Bloomberg Law Reports® Intellectual Property

Vol. 3, No. 15 April 13, 2009

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Featured Article

The Erosion of Licensor's Rights

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A license agreement traditionally has been thought of as a promise from an intellectual property owner not to sue the licensee for engaging in conduct that would otherwise violate the owner's rights. A license agreement enables the licensor to generate revenue, while retaining ownership of the intellectual property. In negotiating a license agreement, the licensor tries to retain maximum rights in the intellectual property while granting sufficient rights to justify royalty payments by the licensee. On the other hand, the licensee seeks to pay for only a well-defined set of desired rights. For these reasons, license agreements typically contain lengthy lists of specifically permitted and prohibited uses of the licensed intellectual property that maintain the licensor's control by fencing in the licensee's rights.

However, court decisions from the past year have challenged several of these underlying assumptions about licensing agreements and may materially impact the relationship between many licensors and licensees:

- In *MedImmune v. Genentech*[3], the Supreme Court held that a licensee with a license agreement in good standing can still file a declaratory judgment action against the licensor challenging the licensed intellectual property.
- In *Quanta v. LG*[4], the Supreme Court held that a patent licensor can only sue the licensee for patent infringement at the first level of a patented production process, but cannot also sue the downstream users of the products for infringement.
- In *Vernor v. Autodesk*[5], the U.S. District Court for the Western District of Washington (Seattle) held that, in certain circumstances, a licensor can lose control of copies of licensed software when the software is subsequently sold by a licensee.
- In *Datatreasury v. Wells Fargo*[6], the Federal Circuit held that, under certain state law, a purchaser of patent rights cannot be bound by an arbitration clause in a preexisting license agreement.

- In *Nano-Proprietary v. Canon*[7], the Fifth Circuit refused to allow a licensor to terminate an "irrevocable" and "perpetual" license, even though the licensee was in material breach of a license agreement.

Licensors of intellectual property that fail to negotiate or adjust the terms of their license agreements in light of these new decisions are at increased risk of losing control over their intellectual property.

The Wayward Licensee

Before *MedImmune v. Genentech*, a licensee was unable to challenge a licensed patent with a declaratory judgment action unless the licensee (i) had a reasonable apprehension that the patentee would file suit and (ii) conducted "meaningful preparation" toward potentially infringing activity, such as breaching the license agreement. The underlying reasoning for this test was that a licensee in good standing feels no apprehension of suit, since the license is essentially a settlement between the parties. However, in *MedImmune*, the Supreme Court eliminated the first prong of the test, finding that the reasonable apprehension prong was too "rigid."

Now, under *MedImmune*, licensors must recognize that today's licensee can turn into tomorrow's plaintiff, because licensees have more incentive to be on the lookout for potential grounds for filing a declaratory judgment action if they spot a weakness in the licensor's intellectual property. Licensors should consider incorporating clauses into their license agreements addressing the impact of a declaratory action by a licensee (such as, for example, giving the licensor the ability to terminate the license immediately).

Managing Your "Exhaustion"

In *Quanta v. LG*, the Supreme Court found that a certain license agreement did not effectively limit the scope of what products the licensee could sell. Rather, the license agreement permitted the licensee to "make, use, [or] sell" all products embodying the patent in question. Under the Court's interpretation of this licensing agreement language, the licensor's patent rights were "exhausted" as soon as a component that embodied the patent was first sold by the licensee, regardless of the existence of additional contractual restrictions on the licensee or downstream users. As a result, the Supreme Court held that the "exhaustion" doctrine applied to the authorized sale by the licensee to a downstream user of components that substantially embodied the patented process, and this sale effectively "exhausted" the licensor's right to sue the user for infringement.

The practical impact of *Quanta* is that a licensor has patent enforcement power through only the first level of the production process; otherwise, the licensor is forced to rely on contract damages for relief from unauthorized sales by licensees to downstream users, rather than patent damages. Because there is usually a lack of contractual privity with downstream users, and licensees are unlikely to agree to be liable for infringing downstream uses, licensors will now have more difficulty controlling their licensed intellectual property downstream after *Quanta*.

However, the Supreme Court gave some guidelines to licensors attempting to limit the impact of patent exhaustion. The Court stated "exhaustion turns only on [the licensee]'s own license to sell products practicing the [licensor's] patents." This language suggests that a licensor can retain the right to sell under the patent, rather than granting that particular right away to the licensee, to avoid triggering patent exhaustion. Accordingly, after *Quanta*, licensors should carefully consider the implications of granting a licensee the right to sell products embodying the licensed intellectual property. Granting a right to sell forgoes the possibly of suing downstream users for infringement, regardless of any additional contractual agreements the licensor has in place with the licensee or downstream users.

When a License Is Really a Sale

Next, in *Vernor v. Autodesk*, the U.S. District Court in Seattle held, under the circumstances of the case, the sale of physical media containing software by a licensee was protected by the "first sale" doctrine, even though the software was the subject of a restrictive license agreement. The "first sale" doctrine permits those who own a lawful copy of a copyrighted work to sell or otherwise dispose of that copy by distribution. Since the licensee was given the physical media with the copies of the software under the license agreement, the District Court found "the transfer of [the software] packages from [licensor] to [the licensee] was a sale with contractual restrictions on use and transfer of the software." Since the District Court held that the transaction contemplated by the license agreement was actually a sale, the licensor was limited to a breach of contract claim against the licensee, and could not sue the licensee (or subsequent owners of the software) for infringement.

The licensor claimed (quite understandably) that since it licensed the software, there was no sale by the licensor to the licensee, and the licensee was not an owner of the copy of the software. Therefore, the licensee, as a mere licensed user of the copy, should not be entitled to freely transfer the physical copy obtained from the licensor. The District Court answered this claim by saying that there is no bright-line rule as to what constitutes a sale versus a license, but that "…the critical factor is whether the transferee kept the copy acquired from the copyright holder."

Although the seller won in *Vernor*, the District Court gave some hope to licensors attempting to limit the impact of the "first sale" doctrine through careful drafting of license agreement terms. The District Court noted in a footnote that: "[e]ven if [the licensor] could revive its 'exhausted' distribution rights by reclaiming title to software copies it sold, Autodesk did not reclaim title. It merely required [the licensee] to destroy its copies." This language indicates that licensors should give serious consideration to changing their license agreements to require return of the software upon expiration of the agreement, along with more aggressively policing third-party possession of the licensed software. Alternatively, licensors may want to consider limited-term renewable licenses involving digital right management tools designed to render software unusable without a key from the licensor.

The Stationary Arbitration Clause

In *Datatreasury v. Wells Fargo*, the Federal Circuit Court of Appeals held that purchasers of patent rights cannot be bound by an arbitration clause agreed to by the previous patent rights holder in a license agreement. The Federal Circuit applied the Fifth Circuit's interpretation of the Federal Arbitration Act and Minnesota state law to find that an arbitration clause does not operate as a servitude upon a patent because the clause is "unrelated to the actual use of the patent." In other words, the duty to arbitrate set forth in the original license agreement does not run with a conveyance of the patent rights to third parties. Rather, the arbitration provision in the licensing agreement is a personal contract binding only the original parties to the agreement.

Datatreasury highlights the potential danger to licensors when licensees are acquired, merged, or assign license rights to a third party. Since, under certain state law, the arbitration provisions in a license agreement can bind only the original parties, a third party assignee can acquire rights to a licensed patent without the accompanying duty to arbitrate. Although the Federal Circuit did not speak to provisions other than arbitration clauses in *Datatreasury*, the Federal Circuit's reasoning could be extended to other licensing provisions that are not directly related to "use of the patent," further limiting licensors' control over their patent rights.

In light of *Datatreasury*, licensors should look to protect their patent rights upfront in a license agreement by making assignment or transfer of the rights and obligations in the license agreement contingent on acceptance of the arbitration clause (and other vital terms of the license) by an assignee. A carefully worded assignment provision would allow licensors to either void improper attempted assignments by the licensee or bring a breach of contract claim against the licensee if an assignee fails to accept the required terms.

The Forever License

Lastly, in *Nano-Proprietary v. Canon*, a patent license agreement involving flat-panel TV technology was forcibly reinstated by the Fifth Circuit, which ruled that an "irrevocable" license cannot be terminated, even if the licensee had committed a material breach of the license agreement terms. In this case, the licensor granted an "irrevocable," "fully paid-up," and "perpetual" license, but the agreement contained no clause governing a party's right to terminate the agreement. The Fifth Circuit held that the term "irrevocable" is defined as "[u]nalterable; committed beyond recall," or "[i]mpossible to retract or revoke." Based upon the this definition of "irrevocable," the Fifth Circuit found that the patent license agreement could not be terminated, notwithstanding the licensee's material breach of the agreement. Otherwise, the terms "irrevocable" and "perpetual" would be rendered superfluous. The licensor was therefore entitled to sue the licensee for relief based on a contractual breach, but termination of the underlying license agreement was not permissible.

Because the licensor in *Nano-Proprietary* neglected to include termination language to accompany an "irrevocable" license, the licensor is now stuck dealing with a delinquent licensee. Instead of going through expensive litigation every time the delinquent licensee commits a new breach of the license agreement, a prospective licensor may be able to better protect its intellectual property rights by drafting its form license agreement to include language designed to allow the licensor to terminate sour deals and recoup control over the licensed intellectual property.

In conclusion, these five court decisions challenge several underlying assumptions about licensing agreements and threaten to erode a licensor's traditional rights. In view of these shifts in the case law, licensors may no longer be able to rely on their old form licensing agreements to adequately protect their intellectual property. Nevertheless, attentive licensors can preemptively limit many of the adverse impacts of these five decisions by carefully redrafting their license agreements. When drafted appropriately, new licensing terms can ensure that the licensor licenses only the desired set of limited rights to the licensee, while maintaining control of the licensed intellectual property.

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[3] *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007)

[4] *Quanta Computer, Inc., v. LG Electronics, Inc.*, 128 S.Ct. 2109 (2008)

[5] *Vernor v. Autodesk, Inc.*, 555 F. Supp.2d 1164 (W.D. Wash. 2008)

[6] *DataTreasury Corp. v. Wells Fargo & Co.*, 522 F.3d 1368 (Fed. Cir. 2008)

[7] *Nano-Proprietary v. Canon*, 537 F.3d 394 (5th Cir. 2008)