

So, You Received A Big Check, But It Could Have Been A Really Big Check



BY HOWARD J. SCHWARTZ AND JASON B. LATTIMORE*

It was over 84 years ago that Benjamin Cardozo, one of America's most noted jurists, handed down the decision in *Wood v. Lady Duff-Gordon*.¹ In that case, Justice Cardozo set forth the principle that an exclusive licensee has a duty to use "best efforts"² to exploit the exclusive license when that license is granted in exchange for a promise to pay royalties to the licensor. Despite the many years that have passed since *Wood*, it remains the guideline that courts follow to determine the propriety of implying a covenant to use best efforts in exclusive licensing agreements.

Some courts, however, have refused to imply a best efforts obligation in cases where the exclusive licensing agreement calls for a minimum guarantee or advance payment of royalties.³ Those courts have based their decisions on the assumption that a licensing agreement that calls for a substantial advance or guaranteed royalty payment always provides the licensee with an incentive to make the license profitable, thereby minimizing the chances that the licensee will neglect to exploit the license. That assumption is invalid. Although the invalidity of that assumption apparently has yet to be

addressed in any published opinion, the weakness in the foundation of this line of case law could have significant implications both for those who face litigation over exclusive licensing agreements and those who are involved with the drafting of exclusive licensing agreements.

Origin of the Best Efforts Doctrine: *Wood v. Lady Duff-Gordon*

In *Wood*, Lady Duff-Gordon, a famous fashion designer, granted Wood an exclusive license to permit others in the clothing and fabric industry to place her name on their products. In return, Wood was obligated to pay Duff-Gordon a percentage of the profits earned from the sale of her name.⁴ In violation of the exclusive license granted to Wood, Duff-Gordon began licensing to others the right to place her name on "fabrics, dresses and millinery" without Wood's permission and without paying Wood his portion of the profits.⁵ Wood sued Duff-Gordon when Wood discovered Duff-Gordon's violation of the exclusive license.

In an attempt to establish that her agreement with Wood was unenforceable, Duff-Gordon argued that the agreement lacked mutuality of obligation because it did not explicitly state that Wood had a duty to exploit the license. Duff-Gordon argued that a promise to pay royalties without an obligation to bring those royalties into existence was no

promise at all. The court rejected that argument, holding that the contract between the parties evidenced an implicit obligation on the part of Wood to use reasonable efforts to generate royalties.⁶

The court in *Wood* implied an obligation on the part of Wood to use "reasonable efforts" because Duff-Gordon's sole revenue from the subject matter of the license was dependent on Wood's efforts to make the license profitable, which suggested that the parties intended Wood have an obligation to exploit the license. The court reasoned that the only way to give effect to the reasonable expectations – i.e., the intent – of the parties was to imply a duty on the part of Wood to work the license.⁷

The Rationale Behind the Refusal to Imply a Best Efforts Obligation When A Substantial Advance Has Been Paid

The justification for applying a different rule where an advance or guaranteed royalty is paid is based, at least in part, on the assumption that a licensee **always** has an incentive to work a license when the licensee pays a substantial advance to the licensor. It is also based on the assumption that Cardozo's opinion in *Wood* was influenced by the fact that, in the absence of an implied obligation, the contract in that case would have failed for lack of mutuality of obligation.

1. *Wood v. Lady Duff-Gordon*, 222 N.Y. 88 (1917).

2. The terms "best efforts" and "reasonable efforts" are interchangeable in the context of exclusive licensing agreements. See *Vacuum Concrete Corp. v. American Mach. & Foundry Co.*, 321 F. Supp. 771, 775 (S.D.N.Y. 1971). "Reasonable efforts" was the term used in *Wood*.

3. *Emerson Radio Corp. v. Orion Sales, Inc.*, 253 F.3d 159 (3rd Cir. 2001); *Behra v. Baxter Health Care Corp.*, 956 F.2d 1436 (7th Cir. 1992) (applying Pennsylvania law); *Permanence Corp. v. Kennametal, Inc.*, 908 F.2d 98 (6th Cir. 1990).

4. *Wood*, 222 N.Y. at 90.

5. *Id.*

6. *Id.* at 90-91.

7. *Id.* at 91-92.

*Howard J. Schwartz is a principal at Porzio, Bromberg & Newman, P.C., and serves as Chair of the Intellectual Property practice group. Jason B. Lattimore is an associate at Porzio, Bromberg & Newman and works in the firm's Intellectual Property practice group.

As discussed below, the first assumption is not valid. The validity of the second assumption is a closer question, but Cardozo's opinion indicates that the intent of the parties as gleaned from the contract and the business context in which it was created was the foundation for the implication of a best efforts obligation in *Wood*, not a desire to create mutuality of obligation where the parties intended none. Given that the first assumption is invalid and the second is perhaps debatable, practitioners should proceed with caution when relying on decisions founded on that line of reasoning.

The lead case discussing the propriety of the refusal to imply a best efforts obligation when a substantial advance or guarantee has been promised is *Permanence Corp. v. Kennametal, Inc.*, 908 F.2d 98 (6th Cir. 1990). In *Permanence*, plaintiff granted defendant an exclusive license, subject to a preexisting non-exclusive license, to patents relating to a process for forming an alloy. Plaintiff received an up-front fee of \$150,000 and an advance on royalties of \$100,000 for the exclusive license.⁸ Seven years afterward, plaintiff filed suit against defendant for breach of contract, alleging that defendant had not fulfilled its implied obligation to use best efforts to exploit the patents. Defendant moved for summary judgment, arguing that no obligation to use best efforts could be implied in its contract with plaintiff. The district court agreed, granting defendant's motion, and the Court of Appeals for the Sixth Circuit affirmed.⁹

The Court of Appeals based its decision on two assertions. First, it stated that the doctrine in *Wood* was born in the context of a contract lacking mutuality of obligation, while an exclusive licensing agreement that calls for a substantial advance does not lack mutuality of obligation. Second, the court reasoned that by requiring a substantial minimum or

advance, "the licensor, in lieu of obtaining an express agreement to use best efforts, has protected himself against the possibility that the licensee will do nothing" because the payment of a substantial advance provides the licensee with an incentive to work the license.¹⁰

In a similar case, the Court of Appeals for the Third Circuit, following the *Permanence* rationale, refused to imply a best efforts covenant in an agreement granting an exclusive license to use plaintiff's trademark in connection with the sale of plaintiff's video and television equipment.¹¹ Defendant agreed to pay plaintiff a minimum royalty of \$4 million per year, an amount the court reasoned was substantial enough to eviscerate the need for the implied covenant.

The Problem with the *Permanence* and *Emerson* Decisions

The primary assumption upon which *Permanence* and *Emerson* rest is that the payment of a substantial advance will always provide the licensee with an incentive to work the license (alternatively referred to as the "advance-equals-incentive rationale"). That assumption is invalid. It is true that, absent any external influences, a licensee does have some incentive to attempt to recoup the advance paid to the licensor. But when one steps back and takes a look at the big picture, the reasoning of *Permanence* and *Emerson* fails.

The fallacy of the advance-equals-incentive rationale is that it ignores the economic concept of opportunity cost. "Opportunity cost" is the value of the greatest benefit that is given up in order to engage in an alternative endeavor:

Opportunity Cost - The highest valued alternative foregone in the pursuit of an activity. This is a hallmark of anything dealing with economics – and life for that matter – because any action that you take prevents you from doing

something else. The ultimate source of opportunity cost is the pervasive problem of scarcity (unlimited wants and needs, but limited resources). Whenever limited resources are used to satisfy one want or need, there are an unlimited number of other wants and needs that remain unsatisfied. Herein lies the essence of opportunity cost. Doing one thing prevents doing another.¹²

A licensee will only have limited resources to devote to the exploitation of licenses. In order to maximize its profitability, the licensee will always direct its resources toward those licenses that it believes will be the most profitable. Whenever a licensee believes that the opportunity cost of devoting resources to exploiting an exclusive license will be higher than the advance or guarantee paid for the exclusive license, the potential exists for the licensee to become indifferent to its obligation to use best efforts to work the license because the licensee is sure to recoup its advance by directing its resources toward the alternative endeavor. Moreover, where a licensee perceives the opportunity cost of exploiting a license to be greater than the projected profits from the license, it will invariably redirect its resources to the alternative endeavor because it believes that it will profit more by forsaking the license. Thus, under conditions where a licensee has a choice between exploiting one of two licenses for which the licensee has paid an advance or guarantee on royalties, the licensee will choose to exploit the license that it believes will provide it with the most profit. That same principle applies when a licensee holds a number of licenses.

This, in fact, happened in a case involving the grant of an exclusive license to The Walt Disney Company ("Disney") to market and to promote a cartoon character named "Marsupilami."¹³ In August of 1990,

8. *Permanence*, 908 F.2d at 99.

9. *Id.* at 99-100.

10. *Id.* at 102, 103.

11. *Emerson*, 235 F.3d at 165-69 (predicting New Jersey law).

12. Definition and discussion taken from AmosWebEconomic at www.Amosweb.com.

plaintiff, Marsu, agreed to license Marsupilami to Disney in exchange for \$500,000 up-front and a guaranteed annual royalty payment of \$2 million. The contract explicitly required Disney to use its best efforts to promote Marsupilami.¹⁴

Because of the success of Disney's "Aladdin" and "The Little Mermaid," however, Disney decided not to devote the promotional efforts needed to comply with its obligations to Marsu under their contract.¹⁵ An October 1992 internal memo to Disney's chief executive officer illustrates that Disney breached its contract with Marsu precisely because the opportunity cost of exploiting the Marsupilami license was too great:

Our hot properties were consuming all of our attention (film properties alone will be \$25 million over budget this year!!!). We couldn't divert attention from these major hits to do Marsu.

Our film properties have turned into an embarrassment of riches in licensing. We have more than enough to do to stay busy for years into the future. *Internationally, we have neither the time nor the resources to do Marsu right - we'd be leaving millions of lost opportunity on film merchandise potentially on the table.*

The reception Marsu is receiving from licensees outside the gift category has been very cool. Compared to Aladdin . . . Marsu is a greater unknown and has less Disney weight behind it. *If we didn't have the killer film properties, the reception would be different . . . [Marsu] appeared to be doing better with [its] property than we're able to do, but again that is because we have lots of other Disney priorities, more important both financially and strategically.*¹⁶

In December of 1993, fifteen months after the circulation of the memo,

Disney exercised its option to terminate the contract, having paid Marsu \$5 million in guarantees. Marsu subsequently sued Disney for, among other things, breach of Disney's express duty to use best efforts. The District Court sided with Marsu, awarding over \$8 million in lost profits and the Ninth Circuit affirmed.¹⁷ Economic theory and the facts of *Marsu* thus illustrate that courts cannot assume that a substantial advance or guarantee provides a licensee with a significant incentive to exploit a license.

In addition to being erroneous, the assumption that an advance always protects a licensor's expectation interest can lead to unfair results. Most likely, a licensor's expectation under an exclusive licensing agreement that calls for a substantial advance on royalties is to receive the advance along with the licensee's employment of reasonable efforts to bring additional royalties into existence. As Cardozo stated in *Wood*, a promise to pay royalties tends to imply a promise to bring those royalties into existence.¹⁸ The licensor's expectation interest lies, at least in part, in the licensee's reasonable attempt to exploit the license, and any *per se* interpretation of the contract that ignores that expectation runs the risk of depriving the licensor of its benefit of the bargain. The *Marsu* court's award of over \$8 million in lost profits to Marsu illustrates the need to protect that interest.

In contrast to the advance-equals-incentive rationale, the assertion that the doctrine of *Wood* was born in the context of a contract that would lack mutuality of obligation in the absence of an implied best efforts obligation is valid. It is by no means clear, however, that the court in *Wood* would not have implied a best efforts obligation if *Wood* had paid an advance to Lady Duff-Gordon. While the issue before Cardozo

was whether a court may provide an obligation to use best efforts on the part of a licensee under an exclusive license agreement that would otherwise lack mutuality of obligation, the issue was not whether such an obligation should be implied because an exclusive license agreement lacks mutuality of obligation. It is doubtful that a court would imply a contractual term that contradicts the intent of the parties solely for the purpose of saving a contract that otherwise would not be enforceable.¹⁹ Instead, courts imply contractual terms to give effect to the intent of the parties to the contract – it is a matter of contract interpretation.²⁰

Indeed, Cardozo's opinion in *Wood* focuses almost exclusively on the intent of the parties:

A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed.²¹

Without an implied promise, the transaction cannot have such business "efficacy as **both parties must have intended** that at all events it should have."²²

It is true, of course, as the Appellate Division has said, that if he was under no duty to try to market designs or to place certificates of endorsement, his promise to account for profits or take out copyrights would be valueless. **But in determining the intention of the parties**, the promise *has* a value. It helps to enforce the conclusion that the plaintiff *had* some duties. His promise to pay the defendant one-half of the profits and

13. *Marsu v. The Walt Disney Co.*, 185 F.3d 932 (9th Cir. 1999).

14. *Id.* at 935.

15. *Id.* at 935, 937.

16. *Id.* at 937 (as quoted by the court).

17. *Id.* at 936.

18. *Wood*, 222 N.Y. at 92.

19. See *Wieder v. Skala*, 80 N.Y.2d 628, 634 (1992) (stating that an implied obligation "is in aid and furtherance of the agreement of the parties" and that "no obligation can be implied . . . [that] would be inconsistent with other terms of the contractual relationship").

20. Farnsworth, *Contracts* (2d ed. 1990) ' 7.16, at 544-45 (stating that the process by which courts supply implied terms "is essentially the same as that used for vague and ambiguous language."); cf. *Casriel v. King*, 2 N.J. 45, 48 (1949) (stating that the "polestar" of contract interpretation is the intent of the parties).

21. *Wood*, 222 N.Y. at 91 (citations omitted).

22. *Id.* (emphasis added).

revenues resulting from the exclusive agency and to render accounts monthly, was a promise to use reasonable efforts to bring profits and revenues into existence.²³

Although, as previously stated, the *Permanence* court based its decision on at least one erroneous assumption, it apparently recognized that its endeavor was one of contract interpretation:

In making the determination of whether a covenant to use best efforts should be implied as a matter of law, this court must focus its attention on the terms of the written contract between the parties, and the circumstances surrounding the making of the agreement.²⁴

Interestingly, in discussing the intent of the parties, the *Permanence* court placed weight on the fact that the contract in that case contained a standard integration clause.²⁵ Although the language of integration clauses can vary, such clauses generally state that the contract embodies the 'entire agreement' of the parties, thereby insuring the full effect of the parol evidence rule.

Courts apply the parol evidence rule to exclude evidence of extraneous agreements and representations of the parties to a contract made prior to or contemporaneous with

the execution of the written contract. The parol evidence rule, however, does not preclude a court from engaging in contract interpretation, as Cardozo did in *Wood*, where a court considers evidence tending to explain the terms of a contract when the intent of the parties is not clear.²⁶ That is a fundamental principle of contract law, so it is difficult to determine why the *Permanence* court thought the existence of an integration clause necessarily precluded the implication of a best efforts term.²⁷ To the contrary, an integration clause that does not explicitly exclude implied terms should be given little or no weight in the determination of whether a court should imply a best efforts obligation in an exclusive licensing agreement.

The Uncertainty Caused by the Weakness in the *Permanence* Rationale

In light of the foregoing analysis, there is no guarantee that a court will refuse to imply a best efforts obligation into contracts calling for substantial advance or guaranteed royalties. Indeed, *Wood* suggests that courts should engage in a meaningful inquiry into the intent of the parties. As stated in *Permanence*, a court should look to the terms of the contract along with the circumstances surrounding the contract's formation. Similar to Cardozo's reasoning in *Wood*, significant weight should be given to the notion that because a licensee has agreed to pay royalties in exchange for an exclusive license, the licensee has also impliedly promised to use reasonable efforts to bring such royalties into exist-

ence, despite any advance paid by the licensee to the licensor.²⁸

Of course, other considerations may militate against a finding that the parties intended the licensee to be bound by a duty to use best efforts. For instance, a contract could provide that if royalties do not exceed the advance within a given number of payment periods, then the licensor and/or licensee will have the option of terminating the agreement.²⁹ While not conclusive of the parties' intent, such a provision might suggest that the parties did not intend for the licensee to be bound to use reasonable efforts.

Practical Advice in Light of the Foregoing Analysis

In all, the weakness of the rationale of *Permanence* and its progeny suggests that attorneys, licensors and licensees should proceed with caution when drafting or negotiating exclusive license agreements. Those who are drafting or entering into exclusive licensing agreements should be aware of the implications of not explicitly spelling out the licensee's duties with respect to the exploitation of the license. While the trend with respect to exclusive licensing agreements calling for the payment of a substantial advance or guaranteed minimum royalty payment appears to favor the licensee, the preceding discussion illustrates that there is a legitimate basis to call that trend into question, or at least to avoid it in cases where the licensor can show conduct on the part of the licensee that is akin to that of the defendant in *Marsu*.

For attorneys involved in litigation over exclusive licensing agreements, the considerations will vary depending on which side of the dispute they represent. Attorneys representing licensees should be prepared for the argument that the doctrine followed in *Permanence* and *Emerson* is inapplicable or invalid for the reasons stated above.

23. *Id.* at 92 (emphasis added).

24. *Permanence*, 908 F.2d at 101 (citations omitted).

25. *Id.* at 102. Compare *Permanence* with *U.S. Gypsum Co. v. Schiavo Bros., Inc.*, 668 F.2d 172, 175-76 (3d Cir. 1981) (applying Pennsylvania law to hold that an integration clause in a lease which stated that the lease constituted all "promises, agreements, conditions, or understandings, either oral or written between the parties did not preclude the implication of a clause requiring the return of the leased premises in the condition in which it was received"); *Lagrew v. Hooks-Superx, Inc.*, 905 F. Supp. 401, 407-08 (E.D. KY. 1995) (implying an obligation of continuous occupation in a commercial lease despite clause in lease stating that obligations not set forth in the lease were not to be imposed on either party); *Allapattah Serv., Inc. v. Exxon Corp.*, 61 F. Supp. 2d 1308, 1315 (S.D. FL. 1999) ("Although merger or integration clauses have been considered strong evidence of finality, they are not conclusive on the issue of whether the writing encompasses the entire agreement of the parties").

26. *Farnsworth* ' 7.12, at 520 ("All courts agree that the parol evidence rule permits them to [engage in contract interpretation].").

27. A similar approach was taken by the District Court for the Southern District of New York in *Vacuum Concrete*, however, there was evidence in that case that, during contract negotiation, the parties discussed the issue of how to protect the licensor from non-exploitation of the license and that the parties had purposefully excluded a best efforts provision and instead agreed upon, among other things, minimum payment and cancellation provisions. *Vacuum Concrete*, 321 F. Supp. at 774-75.

28. *Wood*, 222 N.Y. at 92.

29. *Cf. Vacuum Concrete*, 321 F. Supp. at 773-74.

Where possible, the licensee's attorney should press the argument that the intent of the parties to the exclusive licensing agreement was that the licensee would have no obligation to use best efforts.

Of course, the defenses the licensee can assert will turn on the facts of the particular case. The resolution of certain questions, however, could have a significant impact on the potential liability of the licensee. For instance:

1. Did the licensee actually use reasonable efforts to exploit the license?
2. If a significant attempt was not made to exploit the license, was there an excuse other than that the licensee wanted to direct its resources to more profitable endeavors? For example, the argument could be made that reasonable efforts do not include making attempts to exploit a license that clearly would not be profitable (*e.g.*, less costly, superior technology renders the subject matter of the license obsolete).³⁰

Not unexpectedly, much of the licensor's ability to press its case will turn on whether it can establish that the licensee abandoned efforts to exploit the license not because the license would not have been profitable, but because the licensee chose to invest its resources in more profitable endeavors. Any evidence tending to show that the parties intended that the licensee have an obligation to use reasonable efforts to generate profits would also be helpful to the licensor.

Because the court's analysis in a given case could be very fact intensive, the discovery phase of the litigation should be particularly important for both parties.

Conclusion

Considering the weaknesses of the *Permanence/Emerson* rationale, there is uncertainty as to how courts will treat a licensor's suggestion that an implicit obligation exists on the part of the licensee to use best efforts to exploit the license. Perhaps most courts will simply follow *Permanence*. But given the analysis set forth above, a court would be justified in deviating from the *Permanence/Emerson* rationale based on the inapplicability of the assumptions upon which those decisions were founded or factual distinctions elucidated in the course of litigation that render the *Permanence* rationale inapposite. Attorneys and businesspeople should be mindful of that possibility and prepared to deal with its implications.

30. The situation where the value of the license is destroyed should be distinguished from that where the value of the license remains unchanged, but more profitable endeavors present themselves to the licensee. It would be inefficient and unreasonable for a court to require a licensee to use reasonable efforts to exploit a license that has become unprofitable – it would force the fruitless and nonsensical investment of resources by the licensee. It seems fair, however, that where a licensee agrees to pay royalties in exchange for the exclusive right to exploit a license, the licensee has an obligation to use reasonable efforts to exploit the license, despite better opportunities for profit, so long as the value of the license has not been destroyed.