JUDICIAL REGULATION OF PATENT LICENSING, LITIGATION AND SETTLEMENT UNDER POLICIES CREATED IN *LEAR v. ADKINS*

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I. THE LAW OF LICENSE ESTOPPEL PRIOR TO 1969

Prior to 1969, state contract law provided that a patent licensee was estopped from defending an action for royalties by showing that the patent was invalid.[1] A similar estoppel arose against the assignor of a patent.[2]

The estoppel rule applied where the license said nothing about the licensee's right to challenge validity.[3] Similarly, an agreement not to contest validity was lawful and enforceable.[4] There was an exception to the estoppel rule where licenses contained provisions which would violate the antitrust laws, if the licensee could prove the patents invalid, and the antitrust violation would render the royalty obligation unenforceable.[5]

No estoppel applied to activities after the license was terminated or repudiated by the licensee.[6] Even though estopped, an exclusive licensee could defend an action for royalties due on activities after the patent was held invalid in a suit against a third party.[7] At least some courts held that a nonexclusive licensee could not rely on this eviction defense.[8] However, the language of the eviction decisions was broad enough to apply nonexclusive licenses.

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1 Automatic Radio Mfg. Co. v. Hazeltine Research, 176 F.2d 799, 806 (1st Cir. 1949), aff'd 339 U.S. 827 (1950), overruled in pertinent part, 395 U.S. 653 (1969). See also Lear v. Adkins, 395 U.S. 653, 663 n. 11, 668, 670 (1969).

2 Scott Paper Co. v. Marcalus Mfg. Co., 326 U.S. 249 (1945); Westinghouse Electric & Mfg. Co. v. Formica Insulation Co., 266 U.S. 342 (1924).

3 E.g., Universal Rim Co. v. Scott, 21 F.2d 346, 348 (N.D. Ohio 1922).

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

5 Katzinger v. Chicago Metallic Mfg., 329 U.S. 394, 399-401 (1947); MacGregor v. Westinghouse Elec. & Mfg. Co., 329 U.S. 402 (1947); cf. Sola Electric Co. v. Jefferson Elec. Co., 317 U.S. 173 (1942) (In suit for royalties under a license agreement and to enjoin nonperformance of license, the licensee may defend on the ground the license violated the Sherman Act. If the license would constitute an antitrust violation if the patents were invalid, invalidity may be shown.).

6 Bucky v. Sebo, 208 F.2d 304, 305-306 (2d Cir. 1953) (termination); Eskimo Pie Corporation v. National Ice Cream Co., 26 F.2d 901, 902 (6th Cir. 1928) (termination); Universal Rim Co. v. Scott, 21 F.2d 346, 348-49 (N.D. Ohio 1922) (repudiation).

7 Drackett Chemical Co. v. Chamberlain Co., 63 F.2d 853, 854-55 (6th Cir. 1933) (exclusive licensee is evicted as of the date of unappealed decision of invalidity and notice to patent owner that it would no longer pay); Ross v. Fuller & Warren Co., 105 F. 510, 512 (N.D.N.Y. 1900) (an exclusive licensee may defend action for royalties on ground of eviction).

8 Automatic Radio Mfg. Co. v. Hazeltine Research, 176 F.2d 799, 807-08 (1st Cir. 1949), aff'd 339 U.S. 823 (1950), overruled on other grounds, 395 U.S. 653 (1969).

II. IN 1969 THE WARREN COURT'S LAST PATENT DECISION ELIMINATED THE CONTRACT DOCTRINE OF LICENSEE ESTOPPEL

On June 16, 1969, one week before Justice Burger replaced Justice Warren, the Supreme Court held in Lear v. Adkins that the public interest required that the contract doctrine of licensee estoppel "give way."[9] The Court overruled its contrary decision in Automatic Radio Mfg. Co. v. Hazeltine. Based on the reported decisions, there was no provision in the license, which precluded the licensee from challenging validity.[10]

III. THE DECISION IN LEAR IS INCONSISTENT WITH THE PREEMPTION ANALYSIS REQUIRED BY KEWANEE v. BICRON

Lear v. Adkins has not been overruled by the Supreme Court. The Court continues to cite and distinguish it.[11] However, there is good reason to believe the Court would decide Lear differently today.

The Lear v. Adkins licensee estoppel decision could have been the result of three different kinds of legal analyses. First, the decision might be, and properly is, based on federal preemption of state law. The principle of preemption is that, because the Constitution makes federal law the supreme law of the land, any state law which conflicts with federal law is unconstitutional.[12] The Lear decision has two parts, the first relating to licensee estoppel[13] and the second part relating to royalty obligations if the patent is invalid.[14] On the second issue, the Court said it was applying preemption principles, when it said that "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."[15] The reference in the first part of its opinion to "the competing demands of the common law of contracts and the federal law of patents," also suggests that its decision was premised on preemption. Lear was also premised on the Sears and Compco cases, and those were preemption decisions.[16]

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9 Lear v. Adkins, 395 U.S. 653, 670-71 (1969).

10 Lear v. Adkins, 67 Cal. 2d 882 (1967) and 52 Cal. Rptr. 795 (Ct. App. 1966).

11 Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 481 (1974); Aronson v. Quick Point Pencil Co., 440 U.S. 257, 264 (1979).

12 Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 479-480 (1974).

13 395 U.S. at 661-71.

14 395 U.S. at 671-78.

15 395 U.S. at 673.

16 Sears, Roebuck v. Stiffel, 376 U.S. 225, 231 (1965); Compco v. Day-Brite Lighting, 376 U.S. 234, 237-238 (1965).

Second, the Court might have been saying that patent agreements are subject to federal contract law. If licensee estoppel was federal common law, the Supreme Court could change it.[17] However, the Court said that licensee estoppel was state law.[18] Therefore, the Court's power to change it must rest on preemption.

Third, Lear v. Adkins might be an exercise in that Court's idea of its power to refuse to enforce patent license agreements or patents under the doctrine of unclean hands.[19] However, the Court seemed to recognize that it was striking down a rule which arose from state contract law and not from any provision of the agreement made by the licensor.[20] Since the licensor's conduct did not create the alleged injury to public policy, the licensor could not be guilty of unclean hands. Moreover, the Court in Lear did not find the patent unenforceable. The Court said that the licensee would have to show invalidity on remand, not that the licensor would have to show purge.

Hence, Lear is a preemption decision. To determine if Lear is a sound preemption decision, we must first determine the current standards. The Supreme Court, in Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470 (1974), established four principles about the preemption doctrine, which were not applied five years earlier in Lear.

First, Kewanee established that the constitutional grant of power to Congress with respect to patents was not exclusive. The Constitution does not prohibit the states from encouraging inventions within their borders by appropriate laws.[21] With respect to ideas that were within the categories of patentable subject matter under section 101 of the Patent Act, the Court in Kewanee said that state enforcement of contracts to keep trade secrets confidential did not disturb the policy of encouraging invention, because it provided another form of incentive for invention. The Court said that "in this respect, the two systems are not and never would be in conflict."[22] In Lear, the Court premised its decision on the view that federal patent policy requires free use of all discoveries not protected by a valid patent. It relied on the so-called "federal policy favoring free competition in ideas which do not merit patent protection" and the view that "federal law requires that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent."[23] In Justice Black's opinions in Sears and Compco four years

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17 Cf. 395 U.S. at 671.

18 395 U.S. at 673, 663 n.11.

19 Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488, 492-94(1942); B.B. Chemical Co. v. Ellis, 314 U.S. 497-498 (1942).

20 395 U.S. at 668, 670.

21 416 U.S. at 478-79; accord, Goldstein v. California, 412 U.S. 546 (1973).

22 416 U.S. at 484.

23 395 U.S. at 656 and 668 (emphasis added).

earlier, the Court conceived that policy.[24] If the patent law is negatively pregnant with the view that if there is no valid patent on an idea, it must be available for free use, then it is easy to construct an argument that licensee estoppel is inconsistent with that view. Because licensee estoppel might prevent some people from challenging validity, some patents might exist which a court, if it had the chance, would rule invalid. Because such patents exist, they may deter certain people from using those inventions or require others to pay for the privilege. Therefore, licensee estoppel is inconsistent with federal policy.

Kewanee makes abundantly clear that state law may properly limit free use of ideas or "competition" in ideas, if you want to call it that, for which a valid patent could not issue. Therefore, the basic premise of Lear has fallen. Justice Douglas was quite consistent when he dissented in Kewanee, because that decision is "at war with the philosophy" of the Sears and Compco decisions, which he said were the first decisions based on the premise that "every article not covered by a valid patent is in the public domain."[25]

Second, the Court in Kewanee made clear that before preempting state law, the Court must consider the harms or benefits of that law on incentives to invent and incentives to use the patent system, as well as on leaving public domain information in the public domain. The Court in Kewanee noted that the Constitution establishes a single "objective" for Congress's power, and that is to "promote the Progress of Science and Useful Art."[26] The Patent Act, by its terms, promoted that progress in two ways, (1) by giving a right of exclusion for a limited period as an incentive to inventors to risk the cost of time, research, and development, leading to an increased level of new products and processes in the economy, and (2) by requiring disclosure of the invention to stimulate the development of further advances and to facilitate use after the 17-year term of the patent expires.[27] This "facilitate-use-after-expiration "purpose" is really part of the limited term of the grant. The Court in Kewanee also noted that the Court itself had "articulated another policy of the patent law: that which is in the public domain cannot be removed by action of the states."[28] It is impossible to find any support for that policy in the Patent Act, if it means anything other than that, after a patent expires, subsequent activities are not infringement. I credit Justice Burger for not suggesting that he found it there. The Court in Kewanee did not, as it could have, discard the third purpose. Rather, Kewanee redefined the third purpose of patent law to be more limited than what Lear said about it. The Court in Kewanee did not say that everything which is not properly patented must be available for free use or "competition." It said only that things in the public domain cannot be removed from the public domain. As I noted above, unlike the Court in Lear, the Court in Kewanee is very clear that the "public domain" is not defined exclusively by the standards for granting a patent in the Patent Act. The Court said

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24 Sears, Roebuck v. Stiffel, 376 U.S. 225 (1965); Compco v. Day Brite Lighting, 376 U.S. 234 (1965).

25 416 U.S. at 495.

26 416 U.S. at 480.

27 416 U.S. at 480-81.

28 460 U.S. at 481.

that trade secret law did not interfere with the policy because "by definition, a trade secret has not been placed in the public domain."[29] Public domain status was determined by the state law definition of "secrecy," not by the patent law.[30] Ideas may be outside of the public domain and, therefore, protectable by state law, even though they do not merit patent protection. If states elect to treat ideas protected by a presumptively valid patent as outside the public domain, there is nothing in the Patent Act or policy which says that is wrong.

The more important point is that the Court in Kewanee recognized that preemption requires evaluation of the impact of the state law on incentives for invention and incentives for use of the patent system and the disclosure resulting from that use. The Court in Lear simply referred to its different standard of the third purpose of the patent system and, finding that purpose to be inconsistent with state law, struck down the state law. That is about all the Court said in Sears and Compco. There is not a word in Lear about the impact of its decision on incentives for invention or incentives for use of the patent system. As I will show below, the decision in Lear impairs significantly achieving those two purposes, rather than promoting them. Under Kewanee, those effects must be considered.

Third, the Court in Kewanee found that a theoretical possibility of injury to one of the patent system's purposes is not alone sufficient to justify preemption. The Court found that, for certain types of ideas, the existence of trade secret law might deter inventors from using the patent system and might, therefore, lead to lesser disclosures of inventions.[31] However, that conflict was not sufficient to condemn the state law. Kewanee found that some theoretical possibility of injury to one of the purposes of the patent system did not condemn state law. For the Lear Court, any theoretical injury to one patent purpose condemns the state law.

Fourth, the Court in Kewanee established that, in determining how much injury to patent purposes is enough, one must consider whether there are economic benefits, which are served by maintaining the state law.[32] The Court in Kewanee made note of the fact that trade secret law had significant resource allocation benefits. Among these were that trade secret protection permitted licensing, rather than use by an inventor, to achieve most efficient use of inventions. It said, in part:[33]

> Instead, then, of licensing others to use his invention and making the most efficient use of existing manufacturing and marketing structures within the industry, the trade secret holder would tend either to limit his utilization of the invention, thereby depriving the public of the maximum benefit of its use, or engage in the time-

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29 416 U.S. at 484 (Footnote omitted).

30 416 U.S. at 484 n.13.

31 416 U.S. at 484-89.

32 416 U.S. at 487.

33 416 U.S. at 486-487.

consuming and economically wasteful enterprise of constructing duplicative manufacturing and marketing mechanisms for the exploitation of the invention. The detrimental misallocation of resources and economic waste that would thus take place if trade secret protection were abolished with respect to employees or licensees cannot be justified by reference to any policy that the federal patent law seeks to advance.

The Court in Lear made no effort to evaluate whether there were economically desirable benefits flowing from the licensee estoppel doctrine, which might justify injury to any of the three patent purposes. The Court in Lear simply said that licensees "may often" be the only individuals with "enough economic incentive" to challenge patentability. Therefore, "muzzling" them might lead to fewer patents being found invalid in courts. That effect might deter use or decrease licensee output because of royalty obligations. Licensee estoppel was, therefore, theoretically inconsistent with free use of unpatentable inventions.[34]

Lear says not one word about whether licensee estoppel is inconsistent with providing incentives to make inventions or to utilize the patent system, or about the desirable resource allocation benefits from licensing inventions to those who can use them most efficiently and reducing costs of litigation.

If the Lear preemption analysis is correct, the legality of state enforcement of a license depends solely upon the impact of that license on providing the maximum incentives for challenges to patent validity. If that is true, all patent license agreements made prior to a judgment of validity are unenforceable. A patent license agreement, by its very existence, deters the licensee at least temporarily from challenging validity. Surely, an actual or potential infringer, who is denied a license, must then decide either (1) not to continue or enter that business or (2) to risk litigation. The license permits him to delay that decision. If Lear stands for the view that licensees must always have economic incentives to challenge validity, then royalty-free or paid-up patent licenses are also unenforceable. No court has ever found that Lear goes that far. I suggest that they have not solely because the myopic view in Lear is wrong.

Enough about what Lear didn't say. What about what it did? Even there, it does not seem to me the Lear Court's analysis stands up very well in 1985. The discussion in Lear proceeds by saying that patents grant "monopoly power,"[35] an economically incorrect proposition expressly rejected by four members of the current Supreme Court in the Jefferson Parish v. Hyde decision as economic nonsense.[36] The Court then said that patents constitute "a limited exception to the general federal policy favoring free competition."[37] The inference is, of course, that, where there is any doubt as to where the line is to be drawn between free use of an

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34 395 U.S. at 670.

35 395 U.S. at 663.

36 Jefferson Parish Hosp. Dist. No. 2 v. Hyde, ___ U.S. ___,80 L.Ed.2d 2, 29 n.7 (1984).

37 395 U.S. at 663.

invention and use subject to a patent, free use prevails. This is inconsistent with the Supreme Court's recent recognition in Dawson v. Rohm & Haas that the policy of "free competition" and "the policy of stimulating invention that underlies the entire patent system" are of at least equal importance.[38]

The Court then abandons preemption analysis and begins discussion of the equities of the parties. The Lear Court says that a patent licensee gets only two benefits from the license: (1) that he "avoided the necessity of defending an expensive infringement action"; and (2) that the existence of the patent may deter others from competing with him. That makes sense only if you assume all patents are invalid. It was presumably inconceivable to the Lear Court that a patent might be valid and that a patent licensee also avoids liability for damages and injunction. That is, of course, the primary benefit of a license.

The Court then suggested that ordinary contract principles do not apply to patents, but rather that patent license agreements are tested by some "standard of good-faith commercial dealing."[39] There is no basis in law for that. The Court then said that, in deciding whether to enforce a license agreement, without considering validity, it considered the licensor's "equities" and balanced them against "the important public interest in permitting full and free competition in the use of ideas which are in reality a part of the public domain."[40] Certainly, if one were to compare "the equities" of an inventor against the "public interest," it would not be difficult to predict how the Warren Court would come out on that vacuous standard.

Under Kewanee, preemption decisions do not depend upon defining equities or attempting to balance those equities against some public interest. Rather, preemption decisions focus on the economic consequences of the preemption for the country.

The only reason offered by the Supreme Court for refusing to apply a different licensee estoppel rule, where the license was entered prior to the patent issuing, was that such a rule would permit inventors to enter "all important licenses" prior to issue and disable "all those who have the strongest incentive to show that a patent is worthless."[41] If a patent is worthless, a user might accept a license under it, but only at a royalty rate of zero. If all users obtain licenses with a zero royalty, the public obtains the benefits of free use without the cost of litigation to "show" worthlessness. The Lear Court said that, where a licensee obtained a disclosure of an invention prior to issuance of the patent, in return for an agreement to pay compensation, the "core" issue is "whether federal patent policy bars a state from enforcing a contract regulating access to an unpatented secret idea."[42] If that is the core issue, then Kewanee makes clear that federal patent policy does not bar states from enforcing such contracts.

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38 Dawson Chem. Co. v. Rohm & Haas Co., 448 U.S. 176, 221 (1980).

39 395 U.S. at 669.

40 395 U.S. at 670.

41 395 U.S. at 672.

42 359 U.S. at 672.

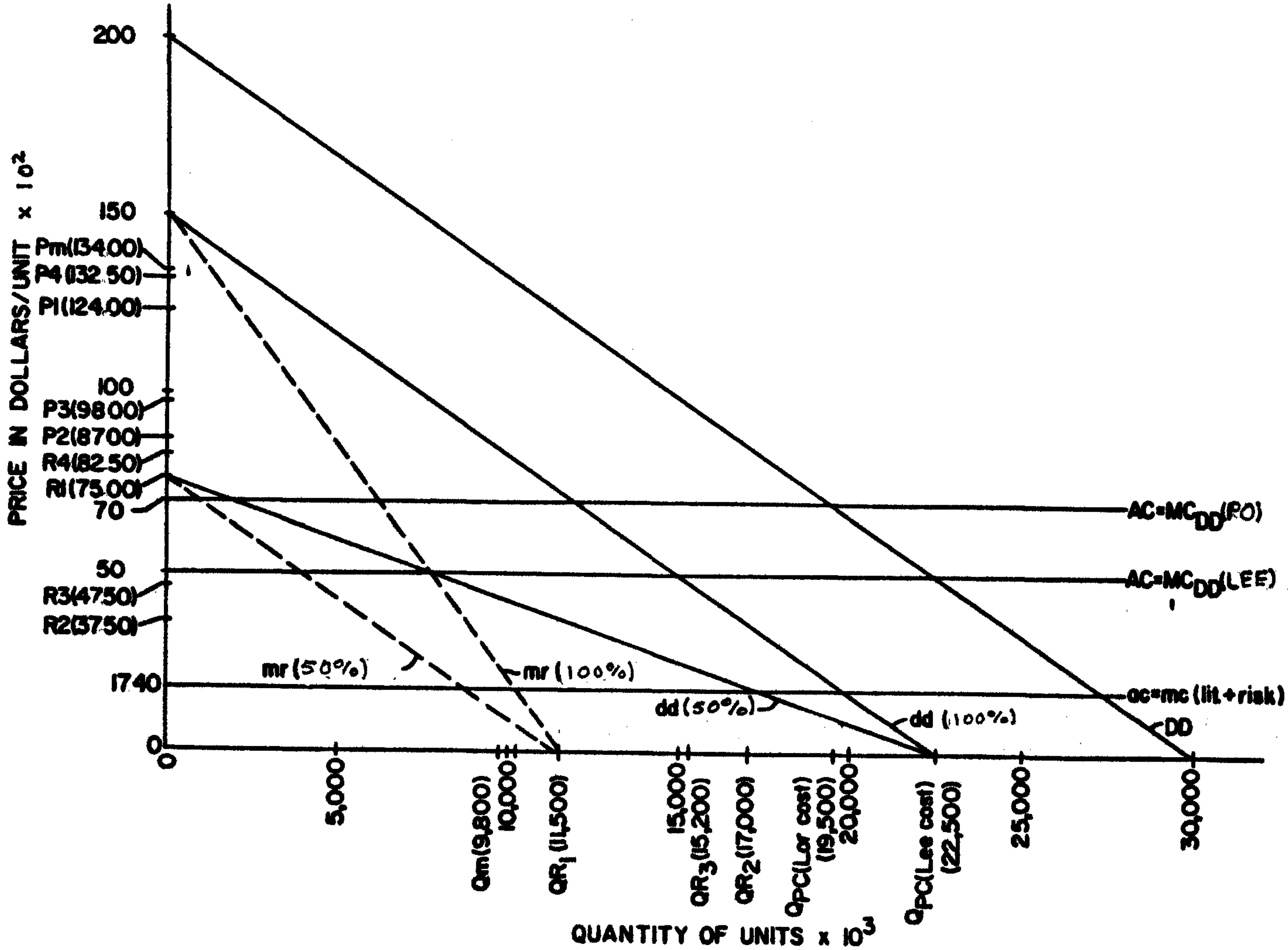
IV. UNDER THE ECONOMIC EFFICIENCY CRITERIA FOR PREEMPTION ARTICULATED IN KEWANEE, LEAR IS DEFICIENT

One might be content to not worry about Lear, even though its legal analysis is deficient if it were not, in fact, economically harmful. The unfortunate fact is that Lear and the cases which have interpreted it dramatically limit the value of a patent, interfere with efficient utilization of inventions, and lead to major resource allocation losses.

To attempt to appreciate the impact of Lear, consider one example of what has happened under the rules as they have changed over the years. Exhibit A, on the following page, shows the demand curve (DD) for some invention, for example, a medical device. The horizontal axis shows the number of units, which would be sold for a period of seventeen years. The vertical axis shows the price of a single machine. The patent owner's cost of manufacturing the machine is a constant \$7,000 per unit, as shown by the curve $AC=MC_{DD}$ (PO). Assume that the patent was 100% certain to be valid. If the patent owner were to use the patent to exclude all competition and produce the machine himself, he would sell Qm units (9,800), at a price of Pm, \$13,400 per machine. His profits would be about \$72,520,000. The deadweight "loss" from monopoly exploitation, which is the area of the triangle between the demand and the supply curves between Qm and Q_{PC} (Lor cost), is \$31,040,000.

Assume that the patent owner has some incentive to license because licensees could manufacture at a lower cost, such as \$5,000 per unit as shown by $AC=MC_{DD}$ (LEE). If the patent were 100% certain to be valid, and costs of negotiation and enforcement of the agreement were zero, then the licensee's demand for the invention is the difference between the demand for the product and the licensee's costs, as shown by the curve dd 100%. The marginal revenue curve for exploiting that demand curve intersects the horizontal axis at QR1, about 11,500 units, and at a royalty R1 of \$7,500 per unit. Licensees will add that royalty to their other costs and, assuming there is competition among licensees, will sell 11,500 (QR1) units at a price of \$12,400 (P1) per unit. Because the output has increased by 1,700 units, profits have increased by 19% to \$86,250,000 and the dead weight loss at the patent owner's cost has decreased by 32% to \$21,600,000. Let us assume that there are ten licensees each producing 1,150 units.

EXHIBIT A



PRICE IN DOLLARS/UNIT x 10²
200
150
Pm(134.00)
P4 (132.50)
P1 (124.00)
100
P3 (98.00)
P2 (87.00)
R4 (82.50)
R1 (75.00)
70
50
R3 (47.50)
R2 (37.50)
17.40
0
mr (50%)
mr (100%)
dd (50%)
dd (100%)
DD
AC=MC DD (PO)
AC=MC DD (LEE)
ac=mc (lit.+risk)
0
5,000
Qm (9,800)
10,000
QR1 (11,500)
15,000
QR3 (15,200)
QR2 (17,000)
QPC (Lor cost) (19,500)
20,000
QPC (Lee cost) (22,500)
25,000
30,000
QUANTITY OF UNITS x 10³

If validity is uncertain, the patent is no longer worth the difference between demand and cost because the licensee, like a patent infringer, can partially substitute risk and litigation costs for payment. If he litigates, there is some chance of having to pay the patent owner zero and some chance of having to pay the patent owner his profits on lost sales or the profit maximizing royalty rate. This reduces the demand for the patent. Suppose there is a 50% chance that this patent will be held valid. Assume the demand for the patent (dd 50%) is half of what it was when validity was certain. The licensee's cost of litigation rather than licensing is litigation costs, plus the increased cost of doing business with customers and lenders because of the risk that the business may be enjoined. The licensor's cost of litigation is his litigation cost, and the same increased cost of doing business. Suppose for the licensor and licensee that turns about $1,740 per unit, shown as ac=mc (lit+risk).

Under pre-Lear law, the patent owner will not have to incur, nor will licensees, the $1,740 per unit cost shown by ac=mc (lit), the cost of litigating patent validity. Prior to Lear, the licensor would ignore these costs and maximize profits against the lower demand curve (dd, 50%). The royalty rate would be $3,750 per unit (R2) (not surprisingly, half the other rate) and licensees' output would increase 48% to 17,000 units. The patent owner's profits would drop to $63,750,000, and the dead weight loss, using licensor's costs would decrease by a factor of 10 to about $2,125,000.

After Lear, the licensor would have to assume that the licensee might decide not to pay royalties and would challenge the validity of the patent. Assume the law had not yet developed, that would permit litigation of validity in situations where the licensor could not terminate. If the licensor can terminate, there is no issue as to royalty payments after a judgment of validity. Lear still changes one important thing to the licensor. He may have to defend validity and incur "litigation" and risk costs. The patent owner will charge a royalty at which marginal revenue from the license equal those costs, a royalty increase to $4,750 per unit (R3). At that royalty, licensee's output would drop to 15,200 units (QR3). Patent owner's licensing profits decrease by 27% to $45,750,000. Output decreases by 10%, and the deadweight loss increases 183% to $6,020,000. For these reasons, the licensor might decide not to license at all, leading perhaps to monopolistic exploitation at higher costs.

The Supreme Court totally ignores these effects. It acts as if the only result of the changed rule is that more patents are held invalid. Under Lear, that is more likely, but what is the net gain? The value of the difference between pre-Lear output of 17,000 units and free or perfectly competitive output of 22,500 units (Q_{PC} (Lee cost)) is the social gain for Lear, $10,175,000. However, it is only 50% likely to be achieved, so the discounted gain is $5,087,500. There are three significant costs which have been incurred even if patent owners continue to license at the same rate: litigation costs of $4 million (assuming there is only one suit); decreased licensee production because of the higher royalty rate (QR3), a loss of $3,895,000; and, in the future, lost inventions and less disclosure because licensed patents, in general, are worth 27% less than they were under the prior rule. If patent owners do not license, output will decrease further, because the patent owner may produce at his higher cost.

If that were not bad enough, some lower courts have interpreted Lear to mean that the licensee may litigate validity in situations where the licensor has no right to terminate. Under that rule, the licensor may be stuck forever with the royalty initially negotiated, even if the patent is held valid. If a patent is valid, the profit-maximizing royalty rate is $7,500 per unit, assuming no litigation costs. If there must be litigation to get there, then the profit-maximizing royalty is even higher, $8,250 per unit. At that rate, licensees will produce 10,250 (Q4) units. Output decreases 6,750 units at a dead weight loss increase to $13,062,000. Licensing profits discounted by the 50% probability that they will fall to zero are $33,363,000, off 42% from the pre-Lear rules. More patents will be held invalid, but what is the net gain? It is, again, $5,087,500, minus litigation costs of $4 million, less $13,062,000 in decreased production by licensees, and the loss of the value of inventions, which are not made in the future because licensed patents are 42% less profitable. To the extent that licensors do not license, there would be a loss by decreased production by the patent owner.

In sum, because the Supreme Court looked only at the gains and ignored the costs (1) in litigation, (2) from decreased production by licensees operating at a high royalty rate, (3) from the decrease in the rate of inventing due to the decreased profitability of licensing inventions, and (4) from inefficient exploitation of inventions from decreased licensing, Lear is not necessarily in the public interest.

V. THE LOWER COURTS HAVE ATTEMPTED TO LIMIT THE DAMAGE DONE BY LEAR

I have suggested that Lear is ripe for overruling. The only way a patent owner is ever going to have the opportunity to make those arguments is by pleading licensee estoppel in actions to enforce an agreement or expressly provide an agreement that the licensee may not challenge validity and seek to enforce that promise. In many instances, this latter course may be unavailable because, in addition to the risk that a court will find such an agreement unenforceable, there is very small risk that a court might also say that the agreement constitutes misuse, rendering the patent unenforceable. Section XI, below. That risk may be unacceptable.

Even though Lear stands as the law today, the lower courts have found that Lear does not always permit licensees to challenge validity. Lear is replete with language concerning monopolies and applying the spirit of contract law. Hence, if the patent does not give an economic monopoly, but rather competes with alternative technology, or if a licensee did not enter the agreement in good faith, a court may find Lear inapplicable.[43]

In Roberts v. Sears, an inventor assigned his rights to an invention for royalties not to exceed $10,000. During negotiations, the assignee's attorney said the invention was not novel, the claims would be limited, and the cost of using the invention was higher than it turned out to be. Apparently, the patent issued before the final agreement was signed, but the inventor was not told. The assignee made a great amount of money using the invention. The inventor sued for fraud, breach of a confidential relationship, and negligent misrepresentations. The assignee argued that the patent was invalid. The Seventh Circuit rejected the argument that Lear precluded an award of damages under these claims for two reasons. First, it said that this agreement was a complete assignment, "... thus, the primary evil that the Court in Lear sought to

[43] Roberts v. Sears, Roebuck & Co., 573 F.2d 976 (7th Cir. 1978); Aro Corp. v. Allied Witan Corp., 531 F.2d 1368 (6th Cir. 1976) (Markey, J.).

end – that the public might have to pay tribute to a 'would-be monopolist' – is completely irrelevant to this case ... the public's interest would not be injured by our decision to bar Sears from attacking this patent at this time."[44] The significance of an assignment is presumably that an assignor, unlike a nonexclusive licensor, cannot be a monopolist because he cannot sell anything. However, Mr. Adkins was not selling anything either, as near as you can tell from the Lear decision, so it is difficult to understand the court's explanation of the distinction. Other courts have refused to treat exclusive licensees or assignors any differently than non-exclusive licensees.[45] What one can say about an assignment or an exclusive license that is different from Lear is that the Court in Lear noted that the licensee received only two benefits, avoiding litigation when he could not afford it and a possible deterrence of competition by others. An assignee not only receives those benefits and the ability to market the product without damage liability or the possibility of an injunction (a benefit all licensees also receive) but typically receives the ability to enforce the patent against others, including the former patent owner who must not use the invention. After the agreement, an assignee is the "would-be monopolist," not the former patent owner.

Second, the Court in Roberts focused on Lear's discussion about the spirit of contract law "which seeks to balance the claim of promisor and promisee in accordance with the requirements of good faith" as a necessary element of the application of Lear. It found that "only after satisfied that the equities were balanced on each side did it consider public policy."[46] In fact, of course, the Court in Lear said only that it was balancing between the equities of the licensor against the public interest, and ignored the equities of the licensee, probably because he had none. However, the Seventh Circuit thought that the licensee's interest must somehow have been taken into account. Importantly, it found that, because the assignee's actions in taking the assignment had violated good faith, the contract did not have a balance of equities, and Lear did not apply. The Court relied on Kewanee as supporting the view that the patent law did not require the court to permit "fraud to go unremedied."

The Sixth Circuit in Aro also distinguished Lear. In that case, Aro sued Allied for patent infringement, and Allied counterclaimed for declaratory judgment of non-infringement of any valid claim. That action was settled by a dismissal of all claims without prejudice, and a license for the remaining three-year term of the patent. The licensee refused to pay the first royalty installment. The patent owner made a motion to vacate the order of dismissal and to enjoin Allied from not complying with its agreement. The Court granted that motion, issued the injunction, and dismissed the counterclaim that the patent was invalid. The Court said that Lear was inapplicable, because (1) there is a public interest in the settlement of litigation, which must be balanced against the interest in invalidating the patents, and (2) there was competition

44 573 F.2d at 982.

45 Beckman Instruments Inc. v. Technical Develop. Corp., 433 F.2d 55, 58 (7th Cir. 1970) (exclusive licensee not estopped); Coastal Dynamics Corp. v. Symbolic Display, Inc., 469 F.2d 79 (9th Cir. 1972) (assignor not estopped); Interconnect Planning Corp. v. Feil, 543 F. Supp. 610, 613 (S.D.N.Y. 1982) (inventor, assignor not estopped).

46 573 F.2d at 982.

between the patent owner, the licensee, and other licensees, there was no evidence that the patent, in fact, gave anyone an economic monopoly, and the royalty was small in comparison to the licensee's profits. It also noted that other licensees were in a position to challenge validity. It said that, upon balancing these policies on the facts of each individual case, the policy in favor of settlement of disputes must prevail over the policy relied on by Lear, unless the patent represents a real economic monopoly and the defendant is the only challenger.

Aro is not the first or only decision to find that the policy in favor of settlement prevails over the desirability of challenging validity.[47] In Wells Cargo, Inc. v. Wells Cargo, Inc., 606 F.2d 961, 965 (C.C.P.A. 1979), the court said that the policy in favor of settlement of disputes always prevails over Lear:

> Appellant ignores the competing policy favoring voluntary settlement of actual disputes. The latter has been viewed as overriding the policy of encouraging challenges to patent validity promulgated in Lear....

Given the strong policy in favor of settling litigation once it commenced, it would seem logical that there is an equally strong, if not stronger, policy in favor of settling a dispute before it gets to the courts. If that is true, then Aro means that any license entered to resolve an existing infringement dispute, whether or not an action has been filed, may preclude the licensee from challenging, depending on the facts and circumstances of that case, including the economic significance of the patent and the presence of other potential challengers. And, if that is true, then it is not always contrary to the public interest to preclude a licensee from challenging validity by an agreement designed to settle a future infringement dispute.

If the courts are reluctant to recognize that all patent licenses constitute settlements of existing or potential infringement litigation, another possible distinction is that Lear involved a general contract rule, which provided the parties' rights if they said nothing on the subject. Where the parties expressly provide for estoppel, the licensee has elected to be muzzled but only to the extent agreed to and has, presumably, exacted royalty or other concessions from the patent owner which are more valuable to him than the harm from being estopped. Because a licensee's interest in challenging is the same as consumers' interests, consumers are better off because the licensee made that agreement. If the concession is lower royalties, consumers benefit from lower prices. Hence, Lear could properly be limited to a decision about general contract law, not about the enforceability of express agreements not to challenge.

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47 International Telemeter v. Teleprompter Corp., 592 F.2d 49, 57 (2d Cir. 1979) (a settlement agreement calling for a lump sum payment as liquidated damages for past infringement is enforceable without respect to validity); Rausburg Electro-Coating Corp. v. Spiller & Spiller, Inc., 489 F.2d 974, 977(7th Cir. 1973) (same); Automatic Radio Mfg. Co. v. Hazeltine Research, 176 F.2d 799, 806 (1st Cir. 1949) (the license agreements were made in settlement of litigation and "[i]t is not apparent to us that the public interest would be served by rendering such common-sense business settlement migratory, which would be the result of a ruling that the licensee could reopen the issue of validity when sued for the stipulated royalty."), aff'd 339 U.S. 827 (1950), overruled 395 U.S. 653 (1969).

Once a complaint for infringement or even threatened infringement is filed and jurisdiction over the defendant is obtained, the parties may settle the dispute by the entry of a stipulated judgment that the patent is valid and infringed. That judgment will forever bar that defendant from challenging validity regardless of the economic circumstances. A patent consent decree, which recites both validity and infringement, gives rise to *res judicata* and collateral estoppel in any subsequent proceeding between the parties (or those in privity of a contract with them) over the validity of the patent.[48] To non-lawyers, it may seem bizarre that a license signed before a complaint is filed cannot be binding, but that an agreement signed after a complaint is filed is unassailably binding. The procedural difference is that a consent judgment is an act of the court. Judgments may, if properly framed, finally resolve issues between the parties.

The reasons that the courts have given for according *res judicata* effect to consent decrees are, by and large, the same reasons that it is in the public interest to enforce a provision in a license that the licensee not challenge validity. The courts have noted that refusal to accord *res judicata* effect to consent decrees would lead to continual "expensive and time consuming litigation."[49] The enforcement of an agreement not to challenge would reduce those costs even more efficiently by precluding the litigation in the first place. Second, the courts have said that giving *res judicata* effect to consent decrees encourages the defendant to litigate validity, rather than postpone final adjudication until such time as it better suits licensee's ability or interests.[50] Similarly, enforcing an agreement not to challenge in a license encourages the licensee to decline the license and challenge validity, rather than take the license and challenge when it suits licensee's purposes at some later time. Third, the courts have noted that consent decrees bind only the parties, and those in privity with them, and leave others unrestrained in their abilities to challenge.[51] The same could be said about license agreements in any context in which fewer

48 USM Corp. v. SPS Technologies, Inc., 694 F.2d 505 (7th Cir. 1982); American Equipment Corp. v. Wikomi Mfg. Co., 630 F.2d 544 (7th Cir. 1980); Wallace Clark & Co., Inc. v. Acheson Indus., Inc., 532 F.2d 846, 849 (2d Cir. 1976); Schlegel Mfg. Co. v. USM Corp., 525 F.2d 775, 780-81, 783 (6th Cir. 1975); Broadview Chemical Corp. v. Loctite Corp., 474 F.2d 1391 (2d Cir. 1973).

49 Carter-Wallace & Co., Inc., 532 F.2d at 849; Schlegel Mfg.Co. v. USM Corp., 525 F.2d at 783 ("[I]f every patent-infringement case filed had to be tried, the Courts would be clogged.").

50 Schlegel Mfg. Co. v. USM Corp., 525 F.2d 775, 780-81 (6th Cir. 1975) ("When a consent decree is to be given *res judicata* effect, litigants are encouraged to litigate the issue of validity rather than foreclosing themselves by consent decree... By giving *res judicata* effect to consent decrees, this Court protects the public interest in that an alleged infringer is deprived of a judicial device which can be used to postpone and delay a final adjudication of validity."); American Equipment Corp. v. Wikomi Mfg. Co., 630 F.2d 544, 548 (7th Cir. 1980) (according *res judicata* "encourages earlier and more vigorous challenge....").

51 American Equipment Corp. v. Wikomi Mfg. Co., 630 F.2d 544, 548 (7th Cir. 1980); Schlegel Mfg. Co. v. USM Corp., 525 F.2d 775, 781 (6th Cir. 1975) ("By giving *res judicata* effect to consent decrees, we do not close the doors of the Courts to litigation on the issue of patent validity, except as to parties or their privities, and only after they have had the opportunity to litigate the issue fully. Third parties are not affected by the consent decree....").

than all infringers have been licensed. The only other reason one court has given for enforcement of consent decrees of validity and infringement is that they are judicial decrees, subject to court scrutiny, and entered only after a lawsuit has been filed so that the defendant had the opportunity to employ discovery machinery and otherwise to litigate.[52] A license entered into prior to litigation does not, of course, have that feature. But in many situations where the patent is issued, the licensee is already producing the allegedly infringing product, and the licensor has accused him of infringement, the doors of the courts were open to the licensee for a $60.00 filing fee. A licensee who has not taken advantage of that opportunity is not in a significantly different position than one who has.

When the argument has been made that the public interest in challenging validity precludes court orders from being followed, the courts have noticed that this rule would make the order "a futile, meaningless gesture which will discourage such settlements in the future," Schlegel Mfg. Co., 525 F.2d at 783. The decision in Lear, of course, had precisely the same effect for licensing of patents. The Second Circuit has said that "... absent evidence of collision, judicial decrees disposing of issues in active litigation cannot be treated as idle ceremonies without denigrating the judicial process."[53] The judicial process is, of course, of great importance, but the process of entering into agreements which must be performed is also vital and one which should not be an idle ceremony.

VI. LEAR v. ADKINS SHOULD BE CHANGED BY CONGRESS

In 1983, Senator Mathias introduced a bill which provided, in pertinent part:[54]

> SECTION 295. LICENSEE ESTOPPEL. (a) A licensee shall not be estopped from asserting in judicial action the invalidity of any patent to which it is licensed. Any agreement between the parties to a patent license agreement which purports to bar the licensee from asserting the invalidity of any licensed patent shall be unenforceable as to that provision. (b) In the event of an assertion of invalidity by the licensee in a judicial action, licensee and licensor shall each have the right to terminate the license at any time after such assertion. Unless terminated by either party, the licensee shall pay and the licensor shall receive the consideration set in the license agreement.

A slightly different version of this bill was introduced by Representative Kastinmeier.[55]

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52 Wallace-Clark & Co., Inc. v. Acheson Indus., Inc., 532 F.2d 846, 849 (2d Cir. 1976).

53 Wallace-Clark & Co., Inc., 532 F.2d at 849.

54 S. 1535, 98th Cong., 1st Sess.

55 H.R. 4529.

Because I believe that Lear is unsound, and because I think such agreements would be desirable, I can see no positive effects from the first section of these bills. The first section goes even further than Lear in prohibiting licensee challenges. There was no agreement in Lear that licensee would not challenge. The only issue was the state contract rule of licensee estoppel. It was the lower courts which subsequently held that agreements not to challenge were unenforceable based on the policies articulated in Lear. Section XI, below. The first section of that bill raises the spectre that some court might some day say that, when Congress says that a provision in a license agreement is unenforceable, this reflects a strong public policy that there not be such agreements. Therefore, any party who enters into such an agreement, or one having that effect, has misused the patent and rendered it unenforceable. The next step is, of course, for a court to say that the same agreement violates the antitrust laws. This is exactly what happened in the tie-in area after Congress adopted Section 3 of the Clayton Act, a section of the antitrust laws that has absolutely nothing to do with patent licensing. Compare Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502 (1917) with Morton Salt Co. v. G.S. Suppiger Co., 314 U.S. 488 (1942).

The second section of those bills address a subject not decided by the Supreme Court in Lear. Recall that in Lear, the licensee attempted to terminate under a provision which seemed to give him the unequivocal right to do that on notice. The state court said that the licensee's attempted termination was ineffectual because he was still selling the product. The Supreme Court said that that was purely a matter of state law.[56] Since the licensor was trying to enforce the agreement, rather than terminate it, the only thing Lear decided about termination was that state law governed. If a licensee stops paying royalties to the licensor, except pursuant to some court order, the licensor may terminate the agreement, if he has termination rights.[57] However, some courts have said that, if the licensee continues to pay, he may sue for invalidity without terminating or repudiating the license.[58] Section b of these bills attempts to provide a termination clause for all patent license agreements, which would permit termination in that instance. Under it, if the licensee asserted invalidity "in a judicial action," both licensee and licensor could terminate "at any time" thereafter. No court has, of course, ever said that a licensee had that right, and I cannot conceive of any reason why he should. This provision would make all licenses terminable virtually at will by the licensee. An exclusive licensee having trouble meeting a best-efforts obligation will probably applaud this escape hatch, but I can see no policy reason for that part of the bill. The licensor's right to terminate is certainly an improvement over current law, because it would permit the parties to enter into a license with the discounted royalty rate and leave the patent owner free to terminate and negotiate a higher rate if

[56] 395 U.S. at 661-62.

[57] Nebraska Engineering Corp. v. Shivvers, 557 F.2d 1257,1259-60 (8th Cir. 1977); Morton-Norwich Products, Inc. International Salt Co., ___ F. Supp. ___, 183 U.S.P.Q. 748, 750-51(N.D.N.Y. 1974) ("Nothing in Lear prevents the licensor from treating nonpayment of royalties due...as a breach...and a ground for termination in accordance with its terms.").

[58] E.g., American Sterilizer Co. v. Sybron Corp., 526 F.2d 542, 546-47 (3d Cir. 1975) (licensee may commence an action for a declaratory judgment of invalidity without exercising its right to terminate).

the patent is held valid. But many licensors may want to enforce the license, not terminate it. In addition, it may be more desirable for the parties to agree at the outset to a low rate prior to a decision on validity, and the higher rate if the patent is held valid without termination. The section also raises certain questions. To the extent that this bill gives the patent owner certain termination rights with respect to "judicial actions," does it also give the patent owner, who has agreed to arbitrate validity, the same rights? Moreover, would it permit the licensor to terminate if the licensee sought reexamination?

The second part of section b may be an attempt to eliminate the decisions made by some courts that they should issue an injunction requiring the licensee to pay royalties into escrow, rather than to the patent owner, pending disposition of the action. While I think that is desirable, the section does not expressly deal with who receives or retains those royalties, if the patent is held invalid. The law is now clear that the licensor may not recover royalties due after the licensee challenges validity in Court if the patent is held invalid.[59] It is unclear whether the second paragraph of section b changes that result.

Another draft of a bill has the same basic provision as that of section a of the Senate and House bills, but would have a second section which would let the parties decide whether to adopt these termination provisions. It would provide:

> (b) Any patent license agreement may provide for a party or parties to the agreement to terminate the license if the licensee asserts in a judicial action the invalidity of the licensed patent, and, if the licensee has such a right to terminate, the agreement may further provide that the licensee's obligations under the agreement shall continue until a final and unappealable determination of invalidity is reached or until such right to terminate is exercised. Such agreement shall not be unenforceable as to such provisions on the ground that such provisions are contrary to federal patent law or policy.

This bill would permit the licensor to negotiate some termination rights in some situations, where he cannot now have them. For some licenses, that may be desirable. It would not discernibly help Mr. Adkins because he was trying to enforce the license, not terminate it. This bill also says that, if the licensor can terminate, the licensee's obligations continue until termination. This bill does not seem to interfere with a court's ability to issue an injunction saying that licensees may pay royalties into escrow. The bill seems to mean that, without respect to when the licensee asserted invalidity, a licensee with termination rights must pay royalties until the earlier of termination or final judgment of invalidity, if the parties so agree. That seems sensible enough.

You may have surmised at this point what I would say if I were going to legislate on this front. I would amend the Patent Act to include something along the following lines:

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59 E.g., P.P.G. Industries, Inc. v. Westwood Chemical, Inc., 530 F.2d 700, 707-08 (6th Cir. 1976).

> 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.

VII. A PATENT OWNER MAY WISH TO CONSIDER NOT LICENSING OR ADAPTING ROYALTY TERMS AND OTHER RIGHTS TO ATTEMPT TO REDUCE THE COST OF LEAR v. ADKINS

Because Lear v. Adkins has lead to a situation in which a licensee can litigate validity and retain the license, a patent owner must always consider the option of not licensing at all in the hope that the prospective licensee will decide to stay out of the business rather than litigate. If that is unlikely, the owner of an interferon patent might meet with a prospective user of the invention and offer to supply him with toothpicks in exchange for five percent of the purchaser's sales of interferon. The patent owner might let it be known that it has never enforced its interferon patent against a good toothpick customer, because of a general policy against suing customers, but that no license under the patent was available.

If there are other reasons to license, and the black market idea doesn't appeal to your management, then a patent owner must accept the fact that his licensee may litigate, lose, and, nonetheless, retain the license. If there is uncertainty as to validity, the licensee's royalty obligation may end under current law as soon as he can write a letter to the patent owner asserting unequivocally that the patent is invalid and notifying him not to expect any further royalty checks. 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, he 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. In addition, since a license may be only anti-injunction insurance, the patent owner should charge an appropriate premium for that policy, collectible in a lump sum concurrently with execution of the license. The licensor may also simply load royalties toward the front end of the term, perhaps loading them all into signing day. Another idea would be to license patents in exchange for some non-monetary consideration, such as a cross-license. Even if such a licensee would prove invalidity, it may not be able on that basis to terminate the patent owner's license under the licensee's patent.

Lear v. Adkins unnecessarily limits the profitability of licensing inventions. Since the true value of the patent cannot be directly exploited by royalties, a patent owner may attempt to shift his prices from the patent to payments for complementary goods, such as know-how or other personal property, such as microorganisms or computer tapes containing semiconductor chip designs. Any time governments make economically unsound laws, an opportunity exists for price shifting tie-ins. For example, banks were prohibited for years from paying depositors market-clearing interest rates for deposit accounts. Banks would have been happy to pay more for the use of that money, but were prohibited from doing so directly. Hence, banks offered deposit accounts in exchange for interest and a branch office conveniently located near the depositors' homes. If patent owners cannot charge directly for what patents are worth, then they will go into the business of providing a package of services, which includes the patent, at a single price.

For the most part, this strategy has been litigated in connection with a package of patents and know-how. As we know, where secret know-how is disclosed and licensed, the licensee agrees to pay for the use of that know-how, whether or not it continues to be secret, and no patent covering the know-how issues, the obligation to pay is enforceable.[60] One court has held the same result follows where only know-how is licensed but a patent does issue.[61] However, some courts have said that where both patents and know-how related to the same subject matter are licensed, and the licensee agrees to pay at a single rate based on use of patents and know-how, those royalties may not be collected after the licensed patents are held invalid or expire.[62] One District Court in Ohio recently found no basis for refusing to enforce an agreement made at a time when no patent application had been filed, which called for royalties for the longer of the life of any patent or 25 years. There being no application, the court said that there can be no leverage to extend the patent monopoly.[63] In another case a person sold his title to a pending patent application, an experimental model of a machine, drawings of it and tools used in its development in exchange for an agreement to pay "royalties" for 17 years on products that make

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60 Aronson v. Quick Point Pencil Co., 440 U.S. 257 (1979).

61 Pitney-Bowes, Inc. v. Mestre, 517 F. Supp. 52, 55, 59-60, 62 (S.D. Fla. 1981), appeal dismissed in pertinent part 701 F.2d 1365 (11th Cir. 1983).

62 Chromalloy American Corp. v. Fischmann, 716 F.2d 683, 685 (9th Cir. 1983); Pitney-Bowes, Inc. v. Mestre, 701 F.2d 1365(11th Cir. 1983) dismissing in part and aff'ing in pertinent part 517 F. Supp. 52 (S.D. Fla. 1981) (in a "hybrid" know-how or trade secret and patent license, which does not differentiate between the know-how and patent rights and does not allocate or divide royalties between them, the expiration of all patents makes unenforceable the obligation to pay at the pre-expiration rate); Span-Deck, Inc. v. Fab-Con, Inc., 677 F.2d 1237 (8th Cir. 1982); St. Regis Paper Co. v. Royal Industries, 552 F.2d 309 (9th Cir. 1977); Timely Products, Inc. v. Costanzo, 465 F.Supp. 91 (D. Conn. 1979).

63 Boggild v. Kenner Products Div. of General Mills Fund Group, 576 F. Supp. 533 (S.D. Ohio 1983).

use of a machine "covered by said patent application."[64] The court held that the assignee was obligated to pay royalties regardless of the validity of the patent which subsequently issued. The Court found Lear inapplicable because Lear involved a "licensor-licensee relationship" and payments were installment payments for conveyance of the application, drawings and tools.

Lest you be put off by some of these decisions, it seems to me that they are inconsistent with the decision in Aronson v. Quick Point. Aronson stands for the proposition that if an inventor with a pending patent application licenses someone to use the know-how embodied in that application and any patent which might issue, in exchange for some agreeable royalty arrangement, that agreement is enforceable in spite of the fact that the invention subsequently enters the public domain by being disclosed to the public and the failure of the patent to issue. The only significance of the royalty rate reduction in the Aronson agreement was to establish clearly that the licensee recognized that it was receiving something of value, even if no patent issued. Because the licensee recognized that fact and agreed to pay nonetheless, he cannot avoid that obligation, because the invention under which he was licensed subsequently enters the public domain. I cannot read the Court's decision to say that, had the patent issued and been held invalid, the agreement to pay would have been unenforceable. Any other ruling simply penalizes patent owners, because the courts and the patent office cannot always agree what constitutes a patentable invention. However, it is possible to read Aronson narrowly to hold only that a combination know-how/patent license is enforceable only if the royalty rate is reduced when the patent issues but expires or is held invalid. This is, presumably, because the second half of the Lear decision supports the view that the licensee must always be given some incentive to challenge validity.

The Supreme Court in Lear said that termination rights are purely a matter of state law, and was not offended by a ruling by the California Supreme Court that a licensee with apparent right to terminate on notice could not terminate unless he first discontinued use of the product. Patent owners should always have the right to terminate without delay for any breach, including any non-payment of royalties or late payment. The licensor may also wish to have the right to terminate at any time in the licensor's sole discretion. In a variety of contexts, such as an exclusive license, any such rights might destroy necessary economic incentives for a licensee.

I can see no way confidently to modify a licensee's rights or obligations to help with Lear. Some licensors have argued that, because the licensee had the right to terminate and failed to do so, he should not be permitted to challenge validity. The courts have ruled that licensees need not exercise their termination rights as a precondition to proving invalidity. If Lear says a licensee must have the right to challenge, presumably Lear would permit a provision requiring the licensee to challenge validity within one year after the licensee receives information establishing invalidity. If the licensee breaches that agreement, the licensee shall thereafter be precluded from challenging validity of the licensor may terminate. I am aware of no cases deciding the fate of that idea, though it seems consistent with Lear. If licensee's challenges are in the public interest, certainly the licensee can be compelled to act accordingly.

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64 Heltra, Inc. v. Richen-Gemco, Inc., 395 F. Supp. 346, 348, 351-51 (D.S.C. 1975), rev'd on other grounds, 540 F.2d 1285(4th Cir. 1976).

It is now lawful for a patent owner and his licensees to agree to resolve validity by arbitration.[65] If a patent owner is satisfied that his chances of having the patent held valid are better in arbitration, rather than in litigation, then he may have additional incentives to require licensees to agree to arbitrate all validity disputes.

Under the California Evidence Code, "the facts recited in a written instrument are conclusively presumed to be true as between the parties thereto, or their successors in interest; but this rule does not apply to the recital of a consideration."[66] If a licensee agrees in the recitals that the patent is valid and that the licensee's products would infringe it, those facts would be established in any state Court action in California to enforce the license. In addition, such recitals might be used as the basis for showing that the licensee entered the license in bad faith, thereby violating the "spirit" of contract law, upsetting the balance of equities, and perhaps rendering Lear v. Adkins irrelevant. Two sections later, the same Evidence Code provides that "a tenant is not permitted to deny the title of his landlord at the time of the commencement of the relation."[67] Patent licensees are, of course, much more needing of government protection than tenants. So it is not shocking to see that estoppel by deed, one original basis for licensee estoppel, continues to have validity.

VIII. LEAR'S LIMITATION OF A LICENSEE'SROYALTY OBLIGATION IS DIFFICULT TO UNDERSTAND AND MORE DIFFICULT TO JUSTIFY ON PREEMPTION GROUNDS

The patent owner in Lear argued that the licensee, even though not estopped to prove invalidity, must pay the $800,000 judgment based upon its activities prior to 1960, when the patent issued, and from 1960 to 1963, the cut-off date for the damage award. The arguments were that (1) because the licensee obtained access to the patent owner's ideas prior to their publication in the patent, it was required to pay royalties both before and during the entire patent term without regard to validity and (2) the parties had agreed that royalties would be paid until the patent was held invalid and no court had so held.[68]

The Court said that, if the patent is about to become technically obsolete, the licensee has "little incentive" to litigate "unless he is freed from liability at least from the time he refuses to pay the contractual royalties."[69] That is the first of the three different Lear conclusions on when royalty liability ceases for patents later held invalid.

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65 35 U.S.C. § 294.

66 California Evidence Code, § 622 (1965).

67 California Evidence Code, § 624.

68 395 U.S. at 672 and 673.

69 395 U.S. at 674.

The second is that "... Lear must be permitted to avoid the payment of all royalties accruing after Adkins' 1960 patent issued if Lear can prove invalidity."[70] That is what Justice White separately said the Court was holding.[71]

The third rule to arise from Lear's jumbled thinking was that licensees could not be "required to continue to pay royalties during the time they are challenging patent validity in the Courts."[72]

The facts do not help much to decipher what the Court was saying because the licensee in Lear stopped payments prior to the issuance of the patent. The action in which the licensee challenged validity, a state court action to enforce the agreement, was commenced shortly after the patent issued and the licensee presumably promptly pleaded invalidity in that action. All we know is that the Court vacated the judgment in its entirety, including the part of the judgment calling for royalties paid during the first three years of the patent's term. Because I believe the decision to unmuzzle licensees is not based on sound preemption analysis, the Court's decision to limit a licensee's royalty obligations for activities prior to the finding of invalidity is unsound. The unmuzzling part of Lear at least has the benefit that some patents, which were improperly issued, would be held invalid. The royalty limitation decision cannot claim the same benefit, because many unmuzzled licensees would sue without the royalty relief. As to them, the royalty relief is a pure windfall, with no social value. On the cost side, the royalty decision has the same type of effects as the unmuzzling decision.

The Court found that a contract which permits a challenge to validity, but requires the licensee to comply with its terms and "continue to pay royalties until its claim is finally vindicated in the courts," is "inconsistent with the aims of federal patent policy."[73] Without so much as a nod toward policies of encouraging invention, disclosure of inventions through use of the patent system or efficient use of inventions through licensing, the Court concluded that "...[E]nforcing this contractual provision would undermine the strong federal policy favoring the full and free use of ideas in the public domain."[74]

Under Kewanee, if an unpatentable invention is not in the public domain under state law, then no federal policies are offended by state laws, which prohibit its use. If you look to the patent statute to decide when an invention enters the public domain under federal law, an invention covered by a patent does not enter the public domain until a final decision by a Court. The Patent Act provides that a patent shall be presumed to be valid.[75] It also provides that the

[70] 395 U.S. at 674.

[71] 395 U.S. at 682 n.2.

[72] 395 U.S. at 673.

[73] 395 U.S. at 673.

[74] 395 U.S. at 674.

[75] 35 U.S.C. § 282.

burden of establishing invalidity of a patent shall rest on the party asserting invalidity.[76] A patent is not invalid unless and until a Court so rules. In 1969, even if a patent was held invalid in a suit against one infringer, the invention did not automatically enter the public domain as to all infringers. In spite of Blonder Tongue Labs v. University Foundation, 402 U.S. 313 (1971), that is still the law. Since the idea is not in the public domain under patent law prior to judgment, the requirements not to challenge or to pay until judgment, take nothing out of the public domain.

Under Aronson v. Quick Point Pencil Co., 440 U.S. 257 (1979) if an agreement to pay is made when an invention is not in the public domain under state law, the fact that a licensee is obligated to pay royalties for use before and, indeed, after it enters the public domain under both state and federal law does not condemn it. Regarding the third "policy," Aronson says that, if a licensee received some benefit from the authority to use information not yet in the "public domain" under state law, then the obligation to pay royalties after an invention enters the public domain by virtue of public disclosure and the absence of a patent is not inconsistent with federal policy. Again, an invention subject to an issued patent does not enter the public domain under federal law until a court finds a patent invalid. Hence, the requirement to pay royalties for an invention not in the public domain under federal law cannot violate Kewanee's third policy of not taking things out of the public domain that are in it. Aronson also says that payments for use after an idea enters the public domain by disclosure and the failure of a patent to issue does not violate federal policy.

Brulotte v. Thys Co., 379 U.S. 29 (1964), says nothing to the contrary. Brulotte simply said that royalty payments based upon activities after the patent expires, and the patent owner has benefited from the full 17-year term, are unenforceable. It said nothing about a patent being held invalid. The Court's opinion in Lear did not even cite Brulotte. A decision that royalties may not be collected after expiration does not compel the view that royalties may not be collected after a holding of invalidity, much less compel the view that royalties may not be collected for activities before a holding of invalidity. Under Aronson, if no patent issues, a promise to pay for 17 years or 100 years without respect to whether the idea enters the public domain was entirely acceptable to the Supreme Court in 1979.

If that is the law when the Patent Office determines that an invention is not patentable, it is bizarre to apply a different rule when the Patent Office initially determines that an invention is patentable, but a Court subsequently disagrees. What sensible policy requires that inventors with ideas of uncertain patentability capture less of the value of those inventions than inventors of clearly unpatentable inventions? What sensible policy requires that owners of inventions of uncertain patentability earn greater income if they do not use the patent system, than if they do? What policy is served by requiring inventors to bear all the risk created by the inability of the Courts and Patent Office to agree on whether an invention is patentable?

The Lear Court did not say that the licensee should not be liable for royalties prior to a finding of invalidity, because the patent was all the time in the public domain. It said that it was not enough that the licensee have the opportunity to challenge validity. It is, Lear said, federal

[76] 35 U.S.C. § 282.

policy that the licensee have sufficient economic incentives to do so. Those incentives are increased by increasing the amount of money a licensee can retain, if he is successful. There is, of course, no support for that view in the Patent Act. For example, except in extraordinary cases, a successful defendant in a patent case bears his own attorneys' fees.[77] If Congress were concerned about an infringer's or a licensee's incentives to litigate, the least it would have done is awarded them attorney's fees. Likewise, if Congress had been concerned about challenging the validity of issued patents, it would have been a simple matter to authorize the Attorney General to bring suit to invalidate them. Congress has not done that.[78] The Lear Court, not Congress, devised that "policy."

If one accepts the Court's opinion on face value, the Court was attempting to devise some rule of licensee's ultimate liability if the patent is found invalid. The rule is designed either to give a licensee sufficient incentives to litigate or to reduce the licensor's incentives to delay judgment.

If one assumes that public policy is furthered by reducing incentives to delay judgment, the Court did not suggest a sensible rule to achieve it. By focusing only on the licensor's incentives to delay, the Court suggested that requiring the licensee to pay until the patent was held invalid violated the policy. The Court ignored the fact that any rule which gives the licensor incentive to delay gives the licensee an equal and opposite economic incentive to hurry. There is no reason to believe that licensors are more efficient delayers than licensees are hurriers. It is the judgment, not the lawsuit, which theoretically benefits the public, so it is the judgment which licensees should be encouraged to obtain. If the policy goal is the earliest possible judgment, then a rule under which the licensee must pay until he obtains such a judgment maximizes his incentive to obtain it promptly. A rule that the licensee has no royalty liability from the date of suit until judgment of invalidity, reduces licensor's incentives to delay judgment and reduces a licensee's incentives to hurry to judgment by an equal amount of dollars. Such a rule also increases the licensor's incentives to terminate an otherwise valuable arrangement.

The Courts have struggled and will continue to struggle, because Lear also said that the issue must be decided based upon giving the licensee's economic incentives to litigate. The total pie at stake in a dispute between a licensor and a licensee on validity is equal to the present value of the royalty payments over the remaining term of the patent. If the licensee litigates validity without terminating the agreement, its incentive to litigate is equal to the probability of invalidity times the present value of the royalty stream, minus the cost of suit. The licensor's incentive to litigate is exactly the same.

If the goal is to maximize the licensee's incentives to litigate, the obvious answer is to award the licensee everything that he paid to the licensor at any time and let him retain the license. That maximizes the value of a finding of invalidity to the licensee and will lead to the maximum number of lawsuits. Shortly after Lear, one District Court held that to be the result

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77 35 U.S.C. § 285.

78 United States v. Glaxo Group Limited, 410 U.S. 52 (1973).

compelled by Lear.[79] The Court of Appeals reversed on the basis that (1) the licensee benefited from the license prior to its termination, and (2) the District Court rule would be inconsistent with encouraging use of the patent system and encouraging licensing of patents.[80] The Court of Appeals compelled the licensee to pay under the license, until the patent was held invalid by a final unappealable judgment in a third-party action. The date on which a patent becomes ineffective, because invalid, is the date on which a Court of Appeals affirms a decision that the patent is invalid. The eviction rule applied in some circumstances prior to Lear.[81] If one accepts the Court of Appeals' view that one should consider the benefits of the license to the licensee, and the impact of the rule on incentives to use the patent system and to license, the royalty rule follows simply. Royalties must be paid, whether or not the patent is ultimately held invalid, until the time the license is terminated or, if it is not, until a judgment of invalidity is final and unappealable. To be sure, this reduces incentives to litigate but only to the extent that the licensee's royalty payments are worth the benefits he is receiving from the license. There is no reason to apply a different rule when the licensee is challenging validity, rather than validity being challenged by a third party. In either case, the licensee is receiving benefits, which exceed the cost of the royalties.

If one attempts to define some rule which ignores the benefits reaped by the licensee and ignores the corresponding effect of the rule on incentives to use the patent system and to license, it is difficult to conceive of any line other than one which maximizes the size of the carrot for the challenging licensee. The Court of Appeals in Troxel tried to find one by saying that Lear was designed to achieve an "early" test of validity, not simply to create maximum incentives to test validity at any time. The Court of Appeals said that, if the licensee could recover everything in the past, it would have little incentive to litigate until the patent had expired. The Court thereby rejected the idea that Lear requires that the size of the carrot, i.e., the total economic gain from a successful challenge, be maximized. It replaced that idea with creating incentives for an early test of validity.

Had the Court said Lear seeks an early judgment, and that did concern the Lear Court, then the "eviction" rule maximizes the licensee's incentives to obtain it. Early judgments benefit the public, not early complaints. The Troxel Court of Appeals, however, said that an early test is

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79 Troxel Manufacturing Co. v. Schwinn Bicycle Co., 465 F.2d 1253 (6th Cir. 1972).

80 465 F.2d at 1257-58; Troxel Manufacturing Co. v. Schwinn Bicycle Co., 489 F.2d 968, 972-73 (6th Cir. 1973).

81 Dracket 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 at 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.").

the goal so licensee's must pay until they initiate the test.[82] Even under that view, there is no reason to suppose that a licensee determined to challenge will file suit earlier, if his royalty liability ceases at that time than if his royalty liability ceases on the day of judgment. To obtain an early judgment, the licensee must file an early suit.[83]

Taking their lead from the Troxel decision, many courts have attempted to draw a line based upon whether or not the licensee had done something which would prompt a lawsuit. If the licensee does something which would prompt a lawsuit, then the courts generally say that he is freed from his royalty obligation from the date of that act, if the patent is ultimately shown to be invalid. The "logic" is simply that Lear attempts to create rules which encourage challenges to validity, and, if the licensee "challenges" validity, he is doing what Lear wants him to do. Lear does not compel such a rule because the licensee in Lear had both withheld royalties and had challenged validity in a pending suit. One court said that "... the obligation to pay royalties on an invalid patent ceases when a licensee takes affirmative steps aimed at adjudication of the patent's invalidity."[84] In Chromalloy, the Chromalloy Company acquired a patent license, know-how, and the business assets of Fischmann in 1968, stopped paying royalties in January 1975, and repudiated the agreement and commenced an action for a declaratory judgment that the agreement was void because of invalidity in 1976. The court held that the patent was invalid, but that Chromalloy was obligated to pay royalties up until the date on which it had stopped payment, repudiated, and sued. In PPG Industries, Inc. v. Westwood Chemical, Inc., 530 F.2d 700, 708 (6th Cir. 1976), the court announced the rule as follows: Under Lear, liability for royalties ordinarily is terminated on one of two dates (i.e., if before eviction), whichever first occurs: (1) on the date the licensee ceases the payment of royalties for the purpose of prompting an early adjudication of invalidity, or (2) on the date the licensee files suit (or counterclaim) attacking the validity of the patent. It is only when the licensee continues to pay royalties, and does not file suit until after the patent has been adjudicated invalid, that the cutoff date for liability is the date of eviction of the patent. In PPG, the licensee withheld the royalties from January, 1969, but without stating any reason. In July of 1970, a District Court in an infringement action against a third party held the patent invalid. In January of 1971, the licensee commenced an action to have the license declared unenforceable. In August, 1971, the judgment of invalidity in the third-party action was affirmed by the Court of Appeals. The court held that, while the eviction occurred on the date of the Court of Appeals' decision, the licensee was liable for royalties only until the date it commenced suit to have the license declared unenforceable in January, 1971. Simply ceasing to pay royalties was not sufficient action to prompt an early adjudication of validity.[85] This seems to me to be somewhat arbitrary because it ignores the

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82 Accord, Transition Electronic Corp. v. Hughes Aircraft Co., 649 F.2d 871, 874-75 (1st Cir. 1981) (absent fraudulent inducement, a licensee may not recover royalties paid prior to bringing suit).

83 465 F.2d at 1257.

84 Chromalloy American Corp. v. Fischmann, 716 F.2d 683, 685 (9th Cir. 1983).

85 530 F.2d at 706. Accord, Rite-Nail Packaging Corp. v.Berryfast, Inc., 706 F.2d 933, 936 (9th Cir. 1983) (licensee must pay royalties until it notified the licensor that the payments were being stopped because the patent was believed to be invalid); Hull v. Brunswick Corp., 704 F.2d

licensee's benefits from the license, the effect of the rule on the value of patents and licensing, and a licensee's incentives to push the action to final judgment.

Some courts, after Lear, thought that the Supreme Court was saying something about preliminary relief freeing the licensee from royalty obligations pending judgment. Some courts issued orders that licensees could deposit royalties in escrow.[86] Most courts have refused to issue such orders usually noting the licensor's solvency.[87] Lear, of course, says nothing about such orders, so they should be treated under normal preliminary injunction standards.

The rule that a licensee's ultimate royalty obligations may depend on whether or not it commenced suit for infringement, places great importance on the jurisdictional rules which define what actions a licensee may or may not initiate. Lear said nothing about federal jurisdiction, but, as in most other areas, it has had some effect there.

IX. THE IMPACT OF LEAR v. ADKINS ON FEDERAL JURISDICTION

Lear involved an appeal from a state court action for breach of an agreement. Hence, Lear did not and could not say anything about the subject matter jurisdiction of the federal courts. Lear certainly said that the licensee could defend a state court action for breach, based on invalidity, but that does not imply that the licensee must necessarily be able to do so in federal court.

The jurisdictional limits on patent owner actions in the federal courts are well known, and continue to be applied in the same manner in which they were applied prior to 1969.[88] However, the courts after Lear greatly expanded the ability of a licensee to bring an action in federal court to declare a patent invalid. There are two separate and independent requirements for maintaining

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1195, 1202-03 (10th Cir. 1983) (the licensee "must notify the licensor that they are suspending payment because they question validity..."); Bristol Locknut Co. v. SPS Technologies, Inc., 177 F.2d 1277, 1283 (9th Cir. 1982).

86 Precision Shooting Equipment Co. v. Allen, 646 F.2d 313, 319-21 (7th Cir. 1981) (licensee would have no adequate remedy at law to recover post-suit royalties; and denying licensor those payments results in "safekeeping" them and minimizing" financial risk" for both parties); Atlas Chemical Industries, Inc. v. Moraine Products, 509 F.2d (6th Cir. 1974) (in licensee's declaratory judgment action, royalties ordered paid into escrow to "preserve the status quo.")

87 Nebraska Engineering Corp. v. Shivvers, 557 F.2d 1257 (8th Cir. 1977) (reversing grant of preliminary injunction, noting that payment into escrow is not the same as payment to the licensor); Warner-Jenkinson v. Allied Chemical Corp., 567 F.2d 184 (2d Cir. 1977); USM v. Standard Press Steel Co., 524 F.2d 1097, 1098-1100 (7th Cir. 1975) (ultimate entitlement to royalties accruing during action does not depend on possession and licensee failed to show irreparable injury); Telectronics Pty Ltd. v. Cordis Corp., ___ F. Supp. ___, 217 U.S.P.Q. 374 (D.Minn. 1982).

88 E.g., Air Products & Chemicals, Inc. v. Reichhold Chemicals,Inc., 755 F.2d 1559 (Fed. Cir. 1985).

a declaratory judgment action in federal court. First, declaratory judgments may be rendered only in "a case of actual controversy within its jurisdiction."[89] Second, the complaint must either allege diversity or that the action is one "arising under an act of Congress relating to patents...."[90]

Assume that a licensee stops paying royalties and asserts that the patent is invalid. The licensor, who does not wish to terminate the license, but enforce it, must bring his action for breach in a state court in the absence of diversity. "A suit arises under the law that creates the cause of action."[91] Thus, an action to enforce an agreement to pay royalties for use of a patent does not arise under the patent laws.[92] A licensee, as declaratory judgment plaintiff, is seeking to establish a defense to a threatened action by his licensor. It is the underlying threatened action by the declaratory judgment defendant which creates the controversy, and the nature of that threatened action determines under what law the declaratory judgment action arises.[93] When a licensee stops paying royalties and the license has not been terminated, the only cause of action available to the licensor is an action under the contract for specific performance or damages for breach. Hence, a declaratory judgment action seeking invalidity, commenced prior to termination of a license, can only constitute an action asserting a defense to a threatened action for breach. Thus, the action cannot arise under the patent laws.[94] A declaratory judgment action commenced after termination of a license may state a claim arising under the patent laws.[95]

However, some courts have found that declaratory judgment actions arise under the Patent Act, even though the license continued in force at the time the declaratory judgment action was commenced.[96] In Bard, the licensee stopped paying royalties under an exclusive license, the licensor commenced an action in state court for breach, and the licensee commenced

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89 28 U.S.C. § 2201; Aetna Life Ins. Co. v. Haworth, 300 U.S. 227, 240-41 (1937).

90 28 U.S.C. §§ 1332 and 1338(a).

91 American Well Works Co. v. Layne & Bowler Co., 241 U.S. 257, 260 (1916).

92 Luckett v. Delpark, 270 U.S. 496, 502, 510 (1926); Air Products and Chemicals, Inc. v. Reichhold Chemicals, Inc., 755 F.2d 1559 (Fed. Cir. 1985).

93 Public Serv. Comm'n v. Wycoff Co., 344 U.S. 237, 248 (1952).

94 W.R. Grace & Co. v. Union Carbide Corp., 319 F. Supp. 307, 312 (S.D.N.Y. 1970); Thiokol Chemical Corp. v. Burlington Industries, Inc., 313 F. Supp. 253, 256 (D. Del. 1970), aff'd in pertinent part 448 F.2d 1328 (3d Cir. 1971); Milprint, Inc. v. Curwood, Inc., 562 F.2d 418, 422 (7th Cir. 1977).

95 Thiokol Chemical Corp. v. Burlington Industries, Inc., 313F. Supp. 218, 220-22 (D. Del. 1970), aff'd in pertinent part, 448 F.2d 1328 (3d Cir. 1971).

96 C.R. Bard, Inc. v. Schwartz, 716 F.2d 874, 880 (Fed. Cir. 1983); Geni-Chlor Intern. v. Multisonics Dev. Corp., 580 F.2d 981, 984 (9th Cir. 1978) (a declaratory judgment action arises under the patent law where "the plaintiff's purpose was to test the validity ... and to establish that what Lear [plaintiff] is doing does not infringe the patent....").

declaratory judgment action in federal court seeking judgment of invalidity. The District Court dismissed the claim for a lack of federal jurisdiction on the basis of Thiokol. The Court of Appeals rejected the Thiokol rule to the extent that it always required termination as a precondition to declaratory judgment action for the reason that, you guessed it:[97]

> "To always require the termination of a license agreement as a precondition to sue would mean that a licensee must then bear the risk of liability of infringement. This would discourage licensees from contesting patent validity and would be contrary to the policies expressed in Lear."

The court went on to say that, under all of the circumstances, the declaratory judgment plaintiff had a reasonable apprehension of an infringement suit even though the license was still in effect, and thus there was "arising under" jurisdiction.

Other courts have gone even further and found that the policies of Lear somehow permit federal jurisdiction to encompass a declaratory judgment action seeking invalidity, even though the licensee had not breached the agreement and there was no possibility of termination.[98] In Warner, the Court of Appeals simply said that it is in the public interest that there be "no impediment" in the way of contesting validity. It said the licensee need not withhold royalties as a precondition to challenging validity, nor terminate the license. It said that if the licensee did stop payment, it could be subject to a federal or a state claim. Therefore, invalidity was a defense to a federal action. If Warner is the law, then virtually any declaratory judgment pleading seeking invalidity arises under the Patent Act.

The second jurisdictional requirement facing the licensee is that there must be an actual controversy within the court's jurisdiction. The courts have interpreted the actual controversy requirement in patent cases by requiring that a patent owner must have engaged in some conduct or made some statements which caused the declaratory judgment plaintiff to believe actually and reasonably that it would be sued for patent infringement, and that the declaratory judgment plaintiff must have made or sold the accused products or had the capability or intent to do so immediately.[99]

A licensee, which is performing all of its obligations under the license, cannot be charged with infringement. Any threat to sue such a licensee for infringement cannot give rise to a reasonable apprehension that the patent owner will actually do so, because such a suit would be frivolous. Unless the licensor has the right to terminate at any time without cause (an almost unheard of provision in a license), whether a licensee will be sued for infringement is a matter

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97 716 F.2d at 880.

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

99 E.g., C.R. Bard, Inc. v. Schwartz, 716 F.2d 874, 879 (Fed. Cir. 1983); Societe de Conditionnement v. Hunter Engineering Co., Inc., 655 F.2d 938, 940-41, 944-45 (9th Cir. 1981); International Harvester Co. v. Deere & Co., 623 F.2d 1207, 1211-15 (7th Cir. 1980); Dr. Beck & Co. GMbH v. General Electric Co., 317 F.2d 538, 539 (2d Cir. 1963).

entirely within the licensee's control. Unless the licensee has breached the agreement, it is difficult for me to conceive that there is a controversy with respect to a patent infringement claim. However, some courts have permitted a licensee to maintain a declaratory judgment action without doing anything which would jeopardize the continued status as a licensee.[100] In Bard, the Court of Appeals, after talking about the need not to discourage licensees, found that the licensee had a reasonable apprehension of an infringement suit where, (1) it had ceased payment of royalties, enabling the patent owner to terminate, (2) the patent owner filed suit to recover royalties in the state court, thereby showing "a willingness by Schwartz to enforce his patent rights," (3) the patent owner demanded "future royalty payments." The apprehension was reasonable in spite of the patent owner's affidavit that he did not have, and never had, any intention of terminating the license or suing for infringement.

X. THERE SHOULD BE NO ANTITRUST OR PATENT MISUSE RULES DERIVED FROM LEAR

Based on Lear, the courts have said that a license provision barring a licensee from contesting validity is unenforceable.[101] Most courts have held that such a provision does not constitute patent misuse.[102] One court held that an agreement not to contest during and after termination of the license constituted misuse but not a violation of the Sherman Act under the rule of reason.[103]

If no contest clauses constitute patent misuse or antitrust violations because they deter challenges to validity, then all patent license agreements constitute misuse and an antitrust violation, because all license agreements have that effect and purpose. That is not the law. But there are troublesome signs. In United States v. Studiengesellschaft Kohle,m.b.H., 670 F.2d

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100 Precision Sporting Equipment Co. v. Allen, 646 F.2d 313,317-18 (7th Cir. 1981) (without considering whether the licensee intended to breach, the Court said a controversy exists if the licensee "suffer[s] a reasonable apprehension that the patentee will bring an infringement suit against him if there is noncompliance with the license."); Warner-Jenkinson v. Allied Chemical, 567 F.2d 184 (2d Cir. 1977).

101 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., 366 F. Supp. 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).

102 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).

103 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).

1122, 1136 (D.C. Cir. 1981), an antitrust action, the court said: "A patent license might also restrict competition by undermining incentives to attack the validity of the patent or to invent around it." The court's main authority was United States v. Masonite, 316 U.S. 265, 278-81 (1942), a decision which held that agency agreements for the resale of a patent product at fixed prices, which became effective only upon all competing resellers agreeing to identical contracts, violated the Sherman Act. No patent license was involved and the Supreme Court said nothing of the kind. The Court of Appeals found that the exclusive license to sell unpatented products of a patent process may have undermined incentives to challenge. The Court said that did not condemn it because other licensees had incentives to challenge and, perhaps more importantly, all exclusive licenses do the same thing and they are not illegal. Since that Court did not say all licenses to the same thing, and all licensees are not illegal, it is still at least open of lawyers to attempt to build antitrust cases out of Lear policies.

XI. CONCLUSION

I have said little about what licensees might do in the aftermath of Lear v. Adkins. They should do exactly the opposite of what I have suggested for licensors. I offer them little advice because they do not need it and my belief that the law has been developed to favor them more than it should.