Second Circuit Holds Patent No-Challenge Clause Unenforceable

On July 10, 2012, the United States Court of Appeals for the Second Circuit held that a broad patent no-challenge clause in a Covenant Not to Sue agreement resolving a pre-litigation enforcement licensing effort was unenforceable on public policy grounds. The case, *Rates Technology Inc. v. Speakeasy, Inc.*, calls into question some of the techniques licensors have adopted following the Supreme Court's *MedImmune* decision to try to restrict licensees' ability to challenge licensed patents.

Rates Technology had contacted Speakeasy and suggested Speakeasy was infringing certain Rates Technology patents. For a one-time payment, Rates Technology offered to release Speakeasy from liability. The parties proceeded to execute a Covenant Not to Sue, which included a release of liability and covenant not to sue under the patents by Rates Technology and a broad representation and warranty by Speakeasy that it would not challenge, or assist others in challenging, any of the subject patents. The agreement also included a significant liquidated damages provision requiring Speakeasy to pay $12 million and legal expenses if the warranty were breached. Rates Technology never filed a patent infringement action against Speakeasy before the Covenant Not to Sue was executed.

Through a series of corporate transactions, Speakeasy became affiliated with Covad Company. Covad also was contacted by Rates Technology regarding the same patents, and Covad responded by filing a declaratory judgment action challenging the patents' validity and enforceability. Rates Technology responded by filing a breach of contract action against Speakeasy in New York federal court, alleging it violated the non-challenge clause by assisting its affiliate, Covad, and seeking to enforce the liquidated damages clause. The district court dismissed Rates Technology's complaint for failure to state a claim, holding the no-challenge clause to be invalid under *Lear, Inc. v. Adkins*, 395 U.S. 653, and Rates Technology appealed.

The Second Circuit analyzed Rates Technology's no-challenge clause under the public policy principles articulated by the Supreme Court in *Lear*. In *Lear,* the Supreme Court repudiated the doctrine of licensee estoppel and established generally a balancing test for when the public interest in discovering invalid patents should outweigh other competing interests. In applying *Lear*'s balancing test, the Second Circuit appeared to draw a line between no-challenge clauses entered into before litigation and discovery, and those entered into after litigation has been commenced and meaningful discovery conducted into validity issues.

The Second Circuit did not view how the Rates Technology agreement was couched – whether as a license or settlement – as determinative. The difference between the two, the court opined, is merely a drafting choice and it looked askance at recitations of a pre-litigation "dispute" concerning validity in the Rates Technology Covenant Not to Sue. The court also distinguished situations where there has been active litigation and discovery, since that suggests the dispute is real and the challenging party provided a full opportunity to assess a patent's validity. So, despite the public policy favoring settlement of disputes generally, the court's concern that enforcing no-challenge clauses in pre-litigation agreements would "too easily enable patent owners to muzzle licenses" led it to strike the *Lear* balance in the licensee's favor.

The Second Circuit's *Rates Technology Inc.* opinion is a significant development regarding no-challenge clauses. The decision should prompt licensors of patents, whether in a commercial or enforcement context, to take care when considering how to handle potential licensee patent challenges. Although

licensing transactions vary tremendously and there is no one-size-fits-all approach, there are techniques that a licensor potentially could use to provide its licensee with incentives to not challenge licensed patents that are more likely to withstand judicial scrutiny.

For more information regarding the potential impact of *Rates Technology Inc.*, please contact one of the Ropes & Gray attorneys listed below or your regular Ropes & Gray contact.

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