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LICENSORS BEWARE! SECOND CIRCUIT DECISION CONFIRMS POLICY CONCERNS IN PATENT LAW TRUMP CONTRACT LAW

Intellectual Property Litigation Alert
January 9, 2013

Practices & Industries

Intellectual Property Litigation

A recent decision of the Federal Appeals Court for the Second Circuit, holding that private contract agreements must yield to public policy concerns in patent law, may well require a reevaluation of the risks in technology licensing. A common provision in license agreements, particularly those negotiated after a patent owner has asserted its patent against a potential infringer, is a "no-challenge clause," precluding the licensee from challenging the validity of the licensed patent. The security of the no-challenge provision is part of the compensation received by the patent owner, potentially resulting in a lower royalty charge, and theoretically advancing public policy by encouraging the spread of technology.

But in *Rates Technology, Inc. v. Speakeasy*, 685 F.3d 163 (2d Cir. 2012), the Second Circuit held that such no-challenge clauses are unenforceable. Specifically, the court stated that a no-challenge clause in a pre-litigation settlement agreement is void because it is against public policy. Examining the context of a pre-litigation license agreement, the court recognized that the grant of a patent is a mere conclusion reached in an *ex parte* proceeding, based on factors "as to which reasonable men can differ widely." *Id.* at 168 (citing *Lear, Inc. v. Adkins*, 395 U.S. 653, 670, 89 S.Ct. 1902 (1969). Preventing a licensee from challenging a patent's validity will stifle the public interest in permitting full and free competition in the use of ideas, which may properly be in the public domain. And because, as the court in *Lear* explained, "Licensees may often be the only individuals with enough economic incentive to challenge the patentability of an inventor's discovery," muzzling them may result in improper monopolistic practices by patentees. See *Lear*, 395 U.S. at 670-71. Therefore, the court held that such no-challenge clauses, negotiated pre-litigation, are unenforceable.

Rates Technologies relies on the Supreme Court decision in Lear, Inc. v. Adkins, 395 U.S. 653; 89 S.Ct. 1902; 23 L.Ed. 2d 610 (1969), where the court held contract law estoppel provisions must give way to the public policy supporting free and open use of ideas. As "[l]icensees may often be the only individuals with enough economic incentive to challenge the patentability of an inventor's discovery. If they are muzzled, the public may continually be required to pay tribute to would-be monopolists without need or justification. We think it plain that the technical requirements of contract doctrine must give way before the demands of the public interest in the typical situation involving the negotiation of a license after a patent has issued." *Lear*, 395 U.S. at 670-71.

While *Rates Technologies* highlights the danger in relying on a licensee conceding validity of a patent that was never challenged in court, it explains the distinction between pre-litigation license/settlement agreements and during-litigation/post-litigation agreements. For example, in *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362, 1370 (Fed. Cir. 2001), the federal circuit held that a no-challenge clause in a settlement agreement—post-discovery and post-summary judgment—was held to be valid and enforceable. The significance of the timing of the parties' negotiations is two-fold:

• First, because the alleged infringer conducted discovery, she had a full opportunity to assess the validity of the patent, and therefore made an informed decision to abandon her challenge to its validity.

• Second, conducting discovery and briefing summary judgment on the validity of the patent at issue indicates that the parties had a genuine dispute over the patent's validity and that the patent owner was not seeking to prevent its monopoly from being challenged by characterizing an ordinary license agreement as a settlement agreement.

Rates Tech., 685 F.3d at 172. Stated more succinctly, a license agreement or settlement agreement reached after discovery on the validity of the patent(s) at issue provides the licensee with his or her "day in court." The *Rates Technologies* decision implicitly grants greater security to those engaging in litigation prior to licensing, hardly the best way to promote movement of intellectual capital. And consistent with this "grant" is the holding in *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007), where a licensee was permitted to challenge the validity of a newly issued patent that was potentially subject to its already existing license agreement. The court held that the licensee should not be forced to breach its license agreement, in order to have standing to challenge the validity of a newly granted child patent of an existing licensor-licensee relationship. While it is unclear whether a no-challenge clause was part of the license agreement in *MedImmune*, what is clear is that authoritative courts continue to promote validity challenges in litigation, i.e., under the Declaratory Judgment Act.

The ability to license technology is an essential tool for investors to recoup investments in new technology. Because the Second Circuit decision essentially nullifies no-challenge clauses—at least those governed by Second Circuit law—licensors must factor this risk into their royalty rate calculation for future license negotiations. Consider revising your standard license agreements accordingly.