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Recommended Citation

Sol M. Linowitz and George W. F. Simmons, *Antitrust Aspects of Grant Back Clauses in License Agreements*, 43 Cornell L. Rev. 217 (1958)

Available at: <http://scholarship.law.cornell.edu/clr/vol43/iss2/1>

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ANTITRUST ASPECTS OF GRANT BACK CLAUSES IN LICENSE AGREEMENTS

Sol M. Linowitz and George W. F. Simmonst

In the shifting sands of antitrust law, one area has during the past ten years shown a refreshing degree of stability. This is the area marked by the legal limits on the power of a licensor to require a grant back of improvement patents. With increasing industrial dependence on research and greater necessity for cross-licensing to permit effective exploitation of new fields of technology, the problem is of growing significance to both business and the Department of Justice.

The grant back clause is hardly a johnny-come-lately in the licensing field. But while its use certainly antedates the Sherman Act¹ the possibility that it might raise antitrust problems was not suggested frontally until 1927 when a Texas state court held that a grant back clause in a license was not illegal under the Sherman Act.² The first case to reach the federal courts was *Allbright-Nell Co. v. Stanley Hiller Co.*³ There, the court made short shrift of the question and upheld the legality of such a clause without much discussion.

This, then, was the legal situation when in 1946 Stokes & Smith Co. brought action against Transparent-Wrap Machine Corp. to have a grant back clause in a license declared invalid. The clause there required the licensee to execute a complete assignment of all improvement patents to the licensor.⁴

The district court upheld the clause; and on appeal the court of appeals reversed by a split vote.⁵ The rationale of the decision in the court of appeals was Judge Hand's analysis of recent Supreme Court decisions holding illegal the use of a patent monopoly to control an unpatented product⁶ or combination.⁷ Although no precedent bore directly on the question before the court, the majority held that the judicial philosophy of these decisions should properly extend to the situation where a patent

† See Contributors' Section, Masthead, p. 263, for biographical data.

¹ See, e.g., *Bunker v. Stevens*, 26 Fed. 245 (C.C.N.J. 1885).

² *American Refining Co. v. Gasoline Products Co.*, 294 S.W. 967 (Tex. Civ. App. 1927).

³ 72 F.2d 392 (7th Cir. 1934).

⁴ The grant back clause read as follows: "If the Licensee shall discover or invent an improvement which is applicable to the Transwrap Packaging Machine and suitable for use in connection therewith and applicable to the making and closing of the package, but not to the filling nor to the contents of the package, it shall submit the same to the Licensor, which may, at its option, apply for Letters Patent covering the same." 156 F.2d 198, 199 (2d Cir. 1946).

⁵ *Stokes & Smith Co. v. Transparent-Wrap Machine Corp.*, 156 F.2d 198 (2d Cir. 1946).

⁶ *Morton Salt Co. v. G. S. Suppiger Co.*, 314 U.S. 488 (1942).

⁷ *Mercoid Corp. v. Mid-Continent Investment Co.*, 320 U.S. 661 (1944).

license was conditioned on a grant back of improvement patents. Certiorari was thereupon granted by the Supreme Court to resolve the conflict between the second and seventh circuits.

Thus, in 1947, in the *Transparent-Wrap* case the Supreme Court for the first time laid down general rules and guideposts for determining the validity of grant back clauses. Speaking for a five-to-four Court, Justice Douglas held that such a clause was not per se illegal under the antitrust laws.⁸

In reaching its conclusion, the Court reasoned that Congress had made all patents assignable without any express or implied provision that such assignment might be only for a specific type of consideration; that, therefore, the licensor was free to assign part of his patent monopoly for any consideration permitted by the law; and that such consideration might be either money or any other species of property, including a patent.⁹ Since in this case the licensor was exchanging one *legal* patent monopoly for another, the combination of the two was not illegal, said the Court, unless the over-all effect of the transaction was "to substantially lessen competition or tend to create a monopoly." The case was therefore remanded to the court of appeals to determine the effect of the grant back on competition in the industry.

On remand, Judge Learned Hand found that there was no evidence showing any unreasonable restraint of trade and held the agreement valid. In his opinion upholding the grant back clause, Judge Hand specifically dealt with the question of the double monopoly arising from (1) the control by defendant of both plaintiff's and defendant's patents during the period when the terms of the patents overlapped, and (2) the temporal extension of the monopoly due to the longer unexpired terms of the improvement patents. Since during the joint period no one could make the patented device if defendant held either set of patents, he pointed out, the fact that a possible competitor would be twice excluded would have no practical effect on the market. As to the longer term of defendant's monopoly, Judge Hand concluded, since the patents on the improvement had issued and since someone obviously was entitled to the monopoly for the patent period, there was nothing per se illegal in having such ownership in the defendant rather than in the plaintiff.¹⁰

This balanced and reasonable analysis was made against the backdrop

⁸ *Transparent-Wrap Machine Corp. v. Stokes & Smith Co.*, 329 U.S. 637 (1947).

⁹ The considerations prohibited by the *Morton Salt* case was the exchange of a legal (patent) monopoly for an illegal monopoly (i.e., a monopoly in an unpatented commodity, illegal under the Sherman Act).

¹⁰ *Stokes & Smith Co. v. Transparent-Wrap Machine Corp.*, 161 F.2d 565 (2d Cir.), cert. denied, 331 U.S. 837, rehearing denied, 332 U.S. 787 (1947).

of the Sherman Act which by its terms purports to prohibit absolutely certain types of commercial behavior. Courts in recent years, however, have been willing to read into the statutory language a required standard of reasonableness—holding that only “unreasonable” restraints are forbidden.¹¹ While this “rule of reason” has had a weary up-hill fight in certain areas, it has, since the *Transparent-Wrap* case, remained consistently and firmly established in the field of grant back; and the doctrine there enunciated has been surprisingly free of subsequent judicial erosion.

Thus, in *Modern Art Printing Co. v. Skeels*,¹² Judge Monterelli summarized the established view:

As to paragraph 6 of the agreement, [the grant-back clause] in a case upholding a similar provision in a patent license agreement, the Supreme Court held “that the inclusion in the license of the condition requiring the licensee to assign improvement patents is not *per se* illegal and unenforceable.” *Transparent-Wrap Mach. Corp. v. Stokes & Smith Co.*, 329 U.S. 637, 648. Since in the case at bar there is no evidence whatsoever pertaining to the effect that that provision in the agreement has had on the printing on squeeze bottle industry, and since that provision is not *per se* illegal, defendants’ argument is without merit.¹³

A similar conclusion was reached in *United States v. E. I. DuPont de Nemours & Co.* (Cellophane case).¹⁴ There, Judge Leahy stated:

This agreement contained provisions for licensing of certain future patents, but these were drawn so as to limit both the number of patents and the effect of any future licensing. DuPont was obligated only to license those patents which related to moistureproof cellophane and to offer them for licensing so long as the basic patents were in effect. In addition, duPont reserved right to charge additional royalty for significant inventions and, in fact, made such charge in certain cases. Sylvania, on the other hand, was obligated only to offer licenses to duPont under patents which it might develop at a later date which fell within the field of the basic moistureproof patent.

This grant-back, which in actual practice involved the licensing of only nine patents, was within the rule most recently enunciated in *Transparent-*

¹¹ *United States v. United States Gypsum Co.*, 333 U.S. 364, 400-01 (1948). Judge Hand phrased it this way in the *Transparent-Wrap* case: “It is hornbook law that not every restraint of competition is ‘unreasonable’ and that only ‘unreasonable’ restraints are unlawful.” 161 F.2d at 567.

¹² 123 F. Supp. 426 (D.N.J. 1954), rev’d, 223 F.2d 719 (3d Cir. 1955) solely on other grounds (invalidity of patent).

¹³ *Id.* at 433. The grant back clause in this case reads as follows: “Any improvement made on apparatus or methods of printing which are the subject matter of this agreement, by or through the efforts of the licensee or acquired by it, or which come under its control, during the life of this agreement shall be the property of and properly assigned to the licensor to the full extent of the interest therein of the licensee.”

¹⁴ 118 F. Supp. 41 (D. Del. 1953), aff’d, 351 U.S. 377 (1956). The grant back provided (at p. 151) for: “a license under any future patent granted to or acquired by Sylvania prior to Oct. 6, 1948, where the inventions claimed were concerned with the manufacture of moisture-proof cellophane and fell within the scope of the five recited patents.” (The basic DuPont patent in the license expired Oct. 6, 1948.)

Wrap Machine Corp. v. Stokes and Smith Company, 329 U.S. 637 The patents which duPont received from Sylvania under the agreement in no way enhanced duPont's power as to moistureproof cellophane. Sylvania could not have lawfully manufactured moistureproof cellophane without a license. It used a number of the patents licensed under the agreement, which enabled it better to compete with duPont. There is no proof anyone ever requested a license under either duPont's patents or Sylvania's patents to manufacture moistureproof cellophane and was refused a license. . . .

There is no decision which I could find, after long research, which holds a license agreement such as the one involved here violates the Sherman Act. Granting validity and scope of duPont's basic moistureproof patent, it is difficult to show how duPont can be held to have restrained trade by granting a license which permitted another to manufacture lawfully the patented product, when there is no showing that as a result of the agreement duPont's position was in any way enhanced or others who might have desired a license were precluded from entering the field. Cases on which plaintiff relies deal with combinations of patents under circumstances where the cross licensing parties sought to create a position of market control beyond that which either of them was entitled to through the exercise of its own patents. None of the cases affect legality of the grant-back provisions of the Sylvania license under the tests stated by Judge Hand in the *Transparent-Wrap* case.¹⁵

Several factors were cited by the court as decisive in favor of the validity of the grant back clause: (1) There was no showing that anyone was ever refused a license; (2) DuPont held the basic patents and as no one could do anything without a license under these, it did not matter that DuPont also obtained the improvement patents; (3) The agreement was limited to moistureproof cellophane; and (4) DuPont charged additional royalty for its improvement patents which were later added to the license.

In the most recent case squarely involving the *Transparent-Wrap* doctrine, *United States v. Birdsboro Steel Foundry & Machine Co.*,¹⁶ the court held fast to the "Transwrap principle." There two companies granted each other exclusive cross licenses of blocking and complementary patents so that each might make cooling beds. The defendants had only a small portion of the cooling bed business and the companies were not competitors but sold their beds in different markets. Although the cross license was exclusive, it appeared that this merely ratified the pre-existing competitive position between the companies. In reaching its decision the court placed heavy reliance on the *Lyophile-Cryochem* case¹⁷

¹⁵ Id. at 224-26.

¹⁶ 139 F. Supp. 244 (W.D. Penn. 1956).

¹⁷ *Lyophile-Cryochem Corp. v. Cutter Laboratories*, 78 F. Supp. 905 (N.D. Cal. 1948), modified, 179 F.2d 80 (9th Cir. 1949). Here two companies holding competing patents, but not themselves competing, assigned their patents to a third corporation created by them as a patent licensing corporation. As the two patent companies owned the subsidiary, in effect

and stated that the proper test for determining illegality was the "rule of reason" set forth in the *Gypsum* case. Accordingly, since the Government had shown neither the power nor an intent to exclude competitors from the cooling bed industry, the court held that the Sherman Act was not violated by the agreement.

Significantly, in the *Birdsboro* case, the Government laid great stress on the provision in the cross license which automatically included future patents. The court specifically held, however, that such an agreement was not illegal per se¹⁸ and distinguished the *Line Material* case¹⁹ relied upon by the Government on the ground that in that case there were additional elements (such as price fixing) present in the license which rendered the agreement illegal when combined with the provision for inclusion of future patents.

Obviously these decisions do not mean that the grant back clause has become a favored child of the courts. Like all aspects of business behavior, it has its very real limitations and restrictions. Mr. Justice Douglas indicated in the *Transparent-Wrap* case that other factors combined with a grant back might well constitute a Sherman Act violation and cited the *Hartford-Empire*²⁰ case as a classic example.

It is, therefore, hardly surprising that since the *Transparent-Wrap* case, several other courts have found a violation of the antitrust laws in cases where a grant back clause has been accompanied by clearly illegal restraints. Thus, in *United States v. General Electric Co.* (Cemented Carbide case),²¹ the court held the existence of a clause requiring licensees to assign all improvement patents to the licensor illegal when the subject of the original license was a basic patent.²² The defendant in that case, however, was also found guilty of clearly prohibited conduct—price fixing and territorial allocation—specifically stated by Mr. Justice Douglas to be illegal when combined with the grant back. Accordingly, while the court's opinion refers to the grant back provision as illegal in and of itself, the statement is manifestly dictum and must be considered in the context of the total facts of the case.

A similar result was reached in another case a year later, also involv-

joint consent was necessary to grant a license. The court found no Sherman Act violation as the companies tried to encourage the grant of licenses to all who wanted them and quoted with approval a clause in the agreement indicating that their intent was to make licenses freely available.

¹⁸ The court cited the *Transparent-Wrap*, *Lyophile-Cryochem*, and *Cellophane* cases.

¹⁹ *United States v. Line Material Co.*, 333 U.S. 287 (1948).

²⁰ *Hartford-Empire Co. v. United States*, 323 U.S. 386 (1945). In this case, the Court found a regimentation of an entire industry with allocation of fields of operation, setting quotas, etc.

²¹ 80 F. Supp. 989, 1005 (S.D.N.Y. 1948).

²² In fact, though such assignments were offered to licensor, the licensor always refused to accept.

ing General Electric—*United States v. General Electric Co.* (Light Bulb case).²³ There the court held a much more limited grant back illegal. General Electric contended in that case that complete title remained in the licensee, while it received merely a non-exclusive, royalty-free license with a right to sublicense. The court dismissed the limited nature of the grant back as immaterial since it was still sufficient to render “impotent any possible advantages to which one of its licensees would normally be entitled as the owner of a patent.” The court found that the grant back clause was part of a patent acquisition policy to perpetuate control over light bulbs long after the expiration of the basic patents and thereby regiment the entire industry.

On its face, this decision clearly is distinguishable from the *Cellophane* case, for here the court found that an industry was being regimented long after the expiration of the basic patents by a broad patent acquisition policy of which the grant back clause was but one instrumentality. It should be noted, however, that *in the Cellophane case DuPont would be in precisely the same position as General Electric with respect to the industry generally after the expiration of its basic patents and would also own all improvement patents.* The *Transparent-Wrap* case, however, held such extension not to be per se objectionable and in the *Cellophane* case the district court in Delaware refused to speculate on possible future regimentation which might never occur.

Three years later, in *United States v. I.C.I.*,²⁴ the court held a grant back clause drafted in the very terms approved in the *Transparent-Wrap* case to be illegal when used to help effect a division of territories in restraint of trade. The patents involved were basic patents (on polyethylene) *but, significantly, the court did not rest its decision on this alone as it had in the Cemented Carbide case four years earlier, but rather on the combination of the grant back and the division of territories.*

A like view was taken by the court in *United States v. Associated Patents, Inc.*²⁵ That case involved a patent pool among manufacturers of machine tools in which the companies in the field assigned all inventions to Associated Patents, Inc., a corporation organized by the defendants as a patent holding company. Associated Patents, Inc., then granted an exclusive license to each of the defendants for each of their specific fields. The license required that all improvement patents be assigned to Associated Patents, Inc. Here the court specifically found: “Invention and technological development have been discouraged by the limitations

²³ 82 F. Supp. 753, 815 (D.N.J. 1949).

²⁴ 105 F. Supp. 215, 232 (S.D.N.Y. 1952).

²⁵ 134 F. Supp. 74 (E.D. Mich. 1955).

imposed on the members' rights to use and license improvement patents developed by them." As a result of its findings, the court held the defendants guilty of violating section 1 of the Sherman Act. In this case, however, it again appeared that the grant back was combined with an allocation of territories, and it was also shown that the defendants had refused licenses to competing firms in order to preserve their own exclusiveness.

CONCLUSION

In the light of this analysis of the relevant decisions—and despite occasional suggestions to the contrary—it is clear that in no case has a court held a grant back clause to be in violation of the antitrust laws when it was unaccompanied by illegal restraints. Nor is the question as to whether the grant back is exclusive or non-exclusive determinative.²⁶ The essential point is that where a grant back clause is part of a license agreement which contains unlawful restrictions, a court is apt to find that there has been forged a *combination* which is an illegal restraint of trade; and, therefore, the combination—of which the grant back is a part—will be struck down.²⁷

Accordingly, if in a business arrangement a grant back is deemed to be desirable as partial consideration for a patent license, there is no compelling reason why a businessman should be more constrained to forego such a provision than to surrender a cash royalty which may constitute the remainder of the consideration. However, since a patent by its very nature grants a legal monopoly and therefore constitutes an exception to the prohibition against monopolies, any patent license arrangement will unquestionably be subject to ever closer scrutiny by both the

²⁶ See, e.g., *United States v. General Electric Co.*, 82 F. Supp. 753 (D.N.J. 1949). Cf. Report of Attorney General's Committee on the Anti-Trust Laws 228-29 (March 31, 1955):

If the grant back is a license, its reasonableness may depend in some circumstances on whether the license is exclusive or non-exclusive. A grant back by assignment or an exclusive license, which is in effect an assignment, should be subject to close scrutiny as a factor which may dull the grant back licensor's incentive to invent. On the other hand, grant back of a non-exclusive license, especially with authority to sublicense, may diffuse the benefits to all licensees and thus tend to encourage competitive use of the innovations.

²⁷ In an address to the New York State Bar Association in January, 1955, Judge Stanley Barnes, then Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, set forth the following elements as leading to objectionable grant back arrangements: (1) allocation of research; (2) pooling arrangements that might stifle research; (3) anything frustrating independent exploitation of patents; and (4) joint action in granting licenses plus a common litigation fund.

Substantially the same view was taken by the Attorney General's Committee on the Anti-Trust Laws in its recent Report: "Summing up, in determining the legality of grant backs, their purpose and effect is relevant; more particularly, what is their effect on (1) the licensor's position as to patents or the products they cover, and (2) each party's incentive to research." Report of Attorney General's Committee on the Anti-Trust Laws 229 (March 31, 1955).

Department of Justice and the courts. And grant back clauses—since they involve an exchange of patent monopolies—are apt to be doubly sensitive. In short, while the grant back clause is a legal and tremendously valuable licensing tool, it is obviously one to be handled with circumspection and with due regard to the other provisions of the agreement of which it is to be made a part.