



INTELLECTUAL PROPERTY NEWSLETTER

- 9th EDITION -

Another year has passed and this is reason enough to distribute the 9th TerraLex Intellectual Property Newsletter. I wish to thank all authors who contributed to this edition and special thanks go to my secretary Tina Goede for melting different formats and fonts from all over the world into one document with everlasting patience.

We will continue to distribute the TerraLex IP-Newsletter by email to all TerraLex member firms and on the TerraLex Website. As with the prior editions, please do print copies and make them available, whether electronically or in print, to your colleagues and clients.

The 9th edition of our Newsletter has brought 27 articles covering legal issues from 12 jurisdictions (plus 10 different state law jurisdictions in the U.S.). This amount initiated the idea of using this tool twice a year to distribute our knowledge among the network's firms and their clients, also in order to be more current on new developments.

This year's articles again describe developments in the full scope of intellectual property law, such as patent law, design protection, trademark law and unfair competition which do affect our daily business when counseling clients in IP-matters.

As indicated above next time you will hear from me sooner in order to bring the 10th edition of the TerraLex IP Newsletter in October of this year. If you have any comments or suggestions, please contact me. If you find a topic interesting enough for it to be published later this year, feel free to send in your submission at any time from now on. We think that any case notes of interesting decisions in your jurisdiction would be very appropriate for our newsletter. A single page may do.

Let's keep up the good work!

Wolfgang Leip

TerraLex Intellectual Property Practice Group
Frankfurt am Main, April 2004

Erroneous Small Entity Designation Can Jeopardize Patent Rights

By Todd E. Garabedian, Ph. D.
Wiggin & Dana LLP – Hartford, Connecticut

The U.S. Patent Office permits individuals, nonprofit organizations, and small business concerns to pay reduced fees during prosecution and maintenance of U.S. patents and patent applications if they claim status as a “Small Entity”. However, a U.S. court recently articulated the consequences of improperly claiming small entity status. In Ulead Systems, Inc. v. Lex Computer Management Corp. (351 F.3d 1120 (Fed. Cir. December 9, 2003)), the U.S. Court of Appeals for the Federal Circuit vacated the decision of the U.S. District Court granting summary judgment that U.S. Patent No. 4,538,188 was unenforceable and expired because Lex falsely claimed “Small Entity status” and paid small entity maintenance fees. This case highlights the importance of making thorough and continuing investigations into whether a patent applicant or patentee is qualified for Small Entity status for purposes of fee payments to the U.S. Patent Office.

In 1980, the United States Congress amended the U.S. patent laws to require for the first time the payment of periodic maintenance fees to maintain the life of a patent. Further amendments in 1982 imposed substantial increases in filing, processing, maintenance, and issue fees. Concerned that this new legislation would be overly burdensome to individuals, non-profit organizations, and smaller businesses, the U.S. Congress provided a discount of 50% for “Small Entities”, and the U.S. Patent and Trademark Office (USPTO) adopted rules now codified at 37 CFR §§ 1.27 and 1.28. The USPTO rules define a “Small Entity” as an independent inventor, a non-profit organization, or a “small business concern”. A “small business concern” is further defined in accordance with the definition used by the Small Business Administration (SBA), and states that:

a small business concern for purposes of paying reduced fees ...

to the Patent and Trademark Office means any business concern (1) whose number of employees, including those of its affiliates, does not exceed 500 persons, and (2) which has not assigned, granted, conveyed or licensed, and is under no obligation under contract or law to assign, grant, convey, or license any rights in the invention to any person who could not be classified as an independent inventor ... or to any concern which would not qualify as a small business concern or a nonprofit organization under this section. (13 CFR §121).

In the Ulead decision, it was undisputed that Lex Computer Management (“Lex”) never had more than 20 employees and qualified as a small entity when it acquired the ‘188 patent and paid the first maintenance fee at the reduced rate in 1988. However in 1993, Lex granted a non-exclusive license to Adobe Systems Inc., a company with more than 500 employees, and later granted non-exclusive licenses to at least two more large entities. Later in 1993, and again in 1998, Lex paid maintenance fees on the ‘188 patent at the reduced rates.

In 1998, Ulead filed a Declaratory Judgment action alleging that the ‘188 patent is unenforceable, invalid, and/or expired. Ulead’s grounds for these allegations were (1) that the ‘188 patent is unenforceable and/or invalid because of Lex’s misrepresentation of small entity status to the USPTO, and (2) that the ‘188 patent had expired because Lex failed to pay the correct maintenance fees and did not pay the incorrect small entity fee in “good faith” as required by the USPTO regulations. Lex acknowledged that it was not entitled to claim small entity status at the time it paid its second and third maintenance fees, and immediately petitioned the USPTO to accept the balance of the deficiency owed on

the maintenance fees. The USPTO granted that petition and accepted payment. Lex then opposed the Ulead's action on the ground that it did not intend to mislead the USPTO to believe it was entitled to small entity status, and that the patent was not expired because the USPTO had properly excused its erroneous claim to small entity status and underpayment of fees. However, the district court held that the patent was unenforceable because Lex had committed inequitable conduct in misrepresenting its small entity status, and that it had intent to deceive the USPTO. The district court also held that the patent had expired due to failure to pay the full maintenance fees. The court's findings of inequitable conduct and bad faith dealings also resulted in an award of attorney's fees and costs to Ulead in the amount of \$470,000. Lex appealed to the Court of Appeals for the Federal Circuit (CAFC).

The CAFC began its analysis by reviewing the elements of inequitable conduct. The court stated that

[u]nder our precedent, inequitable conduct that renders a patent unenforceable arises when there is evidence of affirmative misrepresentation of a material fact, failure to disclose material information, or submission of false material information, coupled with an intent to deceive.

The court first noted that historically issues of unenforceability have arisen in cases involving inequitable conduct occurring in the prosecution of patents. The court then announced:

But, we see no reason why the doctrine should not extend into other contexts, like the present one, where the allegation is that inequitable conduct has occurred after the patent has issued and during the course of establishing and paying the appropriate maintenance fee. In this context, it is equally important that the PTO receive accurate information from those who practice before it.

Turning first to the materiality element of the inequitable conduct analysis, the Court stated that there was no serious question regarding materiality. The court concluded

that Ulead established at least a threshold level of materiality because Lex's misrepresentation of its small entity status was material to the USPTO's acceptance of reduced maintenance fees and, by extension, survival of the patent. However, the Court found the element of intent to be in dispute. The court found that although Lex admitted that it was not entitled to small entity status when it filed its affidavit of small entity status and paid reduced fees, these were innocent errors, that it was grossly negligent at worst, and that it did not have an intent to deceive the USPTO.

With respect to Ulead's assertion that the '185 patent had expired for Lex's failure to pay the proper maintenance fee, the Court stated "the question here is whether Lex committed inequitable conduct by knowingly misrepresenting that it was entitled to have the error excused." The Court added:

To be sure, if the patentee makes a request to correct incorrect payment of fees as a small entity knowing that it does not satisfy the good faith error standard ... the patentee may be found to have engaged in inequitable conduct.

The court concluded that the issue of whether the '188 patent was expired for failure to pay the proper maintenance fee should be resolved by the district court, especially on the issue of intent as it relates to whether Lex acted in ad faith when it initially asserted small entity status.

Lessons from Ulead

Under the rules of the U.S. Patent Office, a party may qualify for "small entity" status and pay reduced fees if it is an individual, a nonprofit organization, or a small business concern. For an individual to qualify for small entity status, that individual must not have assigned, granted, conveyed, or licensed the rights in the invention, or be under an obligation to assign, grant, convey, or license such rights, to a large entity. Thus, if an individual inventor has agreed to license his technology to a company that is a large entity, large entity fees must be paid. Nonprofit organizations that may qualify for small entity status include institutions of higher learning located in any country, certain tax-exempt organizations, a nonprofit scientific or educational institution, or a nonprofit

organization in another country, which, if it were located in the United States, would qualify as a nonprofit organization. Like the individual inventor, the nonprofit organization must also not have assigned, granted, conveyed, or licensed, or be under an obligation to assign, grant, convey, or license, rights in the invention to a large entity.

Small business concerns have traditionally been the most difficult to evaluate for small entity purposes. Under the Patent Laws, to qualify as a small business concern, an entity must meet the requirements set forth in the Small Business Administration (SBA) regulations (13 CFR §121), including a size requirement that the entity have 500 employees or fewer, including affiliates. In addition, the entity must not have assigned, granted, conveyed, or licensed, or be under an obligation to assign, grant, convey, or license rights in the invention to a large entity. Thus, in one scenario, if Small Biotech Company having 50 employees licenses its patented technology to Mega Pharma Company having 5000 employees, large entity patent fees must be paid.

The definitions of “employees” and “affiliates” are crucial in the determination of whether a small business concern meets the size standard of 500 employees or fewer, including affiliates. According to SBA regulations, the number of “employees” is defined as the average number of individuals employed by the concern on a full-time, part-time, temporary, or other basis for each pay period in the past twelve (12) calendar months. “Affiliates” are defined by the SBA as “when one concern controls or has the power to control the other concern, or a third party or parties controls or has the power to control both”. In addition, “SBA considers factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.” Investors, in particular, may affect small entity status of a business concern. Frequently, investors have some degree of control over small business concern. In addition, investors often have a security interest in the patent assets of a small company, such that the patent assets are used as collateral and the business concern is obligated to assign or convey those assets to the investors if the company goes bankrupt. In either case, small entity status may not be appropriate.

Ambiguities in the present small entity rules have lead to confusion over whether a small business concern is entitled to claim small entity status. For example, the provision in the rule that “the entity must not have assigned, granted, conveyed, or licensed, or be under an obligation to assign, grant, convey, or license rights in the invention to a large entity” raises the issue of what constitutes “an obligation”. Moreover, it is not clear whether non-US companies that would otherwise qualify as small entities are entitled to claim such status simply because they are based outside the United States. In September, 2003, the USPTO proposed several changes to the small entity rules that would clarify small entity status. Among the proposed changes are clarifying amendments which generally provide that: (1) a party entitled to small entity status is one who is not under a “currently enforceable” obligation under contract or law to assign, grant, convey, or license, any rights in the invention. For example, a security interest held by a large entity would not be sufficient to bar entitlement to small entity status; (2) the requirements for small business concerns regarding transfer of rights and size standards of the Small Business Administration are additive; and (3) business concerns are not precluded from claiming small entity status merely because they are located in or operate primarily outside the U.S. These changes are expected to be adopted during 2004.

As the Ulead decision makes clear, if small entity status is to be claimed, a thorough investigation into whether claiming such status is appropriate must be conducted. Failure to conduct such an investigation before making any claim for small entity status could form the basis of an inequitable conduct claim if the patent assets are challenged in court. In all cases (individual, nonprofit, or small business), one must investigate whether there has been an assignment, grant, conveyance, or license of the assets in question, or whether there is an obligation to assign, grant, convey, or license rights in the invention to a large entity. Any transactions involving licensing, conveyance, granting, or assignment of any patent assets should be reported the patent attorney so appropriate steps can be taken to review the transaction and determine if small entity status should be changed. Further, with respect to small business concerns, a thorough investigation of all affiliations and relationships, including investor relationships and obligations, are required. Moreover, the

issue of whether small entity status is proper must be continuously reviewed and any change in status promptly disclosed to the USPTO. It should also be noted that if the applicant or patentee makes an improper attempt to claim small entity status with the intent to deceive, the USPTO will regard that attempt as fraud, and expose the applicant or patentee to a variety of sanctions as well as placing the enforceability of the patent in jeopardy.

In many cases, the investigations described above could be costly, and not provide a definitive solution with respect to small entity status. In addition, given the potentially severe consequences of improperly claiming small entity status in terms of claims of inequitable conduct and potential patent unenforceability, applicants or patentees should consider carefully whether to claim small entity status even though they may be entitled to do so. In certain situations, applicants and patentees may wish to consider not claiming small entity status, and instead simply pay large entity fees. As the USPTO has noted:

It should be appreciated that the costs incurred in appropriately conducting the initial and subsequent investigations may outweigh the benefit of claiming small entity status. For some applicants it may be desirable to file as a large entity (by not filing a small entity statement and by submitting large entity fees) rather than undertaking the appropriate investigations which may be both difficult and time consuming. (Definition of Small Entities and Establishing Status as a Small entity to Permit Payment of Small Entity Fees, 65 Fed. Reg. 54, 604 (2000)).

Until the USPTO and the courts clarify the small entity requirements, payment of large entity fees may be the safest course of action if there is any doubt whether an entity qualifies for Small Entity Status.