

In Search of Lower Cost Resolution: Using Arbitration to Resolve Patent Disputes

By David A. Allgeyer

Patents and other forms of intellectual property are extremely important to most businesses. Companies have come to realize that their intellectual property often represents their most important asset. Having adequate intellectual property protection can be crucial to startup companies attempting to find the financing they need. In contrast, a developed intellectual property portfolio is often the key to maintaining a favorable competitive position for established business enterprises. In addition, licensing IP to others can provide much needed income flow, while licensing from others is often the most efficient way for a company to enhance its product or service offerings.

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The high cost of patent litigation

The pivotal role played by patents and other forms of intellectual property enhances the likelihood that any given company will one day become embroiled in litigation in an effort to protect IP rights. This type of litigation is typically very expensive for several reasons: (1) heavy reliance upon expert witness testimony during trial; (2) extensive discovery of documents; (3) a significant number of pretrial depositions; and (4) the inevitable disputes regarding the discovery process that must be resolved by the court. “Markman” hearings concerning the proper construction of a patent’s claims add another level of complexity and expense. The availability of jury trials interjects a potentially negative variable as jurors who are unfamiliar with the involved technology and law are asked to decide key issues. Finally, there is an unusually high rate of reversal on appeal of technical decisions courts make construing the claims, adding further expense to the proceedings.

No wonder, then, that the American Intellectual Property Association reported in a 2005 economic survey that the typical cost of patent infringement litigation for matters with claims under \$25 million averaged over \$2 million - with the average in some larger cities coming closer to \$3 million.¹ The survey found that costs of discovery alone in cases of that size averaged \$1.6 million.²

The Arbitration Alternative

For some cases, there is a better way forward. In recent years, a number of companies have seen the wisdom of requiring that IP disputes be resolved by binding arbitration rather than through litigation. Arbitration is a voluntary process where the parties agree to have a neutral third-party, generally a well-qualified lawyer or other professional with experience in patents and/or technology, decide the case. Arbitration still provides each party an opportunity to present their side of the case, but with far less access to discovery. The hearing is much more informal, with a relaxation of the formal rules of evidence and a much quicker pace than a court trial. Unless the parties agree otherwise, an appeal on the merits is not available, and the decision of the arbitrator—or, for larger cases, a panel of arbitrators—is final and binding. This may be just what a company needs in the proper case.

Two case studies: Trial versus Arbitration

Let’s take a quick look at a study in contrasts. In the first case litigated a number of years ago, an inventor licenses his patent portfolio and trade secrets to a company. The company launches a new product line. The inventor decides that the company is not doing enough to commercialize the product and demands more money. The company believes that the inventor doesn’t actually own the intellectual property and stops paying the inventor. The inventor sues for breach of the license agreement, patent infringement and misappropriation of trade secrets. The company counters that its products do not actually infringe the patents, the patents are invalid and the claimed trade secrets aren’t legitimate secrets at all. The matter is subject to discovery and motions for about one and one half years. Adding to the delay, the plaintiff sues in both federal and state court, hoping to achieve a strategic advantage. There are numerous depositions, some lasting two or three days. The matter culminates in a trial lasting over eight weeks. In the end, the jury agrees that the company did not infringe the patents, the inventor has no true trade secrets and the company owes the inventor nothing. An appeal is then taken, increasing the legal costs. The case is ultimately affirmed on appeal, but for almost three years the company’s IP rights and product lines have been in legal limbo. The attorney’s fees and costs are well over a million dollars for each side – in today’s dollars the costs incurred would have been much more.

Contrast this to a second case. A small company hires a large company to do some product finishing, using the small company’s patented process and know-how. The executed contract states that the large company will use the

proprietary process only to manufacture products for the small company. The relationship between the two companies deteriorates, and their business association ends. The large company then introduces a new product that the small company claims uses its protected process and secrets. The small company wants the large company to stop using the proprietary process and pay compensation for the prior use of the process. The large company denies use of the small company's process, claiming to have developed and patented its own proprietary process.

Arbitration offers a number of advantages including Confidentiality, Special Rules for Patent Disputes, and Final and less expensive results.

The parties' contract contains an arbitration clause providing for administration by the American Arbitration Association. The arbitration is to be heard before an arbitrator in a city agreed upon by the parties. The parties are given a long list of qualified potential arbitrators with extensive experience in intellectual property. Under the arbitrator's direction, the parties exchange documents necessary to understand the background of the dispute. The parties agree that key depositions of limited duration may be undertaken. Because the arbitrator understands patent law, she is able to efficiently review and understand a large volume of testimony and evidence, including complex technical data. The testimony takes one week, followed by simultaneous written submissions regarding the parties' legal and factual arguments. Thirty days later the arbitrator issues a written decision explaining the outcome and reasoning. No appeals are involved, and the parties move on. The fees to each side are less than \$350,000. The whole process from beginning to end takes just over a year.

The key difference in these two situations is the existence of the arbitration clause in the license agreement. Without it, the second case would certainly have taken months longer through trial and another year for the appeal. The costs would have been a multiple of what they actually were.

Arbitration Advantages

Arbitration offers a number of advantages besides savings in terms of costs and time expended. Arbitral panels are often used in larger cases and can be tailored to fit the specific dispute. For example, the parties can agree to create a panel consisting of a lawyer familiar with patents, an expert in the applicable technical area and an accountant to assist with the analysis of damages.

Confidentiality

Unlike trial, arbitration is a private process. Arbitrators and arbitration service providers are sworn to secrecy regarding the proceedings. Parties are not automatically sworn to secrecy. Businesses, however, generally want their IP disputes decided without scrutiny from the press and competitors that occurs in a court setting. With the advent of electronic filing and public availability of court documents on the internet, the desire for increased confidentiality has become more and more widespread. Companies, therefore, will usually agree to either include a confidentiality provision in the arbitration agreement pre-dispute or execute a separate confidentiality agreement post dispute.

In license disputes, the licensee or licensor may not want competitors or other licensees to have access to royalty rates or other sensitive terms and conditions of the business relationship. While protective orders may be used to protect sensitive financial information in court, the very existence of a dispute can be kept secret in an arbitral setting by agreement of the parties. Confidentiality can also prove valuable to the licensor if the validity of a patent is at issue. One commentator has suggested that by providing in the arbitration agreement that the issue to be decided by the arbitrator is simply whether royalties are due under the agreement or not, the possibility of an adverse validity finding being made public is obviated.³ In contrast, if the matter per the terms of the arbitration agreement is to be decided on the basis of validity or infringement, to be enforceable notice of the arbitral award must be given to the Director of the Patent and Trademark Office – thus, rendering the award a public document.⁴

Special Rules for Patent Disputes

As arbitration of patent disputes has become more common, ADR service providers have made adjustments to their rules. For example, the American Arbitration Association has adopted a set of procedures for patent disputes that supplement the normal commercial rules.⁵ The supplementary patent rules address under the guidance and direction of the arbitrator such issues as: disclosure of the claims infringed; identification of the alleged infringing products; creation of an element by element infringement chart; identification of prior art; creation of an element by element invalidity chart; and provision for a claim construction hearing. If the parties do not want the supplemental patent procedures to govern the arbitration, they can opt out by mutual agreement.

Final and less expensive

For all practical purposes, arbitrations are final. The standard of judicial review is very limited. Grounds for overturning an award include such things as absence of an arbitration agreement; arbitrators exceeding their powers; fraud or corruption; evident partiality; refusal to postpone a hearing

on good cause shown.⁶ There is no de-novo review of claim construction decisions or matters of law and virtually no chance to review the arbitrator's findings of fact.

The expense differential for arbitration can make the difference between a start-up company being able to assert its rights or not. The author represented a start-up medical company that had exclusively licensed its patents and other intellectual property to a large medical manufacturer. The agreement required the manufacturer to use reasonable efforts to develop the technology into a product and market it throughout the licensed territory, the entire world. The manufacturer, however, lost interest in the technology. Still, it held onto the exclusive license, foreclosing the ability of the start-up to do anything profitable with the technology. Other companies were interested in buying the startup to gain access to the technology; but the deals were never consummated because no company wants to buy a lawsuit. Because of the nature of the dispute - complex medical technology and data, as well as a fairly complex licensing agreement - the start-up could not afford the extremely costly litigation. And it was feared that during the time it would take to resolve the matter in litigation, the companies interested in purchasing the startup would lose interest as the technology became dated.

Although license agreements provide a perfect opportunity to include an arbitration provision, such inclusion may not be appropriate in every situation.

Fortunately, the licensing agreement contained an arbitration clause. The startup initiated arbitration. A panel of knowledgeable patent lawyers was appointed. At the start-up's request, discovery was limited to one deposition per side and the provision of relevant documents. After a motion was heard and decided regarding legal challenges to the startup's claims, the matter settled on a fair basis. The startup recouped at least some of the money it should have received had the manufacturer fulfilled its end of the bargain. Most importantly, the intellectual property rights were returned to the start-up and were soon sold to another company. The entire matter was resolved in less than one year at a fraction of what the discovery costs alone would have been had the matter been litigated.

Is your situation right for arbitration?

Should every intellectual property dispute be submitted to arbitration? Although license agreements provide a perfect opportunity to include an arbitration provision, such

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inclusion may not be appropriate in every situation. For example, the licensing arrangement may be so critical to the survival of either or both parties, that neither is willing to forego full blown court review and access to an appeal. But in the majority of situations a properly drafted arbitration provision will result in licensing disputes being resolved inexpensively and quickly so the parties can get back to the real business of business which is conducting business. The parties can customize the arbitration provision in a number of ways, such as providing for limited discovery and review of the decision by another arbitrator or panel of arbitrators.⁷

Even if privity of contract does not exist, the patent owner and alleged infringer can elect post-dispute to utilize arbitration. One way to encourage a party to agree to arbitrate in such a situation is to reduce the risk of a run away award. This can be accomplished by structuring the arbitration in one of several ways:

Last/Best Offer: Each party proposes a monetary amount, terms and conditions. The arbitrator's award is limited to selection of one party's settlement proposal.

Night Baseball: Each party proposes a monetary amount, terms and conditions. The arbitrator independently reaches a decision. The arbitrator's decision is compared with the parties' proposals. The party's proposal that is closest to the arbitrator's determination constitutes the final, binding award.

High-Low/Banded Arbitration: Each party proposes a monetary amount, terms and conditions. The arbitrator is at liberty to award any amount, term or condition that falls between the party's proposals.

A final case study

The plaintiff sued for patent infringement. A series of motions, including a successful motion to change venue from the east coast to the Midwest, were addressed by the court. A great deal of discovery was exchanged, with the usual disputes over what should and should not be produced. As often happens, the parties eventually settled the matter with the defendant executing a license agreement. After experiencing during the prior one and a half years the emotional stress and costs associated with extensive patent litigation, the license agreement included a provision that all future disputes between the parties would be decided by —

you guessed it — binding arbitration.



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¹ AIPLA Report of the Economic Survey 2005, p. I-109 (2005).

² *Id.*

³ See Skaff, *ADR for Patent Validity Issues After Medimmune*, p. 40, *IP Litigator*, May/June 2007.

⁴ *Id.*; 35 U.S.C. § 294(d) and (e). Note that awards of the arbitrator are binding only between the parties and “shall have no force or effect on any other person.” § 294(c). Still, most licensors would rather not have a public record of losing an infringement or validity dispute if other licensees may later challenge the infringement or validity of the licensed patent.

⁵ For the text of the AAA’s Supplementary rule for the Resolution of Patent Disputes, go to www.adr.org and click the links to Commercial Rules, Intellectual Property and Supplementary Patent Rules.

⁶ Federal Arbitration Act, 9 U.S.C. § 10.

⁷ The Third and Fifth Circuits have ruled that private parties may expand the scope of judicial review in their arbitration agreement. *Roadway Package Sys. Inc. v. Kayser*, 257 F.3d 287, 293 (3rd Cir. 2001); *Gateway Tech., Inc. v. MCI Telecomm. Corp.*, 64 F.3d 993, 997 (5th Cir. 1995). This suggests that, in some instances, the parties could agree to a more thorough judicial review of awards than permitted under the Federal Arbitration Act. Other courts, however, have refused to allow an expansion of the scope of review. See, e.g. *Kyocera Corp. v. Prudential-Bache Trade Svcs, Inc.*, 341 F.3d 987 (9th Cir. 2003); *Chicago Typographical Union v. Chicago Sun-Times, Inc.*, 935 F.2d 1501, 1505 (7th Cir. 1991); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925, 937 (10th Cir. 2001). It does not appear the Court of Appeals for the Federal Circuit has taken a position on the matter to date. This all suggests that contracting for expanded appellate judicial review of a decision in a patent arbitration would not be wise in most jurisdictions.