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The author reviews a recent Second Circuit ruling invalidating a ''no challenge'' clause in a patent infringement settlement agreement, and he offers practical considerations to patent owners and licensees.

Second Circuit Revives *Lear* Doctrine to Void 'No-Challenge' Clause in Prelitigation Patent Infringement Settlement

BY RONALD ABRAMSON

The U. S. Court of Appeals for the Second Circuit recently held that a clause in a pre-litigation settlement agreement that bars a patent licensee, either alone or assisting others, from later challenging the patent's validity is void for public policy reasons. *Rates Technology Inc. v. Speakeasy Inc.*, No. 11-4462-cv, 2012 BL 170872 (2d Cir. July 10, 2012) (84 PTCJ 463, 7/20/12).

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The decision is important because clauses such as those struck down in this case are very common in licenses and settlements of intellectual property disputes involving trademarks and copyrights as well as patents. These licenses and settlements occur in a variety of contexts, including disputes between competitors, as well as disputes between operating companies and ''non-practicing entities''—companies whose principal business concerns licensing and enforcing patents.

Where possible, would-be litigants routinely resolve such disputes prior to or shortly after they arise, in order to avoid the expense of protracted litigation. The recent Second Circuit decision highlights some of the uncertainties remaining in this area in entering these agreements.

The decision also raises questions concerning the allocation of appellate jurisdiction and precedential rulemaking authority between the Federal Circuit and the regional courts of appeals, in cases concerning patent policy.

More broadly, the decision, which breathes new life into the *Lear v. Adkins* doctrine of the late 1960s, demonstrates the continued tension between IP and competition concerns in assertion of IP rights and resolution of IP disputes. Both private parties and government regulators have in recent months renewed focus on enforcement of questionable or ''weak'' patent rights, ''pay for delay'' settlements in the pharmaceutical industry, and efforts to exploit standard-essential patents.

The plaintiff in the action was Rates Technology Inc., a company that has brought over a hundred lawsuits to enforce two patents that it owns relating to automatically routing telephone calls based on cost. The action was for breach of contract and arose out of a 2007 agreement between Rates and Speakeasy Inc., a company that was then about to be acquired by Best Buy.

The 2007 agreement released any claims for infringement of the two Rates patents that Rates had asserted against Speakeasy. The agreement granted a license of the asserted patents to Speakeasy and its affiliates, in exchange for a one-time payment of $475,000.

The agreement contained a clause providing that the licensee would neither challenge the validity of the licensed patents nor ''assist any other individual or entity'' to do so, and making the licensee liable to pay $12 million in ''liquidated damages'' in the event it violated the no-challenge provision. The agreement was styled a ''Covenant Not to Sue,'' and was entered into before any litigation had been filed.

Three years later, Speakeasy was divested by Best Buy to entities affiliated with Covad Communications Co. Around the same time, Rates asserted its patents against Covad Co. (another Covad affiliate that evidently was not covered by Speakeasy's license).

Covad Co. filed an action in the Northern District of California seeking a declaratory judgment that the Rates patents were invalid. It came to Rates' attention that as a result of due diligence in connection with Speakeasy's divestiture from Best Buy, Speakeasy and/or Best Buy had provided to the Covad entities information concerning the Rate patents; and that this information was in turn provided to Covad Co., which used it to fashion its declaratory judgment complaint.

Shortly thereafter, Rates filed a separate action in the Southern District of New York against Speakeasy, Best Buy, and the various Covad entities, seeking to hold them jointly and severally liable for breach of the 2007 agreement between Rates and Speakeasy. The district court dismissed the action, on the basis that the no-challenge clause in the 2007 agreement was unenforceable in view of *Lear*.

Since the suit was based on contract, and not on patent infringement or invalidity, it was not within the exclusive appellate jurisdiction of the Federal Circuit, and therefore was subject to review by the responsible regional court of appeals, i.e., the Second Circuit. (In fact, the appeal was originally filed in the Federal Circuit, but transferred by it to the Second Circuit.)

The Second Circuit affirmed the dismissal.

The Second Circuit began its analysis with the Supreme Court's decision in *Lear Inc. v. Adkins*, 395 U.S. 653, 162 USPQ 1 (1969). *Lear* had abolished the rule of ''licensee estoppel'' for patent licenses. The Supreme Court held in *Lear* that although pure contract principles might support the conclusion that a licensee was estopped, by virtue of having taken a patent license, from challenging the validity of the licensed patents, such result was precluded by overriding federal policies favoring the ability of members of the public to challenge the validity of patents.

The licensee in *Lear* repudiated its agreement and had stopped paying royalties. More recently, in *MedImmune Inc. v. Genentech Inc.*, 549 U.S. 118, 81 USPQ2d 1225 (2007) (73 PTCJ 242, 1/12/07), the Supreme Court dealt with a case in which a non-repudiating licensee under a license providing for a running royalty sought a declaratory judgment for noninfringement and invalidity, while it continued to pay royalties. The court, applying the general principles of its declaratory judgment jurisprudence, rejected the patent-specific rule of the Federal Circuit that had required a ''reasonable apprehension of suit'' as a basis for seeking a declaratory judgment, and held that the case presented a contract claim that was appropriate for declaratory relief. In so ruling, the Supreme Court determined that it was not necessary to reach the question whether *Lear*'s rule against contractual estoppel applied to non-repudiating licensees (549 U.S. at 124-25).

The facts in *Rates* differed from those in *Lear* in a number of respects: the licensee in *Lear* had a running royalty obligation, whereas the license in *Rates* was for a lump sum up-front payment, already paid in full; *Rates* involved an express no-challenge contract provision whereas *Lear* did not; and the agreement at issue in *Rates* was positioned as a prelitigation settlement, whereas the agreement in *Lear* was a simple license agreement.

Notwithstanding these differences, the Second Circuit held the no-challenge clause before it unenforceable under the rationale of *Lear*. The court, in its opinion, developed a spectrum of potential licensing scenarios, and arranged a number of legal precedents in the area along this spectrum.

At one end of this scale (at which patent challenges were to be favored) was *Lear*, in which there never had been a litigated dispute, there was no express no-challenge provision, and the licensee later sought to challenge patent validity as a contractual defense to its continuing royalty obligation. At the other end of the spectrum were cases in which patent validity had been fully litigated and in which res judicata (if nothing else) barred relitigation.

In between these extremes were cases having varying results: consent decrees (which were given res judicata effect), private settlements occurring after actual discovery, private settlements occurring after an opportunity for discovery, and agreements with express no-challenge provisions entered into before actual litigation.

The court focused particularly on two cases in the middle of its spectrum. The first of these was *Flex-Foot Inc. v. CRP Inc.*, 238 F.3d 1362, 57 USPQ2d 1635 (Fed. Cir. 2001) (61 PTCJ 349, 2/9/01), in which the Federal Circuit held that, notwithstanding *Lear*, estoppel to challenge a licensed patent would apply, where there was a clear and unambiguous no-challenge provision entered into after the accused infringer had challenged patent validity in litigation; where the accused infringer had an opportunity to conduct discovery on validity issues; where the parties had fully briefed opposing summary judgment motions on the issue of invalidity; and where the parties had thereafter elected to voluntarily dismiss the litigation with prejudice.

The second case discussed at length was the Ninth Circuit's decision in *Massillon-Cleveland-Akron Sign Co. v. Golden State Advertising Co.*, 444 F.2d 425, 171 USPQ 322 (9th Cir. 1971) (''*MCA*''), in which there was a prelitigation agreement, denominated as a settlement agreement, which had an express no-challenge provision. The Ninth Circuit held that the patent challenge was precluded by the policies favoring patent challenges that were articulated in *Lear*. The Ninth Circuit found it ''unimportant'' that the no-challenge provision at issue was part of an agreement cast as a ''settlement,'' suggesting that if this were given weight it would be too easy to circumvent federal policy simply by adapting the form of the agreement.

The Second Circuit found that *MCA* was the closest precedent, due to the fact that it also involved a prelitigation agreement containing a no-contest clause; found its reasoning persuasive; and came to the same conclusion of unenforceability. In discounting the drafter's characterization of the agreement at issue as a ''settlement,'' the court reasoned that ''if no-challenge clauses in pre-litigation agreements were held to be valid and enforceable, *Lear*'s strong policy 'favoring the full and free use of ideas in the public domain' could be evaded through the simple expedient of clever drafting.''

In reaching its conclusion, the Second Circuit rejected Rates' contention that *Lear* should be distinguished by the absence of running royalty. *Lear* had relied upon the existence of a continuing royalty obligation in its observation that the licensee there was particularly incentivized to challenge the patent. In *Rates*, the licensee had already fully paid for its license, and thus had no remaining payments that it could challenge.

The Second Circuit, in rejecting this argument, relied instead on the continuing nature of the contractual obligation not to assist third parties to challenge the patents. The Second Circuit concluded that this obligation was subject to the same policy balancing analysis that had been applied in *Lear*, i.e., determining whether the interests in favor of contract enforcement ''outweigh the public interest in discovering invalid patents.''

Potential Circuit Split

The *Rates* decision gives rise to a potential conflict with the Federal Circuit. In a recent case, the Federal Circuit stated in dictum that a clear and unambiguous no-challenge clause in a license would be sufficient to bar a validity challenge, even if invalidity claims had not been previously at issue and had not been actively litigated. *Baseload Energy Inc. v. Roberts*, 619 F.3d 1357, 1363, 96 USPQ2d 1521 (Fed. Cir. 2010) (80 PTCJ 656, 9/17/10)(a case in which the author's law firm represented the patent owner).

A future case involving these issues could well arise under the exclusive jurisdiction of the Federal Circuit, for example, in a case also asserting other claims that invoked patent jurisdiction. In such a case, the Federal Circuit might well rule differently from the Second Circuit.

Alternatively, such a case could come up as a contract case in another regional circuit, which would not be bound by either *Rates* or any Federal Circuit decisions. Such a dispute could also arise based on a license entered into upon settling a patent interference, inter partes reexamination, ITC proceeding, etc., as opposed to federal court litigation; no authority on the enforceability of no-challenge clauses as yet addresses licenses entered into in such administrative scenarios.

In addition, there is the issue of which court's precedents are binding. Appellate jurisdiction is dictated by statute—28 U.S.C. § 1295. Under this provision, the Federal Circuit has exclusive appellate jurisdiction of appeals where the lower court's jurisdiction was based at least in part on an action arising under the federal patent statute.

Since *Rates* was a contract dispute, the Federal Circuit's appellate jurisdiction (as the Federal Circuit itself determined) was inapplicable. However, the rules of decision for particular issues—as between the Federal Circuit and regional circuits—are not similarly controlled by express statutory authority.

There is no statutory authority for deciding whether Federal Circuit or regional circuit law applies to particular patent or nonpatent issues. The Federal Circuit ordinarily defers to regional circuit law on nonpatent issues (e.g., summary judgment and injunction standards), but there is no firm rule requiring corresponding deference by the regional circuits on patent issues that come within their purview. *See Christianson v. Colt Industries Operating Corp*., 822 F.2d 1544, 1552 n.10, 3 USPQ2d 1241 (Fed. Cir. 1987), *vacated and remanded with instructions to transfer appeal to the Court of Appeals for the Seventh Circuit*, 486 U.S. 800, 7 USPQ2d 1109 (1988), *on remand*, 870 F.2d 1292, 10 USPQ2d 1352 (7th Cir. 1989) (''The regional circuits are, of course, perfectly competent, as are state courts, to determine patent 'questions' or 'issues' that may occasionally arise in cases within their jurisdiction. 'Uniformity' is not *necessarily* thereby abandoned. . . . [T]he regional circuits *might elect to* apply the patent precedents of this court in such cases, just as this court applies regional circuit precedents in areas of law and procedure not within its exclusive jurisdiction.'' (Emphasis added.)).

The particular rule of decision applied in *Rates* involved the controlling application of federal policy under *Lear* to override state contract law. As noted footnote 9 of the *Rates* decision (*citing Foster v. Hallco Manufacturing Co.*, 947 F.2d 469, 475, 20 USPQ2d 1241 (Fed. Cir. 1991)), for cases within the Federal Circuit's jurisdiction, the Federal Circuit ''does not defer to the interpretation of *Lear* issued by other circuits because of the 'need for uniformity and certainty' in patent law.''

Whether the Second Circuit defers to the Federal Circuit on such issues remains an open question. Clearly, the Second Circuit saw uniformity as desirable. According to the Second Circuit, there was no actual conflict between its decision and the prior holdings of Federal Circuit, in that the latter's decision in *Baseload Energy* would conflict only with respect to dictum.

The court did, however, state in the same footnote that ''district courts in this circuit remain bound to follow the holdings of the Federal Circuit in cases falling within the appellate jurisdiction of the Federal Circuit''—again not suggesting that the Second Circuit would consider itself bound by a conflicting holding of the Federal Circuit regarding *Lear*. Thus, should a clear difference in the law develop in this area as between the Federal Circuit and a district court's regional circuit, the district court could well have to select a rule of decision based on which court of appeals had appellate jurisdiction over the case before it.

Comment

The facts before the Second Circuit in *Rates* involved a situation in which there had not even been an ''opportunity'' for discovery prior to the execution of the underlying license agreement. Thus, the ruling did not address what difference (if any) it might have made had there been a litigation filed but no actual discovery.

The Second Circuit also never addressed the significance of discovery in these cases: in patent cases, more often than not, validity turns on the content of publicly available prior art documents, which are available without discovery. These publicly available prior art references are generally considered, at least to some extent, before agreeing to pay for a license. To be sure, there are aspects of validity that are also particularly within the scope of discovery, e.g., for those statutory provisions where patentability turns on the date of invention rather than the date of filing.

The Second Circuit, in discussing the Federal Circuit's *Flex-Foot* decision, focused on the availability of discovery prior to the license agreement. However, *Flex-Foot* also had the much stronger facts of fully litigated summary judgment motions on both sides as to validity. While it is clear that discovery could be a factor in this analysis, the court could assist future litigants by explaining the significance and weight to be accorded to this factor.

The Second Circuit, deciding the case as it did, did not decide whether the $12 million automatic damage figure provided for breach of the no-challenge clause was valid as liquidated damages or void as a penalty. Clearly, clauses of this nature still appear to be open to dispute as to their enforceability, apart from the enforceability of the no-challenge clause per se.

Further, the Second Circuit's discussion of the policy ''balancing'' required by *Lear* did not articulate how the balancing test applied to the provision prohibiting the licensee from assisting a third-party patent challenge. The concern addressed by this provision is that licensees may have done some validity investigation prior to taking a license, and the possibility that the results of the investigation might be shared with subsequent licensing targets could make it easier for them to challenge the licensed patents or more effectively negotiate. While it is clear that the court did not favor upholding such a provision, its decision does not extensively analyze its potential effect.

The case also creates a potential conflict among the circuits. Such a conflict might be avoided if the Federal Circuit had appellate jurisdiction of cases such as *Rates*. The outer bounds of Federal Circuit jurisdiction is reflected, for example, in recent decisions taking appellate jurisdiction over patent prosecution malpractice cases—*see Minkin v. Gibbons P.C.*, 680 F.3d 1341, 102 USPQ2d 1573 (Fed. Cir. 2012) (84 PTCJ 63, 5/11/12).

However, as noted, the Federal Circuit actually turned the *Rates* case away, and it would be difficult to argue even under *Minkin* that the case was within its appellate jurisdiction. *See id*. at 1353 (O'Malley, J., dissenting).

Such conflicts might also be avoided if the regional courts of appeals generally adopted an approach whereby they defer to the Federal Circuit on matters concerning federal patent policy. As noted, the Second Circuit clearly recognized the importance of uniformity. Nevertheless, the fact remains that the decisions of the Second and Federal Circuits definitely appear to be in tension, creating the potential for forum shopping, at least in the short term.

Practical Considerations

In light of the *Rates* decision, and the possibility of like decisions elsewhere, a patent owner might file (but not necessarily serve) a complaint for infringement prior to making a license demand. Indeed, filing a suit in advance of license or enforcement discussions has become commonplace in patent assertion practice since the Supreme Court's decision in *MedImmune*, *supra*. *Medimmune* changed the landscape insofar as it was no longer necessary for a licensing target to show an overt threat or apprehension of suit in order to bring a preemptive declaratory judgment action.

If the patent owner files an infringement action before approaching the licensing target, a subsequent license would then constitute a settlement of actual litigation, likely distinguishing the situation from *Rates*.

Further, in negotiating the settlement/license, the patent owner might insert into its form of agreement a recitation to the effect that the licensee had the opportunity to pursue discovery in the action, but was satisfied with its own due diligence and elected not to do so, further distinguishing *Rates*.

A prospective licensee will not be able to control whether a prior infringement suit is filed, and may not have much ability to negotiate a no-challenge clause completely out of the agreement, insofar as such a clause is a principal protection relied upon by the patent owner in agreeing to settle. It is a provision on which the patent owner will likely insist, despite doubts about its enforceability.

Other negotiating points include the scope of the license (including extension to existing and even future affiliates); the scope of the release (e.g., the persons released, as well as the release of then unknown as well as known claims); the patents covered (including any patent applications ''in the pipeline''); irrevocability; right to sublicense, etc. Further, short of a no-challenge clause (or out of concern for its enforceability), the licensor could seek to disincentivize a challenge by conditioning any of the provisions mentioned above on the absence of a challenge.

Beyond these aspects, clearly another key provision to seek to negotiate, in light of *Rates* and recent Federal Circuit decisions, would be the forum selection and choice of law clauses. Selecting New York or another state within the Second Circuit, at least as to venue, if not controlling law, could be advantageous to the licensee (at least in the short term), in order to take advantage of the *Rates* decision, which is highly favorable to licensees.

Although the ultimate enforcement scenario may involve factors beyond either party's direct control, such a clause might be effective in the event the enforcement action is based solely on contract, and in which case the exclusive appellate jurisdiction of the Federal Circuit is not triggered.

The general topic of settlement of intellectual property disputes of course involves considerations well beyond the scope of this article, such as antitrust, tax, res judicata, collateral estoppel, and declaratory judgment, as well as subtle patent issues, such as exhaustion and implied licenses. Even seemingly simple licensing issues raise a wide range of concerns and should, at a minimum, be reviewed by knowledgeable legal counsel.

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