Best-Efforts Clauses — A Review

Performance clauses are routinely written into agreements, but what is their real meaning, effectiveness?

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What are performance clauses? They are clauses to ensure that a licensee lives up to his obligations. A clause requiring the licensee to pay minimum royalties is a performance clause. A clause requiring a licensee to maintain certain quality standards is a performance clause.

No doubt you know of other examples of performance clauses. There is little that needs to be said about this type of performance clause. It clearly defines the minimum royalties to be paid or the quality standards to be maintained, and there can be little argument if the provisions are not observed by the licensee.

The type of performance clause which I would like to consider today in detail is one which I think most of us have been in a habit of tossing into a license agreement with the same nonchalance as we toss salad dressing onto a salad. We tend not to give much thought to its real meaning and effectiveness.

An example of such a performance clause is as follows:

> *The Licensee covenants with the Licensor that it will use its best endeavors to promote the sale and use of Licensed Products in the Exclusive Territory and will meet the demand for the Licensed Products therein and shall provide proper service facilities for purchasers of the Licensed Products."*

Another example taken from the Revised Third Edition of L.W. Melville's "Forms and Agreements on Intellectual Property" is one which defines the performance clause with a greater degree of decision:

> *"The Licensee shall allocate sufficient of its resources, capital equipment, material and labor as to make the products readily available and Licensee shall advertise and promote the sale of products in all countries of the Territory in the manner best calculated to yield maximum benefit to both parties hereto in the light of prevailing circumstances and to the extent to which the product is at the relevant time competitive with other articles within the field of this agreement in the relevant part of the Territory"*

In order to gain some understanding of the effectiveness of such clauses we should review the decided cases relating to this type of performance clause. Until the recent case of *Arlo v Transfield*— decided in the Supreme Court of New South Wales and the High Court of Australia, the most relevant case, and indeed so far as I can determine the only one, was the well known case of *Terrell v Mabie Todd & Co. Ltd.*[2] I understand that the Terrell involved is the author of the well known text on patent law. The facts of the case are:

Terrell granted two licenses to Mabie Todd under certain patents and designs to manufacture and sell fountain pens and ink bottles.

The fountain pen agreement contained a clause requiring the licensee to make its best endeavors to promote the sale of as many fountain pens made under the patent as reasonably possible in the countries named in the said agreement and should with all diligence place the said invention on the market and proceed to exploit it in accordance with the license scheduled in the agreement. The ink bottle license contained a similar provision.

The plaintiff alleged that the defendants had broken their obligations under both license agreements in that they had not used their best endeavors to promote the sale of either the fountain pens or ink bottles as agreed, and had failed to use all diligence to place the said inventions on the market or to exploit them.

The defendants' pens under the trade names "Swan" and "Blackbird" were widely known over many years. In January 1950 the plaintiff became a director of the defendant company and then found that the company's financial and trading position was not satisfactory and was deteriorating. By January 1952 the control of the company had passed into new hands.

The controlling interest in the defendant company was obtained by Biro Pens Ltd., and a Mr. Richard Coit seems to have taken command. He was not called as a witness and there was some suggestion that his interest or control of the defendant company was short-lived.

While it lasted, he, acting on behalf of the defendants, unquestionably repudiated both the agreements at a meeting on January 18, 1952. He said that it would no longer fall within the commercial policy of the defendant as reconstructed to include the plaintiff's fountain pen as one of their future models.

The defendants were unwilling to market either of the inventions or advertise or promote their sale. It was even somewhat arrogantly suggested that the plaintiff should refund part of the sums which had been paid to him in respect of the two patents without reason being given why he should do so.

Very little if any attempt was made by the defendants to find a reason or excuse for this peremptory refusal to perform to their contractual obligations. In the pleaded defense there was nothing alleged to

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justify a refusal by the defendants to perform the agreements into which they had entered. At the trial no evidence was directed by the defendants to this high-handed disregard of their obligations, and there was no real attempt on the part of the defendants to justify their conduct.

Mr. Justice Sellers found that the repudiation was a clear breach of both contracts. Mr. Justice Sellers wrote, "On the issue whether the defendants used all diligence or their best endeavors to promote the sale of pens many documents were referred and some oral evidence was given. The question arises to how the court ought to approach this question and what are the material factors for its consideration. Each contract must be interpreted according to its own terms and according to its nature and purpose and it is therefore not surprising that there appears to be little authority to serve as a guide in the present case.

"It was not suggested that if the defendants were to manufacture and sell the pen and the last drop ink bottle it would have lead to disaster. Indeed, the plaintiff asserted that this pen invention properly exploited would have restored the defendant's fortunes.

"In my opinion, contractual obligations to use due diligence and their best endeavors to promote sales under such contracts as these would not require the directors to carry on the manufacture and attempted sale to the certain ruin of the company or to the utter disregard of the interest of the shareholders; but, before that extreme position could be reached—and as I have said, it was not pleaded or alleged that any such consideration arose—there would arise questions some of which would have arisen here as to the amount of money to be expended on the production and on advertisement and vending of the goods and how far money was to be borrowed for the purpose, if it could be and was not already available. The submission of the defendants that the contract read as a whole required them to do only what was commercially practicable and this was interpreted to mean that the defendants were to vend the goods to the extent that was consistent with the running of the company efficiently and prudently and in the interest of the company and to no greater extent."

Mr. Justice Sellers considered the decisions in *Davis Limited v Tooth & Company Limited*[3] and *Sheffield District Railway Company v Great Central Railway Company*[4] and went on to find that applying a construction as favorable as he could to the defendants that they did not use diligence and their best endeavors to promote the sale of either of the inventions. He also stated this is far from saying that if the defendants had used their best endeavors all would have been gone satisfactorly. Difficulty and certainties and uncertainties existed and these are relevant to the assessment of damages.

One point made by Mr. Justice Sellers which is worth bearing in mind is "in agreements of this kind I think that the inventor must take contracting party as he finds him. He cannot expect from a small company the same expenditure and production as from a large and powerful company. He cannot expect from an old-fashioned and financially embarrassed company that which he should receive but from a better equipped and more flourishing concern."

In my view this is just another way of saying that he should select his licensee with as much concern or even more concern than he would in selecting a spouse.

One cannot help wonder whether justice was done in this case. Those of you, who like me are old enough, will recall that at the relevant period ball-point pens were making a considerable impact on the pen market throughout the world and it would not have mattered what endeavors the defendant made to exploit the Terrell inventions they would have been doomed to failure not because of lack of best endeavors but purely because of market forces.

Before going on to consider the *Arlo v Transfield* decision let us have a look at two other British decisions which are relevant. The first is *IBM United Kingdom Limited v Rockware Glass Limited.*[5]

Interpretation

Despite the involvement of IBM this is not a case involving interpretation of a patent license. It involves the interpretation of a contract for the sale of land. Clause 7 of the contract contained three provisions as follows:

(a) This agreement is conditional upon the purchaser obtaining planning permission

(b) The purchaser will make an application for planning permission and use its best endeavors to obtain the same *and will not withdraw said application without the vendors' written consent*

(c) In the event of the planning permission not being obtained by the 1st November, 1975, the vendors shall be entitled to serve notice to rescind this agreement.

Planning permission was sought and refused. The purchaser did not exercise the right to appeal. It was held that by not appealing the purchaser had not used its best endeavors to obtain planning permission and the court ruled that the test of using best endeavors is, what would an owner of the property in this case who is anxious to obtain planning permission do to achieve that end? It was observed by one judge that these words (best endeavors) obliged the purchaser to take all those reasonable steps which are prudent, and determine man, acting in his own interests and anxious to obtain planning permission, would have taken.

Another more recent case is that of *Imasa Limited v Technic Incorporated.*[6] In this case the defendant granted an exclusive license to the plaintiffs to manufacture use and sell certain metal products and processes in the United Kingdom and to sell those products in certain territories in Europe. The agreement contained a clause that the plaintiffs would use best endeavors to promote the sale of products and processes.

The defendants pleaded that the plaintiffs had failed to use any or best endeavors to promote the sale of the products or processes and that such failure constituted a breach of the terms of the agreement whereby the defendants suffered damage. The plaintiffs requested further and better particulars of the alleged breached and the defendants refused to give such particulars.

Peter Gibson J. refused to order the plaintiffs to provide further and better particulars on the ground that having made an allegation of complete failure to use best endeavors the plaintiff was not obliged to expand

on it. One wonders what decision would have been if the plaintiff had alleged a partial failure to use best endeavors. Clearly in drawing pleadings it is desirable to allege complete failure to use best endeavors if it is possible to do so.

Let us now turn to the case of *Arlo v Transfield.* This was the subject of a paper by Mr. W. Madgewick at the Adelaide Conference in 1980. It is interesting to observe that most of the arguments advanced by Mr. Madgewick in support of the best Arlo's case have been unreservedly accepted by the majority of the High Court of Australia.

Arlo granted Transfield a license to manufacture and sell poles for use in the construction of electricity transmission lines. Transfield was connected in a substantial way with a construction of electricity transmission lines and was one of the three main operators involved in that work in Australia.

System

The Arlo pole is basically a structural system consisting of a series of steel tubes which nest one inside the other. The end of the innermost tube (which is the uppermost tube when erected) is capped with a plate having small holes to prevent air entrapment. The largest and outermost tube is anchored to a base tube set in concrete into the ground. When concrete is pumped through a port of entry in the base tube, the interior of the tube nest or bundle becomes filled with concrete and additional pumping forces the nested tube bundle to telescope vertically. When a section has telescoped its design length, it is prevented from extending any further by a system of stop rings. Splines are used below the exterior stop ring to maintain the pole in a stable position as it telescopes.

The number of tubes or sections will vary according to the height and weight bearing capacity of the role to be erected. The required cross arms are usually attached to the next of tubes ex factory. An advantage claimed for the Arlo next of steel tubes system is that they are more easily transported than a pole in one piece or with only a few sections from the factory and much lighter cranes are needed to lift them from the truck onto the prepared base tube and to erect them than a pole or the last-mentioned type. After the next of tubes are lifted onto the base tube, pumping commences, which results in filling the tubes with concrete and lifting them to the required height. The concrete, of course, adds greatly to the pole's strength.

Clause 7 of the license stated that "the licensee covenants during the period of Power Transmission Line License at all times to use its best endeavors in and toward the design fabrication installation and selling of the Arlo PTL pole throughout the licensed territory and to energetically promote and develop the greatest market for the Arlo PTL pole."

A number of the poles were erected in Western Australia by Transfield and a number of difficulties were encountered. One pole jammed during erection and there was difficulty in maintaining the poles vertical.

The State Electricity Commission of New South Wales called tenders for the construction of what was known as the Wallerawang transmission line. Doubts were expressed by the Commissioner's offices as to the suitability of the Arlo pole for the purposes of construction of the Wallerawang line and Transfield decided to overcome these doubts not by pressing the suitability of the Arlo pole and for this purpose accepting the assistance of Arlo's technical officers, but by the use of a pole of its own devising.

It was evident that in devising this pole Transfield drew upon information he had received from Arlo in connection with the Arlo pole. The Transfield pole satisfied the officers of the commission which awarded the contract on the footing that Transfield's pole and not Arlo's pole would be used in the construction.

Arlo claimed in the action that Transfield had not used its best endeavors to promote the Arlo pole as required by Clause 7. It was common ground that as a result of the use of Transfield's pole the potential market for the Arlo pole in Australia was effectively destroyed.

The trial judge held that Transfield had not used its best endeavors as required by Clause 7 and there was a 75% chance that the commission could have been persuaded to accept the Arlo pole. He also held that there was a 20% chance of the Arlo pole capturing the Australian market had it been used in the Wallerawang contract. He entered a verdict for a sum of $294,000 which included interest from the date of commencement of the proceedings until judgment at the rate of 10% per annum.

Transfield appealed to the Court of Appeals, Supreme Court of New South Wales against the verdict and the amount of damages and interest awarded was dismissed. The Court of Appeal held that a 50% chance better reflected the chance of capturing the Australian market and differed from the trial judge as to the amount and rate of interest.

On its reassessment of the damages the Court of Appeal reached a figure much in excess of the verdict but there being no cross-appeal there was no basis for interfering with the verdict. Before the trial judge and the Court of Appeal Transfield raised two defenses to Arlo's claim:

> (i) that Section 112(1) of the Patents Act 1952 made Clause 7 of the deed unlawful and in consequence was void in that it prevented Transfield from using an article of process supplied or owned by some other person than the Licensor, and
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> (ii) Section 45 of the Trade Practices Act rendered unforceable as against a corporation a provision of the contract which had the purpose or had or was likely to have had the effect the substantially lessening competition. The trial judge did not analyze these defenses in any detail. The Court of Appeal held both defenses to be without substance. The Appeal to the High Court was founded on the two defenses only. The High Court by a majority held that both defenses failed.

It is important to note that in the decision the High Court of Australia did not decide the question as to whether the licensee had used its best endeavors. It is necessary to go to the decision of the original judgment of the Supreme Court of New South Wales to learn the Court's view of the best-efforts clause.

Construction

During the course of the trial, counsel for Transfield submitted that Cl. 7 was capable of the following three

constructions:

(a) To sell and promote the Arlo pole in suitable markets; or

(b) To use best endeavors toward selling the Arlo pole to persons who may reasonably be expected to buy it; or

(c) To use best endeavors to promote the greatest possible market for Arlo for which it is really suited.

On any of these constructions, he submitted, it is not necessary for the licensee to use best endeavors to sell or promote the Arlo pole for contracts for which it is not reasonably suitable. The Judge declared that he was satisfied on a consideration of the whole of the evidence and particularly the evidence of the plaintiff's expert, that the Arlo pole was suitable for the Wallerawang contract.

He also declared, "I am, moreover, satisfied, on the evidence, that there was a reasonable expectation that the Commission would have accepted it. Undoubtedly it needed to be reassured as to certain matters and no doubt it would have required one or more test poles to be erected, but such a reasonable expectation, however, was completely destroyed by the defendant's deliberate act in answering the Commission's problems by offering to it an acceptable substitute which did not present the majority of the problems raised by the Commission; and so, in my opinion, even if one accepts any of Mr. Priestley's (the Council for the Defendant) alternative constructions there has been a clear breach of Cl. 7 by the defendant".

The Judge then referred to the passage in the 4th ed. of T.A. Blanco White's "Patents for Invention", 10-308, at p. 388:

> A common provision requiring a licensee to use his "best endeavors" to develop and promote the invention the subject of the license is not, as is sometimes supposed, in the nature of the mere expression of hope, but is an effective and unforceable clause requiring a high standard of endeavor on the part of the licensee.

and said:-

> This proposition is, I think, supported by the decision of Sellers, J., as he then was, in *Terrell v. Mabie Todd & Coy. Ltd. (1952) 69 R.P.C. 234;* and as the Court said in *Sheffield District Railway Coy. v. Great Central Railway Coy. (1911) 27 T.L.R. 451;* ..."best endeavors" means what the words say; they do not mean second-best endeavors.
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> No doubt the obligation must be interpreted upon a consideration of the agreement as a whole and, in particular, its nature and purpose; and, in considering whether the obligation has been performed, the licensor, as was told by Sellers, J. in Terrell's case (supra) at p. 239, must take his contracting party of business or without reputation or expertise. It was a substantial company with a considerable reputation and experience in the field the subject of the license; it was a substantial contractor for the construction of electrical transmission lines in Australia and, as far as New South Wales was concerned, was one of but two contractors who had constructed such lines for the Electricity Commission of New South Wales.
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> Clause 7 contained a convenant on the defendant's part to use its best endeavors not only toward the design, fabrication, installation and selling of the pole but energetically to promote and develop the greatest possible market for it. In my opinion, the defendant owed a duty to use, within the limits of reason, its best and not its second-best endeavors in the light of its capabilities, resources and resources and experience.
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> As far as the Wallerawang contract was concerned, the defendant, far from using its best endeavors, on the evidence made no real effort to face up to and resolve any of the design or fabrication problems raised by the Commission; its best endeavors, as far as the Wallerawang contract was concerned, were its own and as a result to sell the Transfield pole. In so acting, far from developing the greatest possible market for the Arlo pole, it ... totally destroyed it ...

Western Geophysical Company of America Inc. v Bolt Associate's Inc.

In this case, it was decided that a licensee's unsuccessful but diligent efforts satisfy a best-efforts clause even where the licensor successfully exploited the patented product shortly after the termination of the agreement.

Bolt granted Western an exclusive license to use and to sub-license a pneumatic acoustical refiater (P.A.R.) (an air gun to be used as a sound source in underwater seismic exploration). The agreement includes a clause which required Western "to use its best efforts to promote worldwide licensing and use of the licensed apparatus ...".

To its dismay, Western found that the P.A.R. failed to operate satisfactorily. It directed its efforts to modifying and improving the P.A.R. but the modified unit had a noise problem which rendered it unsatisfactory for deepwater use although it could be used in shallow water. Western decided not to sub-license the P.A.R. and spent considerable money developing a system in which P.A.R. could be used in deep water.

Bolt terminated the agreement on the ground that Western had not used its best endeavors to sub-license the P.A.R. worldwide. After termination Bolt itself succeeded in exploiting the P.A.R. Western sued Bolt for damages for breach of contract.

The District Court agreed with Western that its attempts to eliminate the noise problem was sufficient to satisfy its best-efforts obligation and awarded Western damages. On appeal the decision was upheld, the Court of Appeal holding (1) the licensee has expended substantial sums in good faith in an effort to improve the patented apparatus, (2) a good-faith judgment had been made that a sales effort before perfection of the apparatus was achieved would be fruitless, (3) the licensor was aware of the licensee's activity but never expressed its dissatisfaction or complained that the licensee was failing to comply with the requirements of the agreement, and (4) the broad phrase "best efforts to promote licensing" indicates a degree of discretion in the selection of the promotional plan; no absolute requirement that Western sub-license can be read into these words. The Court of Appeal also approved the standard by which the lower Court determined whether "best efforts had been employed", i.e. active exploitation in good faith was also proper.

The test of "practical business sense" was adopted in other U.S. cases, notably *Carbo-Frost Inc. v Pure Carbonic Inc.*[8] and *Eclipse Bicycle Co. v Farrow.*[9] In the first, the court ruled that royalties were payable in respect of the sale of a competitive unit which it said was not superior "in a practical business sense" to the licensed unit.

Another interesting case is *Perma Research and Development Co. v Singer Co.*[10] which took 10 years to litigate through the Court of First Instance. This involved an "assignment" of a patent for an anti-skid control device in return for royalty payments. The

assignee was required to use its best efforts for a reasonable time to perfect the product under all circumstances. On the basis of expert testimony the court found that the device could have been perfected and made marketable without unreasonable effort and that the assignee had breached its obligation by failing to seize reasonable opportunities to perfect the device. The decision was affirmed on appeal but with a lengthy dissenting opinion.

The damages awarded against the assignee were $5m.

This consideration clearly establishes that the courts in that country adopt a somewhat different attitude to the best-endeavor clauses than do the Australian and the United Kingdom courts. For those who wish to study the U.S. situation in detail I would recommend them to an excellent paper entitled, "The Best Efforts Obligation - A Useful Tool for the Licensor" by Kenneth E. Payne and Allen M. Sokal in the "Licensing Handbook for 1981". Indeed the U.S. position is summarized in the following quotation from that paper:

> A properly drafted best-efforts provision can be a useful tool for the licensor and can clearly delimit the licensee's obligation under circumstances that make exploitation of the license technology impracticable. Relying on an implied or broadly worded best-efforts obligation, on the other hand, seriously risks uncertainties and expense of litigation and the destruction of a profitable relationship between the licensor and the licensee. The best-efforts provision should specify in detail the obligations to the licensee but should not expressly restrain the licensee from dealing in competing technology. Following these steps would reduce the possibility of misunderstandings and afford adequate relief if one of the parties breaches its covenants.

Now, what can we learn from so much verbage? I think we can say that, best-endeavor clauses in a license agreement are a very useful tool and under Australian and U.K. and indeed New Zealand law the simple, straight-forward best-effort clauses quoted at the beginning of this paper are effective. If one is concerned with the possibility of having the best-efforts clauses construed by United States court, perhaps more detailed best-efforts clauses along the lines of that quoted, the second typical example quoted at the beginning of this paper, should be used.

NOTES

1. *Transfield Pty. Ltd. v Arlo International Ltd.* 30 ALR 201.
2. *Terrell v Mabie Todd & Co. Ltd.* (1952) 69 R.P.C. 234.
3. *Davis Ltd. v Tooth & Co. Ltd.* (1937) 4 All. E.R. 118.
4. *Sheffield District Railway Co. v Great Central Railway Co.* (1911) 27 T.L.R. 451.
5. *IBM (United Kingdom) Ltd. v Rockware Glass Ltd.* 1980 F.S.R. 335.
6. *Imasa Ltd. v Technic Inc.* 1981 F.S.R. 554.
7. *Western Geophysical Company of America Inc. v Bolt Associate's Inc.* 200 U.S.P.Q. 1 (2d lir 1978).
8. *Carbo-Frost Inc. v Pure Carbonic Inc.* 308 U.S. 569(1939).
9. *Eclipse Bicycle Co. v Farrow* 199 U.S. 581 589 (1905).
10. *Perma Research & Development Co. v Singer Co.* 429 U.S. 987 (1976).