Specific Problems Associated with Patent License Agreements

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Specific problems with patent license agreements will be looked at from the standpoints of:

1) Problems originating from the diverging interests of the parties.

2) Inherent problems of patent protection: limitations of the patent system and inadequate protection in any given case.

3) Legal problems with the Agreement, its interpretation and enforcement.

4) Problems as they occur during the life of a successful agreement.

Questions relating to the structure and the content of the Agreement are dealt with in more detail in the article Structure/Heads of Agreement of a Typical International Licensing Contract - Patents combined with Know-How.

1) DIVERGING INTERESTS OF THE PARTIES

Patent licences result from different relationships:

Willing licensor - Willing licensee:

- This is perceived as the most usual condition for granting a license; however the relationship can evolve over time.

Unwilling licensor - Willing licensee:

- This includes infringers who break in, possibly by means of compulsory licences.

Willing licensor - Unwilling licensee:

- This includes infringers who refuse to acknowledge that they need a licence and won't take a licence until forced to.

Additionally the parties to a patent licence may have diverging or split interests:

Licensor with split interests:

- Selling products in competition with licensee(s)
- Preferred interest in one licensee.
- Lack of commitment to licensing.
- That only licences obsolete products etc.

Licensees' diverging interests:

- Licence fees represent a drain on resources.
- does the patent ensure a competitive edge?
- "Most favoured nation" mentality.
- Desire to have activities outside the licence (more territory, competing products...).

These interests fluctuate over time and the relationship evolves :

During the life of the relationship licensor and licensee will go through phases where their interests are common or complementary to one another, and periods where their interests diverge or may be in direct conflict. Similar considerations arise in relationships with competitors and third parties in general.

Sometimes licensor and licensee will be fully united against intruders. At other times, attitudes can differ. For example, an infringer may represent a serious competitive threat for the licencee but could be regarded as a potential source of increased revenue for the licensor.

The licensor-licencee relationship can be further complicated by intruders:

Often, intruder's activities will place the licensing relationship under stress.

A licensor's success may depend on the ability to exclude newcomers (enforce the patents against them) or to accommodate them in the licensing set-up without upsetting existing licencees.

In summary, there can be a wide variety of licensor-licencee relationships that fluctuate over time and as a function of intruder’s activities. These varying relationships will place the licence under stress. The licence agreement needs to be able to accommodate for this.

2) LIMITATIONS OF THE PATENT PROTECTION

Inherent limitations of the patent system include:

- Time / Initial Uncertainty.
  The procedures for granting patents may take several years. Meantime there is uncertainty as to what protection, if any, may be granted. Pre-grant provisional protection is impossible or difficult to enforce. Uncertainty may be prolonged after grant by opposition proceedings. It may take as long as 10 years for an opposition to be resolved at the EPO. Meantime licensing arrangements are in jeopardy.

- Time / Duration.
  Patents are granted for a limited time, in many countries 20 years from filing. Some licensing set-ups will just be in full swing by patent expiry. Others may hardly have made any profit before the

patents expire. Attempts to perpetuate revenues beyond patent expiry – "life after death" - are problematic.

- Scope/avoidance/validity-invalidity.
  The licensed products must fall under the patent scope. The licensee may be able to develop competing products, evading the patent. During the patent lifetime the scope may shrink or the patent may be declared invalid. Retrospective invalidity can create problems about refunding past payments.

- Enforcement/uncertainty.
  The basis of patent licensing is the power given by the patent to exclude others. But patents can only be enforced by costly infringement lawsuits where the outcome is often uncertain. Licensing is sometimes entered into as a compromise to avoid litigation or bring litigation to a halt. Patent litigation may have to be brought to defend a licencee's interests. The nature of patent litigation gives patent licensing a special flavour.

- Costs.
  Obtaining and enforcing patents is costly, and the costs are not necessarily in phase with licensing income. Many patent licences barely succeed in covering the patent costs.

- Territory.
  Patents are protected only where they are applied for and granted. There are usually high initial costs before licensing potential is established. As a result, valuable territories may be unprotected.

- Maintenance.
  Costs for maintaining patents escalate over the lifetime and licensing arrangements sometimes include maintenance obligations. This can be a problem, especially when packages of patents are licensed.

- Monopoly abuse.
  The Statute of Monopolies 1624 exceptionally allowed patents to be granted for inventions if "… *they be not contrary* to *the law* or *mischevious* to *the state, by raising prices of commodities at home, or hurt of trade,* or *generally inconvenient".* Ever since, patents have been tolerated subject to numerous safeguards designed to limit abusive practices by patentees. Patent licensing in the USA developed in a climate of anti-trust; more recently, the EC commission has used these old principles in developing the rules of the common market. All attempts to extend patent protection by contractual provisions are potentially illegal.

Specific weaknesses in patent protection:

For various reasons, licensors will find themselves working under the handicap of inadequate patent protection.

The example of Windsurfing illustrates the effects of inadequate territory/scope:

- The basic Schweitzer-Drake patent did not cover France, the largest market in Europe. In France Windsurfing's licencee’s had less than 20% of the market in 1980 compared to 70% in Germany where they had the patent.
- In Germany, the patent application originally covered the entire sailboard (board + rig) but during examination was limited to the novel rig. This gave rise to problems in attempts to control the non-patented parts. It also critically affected the basis on which a patent royalty could be levied.

Making maximum profits from patent licensing implies filing key patents as late as possible - just before commercialisation. This can be done successfully, but often the patents are filed under stress, just before publication or sale, with poor knowledge of the prior art or with embarrassing prior art and little conviction that there is anything patentable. The

result may be shaky patents forming an inadequate foundation for a patent licence.

3) THE AGREEMENT - LEGAL PROBLEMS

The key problem areas with patent licence agreements, to be dealt with in turn, are:

- Exclusivity;
- Restrictive Conditions;
- Problems of Breach of the Licence Agreement;
- Improvements/Grantbacks;
- Patent Defense;
- Combined Agreements (Patents + Know-How etc.)

Exclusivity:
In my view the most difficult problems in patent licensing are associated with exclusive licences. Non-exclusive licences, for example granted on an industry wide basis for moderate/low licence fees, can be the best and most problem-free solution in some cases. The main problem with non-exclusivity can be the scale of litigation necessary to force infringers to pay for a licence.

Exclusive licensing, on the other hand, means high total payments from the licensee who expects his exclusive position to be defended. Exclusivity involves a triangular relationship between the licensor, the licensee and competitors. Non-exclusive licensing involves a one-to-one relationship between the licensor and each licensee and between the licensor and each competitor or infringer (potential new licensees).

There are different degrees of exclusivity, so exclusivity has to be defined. The two main problems with exclusivity are:

- How to define exclusivity?

- How to defend exclusivity?

Defining exactly the right degree of exclusivity can be one of the big difficulties in drafting a patent licence agreement. Defending exclusivity can be the biggest challenge during the life of the agreement.

Defining the "degree of exclusivity" can be done by granting an exclusive licence subject to explicit reservations or exceptions, or by using open language that allows the erosive effect of legal developments to take place without including counter-measures (restrictive conditions).

The provisions of the Agreement can qualify or dilute exclusivity in a number of ways: its duration, making exclusivity subject to continued payment of royalties with possible conversion to a non-exclusive licence or termination for lack of performance, allowing the licensor to retain rights (for example a right to continue in-house use or a right to supply if the licensee is unable to meet a market demand or supply to a particular customer). An exclusive licence with a reservation for the licensor corresponds to a "sole" licence. Similar reservations can cover previously granted non-exclusive licences or can leave a limited right to grant licences.

Field-of-use limitations are another way of giving limited exclusivity, e.g a pharmaceutical use of a chemical composition as opposed to veterinary use.

Territorial exclusivity is an attractive approach to the global market. But patent licensing alone can leave loopholes: problems with export bans; activities in non-patent territories …

EC anti-trust law relating to the free movement of goods has created problems with granting truly exclusive sales rights in different member countries. Nevertheless a grant of exclusive rights can be made to manufacture in the territory and to sell the manufactured goods there or "put them on the market", leaving open the question of export rights and sale in the territory of imported goods.

Exclusivity is usually important where the licensed products may be subject to competition on the market; in this case exclusivity becomes a major consideration and must be carefully handled in the contract. Non-exclusive licensing - which is more likely to be acceptable for industrial processes or products - involves less arduous problems in the contract.

Restrictive Conditions:

The grant of a patent licence is a permission to operate under given patents, not an interdiction to work outside the patents or outside the territory. Clauses in the licence agreement which tend to distort this basic position in favour of the licensee are likely to be illegal/unenforceable.

Restrictive conditions are not necessary for successful patent licensing in optimum conditions. Restrictions may be symptomatic of weaknesses in the licensing set up: licensor & licensee in competition; only part of the territory covered by patents; unsatisfactory patent scope etc. The Windsurfing case gave an illustration of various restrictive clauses considered improper under EC law. If restrictions are necessary, then these have to be carefully formulated under the local law possibly using the block exemptions for inspiration in the EC.

When restrictive conditions are included, there is a problem of making them acceptable, i.e. not to lose the benefit of block exemption. Black-looking clauses can be laundered so that upon careful reading they are seen to be white.

Breaches of agreement? Reliance on patent protection:

When a licensee operates to the licensor's disadvantage by doing something outside the scope of the licence (e.g. marketing a competing product outside the patent, exporting outside the patent territory) this is often perceived as a "breach of the licence contract" but may only be actionable through patent enforcement.

Example: A non-exclusive license to manufacture patented devices for use exclusively in the licensee's factories (no licence to sell).

Suppose the licencee sells. Would this be breach of agreement or patent infringement?

An axiom of patent licensing is that to prevent or limit anything outside the scope of the licence, the licensor should rely primarily on his patent rights.

Improvements/Grantbacks:

The ownership of and the rights to use ongoing developments - especially new patents - may give rise to difficulties. Here a distinction is often drawn between "supporting" improvements to the licensed product covered by the licensed patents and new developments forming a new product line falling outside the licensed patents.

There can be a wide divergence of opinion between the licensor who would like automatic grant-back of exclusive world-wide rights, and the licensee who expects to keep his own improvements yet have all the licensor's future improvements without paying more. On points like this, the EC block exemptions can be helpful in arriving at a compromise.

Patent Defense Clauses:

The greater the chances are that the licensed product will become a success, the greater is the likelihood of having to face up to infringements. Drafting mutually acceptable clauses to cope with this is one of the most difficult parts of the contract because there is no exact way of relating the different interests of the parties and the liabilities they face. A different aspect of the problem is: what to do if the licensee or one of its customers is sued for infringement of someone else's patent or is threatened with such action?

Sometimes the licensor is in no position to cover this risk that has to be assumed by the licensee. This can be dealt with in a waiver or "pseudo-warranty" or can

simply be left out. The problem is that without any form of guarantee the value of the licence may be reduced and protections must then be given for the licensee: the possibility of easy termination to avoid minimum payments etc.

At the other end of the scale, the licensor may assume the entire risk. The danger here is that the licensee has little incentive to minimise legal expenses that can easily get out of the licensor's control.

When the licensor accepts liability, to avoid problems some appropriate safeguards can be included:

- Set a limit on the licensor's liability (e.g. relate it to royalties paid).
- Allow for the possible supply of alternative non-infringing technology instead of defending a lawsuit.
- Make damages due to a third party reimbursable only by offsetting against future royalties or up to a given fraction of future royalties.
- Limit the liability e.g. by excluding damages for loss of profit.
- If the licensor assumes full defense, require the licensee to assist in the defense and bear its own costs and expenses.

Dealing with infringements of the licensed patents should preferably be subject to a sharing arrangement. The problem is that the benefit of the action - preserving the licensee's market exclusivity or share - goes essentially to the licensee while the risk of patent invalidation (even if the market position is preserved during the litigation) is very serious for the licensor. A good arrangement will keep the patent owner reasonably in control, confine obligations (or licensee's options) to take legal action to those cases where the infringement is a substantial problem (e.g. a virtually identical product which is a real danger on the market) and provide a sharing of costs and benefits in line with

the two parties interests. Often, the royalty corresponds to 20-30% of the licensor's profit and it would seem reasonable to share the licensor/licensee litigation commitment in a ratio from 1:5 to 1:2. ln practice, the licensor's share is often higher.

It is also possible to provide a cascade of possibilities, firstly action by the licensor, then action by the licensee if the licensor declines to go ahead etc. The basic problem is that it is virtually impossible when the contract is drawn up to foresee such events several years later. Most usually, both parties have to get together and work out a plan of action; the contractual arrangements really serve more as a guide and sometimes it may be advantageous to depart from them. This can be encouraged in the contract by preceding the specific commitments by: "Unless the parties agree otherwise,…"

Problems with (and advantages of) Combined Agreements:

Except when resolving patent infringements, patent licences are often combined with:

- Know-how

  Care is needed: to differentiate the licence under the two rights; regarding termination/payments beyond patent expiry; in apportionment of payments between patents & know-how …

- Trade Marks

  Avoid generic use of the mark during the patent term. Technical people often show little interest in trade marks: "technical" licensees are reluctant to be bound to use the licensor's trademark. Apportionment of patent and trademark costs …)

- Supply of Goods/Equipment/Distribution (illegal tie-ins …).
- Package deals (turn-key factories..)

As a general principle, to avoid the stress of having royalties based on patent rights (possible invalidity) it is possible to grant the patent licence royalty free

(or for a low payment) and base the income stream on e.g. knowhow and trade marks. This can also be done with patent packages where it is difficult to apportion payments between the different patents. Combinations are obviously attractive when the remaining patent lifetime is short.

4) PROBLEMS OVER THE LIFE OF SUCCESSFUL AGREEMENTS

Many problems can unfold over the patent life (20 years), creating a need for flexibility to accommodate for growth. Here are some examples:

Ownership challenge/settlement

When a patent becomes successful, challenges emerge including ownership. This was so in the case of the DSA and an early settlement of these problems was a key to the successful start up of the venture. These settlements nevertheless periodically came up for review with renewed challenges as the success grew. At each stage it was necessary to patch up the issue.

Performance guarantees

If a licensor promises performance he has to live up to the promise. If he doesn't promise performance this creates leverage for lowering the price. In the case of the DSA the initial performance was guaranteed by comparison with carbon anodes and savings in electricity. These parameters fluctuate over time, on the one hand power costs escalating (during the oil crisis) and on the other hand competitive products emerging. This creates constant opportunities for users to request reductions; it being more difficult for a licensor to increase rates.

Licensee support during market penetration

As the patented product captures market share, the patents serve to deter competition. Initially, providing there is freedom from dominating rights, the licencees can evolve freely under the licensed package, whereas competitors are more "in the dark" and on the defensive, working on devising ways of evading the patents.

As the success grows and market penetration increases, so it becomes all the more necessary for excluded competitors to attempt to destroy the patents by oppositions and litigation. We arrive then at patent warfare, where the competitors individually or in concert are attacking the central patents, and the patentee-licensor is selectively attacking the intruders patent applications in defense of the licencees' exclusivity.

Licencees have an ambiguous attitude. If the patent holds good, they are happy to keep their exclusivity. If the patent falls they are happy to stop paying licence fees to be able to compete on an equal footing. It follows that patentees cannot rely on their licencees in the defense of their patents.

Once the patents are upheld for good, market penetration can continue to increase free from the uncertainties of litigation.

Patent infringements may be settled by granting licensing rights, if this does not upset the existing licencees. Segmentation by the grant of limited licenses (in-house use etc.) may be necessary. Revenue sharing with existing licencees may also be needed.

In the case of DSA, all forms of intrusion into the license family were encountered, including litigation leading to settlement by licensing, compulsory licensing (Spain) and licences of right (UK).

Approaching market saturation anti-trust issues come in and this can place stress on an exclusive licensing arrangement.

Approaching patent expiry competitors tend to want to jump the gun. To preserve the licencees' market position, litigation to obtain short term injunctions before patent expiry may be necessary.

Patent expiry - life beyond death?

It is difficult to extend patent protection and licence fees beyond patent expiry. There are some legitimate exceptions, for instance when patent royalties after expiry constitute a deferred payment

for sales before expiry.

Otherwise, reduction of fees to know-how rates may be needed, but can be controversial.

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Overall

A successful patent licence involves market growth and different problems arise over the life of the licence.

A successful patent licence can be defined as one where both parties derive substantial profits. But as we have seen it is also one where both parties face substantial problems, and the success - the profit - comes by setting up the licence agreement to provide a flexible framework allowing for growth and possible changes in the parties' relationship, while disposing of some problems and anticipating others.