

The Patent Misuse Defense after *Princo*

By Timothy J. Barron and Olivia T. Luk

The president of your best client, Genius Gel, Inc., calls seeking emergency legal advice. Genius is a leading cosmetics manufacturer that makes high-end anti-aging creams. A competitor, Beauty & Brains Co., which had been faithfully paying Genius lucrative royalties under a patent license agreement, abruptly stopped paying. Beauty asserts that it owes no royalty because several Genius licensing practices constitute “patent misuse.”

The dispute arose out of a business arrangement between Genius and another competitor, Smartie Serum, Inc. Responding to consumer demand, Genius and Smartie joined forces to develop anti-aging creams that also increase brain power. The joint venture resulted in several patents, including Genius patents covering various aspects of the manufacturing process for a cream that uses only organic ingredients and increases test patients’ IQ scores and a Smartie patent covering a manufacturing process for a cream using artificial and synthetic ingredients with an inconsistent effect on IQ scores. Only the Genius cream received FDA approval.

Genius and Smartie licensed the technology to industry competitors, using

ucts made. Genius and Smartie also agreed that Smartie would not separately license the Smartie patent to any company outside the standard license agreement.

About a year ago, Beauty entered into a standard license with Genius. Under the license, Beauty used the Genius technology to manufacture its balm in France, which it then imported into the United States. Now, however, Beauty continues to import the product without paying royalties, based on its belief that the license is illegal. According to Beauty’s president, two of Genius’s practices constitute patent misuse: forcing licensees who wanted the Genius technology to also license the inferior Smartie technology and agreeing with Smartie to refuse licensing the Smartie patent outside of the standard package license. Genius wants to sue Beauty for patent infringement, but its president is concerned about Beauty’s contention that no royalty is due because Genius is guilty of “patent misuse.”

You explain to your client that patent misuse is a defense related to antitrust law that can be used in a patent infringement action. Luckily, the U.S. Court of Appeals for the Federal Circuit recently clarified the scope of the defense in its en banc decision in *Princo Corp. v. Int’l Trade Comm’n*, ___F.3d ___, No. 2007-1386, 2010 WL 3385953 (Fed. Cir. Aug. 30, 2010). Indeed, *Princo* extended the recent trend of decisions that have significantly narrowed the circumstances in which a defendant in a patent case can prevail on a misuse defense.

What Is Patent Misuse?

The doctrine of patent misuse, which usually concerns a patent owner’s licensing practices, is a defense available to a party accused of patent infringement. Generally, the doctrine limits a patent owner’s ability to include provisions in a license that impermissibly broaden the owner’s rights under a patent. The defendant itself need not have been a licensee or prospective licensee to raise the defense.

Development of the Misuse Defense

The principle of patent misuse originated

in a 1917 U.S. Supreme Court decision, *Motion Picture Patents*.¹ There, the patentee owned a patent on projector technology that it was willing to license, but it refused to do so unless the licensee also agreed to purchase unpatented film the patentee manufactured. The Supreme Court held that the license’s requirement that all licensees purchase the patentee’s unpatented film was an improper broadening of the patentee’s rights under the projector patent.

In subsequent decisions, the Supreme Court explained that the doctrine of patent misuse bars a patent owner from using the “patent’s leverage” to “extend the monopoly of his patent to derive a benefit not attributable to the use of the patent’s teachings.”² The Federal Circuit has since indicated that the “key inquiry is whether, by imposing conditions that derive their force from the patent, the patentee has impermissibly broadened the scope of the patent grant with anticompetitive effect.”³

In 1986, the Federal Circuit identified a few “specific practices as constituting *per se* patent misuse, including so-called ‘tying arrangements’ in which a patentee conditions a license under the patent on the purchase of a separable, staple good, and arrangements in which a patentee effectively extends the term of its patent by requiring post-expiration royalties.”⁴ Price-fixing has also been considered misuse *per se*, requiring no further analysis of competitive effect.⁵

The State of Patent Misuse Before *Princo*

Recently, the scope of actions that constitute misuse *per se* has narrowed markedly. For example, under the 1988 revision to 35 U.S.C. § 271(d), a tying arrangement in which a patentee conditions a license under the patent on the purchase of a separable, staple good does not amount to patent misuse “unless in view of the circumstances, the patent owner has market power in the relevant market.”⁶ Section 271(d) codifies this and other restrictions on relief for infringement or contributory infringement when the patent owner has done one or more of the following:

- (1) derived revenue from acts which

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a single standard license agreement that required a license to several patents in a pool of Genius patents and the Smartie patent, although it did not require licensees to practice the Smartie technology. Royalty payments to Genius under a license are not calculated based on the number of patents licensed, but rather on the number of prod-

if performed by another without his consent would constitute contributory infringement of the patent; (2) licensed or authorized another to perform acts which if performed without his consent would constitute contributory infringement of the patent; (3) sought to enforce his patent rights against infringement or contributory infringement; (4) refused to license or use any rights to the patent; or (5) conditioned the license of any rights to the patent or the sale of the patented product on the acquisition of a license to rights in another patent or purchase of a separate product, unless in view of the circumstances, the patent owner has market power in the relevant market for the patent or patented product on which the license or sale is conditioned.

With the constriction of the circumstances in which licensing practices are deemed *per se* patent misuse, these practices are now commonly analyzed under the “rule of reason.” The U.S. Supreme Court described this analysis as follows:

When a practice alleged to constitute patent misuse is neither *per se* patent misuse nor specifically excluded from a misuse analysis by § 271(d), a court must determine if that practice is reasonably within the patent grant, *i.e.*, that it relates to subject matter within the scope of the patent claims. If so, the practice does not have the effect of broadening the scope of the patent claims and thus cannot constitute patent misuse. If, on the other hand, the practice has the effect of extending the patentee’s statutory rights and does so with an anti-competitive effect, that practice must then be analyzed in accordance with the “rule of reason.” . . . Under the rule of reason, the finder of fact must decide whether the questioned practice imposes an unreasonable restraint on competition, taking into account a variety of factors, including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint’s history, nature and effect.⁷

Naturally, a rule of reason inquiry typically involves a detailed analysis of the pro-competitive benefits as well as the anti-competitive harms of any challenged practice.⁸

After you explain this general background of patent misuse, your client asks

for the bottom line: “Will Beauty be able to successfully assert that we committed patent misuse?” You explain that the Federal Circuit’s recent *Princo* decision sheds some light on the situation.

The Federal Circuit’s *Princo* Decision

The facts of the *Princo* case are very similar to those of Genius’s predicament, although the case had a rather tortuous procedural history. In *Princo*, Sony and Philips competed in manufacturing recordable and rewritable compact discs. However, several years ago, they were concerned about adopting competing technologies that would limit the growth of both parties’ technology. Thus, they agreed to work together to develop a standard technology for compact discs that consumers could use to record information.

At the time, both companies owned patents covering methods of writing on discs. Philips’s patent used an analog method, while Sony’s patent employed digital technology. For various reasons, they agreed that Philips’s patented technology was more suitable for the market, and thus, the companies decided to pursue only the technology covered in Philips’s patents. In so doing, they developed and published technical standards—the Recordable CD Standard—which the industry dubbed the “Orange Book.” Companies manufacturing the machines used by consumers to record on compact discs followed the Orange Book standard to be compatible.

Sony and Philips licensed their patents, among others, as a group in a “package license” agreement. Companies who wanted to make and sell such recordable compact discs entered into a package license agreement with Philips that included a “patent pool” of patents. The Philips patents that were actually adopted as the standard were in the patent pool, as was the Sony patent on the digital writing method, even though that technology was incompatible with the Orange Book standard. The licenses required the manufacturers to pay a royalty of one half to two thirds of the selling price per disc.

Like many others in the industry, *Princo* wanted to make recordable compact discs that were compatible with the industry standard. Accordingly, *Princo* entered into the standard package license agreement with Philips. Shortly thereafter, however, *Princo* stopped making the steep

royalty payments.

The First Trial and Appeal

Philips sued *Princo* for patent infringement in the U.S. International Trade Commission (ITC), where the administrative law judge (ALJ) ruled that although *Princo*’s recordable compact discs infringed the Philips patents at issue, all of the patents were unenforceable due to *per se* patent misuse. The ITC affirmed the ALJ’s ruling that the Philips-Sony package licensing arrangements were illegal “tying” arrangements because they were patent misuse *per se* and there was also patent misuse under

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the “rule of reason” analysis.

On appeal, the Federal Circuit reversed, finding that Philips’s license agreement did *not* constitute patent misuse because it did not broaden the scope of Philips’s patents or involve an illegal tying arrangement. In addition to citing other errors, the Federal Circuit held that even though the package license tied different patents together, the license was not illegal because it did not charge the licensee extra for the nonpracticed patent, but rather, charged a fixed fee.⁹ Therefore, including additional patents in the license program may actually have *pro*-competitive effects such as minimizing transaction costs and ensuring against the risk of post-agreement disputes. The Federal Circuit remanded the case back to the ITC for further “rule of reason” analysis on issues including whether there had been price fixing, whether the licenses covered technologies that were close substitutes, and whether the pool licensors would have competed in the technology-licensing market absent the pooling arrangements.

The Second Trial and Appeal

On remand, the ITC determined that “there has been no showing that the [tied]

patent competes with another patent in the pool, no showing that the pool licensors would have competed in the technology licensing market absent the pooling arrangement, and no showing of the anti-competitive effect required under a rule of reason analysis.” Thus, the ITC concluded there was no patent misuse.¹⁰ *Princo* again appealed to the Federal Circuit, in *Princo II*, focusing on an alleged side agreement between Sony and Philips barring Sony from licensing its patent on digital disc writing methods outside of the package license. *Princo* argued that this arrangement was a “horizontal agreement” between Sony and Philips that illegally suppressed competition. *Princo* contended that the Sony patent was a commercially viable technology and would have been fully able

There is no patent misuse if the anticompetitive activity in a “horizontal agreement” involves a licensed patent that is not asserted in the infringement action.

to compete in the market had the technology not been suppressed.¹¹ The Federal Circuit initially remanded the case again to the ITC for further fact finding regarding the alleged horizontal agreement. However, before the remand was effected, the Federal Circuit granted rehearing en banc.

The Federal Circuit’s Decision on Rehearing

On rehearing, the Federal Circuit applied the doctrine of patent misuse narrowly and upheld the ITC’s decision finding Philips had committed no patent misuse. The court held that even if Philips and Sony had agreed to suppress the technology embodied in Sony’s patent, such an agree-

ment would not constitute patent misuse and would not be a defense to *Princo*’s patent infringement. The court based its ruling on the fact that the activity that forms the basis of the defense of patent misuse must involve the patent that the defendant is accused of infringing, which were Philips’s patents. Because the alleged misuse related only to Sony’s patent, which was not at issue in the infringement case, *Princo* could not prove the defense of patent misuse.¹²

The Federal Circuit also held that *Princo* failed to establish that the alleged horizontal agreement had anticompetitive effects. To the contrary, the court reasoned that Philips and Sony had acted legitimately in choosing not to compete against their own joint venture. And, pointing to evidence that the Sony patent was prone to errors, unreliable, and unworkable, the court determined that the alleged “suppressed” Sony technology was not a viable potential competitor to Philips’s technology.¹³

In his dissent, Judge Dyk presented a different analysis of the patent misuse doctrine and explained why the majority’s narrow approach was improper. He explained that neither Philips nor the ITC even advanced the position the majority ultimately adopted—that the failure to assert infringement of Sony’s patent in the ITC proceedings barred a finding of patent misuse. He also pointed out that the majority’s holding—that there could be no misuse unless the accused infringer shows that the technology was, or would probably have become, commercially viable—contravenes established patent misuse doctrine. The dissent asserted that the majority holding contradicts the Supreme Court’s latest decision on patent misuse, *Illinois Tool Works*, in which the Court concluded that “[i]t would be absurd to assume that Congress intended to provide that the use of a patent that merited punishment as a felony [under the Sherman Act] would not constitute ‘misuse.’”

Judge Dyk further argued that if the horizontal agreement and the license agreements constitute misuse with respect to Sony’s patent, they should also constitute misuse of Philips’s patent at issue. He contended that the majority decision effectively emasculates the patent misuse doctrine and leaves the enforcement of antitrust violations (outside illegal tying arrangements and patent term extensions) to private and government antitrust proceedings, which are “likely inadequate to the task.”¹⁴

Despite the dissent’s misgivings, in the end, the majority opinion in *Princo* does provide clear guidance on two points:

- There is no patent misuse when a license agreement that ties a nonessential, or nonpracticed, patent to an essential, or practiced, patent results in procompetitive effects, including decreased post-agreement disputes, that outweigh any anticompetitive effects such as restraint on trade or competition.
- There is no patent misuse if the anticompetitive activity in a “horizontal agreement” involves a licensed patent that is not asserted in the infringement action.

How Princo Affects Genius

After hearing this explanation of *Princo*, your client asks again for the bottom line: How does *Princo* affect Genius’s situation? You explain that there are two separate Genius activities that potentially constitute misuse: the requirement that all package licenses include both Genius and Smartie patents even though some licensees do not want the inferior Smartie technology, and the side agreement between Genius and Smartie that Smartie will not license its patent outside the package license agreement.

The Package License’s Inclusion of the Smartie Patent

On the first issue, *Princo* sets forth several factors related to whether the agreement is procompetitive or anticompetitive that guides the determination of whether Genius’s package license agreement amounts to misuse. For example, one anticompetitive factor is whether Genius’s licensees have to pay more because the license includes the Smartie patent or if instead, the price of the license agreement is fixed regardless of whether the Smartie patent is included. If the price of the license increases when it contains the Smartie patent, a finding of misuse is more probable, whereas if the price remains the same, misuse is less likely. Another anticompetitive factor is whether Genius’s licensees are forced to practice the Smartie patented technology, even if they do not wish to. Based on the facts your client related, however, neither of these factors is present, and thus, under the *Princo* holding, the license agreement does not at first blush appear to be anticompetitive in nature.

Based on the *Princo* decision, an ad-

ditional factor to investigate is whether Genius believed the Smartie patent was reasonably necessary to practice anti-aging intelligence cream manufacturing according to FDA standards. If even one of the claims in the allegedly unwanted Smartie patent is arguably necessary to meet the industry standard, the patent would be considered a so-called blocking patent. Under *Princo*, the licensing of blocking patents actually promotes competition by permitting all licensees to practice industry standard technology and by preventing overlapping patent litigation.¹⁵ Thus, if Genius believed the Smartie patent was necessary to practice the FDA standard, including the Smartie patent in the package agreement would more likely be considered procompetitive in nature.

The Horizontal Agreement to Restrict Licensing the Smartie Patent

The second issue is whether the “horizontal” agreement between Genius and Smartie to restrict licensing of the Smartie patent to the package license agreement amounts to misuse. Once again, *Princo* lays out several relevant factors to determining whether the restriction is anticompetitive in nature. For example, one consideration is how well the Smartie technology works. Because your client has indicated that the Smartie technology has unpredictable results, the technology would not likely be considered a viable alternative to the Genius patent, and therefore, its restriction would not be anticompetitive.

Another factor *Princo* considered in the analysis of this issue is the reason Genius and Smartie teamed up in the first place to research and develop the intelligence cream

technology. If Genius entered into the joint venture to share royalties with Smartie in exchange for Smartie’s agreement not to compete against the Genius technology, the action would likely be seen as anticompetitive.

Finally, *Princo* made clear that the anticompetitive behavior must concern *the patent that is the subject of the infringement action* to be the basis for a misuse defense. Based on the *Princo* holding, because the alleged anticompetitive acts concern the Smartie patent, but your client would only assert that Beauty infringed the Genius patent, the misuse defense would have little chance of success.

Conclusion

The *Princo* decision continues the trend of narrowing the patent misuse doctrine. The Federal Circuit’s holding that the alleged misuse must involve the specific patent at issue in the infringement litigation and not any of the other licensed patents is another clear statement that the doctrine applies in very limited circumstances.

Princo may still petition the Supreme Court to grant certiorari, however. If the Supreme Court does so, of course, you may need to reconsider Genius’s actions in light of the Court’s subsequent ruling. In addition, Genius must also consider its actions in light of antitrust law, because actions that do not rise to the level of patent misuse may still constitute antitrust violations. ●

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Endnotes

1. Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917).
2. Zenith Radio Corp. v. Hazeltine Research Inc., 395 U.S.100, 136 (1969); see 6 *Chisum, Chisum on Patents*, § 19.04[3] at 19–451.
3. C.R. Bard, Inc. v. M3 Sys., Inc., 157 F.3d 1340, 1372 (Fed. Cir. 1998).
4. Vir. Panel Corp. v. MAC Panel Co., 133 F. 3d 860 (Fed. Cir. 1997).
5. HERBERT HOVENKAMP ET AL., IP AND ANTITRUST: AN ANALYSIS OF ANTITRUST PRINCIPLES APPLIED TO INTELLECTUAL PROPERTY LAW § 3.2 (2d ed. 2010).
6. 35 U.S.C. § 271(d)(5); Ill. Tool Works Inc. v. Indep. Ink, Inc., 547 U.S. 28, 46 (2006) (holding that in all cases involving tying arrangements, the plaintiff must prove that the defendant has market power in the tying product).
7. *Id.*
8. See IP AND ANTITRUST, at § 3.2e.
9. *Id.* (holding no patent misuse where a license did not force licensees to manufacture or practice the Sony patent and explaining patent misuse is found only if there is proof the patentee had market power and proof the license agreement’s effect is to restrain competition in a relevant market.)
10. Princo Corp. v. Int’l Trade Comm’n, 563 F.3d 1301, 1306 (Fed. Cir. 2009).
11. *Id.* at 1315.
12. Princo Corp. v. Int’l Trade Comm’n, 2010 WL 3385953, at *10 (“Such an agreement would not have the effect of increasing the physical or temporal scope of the patent in suit, and it therefore would not fall within the rationale of the patent misuse doctrine as explicated by the Supreme Court and this court.”)
13. *Id.* at *12.
14. *Id.*
15. See *Id.* at *3; see IP AND ANTITRUST, at § 3.3g.