

The “Longer Walk” After *eBay v. MercExchange*

By David Orozco and James G. Conley

Introduction

The “Long Walk” is the title of a 1950’s book that recounts the remarkable story of Slavomir Rawicz, a Polish cavalry officer who surrendered to the Russians in 1939 and was harshly imprisoned. After being transported and marched to Siberia (2,000 miles) by his hosts, he escapes into the surrounding wilderness. Surviving more than a year of chronic starvation, pestilence, deserts, swamps, mountains and the elements, he miraculously makes his way across the Asian land mass, north to south, completing a journey of close to 5,000 miles.

In an earlier article, attorney Joe Hosteny makes a clever analogy between the horrific struggles of Mr. Rawicz and the contemporary experience of the independent inventor/patent holder who seeks to use the Federal legal system to license and enforce their invention rights.¹ In many cases, enforcement is sought against an accused infringer who has economic resources that far exceed that of the independent inventor. This resource advantage favors the accused infringer and translates into a long walk for the inventor towards a destination (remuneration), whose legal certainty has now been compromised.

Until the recent Supreme Court decision in *eBay v. MercExchange*,² the independent, typically cash-starved inventor who sought to use litigation to enforce his rights had only one effective weapon to compel the accused infringer to “settle” the dispute, i.e. the permanent patent injunction. This tool of the courts, rarely implemented, had the effect of balancing the interests of inventor/entrepreneurs against the considerable resources of those that may be using the invention in an unlicensed manner.

In this article, we argue that after *eBay*, the ability of the independent inventor to achieve legal certainty (viable injunction threat) and hence settlement of the patent dispute through licensing is diminished. The new standard is reviewed and examined in terms of the impact on the balance of negotiating power. We then describe recent applications of the

new standard and comment on the outcome for both the resource poor patent holder and the prospective licensee accused of infringement.

Background

On May 15, 2006, the U.S. Supreme Court decided *eBay v. MercExchange*. This decision addressed the standard that federal trial courts apply when deciding whether to grant injunctive relief. By granting greater discretion to trial court judges, the *eBay* decision disrupts the established American legal tradition that property owners ought to have well defined, effective and legally enforceable property rights.³ The *eBay* decision complicates the enforcement of patent rights via injunctive relief for the patentee and hence tilts the balance of negotiating power to the party with greater resources. We give examples of this point through the analysis of a recent permanent patent injunction case, *z4 Technologies v. Microsoft Corp.*, decided June 14, 2006, and *Finisar Corp v. The DirectTV Group*, decided, July 7, 2006.

From Article I Section 8 Clause 8, the Congress has authority to craft patent laws that promote the progress of science and useful arts, e.g. the law that patentees are granted “the right to exclude others from making, using, offering for sale, or selling the invention.”⁴ Along with granting limited life exclusivity rights, the Congress has crafted remedies in the event a patent owner’s rights are trespassed by infringers. Specifically, the statute states that courts:

may grant injunctions in accordance with the principles of equity to prevent the violation of any right secured by patent, on such terms as the court deems reasonable.⁵

The permanent patent injunction, essentially a cease and desist order, is an important legal remedy for patent owners who demonstrate through litigation that a defendant infringed their valid pat-

1. Joseph P. Hosteny, “The Long Walk From the Gobi Desert to the River Styx,” *Intellectual Property Today*, January 2001.

2. 126 S. Ct. 1837 (2006).

3. This ancient principle extends logically to intellectual property, and is effectively codified in the U.S. Constitution under Article I, Section 8, Clause 8: The Congress shall have Power To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.

4. 35 U.S.C. § 154(a)(1).

5. 35 U.S.C. § 283.

ent rights (validity usually determined twice, once by the USPTO and then again at trial). If the court grants the injunction, defendants are required to comply with the order or face the prospects of U.S. Marshals arriving to “pull the plug” on all infringing activities. The policy reasoning for granting the injunction is clear. Patents grant *exclusionary* rights that allow the owner to determine who can practice their claimed invention. Without the injunction as a credible remedy, the patent owner faces the prospect of court sanctioned compulsory licenses to multiple parties who willfully infringe. This outcome, if imposed by the court, substantially compromises the power of the patentee to exclude, and hence the ability to negotiate a license through settlement.

The Court of Appeals for the Federal Circuit (CAFC), a specialized jurisdiction that oversees patent appeals from Federal trial courts, established the general rule that trial courts should grant permanent patent injunctions *absent exceptional circumstances*.⁶ Exceptional circumstances were rare instances when public safety would be endangered if the injunction went through. A number of these cases involved public safety where the injunctions were denied because:

- Patented test kits ensured public health.⁷
- Patented catheters were preferred by physicians.⁸
- Closing a city sewage plant would pose a serious public health threat.⁹

These exceptions are clear standards for denying injunctive relief. After eBay, the standard for obtaining injunctive relief is much less clear.

Context of the eBay Decision

MercExchange sued eBay over infringement of their U.S. patent 5,845,265. After the trial court determined infringement, a motion for permanent patent injunction was filed. The trial court denied the motion and on appeal the CAFC reversed, citing its own general rule.¹⁰ On appeal, the U.S. Supreme Court agreed to hear the case. Justice Thomas, speaking for a unanimous court, sent the case back to the trial court holding that permanent patent in-

junctions ought to follow the existing four factor test for all types of injunctions.¹¹

The Four Factor Test

To obtain permanent injunctive relief, plaintiffs must now show that:

1. They have suffered an irreparable injury;
2. That remedies available at law, such as monetary damages, are inadequate to compensate for that injury;
3. That considering the balance of hardships between the plaintiff and the defendant, a remedy in equity is warranted;¹²
4. That the public interest would not be served by a permanent injunction.

It is apparent that the four factor test establishes a greater burden of proof on the patent holder who wishes to obtain a license from the accused infringer. This added burden reduces the likelihood of litigation success and the effectiveness of the permanent patent injunction as a deterrent to infringement.

The key question then is how will the new four factor test impact the competitive dynamics of intellectual property licensing for independent inventors and entrepreneurs? The question is critical since the innovation economy is governed by the rules of intellectual property as incentives for independent inventors and entrepreneurs to innovate.¹⁴ Two recent cases demonstrate the increased legal uncertainty and burdens borne by the patentee under eBay.

■ **David Orozco, Kellogg School of Management, Northwestern University, Law & Business Research Fellow, Evanston, IL, USA.**
E-mail: d-orozco@kellogg.northwestern.edu

■ **James Conley, Kellogg School of Management and McCormick School of Engineering, Northwestern University, Faculty Contributor and Faculty Fellow, Evanston, IL, USA.**
E-mail: j-conley@kellogg.northwestern.edu

6. 401 F.3d 1323, 1339 (2005).

7. *Hybritech, Inc. v. Abbott Labs.*, 849 F.2d 1446, 1458 (Fed. Cir. 1988)

8. *Datascope Corp. v. Kontron Inc.*, 786 F.2d 398, 401 (Fed. Cir. 1986)

9. *City of Milwaukee v. Activated Sludge, Inc.*, 69 F.2d 577, 593 (7th Cir. 1934)

10. 401 F.3d 1323, 1339 (2005).

11. Patent and non-patent related.

12. Non-monetary awards decided upon by a judge (*www.answers.com* accessed July 27, 2006).

13. See, “*The Innovation Economy*,” *BusinessWeek*, October 11, 2004.

14. Federal Reserve Chairman Alan Greenspan, “*Intellectual Property Rights Speech*,” Stanford Institute for Economic Policy Research Economic Summit, Stanford California (February 27 2004), at: <http://www.federalreserve.gov/BoardDocs/speeches/2004/200402272/default.htm> (accessed July 24, 2006).

*z4 Technologies v. Microsoft Corp.*¹⁵

z4 Technologies owns patents on digital rights management technology, i.e. anti-piracy software called product activation. At trial in the Eastern Federal District Court of Texas, a jury found Microsoft willfully infringed one claim of z4's U.S. 6,044,471 Patent and two claims of their U.S. 6,785,825 patent. The jury awarded \$115 million in damages against Microsoft. After the trial, z4 requested a motion for a permanent patent injunction. Specifically they requested: "the Court to enjoin Microsoft from making, using selling, or offering for sale, and/or importing its current software products that use product activation, i.e. Windows XP, products since 2001 and Office products since 2000" and "deactivating Microsoft's product activation servers." On June 14, 2006, the Court denied z4's motion based on the application of the four factor test mandated after eBay. The trial Court's analysis proceeded as follows:

Factor 1: Irreparable Harm

z4 argued:

- It would suffer irreparable harm by Microsoft's infringement because there is no way to calculate the economic success z4 would have enjoyed but for Microsoft's infringement.

The Court replied:

- There is no logical reason why a potential z4 customer would have been dissuaded from buying or licensing z4's product due to Microsoft's infringement (no loss of customers).
- Microsoft's infringement does not inhibit z4's ability to market, sell, or license its patented technology to other entities in the market, because Microsoft does not compete directly with z4 in the market for digital rights management software.
- Microsoft used z4's technology as a component in its software bundle.
- z4 will not suffer lost profits.
- z4 will not suffer loss of brand name recognition.
- z4 will not suffer loss of market share.

Analysis of the First Factor: the facts weigh against the permanent patent injunction.

Factor 2: Inadequacy of Monetary Damages

z4 argued:

- monetary damages for Microsoft's future infringement are inadequate because they

cannot compensate z4 for the loss of the right to exclude.

The Court replied:

- eBay makes it clear that the right to exclude alone is insufficient to support a permanent patent injunction.
- z4's patented invention is a small component of Microsoft's infringing product.
- Some situations do exist where adequate relief can only be obtained by injunction (but not demonstrated by z4):
 - When an infringer saturates a market for a patented invention with an infringing product.
 - When an infringer damages the patent holder's good will.

Analysis of the Second Factor: the facts weigh against the permanent patent injunction.

Factor 3: Balance of Hardships

z4 argued:

- It will suffer hardship because Microsoft will be using its patents.
- Microsoft's hardship arguments in the event of a permanent patent injunction are unlikely and purely hypothetical.

The Court replied:

- Microsoft has demonstrated through testimony that it would face the hardship of enormous expense if it were forced to redesign Windows.
- Microsoft has shown that if its product activation servers were turned off, the market could be flooded with pirated software.
- Although Microsoft's arguments are hypothetical they are not out of the realm of possibility and in some instances quite likely.
- The potential hardships Microsoft could face given the permanent patent injunction outweigh any limited and irreparable hardships that z4 would suffer absent the injunction.

Analysis of the Third Factor: the facts weigh against the permanent patent injunction.

Factor 4: The Public Interest

z4 argued:

- No arguments were advanced.

The Court replied:

- Microsoft manufactures the world's most popular software products, creating public reliance.
- Microsoft has shown that its value chain is complex and the permanent patent injunction would affect everyone downstream negatively.

15. 2006 U.S. Dist. Lexis 40762 (2006).

- Deactivation of servers would negatively affect the public due to piracy.

Analysis of the Fourth Factor: the facts weigh against the permanent patent injunction.

Based upon the above analysis, the Court denied injunctive relief to z4. Microsoft's infringing operations, as determined by the trial court, continue unabated.

*Finisar Corp. v. The DirectTV Group*¹⁶

In this case, also tried in the Eastern District of Texas, the defendant DirectTV was found to be infringing seven claims of Finisar's U.S. Patent 5,404,505 (found valid by the jury). Using the four factor test, the Court determined Finisar would not be irreparably harmed without the injunction.¹⁷ During oral comments, the Court additionally rationalized that an injunction would effectively deny millions of DirectTV customers the access to news, weather and other information. Further, the Court reasoned that monetary awards determined by the jury seemed adequate. Hence a compulsory, per unit fixed royalty rate license was superimposed by the Court in a ruling dated July 7, 2006. Here, the Court's views superseded the wisdom of a free market licensing transaction.

The authors appreciate that plaintiff and patentee Finisar is a large corporate entity that cannot be described as an independent or under resourced inventor. This case is noteworthy, however, because it demonstrates how the eBay decision has compromised the inventor (Finisar's) ability to determine who can legally license their technology. Absent the legal certainty of an injunction or the credible threat thereof, DirectTV continues its unlicensed activity assured that in the end, the worse that could happen is a compulsory license. Note that the "public interest" that is disserved by the injunction exists in part because of the unlicensed, illicit use by DirectTV of the patentee's right to exclude. The same is true of Microsoft in the z4 case. Under this legal logic, why would any company worry about third party patent rights if the only downside is a compulsory license at a court determined rate of royalty? This suggests that the calculus of licensing negotiations has changed.

16. At: <http://www.fr.com/news/Finisar-Judgement.pdf> (accessed August 3, 2006).

17. At: http://www.fr.com/news/Finisar-v-Directv_Transcript1.pdf; http://www.fr.com/news/Finisar-v-Directv_Transcript2.pdf (accessed August 3, 2006).

Strategic Summary

The following table (Table 1) summarizes some of the factual arguments discussed above, and a few others, that could impact the four factor analysis.

Policy Implications

There are arguments for and against a rule that weaken the strength of permanent patent injunctions. Some arguments in favor of such a rule and in favor of the four factor test include:

- Some view this tactic as a hold up for extorting exorbitant licensing fees.¹⁸
- If the infringed patent is but a small component of the infringing product, money damages may be adequate.¹⁹
- Business method patents of potential vagueness and suspect validity can be discriminated against using the four factor test.²⁰
- Innovation may be inhibited if patent holders prevent others from practicing their inventions.

Some arguments against weakening the permanent patent injunction include:

- The right to exclude is explicitly stated in the Constitution²¹ and the Patent Act.²²
- Permanent patent injunctions were one of the few legal weapons inventors and smaller firms could rely upon to impede infringement by larger firms.
- Higher systematic legal uncertainty due to a few patents of "suspect validity" punishes all independent inventors and entrepreneurs alike.
- The general rule favoring permanent patent injunctions created the *ex ante* incentive to:
 - Settle before expensive, uncertain and protracted litigation.
 - Perform the due diligence whether one's activities would infringe existing patents and if so, approach the patent owner for a license or design around the technology.
- The four factor test allows the judiciary to craft compulsory licenses that usurp the wisdom of market mechanisms.
- A reasonable royalty standard will become more prevalent than arm's length negotiations.

18. As mentioned in the eBay concurrence authored by Justice Kennedy.

19. *Ibid.*

20. *Ibid.*

21. U.S. Constitution, Article I, Section 8, Clause 8.

22. 35 U.S.C. § 154(a)(1).

Table 1: Arguments that Impact the Four Factor Test

	Factual Arguments Favoring:	
	Patent Owner	Infringer
Factor 1: Irreparable Harm	<ul style="list-style-type: none"> • profits were negatively impacted (direct competition) • brand equity was negatively impacted • market share was negatively impacted • loss of an exclusive license (monopoly pricing) • loss of a cross license • the patented invention was not bundled by infringer 	<ul style="list-style-type: none"> • infringement did not detriment patent owner's profits (no direct competition) • infringement did not detriment patent owner's brand equity • infringement did not detriment patent owner's market share • infringement did not detriment patent owner's loss of an exclusive license (monopoly pricing) • infringement did not detriment patent owner's loss of a cross license • the infringer bundled the patented invention with other inventions
Factor 2: Inadequacy of Monetary Damages	<ul style="list-style-type: none"> • brand equity was negatively impacted • market share was negatively impacted • loss of an exclusive license (monopoly pricing) • loss of a cross license • the patented invention was not bundled by infringer 	<ul style="list-style-type: none"> • infringement did not detriment patent owner's brand equity • infringement did not detriment patent owner's market share • infringement did not detriment patent owner's loss of an exclusive license (monopoly pricing) • infringement did not detriment patent owner's loss of a cross license • the infringer bundled the patented invention with other inventions
Factor 3: Balance of Hardships	<ul style="list-style-type: none"> • the patented invention was not bundled by infringer • infringer's hardship arguments are not credible • low transaction costs to discontinue infringement • infringer is a downstream producer • infringer has a small share of a market 	<ul style="list-style-type: none"> • the infringer bundled the patented invention with other inventions • infringer's hardship arguments are credible • high transaction costs to discontinue infringement • infringer is an upstream producer • infringer has a large share of a market
Factor 4: The Public Interest	<ul style="list-style-type: none"> • infringer is a downstream producer • infringer has a small share of a market 	<ul style="list-style-type: none"> • infringer is an upstream producer • infringer has a large share of a market

The Longer Walk

The subject of economics and patent licensing was recently the focus of a workshop attended by leading academics and Nobel Laureates²³ from across the globe. Many scholarly papers were presented that used game theory and other modeling

23. 17th Annual Game Theory Conference at SUNY Stony Brook, July 16-18, 2006, at: <http://www.gtcenter.org/Start.php?page=Conference.html> (accessed July 31, 2006).

techniques to determine the most “logical” result of two or more parties involved in a negotiation for licensing a patented technology. It is interesting to note that all papers presented at this workshop assumed that non-licensed parties would be excluded from using the patented technology absent an appropriate license. The foundation behind the assumption is the legal certainty of the courts enforcing the permanent patent injunction. When queried about the effect of relaxing this assump-

tion, a conference presenter commented, “the economic models all break down.”

The four part test increases the level of legal uncertainty in the marketplace with respect to the licensing of patented inventions. There is strong evidence that higher legal uncertainty favors the resource rich entity. One recent law and economics study from Tel Aviv University School of Law shows that the shift from a legal certainty regime to a legal uncertainty regime transfers wealth from the resource poor to the resource rich.²⁴

The additional burden of the four factor test may further embolden the infringing, unlicensed activity that the patent is supposed to bar. Without strong, clearly defined patent rights, including the right to exclude by way of an injunction or the credible threat thereof, the resource rich company has the advantage. Absent the credible threat of “being unplugged,” the resource rich firm continues with their operations unabated by rulings with no teeth.

By requiring the patentee to satisfy a four part test to establish the need for an injunction, the Court has played into the hands of the resource rich. Now, satisfying patent infringement and validity attacks are not enough to realize the injunction. The patentee must expend more resources, despite the aggravation, lost time and financial

capital already expended, to attain their licensing goals. Further, the accused infringer now realizes that their opponent must climb a much higher mountain to meaningfully enforce their rights. It is not difficult to imagine the effect of this new standard on the independent inventor: to transform the difficult *long walk* into a proverbial death march.

An interesting case of resource rich behavior is Microsoft’s disposition in the face of a European antitrust order issued in 2004.²⁵ A \$400 million fine was recently assessed against the firm for failure to comply with that order.²⁶ Interestingly, neither the ruling, the initial fine, the daily fine of \$3 million per day, or any other conceivable remedy of the court has changed what is referred to as anti-competitive behavior.

Summary

Clearly defined patent injunctions are important legal remedies that put teeth into the mouth of the independent, often under-resourced inventor seeking to license their patent rights. Adding additional hurdles in the litigation path to successful licensing heightens the legal uncertainty of enforcement for all patentees. This increased uncertainty regressively discriminates against the independent inventor, the agent of innovation whose entrepreneurial risk taking we seek to motivate. ■

24. Uri Weiss, *The Regressive Effect of Legal Uncertainty*, Tel Aviv University Law Faculty Papers, available at: <http://law.bepress.com/taulwps/jp/art30> (accessed July 25, 2006).

25. Microsoft, COMP/C-3/37.792

26. Paul Meller & Steve Lohr, *Regulators Penalize Microsoft In Europe*, *The New York Times*, Thursday, July 13, 2006 at C1.