

CHARACTER AND MERCHANDISE LICENSING

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LICENSING AGREEMENTS IN THE ENTERTAINMENT INDUSTRY

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By

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1. INTRODUCTION

It has always been an advantage of trade mark ownership that the recognition and goodwill tied up in a trade mark can be used to launch new products and services. The existing reputation gives the new product recognition and goodwill which lowers the cost of entry and creates an immediate market.

The last twenty years have shown a tremendous expansion in the application of this concept. Owners of products with mass appeal, such as comic book characters, movie rights, personality rights and sports logos, have capitalized on those images by attaching them to every imaginable type of product or service. The results have been stunning.

Licensed merchandise sells for a substantial premium over unlicensed merchandise.

Virtually everyone you see is wearing licensed merchandise of some kind.

As much as a third of the revenue of some feature films is budgeted to come from spinoff merchandise.

Does fame always work?

Only 40,000 copies of O.J. Simpson's post-trial video have been sold.

Making Finite Rights Infinite

Copyright in published works lasts a finite period of time. For example, copyright in photographs lasts 50 years. But trade mark rights last indefinitely, so long as the trade mark remains in use. So use the copyright work as a trade mark, and make it last as long as it has value.

2. DEFINING THE RIGHTS

(i) Definition of "License"

A license is a grant of permission, a power or authority to another to do some otherwise unlawful act. It may be written or verbal and when written the paper containing the authority is called a license.² Black's Law Dictionary³ defines "license" as follows:

A personal privilege to do some particular act or series of acts on land without possessing any estate or interest therein, and is ordinarily revocable at the will of the licensor and is not assignable. *Lehman v. Williamson*, 35 Colo. App. 372, 53 P.2d 63, 65. The permission by a competent authority to do an act which, without such permission, would be illegal, a trespass, a tort, or otherwise not allowable. *People v. Henderson*, 391 Mich. 612, 218 N.W. 2d 2, 4. Certificate or the document itself which gives permission. Leave to do a thing which the licensor could prevent. *Western Electric Co. v. Pacent Reproducer Corporation*, C.C.A.N.Y., 42 F. 2d 116, 118. Permission to do a particular thing, to exercise a certain privilege or to carry on a particular business or to pursue a certain occupation. *Blatz Brewing Co. v. Collins*, 88 Cal. App. 2d 639, 160 P.2d 37, 39, 40.

Therefore a license is a grant of rights, other than ownership rights, including intellectual property rights, which permit the grantee to commercially exploit such intellectual property.

Intellectual property licenses are usually referred to as being either non-exclusive licenses, sole licenses or exclusive licenses.

² The Canadian Law Dictionary (Don Mills: Law and Business Publications, 1980), citing *Jenny Lind Co v. Bradley Co.*, (1883), 1 B.C.R. (Part 2) 185.

³ Black's Law Dictionary, 6th Ed. (St. Paul: West, 1990).

A non-exclusive license is an agreement not to sue. In other words it is the authorization to do something for which authorization is required. The non-exclusive licensee usually has no right to sublicense or any such right would be very narrow.

A sole license is a license granted with the representation that no license is outstanding to someone else and the promise that no license will be granted in the future to another. The owner may itself exercise the licensed right.

An exclusive license is a license coupled with a promise by the licensor (i) not to license others and (ii) not to compete directly or indirectly with licensee. The exclusive licensee generally has a right to sublicense.⁴

A license is not an assignment. Legal ownership remains with the licensor, even if many of the indicia of ownership are given to the licensee.

(ii) Definition of "Trade mark" and "Service Mark"

A trade mark is a mark which a trader uses to distinguish its wares or services from those of its competitors.⁵ Almost every kind of business uses a trademark or service mark of one kind or another to identify its wares or services.⁶

Quality Assurance

Historically, any attempt by a trademark owner to license its mark in the United States would be considered abandonment of the mark resulting in a relinquishment of ownership.⁷ However, the American courts began to demonstrate a more flexible and tolerant approach to trademark licensing as the "quality assurance" or

⁴ *Western Electric Co. v. Patent Reproducer Corp.*, 42 F. 2d 116, 5 U.S.P.Q. 105 (2d Cir. 1930), cert. denied 282 U.S. 873 (1930); *Cutter Laboratories, Inc. v. Lyophile-Cyrochem Corp.*, 179 F. 2d 80, 92-93 (9th Cir. 1949)

⁵ Trade Marks Act, s.

⁶ This article does not distinguish between trademarks and service marks. The term "trademark" refers to both.

⁷ *Kmart Corp. v. Carrier Inc.*, 486 U.S. 281, 313, (1988) (Brennan J. dissenting), citing *Everett O. Fisk & Co. v. Fisk Teachers' Agency, Inc.*, 3 F.2d 7, 9 (8th Cir- 1924). See Kevin Parks, "'Naked' is not a Four-Letter Word: Debunking the Myth of the 'Quality Control Requirement' in Trademark Licensing" (1992), 82 T.M.R. 531 at 533 [hereinafter "Parks"]

"guarantee" theory of trademarks replaced the "source" theory.⁸ The current position taken by American courts and legislators is that consumers generally understand that wares and services cannot always originate from the same source but are nevertheless prepared to rely on a trademark as an indicator of consistency of quality.

In order to retain the trademark's distinctiveness and protection from unauthorized use by others, therefore, it is incumbent on the licensor to retain sufficient control over the quality of the goods and services of the licensee that are associated with the mark. If a licensor grants a "bare" or "naked" license and maintains no control over the quality or characteristics of its licensees' goods, the public may be damaged by products that do not have the normal quality of goods generally associated with the mark. This is directly at odds with the purpose of the trademark law: to prevent consumer deception.⁹

⁸ The "quality assurance" theory of trademark licensing has been attributed primarily to the work of Frank I. Schechter, a New York attorney who in 1927 published an analysis of trademark and unfair competition law entitled "The Rational Basis of Trade Mark Protection" (1927), 40 Harv. L.R. 813. However, see Parks, *ibid.* at 532, in which it is submitted that Schechter never argued that a trademark's second function was tantamount to a legal "guaranty" of the quality level of the marked goods: "the dubbing of the 'guaranty' function of trademarks was probably a mistake, or at least an overstatement of what might have been coined more precisely as the 'persuasive' or 'advertising' function."

⁹ *United States Jaycees v. Philadelphia Jaycees*, 639 F.2d 134, 140 (3d Cir. 1981) [hereinafter Jaycees].

The following passage from the decision of the 5th Court of Appeals in the *Kentucky Fried Chicken* case¹⁰ is often cited in support of the "quality assurance" theory:

Courts have long imposed upon trademark licensors a duty to oversee the quality of licensees' products... The rationale for this requirement is that marks are treated by purchasers as an indication that the trademark owner is associated with the product. Customers rely upon the owner's reputation when they select the trademarked goods. If a trademark owner allows licensees to depart from his quality standards, the public will be misled, and the trademark will cease to have utility as an informational device. A trademark owner who allows this to occur loses its right to use the mark.

The extent of the evolution of the American "quality assurance" theory of trademarks away from the traditional "Source" theory is illustrated in the recently decided *Taco Cabana* case.¹¹ The 5th Court of Appeals accepted the argument that a cross-licence permitting two companies to use the same trade-dress for its restaurants did not cause public deception and was therefore not a "naked" licence. The party that alleged the "naked" licence argued that the cross-license created two separate sources of goodwill and thus could not indicate a single origin. The court stated however that this argument ignores the emergence of the "quality assurance" theory which broadens the older "source" theory to include not only manufacturing source but also the source of the standards of quality of the goods bearing the mark or dress. In effect, the two parties to the cross-license constituted a dual source of quality control.

Lanham Act Statutory Codification of Quality Assurance Theory

The "quality assurance" theory of American trademarks was incorporated in the *Lanham Act* of 1946 after considerable debate. The *Lanham Act* permits the trademark licensing by "related companies" by stipulating that the use by a related company would inure to the benefit of the trademark owner.¹² The definition of

¹⁰ *Kentucky Fried Chicken v. Diversified Packaging*, 549 F.2d 368, 387 (5th Cir. 1977) [hereinafter *Kentucky Fried Chicken*].

¹¹ *Taco Cabana International, Inc. v. Two Pesos, Inc.*, 932 F.2d 1113, 1121 (5th Cir. 1991), *cert. granted in part*, -U.S.-, 112 S.Ct. 964, 117 L.Ed.2d 130 (1992) thereinafter *Taco Cabana*].

¹² 15 U.S.C.A § 1055 (*Lanham Act*, s.5), as amended Nov. 16,1988, Pub. L. 100-667, Title I, § 107, 102 Stat. 3938.

"related companies" is not limited to relationships governed by the ownership share capital. It includes those "whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used."¹³

In addition, American courts have considered the definition of "abandoned"¹⁴ which is often relied upon to attack the validity of a trademark based on the assertion that the licensor did not demonstrate sufficient control over its licensees' use of the trademark.¹⁵ A trademark is deemed to be abandoned when "any course of conduct of the owner, including acts of omission as well as commission, cause the mark to [...] otherwise lose its significance as a mark." If a trademark has been abandoned its registration may be canceled.¹⁶

Determining the Level of Quality Control

The quality control requirements contained in trademark licenses have not been well defined and may only be nominal. There is no guidance to suggest the threshold of the control test. Furthermore, the American courts have not provided a

Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public [...]

¹³ 15 U.S.C.A. § 1127 (*Lanham Act*, s.45), as amended Nov. 16, 1988, Pub.L 100-667, Title I, § 134(1), 102 Stat. 3946.

The term 'related company' means any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services in connection with which the mark is used.

¹⁴ 15 U.S.C.A. § 1127 (*Lanham Act*, s.45), as amended Nov. 8, 1984, Pub. L 98-620, Title I, § 103(3), 98 Stat. 3335.

A mark shall be deemed to be "abandoned" when either of the following occurs:

(a) [...]

(b) When any course of conduct of the owner, including acts of omission as well as commission, causes the mark to become the generic name for the goods or services on or in connection with which it is used or otherwise to lose its significance as a mark. Purchaser motivation shall not be a test for determining abandonment under this paragraph.

¹⁵ *Taco Cabana*, *supra*, note 12.

¹⁶ 15 U.S.C.A. § 1064.

concrete test for such control.¹⁷ The methods of exercising control "run the gamut from written to oral contract to no contract."¹⁸ Although it has been held that the amount of control required varies with the circumstances,¹⁹ it is possible to extract the general principles that the American courts have considered important.

Two important cases that determined the level of quality control required under the provisions of the *Lanham Act* are *Du Pont*²⁰ and *Denison Mattress*.²¹ In the *Du Pont* case, the license in question was not a "naked" licence. The owner of the trademark permitted its use on the licensee's dyestuffs of a standard approved by the licensor. The licensor had the right to inspect the dyestuffs and under the contract was permitted to terminate the agreement by giving six months notice in writing.

Although the *Denison Mattress* case was an anti-trust case, it is often cited for setting out the duty of a licensor to oversee the quality of its licensee's products. The contract provided for (1) the division of trade territory; (2) restrictions relating to purchase of materials (to assure uniformity of the nature and quality of the products manufactured); (3) price fixing; (4) restrictions on the manufacture and sale of competing products and the use of Spring-Air's specifications and products; and (5) restraints on sale or use of products or materials upon termination of the contract. The 5th Circuit Court of Appeals would not find that the agreement violated the antitrust laws since the owner of the mark was required to control its use. With respect to the territorial demarcation provisions in the contract in question, for example, the court held that there is "an affirmative duty to itself and to the public to invoke some kind of control and restraint upon its various licensees to prevent losing its property rights there under."²²

¹⁷ See Parks, *supra*, note 8, in which he questions the very basis of the quality assurance theory of trademarks and argues that such a theory has no sound theoretical foundation, has no practical benefits, and is inconsistent with the realities of the modern market place.

¹⁸ Siegrun D. Kane, *Trademark Law A Practitioner's Guide* 2nd ed. (New York: Practising Law Institute, 1991) at 338 [hereinafter "Kane"].

¹⁹ [ibid. at 140 citing *Edwin K. Williams & Co. Inc. v. Edwin K. Williams & Co.-East*, 542 F.2d 1053, 1059 (9th Cir. 1976), *cert. denied*, 433 U.S. 908 (1977).

²⁰ *E.I. Du Pont De Nemours & Co. v. Celanese Corp.*, 167 F.2d 484, (C.C.P.A. 1948).

²¹ *Denison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403 (5th Circuit 1962).

²² *Ibid.* at 409.

Affirmative Duty to Take Reasonable Measures

The courts have generally held that the licensor of a registered trademark possesses an affirmative duty to take reasonable measures to detect and prevent misleading uses of its mark by licensees or suffer cancellation of its federal registration.²³ There is a need to retain some right to control licensing in order to avoid a finding of abandonment.²⁴ The court in the *Dawn Donut* case, for example, found that it was not sufficient to have chance inspections by cursory examinations of licensees' operations carried out by technically untrained salesmen.²⁵

In *McAlpine v. AAMCO*²⁶ it was held that a registered trademark owner owes a duty to the public to monitor the quality of parts sold through its licensed dealers. By relaxing the control over quality and permitting the sale of inferior products, the licensor might well be deemed to have abandoned its mark.

Stringent Test to Find "Naked" License

Despite the fact that there is an affirmative duty on the licensor to control the use of its mark in association with the goods and services of its licensees, the burden of proving the allegation of abandonment for lack of control is on the party making the allegation. Furthermore, the burden of proof can be extremely high which suggests that the American courts are reluctant to find a "bare" license unless there exists almost no quality control restrictions.²⁷ In the *Jaycees* case,²⁸ for example, the court refused to find that a trademark had been abandoned stating that chapters of the organization which had deviated from the by-laws had not in fact offered a lower quality of service to its members. In the *Sheila's Shine* case,²⁹ the court refused to find that the owners of a

²³ *Dawn Donut Company Inc. v. Hart's Food Stores, Inc.*, 267 F.2d 358, 366 (2nd Cir. 1959) [hereinafter *Dawn Donut*]; *Denison Mattress*, *supra*, note 124 at 409.

²⁴ *Robinson Co. v. Plastics Research & Development Corp.* 264 F.Supp. 852 (D.C. Ark 1967).

²⁵ *Dawn Donut*, *supra*, note 23 at 368.

²⁶ *McAlpine v. AAMCO Automatic Transmissions, Inc.*, 461 F.Supp. 1232 (D.C. Mich. 1978).

²⁷ *American Foods, Inc. v. Golden Flake, Inc.* 312 F.2d 619, 624-625 (5th Cir. 1963).

²⁸ *Jaycees*, *supra*, note 9 at 140.

²⁹ *Sheila's Shines Prods., Inc. v. Sheila Shine, Inc.*, 486 F.2d 114 (5th Cir. 1973).

trademark had abandoned the mark notwithstanding the fact that the owners of the mark had enforced no quality control over its licensees for a period of six years. The fact that the owners thereafter visited the licensees in order to assert control was sufficient to overcome the abandonment argument.

The high standard of proof necessary to establish abandonment is perhaps best demonstrated in the *Penta Hotels* case.³⁰ The court held that defendant had not met the high burden of proof necessary to establish abandonment, notwithstanding the following finding:³¹

1. The agreements between the plaintiff Penta Hotels and his licensee "did not provide for any quality control by inspection or otherwise";
2. the plaintiff failed to provide to the licensee any written guidelines for quality standards aside from the actual agreements;
3. the plaintiff's representatives used no written standards when inspecting licensee's premises, and filed no written reports of those inspections; and
4. the plaintiff did not set forth any evidence that he had relied on licensee's own quality control standards and practices as sufficient.

No Requirement for Complete Control

Clearly, the licensor is not required to take complete control over operations of its licensees' in order to avoid the issue of abandonment. There is no requirement that the licensor be saddled with the responsibilities to control day-to-day operations of the licensees beyond that necessary to ensure uniform quality of the product or services in question. A licensor is not the principal for its agent.³²

³⁰ *Penta Hotels Ltd. v. Penta Tours*, 9 U.S.P.Q.2d (BNA) 1081 (D. Conn. 1988) [hereinafter *Penta Hotels*].

³¹ Kane, *supra*, note 18 at 337.

³² *Oberlin v. Marlin American Corp.*, 596 F.2d 1322 (C.A. Ind. 1979).

In fact, actual control may be nominal. The court in *Kentucky Fried Chicken*³³ held that depending on the context, only minimal quality control may be required. In that case, it was sufficient that the franchisor and owner of the trademark "stands behind" the products and services of the licensee. Most recently, the 5th Circuit Court of Appeals held that there need not be formal quality control where "the particular circumstances of the licensing arrangement [indicate] that the public will not be deceived."³⁴

The idea of minimal quality control was all that was necessary in *House of Hunan*.³⁵ The defendant in that case argued that the quality of the trademark as an informational device was eroded and no longer symbolized quality food. The court would not find that there existed a naked license necessary to establish an abandonment merely because one of the plaintiff's licensees did "not enjoy as fine a reputation as the plaintiff." The court referred to *Kentucky Fried Chicken* stating that the retention of a trademark requires only minimal quality control and refused to find that the defendant had discharged its heavy burden of proving abandonment.

De Facto Control is Sufficient

The American courts have held that there was no need for an express contractual right of inspection and supervision over licensee's activities. Generally, sufficient control over the licensee may be found in the absence of contractual provisions where "there was de facto control over the licensees' use, ... high standards of quality were, in fact, maintained during the period of the license, and... there was no evidence that purchasers had been deceived."³⁶ The amount of control varies with the

³³ *Kentucky Fried Chicken, supra*, note 10 at 387.

³⁴ *Taco Cabana, supra*, note 11.

³⁵ *House of Hunan, Inc. v. Hunan Art Pavilion*, 227 U.S.P.Q. (BNA) 803, 807 (D.D.C. 1985).

³⁶ *Penta Hotels, supra*, note 31 at 1108 citing *Stockpot, Inc. v. Stock Pot Restaurant, Inc.*, 220 U.S.P.Q. 52, 59 (T.T.&A. Bd. 1983), aff'd, 737 F.2d 1576 [222 U.S.P.Q. 665 (fed. Cir. 1984)]

circumstances.³⁷ However, "infrequent, irregular, superficial and uninformed" quality control efforts by an untrained and inexperienced individual are not sufficient.³⁸

In the *Dawn Donuts* case, for example, the contracts provided that the purchaser use the mix as directed and without adulteration, but failed to provide for any system of inspection and control. The court found that the absence of such an express contract right to inspect and supervise a licensee's operations was not fatal in determining the validity of the trademark in question. The owner of the mark may have exercised control despite the lack of express grant by the licensees of the right to inspect and supervise. It was held that in such cases, the courts looked for control exercised apart from the written agreement. As is often the case with a parent licensing its trademark to its subsidiary, a licensing agreement may simply be an oral contract.³⁹

Deemed Control

Although a licensor would never be expected to govern the operations of its licensees and it is arguable that in the absence of public deception that quality control standards need only be minimal, the courts have gone even further in finding that quality control may be "deemed" to exist. In the *Carl Zeiss* case,⁴⁰ the court stated that control could be established through reasonable inspection. Furthermore, the defence of naked licensing will fail where there is reasonable inspection by the licensor, even though each item is not inspected, and there is no showing that the goods fell below essential quality standards.

The courts however have gone further than reasonable inspection.⁴¹ A licensor may reasonably rely on the licensee's past experience with the product, the licensee's expertise and reputation, and the fact that quality was maintained.⁴² The

³⁷ *Ibid.* at 1108 citing *Edwin K. Williams & Co., Inc. v. Edwin K. Williams & Co.-East*, 542 F.2d 1053, 1060 (9th Cir. 1976) cert denied, 433 U.S. 908 (1977).

³⁸ *Ibid.* at 1108 citing *Yamamoto & Co. (America), Inc. Victor Untied, Inc.* 219 U.S.P.Q. 968, 975 (C.D. Cal. 1982).

³⁹ *Council of Better Business Bureaus, Inc. v. Better Business Bureau*, 200 U.S.P.Q. (BNA) 282.

⁴⁰ *Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena*, 293 F.Supp. 892, 918 (S.D.H.Y. 1968), *modified on other grounds*, 433 F.2d 686 (2d Cir. 1970), cert. denied, 403 U.S. 905 (1971).

⁴¹ Kane, *supra*, note 18 at 341.

general argument in favour of this finding is that if, in fact, quality has been maintained, there has been no deception, the mark has not lost its significance as an indication of origin, and there has been no abandonment.

In the *Land O'Lakes* case,⁴³ the court held that reliance on the licensee's own quality control may be sufficient to protect the quality of the goods bearing the mark. The agreement provided that the licensee would use its "best efforts to preserve the high standard and good will" of the mark. Although the owner of the mark retained the right of supervision over all labels and products bearing the mark, no testing took place. The licensor did not know of the source of the goods to which the mark was attached. The owner merely relied on the control exercised by the licensee, on its familiarity with the quality products of the suppliers of the licensee, and on the knowledge that complaints would come back to the licensee as well as the trademark owner since the owner's name also appeared on the labels.⁴⁴ The court effectively relied on the fact that there was no proof of any deficiencies in the licensee's products for quite some time.

The court in the *First Interstate* case,⁴⁵ however, held that reasonable reliance on licensee's own quality control was not alone sufficient. It held that the owner of the trademark could not rely on "numerous contacts" in person or over the telephone where the two parties discussed various aspects of the real estate business. The court distinguished the case at bar with *Land O'Lakes* stating that the licensor must never have received any complaints about the licensee's performance or must have dealt with the licensor for quite some time in order to rely on the licensee's own quality control.

⁴² *Transgo, Inc. v. Ajac Transmission Parts Corp.*, 768 F.2d 1001, 1017-18 (9th Cir. 1985); *Syntex Laboratories, Inc. v. Norwich Pharmacal Co.*, 315 F. Supp. 45, 56 (S.D.N.Y. 1970), *aff'd* on other grounds, 437 F.2d 566 (2d Cir. 1971); *Winnebago Indus., Inc. v. Oliver & Winston, Inc.*, 207 U.S.P.Q. (BNA) 335, 340-341 (T.T.A.B. 1980); *Edwin K. Williams & Co. v. Edwin K Williams & Co.-East*, 542 F.2d 1053, 1059-60 (9th Cir. 1976).

⁴³ *Land O'Lakes Creameries, Inc. v. Oconomowoc Canning Co.*, 221 F. Supp. 576, 581 (E.D. Wis. 1963), *aff'd*, 330 F.2d 667, 670 (7th Cir. 1964) (hereinafter *Land O'Lakes*).

⁴⁴ The court noted that the licensor's name on the licensee's label is not a requirement for a valid licence. *Pneutek, Inc. v. Scherr*, 211 U.S.P.Q. (BNA) 824 (T.T.A.B. 1981).

⁴⁵ *First Interstate Bancorp v. Stenquist*, 16 U.S.P.Q.2d (BNA) 1704, 1707 (N.D. Cal. 1990)

The 5th Court of Appeals held that a trademark licence need not contain explicit provisions for supervisory control or actual inspection where the prior working relationship established a basis for reliance on licensee's integrity and history of manufacture was "trouble-free".⁴⁶ Where the parties to the licence have engaged in a close working relationship, and may justifiably rely on each parties' intimacy with quality standards, the court was not prepared to find abandonment. In this case, two brothers had operated a restaurant for 8 years. Both entered into a licensing agreement in which each brother was permitted to use the trade dress of the original restaurant. The court relied on the fact that each party to this cross-licensing agreement did not use significantly different procedures or products and were expected to draw on their mutual experience to maintain the requisite quality consistency.

In the case of trademarks, the license can be limited to specific marks. The licensee should not be permitted to alter design marks. If alterations are permitted, they should be approved by the licensor.

(iii) Definition of "Patent"

A patent is a limited exclusive right to the manufacture, sale and use of an invention granted by the government (in the case of a U.S. patent, by the Government of the United States) in return for disclosure of that invention in a patent specification. The rationale underlying patents is that in return for granting the exclusive right, the government ensures disclosure of inventions to the public and hence expansion of the pool of knowledge available to the public. If there were no patents, many inventions might be kept secret.

⁴⁶ *Taco Cabana, supra*, note 12 at 1121.

(iv) Definition of "Design Patent"

A design patent is a limited exclusive right granted for giving a new and pleasing appearance to an article of manufacture.

(v) Definition of "Trade Secret"

A trade secret is a secret formula or process, unpatented, known to a limited number of individuals who use it, to competitive advantage, in the manufacture of an article of trade having commercial value.⁴⁷

3. OWNERSHIP AND INFRINGEMENT

It is essential to make sure that the Licensor actually owns or has the right to license the rights and that they are not owned or otherwise exclusively or otherwise licensed to or by any other party. In particular, one must make sure that the licensor has sole legal and beneficial ownership of all the rights in the intellectual property and that it holds the intellectual property rights free and clear of all encumbrances. In other words, the property must be free to be licensed.

Directors and officers need to be aware of the recent decisions in the United States which increase their exposure to personal liability for corporate patent infringement. The basis for liability is section 271 of the *Patent Act*⁴⁸ which provides,

(a) Except as otherwise provided in this title, whoever without authority makes, uses or sells any patented invention, within the United States during the term of the patent therefor, infringes the patent;

(b) Whoever actively induces infringement of a patent shall be liable as an infringer.

Liability under 271(a) may be imposed on officers and directors on the basis of their direct participation in the tort of patent infringement.⁴⁹ Directors and

⁴⁷ The most widely adopted definition for a trade secret may well be that provided by the committee on torts of the American Law Institute and set out in section 757, comment b of Restatement of Torts (1939).

⁴⁸ 35 USC § 271.

officers may be personally liable under 271)(b) if they actively assist with the corporations infringement.⁵⁰ Furthermore, circumstantial evidence may be sufficient to prove the intent to actively assist.⁵¹

The licensee will want a representation and warranty from the licensor that the intellectual property rights are valid. This may be difficult for the licensor to give but, at least, the licensee will want to make sure that the rights have been registered or that the patents have issued. With respect to trademarks it is important that they have been properly used by the Licensor or its other licensees and are therefore not invalid. With respect to patents, the inventions claimed in the patents may be held through patent litigation to be invalid for a number of reasons including the fact that the patent should never have issued because the inventions were obvious and unprotectable.

With respect to ownership, there is a significant difference between Canadian and American law on the transfer of trademarks. In Canada, the Canadian *Trade-marks Act* allows for transfer of a trademark with or without the goodwill attached to it. In the United States, goodwill must be transferred along with the trademark or that the assignment is invalid (15 U.S.C. ss. 1060). Assignment of a trademark in the U.S. without goodwill or business attached to it leaves nothing for the mark to signify and it loses its inherent function and is abandoned.⁵²

The licensor should disclose any intellectual property litigation to the licensee. The licensee may also want the Licensor to indicate that it has no knowledge that any claim has been made that the use of the intellectual property rights does or may violate the rights of any third party in any material respect or that any products based on or using the intellectual property rights manufactured, produced, used or sold by the licensor do or may violate the rights of any third party in any material respect.

⁴⁹ *Orthokinetics, Inc. v. Safety Travel Chairs, Inc.*, 806 F.2d 1565 (Fed. Cir. 1986); *Symbol Technologies v. Metrologic Instruments*, 771 F. Supp. 1390 (DNJ 1991); *Consider Manville Sales Corp v. Paramount Systems, Inc.*, 917 F.2d 544 (Fed. Cir. 1990).

⁵⁰ *Manville Sales Corp v. Paramount Systems, Inc.*, 917 F.2d 544 (Fed. Cir. 1990).

⁵¹ *Water Technologies Corp v. Calco Ltd.*, 850 F. 2d 660 (Fed. Cir.).

⁵² *Otis Elevator Co. v. Echlin Manufacturing Co.* 187 U.S.P.Q. 310, 314 (TTAB 1975).

There is an issue as to who should commence or defend any action for infringement of the intellectual property rights in the future. Depending upon the situation, it may be most practical to have the action or the defense of an action and all the financial obligations shared by the licensor or licensee. Furthermore, if a licensing agreement conveys all substantial ownership rights to the licensee so that in reality the licensee has become assignee of the patent, the licensee may be a necessary party to an infringement action brought by the licensor.⁵³

Improvements

One concern is derivative and successor intellectual property rights. Patent and trade secret licenses must address this since the licensees are often utilizing or customizing the intellectual property to a format which differs from the original. The licensor will want to ensure that the licensee's continued use of the new and improved intellectual property will be contingent upon the ability to remain a licensee of the original intellectual property. Therefore, one issue is the extent to which the licensor is to obtain ownership of the new intellectual property and to address the manner and terms upon which that ownership is established together with the continuing rights of the licensee in the new and improved intellectual property.

Improvements are not restricted to patents. They are typically the result of on-going analysis and development of the technology which is a subject of the license. However, since they occur after the license has been negotiated and can not be ascertained in advance they provide a unique set of challenges to the drafters of the agreement.

While the licensor may be more likely to develop improvements given that it developed the original invention it is also possible for the licensee to

⁵³ *Zenith Electronics Corp. v. ExZec Inc.* 34 U.S.P.Q. 1852.

develop improvements since it is continuing to use the invention. It is therefore important to determine the following issues in advance:

1. Disclosure requirements of the party who has developed the improvement;
2. Proprietary interest in the improvements and the right to sublicense the improved technology;⁵⁴ and
3. Obligations of the party with respect to seeking further patent protection and the associated cost.

One of the questions of course is which improvements are going to be the subject matter of the license. If the invention is patented, the improvements can be tied to the claims of the patent. The obligations and the agreement regarding ownership and prompt disclosure could then extend to those improvements made to items or processes to find in the claims of the patent. Alternatively, the obligation could be expanded to include improvements in the same or general area of technology.

One other method of dealing with it is to have the improvements clause of the license agreement only deal with those improvements which are capable of attracting patent protection on their own.

4. REGISTRATION

The issue of registration of trademarks and the protection of inventions through patents must be covered in the license. It is usually incumbent upon the Licensor to do this. With respect to trade secrets, what is important is that the confidentiality or secrecy of the trade secrets. Clearly the obligation must be on both the licensor and licensee to keep the trade secrets confidential.

5. WHY AND WHEN TO LICENSE

From the perspective of both parties, in evaluating a licensing partner some of the important factors include the party's resources, including financial and

⁵⁴ Provisions for the ownership of improvements vary from having an undivided interest in the licensee's improvement transferred to the licensor, subject to the licensee free use of having the improvement remain the property of the licensee/inventor with certain rights flowing to the licensor.

existing business resources, prior business experience, financial stability, management personnel and geographic location. From the licensor's perspective it wants to make sure that the licensee has the wherewithal to produce the product, to distribute it into the market place and to follow up on any warranty and servicing that is necessary.

From the licensee's perspective, he wants to make sure that what he is obtaining that is owned by the licensor, is of commercial value to him and will continue to be and that the licensor has the management capability to oversee that particular license and, in addition, all other licenses which it has for any intellectual property rights.

One must also keep in mind the joint venture style of licensing. This is becoming increasingly popular. The two licensors create a third company which is the joint venture company. Each of the entities owning intellectual property rights license its rights into the joint venture company. The joint venture company then can exploit markets to which the licensors do not otherwise have access.

Trademarks

One important point with respect to trademark licensing is to determine whether a particular commercial arrangement really requires a formal trademark license. The user only needs a trademark license where they are in fact "using" the trademark. A mere distributor of products does not need a full trademark license. The issue is whether the use of the trademark would be considered to be carrying on an activity with a trademark that would, but for the permission of the trademark owner, be considered to be unlawful. In other words is the use in any manner constituting an infringement of the trademark? If the mark is being used to identify to the consumer that the products or services are sourced from the trademark owner, no license is required. One may however want to enter into an agreement with a distributor with respect to certain controls with respect to the manner or use of the trademarks and distribution of product.

Patents and Trade Secrets

There is a fundamental distinction to be made between patents on one hand and trade secrets, confidential information and know how on the other hand. Patents are governed by a well defined legislative system and do not depend for their continued validity upon any confidentiality. Trade secrets and related rights are much

more fragile and can be lost or rendered unenforceable at any time by the subsequent actions of third parties including licensees. As a result the terms of a license respecting such trade secrets may be far more stringent than those of a patent license. Know-how is a loosely defined class of information that is made up of the licensor's knowledge, experience and skills. It can be reviewed as the information necessary to perform a task or facilitated process or procedure in a manner which is a significant improvement over that performance of the same task or process without the use the information. Alternatively, know-how can also involve a much more complex understanding of how to undertake a procedure or process, which could be patented but which the licensor has declined to patent and instead chosen to keep confidential.

Know-how can be made up with any number, in combination, of techniques, formula, temperatures, recipes and designs. It is often comprised of information and technical details which could be produced by licensees. If they expended the same time, effort and expenses the licensor. Therefore, for a know-how license to have value it must be available at a cost that is significantly less than the cost of independent development of the same information (both in terms of time and money). Alternatively, a license for know-how which is otherwise fairly accessible that may have value if it is "packaged" with one or more patents or other less readily available technology. A license involving know-how should describe the information granted to the licensee in the greatest detail possible.

Guidelines

If you are interested in some "rules" for lowering frustration level of successful licensing in or licensing out you may wish to read "Guidelines for Marketing Technology".⁵⁵

Anti-Trust

When thinking about a license one must also consider the friction between competition law enforcement and intellectual property rights. The intellectual property laws and the anti-trust laws share the common purpose of promoting "innovation, industry and competition". Intellectual property laws provide incentives for innovation

⁵⁵ Charles Murray, Les Nouvelles, Journal of the Licensing Executives Society, Vol. XXIX No. 2 June 1994, p. 82.

by establishing enforceable property rights for the creators of new and useful products and more efficient processes. The anti-trust laws promote innovation enhance consumer welfare by ensuring that owners of intellectual property rights do not abuse those rights, for example, to suppress competition in alternate technologies and in adjacent markets.⁵⁶ Some business practices including some licensing arrangements may extend beyond the permitted limits of these exclusive rights and run afoul of the competition laws.

On Thursday April 6, 1995, the Department of Justice and Federal Trade Commission (FTC) jointly issued Antitrust Guidelines for the Licensing of Intellectual Property. Clearly if you are dealing in this area you should make yourself familiar with such guidelines.⁵⁷

6. NEGOTIATING THE AGREEMENT - PRELIMINARY ISSUES

Some of the most important aspects of the license agreement are:

- (a) The identification of the intellectual property that is the subject of the license.
- (b) The scope of products or services which can be exploited by the licensee.
- (c) Minimum royalty payments.
- (d) Unique reporting requirements.
- (e) Quality assurance standards.
- (f) The parties obligations to protect intellectual property rights.

There are some basic terms of the license which should be negotiated "upfront". These include the scope of the license including the term and renewal rights, exclusivity, sublicensing and ability to transfer. Secondly important is the royalties and the reporting requirements on the royalties. Other matters of importance include confidentiality obligations, new and improved intellectual property rights created by

⁵⁶ Anne K. Bingaman, Assistant Attorney General, Anti-Trust Division, U.S. Department of Justice, Address before the American Bar Association Annual Spring Meeting, (April 8, 1994).

⁵⁷ Richard J. Gilbert, "The 1995 Antitrust Guidelines for Licensing of Intellectual Property: New Signposts for the Intersection of Intellectual Property and the Antitrust Laws " Address to American Bar Association Section of Antitrust Law Spring Meeting, (April 6, 1995).

the licensee, infringement of intellectual property rights, rights of termination in the events of default including cure provisions and obligations on termination and hold harmless and any indemnification requirements.

It is frequent that a non-disclosure and non-use agreement will be entered into prior to negotiation. By doing so, the parties contractually bind themselves from using the ideas and the information they obtain through negotiation after a negotiation and exploiting those ideas and information for their own gain. Therefore, its extremely important to define one's confidential information and flag it before any communication. The nature of the business does not always lend itself to this kind of confidentiality arrangement prior to informal discussions. Frequently these initial meetings are designed to explore the possible benefits each side could bring to a joint venture and a need to execute an agreement can introduce an unwelcome sense of obligation and formality. Particularly where there is a desire to attract the right suitor. Important and valuable information may be disclosed without the necessary structure and place. Parties therefor should take the time to consider what they wish to disclose and to do whatever is necessary to protect that confidential information or trade secret. Also bear in mind that confidentiality provision which may be fine for patent matter may not be suitable for a trade secret matter.

In many of these circumstances it is important to do due diligence. This is important from each of the parties point of view. While representations and warranties together with indemnification can to a certain extent take the place of due diligence that is not always the preferable route. A thorough review of due diligence is beyond the scope of this paper.

7. IDENTIFYING THE PROPERTY RIGHT(S) IN THE AGREEMENT

In any licensing arrangement it is crucial to identify all the intellectual property rights being licensed. These must be listed and identified in some manner. Frequently specific intellectual property rights are listed in a schedule to the license.

The following are some suggested general definitions for intellectual property assets which could be used in a license agreement. However these definitions should be tailored to the facts of each transaction. Also the Schedules to the agreement should list the actual rights involved and the registrations of those rights which are to be licensed. For ease of reference these definitions relate to the "Business". Therefore

the definition of the "Business" should be specific such that easy identification of the intellectual property rights licensed is possible.

"Confidential Information" means the trade secrets, confidential information and confidential know-how that the Licensor owns and which relate to the Business. Confidential Information includes the following aspects of the Business:

- (i) all unpatented inventions
- (ii) all customer and supplier lists for the Business;
- (iii) all unpublished studies and data, prototypes, drawings, design and construction specifications and production, operating and quality control manuals used in connection with the Products;
- (iv) all marketing strategies,
- (v) all current or proposed business opportunities, and
- (vi) all documents embodying such items of Confidential Information including, without limitation, those listed in Schedule • hereto

"Copyrights" means all copyrights that the Licensor owns which relate to the Business, and all registrations and recordings thereof, including, without limitation, those listed in Schedule • hereto.

"Designs" means all industrial designs, design patents and other designs that the Licensor owns which relate to the Business, and all registrations and recordings thereof, including, without limitation, those listed in Schedule • hereto.

"Intellectual Property" means all Confidential Information, Copyrights, Designs, Patents and Trademarks.

"Patents" means all letters patent and all applications for letters patent, renewals, reissues, extensions, divisions, continuations, and continuations-in-part thereof that the Licensor owns which relate to the Business, including, without limitation, those listed in Schedule • hereto.

"Trademarks" means

- (i) both registered and unregistered trademarks and service marks,

- (ii) designs, logos, indicia, trade names, corporate names, company names, business names, trade styles, and other source or business identifiers,
- (iii) all registrations and applications that have been or shall be made or applied for in the U.S. Patent and Trademarks Office or any such or similar office in any country in the world and all recordings thereof and all reissues, extensions, or renewals thereof, and
- (iv) all common law and other rights therein

which relate to the Business and including, without limitation, those listed in Schedule • hereto

One of the most difficult aspects of negotiating the definitions frequently is which intellectual property assets are licensed to the Licensee when the Licensor is retaining one or more business lines. The conflict is that the Licensee wants to ensure it is obtaining a license for all the needed intellectual property rights but the Licensor wants to make sure that there is no over reaching into or competition with its business lines.

The issue of licensee estoppel is important in dealing particularly with patents. The principal in the U.S. is that the ability of a licensor to require a licensee to agree that it will not attack the validity of a license patent is restricted.⁵⁸ If there is any doubt as to whether a patent is going to be need by the licensee, it is probably a better position not to put it in and only include those patents which are absolutely necessary for the business of the licensee.

8. PRACTICAL POINTS ON DRAFTING THE LICENSE AGREEMENT

Of course, this article cannot get you to draft a license agreement. There are many excellent texts which have samples of agreements. I recommend that you use these texts if you are needing specific language for drafting purposes. Or if possible to obtain precedents from an intellectual property practitioner.

⁵⁸ *Lear Inc. v. Adkins*, 395 U.S. 653 (1969).

Trademarks

Frequently, and particularly in trademark matters, strict quality assurance standards are important. These quality assurance standards can include:

- (i) The specification of the formula materials to be used in the production of the licensed goods.
- (ii) Warranty requirements to be included with the sale of the goods.
- (iii) The requirement that licensor approve samples of the goods.
- (iv) The requirement to supply licensor with samples of production run licensed goods from time to time to permit the licensor to review the quality.
- (v) The requirement that the licensor attend and license factory to oversee production.
- (vi) Specific testing, analysis and reporting functions to be performed by licensee from time to time.

The following is a list of licensing provisions and conduct extracted from the case law from which a trademark owner and licensee may create a relationship that conforms to quality assurance standards.

1 Registration

- licensor should obtain registration of its trademark for all wares and services to be sold or performed by the licensee.

2 Writing Requirements

- licensor should provide all control terms within the trademark licence and all such terms should be evidenced in writing
- any quality or other control in fact exercised should be documented.

3 Corporate Governance

- licensor could control the licensee in the sense in which a parent controls a subsidiary.

- licensor could control the policy of the licensee generally or with respect to the wares or services associated with the trademark.

4 Advertising and Linking Use of Mark to Owner of Mark

- licensee should notify the public, either on product labels or by advertising, that the particular use is licensed and that the mark is owned by the licensor.
- licensor could require that licensee guarantee the wares or services to consumers according to licensor's specifications (i.e. "money refunded if not satisfied")
- licensor should require that the licensee use statements that generally indicate that the mark is that of the licensor (i.e. advertising that the goods and wares are associated with "the world famous Levis Company").
- licensor could make independent claims to the public in advertising that the owner of the mark stands behind all of its products.

5 Quality Control and Inspection

- licensor should require that goods or services associated with the mark meet certain specifications or that they are built or performed according to specific guidelines.
- licensor should require that the licensee agree to quality standards established by licensor. Standards may vary from the specific (i.e. adherence to a certain formula) to the general (i.e. adherence to the quality of sample products approved by licensor).
- licensor should maintain a systematic method of testing with checklists.
- licensor should require that the licensee provide samples to the licensor on a regular basis.
- licensor or licensee should keep written reports that evidence the inspection and control over the licensee.
- licensor and licensee could apply an independent standard (i.e. an industry standard or government approval).

- licensor could maintain testing facilities to inspect the licensee's work.
- licensor could supply a qualified inspector at the licensee's premises on a continuing basis.
- licensor could provide for qualified staff to inspect the licensee's goods on a regular basis. It is probably not sufficient to view the goods on the market or rely on infrequent visits by unqualified staff.
- licensor could arrange testing by a reliable third party, reserving the right to cancel the agreement upon certain terms that would demonstrate a concern for quality.
- licensor could rely on licensee's past experience with the product, the licensee's reputation and the record for good quality if it was possible to prove that this was reasonable reliance.
- licensor could agree to the standards as currently applied by the licensee in the manufacture of similar products.
- licensor could attempt to provide other forms of "reasonable inspection" when impractical to provide continuous inspection or regularly scheduled inspections.
- licensor could reserve the right of selection of raw materials to assure uniformity of the nature and quality of products manufactured.
- licensor could supply essential components to the licensee and only permit local procurement for non-essential parts.

6 Supply of Experience and Know-How

- licensor could supply product formulae, manufacturing methods and production equipment.
- licensor could supply relevant materials including working drawings, manufacturing and assembly data as well as specimen components for reproduction.
- licensor could supply know-how and services of mechanics and other trained personnel (whether under the employ of the licensor or not) to the licensee.

- licensor could train the licensee's personnel.

7 **Repair Policies**

- licensor could require that the licensee provide servicing for products associated with its mark.
- licensor could specify the repair procedures and standards expected for the products associated with its mark.
- licensor could provide its own repair facilities.

8 **Policing Use of the Mark**

- licensor should retain control over which goods and services the licensee is permitted to affix the trademark.
- licensor should restrict use of mark to within the scope of its registration.
- licensor should provide for and take active measures to prevent continued use when it is determined that the mark is used on goods or services outside the registration or contrary to any control agreement.
- licensor should prohibit sublicensing except with its express permission.
- licensor should require approval of licensee's packaging, advertising and manner of trademark use.
- licensor should require consent for any other use of the mark.
- licensor could determine the goods and services to be sold by the licensee.

9 **Acknowledgement of Ownership and Control of Mark**

- licensor should require that the licensee acknowledge its limited right to use the trademark and that any right to use the mark will cease upon termination of license with all rights reverting to licensor.
- licensor should require that the licensee acknowledge the licensor's right to control quality.

- licensor should require that the licensee acknowledge that use of the mark inures to the benefit of licensor.
- licensor should require that the licensee acknowledge the validity of the trademark, acknowledge ownership by licensor, and agree not to challenge ownership or validity.

PROVISIONS OF THE AGREEMENT

I have listed below provisions that one would normally include in a license. With respect to some of them I have made a few comments.

Subject Matter of the License Agreement

See above notes in section 8. Also, intellectual property rights include various "sub rights". If it is not intended that the whole bundle of rights is to be given to the licensee then this must be specifically set out in the license agreement. This of course is as important as defining the subject matter of the license. With respect to patents, division rights can be complex.

Grant Provision

One should be careful when one is drafting a hybrid license, ie. a license with both patents and trade secrets. Clearly the invalidity of a patent ends the obligation to pay royalties.⁵⁹ There is some suggestion that a license which allocates between the patent and non-patent consideration would be upheld with respect to the non-patent consideration. Also, payment for the use of a property right would be granted on the theory of unjust enrichment.⁶⁰ Therefore, it is advisable whenever possible to treat patents separate and apart from know-how for licensing purposes.

⁵⁹ See Lear, footnote 54 above.

⁶⁰ Chromalloy American Corp. v. Fischmann 716 F.2d683 (9th Cir. 1983); Pitney Bowes Inc. v. Mestro 701 F.2d1365 (11th Cir. 1983); Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation et al 402 U.S. 313 (1971).

Transferable v. Non-transferable

Assignability should always be considered and expressly dealt with in the agreement. If there is to be no assignment of the agreement it should be specifically stated.

Sublicensing

If it is an exclusive license there may be an inherent right to sublicense, if this is not intended then it should be specifically so stated. It is always a good idea to specifically indicate whether the licensee can sublicense the intellectual property rights and on what terms and conditions *vis a vis* the licensor.

Milestones

This is particularly important in a start up project. The licensor may wish that the duties and responsibilities of the licensee be specifically outlined and the time period over which these are going to be met.

Territory

The license should identify the geographical restrictions of the grant. For instance, if the licensor holds only registered trademarks and issued patents in the US it should not grant a "worldwide" license. Also the Licensor may want to restrict the geographic scope of the license in order to maximize the number of licenses. This however may violate local competition, anti-trust and anti-trade laws. Also, the issue of grey marketing is beyond the scope of this paper.

Royalty Provision

There can be as many different royalty arrangements as there are licenses. Usually, though, a base is defined on which royalties are calculated. It is important that this base be accurately defined in the context of the business subject to the license. Also the definition should be one that is not capable of manipulation by either party and is also based on an arm's length sale in the ordinary course of business.

Royalty Rates

This can be difficult to determine depending on the business. Clearly it is a question of what the parties negotiate and what is common (or at least negotiable) in the marketplace for that type of license. See discussion below in section 10 and the article entitled Factors Effecting Royalty Rates.⁶¹

Minimum Guaranteed Royalties and Advances

Licensors often seek to include a provision which guarantees a minimum earning stream for themselves and termination rights if there is evidence that the licensee is not working the license in a manner they consider adequate. Therefore the licensor wants a minimum royalty payment, minimum performance standards and a best efforts clause. Minimum payments are typically fixed sums which are owed to the Licensor regardless of the sales performance achieved by the licensee.

Quarterly payments are common but annual and semi-annual royalty periods are also used.

Statements/Reports, Payments, Books of Account and Audits

The time that royalties become due and the manner in which they are payable should be covered in the license. The royalties are usually paid on a periodic basis with the length of each period that is subject to negotiation.

Notices and Markings

Care should be taken to include in the license the required statutory marking. As well, the Licensor may or may not want its own name to appear on or in connection with the licensed product or service. This should be made clear in the agreement.

⁶¹ Daniel M. McGavock, David A. Haas and Michael P. Patin, *Les Nouvelles*, Journal of the Licensing Executives Society, Volume XXVII No. 2 June, 1992, p. 107.

Disclosure of Information - Confidentiality

It is also important to think about employee contracts with respect to all staff employees, contract employees and consultants of the licensee who would be engaged in the project. Not only do you want to ensure confidentiality from all of them but also you would want to consider the ownership of any designs, inventions, improvements and know how generated by such persons in relation to the project.

Intellectual Property Protection and Infringements

Intellectual property protection can be expensive. Few companies can afford to patent an invention throughout the world. Therefore, it is important to have an understanding of the comparative value of obtaining patent protection in various countries around the world.⁶²

Representations and Warranties/Hold Harmless and Indemnification

These serve two purposes, namely risk allocation and a back-up to due diligence.

Most Favored Nations Clause

This is used in non-exclusive licenses. Discussion of such clauses is beyond the scope of this paper.⁶³

Termination

Since the license is a contract it is up to the parties to tailor the termination provisions to their needs. Some examples of events which would give rise to a right to terminate include:

1. Failure to pay royalties or their persistent late payment

⁶² Global Patent Strategy, Michael D. Bednarek, Managing Intellectual Property, Issue 44, November, 1994, P. 12.

⁶³ MFN, Durable Goods Monopoly, and Licensing, Lawrence P. Shanda and Mark D. Kleinginna, Les Nouvelles, Journal of the Licensing Executives Society, Volume XXVII No. 2 June, 1992, p. 87.

2. Failure to provide services or materials
3. A change in the ownership or control of a party after the licensor or the licensee
4. A substantial change in circumstances
5. The bankruptcy of the licensee.⁶⁴

A licensee will want the license to terminate if the intellectual property is declared invalid or unenforceable. As well an exclusive licensee will want termination of the agreement if its exclusivity is no longer effective in the marketplace because of infringements. In this instance an exclusive licensee, as an alternative to termination, could change to a non-exclusive arrangement with a different royalty structure. There are certain provisions of an agreement which should never terminate, particularly those relating to confidentiality.

Disputes - Arbitration

These arbitration clauses can be tricky and complex. A discussion is beyond the scope of this paper.⁶⁵

Entire Agreement

One should pay particular attention when drafting a successor or renewal agreement which contain an entire agreement clause to provide expressly for the status of the confidential information passed under early agreements.

Using the Intellectual Property Itself or Any Licenses as Collateral on Financing

9. CONFIDENTIALITY PROVISIONS

Some of the factors which make a trade secret valuable include its secrecy, i.e. the extent to which the information is not known in industry and the extent to which measures are taken to safeguard the secrecy of the information. One way of looking at it is trying to determine the value of the information to competitors. Information that is

⁶⁴ But note that the Bankruptcy laws govern the rights of the parties in bankruptcy or in insolvency situations. These laws are too complex to discuss in this article.

⁶⁵ For a discussion, see Arbitration? Here are Real Recommendations, Tom Arnold, Les Nouvelles, Journal of the Licensing Executives Society, Volume XXVIII No. 1, March, 1993, P. 24.

the subject of a trade secret should only be disclosed under an agreement of confidentiality. The trade secret will be lost if it is disclosed for instance by a patent or by a breach of confidentiality.

An interesting recent case is that of *Tracer Research Corp. v. National Environment Services Corp.*⁶⁶ No. 94-16211, 9th Circuit. A three judge panel of the 9th Circuit U.S. Court of Appeals reversed a ruling by a US judge of the District of Arizona dissolving an injunction entered against National Environmental Services Co. in a suit brought by Tracer Research Corp. In that action the claim for misappropriation of trade secrets did not "arise out of" a licensing agreement and was therefore not governed by the agreement's arbitration clause. The misappropriation of trade secrets count of Tracer's complaint was a tort claim. The fact that the tort claim would not have arisen "but for" the parties licensing agreement was held not to be determinative. If proven, the defendants' continuing use of Tracer's trade secrets would constitute an independent wrong from any breach of the licensing and non-disclosure agreement. Therefore, the Court held that it did not require interpretation of the contract and was not arbitrable.

10. ROYALTY MECHANISMS

With respect to royalties there are some important issues including the rates charged by the Licensor to other licensee as well as the commercial success of the products or services covered by the intellectual property rights.

High profitability items typically command a higher royalty rate as do high tech items. Also one aspect of determining commercial value is whether the intellectual property rights have been properly and appropriately protected and whether the duration protection is finite, the term of the license and the remaining life of the protection.

There are usually higher royalties for exclusive licenses whereas licenses which are geographically restricted tend to have lower royalties.

Another issue is the competition between the licensor and the licensee. From the Licensor's position it wants a relatively high royalty rate to compensate for

⁶⁶ *Tracer Corp. v. National Environmental Services Co. et al.* 42 F. 3d 1292, petition for a writ of certiorari dismissed, 116 S. Ct. 37.

that competition. From the licensee's perspective it wants a lower royalty rate since it must meet the competition of the licensor in the market.

As an example, some factors to be considered in determining a reasonable royalty were listed in *Georgia-Pacific Corp.*⁶⁷ as follows:

1. The royalties received by the patentee for the licensing of the patent in suit, i.e. an established royalty.
2. The rates paid by a licensee for the use of other patents comparable to the patent in suit.
3. The nature and scope of the license, as exclusive or non-exclusive; or as restricted or non-restricted in terms of territory or with respect to whom the manufactured product may be sold.
4. The licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly.
5. The commercial relationship between the licensor and the licensee, such as, whether they are competitors in the same territory in the same line of business; or whether they are inventor and promoter.
6. The effect of selling the patented specialty in promoting sales of other products of the licensee; the existing value of the invention to the licensor as a generator of sales of his non-patented items; and the extent of such derivative or convoyed sales.
7. The duration of the patent and the term of the license.
8. The established profitability of the product under the patent; its commercial success; and its current popularity.

⁶⁷ *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), *modified and aff'd*, 446 F.2d (2d Cir.), *cert. denied*, 404 U.S. 870 (1971).

9. The utility and advantages of the patent property over the old modes or devices, if any, that had been used for working out similar results.
10. The nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention.
11. The extent to which any infringer has made use of the invention; and any evidence probative of the value of that use.
12. The portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions.
13. The portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer.
14. The opinion testimony of qualified experts.
15. The amount that a licensor (such as the patentee) and a licensee (such as an infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement.

It is important to remember that there are accounting firms and consultants who specialize in valuing technology for the purposes of licensing. Licensors may wish to retain such professionals if arrangements can not be easily made through negotiation with the Licensee.

Upon Expiration of Patents

A license for the use of know-how and confidential information which is immune to reverse engineering or independent discovery could be perpetual. Similarly, improvements to patents which in turn cause other patents to issue could extend the life of a license until the last patent expires. For this reason the duration and termination provisions of these intellectual property licenses should be drafted with considerable care.

In the case of patent licensing, the Courts have held that where an express provision regarding term is included, it will govern: otherwise the original term of patents supply is the term of the license.⁶⁸

In cases dealing with confidential information which remain confidential at the expiry of the license, it is especially important to consider the rights of the parties at the end of licensed term. Courts have held that, absent any express contractual obligation, a licensee has an implied duty to refrain from using the information when the license expires.⁶⁹

Another difficulty which can arise if duration provisions are not drafted carefully is the invalidation of the subject matter of the license. If the license provides for the use of both patents and other intellectual or industrial properties such as confidential information or know-how, and the royalty is based on the percentage of sales, then the invalidation or expiration of the patent or the public disclosure of the confidential information or know-how could leave the respective rights and duties of the parties extremely and clear. Should the license terminate immediately? Is it possible to maintain the license and fix a reasonable royalty based on the surviving subject matter property? In fact, some licenses provide that as long as one patent claim remains valid, or one bit of know-how continues to be used, the entire license fee will be continued to be due and owing.

In the United States, the duration of licenses for patents was firmly fixed by the American Supreme Court. In *Brulotte v. Thys Co.*⁷⁰, the Court held that the obligation to pay running royalties ceases with the expiration or invalidation of the license patent. The rationale here is that to allow otherwise would convert an exclusive license into an extension of the statutory monopoly created by the grant of the patent.

In licenses which include both patents and know-how, a licensor may wish to schedule the rates of royalty for the patents and the know-how separately. Then the royalties dealing with the patents would expire at the expiration of the patent. This would leave the term of royalty for the know-how intact. The question then

⁶⁸ *Poles Inc. v. Beecker* 461 F. Supp 878, at 881 (1978).

⁶⁹ See *Painton v. Bourns Inc.* 442 F. 2d 216 (1971).

⁷⁰ *supra*

becomes how does one allocate the royalty rate between the patents and the know-how. One must be very careful in so doing.

A running royalty based on sales is the most common form of consideration. They may however be up-front lump sum payments or fixed annual payments. They can also be payments by way of installments which may be set independently of sales. However, when structuring an installment plan for payment in a license with an American firm, subject to American law, drafters must take into account *Brulotte v. Thys Co.*⁷¹ The Court held that a licensor cannot extract running royalties for a term beyond the life of the patent. Therefore, an installment that comes due after the patent expires may be interpreted as a royalty and therefor be unenforceable.

11. DISCLOSURE REQUIREMENTS

These requirements include reporting requirements including financial reports, production reports. These should be followed through with the licensor having access to the licensee's books and records.

There may also be minimum standards or quotas. These may be compared to other licensees. They may also require annual renegotiations with minimum royalties for maximum production.

There may be other types of disclosure obligations. The Federal Trade Commission's Pre-Merger Notification Office views the acquisition of an exclusive intellectual property as an assets acquisition under the *Hart-Scott-Rodino Antitrust Improvements Act*, 15 U.S.C. Section 18(a). Therefore, parties to an exclusive intellectual property license must comply with the Act's reporting and waiting requirements.⁷² The FTC stated that the grant of an exclusive license for a specific product use and limited in time and geographic scope is the transfer of an asset and subject to the HSR Act. Product, time and geographic limitations go to the value of the asset. There are certain issues which must be renewed including the parties to the transaction and the size of

⁷¹ 379 U.S. 29, 85 S. Ct. 176 (1964).

⁷² Note FTC: Watch Hart-Scott-Rodino Mailbag, FTC: Watch No. 377 (Washington Reg. Rep. Assoc. November 9, 1992).

the transaction to determine whether the license meets the Act's minimum requirements.

12. GRANT BACK CLAUSES

There are certain circumstances where a vendor may sell all its intellectual property assets to the purchaser but require a license back to the vendor for a certain aspect of the vendor's business. If the intellectual property rights mainly flow with the business sold to the purchaser, then the transfer to the purchaser should take place. However, the purchaser would then license back to the vendor whatever intellectual property assets are required for the vendor to be able to carry on its remaining business. This is frequently the case with respect to patented technology and to software.

Grant back arrangements also exist where a licensee agrees to extend to the licensor of the intellectual property the right to use the licensee's improvements to the licensed technology. The draft Intellectual Property Guidelines of the Anti-trust Division specifically deal with grant back provisions of this nature.⁷³

13. NON-ASSERT CLAUSES

There are certain transfer arrangements where the vendor transfers intellectual property rights to the purchaser and one of two things may happen:

1. The vendor may hold back in its ownership and possession certain intellectual property which it needs for its business. The purchaser, however, may require that the vendor agree not to assert those intellectual property rights against it. For instance, where the purchaser manufactures a product and that product has many end uses, the purchaser may require the vendor to include a non-assert clause against the purchaser and its customers with respect to certain uses of the product in certain business applications. Therefore, the purchaser may sell its product to an end user who may use that product for the purposes for which it is intended to be used even though that end use may infringe an intellectual property right of the vendor.

⁷³ See footnote 54 Supra.

2. As well, the same can happen where the vendor transfers the intellectual property rights to the purchaser but the vendor needs a non-assert clause with respect to its ongoing business or at least certain aspects of its ongoing business.

The above non-assert clauses are really in lieu of license agreements. They are usually used for situations where the end use of the product is identifiable.

14. REMEDIES FOR INFRINGEMENT

In dealing with third party infringements of the intellectual property rights which are the subject matter of the license, usually, the licensor will have control over the bringing of infringement action. However, usually the licensor doesn't want to be required to bring an action but to have the sole right to bring that action without the licensee being involved. An exclusive licensee on the other hand will usually want to be involved, particularly if the owner refused to bring such an action since it will affect its commercial position most directly.

If the licensor retains a joint right with his licensee to agree and what action is to be taken upon discovering patent infringement and how to share in any recovery, that licensor is deemed the necessary party to the lawsuit. The lawsuit may proceed without the licensor as a party if the licensor assures the court that it will not bring another action, will be bound by the outcome in a litigation in cooperate in discovery.⁷⁴

15. CONCLUSION

The market distinctions between inventors, manufacturers, distributors, marketers and licensors are blurring as these parties tend to partner together to increase their market penetration. One "partnering" is via a licensing arrangement. That license must be carefully negotiated and drafted to achieve the maximum benefit from the arrangement for each party at the same time as protecting each party's position in the "partnership" and for its own business. Whether for the licensor or the licensee, the licensing project must have a long-term strategy with full management support. The

⁷⁴ For a discussion of this see Recent Developments in the Law Relating to Licensing, by Brian G. Brunsbuld and J.C. Paul, *Les Nouvelles*, Journal of the Licensing Executives Society, Volume XXIX No. 2, June 1994 p.111.

company must be committed to its licensing program in order for that program to be successful.