

## Outside Counsel

## Expert Analysis

# Second Circuit Holds Clauses Not to Challenge Patents Unenforceable

In July 2012, the U.S. Court of Appeals for the Second Circuit ruled in *Rates Technology v. Speakeasy*, 685 F.3d 163 (2012), that a provision in a pre-litigation settlement agreement precluding a party from challenging the validity of a patent was unenforceable as against the public policy announced in *Lear v. Adkins*, 395 U.S. 653 (1969). The opinion calls into question a number of standard clauses which patent owners have used to control validity challenges by licensees and settling parties. When the opinion is combined with the Supreme Court's decision in *MedImmune v. Genentech*, 549 U.S. 118 (2007) (holding that licensees need not repudiate their license before challenging patent validity), licensees are now in a prime position to challenge patent validity. Patent owners are advised to factor in an increased risk of challenges to patent validity in their settlement positions.

### Background

Rates Technology Inc. (RTI) owns a number of patents for telecommunications technology and is a frequent litigator. In 2007 it accused Speakeasy Inc., a telecommunications company, of infringing two patents. After some negotiations, the parties entered into a "covenant not to sue," which included a provision barring Speakeasy from ever challenging or assisting others in challenging the validity of the licensed patents. The no-challenge clause was accompanied by a liquidated-damages provision that provided that in the event Speakeasy were to violate its terms, it would have to pay \$12 million in liquidated damages, plus legal expenses to collect that amount. At the time, Speakeasy was in the process of being acquired by Best Buy Co. Inc.; Best Buy joined in the covenant not to sue.

Three years later, Best Buy announced plans to sell Speakeasy and merge it with a business consortium named the Covad Group. After the announcement, RTI notified one of the entities in the Covad Group that it believed it was infringing its patents, including those that had been licensed to Speakeasy. In response, Covad filed an action in the Northern District of California seeking a declaratory judgment that the patents were invalid.



By  
**David A.  
Kalow**



And  
**Milton  
Springut**

RTI then filed suit in the Southern District of New York, alleging that during the merger negotiations, the parties had learned of RTI's charges of patent infringement, and Speakeasy or Best Buy provided information relating to RTI's patents, which Covad Group allegedly used to file the California declaratory judgment action. RTI accordingly sought to collect the contractual liquidated damages.

Speakeasy and Best Buy moved to dismiss the New York action, arguing that under *Lear*, the no-challenge clause was void as contrary to public policy. The district court agreed and dismissed RTI's Complaint. 2011 WL 1758621 (S.D.N.Y. 2011). RTI appealed to the U.S. Court of Appeals for the Federal Circuit, which held that it lacked jurisdiction and then transferred the action to the Second Circuit. 437 Fed. Appx. 940 (Fed. Cir. 2011). The Second Circuit affirmed.

### Second Circuit Reasoning

The Second Circuit began by noting that *Lear* held that the common law doctrine of licensee estoppel is void as contrary to federal patent policy. Licensee estoppel, rooted in contract law, generally forbids a party to both benefit from the contract and challenge its terms. Accordingly, a patent licensee that benefitted from a patent license is estopped from challenging the validity of the licensed patent. In contrast, federal patent policy requires that "all ideas in general circulation be dedicated to the common good, unless they are protected by a valid patent." In *Lear*, the Supreme Court held that licensee estoppel was contrary to this federal patent policy and could not be enforced.

*Lear* itself only dealt with the implicit legal doctrine of estoppel, not express no-challenge clauses. It did, however, hold that a different express license provision—that the licensee would have to continue paying royalties until invalidity had been determined by a court—was invalidated by *Lear* on the same policy grounds. 395 U.S. at 673. Later cases have

generally interpreted *Lear* as invalidating even express no-challenge clauses in ordinary patent licenses. See *Idaho Potato Commission v. M&M Produce Farm & Sales*, 335 F.3d 130, 137-38 (2d Cir. 2003).<sup>1</sup> However, the question remained how *Lear* applies to agreements meant to resolve infringement disputes between intellectual property owners and those accused of infringement.

The Second Circuit in *Rates Technology* noted that disputes regarding patent infringement validity often are resolved by parties consensually. The court understood *Lear* as establishing a "balancing test" between the competing public interests of encouraging settlement and identifying invalid intellectual property, which it applied in the case. It then noted several methods by which disputes can be resolved:

Patent owners are advised to factor in an increased risk of challenges to patent validity in their settlement positions.

1) **Through litigation and entry of a final judgment.** A final judgment is usually conclusive among the parties under *res judicata*. The Second Circuit noted that no court has ever held that *res judicata* should not apply because of *Lear's* public policy.

2) **Through entry by the parties of a consent decree so ordered by the court.** Most such decrees estop future challenges to patent validity. The Second Circuit so held in *Wallace, Clark & Co. v. Acheson Industries*, 532 F.2d 846, 849 (2d Cir. 1976). The policy of finality of judgments was deemed to be more important than the *Lear* policy.

3) **Through private settlement by execution of a settlement agreement and a dismissal, after the initiation of litigation.** Prior Second Circuit law held that a mere settlement agreement, without more, does not estop a future challenge to patent validity. However, the Second Circuit had left open the possibility that an express no-challenge clause in such an agreement would be valid. In *Flex-foot v. CRP*, 238 F.3d 1362, 1367-70 (Fed. Cir. 2001), the Federal Circuit upheld such a clause, reasoning that the public policy of enforcing settlements was more important than the *Lear* policy of identifying invalid patents identified.

DAVID A. KALOW and MILTON SPRINGUT are partners at Kalow & Springut. TAL S. BENSCHAR, a partner at the firm, assisted in the preparation of this article.

4) **Through private settlement agreement prior to the initiation of any litigation.** In *Massillon-Cleveland-Akron Sign v. Golden State Advertising*, 444 F.2 425 (9th Cir. 1971) the court held that the *Lear* public policy was more important than the policy of enforcing settlement contracts, and thus held that a no-challenge clause contained in a pre-litigation settlement agreement was unenforceable.

The Second Circuit found that the pre-litigation settlement agreement in *Rates Technology* most closely matched that found unenforceable by the Ninth Circuit in *Massillon* and therefore the no-challenge clause was unenforceable. It reasoned that if no-challenge clauses in pre-litigation settlement agreements are upheld, then every license will simply be labeled a “settlement agreement,” and the result in *Lear* could be easily circumvented through mere clever drafting.

*Rates Technology* distinguished a line of Federal Circuit cases, beginning with *Flex-foot*, that hold that a different rule applies once litigation has been initiated, by holding that those Federal Circuit cases applied only to post-litigation agreements and consent orders, not to pre-litigation agreements. The Second Circuit did note *Baseload Energy v. Roberts*, 619 F.3d 1357 (Fed. Cir. 2010), which considered a pre-litigation contractual release, but held that the release did not preclude a validity challenge.

Long-standing Federal Circuit precedent requires “clear and unambiguous language” to estop patent validity challenges, and the requisite clarity was found lacking. While *Baseload Energy* certainly suggests that, had the language been clear enough, it would have barred an invalidity claim, the Second Circuit rejected that implicit suggestion as mere dictum.

*Rates Technology* is in tension with these Federal Circuit cases. The Federal Circuit view seems to be that any time there is an infringement dispute, the federal interest in settlement of patent disputes is more important than the *Lear* policy of identifying invalid patents. If a no-challenge clause is “clear and unambiguous,” the Federal Circuit would likely uphold it.

### Pre- and Post-Litigation

The distinction between pre- and post-litigation agreements seems forced. The Second Circuit was concerned that, if it upheld the no-challenge clause, then it would be too easy for every licensor to manufacture a “good faith” infringement dispute and then draft a “settlement agreement,” thus rendering *Lear* too easily circumvented. It also reasoned that prior to litigation, parties will not have had an opportunity to conduct discovery that may shed light on validity issues. Conducting discovery (a) suggests that the contracting party has had an opportunity to investigate the patent validity and make an informed decision and (b) evidences that the parties have a genuine dispute over the patent’s validity, rather than being a case of a patent owner “seeking to prevent its monopoly from being challenged by characterizing ordinary licensing agreements as settlement agreements.”

But the Second Circuit’s distinction itself seems too easily circumvented. Parties can always file an action and then agree to settle. RTI made this very argument—that parties to such agreements would simply go through the “charade” of filing and then settling litigation. The Second Circuit pooh-poohed that suggestion: “[O]ur holding does not bar pre-litigation patent settlements, and patent owners need not go through the ‘charade’ of litigating an infringement

action in order to collect any royalties due to them. We doubt that parties would find it desirable to conduct expensive discovery in order to validate a no-challenge clause.” 685 F.3d at 173.

This response ignores the economic realities of patent practice. Settlement agreements typically contain some form of license in exchange for payment. A no-challenge clause has value to a patent owner—it precludes it from needing to deal with the contingency of a future challenge to its patent and further ensures any agreed-to future revenue stream. Presumably, this value is built into the licensing price—and a party who refuses to agree to a no-challenge clause would have to pay a higher rate to compensate for this contingency. Given that patent litigation is so expensive, the possibility of precluding future patent challenges may well be valuable enough to justify the expense of filing an action to validate such a clause.

---

While certainly a party will usually learn more through formal discovery, the issue is whether a party that has agreed to a no-challenge clause has made an “informed decision,” not whether the decision was made on the maximum possible knowledge.

The Second Circuit’s distinction is also problematic in presuming that a pre-litigation decision to settle a case is not well informed. There is no reason that parties cannot conduct discovery informally even before filing a case. Although pre-litigation depositions rarely occur, parties accused of infringement can and often do perform substantial due diligence. The most common reason for invalidating a patent—the existence of “prior art” which either anticipates the invention or renders it obvious—does not require formal discovery at all. By definition, “prior art” must be publicly available. Parties can and typically do conduct thorough prior art searches wholly outside the discovery rules—through review of public databases of worldwide patent offices, and through use of patent search companies.

While certainly a party will usually learn more through formal discovery, the issue is whether a party that has agreed to a no-challenge clause has made an “informed decision,” not whether the decision was made on the maximum possible knowledge. The availability of substantial pre-trial investigation and due diligence may often be more than enough to make such a decision “informed.”

### Licensing and Settlement

**Boundary Between Pre- and Post-Litigation Agreements.** According to *Rates Technology*, what must be done to transform a situation from pre-litigation to post-litigation, and hence validate a no-challenge clause? The Second Circuit’s statement— “[w]e doubt that parties would find it desirable to conduct expensive discovery in order to validate a no-challenge clause”—suggests that merely filing and serving a complaint, and then settling the case with an agreement and dismissal, are insufficient. How much

discovery must be conducted? Is written discovery (document requests and interrogatories) sufficient, or do depositions have to be taken? If so, whose and how many? What invalidity issues (or, in some cases, unenforceability issues) need to be the subject of discovery—anticipation, obviousness, enablement, best-mode, inequitable conduct, patent misuse?

**Validity of Challenge Discouragement Provisions.** *Rates Technology* also raised the issue of what other provisions often used to deter validity challenges might be found void as against public policy. In *MedImmune*, supra, the Supreme Court held that a patent licensee need not cease paying royalties and open itself up to a charge of infringement in order to sustain a justiciable claim challenging the validity of a patent. After *MedImmune*, patent licensing practitioners suggested a number of provisions to discourage (although not completely prohibit) licensee challenges. Such suggested challenge-discouragement provisions include:

1. License termination provision—either automatic or at the licensor’s option—in the event of a challenge to the patent.
2. Increased royalty payments in the event of a patent challenge (alternatively, in the event of an unsuccessful patent challenge.)
3. Attorney fees and costs for unsuccessful challenges.

After *Rates Technology*, these types of discouragement clauses are arguably subject to legal challenge.

**Increased Licensing Costs.** Patent owners need to be aware that after *MedImmune* and *Rates Technology* licensing their patents has an increased risk of resulting in challenges to patent validity—which can be both expensive and risky to the underlying patent. Such increased risks need to be factored into the licensing or settlement costs. In fact, we believe one (unintended) consequence of *Rates Technology* will be increased costs of licensing patents or settling patent disputes.

Finally, we note one aspect not touched upon by the *Rates Technology* opinion. The covenant not to sue contained a provision that the parties would not “challenge, or assist any other individual or entity to challenge” the identified patents. Speakeasy and BestBuy did not themselves challenge the patents, they merely assisted the Covad Group, then a potential merger partner, to do so. In our view, the public policy implications of a “no assistance” clause are more serious, and are more likely to implicate *Lear*, than merely barring that party itself. Such a “no assistance” clause comes close to trying to conceal or restrict access to information relevant to a patent’s validity. Parties litigating future cases would be well advised to consider such an argument when dealing with such provisions.

---

1. Interestingly, *Idaho Potato Commission* involved a trademark license, but the Second Circuit held that *Lear* applies to all intellectual property agreements. See also *Twin Books v. Walt Disney*, 877 F.Supp. 496, 500 (N.D.Cal. 1995), *rev’d on other grounds*, 83 F.3d 1162 (9th Cir. 1996) (*Lear* applies to copyright license).