

PATENT COSTS OF MILITARY PROCUREMENT IN WARTIME

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“Our mission,” said Robert P. Patterson, then Under Secretary of War, addressing the assembled Army patent staffs in December, 1944, “is to put in the hands of our fighting forces weapons and equipment that will be better than anything the enemy has produced or will produce. We are not fighting this war with weapons of the prior art.”¹ These words reveal the underlying reason why patent costs are an inevitable part of the cost of war, because the manufacture of weapons and equipment suited to modern combat is almost certain to involve the use of patented inventions. In wartime military purchasing these costs create an administrative problem, not only to control their reasonableness but to discover where the liability exists and to provide for its existence when unknown.

Patent costs began to be recognized in and following World War I as an appreciable item in the cost of military supply. During that conflict the Army saw the need of patent supervision, and its earliest “patent section” was created late in 1917 in the Signal Corps. Others were created, before the armistice, in the Ordnance Department, Quartermaster and Motor Transportation Corps, and the Chemical Warfare Service. Corresponding and contemporaneous growth occurred in the Navy Department. While these patent staffs sought and negotiated licenses for the Government under certain patents and devoted some time to contract matters, their major task then and throughout the inter-war years was the solicitation of patents for service inventors.

The work of numerous commissions and boards, and of the Court of Claims, during the inter-war years, in determining the liability of the Government for patent infringements committed during World War I, gave clear warning that these liabilities might involve substantial figures in a future conflict.² Moreover, the

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¹ *Report of Speeches and Discussions at the Under Secretary of War's Patent Conference*, Aberdeen Proving Ground, Aberdeen, Md. (Dec. 15-16, 1944). This report, which was printed by the War Department for circulation to its patent staffs, will be cited here as “Aberdeen Report.”

² Portner, Gondos, and Eddy, *The Preliminary Checklist of the War Department Foreign Patent Claims Records* (The National Archives, PC 10 (43-25), Sept., 1943), states that the Commission for Adjustment of Foreign Claims (1924) paid \$57,340.10 to settle 27 patent claims (pp. 13-16); that the German-Austrian Claims Unit (1929-1931), acting under authority of the War Claims Act of 1928, 45 STAT. 254, paid \$12,485,387.83 to German nationals and \$966,487.50 to Austrian and Hungarian nationals to settle 1,069 claims involving about 6,000 patents (pp. 16-22); and that the Commission for

history of such litigation in the Court of Claims indicated that at least a generation might be required to settle them all, at great expense both to the Government and to the litigants.³

In World War II, the armed forces were fully aware of the magnitude of the costs and liabilities involved, and maintained substantial staffs to deal with them. The problem was not merely one of negotiation with known patent owners. It consisted mainly in establishing and applying measures to detect accruing patent costs or liabilities, to deal with adverse claims and unreasonable royalty charges, to assemble officer personnel qualified to handle such questions, and to guide them in their work according to a uniform pattern of policy.

Two primary goals were recognized as the objectives of this program: (1) that as far as possible no unsettled patent liabilities should be left behind when the war came to an end, and (2) that unreasonable and excessive patent royalty charges should so far as possible be currently eliminated from the costs of wartime procurement.

The purpose of this paper is to review briefly the efforts of the War and Navy Departments in the years 1941-5 to achieve these two goals, and to discuss some of the problems involved. It is divided into two parts: (1) a discussion of certain problems relating to Government liability for unlicensed infringement, and the policies adopted by the War and Navy Departments in respect thereto; and (2) a discussion of certain problems arising in connection with administration of the Royalty Adjustment Act of 1942, and the policies adopted by the War and Navy Departments in respect thereto. This paper does not undertake to discuss contracting procedure with regard to rights in inventions made by War and Navy Department employees in the course of their employment, or by War and Navy Department contractors in the performance of research and development contracts.

I

PROCUREMENT FROM UNLICENSED SOURCES

Prior to enactment of the Act of June 25, 1910,⁴ government suppliers were subject to liability for infringement under the patent laws in the same manner and to the same extent as private suppliers. Damages could be recovered against them and they were subject to injunction at the discretion of the court. The Government itself, however, could not be sued for infringement. Government liability for infringement was therefore involved only in those cases where (1) action could be shown on the part of government officers imposing upon the Government a con-

Adjustment of British Claims (1932-33) paid \$255,500. to settle 17 patent claims (pp. 22-25). A survey by one of the authors indicates that the total amount awarded in all judgments of the Court of Claims, entered in patent infringement cases based on War Department procurement during World War I, was \$2,862,733.91.

³ The last patent infringement case in the Court of Claims involving military procurement during World War I was decided December 4, 1944. *Thompson v. United States*, 102 Ct. Cl. 402, 63 U.S.P.Q. 281 (1944).

⁴ 36 STAT. 851, as amended, 35 U. S. C. §68 (1940).

tractual obligation to pay reasonable compensation for the invention used⁵ or (2) a special enabling act waived the sovereign's immunity from suit. The Act of June 25, 1910, merely gave the sovereign's general consent to be sued, but did not relieve the supplier of direct liability.⁶

Procurement of military weapons and supplies for use in the Spanish-American War is said to have involved the first use of patent provisions in government purchase contracts. These took the form of what would be called today "counter-indemnity," under which the Government agrees to indemnify the supplier against patent damage claims arising out of his performance of the contract. The practice of using counter-indemnity is said to have fallen into disuse at the close of the Spanish-American War, and not to have been revived until inauguration of the procurement program associated with World War I. During World War I counter-indemnity was extensively used.

Counter-indemnity could not protect the contractor against the issuance of an injunction, nor did the Act of June 25, 1910, do so.⁷ The granting of an injunction against a government supplier, particularly in wartime, is a matter of serious concern to the armed forces, since it may hinder or delay the delivery of vitally needed supplies. This jeopardy to national security was pointed out to Congress in a letter dated April 20, 1918, from Franklin D. Roosevelt, then Acting Secretary of the Navy.⁸ In response to this letter Congress enacted the Amendment of July 1, 1918,⁹ to the Act of 1910 which cut off completely the patentee's remedy against the contractor, both by way of injunction and damages, and substituted in lieu thereof an action against the Government for "reasonable and entire compensation."¹⁰ The 1918 amendment came too late to affect materially the use of counter-indemnity provisions during the few remaining months of World War I, but as the War and Navy Departments resumed normal peacetime purchasing it appears that the use of counter-indemnity was largely dropped.

During the inter-war years 1919-1940, War and Navy Department supplies were purchased upon advertisement and bid in conformity with the requirements of Section 3709 of the Revised Statutes,¹¹ and upon a form of government contract, applicable to all departments, known as "U. S. Standard Form No. 32." Soon after the armistice, those charged with responsibility for government procurement policy began to consider the advisability of having the Government seek, from its supplier, an "indemnity" provision under which the supplier agrees to hold the Government harmless with respect to liability falling upon it under the Act of 1910 (as amended) for the manufacture or use of the articles which he supplies. A case

⁵ E.g., *United States v. Bethlehem Steel Co.*, 258 U. S. 321 (1922).

⁶ *William Cramp & Sons Ship and Engine Building Co. v. International Curtis Marine Turbine Co.*, 246 U. S. 28 (1918).

⁷ *Marconi Wireless Co. v. Simon*, 246 U. S. 46 (1918).

⁸ *Richmond Screw Anchor Co. v. United States*, 275 U. S. 331, 342 (1928).

⁹ 40 STAT. 705, 35 U. S. C. §68 (1940).

¹⁰ See *Richmond Screw Anchor Co. v. United States*, 275 U. S. 331 (1928).

¹¹ REV. STAT. §3709 (1875), 41 U. S. C. §5 (1940).

in point which gave impetus to this movement was that in which the War Department, calling for bids for a number of the well-known Lundin lifeboats (which were the subject of patent claims then pending in the courts), received a low bid from a competitor of the patentee. The War Department, obliged by law to award the contract to the low bidder, insisted that he agree to indemnify the Government. Subsequently, the Government was in fact held liable,¹² was mulcted in damages, and recouped them from the supplier.¹³

The War Department's experience in the lifeboat case prompted an opinion of the Comptroller General on December 21, 1933, in which it was said:

Where it is known with certainty that patents are involved, bidders may properly be required to show legal right to manufacture thereunder, or the United States may directly obtain such right for its own use or use through its contractors, with provision in the specifications accordingly, but where the matter is doubtful, the interests of the Government should be protected through including in the contract the patent infringement indemnity clause and requiring ample security.¹⁴

The effect of this ruling was to require contracting officers of the Government to insist upon a patent indemnity clause wherever "the matter is doubtful," and caution soon dictated a widespread and growing insistence upon such provisions in all contracts. Furthermore, the direction of the Comptroller General that there be "ample security" led to the insertion in many contracts of a requirement that the supplier not only indemnify but also furnish a bond. It followed, as a matter of course, that the cost of the premium on such bonds became an element tending to inflate bids.

The Act of July 2, 1940,¹⁵ the First War Powers Act of December 18, 1941,¹⁶ and Executive Order No. 9001 of December 27, 1941,¹⁷ authorized purchases by the War and Navy Departments by negotiated contract, without advertisement and bid. At first this change in procurement method had little effect upon the use of indemnity and counter-indemnity clauses.

The Navy, having a centralized purchasing system which subjected all the terms of major contracts to approval by high-level authority before execution, adopted on December 6, 1941, a policy of requiring indemnity in most of its larger contracts, and of not giving counter-indemnity. The Navy did, however, on occasion give its express authorization and consent to the contractor's use of certain inventions in the performance of the contract, this having the effect of governmental assumption of liability under the Act of 1910 and relieving the contractor of direct liability

¹² *Welin Davit & Boat Corp. v. United States*, 78 Ct. Cl. 772, 20 U.S.P.Q. 206 (1934).

¹³ *United States v. Lane Lifeboat Co.*, 118 F. 2d 793 (C.C.A. 2d 1941).

¹⁴ 13 COMP. GEN. 173, 176 (1933-34). To the same effect are Opinion of Oct. 10, 1934, 14 COMP. GEN. 298 (1934-35), where neither the Government nor the supplier could state specifically what patents were involved; and Opinion of Nov. 22, 1934, 14 COMP. GEN. 406, 407 (1934-35), where the contract called for delivery of one experimental aircraft and the risk on its face was negligible in amount.

¹⁵ 54 STAT. 712, 50 U. S. C. A. App. §1171 (Supp. 1946).

¹⁶ 55 STAT. 839, 50 U. S. C. A. App. §611 (1944).

¹⁷ 50 U. S. C. A. App., note following §611 (Supp. 1946).

therefor. When such action was taken in the absence of an indemnity provision in the contract, it had nearly the same effect as if express counter-indemnity had been provided.

The Army, having a highly decentralized purchasing system in which most contracts were negotiated and executed by contracting officers in branch or field offices, was faced with a problem of formulating and issuing appropriate instructions. On September 16, 1941, the Under Secretary of War promulgated a standard form of contract, known as War Department Contract Form No. 1, to be used in all negotiated and other purchases of the Army. To this form were appended a series of optional contract articles, and instructions for their use. Forms of patent indemnity and counter-indemnity were supplied. Unfortunately, the accompanying instructions were not well suited to guide the rapidly expanding number of contracting officers. These instructions directed the contracting officer that "where patented articles" are purchased he "may desire" to include indemnification, and in that event was directed to use the form provided. The defect in these instructions was that, under pressure of wartime procurement, no contracting officer is likely to know whether the item he buys is or is not "patented." Furthermore, delegation to the contracting officer of unrestricted authority to include or omit indemnification, virtually without supervision over the exercise of his discretion, led to great diversity for want of a consistent policy.

The instructions for the use of counter-indemnity likewise left full discretion to the contracting officer and did not afford control by higher authority over the use of such provisions, which might involve the commitment of unappropriated funds and subject the Government to large and unascertained liabilities.

On June 29, 1944, the War Department established a new policy with regard to indemnity and counter-indemnity, and promulgated general regulations governing the use thereof. In essence this policy was (1) that indemnity should be required to the extent, but only to the extent, that contractors supply to the War Department their regular commercial item,¹⁸ and (2) that counter-indemnity should be given only with the approval of the Director¹⁹ in each particular case,²⁰ but clauses were supplied for general use giving the Government's authorization and consent to the use of inventions embodied in the articles delivered and inventions whose use in manufacture necessarily resulted from the contractor's compliance with instructions given him by the contracting officer.²¹

The result was to terminate altogether the Army's use of counter-indemnity.

¹⁸ ARMY PROC. REGS. §§1117.3 and 1117.5.

¹⁹ "The Director" was the term used in Army Procurement Regulations to describe the Director, Purchases Division, Headquarters, Army Service Forces. To this officer the Under Secretary of War delegated his power and authority to give, by signature, final approval to any contract which required signature by or on behalf of the Under Secretary. The Director therefore constituted the highest contracting authority in the Army in all cases except where he referred a specific contract to the Under Secretary for personal approval.

²⁰ ARMY PROC. REGS. §1118 (3).

²¹ ARMY PROC. REGS. §335.6.

In no case was the Director's approval sought after June 29, 1944, for a contract containing such a provision.

As to indemnity, the theory was that contractors should be expected to warrant the freedom of their regular commercial items from patent risk, but should not be expected to do so on items made to military specifications or outside their regular commercial experience. Thus, for example, in the supply of .45-caliber pistols, indemnity would not be required from a company which had never made them in peacetime, but would be required from a regular manufacturer of pistols. Some items, however, could not be classified so simply. These were items known as "hybrid," which were made partly to the supplier's standard specifications and partly to the Government's specifications. An example was a commercial truck, modified according to Ordnance specifications to convert it to a mobile machine shop. The "hybrid" situation was taken care of, contractually, by use of the standard indemnity clause to which were added the words "*excepting however* infringements necessarily resulting from the Contractor's compliance with specifications (unless originating with the Contractor) now or hereafter forming a part of this contract or with specific written instructions given by the contracting officer for the purpose of directing the manner in which the Contractor shall perform this contract."²²

The difficulty of assuring consistent use of indemnity provisions, in the manner required by the new policy, throughout a vast decentralized purchasing organization, was dealt with in the Army by a system of delegations of authority. The procurement regulations were amended to describe the policy, for the information of all contracting officers and supervising officials. There was delegated to the chief patent officer in the headquarters of each service²³ full authority to apply and administer that policy within his service.²⁴

An example of regulations within a service is afforded by the Army's Ordnance Department, which issued instructions to its contracting officers dividing all procurement into two parts, commercial items and Ordnance items. In all purchases of "commercial items" the Ordnance district offices were directed ordinarily to use unconditional indemnification; where, however, the item was "modified by Ordnance specifications to meet Ordnance requirements" the qualified or hybrid indemnification clause was to be used. In purchases of "Ordnance items" hybrid indemnification was to be used wherever the item "may be made by any one of several processes within the Contractor's discretion" or where the item was procured "from a Contractor provided partly or entirely with facilities owned or to be owned by the Government"; in all other purchases of Ordnance items no indemnity was to be sought.²⁵

²² ARMY PROC. REGS. §335.5.

²³ "Service" is here used in reference to the eight major purchasing units of the Army—Air Forces, Ordnance, Signal Corps, Quartermaster, Engineers, Chemical Warfare Service, Medical Corps, and Transportation.

²⁴ ARMY PROC. REGS. §1118.

²⁵ Ordnance Procurement Instructions, §59,104.1.

While the foregoing system of delegated administrative powers introduced the danger of non-uniformity between Army services, this danger was faced and accepted because of the need for flexibility. It had proved to be impracticable to educate all of the thousands of contracting officers in the field to observe a wholly consistent pattern in the use or omission of indemnity or hybrid indemnity, or to grasp the differing implications of "authorization and consent" in the presence and absence of indemnity. Nor was it feasible for every contract presenting such questions to be referred to the Director. The scheme adopted was a compromise made necessary by decentralization of Army procurement.

It is too much to hope that the methods of administration just described produced perfect consistency. Some contractors have complained of unnecessary insistence upon indemnity by the armed forces. On the other hand, this insistence in a large number of contracts undoubtedly caused suppliers to exercise caution in using patented inventions without license, and probably had the effect of inducing some suppliers to take licenses where they knew that infringement was involved. The Army and Navy felt justified in thus delegating to their prime contractors the tasks of investigation and license procurement because (1) in most cases these contractors were in a better position than the armed forces to know of the applicable patents, and (2) the patent staffs of the Army and Navy were too small in number, and too lacking in search facilities, to be able to investigate and weigh adequately the patent risks involved in a vast and highly diversified purchasing program. The use of indemnity provisions, while a recurring source of contractor complaint, will probably have the effect of greatly reducing the volume of postwar patent litigation in the Court of Claims.

Certain special problems and situations arising out of the use of indemnity may be mentioned:

1. In a number of situations contractors urged, on renegotiation, that they be allowed to charge as costs a reserve against the infringement liabilities on which they had indemnified the Government. Under the Renegotiation Act the allowability of such a reserve was purely a question of tax law. In as much as the taxing statutes and regulations permit reserves only against known liabilities, accruing within the taxable year, the result was disallowance on renegotiation of all reserves except those accumulated against a known patent. While it is recognized that this may operate unfairly in cases where patent liability is not discovered or established until years after the war, it is not believed to be an adequate ground on which to criticize the use of indemnity provisions by the War and Navy Departments under the policy described above. Congress will always have power to grant relief in meritorious cases.

2. In some situations Government procurement, not covered by indemnification, was found to infringe a particular patent, but the owner thereof had neither called the matter to the Government's attention nor taken any steps indicating his desire to make a claim. Situations of this kind seem to have occurred with some frequency

in the Army's Quartermaster Department. The problem was the old one of whether to let a sleeping dog lie, thereby risking the possibility of prolonged litigation in postwar years and heavy liability falling upon the Government, or to take the initiative in seeking a license. In general the policy was adopted in both the Army and the Navy, where infringement was reasonably clear, the volume of procurement large, and the patent apparently valid, of seeking a license. Almost without exception, in these cases, a license was obtained for the Government. In many instances, such licenses provided freedom from royalty on wartime purchases.

3. In a series of contracts with the War and Navy Departments, all identical in form, signed at various times during the war, it was provided that the signing company, in consideration of the Government's agreement not to seek indemnity from the signer in any contract for the purchase of communication and signalling equipment, granted to the Government a royalty-free license for the duration of the war under all patents of the signer relating to such equipment. Approximately 165 such contracts were entered into. Virtually the entire electronics industry signed without compensation. So widespread was the execution of these contracts that problems of patent liability in the field of electronics were largely wiped out, except for claims originating outside the ranks of electronics suppliers. The primary effect was to remove electronic procurement from within the framework of the heavy royalty schedules which for many years had blanketed that industry. At peak wartime procurement, it has been estimated, these royalties would have cost the Government substantially more than thirty million dollars per year.

4. A similar proposal was suggested to the Navy and the Air Forces by the principal suppliers of aircraft and components. Since the final negotiations were concluded in 1945, the agreements were retroactive in nature and involved a waiver, by the Government, of its rights of indemnification against the signer, in return for his waiver of patent damage claims against the Government, covering all procurement of aircraft and components from September 8, 1939, to the end of the war, without money payment in either direction. While two of the principal aircraft supply concerns refused to join in these agreements, substantially the whole of the remainder of the industry did, and on this basis the transaction as a whole was accepted by the Secretaries of War and Navy. Since much Government aircraft procurement, from the beginning of the war, involved broad indemnification, even on military types of planes, the primary effect of the transaction was an exchange of releases between members of the industry. The Government, however, benefited in so far as non-indemnified procurement was concerned.

II

ADJUSTMENT OF ROYALTIES

A significant out-of-pocket cost item in armed forces procurement was royalty payments under patent license agreements, privately entered into between patent owners and government contractors or subcontractors. Ordinarily the royalty pro-

visions of a contract of this kind provide for payment in terms of a percentage of the licensee's selling price, or so much per unit made or processed by the licensee. Under such contracts the unprecedented increase in armed forces procurement, early in the war, caused an unprecedented increase in royalty payments to certain patentees. In most instances the royalty rates or amounts had been privately negotiated before the war in arm's-length dealing, in the setting and prospects of peacetime production, and without contemplation of the huge volume of production which the war brought about and which, had it been foreseen, would probably have led to express provision for reduced rates on the higher increments of such production. As applied to wartime production the rates or amounts of royalty specified in some of these contracts produced annual payments that appeared to be unreasonable and excessive. The following table sets forth eight examples revealed by investigations of the War and Navy Departments during the war:

TABLE I
CASES ILLUSTRATIVE OF WARTIME EXPANSION OF ROYALTIES

PATENTED ARTICLE OR PROCESS INVOLVED	ANNUAL ROYALTIES UNDER THE LICENSE	
	1938	1943
Rotary wing aircraft and parts	\$20,000.	\$12,000,000.
Turn and bank indicators	10,150.	2,201,175.*
Radio tube sockets and electrical connectors	16,000.	2,000,000.
Reduction gears, dynamic dampers, low-speed superchargers and torque meters	33,800.	4,200,000.**
Propellers	18,216.	2,126,442.
Stop nuts	15,521.	1,213,421.
De-icers	14,067.	972,200.
Aviation training apparatus	50,626.	2,400,000.

* In 1942.

** In 1944.

Successive statutes enacted in the spring of 1942, calculated to prevent price inflation²⁶ and excessive profits,²⁷ failed to reach all cases of excessive royalties. Thus the armed forces were confronted with the practical situation that, in purchases of a patented device from an unlicensed source, the patentee would be able to recover "reasonable and entire compensation" from the Government under the Act of 1910; but in purchases thereof from a licensed source, the royalties became a charge against the Government without regard to their reasonableness in rate or total amount, and without opportunity for the Government to question the validity of the patent even though the Government could show it to be invalid. Thus the

²⁶ 56 STAT. 23 (1942), 50 U. S. C. App. §901 *et seq.* (Supp. 1946).

²⁷ 56 STAT. 245 (1942), 50 U. S. C. App. §1191 (Supp. 1946).

armed forces were faced with the dilemma of paying exorbitant royalties or foregoing production of critical war items at certain licensed plants.

These considerations, presented to Congress by the armed forces and other departments of Government, led to the enactment on October 31, 1942, of what came to be known as the Royalty Adjustment Act.²⁸ In brief, this Act provides that when the head of a department believes the royalties on any item he is purchasing are unreasonable or excessive, he is authorized to give notice of that fact to the licensor and licensee. After giving the parties opportunity to be heard, the head of the department is authorized, by order, to fix and specify "such rates or amounts of royalties, if any, as he shall determine are fair and just, taking into account the conditions of wartime production." The issuance of notice has the effect of requiring the stoppage of further royalty payments. The making of an order has the effect of authorizing the licensee to pay royalties to the licensor at the rates or amounts fixed in the order, and no more. As to the excess, all rights of action of the licensor against the licensee are forever cut off; in lieu thereof the licensor is given a right of action against the Government for the recovery of "such sum, if any, as when added to the royalties fixed and specified in such order, shall constitute fair and just compensation . . . taking into account the conditions of wartime production." In such an action there is reserved to the United States the right to challenge the validity of the patent.

A further provision of the statute authorized the head of such department to enter into an agreement with the licensor, provided no suit had been filed against the United States, in full settlement and compromise of the liability incurred by an order issued under the Act.

The scheme of the Act warrants comparison with corresponding legislation in Great Britain.²⁹ There are two important differences. The American statute does not directly affect the existing private contract, but modifies the remedies available to the licensor for non-payment of royalties; the British statute provides that private licenses shall be altogether inoperative so far as concerns manufacture for or sale to the Government. The American statute is temporary wartime legislation; the British statute is permanent and applies in peacetime as well as in war.

The War and Navy Departments construed the Royalty Adjustment Act as a direction from Congress that, within the limits of administrative expediency, the entire field of royalty payments chargeable to these departments should be surveyed and regulated, rather than that action should be confined to these few known cases where royalties had expanded excessively. Consistently with that view the

²⁸ 56 STAT. 1013, 35 U. S. C. A. §§89-96 (Supp. 1946).

²⁹ Section 29 of the (British) Patents and Designs Act, 1907, as amended by §8 of the Patents and Designs Act, 1919 (effective April 23, 1920), provides in part as follows: "A patent shall have to all intents the like effect as against His Majesty the King as it has against a subject. . . . And the terms of any agreement or licence concluded between the inventor or patentee and any person other than a Government department, shall be inoperative so far as concerns the making, use or exercise of the invention for the service of the Crown. . . ." 9 & 10 Geo. V, c. 80.

departments promulgated standards for determining reasonable royalties, and took steps to bring to light all royalty costs involved in their purchases.

A basic principle of administration, in the two departments, was that every effort should be made to deal with excessive royalties by negotiation and agreement, rather than by order. Excessive royalties had in fact been eliminated by voluntary agreement in a few instances before the statute was enacted, and the War and Navy Departments believed that passage of the Act would not diminish the number of individuals and corporations who did not wish to profit excessively from the war. In this they were not mistaken, as the figures given below clearly show. In the War Department insistence upon procedure by negotiation took the form of published regulations, binding upon all delegates,³⁰ that before issuing notice they should afford the licensor a fair opportunity to effect a voluntary adjustment.³¹ No delegate had power to waive this requirement except in emergency cases upon express authority specially obtained from the Director.³² In the Navy Department a like policy was applied by its Royalty Revision Board.

The negotiation procedure followed by the Royalty Adjustment Board, Army Air Forces, was described as follows by a member of that board, addressing a gathering of delegates from other Army services:³³

At the outset of the conference express appreciation to the persons attending and briefly explain the purposes of the Act, stressing the policy of affording the licensor an opportunity to tell his story and that the ultimate aim is to amicably adjust the matter. It is well to state that no definite conclusion has been reached as to whether the royalties are fair and reasonable in view of wartime production. It is also well to emphasize that the royalty rate may be fair and reasonable, based on peace time standards, but that the Act is primarily concerned with whether the dollar amount is fair and reasonable in view of the tremendous increase in wartime production over which no one has control and the limits of which depend upon our enemies.

A graph showing the increase in airplane production over peace time procurement has been used very effectively by the Army Air Forces. It is well to explain that the Royalty Adjustment Act is only a part of the overall legislation designed to prevent inflation and prevent anyone from unduly benefiting from the war. It can be pointed out that it would be obviously unfair to renegotiate the manufacturer who is producing the patented article and limit his profits without, at the same time, curtailing the profits made by the licensor based on the same procurement. The whole atmosphere of the conference should be one of informality and conducted as business men discussing a problem around the table. Obvious grouping of the representatives of the licensor and licensee should be avoided.

³⁰ Decentralization of Army procurement necessitated delegation of the power of the Secretary of War under the Royalty Adjustment Act to issue notice, to hold a hearing, to make an order, and to execute contracts in settlement and compromise. However, no order became effective as the act of the Secretary of War until signed by the Director. The subordinate powers were delegated to various officers and royalty adjustment boards in each of the services. Those holding such powers are referred to here, and in the Army regulations, as "delegates."

³¹ ARMY PROC. REGS. §1112.13. "The policy of the War Department is . . . that, so far as practicable, each licensor shall, where such royalties are believed to be unreasonable or excessive, be given fair opportunity to effect a voluntary adjustment thereof before notice is given."

³² ARMY PROC. REGS. §1112.4(4).

³³ *Aberdeen Report*, pp. 49-50.

The spokesman for the licensor should be afforded every opportunity to tell his story. Interruptions should be avoided as much as possible and under no circumstances should the conference develop into personalities, or the delegate or his representatives assume the role of a prosecutor. Under no circumstances is there an excuse for discourtesy. The visitor should not be given the impression of being hurried or cut short. Many times his story may involve immaterial and irrelevant matters but remember that what he is discussing may represent hours and days of effort and it naturally means a great deal to him.

. . .

After the licensor or his representative has had ample opportunity to tell his story, pertinent questions may be asked designed to bring out additional facts but not to embarrass the other party. It is surprising how uniform the story becomes, but a successful negotiator can never afford to lose his perspective and become impatient. It is a new experience to the teller and he probably has spent much time in preparation.

. . .

In a second conference the delegate, or his representative, should be in position to carry the initiative. He will have had an opportunity to appraise the invention, analyze the statements made by the licensor, and have reached some determination as to what might be a fair and reasonable royalty as a settlement figure. The same courteous treatment should pervade the conference but the negotiator can take a more positive position as to what he would recommend to the delegate as a basis of settlement. Appearances of trading should be eliminated as far as possible and if the licensor, or his representative, has a counter proposal, the negotiator can always agree to submit the same to the delegate for final acceptance or refusal without materially changing his position.

If the parties are so far apart that no settlement can be made, then the licensor should be promptly notified and a Notice promptly issued.

In the administration of the Act a number of problems were encountered, of which some are briefly mentioned below:

1. Since the royalties payable under a single license, or under a series of licenses granted under the same patent, were often chargeable to more than one service of the Army, or to an Army service and to the Navy, it became necessary at an early date to provide for extensive inter-service and inter-departmental cooperation. To this end, the Director set up and maintained a master index of all cases under investigation by the Army. In order to prevent duplicating action by different Army services, Army regulations were issued requiring a delegate who had discovered the existence of substantial royalties, before interrogating the licensor in detail or seeking justification as to the rates or amounts, to report the case to the Director and obtain from him "clearance" to proceed. The effect of clearance was to vest in the delegate exclusive jurisdiction (so far as concerned the War Department) to investigate, settle, give notice, hold a hearing, and recommend the making of an order with respect to the particular royalties involved.³⁴ With this mechanism of supervision at his disposal, the Director was in a position to insure that Army delegates would move in unison with the Navy Royalty Revision Board in cases involving a joint Army-Navy interest. Coordination between the two departments took the

³⁴ ARMY PROC. REGS. §§1112.14 and 1112.16.

form of joint negotiations, joint hearings, and settlement agreements signed jointly on behalf of the Secretaries of War and Navy. While the Act required each department to issue its own notices and orders, coordination between Army and Navy representatives was maintained to such an extent that in virtually every case of joint Army-Navy interest where negotiation failed and mandatory action became necessary, notices were issued approximately contemporaneously, and orders were made in identical terms, by the two departments.

The resulting relationship between Army delegates and the Navy Royalty Revision Board and its advisors was so close that in applying standards of fair and reasonable royalties the two departments adopted policies which were substantially identical. The following paragraphs refer to the policy and procedure of both the War and Navy Departments except where the contrary is expressly stated.

2. Where the annual amount of royalties payable under a license in a wartime year greatly exceeded the amount paid in peacetime years, it was ordinarily concluded that the case warranted investigation. Where the increase was very striking, as for example in the cases indicated in Table 1, action was taken to effect an adjustment. On the other hand, cases appeared in which the use of the inventions had been steadily growing, and the royalty income increasing from year to year, during peacetime. In this situation the policy was to regard as excessive only those amounts by which the royalties in war years exceeded the normal growth expectancy.

3. Some cases involved annual royalty receipts approximately the same in wartime as in peacetime, but a shift had occurred in the end-use of the licensed invention from a predominantly civilian to a predominantly military character. In such cases there was no policy that such royalties should be exempt from adjustment merely because there was no increase from a typical peacetime year to a typical wartime year. The portion chargeable to the Government was evaluated as to its reasonableness, standing alone; it was believed that the armed forces should not undertake to allow compensation for the loss of civilian markets. Also, where royalty clauses in a series of licenses provided for declining rates as the volume of business of each licensee increased, the position was taken that the armed forces were entitled to view their total procurement as coming within the rate bracket applicable thereto, as if there were but a single license. Furthermore, in a few cases where annual royalties had not increased in wartime, downward adjustment of royalties was made because validity of the patent was seriously in question, or because expiration of senior patents had removed significant elements of value from the license base. In one case, of the last-named type, where the sole surviving patent in a high-rate license covered a minor detail that was clearly anticipated, an order for zero royalties was made.

4. In a number of cases it was discovered that the license was entered into between a licensor and a war contractor (licensee) during the war at a time when the

parties must have contemplated that substantially the entire royalty burden would be passed on to the Government, or between a licensor and licensee having such close business, personal, or family relationships as to warrant the conclusion that the royalties agreed upon were not the result of arm's-length dealing. In cases of this type the policy was adopted of making an independent appraisal of the value of the patent rights involved, in much the same way as if the United States had been asked to take a license on the terms set forth. The practice was to regard as unreasonable all royalties in excess of those which the Government would have been willing to pay, on the volume of production involved, in direct negotiation with the licensor.

5. Except in cases where there was an absence of arm's-length dealing, or where the expiration of senior patents had removed significant elements of value from the license base, it was the practice during negotiations prior to the giving of notice to assume the validity of the patent. Where, however, it proved impossible to adjust excessive royalties by agreement and it became necessary to issue a notice under the Act, the policy was to make inquiry with regard to the validity and scope of the licensed patent, and to take into account, in fixing fair and just compensation, the findings in regard thereto. Even in such cases, however, it was the practice to limit the use of zero-royalty orders (on grounds of patent invalidity) to those cases where a prior patent or printed publication, or indisputable evidence of prior use, was available to support the conclusion of invalidity as a matter of direct anticipation.

6. In some cases, involving a substantial increase of annual royalties in wartime as compared with prior peacetime years, it was pointed out by the licensor that the Government's probable future disposal of surplus stocks would have the effect of saturating the postwar civilian market with the patented devices, and reducing the patentee's royalty expectancy in years immediately following the war. This situation tended to appear in cases involving royalties on fire-fighting equipment, machine tools, and other apparatus of long life which was bought in large quantities during the war, would be expected to have a long postwar life, and was likely to find its way through the machinery of surplus disposal into civilian hands after the war. In situations of this kind it was the policy of the two departments to take into consideration, in the licensor's favor, anticipated diminution of his post-war royalty income. In a few cases of this kind the factor mentioned was held to justify considerably higher wartime royalties than might otherwise have been approved.

7. In a few cases it was found that excessive and unreasonable royalties were being charged to the departments under a private agreement which, in terms, transferred to the war contractor the entire ownership of the patent, leaving in the grantor no title or ownership whatsoever except the right to receive royalties. Most of these cases, as it happened, were of the type mentioned in paragraph 4 above—*i.e.*, the private agreement was entered into with the expectation that the royalty burden would be passed on to the Government, and there was a lack of arm's-length deal-

ing. The departments determined that such transactions, even though literally sales and not licenses, were, when they produced unreasonable or excessive royalties, the kind of agreements which it was the purpose and intent of the Act to reach. Accordingly, mandatory orders were made in at least two such cases. While the administrative construction thus placed upon the Act is believed to be a sound one, and fully justified by its legislative history, it would no doubt be well, in drafting similar legislation for a future emergency, to provide expressly for the adjustment of excessive royalties arising in connection with a sale of the patent, as well as in licenses.

8. In a considerable number of cases it was found that the licensee had agreed to pay a percentage on sales or a fixed sum per unit (sometimes labeled "royalties" or "engineering fees," or not specifically entitled or described) in consideration of the licensor's both granting a license to use an invention and undertaking to supply engineering services or assistance to the licensee. Sometimes such assistance consisted merely of furnishing drawings at the inception of the contract without subsequent assistance; sometimes engineering supervision and assistance was to continue throughout the term of the contract. The two departments took the position that, while the Royalty Adjustment Act gave authority to adjust that part of the agreed payment which was made in consideration of the grant of a license to use an invention, it did not authorize the adjustment of fees paid solely for technical information or engineering services. In dealing with cases of this kind, the War and Navy Departments adopted the policy of making a preliminary administrative determination as to the value of the technical information or engineering services actually rendered. When this value had been deducted from the total payments due under the agreement, the balance was considered to be royalties for the use of the invention. This policy was based upon the belief that the effect of the statute upon that portion of the payments attributable to a license for the use of an invention could not be avoided or defeated by reason of the fact that such royalties were intermingled with payments for something else. In one or two cases of this type the contract itself afforded means of severance; in others it became necessary to make the administrative determination referred to above.

9. A somewhat similar question arose in connection with leases of patented machinery, where the stipulated consideration was a rental or royalty based upon the extent of use. Most contracts of this kind were found to be drawn in the form of a patent license, authorizing use of a particular machine for a particular purpose, upon a royalty of so much per item produced or processed. Usually there were many hundreds of such licenses outstanding under a particular patent or group of patents. In these situations the War and Navy Departments took the position that the payments specified in the contract covered not only royalty for the use of the invention, but also rental for the use of the machine, since in most cases the risks and burdens of ownership were retained by the licensor. Thus, these cases were,

in effect, dealt with in a manner similar to those mentioned in paragraph 8, above. An administrative determination was first made as to the fair rental value of the machines, apart from the value of license rights under the patents thereon. The residue of the specified payments was then deemed to be royalties for the use of inventions, and was examined for reasonableness in accordance with the requirements of the statute.

10. A few licenses were found to contain price-fixing provisions. Where purchases by the armed forces from the licensee at prices below those specified in the license were, by the terms of the instrument, unlicensed sales, the War and Navy Departments took the view that no royalty payments under the license would be reimbursed to the licensee and the Government would treat the procurement as unlicensed and as giving to the patentee his normal rights under the Act of 1910. Where, however, Governmental purchases from the licensee were licensed even though his sales were in breach of a price-maintenance agreement, the policy was adopted by the War Department (the Navy Department had no such cases) that the price-fixing provisions would be regarded, in part at least, as a benefit flowing to the licensee under the agreement which was not availed of by the Government. Consequently, it was concluded that a part of the royalty payment was attributable to this benefit, and an administrative determination was made allocating part of the royalties to the benefit stated. This part was treated as a non-reimbursable cost item. The balance was treated as royalty for the use of the invention, and examined for reasonableness under the statute.

11. Late in the war the question arose whether, in fixing a reasonable rate or amount for future wartime years, there should be taken into consideration the amount of royalties which the licensor had actually received in prior wartime years before the royalties were discovered. Favoring this procedure was the statutory obligation resting upon department heads to specify royalties which should be fair and just taking into account the conditions of wartime production, which arguably included the entire span of wartime years. Opposed to this procedure, however, was the fact that some licensors (but not all) were subject to renegotiation under the Renegotiation Act for the prior wartime year in which they had received royalties, and these royalty receipts were subject to renegotiation. The question was settled, in the War and Navy Departments, by adoption of the policy that, if a licensor's royalty receipts for a prior year were subject to the Renegotiation Act, these receipts would not be regarded as having been excessive for the prior year in question, and the reasonableness of future rates or amounts would be determined without regard to what had been received in the past. However, the findings made in prior renegotiation proceedings were not to be taken as binding in determining the reasonableness of royalties to be received in the future.³⁵ This policy was made necessary by the fact that renegotiation did not apply to all licensors. It produced

³⁵ ARMY PROC. REGS. §1112.11(2) as amended April 5, 1945.

the result, consequently, that the reasonableness of future wartime royalties, in those cases where licensors were not subject to renegotiation, was determined in the light of, and taking into account, the amounts actually received in past wartime years.

12. The interests of the licensor in a considerable number of license agreements were found to have been vested, on behalf of the United States, by the Alien Property Custodian. Consequently, the Custodian was the recipient of royalties accruing on war production, and in several such cases the War and Navy Departments considered these royalties to be excessive. The two departments took the position initially that the Custodian should waive such royalties altogether. The Custodian replied that some of these licenses had been vested from nationals of enemy countries, whereas others had been vested from nationals of countries occupied by the enemy. As to the former, he agreed that royalties would be waived. As to the latter, he pointed out that he was a trustee of the patents and licenses which he had vested, and that he hesitated to enter into any agreement for the reduction of royalties payable thereunder. When efforts to settle by negotiation proved fruitless in cases of the latter kind, the War and Navy Departments were compelled to proceed therein by notice and order. A considerable percentage of the orders ultimately made by the Secretaries of War and Navy were against the Alien Property Custodian as trustee for nationals of enemy-occupied countries. It should be noted that the statute authorizing the Custodian to return seized patents to such aliens expressly provides that the alien shall be bound by any notice or order, with respect to the returned patents, issued under the Royalty Adjustment Act, and shall acquire with the returned patents all rights assertable by a licensor against the United States pursuant to Section 2 of the Act.³⁶

13. Where the licensee's product made under the license was sold (often through ordinary trade channels) in part to war contractors and in part to manufacturers supplying the civilian economy, the question was presented what part of the total royalty payments were chargeable to the War and Navy Departments. This situation was involved in almost every case where the licensee was a subcontractor. Usually a fairly accurate estimate could be made, based on sales records of the licensee, allocations of the War Production Board, and military requirement forecasts, showing the percentage of total royalties which would be chargeable to the armed forces. In negotiated settlements the two departments and the licensors were uniformly successful in finding a percentage or formula mutually regarded as fair. In cases where it was clear that a substantial or very large part of the total royalties was chargeable to the armed forces, and failure of negotiation made it necessary to proceed by notice and order, the two departments left it to the licensor to submit his own evidence of segregation in any future litigation arising under the order.

14. In working out the terms of settlements and orders, the two departments sought where possible to cause the benefits of royalty reduction to inure to the Gov-

³⁶ 60 STAT. 50, 50 U. S. C. A. App. §32(c) (Supp. 1946).

ernment in the form of a reduction in price, rather than in the form of a refund by the licensee or the licensor. This objective could not, however, always be conveniently or effectively achieved, especially in cases where the licensee was a remote subcontractor, or where there were many licensees at the same or different levels in the supply ladder, or where there were so many licensees that supervision would be costly and ineffective. In entering into settlements in such cases the licensor was permitted in several instances to collect in full from his licensees and agreed to pay over to the Treasury, forthwith upon receipt, the amounts determined to be excessive. In making orders in such cases, however, the uniform practice (where price reduction was not feasible) was to require the licensee to refund to the Government the portion of the royalties found to be excessive.

During the period beginning October 31, 1942 (when the Royalty Adjustment Act became law), and ending June 30, 1945, the War and Navy Departments entered into 541 agreements adjusting royalties believed to be excessive, without the giving of notice or the commencement of formal proceedings. During the same period the Government issued 117 notices, all but about a half dozen by the War and Navy Departments. In a substantial number of cases notices were issued contemporaneously by both the War and Navy Departments to the same licensor in respect of the same license or set of licenses. As of June 30, 1945, these 117 notices had resulted in five cases closed without adjustment upon a finding that the royalties were in fact fair and reasonable, twenty settlement agreements adjusting the royalties, and forty-two orders. The remainder, 50 notices, were outstanding cases not disposed of on June 30, 1945. Of the forty-two orders mentioned, six had been converted into settlement agreements on or before June 30, 1945, leaving thirty-six orders outstanding on that date. So far as is known, only four of these orders were made by departments other than the War and Navy Departments.

In each royalty adjustment case, the Army delegate handling the matter was required to supply an estimate, based on the facts before him, as to the amount of royalty costs saved to the Government by the action taken under the Act, whether by agreement or order. For this purpose future procurement was estimated in accordance with existing military supply schedules to the end of 1945. Similar estimates were prepared by the Navy Royalty Revision Board. The total estimated savings effected by the War and Navy Departments, compiled from these sources, had reached the impressive total of \$500,000,000 by June 30, 1945. Of this amount \$17,087,580 was represented by outstanding orders. The sum last-named is, of course, contingent, because it is subject to reduction by such amounts as may be recovered in the Court of Claims. The balance, over \$475,000,000, represents patent royalty costs estimated to have been saved to the Government without possibility of offsetting recoveries, through War and Navy Department administration of the Royalty Adjustment Act.³⁷

³⁷ The figures set forth in the text are taken from a letter (and annexed exhibits), dated June 5, 1946, addressed to the Hon. H. M. Kilgore, Chairman, Subcommittee on War Mobilization, U. S. Senate,

The magnitude of the figures involved amply demonstrates the need for the Royalty Adjustment Act, and the high percentage (both numerically and dollar-wise) of adjustments effected by agreement indicates the wisdom of a policy which placed a premium upon settlement by negotiation and limited the use of mandatory powers to a minority of the cases involved. On the other hand, it is no doubt true that the methods of determining reasonableness were, to some extent, hit-or-miss. Under pressure of the war it was not feasible to make the detailed study of patent validity and scope which private parties make under peacetime conditions before entering upon extensive financial commitments. Rules of thumb, to some extent, took the place of exhaustive search and analysis. It is too much to hope that logical and perfect results were reached in all cases. Nevertheless, the achievement of a group of officers, many of them comparatively inexperienced in patent negotiation of such magnitude, in saving nearly half a billion dollars in patent costs is an operation which deserves its modest share of credit alongside the more extensive operations of re-pricing, cost analysis, renegotiation, and other legal instruments by which the armed forces undertook to exclude unreasonable profits from the costs of war.

and signed by John Kenney, Acting Secretary of the Navy, and Robert P. Patterson, Secretary of War. A copy of this letter, with annexed exhibits, was filed as a supplement to the Brief for the United States on Reargument, in *Alma Motor Co. v. The Timken-Detroit Axle Co.* (United States of America, Intervenor), No. 11, October Term, 1946, in the Supreme Court of the United States (329 U. S. 129 (1946)).