

# Importance Of Termination Clauses

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Well-drafted termination clauses can save both parties to license major problems later.

Many licenses include boilerplate or standard language, and in most situations this is an efficient license drafting procedure. Boilerplate or standard language is also often used in license termination clauses. For example, a standard termination clause in a patent license is usually written as follows:

*This agreement shall not be deemed to be the life of the licensor or expire at the licensed party's and shall terminate*

*terminat*. Use of standard termination clauses often causes problems for the licensor and licensee, however, since boilerplate language does not take into account the fact that terminations are usually mutually pronged. A properly drafted termination clause should be custom drafted to set forth the conditions for termination of every license right and obligation since continuity in these rights and obligations will be of central significance to the parties once the relationship under the license ends.

An example of the importance of a carefully drafted termination clause was presented in a recent court decision that focused on a clause of a license agreement providing:

*"This agreement shall take effect as of July 1, 1975 and shall continue in effect until June 30, 1980 and thereafter for successive periods of five years."*

The licensee argued that this clause allowed the licensee to be terminated after five years. According to the licensee, the phrase "for successive periods of five fiscal years" had to be interpreted to mean that the parties could terminate when:

over a five-year period expired.

The court noted that the license included a paragraph that listed all of the ways that the license could be terminated, such as by the default or insolvency of the licensee, by mutual consent of the licensor and licensee, or by the licensee unilaterally terminating upon at least a 12-month prior notice. The court found that nowhere in the license was the licensee given the right to terminate at the end of every five-year period nor were notice requirements established to do so. The court concluded that where termination has been provided for in a license, a court should not refuse to enforce such a termination clause or read in different conditions of termination.

## *A Termination Should Be Defined For Each Right*

A good approach for drafting a termination clause is first to determine all of the rights in the license that require termination, and then draft a termination clause for each group of similar rights. A mistake commonly made is to draft all rights under the license as terminating at the same time. Often this is not the intent of or the best procedure for the parties. For example, in most licenses it is to the benefit of the parties for certain rights to survive the termination of the license. In these situations, the termination clause should be drafted so as to preserve these rights. Consequently, the preparation of a complete termination clause imposes on the drafter the burden of working out and listing all rights under the negotiated license that are actually intended to survive the termination of the license.

One right that may have a different termination date is the minimum royalty clause. Many license

agreements assume that if a licensee includes a minimum royalty clause, failure to pay minimum royalties automatically terminates the license and the agreed minimum royalties are due upon termination. In order for minimum royalties to be due under a termination clause, or in order for failure to pay minimum royalties to serve as a basis for terminating a license, however, the requirement for minimum royalties and the terms for payment must be specifically stated in the termination clause.

There should be a similar concern regarding a best efforts clause. The courts have held as a matter of law that a termination clause does not include an implied duty of best efforts in the exploitation of the invention. Accordingly, if your client desires termination of the license if best efforts are not made, you should include that requirement in a termination clause.

## *Question of Use of Intellectual Property*

The contractual obligation to pay royalties should survive the termination of a license for as long as the licensee continues to use the licensed technology and intellectual property. This is because licensors of intangible technology or intellectual property have substantial control over compliance with their obligation since the licensor cannot easily remove the technology or intellectual property from the possession of the licensee due to its intangible nature. In addition, the opportunity to use the knowledge without paying is inviting. Consequently, some provisions should be made in the termination clause requiring royalties to be paid for any

\*Of note, White and Dunlap, Chicago, Illinois.

continued use of the technology or intellectual property after termination. Otherwise, the licensee would be excluded from rightful income.

To ensure that rightful income is paid to the licensor, a termination clause including a requirement that the licensee cease using the intellectual property and return it to the licensor upon termination should be included in the license. The termination clause should also set a limit on the volume of sale of product made by the licensed technology or intellectual property after the termination of the license. These contractual terms should be written so as to preserve the going of the nature of termination. In addition, the termination clause should provide that the obligator is pay royalties will continue after termination for as long as the licensee licensee continues to sell product produced using the licensed technology or intellectual property. These provisions should stop the use of the licensed technology and intellectual property as soon as possible while allowing the licensee all rightful royalty income.

#### Obligations That Extend Beyond Termination

In spite of a purported license termination, a licensee is often committed to pay accrued royalties and to make reports after termination. The licensee can also have rights of audit and recovery after termination. Can these obligations and similar rights, invariable after the date of termination, exist if not provided for under the license itself? This question was raised with regard to a license entered into between RCA and Westinghouse and General Electric in which rights, including sublicensing rights, were exchanged between the parties. One of the provisions of the license stated: "the termination date shall be December 31, 1954." Another provision expressly continued beyond the 1954 date licensee under patents based on pre-termination inventions, but there was no provision expressly extending the right of RCA to grant sublicenses under the patents beyond 1954. This right was validly and General Electric brought suit joined in by Westing-

house and supported by the United States Government to establish that the sublicensing right had ended on the termination date of the license.

In light of the total content and its spite of the seemingly unqualified definition of the termination date, the court concluded that the sole purpose of the termination date was to establish a cutoff of the period during which new inventions would become subject to the license. Sublicensing rights were held to be part and parcel of the patents and the rights were to extend beyond the 1954 termination date. A licensee to be licensed from this decision is that it certain rights are to extend beyond the termination of other rights, this extension should be explicitly set forth in the termination clause. Conversely, if certain rights are not to extend beyond the termination date, this should be explicitly stated in the termination clause.

#### Termination Should Include Orderly Disposal of Inventory

The orderly business of a licensee often requires that a manageable inventory of licensed goods be maintained up to the date of termination. Normally, a licensee will want a right for disposal of inventory for a defined period of time after termination. If this is agreeable to both parties, this right should be included in the termination clause. An example of such a clause is as follows:

Upon expiration or termination of this license, licensee shall cease the manufacture of licensed articles, but, except in the event of termination for breach, the licensee may continue to sell or offer for sale, for a period of three months, all the articles in inventory during the three month period immediately preceding the expiration of the term of the license. Licensor shall not have in hand an inventory of licensed articles in excess of the inventory of such articles which it possessed during the three month period immediately preceding the final three month period of the license.

Courts have accepted these clauses on the basis that they provide for orderly termination of the licensing relationship.

#### Avoid Legal Liabilities

In addition to a termination that is acceptable to the licensor and the licensee, a properly drafted termination clause will avoid potential legal liabilities between the parties or between one of the parties and a third party. For example, the right to terminate a license in accordance with a properly drafted termination clause has been held by our courts to be a fundamental business right. According to the courts, basic to our free enterprise system is the right to enter into or to refrain from entering or continuing a contractual relationship. Under this reasoning, the termination of a license in accordance with its expressed terms is a right that is unaccompanied by the threat of tort liability. According to the courts, if one party is held liable in tort for termination of an existing contractual relationship according to its terms, the characteristically consensual nature of the contract relationship would be undermined.

This issue arose in a lawsuit in which the court ruled that the termination of an existing contract according to its own terms, if properly drafted, cannot give rise to a tort claim such as malicious interference with contract. The parties entered into a license that allowed the licensee immediately to terminate the license if the licensee breached any of the provisions prohibiting the licensee from directly or indirectly arranging for manufacture of the licensed product by a third party. The licensee was required to obtain a written approval from the licensor of any arrangement that the licensee made with third party manufacturers. The written approval of the licensee was to be evidenced in a standard manufacturer's agreement signed by representatives of the licensee, the licensee and the third party manufacturer. Without obtaining the approval of the licensee, the licensee subcontracted a company, AC, to make the licensed product. Upon discovering the subcontract, the licensee terminated the license. The licensee argued this termination was improper since it interfered with its contract with AC.

The court determined that this

termination was within the legal rights of the licensee, and ruled that such a termination of a contract was ample justification for entering with another contract. The court ruled that the termination of the licensee is accordance with the properly drafted termination clause could not support a claim for malicious interference with a contract between the licensee and AC.

#### Effect of Bankruptcy on Termination

One concern that counsel drafting a termination clause should have is the effect of the Bankruptcy Reform Act of 1980 on licensees. For a complete discussion of the effect of bankruptcy on licensees, the reader should review Duffy and Frank, *Bull. of the Bar — Is One of the Patent License Agreement Among Chapter 7 or Chapter 11 Bankruptcy?* (Journal of The Patent and Trademark Society 72:11-November, 1980). Many of the following comments are discussed in detail in the Duffy and Frank article. Under the Reform Act, all patent licensees that a bankrupt party has rights in license part of the bankrupt's estate. Before the Reform Act, patent license commonly included an *ipso facto* bankruptcy termination clause. This clause provided for automatic termination of the license in the event of an appointment of a trustee, an assignment for the benefit of creditors, any levy of execution of the license granted, or an adjudication of bankruptcy. The validity of an *ipso facto* bankruptcy termination clause has been called into question under the Reform Act. Although *ipso facto* bankruptcy termination clauses are still used in patent licenses, they are of questionable effectiveness under §365 (a)(3) of the Reform Act. One of the powers granted to a trustee under the Reform Act is the authority to dispose of executory contracts in the estate. Patent licenses are normally considered executory contracts because they are continuing obligations to be performed by both parties. As executory contracts, patent licenses can be assumed or rejected by the trustee. If assumed, the trustee has the power to assign the patent license despite a provision such as an *ipso facto* termination clause contained in the license prohibiting such an assignment.

Although reliance on an *ipso facto* bankruptcy termination clause is questionable, a licensee probably can terminate a patent license due to bankruptcy of the licensee if the termination is prior to the licensee filing for bankruptcy. Section 365 (a)(3) of the Reform Act prohibits the termination of an executory contract for reasons of bankruptcy after the filing of a petition in bankruptcy, but the licensor can terminate the license prior to the licensee's filing. Consequently, a preferred termination clause should be worked along the lines of the following:

At least 30 days prior to filing a petition in bankruptcy, each party must advise the other of its intention as to the parties or of another's intention to file an involuntary petition in bankruptcy. Further, failure to comply with this requirement shall be deemed a material, pre-petition incurable breach.

Once informed of the licensee's bankruptcy, a licensor, under this clause, has 30 days to advise notice of termination. A filing for bankruptcy after the licensee receives notice of termination will not prevent the license from being terminated even though the only reason for termination was based on insolvency.

Even though an *ipso facto* bankruptcy termination clause is not effective against a bankrupt licensee who files for bankruptcy, a party to a patent license may still wish to include such a termination clause in its license. This type of clause may still permit the non-bankrupt party to terminate a patent license when a voluntary or a involuntary petition of bankruptcy filed against the other party is subsequently dismissed.

#### Avoid an Anticompetitive Termination

A concern a patent licensee draftsman should have is the possible anticompetitive impact the termination of a license can have. The termination of a patent license for the purpose of imposing a licensee's fair opportunity to compete in the sale of non-patented products is an anticompetitive contract. When a patent owner licenses an important patent to a non-monopolistic hori-

zontal competitor and the licensee gains some control over a portion of the relevant market sharing the license, antitrust implications may result if the licensee is suddenly terminated. The monopolist who terminates a patent license does so at its peril, unless there is a good economic business justification for the decision. If the termination was reasonable, then the licensor licensee's diminished capacity to compete results from an exclusionary right that is contemplated by the Patent Act and no antitrust violation exists. Therefore, the termination clause should provide for termination for all of the good business reasons the parties agree on at the time of entering the license.

#### Termination Delayed Under Equitable Circumstances

Courts have held that although a properly drafted termination clause is enforceable, compelling equitable circumstances may justify delay from termination. An example of this occurred in a recent lawsuit in which the parties had entered into a nonexclusive license providing for monthly royalties and authorizing the licensee to terminate if royalties were not paid. The licensee paid quarterly royalties and the licensor never objected to the amount of the timing of the royalty payments.

The licensee eventually terminated the license for failure to pay royalties since they were paid on a quarterly rather than a monthly basis. After notifying the licensor of termination, the licensor audited the business records of the licensee. The audit revealed \$600 in unpaid royalties. The audit also established that the licensee did not have a copy of the fully executed license, and the audit did not include a minimum royalty clause nor did it provide for monthly payments of royalties. The licensor immediately offered to pay any deficiency in the royalties, but the licensee never informed the licensor of the amount of underpayment. Shortly thereafter, the licensor notified the licensee the amount of deficiency plus interest as calculated by the licensee.

The court ruled that in some

states although termination clauses are enforceable, compelling equitable circumstances may justify relief from forfeiture. The equitable circumstances in this case, according to the court, were: termination would destroy the licensee's primary business and render its primary asset worthless; nonpayment would be in honor of the licensee offered to pay any delinquent; and the licensee tendered payment for royalties due since termination. The court determined that the licensee's reasonable good faith and the circumstances surrounding the licensee relationship justified reinstatement of the licensee agreement. Accordingly, regardless of how well drafted a termination clause is, the circumstances surrounding any termination should be reasonable.

A large percentage of the disputes arising under licensee result from differing interpretations of a termination clause. For this reason, in drafting a licensee, careful consideration of the language of the termination clause should be made. To assist in the considerations and drafting of a termination clause, the

following sample clauses are provided:

#### SAMPLE TERMINATION CLAUSES

The words "terminated," "term," and "terminate" used in this license are to be read, except where the contrary is indicated, as meaning that they affect the following rights and obligations, all of which shall survive any termination to the degree necessary to permit their complete fulfillment or discharge:

- a. licensee's obligation to supply a final report with respect to the terminated license;
- b. licensee's right to receive or receive and licensee's obligation to pay royalties, including accrued royalties, accrued accounts receivable for payment at the time of any termination;
- c. licensee's obligation to maintain records.

Unless otherwise terminated as provided above, this license shall run to the end of the life of the last to expire of the licensed parties and shall thereafter terminate.

The licensee may prospectively terminate this license and constitute licensee obligations in respect to any licensed party upon 30 days' written notice to licensee.

With respect to acts of licensee other

than those set forth above, the licensee may terminate this agreement at any time in the event of a default by licensee in the observance or performance of any covenant, condition, or obligation of this license required to be performed by licensee, but only if licensee shall not have remedied its default within 30 days after receipt from licensee of written notice of such default.

Examples of clauses requiring return of intellectual property:

Upon the termination or expiration of this license, the licensee must immediately cease use of the licensor's technology and intellectual property and shall deliver all technology and intellectual property to the licensor or to whomsoever the licensor may direct as promptly as is practical.

Example of termination by time:

Term of this license expires at the end of the \_\_\_\_\_ month year. Commencing within four months prior to the termination of this license, the parties will in good faith attempt to negotiate upon terms and conditions satisfactory to both parties.

The clauses set forth in the text of this article should also be considered for inclusion in a termination clause.