

When a License Agreement Fails

Or, how to cope with the tyranny of the licensee

BY JAMES M. WETZEL*

I don't want to get into a heavy discourse on law, but the theme of this inquiry is much like the lament of the spurned lover as told by an ancient poet:



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"And that tame lover who unlocks his heart,
Unto his mistress, teaching her an art
To plague himself, shows her the secret way
How she may tyrannize another day."

That, by allegory, is a characterization of the licensor-licensee relationship. The tyranny is the unfortunate cynical result of the decision in *Lear v. Adkins*¹. To understand what to do when a license agreement comes apart, we have to take a look at the tyrannical results of *Lear*.

Back in April of 1970, I gave a talk on *Lear* before this very group and said the following: "Remembering that the rule of law of *Lear* is simply that there is no licensee-estoppel, it is clear that the only patent licenses free from the validity challenge are those licenses which result from litigation, where the issue of validity has been judicially decided."

My advice at that time to one who was licensing a patent ran as follows:

"What can one who believes that he holds a valid patent do in granting licenses? . . .

The real implications are dismal: without litigation there can be no positive, placid, patent license agreement. If that's true, one can imagine that there would be no licensing among competitors because a party with a patent right would rather try to utilize the monopoly himself, using the patent to destroy any competition that might arise. The long-term impact on the innovator, of course, will be that there is little to be gained from patent ownership unless he is a manufacturer: (1) with a unique product on which substantial patent protection can be derived; and (2) who is of a mind that he will sue anyone who sets foot within the area of his patent property. Certainly, the widely accepted view of licensing in lieu of litigating will be done away with because the parties to a license, rather than being

close partners in an agreement, will always find the scepter of the 'strong federal policy' standing between them."²

And I am sorry in this instance to be such an accurate predictor, but that is just about where the patent licensing law stands today. There is no positive, placid patent license agreement unless the licensee wants it that way.

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Today, and under the rule of *Lear* as it has been misapplied, a licensee is a hero in the eyes of the judiciary for taking to himself the charge of public policy and seeking to ventilate validity by punching a hole in the patent.

Licensees as Lovers

With that as a background, let us consider what happens when a license agreement comes apart.

There is no panacea; there is no one answer; there is no real pattern that one can turn to to find the solution. But I think it's helpful in analyzing the situation to look at the relationship of a licensor-licensee as one similar to those of lovers.

If the "coming apart" is merely a condition of unsettled relations from what had been an understanding relationship and both parties can see it, maybe they should try to talk it out. Communication can do wonderful things, although I am not too hopeful in this arena where the problem on both sides is usually money. Alternatively, I would suggest calling in a licensing expert, not a litigator but a counselor, just as one would call in a marriage counselor. A third party who might look objectively at both, identify the problem and deal with it. Having made those nice proposals, let me tell you that in my view, the chance of success is slight for the simple reason that money is most always the seat of the problem. In the eye of the licensee, the basic problem is that he is paying too much. In the eye of the licensor, he made an agreement that was unfair to him in the first instance and that now if the licensor-licensee has feelings of uncertainty then he (the licensor) is justified in having feelings of uncertainty also. The only thing that can be renegotiated, and the only thing that should be renegotiated is the royalty.

Let me digress for a moment because I said the only thing that should be renegotiated is the royalty. I have long been a strong advocate of simple agreements. If what you are licensing includes patents, trademarks and know-how then you need three agreements, each of which will

1. 365 U.S. 653 (1969).
2. J. Wetzel and R. Niro, "The Look of Lear — An Advocate's View", 46 Notre Dame Lawyer 475 (1971).

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stand on its own. The problem is that in a bundle license, which was quite common 30 years ago, the matter of consideration gets lost because time spans are different. Know-how may last only for five years; the patent license may last for 17 years; the trademark license may go on forever; and, of course, money is paid but it isn't certain as to what it is for the money is being paid. Then consideration gets lost, tie-ins start to sneak in, and the seed of illegality is planted. The problem in trying to compromise a license agreement where money is the focus is that human nature, being what it is, will try to enter in to a give-and-take proposition so that in addition to changing the royalty rates, then there may be other things like supply discounts, market splitting, general back-scratching.

An additional trouble with renegotiating royalty rates is that you may be setting a precedent. You will have to ask yourself how long will it be before it happens again. Next year? Two years from now? By doing so, have you only made certain that ultimately there will be a break in the entire relationship? I think so.

Rx After the Fact

Let's suppose so. Let's take the circumstance where the agreement has actually come apart. Then there are two things that can be done. The first is nothing. In that case, the licensor loses. By doing nothing, he gives up his property rights. It may be a good economic decision, when you balance the cost of trying to enforce his property rights versus what he might anticipate getting back from it.

The other alternative is to sue for breach of contract, or cancel the contract and sue for infringement. It makes little difference which way you proceed for in either case validity and infringement will be the issue in the lawsuit.

If the lawsuit proceeds, and this is the economic consideration, you can expect an out-of-pocket expense of \$100,000 or more, depending on the complexity of the subject matter involved. And that's \$100,000 for each side. Therein lies a deterrent aspect too. As a matter of fact, to the defendant, it may even cost more than \$100,000. It may cost more than the plaintiff from the standpoint that it is usually the case that a defendant will try to find the anticipation by scrounging the countryside and scrounging costs money whether it's successful or not. So it is even possible that it could cost the plaintiff \$100,000 and it might cost the defendant-licensee-infringer maybe \$125,000 just for the extra work that he would have to do to find the formula. Of course, if he can kill the patent right from the very beginning, that's something that ought to be laid out on the deck, because there shouldn't be a lawsuit in that instance.

It's a hard, calculated view; a bit of a game and a gamble on the proposition that the licensee will come back to the fold. But it is only the other side of the same gamble faced by the licensee. If the licensor is going to call the bluff, he should make the decision boldly with the understanding that it might cost \$100,000 to maintain his licensor position and that if the strong position is effective and he gets out for \$5,000, he can consider himself very lucky.

Having started using the love affair as analogous to a licensing relationship, I am now coming back to that subject to say that the analogy is not really apt. As I said

earlier, when the license agreement comes apart, it's usually because of economics. A love affair usually involves emotions not evident in a licensing affair. Having said that, let's go to the full circle, and say that I think that the best deterrent to preventing a license agreement from coming apart is to approach the initial licensing negotiations at arms length. Often management gets excited over the proposition of getting into a license agreement. All they want is to get the arrangement going without regard to the potential problems. That's the circumstance in which you can predict that problems will become real probably neither side has exercised proper caution. If it's a 15 percent royalty that they have agreed upon, it is likely after two years the licensee will look at the bottom line of his financial statement and probably decide that he is chief donor in a give-away program. So the best approach to avoiding a license agreement from coming apart is to approach the initial negotiations with caution and at arms length. It does not have to be antagonistic, but firm and determined.

An Illustrative History

I have a very interesting case history because it's one in which neither party lost but it's one in which the licensee lost more than the licensor. I am talking about the case of *Mary Kraly vs. National Distillers & Chemical Corp.*³

Mary Kraly is a lady who lives in Cicero, Illinois and whose husband was an inventor. He died and Mary Kraly inherited her husband's patent. Back in 1967, she sued for infringement. The lawsuit was settled and the defendant entered into a license agreement. As part of the settlement, Mary Kraly was paid \$8,000.

The licensing agreement went on nicely for a few years, during which time the royalty payments to Mary Kraly were \$12,000 to \$15,000 a year. Then royalty reports began arriving but the royalty money stopped. By that time, Mary Kraly had received about \$40,000 from the licensee plus the \$8,000 that she had received in 1970 in the settlement. Her receipts totaled \$45,000 to \$50,000. Had the licensee's agreement run to the term of the patent at that rate, Mary Kraly would have received \$120,000 to \$130,000 from the patent. Seemingly, someone in the licensee's accounting department looked at the bottom line and asked why the licensee was paying a little old lady from Cicero, Illinois, \$15,000 a year. That's when the payments stopped, and we sued for breach of contract. There were many legal controversies that made the lawsuit more expensive than the usual lawsuit, but finally, the matter went to trial. Mary Kraly won on the breach of contract issue, but the patent was declared invalid on an obviousness defense. So Mary Kraly was awarded \$12,000 to \$15,000 for the time period when the licensee should have been paying and wasn't.

Mary Kraly's total royalty return from the license arrangement was something around \$60,000, all of which she got from that one licensee. She spent that in the litigation and the licensee spent at least that. Considering that in the time frame from 1967 to 1974, the licensee at different times had three sets of attorneys involved, the total attorney's fees to the licensee must have been in

3. 502 F.2d 1366 (7th Cir. 1974).

(Please turn to Page 88)

British Law and the EEC

(Continued from Page 62)

that the great majority of those reported have dealt with Industrial Property. Thus the field of licensing is one of the prime areas affected by membership of the European Economic Community. It follows therefore that any consideration of a significant licensing program involving the United Kingdom is incomplete unless the Treaty of Rome is borne in mind. However, the future is shrouded with confusion and uncertainty. To quote from the Master of the Rolls in *Bulmer v. Bollinger*:

"The European Court is not absolutely bound by its previous decisions. It has no doctrine of *stare decisis*. Its decisions are much influenced by considerations of policy and economics and, as these change, so may their rulings change. It follows from this that if the House of Lords in a subsequent case thinks that a previous ruling of the European Court was wrong — or should not be followed — it can refer the point again to the European Court and the European Court can reconsider it. On reconsideration it can make a ruling which will bind the parties in that particular case, but not in subsequent cases, and so on."

To those of us who have been brought up in a Common Law jurisdiction with the reverence held due to the doctrine of the binding effect of previously decided cases, this is a difficult new principle by which to be governed!

Another area where there is little authority for guidance is the confusion that may arise where there are related proceedings before both the English Courts and the Commission of the European Economic Community. It is not too difficult to visualize situations where conflicting decisions may be given through these separate channels of judicial and administrative review.

Where we shall probably see much argument in the future is in the general field of antitrust cases of action in Industrial Property litigation. The United Kingdom has a well-developed statute law and case law in the field of Restrictive Trade Practices or Antitrust law. Industrial Property litigation has hitherto been conducted very much in a separate watertight compartment. We are now beginning to see a significant change and can expect that in the future the new torts of undue restriction of competition within the EEC and abuse of a dominant position within the EEC will be pleaded more frequently. The barrier, which some of us may think is artificial, between Industrial Property Law and Restrictive Trade Practices law has not been breached, but it is certainly cracking.

CITATIONS

LeRose Ltd. and Another vs. Hawick Jersey International Ltd., (1973) CMLR 83; (1974) RPC 42.

Minnesota Mining and Manufacturing Co. v. Geerpres Europe Ltd., (1973) CMLR 259; (1974) RPC 35.

Eso Petroleum Co. Ltd. v. Kingswood Motors and Others (1973), CMLR 665; (1973) 3 All ER 1057.

Aero Zip Fasteners and Another v. YKK Fasteners (U.K.) Ltd. (1973), CMLR 819; (1974) RPC 624.

Löwenbrau München and Another v. Grunhalle Lager International Ltd., (1974) CMLR 1; (1974) RPC 492.

Application des Gaz S.A. v. Falks Veritas Ltd., (1974) 2 CMLR 75; (1974) 3 All ER 51.

J. Bollinger S.A. and Others v. Goldwell Ltd., (1974) FSR 256.

H. P. Bulmer Ltd. and Another v. J. Bollinger S.A. and Others, (1974) CMLR 91; (1974) 2 All ER 1226.

Van Duyn v. The Home Office, (1974) 3 All ER 178; (1975) CMLR 1.

E.M.I. Records Ltd., v. C.B.S. United Kingdom Ltd., Times Law Report, March 13th 1975.

When a License Agreement Fails

(Continued from Page 66)

excess of \$100,000. So that lawsuit cost them more than \$160,000. There is no way to measure the additional peripheral expenses of the lawsuit to the licensee. If they had just lived with the license, it would have cost them only about \$120,000. The point that I make is that here is the history of a licensor-licensee fall-out which went to mat and in which the licensee was successful in invalidating a not obviously invalid patent and paid more than he would have had he lived with his license.

A Final Look

Coming back to the theme of what to do when a license agreement comes apart, the best advice is to be extremely cautious in entering into the license agreement. If sufficiently cautious and perceptive, you may not have to worry about what to do when the agreement comes apart. But if the agreement does come apart, then your planning should tell you what to do. You should be decisive in whatever you do, whether it is suit or abandonment of the license arrangement. Remember if the license agreement comes apart, it's because one of the parties is inclined to make a gamble and play a game. Your only resort is either to enter into the game determined to win or to completely refuse to play. And that decision should be based upon the economics of the circumstance.

Licensor/Licensee Research

(Continued from Page 67)

Please don't confuse this word feasibility with reduction to practice. It is much more than that. It perhaps can best be defined as the point in development when a potential licensee can be convinced the idea is worth spending money for development.

Naturally, this strategy has an effect on the type of idea we accept for development. If, in our estimation, the amount of time and money necessary to get feasibility is too long or great, it is no longer an attractive business proposition. We place the upper limit on time at 18 months with the amount of money limitation depending on what our estimate of the potential return might be. We are interested in returns that throughout the licensing of the patent will give us 10 to 1 on our investment.

We know that potential licensees would much rather pick up a license at a point further down the line towards commercialization. Therefore, we attempt to design our license package to take this into consideration. When we license at the feasibility point, we reduce front-end payments to an absolute minimum. In addition, the license is such that it gives the licensee an opportunity to invest money in contract research on the subject at a Battelle laboratory. This provides an obvious advantage to the