

Negotiating and Drafting Licenses to Address Potential Patent Validity Challenges

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*In January 2007, the Supreme Court handed down a decision in *Medimmune v. Genentech*, holding that a licensee did not have to terminate or breach a license agreement to have standing to bring a declaratory judgment action that a licensed patent is invalid.¹ In the aftermath of this decision, licensors began including a variety of agreement provisions intended to discourage licensees from challenging the validity of a licensed patent. However, the effectiveness of these provisions, particularly those that prohibit a licensee from ever challenging the validity of a licensed patent, continues to be an issue. In the wake of what some commentators have described as an “anti-patent” tendency of the courts,² what can a licensor do to avoid having to litigate the validity of a licensed patent with its licensee?*

LEGAL BACKGROUND ON NO-CHALLENGE PROVISIONS AND LICENSEE ESTOPPEL

Determining whether to include a restrictive covenant in a patent license preventing the licensee from challenging the validity of the licensed warrants a brief review of the case law on this topic.

In 1950, the Supreme Court in *Automatic Radio Mfg. Co. v. Hazeltine Research* announced a general rule “that a licensee under a patent license agreement may not challenge the validity of the licensed patent.”³ However, this “general rule” did not persist.

Nineteen years after the Supreme Court decision in the *Hazeltine* case, the Supreme Court had an opportunity to review the *Hazeltine* decision and the rule of patent licensee estoppel.

In *Lear Inc. v. Adkins*,⁴ the Supreme Court reviewed again the question of whether licensee should be prevented from challenging a patent covered by a license agreement with the inventor.

The Supreme Court overruled the *Hazeltine* decision that licensee estoppel is the “general rule,” holding that “in the accommodation of (1) the common law of contracts, and (2) the federal law of patents requiring that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent, the technical requirements of contract doctrine must yield to the demands of the public interest in the typical situation involving the negotiation of a license after a patent has issued.”⁵

Of particular interest in considering the viability of restrictions on the ability of the licensor to challenge the validity of a patent, the court cited with approval its earlier holding in *Pope Manufacturing Co. v. Gormully*.⁶

In *Gormully*, the court was confronted with a license agreement containing a provision that required the licensee to not dispute the validity of the licensed patents. In affirming the lower court’s decision not to grant specific performance of the agreement to the licensor, the Supreme Court stated, in pertinent part, that:

The real question is whether the defendant can estop himself from disputing patents which may be wholly void, or to which the plaintiff may have no shadow of title. . . . It is as important to the public that competition should not be repressed by worthless patents as that the patentee of a really valuable invention should be protected in his monopoly, and it is a serious question whether public policy permits a man to barter away beforehand his right to defend against unjust actions or classes of actions, though in an individual case he may doubtless assent that a judgment be rendered against him, even without notice.⁷

In essence, the *Gormully* decision seems to contemplate weighing the public interest in not being subject to invalid patents with the individual's ability to resolve litigation in a manner that may restrict their behavior going forward.

After *Lear*, a number of lower courts found no-contest provisions in licenses to be unenforceable.⁸

In *Medimmune v. Genentech*, the Supreme Court again reviewed the issue of a licensee's ability to challenge the validity of a licensed patent.

In *Medimmune*, the Supreme Court granted certiorari to review a Federal Circuit's decision dismissing a declaratory judgment complaint by a licensee in good standing to challenging the infringement and validity of a licensed patent for lack of subject matter jurisdiction.

In 1997, Genentech licensed Medimmune to an existing patent and a pending patent application. The license agreement required Medimmune to pay royalties on the sales of "Licensed Products."

The license further defined the royalty-bearing products as an antibody that would infringe either licensed patent unless the patent had expired or been determined to be invalid by a court.

Upon issuance of the second patent in 2001, Genentech informed Medimmune that it was required to pay royalties under the second patent.

However, since entering into the license and the issuance of the second patent, Medimmune's sale of licensed products increased to over 80 percent of its revenue since 1999.

In an effort to avoid a patent infringement action from Genentech, Medimmune responded by paying the royalties under protest and filing the underlying declaratory judgment action alleging that royalties

were not owing under the second patent because the patent was not valid or infringed.

The Supreme Court held that Medimmune was not required to terminate its 1997 license agreement before seeking declaratory judgment that the underlying patent is invalid, unenforceable, or not infringed and remanded the proceedings.

Of importance to this analysis is the Supreme Court review of Genentech's argument that a party to a contract cannot challenge the validity of the patents while continuing to enjoy its benefits; that is, the quid pro quo for the license was licensee's willingness to forego such challenges.

In response to Genentech's argument the Court stated, in pertinent part, that:

Of course, even if it were valid, this argument would have no force with regard to petitioner's claim that the agreement does not call for royalties because their product does not infringe the patent. But even as to the patent invalidity claim, the point seems to us mistaken. To begin with, it is not clear where the prohibition against challenging the validity of the patents is to be found. It can hardly be implied from the mere promise to pay royalties on patents "which have neither expired nor been held invalid by a court or other body of competent jurisdiction from which no appeal has been or may be taken," App. 399. Promising to pay royalties on patents that have not been held invalid does not amount to a promise *not to seek* a holding of their invalidity.⁹

In the aftermath of *Medimmune*, commentators read the court's decision as implying that the court might enforce a provision in the license agreement under which the licensee agreed not to challenge the validity or noninfringement of the patents covered by the license.¹⁰

In response to the decision, licensors began including no-challenge clauses in their license agreements.

One such license agreement was entered into less than four months after the issuance of the *Medimmune* decision and later became the subject of a decision by the Second Circuit Court of Appeals.

In *Rates Technology Inc. v. Speakeasy, Inc.*,¹¹ the Second Circuit Court of Appeals, on transfer from the Federal Circuit Court of Appeals, reviewed

“[I]t is clear that the licensor cannot rely on a no-challenge clause to prevent the licensee from subsequently challenging the licensed patent,”

a district court’s holding that a no-challenge clause in the April 30, 2012, license agreement was unenforceable.

The no challenge provision read as follows:

Speakeasy hereby warrants and represents to RTI that on and after the execution date of this Covenant Speakeasy will not anywhere in the world challenge, or assist any other individual or entity to challenge, the validity of any of the

claims of the Patents or their respective foreign counterpart patents or their respective foreign counterpart patent applications, except in defense to a Patent infringement lawsuit brought under the Patents against Speakeasy, its [products and services], and except as otherwise required by law.¹²

The license agreement further included a following liquidated damages clause which would be triggered by a breach of the no-challenge provision:

In the event that the above representation is incorrect then Speakeasy agrees that it shall pay to RTI as liquidated damages the additional amount of Twelve Million U.S. (\$12 Million) Dollars plus all legal expenses necessary to collect this added amount.¹³

In affirming the District Court’s dismissal of RTI’s complaint-seeking enforcement of the liquidated damages provision agreement, the Second Circuit noted that competing policy decisions may affect the enforceability of a no-challenge provision.

In particular, the court reviewed the public interest in resolving litigation disputes against the public interest in eliminating invalid patents.

The court went on to differentiate a license agreement made prior to litigation between the parties with one entered into in settlement of ongoing litigation where the parties have had an appropriate opportunity to explore the merits of an invalidity challenge.

After reviewing these competing policies, the court held that covenants barring future challenges to a patent’s validity entered into prior to litigation are unenforceable.¹⁴

Recently, the Patent Trial and Appeal Board (PTAB) reviewed the applicability of a no-challenge clause between the parties to an inter partes review.

In *Dot Hill Corp. v. Crossroads Systems Inc.*,¹⁵ the patent owner responded to a petition for review arguing that a previous settlement agreement between the parties containing a no-challenge clause warranted denial of the petition.¹⁶

In response to the patent owner’s argument, the petitioner replied that the PTAB was not given jurisdiction by Congress to consider the patent owner’s estoppel argument.¹⁷

Siding with the petitioner’s position, the PTAB found that there was no statutory basis for affirmative estoppel-based defenses precluding institution of an inter partes review and instituted the requested review.¹⁸

POTENTIAL STRATEGIES FOR THE LICENSOR

Given the above legal background, it is clear that the licensor cannot rely on a no-challenge clause to prevent the licensee from subsequently challenging the licensed patent, except in limited circumstances.

However, there are other strategies that may be implemented to maintain the intended relationship with the licensee.

- **Portfolio Licensing.** To the extent that you are licensing competitors and have a number of patents that may be relevant to their product portfolio, the more patents that the license covers the less likely you are to face invalidity challenges.

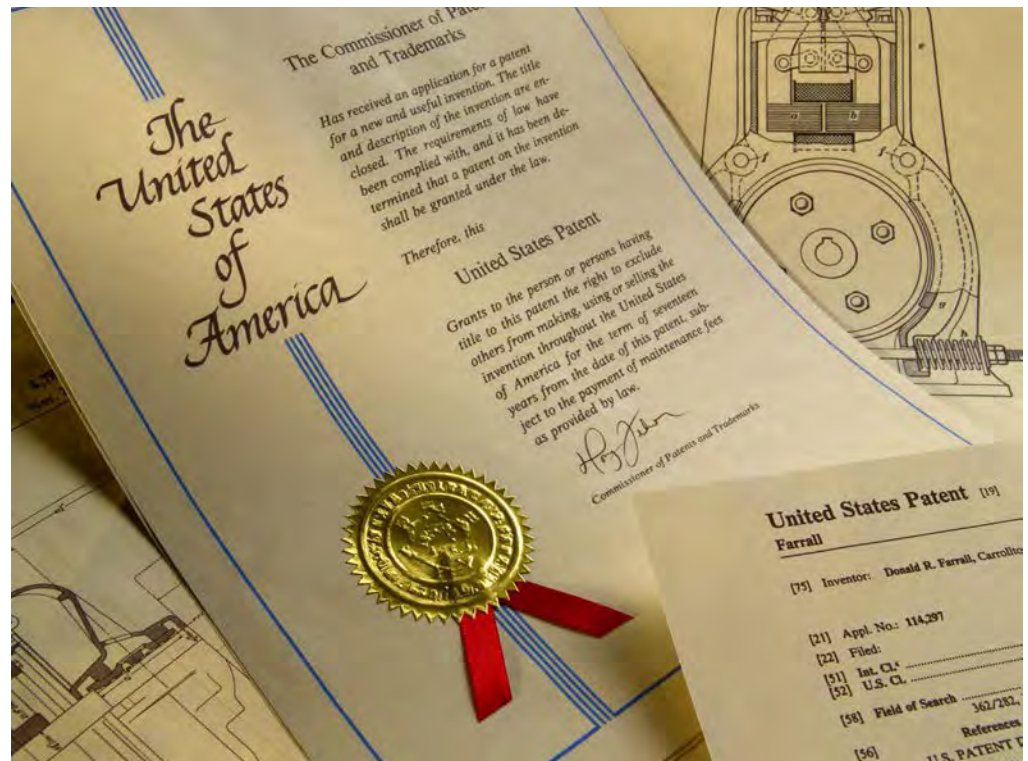
Obviously, the decision whether to proceed with a portfolio license depends on the size of the portfolio and an understanding of the competitive environment.

Among the important issues to consider is whether certain patents in the portfolio cover important product features that differentiate your products from those of your competitors in the marketplace. A portfolio license by necessity must include a license back from your licensee of appropriate scope.

- **Hybrid Licenses.** Consider whether you have other intellectual property that may be included in the agreement.

To the extent you have trade secrets or software which implement the technology that you are willing to license in exchange for an appropriate royalty, a licensee is less likely to challenge the validity of a patent that is encompassed by the license.

In the event that the licensee does challenge the patent validity, the royalty stream accountable to the licensed technology or software should continue during and after the challenge to the licensed patent.



While a no-challenge clause is likely to be unenforceable except in the case of litigation settlement agreements, there are other provisions which may deter a licensee from challenging a licensed patent.

Among the potential provisions to consider are the following:

- Add an option to terminate the license (or at least the license to the challenged patent) in the event the licensee initiates an invalidity proceeding.
- Require that the licensee pay attorney's fee and costs in the event that the challenge is unsuccessful.
- Identify a patent-friendly jurisdiction and venue where a licensee would be required to challenge the patent.
- Include a notice provision requiring the licensee to inform you before initiating any challenge, requiring that the parties confer before initiating the proposed challenge regarding the basis for the challenge in an effort to resolve the issue.
- Include a provision modifying the royalty in the event of a challenge and a decision in your favor by increasing the royalty rates or accelerating the royalty payments.

- Consider requiring a nonrefundable lump sum royalty payment in the event of a challenge.
- Since most license negotiations are not concluded without significant deliberations about the patents and technology at issue, consider summarizing the effort engaged in by the parties.
- Define the licensed products broadly to capture the technology covered by the licensed patents.

Many of the licenses the author sees generally define the licensed products as any product that may infringe a valid claim of any of the licensed patents.

This definition leaves in question what particular products are subject to the license as well as the validity of the patents at issue, which are the very concerns that started the *Medimmune* case.

- Consider the term of the license and whether it should be limited to a specific term or the lives of the patents at issue.

CONCLUSION

Your ability to implement these strategies and incorporate some of these provisions in your

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agreements obviously will depend on the nature and strength of the intellectual property at issue as well as the relative bargaining positions of the parties involved.

However, the potential reward in both monetary royalties and the freedom of action to proceed with your business that can be achieved through licensing your intellectual property can be significant to your business and well worth the effort involved.

Notes:

1. *Medimmune v. Genentech*, 549 U.S. 118 (2007).
2. See: e.g., <http://www.ipwatchdog.com/2014/11/13/is-there-an-anti-patent-bias-at-the-federal-circuit/id=52139/>; <http://www.insidecounsel.com/2014/08/13/like-a-wrecking-ball-the-troubling-trend-of-patent>.
3. *Automatic Radio Mfg. Co. v. Hazeltine Research Inc.* 339 U.S. 827, at 836 (1950).
4. *Lear Inc. v. Adkins*, 395 U.S. 653 (1969).
5. *Id.*, at 655.
6. 144 U.S. 224 (1892).
7. *Id.*, at 234.
8. See: e.g., *Bendix Corp. v. Balax, Inc.*, 471 F.2d 149, 158 (7th Cir. 1972) (holding the clause in a license agreement which stated that licensee “will not contest the validity of any patent which is now a part of this agreement during the life of this agreement” is null and void under *Lear*); *Panther Pumps & Equip. Co., v. Hydrocraft, Inc.*, 468 F.2d 225, 231 (7th Cir. 1972) (“[I]n 1969, the Supreme Court held that a licensee is not estopped to challenge the validity of a patent; in view of that holding, the “no contest” provision in [a] license is plainly unenforceable.”); *Plastic Contact Lens Co. v. W.R.S. Contact Lens Labs., Inc.*, 330 F. Supp. 441, 443 (S.D.N.Y. 1970) (“Each such defendant likewise violated the no-contest covenant of the respective license agreements, but that covenant does not estop defendants from challenging the patent’s validity”); *Congoleum Industries, Inc. v. Armstrong Cork Co.*, 366 F. Supp. 220, 232 (E.D. Pa. 1973) (aff’d, 510 F.2d 334 (3d Cir. 1975)) (“The decision in *Lear* struck down the enforceability of contractual provisions which preclude licensees from contesting the validity of the licensed patent.”); *Kraly v. Nat’l Distillers & Chem. Corp.*, 319 F. Supp. 1349, 1353 (N.D. Ill. 1970) aff’d, 502 F.2d 1366 (7th Cir. 1974) (concluding that “the *Lear* reasoning vitiates the force and effect of the covenant not to contest the validity of the patent . . .”); *Blohm & Voss AG v. Prudential-Grace Lines, Inc.*, 346 F. Supp. 1116, 1141 (D. Md. 1972) (rev’d on other grounds, 489 F.2d 231 (4th Cir. 1973)) (“*Lear* certainly held that a licensee was not, by virtue of a license, estopped to raise the question of invalidity of the patent when sued for infringement. A fortiori, clauses specifically negating this right are invalid.”); *Massillon-Cleveland-Akron Sign Co. v. Golden State Advert. Co.*, 444 F.2d 425, 427 (9th Cir. 1971) (holding a no-contest clause was in “direct conflict with the ‘strong federal policy’ referred to repeatedly in *Lear*, as was the estoppel doctrine and the specific contractual provision struck down in that decision.”); *Robintech, Inc. v. Chemidus Wavin, Ltd.*, 450 F. Supp. 817, 821 (D.D.C. 1978) (“Though no-contest clauses indubitably are unenforceable against the licensee under *Lear*, . . . such a clause, standing alone, is unlikely to constitute patent misuse, particularly if the patentee has indicated, as did defendant here, that the clause will not be enforced.”); *Wallace Clark & Co. v. Acheson Indus., Inc.*, 401 F. Supp. 637, 639 (S.D.N.Y. 1975) (“The effect of *Lear* was to render unenforceable any license agreement provision that attempts to prevent the licensee from contesting the validity of the patent as a defense to an action by the licensor to enforce the license agreement.”).
9. *Id.*, at 135.
10. See, e.g., <http://www.paulweiss.com/media/103975/NYLJ2-1-07.pdf> and <http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=d16c3352-ac57-4cd7-a84d-5ad5525281a1>
11. *Rates Technology Inc. v. Speakeasy Inc.*, 685 F.3d 163 (2nd Cir, 2012).
12. *Id.*, at 165.
13. *Id.*, at 165.
14. *Id.*, at 172.
15. *Dot Hill Corp. v. Crossroads System Inc.* Case IPR2015-00822 (PTAB, February 27, 2015).
16. *Id.*, Paper No. 13 (PTAB, June 16, 2015).
17. *Id.*, Paper No. 16 (PTAB, July 17, 2015).
18. *Id.*, Paper No. 20, (PTAB, Sept. 17, 2015).

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