

PATENT LICENSING, WHAT TO DO AFTER *MEDIMMUNE* v. *GENENTECH*

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I. Introduction

Since *Lear v. Adkins* in 1969, patent licensing has occurred under legal constraints on how the validity or invalidity of a patent affects the rights of a patent owner and the obligations of a licensee. For about fifteen years after 1969, the law was in a state of mild chaos.¹ The legal situation then settled down, and people generally adapted licensing practices to the law. On January 9, 2007, the Supreme Court stirred the pot again in *Medimmune v. Genentech*.²

Section II of this paper is a summary of the significance of this decision. Section III describes the facts, the legal issue, and the result in *Medimmune*. Section IV explains how *Lear* and now *Medimmune* influence future licensing and royalty decisions. Sections V and VI offer recommendations for what licensees and patent owners should do. Section VII describes legislation I suggested 20 years ago for addressing this problem, one the patent reformers have ignored.

II. Summary

A *Medimmune* problem arises when a patent owner grants a license that defines the royalty obligation by reference to validity. In that situation, *Medimmune* means that, if a patent owner says something that permits the licensee to allege that it believed the patent owner would terminate the license and sue for infringement if the license failed to pay royalties, the licensee may pay under protest, and bring an action for a declaratory judgment that the license means royalties are payable only if the patent is valid, and the patent is invalid. If the licensee wins on both issues, the royalty obligation ends at some time the *Medimmune* decision declined to identify. If the licensee loses on the contract issue or invalidity, it loses nothing.

Medimmune says only that a court has jurisdiction to decide whether a license, as properly interpreted, means that royalty payments are dependent on validity. The Court did not say how the issue should be decided in that case. Therefore, the full implications of *Medimmune* are unknown. If a patent owner wins on the contract issue, such as by showing that the reference to validity applied only to judgments in actions between the patent owner and a third party, the patent owner may avoid a decision on validity. If the owner loses, the licensee may try to prove invalidity. Many patent licenses have been written in a way that will make it very difficult for the patent owner to win on the contract issue.

Medimmune has the following effect. If patent owners define royalty obligations by reference to validity, and the courts interpret those definitions to mean that royalties are payable

¹ I described these issues in two articles in the mid-1980s, and my patent law book. John W. Schlicher, *A Lear v. Adkins Allegory*, 28 Journal of the Patent and Trademark Office Society 427 (1986); John W. Schlicher, *Judicial Regulation of Patent Licensing, Litigation and Settlement under Judicial Policies Created in Lear v. Adkins*, American Intellectual Property Law Association, Selected Legal Papers (1985); John W. Schlicher, Chapter 12, *Patent Law: Legal and Economic Principles*, West Group (1992, Second Edition 2003).

² *Medimmune, Inc. v. Genentech, Inc.*, __ U.S. __, 127 S.Ct. 764, 2007 WL 43797 (U.S.), 81 U.S.P.Q. 2d 1225 (2007).

only if the patent is valid, patent owners must choose between having rights under the license (royalties) or patent rights (damages and an injunction). Potential licensees need not choose. They may have rights under the license (freedom from damages and an injunction), and the right to litigate whether the patent is valid. If successful in litigating validity, the licensee eliminates the patent owner's rights under the license, the royalties. In sum, if licenses are written in that way, patent owners must choose between having the benefits of licensing or infringement litigation. Licensees may have the benefits of both licensing and validity litigation.

If a patent owner has defined royalties in that way, the owner's main hope of avoiding a *Medimmune* declaratory judgment action is that the licensee will conclude that its business interests are not served by trying to kill the patent, or that the royalty savings do not justify the investment in invalidity litigation. Patent owners will try to avoid *Medimmune* actions by not saying anything to licensees that could be understood to indicate that the patent owner would terminate and sue for infringement, if the licensee does not pay. However, if, as happened in *Medimmune*, a patent owner creates a controversy by telling a licensee that it expects the licensee to pay royalties on some product, careful language is unlikely to prevent declaratory judgment actions.

Medimmune should not control licenses that define royalty obligations without reference to validity. Patent owners should be able to avoid *Medimmune* declaratory judgment actions by defining royalty obligations in that way, and dealing separately with the effect of invalidity judgments in third party actions. See Section VI, A. I have recommended these approaches for years. Patent owners who have defined the royalty obligation without referring to validity should be unaffected.

However, many licensees will argue that *Medimmune* applies to all licenses. They will commence declaratory judgment actions to have the patents declared invalid, and say *Lear* requires that all licensees may defend an action for royalties by proving invalidity. They will say *Medimmune* means the federal courts have jurisdiction to decide those actions, if the licensees believe the patent owner would sue to require payment, if they stopped. If the lower courts agree, *Medimmune* will apply regardless of how the patent owner defined the royalty obligation. It is difficult to predict how the lower courts will deal with those actions.

Medimmune should cause patent owners to refocus on how they deal with *Lear*, and the possibility that *Medimmune* will be extended to all licenses. The simplest and most direct response to *Lear* and an extension of *Medimmune* is to provide that the patent owner may terminate the license, if the licensee alleges in any action that the licensed patent is invalid. See Section VI, B, 2. Patent owners should also consider a provision that the licensee will not assert in any action that the licensed patent is invalid and will not commence or prosecute any action or claim seeking judgment that the patent is invalid. See Section VI, B, 1. The lower courts have said, I believe incorrectly, that *Lear* makes such a provision unenforceable. However, there is little risk in using this provision, and, if the courts or Congress some day say the provision is enforceable, it will be too late to add it. If a patent owner does not believe these provisions are sufficient to deter or prevent a licensee from stopping payments and defending a contract action under *Lear*, or from paying and commencing a *Medimmune* action, there are a variety of other approaches to termination rights, royalty obligations, and other terms to deal with *Lear* and *Medimmune* actions. See Section VI, B.

Ultimately, if a patent owner believes that there is any chance that it will face a *Medimmune* action in which royalties are found to be dependent on validity, the patent owner should license only at rates that are not discounted based on the likelihood of a validity judgment, not discounted based on the risk of validity litigation, and not reduced based on saving infringement litigation costs.³ This will often prevent licensing. When it does, those patent owners will be better off capturing the value of their inventions through infringement litigation. See Section IV.

If all efforts to avoid *Medimmune* fail, and royalties always ultimately depend on validity judgments, the value of patents will decline for companies that license patents for royalty revenue exceeding validity litigation costs by a margin that justifies licensee litigation. There will be much less licensing, and much more patent infringement litigation. Patent owners and licensees have a mutual interest in legislation to solve this potential problem. See Section VII.

III. The Decision In *Medimmune v. Genentech*

This section is mainly for lawyers.

A. *Lear*

It is difficult to understand the significance of *Medimmune* without understanding something about the developments that preceded it. For years, patent owners and their licensees have been dealing with the fact that a patent is rarely certain to be valid or invalid. If you asked several different judges or juries whether a patent is valid or invalid, gave them all the facts, and explained the law to the juries, they would only rarely all reach the same conclusion.⁴

Before *Lear*, business people and lawyers used various license terms to specify how the validity of a patent affected royalty obligations. There were two separate issues. One was whether the patent owner and the licensee had to litigate validity to determine whether royalties were payable. The other was the effect on royalty obligations of a judgment that the patent was invalid in an action between the patent owner and a third party infringer. Licenses dealt with these two issues in a variety of ways. Law also provided default responses, where an agreement

³ This means the patent owner should determine a rate that would be acceptable without these problems, and calculate the rate at which it will license by (1) dividing that rate by the probability the patent would be found valid if litigation (such as 0.5), (2) divide the resulting rate by the percentage discount the patent owner would use, if infringement litigation risks were avoided (such as 0.5), and (3) add to the rate an amount approximating validity litigation costs. For the reasons, see Section IV. If the patent owner is willing to gamble that the licensee will not use *Lear* and *Medimmune*, the patent owner could multiply the resulting rate by its estimate of the probability that the licensee will not do so.

⁴ In other words, if the same patent issue was presented for decision to 10 different judges or 10 different juries, the issue would rarely be decided the same way all 10 times, or even 9 out of 10 times. The issue might be decided one way 5 times and the opposite way 5 times, and it is difficult to predict in advance exactly how things would turn out. The same thing is likely to happen if the same issue is presented to 10 different lawyers.

failed to address these issues. One such rule called licensee estoppel said that a licensee could not defend an action for royalties on the basis that the patent was invalid.⁵

In 1969, the Supreme Court in *Lear* eliminated the licensee estoppel rule.⁶ The Court vacated a decision of the California Supreme Court that the licensee estoppel doctrine prevented the Lear airplane company from defending a contract action for royalties based on invalidity. The Court believed there was too little patent infringement litigation over validity, and the country needed licensees to be free of the estoppel rule so they would be able to litigate that issue.

Since *Lear*, most patent owners have granted licenses on the assumption that their licensees could not force the patent owner to litigate the validity of the licensed patents, while paying the royalties and preventing the patent owner from terminating. For many, this assumption has probably turned out to be wrong.⁷

B. *Medimmune*

Genentech granted Medimmune a license under an existing patent and a patent that might issue from a pending application. The Genentech license called for royalties on “Licensed Products,” and defined “Licensed Products” as a specified antibody, “the manufacture, use or sale of which . . . would, if not licensed under th[e] Agreement, infringe one or more claims of either or both of [the covered patents,] which have neither expired nor been held invalid by a court or other body of competent jurisdiction from which no appeal has been or may be taken.”⁸

A patent issued on the pending application. Genentech wrote Medimmune a letter saying that Genentech believed a Medimmune product was covered by this patent, and expected Medimmune to pay royalties. Medimmune did not believe royalties were owed, because this patent was invalid, unenforceable, and not infringed by that product. Medimmune informed Genentech that it was paying royalties “under protest, and with reservation of all [its] rights,” and commenced an action against Genentech in a federal court for a declaratory judgment that

⁵ Another rule governed the effect of an invalidity judgment in an action involving a third party, typically an infringer. This rule was sometimes referred to as the eviction doctrine. The existence of these two entirely different rules, and the licensing practices that developed in response to them, has caused much of the current confusion.

⁶ *Lear v. Atkins*, 395 U.S. 653, 670-78 (1969).

⁷ Many patent owners have granted licenses defining the products on which royalties are payable as those covered by a “Valid Claim” of a licensed patent. I say probably only because such a license must first be interpreted to mean that royalties are contingent on validity as determined in an action between the patent owner and the licensee, and there is a possible alternative meaning.

⁸ The Genentech language had been used before. After *Lear*, this provision was unenforceable as to invalidity judgments in actions involving the licensee, and therefore applied only to the effect of judgments in third party actions. See *Congoleum Industries, Inc. v. Armstrong Cork Co.*, 366 F. Supp. 220, 232-34 (E.D. Pa. 1973), *aff’d*, 510 F.2d 334 (3d Cir. 1975).

the patent was invalid, not infringed, and no royalties were payable under the license. Medimmune alleged that it considered Genentech's letter a threat to terminate the license and sue Medimmune for patent infringement, if Medimmune did not pay. The Court said Genentech did not dispute those contentions.

When the action was filed, the license continued to exist, and Medimmune had performed all of its obligations under the license. Therefore, at the time of this action, Genentech had no contract or patent infringement claim against Medimmune. The district court dismissed the action for lack of a justiciable controversy, and the Court of Appeals affirmed.⁹

The Supreme Court disagreed. The legal issue was whether that action involved a case or controversy under the Constitution and an actual controversy under the Declaratory Judgments Act. The Supreme Court said there was a contract dispute between the parties about whether the licensee was obligated to make payments, if the licensed patent was invalid. Medimmune said that the definition of Licensed Products meant that it was not obligated to pay royalties on a patent that was invalid. Genentech said that the license required Medimmune to pay whether or not the licensed patent was valid. The Supreme Court said there was a dispute over who was right, and if Medimmune's view of the contract was correct, Medimmune could eliminate its royalty obligation by proving invalidity.

The Court said that a federal court could decide that dispute even though the licensee was paying royalties, and the patent owner had no basis for commencing any type of action against the licensee.¹⁰ The Court did not expressly address how a federal court had subject matter jurisdiction over a contract dispute on patent license obligations in the absence of diversity.¹¹ The Court also did not say whether there would have been a justiciable controversy if the patent owner threatened only to enforce the royalty obligation.

The action now returns to the lower courts for an interpretation of the contract. Genentech is likely to say that Licensed Products was defined only to specify the time when royalties end if the patent is found invalid in an action between Genentech and a third party. Genentech is likely to say this language deals only with eviction. Medimmune will say the language applies to any judgment of invalidity.

⁹ *Medimmune, Inc. v. Genentech, Inc.*, 427 F.3d 958, 961-64 (Fed. Cir. 2005), *rev'd and remanded*, 127 S.Ct. 764, 2007 WL 43797 (U.S.), 81 U.S.P.Q. 2d 1225 (2007). The Court of Appeals' decision assumed that the patent owner had no basis for terminating or canceling the license, and could not bring any type of action against the licensee. Therefore, the Court of Appeals reasoned that there was no existing controversy a federal court had jurisdiction to decide.

¹⁰ Medimmune sought a declaratory judgment of both non-infringement and invalidity. However, the Court said the same result would follow if only an invalidity judgment was sought.

¹¹ The only issue the Court was asked to decide was whether there was an actual controversy. The Court was not asked whether the controversy was one over which a federal court had subject matter jurisdiction because it arose under the Patent Act. 28 U.S.C. § 1338(a). There is likely to be disagreement about whether *Medimmune* says anything about this issue.

Medimmune should not have been a complete shock. This had happened before,¹² and at least one lawyer warned of this possibility.¹³

C. The Limits of *Medimmune*

Medimmune says there was a contract dispute between *Medimmune* and Genentech over the impact of possible invalidity on royalties. *Medimmune* does not say that a similar contract dispute would arise, if a license defined the royalty obligation without reference to validity. *Medimmune* also does not say the law requires that royalties under all patent licenses depend on validity. If the law so required, there would have been no contract dispute to decide. The law would dictate the result. Therefore, patent owners should not be subject to a *Medimmune* declaratory judgment action, if they used a definition of royalty-bearing products that did not refer to validity.¹⁴

However, every time the Supreme Court says something on patents, litigants attempt to push the decision and the language to its limits. Many licensees will argue that *Medimmune* applies to all licenses. Licensees will commence declaratory judgment actions to have the licensed patent declared invalid, and say *Lear* requires that all licensees may defend an action for royalties by proving invalidity, regardless of the language of the royalty obligation. They will say *Medimmune* means the federal courts have jurisdiction to decide those actions, if the licensee pays under protest due to invalidity, and believes the patent owner would sue to require payment, if it stopped.

If the lower courts agree, *Medimmune* will apply no matter how the patent owner defined the royalty obligation. The outcome of those actions will depend in part on the courts' views of what *Lear* decided. The question will be whether *Lear* decided that, with the licensee estoppel doctrine out of the way, invalidity was a defense to an action for royalties in that action, because the Atkins-Lear license made royalties contingent on validity (as the Court indicated in *Medimmune*), or patent law and the preemption doctrine require that royalties in all licenses be contingent on validity.¹⁵

¹² *Warner-Jenkinson v. Allied Chemical Corp.*, 567 F.2d 184 (2d Cir. 1977).

¹³ See John W. Schlicher, *A Lear v. Adkins Allegory*, 28 Journal of the Patent and Trademark Office Society 427 (1986).

¹⁴ See e.g., John W. Schlicher, *Patent License Provisions* (2001) (e.g., “‘Licensed Products’ shall mean all products the making, use, importing, offering for sale, sale or supply of which would, in the absence of the license granted by this Agreement, infringe a patent of the Licensed Patents.”).

¹⁵ There are two other possibilities. One is the Court in *Lear* did not decide that question, and sent the action back to the California courts to decide whether invalidity would have been a defense for *Lear*. The decision indicates that the Court believed invalidity would be a defense. Justice White's concurring opinion said the Court should not to decide that question. Another is that the Court believed that licensee estoppel applied to all licenses as a matter of contract law and without regard to the manner in which the license defined the royalty obligation, and

Lear does not provide a straightforward answer. My reading of pre-*Lear* decisions is that licensee estoppel was a gap-filling rule applied where a license did not address whether a licensee could contest validity to defeat the royalty obligation. If that is correct, the *Lear* Court's decision to eliminate this default rule simply forces the parties to address the issue. They may no longer rely on the law to provide the desired result. Under this view, the main decision in *Lear* does not preclude the parties from agreeing that royalties will be paid regardless of the licensee's views or contentions on validity. In the situation of the Atkins-Lear license, with licensee estoppel gone, the *Lear* Court apparently believed the license permitted Lear to defend the royalty action based on invalidity. Under this interpretation, *Lear* does not mean that the law requires that invalidity be a defense to a contract action for royalties in all licenses, and *Medimmune* should apply only to licenses that define the royalty obligation by reference to validity.

Licensees will disagree with that interpretation and say *Lear* implicitly decided that a license may not lawfully provide the licensee estoppel result. This argument will be based on the Court's decision on another issue – when the royalty obligation ends if the licensee proves invalidity. Adkins granted the Lear company a license before a patent issued. A patent issued later. Lear paid no royalties before or after the patent issued. Adkins argued that Lear owed royalties until there was a judgment of invalidity under a provision of the license. In that context, the Court said that, if Lear wins on invalidity, the royalty obligation ends as of the date Lear challenged validity in court, and the contract could not properly provide otherwise.¹⁶ The Court should have said there was nothing in the contract about the date the royalty obligation ended in the event of an invalidity judgment in a contract action between Atkins and Lear.¹⁷ In

therefore, with licensee estoppel no longer part of contract law, invalidity was necessarily a defense.

¹⁶ *Lear v. Atkins*, 395 U.S. 653, 673 (1969) (“Nor can we accept a second argument which may be advanced to support Adkins’ claim to at least a portion of his post-patent royalties, regardless of the validity of the Patent Office grant. The terms of the 1955 agreement provide that royalties are to be paid until such time as the ‘patent * * * is held invalid,’ s 6, and the fact remains that the question of patent validity has not been finally determined in this case. Thus, it may be suggested that although Lear must be allowed to raise the question of patent validity in the present lawsuit, it must also be required to comply with its contract and continue to pay royalties until its claim is finally vindicated in the courts. The parties’ contract, however, is no more controlling on this issue than is the State’s doctrine of estoppel, which is also rooted in contract principles. The decisive question is whether overriding federal policies would be significantly frustrated if licensees could be required to continue to pay royalties during the time they are challenging patent validity in the courts. It seems to us that such a requirement would be inconsistent with the aims of federal patent policy.”).

¹⁷ Section 6 of the license said “‘In the event that * * * the U.S. Patent Office refuses to issue a patent on the substantial claims of the application attached as Exhibit ‘B’, or if such a patent so issued is subsequently held invalid * * * Lear at its option shall have the right forthwith to terminate the specific license so affected or to terminate this entire Agreement and no further royalties shall thereupon be payable under the license so terminated or under this Agreement if Lear shall have elected to terminate this Agreement in its entirety.’” See *Adkins v. Lear, Inc.*, 67

any event, licensees will say this feature of *Lear* means the parties may not expressly invoke the estoppel result. If *Lear* means the patent owner and licensee may not agree that royalties are payable until the date of an invalidity judgment in an action between them, licensees will say they may also not agree to foreclose litigation that might lead to such a judgment.

Medimmune addressed a Genentech argument that touched on the issue. As characterized by the Court, Genentech argued that the parties in effect settled the validity dispute when they entered the license, and the license precluded the licensee from challenging validity. The Court said that argument did not relate to jurisdiction. The Court said that, if the license precluded the licensee from challenging validity, Genentech would win on the merits. The Court seemed to assume that an agreement not to contest validity would be enforceable, and that *Lear* did not require otherwise.

IV. How to Decide Whether to License under *Lear* and *Medimmune*, and for What Royalty

Lear and *Medimmune* change the way patent owners and potential licensees decide whether to license and for what royalty. This section uses an example to describe how those decisions are likely to be made under *Lear* and *Medimmune*. For those who do not want to walk through an example, the next section summarizes the effect of those decisions.

A. Summary of Licensing under *Lear* and *Medimmune*

There are three features of the decision to license and the royalty amount that are changed by *Lear* and *Medimmune*.

First, without those decisions, a patent owner and potential licensee will agree to a payment that reflects their views of the infringement litigation alternative. They will be willing to license for payments discounted based on their views of the probability the patent is valid. They will agree to higher payments for patents highly likely to be valid and lower payments for those less likely to be valid. If payments are dependent on validity, a patent owner will license only for a higher payment. A potential licensee might be willing to pay a higher rate, if total expected royalty payment is sufficiently large to justify validity litigation.

Second, without those decisions, licensing will avoid infringement litigation costs. If licensing avoids infringement litigation costs, a patent owner will be willing to license for a lower payment, and an infringer will be willing to pay more. The likelihood of licensing

Cal. 2d 882, 898 (1967), vacated, 395 U.S. 653(1969). This provision said that if a patent issued, and was held invalid, the *Lear* company could terminate, and the royalty obligation ended on the date of any termination (not the date of the judgment). Since licensee estoppel prevented the licensee from obtaining a judgment of invalidity during the term, the only possible invalidity judgment the parties could have intended be governed by the provision was a judgment in an action against a third party. With licensee estoppel gone (and an invalidity judgment possible in an action between *Atkins* and *Lear*), the provision still did not govern *Lear*'s royalty obligation in an action for breach, because *Lear*'s attempt to terminate had been found ineffective by the California courts. There being no termination, there was no agreed end to the royalty obligation.

increases. If licensing does not avoid validity litigation costs, a patent owner will license only for a higher payment. A licensee is likely to continue to be willing to pay more, since its infringement litigation costs are saved. However, the licensee may not be willing to pay as much if it believes that it is likely to incur validity litigation costs.

Third, without these decisions, licensing would involve less risk for patent owners, and they would be willing to license for lower payments. Patent litigation is risky. Predictions about the outcome of infringement litigation are often highly unreliable. A patent owner and an infringer must take the risk that their predictions of the probability of winning and losing are wrong.

If a license payment involves no risk, a risk-averse patent owner will license for a payment that is less than the expected value of infringement litigation, and perhaps several times less. Conversely, a risk-averse infringer will agree to payment greater than the expected cost of litigation. If the parties are risk-averse, and licensing avoids risk, the likelihood of licensing increases.¹⁸ If licensing requires a patent owner to take the risk that the payment will be zero due to invalidity, the patent owner will be willing to license only for a higher payment. With *Lear*, the licensee bears less risk under a license, and with *Medimmune* bears no risk. The effect on payment rates that will be acceptable to a licensee is unclear.

If a patent owner does not believe that *Lear* and *Medimmune* problems may be avoided by contract terms, and that a licensee or licensee group may take advantage of the law, there are two ways to arrive at a payment rate that makes sense given *Lear* and *Medimmune*. One is to determine an appropriate rate, if these problems did not exist. The method described below is a first approximation of how to do so.¹⁹

Whatever method one chooses, the patent owner should determine a rate that would be acceptable without these problems, and calculate the rate at which it will license by (1) dividing that rate by the probability the patent would be found valid if litigated (such as 0.5), (2) dividing the resulting rate by the percentage discount the patent owner would use, if infringement litigation risks were avoided, and the royalty payment certain (such as 0.5), and (3) adding to this rate an amount approximating validity litigation costs. If the patent owner is willing to gamble that the licensee will not use *Lear* and *Medimmune*, the patent owner could multiply the resulting rate by its estimate of the probability that the licensee will not do so.

If *Medimmune* applies to all future licenses, the effect is that there will be much less licensing of patents the parties believe have a 40 to 60 percent probability of being found valid, and perhaps patents having a 30 to 70 percent probability. This will occur because patent owners will license those patents only at very high rates. For example, if the patent owner would have a

¹⁸ If the infringer prefers risk in this setting (as some theories hold), the infringer will license only for a payment that is less than the expected cost of infringement litigation and liability.

¹⁹ For a more comprehensive approach, see John W. Schlicher, *The Economic Factors Governing Decisions to Settle Patent Litigation and License Patents* (2005, 2006), and John W. Schlicher, *A Procedure for Evaluating the Likelihood and Terms for Settlement of Patent Actions, and Licensing Patents*, (2005, 2006).

50 percent chance of winning on validity in an infringement action, it must, given *Medimmune*, double the royalty rate at which it would license. Royalties increase by 100 percent. In this range of probabilities, it is also likely the parties' uncertainty about the result will be high, and the patent owner's risk discount will be high. If the patent owner would be willing to license at 50 percent of the rate it would charge if infringement litigation involved no risk and royalties were certain, it will again double the rate. This means that royalties will be four times higher. Finally, if patent owners believe the validity litigation will cost, for example, \$1.5 M, they must increase the rate to generate that amount, or require its payment in some other way.

Patents that have an 80 to 90 percent probability of being valid will be less affected, because the percentage increase in rates will not be as large. For example, a patent owner with a patent with an 80 percent probability of being valid will increase the rate by 25 percent. Uncertainty about the result is likely to be lower, so the risk discount should also be lower, such as 80 percent, leading to an increase of 50 percent. Finally, patents having a total value exceeding \$3 M are likely to be affected more than patents having values in the range of \$2 M to \$.5 M, since a licensee or licensees as a group are much more likely to bring *Medimmune* actions where patent royalty savings exceed validity litigation costs.

If you do not believe that these decisions will cause higher royalty rates, and will not reduce the amount of licensing, these decisions reduce the profitability of licensing in comparable ways.

B. Licensing Unconstrained by *Lear*

First, assume *Lear* did not exist or the parties could contract out of *Lear*. The licensee must pay the royalties regardless of validity. Take the simplest possible situation for licensing. A company owns a patent on a product it could make and sell. One other company could make and sell a better product at lower cost and sell it at higher prices – the ideal situation for licensing. They will consider two factors – the real expected economic value of the invention to each, and the expected value and cost of patent infringement litigation.

The parties consider whether the true economic value of the invention is such that each is better off licensing than not licensing. This means the potential licensee may earn greater profits from using the invention than the patent owner could earn if it did not license. For licensing to occur, there must be some amount that the owner expects to receive and licensee expects to pay, "EP," that is less than the additional profits the licensee expects to make by using the invention, "dEV_{l,licensee}," and greater than the additional profits the patent owner expects to make if it does not license, "dEV_{nl,owner}."

The first condition for licensing is:

$$(1) \quad dEV_{nl,owner} < EP < dEV_{l,licensee}.$$

The potential licensee has the option of using the invention without a license, and litigating. The patent owner also has the option of not licensing, and suing for infringement if the potential licensee infringes. The patent owner will license rather than litigate infringement only if the expected payment, EP, exceeds its expected value of litigating an infringement action to judgment, "EV_{lit,owner}." A potential infringer will license only if the expected payment

under the license, also EP, is less than its expected cost of an infringement judgment, “EClit,inf.” The second condition for licensing is:

$$(2) \quad EV_{lit,owner} < EP < EClit_{infringe}.$$

At first approximation, the patent owner’s expected value of an infringement action, $EV_{lit,owner}$, is the owner’s estimate of the probability it would win, “ Pw_{owner} ,” times the value of winning, “ Vw_{owner} ” minus the owner’s costs to litigate the action, “ LC_{owner} .” The expected cost of an action to a potential infringer, $EClit_{inf.}$, is the infringer’s estimate of the probability it will lose, “ $Pl_{inf.}$ ” times the cost of losing, “ $Cl_{inf.}$ ” plus the infringer’s costs to litigate the action, “ $LC_{inf.}$ ” The second condition for licensing becomes:

$$(3) \quad Pw_{owner} \times Vw_{owner} - LC_{owner} < EP < Pl_{inf} \times Cl_{inf} + LC_{inf}.$$

Prior to *Lear*, the patent owner would receive the payments as long as the license continues without regard to validity, and without the cost and risk of validity litigation, unless the parties agree otherwise. Assume the patent owner could make a product at a cost of \$100 per unit, and sell it for \$150 per unit, if it does not license. The patent owner would sell 75,000 units and earning profits of \$50 per unit totaling \$3,750,000. The potential licensee could make a better product for \$50 per unit (half the cost), and sell it for \$150 per unit, selling 130,000 units (because the product is more desirable) and earning profits of \$100 per unit, totaling \$13,000,000. In those circumstances, the invention yields three and one-half times the profits when used by the licensee than when used by the patent owner.

The commercial condition for license is satisfied.

$$(1) \quad \$3.75 \text{ M} < EP < \$13 \text{ M}$$

Assume there are the usual issues involving validity. The patent owner believes that, if litigated, it would have a 50% chance of winning, and the potential licensee believes it would have a 50% probability of losing. If the patent owner wins, each believes the patent owner will receive damages measured by the infringer’s total profits, and obtain an injunction against future sales.²⁰ Each estimates litigation costs at about \$3 M. The litigation condition is also satisfied.

$$(3) \quad 0.5 \times \$13 \text{ M} - \$3 \text{ M} < EP < 0.5 \times \$13 \text{ M} + \$3 \text{ M}, \text{ or}$$

$$(3) \quad \$3.5 \text{ M} < EP < \$9.5 \text{ M}$$

Assume the negotiation results in the parties splitting equally the gains from licensing. The payment based on commercial value is \$8.75 M, and on litigation value and cost is \$6.5 M. In most situations, the parties are likely to agree to the lower payment that satisfies both conditions. Prior to *Lear*, there would be a license and a royalty payment totaling \$6.5 M, payable at some rate such as \$50 per unit over the term of the patent.

²⁰ I make this assumption regarding the measure of damages to avoid the distortions caused when damages are more or less than the value of the invention.

C. Licensing Constrained by *Lear*

After *Lear*, the decision to license becomes far more complex. The payment the patent owner expects to receive, EP, is no longer the payment the licensee agreed to make.

The owner must now consider two possible outcomes. One is that the licensee will pay. The other is that the licensee stops paying on invalidity grounds, forcing the patent owner to bring an action for breach, and litigate the invalidity defense. The patent owner must try to predict how the licensee will act.

The patent owner will view the expected payment, EP, to be its estimate of the probability the licensee will pay the royalties, "Ppay,owner," times agreed payment, "AP," plus the owner's estimate of the probability the licensee will not pay and the owner will have to bring a contract action, "Pcontract action, owner," times the agreed payment, "AP," times the probability that the owner will win on validity, "Plw,owner," minus its cost of validity litigation, "LCv,owner." The expected payment from the owner's perspective is:

$$EP = P_{\text{pay,owner}} (AP) + P_{\text{contract action,owner}} (P_{\text{wv,owner}} (AP) - LC_{\text{v,owner}}).$$

The expected payment from the licensee's perspective is the probability it will pay, "Ppay,licensee," times the agreed payment, "AP," plus the probability it will not pay and force the patent owner to bring a contract action, "Pcontract action,licensee," times its assessment of the probability that it lose on invalidity, "Plv,licensee," times the agreed payment, "AP," plus the cost of validity litigation, "LCv,licensee."

$$EP = P_{\text{pay,licensee}} (AP) + P_{\text{contract action,licensee}} (Pl_{\text{v,licensee}} (AP) + LC_{\text{v,licensee}}).$$

The commercial decision to license becomes:

$$(4) \quad dEV_{\text{nl,owner}} < P_{\text{pay,owner}} (AP) + P_{\text{contract action,owner}} (P_{\text{wv,owner}} (AP) - LC_{\text{v,owner}}) < P_{\text{pay,licensee}} (AP) + P_{\text{contract action,licensee}} (Pl_{\text{v,licensee}} (AP) + LC_{\text{v,licensee}}) < dEV_{\text{lic,licensee}}.$$

The litigation decision to license becomes:

$$(5) \quad P_{\text{w,owner}} \times V_{\text{w,owner}} - LC_{\text{owner}} < P_{\text{pay,owner}} (AP) + P_{\text{contract action,owner}} (P_{\text{wv,owner}} (AP) - LC_{\text{v,owner}}) < P_{\text{pay,licensee}} (AP) + P_{\text{contract action,licensee}} (Pl_{\text{v,licensee}} (AP) + LC_{\text{v,licensee}}) < Pl_{\text{inf}} \times Cl_{\text{inf}} + LC_{\text{inf}}.$$

However, this is not the complete picture after *Lear*, because patent owners typically contract for the right to terminate if the licensee fails to pay.²¹ If the licensee does not pay, the patent owner may or may not terminate. This compounds the complexity of the decision to license. Now there are three possible outcomes. The first is the licensee pays “Ppay,owner (AP).” The second is that the licensee does not pay, the owner does not terminate, and the owner brings a contract action, “Pcontract action,owner,no termination ((Pwv,owner x AP) – LCv,owner).” The third is that the licensee does not pay, the owner terminates, and brings an infringement action, “Pinfr’ment action,owner,termination ((Pw,owner x Vw,owner) – LC,owner).” The value of the third possibility for the owner is its estimate of the probability that the licensee will not pay on grounds of invalidity and that it will terminate times the net expected value of the action for patent infringement. Given this possibility, the expected payment, EP, for the patent owner is

$$EP = P_{\text{pay,owner}}(AP) + P_{\text{contract action,owner,no termination}}((P_{wv,owner} \times AP) - LC_{v,owner}) + P_{\text{infr'ment action,owner,termination}}((P_{w,owner} \times V_{w,owner}) - LC_{,owner}).$$

The sum of the probabilities of these three outcomes must be 1.

$$P_{\text{pay,owner}} + P_{\text{contract action,owner, no termination}} + P_{\text{infr'ment action,owner, termination}} = 1.$$

The expected payment for the licensee has the same components based on the licensee’s views of the probabilities and the outcomes, so that EP from the licensee’s perspective is

$$EP = P_{\text{pay,lice}}(AP) + P_{\text{contract action,lice,no termination}}((P_{lv,lice} \times AP) + LC_{lice}) + P_{\text{infr'ment action,lice,termination}}((P_{linf} \times C_{linf}) + LC_{,inf}).$$

These formulas assume the termination option, if exercised, will be exercised immediately after nonpayment.²²

The litigation condition for licensing becomes:

²¹ In the worst case for the patent owner, the licensee fails to make the first payment, the patent owner terminates immediately, and the owner is in the same situation it was before the license. The owner has its infringement claim. If the licensee does not pay, the worst case is that the owner terminates, and the licensee is confronted with potential infringement litigation. The patent owner and the licensee have wasted time and some money on the license, and that is all. Given the termination threat, a licensee has nothing to gain by failing to pay for reason of invalidity other than to try to get out of the license through owner termination.

²² One could try to build in when these events happen. For the period before nonpayment, the patent owner receives the agreed payment. For the period after nonpayment and before termination, the owner will, under *Lear*, receive the agreed payment times its likelihood of winning minus validity litigation costs. For the subsequent period, the owner will receive the value of patent infringement litigation. However, these formulas suffice for this purpose.

- (5) $P_{w,owner} \times V_{w,owner} - LC_{owner} < P_{pay,owner} (AP) + P_{contract}$
 action,owner,no termination $((P_{w,owner} \times AP) - LC_{v,owner}) + P_{infr'ment}$
 action,owner,termination $((P_{w,owner} \times V_{w,owner}) - LC_{owner}) < P_{pay,licee}$
 (AP) + P_{contract} action,licee,no termination $((P_{lv,licee} \times AP) + LC_{licee}) +$
 P_{infr'ment} action,licee,termination $((P_{linf} \times C_{linf}) + LC_{inf}) < P_{linf} \times C_{linf} +$
 LC_{inf}.

The commercial condition is altered in the same way.

The patent owner needs to guess about the likelihood that the licensee will not pay based on perceived invalidity, and the licensee has to guess about the likelihood of termination. The licensee may no longer make a simple calculation of the royalty savings from nonpayment, because nonpayment has another possible consequence, infringement liability. So the game is, the licensee calculates whether there is a net savings from nonpayment and validity litigation in an action for the royalties, tries to predict the probability the patent owner will terminate, estimates the cost of infringement liability and litigation, and decides whether to license and for how much based on its views. The patent owner guesses about how the licensee is likely to come out on nonpayment, how it would act on termination, and decides whether to license accordingly.

Merely stating the problem suggests that the decision to license is almost intractable, and involves enormous risk, because neither party is likely to have much confidence in its predictions about how the other will behave.

Prior to *Medimmune*, two assumptions made life simpler.

One, the licensee is highly likely to pay. If the licensee does not pay, it faces its expected infringement litigation costs, and the licensee would not have entered the license, if infringement costs, C_{linf} , were less than the agreed payment, AP. In the example, the licensee agreed to pay \$6.5 M. If it does not pay, and there is an action for breach and no termination, the licensee's expected payment is \$4.75 M, and after validity litigation costs, it saves \$1.75 M. However, the licensee will not do so, because it will likely be terminated, and it then faces costs of \$9.5 M.

Two, if the licensee does not pay, the patent owner is highly likely to terminate. The patent owner's value of winning an infringement action, $V_{w,owner}$, is likely to exceed the agreed payment, AP. In this example, if the licensee does not pay, and the patent owner sues on the license and does not terminate, the expected payment is \$1.75 M. If the patent owner terminates, and sues for infringement, the expected net value of the action is \$3.5 M.

If the licensee expects termination (and it is sensible to do so), there is unlikely to be nonpayment, and unlikely to be any validity or infringement litigation. The licensee and owner are likely to view the probability of payment, P_{pay} , to be very high, and the probability of a contract action or an infringement action to be very low. Under those conditions, the agreed payment, AP, is the same as the expected payment, EP. If both parties assume this is how things will work out, the patent owner will be willing to license for a payment discounted based on the probability it will win on validity, litigation risks avoided, and the litigation costs saved.

The only situation in which a licensee would likely not pay is where it made a very bad deal initially, and the agreed royalty payment turns out to exceed its expected infringement litigation costs. This might happen because the business turned out to be much less profitable than expected, and the true cost of infringement liability has gone down. *Lear* offers a licensee a possible way out of a bad deal. Unfortunately for the licensee, the patent owner might elect not to terminate, if it made an incredibly good deal initially or as things turned out. In this example, if the commercial value of the invention for the licensee turned out to be \$6.5 M, instead of \$13 M, the licensee would like the license terminated, because its expected cost of litigation is \$6.25 M, rather \$9.5 M. However, the patent owner will not terminate, preferring to litigate validity and expect \$1.75 M, rather than terminate, and litigate infringement for net gain of \$0.25 M.

The net effect is that the situation in which the licensee might use *Lear* to try to evoke termination to get out of its payment obligation is the same situation in which the patent owner might not terminate. Therefore, a patent owner may license in spite of *Lear*, believing that the licensee is highly likely to pay, and validity litigation will be unnecessary. In spite of *Lear*, a patent owner will license at an agreed rate, AP, equal to its expected payment, EP.

The same thing might happen because the licensee later learned of prior art that reduced the likelihood that the patent owner would win (so that the likelihood of losing has gone down). In the example, if the probability of losing on validity fell from 50 % to 20%, the cost of infringement litigation is less than the agreed royalty, and the licensee will stop payment regardless of termination and infringement litigation. If the patent owner agreed to a payment that was lower than the value of its infringement claim, Vw,owner, because of the less than certain probability of validity, (in the example agreeing to \$6.5 M, when its infringement claim was worth \$13 M), and it turns out that the probability of validity is lower, the owner's infringement claim has negative value (given litigation costs), and its royalty claim also has negative value. The patent owner will do nothing, and the licensee is freed of the license. In that situation, *Lear* essentially gives the licensee a way out of the license. *Lear* forces the patent owner to assume all the risk that additional and important prior art will later show up.

This leads to *Medimmune*.

D. Licensing Constrained by *Medimmune*

Assuming *Medimmune* governs a license, the licensee may seek a judgment that the patent is invalid without risking termination. The licensee will not pay if future royalties exceed validity litigation costs, and the existence of the patent provides the licensee's business no other benefits. The owner will have to litigate validity, and will collect only at the agreed payment rate if successful. Licensing for an agreed payment equal to the expected payment is now pure folly for a patent owner.

After *Medimmune*, there is a much higher likelihood that the licensee will not pay on invalidity grounds, because the termination threat is gone. Assuming the continued existence of the patent provides the licensee with no benefits, the patent owner tries to guess whether the licensee would regard the royalty savings from validity litigation to exceed validity litigation costs.

A little math shows that the potential licensee in this example will litigate at \$6.5 M payment rate. It will stop payments and force validity litigation, because expected royalty savings of \$3.25 M is much greater than validity litigation costs, \$1.5 M. Assume the patent owner understands this or simply makes the worst-case assumption that this is what the licensee will do. The owner has the same 50% probability of winning on validity, and validity litigation will cost about half of full-blown infringement litigation. If the patent owner and potential licensee agree to the \$6.5 M payment, the commercial condition for licensing is

$$(4) \quad \$3.75 \text{ M} < 1.0 \times (0.5 \times \$6.5) - \$1.5 < 1.0 \times (0.5 \times \$6.5) + \$1.5 < \$13 \text{ M, or}$$

$$(4) \quad \$3.75 \text{ M} < \$1.75 \text{ M} < \$4.75 \text{ M} < \$13 \text{ M.}$$

The litigation condition is:

$$(5) \quad 0.5 \times \$13 \text{ M} - \$3 \text{ M} < 1.0 \times (0.5 \times \$6.5) - \$1.5 < 1.0 \times (0.5 \times \$6.5) + \$1.5 < 0.5 \times \$13 \text{ M} + \$3 \text{ M, or}$$

$$(5) \quad \$3.5 \text{ M} < \$1.75 \text{ M} < \$4.75 \text{ M} < \$9.5 \text{ M}$$

Under those conditions, the patent owner will not license. The owner is better off using the invention itself, and, if necessary, litigating (expecting to net \$3.5 M) rather than licensing (expecting to net \$1.75 M). The potential licensees will happily license for the \$6.5 M payment, since it expects to have to pay only \$4.75 M.

The numbers shown are the expected value and cost of litigation and licensing options. Validity litigation is also risky. If the parties do not like risk, the situation is even worse. For a risk averse patent owner, the value of patent infringement litigation is less than its expected value, \$3.5 M. It is not unreasonable to believe that a patent owner would prefer a certain payment of half that amount (\$1.75 M), to the uncertain prospect of pursuing a patent infringement action having an expected value of \$3.5 M. Before *Medimmune*, and assuming the patent owner believed the licensee would pay to avoid termination, licensing was still possible (though barely). After *Medimmune* it is not, because the \$1.75 M payment is no longer certain, and could be as risky as the infringement action.

Even ignoring risk, after *Medimmune*, a patent owner would license only for an agreed payment greater than about \$11 M, twice what it would have found agreeable before *Medimmune*. With an agreed payment of \$11 M, the commercial condition for licensing is:

$$(4) \quad \$3.75 \text{ M} < \$4 \text{ M} < \$7 \text{ M} < \$13 \text{ M.}$$

The litigation condition is:

$$(5) \quad \$3.5 \text{ M} < \$4 \text{ M} < \$7 \text{ M} < \$9.5 \text{ M}$$

At that rate, the patent owner is better off licensing and litigating to obtain the royalties, than not licensing and obtaining infringement remedies. The license is much less valuable to the patent owner after *Medimmune* (\$4 M) than before (\$6.5 M). The license is also more costly for

the licensee, \$7 M instead of \$6.5 M. Each also spends \$1.5 M more on litigation than it would have otherwise.

For this patent, in order for the patent owner to capture the same amount it did prior to *Medimmune*, \$6.5 M, the patent owner must license for an agreed payment of \$16 M. At that rate, the commercial condition for licensing is:

$$(4) \quad \$3.75 \text{ M} < \$6.5 \text{ M} < \$9.5 \text{ M} < \$13 \text{ M}.$$

The litigation condition is:

$$(5) \quad \$3.5 \text{ M} < \$6.5 \text{ M} < \$9.5 \text{ M} < \$9.5 \text{ M}$$

At that rate, the licensee will no longer be interested because it is equally worse off licensing or litigating infringement. The law prevents licensing that should have occurred.

The patent owner's unwillingness to license is not an artifact of the assumption that there is only a 50% probability the patent is valid.²³ If both parties believed there was a 60% probability of validity, they would in the absence of *Medimmune*, license at \$7.8 M. With *Medimmune*, the commercial condition for licensing is

$$(4) \quad \$3.75 \text{ M} < \$3.18 \text{ M} < \$6.81 \text{ M} < \$13 \text{ M}.$$

The litigation condition is:

$$(5) \quad \$4.8 \text{ M} < \$3.18 \text{ M} < \$6.18 \text{ M} < \$10.8 \text{ M}.$$

Again, the owner is unwise to license because it will make more using the invention itself and hoping the licensee will not infringe. If the potential licensee does infringe (and it gains by doing so), the patent owner is still better off with its litigation option than with licensing. Again, the licensee will license.

Without going through the numbers, the same result follows if the patent has a 70% chance of being valid. It is only when the patent has an 80% probability of being valid that the patent owner has something to gain by licensing, and even then it is a close call, because its gain depends on the licensee not infringing without a license, and the infringer's expected costs of litigation only slightly exceed the commercial value of infringing.

²³ Those inclined to discard the significance of this example because it assumes that the patent owner and the potential licensee believe there is only a 50% probability that the patent would be found valid should consider that, in actions resolved by pretrial motion or trial during the period 1987 through 2000, the win rate for plaintiffs in any year varied between 28 percent and 52 percent, with plaintiffs over that period winning 41 percent of actions. In the six year period from 1995 through 2000, the plaintiff win rate each year fell in the range of about 30 to 40 percent. John W. Schlicher, *Data on Patent Litigation and Settlement* (2005, 2006).

I have not described all possible cases. However, if the parties are unable to license in a situation where the patent has a 70% probability of being found valid, and where the gains from licensing for both parties are enormous, because the licensee may produce a better product at half the cost, and make three and one-half times the profits the patent owner could make, it is safe to say that the law will result in way too little licensing.

The patent owner's unwillingness to license is also not an artifact of the fact that the agreed royalty without the legal problems would be only \$6.5 M, and litigation costs are assumed to be in the millions.²⁴ Consider the same case with the stakes 10 times higher. Without licensing, the patent owner would earn profits of \$37.5 M. With licensing, the potential licensee earns profits of \$130 M. Infringement litigation costs are now relatively small. Again, the parties estimate a 50% chance of winning and losing. Without *Lear* and *Medimmune*, the commercial condition for licensing is

$$(1) \quad \$37.5 \text{ M} < EP < \$130 \text{ M},$$

and the litigation condition is.

$$(3) \quad \$62 \text{ M} < EP < \$68 \text{ M}$$

Splitting equally the gains from licensing, a payment based on commercial value is \$83.75 M, and on litigation value and cost is \$65 M.

With *Medimmune*, the potential licensee will litigate at the \$65 M payment rate. It will pay and force validity litigation, because expected royalty savings of \$32.5 M are much greater than validity litigation costs, \$1.5 M. If the patent owner and potential licensee agree to the \$65 M payment, the commercial condition for licensing is:

$$(4) \quad \$37.5 \text{ M} < \$31 \text{ M} < \$34 \text{ M} < \$130 \text{ M}.$$

The litigation condition is:

$$(5) \quad \$62 \text{ M} < \$31 \text{ M} < \$34 \text{ M} < \$68 \text{ M}$$

Again, the patent owner will not license. It is better off using the invention itself, and, if necessary, litigating (expecting to net \$62 M) rather than licensing (expecting to net \$31 M). The potential licensees will happily license for the \$65 M payment, since it expects to have to pay only \$34 M.

²⁴ Those inclined to discard the significance of this example because the amounts at stake are small should consider that, in the 11-year period from 1990 through 2000, the mean damage award in patent infringement trials was \$4.7 M, and the median award was \$2.1 M, measured in constant year 2000 dollars. John W. Schlicher, *Data on Patent Litigation and Settlement* (2005, 2006). Based on the data reported by Kimberly Moore, in 501 patent actions terminated from 1983 to 1999 in which damages were awarded, the mean award was about \$5.4 M, and the median award was about \$0.8 M in unadjusted dollars. Eighty-three percent (83%) of awards were less \$5 M. Therefore, this example could easily describe over 50% of litigated patents.

There will be patent licensing after *Medimmune*, because many patent owners have no option – the commercial value of the invention to them without licensing is zero, and any amount of money is more than zero.²⁵ However, for all others, licensing is likely to occur only for patents highly likely to be valid, and these will be licensed at rates much higher than would have been the case prior to *Medimmune*.

V. What Licensees Should Do After *Medimmune*

A. Define Royalty Obligations Based on Validity

In future licenses, licensees should try to define the products on which royalties are payable in some manner that refers to validity.

B. Check Existing Licenses for Royalty Obligations Dependent on Validity

Licensees should review their licenses to determine whether the products on which royalties are payable is defined by reference to validity. This may happen due to Genentech-type language, or licenses defining the products on which royalties are payable as those covered by a “Valid Claim.” Licensees have some decisions to make if they are fortunate (or insightful) enough to have licenses subject to the possible interpretation that royalties are payable only if a patent is valid.²⁶

C. Decide Whether It Makes Economic Sense to Pursue a *Medimmune* Claim and Try to Have the Patent Declared Invalid

If there is the possibility of making a *Medimmune* claim, the issues for the licensee are straightforward.

First, if the licensee pursues this claim, the patent owner will have powerful incentives to terminate. Therefore, the licensee must decide whether there is any way the patent owner will be able to terminate.

Second, assuming the patent owner has no basis for terminating, the licensee must evaluate the probability it will succeed on its interpretation of the contract and, if so, on invalidity. Assuming there is a reasonable basis for both the contract and patent contentions, there is no risk in going forward – the patent owner has no claims.

Third, the licensee must assess the royalty savings from winning. The royalty savings will depend on when the royalty obligation ends, if the licensee wins on invalidity. The Court in *Medimmune* said it was not deciding when the royalty obligation ends in the situation of a

²⁵ For these patent owners, litigation will yield more money than licensing, except for the patents having a very high probability of being valid.

²⁶ Patent owners may argue that *Medimmune* is a sufficiently significant change that it should apply only to future licenses. However, they are unlikely to succeed. The courts have made many major changes to patent law, and all have applied to earlier and later patents.

“nonrepudiating licensee,” presumably meaning a licensee such as *Medimmune* that is paying the royalties. Since *Lear*, the lower courts have generally said that the licensee’s royalty obligation ceases, if it ultimately proves invalidity, on the date the licensee stopped paying the royalties and informed the patent owner that it is doing so based on the invalidity of the patent.²⁷ This is what happened in *Lear*, and not what happened in *Medimmune*. If the effect of invalidity is governed by the contract, as the Court believed in *Medimmune*, the date the royalty obligation ends, if at all, should also be governed by the contract.

Fourth, the licensee must consider whether the litigation costs of the action are greater than the expected royalty savings, discounted for the risk of losing.²⁸ The risk is not that of infringement or contract liability. The risk is that the costs of litigation are certain, and the benefits of litigation are not. Therefore, the investment in litigation is sensible only if the royalty savings exceed litigation costs by an amount sufficient to justify this investment.

Fifth, the licensee should evaluate whether a judgment of invalidity will have indirect costs to its business, because an invalidity judgment will free everyone to use the invention and free other licensees from their royalty obligations. Exclusive licensees may not want to destroy the patent to save royalties.

Sixth, the licensee should consider whether it should do nothing, because some other licensee has or is likely to bring and prosecute a *Medimmune* action to a successful conclusion. The filing of a *Medimmune* action does not guarantee a judgment. A licensee inclined to wait must take into account that a patent owner has a powerful incentive to settle *Medimmune* actions. The patent owner gains nothing from winning, and has everything to lose. One successful *Medimmune* claim eliminates the owner’s rights against other infringers, and probably all royalties from other licensees. If a *Medimmune* action is pending, the patent owner and the *Medimmune* claim licensee may agree that the licensee will dismiss its claim, and consent to a judgment that the patent is valid.

D. If It Does Make Economic Sense, Pay, Send a Protest Letter, Hope the Patent Owner Responds, and Sue or Negotiate a Royalty Reduction

If it is profitable to go forward, the licensee must pay, and inform the patent owner that the licensee believes the licensed patent is invalid, is paying royalties under protest, and is

²⁷ E.g., *Studiengesellschaft Kohle, M.B.H. v. Shell Oil Co.*, 112 F.3d 1561, 1568 (Fed. Cir. 1997) (“However, a licensee, such as Shell, cannot invoke the protection of the *Lear* doctrine until it (i) actually ceases payment of royalties, and (ii) provides notice to the licensor that the reason for ceasing payment of royalties is because it has deemed the relevant claims to be invalid. Other circuits addressing this issue have arrived at the same conclusion.”).

²⁸ A number of licensees may also decide to assess their collective royalty savings from a *Medimmune* claim relative to the costs of one action, and form a fund for one of them to take a shot at the patent.

reserving all its rights. This protest language seems to have been used because a licensee used similar language in an action the Court found instructive.²⁹

A patent owner may attempt to prevent an actual controversy by not responding at all or responding in a way that will permit it to argue that it did not threaten to terminate the license, if the royalties were not paid, and did not threaten to commence an infringement action after termination. If the patent owner responds in some way that permits the filing of a complaint alleging that the licensee believed that the owner would terminate and sue for infringement if royalties were not paid, the licensee may proceed.

The licensee may either file the action or attempt to negotiate a royalty reduction in exchange for an agreement not to file that action.³⁰

VI. What Patent Owners Should Do After *Medimmune*

A. What to do if *Medimmune* Applies Only to Licenses that Create the Contract Issue

1. Do Not Respond or Respond Carefully to Protest Letters

If a patent owner has defined the royalty obligation in an unfortunate way, and it receives a letter from its licensee saying that it believes the licensed patent is invalid and is continuing to pay royalties under protest, the patent owner should not respond to the letter. If it does respond, the patent owner should do so in a way that, as much as possible, precludes the licensee from alleging that it interpreted the response to mean that the patent owner would terminate the agreement, if the royalties were not paid, and would commence an action for patent infringement.

2. Define the Payment Obligation without Reference to Validity

In future licenses, patent owners should obviously define the products on which royalties are payable without reference validity.³¹ They should not use the language Genentech used, and should not, as many have, define licensed products as those that would infringe a "Valid Claim" but for the license. One such formulation is "'Licensed Products' shall mean all products the

²⁹ *Altwater v. Freeman*, 319 U.S. 359, 360 (1943).

³⁰ I discuss the enforceability of such an agreement elsewhere.

³¹ If a patent owner has granted a license that defines the products on which royalties are payable by reference to validity, a patent owner may try to amend the license. This requires the cooperation of its licensee, and there is no reason a licensee would agree. However, if the relationship between the patent owner and licensee makes changes possible or the licensee is compensated for cooperating, patent owners would be wise to do so, unless it has some reason to believe that it would not be in the licensee's interest to have the patent declared invalid.

making, use, importing, offering for sale, sale or supply of which would, in the absence of the license granted by this Agreement, infringe a patent of the Licensed Patents.”³²

Patent owners may wish to go even further. Using this example, patent owners may want to add, “Products that would infringe a patent of the Licensed Patents is a Licensed Product without regard to and independent of whether the Licensed Patents are valid or invalid, or enforceable or unenforceable under the facts and the law, or as determined by a judgment of a court in any action binding on both parties.” Such a provision is designed to make it impossible for a licensee to make a non-frivolous contention that the royalty obligation is dependent on validity.

Some may even wish not to define licensed products by asking whether they would “infringe” a patent but for the license in favor of saying they are products that fall within the scope of or are covered by a patent of the licensed patents.³³

3. Define the Payment Obligation without Reference to the Patent

Patent owners should also consider defining the products on which royalties are payable without reference the patent.³⁴ There are perfectly legitimate reasons for such a provision. However, it raises the *Zenith* problem.³⁵ *Zenith* is commonly understood to mean that a patent becomes unenforceable if its owner grants a license only on the condition that the licensee pays royalties on products that are made and sold without any use of the invention. However, the law is not that simple. The *Zenith* Court seemed to insist that royalty payments may sometimes be based on activities that do not use the teachings of the patent. A patent owner may insist on such

³² See John W. Schlicher, *Patent License Provisions* (2001).

³³ An example is “‘Licensed Products’ shall mean all products that, if made, used, or sold, would be within the scope of or covered by a patent of the Licensed Patents literally or under the doctrine of equivalents.” Some additional words will be needed, if the patent owner wanted to make clear that licensed products included those that would infringe only by inducement or contributorily. An example is “‘Licensed Products’ shall mean (a) all products that are within the scope of or are covered by a patent of the Licensed Patents, (b) all products the making of which is within the scope of or is covered by a patent of the Licensed Patents, and (c) all products the use of which, alone or with other products, by Licensee or a customer of Licensee, direct or indirect, is within the scope of or is covered by a patent of the Licensed Patents, and, for all such products, whether the product, its making, or its use, is within the scope of or is covered by a patent literally or under the doctrine of equivalents.” A patent owner may, of course, wish to do exactly the opposite.

³⁴ See e.g., John W. Schlicher, *Patent License Provisions* (2001) (“‘Licensed Products’ shall mean all [e.g. computer; semiconductor device; television; dog food] products made, used, sold or otherwise transferred by Licensee during the term of this Agreement.”).

³⁵ In 1969, the Court held that patent misuse occurred where the patent owner was “... conditioning the grant of a patent license upon payment of royalties on products which do not use teaching of the patent....” *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 135 (1969).

a royalty base to recover the costs of granting a license, capture the value of providing the licensee with an opportunity to use the invention, or reduce the costs of calculating, collecting, and enforcing payment of royalties -- all of which the Court seemed to say were perfectly proper reasons for the patent owner to insist on payments.³⁶

If only patents are licensed, a patent owner may propose a total sales royalty provision, and if the potential licensee does not object and insist on a provision limited to use of the patents, there is no misuse problem. If the potential licensee objects, the patent owner and the licensee have a potential problem. If the patent owner is courageous enough, it may explain why this provision operates for their mutual convenience and efficiency, and enter a license if the licensee agrees. A recital should be used to explain this mutual desire.³⁷ In this situation, payments should not be called “royalties.”

4. Deal with Eviction Separately

For at least 70 years, the law has said that a licensee is excused from its royalty obligation if the patent under which it is licensed, and for which it is paying royalties, is found invalid in a final judgment in any action between the patent owner and some other entity.³⁸ When the patent was found invalid, the licensee was said to have been evicted from the license, and therefore its

³⁶ One interpretation of *Zenith* is that a patent owner may condition the grant of a license on the payment of royalties on activities that do not use the invention, if based upon an effort to measure the value to the licensee of the opportunity to use the invention, to recapture the costs of granting the license, or to reduce the cost of negotiating, policing, and collecting royalties. The only prohibited ground would be that royalties may not be based upon activities that do not use the invention in order to reduce competition between those products and the patented product.

³⁷ E.g., John W. Schlicher, *Patent License Provisions* (2001) (“WHEREAS, Licensor will provide Licensee with valuable patent rights under this Agreement; the parties are unable to assign any specific value to these patent rights, or to separate the value of various patent rights; the parties also recognize that it is often difficult to determine with certainty whether particular products use or employ particular patent rights, and that it is often expensive to attempt do so; the parties also recognize that no patents covering the making, use or importing, offering for sale, sale of products ultimately sold under this Agreement may be obtained and those that issue will, like all patents, expire, and may, like all patents, be held invalid; therefore, the parties have resolved that the most convenient, efficient and equitable way to compensate each of them for the risks and obligations undertaken is in the manner provided in this Agreement.”).

³⁸ *Drackett Chemical Co. v. Chamberlain Co.*, 63 F.2d 853 (6th Cir. 1933) (as noted by *Lear*, 395 U.S. at 667); *Troxel Mfg. Co. v. Schwinn Bicycle Co.*, 465 F.2d, 1235, 1255 (6th Cir. 1972) (“It has been an established rule in this Circuit for nearly 40 years that a final adjudication of invalidity of a licensed patent operates as an eviction from the license, terminating the licensee’s obligation to continue making royalty payments after that date, but giving no right to recoup royalties already paid.”).

royalty obligation ended.³⁹ The current version of the eviction rule is that, absent some other agreement, a licensee's royalty obligation ends on the date the patent is found invalid in a final judgment of a district court in an action to which the licensee is not a party, unless that decision is appealed, and in that case, the obligation ends on the date of the court of appeals decision affirming the judgment.⁴⁰

While the law addresses the issue, the parties to licenses often specify the effect of invalidity judgments in third party actions. When they do, they must do so carefully so that their eviction provision is not misinterpreted (as may have happened in *Medimmune*) to mean that the royalty obligation depends on validity as decided by any court in any action.⁴¹

5. Define the Products on which Royalties are Payable

Medimmune arose from a dispute over whether a Medimmune product was covered by a licensed patent, and therefore, required royalty payments. When a potential licensee has products, and the patent owner believes a patent covers them, it is in the patent owner's interest to provide that those specific products are licensed products.⁴² This provision may avoid

³⁹ The eviction rule originated in cases involving exclusive licenses, and eventually spread to all licenses. The eviction rule predates *Lear* and *Blonder-Tongue*.

⁴⁰ *Troxel Manufacturing Co. v. Schwinn Bicycle Co.*, 465 F.2d 1253, 1255, 1257-59 (6th Cir. 1972) ("It has been the established rule in this Circuit for nearly forty years that a final adjudication of invalidity of a licensed patent operates as an eviction from the license, terminating the licensee's obligation to continue making royalty payments after that date but giving no right to recoup royalties already paid. See *Drackett Chem. Co. v. Chamberlain Co.*, 63 F.2d 853, 855 (6th Cir. 1933). In *Drackett* the patent was held invalid in a District Court decision that was not appealed. See 63 F.2d at 854. Absent a showing that Schwinn prosecuted its appeal to the Ninth Circuit in bad faith, the eviction in this case occurred on the date of the decision of the Court of Appeals. Cf. *Scherr v. Difco Laboratories, Inc.*, 401 F.2d 443, 445 (6th Cir. 1968). *** We hold that *s* did not overrule *Drackett Chem. Co. v. Chamberlain Co.*, 63 F.2d 853 (6th Cir. 1933), and that the rationale of *Drackett* remains the law of this Circuit except insofar as it expresses the licensee estoppel doctrine."); *Troxel Manufacturing Co. v. Schwinn Bicycle Co.*, 489 F.2d 968, 972-73 (6th Cir. 1973).

⁴¹ E.g. John W. Schlicher, *Patent License Provisions* (2001) ("In the event that any claim of a Licensed Patent is found invalid or unenforceable in an action between the Licensor and a third-party by a final judgment of any court having jurisdiction from whose judgment no appeal has or can be taken, Licensee's obligations under Section 4.2 shall cease as to Licensed Products for which royalties accrue only by virtue of such claim, after such decision becomes final and unappealable or unappealed, provided that, with respect to a claim found unenforceable, Licensee's obligation shall cease only during the period such claim remains unenforceable.").

⁴² E.g. John W. Schlicher, *Patent License Provisions* (2001) ("1.2 "Licensed Products" shall mean all products the making, use, importing, offering for sale, sale or supply of which would, in the absence of the license granted by this Agreement, infringe a patent of the Licensed Patents. Licensed Products include, but are not limited to, the products previously marketed by Licensee

Medimmune invalidity claims in situations where the licensee's real concern is the scope of the patents. However, eliminating disputes on infringement or scope probably does not eliminate validity disputes.

B. What to do if *Medimmune* Applies to All Licenses

If the lower courts say *Lear* requires that all licensees may defend an action for royalties by proving invalidity, regardless of the language of the royalty obligation, *Medimmune* will apply regardless of how the patent owner defined the royalty obligation. There may also be situations where, for some reason, a patent owner believes it must agree to make payment obligations dependent on validity. If *Medimmune* applies by agreement or extension, patent owners must respond. If they do not, their licensees will assert a *Medimmune* claim, if litigation costs and other business interests make it profitable to try to kill the patent. There are many options.

1. Agreement Not to Challenge Validity

Prior to *Lear*, a licensee's agreement not to contest validity was lawful and enforceable.⁴³ After *Lear*, many companies attempted to deal with this problem by the licensee agreeing not to challenge validity. Several lower courts declared those provisions unenforceable as inconsistent with the *Lear* policy or the *Lear* ruling on when royalties end, if the patent is found invalid.⁴⁴ The courts generally rejected contentions that this agreement was patent misuse or an antitrust violation.⁴⁵ Other than in the context of settlement of pending litigation, the practice largely disappeared.

Medimmune did not decide the enforceability of such a provision. However, as mentioned earlier, the Court seemed to assume that an agreement not to contest validity would be enforceable. If a patent owner included such a provision in the license, it would undoubtedly be

as the _____ product and the _____ product.”). There are, of course, other ways to do this.

⁴³ *Steiner Sales Co. v. Schwartz Co.*, 98 F.2d 999, 1009-10 (10th Cir. 1938).

⁴⁴ *Panther Pumps & Equip. Co. v. Hydrocraft*, 468 F.2d 225, 230-32 (7th Cir. 1972); *Massillon-Cleveland-Adron v. Golden State Advertising Co.*, 444 F.2d 425 (9th Cir. 1971); *Wallace Clark & Co. v. Acheson Industries, Inc.*, 401 F. Supp. 637, 639 (S.D.N.Y. 1975), *aff'd* 532 F.2d 846 (2d Cir. 1976); *Congoleum Industries, Inc. v. Armstrong Cork Co.*, 360 F. Supp. 220, 232-34 (E.D. Pa. 1973), *aff'd*, 510 F.2d 334 (3d Cir. 1975); *Blolm-Voss A.G. v. Prudential-Grace Lines, Inc.*, 346 F. Supp. 1116 (D. Md. 1972), *rev'd* on other grounds, 489 F.2d 231 (4th Cir. 1973).

⁴⁵ *Panther Pumps & Equip. Co. v. Hydrocraft, Inc.*, 468 F.2d 225, 232 (7th Cir. 1972); *Wallace Clark & Co. v. Acheson Industries, Inc.*, 401 F. Supp. 637, 639 (S.D.N.Y. 1975), *aff'd* 532 F.2d 846 (2d Cir. 1976); *Congoleum Indus., Inc. v. Armstrong Cork Co.*, 366 F. Supp. 220, 233 (E.D. Pa. 1973), *aff'd*, 510 F.2d 334 (3d Cir.), *cert. denied*, 421 U.S. 988 (1975). *But see, Bendix Corp. v. Balax, Inc.*, 471 F.2d 149, 158-159 (7th Cir. 1972), *cert. denied*, 414 U.S. 819 (1973), *rev'ing* 321 F.Supp. 1095 (E.D. Wisc. 1971).

met with the argument that the provision is unenforceable, and probably worse. However, agreements not to challenge validity should be enforceable, as they are in copyright and trademark licenses, and there is little additional misuse and antitrust risk in trying.⁴⁶ Those not wishing to try now must await legislation or a decision saying, correctly, that *Lear* did not decide the issue, and the modern preemption doctrine does not forbid it.

If a licensee's agreement not to challenge is unenforceable, patent owners must try to remedy the situation by creating disincentives for invalidity challenges through termination rights, royalty adjustments, and other ways. Of course, any provision that creates a disincentive for a licensee to challenge validity is theoretically subject to an argument that *Lear* renders the provision unenforceable.

2. Termination Rights

a. Patent Owner Termination for Challenge

For years, I have recommended that patent owners use a termination provision that permits the patent owner to terminate the license, if the licensee alleges in any action that the licensed patent is invalid.⁴⁷ This is the simplest and most direct response to *Medimmune*, because it puts the situation back to where it was before *Medimmune*. This also helps with *Lear*. Patent owner termination rights were not involved in *Lear*. There is nothing in *Lear* that says such a termination provision is unenforceable or contrary to any perceived public policy. There is nothing in *Medimmune* that would suggest such a provision is unenforceable.

b. Patent Owner Cancellation for Challenge

It is possible to increase the stakes for a licensee by providing that, if the licensee asserts invalidity in any action, the patent owner has the right to cancel and terminate the license as of the effective date of the license. Such a provision is probably impractical, because no licensee would agree, unless the patent owner also agreed to pay back the royalties.

c. Patent Owner Termination if the Licensee Challenges and Loses

Another option is to provide that, if the patent is found valid in any action whether commenced by the licensee, or by the patent owner against the licensee on a claim for breach of any obligation under the license, the patent owner has the right to terminate the license. This

⁴⁶ See John W. Schlicher, *Judicial Regulation of Patent Licensing, Litigation and Settlement under Judicial Policies Created in Lear v. Adkins*, American Intellectual Property Law Association, Selected Legal Papers (1985).

⁴⁷ John W. Schlicher, *Patent License Provisions* (2001) ("In the event Licensee, directly or indirectly, alleges in any action that any of the Licensed Patent is invalid, Licensor may terminate the license granted to Licensee in its entirety at any time by giving notice to Licensee. Licensee's obligations, including, but not limited to, the obligation to pay royalties to Licensor shall continue as provided above or until such license has been so terminated.").

makes it risky for the licensee to challenge and permits the patent owner to say that the termination rights do not eliminate the licensee's incentive to challenge validity.

d. **Patent Owner Termination at Will**

Another approach is to permit the patent owner to terminate the license at any time for any reason. The patent owner's ability to terminate at will obviously makes the license less valuable to the licensee. This termination provision is also not useful in situations where a patent owner is trying to provide incentives for the licensee to invest money in development and marketing activities that enhance the value of the licensed rights, such as in most situations where licenses are exclusive.

e. **Licensee Termination before Challenge**

Another option is to provide that the licensee has the right to challenge validity, subject to the prior condition that the licensee terminates its license effective as of a date before it asserts invalidity in a court. This provision is less useful to patent owners than one permitting it to decide whether or not to terminate.

3. **Royalty Obligations**

Patent owners should consider how *Lear* and *Medimmune* affect the basic decision to license, and, if licensing is still the most profitable course, the royalties that are appropriate. I described one way of doing this in Section IV.

a. **License at a Rate Appropriate For a Patent That Is Valid as Between the Parties**

A patent owner, who is not confident that other measures will deter *Lear* and *Medimmune* actions, should license at a rate appropriate for a patent that is certain to be valid, and that will require validity litigation costs to collect. See Section IV, A. This rate is much higher than a rate appropriate to a legal setting free of *Lear* and *Medimmune*.

b. **License at the Rate Appropriate for a Patent That Is Valid as Between the Parties, and Reimburse a Portion of those Payments so Long as there Is No Challenge**

A licensee may not agree to a rate appropriate for a patent certain to be valid. To address this problem, a patent owner may propose that royalties be defined and paid at that rate, and that the patent owner pay back or rebate part of those royalties to the licensee so long as the licensee does not seek a declaratory judgment of invalidity (while paying). Under that approach, if the licensee does not assert a *Medimmune* claim, its effective royalty rate is the lower rate appropriate to the pre-*Medimmune* situation. Once it asserts a *Medimmune* claim, the rebate ends, and the patent owner retains the full royalty, appropriate for the risk that the payment will end if the patent is found invalid. In order to keep the license during a *Medimmune* action, the licensee must continue paying at the appropriate rate. If the patent is found valid, payments continue at the appropriate rate.

c. Increase Royalties if the Licensee Challenges and Loses

A patent owner should consider a royalty provision under which royalties increase if a licensee challenges validity and loses.⁴⁸ If the law insists that a licensee may eliminate its royalty obligation if a patent is invalid, patent owners should be permitted to charge increased royalties, if the patent is found valid. This is consistent with *Lear*'s directive that licensees have an incentive to challenge. If the licensee wins, royalties end.

Such a provision must, of course, be negotiated, and could preclude a great deal of licensing. However, if the law insists that a licensee have the option of reducing the royalty rate to zero in the case of invalidity, it seems entirely appropriate that the law would permit, if not encourage, payment at a rate equal to the full economic value of the patent in the event of a judgment of validity.

d. Increase Royalties if the Licensee Challenges Validity

A patent owner should also consider a royalty provision under which royalties increase in the event a licensee challenges validity, and regardless of the outcome. Such an increase is more likely to run into *Lear* unenforceability issues.

e. License at the Rate Appropriate for a Patent That is Valid and Spread Payments over a Specified Period

Lear commands that, if the patent is found invalid, royalties end when a licensee challenges validity in court, and perhaps even earlier. *Medimmune* does not say when the royalty obligation ends for a paying and litigating licensee. These rules encourage shifting royalties from the post-challenge period to the pre-challenge period. Doing this requires the cooperation of the licensee. One possible way to obtain that cooperation is to license at a high rate (the valid rate) for the period before a licensee challenges, and permit the licensee to spread the payments over time. The obligation to make these payments should be enforceable, since the amount of those payments is based on the licensee's activities before a challenge and before a judgment.

⁴⁸ John W. Schlicher, *Judicial Regulation of Patent Licensing, Litigation and Settlement under Judicial Policies Created in *Lear v. Adkins**, American Intellectual Property Law Association, Selected Legal Papers (1985) ("Since the licensee is not bound to pay royalty rates discounted to reflect the uncertainty as to validity, the patent owner should not agree to those rates. Rather, it must insist upon a royalty rate equal to that he would ask if the patent is 100% certain to be valid. The only alternative I see is to negotiate the royalty rate at a discount based on uncertainty, but provide that, if the patent is held valid in any action, or perhaps merely in an action binding on the defendant, the royalty rate will increase. I am aware of no decision in which such a provision has been upheld, but one can be certain that, if tried, the argument would be made that the increase in royalty rate deters the licensee from challenging, and is as unenforceable as an express agreement not to challenge. To my mind, that argument is lacking in merit for the same reason that an express agreement not to challenge should be enforceable. In addition, if the patent is held valid, the license is more valuable and the price that the licensee pays for it should reflect that value. Any decision to the contrary is simply a denial of a patent owner's right to charge what a patent is worth.").

4. Litigation Cost Provisions

a. Require the Licensee to Pay Validity Litigation Costs in All Situations

Patent owners should consider a provision that, if the licensee alleges invalidity and pays royalties, the licensee becomes obligated as of the date of the challenge to make a lump sum payment approximating patent owner's expected validity litigation costs or a series of payments over time roughly equal to the patent owner's costs of litigating validity. This provision could be combined with the royalty increase provision.

b. Require the Licensee to Pay the Patent Owner's Litigation Costs, Including Attorneys Fees, If the Licensee Challenges and Loses

If a licensee forces validity litigation and loses, a patent owner could also require the licensee to pay the patent owner's litigation costs, including its attorney fees. Again, licensees will argue that this reduces their incentives to challenge validity, and is unenforceable. However, *Lear* says that the royalty obligation must end when the litigation begins, if the licensee wins on invalidity. If the licensee loses, and the patent is found valid, the licensee (under *Lear* logic) has done nothing of value to anyone, and has wasted the patent owner's money. Therefore, this obligation should be enforceable.

5. Other Approaches

There are a variety of other responses I described in the 1985 and 1986 papers. They are tersely described here.

a. License only after Litigation and Settlement

Lear and *Medimmune* do not apply if there is a judgment or litigation settlement agreement resolving validity, and otherwise in the necessary form. Therefore, a patent owner may decide to license only after the licensee begins to sell, it has sued the potential licensee, and eliminated validity issues by a well-written consent decree or settlement agreement.

b. License in Exchange for Products or Licenses rather than Royalties

Lear and *Medimmune* are about royalty obligations. Since those decisions make it risky and costly to be paid in money, patent owners have an incentive to license in exchange for products or licenses rather than royalties.

c. License Patents only with Know-how or Other Things of Value

Lear and *Medimmune* are about royalty obligations in patent licenses. Those decisions create an incentive to license patents only with know-how or other things of value, and employ any appropriate payment adjustment provisions.

d. **Sell the Licensee a Product and Do Not Grant an Express License**

Lear and *Medimmune* are about express patent licenses. There are other ways to authorize someone to use an invention. If the patent owner has the ability to sell a product under conditions necessary for the buyer to receive an implied license, the patent owner may charge any price it wishes, and will be paid regardless of validity.

e. **Resolve Validity Disputes by Arbitration and After Other Dispute Resolution Procedures**

Since the early 1980s, patent owners and licensees may agree to resolve validity disputes by arbitration. Patent owners and licensees also often provide mechanisms for privately resolving license disputes. They should consider providing that validity disputes will be resolved only by arbitration, and only after a lengthy and elaborate private dispute resolution procedure. Patent owners should also consider asking Congress to amend sections 294(c) and (d) of the Patent Act to make clear that an arbitration award will have no effect on the patent owner's rights as to any other person, and remove concern that an invalidity decision might have adverse effects in later actions involving others.

f. **Require the Potential Licensee to Disclose Prior Art before Licensing, and Limit Validity Challenges to Other and Closer Prior Art the Licensee Learns of Later**

A patent owner might consider requiring that the licensee disclose the prior art it knows about before entering the license, and providing that the licensee will have the right to challenge validity in defense to an action for royalties, or as declaratory judgment claim based only on other and closer prior art that the licensee learns of after entering the license.

g. **Grant Licenses only to Companies that Do Not Play This Game**

Another response to the problems the law creates is to do business only with companies that operate based on principles other than taking advantage of every quirk in the law.

h. **Do Not License, Litigate Infringement Actions**

The appropriate response in many situations is do not license, unless there is absolutely no alternative, and earn money through patent litigation.

VII. Legislation

The problem with patent validity is that the issues are often not black and white, and the answer not plainly right or wrong. When validity issues exist, they may be resolved by agreement or by litigation. Agreements are cheap, and if the law allows, define the effects of validity issues with certainty. Litigation is expensive and risky.

The issue is, do we prefer a patent system with lower royalty rates, less risk, lower litigation costs, more licensing, and a few hundred more patents, or a patent system with higher

royalties, higher risk, higher litigation costs, much less licensing, and a few hundred fewer patents? At a more general level, do we prefer a system where the law allows people who own patents and use patented inventions to solve validity issues for themselves as they have in the past for well over 99 percent of all patent disputes, or a system where law compels them to resolve these issues only through litigation? My view is that we are better off allowing the people affected to solve these problems in whatever fashion they find mutually advantageous.

The legal community, lawyer organizations, and Congress failed to act when the problem first arose, or when at least one person raised the issue later.⁴⁹ Perhaps, after *Medimmune*, people will refocus on the desirability of amendments to the Patent Act.

I suggested an amendment to the Patent Act in 1985. It was:

Any agreement between the parties to a patent license agreement shall not be unenforceable to the extent that it prohibits or deters the licensee from asserting invalidity, including provisions that (1) the licensee shall not assert in any action or proceeding that the licensed patent is invalid or shall not commence or prosecute any action or claim seeking judgment that the patent is invalid, (2) the licensor may terminate such license in the event licensee does so, or (3) the licensee's obligation to pay royalties shall continue without respect to whether the licensee does so.

The purpose of that provision was to allow patent owners, patent infringers, and patent licensees to work out issues related to the effect of validity issues. If a patent owner and a potential licensee wished to agree that invalidity would not be a defense to an action for royalties, the licensee would not file a declaratory judgment action seeking a judgment of invalidity, and the license will be granted at lower royalty rates, they would be free to do so. If they wished to agree that invalidity would be a defense to an action for royalties, and agree that the licensee could file a declaratory judgment action seeking a judgment of invalidity, they would also be free to do so, and license at higher royalty rates. If they wished to agree that invalidity would be a defense to an action for royalties, and that the licensee would not file a declaratory judgment action seeking a judgment of invalidity, they could do so, with royalties somewhere in between. If they wished to agree that invalidity would be a defense to an action for royalties, and agree that the licensee could file a declaratory judgment action seeking a judgment of invalidity, and specify that the royalty obligation would continue until the date of a final judgment of invalidity, they could do so. If they wished to deal in a myriad of other possible ways with the effect of validity or invalidity judgments in third party actions, they could do so.

⁴⁹ Statement of John W. Schlicher, Before the United States Patent and Trademark Office Concerning Notice of Public Hearings and Request for Comments on Patent Protection for Biotechnological Inventions, San Diego, California, October 17, 1994 ("There are a number of changes to patent law that I believe would have a positive impact on the patent system. I have described many of them elsewhere. Among other substantive issues I would focus on are ... (2) the Lear doctrine and related rules that limit potential agreements that reduce the risks and costs of litigation").

If patent owners and potential licensees wish to make clear that licensee estoppel is not the default rule, if the parties do not address these issues, the following additional language could be added:

In an action involving a claim for royalties under an agreement authorizing a person to use any rights granted under a patent that requires payment of such royalties based on activities involving a product or process employing the invention of such patent, the invalidity of such patent shall be a defense to the obligation to pay such royalties accruing after entry of a final judgment of invalidity by a court of competent jurisdiction, unless the agreement provides otherwise. An agreement providing that royalties are payable notwithstanding the validity or invalidity of a patent, or making other provisions with respect to the effect of validity or invalidity on the rights or obligations of a party to the agreement, including royalties payable, shall be enforceable.

I also believe that we should take close look at the way the eviction doctrine works, and consider whether to change the situation by legislation.

I would also amend section 294 to permit arbitration to play a more helpful role in these and other type of patent disputes. The first sentence of section 294(c) should be amended to say:

An award by an arbitrator shall be final and binding between the parties to the arbitration, and shall have no effect on the patentee's rights under this title 35 with respect to any other person.

The purpose is to make clear that an arbitration award will have no effect on the patent owner's rights as to any other person, and remove any concern that an invalidity decision might have adverse effects in later actions involving others. Section 294(d) should also be repealed. There is no reason the Director needs information about an arbitration award, and no reason a copy of an award should be placed in the prosecution history. If an award is made public, people will try to use it to their advantage.