Restrictions on Technology Transfer

The practical effect of international restraints on the licensing process

BY MARCUS B. FINNEGAN*

I. OVERVIEW OF LAWS AFFECTING TRANSFER OF TECHNOLOGY

M. Finnegan

American antitrust law structures the environment within which American business, and foreign business operating within the United States, must live. It is safe to say that, given the realities of governmental development within the last 60 years, there is virtually no important or sizeable economic activity, within the United States, whose practitioners do not have constantly to keep alert as to the development and operation of the antitrust laws. The broad constitutional meaning of "commerce", coupled with the enormous expansion of the size and power of the national government, have assured the reach of the antitrust laws into every economic corner.

Similarly, there exists in countries outside the United States comparable laws whose purpose is to govern the international transfer of technology to and from the particular country and whose impact may extend beyond the narrow borders of these economic entities. Thus, for example, Articles 85 and 86 of the Treaty of Rome (EEC Treaty) must be considered when dealing with the European Economic Community to be assured that the agreement is valid and enforceable in the member countries. Other examples of bodies of law affecting licensing agreements, which laws must be carefully scrutinized when the respective countries are involved, include the new laws of Mexico, particularly Article 7, and the Fair Trade Commission Guidelines for Japan.

A brief summary of these representative laws follows:

A. U.S. ANTITRUST STATUTES.

Section 1 of The Sherman Act /15 U.S.C. § 1/

"Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

Section 2 of The Sherman Act /15 U.S.C. § 2/

"Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor. . ."

Section 3 of The Clayton Act /15 U.S.C. § 14/

"It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption or resale within the United States . . . or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee of purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce."

Section 7 of The Clayton Act /15 U.S.C. § 18/

"No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

Section 5/a/ /1/ of The Federal Trade Commission Act /15 U.S.C. § 45/a/ /1//

"Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful."

B. THE EEC RULES OF COMPETITION

Article 85; Prohibited Practices

"(1) The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertaking and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development, or investment;

**Senior partner, Finnegan, Henderson, Farabow & Garrett, Washington, D.C.; paper delivered at the Licensing Symposium, Budapest, Hungary, September 1975.*

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

(2) Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

(3) The provisions of paragraph (1) may, however, be declared inapplicable in the case of:

— any agreement or category of agreements between undertakings;

— any decision or category of decisions by associations of undertakings;

— any concerted practice or category of concerted practices;

which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question."

Article 86; Abuse of Dominant Market Position

"Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts."

C. NEW LAW FOR TECHNOLOGY TRANSFER IN MEXICO

ARTICLE 2: The registration in the Register mentioned in the preceding article is obligatory for all documents containing acts, contracts or agreements of every nature which are effective in the National Territory and which have been entered into for the following purposes:

(a) The licensing of the use or exploitation of trademarks.

(b) The licensing of the use or exploitation of patents for inventions, improvements, industrial models, and drawings.

(c) The furnishing of technical information by plans, diagrams, models, instruction sheets, instructions, formulas, specifications, formation, and training of personnel or otherwise.

(d) The supplying of basic or detailed engineering plans for the building of facilities or manufacture of products.

(e) Technical assistance in whatever form it may be furnished.

(f) Services for the administration and operation of business enterprises.

ARTICLE 3: The following shall have the obligation to apply for the registration of the acts, agreements or contracts specified in the preceding article when they are parties to or beneficiaries thereof:

I. Individuals or companies of Mexican nationality.

II. Foreigners residing in Mexico and the foreign companies established in the country.

III. Agencies or branches of foreign companies established in the Republic.

The suppliers of technology who reside in a foreign country may request the registration in the National Register for the Transfer of Technology of the acts, agreements or contracts to which they are parties.

ARTICLE 7: The Ministry of Industry and Commerce shall not register the acts, agreements or contracts mentioned in Article 2 in the following cases:

I. When their purpose is the transfer of technology freely available in the country, provided this is the same technology.

II. When the price or consideration does not represent the technology acquired or constitutes an unjustified or excessive burden on National Economy.

III. When provisions are included which permit the supplier to regulate or intervene, directly or indirectly, in the administration of the transferee of the Technology.

IV. When there is an obligation to assign onerously or gratuitously to the supplier of the Technology, the patents, trademarks, innovations or improvements obtained by the transferee.

V. When limitations are imposed on technological research or development by the transferee.

VI. When there is an obligation to acquire equipment, tools, parts or raw materials exclusively from any given source.

VII. When the exportation of the transferee's products or services is prohibited, against the best interests of the country.

VIII. When the use of complementary techniques is prohibited.

IX. When there is an obligation to sell the products manufactured by the transferee exclusively to the supplier of the technology.

X. When the transferee is required to use permanently personnel designated by the supplier of the technology.

XI. When the volume of production is limited or sale and resale prices are imposed for domestic consumption or for exportation.

XII. When the transferee is required to appoint the supplier of technology as the exclusive sales agent or representative in Mexico.

XIII. When an unreasonable term of duration is established. Such term shall in no case exceed 10 years, obligatory for the transferee.

XIV. When the parties submit to foreign courts for decision in any controversy in the interpretation or enforcement of the foregoing acts, agreements or contracts.

The acts, agreements or contracts referred to in Article 2 which are effective in Mexico shall be governed by the laws of Mexico.

ARTICLE 8. The Ministry of Industry and Commerce may register in the National Register for the Transfer of Technology the acts, agreements or contracts which do not satisfy one or more of the requirements mentioned in the preceding article, when the technology transferred is of special interest to the country. This exception shall not apply to the requirements cited in Sections I, IV, V, VII, VIII, and XIV of the preceding article.

D. THE FAIR TRADE COMMISSION GUIDELINES IN JAPAN

I. Among the restrictions which are liable to come under unfair business practices in international licensing agreements on patent rights or utility model rights (hereinafter referred to as patent rights, etc.) the following are the outstanding:

(1) To restrict the area to which the licensee may export the goods covered by patent rights, etc. (hereinafter referred to as patented goods).

However, cases coming under a, b, or c listed below are excluded.

a. In case the licensor has patent rights, etc. which have been registered in the area to which the licensee's export is restricted (hereinafter referred to as the restricted area);

b. In case the licensor is selling patented goods in the restricted area in his normal business;

c. In case the licensor has granted to a third party an exclusive license to sell in the restricted area.

(2) To restrict the licensee's export prices or quantities of patented goods, or to make it obligatory for the licensee to export patented goods through the licensor or a person designated by the licensor.

However, such cases are excluded where the licensor grants license to export to the area coming under either of the preceding a, b, or c and the said restrictions or obligations imposed are of reasonable scope.

(3) To restrict the licensee from manufacturing, using or selling goods, or employing technology which is in competition with the licensed subject.

However, such cases are excluded where the licensor grants an exclusive license and imposes no restriction on goods already being manufactured, used or sold, or technology already being utilized by the licensee.

(4) To make it obligatory for the licensee to purchase raw materials, parts, etc. from the licensor or a person designated by the licensor.

(5) To make it obligatory for the licensee to sell patented goods through the licensor or a person designated by the licensor.

(6) To restrict the resale prices of patented goods in Japan.

(7) To make it obligatory for the licensee to inform the licensor of knowledge or experience newly obtained regarding the licensed technology, or to assign the right with respect to an improved or applied invention by the licensee to the licensor or to grant the licensor a license thereon.

However, such cases are excluded where the licensor bears similar obligations and the obligations of both parties are equally balanced in substance.

(8) To charge royalties on goods which do not utilize licensed technology.

(9) To restrict the quality of raw materials, parts, etc., or of patented goods.

However, such cases are excluded where such restrictions are necessary to maintain the creditability of the registered trademark or to insure the effectiveness of the licensed technology.

II. The aforementioned guidelines shall apply to international know-how licensing agreements.

III. In international licensing agreements on patent rights, etc., the following acts shall be regarded as the exercise of rights under the Patent Act or the Utility Model Act:

(1) To grant license to manufacture, use, sell, etc., separately;

(2) To grant license for a limited period within the life of patent rights, etc., or for a limited area within the whole area covered by patent rights, etc.;

(3) To restrict the manufacture of patented goods to a limited field of technology or to restrict the sale thereof to a limited field of sales;

(4) To restrict the use of patented processes to a limited field of technology;

(5) To restrict the amount of output or the amount of sales of patented goods or to restrict the frequency of the use of patented processes.

II. AMELIORATION OF STRICT RULES (THE RULE OF REASON, EXEMPTIONS CLEARANCES, EXCEPTIONS, AND THE LIKE)

The harsh impact or "strictness" of the foregoing rules regarding international technology transfer through licensing and similar agreements is oftentimes softened by the application of court-made rules or by a lenient interpretation of the relevant statutes. Such ameliorating devices include the "rule of reason" as applied by the U.S. courts and the "exemptions" granted by the EEC commission.

The rule of reason as it is applied today by United States courts includes three important tests. First, the restriction or limitation must be *ancillary* to the lawful main purpose of a contract, such as a patent or know-how license. Second, the *scope* of the limitation must not be substantially greater than necessary to achieve the lawful main purpose.

In applying this second criteria, courts first look critically to see if the licensee's activities are restrained in an area of commerce that is broader than the technology covered by the licensed patents or know-how. If the restraint is broader than the technology transferred, there exists a high probability that a court will find a misuse, and possibly an antitrust violation.

The third important criteria in considering reasonableness is the *duration,* or term, of the restraint. A restraint having a duration of ten years might be reasonable, while a restraint extending for an indefinite period might be unreasonable.

The rule of reason is applicable to both patent and

know-how licensing situations. As discussed above, with respect to know-how licenses, such licenses, to support any restrictions at all, must transfer technology not known to the public generally — that is, the know-how must not be in the public domain. Otherwise, a restriction in a know-how license is a naked agreement in restraint of trade, and illegal.

The reason for the requirement of secret or confidential subject matter can be illustrated in terms of the rule of reason. If technology is in fact in the public domain, anyone including a potential licensee is entitled to use it without paying a fee or other consideration to a licensor and without being subjected in his use of it to restrictions imposed by the licensor. Accordingly, a contract for the transfer of technology, which in fact is known to the general public or in general circulation, can have no "lawful main purpose" under the rule of reason.

However, a contract for the transfer of technology — that is of value to the recipient licensee and that is not publicly available — does have a lawful purpose. The purpose generally will be to enable the licensee to take advantage of something which he did not have before — that is, the secret technology. The existence of a lawful primary purpose, permits reasonable ancillary restrictions on the use of the technology to be imposed.

Exemption

Any agreement, decision, or concerted practice may be *exempted* from the provisions of Article 85 (1) if it falls within the policy considerations of Article 85 (3). Such an exemption will apply if the behavior:

1. Contributes to the improvement of production or improvement of products, or to the promotion of technical progress, and
2. Allows consumers a fair share of the resulting profit.

At the same time, the behavior must not:

1. Subject concerns to restrictions not essential to the affirmative objectives above, or,
2. Enable concerns to eliminate competition in respect of a substantial part of the products involved.

All of these conditions, both affirmative and negative, must be met before an 85(3) exemption will be granted.

The commission has issued guidelines explaining the kinds of cooperation which would go to qualify for an 85 (3) exemption:

1. Where small- and intermediate-size concerns cooperate to increase economy and productivity, the commission will look favorably on such activity. In some cases, cooperation between large concerns may also be found economically justifiable.
2. Where cooperation occurs between concerns whose market position is too weak to be a threat to Common Market competition or to impair community trade, the commission will be inclined to permit such cooperation.

These considerations reflect concern by the commission that not only was it important to protect competition within the market, but it was also important to allow enterprises the ability to compete in the world market with large international firms. The commission has attempted to strike a balance between the two.

The commission first declared an Article 85 (3) exemption applicable to *DRU-Blondel*. DRU, a Dutch firm granted Blondel, a French firm, the sole selling rights in France for DRU's enamel household goods, some of which were specially manufactured for French users. DRU agreed to forward to Blondel all requests and orders received from France. Blondel was free to establish its own sales prices, and was not forbidden to export out of France.

The commission found that because Blondel was the only company allowed to import directly from DRU, the agreement constituted a territorial restriction affecting trade between Member States, and within the prohibitions of 85 (1). However, the commission found that the arrangement allowed for a less complex distribution arrangement which in turn allowed Blondel to get the products into the French market more easily. This was seen to be of benefit to the French consumer desirous of purchasing the Dutch manufactured products. The commission noted that parallel imports of rival products were not inhibited, which would tend to keep the prices for the products at a competitive level; in fact, indirect deliveries from DRU into France of the same products were not precluded by the agreement. In the commission's view, the agreement allowed easier access by French consumers to the products, at no increase in price. This was sufficient for the commission to grant a five-year exemption from the stricture of 85 (1).

III. TYPICAL RESTRICTIONS THAT ARE GENERALLY FORBIDDEN IN LICENSE AGREEMENTS

The judicial treatment of the following restrictions commonly found in licensing agreements will be discussed in terms of U.S. antitrust decisions. However, the impact of the other laws is, in reality, quite similar, and the analyses probably can be considered universally applicable.

A. Tying Arrangements, or Tie-ins

A "tie-in" is an arrangement under which a licensor forces his licensee to purchase or lease *non-patented* goods or services as a necessary condition to securing a license under a patent. The practice is objected to because the patentee or licensor can effectively extend, sometimes quite widely, the monopoly of his patent beyond its scope by conditioning its license upon the licensee's commitment to purchase or lease other goods, not covered by the patent, from the licensor. The impact on competition is obvious: the licensor frees himself from competition in the purchase of unpatented goods by "tying" their purchase to a license under the patent, or the lawful exclusion from competition that is permitted by the scope of the claims of the patent.

This practice was declared illegal *per se* by the U.S. Supreme Court in *Motion Picture Patents Co. v. Universal Film Mfg. Co.* There, plaintiff owned a patent on a part of a film projector. He licensed it to defendant with a covenant that the projector was to be used only with film also patented by plaintiff. After plaintiff's film patent expired, defendant dealt in other films and plaintiff sued.

In affirming a judgment against plaintiff, Mr. Justice Clarke said:

> "It has long been settled that the patentee receives nothing from the law which he did not have before, and that the only effect of his patent is to restrain

others from manufacturing, using or selling that which he has invented.

The Court rejected the tying restriction, arguing that:

"It is an attempt, without statutory warrant, to continue the patent monopoly ... after it has expired, and ... to enforce it would be to create a monopoly ... wholly outside of the patent in suit and of the patent law as we have interpreted it."

Nineteen years later, the Supreme Court in *International Business Machines Corp. v. United States,* said flatly that tying clauses violate Section 3 of the Clayton Act, and refused to create any exceptions.

Courts were, however, continually pressed to create exceptions, where the goods tied were argued to be "necessary" to the correct functioning of the patented article, and some exceptions were created for tied articles, when use of articles other than the tied articles were shown to injure functioning of the patented device. Other exceptions were occasionally allowed where "good will" of the licensor was found to be deeply dependent upon the use of the tied article with the licensed article.

Fewer Exceptions

In recent years, however, the exceptions have become fewer and fewer, until today any restriction in a licensing agreement which requires the licensee to purchase or lease unpatented articles will be automatically struck down as a *per se* violation of the antitrust laws. Indeed, the tying device may be an extremely subtle one and still be sufficient in law to establish an antitrust violation.

For example, where a patent owner holds a patent covering a process, such as, for example, a patent for a process of applying a herbicide to an agricultural crop, such as rice. The patent owner who is selling the unpatented herbicide for use in the process, by the very sale of the herbicide, grants to the purchaser an *implied license* to use the herbicide in the patented process.

In *Ansul Co. v. Uniroyal, Inc.* this kind of licensing practice was held to be a violation of the antitrust laws, because the only way to obtain the implied license to use the process was through purchase of the unpatented herbicide. The court also found that the patent owner had failed to make a license to use the process available to his competitors at a reasonable royalty rate. Presumably, in this kind of a fact situation, if the patent owner had been willing to make licenses to use the process available to his competitors at a reasonable royalty rate, there would have been no violation of the antitrust laws through the tying arrangement created by the implied license.

The *Ansul* case, however, illustrates the need to be extremely careful in devising licensing practices and schemes to be certain that something as intangible as an implied license will not be held to create a tying arrangement. The case also illustrates the ingeniousness of defense lawyers in thinking up legal theories that will support a patent misuse or a violation of the antitrust laws under the facts of the particular situation that confront them — such as, the implied license arrangement in the *Ansul* case.

B. Restriction on Licensee's Right to Deal in Competitor's Products ("Tie-Outs")

A "tie-out" is actually a corollary of a "tie-in". In a "tie-out" restriction, a licensor attempts to restrict his licensee's freedom to deal in a competitor's products. For example, a typical "tie-out" restriction would bar a licensee from purchasing or using products similar to, or in the same category as, the products covered by the licensed patent. This practice has been found to constitute a misuse, and a *per se* violation of the antitrust laws, by various Circuit Courts of Appeal, with tacit Supreme Court approval.

In *National Lockwasher Co. v. Garrett Co.,* and *McCullough v. Kammerer Co.,* the rule was fashioned that restraining competition with the patented article by binding distributor-licensees not to purchase or use competing articles rendered the patent unenforceable against an infringer, and opened the licensor to an antitrust counterclaim. This rule still governs the law in this area.

C. Mandatory Package Licensing

Basically, a package license is a license by a patent owner, usually a corporation holding many patents, in which the licensee is licensed *under more than one patent.* Sometimes a package license may even include all of the licensor's patents. Essentially, however, a package license in its simplest form, is merely a license under more than one patent.

"Package licensing is frequently used to avoid troublesome questions of infringement, complex bookkeeping, the difficulty of determining which patent controls the present and future needs of the licensee, cost differences, and similar practical consideration." Because of the closely-related and dependent nature of many modern improvement patents, package licensing is a very common phenomenon today, and its use is increasing.

In *Zenith Radio Corp. v. Hazeltine Research, Inc.,* there were over 500 patents included in the Hazeltine package license. Hazeltine Research, Incorporated (HRI) had for many years issued standard licenses to manufacturers of radio and television receivers under all of its existing and future patents.

Until 1959, Zenith had obtained rights to use all of HRI's domestic patents through HRI's so-called "standard package license". In 1959, however, with the expiration of Zenith's package license imminent, Zenith declined to accept HRI's offer to renew the license.

In November 1959 HRI sued Zenith claiming that Zenith television sets infringed HRI's patents on an automatic control system. In answer to the complaint, Zenith asserted that HRI's claim was unenforceable, because HRI had misused its patents through package licensing.

The Supreme Court found that the critical question on the issue of whether HRI had committed patent misuse through its package licensing program was whether Zenith was *coerced* or forced to take either the complete package license from HRI under all of its 500 patents, or no license at all. HRI refused to offer Zenith the license at a reduced royalty rate for less than the total package.

The Supreme Court held, in essence, that HRI could not force Zenith to take the full package license and pay a royalty based on a percentage of Zenith's total sales of television and radio receivers. The court concluded that if Zenith was actually coerced, there would be a misuse of the patents.

It left an escape for HRI, however, by saying that, if the package license had been granted to Zenith or offered to it *for the mutual convenience* of the parties on the basis that

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taking a package license and paying royalties based on a percentage of total sales would be the most convenient and efficient way to reach and administer the agreement, then there would be no misuse.

There is a lot of discussion getting around to it, but the basic point boils down to this: If the parties to serve their mutual convenience are willing to enter into the package licensee agreement, it's all right. But if the package license is coerced or crammed down the throat of the licensee by the licensor, then there is a patent misuse and an antitrust violation.

Under Zenith, the law thus seems to be that *voluntary* package licensing is acceptable and does not constitute a patent misuse but that *mandatory* package licensing does.

To avoid any question as to whether a package license is voluntary or mandatory, licensors should offer a clear alternative to the licensee's being required to take a license under the entire package. If the licensee wants only a few patents in the package, rather than the entire package, he should be able to secure a license to the selected patents at a lower royalty than the licensor is charging for the entire package. When this is done, it would seem to be clear that the licensee is not being coerced — he has been offered a practical alternative to taking the entire package.

It has, however, been held in one case that a demand for individual licenses was not needed to prove misuse through package licensing. On the other hand, in another case, mandatory package licensing of "blocking patents", *i.e.*, patents claiming interdependent parts of the same product, was found to be *free* of patent misuse.

In *Rocform Corp. v. Acitelli-Standard Concrete Wall, Inc.*, the Circuit Court of Appeals for the Sixth Circuit found a patent misuse existed where a package license did not specifically provide:

(1) for the reduction of royalties upon the expiration of the most important patent in the package, and

(2) for the right of the licensee to terminate the license at will.

Frequently, as occurred in *Recform*, a licensee may successfully contend that the patent owner was collecting royalties on an expired patent. This raises the issue of another form of *per se* licensing restriction, namely, postexpiration royalties, which will be discussed in detail below.

When a patent owner is licensing a group of patents, he should "not be required to justify on any proportional basis the royalty rates for less than the complete package", if "the rate set is not so disproportionate as to amount to a refusal to license less than the complete package." Accordingly, if a substantial group of patents is offered at a flat royalty rate, the deletion or omission of one or several of the specified patents need not necessarily affect the royalty rate.

As can be understood from the discussion above, there are many subtle problems involved with package licensing. From the viewpoint of the patent owner, the all-important consideration is that he not take any steps that could be construed to amount to coercing his licensee to take licenses under patents that he does not actually want. It is thus important that the licensor carefully document the negotiations that lead up to a package license and be certain that this documentation shows that there is no forcing or coercion on the licensor's part.

One useful device to counter a possible later charge of coercion is to use a "whereas" clause at the beginning of the license agreement which states, in effect, that the licensee desires a license under all of the patents listed in Schedule A (or equivalent). Then the licensee will be hard pressed to later contend that he was coerced into accepting a full package license from the licensor, particularly when the licensee has signed the license agreement himself.

D. Restrictions That Extend Beyond the Scope of the Transferred Technology — Total Sales Royalties

It is considered a *per se* illegal violation of the antitrust laws for a licensor to impose a mandatory total sales royalty restriction upon his licensee. In *Zenith v. Hazeltine* the Supreme Court held that Hazeltine, as licensor, had conditioned the granting of the license upon Zenith's willingness to pay royalties on its total sales of radio and television receivers, regardless of whether such receivers infringed the claims of any of Hazeltine's patents, such action by Hazeltine would constitute a *per se* violation of the antitrust laws:

In *Zenith* the Supreme Court remanded the case to the lower federal court for specific fact findings to determine if the payment of royalties on total sales was mandatory, or whether it was merely for the mutual convenience of the parties in simplifying the bookkeeping and accounting for royalties. The latter situation was quite possibly the actual one in the *Zenith* case, because more than 500 patents were involved. Manifestly, it would have been difficult to determine each time Zenith built a new radio and television receiver whether the circuits in the receiver infringed any one of the claims of more than 500 patents, most of which were patents claiming complex electronic circuitry.

It is thus clear that a licensee may insist on paying royalties only for actual *use* of the licensed patents. The question of mandatory total sales royalties can also arise where only a part of a fairly complex machine or apparatus is covered by a patent, but the royalty is based on the net sales price of the entire machine or apparatus.

Similarly, the same problem, of course, can occur where a patent covers only a portion of the steps in a process and not the entire process, but the royalty is determined by the use of the entire process. Also, with process patents care must be taken where the royalty is computed based on the sales of the *product* of the process, but the patent covers only the *process* itself. Here again in requiring the licensee to pay royalty based on the sales of the product, the licensor is stepping outside the scope of the patent claim coverage and the licensee's payment based on sales of product must be voluntary and willing rather than coerced by the licensor.

As mentioned earlier with respect to package licensing, it is desirable to have a statement in the license agreement indicating the licensee has willingly and voluntarily agreed to measure royalties on some basis other than the exact coverage of the claims of the licensed patents. Since the licensee executes or signs the license agreement, he would be hard pressed later to contend that the basis for

legal *per se*. We are concerned here with those *legal* restrictions which may be placed upon a *manufacturing* licensee. It is important, then, to carefully distinguish between the situation where a restriction is placed upon a manufacturing licensee (frequently legal), and that where a restriction is placed on a purchasing licensee (always illegal).

In general, field-of-use licensing can be used to divide markets and customers to the public detriment. Use restrictions in licenses can allow a patent owner to organize his market into a collection of discreet, noncompetitive submarkets. Licenses in each of the submarkets are thereby insulated from competition with licensees in other submarkets. This effect is analogous to the classic horizontal conspiracy among competitors not to compete, where each benefits from the restrictions imposed upon all.

However, field-of-use restrictions may benefit the public by spurring commercial exploitation of patents held by small or weak companies which, without the possibility of the restrictions, would be reluctant or tardy in exploitations because of lack of market strength. Let us, for example, assume that a small chemical company, making only organic herbicides, develops a new catalyst effective in a wide variety of organic chemical reactions. The company might find it profitable to grant a license to use the catalyst to a large chemical company, but be unwilling to do so for fear that the large company would come to dominate the licensor's own market. Thus, commercial exploitation of the catalyst in fields other than that occupied by the patentee would be stifled, unless the patentee can license his patent with a field-of-use restriction to keep its licenses out of its own market.

Leading Case

The leading case sanctioning field-of-use restrictions upon manufacturing licensees was decided by the Supreme Court in 1938, in *General Talking Pictures Corp. v. Western Electric Co.* There, plaintiff licensed its patented vacuum tubes to defendant for use in the commercial field. There was a covenant, whereby defendant was excluded from using the licensed tubes in manufacture for the private or home field. In a suit testing the field-of-use restriction, the Supreme Court held flatly that the restriction was within the "reward" which patentee had a right to secure.

Problems arise, however, when a field-of-use restriction begins to look like a covert attempt to divide markets or customers, and to put restraints on resale. In *United States v. Glaxo Group Ltd.*, the court found such a covert attempt and used the *Schwinn per se* rule to strike down the license.

It thus seems appropriate to reiterate the admonition that "rule-of-reason" adjudication proceeds on a case-by-case basis, with the courts seeking to tailor the rules to the facts before them. Competent counsel is usually needed to determine the legality of specific restrictions that fall within the scope of the rule of reason.

A licensor can easily be advised of the relatively few things he clearly must not or should not require of his licensee today; that is, the *per se* illegal and virtually *per se* illegal practices described above. Advising a licensor how to negotiate now, an arrangement which will surely avoid antitrust and misuse problems over the life of an agreement, perhaps the next 10-17 years, is very difficult. This is true because the record of the last 40 years clearly demonstrates a tendency toward stricter application of the antitrust laws and an equally clearly emerging hostility to patents and licensing of know-how.

B. Territorial Restrictions

Section 261 of Title 35 of the United States Code, or the Patent Laws, specifically authorizes a patent owner to "convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States." Accordingly, patent licenses have been granted under which a licensee is territorially restricted to United States geographical and trading areas of use. So far, the Justice Department has not seriously questioned such an interpretation of this part of the patent code.

The rights under Section 261 are limited to dividing domestic markets into sales territories or regions, by the patent owner, but any combination of patent owners, for example, dividing world markets would clearly run afoul of the Sherman Act.

The validity of territorial restrictions is thus determined under the rule of reason. First, if there is a territorial restriction, it must be shown that it is ancillary to a lawful main purpose of the contract. If it is possible to establish through testimony and documentary evidence that the intent of the parties was a bald division of world markets, then the territorial restriction will not hold up, because the basic purpose is regarded as unlawful rather than lawful. Also, it must be established that the scope of technology to which the territorial restriction applies is appropriate. The territorial restriction must not embrace technology other than that which is transferred under the license agreement.

Similarly, the duration of the restriction must not exceed a reasonable limit. In determining what is a reasonable duration for the restriction, one important rule of thumb is the restriction should not exceed the length of time in which it would take the licensee to independently develop the technology.

This length of time is, of course, something of an intangible period. However, a good index for determining how long it would take the licensee to develop the technology independently is for the licensor to establish how long it took him to develop the technology in the first place. For example, if it took the licensor ten years to develop the technology, and he can establish this fact through evidence, then it would not be unreasonable for the licensor to impose an eight-year restriction on the licensee. The reduction in time would allow for the general acceleration in the development of technology which is taking place in the world today.

C. Nonexclusive Grant-backs

It seems clear that nonexclusive grant-backs of improvement technology developed by a licensee will generally be acceptable under the rule of reason. The only problem that would seem to arise in this area is where a licensee makes a breakthrough invention as an improvement under the licensed technology. In such a case the licensor may be well advised to agree to pay royalties to the licensee even for the nonexclusive license under the newly developed technology.

Thus, depending on the circumstances, a royalty-free nonexclusive grant-back may be acceptable in most instances, but if the improvement invention, which was

this warning, patent and antitrust lawyers have been advising clients not to rely on the *General Electric* case and not to insert price-fixing provisions or restrictions in license agreements. Accordingly, for all practical purposes a price-fixing restriction in a United States license agreement has become a virtually *per se* illegal type of restriction.

H. Provisions Giving A Licensee Power to Veto the Granting of Further Licenses

It was clearly established in *United States v. Besser Mfg. Co.,* that it is *per se* illegal for two competitors, who together control a relevant market and where one has licensed the other, to agree that they will neither of them grant further licenses without first obtaining the consent of the other. Thus, where a licensor and licensee are competitors and they control a substantial part of the relevant market, it is *per se* illegal for the licensor to give the licensee a veto power over the granting of further licenses.

In other words, it is illegal for a licensor and licensee who together dominate a relevant market to agree to share technology through a license agreement and at the same time agree that they will not share this technology with any other person. There cannot be a private club between the licensor and licensee which no others can join except with the joint action of the licensor and licensee.

The Antitrust Division of the Justice Department has gone so far as to suggest that it is improper for a licensor to grant an exclusive license to a licensee without also giving that licensee the power to grant sublicenses. This is under the theory that if an exclusive licensee does not have the power to grant sublicenses and wishes to secure that power, he must go back to his licensor and secure the consent of the licensor to give him the power to grant sublicenses.

The Justice Department contends this is an implied veto power held by the licensor because it takes the joint action of both the licensor and licensee to grant further licenses or to give the licensee permission to grant a sublicense. There is no court decision on this point, but the Justice Department is pressing to find a good situation in which to litigate the question.

For practical purposes, it is considered very dangerous for a licensor to give a licensee a veto power over the granting of further licenses, regardless of whether or not the licensor and licensee are competitors. This again is another situation in which lawyers have been careful to advise their clients not to grant such veto powers, since it would merely give the Justice Department an opportunity to test its legal theories in court. Accordingly, the granting of any veto power to a licensee over the granting of further licenses is considered to be a virtually *per se* illegal violation of the antitrust laws, even when the licensor and licensee are not competitors.

I. Exclusive or Assignment Grant-Backs

Theoretically, under *Transparent-Wrap Machine Corp. v. Stokes et Smith Co.,* an assignment or exclusive license grant-back of an improvement invention is still legal. The Antitrust Division of the U.S. Justice Department has, however, indicated that it will attack any appropriate agreement that contains a licensing restriction requiring the licensee to grant-back either an assignment or an exclusive license as to any improvement invention that it makes within the scope of the licensed technology.

Accordingly, it is considered virtually *per se* illegal in the United States today for a licensor to require his licensee to give either an assignment or an exclusive license grant-back of improvement inventions within the scope of the licensed technology.

J. Quantity or Volume Restrictions

The Antitrust Division of the U.S. Department of Justice has taken the position that any quantity or volume restrictions are *per se* illegal. The decided cases do not, however, support the Justice Department position.

It seems clear that a quantity or volume restriction with respect to output of a product cannot be legally imposed where the licensed patent is for a process only. On the other hand, the cases which are meager in number, seem to support a quantity or volume restriction when a product patent constitutes the licensed subject matter. Nevertheless, quantity and volume restrictions are in the area of restrictions that are considered to be illegal *per se* by the Justice Department and which are accordingly virtually *per se* illegal because of the Department and which are accordingly virtually *per se* illegal because of the Department's interest in finding a test case in which to prove its point. Licensing lawyers in the U.S. are accordingly advising their clients not to impose quantity or volume restrictions on their licensees.

IV. LICENSING RESTRICTIONS THAT ARE TESTED BY THE RULE OF REASON TO DETERMINE LEGALITY

The licensing restrictions discussed under this heading are those with respect to which legality is determined as tested by the rule of reason. These restrictions are thus not presumed to be either *per se* illegal or virtually *per se* illegal, but rather restrictions that are generally presumed to be legal unless, when tested under the rule of reason, they are shown to be otherwise.

A. Field-of-Use Restrictions

In the absence of patent rights, it has been settled American antitrust law for more than 70 years that agreements which divide customers of markets are *per se* illegal.

Field-of-use licensing is a term of art describing agreements under which a licensor grants a licensee a restricted use of patented subject matter, but declines to grant all possible uses to one licensee, reserving some uses for self-exploitation, or for exploitation by other licensees. Thus, field-of-use licensing partakes of the quality of market division, classically declared to be *per se* illegal in *Addyston Pipe et Steel.* However, field-of-use restrictions have qualities which may, under some circumstances, sanitize them for purposes of U.S. antitrust law.

Field-of-use restrictions permit a patent owner substantially to increase royalty income, regulate the use of his patent, test the feasibility of inventions in new fields, maintain exclusivity for a patentee or licensee, and meet the specific needs and capabilities of a licensee. Because of these advantages, field-of-use licensing is a common practice in the United States.

Particular note must be made, however, to distinguish analytically between two generic categories of licensees. Field-of-use restrictions (indeed, almost all restrictions) placed on a *purchasing* licensee are, as we saw above, il-

measuring royalties was forced upon him — or that he was coerced into accepting it.

E. Resale Restrictions

It is an ancient doctrine at common law that one who obtains title to goods must be free to alienate them, or, in broader language, there must be freedom of alienation with respect to goods. It has been settled American law for more than 100 years that resale restrictions cannot be imposed upon a purchasing licensee. This doctrine was applied to patented goods in *Adams v. Burks* by the Supreme Court in 1973.

In that case it was held that the purchaser of a patented coffin lid from a licensee who was only authorized to make, use and sell the lids within a ten-mile radius of the city of Boston, was free to use the coffin lids wherever he pleased without regard to the territorial restriction. The territorial restriction sought to be imposed by the licensor was held to have been obliterated by the first sale. Thus, the license restriction could not run with the goods once they were sold. Another way to express this doctrine: The first sale exhausts the patent monopoly.

In spite of this long-established doctrine in *United States v. Glaxo Group, Ltd.*, Glaxo, a British licensor, attempted to impose a restriction on its U.S. licensees which prevented them from making bulk sales of a patented drug. Glaxo, however, *sold* the drug to its U.S. licensees, and they were thus purchasing licensees. The court therefore found that Glaxo's attempt to impose a restriction upon its purchasing licensees as to the form in which they could sell the drug was a *per se* violation of the antitrust laws.

The attempt to impose any restrictions whatsoever on a purchaser of goods, once title, dominion and control have passed from the owner was held by the Supreme Court in *United States v. Arnold, Schwinn et Co.* to be a *per se* violation of the antitrust laws. In that case Schwinn attempted to impose territorial restrictions on dealers and distributors of its bicycles. The Supreme Court, in essence, held that with respect to those dealers who merely took the bicycles on consignment from Schwinn and did not actually purchase them, territorial restrictions (for example, a restriction on a dealer allowing him to sell bicycles only in the State of New York) would be tested under the rule of reason and were thus capable of being legal. With respect to those dealers, however, who *purchased* the bicycles from Schwinn, any attempt to impose any sort of territorial restriction upon them was found to be a *per se* violation of the antitrust laws.

The *Schwinn* case was used by the Court in *Glaxo* in finding a clear violation of the antitrust laws. The *Schwinn* decision has thus made it abundantly clear that there are no circumstances under which a licensor can safely attempt to impose any restriction on a purchasing licensee with respect to how the patented goods will be handled or treated once title has passed to the licensee.

F. Post-expiration Royalties

In *Brulotte v. Thys Co.*, the Supreme Court found that "The exaction of royalties for use of a machine after the patent has expired is an assertion of monopoly power in the post-expiration period when ... the patent has entered the public domain." In *Brulotte*, a patent owner sold hop-picking machines incorporating his patents for a fixed price. There were 12 patents, although the licensees used only seven.

At the time the dispute arose the seven patents had expired. But the licenses associated with the sales of the hop-picking machines required separate royalty payments measured by the *use* made of the machines. The royalty rates were exactly the same both before and after the patents involved expired. The Supreme Court found that the payments made after expiration of the patents were royalties and not merely installment payments. It, therefore, declared the licensing agreements to be *per se* illegal.

The *Brulotte* decision destroyed much of the vitality of the holding in *Automatic Radio-Hazeltine,* where royalties sought were *not* for a period when *all* of the patents had expired, and the license agreement in issue had extended to several hundred patents, not merely a handful.

In *McCullough Tool,* a 1965 Tenth Circuit ruling, the Hazeltine decision was held to have survived because its facts were distinguished in *Brulotte.* The license agreement upheld in *McCullough Tool* had provided that royalties would be payable under a package of patents "some of which have expired or will expire during the effective period of the agreement".

In 1959, however, the Third Circuit found to be a patent misuse a license agreement which had extended payment of royalties until the expiration date of the last patent, when some of the patents might have actually expired prior to the termination of the agreement.

The important point emanating from the *Brulotte* case is that royalties may not be collected in the post-expiration period, if they are based on *use.* The way still seems to remain open, however, for royalties to be collected on a deferred-payment basis so long as they are measured on use that occurred while the patent was still unexpired. This illustrates the importance of proper draftsmanship in license agreement to avoid such serious problems such as antitrust violations.

Four licensing restrictions are discussed as to which — although the courts have not yet held them to be *per se* illegal — the Justice Department has indicated that it will seek court holdings determining that these restrictions are *per se* illegal. In other words, the Justice Department Antitrust Division is looking for cases in which to test the restrictions discussed below for *per se* illegality. Apparently the Justice Department believes, in each instance, that if it could find a good case clearly illustrating the use of the licensing restriction, it could persuade the Supreme Court to declare each of these restrictions to be *per se* illegal.

G. Price-Fixing Restrictions

Theoretically, *United States v. General Electric Co.,* is still good law today, although cases subsequent to this 1926 decision have narrowed the rule of this case to its specific facts. In other words, it is still theoretically legal for a licensor to require a manufacturing licensee to adhere to the licensor's price schedules. But the rule seems to be limited to the situation where a licensor has *only one manufacturing licensee,* it having been declared illegal for a licensor to require as few as two licensees to maintain fixed prices, and the rule today thus has very limited scope.

The Antitrust Division of the United States Justice Department has announced that it is looking for a test case to take up to the Supreme Court to try to get the 1926 *General Electric* decision overruled. As a consequence of

granted back to the licensor is a breakthrough invention or a truly important invention, it might be required that the licensor pay royalties back, or rebate royalties, to the licensee.

D. Cross-licensing and Patent-Pooling Agreements

Cross-licensing, or an arrangement under which all or part of the consideration for licensing a particular patent is the licensing back of another patent, raises no threshold antitrust problems. Problems of anticompetitive conduct can arise, however, in terms of the use of cross-licensing in conjunction with licensing restrictions which have been discussed above.

Cross-licensing, in those situations which combined patents are licensed to others, can develop rather easily into illegal patent pooling. The *National Lead* case illustrates the illegal domination of a market by patent owners. Similarly, the *Singer* case, under which Singer conspired with two foreign competitors to exclude Japanese sewing machines from the United States through cross-licensing agreements, was an occasion for the Supreme Court to condemn this practice, under the Sherman Act. In the *Line Material* case, the Supreme Court found that any price fixing limitations contained in cross-licenses were beyond the bounds of the patent grant.

It is apparent that cross-licensing increases the risk of determining that a licensing practice is illegal, because it involves the reciprocal licensing between licensor and licensee and thus automatically raises the question of whether there is a possible group boycott involved vis-á-vis the rest of the industry.

Patent pooling differs from cross-licensing only in that with patent pooling there are more than two parties involved. In patent pooling, more than two companies agree to mutually share their patent properties with one another. Thus, a patent pool can be created where three or more companies agree to place their patent rights into a common pool in which each has the freedom to use the patents of the other. When a patent pool is created within a given industry the risks of an antitrust violation are multiplied. About the only safe way today to insure that a patent pool is operated under the rule of reason is to make the pool open to all persons desiring a license at a reasonable royalty rate. A closed pool between competitors would pretty clearly be a *per se* illegal violation under the Sherman Act.

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Technology Transfer to Eastern Europe

(Continued from Page 85)

to consumer needs and, therefore, represents not only a good market for U.S. licenses but also a good source for technology.

C. Hungary

Hungary is increasing its interest in Western technology and particularly is interested in computers, pharmaceuticals, food processing, and agricultural machinery. The aluminum and chemical industries will probably find a very good market for their technology in Hungary. We have a licensee in Hungary for the manufacture of refrigerated display cases of the type used in supermarkets. Our experience with this licensee has been excellent; in fact, it has been superior to that of our average Western licensee. The aid required has been minimal, the licensee has paid its fees on time, and it has cooperated in every way. The licensee built a new plant to manufacture these display cases and will soon expand this plant drastically to keep up with the current East European boom in supermarket construction.

D. Poland

Poland is rapidly expanding its industrial base, spending about 30% of its gross national product for expansion of industry, farming, etc. As an example of this expansion, one of our licensees will build forging and casting facilities at a cost of well over $150 million. Forgings and castings are in short supply in East Europe, just as they are in U.S.A. Poland suffers from a shortage of hard currency but they have a very great appetite for American technology. The people-to-people relationship is extremely good and we have been highly satisfied with our license in Poland. Our licensee there built a new plant and it is now in full production. We advised the licensee on the facilities to be used and aided it in setting up the plant. Poland's economy was given a substantial boost by recently discovered copper resources and expanding enormous coal and sulfur mining operations. Poland offers a very good licensee route to the East European market.

E. Romania

Floods caused Romania to suffer a severe economic blow. It, however, has a very rapidly expanding economy and I am personally very enthusiastic with regard to cooperation agreements in Romania. We recently signed our biggest license ever in Romania and during my last two years of visiting this country, I have become convinced that it has the technical infrastructure to rapidly grow industrially. The emphasis here is on farm machinery, oil refining capacity, machine tool industry, and petro-chemical plants. While they do not have sufficient oil resources for export, they are almost self-sufficient. This gives them considerable independence from external domination. Romania also has laws permitting joint ventures.

F. Soviet Union

The Soviet Union is by far the largest and also the most difficult market for U.S. licenses. Its automotive and construction vehicle industry is expanding rapidly and it now has a new truck plant on the drawing board which will