Expanding the Customer Suit Exception in Patent Law

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"First to File" Rule

- "First to File" allows a federal district court to transfer, stay, or dismiss an action when a similar complaint has already been filed in another federal court."
  - *Alltrade, Inc. v. Uniweld Products, Inc.*, 946 F. 2d 622, 623 (9th Cir. 1991).

- "While the first-filed rule may ordinarily be a prudent one, it is only because it is sometimes more important that there be a rule than that the rule be particularly sound."
  - *Codex Corp. v. Milgo Electronic Corp.*, 553 F.2d 735, 737 (1st Cir. 1977)

"Customer Suit" Exception

- A later filed patent case against (or by) the manufacturer of an allegedly infringing product takes precedence over an earlier filed suit against customers of the manufacturer.
  - *Pragmatus Telecom, LLC v. Advanced Store Company, CA No. 12-088-RGA (July 10, 2012)*
- Courts stay the earlier filed patent case against the customer so that the later-filed case involving the manufacturer proceeds in a different forum than the customer case.
  - *Katz v. Lear Siegler*, 909 F.2d 1459, 1464 (Fed. Cir. 1990)

Rationale

- Manufacturer is the "true defendant in a customer suit" since it "must protect customers, either as a matter of contract, or good business, in order to avoid the damaging impact of an adverse ruling against its products."
- Manufacturer has a greater interest in defending patent claims than an individual customer, who may be more concerned with reducing the litigation costs than litigating the merits of the patent case.
  - *Katz v. Lear Siegler*, 909 F.2d 1459, 1464 (Fed. Cir. 1990)
  - *Kahn v. General Motors Corp.*, 889 F.2d 1078, 1081 (Fed. Cir. 1989)
  - *Delamere Company v. Taylor-Bell Co., Inc.*, 199 F.Supp. 55, 57 (S.D.N.Y. 1961)

"True" Defendant: Legal

1. Resolution of the manufacturer case is more likely than the customer case to resolve dispute regarding accused technology.
2. Manufacturer case will result in collateral estoppel and/or res judicata against (1) patent holder or (2) manufacturer and (potentially) manufacturer customers (party and non-party).
3. In contrast, the customer case will not result in collateral estoppel or res judicata against manufacturer or non-parties (i.e., other customers).

"True" Defendant: Reality

1. Manufacturers make long term investments in the accused technology.
2. Manufacturers focus on current and future products that incorporate the accused technology.
3. As a result of its investments, manufacturers build engineering departments with deep technical expertise in the field of the patent and management teams that are well-versed in the economics associated with their products.

"True" Defendant: Reality

4. Manufacturer possesses incentives and greater capability to (1) vigorously litigate the case on the merits and/or (2) negotiate settlement consistent with the actual value of the patented technology and the financial realities of businesses in the field of the invention.
5. In contrast, customers have not invested in the accused technology and are focused on minimizing the cost and disruption associated with litigation.

"True" Defendant: Merits

1. Non-Infringement: Manufacturer possesses detailed knowledge of accused product. Best position to generate non-infringement arguments and create "design around" options to the asserted patent.
2. Invalidity: Manufacturer often has engineers who have worked in the field of invention for substantial period of time. As a result, manufacturer in best position to identify prior art to invalidate patent.

"True" Defendant: Merits

3. Damages: Manufacturer understands the economics of the accused technology and is in best position to assess the alleged value of the patented feature.
4. Manufacturer in a better position to attack patent holder attempt to apply "entire market" rule to the calculation of a "reasonable royalty."
5. Manufacturer in a better position to "apportion" value of non-patented and patented features.

Courts Unduly Restrict Exception

- Courts restrict the "customer suit exception" to situations that "advance" judicial economy.
- Namely, courts limit the customer suit exception to situations where two conditions are met: (1) manufacture is responsible for 100% of the accused products and (2) the manufacturer suit would substantially resolve the first filed litigation against the patent holder and the customer.

Non-Practicing Entities ("NPE")

- NPE cases are increasing over time.
  - 22% of patent cases from 2000-2001
  - 36% of patent cases from 2006-2008
  - Colleen Chien, *Of Trolls, Davids, Goliaths, and Kings: Narratives and Evidence in the Litigation of High-Tech Patents*, 887 N.C.L. Rev. 1571, 1572 (2008-2009)
- NPEs typically assert multiple patents where each patent has been issued for 8+ years.
- NPEs often sue multiple defendants in the same litigation (or simultaneously).

Non-Practicing Entities ("NPE")

- Current system rewards NPEs for not manufacturing or selling products.
  - NPEs are immune to patent counterclaims.
  - Other than legal expenses, "downside" risk of patent litigation are disproportionately borne by defendants.
  - NPEs minimize legal expenses through "contingency" fee plaintiffs' bar.
- NPEs exploit the inefficiencies and costs of the patent system to generate revenue from defendants.
- NPEs obtain a premium on weak patents.

Non-Practicing Entities ("NPE")

- NPEs choose customer defendants over manufacturers because a customer defendant is typically a one-time player with no incentive to help its manufacturer or stop the NPE.
- NPEs recognize that – independent of the merits of the case – most customers will take the option that costs them the least.
- Generally, a settlement is priced less than expected cost of litigation.

Customer: Economics of Litigation

EC = P*DM + CD

- Expected Cost of Litigation (EC)
- Probability of Patent Holder Success (P)
- Expected Damages Amount if Patent Holder Successful (DM)
- Cost of Defense (CD)

Customer: Economics of Litigation

- From the stand point of a one-time defendant such as a customer, it is rational to settle a case where the settlement amount ("SA") is less than expected cost of litigation ("EC")

SA < EC

Customer: Economics of Litigation

EC = P*DM + CD

- No Merits. P= Zero (0).

EC = CD
SA < CD

- Even where patent holder has **no chance of success**, the customer is incentivized to pay money to patent holder.
- Overpayment to NPEs for weak patents.

Customer: Economics of Litigation

Cost of Defense

- Patent Litigation $1-$25M in Dispute
  - End of Discovery: $1.5 Million
  - Inclusive of All Costs: $2.5 Million
- Patent Litigation More Than $25 Million In Dispute
  - End of Discovery: $3 Million
  - Inclusive of All Costs: $5.5 Million
- AIPLA Report of the Economic Survey (2009)

Manufacturer

- Manufacturer more likely to take broader view relating to the impact of litigation than customer.
- Manufacturer more likely to focus on:
  1. Current and future population of customers
  2. Current and future products that use the accused technology
  3. Manufacturers competitors and impact on competition
  4. “Design Around” options
  5. “Royalty Stacking” and impact on profitability

Manufacturer: Economics of Litigation

$$EC = P*DM + CD - (1-P)*B$$

- Expected Cost of Litigation (EC)
- Probability of Patent Holder Success (P)
- Expected Damages Amount if Patent Holder Successful (DM)
- Cost of Defense (CD)
- Benefit of Litigation (B)

Manufacturer: Economics of Litigation

$$EC = P*DM + CD - (1-P)*B$$

- No Merits. P= Zero (0).

$$EC = CD - B$$

$$SA < (CD - B)$$

- For manufacturers, the benefits of litigation could exceed the cost of defense. As a result, there may be no incentive to pay patent holder.

Manufacturer: Benefits of Litigation

- Manufacturer can obtain a number of benefits from litigation including:
  - Claim Construction Order
    - Non-Infringement
    - Road Map for "Design Around." Eliminate future patent exposure.
  - Protection of other customers. Reduce exposure to additional indemnification and indemnification claims (e.g., limits CD to a single case).
  - Negotiate Licensing Terms Consistent with Manufacturer Economics

Manufacturer: Benefits of Litigation

- Patent settlement / licensing offers are often priced in the following manner:

SO = RR * PS * D

- SO = Settlement Offer
- RR = Royalty Rate
- PS = Projected Sales of "Infringing" Products From Notice of Infringement to Patent Expiration
- D = Settlement / Time Discount

Manufacturer: Benefits of Litigation

- "Design Around" can substantially reduce projected sales and the time period for potentially infringing sales.
- For a patent with 7 years of potential damages from filing of lawsuit, a "design around" implemented 2 years from the filing of the complaint would eliminate 5 years of potential damages.

$$B = (PS-PSD) * RR * D$$

$$\mathbf{SO = RR * PSD * D}$$

- PSD = Projected Sales of "Infringing" Products From Notice of Infringement to Implementation of Design Around Expiration

Manufacturer: Economics of Litigation

$$EC = P*DM + CD - (1-P)*B$$

- No Merits. P= Zero (0).

$$EC = CD - B$$

$$SA < (CD - B)$$

- Where **B > CD**, manufacturer has little or no incentive to pay NPE for weak patents.

New Test for "Customer Suit" Exception

- Is the manufacturer in the later filed case "the true defendant in patent case filed against customer?"
- Three-Factors to Consider:
  - Does manufacturer have duty to defend and indemnify customer?
  - Does the product supplied by manufacturer to the customer (directly or indirectly) "substantially embody" the accused features of the allegedly infringing customer product?
  - Is the manufacturer case likely to resolve the liability issues with respect to an asserted patent and manufacturer's product?

New Test for "Customer Suit" Exception

- The test for "substantially embodies" the accused features of the customer product analogous to some of the inquiries made in the context of contributory infringement.

- The part of customer product not provided by the manufacturer cannot result in elimination of manufacturer's indemnification obligations to customer.

New Test for "Customer Suit" Exception

- No requirement in new test to completely resolve customer suit. The test is applied on a patent-by-patent basis.

- No requirement in eliminate patent claims with respect to all the customer defendants.