North Carolina’s New Anti-Patent Trolling Statute: As Many Questions as Answers

North Carolina has joined more than a dozen other states that have taken action to crack down on abusive patent infringement litigation by so-called “patent trolls.” The troll problem is far from solved, but companies targeted by patent trolls now have some potential legal leverage. We say “potential,” because it is still unclear whether the federal courts will permit the anti-troll lawsuits that these state statutes envision.

Patent trolls, also known as non-operating or patent assertion entities, often acquire unused patents on the cheap simply for the purpose of asserting patent infringement claims and collecting licensing fees from businesses seeking to avoid costly litigation. Among the most notorious is MPHJ Technology Investments, the “scanner troll.” MPHJ and its web of affiliates hold patents of dubious validity that they claim will cover the everyday act of scanning a document and emailing it back to your office. MPHJ has used a McDonald’s-style business model: low price, high volume. MPHJ’s lawyers, the Texas firm Farney Daniels, has sent thousands of demand letters to small and medium-sized businesses threatening infringement litigation unless the recipient pays a licensing fee, usually $1,000 per employee. Uncertain about whether MPHJ would actually sue, and fearing the cost of even filing a motion to dismiss a patent infringement case, many of these targets have paid a few thousand dollars to settle. The Federal Trade Commission and multiple state attorneys general have taken action against MPHJ, its principal, Texas lawyer Jay Mac Rust and Farney Daniels, but it is unclear how much deterrent effect these actions have had.

Article 8 attempts to discourage typical patent troll behavior and provide remedies for targets of patent trolls by giving them the right to bring suit in a North Carolina state court in response to “a bad-faith assertion of patent infringement.” If a court finds a reasonable likelihood of bad faith, the new law requires the party asserting the infringement claim to post bond in an amount sufficient to cover an estimate of both the cost to litigate the claim and the amount likely to be recovered by the target in a suit filed under the law. The bond is capped at $500,000, but that does not limit the target’s damages. If the target of a bad-faith assertion is victorious in court, the law allows for equitable relief (an injunction against the troll), damages, costs and fees (which include reasonable attorneys’ fees), and exemplary (or punitive) damages equal to the greater of $50,000 or three times the total of the actual damages, costs and fees.

The law provides a list of factors that the North Carolina court should weigh when determining whether a claim of patent infringement is made in bad faith. These include failure to include detailed information about the patent and the claimed infringement in the demand letter, demanding payment of a licensing fee or a response within an unreasonably short period of time, offering to license at a price not reasonably related to the value of the license, asserting claims against multiple recipients without differentiating demands, making claims of infringement that are meritless and pursuing patent infringement claims that have previously been found to be meritless. Not surprisingly, the list of factors tracks the business practices of many patent trolls. The law also gives broad discretion to the court, permitting it to consider any other factor it finds relevant. There is a mirror-image list of factors that the court could use to find the absence of bad faith. Significantly, the law does not apply at all to “a demand letter or assertion of patent infringement made by an operating entity or its affiliate.” This ensures that the statute cannot be used to inhibit an operating business from enforcing its own patents.

Because patent trolls are often thinly capitalized and may be unable to pay the amounts required under this new private cause of action, the new law allows the court to join interested parties in the case and hold them jointly and severally liable if the party making the assertion is unable to pay the amounts awarded by the court—a provision clearly directed at MPHJ’s welter of more than 100 shell corporation affiliates. The new law gives the North Carolina courts jurisdiction over any person who delivers or sends a demand letter to a target in North Carolina, regardless of their location and whether or not they have actually transacted any business in the state.

There are no reported cases yet under the North Carolina law or any of the other state statutes, so it is too early to judge their practical impact. It is also too early to judge their deterrent effect. Patent trolls may well be waiting to see how much exposure they face under these laws before deciding whether to abandon the trolling business.

All of the state anti-trolling laws face a major and still-unresolved legal threat: invalidation under the constitutional doctrine called “preemption.” Because federal law is the supreme law of the land, state laws that conflict with federal law are preempted and thus invalid. Congress has exclusive control over patents and patent infringement litigation, and the Patent Act explicitly prohibits state courts from deciding “any claim for relief ... relating to patents.” The obvious question is whether state suits filed under the new anti-trolling statues amount to claims for relief relating to patents. The problem is compounded by federal case law that holds that any attempt by the state courts to engage in substantive consideration of the validity of a patent is preempted.
The North Carolina statute acknowledges the possibility of preemption, asserting in the preamble that “The General Assembly also recognizes that North Carolina is preempted from passing any law that conflicts with federal patent law.” A claim under the new law would not be the equivalent of a patent infringement suit, so preemption on that basis is unlikely. However, despite the legislature’s disclaimer, some provisions of the new law strongly suggest that the state court would engage in the substantive analysis of patent validity and thus subject the law to preemption. Specifically, when determining bad faith, the Act provides that the court may consider whether “the claim or assertion of patent infringement is meritless...” It is difficult to see how a state court could determine whether an alleged troll’s claim is meritless without evaluating the validity of the patent. Preemption is also likely if additional federal laws are passed that directly conflict with the provisions of this statute. While several anti-trolling bills have been introduced in recent sessions of Congress, nothing seems likely to pass in the immediate future.

There is federal appellate case law suggesting that it is possible for state-law actions in response to bad-faith patent assertions to survive federal preemption, but the prohibited assertions must be “objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits.” However, the North Carolina law as currently written allows the state court to consider any or all of a broad range of subjective and objective factors in determining bad faith. Perhaps if state courts were to take a purely objective approach in practice—ignoring the subjective statutory factors—the law would have a better chance of surviving preemption. Because the issue has not yet been litigated, all of this remains speculative.

Even at this early stage, businesses that are harassed by trolls asserting dubious patents should carefully consider threatening and, if necessary, bringing, a lawsuit under North Carolina’s new anti-trolling laws. In deciding on a course of action, the key question will be whether the troll chooses your case to litigate the various uncertainties in the law or simply goes away. Even if the troll does choose to fight, the costs of litigating a patent abuse case are likely to be far less than the cost of defending a patent infringement case. We have substantial experience helping our clients deal with patent trolls, and stand ready to help you work through your options.