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Patent Reform And The New Insurance Market That May Follow

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Congress is set to resume deliberating proposed patent reform legislation intended to curb the filing of questionable patent lawsuits. Prior to the summer recess, the Innovation Act of 2015 (H.R. 9) and the Protecting American Talent and Entrepreneurship ("PATENT") Act of 2015 (S. 1137) passed the House and Senate Judiciary Committees, respectively, but neither made it to a floor vote. Both bills ostensibly are aimed at so-called "patent trolls," and include everything from raising pleading standards for patent suits and putting limits on discovery to allowing defendants to force real-parties-in-interest into litigation.

Arguably the most controversial provisions, however, are the proposed fee-shifting terms, known as "loser-pays." The proposed legislation would replace the traditional "American rule" — where each party pays its own fees absent exceptional circumstances — with an English-style loser-pays rule that requires the losing party in patent litigation to pay the winning side's reasonable attorneys' fees and costs. Now that Congress is back in session, it remains to be seen whether the full House of Representatives and Senate will pick up and pass the legislation. We first explore the proposed loser-pays provisions, and then examine the legal expense insurance market that emerged in England's system as a result of loser-pays, and which could soon be imported here.

Is "Loser-Pays" Coming to a Court Near You ... or Is it Already Here?

Title 35 U.S.C. § 285 currently provides that "[t]he court in exceptional cases may award reasonable attorney fees to the prevailing party." Both the Innovation Act and the PATENT Act would modify § 285 to make explicit the circumstances under which fee-shifting is appropriate.

"Loser-Pays" in the Innovation Act

The Innovation Act, if passed, would modify § 285 to mandate that the losing party in patent cases pay the prevailing party's "reasonable" attorneys' fees and costs, with a possible waiver of fee-shifting based on subjective criteria i.e. the court finds that plaintiff's positions were "reasonably justified in law and fact," or "special circumstances [would] make fee-shifting unjust."[1] Thus, the presumption would be that the losing party must pay the prevailing party's reasonable fees and costs, and the burden would be on the non-prevailing party to show otherwise. Such fee-shifting provisions would retroactively apply to cases pending for less than six months prior to the date of enactment.[2]

"Loser-Pays" in the PATENT Act

In contrast to the Innovation Act, the proposed loser-pays provision in the PATENT Act would modify § 285 to require courts to determine, upon motion, whether a non-prevailing party's position and conduct is "objectively reasonable in law and fact"; thus, there is no presumption of recovery of attorney fees to the prevailing party.[3] Further, under the PATENT Act, if a non-prevailing party's position and/or conduct is not "objectively reasonable," the court would be able to award "reasonable attorney's fees," absent special circumstances making an award unjust.[4] What's more, it would be the prevailing party's burden to demonstrate entitlement to an award of attorneys' fees.[5]

Octane Fitness/Highmark Interpretations Are Consistent with the Proposed PATENT Act

In many ways, the loser-pays provision in the proposed PATENT Act is consistent with the U.S. Supreme Court's recent decisions in Octane Fitness[6] and Highmark,[7] applying § 285 as it currently stands. In these cases, the Supreme Court lowered the "objectively baseless" and "subjective bad faith" threshold for fee-shifting. In so doing, the court gave district courts greater discretion to award fees by reinstating a preponderance of the evidence standard wherein the "totality of circumstances" based on the losing party's conduct and substantive litigation positions makes the case "stand out from others."

Indeed, courts are applying Octane Fitness/Highmark in a manner that is consistent with the loser-pays provision proposed in the PATENT Act. The Federal Circuit recently affirmed a decision ordering a plaintiff to pay NetApp \$1.4m in fees for filing a "reckless and wasteful" and "impossible" computer storage patent infringement suit, despite voluntary dismissal, since NetApp was already licensed.[8] In another decision, that court held a district court "did not abuse its discretion in finding the case 'exceptional'" based on plaintiff's repeated failure to introduce admissible evidence of infringement, and its filing of unsolicited briefs and multiple meritless motions for reconsideration.[9]

Is Loser-Pays a Winning Proposition for Curbing Abusive Nonpracticing Entity Litigation?

According to proponents of the English-type loser-pays provisions in the pending bills, patentees presently have an undue advantage under the traditional American rule. Because accused infringers often face higher fees and costs of litigation, the American rule arguably drives wrongly accused parties to settle meritless suits, especially when settlement will cost less than the total cost required to defend the case. These proponents argue that such low-merit legal cases clog the U.S. legal system and raise the cost of goods and services to consumers because businesses that are sued must pass their legal costs on to consumers.

According to opponents of loser-pays provisions, such a rule in U.S. patent litigation would deter legitimate activity and stifle innovation. Some argue that loser-pays provisions greatly reduce judicial access for small litigants because of the outsized risk of a loss in court. A small entity holding a strong patent enforcement right or facing a weak allegation of infringement may nevertheless be unwilling to

engage in legitimate patent enforcement or defense, or exercise its right to operate, because of the risk of having to pay the opposing side's legal fees in the event of a loss.[10] For example, loser-pays creates impediments for many contingency fee arrangements ("CFAs") over legitimate patent suits because there is a disincentive for plaintiffs' lawyers to take on close or difficult cases that might otherwise be acceptable, but for the threat of loser-pays. Often, without such arrangements, the cost to file suit becomes impractical for small businesses. Further, opponents argue that recent Supreme Court decisions such as Octane Fitness have dramatically changed the landscape by making it easier for courts to award fees against losing patent litigants, thus eliminating the need for the proposed reform.[11]

The Market for LEI in "Loser-Pays" Systems

While stakeholders on both sides of the loser-pays debate raise legitimate concerns, there is no dispute that a new loser-pays regime will result in collateral changes to the existing patent litigation system. One possible example is the emergence of a legal expense insurance ("LEI") market to address the increased consequences of a loss in patent litigation. LEI policies are specialized insurance policies designed to protect the policyholder against the potential costs and fees involved in legal action brought by or against that policyholder.

In England, where loser-pays fee-shifting is already the default — not just in patent litigation, but in all civil litigation — LEI policies are available to insure litigants for attorneys' fees in the event of a courtroom loss.[12] That is, to address concerns that loser-pays reduces access to the judicial system and discourages innovation and assertion of legitimate rights, England has made available a combination of LEI and public-funded legal aid programs that insure against the risk of a legitimate claims' loss, such as that of an intellectual property plaintiff or defendant.[13] The introduction of a loser-pays rule in the U.S. — or even an increase in fee-shifting under Octane Fitness — may similarly create a market for patent-infringement LEI, like the broader, general LEI market for all civil litigation that exists in England.

LEI in England as a "Laboratory" for the U.S. Market

LEI typically takes two common forms in loser-pays jurisdictions — traditional aka "before-the-event," and "after-the-event." Before-the-event (BTE) policies are typically taken out by those wishing to protect themselves against potential litigation costs that could be incurred following a hypothetical future event. After-the-event (ATE) policies are usually obtained after a lawsuit has been filed by those that do not have existing BTE policies. The policy rationale underlying both these forms of insurance is twofold: (1) incentivize prosecution of those cases with real merit and spread the risk of losing such cases across all insured-litigants; and (2) discourage either frivolous cases or those with little or no merit by charging relatively higher premiums or denying coverage under carefully underwritten policies.

In traditional or BTE LEI, the insurer generally charges a premium periodically and any legal expenses of either a future plaintiff or defendant of litigation are covered.[14] In England, BTE LEI is a common add-on to domestic homeowner's or automobile insurance policies, as well as directors' and officers' policies. Typically in England, BTE covers the offense or defense of personal injury claims, employment, or consumer-related disputes and certain property-related claims, including intellectual property. BTE policies pay the legal expenses of suits either initiated or brought against the covered party, assuming that the insurance company deems the insured-party's legal position(s) to have merit.[15] These policies also cover the risk of an adverse fee award, up to a certain limit.[16] The cost of traditional LEI usually is relatively modest, and coverage includes the hourly fees the insured-party owes its attorneys (unless the insured-party wins and the opposing party pays), thus eliminating the need to hire attorneys on a contingency basis.

In ATE LEI, a party claiming or defending against an alleged injury seeks coverage after the "harm" has occurred.[17] For particularly weak claims or defenses, the party may not be able to obtain ATE coverage, discouraging frivolous allegations. ATE policies relieve the insured-party of the obligation to pay its own costs as well as adversaries' fees out of pocket if the insured-party is unsuccessful in the lawsuit, and often provide protection against adverse cost orders.[18] In England, these policies are most often taken out by contingency-fee plaintiffs' attorneys on behalf of their clients, and can be a requirement of the client-engagement so that costs are covered if the case is lost.[19] In such a scenario, ATE policy premiums are typically either advanced by the plaintiffs' lawyer as recoverable costs from the losing party, calculated as a percentage of the total costs incurred at the date a claim is concluded (e.g., via settlement or court verdict), or in exchange for a percentage stake in the total recovery. Although premiums in ATE policies can be high, they are usually "contingent-upon-success" (i.e., deferred) and only become payable when the litigation concludes. Thus, if the insured is ultimately unsuccessful, there is no premium to pay, and the insurance kicks in to cover the cost of the premium itself as well as any adverse costs.[20] But if the insured is successful, the premium is often recoverable from the losing party.[21]

The LEI market in England is exemplary when assessing whether fee-shifting under either the proposed legislation or the Octane Fitness jurisprudence will result in a demand for patent infringement LEI. Policy changes in England show that insurers are quick to respond by filling in the gap for needed products. [22] For instance, in the '90s, British Parliament legalized CFAs for all IP and civil proceedings, except family law. [23] At the same time, Parliament phased out public- and union-funded legal aid for personal injury plaintiffs, effectively privatizing personal injury litigation. [24] Insurers quickly moved to fill this gap by introducing ATE policies, which plaintiffs could obtain to fund their litigation and mitigate the risk of a loss. [25] In 2003, ATE constituted about 29 percent of the larger LEI market in the U.K. and collected approximately £110 million in premiums. [26] By 2008, ATE insurance was purchased for three in four lawsuits filed under CFAs. [27] The rapid growth of the ATE market in England informs U.S. patent practitioners that if a default loser-pays rule is adopted in patent litigation in the U.S., LEI is a mechanism for ensuring continued access to U.S. courts.

Takeaways

If the proposed Innovation Act version of the loser-pays provision is adopted, fee-shifting would become the default rule in U.S. patent litigation, always awarding the prevailing party reasonable fees and expenses, unless the losing party's position and conduct is "reasonably justified" or "special circumstances make an award unjust." The proposed PATENT Act provision does not go so far as to make fee-shifting mandatory; it merely puts the burden on the winning party to argue on motion that the losing party's position was not "objectively reasonable" in law and fact. This is not so different from the Octane Fitness jurisprudence, making the PATENT Act's loser-pays provision look redundant.

The question lies — in light of Octane Fitness and its progeny, are loser-pays provisions in the Innovation and PATENT Act bill proposals necessary? It remains to be seen whether Congress will pass some form of loser-pays provision into law despite Octane Fitness. In any event, if fee-shifting becomes the norm — either through legislation or in the wake of Octane Fitness — it is not clear whether currently existing specialized IP coverage is equipped to address "loser-pays" scenarios in patent litigation. Should Congress adopt loser-pays, the U.K. model demonstrates that a market for LEI could rapidly emerge in the U.S.

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- [1] See H.R. 9 Amendment to 35 U.S.C. § 285(c)(3), Report No. 114–235, Union Calendar No. 177, 114th Congress 1st Session (reported in House on 7/29/15).
- [2] Id.
- [3] See S. 1137 Amendment to 35 U.S.C. § 285(a), Calendar No. 203, 114th Congress 1st Session (reported to Senate on 9/8/15).
- [4] Id.
- [5] Id.
- [6] Octane Fitness, LLC v. Icon Health & Fitness, Inc., 134 S. Ct. 1749 (2014).
- [7] Highmark Inc. v. Allcare Health Management System, Inc., 134 S. Ct. 1744 (2014).
- [8] Summit Data Systems LLC v. NetApp Inc., No. 15-1103, --- Fed. Appx. ---, 2015 WL 5894214 (Fed. Cir. Oct. 9, 2015).
- [9] Homeland Housewares, LLC v. Sorensen Research & Dev. Trust, 581 Fed. Appx. 877, 881 (Fed. Cir. 2014).
- [10] See J. F. Vargo, The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice, 42 Am. U. L. Rev. 1567, 1609-10 (1993).
- [11] On July 15, 2015, two members of the House of Representatives (Reps. Deutch, D-Fla. and Bass, D-Calif) who supported a prior iteration of the Innovation Act, switched sides and urged Congress to vote against a new version of the bill. Further, Sens. Coons, D-Del., Vitter, R-La. and six House members criticized the Innovation Act, claiming the proposed legislation's effects "overreach[]" the issue of patent trolls and "would cause significant harm to small inventors who have disruptive technologies that would be taking on big established interests."
- [12] See N. Rickman, P. Fenn & A. Gray, The Reform of Legal Aid in England and Wales, 20 Fiscal Stud. 261, 262 (1999).
- [13] See M. Gryphon, Assessing The Effects of a "Loser Pays" Rule on the American Legal System: An Economic Analysis and Proposal for Reform, Rutgers Journal of Law & Public Policy, Vol. 8:3 at Part V, pp. 602-603 (Spring 2011).
- [14] BTE policies are different from specialized IP policies. While specialized IP policies can cover the insured's damages liability, legal fees, and costs involved in bringing or defending against IP infringement lawsuits, BTE policies typically cover legal fees and costs (but not damages awards) of both

the insured and the opposing party if the insured loses. See K. Sabharwal, N. Desai and K. Thakker, The Interplay Between Advertising Injury Insurance and IP, Law360 (Aug. 12, 2015) at pp. 5, 6 n.3.

- [15] See A. Heyes, N. Rickman & D. Tzavara, 24 Int'l Rev. L. & Econ. 107, 108 (2004).
- [16] See J. Robins, Can the Insurance Industry Plug the Justice Gap?, Legal Action, Jan. 2009, at 10.
- [17] See M. Gryphon, supra, at Part V, p. 604.
- [18] Id.
- [19] See, e.g., "CFAs / ATE Insurance" blog, Herbert Smith Freehills Dispute Resolution (Nov. 10, 2014), available at: http://hsfnotes.com/litigation/jackson-reforms/conditional-fee-agreements-cfas-after-the-event-ate-insurance/
- [20] The insurer's financial risk is often mitigated by reinsurance.
- [21] In England, as long as the ATE policy incepted before April 1, 2013, then such premiums are usually recoverable in whole or in part by the successful party as an award of "costs" from the losing party. See, e.g., § 58C(1) Courts and Legal Services Act 1990, inserted by §§ 44, 46(1) Legal Aid, Sentencing and Punishment of Offenders Act 2013. In contrast, the cost of BTE insurance is never recoverable as part of an award of costs. Id. The losing party can challenge the level of the ATE policy premium if it does not consider it to be "reasonable" or "proportionate." See K. Hayward, "Recovering ATE Premiums Case Law," Victory Legal Costs Solicitors, available at:

https://www.victorylegal.co.uk/PDF/Recovering%20ATE%20premiums%20-%20case%20law.pdf. But, courts are usually reluctant to interfere with the pricing of ATE premiums. Id.

- [22] See generally M. Gryphon, supra, at Part V, pp. 602-607.
- [23] See A. Walters & J. Peysner, Event-Triggered Financing of Civil Claims: Lawyers, Insurers and the Common Law, 8 Nottingham L.J. 1, 8 (1999).
- [24] White Paper from the Office of the Lord High Chancellor, "Modernising Justice" 22 §§ 2.35-2.43 (1998), at 24 § 2.43.
- [25] See, e.g., After the Event Insurance (ATE Insurance), THE JUDGE, http://www.thejudge.co.uk/after-the-event-insurance.
- [26] See Office of Fair Trading, The UK Liability Insurance Market: A Follow-up to the OFT's 2003 Market Study 34 §5.8 (2005), available at:

http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oft/report s/financial_products/oft802.pdf.

[27] See K. Dowell, False Economy, The Lawyer (Feb. 18, 2008).

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