Loopholes, Nooses in Canada Law

Overview of possible ways to get out of license; where termination doesn't get desired results

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The contents of this paper is divided into two parts:
1. Possible ways to get out of a license in respect of which one may be entertaining second thoughts (loopholes).
2. Situations where, upon termination, the effect may well not be that contemplated by the express terms or the intention of the contracting parties (nooses).

TERMINATION LOOPHOLES

I shall ignore the obvious and last-ditch methods of avoiding one's responsibilities under a license agreement including suicide, homicide, declaring bankruptcy and, if all else fails, renegotiation. Any of these or combinations thereof may well commend themselves to a particular situation.

I should also make it clear that my remarks throughout this paper are written from a Canadian perspective based on Canadian law and Canadian precedent where it exists. For these and other reasons, this brief overview should be considered as suggestions to be approached, if at all, only with caution and having due regard to the *lex fori.*

Public Policy

It is axiomatic in Canada, in Great Britain and, I believe, in other courts with common-law traditions, that a contract that is illegal or in restraint of trade, is not enforceable whatever its express and unambiguous terms may be. Thus, a contract amounting to a wager, may be unilaterally terminated or dishonored without penalty as may a contract which requires the performance of an illegal act, e.g. a license to produce heroin for street sale using the licensor's technology.

Such situations are rare. Not so rare, however, are contracts or licenses in restraint of trade or otherwise contrary to public or commercial policy. In Canada, our Combines Investigation Act is but a pale imitation of, and far less sophisticated then, U.S. antitrust laws. A license contrary to the provisions of that act, however, would not be enforceable by either party and thus would be cancellable by either without liability to the other. The Canadian Combines Investigation Act contains provisions designed to prevent monopolies or activities which unduly lessen competion.

Any contract in furtherance of such activities would fall into the prohibited category. Conventional examples would include tied selling (an attempt to control all activities of a licensee beyond the legitimate monopoly), refusal to deal with some buyer on reasonable terms in order to drive him out of business, agreements between "competitors" to divide the market to avoid further competition, etc. In the licensing context, where use has been made of the exclusive rights and privileges conferred by patents or trademarks to unduly limit trade or commerce in an article or commodity, the state may ask the Federal Court to declare any agreement void, to grant an injunction or a compulsory license, or to revoke a patent or expunge a trademark.[1]

Quite apart from the Combines Investigation Act, the most usual contractual provisions struck down as being in restraint of trade are those dealing with the rights of the parties to carry on business following termination. Normally, a party should be allowed to earn his livelihood in a reasonable way. Thus, a clause preventing one party from carrying on a particular business following termination must be limited to a reasonable length of time, geographical area, and range of business activities. Normally, an offending restrictive covenant is simply severed from the contract so that the rest of the agreement remains binding.[2]

Cancellation for Breach by the Other Party

There are two problems here. First of all, a contract in its entirety may be terminated by reason of a breach by the opposing party only if the breach is in respect of a fundamental term or condition of the agreement and this may well be so notwithstanding a "boiler-plate" clause in the agreement that each and every provision of the agreement is to be deemed fundamental.

Thus, whatever the contract may say, a provision such as that requiring notice of a change of address by a contracting party to be given within 30 days of its taking place would never be considered a fundamental breach. A sustained failure to pay royalties or a complete refusal to allow inspection of books to verify royalty payments in contravention of the agreement almost certainly *would* be considered fundamental breaches. There is a host of matters falling in the grey area which could go either way. In each case, the question is to be decided bearing in mind the express terms of the agreement, the reasonable expectations of the parties, and the surrounding circumstances that might excuse even a serious breach. A fundamental breach gives the injured party the right to terminate and/or to seek damages. A minor breach will entitle him to damages only.[3]

An interesting question arises with respect to the not

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uncommon "best-efforts" covenant on the part of a licensee. For many years, such provisions were considered formalities and unenforceable. It may well be, however, that the jurisprudence in Great Britain and in Canada is changing and that an obligation to devote best efforts, if not complied with, could constitute a fundamental breach.

Such a clause may also prevent a licensee from relying on his lack of performance should the contract be conditional upon events at least party under his control. Clearly, a best-efforts covenant would be breached if the licensee took on a competing line, or designed around the licensed article by producing a similar product (see below), or spent the winter on a beach in Hawaii instead of attempting to meet his minimum sales requirements. The party charged with not making his best efforts must have failed to do something that he could reasonably have been expected to do.[4]

There is a second major problem with respect to a breach: the law is quite clear that breach of contract may be waived by conduct of the opposite party. A breach may also be waived expressly depending on the circumstances. For example, a party may decide to let bygones be bygones and continue the relationship since it is worth more to him alive than dead. If an injured party elects to take no action on a breach, after a reasonable length of time he will be held to have forfeited his right of action.

Fraud or Negligent Misrepresentation

If a party has been induced to enter into a license agreement or other contract by outright fraud of the other party, the contract is clearly terminable, provided of course the defrauded party acts promptly as soon as the fraud is discovered. One could envision a license situation where the licensor guaranteed the efficacy of his technology knowing that it did not work and would never work.

Negligent misrepresentation falling short of outright fraud can also be grounds of annulment of a license, if fundamental, or for damages. For example, a Canadian licensor or licensee who grossly and recklessly overestimates the market for a product or the efficiency of his process may be guilty of negligent misrepresentation.[5]

Designing Around

Most license agreements provide for royalty payments related to the extent of use of the licensed technology, patents or other property. Subject to a "best-efforts" provision, as referred to above, there are other opportunities in any license to produce an acceptable substitute without the use of the licensed technology or property, i.e. designing around the license obligations. This is fair game and will depend on the precise terms of the royalty obligation, having due regard to the fact that a Court of Equity would probably require more changes from a licensee than from a third party. In this regard, it should be noted that one loophole clearly available in Canada, is the right to dispute the validity of the patent. Unlike the situation which pertains in the U.S., a licensee in Canada, whether he expressly states so in his license agreement or not, is estopped from disputing either the validity of the protected right or the title of his licensor to the licensed property. If the licensee admits use of the patent under the agreement, unless there is an express or implied warranty of patent validity, or unless fraud is alleged, the validity of the patent is wholly immaterial to such an action; the licensor merely relies upon the contractual promise to pay.

Covenant

Where the licensee has covenanted not to dispute or contest the validity of the patent, in an action by the patentee for an accounting and payment of royalties, the licensee is almost certainly precluded from raising the defense of invalidity in the absence of an express warranty of validity by the patentee. The mere facts that a patentee is purporting to sell a "property right" or that he agrees to defend the patent against infringement, do not constitute such warranties of validity by the licensor.[6]

The normal rule is that where the license has been terminated and the patentee later sues the ex-licensee for infringement instead of for royalties under the license, the defendant may contest the validity of the patent. Apparently, he is not estopped from alleging invalidity merely because he was a licensee at one time.

On the other hand, if the licensee has agreed not to contest the validity of the patent during the term of the license or thereafter, he may well be bound by that provision. The high water mark of estoppel in Canada is the case of *Coyle v. Sproule.*[7] In that case, there was no express covenant not to contest patent validity. The agreement provided, however, that nothing therein contained should "relieve the licensee in any way from the position of an infringer, if he continues thereafter to use the invention without a new license" to be granted at the option of the licensor. It was held that since only a valid patent could be infringed, the licensee had admitted by that provision that continued production would place him in the position of an infringer of a valid patent. Thus, he was estopped from raising invalidity as a defense even after termination.

Normally, however, an implied warranty of validity is not sufficient; it must be express. A court will not readily extend the meaning of doubtful words to convert them into an express warranty of validity.[8]

TERMINATION NOOSES

There are many situations in which a party may, pursuant to the terms of a license, terminate that license, but discover that the effect of such termination is not as provided in the agreement or in accordance with his understanding or intention.

Termination as Provided in the Agreement

Most agreements provide for a fixed term and/or for termination on a stated period of advance notice following the fixed term or throughout an indeterminable length of the agreement. A court might well decide, however, having regard to the nature of the license, the relationship of the parties and the history of the license, that a longer notice period is required than that provided in the agreement. This potential is particularly acute in the case of exclusive license agreement such as distributorship agreements, etc., where the parties have had a longstanding relationship and do not consider the written agreement to govern their daily affairs. Where a special relationship exists apart from the contract, the court may set a termination period which appears to be reasonable in the industry and in the particular circumstances.[9]

Termination for Bankruptcy or Insolvency of the Other Party

Most license agreements provide that upon the licensee committing an act of insolvency or going bankrupt, the license is terminated and the licensed property reverts to the licensor. It may well be that such an agreement is unenforceable; this question has yet to be tested in the Canadian courts. There are two main competing principles in issue.

First, there is the right of any party to enter into virtually any contractual term which he wishes, subject to the requirements of legality. Second, there is the public policy that the assets of the bankrupt be secured by the trustee for the benefit of the creditors and not artificially disposed of prior to an impending bankruptcy. It is possible that different results might be reached depending upon the drafting of the "revert-back" clause.

Of course, in any agreement that does *not* have an express provision providing for termination upon the bankruptcy or insolvency of the licensee, there is no doubt as to the situation. The license is not terminated. The rights under the license are an asset of the bankrupt that become vested in the trustee. The trustee can dispose of the rights under that license for the benefit of the creditors just like all other assets of the bankrupt party.

Penalty Clauses

More so in the past than at present, license agreements have occasionally contained provisions providing for a penalty as well as the right to terminate in respect of the default of the licensee. In general, a court of equity will refuse to enforce a penalty clause that provides some Draconian relief to the "injured" party, such as immediate payment of a huge and unreasonable sum of money. On the other hand, if a clause is carefully drafted and purports to set a reasonable amount as liquidated damages, the provision may be enforced as a reasonable allocation of risk and damages.[10]

Exculpatory Clauses

Clauses of this sort fall between Type A Loopholes and Type B Nooses. They are the kind of clauses not uncommon in license agreements where, after providing for the license, the transfer of property rights and a loophole-free obligation to pay royalties, there is a further provision exempting the licensor from any liability, whether caused by negligence or otherwise arising through the exercise by the licensee of his rights under the agreement. These are somewhat analogous to the "ticket cases" where the parking garage disclaims all liability for a car left in its care, except that in the commercial licensing context such clauses are deemed to be negotiated and agreed upon rather than merely foisted without notice on an unsuspecting individual. Such exculpatory clauses may well not be enforceable if not properly drafted.

The most recent word from the House of Lords in Britain, as followed by certain Canadian courts, however, is that even a party in breach of a fundamental term of the agreement may rely upon a clear exculpatory clause to limit liability for damages. Such a clause would not normally affect the right of a party to terminate an executoryexecutory contract (where further performance by either party is necessary to complete the agreement) on grounds of fundamental breach although it might well limit liability for damages.[11]

NOTES

1. *Combiners Investigation Act,* R.S.C. 1970, Chap. C-23, s. 29.
2. *Dyform Engineering v. Ittup Hollowcore* (1982), 71 C.P.R. (2d) 72 (BCSC); *Tank Lining Corp. v. Dunlop Industrial Ltd.* (1982), 68 C.P.R. (2d) 162 (Ont. C.A.).
3. *Respirex of Canada Ltd. v. Flynn* (1975), 22 C.P.R. (2d) 104 @ 131 (Ont. H.C.).
4. Ibid
5. *Ronald Elwyn Lister Ltd. v. Dunlop Canada Ltd.* (1978), 19 O.R. (2d) 380 (H.C.), affd. 27 O.R. (2d) 168 (C.A.), varied 135 D.L.R. (3d) 1 (SCC).
6. *Trubenizing Process Corporation v. John Forsyth, Limited,* [1943] S.C.R. 422.
7. *Coyle v. Sproule,* [1942] O.R. 307 (H.C.).
8. *Rymland v. Regal Bedding Co. Ltd.* (1966), 59 D.L.R. (2d) 316 @ 319-320 (Man. C.A.).
9. *Toronto Type Foundry Ltd. v. Miehle-Goss-Dexter, Inc.,* [1969] 2 O.R. 431 (H.C.); *Paper Sales Corporation Limited v. Miller Bros. (1962) Ltd.* (1975), 7 O.R. (2d) 460 (C.A.); *Clarke, Irwin & Company Limited v. George Harrap & Company Limited* (1980), 9 B.L.R. 97 (Ont. H.C.).
10. *H.F. Clarke Ltd. v. Thermidaire Corp. Ltd.* (1974), 54 D.L.R. (3d) 385 (SCC).
11. *Hayward v. Mellick* (1984), 45 O.R. (2d) 110 C.A.; *Photo Production Ltd. v. Securicor Transport Ltd.,* [1980] 1 All E.R. 556 (H.L.).