Second Circuit Ruling May Have Important Consequences for Drafting Licensing, Settlement and Other Agreements Containing 'Covenants Not to Sue'

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On July 12, 2012, the Second Circuit Court of Appeals unanimously held that patent licensing agreements reached *before litigation* cannot be used to bar a licensee from later challenging the validity of a patent, even if the deal is styled as a legal settlement or covenant not to sue. The Second Circuit ruling clarified a well-known 1969 United States Supreme Court case, *Lear v. Adkins*, and rejected a proposed limitation on its scope.

In *Lear v. Adkins*, the Supreme Court held that a patent licensing agreement cannot bar a licensee from later challenging the patent's validity because of "the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain."[1] Over the years, the *Lear* doctrine has been extended to other forms of intellectual property.

The recent Second Circuit ruling may have important consequences for the drafting of "covenants not to sue," which have become an increasingly common means by which to resolve patent disputes. Additionally, although the Second Circuit did not reference the Supreme Court's 2007 *MedImmune v. Genentech* decision,[2] the Court of Appeals' ruling may also raise questions as to some techniques by which licensors have attempted to reign in a licensees' ability to challenge a licensed patent in the wake of *MedImmune*.

Background and Lower Court Ruling

The case before the Second Circuit, *Rates Technology, Inc. v. Speakeasy, Inc. et al.*, was initiated by Rates Technology, Inc., a prolific patent litigant in the telecommunications industry. Rates Technology is well-known for its policy of settling patent claims in exchange for a one-time payment based on the size of the accused infringer's sales. Typically, in exchange for the payment, Rates Technology would enter into a settlement agreement styled as a "covenant not to sue" to resolve the dispute.

In 2007, Rates Technology sent a demand letter to Defendant Speakeasy, a Best Buy subsidiary, accusing the entity of infringing two of its patents for automatic routing of telephone calls based on

cost. Before formal litigation began, the companies settled the dispute with Speakeasy paying $475,000 to Rates Technology in exchange for a licensing agreement styled as a covenant not to sue.

In addition to the traditional clauses providing that Rates Technology would not sue Speakeasy or Best Buy for infringement of the relevant patents, the licensing agreement included a provision barring Speakeasy and Best Buy from ever challenging the validity of patents or assisting others in engaging in such challenges. The no-challenge clause was accompanied by a liquidated damages clause providing for $12 million in liquidated damages to be paid to Rates Technology if either party were to breach the no-challenge provision.

Three years later, Best Buy sold Speakeasy to Defendant Covad Communications. Shortly thereafter, Rates Technology accused Covad (and other Covad affiliates) of infringing the same patents that laid the basis of Rates Technology's settlement with Speakeasy and Best Buy in 2007. Before Rates Technology could initiate litigation, Covad filed a declaratory judgment action in California seeking to invalidate the patents-at-issue.

Rates Technology responded by suing the Defendants in New York, alleging that Speakeasy and/or Best Buy provided Covad with information to aid Covad's declaratory judgment action. Rates Technology claimed such assistance violated the no-challenge clause of the parties' 2007 agreement. Rates Technology also claimed that Covad and its affiliates breached the agreement by virtue of the Speakeasy acquisition. Covad dismissed its California declaratory judgment action, and only Rates Technology's New York suit remained.

United States District Judge Denise Cote dismissed the case in May 2011, ruling that the no-challenge clause was void under *Lear*. Rates Technology appealed.

Second Circuit Decision and Consideration of the Supreme Court's Ruling in Lear

The Second Circuit affirmed Judge Cote's decision and agreed that, as guided by *Lear*, the technical contract requirements represented by honoring a no-challenge clause must give way to the more important public policy interests of invalidating meritless patents. As the Supreme Court stated in *Lear*, if licensees "are muzzled, the public may continually be required to pay tribute to would-be monopolists without need or justification."[3]

Rates Technology argued that (1) the *Lear* holding should be limited to its facts and only applied to continuing royalty payments, and not to one-time cash payments made before litigation, and (2) there

was also a strong public interest in avoiding litigation. The reasoning underlying Rates Technology's second argument had been used in several cases since *Lear* to justify the enforcement of no-challenge agreements. Defendants countered by arguing for an expansive view of *Lear*.

Although recognizing the balancing act between the policy concerns articulated in *Lear* against the countervailing policy interests in favor of holding parties to their contracts, the Second Circuit ultimately sided with Defendants and adopted a broad reading of the Supreme Court's decision in *Lear*. The Second Circuit distinguished the cases justifying enforcement of no-challenge agreements by finding that they allowed for no-challenge enforcement *only after the parties had engaged in formal litigation and, thus, discovery as to the patents-in-suit*. In other words, in those cases, the patents were well-vetted, and any no-challenge clause was made with full consideration of its merits and consequences. This also provided evidence that the parties engaged in a "genuine dispute" over the patent's validity.

By contrast, the no-challenge clause presented in the settlement agreement between Rates Technology and Speakeasy/Best Buy was entered into entirely *before litigation* and, therefore, before substantial discovery. According to the Second Circuit, only the formal discovery process attendant to a formal lawsuit can enable the putative licensee to fully consider a patent's validity prior to agreeing to settlement which includes a no-challenge clause.

As stated by the Court of Appeals: "While we recognize the important policy interests favoring the settlement of litigation . . . and we are conscious of the great costs that can be associated with patent litigation, we believe that enforcing no-challenge clauses in prelitigation settlements would significantly undermine the public interest in discovering invalid patents."[4]

The Second Circuit also noted that *no matter how styled*, a prelitigation settlement/licensing agreement/covenant not to sue would not be enough to bypass *Lear's* limited prohibition on no-challenge clauses: "If no-challenge clauses in prelitigation 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 draftsmanship."[5]

Implications and Open Questions for Licensing Agreements Moving Forward

Although it is clear that no-challenge clauses in past settlement agreements may be void or unenforceable, nothing from the Second Circuit's ruling prevents parties from entering into pre-litigation

licensing agreements designed to thwart future litigation. There remain numerous means by which a licensor can minimize future validity challenges.

For example, as opposed to a prohibition on challenges to validity, future contract language might provide a variety of incentives to a licensee to delay or not to challenge a licensor-patent's validity. Contract language may also include a framework for alternative dispute resolution and discovery should validity later be challenged.

Finally, several questions remain open in light of the Second Circuit's decision that may substantially impact pre-litigation settlements in patent disputes. For example:

- In what circumstances are no-challenge clauses, after some litigation between parties has occurred, likely to be upheld by future courts?
- How does a potential defendant negotiate with a putative plaintiff to settle a patent dispute in which the putative plaintiff insists on incentives not to challenge the validity of a patent or other form of intellectual property?
- Is there a possible pre-litigation means of informal and inexpensive targeted discovery that might persuade future courts to read around the Second Circuit's mandate on entering into formal litigation to agree to an enforceable no-challenge clause?
- What level of discovery is necessary to justify enforcement of a no-challenge clause?

Should you have any questions, please contact your Bracewell & Giuliani LLP attorneys. We will, of course, keep you advised as to any new developments in this area.

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[1] *Lear, Inc. v. Adkins*, 395 U.S. 653, 670-71 (1969).

[2] *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007).

[3] *Lear*, 395 U.S. at 670-71.

[4] *Rates Tech., Inc. v. Speakeasy, Inc.*, 2012 WL 2765081 at *8 (2nd Cir. July 10, 2012).

[5] *Id*. at *16.