Patent Licenses Versus Covenants Not to Sue: What Are the Consequences?

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Covenants not to sue and patent licenses are closely related, and often are treated similarly by courts. In certain situations, however, the two devices can have different effects—effects that may be unintended, and more importantly, undesirable. When choosing a license or a covenant not to sue, the practitioner needs to know the consequences of the instrument being drafted.

For example, do assignees of a patent take subject to a preexisting covenant not to sue in the same way they take subject to a preexisting license? Does the doctrine of patent exhaustion apply when a patented product is sold by a party acting under a covenant not to sue? Do the same protections exist for a party acting under a covenant not to sue as they do for a licensee when the grantor enters bankruptcy? Given that courts in different jurisdictions often reach different results, even when dealing with similar facts, what are the effects of choice of law provisions? This article addresses these issues and others as it attempts to provide some insight for the practitioner who is drafting an agreement or handling issues related to an existing agreement.

Similarities and Differences

In one case, addressing the similarities between the two instruments, the Seventh Circuit directly equated a nonexclusive license with a "forbearance of suit" in holding that the nonexclusive license was personal, and therefore non-assignable.[1] Moreover, the Federal Circuit stated that "a patent license agreement is in essence nothing more than a promise by the licensor not to sue the licensee."[2] The court noted that even if a licensor purports to grant the right to make, use, or sell, the agreement cannot truly convey that right, since the patent owner itself only has the right to exclude, not the affirmative right to make, use, or sell.[3]

The general similarities notwithstanding, courts may find some differences between a license and a covenant not to sue, particularly in the case of an exclusive license. For example, the Federal Circuit noted that a license that grants to the licensee some of the proprietary rights of a patent, as in, for example, an exclusive license—"does more than provide a covenant not to sue, *i.e.*, a 'bare' license."[4] Thus, the court distinguished a covenant not to sue from an exclusive license, though it did at least imply its similarity to a nonexclusive—*i.e.*, "bare" license. The implicit similarity notwithstanding, there is an important distinction: a patent licensee can grant a covenant not to sue, but without an expressly granted right to sublicense, the licensee probably cannot grant a license, even a nonexclusive license. This is particularly true for a nonexclusive licensee, [5] but the general prohibition against sublicensing also may apply to exclusive licensees.[6] It is worth noting, however, that the failure to grant an *exclusive* licensee the right to sublicense may raise antitrust issues.[7]

Patent Applications and Future Patent Owners

Another difference between a covenant not to sue and a license is that the grantor of a covenant not to sue may be presumed to have a right of action against the grantee at the time the covenant is granted.[8] As a result, at least one court held that a covenant not to sue cannot be granted on a pending patent application, since there is not yet a right to sue.[9] If such a covenant is entered, however, a court may find that the covenant in actuality grants a license under the application and subsequent patent.[10]

In addition to the foregoing, a party to an agreement should be aware that a covenant not to sue may not bind future patent owners.[11] This is in contrast to a license, which, absent language to the contrary, will probably be binding on future patent owners.[12] The general rule notwithstanding, the First Circuit has at least implied that a covenant not to sue would bind future patent owners.[13] In *GTE Wireless*, there was a covenant not to sue granted by Cellexis to GTE and its affiliates under certain patent applications. The applications were later sold to Freedom Wireless. Subsequent to entering into the covenant not to sue, GTE underwent a number of corporate "transmutations," resulting in certain companies becoming related to GTE. After the patent applications issued into two US patents, Freedom Wireless sued under the patents a number of the companies newly related to GTE.[14] GTE entered the case by suing Freedom and Cellexis for violation of the covenant not to sue.[15]

Although the focus of the court's analysis was on whether the newly related companies met the definition of "affiliates" as contemplated by the covenant not to sue, it is instructive to note that there was never a question of whether Freedom, as a new patent owner, was bound by the covenant not to sue entered into by Cellexis. The First Circuit reversed a grant of summary judgment that the District Court had entered against GTE, holding that there were factual issues regarding the contract language that needed to be resolved by the factfinder.[16] Thus, the court implied that the covenant not to sue would be binding on Freedom, the purchaser of the patent applications. It is important to note, however, that the full language of the contract was not included in the reported case, and it is not known whether the contract included an express provision binding future patent owners to the covenant not to sue. It also is worth noting that the First Circuit, unlike the District Court in *Barton Nelson*, did not find that the covenant not to sue was really a license, even though it was granted on pending applications and not issued patents.

Based on the foregoing, a practitioner should be aware that in contracts containing covenants not to sue, such covenants may not automatically bind future patent owners. This is in contrast to a license, which probably will bind future patent owners. Therefore, good practice would dictate enumerating with specificity the disposition of rights and obligations with regard to future transfers of the intellectual property at issue—especially when the grant is a covenant not to sue, and not a license. Further, as stated above, a grant of a covenant not to sue may carry with it an implication of the right to sue at the time the covenant is entered; thus, a court may treat as a license a covenant granted on a pending patent application, the covenant language notwithstanding.

Patent Exhaustion

Another aspect of a covenant not to sue when a distinction from a license has at least been implied is in the area of "patent exhaustion," where a patent owner's rights are exhausted after the first authorized sale. As the following examples suggest, there is no universal agreement among the courts regarding such a distinction. In *Sharper Image Corp. v. Honeywell Int'l, Inc.*, Kaz, one of the defendants, previously settled a patent infringement action with Sharper Image, who released Kaz from all claims relating to certain allegedly infringing products sold by Kaz.[17] In the instant case, Kaz had counterclaimed for patent non-infringement and invalidity of the (former) patents-in-suit. Plaintiffs moved to dismiss on the grounds of a lack of subject matter jurisdiction, alleging that in light of the settlement agreement—effectively granting Kaz a covenant not to sue—Kaz had no reasonable apprehension that it would face suit. Kaz countered, noting that it had a duty to indemnify its customers, and therefore, might still need to defend an infringement suit despite the settlement agreement. The court noted that Plaintiffs had, in their reply brief, covenanted not to sue any of Kaz's customers.[18] The court found this covenant effective, and Plaintiff's motion was granted.[19]

By specifically finding the covenant not to sue any of Kaz's customers effective, the court in *Sharper Image* implied that such a suit would be possible absent the covenant—even in light of the settlement agreement with Kaz, in which Plaintiffs released Kaz from claims under the patents. Therefore, the California District Court implied that there is a difference between a license and a covenant not to sue, at least with regard to patent exhaustion. This specific issue, however, was not directly addressed, and as the discussion below indicates, other courts at least imply the opposite—*i.e.*, that with regard to patent exhaustion, there is no difference between a covenant not to sue and a license.

In *Minebea Co., Ltd. v. Papst* (*Minebea Co. I*), the plaintiffs were licensees of certain Papst patents, but with certain other patents, the "drive patents," the plaintiffs had been granted by the defendants merely a covenant not to sue under a prior settlement agreement.[20] The patent owner defendants warranted that Plaintiff's products did not directly infringe any of the drive patents, and therefore, covenanted not to sue Plaintiffs as a contributory or inducing infringer if Plaintiff's customers combined Plaintiff's products with other components to create an assembly that infringed one or more of the drive patents.[21] Although not discussed in this opinion, Plaintiffs had indemnification agreements with their customers, which could have resulted in Plaintiffs defending an infringement suit based on their customers' products that directly infringed one or more of the drive patents.[22] Therefore, in the later proceeding, Plaintiffs moved for summary judgment on the issue of patent exhaustion acting to preclude any infringement action by Defendants against Plaintiff's customers.[23]

In its analysis of the exhaustion issue, the court enumerated four requirements for establishing that sales (of electric motors) by Plaintiffs exhausted Defendant's rights under the drive patents. The court said that for a finding of patent exhaustion, Plaintiffs would need to "establish that: (a) it had authority to sell the [ ] motors; (b) there were no conditions on its sale of motors; (c) its motors are the 'essential feature' of the [drive] patents … and (d) the sale of its motors occurred 'under' the United States patents."[24] In determining whether Plaintiffs had authority to sell the motors, the court looked to a number of agreements, including previous license agreements and the covenant not to sue under the settlement agreement.[25] The court found that the covenant not to sue provided authorization for Plaintiffs to sell the motors.[26]

With regard to part (b), the court noted that the settlement agreement contained specific language that reserved Defendant's right to sue Plaintiff's customers.[27] The court determined, however, that this was not enough. It stated that Defendant's intent to retain a right to sue Plaintiff's customers was not relevant to the question of whether conditions were placed on Plaintiff's sales to its customers.[28] The court concluded that despite the clear intention of Defendants to reserve the right to sue Plaintiff's customers, the settlement agreement, including the covenant not to sue, did not place restrictions on Plaintiff's sales of the motors.[29]

The third part of the patent exhaustion analysis, *i.e.*, whether the motors were an essential feature to the hard disk drives covered under the drive patents, was required only because the motors sold by Plaintiffs did not directly infringe the drive patents.[30] The court stated that "a finding of exhaustion is proper only 'where one has sold an uncompleted article which, because it embodies essential features of [its] patented invention is within the protection of the patent.'"[31] The court found genuine issues of material fact with regard to this element of the analysis, and therefore, could not determine whether the motors were essential features of the drives.[32] Similarly, the last part of the analysis required Plaintiffs to show that the motor sales were "under" the US drive patents. Because Plaintiff's could not definitively show that any of its motor sales were in the United States—and therefore "under" a US patent as used in a patent exhaustion analysis—and because there were fact intensive issues to resolve, the court could not determine if this requirement was met.[33] Ultimately, the court denied both parties' motions for summary judgment.[34]

Another case in which the court used a "typical" patent exhaustion analysis applied to a covenant not to sue is *Kabushiki Kaisha Hattori Seiko v. Refac Tech. Dev. Corp.*[35] In *Refac*, Defendants granted to Plaintiffs a license and a covenant not to sue under certain patents. The covenant not to sue stated that none of Defendant's patents would "be the subject of a suit charging infringement by any timepiece, timer, metronome, [etc.] manufactured, used or sold by Hattori and/or a related company thereof…."[36] Plaintiffs (Hattori) sold certain timepiece modules abroad, which were later incorporated into watches and resold in the United States by Plaintiff's customers.[37] Defendants brought an infringement action against Plaintiff's customers, and Plaintiffs sued for breach of contract.[38]

At the outset, it is worth noting that in its patent exhaustion analysis, the court found no difference in a sale abroad and a sale in the United States.[39] This has been directly contradicted by two subsequent Federal Circuit decisions that require a sale to be in the United States in order for it to be "under" a US patent for purposes of a patent exhaustion analysis.[40] The court's opinion is still instructive, however, in that it treats a covenant not to sue no differently from a license for purposes of a patent exhaustion analysis. The court specifically stated that the covenant, on its face, "clearly provides that Refac may not bring suit against Hattori *or its customers* for infringement of the patents at issue."[41] The court went on to hold, very particularly, that Defendants were liable for breach of contract, based on the covenant not to sue.[42]

In the case in which a grantor grants a covenant not to sue another party under patents it has a right to sue on, and the grant of the covenant does not impose conditions on the right to sell products under the patents, the patent exhaustion doctrine likely will preclude the grantor from bringing an infringement action against the other party's customers who purchased under an authorized sale. It is worth noting, however, that this same result would occur if the grantor granted a license, rather than a covenant not to sue.

Bankruptcy

One other aspect of a covenant not to sue is addressed briefly: Specifically, what the disposition is of a covenant not to sue if the grantor enters bankruptcy. There appears to be a paucity of relevant case law and commentary specifically addressing this issue. With regard to an intellectual property license, US bankruptcy code provides specific protections for licensees.[43] Generally, a bankruptcy trustee may, subject to the court's approval, reject any executory contract of the debtor.[44] Many, if not most, licenses are executory contracts, which, by definition, only require some unperformed obligation of both parties.[45] To protect licensees, the bankruptcy code provides that if a trustee rejects a license, the licensee can treat the license as terminated, or retain its rights (except as to specific performance of the debtor/licensor).[46]

No cases were found specifically addressing the issue of whether a covenant not to sue falls within the ambit of Section 365(n). The lack of on-point law notwithstanding, a reasonable argument could be made that covenants not to sue are treated as licenses in many respects (see discussion above) and that they should be treated as licenses for purposes of applying Section 365(n). Of course, arguments could be made that a covenant not to sue and licenses do have some differences, and that these differences should include their treatment under the bankruptcy code. Therefore, if bankruptcy is a concern, a license may afford a licensee greater protection than a covenant not to sue provides to a covenantee.

Conclusion

Although a covenant not to sue may appear to be the same as a license, and a practitioner may be tempted to substitute one for the other, they are not the same and they should be used only with an understanding of what each carries with it. The first problem to understanding the implications of using a covenant not to sue as opposed to a license is that different courts tend to treat such covenants differently. Whereas one court may find the covenant to be, in fact, a license, another court may not; similarly, on one set of facts, a court may distinguish the covenant from the license and on another set of facts, it may not. In sum, the contract drafter needs to choose the instrument carefully, and when handling an existing agreement that grants a covenant not to sue, not assume that all of the rights attendant to a license are present. In many situations, if not most, there will be little practical difference between the two instruments; however, practitioners who rely on this without further inquiry do so at their own peril.

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[1] Unarco Indus., Inc. v. Kelley Co., 465 F.2d 1303, 1307 (7th Cir. 1972).

[2] Spindelfabrik Suessen-Schurr, Stahlecker & Grill GmbH v. Schubert & Salzer Maschinenfabrik Aktiengesellschaft, 829 F.2d 1075, 1081 (Fed.Cir.1987).

[3] Spindelfabrik at 1081.

[4] Ortho Pharm. Corp. v. Genetics Inst., Inc., 52 F.3d 1026 (Fed. Cir. 1995) (distinguishing the transfer of proprietary rights in an exclusive license from a covenant not to sue, in the context of an analysis determining whether licensee had standing to sue).

[5] E.I. du Pont de Nemours & Co. v. Shell Oil Co., 498 A.2d 1108, 1113–1114 (Del. 1985); In re CFLC, Inc., 89 F.3d 673, 679 (9th Cir. 1996) (*citing* Shell Oil, 498 A.2d at 1114); and Milgrim on Licensing, Vol. 2, § 15.13

[6] *See, e.g.*, Aaron Fellmeth, "Control Without Interest: State Law of Assignment, Federal Preemption, and the Intellectual Property License," 6 *Va. J. L. & Tech.* 8, 41, (2001) (noting that "[i]n patent cases, courts have consistently held that, absent contractual permission, an exclusive license of a patent has no right to assign or sublicense his rights… .").

[7] Milgrim, *supra* n.5 at 15–65, 66.

[8] 3M Innovative Properties Co. v. Barton Nelson, Inc., 2003 WL 22989077 at *2 (D.Minn.).

[9] *Id*. (holding as a matter of law that an agreement made during the pendency of a patent application cannot be a covenant not to sue).

[10] *Id*. (holding that "[a] grant of immunity from suit for future infringements of a patent is equivalent to a license").

[11] Brian G. Brunsvold & Dennis P. O'Reilley, Drafting Patent License Agreements 18 (5th ed., BNA Books 2004) (noting that it is always good practice to require the grantor to impose the promise not to sue on any future patent owners).

[12] *See, e.g.*, Am. Dirigold Corp. v. Dirigold Metals Corp., 125 F.2d 446, 452 (6th Cir. 1942).

[13] GTE Wireless, Inc. v. Cellexis Int'l, Inc., 341 F.3d 1 (1st Cir. 2003); *see also*, Pratt v. Wilcox Mfg. Co., 64 F. 589 (N.D. Ill. 1893) (finding that a corporate successor was bound by its predecessor's agreement not to sue another party).

[14] GTE Wireless, Inc. at 2–4.

[15] *Id*. at 4.

[16] *Id*. at 7.

[17] Sharper Image Corp. v. Honeywell Int'l, Inc., 2005 WL 2176903 (N.D. Cal.).

[18] *Id*. at *2.

[19] *Id*. at *2–3.

[20] Minebea Co., Ltd. v. Papst (Minebea Co. 1), 374 F.Supp.2d 202, 206–207 (D.D.C.2005).

[21] *Id*. at 206.

[22] Minebea Co., Ltd. v. Papst, 229 F.Supp.2d 1 (D.D.C. 2002).

[23] *Minebea*, 374 F.Supp.2d at 204.

[24] *Id*. at 205.

[25] *Id*. at 205–209.

[26] *Id*. at 209.

[27] *Id*. at 210.

[28] *Id*.

[29] *Id*. at 212.

[30] *Id*. at 213.

[31] *Id*. (*quoting* United States v. Univis Lens Co., 316 U.S. 241, 250–251 (1942)).

[32] *Id*. at 215.

[33] *Id*. at 218.

[34] *Id*. at 219.

[35] Kabushiki Kaisha Hattori Seiko v. Refac Tech. Dev. Corp., 690 F.Supp. 1339, 1341 (S.D.N.Y. 1988).

[36] *Id*.

[37] *Id*.

[38] *Id*. at 1342.

[39] *Id*.

[40] *See, e.g.*, Jazz Photo Corp. v. ITC, 264 F.3d 1094, 1105 (Fed. Cir. 2001); Fuji Photo Film Co., Ltd. v. Jazz Photo Corp., 394 F.3d 1368, 1376 (Fed. Cir. 2005).

[41] *Refac*, 690 F.Supp. at 1345 (emphasis added).

[42] *Id*. at 1346.

[43] 11 U.S.C. § 365(n).

[44] 11 U.S.C. § 365(a).

[45] Black's Law Dictionary 570 (6th ed. 1990).

[46] 11 U.S.C. § 365(n)(1).