

# EC Know-How Regulation Analyzed

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Recently published Regulation sets out statement of lawful licensing practices, but not all situations covered (Complete text in *How* pages)

In December 1988, the Commission of European Economic Community adopted Regulation No. 3030/88<sup>1</sup> on the application of Article 85(2) to certain categories of know-how licensing agreements<sup>2</sup> and this came into force on April 1, 1989 (hereinafter referred to as "the RHR"). Thus, we now have a clear statement of what practices are assumed to be lawful in licensing know-how and patents in the Common Market. The December 1988 *in Novelties*, at page 161, contained an article by the writer entitled "A Guide to EC Block Exemption Regulations," and it is recommended that the reader should be familiar with this earlier article as it will help in understanding what follows.

The present article will attempt a detailed analysis of the new Regulation as it is believed that many members will use the Regulation in setting out what may and may not be permissible in the contractual licensing of know-how and patents in Europe. This is only partially true and there will be many situations in which the Regulation does not provide any guidance.

## LIMITATIONS OF THE REGULATION

1. Not All Agreements between two companies are within the scope of Article 85(1) of the Rome Treaty, and if they are outside there is no need to obtain negative clearance or exemption. A Notice on Agreements of Minor Importance was first published in 1968 (for latest text see OJEC 1986 C211/2) and examples

automatically from the effects of Article 85(1) agreements in which the goods or services the subject of the agreement do not represent more than 5% of the total market for such goods or services in the area of the Common Market affected by the agreement; and the aggregate annual turnover of the participating undertakings does not exceed 300 million ECU. This Notice has been narrowly construed to a number of Commission decisions but does provide some relief to small companies.

2. Many license agreements are concluded between a parent corporation and its wholly-owned subsidiaries. These do not require exemption as they are not separate undertakings within the meaning of Article 85(1) and form one economic unit so long as the subsidiary has no real freedom to determine an independent course of action.

3. EEC law in this area is primarily concerned with free flow of goods within the Common Market and the prevention of trade barriers between the Member States. Export bans on one party exporting from the Common Market are generally of no concern to the antitrust authorities in Brussels. They are not dealt with in the RHR and this is discussed in the cited article in the December 1988 issue of *in Novelties*.

4. Not all European countries are members of the Common Market, and there are Treaties of Association with former members of the European Free Trade Association (EFTA) containing provisions similar in terms to Article 56 and 58 and 85(1) of the Rome Treaty. These Treaties were mostly signed in 1972 or 1973 and exist with Austria, Iceland, Finland, Norway, Sweden, Switzerland and Israel. A general analysis of the effects and significance of these Treaties is outside

the scope of the present article. Comment will be restricted to the effect of these Treaties on any license agreement concluded between, for example, a Swedish company and a company from a Member State of the Common Market.

In practice, any problems will often be theoretical because many companies based in an EFTA country will have a manufacturing facility inside the Common Market. However, if this is not the case, there are unassorted problems.

5. An export ban on an EFTA country licensee permissible (see the discussion under 2 above) The answer rarely must be that it is usually not objectionable (see, for example, the European Court of Justice decision in *Debyer v. Harlequin* (Case 233/86) [1987] ECR 329 and the Commission decision in the matter of *David Bull Company Milners* (1988) L 70/89 of March 13, 1988, [1988] 2 OMLR 397).

6. The RHR deals with manufacturing licenses only (see Article 3), although license agreements where for an initial period the licensee is a sales only licensee are also covered (see Recital 6).

However, there is no clear guidance as to whether the manufacture may take place within the Common Market. Thus, if the licensee manufactures outside the Common Market and sells within the Common Market, he may or may not be able to benefit from the RHR.

Recital 4 was added to the RHR at a late stage in its drafting and reads as follows:

"When such joint or mixed know-how licensing agreements concern not only off-gate sales relating to territories

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with the common market but the obligations relating to non-member countries, the process of the latter does not prevent the present legislation from applying to the obligations relating to countries within the common market.

However, indications have been given, in the form of a letter to the Member States, as to the difficulties which, raised beyond the limits of the Common law, have arisen within the Common market which may lead either to the suppression of Article 171 or to the adoption of a new regulation. It is the intention of the Commission to study the possibility of the conclusion of mixed agreements for countries situated outside the common market.

This agreement is interrupted by the EC Commission to deal with questions such as those raised in these paragraphs 3, 4 & 5.

#### THE BLOCK EXEMPTION REGULATION CONCERNING PATENT LICENSING

This regulation (hereinafter referred to as the PR) was adopted in 1984 under the Number 209/84 and was published in 1984 in its Official Journal of December in the blue pages at page 19. It relates to license agreements involving patents only and also some involving both patents and know-how and the relationship between the EEC and the PR is an important question, as different criteria for exemption may apply, depending on which regulation is relevant. In the writer's opinion, the existence of two Regulations is an historical accident and legal certainty would be promoted if there had only been one. It is reasonable to expect that at some time in the future there will only be one Regulation dealing with patentable practices in patent and know-how licensing.

#### RELATIONSHIP BETWEEN THE EEC AND THE PR

To explain the relationship between the two Regulations involves an understanding of what is meant by "necessary" patents and that the know-how must be "secret, substantial and identified in any appropriate form" and these terms will be explained later.

The basic requirement for exemption under the PR is that there must be necessary patents in the Common Market countries covered by the license agreement. Some mixed agreements to have know-how is also licensed fall within the scope of the PR but there is no requirement for the know-how to be identified. There are many license agreements where the patents are not necessary and many where the patent protection does not exist in all the countries, the subject of the license agreement. Thus, Article 2 of the EEC identifies two types of mixed agreements not covered by the PR (see also Recital 3 and Article 1, para 30D).

mixed agreements which the licensed patents are not necessary for the achievement of the objects of the licensed technology containing both patented and non-patented elements, this may be the case where confidentially disclosed technical information governs the exploitation of the technology by third parties.

Another type of mixed agreement is

mixed agreements which, regardless of whether or not the licensed patents are necessary, do not fulfil the objectives of the objects of the licensed technology, contain obligations which relate to the exploitation of the licensed technology by the licensee or the licensee's Member States without patent protection, include and or long account obligations not limited to trade or in part on the exploitation of the licensed know-how and EEC Member countries set out in the Regulation.

Thus, if a patentee licenses patents and know-how in France and Germany and thinks that the licensed patents are not necessary, as that term is used in the EEC, it cannot benefit from the PR. Similarly, if the license agreement involves in another Common Market Country where there is no patent protection, the license agreements cannot benefit from the PR, whether or not the patents are necessary.

#### DEFINITION OF KNOW-HOW AND NECESSARY PATENTS

To benefit from the EEC the know-how is defined in Article 1,

part 7, sub-para (1) as "a body of technical information that is secret, substantial and identified in any appropriate form." In sub-paragraph (2) there is a definition of "secret" and in sub-paragraph (3) there is a definition of "substantial," while in sub-paragraph (4) the term "identified" is defined.

The term "identified" means that the know-how is described or treated in such a manner as to make it possible to verify that it fulfils the criteria of secrecy and substantiality and that the licensee is not readily enabled to his exploitation of his own technology. To be identified the know-how must be described in one of the license agreements or in a separate document or in a contract with the licensee or in the fact that the know-how is transferred or directly transferable provided that the separate document or other record can be made available to the third party.

The italicized language was only added to its draft EEC at a late stage in its preparation and thus it is the requirement as all for identification of the know-how in the PR and no Commission decision that explains the need for identification. The problem that this may cause in deciding which of the two Regulations is pertinent will be considered later.

Necessary patents is a term that is explained in Recital 3 of the EEC quoted above. "This may be the case where such patents do not afford effective protection against the exploitation of the technology by third parties." It is submitted that although this is a subjective test, where facts might only be shown by litigation, very often it will not present real problems in interpretation. There are many license agreements where the parties know that the patents are vital but the agreement has only been concluded because the licensee wants the know-how.

#### INDUCTIVE OF THE KNOW-HOW REGULATION NOT INVENT

The structure of the EEC is similar to that of the PR in that Article 1 deals with possible restrictions on manufacture and sales within the Common Market culture

wise known as territorial restrictions).

Article 2 sets out clauses that are often present in any license agreement, e.g. grant-back clauses and know-how clauses, and which are acceptable — the so-called white clauses, while Article 3 sets out the type of clause whose presence is not acceptable — the so-called black clauses. There are almost as many pages of recitals as there are of the Articles of the KMR itself. Recitals are vital to the interpretation of a Community Regulation and reference is made to a number of them in this analysis. If interpretation of one of the articles is unclear, reference should be made to the appropriate recital for possible explanation.

#### TERRITORIAL RESTRICTIONS — ARTICLE 3

Many European companies are primarily concerned to secure the activities of any manufacturing licensee in part of the Common Market. They will only grant a license as long as they can reserve part of the Common Market to themselves. Thus, permissible territorial restrictions are an essential part of the KMR, as are the possibility of active and passive sales by the parties.

An active sale is one in which the seller actively solicits orders by advertising or otherwise in the territory concerned. A passive sale is one that the seller simply responds to an order that has not been solicited. These sales concepts are also found up with the idea of exclusivity, and these are industries where the concept has little meaning.

The importance of the permissible forms of manufacturing exclusivity cannot be overstated. There is a school of thought that considers these to be the most significant part of the Regulation. It is argued that without the need to specify what export bans may be contractually agreed upon to divide up the Common Market, no KMR would be needed. Thus, Article 3 deals with permissible horizontal restraints on competition within the Common Market. These can be

summarized as follows:

1. The grant of an exclusive license for all or part of the Common Market, provided that if the licensed territory is only part of the Common Market, exclusivity cannot be for more than 10 years from the date of signature of the first license agreement for the territory concerned.

2. The exclusive licensee of (1) can exclude the licensor for the same period of 10 years.

3. A licensee may not exploit (manufacture or sell) in a territory reserved to the licensor for the same period of 10 years.

4. A licensee may not manufacture or sell in a territory reserved to other licensees for a period of 10 years from the date of signature of the first license agreement within the EEC in respect of the same technology.

5. A licensee may not engage in passive sales in territories reserved to other licensees for a period not exceeding five years from the date of signature of the first license agreement within the EEC.

This summary has been made by studying Article 1 part 1, sub-paragraphs (1), (2), (3), (4), (5) and in conjunction with Article 1 part 2. It is complicated to analyze the permissible restrictions with regard to any particular license program in which the intention is to divide up the Common Market. However, a very delicate attempt has been made in the KMR to permit all licensees to make passive sales throughout the Common Market. Thus, a licensee may only be prevented from making passive sales in the territory of other licensees (see Article 1, part 1(c)) for a period of five years (see Article 1, Part 2, third paragraph) from the first license agreement within the EEC. However, he can prevent passive sales in a territory reserved to him by the licensor for a longer period, and likewise the licensor can prevent passive sales in a territory reserved to himself for a longer period.

The period of ten years has been chosen arbitrarily — the EC Commission originally proposed seven years — as a limit to the exclusive

territory protection that may be contractually agreed between licensor and licensee. In those Member States in which there are "necessary" patents, the period of exclusive protection may be extended for the life of the patents — see Article 1, part 4 of the KMR.

Issues as to the obligations, active and non-paragraph 1(c) to its licensees, including Member States in which the same technology is protected by necessary patents, the exceptions provided for in paragraph 1 shall extend to those Member States in which a licensed product or process is protected in those Member States under such patents, while the duration of such protection exceeds the period specified in paragraph 1.

However, on the reverse side, note that the licensee must have the right to terminate exclusivity if the licensor does not exploit at the latest five years from the date of the agreement (see Article 7(3) and also if the licensee engages in certain forms of competing activities (Article 3(5)).

#### Article 2 — White Clauses

These are clauses that are not normally considered to be restrictive of competition. In other words, they are outside the scope of Article 86(1) and their presence in an agreement means that competition is not needed.

Licensees can be bound to an obligation of secrecy in respect of the communicated know-how and this can extend beyond the expiry of the agreement (sub-paragraph 1).

Sub-clauses may not be granted and the licensor may not be assigned (sub-paragraph 2).

Use of the know-how after the termination of the agreement may be prohibited subject to certain qualifications (sub-paragraph 3). The licensor and licensee can enter into mutual undertakings to communicate improvements to each other but the actual wording of this complicated sub-paragraph (sub-paragraph 4) should be thoroughly studied.

The licensee can be required to observe minimum quality specifications and to provide goods or services from the licensee provided that these specifications are necessary

for technical reasons as detailed in sub-paragraph 5.

The licensee can be required to indicate the location of any theft of the know-how or infringement of the patents but cannot be stopped from challenging the validity of the licensed patents (sub-paragraph 4).

A field-of-use restriction in one or more technical fields of application is permissible (sub-paragraph 9).

Licensee can be required to pay a minimum royalty or produce a minimum quantity (sub-paragraph 9) and to mark the licensed product with the licensor's name (sub-paragraph 11).

Licensee can be obliged to grant to licensor any more favorable terms than he grants to another licensee (sub-paragraph 10).

#### Article 3 — *Black Classes*

Many of these are simply the corollary of the permissibility limitations set out in Article 1. An analysis of subject matter rather than its simple chronological order may be more helpful.

##### *Not To Be Done*

It is permissible to require a licensee to stop using the licensed know-how after the usual termination of the agreement. However, if the know-how has become publicly known, other than by the fault of the licensee, the licensee may continue (Article 3(3)). Moreover, if the operation of the post-term use ban prevents the licensee from working an expired patent that can be worked by other manufacturers, the benefit of the exception can be withdrawn (Article 7, part 4).

##### *Improvements*

The EHR does not simply say that licensee and licensor can grant each other nonexclusive licenses for improvements and that an exclusive grant-back license to licensee is not permitted. The complicated language of Article 2 part 1(4) dealing with permissible classes of this nature has already been noted. Article 3(7) sets out the nonpermissible obligations concerning improvements. These include an obligation to assign improvements to the licensee and to grant exclusive licenses, in certain

circumstances, to the licensee.

##### *Trade Classes and Quality Standards*

Article 2(5) permitted these in certain circumstances and Article 3(5) is almost the corollary in defining when these are not permissible.

##### *Royalties*

Article 15 contains a long explanation as to why the permissible and nonpermissible restrictions on royalty payments have been included in the EHR. The permissible restrictions are set out in Article 2, part 1, (7), (8) and (9), while the corresponding black classes are set out in Article 3(6). Thus, turnover-related royalties called for by a license agreement can continue to be due, even if the know-how becomes publicly known, but note Article 7(7) which states this period must not exceed the lead time acquired because of the lead time in commercialization. There is an obvious opening here for a licensee to ask for renegotiation of an agreement once the know-how is no longer secret.

##### *Duration of the Agreement*

As adopted, the EHR contains no restrictions on the initial duration of the license agreement, but if it is automatically prolonged by the inclusion of new improvements there must be a right of termination — see Article 3(8).

Article 3(6) deals with price fixing and Article 3(9) sets out the circumstances in which the licensee can require the licensee not to compete with him with respect to competing products. Quantity restrictions are generally not possible — see Article 3(7) and subject to Article 1, part 1 (8) and second source manufacture licensing discussed in Article 4(2).

The above is not a complete analysis of the Black classes of Article 3 but, as stated, some are simply corollaries of the permissible white classes of Article 1.

##### *Opposition Procedure*

Article 4 of the EHR provides a quick clearance procedure for agreements with gray classes, that is agreements not containing any of

the Black classes of Article 3, but containing restrictions beyond those permitted by the white classes of Article 2. There is a similar procedure in Article 4 of the PR and its value has been the subject of some debate, since it has been little used.

##### *Cross-Licensing*

Article 3 states that the EHR does not apply to members of a patent pool (Article 3(8) (10)) and to know-how licensing agreements between competing undertakings that hold interests in a joint venture (Article 3(12)). Reciprocal licensing is referred to in Article 3(10) and is also outside the scope of the EHR, unless there are no territorial restrictions within the Common Market or manufacture, use or sale (Article 3(2)). The Regulator does not use the term cross-licensing for linguistic reasons, but reciprocal licensing is the equivalent term.

There is similar language in the PR and its exact significance has never been clearly explained. However, it would appear that if two competitors cross-license each other in relation to competing products, the agreement cannot be developed under the EHR unless the cross-licensing agreement involves throughout the Common Market.

The above is not meant to be an exhaustive analysis of the EHR, since there are many details in the wording that require careful study if they are significant in a specific situation. Considerable work was made by the authorities in Brussels to accommodate many parties with special interests, and this has meant that in places reviews clauses contain very detailed provisions.

#### RECOMMENDATIONS

1. In the author's opinion, the adoption of the EHR means that the PR has a greatly reduced significance and in writing any agreement involving patents and know-how it will be safer to assume that the applicable regulation is the EHR and not the PR. This means that the know-how should be identified in the way discussed in this article. Where notification is not carried out because it is believed that a particular Black Exception Regulation

make this unnecessary, the agreement concerned is not marked in any way with a reference to the appropriate regulation. By identifying the know-how the parties keep their options open as to which is the relevant regulation.

3. While the EPCB does have certain transitional provisions, the Regulation applies retroactively in the sense that it applies to existing agreements. It may be that some

agreements should be modified to conform with the new Regulation.

5. Exclusive licensing, the possibility of territorial restrictions on manufacture and export limits on sales between Member States of the Common Market are central to the new Regulation. If a license is non-exclusive and there are no restrictions on sales throughout the Common Market, many Europeans will say that there should be no real

problem in benefiting from the new Regulation. Non-Europeans may find this concept strange, but the Common Market is a fiction being one sovereign state with free flow of goods throughout its territory, and a main aim of the new Regulations is to help to promote free flow of goods between the Member States. It is not concerned with trade between the member states and the rest of the world.