Recent U.S. Court Decisions And Developments Affecting Licensing

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Courts May Enforce Covenants Not to Challenge the Validity of Licensed Patents Contained in a License Agreement Settling Litigation When the Parties Clearly Waived Future Challenges to Validity

When drafting a patent license agreement, licensors often want to include provisions prohibiting the licensee from challenging the validity of the patents involved or shifting the burden of proof for infringement, requiring that the licensee prove noninfringement. The enforceability of these provisions often turns on whether clear and unambiguous language indicates the intent of the parties. This is particularly the case for provisions seeking to bar validity challenges as such provisions may run afoul of the Supreme Court's decision in *Lear v. Adkins*, which overruled the doctrine of "licensee estoppel."

In *Lotes Co. v. Hon Hai Precision Industry Co.*, the Northern District of California addressed what constitutes clear and unambiguous language in the parties' agreement on these issues and discussed the proper scope of the products licensed under the agreement. It held that the covenant is enforceable because it was a clear and unambiguous waiver of future challenges and the agreement resulted from settlement of litigation. The court also addressed the proper scope of products licensed under a patent license agreement, looking to communications between the negotiating parties to determine their intentions. Finally, the court held that merely stating that a licensee must "establish" or "prove" noninfringement is insufficient to shift the burden of proof on that issue to the licensee.

Background

Defendants Hon Hai and Foxconn own patents related to connecting electrical packaging to printed circuit boards. Lotes and the defendants had previously engaged in litigation over the patents, which ultimately ended in a settlement agreement and patent license agreement granting Lotes a license under the defendants' patents. The agreements also included a covenant by Lotes not to challenge the validity of the defendants' patents. The present litigation arose from a dispute regarding those agreements.

The parties filed motions for summary judgment on three specific issues: (1) whether the covenant-not-to-challenge provision of the license agreement is enforceable; (2) the proper scope of products licensed under the license agreement; and (3) whether the license agreement shifted the burden of proving noninfringement to Lotes.

The *Lotes* Decision

The district court addressed the enforceability issue first, holding enforceable the covenant not to challenge the validity of the patents. Relying on the Federal Circuit's analysis in *Flex-Foot, Inc. v. CRP, Inc.*, the court found that Lotes could not challenge validity because the settlement agreement contained a "clear and unambiguous" waiver of future challenges. Despite Lotes's arguments to the contrary, the district court found the Supreme Court's decision in *Lear, Inc. v. Adkins*—which eliminated the doctrine of "licensee estoppel"—inapplicable because *Lear* did not involve licenses created as a result of a litigation-settlement agreement.

Lotes offered several additional arguments on why the covenant not to challenge should not be enforced, none of which the district court accepted. First, according to Lotes, the waiver was not "clear and unambiguous" because the settlement agreement provided for neutral third parties to opine on the validity of the patents. The court reasoned, however, that those separate provisions had no bearing on the clear language of the licensee's covenant not to challenge. Second, Lotes asked the court not to enforce the waiver under a theory of economic duress. But, according to the court, Lotes failed to submit any evidence of the defendants' "coercive acts"—an element required for economic duress.

Having declared the covenant enforceable, the court next addressed the scope of the licensed products covered under the license agreement. Finding the language on the scope of the accused products ambiguous, the court then turned to parole evidence—evidence outside the contract submitted to show what the parties intended at the time of agreement. The portion of the license agreement listing the licensed products included two different headings: "product categories" and a corresponding chart of "product numbers." The defendants argued that the agreement's "product categories" section (the broader group) defined the scope of covered products. Lotes, on the other hand, argued that the section listing specific "product numbers" (the narrower group) defined the scope. Because the parties submitted adequate evidence in favor of their respective interpretations, the court found a genuine issue of material fact, precluding summary judgment. The court did, however, proceed with its analysis of the facts since the parties had agreed to have the court resolve issues of fact if it found summary judgment inappropriate. Based on the evidence the parties submitted, the district court found in favor of Lotes's "product numbers" interpretation.

In doing so, the court focused on the fact that in one of the communications between the parties discussing an exhibit to the license agreement, the defendants wrote: "If Lotes won't agree to [listing by product name instead of product number], we would need its help in listing each product number." The court reasoned that because Lotes never agreed to define the accused products by name, it followed that the parties settled on listing specific product numbers. Also, in an earlier draft of the agreement, placeholder language stated: "We need to agree on a list of products that include those accused and exclude those not addressed by this agreement." That placeholder language was ultimately replaced with a chart containing product numbers, which the court found indicative of intending a product scope defined by "product numbers."

Finally, the district court addressed whether the license agreement shifted the burden of proof to Lotes to prove noninfringement. Finding for Lotes, the court found no evidence of "language that clearly alters" the default rule that a patent holder bears the burden of proof on infringement. While parties are free to contract around this default rule, their intent to do so must be "clear and unambiguous." Here, the question was whether the phrase "Licensee establishes…that a given Licensed Product…no longer infringes" and shifted the burden of proving noninfringement to Lotes. It did not because, as the district court explained, even if the term "establish" means "prove," or even "ultimately succeed," that did not mean that Lotes would bear the burden of proving noninfringement.

Strategy and Conclusion

1. Importance of Careful Drafting. This order reinforces the importance of using clear and explicit language when drafting settlement agreements and license agreements. Covenants not to challenge the validity of the patents may be held enforceable if they arise from a litigation settlement and the parties express a clear and unambiguous intent to preclude validity challenges, notwithstanding the Supreme Court's elimination of the doctrine of licensee estoppel.

2. Considering Extrinsic Evidence. Generally, courts look only at the language of a license agreement in determining the scope of that agreement. When faced with ambiguity, however, courts will look to extrinsic evidence to resolve that ambiguity. This again highlights the importance of careful drafting to ensure that the agreement is not ambiguous on its face.

3. Considering the Effect of Negotiation Discussions. Courts looking at extrinsic evidence to determine the intent of the parties to an agreement will consider negotiation discussions. Unresolved points often end up being less clearly and less explicitly presented in the resulting written agreement. As a result, during the negotiations and when drafting an agreement, the parties should consider the effect of the discussions on how the resulting agreement will be interpreted.

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Continued Employment May Constitute Consideration to Support an Agreement Modifying Terms of Employment, and Courts Will Narrowly Construe Terms Excluding Inventions from Assignment to the Employer.

In *Yale Preston v. Marathon Oil Co*, the Federal Circuit confronted the issue of whether an invention by an employee was properly assigned to his employer through an employment agreement entered into shortly after he began work as an at-will employee. The Federal Circuit determined controlling Wyoming law by certifying a question to the Wyoming Supreme Court. Under that law, continued employment constitutes sufficient consideration to support an agreement modifying the terms of employment. The Federal Circuit construed terms of the agreement to effect broad assignment of inventions to the employer and narrowly viewed inventions excluded from that requirement.

Background

In March 2001, Mr. Preston started working for Marathon Oil. A month later, Preston signed an Employee Agreement with Marathon, which contained provisions (1) defining "Intellectual Property" as "made or conceived by EMPLOYEE during the term of employment with MARATHON"; (2) assigning "Intellectual Property" to Marathon; and (3) excluding from "Intellectual Property" any invention specifically listed in the agreement. For the exclusion clause, Preston wrote "CH4 Resonating Manifold."

Preston raised the idea of using baffles to reduce water in a methane well to another Marathon employee, showing him a "conceptual drawing." Preston drew these baffles plates using a company computer and met with a Marathon engineer to discuss the baffles. On Marathon's behalf, Preston hired a company to make baffle plates and begin installation in Marathon's wells, and he personally participated in several installations. Preston's employment with Marathon ended in April 2003. Then, between April and July, Marathon installed Preston's baffle system in eight additional wells. Although the parties disputed when Preston conceived of his baffle system, they agreed that that he never actually "made" the baffle system until after joining Marathon.

The Marathon engineer with whom Preston had met started Marathon's internal patenting process, explaining that Preston had designed and installed a significant new technology. According to the district court, Preston never objected to this internal patenting process, despite knowing that it was underway. Separately, Preston filed his own patent application for the baffle system.

About a year later, Marathon filed a patent application. Patents ultimately issued from both applications—Preston's and Marathon's. The patent that Preston obtained named only himself as the inventor. Marathon's patent named both Preston and the other Marathon engineer.

Marathon sued Preston, alleging that he breached his employment agreement by refusing to assign his patent to Marathon. Preston counterclaimed for patent infringement and conversion. Preston then filed his own complaint asserting patent infringement, unjust enrichment, conversion, breach of implied contract, and misappropriation of trade secrets, and sought a declaration that Preston is the sole inventor of Marathon's patent.

The district court found that Marathon acquired a shop right to Preston's baffle system, which absolved Marathon of any infringement liability. The district court also found that Preston's claims for unjust enrichment, conversion, and trade-secret misappropriation were barred by the shop-right doctrine or because they were untimely. On summary judgment, the district court held that Preston was the sole inventor of both patents, but that his employee agreement required him to assign his interest in both patents to Marathon and that he breached the agreement by not doing so.

The Marathon Decision

On appeal, Preston challenged the district court's holdings regarding Marathon's shop right and ownership. Marathon filed a "protective" cross-appeal, seeking reversal of the district court's holding that Preston was the sole inventor of Marathon's patent.

According to Preston, the employee agreement was invalid for a lack of consideration because the initial offer letter he signed was an express, written, employment agreement embodying the terms of his employment. Therefore, he argued, the employee agreement was not a valid, enforceable modification of those terms unless he received additional consideration beyond continued employment.

The Federal Circuit disagreed, finding the employment agreement valid and enforceable. The district court had rejected this argument, finding that, under the controlling Wyoming law, additional consideration is not required to modify the terms of an at-will employment agreement. After oral argument on appeal, the Federal Circuit certified this question to the Wyoming Supreme Court, which responded that continued employment was sufficient consideration for an agreement requiring assignment of intellectual property. Accordingly, the Federal Circuit found that the employee agreement is valid and enforceable.

Under Preston's next argument, even if the employee agreement is enforceable, it did not assign rights to Marathon. Specifically, Preston claimed, his invention was not "Intellectual Property" as defined by the employee agreement because Preston conceived of the invention before working at Marathon. Alternatively, Preston argued, even if his invention were considered "Intellectual Property" under the agreement, he expressly excluded it from the employee agreement because he listed "CH4 Resonating Manifold" under the "Previous Inventions and Writing" section.

Under the district court's ruling, Preston did not invent the CH4 resonating manifold until after beginning his employment with Marathon because, before that point, he had little more than a vague idea. Accordingly, the district court found, Preston invented the manifold while employed by Marathon and was therefore required to assign his interest to Marathon. The Federal Circuit took a different approach: because the agreement assigned to Marathon any invention "made or conceived" by an employee while employed at Marathon, the court held that Preston had to both make and conceive of the invention before his employment with Marathon in order to exclude it from the assignment requirement. In other words, by first making the invention at Marathon, Preston triggered the assignment.

Regarding whether Preston's invention was properly excluded from the employee agreement as a listed previous invention, the Federal Circuit found that an invention necessarily requires at least some definite understanding of what has been invented, which Preston did not have, even under a broad interpretation of the term "conceive." Because the district court had found that Preston lacked even that, the Federal Circuit did not determine what level of invention would be required under the "Previous Inventions and Writing" section of the employee agreement or whether that level of invention differs from the level of invention required under the "Intellectual Property" section. Accordingly, the court affirmed the district court's decision that Preston had, by operation of his employee agreement, assigned his rights in both patents to Marathon. Because the assignment was automatic under the terms of the agreement, the court vacated the district court's holding that Preston stood in breach of the agreement. Finally, because of the automatic assignment, the court did not need to address the issues of inventorship or Marathon's shop right.

Strategy and Conclusion

The key argument in this case—consideration for a modification to terms of employment—turned on an interpretation of state law. It behooves both employers and employees to make sure they understand the applicable law in this regard and structure agreements accordingly.

Although it had not been raised by either party, the Federal Circuit went out of its way to note that the district court's finding that Preston breached his employment agreement by not assigning his patent rights to Marathon conflicted with the automatic assignment of the patents to Marathon, which occurred under the Employee Agreement. As the Federal Circuit noted, execution of an assignment of rights to Marathon was not necessary because it was accomplished automatically by the Employee Agreement.

Infringement Can be Based on Product Specified in a Sales Contract Even Where the Product Actually Delivered Does Not Infringe

The typical patent-infringement case involves a determination of whether the sale of a particular product meets all the limitations of the asserted claims. In a recent decision, the Federal Circuit considered the somewhat unusual case where the device sold pursuant to the contract met all the limitations of the claims, but was modified before delivery in an attempt to avoid infringement. Notwithstanding the modifications, the Federal Circuit found that sale infringing based on the terms of the contract.

The Federal Circuit reinstated a jury's verdict overturned by a district court as a matter of law, holding that the jury's findings of no invalidity and infringement, and its damages award were supported by substantial evidence. Although the accused infringer had modified its product before delivery, the Federal Circuit held that this neither precluded infringement nor affected the permissible amount of damages because both depended on contracting to sell an infringing design.

In *Transocean Offshore Deepwater Drilling, Inc. v. Maersk Contractors USA, Inc.,* Transocean Offshore Deepwater Drilling, Inc. owned several patents related to oil rigs. Maersk Drilling USA, Inc., entered into a contract to allow Statoil Gulf of Mexico LLC to use one of Maersk's rigs. The contract expressly indicated that the final drill design could be modified as a result of pending district-court litigation. And several months after the contract was signed, Maersk modified the rig in an effort to avoid infringement of Transocean's patents

Transocean subsequently sued Maersk in the Southern District of Texas for its sale of the oil rig to Statoil. Although the district court initially granted Maersk's motion for summary judgment, holding Transocean's patents obvious, not enabled, and not infringed, the Federal Circuit later vacated that decision and remanded for trial. *Transocean Offshore Deepwater Drilling, Inc. v. Maersk Contractors USA, Inc.*, 617 F.3d 1296 (Fed. Cir. 2010) (*"Transocean I"*). At trial, the jury found that the prior art failed to disclose every element of the asserted claims and that each of seven objective factors indicated nonobviousness—thus that the patent was not invalid—and that Maersk infringed; as a result, the jury awarded Transocean $15 million in compensatory damages. The district court, however, granted Maersk's motions for judgment as a matter of law, holding that Transocean's patent was obvious and not infringed, and that Transocean was not entitled to damages.

Literal Infringement

On appeal, the Federal Circuit addressed the issue of whether Maersk could avoid the claim of infringement based on the fact that the contract between Maersk and Statoil provided that the rig could be modified. The district court had concluded that Maersk did not offer for sale or sell the use of an infringing rig based on this language. The Federal Circuit reversed this decision, however, holding that the right to alter the final design did not affect the result. Quoting from its own opinion in the earlier *Transocean I* case, the Federal Circuit explained that "Maersk USA and Statoil signed a contract and the schematics that accompanied that contract could support a finding that the sale was of an infringing article… The potentially infringing article is the rig sold in the contract, not the altered rig that Maersk USA delivered to the U.S." In particular, the court reasoned that the contract permitted Statoil to access the schematics for the rig and that the jury reasonably concluded that the rig described in the contract and schematics possessed every limitation of Transocean's asserted claims. Thus, Maersk infringed when it offered to sell, and did sell, the infringing rig to Statoil.

Obviousness

On appeal, Maersk also argued that the Federal Circuit's opinion in *Transocean I* established, as law of the case, that the prior art presented a *prima facie* case of obviousness. The "law of the case" doctrine is a rule by which a court does not disturb its own prior decisions without exceptional circumstances. In the prior appeal, the Federal Circuit had held that the two prior-art references at issue taught every limitation of the asserted claims and provided motivation to combine their teachings, thus making a *prima facie* case of obviousness. Accordingly, the district court could not permit a jury to consider whether the prior art taught the limitations of Transocean's claims at issue. But as the court explained in the present appeal, the *prima facie* case did not resolve the ultimate issue of obviousness, which was therefore properly submitted to the jury. Accordingly, the court had to consider whether substantial evidence supported the jury's factual findings on the seven specific considerations of nonobviousness, and affirmed the nonobviousness verdict after identifying evidence to support those findings.

The Federal Circuit then concluded that substantial evidence also supported the jury's finding that the patents were enabled. Accordingly, the court reversed the district court's judgment, which had overturned the verdict of no invalidity.

The Damages Award

On remand, the jury had awarded Transocean $15 million in compensatory damages. On appeal, Maersk argued that the amount was too high, because it never delivered an infringing rig to Statoil. The $15 million reflected the full upfront licensing fee a competitor actually using an infringing drill would pay, and Maersk argued it would not have paid so much for the right to merely *offer* for sale the use of an infringing platform.

But the Federal Circuit was not persuaded. According to the court, while it may not have awarded such a high fee, a damage award is reviewed for substantial evidence. And the Federal Circuit found substantial evidence to support the jury's award of $15 million. Evidence showed that Transocean required both an upfront fee and also a running royalty for the use of its technology. Transocean had presented evidence of the payment of $15 million up-front fees by competitors other than Maersk.

The hypothetical negotiation used to calculate a reasonable royalty is based on the moment of first infringement, and, according to the court, a reasonable jury could conclude that at the time Maersk first infringed by offering an infringing rig for sale, the parties would have negotiated a license granting the right both to offer the rig for sale and to deliver the rig. Thus, that Maersk did not ultimately deliver an infringing rig did not matter.

Strategy and Conclusion

This case illustrates that an agreement in a contract to avoid infringing by modifying the design will not necessarily shield an accused infringer from "offer for sale" liability. As always, careful drafting of an agreement in this type of situation is important. Parties should take care to ensure that whatever is being offered for sale does not infringe at the time of the offer for sale.

After Infringement Verdict, District Court Awards Ongoing Royalty of 2.5 Times the Reasonable Royalty Awarded by Jury

Technology-licensing company Soverain Software sued a number of online retailers in an infringement case involving two of Soverain's online-shopping-cart patents. The suit named eighteen defendants, although only two remained for trial. The jury trial resulted in an infringement verdict and $17.9 million in damages. Following the jury verdict, the defendants moved for a new trial on several grounds, and Soverain moved for the imposition of an ongoing royalty against the defendants' continued infringement. The court refused, however, to overturn the jury's verdict and set an ongoing royalty at a rate two-and-a-half times that found by the jury, reasoning that post-judgment infringement would be willful.

Reasonable Royalty

In their post-trial motions, the defendants moved for judgment as a matter of law on several different grounds related to the testimony of the Soverain's damages expert. In his model for a reasonable royalty, Soverain's expert used the costs of implementing Soverain's software, called Transact, as a starting point for a hypothetical negotiation. The parties agreed that Transact embodied the patents-in-suit and was available at the time of infringement. Soverain's expert used the software as an alternative available to infringers rather than developing their own software. Using Transact involved initial licensing fees, implementation costs, and maintenance/support costs, starting with the 1998 damages period. Because Soverain's model assumed that using Transact meant forgoing the development of a defendant's own system, the model included fees for perpetual use of Transact, extending beyond the life of the patent. The defendants argued that this model was improper because: (1) it sought a reasonable royalty extending beyond the life of the patents, which is a form of patent misuse; and (2) that it relied on the cost of Soverain's own commercial software and the entire market value.

The court acknowledged that seeking post-expiration royalties through a licensing agreement could constitute patent misuse. But it held that Soverain did not try to extract post-expiration royalties but rather "considered the entire cost of implementing an alternative system for the purpose of determining what reasonable royalty rate would have been agreed to as part of the hypothetical negotiation." The court was persuaded by testimony of Soverain's expert that parties to a hypothetical negotiation would have considered the entire cost of the alternative system in determining a reasonable royalty rate. The court also noted that the defendants emphasized this aspect of the royalty model during cross-examination; thus, the jury was able to consider whether the maintenance costs, which went beyond the 2015 expiration date of the patents-in-suit, should form the basis of a reasonable royalty. Further, the court pointed to the expert's testimony concluding that the discounted maintenance and support costs would become virtually nothing beyond 20 years.

Next, the court rejected the defendants' arguments that Soverain violated the entire-market-value rule. Specifically, the royalty base was the value of products sold on the infringing websites. The court held that the entire-market-value rule would be implicated only if Soverain had used the cost of implementing a defendant's entire website. According to the court, it was proper to base the royalty on the value of online sales enabled by the patented technology. The court also briefly endorsed the methodology of using the cost of Transact as the starting point for a reasonable-royalty model and deferred to the jury's findings on which expert's analysis should prevail.

The court also addressed an odd twist in the damages award. Specifically, one of the defendants had sold 95 percent of its goods through one website and the rest through a second website. The jury, however, apportioned 95 percent of the damages to the second website. The court relied on its power to correct clerical errors, switching the verdict so the damages against the defendant represented the actual sales apportionment. It reasoned that defendant's counsel had transposed the two amounts in its own demonstrative—showing that it was easy to confuse the two—and that the evidence only supported the corrected verdict.

Ongoing Royalty

Rather than seeking an injunction, Soverain asked the court to impose an ongoing royalty on any use by the defendants. It asked for a royalty rate quadruple that used by the jury, arguing that the royalty rate should be doubled, based on changed circumstances, and then doubled again, based on willful infringement.

The court declined to impose a higher post-judgment royalty rate due to changed circumstances. The jury, according to the court, considered evidence regarding changed circumstances in arriving at its royalty rate. Specifically, the court noted that Soverain's expert considered post-1998 evidence in arriving at his damages model, which included the costs of implementing Transact through the life of the patents-in-suit and also pointed to trial testimony on how the patented technology was used to improve the profitability of the defendants' businesses and the success of e-commerce sales in 2004 and 2009.

The court did agree with Soverain, however, that continued infringement after judgment warranted a higher royalty rate and imposed a post-judgment royalty of two-and-a-half times that found by the jury. In its analysis, the court found four factors weighing in favor of enhancement of the post-verdict royalty. The first two—whether defendants had a good-faith belief that the patents are invalid or not infringed and the closeness of the case—both strongly favored enhancement. Because the defendants were now adjudged infringers and the patents were deemed not invalid, the court reasoned that the defendants could not assert a good-faith belief of noninfringement or validity. Further, it found that the defendants' statuses as "large, profitable" companies favored enhancement. Finally, it found that consideration of remedial action "favors enhancement because there is no evidence that Defendants have taken any steps to stop infringement." Accordingly, the court found that an ongoing royalty of two-and-a-half times the jury's royalty was appropriate under the circumstances.

Strategy and Conclusion

This case shows an example of how patent owners may be able to base a damages model in part on a time after expiration of the patents. The court seemingly approved of the damages model because it did not directly assess royalties for the post-expiration time, but rather considered an alternate course of action that would have implications beyond the life of the patent. This case also demonstrates one way courts may exercise equitable power to set royalties for the post-judgment period, in lieu of an injunction. In that role, the court is not bound by the reasonable-royalty rate found by the jury and may, as here, increase the royalty significantly. ■