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The Supreme Court Decides that a Patent Licensee Need Not Breach the License Before Challenging the Licensed Patent

January 2007
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On January 9, 2007, the Supreme Court decided that a patent licensee need not refuse to pay royalties under the license before filing a declaratory judgment action against the licensor/patentee for a declaration that the patent is invalid, unenforceable, or not infringed. In *MedImmune, Inc. v. Genentech, Inc.*, U.S. Supreme Court No. 05-608 (Jan. 9, 2007), the Court held that the Article III limitation of federal courts' jurisdiction to "Cases" and "Controversies," as reflected in the "actual controversy" requirement of the Declaratory Judgment Act, did not require a patent licensee to terminate or be in breach of its license agreement before it seeks a declaratory judgment.

The *MedImmune* decision restores to licensees the ability to challenge the infringement, scope, or validity of a licensed patent while continuing to pay royalties. Under such a "pay and sue" strategy, so long as the royalties are paid, the patentee/licensor cannot terminate the license and sue the licensee for infringement because there is no breach of the license. The worst-case scenario for the challenging licensee is that the patentee retains the royalties paid and the terms of the license are maintained. The Court's decision allowing a licensee to "pay and sue" is likely to have an impact on licensee/licensor relationships, the number of patent suits, and the terms found in license agreements.

In 2004, the Federal Circuit had rejected this "pay and sue" strategy in *Gen-Probe Inc. v. Vysis, Inc.,* 359 F.3d 1376 (Fed. Cir. 2004), holding that unless a licensee breaches the license by refusing to pay royalties, there is no actual controversy, and the federal courts lack jurisdiction. In *MedImmune*, in an opinion by Justice Scalia joined by seven other Justices (with Justice Thomas dissenting), the Supreme Court rejected the Federal Circuit's analysis.

Background

In *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969), the Supreme Court held that a party that has entered into a license to pay royalties for the use of a patented invention could attack the validity of the licensed patent. In doing so, the Court rejected the contract-law doctrine of licensee estoppel. The Court also held that the licensee was not required to continue to pay royalties until its challenge to the validity of the patent was resolved. Thus, *Lear* allows a licensee to stop making royalty payments and to challenge the patent's validity at any time.

Lear did not address, however, the related question of whether the licensee was required to stop making payments before challenging a patent. In *C.R. Bard, Inc. v. Schwartz*, 716 F.2d 874 (Fed. Cir. 1983), the Federal Circuit answered that question, holding that a licensee need not terminate a license before filing a declaratory judgment action. Based on *Lear* and *C.R. Bard,* many lawyers believed that a licensee could challenge the validity of a licensed patent while at the same time continuing to pay royalties, thereby avoiding breach of the license agreement (the "pay and sue" strategy).

The Federal Circuit rejected this strategy in *Gen-Probe Inc. v. Vysis, Inc.,* 359 F.3d 1376 (Fed. Cir. 2004). In *Gen-Probe*, the Federal Circuit held that a licensee in good standing could not file a declaratory judgment action regarding the licensed patent without running afoul of the constitutional "case or controversy" requirement for the exercise of federal jurisdiction. The court held that the license "insulated Gen-Probe from an infringement suit instituted by Vysis." *Gen-Probe* at 1381. Thus, the court determined that the license, "unless materially breached, obliterated any reasonable apprehension" of an infringement lawsuit. *Id.*

At the time the Federal Circuit decided *Gen-Probe*, another declaratory judgment case was pending, involving MedImmune, Inc., and Genentech, Inc. MedImmune had licensed certain intellectual property rights from Genentech. In 2003, MedImmune sued Genentech for a declaration that one of the licensed patents (called Cabilly II) was not infringed by MedImmune's activities and/or was invalid. MedImmune continued to pay royalties during the litigation, however, under the "pay and sue" strategy then thought to be allowed under *Lear* and *Bard*. When *Gen-Probe* was decided by the Federal Circuit, the district court dismissed MedImmune's suit for lack of an actual case or controversy. The Federal Circuit affirmed, rejecting MedImmune's argument that it met the requirements of the Declaratory Judgment Act because if it stopped paying the royalties, it could be sued. *MedImmune, Inc. v. Genentech*, *Inc.*, 427 F.3d 958 (Fed. Cir. 2005).

The Supreme Court's Decision

The Supreme Court held that the Federal Circuit erred in affirming the dismissal of MedImmune's action on the ground of lack of subject matter jurisdiction.

The Supreme Court began its analysis by observing that an actual controversy, as required by the Declaratory Judgment Act and Article III of the Constitution, would exist if MedImmune "had taken the final step of refusing to make royalty payments."

> Respondents claim a right to royalties under the licensing agreement. Petitioner asserts that no royalties are owing because the Cabilly II patent is invalid and not infringed: and alleges (without contradiction) a threat by respondents to enjoin sales if royalties are not forthcoming. The factual and legal dimensions of the dispute are well defined and, but for the petitioner's continuing to make royalty payments, nothing about the dispute would render it unfit for judicial resolution.

Id. at 8-9.

The Court then restated the controlling legal question in broad terms, not limited to licensing disputes: "Petitioner's own acts … eliminate the imminent threat of harm. The question before us is whether this causes the dispute no longer to be a case or controversy within the meaning of Article III." *Id.* at 9.

The Court said that its own precedents answer this question "no." First, the Court observed: "where threatened action by *government* is concerned, we do not require a plaintiff to expose himself to liability before bringing suit to challenge the basis for the threat—for example, the constitutionality of a law threatened to be enforced. The plaintiff's own action (or inaction) in failing to violate the law eliminates the imminent threat of prosecution, but nonetheless does not eliminate Article III jurisdiction." *Id.*

Second, the Court turned to "situations in which the plaintiff's self-avoidance of imminent injury is coerced by threatened enforcement action of a private party rather than the government." [emphasis omitted.] *Id.* at 10. The Court noted that its jurisprudence in this area was "more rare," but observed that "[t]he only Supreme Court decision in point is, fortuitously, close on its facts to the case before us. *Altvater v. Freeman,* 319 U.S. 359 (1943), held that a licensee's failure to cease its payment of royalties did not render nonjusticiable a dispute over the validity of the patent." *Id.* at 11. This was so because "[t]he royalties 'were being paid under protest and under the compulsion of an injunction decree,' and '[u]nless the injunction decree were modified, the only other course [of action] was to defy it, and to risk not only actual but treble damages in infringement suits.'" [citation omitted.] *Id.* at 12. Accordingly, the Court previously "concluded that 'the requirements of [a] case or controversy are met where payment of a claim is demanded as of right and where payment is made, but where the involuntary or coercive nature of the exaction preserves the right to recover the sums paid or to challenge the legality of the claim.'" *Id.*

The Supreme Court rejected the Federal Circuit's attempt in *Gen-Probe* to distinguish *Altvater* on the ground that it involved the compulsion of an injunction. The Court also rejected respondents' claims that the parties had effectively settled the dispute by entering into the license agreement, and that "[p]ermitting [the licensee] to challenge the validity of the patent without terminating or breaking the agreement alters the deal …." *Id.* at 16.

The Court also held that "it is not clear where the prohibition against challenging the validity of patents is to be found" in the agreements before the Court. "Promising to pay royalties on patents that have not been held invalid does not amount to a promise not to seek a holding of their invalidity." *Id.*

Finally, the Court held that respondents could not rely upon "the common-law rule that a party to a contract cannot at one and the same time challenge its validity and continue to reap its benefits." Respondents had argued that *Lear* "did not suspend that rule for patent licensing agreements, since the plaintiff in that case has already repudiated the contract." The Court held:

> Even if Lear's repudiation of the doctrine of licensee estoppel was so limited (a point on which … we do not opine), it is hard to see how the common-law rule has any application here. Petitioner is not repudiating or impugning the contract while continuing to reap its benefits. Rather, it is asserting that the contract, properly interpreted, does not prevent it from challenging the patents, and does not require the payment of royalties because the patents do not cover its products and are invalid.

Id. at 16-17.

Significance of the Decision

The decision may have a significant impact on licensee/licensor relationships, the number of patent suits, and the terms found in license agreements.

The *MedImmune* decision may cause licensors to demand higher royalties for the use of their patents. The incentive for the licensor to compromise now, agreeing to a lower royalty percentage that benefits the licensee, is reduced if the licensor knows that the license is not a final resolution with the licensee, but rather that the licensee can simply turn around and sue to invalidate the underlying patent or to argue that it is not infringed. On the other hand, licensees may be more willing to enter into patent licenses, since doing so will not limit their ability to challenge the licensed patent. Licensees may view licenses as a kind of insurance policy, limiting the scope of their liability, when they wish to challenge questionable patents. Additionally, under *Gen-Probe*, if a license involved several patents, a licensee could not challenge only one of the licensed patents without risking the entire license. Thus, in this regard, the *MedImmune* decision restores the pre-*Gen-Probe* balance between licensors and licensees.

The decision may also increase the number of declaratory judgment actions challenging the validity of patents. The Solicitor General filed an amicus brief in support of MedImmune, arguing that the Federal Circuit had made it too difficult to bring challenges to patents by "erect[ing] an unwarranted obstacle to declaratory relief in patent cases." Brief for the United States as Amicus Curiae Supporting Petitioner, *MedImmune, Inc. v. Genentech, Inc.,* U.S. Supreme Court No. 05-608 (May 15, 2006), p. 14. The Solicitor General asserted that invalid patents can hurt efficient licensing, hinder competition, and undermine incentives for innovation. If the Solicitor General's observations about the impact of the *Gen-Probe* rule are correct, the number of validity challenges may increase.

The decision may also impact how future licenses are drafted. In the past, most courts have held that under *Lear* a clause in a patent license agreement preventing the licensee from contesting the validity of the licensed patent (a "no-challenge" clause) was unenforceable. *See, e.g., Bendix Corp. v. Balax, Inc.*, 471 F.2d 149 (7th Cir. 1972). However, while rejecting respondents' arguments based on the notion of "settlement" and the common-law doctrine against reaping the benefits of a repudiated contract, the Supreme Court suggested that licensors might be permitted to require, as a condition of granting the license, that the licensee "promise not to seek a holding [that the licensed patents are] invalid[]," and that the contract might "prevent [the licensee] from challenging the patents." *Id.* at 16. Until the full import of the Court's comments are settled, no-challenge clauses may become a feature of patent licenses.

Likewise, in the past, questions have existed about the enforceability of clauses that, while not

prohibiting a challenge, allowed the licensor to terminate the license if such a challenge were brought. On the one hand, it was argued that termination-upon-challenge clauses were invalid because they discourage challenges to patent validity in violation of the public policy principles stated by *Lear*. On the other hand, it was argued that these clauses were valid because, unlike a no-challenge clause, they do not bar a licensee from challenging the validity of a patent. These arguments became moot after the Federal Circuit's *Gen-Probe* decision, since the licensee could not challenge the patent without stopping royalty payments and subjecting itself to termination for non-payment. In light of the Supreme Court's rejection of *Gen-Probe*, termination-upon-challenge clauses may become a regular feature of patent licenses, though the enforceability of such clauses remains an open question.

Finally, if *MedImmune* means that post-agreement challenges cannot be precluded, then licensors may wish to include a contractual provision in their licenses providing that, if the license is unsuccessfully challenged, then attorney's fees and costs for the declaratory judgment action must be paid by the licensee.

By reversing Federal Circuit law, the *MedImmune* decision represents a change in the law governing patent licenses. Licensees and licensors are likely to try a number of different strategies in future license negotiations until some of the questions raised by *MedImmune* are resolved. The case also suggests a continuing interest by the Supreme Court in the development of patent law. Indeed, in a footnote, the Supreme Court cast doubt on the Federal Circuit's "reasonable apprehension of suit" test for declaratory judgment jurisdiction, stating that it conflicts with several Supreme Court decisions.

Note:

MedImmune also alleged that the patent in suit was the result of an anticompetitive settlement of an interference contesting priority between Genentech and Celltech R&D, Ltd., a British biotechnology company. The district court granted Genentech's and Celltech's motions for summary judgment on MedImmune's antitrust and unfair competition claims, and the Federal Circuit affirmed that ruling. Morrison & Foerster represented Celltech both in the district court and in the Federal Circuit.