

Four 'Musts' for Licensors

Discussion of major imperatives in effective agreements, with precautions and possible pitfalls

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Schematically, the imperatives to be taken into consideration by a would-be licensor before he enters into a license agreement can be said to center on four main poles.

The first imperative is to make sure that the agreement that the licensor is going to conclude will not, directly or indirectly, imperil his monopoly, whether legal (patent) or actual (know-how).

The second imperative is to see to it that his invention is exploited and that it is exploited under optimal conditions.

The third imperative is to secure earnings from that exploitation. (In particular, he will have to avoid to the best of his ability to bear the related costs).

Finally, the fourth imperative may be, beyond the financial profit derived from the exploitation of his invention, to achieve or maintain a reputation which, in turn, will allow him to strengthen his position on the market.

We shall now examine, in view of these four objectives, what are the possible pitfalls for a would-be licensor and what are the precautions to be taken by the latter when drawing up an agreement with his would-be licensee, if such objectives are to be attained.

PRESERVING THE INTEGRITY OF THE LICENSOR'S MONOPOLY

To this end, a licensor will frequently impose on his licensee four sets of clauses — presented here without regard to an order of importance — relating to:

1. The licensee's guarantee that he will not dispute the validity of the patents involved.
2. The rules applicable to improvements.
3. The obligation of secrecy.
4. The licensee's commitment to assist the licensor in fighting against infringements of the patent or patents involved.

Depending on how the agreement is drawn up, these clauses can contain pitfalls that may not be obvious to inexperienced negotiators.

The licensor will often wish to make sure that his licensee does not dispute the validity of the patents that

are the subject matter of the license.

This type of provision has been recognized by the EEC Commission as inadmissible. It has appeared essential to the Commission that freedom should be granted to the licensee to behave like a third party to the licensor and to dispute the validity of the licensed patent.

This provision, however — and that, we think, can to some purpose be emphasized — does not interfere with the licensor's right to terminate the license agreement in the event of the granted right being disputed by the licensee.

Rules applicable to improvements

It is a matter of fundamental importance that care should be taken to define with the greatest possible precision the rules applicable to improvements that may be made either by the licensee or by the licensor during the term of the license.

Actually, there are two basic problems, namely:

1. That of the disclosure of improvements under the agreement.
2. That of the ownership of these improvements and of the right to use them.

Concerning the first point, as a rule the parties undertake to disclose to each other any improvements that they may develop. The parties, however, will sometimes forget to exactly define such disclosable improvements. In order to avoid any dispute, it is therefore necessary to provide a clear definition of the improvements involved. Which are to be disclosed: Patentable improvements? Nonpatentable improvements?

One should also consider whether "improvements" only means technical improvements, or whether the term includes commercial improvements as well. (Let it be reminded that a technical improvement involves an invention that is related to an invention already covered by a patent in such a way that the relation creates dependence on the first invention, whereas "commercial improvement" has a broader meaning, involving an invention that is distinct from the primary invention although it has the same goal and the same scope of application).

Time Limit

The time limit for disclosure of an improvement should also be considered.

Generally, the advantage of such an exact definition in the agreement is not only to avoid an equivocal text likely to give rise to disputes, but also to avoid that the relations between the parties in this respect be governed, as supplementary standards, by legal provi-

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sions, or by case-law interpretations, which might prove to be in the licensee's favor.

Thus, in France it has been ruled that in the absence of a clause relative to improvements, the licensee is entitled to exploit "improvements centered on the licensed patent," in view of the good faith that should prevail in performing the agreement. Moreover, it has been ruled that, failing an exact definition of improvements, this term should be given its broader meaning and should be deemed to include both patentable and non-patentable improvements.

More particularly — with respect to the distinction between technical and commercial improvements, one should consider the possible discovery by the licensor of a result that is entirely distinct from the main invention.

Concerning the second point, the parties will have to define the scope of the right to use the improvement that they are granting to one another, notably to determine who may file a patent application for that improvement and what right that partner who is not the owner may exercise in relation to such a patent.

In respect of a result constituting a commercial improvement, although the agreement entered into does not cover this type of result, it may be difficult to admit that the licensor is entitled to license said result to a third party, as he will then give rise to a competition between the two licensees which might be strongly prejudicial to the first licensee.

Now, to the extent that a prejudice will exist, an action on a guarantee may be taken against the licensor by reason of his failure to comply with his obligation to secure to the licensee the enjoyment and peaceful exercise of the granted right. That would constitute a "pitfall" for the licensor, who could not exploit his result without incurring his licensee's reaction.

In order to counter this danger, the best thing to do is to provide for a right of first refusal allowing the licensee to elect in priority, within a specified time limit, to accept an offer to be granted a license to use that result.

Of course, an improvement may also be made by the licensee instead of by the licensor. In such a case, it is the licensee who will have to grant the licensor a right of first refusal.

Fighting against infringements by third parties

It is necessary to clearly determine who will have to initiate infringement proceedings, in consideration of legal obligations, how court cost and damages will be apportioned, and who will bear the risks of nonexploitation and of any royalties to third parties. A rapid survey can be made of the advantages and disadvantages, or pitfalls, to the licensor of leaving it to the licensee to initiate infringement proceedings (to the extent, of course, that this is not prevented by law).

An advantage may be that perhaps it will be easier for the licensee to detect infringements, to prove them and to follow the procedure, especially where the two partners are in different countries (language problems, acquaintance with local law). The disadvantages lie in the fact that in infringement proceedings the existence of the patent may be challenged and it is up to the licensee to defend that existence on his own initiative. It must therefore be "hoped" that the licensee will be

able to control the procedure and that he will be a good defender of the patent.

As a matter of fact, the licensor then leaves it to a third party to uphold his interests, and that may turn out to be a pitfall if the licensee fails to show the necessary zeal. Moreover, if an action is taken by the licensee alone, any award from such action will be for his sole benefit. Another disadvantage may be that his conduct of the proceedings will lead the licensee to feel all the more definitely entitled to have his license renewed, as he will have contributed to preserving the licensor's monopoly, or to indemnification in the event of early termination by the licensor.

Request Assistance

Where the licensor does not leave it to the licensee to initiate infringement proceedings, he should nevertheless request of the latter his assistance. It will be necessary, however, to define precisely what is meant by "assistance," more particularly with respect to the apportionment of expenses incurred and profit derived.

We shall deal later with the case of infringement by the licensed patent or know-how of a third party's patent. This situation will be approached in the part devoted to the guarantees and charges which the licensor should strive to limit.

Finally, one should mention, in relation to the efforts to preserve the licensor's monopoly, the question of who is to pay the annual patent fee. It is in the licensor's interest not to leave it to the licensee to pay that fee, as such a clause may prove dangerous. If the licensee fails to comply with this obligation, the licensor may only claim damages for the prejudice suffered as a result of forfeiture of his patent.

Secrecy

In order to preserve the value of the know-how it is essential that the licensee be put under an obligation to treat as confidential any information disclosed to him under the license and to use it for the sole purposes of the agreement. It is of course necessary to define that information to which this secrecy obligation will apply. That may be done by listing the information disclosed by the licensor in a report or an appendix to the agreement. This may prove useful in avoiding disputes between the parties as to what has or has not been disclosed among them.

Should the parties be desirous of providing that the secrecy obligation shall not apply to information obtained by the licensee from other sources than the license without infringing the licensor's rights (as would for instance be the case for information known to the licensee before the signature of the license agreement, or for publicly available information, etc.), it must then be clearly stipulated in the license, in the licensor's interest, that the onus of the proof that such information is not included in that disclosed to the licensee under the license and the obligation of secrecy, lies upon the licensee.

Finally, a term must be fixed for that secrecy obligation. Here the pitfall to be avoided is the fixing of similar terms for the secrecy obligation and for the license, to the extent that the licensor will be desirous, upon the expiration of the Agreement, of taking back the exploita-

tion of the licensed product or of having royalties paid to him by the licensee in consideration for the know how, even after the expiry of the patent.

GUARANTEE OF EXPLOITATION

The licensor must have a guarantee that his patent will not be "frozen" and he will derive a real profit from the license. Although it has been a general trend of case law in individual countries to sanction the principle that a licensee should use his best efforts in exploiting an invention, it may not be useless to expressly mention this obligation in the agreement, with two classical clauses that shall be binding on the licensee, namely, minimum sales and no competition. Moreover, in order to guarantee the exploitation the licensor must keep the person exploiting his invention under control; this question is approached with sublicenses and the transfer of the license agreement.

Minimum sales

Minimum sales will as a rule be fixed for every year during the term of the license. If the value thus fixed has not been reached in due time, either the licensee is obligated to pay minimum royalties corresponding to the minimum sales provided for by the agreement, or the licensor may terminate the agreement or convert an exclusive license into a nonexclusive one.

A licensor must, however, be fully aware of certain pitfalls that can be contained in these provisions, or at least of certain practical difficulties restricting their application.

First, the licensee must be cautious when fixing minimum sales. His natural tendency will be to set the threshold too high, in which case the licensee may be "unsteadied." If, on the contrary, the threshold is too low, there will be no more inciting value left to it.

Second, the principle of a minimum royalty or a guaranteed minimum income may induce the licensee to "freeze" the license as he would rather pay the minimum than actually exploit the licensed product. Now it is in the licensor's interest to have his product exploited, if only for the sake of repute, to say nothing of the risk of forfeiture on grounds of failure to exploit the patent (or compulsory license).

Third, in many cases the principle of termination on grounds of failure to reach the minimum sales value may prove difficult to handle. In view of the life of the patent it may be too late to find a successor to the defaulting first licensee, or even to find a competitor if said first licensee retains nonexclusive rights.

Noncompetition

The licensee can be put under an obligation not to market any products directly competing with the licensed product. It is advisable to fully justify such an obligation in the agreement, and narrow limits must also be set if it is not to come within the scope of competition law provisions.

Sublicenses — Transfer of agreement

Obviously, it is in the licensor's interest to control the choice of those who will exploit his invention and the terms and conditions of any sublicense or transfer agreement. One will often be careless about provisions

to this effect, although they do deserve to be paid a great deal of attention. Within the framework of a sublicense the licensor must be certain of receiving his share of income from the sublicensee's sales. Also, all the previously mentioned problems will again arise in relation to the disclosure of improvements, to guarantees, to secrecy, etc. It is advisable to include a provision for the direct payment to the licensor of his share by the sublicensee. In addition, it is essential, so as to preserve confidentiality, to stipulate that the sublicensee must be accepted by the licensor.

Caution dictates to consider the possibility for the licensee of falling under a competitor's control.

The general trend of the French doctrine and case law is to associate a license with the company or other entity to which it has been granted. Accordingly, the license may validly be assigned or contributed together with the business of that company. It is therefore necessary, in order to avoid this kind of risk, to clearly state in the agreement that it is personal in its character. This implies confidentiality of the know-how and will make it possible to include a provision to the effect that the licensor's consent is required for the continuation in force of a license where a new shareholder controls the licensee.

TO SECURE EARNINGS

The various points to be dealt with under this heading are, first of all the question of payment conditions, then the problem of how the licensor will arrange to secure earnings in the event of cancellation of his patent. Finally, and more generally, we shall examine the various charges that may be imposed on the licensor as part of any guarantees or obligations to assist binding upon him with respect to his licensee.

Payment conditions

In addition to the problems of defining the basis of the royalty if this payment system is adopted, a classical pitfall here lies in the taxes which escaped the parties' notice when negotiating the agreement. A typical example is the double taxation of royalties if no tax conventions exist between the respective countries of the two parties.

Another pitfall will result from the lack of provision allowing to revise the minimum royalty amount according to the erosion of the currency. Let us take an example: If the licensee markets a licensed product in a country with a high inflation rate, then it is better to provide for minimum quantities of product to be sold instead of for minimum amounts of money.

Finally, it is necessary to provide for penalties in the case of delayed payment.

Patent cancellation and expiry

The licensor must anticipate the possibility of his patent being cancelled, which would result in drying up of royalties. In order to secure an income in that case, the licensor should associate know-how with the licensed patent so that royalties may be payable in consideration for the know-how. Where no "close" agreement exists between the parties the know-how must have a real contents and have so far remained secret in order to justify a consideration. Ideally, one will define in the

agreement what portion of the royalty is in consideration for the patent and what is in consideration for the know-how. A provision should be included to the effect that invalidity of part of the agreement shall not invalidate its remaining clauses.

A licensor will sometimes make it an obligation for his licensee, where consistent with local laws, to use a trademark owned by him to designate the licensed product. Since the existence of the trademark does not depend on that of the patent or know-how, the licensor thus secures an income for the life of the product.

Charges incurred in relation to patent exploitation

The various guarantees and obligations to assist binding on a licensor with respect to his licensee, if any, imply charges likely to reduce to a considerable extent the profit to be derived by the licensor from his license. One should therefore be extremely careful in this respect.

Also, in the same connection, let us mention the indemnities that may be claimed by a licensee in the event of nonrenewal of the license or of early termination.

Holding the licensee harmless from infringement proceedings by third parties

A licensee will wish to be held by his licensor harmless from possible infringement proceedings by a third party who is convinced that the granted patent and disclosed know-how infringe his own patent.

One must be aware that nowadays it becomes increasingly hazardous to enter into such a commitment, in view of the large number of fairly similar patent applications that are filed by competitor companies and are not published immediately. To protect himself from the serious consequences of any such commitment to his licensee, the best solution for the licensor is simply to represent to the latter that on the day of the signature of the agreement the licensed patent and the know-how have not been the subject of any actions by third parties and are not, to his best knowledge, within the scope of third parties' patents. In fact, it must never be guaranteed to a licensee that he will enjoy permanent safeguard against claims by third parties. Such claims may arise well into the future, or they may result from alterations made by the licensee himself in the invention such that it henceforth comes within the scope of a third-party patent.

Irrespective of to what extent the licensor will have elected to hold his licensee harmless from claims of third parties, he should include in the agreement a provision defining the assistance that he may request of the licensee in the event of actions taken against the licensed patent or know-how.

Depending on the role to be played by the licensee (i.e. his share of liability) it should be stipulated that the compensation due to the third party if his action is successful shall be shared between the licensor and the licensee. Thus, it will be necessary to determine the allocation of legal expenses and who shall, as the case may be, pay royalties to the third party.

Result guarantees

A licensee will also be inclined to demand guarantees of technical and economic results that may be obtained for the practical implementation of the patented invention. Here a distinction should be made between "light" contracts and "heavy" contracts relating for instance to the supply of a production line on a turnkey basis, in which the result — or a result — is guaranteed.

In a "light" contract, the licensor should not take the risk of guaranteeing that the licensee will be able to master his invention and to achieve the expected commercial result.

In a "heavy" contract, on the other hand, the licensor will be obligated to guarantee a result; the nature of that result will have to be precisely defined, as well as the means by which it can be achieved.

Indemnities for termination

It is recommended that it be stated very clearly in the agreement the amount of any indemnities payable by the licensor to the licensee for termination, as the case may be and upon prior notice.

TO PRESERVE OR ACHIEVE A REPUTE

In addition to the quality of the licensed product and to the control procedures, which should secure the constancy of that quality and thereby ensure the good repute of the licensor's products, the main point here will be the trademark used to designate the patented product of consumer goods.

It will be in the licensor's interest to have the product marketed under a trademark that remains his property (to the extent that there are no legal provisions against it in the country of marketing).

Upon early termination or expiration of the agreement, the licensor may in this way continue to commercialize the product under the impetus given by the licensee.

If the parties elect to use a trademark owned by the licensor, he will have to see to it that the licensee undertakes to assign to him any titles (such as copyrights, etc.) that the latter may have acquired during his commercialization of the product.