



## **Why Congress Should Carefully Evaluate the Impact of Recent U.S. Supreme Court and CAFC Decisions Before Enacting Patent Reform Legislation**

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The current patent reform legislation (H.R. 1908/S. 1145) has been a work in progress since bills were first introduced during the 108<sup>th</sup> Congress. Proponents of the various bills have argued, and continue to argue, that the present patent regime is “broken” and sweeping reform is needed to right the ship. However, since the inception of the legislative reform effort, the legal playing field has been dramatically altered by some of the most significant Supreme Court and Court of Appeals for the Federal Circuit (CAFC) decisions relating to patent law since the codification of the U.S. patent laws more than 200 years ago. With the U.S. knowledge-based economy at stake, before rushing to enact legislation that may no longer be needed and may even do more harm than good, Congress and other stakeholders should more closely scrutinize and assess the impact of these key decisions.

### ***eBay v. MercExchange***

The first significant case decided by the Supreme Court last year, during the 109<sup>th</sup> Congress, is *eBay v. MercExchange*. In this case, the Court decided that, in spite of Constitutional language that provides that inventors are entitled to a limited period of exclusivity for their inventions, a permanent injunction should not issue as a matter of course following a final finding of infringement liability. The Court held that a permanent injunction is an equitable remedy and thus, before a patent holder can obtain such remedy, it must satisfy the same four part test that applies in other areas of the law. That test requires a plaintiff to demonstrate that: (1) it has suffered an irreparable injury; (2) remedies available at law are inadequate to compensate for that injury; (3) considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) the public interest would not be disserved by a permanent injunction. In the cases since *eBay* that apply this test, a pattern has developed in which a patent holder can obtain a permanent injunction only if it is making a product and the infringer is a competitor.

Significantly, proponents of the present proposed patent legislation and the *eBay* decision have stressed that the threat of a permanent injunction was the primary tool of patent holders to extort large settlements or royalty fees. In light of *eBay*, that tool has become far more difficult to achieve for many patent holders; as a result, they can, at most, expect to obtain a damage remedy based upon a reasonable royalty. In light of this significant development, and the fact that the proposed damages amendment could lead to greatly diminished damage awards for patent infringements, particularly where inventions are based on patentable combinations of prior art, Congress should maintain the flexibility currently available to the court and jury to equally consider all relevant

market factors in the reasonable royalty determination, as per the seminal *Georgia Pacific* decision.

### ***KSR International v. Teleflex***

The second significant decision handed down by the Supreme Court after introduction of the most recent patent bill is *KSR International Co. v. Teleflex Inc.* In this case, the Supreme Court altered the objective patentability test of obviousness which had been used by the USPTO and the courts over the last two decades. The test was, and is still believed by many to be, necessary to avoid the inappropriate application of 20/20 hindsight to obviate non-obvious, otherwise patentable inventions.

Prior to this decision, in order for an invention to be considered obvious over prior art documents, the so called “teaching, suggestion, or motivation” test had to be met. In order to meet this test, one of the prior art documents had to expressly state or suggest that the technical content of the other documents could be combined to make the invention for which a patent was being sought. Characterizing this objective test of obviousness as too rigid, the Court held that a more flexible “functional approach” to resolution of an obviousness issue was more appropriate. This new approach generally requires a deeper analysis of what the qualifications of a person of ordinary skill in the art are, and then a more subjective inquiry as to whether or not such a person would consider the invention a predictable variation of the prior art solutions. Other additional and more subjective factors required to be considered are effects of demands known to the design community or present in the market factors, and whether the combination of elements constituting the invention was “obvious to try” by such a person. What is most noteworthy about this case is that it creates uncertainty as to the validity of all active U.S. patents granted under the pre-*KSR* obviousness test, thus potentially resulting in significant increases in litigation.

### ***MedImmune v. Genentech***

Another significant decision by the Supreme Court, handed down on January 9, 2007, is *MedImmune, Inc. v. Genentech, Inc.* In this case, the Court held that a plaintiff licensee's declaratory judgment action challenging validity and enforceability of a licensed patent satisfies the case-or-controversy requirement for subject matter jurisdiction under the U.S. Constitution's Article III, even though plaintiff has continued to make royalty payments under license. Under previous CAFC precedent, the licensee was required to stop royalty payments and breach the license agreement to meet the Article III case or controversy requirement. This again is a major change in the law and tips the scales considerably in favor of the licensee. Additionally, it reduces the stability normally associated with arm's length negotiated license agreements and provides incentive to licensees to litigate without risk. Uncertainty will now prevail over the life of the license agreement, and more lawsuits will be filed.

In a subsequent case, *San Disk Corporation v. STMicroelectronics Inc.*, decided on March 26, 2007, the Federal Circuit applied the *MedImmune* analysis for an Article III case or controversy to a license negotiation scenario, holding that where a patentee asserts rights under a patent based on certain identified ongoing or planned activity of another party, and where that party contends that it has the right to engage in the accused activity without a license, an Article III case or controversy will arise and the party need not risk a suit for infringement by engaging in the identified activity before seeking a declaration of its legal rights. The impact of this case is discouragement of open and complete patent license negotiations as well as increased litigation.

### ***Microsoft v. AT&T***

The most recent significant decision by the Supreme Court, decided on April 30, 2007, is *Microsoft Corp. v. AT&T Corp.* In this case, the Court held that providing a master disk with embedded operating system software, which was subsequently copied into computer systems in foreign countries, did not constitute supplying from the United States a component for an infringing product under 35 USC §271(f). Thus, Microsoft was not liable for damages based on the making and selling of infringing products in foreign countries. The greatest impact of this case will be on sole inventors, smaller companies and universities, in that they have limited financial resources for securing foreign patents. A significant foreign patent portfolio will now be required to realize full recovery of investments in innovation.

Not only do the foregoing cases have to be further analyzed to assess their individual impact, as mentioned above, but also to determine their impact in conjunction with some of the proposed provisions of the patent reform bills. Of grave concern is the interplay between these cases and the “mandatory apportionment” provision of the proposed legislation. The admitted intent behind this provision is to reduce damage awards by creating a new method to determine the economic value of the patent’s specific contribution over the prior art. This test supersedes consideration of any of the other methods which have been well established in the case law and well understood by the courts. It is seriously flawed because it eliminates any damages for a patentable combination of known elements; that is, discovering the synergistic effect of known elements will now go unrewarded, even though a patent has been granted for the combination. As mentioned earlier, this is a significant issue because in the post-*eBay* world, the only infringement remedy for some very innovative companies with business models that focus on licensing may be damages based on the reasonable royalty calculation.

The present test for calculating a reasonable royalty was espoused in the 1970 *Georgia-Pacific* decision. In that case, the Court listed 15 factors that should be considered where applicable in arriving at a reasonable royalty. The analysis provides great flexibility for the judge and jury to determine the most relevant factors to apply in the context of the technical subject matter of, and product market for, the infringing device. If the patented invention provided the basis for a product’s market demand, then a reasonable royalty should be based on the value of the product (i.e., the “entire market

value rule”). Alternatively, if the patent holder has a history of licensing the patent at a particular royalty rate, that established royalty is the most objective and relevant factor in determining the reasonable royalty. Indeed, it is well-established under *Georgia Pacific* and its progeny that apportionment, although sometimes relevant to a damages calculation, is not appropriate in cases where an established royalty exists or the entire market value rule applies.

By requiring a court to ignore the full range of relevant factors that impact a patent’s market value, a mandatory apportionment test will increase the cost and uncertainty of enforcing patent rights and in turn diminish the market value of all patents. Existing licensees who currently pay a royalty based upon the patent’s negotiated fair market value will now have an incentive to litigate in order to obtain a lower royalty based on the apportionment calculation, with no downside risk. Similarly, infringers will have an incentive to litigate rather than negotiate a license since a judge or jury may opt to ignore a patentee’s licensing history in favor of a lower royalty rate. This departure from market principles will increase litigation, not reduce it, contrary to the intent of this legislation. When combined with the *eBay* decision, mandatory apportionment will make it far more difficult for patentees to secure fair licensing terms or meaningful remedies against infringers; as a result, it will impede the growth and success of our most innovative companies.

The mandatory apportionment methodology has also become much more difficult, if not impossible, to apply in view of the *KSR* decision. The new method requires the determination of the economic value of the patent’s specific contribution over the prior art. This will require the patent holder to identify the patent’s improvement over the prior art. But prior art is now analyzed differently under *KSR* with respect to patentability and more specifically the test for obviousness. Thus, any arguments made by the patent holder can be used against it to potentially invalidate the patent in either a court or USPTO proceeding and estop the patent holder from further characterizing those arguments to avoid a finding of invalidity.

This creates a serious conundrum for the patent holder and may result in reduced damages based on a guarded approach to discussing improvements over the prior art. Discussions of prior art are more prudently left in patentability and invalidity determination proceedings, not in damage calculation exercises. *Georgia-Pacific* and its progeny recognized this by requiring that apportionment be based upon a comparison of the value of the patented portion of the infringing product with the non-patented portion of the infringing product. Based on this, and the fact that some inventions that are based on patentable combinations of prior art may be left without a damage award, Congress should maintain the flexibility currently available to the court and jury to equally consider all relevant market factors in the reasonable royalty determination, as per the seminal *Georgia Pacific* decision.

Most importantly, Congress expressly and resoundingly rejected mandatory “apportionment” in 1946 when it adopted the existing statutory standard for calculating damages. During hearings on the issue, Congress and other experts noted that

apportionment - the then prevailing standard for calculating damages - was an overly complex and wholly unworkable test, resulting in excessive litigation costs, extreme delays and unfair damages awards for all parties. To revert back to an apportionment standard that was universally condemned more than 60 years ago would represent a major step backwards for our patent system -- the very antithesis of patent "reform."

Another area of great concern is the interplay of some of the above-referenced court decisions with the proposed provisions to add a Post Grant Opposition (PGO) proceeding and amend the Inter Partes Reexamination (IPR) proceeding to relax the estoppel provisions. The PGO proceeding in and of itself overly tilts the playing field in favor of infringers by reducing the burden of proof for invalidity from clear and convincing evidence as presently applied by the courts, to preponderance of the evidence. This will essentially eviscerate the longstanding presumption of validity that patent holders have enjoyed, and that has been the cornerstone of the strong U.S. patent system that has resulted in the strongest economy in the world. The PGO proceeding also provides a "second window" for challenges that lasts for the life of the patent. It also expands the jurisdiction of the already overburdened USPTO to hear all grounds for invalidity, not just prior art based novelty and obviousness determinations. Thus, there will never be any certainty as to the value of the patent.

Further, this new PGO proceeding will be in addition to the existing Inter Partes Reexamination proceeding. Although the IPR proceeding presently is not widely used because of the perceived severe estoppel provisions, relaxation of those provisions will result in an overlapping and duplicative forum for invalidity determinations.

In view of the creation of a new PGO proceeding, a more attractive IPR proceeding and the new KSR test for patentability/validity, one has to wonder if the floodgates will be opened so far that the USPTO will quickly experience the similar unmanageable backlogs in its validity proceedings, that it is presently experiencing with its unexamined patent applications. And these proceedings will require staffing with more highly qualified personnel than those needed for initial examination of patent applications. It has been noted that the five year delays in EPO opposition proceedings are way too long to provide value and achieve the original goals, and some of the European courts now feel compelled to move on with the trials in order to provide a fair forum for patent holders. In view of this, it is doubtful that adding a new PGO proceeding will accomplish the desired goal. It would be more advisable to further amend the IPR proceeding to provide a reasonable balance between patent holders and patent challengers, and that is more feasible to implement and achieve the desired goal.

To summarize, the Supreme Court and CAFC decisions that have been rendered since Congress began the patent reform process have already altered the patent legal system in a way that directly accomplishes the intent of a substantial portion of the Patent Reform bill. In view of *eBay*, the patent holders whose activities were of greatest concern to proponents of the present form of the bill have lost the power of the permanent injunction to extort unreasonable royalties. Users of patents have been provided many additional tools to challenge the validity of patents. Under KSR, the new patentability test

of obviousness enables those users to challenge the validity of a patent, even based on the same prior art that was considered by the USPTO before granting the patent. Further, in view of *MedImmune* and *SanDisk*, patent licensees, both present and prospective, now have the unfettered right to bring a lawsuit pretty much at their own discretion, with no downside risk. Thus it appears that more uncertainty and more litigation will occur without any changes to the patent laws by Congress. Taking all of the foregoing into account dictates a measured approach by Congress. Lawmakers should ensure that legislation is not passed that will provide the proverbial straw that breaks the camel's back, and irreversibly (albeit unintentionally) damage the system that provides continued support for a knowledge-based economy and has been the foundation of the strongest economy in the world.