When Things Don't Go Well

Examples of failures in licensing agreements with suggestions for dealing with them

BY DR. KEISHI NAMIKAWA*

I have been asked to discuss experiences in Japan. But, I am not an economist and, of course, not a politician. I am a modest licensing executive. Therefore, I am reluctant to report proudly on the course of the reconstruction of Japanese economy after the World War II.

Instead, since I deal with licensing contracts, I would like to relate to you some failures regarding licensing contracts in which I have had opportunity to know. I hope you will learn something from the failures.

The first example relates to a smelting process. Smelting is a process to produce raw metal from a metallic ore under a high temperature.

A Japanese company, JA made a contract with FP, a company abroad and introduced from FP a smelting process technology for nonferrous metals. But, engineers in JA were not satisfied with the technology provided by FP, so they decided to improve the technology. They performed a variety of pilot tests based on the technical information disclosed by FP and designed a smelting equipment of an improved version. The smelting furnace according to this revised design was completed three years later. It was found that this new improved furnace was able to process 30% more ore than the original furnace designed by FP. Engineers of JA succeeded in improving the technology originally developed by FP.

Unfortunately, however, the licensing contract of the technology presented a very significant problem later. Although engineers at JA had improved on the given technology, the lawyers at JA had not closely examined the licensing contract at the time it had been concluded. The articles in the contract that presented problems were Articles 6 and 14:

<u>Article 6. Confidence</u>

Licensee agrees to hold in confidence and agrees not to disclose to other any and all technical information relating to the licensor's process disclosed to it by licensor.

<u>Article 14. Termination</u>

This agreement shall terminate after one year from the date it has been approved by Japanese Government, except as agreed upon in Articles 4, 5 and 6 hereof.

According to these provisions, JA is permanently obligated to hold in confidence the technical information in question, and moreover, to hold in confidence even publicly known information. JA recognized the problem when K company made an inquiry to buy the smelting technology of JA after 15 years. Namely, it was found that JA could not disclose their improvements to K, because it had an obligation not to disclose the technical information of FP. It was impossible for JA to explain their improvements without disclosing the original information given by FP. JA asked FP to modify the agreement, but they did not come to agreement. Thus, JA gave up any idea of selling the improved technology to any third parties.

Here arises the question of how long the period of secrecy agreement stipulated in a licensing contract should be, I think it is objectionable that the obligation to keep secret lasts permanently. On the contrary, if the period is too short, the licensor would be reluctant to sell any new technology. I think the period should be as long as that of a patent, and I hope that an international consensus can be made for this problem if possible.

Secrecy Agreement

Next, I would like to show you an example of secrecy agreement. It is important to exclude from the coverage of the secrecy obligation the information which is known publicly, the information that has been owned by the receiving party prior to the disclosure and the information obtained lawfully from a third party.

Each party shall hold any technical information disclosed to it by the other party hereunder in strict confidence and shall not use, except as licensed hereunder, nor disclose to any person, firm or corporation such technical information for a period of 17 years after such technical information is disclosed.

The provisions of Section 6.1 hereof shall not apply to any information which has been or becomes part of the public domain without any fault on the part of the party receiving it, which is known to the party receiving it at the time of disclosure, or which is lawfully obtained from a third party by the party receiving it.

*Manager, Patent Licensing, Nippon Mining Co., Ltd., Tokyo, Japan; paper presented at LES Brasil Technology Transfer Seminar, Sao Paulo, Brazil, September 1986.

HYDROTREATING PROCESS LICENSE

The next example relates to a hydrotreating process. A hydrotreating process is a process of removing sulfur compounds from a petroleum fraction by treating it with hydrogen.

As air pollution control became stricter and stricter in Japan, petroleum refiners were required to supply petroleum fuel with a much lower sulfur content than was previously supplied.

JB company in Japan decided to introduce a hydrotreating technology of the petroleum fraction from FY company abroad and concluded a licensing contract with the latter in 1968. FY company has been developing a hydrotreating technology of the petroleum fraction by using a pilot plant for several years, but it had never constructed a commercial plant before. Therefore, JB was the first company to construct a commercial plant using the FY-type hydrotreating process. With the cooperation of the engineers of the both companies, the first commercial plant of its kind was completed in 1970. Since this time, FY has never constructed another commercial plant. As a result, JB has become the company that has the richest experience in the development and practical use of the FY-type hydrotreating process. JB has naturally made numerous improvements in the hydrotreating process. With respect to the improvements, the licensing contract concluded in 1968 has following provisions.

> *Licensor shall disclose to licensee improvement relating to the technical information and patent rights licensed hereunder and to the hydrotreating process that have been demonstrated to be suitable for commercial use, and that are acquired by licensor within three years from start-up of the plant, for use in the licensed plant without payment to licensor of any additional royalties therefore.*
>
> *Licensee shall disclose to licensor improvements relating to the technical information and patent rights licensed hereunder and to the hydrotreating process that have been demonstrated to be suitable for commercial use, and that are acquired by licensee within three years from start-up of the plant, for the royalty-free right of licensor to use such improvements in licensor's business.*

According to the provisions:

- JB must provide the improvements acquired by it within three years from the start of operation of the industrial plant to FY without compensation.
- FY must provide additionally improvements acquired by it within the same three years to JB without compensation.

Unfair Results

The exchange of the improvements was apparently bilateral in the contract and seemed to present no problem. However, under the conditions where JB had a commercial plant and FY did not have one, FY supplied few improvements to JB, but the disclosure of the improvements by JB to FY amounted to a fairly sizable amount. This is the case where the provisions of the contract were fair but unfairness arose actually.

After 10 years, JB made a licensing contract again with FY to obtain a license of FY's other technology. At this time, however, JB company was careful to exclude the provisions for the exchange of improvements.

Three years later, FY made a proposal to JB:

- To exchange the improvements made by that time.
- To reduce the agreed royalties to a half of the amount.

As JB accepted the proposal, JB could save half of the royalties it had to pay in the original contract.

From this case, we can see it is important to examine whether the provisions in a contract can result in actual fairness even when they look fair from first glance.

METAL COATING PROCESS LICENSE

The third example relates to a metal coating process. Metal coating process is a process to treat the surface of metal with chemicals and give corrosion resistance to the metal.

FD company in Europe had many years' experience in surface treatment technology of nonferrous metals. Several metal fabrication companies in Japan wanted to introduce FD's technology. A Japanese company, JC, intended to introduce FD's technology exclusively, so as to prevent other Japanese competitors from obtaining the technology, and entered into negotiations with FD. Taking this situation into consideration, FD offered a fairly high down payment and minimum royalties. JC agreed with this offer to obtain the exclusive license.

After having learned the FD technology, JC began to market a new product using the technology. JC made efforts to sell the product for three years. However, because the product could hardly penetrate the market, JC began to feel it was a burden to pay the minimum royalties every year.

According to the licensing agreement, FD could terminate the agreement if JC stopped paying the minimum royalties. The provisions of the agreement were:

Article 6(d)

> *Licensee shall pay to licensor the following minimum royalties:*
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> *(i) Fifty thousand U.S. Dollars (US$50,000) in respect of the second Agreement year;*
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> *(ii) Sixty thousand U.S. Dollars (US$60,000) in respect of the third Agreement year; and*
>
> *(iii) Seventy thousand U.S. Dollars (US$70,000) in respect of the fourth and each subsequent Agreement year.*

Article 10(f)

> *In the event that licensee shall not have paid the minimum royalties due in accordance with 6(d), then licensor may terminate this agreement.*

Since JC had invested a large sum of money into this business, it could hardly stop using the FD technology. However, it had become quite difficult for the company to continue payment of the minimum royalties. Four years after the agreement, JC stopped paying the minimum royalties and FD terminated the agreement.

Retrospective of this case, we may make several comments. First, there is an opinion insisting that the minimum royalties should not have been accepted. For FD, however, as long as it gives the Japanese market soley to JC, it can collect profit from the market only through JC. In case FD has not the right to receive the minimum royalties, it may not be able to obtain any in come from the Japanese market, if JC does not run the business diligently. Thus, it is not reasonable to prohibit minimum royalties. However, the rate of the minimum royalties shall not be excessively high. The minimum royalties at the rate of 20-25% of expected royalties are considered to be acceptable.

To solve such a difficult problem I think it is better to include in the agreement a provision by which the exclusive license can be converted to a nonexclusive license under certain conditions. For example, the provision could be as follows:

Article 10(m)

In the event that the royalties actually earned shall have been less than the minimum royalties in accordance with Article 6(d) and licensee elects not to pay such minimum royalties, licensor shall have the right to amend the exclusive license hereof to become a nonexclusive license.

According to this provision, the licensee can stop the payment of the minimum royalties, if it has become difficult to pay them. In this case, the licensor can change the exclusive license into a nonexclusive license. In this way, the interests of the both parties can be adjusted.