Non-Practicing Entities Beware: Federal Circuit Decision Opens Door for Bad Faith Penalties

By Daniel McDonald and Joseph Lee, Merchant & Gould P.C.

Legal entities that own patents but do not make products covered by these patents, commonly known as non-practicing entities (NPEs), or "patent trolls," have attracted much media attention in recent years, primarily due to their propensity for filing lawsuits against companies that actually produce products related to such patents. A frequent tactic by these NPEs is to leverage the high cost in time and money of defending against a patent lawsuit, and use it to extract settlements, or "licensing fees," from businesses that produce products.

In September 2011, as part of the America Invents Act, Congress ordered a study of the consequences of litigation by non-practicing entities on the economy, inventors, job creation, etc. Congress intends to use the study to determine what if any law changes are warranted. In the meantime the typical licensing "negotiations" with NPEs will often continue to follow this script:

> PATENT HOLDER: You infringe our patent. Pay us $100,000 to license it or we will sue.
> ALLEGED INFRINGER: Your patent does not cover our product and is invalid.
> PATENT HOLDER: It will likely cost you millions to defend against the lawsuit and the defense will disrupt your business. Pay us $100,000 or we will sue.

At this point, many businesses opt to pay up and avoid the lawsuit altogether. The high cost and burden of defending against a patent suit compared to the relatively low cost of "licensing" results in a situation where the merits of the lawsuit become almost irrelevant to the negotiations.

On July 29, 2011 the Federal Circuit issued an opinion addressing the situation where a NPE litigated in "bad faith" by exploiting the high cost of defending complex litigation to extract nuisance value settlements from defendants. *Eon-Net LP v. Flagstar Bancorp*, 2011 U.S. App. LEXIS 15650 (Fed. Cir. July 29, 2011)

In *Eon-Net v. Flagstar*, Eon-Net (the NPE) accused Flagstar of infringing its patents, which were directed to methods of processing information from documents. Eon-Net demanded that Flagstar pay it $75,000 for a license to practice the patented inventions. Flagstar explained that it did not practice the patent methods because it did not process information from documents – it instead processed information from a Website. Eon-Net argued that its patents were not limited to processing documents in hard copy form so Flagstar's method of processing information from Websites fell within the scope of its patents.

Flagstar refused to pay the licensing fee and fought the lawsuit. The claims were ultimately interpreted by the district court to only cover products that process information from documents that are in hard copy form (not Websites). The district court dismissed the infringement claims and awarded to Flagstar $489,000 to cover its attorney fees and legal costs, as well as $141,000 in sanctions against Eon-Net. The fees and sanctions were based on the district court's finding that Eon-Net suit was objectively baseless and that it had brought in bad faith.

The court found that the Eon-Net suit was objectively baseless even though Eon-Net's infringement position had some support. Eon-Net's infringement position was supported by the fact that the patent claims, which define the scope of the invention, were not on their face limited to processes that involved documents in hard copy form. The hard copy limitation was based on the text in the written description portion of the application. Moreover, an argument could be made that processing hard copy documents is equivalent to processing electronic documents. The Court finding that Eon-Net's suit was objectively baseless suggests that the claim needs to pass more that the straight-face test. Being able to make an argument that the accused product infringes is not enough to avoid a finding that the lawsuit is objectively baseless; the argument also must be sound.

The court found that Eon-Net brought the lawsuit in bad faith largely because the suit was brought to extract a nuisance value settlement by exploiting the high cost imposed on Flagstar to defend against Eon-Net's claims. In deciding that the lawsuit was brought in bad faith the court noted a number of characteristics of the lawsuit that are typical of suits brought by NPEs:

- Eon-Net had filed nearly identical patent infringement complaints against a plethora of diverse defendants and each time it demanded a quick settlement for a price far lower than the cost to defend the lawsuit;
- Eon-Net has the ability to impose disproportionate discovery costs on Flagstar because it did not itself practice the invention;
- Eon-Net placed little at risk when filing the suit because it was not exposed to counterclaims since it is not a competitor of Flagstar.

The above factors, which are characteristic of NPE litigation, weighed in favor of the court's finding that the suit was brought in bad faith. The opinion suggests that the Federal Circuit considers an underlining business strategy of many NPEs, which is to leverage the high cost of patent litigation to extract settlements, as constituting evidence of bad faith.

In traditional litigation between competitors, an award of attorney fees to the prevailing party is very unlikely even when the merits of the lawsuit are weak and the case is dismissed before trial. This case suggests that when a non-practicing entity brings a weak patent case against a defendant, there is a decent chance that the NPE could be ordered to pay the defendant's attorney fees and costs because a finding of bad faith is much more likely.

Flagstar took a significant financial risk when it spent nearly $500,000 to avoid paying $75,000. The strategy worked, as Flagstar's decision to fight a meritless claim eventually allowed it to recoup its fees and more. More importantly, the company has sent a message to other NPEs that will benefit it for years to come. And perhaps most important of all, NPEs in general should look at this decision as a warning that there are risks and consequences to bringing meritless cases.

Daniel McDonald is a Partner and trial attorney with Merchant & Gould in Minneapolis. Dan has won trials, secured expedited relief, and succeeded in securing multi-million dollar awards for his clients. He has represented clients in cases involving a broad spectrum of technologies, from software, digital imaging, telecommunications and electronics to apparel, aerospace, printing, and materials handling. He

has obtained an "exceptional" case finding after trying a patent case to verdict, obtaining attorneys' fees and punitive damages affirmed on appeal. Dan's practice areas include: Patent litigation, copyright litigation, trademark/trade dress litigation and trade secret litigation with an emphasis on electronics, software, and Internet issues. Dan serves as chair of Merchant & Gould's Litigation Practice Group. He may be reached at 612-332-5300 or dmcdonald@merchantgould.com.

Joe Lee is Of Counsel with Merchant & Gould in Minneapolis. Joe's practice focuses on patent related matters including both patent litigation and patent prosecution. His litigation experiences include developing and implementing litigation strategies, drafting and arguing motions, preparing pleadings, coordinating discovery, and conducting infringement, validity, and enforceability analyses. Joe's transactional and prosecution related experiences include preparing patent applications, preparing responses to Office Actions, conducting examiner interviews, preparing appeal briefs, analyzing patentability and clearance issues, and general intellectual property counseling. Joe uses his litigation expertise in the preparation and prosecution of patents that can be licensed or otherwise enforced. Through his transactional and prosecution practice, Joe has developed an in-depth and practical understanding of the patent laws, rules, and United States Patent Office procedures, which he routinely employs in patent litigation. Joe may be reached at 612-332-5300 or jlee@merchantgould.com.