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A glowing lightbulb is the central focus, set against a dark blue chalkboard background. The lightbulb is surrounded by numerous hand-drawn icons in white chalk, including a pie chart, a bar chart, a line graph, a computer monitor, a calculator, a mouse, a ruler, a triangle, a hand pointing, a gear, a lightbulb, a dollar sign, a group of people, a notepad, a pen, and various arrows. The entire scene is framed by a white, jagged, torn-paper-like border at the bottom.

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# Dear Employee: When You Leave, Please Don't Take My Company with You

By Gina T. Constant and Jeffrey L. Lowry

Please assume the following hypothetical facts: Zachary has been employed by Baca's Landscaping Company, a local mom-and-pop residential yard maintenance business, for 23 years. About 10 years ago, Mr. Baca semi-retired and has since allowed Zachary to manage the day-to-day operations of the business. Unfortunately, Zach and Mr. Baca have not gotten along for the past few years. Zach feels that he is underpaid and under-appreciated. After all, he works long hours, manages all of the company's 35 field employees, and all of the customers of Baca Landscaping know Zach, not Mr. Baca. Mr. Baca feels that Zachary has become disrespectful and insubordinate and often flagrantly ignores Mr. Baca's instructions.

Zach heard that a regional landscaping company, Southwest Yard & Garden, was opening an Albuquerque office. A friend in Phoenix who works for Southwest Yard & Garden put Zach in touch with the company's owner, who offered Zach the job of operations manager for the Albuquerque office.

One Friday morning, Mr. and Mrs. Baca arrive at the office and find a letter from Zach saying that he has resigned effective immediately. Mr. Baca instantly begins calling his customers, but each one tells Mr. Baca that they are following Zach and taking their business to Southwest Yard & Garden. One month later, Baca's Landscaping Company has lost 80 percent of its business and is forced to close its doors. Mr. and Mrs. Baca are devastated because the sale of their family business was supposed to fund their retirement.

Mr. and Mrs. Baca feel that Zachary and Southwest Yard & Garden stole their retirement from them. Zach and Baca Landscaping had no employment contract and no non-compete agreement. Do the Bacas have a cause of action against Zachary and Southwest Yard & Garden?

Depending on the conduct of Zachary and Southwest both before and after Zach left Baca's, the Bacas may have at least two causes of action. One is statutory trade secret misappropriation and the other is breach of the employee common law duty of loyalty.

## The New Mexico Uniform Trade Secrets Act

An owner of a trade secret is entitled to recover damages for misappropriation by another person of the trade secret. NMSA 1978, § 57-3A-1 to -7 (1989). A "trade secret" is information

that (1) derives economic value by virtue of not being known by competitors, and (2) is subject to reasonable efforts to maintain its secrecy. "Misappropriation" is the acquisition by improper means and disclosure or use without consent. "Improper means" includes theft and a breach, or inducement to breach, a duty to maintain secrecy. Damages for misappropriation of a trade secret can include both the actual loss caused by misappropriation and

the unjust enrichment of the misappropriator. If willful and malicious misappropriation exists, the court may award double damages and reasonable attorneys' fees.

Do trade secrets need to be written or on some kind of physical media, or can an employee have trade secret knowledge in his or her head?

In our hypothetical situation, Baca's Landscaping probably had trade secrets, such as:

- Customer lists, customer preferences and purchasing history. Whether customer lists are a trade secret is always a fact issue. Taking a handful of business cards would be different from downloading a database of thousands of customers along with detailed profiles for each one.
- Pricing for goods and services. If this information is publicly available on the web or contained in customer contracts, then it might not be considered trade secret. In addition, general "ballpark" prices for goods or services that are well-known in the industry are not trade secrets. But specific pricing, especially for individual customers, might well be a trade secret if there is an expectation within the company and within the customer contracts that pricing is to be kept confidential.
- Procedures, techniques and formulas. For example, if Mr. and Mrs. Baca had an old family recipe for feeding rose bushes in the mountain desert climate, the recipe was kept locked in a

## Health Care Non-Compete Pacts Nixed

New legislation enacted in 2015 makes non-compete agreements for certain health care professionals unenforceable in New Mexico. The law applies to physicians, dentists, osteopathic physicians, podiatrists, and certified registered nurse anesthetists who execute agreements on or after July 1, 2015, and who are not owners, shareholders, partners or directors of a health care practice. However, if the agreement includes provisions whereby the health care professional has to reimburse his or her employer for expenses such as signing bonuses, relocation expenses and training, those provisions are enforceable if the employment period is less than three years. In addition, agreements with health care professionals not to solicit patients and employees are enforceable for up to a year after the end of employment, and agreements not to disclose confidential or trade secret information also remains enforceable under the new law.

safe, and only employees with a need to know had access to the recipe, then the recipe would be a trade secret.

It is probably easy to see that if Zachary took the above information and gave it to Southwest Yard & Garden, he may be liable for trade secret misappropriation. However, it is

### Make Solicitation a No-No

In addition to non-compete agreements, non-solicitation agreements are also important as they prevent departing employees from soliciting other of your employees and from soliciting your customers. If this solicitation happens during employment, it would constitute a breach of the duty of loyalty. Non-solicitation agreements govern this conduct post-employment.

important to note that Southwest is probably on the hook as well because the definition of “misappropriation” includes not only disclosure of a trade secret but also its “use without consent.” This is important because a new employer generally has deeper pockets than the rogue employee and so the likelihood of collecting on a judgment is greater against the new employer.

Do trade secrets need to be written or on some kind of physical media, or can an employee have trade secret knowledge in his or her head? The general rule is that a former employee may use the general knowledge, skills, and experience acquired during prior employment without violating the Trade Secrets Act.<sup>1</sup> But the employee may not take and use proprietary information such as information that is not publicly available or readily ascertainable by independent investigation. A person’s knowledge itself can be a trade secret if it fits the statutory definition. As a practical matter, it can be difficult to prove that an employee has taken and used trade secrets without some physical evidence of the trade secret misappropriation. Most trade secret lawsuits involve employees who take files or records, download proprietary information or send secret information by email or other means to their personal accounts or their new employers.

### Common Law Employee Duty of Loyalty

The second cause of action that the Bacas may have is the breach of the employee’s duty of loyalty. In New Mexico, every employee owes a duty of loyalty to his or her current employer, and this is true regardless of whether the employee is at will or under contract.<sup>2</sup>

What does “loyalty” mean?

There are nuances and gray areas, but two categories of action are clearly prohibited: sabotage and competition.<sup>3</sup> The interpretation of “competition” will usually depend on the employee’s position and the employer’s business. Upper level managers and key employees are more likely to be “competing” than receptionists and burger-flippers. This duty of loyalty only applies during employment and does not apply after the employment relationship is terminated. Rather than the duty

of loyalty, future (post-employment) competition is governed by non-compete agreements.

In our hypothetical case, Zachary breached his duty of loyalty to Baca’s Landscaping if he did any of the following *before his resignation*:

- Met with Baca’s customers to solicit their business for Southwest Yard & Garden.
- Emailed Baca’s customer lists to Southwest Yard & Garden (even if he did it at night and from his personal computer).
- Texted the ingredients for Baca’s secret rose food recipe to a Southwest Yard & Garden employee so that they could pre-order the ingredients.
- Got paid by both employers for the same timeframe.
- Deleted key documents and communications from Baca’s computers.

New Mexico also recognizes tort liability for aiding and abetting a breach of a fiduciary duty.<sup>4</sup> Thus it would be possible to bring this cause of action against the new employer, Southwest Yard & Garden (although it is not clear whether the employee duty of loyalty is a “fiduciary” duty).

The damages for both of these torts include compensatory as well as punitive damages. The former employer will generally have to elect which damages it will seek. While the Uniform Trade Secret Act allows double damages and reasonable attorneys’ fees, common law tort punitive damages can be as high as nine times the compensatory damages.<sup>5</sup>

### What Employers Can Do To Protect Themselves

Employers are encouraged to remind their employees that they owe a duty of loyalty and that business records belong to the business, not the employee. They should also monitor what their employees are doing, especially if misconduct is suspected. Also, they should check in regularly with customers who may be more loyal to a key employee than to the business.

It is also very important that key employees have written non-compete agreements. To be enforceable, a non-compete agreement must be “reasonable” as to the activities restricted, the geographic scope and the length of time.<sup>6</sup> Of course, what is reasonable depends on the circumstances.

In our hypothetical case, a non-compete clause that prohibited Zachary from working for a competitor of Baca’s Landscaping within the greater Albuquerque area for one year would likely be enforceable.

Additionally, there must be legally sufficient consideration for a non-compete agreement to be enforceable. *Piano v. Premier Distributing* held that continued at-will employment is not sufficient consideration.<sup>7</sup> Therefore, if you ask an existing employee to sign a non-compete with no consideration other than continued at-will employment, the non-compete will not be enforceable. The better practice is to give the at-will employee a bonus or more vacation time in exchange for signing a non-compete agreement. Although New Mexico

Baca’s Landscaping Company has lost 80 percent of its business and is forced to close its doors. Mr. and Mrs. Baca are devastated because the sale of their family business was supposed to fund their retirement.

courts have not expressly ruled on the point, the language in *Piano* implies that a non-compete in exchange for initial employment is probably enforceable.

### What does "loyalty" mean?

Employers can protect their trade secrets in two ways. First, by identifying them by asking, "What does the business have that competitors would love to know?" This could be customer-specific information, business methods, formulas, recipes, manufacturing specifications and the like. Second, they should take reasonable efforts to maintain the secrecy of the information. This could include having a written policy regarding trade secrets, marking documents as "confidential," "proprietary," or "trade secret," keeping them in a secure location and making the trade secrets accessible to only those with a need to know.

Employment agreements can also contain intellectual property assignment provisions, in which the employee would be informed that he or she will have access to the company's trade secrets, whether so marked or not, and the employee agrees to never disclose the trade secrets to anyone. It should be very clear that anything the employee creates at work belongs to the business. For instance, if the employee creates a copyrightable work, then the employee agrees that the work is a "Work for Hire" and is owned by the employer upon creation. Similarly, the employee would assign all right, title and interest to any patentable inventions to the employer.

When hiring new employees away from a competitor, make sure that they do not give you valuable information that they could only know if they worked for the competitor. And take care that they are not working for you at the same time they are working for the competitor. It is best to educate new employees at the time that offers are extended about their duty of loyalty to their current

employer and that they are not to bring their current employer's trade secrets to the new job.

So keep in mind that what might initially look like normal competition between businesses may actually be illegal in New Mexico and result in unanticipated litigation and liability. ■

#### Endnotes

<sup>1</sup> *Numed, Inc. v. McNutt*, 724 S.W.2d 432 (Tex. App. 1987)

<sup>2</sup> *Cent. Sec. & Alarm Co. v. Mehler*, 1996-NMCA-060, 121 N.M. 840, 918 P.2d 1340

<sup>3</sup> Restatement (Second) of Agency § 393

<sup>4</sup> *Rael v. Page*, 2009-NMCA-123, ¶ 28, 147 N.M. 306, 222 P.3d 678.

<sup>5</sup> *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 425 (2003) ("Single-digit multipliers are more likely to comport with due process.")

<sup>6</sup> *Insure N.M., LLC v. McGonigle*, 2000-NMCA-018, 128 N.M. 611, 995 P.2d 1053

<sup>7</sup> 2005-NMCA-018, 137 N.M. 57, 107 P.3d 11 (examining adequate consideration in the context of employment arbitration agreements)

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# Getting the *Royalty Payments* You Deserve

By Jeffrey H. Albright

In the Feb. 12, 2014, issue of the *Bar Bulletin* that contained the *New Mexico Lawyer* insert, the article “How Much is My IP Worth?” provided several methodologies for determining the value for licensing royal rate agreements of intellectual property. Several “best practices” were also provided to ensure that licensing agreements took into account changing market conditions that would protect both the licensor and licensee. This article provides further details about the techniques and strategies the licensor can use to ensure the value of the IP is realized, along with best practices to ensure that full value is obtained from a licensing/royalty agreement. Specific examples of best practices are described to help maximize profits while minimizing the likelihood that licenses and royalty rates will be undervalued or will result in potential litigation.

Intangible assets, such as customer lists, distribution networks, licenses, trained work force and regulatory or compliance know-how add to the value of the

companies. Intellectual property and intangible assets are major assets of both large and small companies, including limited liability companies and sole proprietorships. Tangible assets such as cash, accounts receivable, inventories,

Unless the language is precise and unambiguous, the intent and spirit of the license agreement can lead to errors—and potential litigation.

equipment and buildings once comprised the majority of the assets of companies; however, recent data shows that from 1975 to 2005, Standard & Poors 500 companies collectively have seen the value of their patents, trademarks, copyrights and trade secrets rise from 17 percent to nearly 80 percent of their total valuation.<sup>1</sup>

Many companies have found that they can make more money by selling and/or licensing their intellectual property, even

to a competitor, than by integrating it solely into their own products. Licensing agreements generally have been at relatively low percentages. A broad survey of licensing agreements indicates that the most frequently negotiated royalty term is 5 percent of sales. The percentage generally is consistent across a wide range of industries: agriculture, automotive, chemical, communications, computer hardware, construction, defense industry, energy, electronics, entertainment, food, franchises, fuel, glass, household projects, mechanical, medical, photography, sports, toys, and even waste treatment, to name a few.<sup>2</sup> Pharmaceuticals and computer software frequently command higher royalty rates, often in the 10-20 percent range.

An increasing trend has the inventing company or the inventor retaining more rights. Licensing agreements usually include the following provisions for the inventor or the inventing technology company as licensor:

- License fee
- Equity investment
- Milestone payments
- Royalty income on sales
- Shared manufacturing rights
- Shared promotion rights
- Shared profits from commercialization

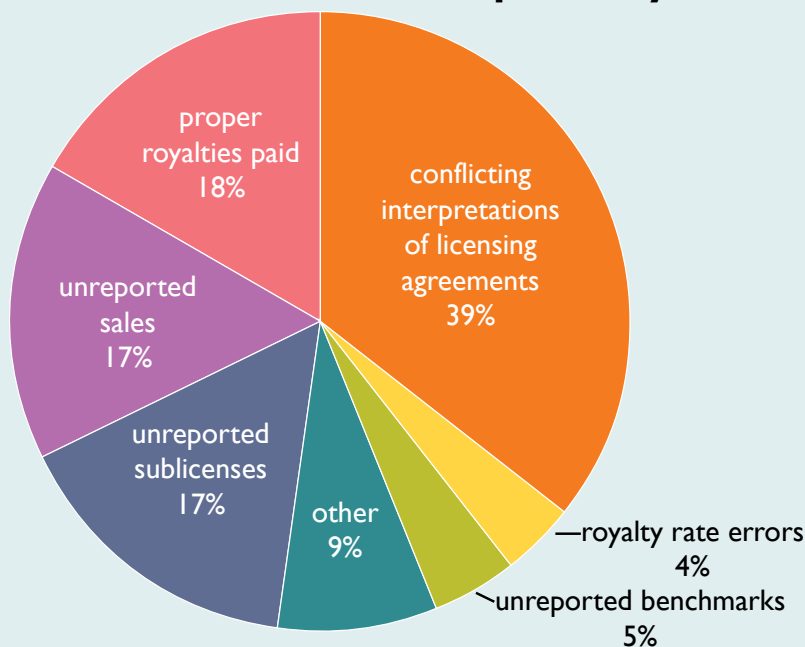
Licensees typically get the following:

- Exclusive development rights
- Exclusive manufacturing and promotion rights in certain territories
- Shared manufacturing rights, shared promotion rights and shared profits from commercialization in non-exclusive territories

Increasingly, commercial responsibilities are shared broadly.

Assuming that the intellectual property rights are valid and enforceable, there are four dynamics that determine the value of intellectual property and royalty rates: (1) the amount of profits; (2) the duration of the profits; (3) the capital investment; and (4) the risk of expected profits.

## Common Causes of Underpaid Royalties





The amount of profits is determined by the economic value of the intellectual property *after* accounting for the amount of investment in the capital investments/complementary assets (marketing, manufacturing and the like) that are spent on bringing the intellectual property (or the widget) to market.

Duration of the profits generally is determined by the life of the patent—or the replacement of the patented technology with new technology. The recent demise of CDs and DVDs in favor of online downloads and Netflix® is an example.

Capital investment requirements are straight forward. Generally, technology that requires less fixed capital costs is more valuable than technology that requires large capital investment. A larger royalty rate is appropriate where the capital investment is small compared to the profits that can be obtained from the technology. Conversely, if a capital investment of \$10 million is required to produce a widget that sells for \$0.05 to be competitive within the market, and the market demand is likely to be only three million widgets, bringing the technology to market under a licensing agreement makes no economic sense.

Risk of expected profits includes all business, economic, political and regulatory factors. Risk of expected profits was more fully discussed in the aforementioned article. Risk can include changes in market conditions, regulatory changes that place more stringent (or less stringent) regulatory requirements on the goods or services or the risk of challenges to the intellectual property itself. Examining publicly available information on royalty rates in comparable classes of goods and services can provide useful guidelines for determining a royalty rate. However, celebrity endorsements, sponsorship by a company that already has an established position within a market or “designer” endorsements can enhance the value of a licensing agreement and the royalty percentage.<sup>3</sup>

Publicly available licenses provide useful templates for developing royalty licenses



in many industries. Nonetheless, a study by CPAs Debora R. Stewart and Judy A. Byrd of Invotex Group identified that 80

percent of the licensees of Intellectual Property underreport and underpay royalties to their licensors (some having multiple errors).<sup>4</sup> Surprisingly, most of the underpayments are not the result of licensees intentionally trying to minimize payments. There are a number of reasons for the underpayment of royalties.

First, nearly 40 percent of the error rate occurs because of the variance between the way auditors interpret the license agreement and the way the licensor and the licensee interpret the agreement. This should not come as a great surprise, since seldom are the licensor or licensee staff the ones who negotiated the terms of the agreement. Unless the language is precise and unambiguous, the intent and spirit of the license agreement can lead to errors—and potential litigation. And remember, royalty audits are not financial statement audits.

Second, unreported sublicenses and unreported sales account for approximately 17 percent *each* of the overall error rate. In a number of instances, the unreported sublicenses were for sales in areas that were not covered by the license agreement. In other instances, the details of the sublicenses are not included in the main license agreement, leaving the sales under the sublicenses open to interpretation. As for sales, in some instances the licensee

was reporting the wrong product, one that was not even included in the licensing agreement. In other instances, second generation products that should have been included in the agreement were omitted.

This is a frequent occurrence for “new” product lines that are products of the original technology.

Royalty rate errors account for 4 percent of the error rate. Errors frequently occur in instances where the license agreement has large numbers of products of varying royalty rates. Furthermore, some agreements are written to include complex rate calculations based on a prime rate or some kind of consumer price index. This consumer price index could refer to the traditional Consumer Price Index for All Urban Consumers (CPI-U), the newer Chained Consumer Price Index for all Urban Consumers (C-CPI-U), or Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), which is based on the expenditures of households. Similarly, foreign sales can complicate the exchange rates that are linked to multiple currencies.

Unreported benchmarks and milestones account for another 5 percent of the error rate. Benchmarks and milestones, such as minimum sales within a certain timeframe, generally are tracked outside of the normal accounting procedures. Occasionally, benchmarks are based on research and development, product trials or sales volumes and geographies.

To solve some of these problems, several simple best practices can be incorporated into the license agreement itself or post-license agreement practices:

1. Simplify the application of royalty rates in the license agreement. If a large number of products exist, or are expected to be developed, group them by type or price range.
2. Be precise if using a standard price index.
3. Include a provision for obtaining all sublicense agreements so those terms and conditions are clear and royalties are paid under the sublicenses.

*continued on page 14*

# Go Ask 'Alice'

## New Criteria for Patent Eligibility

By Kevin Soules

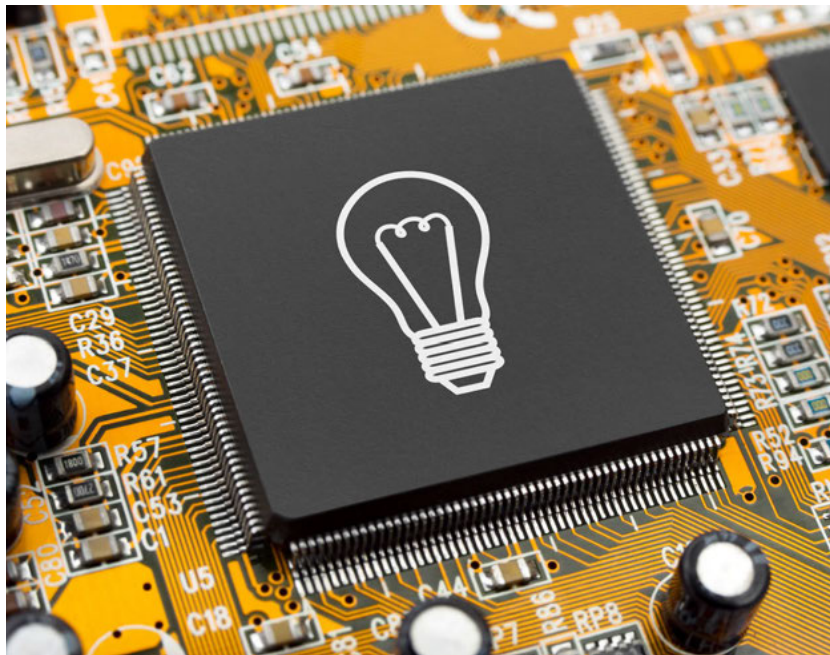
Thanks to a steady stream of technological innovation and relevant case law, patent attorneys work in an ever-evolving landscape where the concept of “patent-eligible subject matter”<sup>1</sup> never stands still. In 2014 for instance, the U.S. Supreme Court’s opinion in *Alice Corp. Pty. Ltd. v. CLS Bank Int’l*<sup>2</sup> catalyzed a seismic shift in patent eligibility.

In the wake of *Alice Corp.*, the U.S. Patent and Trademark Office (USPTO) issued interim guidelines outlining the Office’s new interpretation of patent eligibility.<sup>3</sup> Those guidelines impose a higher standard for patent eligibility in an area that previously had faced far fewer obstacles to patentability.

### The *Alice Corp.* Decision

When the Supreme Court considered the matter of *Alice Corp. Pty. Ltd. v. CLS Bank Int’l.*, the Justices were presented with the question of whether petitioner Alice Corporation’s computer-implemented schemes for financial transactions were patent-eligible. Alice Corporation asserted patent claims “designed to facilitate the exchange of financial obligations between two parties by using a computer system as a third-party intermediary”; respondent CLS Bank International contended that “the patent claims at issue are invalid, unenforceable, or not infringing.”

In layman’s terms, the issue in *Alice Corp.* was whether the basic method implemented by a “generic computer” is patent-eligible, or if the invention is just an amalgamation of patent-ineligible abstract ideas.<sup>4</sup>



Ultimately, the majority opinion, authored by Associate Justice Clarence Thomas, held

**The issue in *Alice Corp.* was whether the basic method implemented by a “generic computer” is patent-eligible, or if the invention is just an amalgamation of patent-ineligible abstract ideas.**

that Alice Corporation’s claims for patent protection were defective because “the introduction of a computer into the claims does not alter the analysis” and “the mere recitation of a generic computer cannot transform a patent-ineligible abstract idea into a patent-eligible invention.”<sup>5</sup>

Prior to *Alice Corp.*, patent attorneys frequently used “computer implementation” as a bridge for bringing abstract ideas into the realm of patent

eligibility. Thus, the *Alice Corp.* holding—and in particular its “generic computer” language—immediately created uncertainty for attorneys drafting patent applications addressed to methods implemented by a computer (i.e., software).

### USPTO Interim Eligibility Guidelines

Following *Alice Corp.*, the USPTO issued *Interim Guidance on Patent Subject Matter Eligibility* that “offers a comprehensive view of subject matter eligibility in line with *Alice Corp.* ... and the related body of case law.”<sup>6</sup>

In keeping with the holding in *Alice Corp.*, the *Interim Guidance* instructs patent examiners to ascertain whether pertinent patent claims fall within a “judicial exception,” i.e., a patent-ineligible category such as an “abstract idea.” If the examiner determines that the claim embodies an abstract idea, the examiner must determine if the claim recites additional elements that amount to significantly more than just the abstract idea.<sup>7</sup>

Although the *Interim Guidance* does not include a bright-line rule for establishing what is “significantly more” than an abstract idea, examples of claim features that satisfy the requirement are provided—leaving the final determination of whether the claim feature should be considered “significantly more” to the examiner. It goes without saying that the sheer breadth of the “significantly more” standard makes it difficult to apply.

If the examiner determines that the claim includes significantly more than the judicial exception, the claim is patent-eligible. If not, the claim is rejected as not directed to patent-eligible subject matter.

## Sample Analysis

One of the avenues the *Interim Guidance* harnesses to provide clarity for patent examiners is to take some of the actual claims at issue in *Alice Corp.* and walk the reader through a sample analysis of them. These examples are instructive. For instance, consider the parameters set forth by Representative System Claim 26, as quoted from the facts of *Alice Corp.* by the *Interim Guidance*:

Claim 26. A data processing system to enable the exchange of an obligation between parties, the system comprising:

a communications controller,

a first party device, coupled to said communications controller,  
a data storage unit having stored therein

(a) information about a first account for a first party, independent from a second account maintained by a first exchange institution, and

(b) information about a third account for a second party, independent from a fourth account maintained by a second exchange institution; and a computer, coupled to said data storage unit and said communications controller, that is configured to

(a) receive a transaction from said first party device via said communications controller;

(b) electronically adjust said first account and said third account in order to effect an exchange obligation arising from said transaction between said first party and said second party after ensuring that said first party and/or said second party have adequate value in said first account and/or said third account, respectively; and

(c) generate an instruction to said first exchange institution and/or said second exchange institution to adjust said second account and/or said fourth account in accordance with the adjustment of said first account and/or third account, wherein said instruction being an irrevocable, time invariant obligation placed on said first exchange institution and/or said second exchange institution. *Id.*



The *Interim Guidance* indicates the claim is directed to an abstract idea (in this case, the concept of intermediate settlement risk). The claim must therefore be further reviewed to determine if it includes “significantly more” than just an abstract idea.

The *Interim Guidance* specifies Claim 26 does not encompass significantly more than the underlying abstract idea because the elements included in the system—a communication device, a first-party device, a storage device and a computer—are generic. Thus, because the hardware components serve no purpose beyond linking the risk analysis steps to a technological environment, the *Interim Guidance* suggests that the claim is not directed to patent-eligible subject matter. In conclusion, *Alice Corp.* does not explicitly preclude the patent eligibility of computer-implemented methods such as software. However, the holding in *Alice Corp.* and the interim guidelines from USPTO suggest computer-implemented methods likely will face patent eligibility challenges where the claims do not recite structural components that go beyond the basic hardware of a general computing system, a policy that would mark a significant shift from previous interpretations of the patent eligibility statute. ■

## Endnotes

<sup>1</sup> Strictly speaking, 35 U.S.C. § 101 defines “patent-eligible subject matter”—but as a practical matter, the application of that law necessarily remains adaptable.

<sup>2</sup> 573 U.S. \_\_\_, 134 S. Ct. 2347

<sup>3</sup> Although these guidelines are not substantive law, they will serve as a primary resource for patent examiners.

<sup>4</sup> See *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 566 U.S. 10, 132 S.Ct. 1289, 182 L.Ed.2d 321 (2012).

<sup>5</sup> 134 S. Ct. 2347

<sup>6</sup> See “Notice of Forum on the Guidance for Determining Subject Matter Eligibility of Claims Reciting or Involving Laws of Nature, Natural Phenomena, and Natural Products,” 79 FR 21736 (Apr. 17, 2014), and “Request for Comments and Extension of Comment Period on Examination Instruction and Guidance Pertaining to Patent-Eligible Subject Matter,” 79 FR 36786 (June 30, 2014).

<sup>7</sup> *Id.* at 74624.

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# Post-Grant Patent Proceedings, and Why You Need To Know About IPR

By Kevin Bieg



The recently enacted America Invents Act (AIA)<sup>1</sup> provides for a number of new post-grant patent proceedings to challenge the validity of U.S. patent claims. The three new proceedings—*inter partes* review (IPR), covered business method (CBM) patent review and post-grant review (PGR)—are administered by a newly created adjudicative Patent Trial and Appeals Board (PTAB) within the United States Patent and Trademark Office (USPTO). The main focus of this article is on the IPR, as that is so far the most commonly used review process.

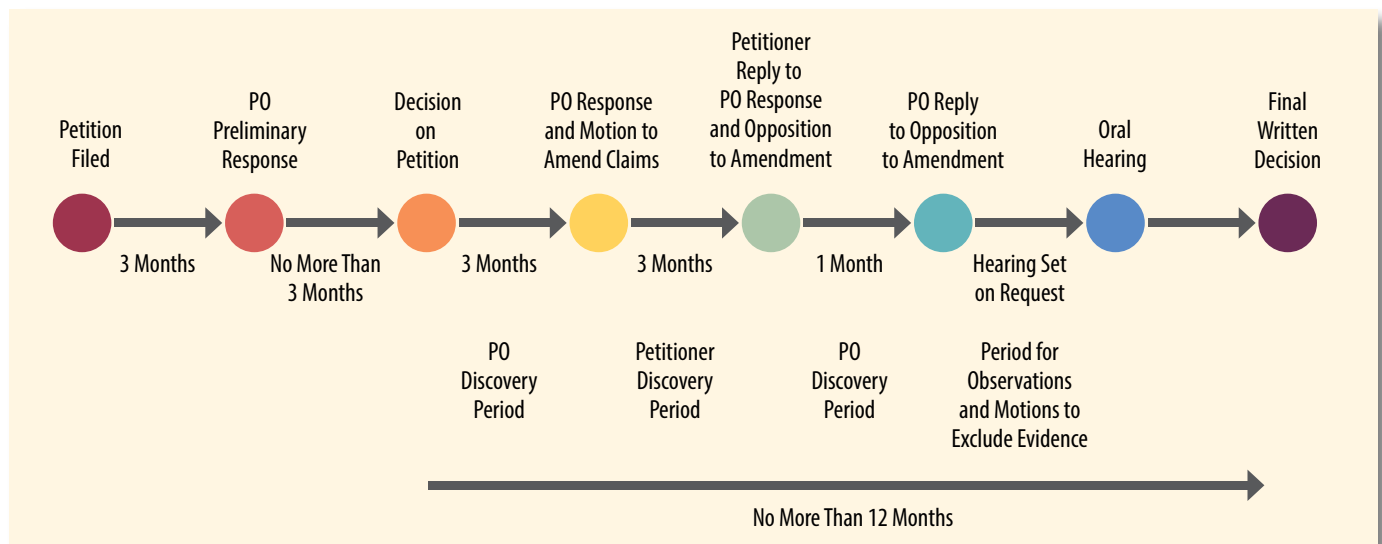
The Congressional intent behind these new proceedings and creation of the PTAB was to push patent validity challenges back to the USPTO and provide a more efficient, accurate and cost-effective alternative to patent litigation in the federal district courts. Congress was particularly concerned about the growing cost of patent litigation and the possible adverse effects on innovation, especially litigation brought by non-practicing entities (NPEs, sometimes referred to as “patent assertion entities” or pejoratively as “patent trolls.”) Patent litigation has risen dramatically in the past decade, to 6,081 new patent cases filed in

2013, and up to 60 percent of those were brought by NPEs<sup>2</sup>. Defending such patent infringement lawsuits through trial can cost between \$1 million-\$6 million, depending on the amount in controversy.<sup>3</sup>

Following enactment of the AIA, almost 1,500 petitions for post-grant proceedings were filed with the PTAB in 2014, with most of the challenged patents subject to co-pending litigation.<sup>4</sup> Concurrently, new patent litigation (original complaint filing) was down 18 percent in 2014 from its peak in the previous year.<sup>5</sup> The drop partially may be due to the Supreme Court’s recent patent law activity, including *Alice Corp. v. CLS Bank* and related decisions on patent-eligible subject matter,<sup>6</sup> but is also likely due to the expanded availability of post-grant proceedings.

## Inter Partes Review (IPR)

The most important new tool for defendants to challenge the validity of a patent in an infringement action is *inter partes* review, which replaces the seldom-used *inter partes* re-examination. IPR is conducted as an expedited trial before a panel of three administrative patent judges of the PTAB. A timeline for IPR is shown in the diagram below.<sup>7</sup> Compared to prior requests for *inter partes* re-examination, petitions for IPR are currently granted at a similar rate, but once instituted, they result in the elimination of every challenged claim about twice as often, reach a final decision



almost twice as quickly and make accused infringers almost twice as likely to win motions to stay co-pending litigation.<sup>8</sup>

A petition for IPR can be filed by any person, other than the patent owner, with certain limited exceptions including that it must be filed within one year after the petitioner/defendant has been sued in district court for infringement of the patent. Typically, the petition includes a list of the challenged claims and how the petitioner proposes they be construed, the statutory grounds for rejecting each challenged claim, exhibits and expert testimony by declaration. The grounds for IPR can only include 35 U.S.C. § 102-103 prior art, i.e., only patents and printed publications that anticipate or make obvious the challenged claims. (*Anticipation* means that the claimed invention has already been fully described in a single prior art reference—in a single patent or a single printed publication—with the exception that a publication by the inventor less than one year before the filing date of the patent application is not prior art. *Obvious* means that the claimed invention is a trivial, non-inventive modification or combination of what has been described in one or more prior art references.)

It has been estimated that more than 80 percent of patents challenged in IPRs have also been asserted in parallel infringement litigations against the petitioner.<sup>9</sup> Considerations for a defendant in a co-pending patent suit in requesting an IPR are primarily concerned with how an unsuccessful IPR might impact the litigation: whether the claim of invalidity is based only on anticipation or obviousness arguments or if there are other defenses that can be used in court, the strength of the patent compared to the prior art, the likelihood of a stay or injunction, the amount of discovery required, if the patent is technically complex and difficult for a district judge or jury to understand, if the forum of the litigation is unfriendly to the defendant and the effect of an IPR on the parties' ability to reach settlement.

The patent owner (PO) may file a preliminary response in opposition to the petition within three months from the date the petition was filed. The PO's preliminary response focuses on attacking the *prima facie* case in the petition and may include the PO's proposed claim construction. The threshold requirement for grant of a petition by the PTAB is a reasonable likelihood that the petitioner will prevail on at least one of the challenged claims.

Currently, IPR petitions are granted ("instituted") about 84 percent of the time.<sup>10</sup>

If the PTAB decides to grant the petition, a trial is instituted and any co-pending litigation may be stayed. District courts have been receptive to stays of on-going litigation pending the outcome of PTAB reviews. Motions to stay have been filed in about 76 percent of instituted trials having co-pending litigations and these cases have been stayed about 82 percent of the time.<sup>11</sup> After the PTAB institutes a trial, the PO will conduct discovery and file a response. The PO may file a motion to amend the claims with its response. Claim amendments cannot broaden the challenged claim scope or introduce new matter; therefore, the burden is on the PO to show that the amendment is supported by the written description in the patent specification and is patentable over the prior art.

The PTAB trial is conducted on the merits and concludes with an oral hearing before the three-judge panel. The PTAB trial must be completed in one year (or a maximum of 18 months in extraordinary circumstances) from when it was instituted. An IPR can terminate by a decision by the PTAB not to grant a petition, settlement, a final written decision from the PTAB or by a request for adverse judgment from the PO.

Approximately 30 percent of IPRs are terminated by early settlement without creating estoppel.<sup>12</sup> Estoppel attaches immediately upon issuance of a final written decision with regards to any prior art that the petitioner raised or reasonably could have raised in the proceeding. The goal of estoppel is to bring closure to the patentability issues and validity defenses that can be raised in another USPTO proceeding, a civil action, or an International Trade Commission proceeding.

Petitioners have been quite successful invalidating patents before the PTAB and ending co-pending patent suits filed against them. Among IPRs that reach a final decision on the merits, all of the instituted claims are invalidated or disclaimed more than 77 percent of the time.<sup>13</sup> The final written decision by the PTAB is appealable directly to the Court of Appeals for the Federal Circuit. Historically, the Federal Circuit has shown great deference to PTAB decisions.

## Covered Business Methods (CBM)

CBM patent review is a specialized post-grant proceeding directed only to patents that have at least one claim directed to or that can be applied to a financial product or service (broadly interpreted) and is not for a technical invention, reflecting Congress' disapproval of the patenting of "business methods." Only a person who is sued or charged with infringement of a CBM patent can file a petition, but there is no one-year litigation bar time limit as with IPRs. The CBM review can be used to challenge the validity of patents filed both under the old first-to-invent patent system and the new first-inventor-to-file AIA patent system, and any ground can be used to challenge a CBM patent under the new system including on-sale activity, public use, ineligible subject matter, and lack of enablement in addition to patents and printed publications.<sup>14</sup>

The CBM statute mandates a four-part stay analysis, including "whether a stay will reduce the burden of litigation on the parties and on the court." To further encourage stays, the unsuccessful movant can seek immediate *de novo* interlocutory review of the decision from the Federal Circuit. These provisions virtually guarantee a stay of parallel court proceedings. However, estoppel in later Federal District Court or International Trade Commission proceedings is narrowly limited to only those grounds that were actually raised during the CBM proceeding. CBM patent review is scheduled to sunset in 2020.

## Post-Grant Review (PGR)

The new PGR is intended to be similar to opposition proceedings in Europe, allowing

*continued on page 14*

## What Is a 'Patent Troll'?

Non-practicing entities (NPEs) are patent owners that do not commercialize the patented technology and, therefore, do not "practice" their patent rights. Universities and national laboratories are sometimes considered NPEs because they are not operating companies that manufacture products or processes. Patent trolls are generally considered as NPEs that buy up patents with the sole intent of suing someone. There is substantial disagreement on whether or not patent trolls are a force for good or evil.

immediate challenges to newly issued patents. Any party, other than the PO, who has not previously filed a Declaratory Judgment action (but not a counterclaim) challenging the validity of a patent can request a PGR of any patent within a narrow, nine-month window of issuance or a broadening reissuance of the patent.

PGR is only available for patents that have an application filing date later than March 16, 2013 (i.e., those patents subject to the first-inventor-to-file provisions of the AIA). Therefore, patents that are eligible for PGR are just now being issued. PGR is similar in most procedural respects to IPR. However, like CBM and unlike IPR, any ground of invalidity can be asserted. Further, a higher threshold is required to institute a PGR than an IPR: that it is more likely than not that at least one challenged claim is unpatentable, or that the petition raises a novel or unsettled question of law that is important to other patents or patent applications. Upon issuance of a written decision by the PTAB, the petitioner is estopped from re-asserting art or other grounds that were raised or reasonably could have been raised in the PGR.

### Conclusion

Due to the statutory requirements of limited discovery, lack of live testimony and speedy resolution, concerns have been raised regarding lack of due process in PTAB trials. Additionally, these new post-grant proceedings may disadvantage small companies with limited patent portfolios, licensors, and Houniversities. Critics also charge that the PTAB process unfairly favors petitioner/defendants.

Although it is too early to draw sweeping conclusions, the new post-grant proceedings appear to be a powerful shield for those accused of patent infringement, and Congress is considering additional legislation to further limit the ability of patent trolls to bring patent suits.<sup>15</sup> ■

### Endnotes

<sup>1</sup> Leahy-Smith America Invents Act, Pub L No 112-29, 125 Stat. 284 (2011), see, generally, 35 U.S.C. Chapters 31 and 32.

<sup>2</sup> Schwartz, David L. and Jay P. Kesan, "Analyzing the Role of Non-Practicing Entities in the Patent System," *Cornell Law Review* 99:425 (2014)

<sup>3</sup> AIPLA 2013 Report of the Economic Survey (available at <http://www.aipla.org>).

<sup>4</sup> <http://www.uspto.gov/patents-application-process/appealing-patent->

[decisions/statistics/aia-trial-statistics](http://www.uspto.gov/patents-application-process/appealing-patent-decisions/statistics/aia-trial-statistics)

<sup>5</sup> <https://lexmachina.com/2015/02/patent-case-trends-business-litigation/>

<sup>6</sup> Kevin Soules, "Go Ask 'Alice': New Criteria for Patent Eligibility," in this issue of *NM Lawyer*.

<sup>7</sup> *Office Patent Trial Practice Guide*, Fed. Reg. 77, No. 157 (August 14, 2012).

<sup>8</sup> Love, B.J. and S. Ambwani, "Inter Partes Review: An Early Look at the Numbers," *The University of Chicago Law Review Dialogue* 81:93 (2014).

<sup>9</sup> *Id.* at 94.

<sup>10</sup> *Id.* at 99.

<sup>11</sup> *Id.* at 104.

<sup>12</sup> <http://www.uspto.gov/patents-application-process/appealing-patent-decisions/statistics/aia-trial-statistics>

<sup>13</sup> *Supra* at 102.

<sup>14</sup> 35 U.S.C. §18(a)(1)(C)-(D).

<sup>15</sup> H.R. 9 – Innovation Act (<https://www.congress.gov/bill/114th-congress/house-bill/9>), and Begay-Campbell, Sandra, "Bill would weaken patent system," *Albuquerque Journal*, March 9, 2015 (available at <http://www.abqjournal.com/551928/opinion/bill-would-weaken-patent-system.html>).

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## Getting the Royalty Payments You Deserve *continued from page 9*

4. Ensure that any transfer price (between one part of a company to another or to another affiliate of the company) is clearly defined.

5. Make royalty reports and payments correspond to public documents and annual reports.

6. Include regular reporting updates with milestones and goals.

7. Know your licensees' products and monitor what is happening in their research and development areas for potential "second-generation" products.

8. Disallow deductions such as "handling," which sometimes are included by licensees for such activities as accounts receivable management, storage facility rent or customer service. Requiring details of both net and gross sales will help solve this problem.

9. Amend the royalty agreement or correct any ambiguous language when the renewal next comes due.

By including these types of provisions in the licensing agreement and taking the aforementioned actions, a licensor will increase the likelihood of recovering the royalty rates due, and will likely avoid costly and time-consuming litigation. ■

### Endnotes

<sup>1</sup> Basara, Justin, Liddy Cooper and Rick Conroy, "The Power of Intangible Assets: An Analysis of the S&P 500," *The Journal of the Licensing Executives Society* (March, 2006), p. 4.

<sup>2</sup> Parr, Russell L. "Royalty Rates for Technology," (5<sup>th</sup> Edition) (Intellectual Property Research Associates, 2015).

<sup>3</sup> See Battersby, Gregory J. and Charles W. Grimes, "Licensing Royalty Rates," (Aspen Publishers, 2009).

<sup>4</sup> Steward, Debora R. and Judy A. Byrd, "The Magnitude and Meaning of Royalty Misreporting," (2012).

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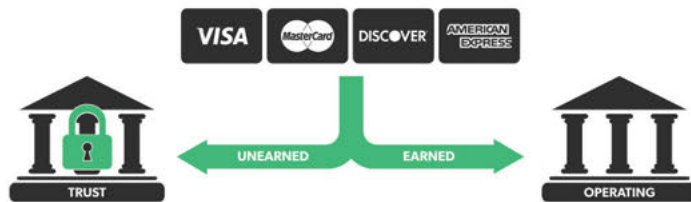


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