

Royalties For Unpatented Technology

By Richard Binns and Nicola Walles

Summary

The Court of Justice has ruled that a licensee could be obliged to pay past royalties under a patent licence agreement even after a patent has expired or been deemed invalid, provided that the licensee has the ability to terminate the licence agreement for convenience.

The Court of Justice's response to the question posed by the Paris Court of Appeal in *Genentech Inc. v. Hoechst and Sanofi-Aventis*¹ suggests that, if a licensee does not have the option to terminate for convenience, requiring it to pay past royalties due under the licence could be anti-competitive, amounting to a violation of Article 101 of the Treaty on the Functioning of the European Union (TFEU).²

This ruling reflects the *status quo* in some jurisdictions, but highlights the importance of careful drafting in respect of royalty obligations.

Royalties in Dispute

In 1992, Genentech entered into a German law governed licence agreement under which it took a non-exclusive, worldwide licence for a patent that covered the use of a human cytomegalovirus enhancer (HMCV enhancer). Originally owned by Behringwerke, the patent was later transferred to Hoechst, of which Sanofi-Aventis is a subsidiary. The licence related, in particular, to a European Patent and two U.S. patents. Under the licence agreement, Genentech undertook to pay:

- A one-off licence fee;
- A fixed annual research fee; and
- A running royalty fee of 0.5 percent of the net sales of relevant finished products.

Genentech made the first two payments but did not make any royalty payments in respect of net sales.

In 1999 the European Patent was revoked, but the two U.S. patents remained in force. In 2008, Genentech gave notice that it was terminating the licence. Hoechst and Sanofi-Aventis believed that Genentech

had used the HMCV enhancer to manufacture Rituxan (for the treatment of non-Hodgkin's lymphoma and rheumatoid arthritis) and that the running royalty on Genentech's sales of the drug remained due and unpaid.

There followed action brought by Sanofi-Aventis in the U.S., alleging Genentech's infringement of the two U.S. patents, and before the International Court of Arbitration (ICC), seeking the payment of outstanding royalties. The U.S. courts found in favour of Genentech, but Genentech was found liable by the ICC for the payment of the running royalties. The arbitral award meant that payments already made by Genentech under licence could not be reclaimed, and that payments due to Sanofi-Aventis were payable whether or not the patent had been revoked or infringed (despite the invalidity of the European patent), on the basis that the licence had been granted to allow Genentech to use the HMCV enhancer for the production of proteins without incurring risk of infringement action. (An interesting aside worth mentioning here is the ICC's consideration of the appropriate test for contractual interpretation. Genentech's arguments were rejected by the ICC on the basis that Genentech's reasoning followed a literal interpretation of the licence agreement, which was contrary to the parties' commercial objectives, namely to allow Genentech to use the technology without the risk of litigation.)

Genentech brought its own action before the Paris Court of Appeal, claiming that an obligation to pay for the use of technology available freely to its competitors left Genentech at a competitive disadvantage, and contravened Article 101 TFEU. A difficulty for Genentech was that the licence agreement was premised on the patent being treated as valid even after it had been found to be invalid, which meant that Article 101 TFEU was at issue. It was on this point that the Paris Court of Appeal asked the Court of Justice to decide the following question:

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1. Case C-567/14 *Genentech Inc. v. Hoechst GmbH and Sanofi-Aventis Deutschland GmbH*.

2. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E101&from=EN>. Accessed 21 September 2016.

Must the provisions of Article 101 TFEU be interpreted as precluding effect being given, where patents are revoked, to a licence agreement which requires the licensee to pay royalties for the sole use of the rights attached to the licensed patents?

Court of Justice's Response

Referring to established case law,³ the Court of Justice decided that, where a licensee may freely terminate a licence agreement by giving reasonable notice, an obligation to pay a royalty throughout the validity of the licence agreement cannot fall within the scope of the prohibition set out in Article 101(1) TFEU (which broadly prohibits all agreements that affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market).

Parties to a licence agreement can therefore agree that royalties are payable to a licensor even after a patent is declared invalid, revoked or non-infringing (or, analogously, once the patent term has expired), provided that the licensee is also able to terminate the licence agreement for convenience. Provided it can, such an arrangement does not injure competition in the internal market, and is permissible under Article 101 TFEU.

Whilst not explicit in its reasoning, the Court of Justice's opinion suggests that if a licensee does not have the right to terminate a licence agreement for convenience, an obligation to pay royalties in respect of an invalid, revoked or non-infringing patent would constitute a breach of Article 101, and such licence agreement would be (at least partially) void as a consequence.

For reasoning not dissimilar to that in *Ottung*, whether or not it constitutes a distortion of competition within the market to require a licensee to pay royalties where that licensee has gained the distinct benefit of a period of exclusivity (whether or not such period extends beyond the patent's period of validity and whether or not the licensee has the option to terminate for convenience), particularly in the life sciences sector where first-mover advantage permitted by such exclusivity can confer significant financial and commercial benefits, remains open to challenge.

Impact Across Europe (and the Position Beyond...)

Genentech confirms what the European Commission has already asserted in its Technology Transfer Guidelines,⁴ namely that parties may agree to extend

royalty payment obligations beyond the expiry date of a patent without breaching competition law. The Court of Justice's response therefore reinforces that such agreements do not distort competition if the licensee has the right to terminate for convenience, and gives some measure of comfort to EU patent holders and licensors in this regard. But how has the decision affected the position across Europe? Prior to the Court of Justice's decision, did local law permit licensors to collect royalties and other fees accruing under licence agreements: (i) after patent expiry; (ii) where the relevant patent was revoked; or (iii) where there has been a finding of non-infringement (against the licensee)? The table below sets out a high level summary of the position in seven EU jurisdictions. (See Table 1.)

Beyond the EU, in the U.S. for example, typically a licensor cannot collect royalties from a licensee after the expiry of the patent's term. U.S. law does not permit licensors to collect royalties that accrue after patent expiry, and any such post-expiry patent royalty obligations are unlikely to be enforceable.⁵ However, much like in the EU, careful drafting that captures the parties' intentions expressly might enable parties to get around the legal roadblocks which may, for example, allow royalty payments to extend beyond a fixed period.

Looking further afield, in China for example, licensors are not permitted to charge royalties on expired or revoked patents, but may be permitted to charge licensees a reasonable "technical service fee" if the licensor is providing technical services to implement the licence, even if the licensed IP has entered into the public domain. The position on non-infringement is less clear.

Strategic Challenge?

In the EU at least, licensees are generally free to challenge the validity of licensed IP, although exclusive licence agreements are frequently expressed to terminate as a consequence. If the requirement to pay royalties under a licence is not expressed to survive termination, then a strategic challenge by a licensee could, in effect, enable a licensee to circumvent unwanted royalty obligations. That said, a licensee adopting a tactical approach should consider carefully the potential commercial and financial impact of an unsuccessful challenge.

It is worth mentioning here that, when amending the Technology Transfer Block Exemption Regulation⁶ (TTBER) in 2014, the European Commission initially

3. Case 320/87 *Kai Ottung v. Klee & Weilbach A/S and Thomas Schmidt A/S*.

4. Available at: [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0328\(01\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0328(01)&from=EN). Accessed 21 September 2016.

5. Case 11-15605 *Kimble v. Marvel Entertainment LLC*.

6. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0316&from=EN>. Accessed 21 September 2016.

| Jurisdiction | Table 1. Prior To <i>Genentech</i> , Did Local Law Permit Licensors To Collect Royalties/Other Fees Accruing Under Licence Agreements? | | |
|--------------------|---|---|---|
| | (i) After Patent Expiry? | (ii) After Patent Revocation? | (iii) After A Finding Of Non-Infringement? |
| UK | <p>In practice, these issues are usually avoided by careful drafting of the contract.</p> <p>If the term of the licence is not itself tied to patent expiry, licensors can (in general) continue to collect royalties/fees under the licence beyond the term of the patent's validity. A court is unlikely to permit a licence to persist perpetually without implying a voluntary termination clause.</p> | <p>If the only consideration in the contract required the validity of the patent (for a certain term), then the licensor may be in breach of the licence agreement, and as consideration will have partially failed, the licensee may be able to reclaim royalties already paid as "unjust enrichment."</p> | <p>Under English law, a bad bargain is still a bargain. Depending on how the licence is worded, the licensee may still be bound to pay royalties, even if it never needed to license the patent.</p> |
| Italy | <p>No, save in respect of 'hybrid' licences that cover other IP as well as patents (such as know-how), and where the licensee is free to terminate the agreement.</p> | <p>No—save in respect of 'hybrid' licences that cover other IP as well as patents (such as know-how) or where there has been partial revocation of the patent, and where the licensee is free to terminate the agreement. Upon request of the licensee, courts may grant a reimbursement of the fees already paid.</p> | <p>Only if the licensee is free to terminate the licence agreement.</p> |
| Netherlands | <p>Yes—broadly, parties to a licence agreement are free to agree on any royalty arrangement (subject to competition law requirements).</p> | | |
| Germany | <p>No, save in respect of 'hybrid' licences that cover other IP as well as patents (such as know-how), and absent an explicit agreement between the parties, there is no contractual claim for royalties once a patent has expired under German law (and a licence agreement that provides for an obligation to pay royalties after expiration of the patent may be contrary to the German cartel prohibition).</p> | <p>No, save in respect of 'hybrid' licences that cover other IP as well as patents (such as know-how). Broadly, the obligation to pay royalties ends on a finding of invalidity (if a patent is partially invalid, a claim for royalties exists until the patent is finally revoked).</p> | <p>Depends on the construction of the licence (as parties are generally free to determine for which acts a royalty should be due). However, German case law has been critical (on grounds of competition law) of arrangements that seek to impose on a licensee an obligation to pay royalties for unpatented technology.</p> |
| Belgium | <p>No, save in respect of 'hybrid' licences that cover other IP as well as patents (such as know-how).</p> | <p>No, to the extent that invalidity undermines the subject matter and purpose of the licence agreement, but this can depend on the construction of the licence agreement. Royalties (and other fees) paid by the licensee under a patent licence should be reimbursed by the licensor (subject to limited exceptions).</p> | <p>There is no specific rule or case-law in this regard.</p> |
| France | <p>Once the patent has expired, the requirement to pay future royalties generally falls away.</p> | <p>In general, the requirement for the licensee to pay future royalties falls away and, in principle, the licensor should return the royalties already paid, subject to whether it could be argued that the licensee has benefited from "peaceful enjoyment of the licensed invention" during the period prior to revocation.</p> | <p>Non-infringement proceedings are not available under French law.</p> |
| Spain | <p>There appears to be no authority on point.</p> | <p>Broadly, agreements concluded prior to the finding of invalidity shall not be affected, however, licensees may be entitled to reimbursement of fees paid in certain circumstances (such as bad faith).</p> | <p>Declarations of non-infringement are available under Spanish law. Although it is not clear what effect such a finding has, one might expect that it would have the same effect as revocation.</p> |

proposed that *any* restriction on a licensee's ability to challenge licensed IP should fall outside of the TTBER. However, taking account of concerns voiced in consultation, the EC provided instead that "no-challenge" clauses in non-exclusive licence agreements only would fall outside of the TTBER and be assessed on a case by case basis. A non-exclusive licensee therefore has the option to exploit the licence and simultaneously challenge the validity of the underlying IP.

Similarly in the U.S., the court in *Medimmune v. Genentech* (2007) held that the licensee did not have to cease paying royalties in order to bring invalidity proceedings in respect of licensed IP, which arguably goes beyond the position under *Lear Inc v. Adkins* (1969), that licensees of U.S. technology could challenge licensed IP only if they had ceased paying royalties and had put the licensor on notice as to why royalties were being withheld. However, judicial opinion on the enforceability of U.S. licences that contain "no-challenge" provisions which prevent a licensee from bringing an invalidity action without at the same time breaching the contract, has not been entirely uniform. The position in China is less ambiguous, where the Supreme Court has held that a licence provision that prohibits a licensee from challenging the validity of licensed IP is invalid.

Practical Considerations

Many of the issues in *Genentech* can be circumvented by careful drafting. In the life sciences sector (and elsewhere), for example, royalty payment obligations in licence agreements are expressed, typically, to be payable until the last to expire of the licensed patents. Thereafter, a reduced royalty rate may kick in for the use of relevant know-how or trademarks, to extend royalty payments beyond the life of the licensed patents (albeit at a lower rate). The reimbursement of milestone and/or royalty payments for the use of patented technology during the life of patent can also be addressed in the drafting.

Following *Genentech*, parties negotiating royalty obligations in licence agreements may want to consider the following:

- Patent licence agreements should provide expressly for the parties' intentions in the event of patent revocation and/or non-infringement.
- Licence termination provisions should include a right for the licensee to terminate the licence agreement by giving reasonable notice, which renders an obligation to pay royalties throughout the validity of the agreement outside of the scope of Article 101(1) TFEU. Onerous termination provisions run the risk of scrutiny under competition law if they disadvantage licensees in relation to their competitors.
- Licensors should avoid including terms that restrict a licensee's use of the licensed technology following expiry of the licence agreement, which may be deemed to distort competition.
- Royalty payment obligations in agreements that grant licensed rights in respect of both patents and other forms of IP (*i.e.* hybrid licences) should be allocated separately in respect of patent and any non-patent IP rights.
- Licensors could consider stating in the licence agreement that any licence fees, royalties and milestone payments are non-refundable under any circumstances.
- It may be appropriate to include terms providing for an adjustment of the royalty rate applicable where no patent subsists, or where a patent is revoked (or where there has been a patent term extension) in a particular country or territory.
- Care should be taken when drafting licence agreements governed by U.S. law, which does not permit licensors to collect royalties that accrue after patent expiry. ■

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