

Hybrid Trade Secret Licensing

A review of guiding law and hints for drafting successful hybrid licenses

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"Hybrid" trade secret licenses occur when related patent and trade secret rights are treated in the same licensing agreement.¹ These hybrid-type licenses are very prevalent in the U.S. and other countries, no doubt due to the recognition of the value of trade secret rights to an effective transfer of technology. One source recently estimated that of all industrial property licensing agreements, about 50% cover pure trade secrets and another 20-30% are of the hybrid variety.²

While the U.S. law is well developed concerning the separate licensing of pure patent rights and pure trade secret rights, it is still developing for hybrid licenses. The courts in the U.S. are attempting to strike a proper balance between the federal policies underlying patents and the state law protection for trade secrets. Recent federal cases have started to better define the direction of hybrid licensing law. It is very important for lawyers and businessmen dealing with hybrid license agreements to be aware of these recent decisions.

Before moving to an examination of the current status of hybrid licensing law, it is helpful to examine the law and underlying policies of pure patent licenses and pure trade secret licenses.

PURE PATENT LICENSES

The law regarding pure patent licensing is often justified by the frequently repeated dual public policy goals of the federal patent system: (a) to encourage innovation by granting the inventor a limited right to exclude others; and (b) to allow free use of the idea following the expiration of the patent.

The U.S. patent holder is generally privileged to use the bargaining advantage of the patent to structure a license agreement to meet the particular situation. For example, if desired, the patent licensor may legally negotiate different royalty rates between different licensees, despite unsuccessful attempts by some U.S. courts in the 1960s to impose a requirement of uniform treatment. The Tenth Circuit recently held in *Hull v. Brunswick Corp.*, 704 F.2d 1195, 218 U.S.P.Q. 24 (10th Cir. 1983) that it was not impermissible to "bundle" related patents and negotiate royalty payments on the

package as a whole. The court further held that it was not patent misuse *per se* for a licensor to refuse to "unbundle" royalties and offer individual rates, absent a showing that such behavior forced a licensee to accept patents that were not desired. *Id.*, at 1199-1200, 218 U.S.P.Q. at 27-28.³

One of the primary legal restrictions on pure patent licensing is a prohibition on the extension of royalty payments beyond the expiration of the licensed patents. Courts have shown hostility to such extensions, citing the policy as a *quid pro quo* for the grant of the limited right of exclusion. The patent holder in the U.S. is under a duty to relinquish the invention to the public completely unencumbered following the 17-year statutory period for the patent grant. It is a *per se* misuse of the patent monopoly to use the bargaining leverage of the limited monopoly to extend the effectiveness of the patent beyond the patent term. This rule was firmly established by the U.S. Supreme Court in the now famous case of *Brulotte v. Thys Co.*, 379 U.S. 29 (1964).

In *Brulotte*, the owner of various hop-picking patents sold machinery incorporating the patented techniques to farmers. The sales were based on a flat purchase price plus an annual royalty fee of \$3.33-1/3 per 200 pounds of harvested hops or \$500, whichever was greater. The terms of the agreement purported to extend the annual payments beyond the date of the last patent to expire. When the farmers refused to pay the annual fees, the licensor sued under state contract law. The farmers set up the defense, among others, that to allow the royalty payments to continue unchanged past expiration of the patents would contravene federal patent law policies by impermissibly extending the effectiveness of the patents beyond the statutory period.

The Supreme Court agreed. Rejecting the argument that post-expiration payments were merely long-term sale or lease obligations based on use, the court stated that where patents were involved, the extension of monopoly influence by "whatever legal device employed" is impermissible. After noting that other use restrictions likewise continued into the post-expiration period, the court said:

The present licenses draw no line between the term of the patent and the post-expiration period. The same provisions as respects both use and royalties are applicable to each. The contracts are, therefore, on their face 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. We are, therefore, unable to conjecture what the bargaining position of the parties might have been and what resultant arrangement might have emerged had the provisions for post-expiration royalties been divorced from the patent and nowise subject to its leverage.

Id. at 32.

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The Supreme Court emphasized the federal policy that patented ideas must enter the public domain unencumbered by monopoly influences following the patent period. It then concluded that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*." *Id.* at 32.

The *Brulotte* case clearly establishes the rule in the U.S. that royalty obligations for a pure patent license become unenforceable at the expiration of the underlying patent or patents. A similar rule exists in the U.S. for pure patent licenses in which the underlying patent is later declared invalid. *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969). *Lear* additionally overruled the old general rule that licensees were estopped from challenging the validity of underlying patents. The Supreme Court in *Lear* found that there was a strong federal interest in allowing licensees to challenge patent validity. The court reasoned that it is often only the licensee that has sufficient financial interest to challenge validity, and thus promote the strong federal policy that only truly qualified inventions receive and retain patent protection. *Id.* at 671, 673-674.

Thus, the general rule in pure patent licensing is well established. While the patent is in force, the licensor has a great deal of latitude to exact royalty fees. However, all royalty obligations become unenforceable when the underlying patent expires under the *Brulotte* rule, or when the patent is declared invalid under the *Lear* rule.

PURE TRADE SECRET LICENSES

The general rule in pure patent licensing that royalty obligations cease upon the expiration of the underlying patent right is not observed in pure trade secret licensing. Certainly, the "property right" in the trade secret continues to exist, and royalties could be collected, as long as the information is kept secret.⁴ This period of secrecy could continue indefinitely, and could easily exceed the 17-year term for a U.S. patent, depending upon the technology involved. Even if public disclosure of a trade secret destroys the exclusive property right in the information, a license or contract that is drafted to continue the royalty obligations after public disclosure can be enforced in the U.S. under the rule and rationale stated in the well-known case of *Warner-Lambert Pharmaceutical Co. v. John J. Reynolds, Inc.*, 178 F. Supp. 655, 123 U.S.P.Q. 431 (S.D.N.Y. 1959), *aff'd*, 280 F.2d 197 (2nd Cir. 1960).

In *Warner-Lambert*, the inventor of "Listerine" — an antiseptic mouthwash — licensed use of the formula to a small pharmaceutical company in the early 1880s. The licensing agreement provided simply that the inventor, his heirs, executors, or assigns would receive \$6.00 for every gross of Listerine thereafter sold by the company. The product was very successful over the years and was at least partially responsible for the pharmaceutical company growing into a large national concern. Despite the fact that the antiseptic formula had become public (without the fault of either party) in 1931, in an article in the journal of the American Medical Association, the company still retained a 50% market share in the antiseptic field as of 1959, the time of the suit. Total royalty payments through that date were in excess of \$22 million and were running at an annual rate of \$1.5 million.

In 1959, the pharmaceutical company sought a

declaratory judgment that royalty payments were no longer required due to the 1931 public disclosure. The company advanced two arguments, among others, for the unenforceability of the agreement. First, that the agreement failed for want of future consideration when the formula entered the public realm, because the sole consideration for continuing royalty payments was the continuing secrecy of the formula. Second, that an implied term ending royalties at public disclosure should be read into the contract because of the strong public policy favoring free use of ideas in the public domain. Several patent and copyright cases were cited as supporting such a public policy.

Rejects Both

The court rejected both arguments. Noting that early knowledge of the formula had given the company a valuable head start in a large and profitable business in which it retained a substantial market share many years after disclosure, the court called the claim of failure of consideration wholly devoid of merit. It stated that there was nothing in the contract that suggested the company had bargained for continuing secrecy. Rather, the company had simply bargained for disclosure of a formula then unknown to it in return for a promise to pay a royalty on each gross thereafter sold.

Also rejecting the second argument that a public policy of unrestricted use of ideas in the public realm favored an implied term, the court stated that such a public policy was present only where the federal patent system was invoked. Absent federal statutory patent protection, "[t]he parties are free to contract with respect to a secret formula or trade secret in any manner which they determine for their own best interests." *Id.* at 665, 123 U.S.P.Q. at 439. Of course, the parties could have explicitly structured their agreement to end royalties if and when the formula lost its secrecy, but they had not done so. The court found no reason to imply such a term.

The U.S. Supreme Court addressed similar issues in *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979). The case involved a licensing agreement for a keyholder design which was innovative but so simple and obvious that it would be easily copied once marketed if not protected by patent. While the patent application was pending, the inventor and a manufacturer entered into an exclusive licensing agreement that provided royalties of 5% of sales if the pending patent was granted within five years, or royalties of 2.5% if the patent did not issue. The five-year period passed without a patent issuing and the royalty payments accordingly dropped to the lower figure. The patent application was rejected by the Patent Office despite the efforts of the inventor. Other manufacturers eventually entered the market.

After successfully selling the product and paying royalties for 19 years, the licensor sought to have the royalty obligation declared void on the grounds that a strong federal policy favoring the full and free use of ideas in the public realm, as evidenced by the *Lear* opinion discussed above, militated against payments where no patent had issued.

The Supreme Court disagreed. The strong federal policy, it said, was against the withdrawal of ideas already in the public realm. At the time *Aronson* con-

cluded the licensing agreement, her idea was not in the public realm. Thus enforcement of the agreement did not frustrate that federal policy.

The language of the agreement made it "crystal clear" that both parties realized the substantial possibility that a patent might not issue. The experienced manufacturer realized competitors would eventually enter the field in such a case and nonetheless agreed to a perpetual, albeit lower, trade secret royalty. This was persuasive evidence for the court of the high value placed by the manufacturer on the ability to preempt the market, by an early disclosure of the idea by the licensor. Such a business arrangement did not contravene any federal patent law objectives.

The court in *Aronson* skirted a detailed discussion of the more difficult question in the case, in light of *Brulotte*, of whether the pending patent application had been used as improper leverage in negotiating the trade secret contingency royalty. Chief Justice Burger writing for the majority stated:

This case does not require us to draw the line between what constitutes abuse of a pending application and what does not. It is clear that whatever role the pending application played in the negotiation of the 5% royalty, it played no part in the contract to pay the 2½% royalty indefinitely.

Id. at 265.

The U.S. law dealing with pure trade secret licenses is thus fairly well established. The license can call for trade secret royalties indefinitely, as long as the information remains secret. The *Listerine* and *Aronson* cases show that trade secret royalties can be extended even further beyond the public disclosure of the idea without violating public policy or federal law, if the license is drafted to that effect. The significant legal problems arise in the U.S. only when the royalty payments are intertwined in a hybrid license that simultaneously covers patent and trade secret rights.

HYBRID LICENSES

Hybrid licenses are currently causing the most complicated legal problems, and are subject to close scrutiny by the U.S. courts. It is an area of the law that is only partially developed, and several important issues remain to be resolved. The several courts of appeal that have addressed the issue have come to generally consistent results, albeit on sometimes varying theories.

The general rules developing are:

1. In a hybrid agreement in which the royalty obligations for patent and trade secret rights are inseparable (intimately intertwined), the royalty provisions of the agreement become unenforceable upon expiration of the patent under the *Brulotte* rule, or invalidity of the patent under the *Lear* rule;

2. In such a case, a licensor may still be eligible for compensation for trade secrets transferred, most likely on the basis of an unjust enrichment theory; and

3. If a hybrid agreement allocates royalty obligations between patent and non-patent rights, the non-patent royalty obligations may survive patent expiration or invalidity.

The U.S. Federal Court of Appeals for the Ninth Circuit first addressed the hybrid license problem in *St. Regis Paper Co. v. Royal Industries*, 552 F.2d 309, 194 U.S.P.Q. 52 (9th Cir. 1977), *cert. denied*, 434 U.S. 996

(1977). Royal had granted a patent license to St. Regis and transferred related product manufacturing know-how in exchange for 10% of the net sales of the product, plus expenses incurred in the know-how transfer. Under the *Lear* doctrine, the licensee successfully challenged the validity of the patent, and the lower district court granted rescission of the royalty agreement.

On appeal, Royal argued that the royalty provision was not unenforceable under the *Lear* holding because the agreement was alternately supported by consideration provided by the transfer of non-patented know-how, which was valuable because it allowed St. Regis to enter the market sooner. The court of appeals did not accept the argument, saying:

When as here, the patent rights and the know-how are so intimately intertwined, we believe that the same rule that makes royalties for the patent rights uncollectible if the patent is invalid should apply with equal force to know-how. This does not mean that Royal will be deprived of compensation for know-how; it simply means that Royal is not entitled to royalty payments under the license agreement, which did not distinguish between royalties for patent rights and royalties for know-how.

St. Regis, supra, at 315, 194 U.S.P.Q. at 58 (emphasis supplied).

The court of appeals went on to affirm the district court's determination that the value of transferred know-how was \$53,088.90 and that this amount had been fully satisfied by the more than \$174,000 in royalties Royal had received prior to the successful challenge to patent validity. Royal was further entitled to retain the total royalties paid before the suit was filed.

Analogous Situation

The Ninth Circuit faced an analogous situation in *Chromalloy American Corp. v. Fischmann*, 716 F.2d 683, 221 U.S.P.Q. 311 (9th Cir. 1983). In *Chromalloy*, a company bought an ongoing business concern which included physical assets, a patent license, and related manufacturing know-how.

The agreement provided for a flat purchase price plus royalties based on a certain percentage of sales. The company repudiated the agreement and sought a declaratory judgment that the agreement was void for, among other things, invalidity of the patent, citing *Lear*. The district court found that the patent was invalid but awarded damages nonetheless under the terms of the agreement.

The court of appeals, after recognizing that the royalties were based in important part on the value of the patent license, reversed on this point, following the holding of *St. Regis* and again drawing strongly on the policies advanced by *Lear*. As in *St. Regis*, the court held that, despite the unenforceability of the licensing agreement due to the overriding needs of the federal patent law, some form of compensation for the value of the transferred know-how (and other non-patent assets) was justified. Such compensation would not frustrate the full purposes and objectives of the federal patent law. Additionally, the court went on to suggest that "if payments required by the royalty agreement had distinguished between patent and non-patent rights transferred to the licensee, those latter payments could have been enforced." *Chromalloy, supra*, at 685, 221 U.S.P.Q. at 312.

The Eighth Circuit addressed the hybrid license problem in *Span-Deck, Inc. v. Fab-Con, Inc.*, 677 F.2d 1237, 215 U.S.P.Q. 835 (8th Cir. 1982), *cert. denied*, 459 U.S. 981 (1982). The agreement in question involved a franchise-type manufacturing arrangement, where the licensee received patented manufacturing machinery plus related know-how and trade secrets in exchange for an initial lump payment plus ongoing royalties.

Escape Obligations

The licensee sought to escape royalty obligations by challenging the validity of the underlying patent. The court of appeals found that the patent was invalid as a matter of law due to obviousness and next turned to the enforceability of the agreement. The licensor argued that despite patent invalidity, the agreement should remain enforceable because it was alternately supported by trade secret consideration and that *Lear* was distinguishable in that it involved a pure patent license rather than a hybrid license.

The court in *Span Deck*, after noting that patent rights had been of primary importance in determining consideration, and that no allocation between patent royalties and trade secret royalties was provided in the agreement, stated that *Lear* was applicable. The invalidity of the patent thus rendered the entire agreement unenforceable. To hold otherwise, it said, would allow licensors to circumvent *Lear* by merely inseparably combining non-patent consideration with patent consideration in licensing agreements. This would frustrate the important federal policy of encouraging licensees to challenge unworthy patents. Despite the unenforceability of the agreement, however, the licensor was entitled to reasonable compensation for the value of the know-how and trade secrets transferred. The court remanded the case to the lower court for this consideration.

The Eleventh Circuit applied the same rule to void all royalty payments in an intimately intertwined hybrid license when the underlying patent expires, following the rationale of *Brulotte*. In *Pitney Bowes, Inc. v. Mestre*, 701 F.2d 1365, 218 U.S.P.Q. 987 (11th Cir. 1983), *cert. denied*, 464 U.S. 893 (1983), several licenses were issued covering various paper collating machines. One of the licenses was treated as covering solely trade secret information (a pure trade secret license). The court held that enforcement of this license was solely a matter of state law. The other licenses were hybrid and thus a matter of federal law.

One of the hybrid licenses by its terms extended royalties beyond the patent expiration. A complication in the case involved the fact that the underlying patent was pending, but not issued, at the time the licensing agreement was completed. Nonetheless, the court ruled that when a patent does issue, federal supremacy requires that hybrid agreements that do not distinguish between patent and trade secret royalties must be subject to the *Brulotte* rule of *per se* invalidity. This holding was held to be in accordance with the rationale used by the Supreme Court in the *Aronson* decision.

The court in *Pitney Bowes* went on to suggest that if a hybrid agreement allocated royalties between patent and trade secret consideration, and/or changed exclusivity at patent termination, royalty payments after

the patents expired may not conflict with federal patent policies, and would be enforceable. In such a situation, the court said, the licensor should have the burden of proving that patent monopoly leverage was not improperly used to negotiate post-expiration payments. *Pitney Bowes, supra*, at 1372 n.12, 218 U.S.P.Q. at 992, n.12.

Potential for Split

A recent decision by a district court in the Sixth Circuit presented the prospect for a split between circuits on hybrid licenses, forcing a possible consideration of this issue by the Supreme Court. In *Boggild v. Kenner Products*, 576 F. Supp. 533, 222 U.S.P.Q. 393 (S.D. Ohio 1983) a license granting exclusive rights to a toy invention was granted before the contemplated patent application was filed. The contract specifically provided that royalty payments would be required regardless of whether a patent issued. Royalties were to run unchanged for the life of the patent or 25 years, whichever was longer. The patent was obtained, and at the expiration of the 17-year patent term the licensee refused further payments, defending the action on *Brulotte* and *Pitney Bowes*.

The district court rejected the defense and enforced the agreement. In so doing, it distinguished the *Brulotte* rule of *per se* invalidity on the basis of leverage obtained from an issued patent, rather than a contemplated patent. Since the *per se* rule did not apply, the court was free to determine if enforcement of the agreement would contravene federal policies. The lower court concluded that it would not, since no one was prevented from entering the market after the expiration of the patent. The court said that "[a]ll the agreement requires is that the [licensee] continue to pay for the privilege of having been first in the marketplace." *Boggild, supra* at 539, 222 U.S.P.Q. at 398.

If this decision had been affirmed on appeal, the stage would have been set for a direct conflict with the Eleventh Circuit decision in *Pitney Bowes*. However, the Sixth Circuit Court of Appeals reversed the lower court decision in 1985 in *Boggild v. Kenner Products*, 776 F.2d 1315, 228 U.S.P.Q. 130 (6th Cir. 1985) and agreed with the *Pitney Bowes* decision. The court held that the *per se* invalidity rule of *Brulotte* applied where the license called for payments beyond the life of the patent, and where the parties enter into the agreement fully expecting a patent to issue. The decision rests on the contention that a pending or even contemplated patent provides some degree of leverage. Thus, the *Brulotte per se* rule is applicable.

The court specifically noted that "the royalty and use provisions did not distinguish between rates of payment for the pre-expiration and post-expiration periods or between royalties attributable to patent rights and those for any other rights." *Boggild, supra* at 1319, 228 at 133. The court continued that "once the pending patent issues, enforcement of royalty provisions for other rights which conflict with and are indistinguishable from royalties for patent rights is precluded." *Id.*, at 1319, 228 U.S.P.Q. at 134.

The court also agreed with *Pitney Bowes* that the Supreme Court decisions allowed enforcement of potentially conflicting state trade secret provisions only

when no patent issued. Upon issuance of a patent, federal supremacy requires that directly conflicting license provisions be resolved under federal law. The court in *Boggild* further observed that the agreement would have been enforceable if it had provided for a royalty reduction if no patent issued, or when the patent had expired.

THE FUTURE FOR HYBRID LICENSES

Practical considerations dictate that hybrid licenses will continue to be used. In view of the above-discussed decisions, it is now established that hybrid licenses, which do not differentiate between patent and trade secret royalties, can be challenged successfully after expiration or invalidity of the licensed patent rights. No further royalties can be collected or need be paid. Further, compensation for the trade secret rights transferred will be available only under an unjust enrichment theory. Licensing executives dealing with hybrid licenses therefore must be aware of this state of the U.S. law.

DRAFTING SUGGESTIONS

An effective license agreement should define a long-term relationship that is mutually beneficial to both parties. A licensor certainly should not be satisfied with a license that contains questionable royalty provisions. A licensor also should not be content with the prospect of receiving compensation only under an unjust enrichment theory for the trade secrets and know-how transferred in a hybrid license. A licensee also has many sound business and legal reasons for entering into an enforceable and stable license in the first instance. Thus, the drafting stage of a license agreement is the most effective time to resolve the royalty issues in a hybrid license governed by U.S. law.

Although there are remaining uncertainties in U.S. hybrid licensing law, the cases do provide good indications of how a successful hybrid license can be drafted:

1. Treat trade secret and patent rights in separate contractual agreements, if feasible.
2. If not, draft the provisions carefully, considering:
 - a. A differentiation between the trade secret and patent rights.
 - b. An allocation of royalties between the two separate rights.
 - c. A diminished royalty rate if the licensed patents terminate or are declared invalid.
 - d. A diminished royalty rate if pending or contemplated patents do not issue.

e. A possible change in the exclusivity provisions of the license when patents expire or are declared invalid.

3. Be alert to the 17-year term for U.S. patents. If business considerations dictate that the patent and non-patent technology cannot be treated separately, be certain that the term for running royalties will not exceed the term of any licensed patent.

4. To be safe, pick a 15- or 17-year term for the combined trade secret and patent running royalties, rather than the 25-year term that got the licensor in trouble in *Boggild*. It is better to be realistic and reasonable than to face the business dislocation and legal expenses associated with a court challenge to the license after the patents expire.

5. Consider making up for royalties lost through a shorter hybrid license royalty term by other contract provisions, such as by larger up-front payments for the technology; higher royalties; increased technological service fees; etc.

6. Consider whether U.S. patent rights are crucial to the technology being transferred. If not, imaginative license approaches other than patent royalties can be used in the license. For example, the licensee could be granted a nonexclusive, nontransferable and royalty-free license under any related patents, so that patent expiration does not control the royalty term.

This suggested list of drafting ideas to avoid the legal problems in the treatment of hybrid license royalties is by no means exhaustive. Licensing executives and lawyers who deal with technology licensing on a day-to-day basis can devise other effective techniques for negotiating and drafting a hybrid license that meets the requirements of U.S. law.

These drafting ideas also are not limited to use only in future license agreements. It would be prudent to review existing hybrid licenses to determine if any problems exist in the treatment of the royalty terms under existing U.S. law. If existing license agreements present potential problems, plans should be devised to resolve the problems, by re-negotiation or otherwise, before all licensed patents expire and the parties are faced with the prospects of litigation and a potentially unenforceable license.

NOTES

1. The term "trade secret" is used in this context to include not only technical trade secrets, but also what is commonly referred to as "know-how," "proprietary information," and "non-patent technology."
2. Jorda, "Licensing of Know-How in U.S.," *Les Nouvelles*, June 1986 at 87.
3. See also, *Compton v. Metal Products Inc.*, 453 F.2d 38, 172 U.S.P.Q. 263, (4th Cir. 1971), *cert. denied*, 406 U.S. 968 (1972).
4. See *Ruckelhaus v. Monsanto Co.*, 104 S.Ct. 2862 (1984).