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Report on Know-How License Agreements

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American Bar Association Section of Antitrust Law Section of International Law and Practice Report to the House of Delegates

Report on Know-How License Agreements

RECOMMENDATION

BE IT RESOLVED, that the American Bar Association recommends to the Commission of the European Communities that it modify its draft regulation on the application of Article 85(3) of the Rome Treaty to certain categories of know-how licensing agreements so as (1) to expand the scope of know-how license agreements covered by such regulation, (2) to extend the periods permitted by such regulation for restrictions in, and payments under, know-how license agreements, (3) to adopt approaches to such agreements similar to those adopted by U.S. courts, and (4) to make other minor changes of a technical or clarifying nature.

REPORT

I. Introduction and Background

The Antitrust Section, together with the International Law Section and the Patent Section, which Sections fully support this Recommendation and Report, have been concerned for some years that overly strict rules on the part of the European Economic Community ("the EEC") with respect to the licensing of know-how could inhibit the flow of technology

to and from American companies because of concern and uncertainty on the part of these companies that licensing arrangements permissible in the U.S. would be considered as restrictions on competition in violation of Article 85(1) of the Rome Treaty. Unlike U.S. antitrust rules, which permit the application of rule of reason tests to such arrangements, the EEC has taken the position that there is no rule of reason test under Article 85(1) and that know-how license agreements may only be exempted from the scope of Article 85 through the specific grant of an exemption by the Commission, pursuant to its authority under Article 85(3). As stated at the 1985 London meeting of the ABA by Christopher Bellamy, an attorney practicing in the European Economic Community:

Every antitrust system, as we all know, faces the problem of deciding what is a prohibited restraint of trade and what restraints of trade are "to be permitted." In the United States, as I understand it, that dilemma is solved by a combination of per se rules and rule of reason rules. In the Community in Europe, we have a quite different structure: we have a wide prohibition on restrictions on competition under Article 85(1), but a provision for exemption from that prohibition under Article 85(3). The problem is that exemption under Article 85(3) is an administrative act by the Commission in Brussels; (54 Antitrust L.J. 612 (1985))

Based upon the view that the elimination of unnecessary restrictions on the international transfer of technology was of substantial importance to technological growth within the United States and elsewhere, the Antitrust Section in June 1985, after receiving blanket authority, recommended to the Commission of the European Communities ("the Commission") pursuant to a memorandum subsequently published at 55 Antitrust Law Journal 393 (1986) that the EEC issue a regulation setting forth a group exemption under Article 85(3) for certain categories of know-how license agreements. This memorandum made a number of recommendations, generally based on U.S. antitrust principles, with respect to the scope and content of such a regulation.

In August 1987, the Commission issued in draft form such a regulation embodying a number of recommendations made by the Antitrust Section in 1985 and has invited interested parties to submit comments on it. A copy of this draft regulation is attached to this report. Although the invitation from the Commission to submit comments calls for submission of comments by December 1, 1987, the Commission staff has advised that submission of comments by the American Bar Association at this date would be both timely and welcome.

While the draft regulation has adopted a number of the recommendations contained in the Antitrust Section's 1985 memorandum, the Section has concluded that it would be salutary for the American Bar Association to recommend that the Commission make certain specific modifications to the draft. These proposed modifications are summarized in the Recommendation and are set forth below in detail on a topic by topic basis.

II. Analysis of Draft Regulation and Details of Recommendation

A. DEFINITION OF KNOW-HOW (Recital No. 6)

It is, of course, important in a know-how license exemption regulation to define know-how in such a manner that the definition includes information supplied to licensees that is substantial and excludes "information that is trivial or self-evident."

However, based on U.S. experience, it is necessary or desirable to require as a definitive matter that the know-how both be substantial and "necessary or of decisive importance." It may be very difficult for the Commission or the courts to ascertain in an individual case whether particular know-how is indeed necessary or of decisive importance. It is the experience of U.S. attorneys involved in the licensing of know-how that there is often a range and variety of know-how supplied under an agreement and that even the engineers of the parties may differ as to exactly which supplied know-how, if any, is necessary or crucial. Also, inasmuch as the definition of know-how is a threshold question in determining whether a party is entitled to the benefits of this exemption, there is a significant likelihood of disputes or litigation arising over this issue. In the event that one of the parties to a know-how license seeks to enforce a restriction under the agreement in a national court the other party may well try to focus on the "decisiveness" of the know-how, thus adding a complicating and, we believe, unnecessary issue to the proceedings.

Substantively, U.S. courts have not found it difficult to determine whether there is in fact know-how for the purposes of determining whether there is an antitrust violation. In *CVD, Inc. v. Raytheon*, 769 F.2d 842 (1st Cir. 1985), a U.S. Court of Appeals was able to confirm without particular difficulty, where a trade secret claim was asserted, that no trade secrets did in fact exist. In sum, we believe that the Commission can properly protect the Community against restrictive trade practices arising out of non-bona fide know-how licenses without going so far as to require that the parties be in a position to prove that the know-how is "necessary or of decisive importance."

B. DURATION OF RESTRICTIONS AND AGREEMENTS (Art. 3(10))

Article 3(2) of the patent license group exemption precludes an exemption for a patent license agreement where the agreement is automatically prolonged beyond the expiration of existing licensed patents "by the inclusion in it of any new patent obtained by licensor," absent a right to terminate. Article 3(10) of the draft know-how license group exemption, using language that parallels that in the patent license regulation, precludes an exemption for a know-how license agreement where the agreement is

automatically prolonged beyond seven years "by the inclusion in it of any improvements obtained by the licensor," absent a right on the part of the licensee to terminate or to refuse new improvements at the end of the seven-year period. For the reasons discussed below, it is questionable whether, as a matter of legal analysis or public policy, the patent license approach should be extended to know-how licensing in this area. The seven-year limitation should be eliminated or substantially extended.

Significant know-how license agreements may reasonably require a duration at least as long as that of a patent license to fully implement the licensed technology and improvements that may be made by the licensor. U.S. judicial acquiescence in restrictions of such long duration is reflected in at least two U.S. cases which upheld territorial restrictions on imports and exports for periods in the neighborhood of twenty years and longer upon a finding that know-how was continuing to be supplied under the agreements. *See United States v. E.I du Pont de Nemours & Co.*, 118 F. Supp. 41, 218-22 (D. Del. 1953, *aff'd on other grounds*, 351 U.S. 377 (1956) (license since 1923 involving cellophane); *Foundry Services, Inc. v. Beneflux Corp.*, 110 F. Supp. 857 (S.D.N.Y.), *rev'd on other grounds*, 206 F.2d 214 (2d Cir. 1953) (license since 1934). If the final regulation retains the seven-year limitation, the licensee may be prevented from obtaining important know-how developed by the licensor well into the term of the license, relating to cost, quality improvements and other types of improvements. While the regulation would permit the continuation of the restrictions if the licensee is agreeable at the end of the seven-year period, as a practical matter, if the licensor were required to permit the licensee to terminate or refuse improvements after the seven years, the licensor would surely insist on the same right of terminating the flow of know-how for itself at the end of the seven-year period.

As indicated by the *AOIP-Beyrard* case, there is an antitrust nexus to a provision in the patent license regulation which precludes an exemption where, in effect, a patent may be used as leverage to extend the license beyond the life of the patent. However, unlike a patent, which represents a right to exclude granted by statute, know-how, by definition, does not benefit from any such statutory right. As the Commission specifically recognizes in the preamble to the draft regulation, "where know-how is concerned . . . there can be no question of abuse of a legal monopoly" (Recital 21).

Also, if the parties are required to renegotiate after a short period, they will be reluctant to cooperate with each other in further development of the licensed technology. As the Commission is aware, the U.S. has removed the threat of treble damages in license agreements without regard to their duration, which arise out of joint research activities. *See National Cooperative Research Act of 1984*, 15 U.S.C.A. Secs. 4301-4305.

Even if a substantially longer period were permitted, it would not provide unconditional flexibility to the parties of the agreement inasmuch as the Commission would retain the right under the general provisions of Article 9 of the draft regulation to withdraw the benefits of the regulation at any time that the effect of an agreement became incompatible with Article 85(3).

In one aspect, Article 3(10) of the draft know-how license regulation should be revised to make it more parallel to Article 3(2) of the patent license regulation. The latter provision provides that the termination of a patent license agreement shall not prejudice "the right of the licensor to charge royalties for the full period during which the licensee continues to use [the licensor's non-public] know-how . . . , even if that period exceeds the life of the patents." *A fortiori*, the licensor of know-how should be permitted to collect for the use of its non-public know-how while it continues to be used even if the parties are limited in their ability to renew the agreement. Although such a right on the part of a know-how licensor may be considered implied in the know-how regulation, it is desirable that Article 3(10) be modified to expressly parallel the language of Article 3(2) of the patent license regulation in this regard so as to avoid confusion.

C. PAYMENT ON KNOW-HOW WHICH HAS BECOME PUBLIC (Arts. 2(9); 4(2)(9) and 9(6))

It does not help but rather hinders competition to place a three-year limitation on payment on know-how which has become public without fault of the licensor. U.S. courts, including the United States Supreme Court (*see Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979)), take the view that an agreement freely entered into by the parties to pay on publicly known know-how does not raise antitrust or other policy issues. The analysis underlying such cases is that, since competitive restrictions are not involved, the issue is essentially a financial matter between the parties. Stated differently, we agree with the analysis but not the conclusion set forth at Recital 21 of the draft regulation.

If a licensor is prohibited from collecting an ongoing stream of royalties for more than three years after know-how has become public, it would seem that the licensor would seek other approaches to maximizing its income. This could involve the requirement of an initial lump sum payment, a refusal to license or a sale of the know-how. As to this last alternative, the Commission's comment in support of post-term use bans is instructive: "otherwise the licensor would be forced to transfer this know-how in perpetuity and this could inhibit the transfer of technology." (Recital 17).

When the European Court of Justice addressed the analogous issue of payment on unpatented parts in the *Windsurfing* case, the Court saw no difference from a competitive perspective if the licensee paid 5 percent on a combination of patented and unpatented parts or 15 percent on only the patented part, where the total amount paid was the same in each case. The conclusion of the European Court of Justice that Article 85(1) did not apply in the above situation seems to dictate the elimination of the three-year limit on payments in the know-how license regulation. Presumably, the licensor has a certain value that it can extract from the know-how and if the logical approach of an ongoing per unit royalty is barred to it, it will seek other approaches, which may well be more restrictive. Also, as noted in the preceding section, the general provisions of Article 9 remain available to the Commission to permit withdrawal of the exemption if the payment approach were to become restrictive.

The issue of enforceability of payment obligations for licensing of know-how is also a matter of concern. Under the approach set forth in the draft regulation, a licensee would have the right to assert in a proceeding seeking payment in a national court that key elements of the know-how have been public for more than three years. One could envision a complicated trial on the issue of whether and to what extent know-how had become public through the sale of product or otherwise. The resolution of the payment issue could then possibly be further delayed until the European Court of Justice had ruled on the matter. The provisions in the draft regulation permitting notice to the Commission under Article 4(2)(a), and the exemption that would arise if the Commission took no action within six months thereafter, may not be a meaningful solution to this problem in that, as the Commission recognizes, a head start in time may be a key element in the value of the know-how. See *Quick Point, supra*. The Commission should further consider from a competitive perspective whether the best result for the Community might be the total elimination of the three-year limitation on payments.

D. MISCELLANEOUS KNOW-HOW AND PATENT LICENSE AGREEMENTS

The draft regulation focuses on various types of mixed license agreements. It is suggested that the Commission also consider the situation where the license covers necessary patents together with know-how sufficient to meet the standards of the know-how regulation. Licenses of this type may occur fairly frequently and, in view of the magnitude of the technology transferred, should be encouraged. The regulation should specifically provide in such a case that the know-how is covered by this

regulation and the patents by the patent regulation. This would provide the parties with appropriate flexibility for such a situation.

Imports into the Common Market

Numerous cases and commentators in the United States confirm that, absent a cartel, a U.S. company may provide in its license agreements that the foreign licensee is granted no license under the licensor's know-how or patents to sell into the United States. See, for example, Hawk, *U.S., Common Market and International Antitrust*, 388-96 (2nd Ed. 1986). It would appear that the patent license and know-how license regulations support a similar approach with respect to the grant of licenses wherein a Community licensor excludes the whole of the EEC from the scope of the non-EEC licensee's sales license: the sanctions of Article 3(12)(b) of the draft know-how license only apply to "products which have been put on the market within the common market by the licensor or with his consent." However, Recital 12 creates some confusion in this regard by suggesting that there can only be "exclusive licenses for a territory covering the whole of the common market where there is the possibility of parallel imports from third countries." The extension of the parallel import doctrine to third countries—which appears inconsistent with European Court of Justice case law under Article 30—would discourage licensing where the licensor wished to fully reserve its home market, either the EEC or a non-EEC country, to itself.

Know-How Grantbacks

Under Article 3(2)(c) of the draft regulation, no exemption is permitted for a post-term use ban "if the licensor's right to use the improvement is of longer duration than the licensee's right to use the original know-how." Under this provision, as we understand it, if the licensor receives a grantback of know-how of indefinite duration, no exemption will be permitted unless the licensee is granted a similar indefinite right.

Different issues are involved in the grantback of know-how rights than are involved in the imposition of post-term use bans and that the two should not be coupled. In the normal course of the administration of a know-how license, it is likely that some of the licensee's own know-how will become commingled with that of the licensor. For this reason, licensors will normally insist on a right that is unlimited in time to use the licensee's know-how so as to be sure of their continuing right to use their own know-how. A post-term use ban involves a basic and different issue of whether a licensor may have the right to place a durational limit on the use by the licensee of the licensor's know-how. The two are different issues and should not be confused. Accordingly, Article 3(2)(c) [should] be deleted.

Defense

U.S. antitrust jurisprudence recognizes that special factors may exist with respect to agreements with the government in the defense area. The government is, of course, a monopsonist in purchasing for defense and may have special interests which dictate arrangements that would not be permissible in the commercial arena. In the United States, such arrangements receive little note since the same government is responsible for defense procurement and antitrust enforcement. Since this is not the case in the EEC, it would be desirable to expressly provide that know-how license agreements in the defense area granting manufacturing licenses limited to a particular country which are approved by the defense authority of that country be considered outside of the scope of this regulation and Article 85(1).

III. Conclusions

Modification by the Commission of the draft know-how license regulation in accordance with the Recommendation would encourage greater licensing of know-how between companies in this country and in the EEC. In view of the importance of technological development to economic growth, increased licensing should have salutary economic effects both in the U.S. and in the EEC.

The key element in the Recommendation and the Report is that modification by the Commission of the draft regulation in ways that would permit greater flexibility would increase the incentive for licensing know-how in the same manner as the rule of reason antitrust approach utilized by the U.S. courts increases incentives for such licensing in the United States.

Respectfully submitted,

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Chairman
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