U.S. License Agreements Should be Adapted for Use in Canada

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In the new economy, the number of commercial agreements involving U.S.–Canada cross-border use or exploitation of technology or intellectual property has greatly increased. Similarly, the sale of licensed merchandise, such as apparel, toys, computer games and knapsacks, depicting such things as professional sports franchise logos and cartoon characters, has become more prevalent and almost commonplace. As a consequence, the negotiation of license agreements whereby the rightsholder to the underlying intellectual property licenses some of its rights to technology integrators or users, or to manufacturers and/or distributors of licensed merchandise, has also become more prevalent in both the commercial and legal environments.

In many cases, large licensors are U.S.-based. These U.S.-based licensors, as a matter of policy, prefer to use standard form license agreements that they ask each licensee to execute without any, or very few, modifications being made. Usually, these standard form license agreements are used with U.S.-based licensees. They therefore mostly address U.S.-specific commercial and legal issues. From a practical point of view, this allows licensors with extensive licensing programs to maintain certain standards "across the board," which is more cost-efficient in terms of managing the licensing program. However, where such standard form license agreements are used with Canadian-based co-contracting parties without any modifications or adaptations, dangers arise that could affect both parties to the license. These dangers could, for example, affect the enforceability of the agreement, the commercial relationship between licensor and licensee and, perhaps most important, the financial bottom line of the relationship.

In other cases, a large U.S.-based licensee may, for example, enter into a license agreement pertaining to the use in the U.S. of technology developed by a small or mid-sized Canadian technology company. Here again, ignoring certain peculiarities of Canadian law might jeopardize the profitability or enforceability of the agreement in the long run or upon the occurrence of certain events.

The following is a list of the "Top 10" tips or considerations that should be kept in mind when drafting license agreements that involve a Canadian-based party:

THE TOP 10

1. Withholding Taxes

Licensees typically pay royalties to licensors for the right to use the licensor's intellectual property. In many cases, the royalties payable are based on "net sales," as defined in the agreement. It is not uncommon to find that license agreements forbid the licensee to deduct any form of taxes in the computation of "net sales," and hence royalties payable.

In certain cases under Canadian law, licensees are required to withhold from royalties payable to a foreign licensor, taxes otherwise owing by the licensor to the Canadian government on account of royalties (i.e., income) earned in Canada. At present, under the Canada–United States Income Tax Convention, the applicable tax rate is 10 percent (10%). By prohibiting the licensee from withholding taxes from the royalties payable to the licensor, the licensor is in effect requiring the licensee to "gross up" the royalties payable by the amount of the withholding tax, hence the common use of the term "gross up clause."

Although a gross up clause might sound like a good idea from the licensor's standpoint, in reality, it could render the license unprofitable to the licensee and in the long run, also be detrimental to the licensor and the business relationship generally. One way around this problem is to draft the license agreement so that it fits one of a few exceptions to the applicability of this withholding obligation. For example, both the Canada–United States Income Tax Convention and Canada's Income Tax Act exempt from the obligation to withhold

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taxes, royalties or similar payments for the use of a copyright in respect of the production or reproduction of any literary (e.g. software), dramatic, musical or artistic work. Similarly, the Canada–United States Income Tax Convention exempts from the withholding obligation, payments for the use or the right to use computer software or patents. Each particular business agreement should therefore be crafted or reviewed in light of these—and other—potentially applicable exemptions to tax withholding obligations under Canadian law so that, where possible, it can be made profitable to both parties.

2. Bankruptcy and the Sale of the Underlying Technology by a Canadian Licensor

Contrary to U.S. law, Canada's Bankruptcy and Insolvency Act does not include a provision similar to subsection (n) of § 365 of the United States Bankruptcy Code, which affords some protection to most licensees of intellectual property upon the rejection or assumption and assignment of the license by a trustee in bankruptcy. Furthermore, there is a fair amount of uncertainty in Canadian law as to whether or not a license for use of technology can be enforced against a third party acquirer for value—whether in a bankruptcy context or otherwise—of the underlying technology or intellectual property. Although, in reality, the sale of such technology or intellectual property by a licensor is usually accompanied by an effort to assign all related licenses, the risk that a particular license might not, for any given reason, be assigned to and assumed by such acquirer—and thus that the licensee might then only have a damage claim for breach of the license, however so important, against its licensor as opposed to an enforceable license—remains real and important.

Legislation—as has been enacted in the United States through § 365(n) of the U.S. Bankruptcy Code—would obviously also be desirable in Canada. In the meantime, however, various mechanisms are at the disposal of licensees dealing with Canadian licensors to protect their rights.

For example, a company wanting to obtain rights to a key technology should consider obtaining an assignment of the rights it might originally have considered licensing from the owner of such technology. This approach has been increasingly used in Canada in the recent past with respect to software—primarily through the use of Section 13(4) of the Copyright Act of Canada, which expressly allows the partial assignment of a copyright, for example by limiting such assignment with respect to specific types of use, duration, territory and so forth. A company desiring to acquire rights with respect to the use of software that it critically needs as part of its business should therefore consider the possibility of obtaining an assignment of those rights, as opposed to automatically adopting the "licensing route."

Regardless of whether use of a key technology is obtained through a license agreement or an assignment, however, it is desirable to register the rights that are obtained with the Canadian Intellectual Property Office (CIPO). Section 51 of the Patent Act of Canada states, in essence, that unregistered "assignments" are void against subsequent registered assignments of the patent. Section 57 of the Copyright Act of Canada further states that an assignment of copyright, or a license granting an interest in copyright, is void against any subsequent assignee or licensee for valuable consideration without actual notice, unless the prior assignment or license is registered. There is considerable debate in Canada as to whether (or which) license agreements or security agreements constitute "assignments" under these statutes—and therefore as to which of these can or should be registered. Most agree, however, that a subsequent but registered "assignment" of a patent or copyright will prevail over a prior but unregistered "assignment." In fact, in its recent decision of Les Poinçons de Waterloo Inc. v. 3288731 Canada Inc. (February 26, 2001), Montreal 500-09-006534-986 (C.A.), the court of Appeal of Quebec reminded all of the drastic impact that section 51 of the Patent Act can have on a company's business, when it confirmed a Superior court's decision that an unregistered exclusive patent license was void against a subsequent but registered assignment of the patent, even though the assignee had actual notice of the license prior to obtaining the assignment of the patent. Good practices therefore dictate that an attempt to register with CIPO be made for any license agreement, security interest or other similar instrument pertaining to an important patent or copyright—not to mention that all assignments should be registered as a matter of course. Obviously, the cost of registering rights with CIPO might be prohibitive in the long run for corporations with large licensing programs (i.e., there is a fee for each registration), but the necessity or opportunity of registering these rights should nevertheless be considered and then determined case by case on an ongoing basis.

Many contractual techniques or mechanisms can also be used creatively in Canadian license agreements to reduce the risk exposure of licensees. One approach is to include a provision in the license agreement whereby the license will be converted upon the occurrence of certain events that could typically jeopardize a licensee's right to

use the technology or intellectual property. For example, a fixed-term software license featuring yearly royalty payments could be made convertible into a perpetual and fully paid-up license upon the licensor making an assignment in bankruptcy. Similarly, such license agreement could be made convertible into a straight assignment of the technology to the licensee upon that same event occurring. In order to minimize the risk that such contract provisions be held unenforceable or void under Canada's Bankruptcy and Insolvency Act as fraudulent preferences, they should provide for an amount corresponding roughly to the fair market value of the rights so transferred to be paid by the licensee to the licensor/trustee upon receiving these rights (See sidebar, this page).

Another approach commonly used with respect to software licenses is to require the licensor to place the source code and all related documentation in escrow with an escrow agent so that it be available to the licensee upon the occurrence of certain events. This will be especially relevant in cases where a licensee is dependent on its licensor for ongoing services, or support or maintenance of the software—or example, in the case of sophisticated enterprise software. Of course, a source code escrow agreement would not grant the licensee ownership rights in the technology itself—like an assignment would—but at least it would give a licensee the tools necessary to operate its business, while dealing with a trustee or the new owner of the technology concerning the rights to its use.

One could also include in the license agreement a provision that prohibits the licensor from selling the technology and intellectual property that is being licensed without first obtaining the consent of the licensee or without ensuring that the acquirer assume all of the licensor's obligations under the license.

The actual usefulness or efficacy of these various contractual techniques and mechanisms usually depends on whether or not the licensor has already granted a security interest covering the technology or intellectual property to creditors at the time it enters into an arrangement with a licensee. Hence it is key when negotiating a license agreement or an assignment with a Canadian-based party, to conduct the appropriate level of due diligence so as to determine if any third parties have rights in or security interests covering the relevant technology or intellectual property.

Conversely, and in order to increase the ultimate efficacy of the contractual techniques and mechanisms outlined above, a licensee under a Canadian license should itself consider, where appropriate, obtaining a security interest on the technology and intellectual property it intends to license. This can guarantee the performance by the licensor of some or all of its obligations under the license agreement—for example, a licensor's obligation not to sell the technology or intellectual property that is being licensed without first requiring the third party acquirer to assume all of the licensor's obligations under the license. At least, the licensee's security interest should give the licensee some comfort with respect to the licensor's subsequent dealings with the technology and intellectual property. Of course, any security interest obtained by a licensee should be registered, not only with the relevant provincial security registry, but also with CIPO. This will help avoid the risk that the licensee's security interest be later defeated by a subsequent registered assignment of the intellectual property granted by the licensor—on the grounds that such security interest was in fact an "assignment" that should have been registered with CIPO in the first place.

3. Transaction Value of Goods Sold for Export to Canada

Large U.S.-based licensors typically wish to maintain a significant amount of control over the design, development, manufacture and sale of licensed merchandise. This ranges from requiring a licensee to obtain pre-production approval for licensed merchandise to requiring

> The decision of the Supreme Court of Canada in Les Coopérants, Life Insurance Society v. Dubois, [1996] 1 S.C.R. 900, supports this view. In Les Coopérants, the Supreme Court upheld the validity of a co-sale agreement that had been challenged by a liquidator appointed under Canada's Winding-up Act. The co-sale agreement allowed each of two co-owners of an immovable property to force the other one to sell its interest in the property in certain circumstances, including where a liquidator had been appointed with respect to the assets of the other. The price for the transfer under the co-sale agreement was 75 percent of the fair market value of the co-owner's interest in the property, established on the basis of the value of the property as a whole, without regard to the fact that the property was held in co-ownership. The Supreme Court held that there had been no evidence adduced to suggest that an appraisal at 75 percent based on the above guidelines was prejudicial to the other creditors' interests in a liquidation context and upheld the provision as being valid.

the licensee to manufacture licensed merchandise in accordance with design specifications established by the licensor. In some cases, licensees with no manufacturing facilities of their own may be required to use a manufacturer appointed or chosen by the licensor.

In Canada, it is not uncommon for Canadian licensees to arrange for licensed merchandise to be manufactured overseas, and then shipped to the licensee. In certain contractual situations, Canadian tax authorities may require the licensee, for customs purposes, to include the value of the royalties payable to the licensor to the transaction value of the licensed merchandise shipped to Canada. Specifically, the Supreme Court of Canada has held that royalties should be included in the transaction value of the licensed merchandise exported to Canada only where the contract of sale between the vendor of the goods (i.e. ,the overseas manufacturer) and the importer (i.e., the licensee) provides that the payment of royalties (to the licensor) is a condition of sale of the goods.

The above is important to consider when negotiating a license agreement. If the agreement is not drafted carefully, the licensee may be required to pay duties on the value of royalties otherwise payable to the licensor, which may not be intended by the parties. Given the size of the Canadian market, the payment of such duties could render an agreement unprofitable to the licensee, a situation that, in the long run, would be detrimental to both licensor and licensee.

4. Resale Price Maintenance

Some standard form (U.S.-based) license agreements also provide that the licensee shall not be entitled to sell the licensed merchandise or consumer software package to retailers at a price lower than a certain percentage (e.g., 120%) of the manufacturing cost of the licensed merchandise. Ostensibly, the rationale behind the provision is to set a pre-defined wholesale price for the licensed merchandise, in an effort to maintain royalties payable to the licensor at a suitable level. License agreements may even provide that the licensed merchandise cannot be used as "premium sales."

In Canada, a licensor insisting on such a provision could be guilty of a criminal offence under Canada's Competition Act. In particular, section 61 of Canada's Competition Act prohibits, inter alia, any person who has the exclusive rights and privileges conferred by a trademark or copyright from trying, by agreement, threat, promise or any like means, to influence upward or discourage the reduction of the price at which any person (e.g., a licensee) supplies a product (e.g., licensed merchandise or consumer software package) in Canada.

Given the potential serious consequences associated with criminal offences (which could include the imposition of fines and/or incarceration), licensors should be mindful of the provisions of section 61 of the Competition Act.

5. Exclusive Jurisdiction of U.S. Courts

Standard license agreements drafted by U.S. licensors typically provide that U.S. courts shall have exclusive jurisdiction over any disputes arising under the agreement. Although U.S. licensors undoubtedly insist on these provisions due to their familiarity and comfort with the laws and court system in their domestic jurisdiction, an insistence on granting to U.S. courts the exclusive jurisdiction over all disputes may make it more difficult to enforce the license agreement in Canada.

For example, an injunction issued by a U.S. court enjoining a licensee from breaching the agreement would have no effect on a Canadian licensee operating only in Canada. The licensor would then be required to apply to a Canadian court of competent jurisdiction to have the U.S. injunction recognized. This is an additional, time-consuming and costly step and one that is not always effective. The U.S. judgment could be impeached or not recognized in Canada on several grounds, including that the enforcement of the U.S. judgment would be contrary to Canadian public policy or that the procedure by which the judgment was obtained was contrary to Canada's basic requirements of justice. Another issue would be whether the Canadian court would have jurisdiction, under the agreement, to enforce the U.S. injunction, given the specific provision in the agreement that U.S. courts have exclusive jurisdiction over any dispute.

6. "Works-Made-for-Hire"

In an effort to protect the licensor's intellectual property rights, the license agreement will typically require the licensee to assign to the licensor the copyright to any work created by the licensee in the design and development of any licensed products, or associated artwork, hangtags, etc. In this regard, standard form license agreements often require the licensee to acknowledge that such copyright works are "works-made-for-hire" under the U.S. Copyright Act.

However, if the licensee is Canadian, the licensed merchandise is to be distributed and sold only in Canada, and the copyrighted works are created in Canada, then Canadian copyright law, not U.S. copyright law, would apply. Under Canadian copyright law, there is no "work-made-for-hire" doctrine. In Canada, the applicable principle is that a copy-

right work made by an employee in the course of his or her employment is owned by the employer.

7. Attacking the Validity of the Underlying Intellectual Property

It is our understanding that it is a breach of U.S. law to require a licensee to covenant not to challenge or attack, directly or indirectly, the validity of the intellectual property it has licensed, or the ownership of same by the licensor. In Canada, however, such a covenant is permissible. As such, U.S. licensors seeking enhanced protection for their intellectual property, at least in Canada, may wish to require their Canadian licensees to undertake not to challenge the validity or ownership of their intellectual property rights.

8. Expiry of Intellectual Property Protection

Similarly, it is our understanding that it is not permissible in the U.S. to require a licensee to continue to pay royalties after, for example, a patent has expired or a trade mark has been expunged or is otherwise removed from the Trade Marks Register. In Canada, however, provided that the licensor is not abusing a dominant position or otherwise engaging in conduct contrary to Canada's Competition Act, it is permissible for a licensor to require a licensee to continue to pay royalties, if the licensee maintains its use of the patent or trade mark rights in question. Again, these are clauses that the licensor may wish to consider with respect to license agreements to be entered into with Canadian licensees.

9. Language Laws

In an effort to protect their intellectual property rights (especially trademark and copyright rights), licensors will usually require licensees to include certain notice provisions with the licensed products, associated artwork and/or hangtags (e.g., that the licensed merchandise is being sold under license from the licensor). In this regard, license agreements also typically provide that any such notices must be in the English language, and in the licensor's standard form or such other form as is pre-approved by the licensor. The licensor's standard form will rarely include a French-language version.

Where the parties intend the licensed products to be sold in the Province of Quebec, the majority of whose population is French-speaking, all "labels" must be in both French and English. As such, license agreements should give the licensee sufficient flexibility to include French-language labeling on hangtags, artwork, etc. At the very least, the agreement should contain a procedure for French-language labeling to be pre-approved by the licensor.

10. Registered User Laws

Standard form agreements that include a license to use trademark(s) will often require the licensee to register itself as a registered user of the licensed trademark(s). Since Canada no longer has a registered user system, an insistence on maintaining this provision in a license agreement that is applicable only to Canada could lead to unnecessary negotiation between a licensor and licensee.

CONCLUSION

The foregoing list is meant only to illustrate the issues, problems and dangers that arise when standard form U.S.-based license agreements are used and adopted in Canada without modification. Licensors and licensees would therefore be well-served in obtaining Canadian legal advice so that these issues, problems and dangers, among others, are addressed properly. Both parties could then have more comfort in the fact that their respective rights and obligations under the license agreement should be enforceable and that no Canadian laws have been or will be breached.