suit must be accepted. In dicta, the court intimates that it might allow an escrow account if the licensee could show that the licensor was financially irresponsible or might be judgment-proof at the end of litigation. 57

Cordis, the licensee, argued that absent the injunctive relief it asked for, it would suffer irreparable harm by forfeiting any royalties paid pendente lite. The court distinguished the authority Cordis cited 58 as only prohibiting recovery of royalties paid by the licensee when the challenge of the patent was made by a third party. The court, however, made no decision as to which party would be entitled to royalties paid or accrued pendente lite should the patent be held invalid. 59

B. THE RIGHT TO CONTRACT

1. Universal Gym Equipment, Inc. v. ERWA Exercise Equipment Ltd. 60

The most recent federal case applying the Erie Doctrine to a patent licensing action came out of the Court of Appeals for the Federal Circuit in September, 1987. In Universal Gym Equipment, Inc. v. ERWA Exercise Equipment Ltd., 61 the Federal Circuit held that patent law does not preclude applications of state contract law to provide relief for the breach of a patent licensing contract. The plaintiff, Universal, and the defendants, ERWA and its subsidiary Global, manufacture and sell weight lifting machines. Universal and ERWA entered into a licensing agreement in 1972 allowing ERWA to manufacture, market and sell Universal machines in Canada under Universal’s trademark in return for the payment of royalties. The agreement contained a clause prohibiting ERWA from using any features, designs, technical information or said know-how of the Universal equipment in any future manufacturing activities after a termination of the contract. 62 The day after Universal terminated the agreement, Global began making and selling exercise equipment.
machines which Universal claimed infringed upon its patent. The district court found that Global's machines did not infringe; however, the court also ruled that the defendants had breached the 1972 agreement and awarded damages to Universal.

On appeal, Global argued that the district court improperly upheld the agreement contrary to the doctrine set out by the Supreme Court in Sears, Roebuck & Co. v. Stiffel Co.,44 and Compco Corp. v. Day-Brite Lighting, Inc.45 In its argument Global stated "that when a publicly available article is unprotected by a patent or copyright, state law may not forbid others from making that article."46

Global also asserted that the holdings of Kewanee Oil Co. v. Bicron Corp.,47 and Lear Inc. v. Adkins,48 support the argument that federal patent law preempts state law that grants equivalent protection. The court held that the application of state law upholding the contract, which contained a provision for relief for a breach of the contract, did not conflict with federal law.49 The court found that Global's argument applied those cases too broadly; the only broad language in those cases that would support the argument was taken out of context. Focusing on the facts and the holdings of Sears, Compco and Lear, the court distinguished the present case. The rationale of Sears and Compco was that patent law has prerequisites and limitations for the granting of a patent.

To allow a state by use of its laws of unfair competition to prevent the copying of an article which represents too slight an advance to [meet the prerequisites] and be patented would be to permit the state to block off from the public something which federal law said belongs to the public.70

Sears and Compco involved the compatibility of federal patent law and the application of state unfair competition law to prevent copying of an unpatented product of a company that had no contractual relations with the copier.71 The issue in Universal was the validity of the contract between the parties and the contract's compatibility, not the state law under which the contract was created, with federal patent law.

The court went on to address the relevance of the holding in Lear,72 that in order to eliminate the threat to the free use of ideas already in the public domain which an invalid patent represents, a patent licensee is not estopped from challenging the validity of the licensed patent. The issue before the Supreme Court in Lear involved a question totally unrelated to the issue in Universal.73 The only applicable case Global cited was Kewanee,74 where the Supreme Court held that federal patent law did not preempt state trade secret law and the remedies it provides for breach of a confidential agreement. In the present case, the Court distinguished the question "whether the patent law precludes the application of state law to validate and award damages for a licensee's breach" of a contract, from the question raised in Sears and Compco, whether relief under a state's unfair competition law for copying an unpatented article is barred by federal patent law.75 This court's decision affirmed the power that the licensor and licensee have to contract, to limit their right to take action they would otherwise have had. Such a private contract is nullified by the Sears/Compco doctrine only if enforcement of the contract would conflict with federal patent policy. Since their is no conflict in applying state law to provide damages for a breach of the agreement, patent law does not preclude the application of state law.76

2. Aronson v. Quick Point Pencil Company77

The Universal court cites Aronson v. Quick Point Pencil Co.,78 as authority for applying state law which uphold the right of the parties in a contract to limit their rights to take action. Relying on Kewanee Oil, the Court in Quick Point held that the states were free to regulate the use of intellectual property that "may or may not be patentable."79 In Quick Point, an inventor, Ms. Aronson, had exclusively licensed her invention, a key holder which had yet to be patented,80 to the Quick Point Pencil Co. for its manufacture and sale. The royalty payments provided for in the contract started at a rate of five percent of the selling price per item but were to be reduced to two and one-half percent, if, within five years, a patent for the key holder was not granted. The Patent Office did not issue a patent within the five year period81 and Quick Point reduced its royalty payments accordingly. Quick Point continued to pay the reduced royalties for fourteen years; however, when sales began to decline from competition Quick Point brought suit to have the royalty agreement declared unenforceable. The Court upheld the agreement because the agreement did not conflict with federal patent policy.82

Permitting inventors to make enforceable agreements licensing the use of their invention in return for royalties in fact provides additional incentive to invent,83 and, as in this case, does not withdraw ideas from the public domain. The idea was not in the public domain when Quick Point obtained the license; it was Quick Point's exploitation that placed the idea there. Enforcing the agreement would not prevent anyone from copying the key holder; it merely requires Quick Point to pay the consideration which it promised in return for the use of the new device enabling it to preempt the market.84 The Court found that enforcement of this royalty agreement was consistent with its earlier case, Brulotte v. TyrCo.85 In Brulotte, it was held that an obligation to pay royalties in exchange for the use of a patented device may not extend beyond the life of a patent. The principle underlying this theory was that someone may not use the leverage of a patent monopoly to negotiate royalty payments beyond the life of the monopoly.86 In Quick Point, no "patent leverage" was used. In fact, the extended payment plan was contingent upon no patent issuing. The Court stated that:

"Kewanee . . . held that federal patent law did not preempt state trade secret law . . . ."


Winter, 1988/ The Law Forum—19

[...]

[...]
someone's freedom to contract so long as it is clear that the subject matter of the contract is not dependent on federally granted patent rights, even though the possibility of patent rights were secondarily involved in the contract.

V. FEDERAL LEGISLATION

Federal common law is resorted to in the absence of an applicable act of Congress. Because a federal court is compelled to consider federal questions which cannot be answered from federal statutes alone, a federal court must sometimes apply federal common law. But a federal court is subject to the dominant authority of Congress. When Congress addresses a question through statutory and regulatory reforms, the federal courts are compelled to conform their decisions to the new federal law or policy. The freedon to provide for termination of the agreement for nonpayment of royalties by allowing the parties to a licensing agreement to provide for termination of the agreement when the licensee challenges the validity of the licensed patent, even if the license has not stopped making royalty payments. The freedom to provide for termination upon a patent challenge and for royalty obligations to continue until final resolution is a Congressional recognition of the parties right to contract expressed in Universal.

VI. CONCLUSION

America has grown to be a world power in such a relatively short time partly due to the competitive nature of its people. This competitiveness has been stimulated and nurtured by granting rewards for inventiveness, the rights specified in the Patent Act. At times, however, the patent owner’s use of these rights has been found to transgress the federal patent policy. Even seemingly legitimate uses of the patent monopoly may be ruled as inconsistent with federal patent policy.

Where the legislature has failed to deal with these transgressions, the federal courts have developed federal common law. Federal common law was not abolished by the Erie decision; in fact, in the field of patent licensing agreements it is growing at a rapid rate. The area of royalty payments appears to be where the growth will be most abundant; there are still a number of questions regarding royalties that have been raised but not yet answered.

The newly proposed legislation is a sign that Congress is aware of the need to address these questions and more clearly define what “federal patent policy” is and thereby, decrease the need for the courts to fill in the gaps.

NOTES

1 The federal patent system was developed to foster and reward invention; to promote disclosure of inventions to stimulate further invention; to permit the public to practice the invention once the patent expires; and to assure that ideas in the public domain remain there for the free use of the public. 

2 There may be some risk involved if the purchase price of the patent is in some way based upon a percentage of the sales of the invention.

3 A patent owner may even grant a license that is so exclusive that it includes a promise to make, use or sell his or her own invention.

4 For example: the license may be restricted to one particular field of use or to a specified territory. The invention may have uses in more than one field: domestic, industrial or military. The patentee may limit a license to one or more of such fields of use. E.g., General Talking Pictures Corp. v. Western Elec. Co., 304 U.S. 175, aff’d on hearing, 305 U.S. 124, (1938). Section 261 of the Patent Act, 35 U.S.C. 261 (1982), expressly provides for the granting of an exclusive right under a patent “to the whole or any specified part of the United States.” Such territorial restrictions do not preclude an ultimate purchaser from using or reselling the invention elsewhere. E.g. United States v. Basich and Lomb Optical Co., 321 U.S. 707 (1944).

5 "Patent licenses are almost always embodied in and are a part of a contract." Rosenberg, P., Patent Law Fundamentals, Section 16.05[1] (2nd Ed. 1987 rev.). See e.g., Westinghouse Elec. and Mfg. Co. v. Tri-City Radio Elec. Supply Co., 23 F.2d 628 (8th Cir. 1927). Addressing the issue of the reforming of a patent licensing instrument to conform with the intent of the parties, the court stated that "a license to use a patent is a contract," Westinghouse, 23 F.2d 628 at 632.

6 Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938).


9 Erie, supra, note 6; see also, Kansas v. Colorado, 206 U.S. 46 (1906); 16A Am. Jur. 2d Common Law, sections 1 et seq. (1987).


11 Id.


16 Kansas, supra, note 1.


19 See supra, note 6-9 and accompanying text.


Winter, 1988/The Law Forum—21

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