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Slowing the *Rates* of Innovation: How the Second Circuit Ban on No-Challenge Clauses in Pre-Litigation Settlement Agreements Hinders Business Growth

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SLOWING THE *RATES* OF INNOVATION: HOW THE SECOND CIRCUIT’S BAN ON NO- CHALLENGE CLAUSES IN PRE-LITIGATION SETTLEMENT AGREEMENTS HINDERS BUSINESS GROWTH

Abstract: On July 10, 2012, in *Rates Technology Inc. v. Speakeasy*, the U.S. Court of Appeals for the Second Circuit held that no-challenge clauses in pre-litigation settlement agreements are unenforceable. In its ruling, the court determined that sharing ideas and discovering invalid patents are policy considerations that supersede spurring innovation and settling litigation. This Comment argues that spurring innovation and settling litigation are policy considerations better aligned with modern business. As a result, this Comment asserts that no-challenge clauses should be enforceable.

INTRODUCTION

Patent law incentivizes innovation by granting inventors exclusive rights over their inventions for twenty years.¹ Once this right is secured, inventors are able to recoup research and development costs by licensing their innovations to third parties.² When patent holders license their inventions, however, they run the risk that licensees will initiate litigation to challenge the patent’s validity.³ To protect themselves from this risk, patent holders may include a no-challenge clause in a settlement agreement.⁴ No-challenge clauses protect the licensor’s patent by

¹ 35 U.S.C. § 154 (2006 & Supp. V 2011); see Christina Bohannon & Herbert Hovenkamp, *IP and Antitrust: Reformation and Harm*, 51 B.C. L. REV. 905, 918 (2010); Rochelle Cooper Dreyfuss, *Dethroning Lear: Licensee Estoppel and the Incentive to Innovate*, 72 VA. L. REV. 677, 679 (1986). Patent law derives its origin from the Constitution, which grants Congress the power “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” U.S. CONST. art. I, § 8, cl. 8.

² See Dreyfuss, *supra* note 1, at 679–80.

³ See Rochelle Cooper Dreyfuss & Lawrence S. Pope, *Dethroning Lear? Incentives to Innovate After MedImmune*, 24 BERKELEY TECH. L.J. 971, 974–75 (2009); David M. Treadway, Comment, *Has the Supreme Court Forgotten the Patentee? Recent Patent Licensing Decisions Contradict Patent Policy, Harm Licensors, and Alter Negotiation*, 33 U. DAYTON L. REV. 303, 303–04 (2008).

⁴ Christian Chadd Taylor, Note, *No-Challenge Termination Clauses: Incorporating Innovation Policy and Risk Allocation into Patent Licensing Law*, 69 IND. L.J. 215, 236 n.137 (1993) (“No-challenge clauses are license provisions which prevent licensees from challenging the validity

preventing the licensee from challenging the patent's validity.⁵ Accordingly, a no-challenge clause typically decreases the price for the license, which helps to explain why a licensee would agree to its terms.⁶

In 2012, in *Rates Technology Inc. v. Speakeasy, Inc.*, the U.S. Court of Appeals for the Second Circuit became the third circuit to hold no-challenge clauses unenforceable pursuant to public policy.⁷ These circuits have expressed concern that no-challenge clauses effectively broaden the scope of patent protection by making it more difficult to challenge invalid patents.⁸ They reason that this broadening will result in the protection of ideas that rightfully should be in the public domain.⁹ In contrast, the Federal Circuit has diverged from this approach.¹⁰ In its decisions, the Federal Circuit has placed greater importance on enforcing licensing agreements and encouraging freedom of contract between sophisticated parties negotiating at arms-length.¹¹ The inconsistency caused by this divide between courts regarding the enforceability of no-challenge clauses creates uncertainty that is problematic for modern business.¹²

of the licensed patent.”). In the patent context, parties frequently enter into licensing agreements only after an allegation of infringement by the patent owner. *See Rates Tech. Inc. v. Speakeasy, Inc.*, 685 F.3d 163, 171 (2d Cir. 2012), *cert. denied*, 81 U.S.L.W. 3199 (U.S. Jan. 14, 2013) (No. 12-402). Thus, patent owners “have a strong incentive to ‘couch licensing arrangements in the form of settlement agreements.’” *Id.* (quoting *Massillon-Cleveland-Acron Sign Co. v. Golden State Adver. Co. (MCA)*, 444 F.2d 425, 427 (9th Cir. 1971)).

⁵ Richard Weil Goldstucker, Note, *Stop the Bleeding: MedImmune Ends the Unjustified Erosion of Patent Holders' Rights in Patent Licensing Agreements*, 16 J. INTELL. PROP. L. 137, 138 (2008). Often, a licensee will challenge the licensor's patent in an effort to avoid paying continuing royalties. *See id.*

⁶ *See id.*

⁷ 685 F.3d at 172; *see, e.g.*, *Panther Pumps & Equip. Co. v. Hydrocraft, Inc.*, 468 F.2d 225, 232 (7th Cir. 1972); *MCA*, 444 F.2d at 427; *Bendix Corp. v. Balax, Inc.*, 421 F.2d 809, 821 (7th Cir. 1970).

⁸ *See Rates*, 685 F.3d at 172; *MCA*, 444 F.2d at 427.

⁹ *See Rates*, 685 F.3d at 172; *MCA*, 444 F.2d at 427.

¹⁰ *See Baseload Energy, Inc. v. Roberts*, 619 F.3d 1357, 1361 (Fed. Cir. 2010); *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362, 1370 (Fed. Cir. 2001). The Federal Courts Improvement Act of 1982 established the U.S. Court of Appeals for the Federal Circuit, which has exclusive jurisdiction over appeals from district court decisions that relate to patent issues. 28 U.S.C. § 1295(a)(1) (2006 & Supp. V 2011); *see Taylor, supra* note 4, at 244. Congress created the Federal Circuit to help make patent law more uniform and reduce regional circuits' need to handle the specialized technical issues that often arise in patent law. *See Taylor, supra* note 4, at 244.

¹¹ *See Baseload*, 619 F.3d at 1361; *Flex-Foot*, 238 F.3d at 1370.

¹² *See M. Natalie Alfaro*, Comment, *Barring Validity Challenges Through No-Challenge Clauses and Consent Judgments: MedImmune's Revival of the Lear Progeny*, 45 Hous. L. Rev. 1277, 1308 (2008); Goldstucker, *supra* note 5, at 155; Treadway, *supra* note 3, at 303. The inclusion (or noninclusion) of a no-challenge clause greatly affects the terms of the settlement or licensing agreement. *See Treadway, supra* note 3, at 324. Licensors are more willing to accept continu-

Part I of this Comment briefly summarizes the factual and procedural history of the case.¹³ Part II then explores the different interpretations and competing policy interests courts have prioritized when evaluating settlement agreements that involve licensing.¹⁴ Finally, Part III argues that the Federal Circuit's interpretation and the policy considerations it has espoused are more aligned with today's economy, and thus, the Second Circuit in *Rates* should have followed the Federal Circuit's approach.¹⁵ It further recommends that courts should start enforcing clear and unambiguous no-challenge clauses in settlement agreements.¹⁶

I. *RATES TECHNOLOGY V. SPEAKEASY* EMPHASIZES THE DISCOVERY OF INVALID PATENTS

Rates Technology Inc. ("Rates") owns two patents relating to cost-based automatic routing of telephone calls.¹⁷ Around April 2007, Rates became aware that Speakeasy, Inc. ("Speakeasy") was infringing on Rates's patents.¹⁸ Rates has a policy of entering into settlement agreements with infringing companies whereby infringing companies pay Rates a one-time fee to be released from liability.¹⁹ Pursuant to this policy, Rates notified Speakeasy of its infringement on Rates's patents and offered to release Speakeasy from liability if Speakeasy agreed to pay.²⁰ Subsequently, Speakeasy paid Rates \$475,000 and Rates and Speakeasy entered into a "Covenant Not to Sue" ("Agreement").²¹ The Agreement

ing royalty payments, as opposed to an up-front lump sum, if they know that no-challenge clauses are enforceable. See Brief for the American Bar Association as Amicus Curiae Supporting Respondents at 3, *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007) (No. 05-608) [hereinafter ABA Brief] (observing that allowing the licensee to challenge the patent while enjoying its benefits creates risk that the licensor will want to hedge against by requiring a "front-loaded, non-refundable" sum in the event that the licensee challenges the patent and the no-challenge clause is not enforceable). Thus, the enforceability of no-challenge clauses affects both the terms of the licensing agreement and the types of licensees that can afford to pay licensing costs. See Dreyfuss & Pope, *supra* note 3, at 974-75.

¹³ See *infra* notes 17-32 and accompanying text.

¹⁴ See *infra* notes 33-62 and accompanying text.

¹⁵ See *infra* notes 63-89 and accompanying text. Issues relating to declaratory judgments, royalty payments, and patent exhaustion are relevant to this discussion but beyond the scope of this Comment.

¹⁶ See *infra* notes 63-89 and accompanying text.

¹⁷ *Rates*, 685 F.3d at 165.

¹⁸ *Id.* Speakeasy was a telecommunications company that provided broadband, voice, and data services to businesses. *Id.* It was subsequently sold to Best Buy. *Id.* at 166.

¹⁹ *Id.* at 165. This fee is based on the company's annual sales. *Id.*

²⁰ *Id.*

²¹ *Id.*

included a no-challenge clause prohibiting Speakeasy from challenging or helping others to challenge the validity of Rates's patents.²² Further, the Agreement stated that if Speakeasy violated the no-challenge clause, it would be liable to Rates for liquidated damages plus legal expenses.²³

Three years later, Rates notified Covad Company, which had subsequently purchased Speakeasy, that it was infringing Rates's patent; Rates then offered to release Covad from liability in exchange for a one-time fee.²⁴ Covad responded by filing a declaratory judgment action against Rates in the U.S. District Court for the Northern District of California on July 23, 2010, contending that the patents were invalid.²⁵ In response, Rates filed suit against all defendants and the defendants moved to dismiss.²⁶ On May 9, 2011, the district court granted the defendants' motion, holding that the no-challenge clause was invalid because it was contrary to the public interest rationale articulated by the U.S. Supreme Court in the 1969 case, *Lear v. Adkins*.²⁷

Rates appealed to the U.S. Court of Appeals for the Federal Circuit, contending that the district court erred in applying the public policy rationale stated in *Lear*.²⁸ Rates argued that the district court should have relied instead on more recent Federal Circuit decisions that support the enforcement of no-challenge clauses.²⁹ The Federal Circuit transferred the case to the Second Circuit because the case involved contract interpretation, not an issue pertaining to patent law, and there-

²² *Id.*

²³ *Rates*, 685 F.3d at 165. The agreement was signed on April 30, 2007. *Id.*

²⁴ *Id.* at 166.

²⁵ *Id.*

²⁶ *Id.* In addition to Speakeasy, Inc., the other defendants were: Best Buy Co., Inc., Speakeasy Broadband Services, LLC, Megapath, Inc., Covad Communications Company, Covad Communications Group, Inc., CCGI Holding Corporation, and Platinum Equity LLC. *Id.* at 163. For purposes of this Comment, all defendants, with the exception of Speakeasy and Best Buy, are referred to as "Covad." See *infra* notes 27–89 and accompanying text. Rates alleged that Covad learned of the Agreement from Speakeasy, Best Buy, or both during due diligence. *Rates*, 685 F.3d at 163. Further, Rates asserted that Covad used this information for its declaratory judgment action against Rates. *Id.* Rates argued that Speakeasy and Best Buy breached the no-challenge clause, that Covad was liable for breach of contract by virtue of the merger, and thus, that all parties were jointly and severally liable for liquidated damages. *Id.* Three months later, Covad voluntarily dismissed its declaratory judgment action and then moved to dismiss. *Id.*

²⁷ *Rates*, 685 F.3d at 166–67; see *Lear, Inc. v. Adkins*, 395 U.S. 653, 670–71 (1969); *MCA*, 444 F.2d at 427; *infra* notes 38–52 and accompanying text (discussing the policies articulated in *Lear*).

²⁸ *Rates*, 685 F.3d at 167.

²⁹ *Id.*; see *Baseload*, 619 F.3d at 1361; *Flex-Foot*, 238 F.3d at 1370.

fore was out of the Federal Circuit's jurisdiction.³⁰ The Second Circuit affirmed the district court's ruling, holding that the no-challenge clause was unenforceable because the policy supporting the discovery of invalid patents superseded other policy considerations.³¹ In doing so, the Second Circuit distinguished *Rates* from prior Federal Circuit decisions that held that other policy goals superseded the discovery of invalid patents.³²

II. COMPETING POLICY CONSIDERATIONS GOVERNING THE ENFORCEABILITY OF NO-CHALLENGE CLAUSES

In 2012, in *Rates*, the U.S. Court of Appeals for the Second Circuit followed the policy considerations raised by the U.S. Supreme Court in the 1969 case, *Lear v. Adkins*, as well as by the U.S. Court of Appeals for the Ninth Circuit in the 1971 case, *Massillon-Cleveland-Acron Sign Co. v. Golden State Advertising Co.* ("MCA").³³ By following this line of cases, the Second Circuit rejected the policy considerations set forth by the U.S. Court of Appeals for the Federal Circuit.³⁴ Section A of this Part describes the policy considerations articulated in *Lear* and explores the ways in which different circuits have expanded *Lear*'s holding.³⁵ Section B explains how the Federal Circuit's approach differs from the approach taken by other circuits.³⁶ It also explores the policy reasons underlying the Federal Circuit's divergence.³⁷

³⁰ *Rates*, 685 F.3d at 167; see 28 U.S.C. § 1295(a)(1) (2006 & Supp. V 2011) (stating that the Federal Circuit's appellate jurisdiction arises only when relating to patents).

³¹ See *Rates*, 685 F.3d at 172.

³² Compare *id.* at 172–74 (prioritizing the policy goal of discovering invalid patents), with *Baseload*, 619 F.3d at 1361–62 (concluding that settling litigation is the highest priority goal), and *Flex-Foot*, 238 F.3d at 1370 (determining that the policy of settling disputes trumps discovering invalid patents).

³³ *Rates Tech. Inc. v. Speakeasy, Inc.*, 685 F.3d 163, 172 (2d Cir. 2012), *cert. denied*, 81 U.S.L.W. 3199 (U.S. Jan. 14, 2013) (No. 12-402); see *Lear, Inc. v. Adkins*, 395 U.S. 653, 670–71 (1969); *Massillon-Cleveland-Acron Sign Co. v. Golden State Adver. Co. (MCA)*, 444 F.2d 425, 427 (9th Cir. 1971). These are the two cases on which *Rates* relied most heavily for its analysis. See *Rates*, 685 F.3d at 171, 174.

³⁴ See *Rates*, 685 F.3d at 172–74; *Baseload Energy, Inc. v. Roberts*, 619 F.3d 1357, 1361–62 (Fed. Cir. 2010); *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362, 1370 (Fed. Cir. 2001).

³⁵ See *infra* notes 38–52 and accompanying text.

³⁶ See *infra* notes 53–62 and accompanying text.

³⁷ See *infra* notes 53–62 and accompanying text.

A. *Lear and Its Expansion by Circuit Courts*

Prior to *Lear*, licensee estoppel prevented licensees from challenging the validity of a patent.³⁸ In *Lear*, the Supreme Court invalidated licensee estoppel in patent law.³⁹ The Court reasoned that discovering invalid patents would encourage competition and the free exchange of ideas.⁴⁰ Additionally, the Court concluded that these policy goals superseded the policy goals of contract law, including settling litigation.⁴¹ Notably, the parties in *Lear* did not include a no-challenge clause in their agreement.⁴²

Despite the fact that *Lear* did not involve a no-challenge clause, many lower courts have stricken no-challenge clauses as void pursuant to the public policy concerns articulated in *Lear*.⁴³ For example, in two cases in 1971 and 1972, the U.S. Court of Appeals for the Seventh Circuit, citing *Lear*, reasoned that because judicially imposed licensee estoppel was unenforceable, no-challenge clauses in settlement agree-

³⁸ See Lorelei Ritchie, *Reconciling Contract Doctrine with Intellectual Property Law: An Interdisciplinary Solution*, 25 SANTA CLARA COMPUTER & HIGH TECH. L.J. 105, 122–23 (2008). Under the doctrine of licensee estoppel, “a licensee of intellectual property ‘effectively recognizes the validity of that property and is estopped from contesting its validity in future disputes.’” *Lear*, 395 U.S. at 167 (quoting *Idaho Potato Comm’n v. M&M Produce Farm & Sales*, 335 F.3d 130, 135 (2d Cir. 2003)).

³⁹ See *Lear*, 395 U.S. at 671. In *Lear*, the defendant, John Adkins, was hired by Lear to develop a product used in the aviation industry. *Id.* at 655. Lear paid Adkins royalties until Adkins’s patent application was denied for a second time. *Id.* at 659. When Adkins’s patent was later approved, he sued Lear for breach of contract. *Id.* at 660. The California Supreme Court held that the doctrine of estoppel barred Lear from questioning the patent’s validity. *Adkins v. Lear, Inc.*, 435 P.2d 321, 336 (1968), *rev’d*, 395 U.S. 653 (1969); see *Lear*, 395 U.S. at 661. The U.S. Supreme Court reversed the California Supreme Court. *Lear*, 395 U.S. at 661.

⁴⁰ *Lear*, 395 U.S. at 670. Encouraging competition and the free exchange of ideas are policies that help enable the progress of science and the useful arts as prescribed by the Constitution. See U.S. CONST. art. 1, § 8, cl. 8.

⁴¹ *Lear*, 395 U.S. at 670–71. The Court stated:

Surely the equities of the licensor do not weigh very heavily when they are balanced 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. . . . We think it plain that the technical requirements of contract doctrine must give way before the demands of the public interest in the typical situation involving the negotiation of a license after a patent has issued.

Id.

⁴² See Alfaro, *supra* note 12, at 1287–88 (noting that the agreement did not include a no-challenge clause); William C. Rooklidge, *Licensee Validity Challenges and the Obligation to Pay Accrued Royalties: Lear v. Adkins Revisited (Part 1)*, 68 J. PAT. & TRADEMARK OFF. SOC’Y 506, 537 (1986) (noting that the Court did not rule on no-challenge clauses).

⁴³ See, e.g., *Panther Pumps & Equip. Co. v. Hydrocraft, Inc.*, 468 F.2d 225, 231 (7th Cir. 1972); *MCA*, 444 F.2d at 427; *Bendix Corp. v. Balax, Inc.*, 421 F.2d 809, 821 (7th Cir. 1970).

ments also would be unenforceable.⁴⁴ The U.S. District Courts for the Eastern District of Virginia, the Middle District of Florida, and the District of Columbia all have come to similar conclusions based on the same reasoning.⁴⁵

The Ninth Circuit employed similar reasoning in 1971, in *MCA*, and held that a settlement agreement restricting the ability to challenge patent validity was unenforceable.⁴⁶ The court reasoned that no-challenge clauses conflict with federal patent policy, just like licensee estoppel.⁴⁷ Additionally, the Ninth Circuit determined that it did not matter that *MCA* involved a settlement agreement rather than a licensing agreement as in *Lear*.⁴⁸ The court reasoned that making this distinction would allow parties to “couch licensing agreements in the form of settlement agreements.”⁴⁹ Finally, the court stated that policies favoring sharing ideas and discovering invalid patents supersede the policy favoring settling disputes, even if those policies hinder expedient settlement.⁵⁰

In *Rates*, the Second Circuit was persuaded by the reasoning in *MCA*, and, accordingly, held that enforcing no-challenge clauses in pre-litigation settlement agreements would undermine the policy of discovering invalid patents.⁵¹ Acknowledging that the high cost of patent litigation may support no-challenge clauses, the Second Circuit nonetheless reasoned that these policy considerations were less important than the policy of discovering invalid patents.⁵²

⁴⁴ See *Panther Pumps*, 468 F.2d at 231; *Bendix*, 421 F.2d at 821.

⁴⁵ *Callaway Golf Co. v. Kappos*, 802 F. Supp. 2d 678, 687 (E.D. Va. 2011) (“[The plaintiff has not] demonstrated that the public interest in enforcement of settlement agreements outweighs the public interest in patent validity.”); *Mayo Clinic Jacksonville v. Alzheimer’s Inst.*, 683 F. Supp. 2d 1292, 1298 (M.D. Fla. 2009) (“[T]he no-challenge clause, which gravitates against patent policy in a manner reminiscent of *Lear*, receives the strict construction warranted by a provision that constrains a constitutional, statutory, or other legal right.”); *Robintech, Inc. v. Chemidus Wavin, Ltd.*, 450 F. Supp. 817, 821 (D.D.C. 1978) (“[N]o-contest clauses indubitably are unenforceable against the licensee under *Lear, Inc. v. Adkins* . . .”).

⁴⁶ See *MCA*, 444 F.2d at 427. *MCA* accused Golden State of patent infringement and the parties entered into a settlement agreement, which included a no-challenge clause and liquidated damages. *Id.* at 425. Later, *MCA* accused Golden State of infringement and breach of the settlement agreement. *Id.* at 426. One of the co-defendants raised patent invalidity as an affirmative defense, which the lower court denied, holding that the case involved breach of contract, not patent infringement. *Id.* The Ninth Circuit addressed whether the express covenant was unenforceable in light of *Lear. Id.*

⁴⁷ See *id.* at 427.

⁴⁸ See *id.*

⁴⁹ See *id.*

⁵⁰ See *id.*

⁵¹ See *Rates*, 685 F.3d at 171–72.

⁵² See *id.* at 172.

B. *The Federal Circuit's Divergence from Other Circuits*

In contrast to the priority other circuits have given to discovering invalid patents and freely exchanging ideas, the Federal Circuit has emphasized other policy concerns when evaluating settlement agreements, including those of res judicata and enforcing settlement agreements.⁵³ Two recent Federal Circuit cases support the position that no-challenge clauses in settlement agreements should be enforceable.⁵⁴

In 2001, in *Flex-Foot, Inc. v. CRP, Inc.*, the Federal Circuit held that a licensee was contractually estopped from challenging patent validity.⁵⁵ The parties had entered into a settlement agreement while a motion for summary judgment ruling was pending and after both sides had conducted discovery.⁵⁶ The court reasoned that the policy of settling disputes trumped the policy of encouraging the free exchange of ideas.⁵⁷

A decade later, in the 2010 case, *Baseload Energy, Inc. v. Roberts*, the Federal Circuit expanded its *Flex-Foot* reasoning by holding that “clear and unambiguous” language in settlement agreements, including no-challenge clauses, was enforceable even if there had been no prior litigation.⁵⁸ The court followed the reasoning of *Flex-Foot* regarding no-challenge clauses, stating that *Lear* does not bar no-challenge clauses

⁵³ See *id.*; *Foster v. Hallco Mfg. Co.*, 947 F.2d 469, 483 (Fed. Cir. 1991) (holding that the principle of res judicata supersedes federal patent policy in consent decrees); *Hemstreet v. Spiegel, Inc.*, 851 F.2d 348, 351 (Fed. Cir. 1988) (holding that the defendant could not rely on federal patent policy to avoid making payments to which it agreed pursuant to a settlement agreement); *Panther Pumps*, 468 F.2d at 231; *MCA*, 444 F.2d at 427; *Bendix*, 421 F.2d at 821.

⁵⁴ See *Baseload*, 619 F.3d at 1363; *Flex-Foot*, 238 F.3d at 1370.

⁵⁵ See 238 F.3d at 1370.

⁵⁶ See *id.* After *Flex-Foot* and *Springlite* settled a patent infringement claim, *Springlite* brought suit seeking a declaration that *Flex-Foot*'s patent was invalid. *Id.* at 1363. The parties conducted discovery, fully briefed a motion for summary judgment, and while the motion was pending, the parties entered into another settlement agreement, which included a no-challenge clause. *Id.* at 1363–64. Later, *Flex-Foot* alleged that *Springlite* infringed on *Flex-Foot*'s patent, and *Springlite* tried to raise patent invalidity as a defense. *Id.*

⁵⁷ See *id.* at 1370. The Second Circuit distinguished *Rates* from *Flex-Foot* on the ground that the parties in *Rates* did not have an opportunity to conduct discovery. See *Rates*, 685 F.3d at 172; *Flex-Foot*, 238 F.3d at 1370.

⁵⁸ *Baseload*, 619 F.3d at 1363; see *Flex-Foot*, 238 F.3d at 1370. In *Baseload*, the plaintiff, *Baseload Energy, Inc.*, entered into a settlement agreement with the patent holder that included a provision stating that *Baseload* would “forever release and discharge [the patent holder] . . . of and from any and all losses, liabilities, claims, expenses, demands and causes of action of every kind and nature.” *Baseload*, 619 F.3d at 1359. The Federal Circuit held that even if invalidity claims have not been litigated, the no-challenge clause may still be enforceable. *Id.* at 1363. Here, however, because the language of the settlement agreement was not clear and unambiguous, the Federal Circuit allowed the defendant to raise patent invalidity as a defense. *Id.*

from being enforceable because there is a strong jurisprudential policy in favor of settling litigation.⁵⁹ Moreover, the court distinguished *Lear* on the ground that *Lear* did not reach the issue of no-challenge clauses.⁶⁰ Thus, the Federal Circuit has diverged from other circuit courts by upholding settlement agreements as long as they are clear and unambiguous.⁶¹ This approach furthers the policy goals of encouraging and enforcing settlement agreements.⁶²

III. WHY THE SECOND CIRCUIT IN *RATES* SHOULD HAVE ADOPTED THE FEDERAL CIRCUIT'S APPROACH

The Federal Circuit's approach that clear and unambiguous settlement agreements should be enforced is preferable to the approach taken by the Second Circuit in *Rates*.⁶³ In *Rates*, the Second Circuit relied on the Supreme Court's reasoning in the 1969 case, *Lear v. Adkins*, to hold that no-challenge clauses are unenforceable; *Lear*, however, did not address no-challenge clauses, and thus was not binding on this issue.⁶⁴ Moreover, the Federal Circuit's approach is better aligned with the realities of today's economy.⁶⁵ In today's rapidly expanding global economy, the United States is no longer in the same position of power it was when the Supreme Court decided *Lear*.⁶⁶ In the late 1960s, the United States was an "unchallenged economic powerhouse" that did not have to compete with other developing economic blocs like it does today.⁶⁷ Because of the increase in competition, there is now a more

⁵⁹ See *Baseload*, 619 F.3d at 1361.

⁶⁰ See *id.* In *Rates*, the Second Circuit chose to disregard *Baseload*, dismissing the Federal Circuit's analysis on the matter of no-challenge clauses as dicta from another federal court of appeal. See *Rates*, 685 F.3d at 173–74.

⁶¹ See *Baseload*, 619 F.3d at 1363; *Flex-Foot*, 238 F.3d at 1370.

⁶² See *Baseload*, 619 F.3d at 1363; *Flex-Foot*, 238 F.3d at 1370.

⁶³ See *Rates Tech. Inc. v. Speakeasy, Inc.*, 685 F.3d 163, 171–72 (2d Cir. 2012), *cert. denied*, 81 U.S.L.W. 3199 (U.S. Jan. 14, 2013) (No. 12-402); *Baseload Energy, Inc. v. Roberts*, 619 F.3d 1357, 1363 (Fed. Cir. 2010); *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362, 1370 (Fed. Cir. 2001). Notably, the Federal Circuit has exclusive appellate jurisdiction over patent matters. See 28 U.S.C. § 1295(a)(1) (2006 & Supp. V 2011). This puts it in the best position to make determinations regarding the policies that should control patent issues. See *id.*

⁶⁴ See *Rates*, 685 F.3d at 171–72; Alfaro, *supra* note 12, at 1287–88 (noting that the agreement did not include a no-challenge clause); Rooklidge, *supra* note 42, at 237 (noting that the Court did not rule on no-challenge clauses).

⁶⁵ See *Baseload*, 619 F.3d at 1361; *Flex-Foot*, 238 F.3d at 1370.

⁶⁶ See Taylor, *supra* note 4, at 218–19, 228 (arguing that *Lear* and its progeny hinder innovation, causing the United States to fall behind other countries).

⁶⁷ Treadway, *supra* note 3, at 325. The United States has fallen behind many countries in global competitiveness. KLAUS SCHWAB, WORLD ECON. FORUM, THE GLOBAL COMPETITIVENESS REPORT: 2012-2013, at 21 (2012), available at <http://www3.weforum.org/docs/>

pressing need to provide inventors with incentives to invest in research and development.⁶⁸ In this increasingly competitive global landscape, the United States needs to capitalize on innovation by enforcing no-challenge clauses, which reduce the cost and time required to recoup inventors' investment costs.⁶⁹

Specifically, the Federal Circuit's approach to enforcing no-challenge clauses recognizes that for the United States to capitalize on technological advancements, patent holders need to be able to recoup research and development costs by licensing their patents to third parties.⁷⁰ When licensees are able to challenge inventors' patents, licensors assume the risk that there is a higher likelihood their patents will be invalidated.⁷¹ Consequently, patent holders are more likely to increase up-front costs, possibly requiring the full price of the license to be paid up front, to hedge against the risk of invalidation by licensees later.⁷² When licensees lack the capital to pay higher up-front fees, fewer licensing agreements are formed, which makes it harder for inventors to recoup their costs.⁷³ As a result, if patent holders cannot hedge against their patents being invalidated by licensees, both licensors and licensees are in a worse position than if they were able to negotiate a no-challenge clause.⁷⁴ On the other hand, because no-challenge clauses

WEF_GlobalCompetitivenessReport_2012-13.pdf. According to the World Economic Forum's *Global Competitiveness Report* for 2012–2013, the United States currently ranks twenty-ninth in intellectual property protection, thirty-fifth in efficiency of legal framework in settling disputes, thirty-seventh in efficiency of legal framework in challenging regulations, and fourteenth in availability of latest technologies. *Id.* at 389, 397–98, 488. Further, the United States currently ranks seventh in capacity for innovation, seventh in company spending on research and development, and twelfth in number of applications filed under the Patent Cooperation Treaty. *Id.* at 512, 514, 518.

⁶⁸ See Taylor, *supra* note 4, at 217–19 (asserting that shifts in technology and process innovation require the United States to compete more efficiently with other nations by strengthening its capacity to commercialize and protect innovations).

⁶⁹ See SCHWAB, *supra* note 67, at 389, 397–98, 488; Treadway, *supra* note 3, at 303–04 (noting that when patent holders are able to license patents effectively on favorable terms, it takes less time for inventors to recoup their invested funds, thereby quickening the process of generating funds for new innovations).

⁷⁰ See Treadway, *supra* note 3, at 303–04 (stating that the patent holder's monopoly is the primary means of recouping the money used to create the invention worthy of patent protection).

⁷¹ See Dreyfuss & Pope, *supra* note 3, at 974–75; Treadway, *supra* note 3, at 303–04.

⁷² See ABA Brief, *supra* note 14, at 3.

⁷³ See Dreyfuss & Pope, *supra* note 3, at 974–75. This is especially troublesome in emerging sectors, like bioinformatics, that require considerable research and development. *Id.* In emerging sectors, where the value of inventions is hard to calculate at the outset, royalties are a more efficient way of assessing the invention's continued worth. *Id.*

⁷⁴ See *id.*; Treadway, *supra* note 3, at 324.

allow patent holders to hedge against risk and recoup costs, inventors who know the clauses will be enforced are more likely to lower licensing fees and less likely to require up-front payments that licensees may not have the capital to pay.⁷⁵ Thus, no-challenge clauses make the licensing process less risky because licensors have more incentive to continue innovating.⁷⁶

Moreover, the Federal Circuit's approach allows for freedom of contract to protect the public's interest efficiently.⁷⁷ Although freedom of contract may limit the public's exposure to the free exchange of ideas in the short term, decreased licensing costs will provide more innovation on the whole, allowing consumers to access more inventions in the long term.⁷⁸ By allowing unrestricted negotiations, parties are able to form agreements based on business factors that are out of the court's control.⁷⁹ For example, the terms of a settlement agreement implicitly reflect the likelihood that the patent would be successfully invalidated as well as the patent's potential value.⁸⁰ Both licensors and licensees benefit from courts enforcing these agreements, as licensors will be incentivized to continue innovating and licensees will pay lower licensing fees.⁸¹ Thus, decreased licensing fees reduce downstream costs, benefit-

⁷⁵ See ABA Brief, *supra* note 12, at 3; Dreyfuss & Pope, *supra* note 3, at 974–75.

⁷⁶ See Dreyfuss & Pope, *supra* note 3, at 974–75.

⁷⁷ See Goldstucker, *supra* note 5, at 154–56. Voiding no-challenge clauses in settlement agreements also leads to an increase in an inventor's desire to turn to trade secret protection instead of patent protection as a means for protecting innovation. *Id.* at 157. Trade secret protection limits disclosure and licensing, thereby undermining patent law's goal of encouraging the free exchange of ideas. See U.S. CONST. art. 1, § 8, cl. 8; Aronson v. Quick Point Pencil Co., 440 U.S. 257, 262 (1979) (“[P]atent law . . . promotes disclosure of inventions, to stimulate further innovation and to permit the public to practice the invention once the patent expires.”).

⁷⁸ *Cf.* Treadway, *supra* note 3, at 324–25 (stating that alternatively, under the Second Circuit's reasoning, higher licensing costs would be passed on to the consumer, “diminishing the benefit the public currently receives from the patent system”).

⁷⁹ See *In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 831 F. Supp. 1354, 1397 (N.D. Ill. 1993) (“The actual market beats judicial attempts to mimic the market every time . . .”).

⁸⁰ See Dreyfuss & Pope, *supra* note 3, at 988 (asserting that if potential licensees knew that they could not challenge the patent's validity after entering into a settlement agreement and they thought the patent was weak, licensees could opt to negotiate for lower payment terms).

⁸¹ See Michael Risch, *Patent Challenges and Royalty Inflation*, 85 IND. L.J. 1003, 1004 (2010). Licensees will pay a lower price because patent holders will not have to charge a premium to cover anticipated litigation costs in defending their patents against the licensee. See *id.*

ting consumers in the form of lower prices and more technological advancements.⁸²

Conversely, the Second Circuit's decision to invalidate no-challenge clauses for public policy reasons has created real problems not only for innovative activity but also for business planning.⁸³ Because the Federal Circuit has taken a different approach than the Second, Seventh, and Ninth Circuits, it is unsettled whether no-challenge clauses are enforceable.⁸⁴ As a result, parties entering into a settlement agreement are unable to determine accurately what the specific terms should be, including, most importantly, the licensing fee.⁸⁵ Specifically, the inclusion of an enforceable no-challenge clause will decrease the cost of the license, whereas if no-challenge clauses are void, the price of the license will increase to compensate for increased risk.⁸⁶ Because circuits differ on whether no-challenge clauses are valid, businesses are less able to plan for the future, which hinders their ability to conduct business transactions effectively.⁸⁷ Courts should recognize that spurring innovation is the largest policy concern in today's global economic landscape.⁸⁸ Therefore, courts should resolve the uncertainty in favor of the Federal Circuit's approach and begin enforcing no-challenge clauses.⁸⁹

CONCLUSION

Since the Supreme Court's 1969 decision in *Lear*, federal courts have disagreed as to the enforceability of no-challenge clauses in settlement agreements. Many courts, including the Second Circuit in *Rates*, have determined that the policies articulated in *Lear*, which encourage the free exchange of ideas and discovery of invalid patents, supersede the policy of settling litigation. These courts are misguided. In *Rates*, the Second Circuit should have instead followed the Federal Circuit's reasoning, which prioritizes the policy of encouraging dispute settlement. The Federal Circuit's approach is better aligned with the

⁸² See Goldstucker, *supra* note 5, at 156.

⁸³ Richard A. Epstein, *The Disintegration of Intellectual Property? A Classical Liberal Response to a Premature Obituary*, 62 STAN. L. REV. 455, 502 (2010).

⁸⁴ See *id.*

⁸⁵ See *id.*

⁸⁶ See Goldstucker, *supra* note 5, at 138.

⁸⁷ See Epstein, *supra* note 83, at 502.

⁸⁸ See SCHWAB, *supra* note 67, at 389, 397–98, 488; Epstein, *supra* note 83, at 502.

⁸⁹ See Treadway, *supra* note 3, at 303–04. Although the Federal Circuit has not yet ruled on whether no-challenge clauses are enforceable in pre-litigation settlement agreements, the policy goals expressed in *Flex-Foot* and *Baseload* support enforcing no-challenge clauses. See *Baseload*, 619 F.3d at 1361–62; *Flex-Foot*, 238 F.3d at 1370.

realities of modern business, as it encourages sophisticated parties to negotiate settlement terms based on the strength and value of a particular patent. This policy promotes innovation and benefits the public through lower prices and increased access to technological advancements. Thus, courts should adopt the Federal Circuit's approach and hold that clear and unambiguous no-challenge clauses in pre-litigation settlement agreements are enforceable.

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