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Patent Holders' Leverage Continues to Erode



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Yet another Supreme Court decision has chipped away at the power held by patent owners. In May 2006, in *EBay Inc. v. MercExchange LLC*, 126 S. Ct. 1837, the Court held that a patent owner that proved infringement was not entitled to an automatic injunction against the infringing activities. A few months earlier, it had been fear of just such an injunction that impelled the owner of Blackberry to pay \$600 million to settle an infringement case. After *EBay*, courts must apply a traditional balance-of-harms test in deciding whether an injunction is an appropriate remedy for infringement.

Now, the Court has begun 2007 by making it easier for licensees to challenge the patents they have licensed. In *MedImmune Inc. v. Genentech Inc.* (No. 05-608, 1/9/07), the Court rejected the longstanding rule that a licensee must breach its license by withholding royalties before seeking a declaratory judgment that the patent is invalid. Instead, the licensee may choose to remain in good standing and still bring the challenge, as long as the patent owner has threatened to enforce the license. The Court's specific holding was technical and constitutional, focusing on what comprises a "case or controversy" that can be litigated in federal court under Article III and the Declaratory Judgment Act. The practical implications of the decision are substantial, however.

The former rule was a serious barrier to court attacks on licensed patents because withholding royalties subjected the challenger to the risk of damages, even multiple damages for willful infringement and to the risk that the license would be terminated. Now, however, the licensee can make a low-risk challenge: if it wins, it (and anyone else) can use the licensed invention for free; if it loses, it will be back where it started when it signed the license, having gambled only the cost of the litigation (which can be substantial, of course). Many in the licensor community see a heads-I-win, tails-you-lose unfairness in the outcome. But the Supreme Court was clearly focused on the policy that encourages the weeding out of "bad" patents that should not have been granted in the first place.

An obvious question is how the business world will adapt to the ruling. On the licensee side, the lesson is when in doubt, sign a license and worry later about the validity of the patent. In the past, users of dubiously patented technology often agonized over whether to pay for a license or simply go ahead and use the invention, hoping to prove its invalidity in defending an infringement suit. Signing and abiding by the license meant forgoing the right to initiate a challenge, while proceeding without a license (or in breach of one, which amounts to the same thing) raised the specter of massive damages (see, for example, the \$1.52 billion judgment awarded against Microsoft in late February in the MP3 case). Now, a company can sign a license, avoid the accumulation of damages, and reserve the right to assert invalidity at a time of its choosing.

How are licensors likely to respond? One approach may be to attempt to add license provisions that increase the risk of a challenge—in other words, to recreate by license some of the disincentives formerly imposed by the law. A license might, for example, specify a higher royalty rate in the event of an unsuccessful challenge; or stipulate that a licensee that makes a successful challenge cannot recoup royalties paid during the challenge; or require that a challenge be brought in a forum chosen by the licensor; or require a highly specific notice well in advance of a challenge suit, perhaps with mandatory mediation during the notice period. An even more aggressive licensor might demand a higher royalty rate in the mere event of a challenge, the right to terminate the license in the event of a challenge, or a requirement that the licensee pay attorneys fees in the event of an unsuccessful challenge.

Any such provisions face two possible problems: the licensee must agree to them, and courts must be willing to enforce them. Licensees will presumably evaluate onerous provisions against the background of how badly they need the technology and how strong they think the patent is. So as a practical matter, licensees will be most likely to assent in the case of strong and valuable patents—the patents that are most immune to challenge in the first place. As for enforceability, the *MedImmune* decision is a powerful reminder of the policy favoring challenges to suspect patents. It seems unlikely that the courts will permit the decision to be undone by private action. This suggests that relatively modest provisions will be enforced, but the more aggressive ones—higher royalties for simply instituting a challenge, or substantial penalties for an unsuccessful challenge, for example—may be rejected.

Influenced by these considerations, some licensors may choose an entirely different approach by front-end-loading the royalties. The extreme version of this is the fully paid-up, lump-sum license. A successful challenger might seek to recover any royalties paid on a theory of failure of consideration or unjust enrichment. But the licensor could plausibly respond that the licensee took the possible invalidity of the patent into account when paying the up-front royalty, and thus got exactly what it paid for.

At this point, it is hard to do more than speculate on these questions. The one thing that is certain is that the landscape of patent enforcement has changed in a way that diminishes the power of patent owners.

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