Beware of "Guillotine Licenses" for Patents with U.S. Companies

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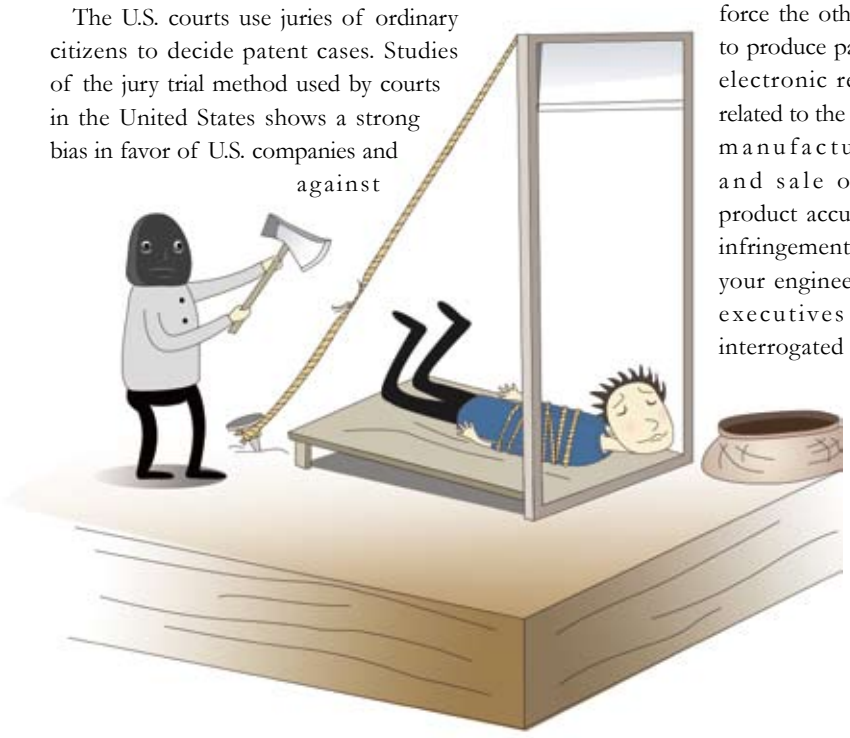
Foreign licensees should try to get a life license for the U.S. patents they use only to avoid a guillotine license that very will possibly lead to costly, lengthy lawsuits and very probably biased jury verdicts in USA when the license expires. If they fail to do so, an arbitration clause for solving future probable disputes is their first choice.

A United States patent gives its owner the right to exclude products that infringe the patent from United States markets. An owner of a U.S. patent can sue someone who it alleges is importing an infringing product in a United States District Court or in the United States International Trade Commission, or both places. Problems for Chinese and other foreign companies with the U.S. legal system often result in the company that is sued in the U.S. taking a license to the patent. However, if your company takes a license to avoid being in a lawsuit in the U.S. or to get out of a lawsuit, you need to protect yourself for when the license expires.

1. Problems for Foreign Companies with the U.S. Legal System

The U.S. courts use juries of ordinary citizens to decide patent cases. Studies of the jury trial method used by courts in the United States shows a strong bias in favor of U.S. companies and against foreign companies. Kimberly Moore, now a Judge on the United States Court of Appeals for the Federal Circuit, did substantial work and published articles on this subject while a law professor; for example, Kimberly A. Moore, Judges, Juries, and Patents Cases -- An Empirical Peek Inside the Black Box, 99 Mich. L. Rev. 363 (2000). Although studies are not unanimous in their conclusions, the weight of authority confirms what most U.S. patent lawyers believe: "patent juries display a pronounced bias in favor of inventors and against foreigners." Vol 2, Intellectual Property and Information Wealth, Issues and Practices in the Digital Age, Peter Yu Editor (2007)(emphasis added).

In addition, the U.S. legal system allows for extensive "discovery" : Discovery is the process where a patent owner can force the other side to produce paper or electronic records related to the design, manufacturing, and sale of the product accused of infringement; force your engineers and executives to be interrogated by the



patent owner's lawyer in a process called a "deposition"; and to answer written questions drafted and sent by the patent owner (interrogatories and requests for admissions). See Federal Rules of Civil Procedure 26, 30, 33, 34, 37 and 45. Your company also can use these discovery tools if sued in the U.S., but U.S. companies have had to incorporate the working of the U.S. legal system into their businesses, while your company may have difficulty coping with this unique and very intrusive discovery.

2. Taking a License to Avoid a U.S. Lawsuit: Plan for Problems when the License Ends, Before You Sign!

Because of the importance of the U.S. market, and because of the unique nature of the U.S. legal system's jury trial and "discovery process", it is common for Chinese and other foreign companies to agree to pay license fees to the owner of a U.S. patent rather than suffer through this process. However, typically these licenses are for a term of years: The practice of licensing patents for a term of years has traps for licensees: Especially in the "guillotine license".

So what is a "guillotine license" and what does that have to do with juries? A guillotine license is where the agreement allows use of the patent or patents for a term of years and then "cuts off": That is, it drops like the blade of a guillotine, upon expiration. The product that was licensed yesterday infringes today.

What should a Chinese company do to avoid having its "head chopped off" when the guillotine falls? Ideally, if a Chinese or foreign company takes a license to avoid the U.S. legal system and guarantee access to U.S. markets, the licensee must avoid a guillotine license if possible and obtain a license for "the life of the patents": That is, once a patent is licensed it remains licensed until the patent expires, and new patents applied for during the license term by the licensor are also licensed for the full term of the patent. Many times, however, the result of the negotiation is somewhere between the "blade dropping" and "life of the patents".

Anything less than "life of the patents" is a "set-up" by the patent owner for the next patent infringement lawsuit in a court in the United States: In a second lawsuit when the license expires, the patent owner now has even more leverage to negotiate for higher royalties than it had in the first negotiation. Why? Because in any U.S. jury trial, the prior license that is expired or coming to an end, will be admitted into evidence for the jury to review, and this prior license will appear to the jury to be an admission of infringement by the Chinese licensee. Why would the licensee have paid in the past but for the fact it had to do so because its products infringe the patents?

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When a company has a license for less than the life of the patents, or has a guillotine license, this arrangement is only a temporary peace: For lasting freedom from suit the licensee must use the time period of the license to design away from the licensor's patents or portfolio, and be able to show how it changed its product. Regardless of whether it is possible to design away, in 'real life' typically the license is seen as permission to continue business as usual; not "breathing room" to switch to some other design or technology. Certainly, during the license period, the licensee can try to build its own patent portfolio through its own applications or purchasing patents for better negotiation leverage at the time of renewal. However, 1) the licensee will still be disadvantaged by the fact it paid royalties in the past; and 2) a Chinese corporation will suffer from jury bias in favor of an American company.

3. Arbitration Clauses Level the Playing Field at Renewal

Chinese companies should generally avoid U.S. courts. How can Chinese companies stay out of U.S. courts when the license expires and no agreement has been reached on a renewal or extension? This can be a done with either one of two courses of action: 1) only take a life of the patent license in the first negotiation so there is not a second negotiation ; or 2) insist on an arbitration clause in the license that requires all future disputes related to patents controlled by either party, the license contract itself, renewal of the license, post-license conduct, or the licensed or accused products, regardless of the type of claim (whether for patent infringement, unfair competition, or any other claim under any state or federal law, including Section 337, the basis for ITC litigation), be arbitrated and not pursued in court.

Often patent owners in the U.S. will agree to arbitration, but want an exception to arbitration that allows the patent owner to go to court for an injunction or order barring the Chinese company's products from being imported into the U.S. There is no need to carve out an exception for an injunction because the fact that the patent owner licensed once for money, shows the patent owner wants money. The patent owner's interest in an exception to arbitration for an injunction, is to circumvent the arbitration, to seek a court order or an ITC exclusion order as a pressure tactic to renew the license at a higher price.

What kind of arbitration? There are two big arbitration agencies operating in the United States that administer arbitrations, as well as many smaller agencies. In addition, the parties can agree to arbitrate on their own without using an agency to administer the arbitration. The two arbitration agencies most used are the American Arbitration Association or the International Chamber of Commerce

Court. These agencies do not decide the disputes, rather they manage the arbitration process through rules they have adopted, and by administering the fees and paperwork to the arbitrators. Their role is ministerial or clerical in nature: The substantive decisions are those made by the separate arbitration panels in each case. Arbitration decisions are enforced by U.S. courts, with only very narrow grounds permitted to challenge the arbitration decision (such as fraud in the arbitration).

The AAA has a set of procedures for routine matters, and a more detailed set of rules for complex cases that allows for American style discovery. The AAA, however, recently issued an advisory document to arbitrators that they should not permit American style depositions and written discovery in arbitrations with foreign parties. AAA arbitrations had come to resemble U.S. lawsuits with extensive discovery, and in rare circumstances, thought to be a "cash cow" for the arbitrators (who are typically paid by the hour). This advisory is an effort to "carve back" the "U.S. style" procedures and reduce expenses, when foreign parties are involved in the arbitration.

The ICC is based in Paris and does not operate in the style of an American court. Typically, there is no discovery except for a small document exchange (the hearing exhibits and perhaps any document immediately on point). Generally, there are no depositions or interrogatories. The ICC rules do appear to give arbitrators authority to permit discovery beyond a confined document production, but the practice is not to do so. ICC arbitrations also function under time limits that generally result in a final decision within one year or less from the demand for arbitration.

Parties can also agree to arbitrate without using an agency to administer the process; selecting arbitrators from an agency that arranges for neutrals to do mediations and arbitrations, like J.A.M.S., or picking their own.

Finally, arbitrators only have the authority to act and make awards as agreed by the parties: Arbitration is a contractual agreement, and the arbitrators have no authority beyond the parties' agreement. Arbitration is not an extra-judicial forum. This means the parties can agree not to permit arbitration of enhanced damages or willfulness, or cost shifting, or "loser pays" attorney's fees.

I have done all three types of arbitrations: AAA, ICC and "self-help". Of the three, ICC arbitrations work best in my experience for foreign companies because ICC arbitrators are inoculated against U.S. style discovery, and the time limits in the ICC rules (while often extended by short time periods), are generally useful in keeping the arbitration from going out of control. Once the arbitrators are confirmed, the first order of business is to have a pre-hearing conference to draft the "Terms of Reference", which is the set of specific questions or issues that the arbitrators will decide for the parties. These Terms of Reference are reviewed and approved for form by the ICC: the Terms of Reference make clear what will be decided by the arbitrators. The ICC sets its administrative fees according to the size of the case.

U.S. companies have less incentives to insist on arbitration because exclusion from most foreign markets is not an equal threat to exclusion from the U.S. market: Foreign markets are typically not as large as U.S. markets. Moreover, in the U.S. court system, there is no administrative fee or arbitrators' fees as there are in arbitration. Nonetheless, it should be noted that many U.S. companies would prefer to be in arbitration than in a case in many foreign courts where the language, procedure and customs are unfamiliar to them. However, most U.S. companies will try to deal with the problem of where to resolve a dispute through choice of venue and choice of forum clauses, designating U.S. law and a U.S. court for dispute resolution, rather than arbitration.

Chinese licensees, be aware, and plan ahead for when the license expires. Use your leverage in the original negotiations to obtain an arbitration clause – it will be too late once the guillotine's blade drops. IP