

Second Circuit Holds Clause in Patent License/Settlement Agreement Preventing Challenge to Validity of Patent Void

By Asim Varma, Edward Han, and Matthew Shultz

Recently, the US Court of Appeals for the Second Circuit ruled that:

a settlement agreement which bars a patent licensee from later challenging the patent's validity is void for public policy reasons under the Supreme Court's decision in *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969), where the parties entered into the agreement after an accusation of infringement by the patent owner but prior to any litigation.¹

This decision is likely to have significant implications for parties contemplating the licensing of patents in settlement of threatened or pending patent litigation.

Background

Courts have struggled to strike the proper balance between society's interest in the enforcement of contracts and its interest in permitting challenges to potentially invalid patents.² In *Lear*,³ the US Supreme Court—expressly overruling its decision 20 years earlier in *Automatic Radio Mfg. Co. v. Hazeltine Research, Inc.*⁴—weighed more heavily “the important public interest in permitting full and free competition in the use of ideas that are in reality a part of the public domain.” In *Hazeltine*, the Court had “invoked an estoppel to deny a licensee the right to prove that his licensor was demanding royalties for the use of an idea which was in reality a part of the public domain.”⁵ In *Lear*, the Court rejected the licensee estoppel doctrine,

finding that “the licensor's equities are far from compelling,” given that patents typically represent the conclusions of the Patent Office “in an ex parte proceeding, without the aid of the arguments which could be advanced by parties interested in proving patent invalidity.”⁶ The Supreme Court observed:

Licensees 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 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.⁷

The issue remains somewhat unresolved, however, when the contract in question is an agreement to settle pending or threatened patent litigation in which the accused infringer expressly covenants not to challenge the validity of the licensed patents. In *Massillon-Cleveland-Akron Sign Co. v. Golden State Advertising Co. (MCA)*,⁸ the parties had entered into a settlement agreement after the patent holder threatened to bring an infringement action. In the agreement, the accused infringers expressly covenanted not to contest the validity of the patent. The patent holder subsequently brought an action for breach of the agreement, alleging that the defendants had resumed their infringing activities.⁹ The defendants, citing *Lear*, asserted affirmative defenses and a counterclaim challenging the validity of the patent, notwithstanding the covenant in the settlement agreement prohibiting such challenges.¹⁰ The Ninth Circuit reversed the district

Asim Varma is a partner in the litigation and antitrust practice groups of Arnold & Porter LLP. **Edward Han** is a partner in the firm's intellectual property practice group. **Matthew Shultz** is an associate with the firm. The authors can be reached at Asim.Varma@aporter.com, Edward.Han@aporter.com, and Matthew.Shultz@aporter.com, respectively.

court's order striking these affirmative defenses and counterclaim:

We think the rationale of *Lear* requires us to hold that the covenant of [the defendants], in the settlement agreement ... not to contest the validity of [the] patent, is void on its face and unenforceable. It is in just as 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.¹¹

In *Flex-Foot, Inc. v. CRP, Inc.*,¹² however, the Federal Circuit distinguished *Lear*, noting that "[t]he license agreement in *Lear* was not created as part of a litigation settlement" and "[i]n *Lear*, notably, the license did not contain, and was not accompanied by, any promise by the licensee not to challenge the validity of the patent." The Court of Appeals emphasized "the strong public interest in enforcing settlements":

Settlement agreements must be enforced if they are to remain effective as a means for resolving legal disagreements. Upholding the terms of settlement agreements encourages patent owners to agree to settlements and promotes judicial economy.¹³

The Federal Circuit, accordingly, announced the following rule:

Once an accused infringer has challenged patent validity, has had an opportunity to conduct discovery on validity issues, and has elected to voluntarily dismiss the litigation with prejudice under a settlement containing a clear and unambiguous undertaking not to challenge validity and/or enforceability of the patent in suit, the accused infringer is contractually estopped from raising any such challenge in any subsequent proceeding.¹⁴

Rates Technology represents the latest judicial effort to bring clarity to this issue.

Rates Technology Decision

In 2007, after Rates Technology Inc. (RTI) notified Speakeasy, Inc. (Speakeasy) that Speakeasy was

infringing two of RTI's patents, RTI and Speakeasy entered into a Covenant Not to Sue (the Agreement), pursuant to which, in exchange for a one-time payment, RTI agreed not to sue Speakeasy for any past or future infringement of the patents.¹⁵ Under the Agreement, Speakeasy: (1) acknowledged the validity of the patents, (2) agreed not to challenge or assist in any challenge to the validity of the patents, and (3) agreed to pay liquidated damages in the event of any breach of the no-challenge provision.¹⁶

In 2010, while Speakeasy was engaged in a merger transaction as a result of which it would become affiliated with Covad Company (Covad), RTI notified Covad that it was infringing RTI's patents.¹⁷ Covad brought a declaratory judgment action challenging the validity of the patents.¹⁸ RTI then brought an action in the Southern District of New York against Speakeasy and other parties involved in the merger transaction, alleging that, in connection with that transaction, Covad had obtained information that it had used in formulating its declaratory judgment complaint, thereby breaching the covenant in the settlement agreement against assisting in any challenge to the validity of the patents.¹⁹

The district court granted the defendants' motion to dismiss RTI's complaint, finding that the no-challenge clause in the settlement agreement was unenforceable under *Lear*.²⁰ RTI appealed to the Federal Circuit, which declined jurisdiction because the dispute did not require resolution of a question of patent law; the appeal was therefore transferred to the Second Circuit.²¹

In analyzing how *Lear* applied to the case before it, the Second Circuit distinguished four potential resolutions of patent disputes:

1. *Litigation to a final resolution.* The Second Circuit was "aware of no court which has even suggested that *Lear* abrogates the application of *res judicata* principles based on a judgment imposed by the court after full litigation."²²
2. *Entry of a consent decree following litigation.* The Second Circuit observed that "[a]fter some initial uncertainty, we and other courts applying *Lear* have recognized that such decrees estop future challenges to a patent's validity."²³
3. *Private settlement after initiation of litigation, without consent decree.* The Second Circuit discussed both

Warner-Jenkinson Co. v. Allied Chemical Corp.,²⁴ which held that a private settlement, by itself, “did not estop a patent licensee from later challenging the validity of the patent,” and *Flex-Foot*, which upheld an express no-challenge clause in a settlement agreement entered into after discovery.²⁵ The Second Circuit noted its “ambivalent dictum in *Warner-Jenkinson*,” suggesting that “the result ... might have been different if the agreement had contained a no-challenge clause.”²⁶

4. *Private settlement prior to any litigation.* The Second Circuit noted the Ninth Circuit’s holding in *MCA* that a covenant barring the defendant from contesting the validity of the patent, which was part of an agreement that initially averted a patent infringement suit, was “void on its face and unenforceable.”²⁷

The Second Circuit found that “[t]he situation in this case most resembles the one in the Ninth Circuit’s *MCA* decision” and that “the Ninth Circuit’s decision in *MCA* [is] persuasive.”²⁸ The Second Circuit expressed concern that “patent owners eager to avoid future challenges to their (possibly invalid) claims” could merely “couch licensing arrangements in the form of settlement agreements” and that the policies underlying *Lear* “could be evaded through the simple expedient of clever draftsmanship.”²⁹ The court further noted that “prior to the initiation of litigation, the parties to a dispute will not have had an opportunity to conduct discovery that may shed light on the patent’s validity” and that “the fact that the parties have conducted discovery is evidence that they had a genuine dispute over the patent’s validity.”³⁰ The Second Circuit concluded: “We therefore hold that covenants barring future challenges to a patent’s validity entered into prior to litigation are unenforceable, regardless of whether the agreements containing such covenants are styled as settlement agreements or simply as license agreements.”³¹

Implications

Patent holders seeking, in connection with agreements settling infringement suits, to preclude future challenges to the validity of the patents at issue by the licensees, must exercise extreme caution. While significant uncertainty remains in the wake of the Second Circuit’s decision in

Rates Technology, the discussion above suggests the following guidelines:

1. No-challenge provisions in settlement agreements entered before the actual initiation of litigation are likely to be found unenforceable.
2. In the case of settlement agreements entered after the initiation of litigation, the likelihood that a no-challenge provision will be enforced increases with the progress of the case; progress with respect to validity-related discovery seems particularly significant.
3. Incorporation of the terms of a settlement into a consent decree dramatically increases the likelihood that a no-challenge clause will be found enforceable.
4. While there certainly is no guarantee that an express no-challenge provision will be found enforceable, it does not hurt; do not rely on an implied estoppel.

Notes

1. *Rates Tech. Inc. v. Speakeasy, Inc.*, No. 11-4462-cv, 2012 WL 2765081, at *1 (2d Cir. July 10, 2012) (citations omitted).
2. The US Supreme Court’s decision in *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007), held that a licensee is not required to terminate or breach its license to have standing under Article III of the US Constitution and the Declaratory Judgment Act. However, the *MedImmune* decision left open the question as to whether the doctrine announced in *Lear* can be invoked by a licensee seeking to challenge the validity of the patent underlying the license until it has (1) ceased royalty payments, and (2) notified the licensor that it is ceasing payments because it has determined the patent to be invalid, as required by *Studiengesellschaft Kohle, M.B.H. v. Shell Oil Co.*, 112 F.3d 1561 (Fed. Cir. 1997). Although *Rates Technology* does not directly address this question, the Second Circuit’s emphasis on the important public policies underlying *Lear* suggests that licensors should be cautious if they intend to rely on *Studiengesellschaft*.
3. *Lear, Inc. v. Adkins*, 395 U.S. 653, 670–671 (1969).
4. *Automatic Radio Mfg. Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950).
5. *Lear* at 656 (citing *Hazeltine*, 339 U.S. at 836).
6. *Lear* at 670.

7. *Id.* at 670–671.
8. *Massillon-Cleveland-Akron Sign Co. v. Golden State Advertising Co.*, 444 F.2d 425 (9th Cir. 1971).
9. *Id.* at 426.
10. *Id.*
11. *Id.* at 427.
12. *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362, 1368 (Fed. Cir. 2001).
13. *Id.* at 1370.
14. *Id.*
15. *Rates Technology*, 2012 WL 2765081, at *1.
16. *Id.* at *1–2.
17. *Id.* at *2.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* at *3. The Federal Circuit concluded that it lacked jurisdiction because “the district court’s jurisdiction did not arise in whole or in part under the laws governing this court’s appellate jurisdiction. The contract dispute does not require the resolution of a related question of patent law, such as inventorship, infringement, validity, or unenforceability.” *Rates Tech., Inc. v. Speakeasy, Inc.*, 437 F.App’x 940, 941 (Fed. Cir. 2011) (citing *Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc.*, 599 F.3d 1277, 1283–1284 (Fed. Cir. 2010)).
22. *Rates Technology*, 2012 WL 2765081, at *4 (quoting *Foster v. Halco Mfg. Co.*, 947 F.2d 469, 476 (Fed. Cir. 1991)).
23. *Rates Technology*, 2012 WL 2765081, at *5 (citations omitted) (citing *Wallace Clark & Co. v. Acheson Indus., Inc.*, 532 F.2d 846, 849 (2d Cir. 1976); *Foster*, 947 F.2d at 476–477; *Am. Equip. Corp. v. Wikomi Mfg. Co.*, 630 F.2d 544, 547–548 (7th Cir. 1980); *Schlegel Mfg. Co. v. USM Corp.*, 525 F.2d 775, 780–781 (6th Cir. 1975)).
24. *Warner-Jenkinson Co. v. Allied Chemical Corp.*, 567 F.2d 184 (2d Cir. 1977).
25. *Rates Technology*, 2012 WL 2765081, at *5–6.
26. *Id.* at *5–6 (citing *Warner-Jenkinson*, 567 F.2d at 188 (“[I]f a settlement agreement contains an explicit prohibition on licensee suits during some future period ... a court may feel that effect should be given to such provisions.”)).
27. *Rates Technology*, 2012 WL 2765081, at *6 (citing *MCA*, 444 F.2d at 427).
28. *Id.* at *7.
29. *Id.* (quoting *MCA*, 444 F.2d at 427).
30. *Rates Technology* at *7.
31. *Id.* at *8. The Second Circuit went on to address four arguments made by RTI: First, RTI urged the court to follow the “strong judicial policy favoring settlement of litigation,” which the court declined because “enforcing no-challenge clauses in pre-litigation settlements would too easily enable patent owners to ‘muzzle[]’ licensees—the ‘only individuals with enough economic incentive to challenge’ the patent’s validity.” *Id.* at *8 (quoting *Lear*, 395 U.S. at 670). Second, RTI argued that the court’s holding would force parties to go through the formality of litigation in order to settle infringement claims. *Rates Technology*, 2012 WL 2765081, at *8. The court rejected RTI’s argument because its holding does not bar patent settlements in the absence of litigation and parties are unlikely to go through discovery just “to validate a no-challenge clause.” *Id.* Third, the Second Circuit declined to follow dicta in *Baseload Energy, Inc. v. Roberts*, 619 F.3d 1357, 1363 (Fed. Cir. 2010), “suggesting that the existence of prior litigation and discovery between the parties is not required to render a no-challenge clause enforceable” because the *Baseload* court did not need to consider the concern that patent owners could “‘couch licensing arrangements in the form of settlement agreements’ in order to prevent licensees from later challenging the validity of their patent.” *Rates Technology*, 2012 WL 2765081, at *9 (quoting *MCA*, 444 F.2d at 427). Finally, the Second Circuit rejected RTI’s attempts to distinguish *Lear* on the facts because RTI could not convincingly explain why *Lear*’s balancing test should not apply anyway. *Id.* at *9.