LICENSING: HOW TO AVOID ENTERING INTO A BADLY DRAFTED AGREEMENT

By
François Painchaud and Panagiota Koutsogiannis*
LEGER ROBIC RICHARD, Lawyers,
ROBIC, Patent & Trademark Agents
Centre CDP Capital
1001 Square-Victoria- Bloc E – 8th Floor
Montreal, Quebec, Canada H2Z 2B7
Tel. (514) 987 6242 - Fax (514) 845 7874
www.robic.ca - info@robic.com

The extent of the rights granted to a licensee is often determined by the types of clauses found in the licensing agreement between the licensor and the licensee. The knowledge and understanding of such clauses is essential to the drafting and interpretation of licensing agreements. The following article describes types of clauses which can be included in licensing agreements.

Grant of rights

The grant provision is the essence of a licensing agreement because it establishes the subject matter of the licence and the rights that are to be extended to the licensee. It is very important to adequately define the technology that will be transferred. If this clause is unclear or improperly understood, it could result in a dispute between the parties which may eventually require the intervention of the courts.

The language used in licensing agreements can sometimes be ambiguous. A term that is known to mean one thing in one country may not be known to have the same meaning in another country. This is especially true when distinguishing between the grant of an "exclusive", "sole", and "non-exclusive" licence. The grant of an exclusive licence customarily precludes the possibility of withholding a right.

However, in some countries, the word "exclusive" standing alone can be ambiguous because although it certainly means that no other licensees can be contemplated, it is not always clear whether the licensor has also

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* Lawyer, François Painchaud is a senior partner in the lawfirm LEGER ROBIC RICHARD, g.p. and in the patent and trademark agency firm ROBIC, g.p.; Panagiota Koutsogiannis is a lawyer with these firms. Publication 237E.

reserved for himself any of the licensed rights (this is usually referred to as a "sole" licence).

The words "sole and exclusive" are sometimes used together to describe an exclusive licence but should be avoided because in fact the terms are contradictory. Furthermore, an expression such as "open exclusive licence" which is sometimes used will not necessarily mean the same thing for one person as it will for another. In such cases it is essential to include further descriptive language in order to leave no doubt as to the legal character of the licence being granted.

The grant provision must also foresee the right to either make, use or sell the licensed product or a combination of these rights. When the grant provides for the right to "make, use and sell", a patentee is completely waiving his right to exclude the licensee from enjoyment of the patented invention within the territory to which the patent pertains. It is therefore viewed as not necessary to use words such as "have made, ...lease, ... or otherwise dispose of". If such words are used, the courts may be forced to interpret the clause restrictively since there has been a departure from the common language used in these clauses. Hence, it is not always wise to try to clarify by adding more legal terms which are not necessary, because this could have the opposite effect and may cause confusion. If such terms must be used because of surrounding circumstances, they should be used in a non-limitative list.

The rights to make, use and sell, although often seen together, are separable. However a grant that only provides for the right to make the product would be useless without the additional right to either use or sell such a product. It is therefore very likely that when the grant provides only for the right to make the product, the courts will also imply a right to use or sell.

FIELD OF USE

The field of use provision requires careful and precise drafting in order to clearly separate the various fields of use which are often too finely divided. The difficulty lies in trying to divide fields of use in areas where the technologies are complex and there is a high potential for overlap between the licensed products. The task becomes even more challenging when the usefulness of technology has yet to be proven.

In order to avoid disputes, the licensor should attempt to licence uses that are indeed separable and non competitive. A problem that may result from the inclusion of a field of use clause in the licensing agreement is the division of a naturally competitive market, which in the U.S. gives rise to antitrust issues.

When the division is a commercial one instead of a technical one, the interference in natural competition is even more apparent. For example, if the licensee is prohibited from selling to companies and can only sell to individuals, he is being refused access to a substantial part of the market. Nevertheless, this type of separation has been found to be legal by the U.S. Courts. Furthermore, this type of provision restricts the potential for initiative and expansion on the part of the licensee who is limited to a specific use of the licensed product. In effect, it prohibits the licensee from realizing the benefits of the licence in certain technical fields.

When the field of use covered by the licence is not clearly defined, the licensee may be tempted to exploit unexpected uses of the licensed technology which might develop. This will be disadvantageous to the licensor who negotiated the original agreement with only a certain use in mind, and who is receiving royalty payments to reflect only that portion of the use, while the licensee is receiving more than he bargained for. A field of use clause should therefore identify the precise field agreed upon by the parties and maintain the Licensor's rights in any new field not foreseen or foreseeable on the day the agreement is executed.

Restriction on the use of a product will not be inferred if there is no express term in the agreement to impose a possible restriction. In *Union Industries Inc*. v. *Beckett Packaging Ltd.* (1993), 48 C.P.R. (3d) 523 (Ont.C.G.D.), the Court came to the conclusion that in the absence of any explicit restrictions, when a purchaser acquires a licence for a patented item, he or she receives a licence to deal with the item in any way.

MOST FAVOURED-LICENSEE

The licensor who enters into a licensing agreement should do everything possible to avoid including a most-favoured-licensee provision in the agreement. The licensee on the other hand will want to make sure that he includes a provision where he is treated as well as a subsequent licensee, if not more advantageously. If the parties do decide to include such a clause in the agreement, it should be drafted very carefully.

In a recent American decision, *Studiengesellschaft Kohle, m.b.* v. *Hercules Inc,* 105 F.3d 629 (Fed.Cir. 1997), we see the disadvantages that could arise for a licensor who includes a most-favoured-licensee provision in the licensing agreement. In this case, the Court was forced to conclude that the licensor had breached the licensing agreement when he had failed to inform the licensee of a licence that he had granted to a subsequent licensee. The original licensee had managed to have included in the agreement a very broad most-favoured-licensee provision and when the time came to have it interpreted, the Court had no choice but to rule in the licensee's favour.

The biggest problem with this type of provision is that not enough thought is given to the content and not enough limitations are placed on its applicability. In negotiating this type of clause there are certain factors that need to be taken into consideration as possible restrictions to the clause: i) a time constraint could be placed in the licence; ii) there could be a limitation to specific patents and/or pending applications; iii) the most-favoured-licensee clause may be limited to non-litigation related licenses.

If such a clause is to be included in the agreement, the licensor should require that the licensee be forced to accept all the terms that appear in the more favourable agreement, rather than allowing him to choose only selected terms that are to his advantage.

BEST EFFORTS

The difficulty arising from this type of provision is in defining the term "best effort" and in deciding what type of effort can be considered as the "best" effort. Although this term is widely used in licensing agreements, the uncertainty over legal treatment of such a provision impedes the ability of parties to contract effectively.

Over the years, the courts in the United States and Canada have been called upon on several occasions to interpret "best efforts" clauses. Each time, the courts have been inconsistent in the treatment of such a clause and it is therefore difficult to appreciate the extent of the obligation placed on a licensee (or licensor) who is bound to put forward his best effort in marketing or developing a certain product.

In *Bloor* v. *Falstaff Brewing Corp.*, 601 F.2d 609 (2nd Cir. 1979) the Court was of the opinion that the best efforts obligation was violated even though the sale of the product was highly unprofitable. However, in *Western Geophysical Co.* v. *Bolt Associates, Inc.*, 584 F.2d 1164 (2nd Cir. 1978), the best efforts obligation was held to be satisfied even though no device had been made or sold. This was due to the fact that the device was not mechanically sound and Western was trying to improve the mechanical reliability of the device before putting it on the market. However the efforts put into developing the product were seen by the Court as being sufficient to satisfy the contractual obligation of using "best efforts".

In *Zilg* v. *Prentice-Hall, Inc.,* 717 F.2d 671, cert. denied, 466 U.S. 938 (2nd Cir. 1983), the test used for deciding whether "best efforts" had been used was limited to whether the product had been given a reasonable chance of achieving market success.

Another test used by the courts in determining whether the obligation of "best efforts" is being satisfied is a subjective test as opposed to an objective one. This test would take into consideration the potentialities of the licensee's business and the circumstances that might arise to affect it. The party with such an obligation can only be asked to do that which is reasonably expected under the circumstances (*Respirex of Canada Ltd.* v. *Flynn* (1975), 22 C.P.R. (2d) 104 (Ont. H.C.) affirmed (1978) 41 C.P.R. (2d) 74 (Ont. C.A.)).

In Canada, there is case law defining the term "best efforts" used in contracts other than technology transfer agreements. The courts in such cases seem to equate the best efforts provision to an obligation to "leave no stone unturned": *C.A.E. Industries Ltd.* v. *R.* (1983), 2 F.C. 616 (F.C.T.D.). This would impose a tremendous obligation upon the licensee to ensure that every single possibility for exploiting or efficiently marketing the product has been thought of and that no angle has been neglected. Such an obligation would imply a substantially greater effort to be given by the licensee than that which is usually required to satisfy this type of obligation by the American courts.

Implied Obligation of Best Efforts

The courts have sometimes had to decide whether, in the absence of an express obligation to that effect in a contract, the licensee is bound to the performance of "best efforts" arising from an implied obligation. This issue was dealt with in detail by the U.S. Court of Appeals in *Permanence Corporation v. Kennametal, Inc.,* 908 F.2d 98 (6th Cir. 1990). The Court acknowledged that such an obligation has sometimes been inferred in certain circumstances where for example "no advance payments were made and the licensor had to rely entirely on the good faith of the licensee in order to receive any consideration in return for the grant of the exclusive agency."

The argument of the licensor in this case was that the provision for royalty payments implies a best efforts obligation because royalties will only be generated if the defendant is under a duty to exploit the patented process. However the Court came to the conclusion that a substantial minimum or advance royalty payment provides sufficient incentive and demonstration of good faith by the licensee to devote best efforts for the development of the technology, and that the implication of a best efforts obligation need not be made. In addition, the Court stated: "Especially, as is true in the present case, when an inventor grants a licence to patented technology, the application of which is unknown, a commitment on the part of the licensee to devote best efforts to the development of the technology is a substantial commitment which should not be automatically inferred".

In light of this, it would seem that a licensor or licensee who wishes to obtain an obligation of best efforts from the other party should make sure to include an express obligation to this effect in the agreement itself.

Alternatives to the "Best Efforts" Clause

The following are alternatives to the "best efforts" clause: i) the priority of developing the licensed product can be stated in relation to other products and technologies that are being developed at the time of formation of the contract; ii) the priority of the new product to be developed could be stated relative to the product lines of the company in terms of per item profit, sales volume, historical importance to the company etc; iii) the limitations of the budget and workforce of the company could be stated as limitations on a "best efforts" obligation; iv) minimum and maximum commitments of manhours and expenses could be detailed; and v) work to be performed could be outlined in some detail, etc.

It is therefore preferable to specify minimum performance requirements rather than broad, vague terms such as "best efforts" or "reasonable efforts".

In conclusion, it is important to note that using a standard model may be helpful but may not always be suitable for all clients who have different needs and objectives. It is essential to read each clause and carefully adapt it to the particular case in question in order to provide the client with a licensing agreement suitable for his or her needs.

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