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Licensing of Know-How

United States

I. Introduction

Importance of Know-How and Know-How Licensing

Know-how and know-how licensing have become increasingly more important and more widely used.

Statistics on licensing of industrial property rights show that there is a predominance of know-how licenses. I am aware of figures for 1981 in Japan where 50% of the licensescovered know-how, another 20-30%, know-how combined with patents or trademarks and only a small percentage were pure patent or trademark licenses. I am also aware of similar statistics for Peru. And these are developed and developing countries, respectively. There is no reason to believe that these data don't hold up also today and in other places.

Naisbitt, the author of "Megatrends", already in his first chapter where he describes the change-over from an industrial society to an information society, has a subchapter on know-how as the new form of wealth. Capital, he says, was the principal asset in the industrial society but in the new society it is information, i.e. know-how.

II. Know-How Licenses - General Principles Scope - Duration - Termination

Unlike in patent licenses, complex problems of scope, duration and termination come up immediately. But first as regards definition of know-how, let me merely mention that the term "know-how" is not limited to technial information and often is used inter-changeably with the term "trade secrets". Both terms are essentially amorphous. There are numerous definitions of "know-how" and "trade secrets" in the literature, especially AIPPI literature (inasmuch as the AIPPI dealt extensively with the definitional question and the question of inclusion of know-how as protectable under the Paris convention).

However, as a practical matter there is often a need to distinguish between trade secrets and non-proprietary know-how - difficult as it may - e.g., for reasons of tax treatment and under anti-trust considerations. Only trade secrets are considered a capital asset in an independent sale of know-how and only trade secrets will get capital gains treatment. Also, it is common for the proprietor of know-how to condition the transfer of know-how with certain restraints but any such restraints must be supported by substantial, valuable and <u>secret</u> know-how. Restraints, be they, e.g., of the territorial or field-of-use type which might otherwise run afoul of the antitrust laws as anti-competitive, will pass muster if ancillary to the tranfer of trade secrets.

In the U.S. it is crystal clear since the <u>Kewanee</u> Supreme Court decision (Kewanee Oil Co. vs. Bicron Corp.) of 1974 that trade secrets are not to be treated as a step-child, an inferior species of industrial property and as pre-empted by the federal patent law so that they can't be protected and enforced by state courts. The Supreme Court placed trade secrets on an equally high pedestal as patents and held them to be a viable alternative to patents and a perfect alternate incentive in promoting innovation, while maintaining commercial ethics, to boot.

More specifically, the Court held:

> "Certainly the patent policy of encouraging invention is not disturbed by the existence of another form of incentive to invention. In this respect the two systems are not and never would be in conflict."
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> "Trade secret law and patent law have coexisted in this country for over one hundred years. Each has its particular role to play, and the operation of one does not take away from the need for the other."
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> "We conclude that the extension of trade secret protection (even) to clearly patentable inventions does not conflict with the patent policy of disclosure."
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This last quotation is the clincher because it followed a three-way categorization of trade secrets (clearly unpatentable, of doubtful patentability and clearly patentable) and a recognition that "the federal interest in disclosure is at its peak" with respect to the third category."

In fact, the Supreme Court clearly endorsed the ownership of trade secrets and gave know-how licensing a boost. The Court recognized the "misallocation of resources and economic waste" that would result if trade secrets could not be freely licensed and ennunciated a strong federal policy favoring the sharing of trade secrets "under binding legal obligation to pay a license fee or to protect the secret" and thus foster dissemination of knowledge.

The subsequent Supreme Court decision, Aronson v. Quick Point Pencil Co., has, if anything, further strengthened the bases for trade secret reliance.

Incidentally, in a series of debates with Frank Robbins of Washington in 1979 (now published in the JPOS, October '79 issue), I relied heavily on the Kewanee case - but also on such other cases as the Dunlop golf ball case from the 7th circuit and others. The issue we debated had to do with the respective rights of the first inventor who elects to hold and use patentable subject matter as a trade secret and the second independent inventor who seeks and obtains patent protection thereon. Robbins took the view that the patentee had superior rights. I defended the trade secret owner and concluded that he prevailed and that it was possible and safer for a first inventor/trade secret owner to stand on this trade secret election inasmuch as his trade secret constituted prior art and the late-comer patentee ended up with an invalid patent. A second inventor, I opined, could obtain a valid patent only if the first inventor's work amounted to nothing more than an abandoned experiment. I also reviewed the extant literature and showed that there was an awareness that the pendulum was swinging toward recognition of the rights of the first inventor/trade secret owner as superior over those of the "Johnny-come-lately" inventor/patentee. Lastly, I pointed out that it was a curious fact that there was actually no case on the books where a first inventor/trade secret owner had been enjoined from practicing his invention/trade secret by a late-comer patentee even though there were literally scores of cases where the second inventor prevailed on the issue of priority in an interference context.

However, now we have the new CAFC with final patent jurisdiction and it appears that the pendulum has started to swing back again and trade secret license parties may be running a greater risk that the trade secret in question may not only be independently discovered by a third party but, worse yet, patented by the third party and asserted. This is something to keep in mind, e.g., in negotiating royalty rates, payment schedules, warranties, etc. in know-how licenses.

Since trade secrets may be important in a know-how license, the licensor in the first instance should guard and maintain their trade secret status. Check lists have been published on how to safeguard trade secrets and this is an area that needs no elaboration. If the licensor does not maintain strict security standards, and impose such standards on the licensee, inadvertent public disclosure or a challenge to the trade secret status are more likely to result. In this context, it is good practice, of course, to transfer only those trade secrets which, in licensor's opinion, will enable licensee to practice the technology.

As regards duration, there are two apsects to the issue: 1) restraints on use and 2) payment of royalties. From the standpoint of the licensee, it appears desirable to establish a reasonable duration for the license with either an option to renew the license if the technology is still secret or the right to continued royalty-free use of the licensed technology. In light of the Aronson and Listerine (Warner Lambert v. John Reynolds, 1960) cases, it goes without saying that a licensee whould not obligate itself to pay royalties for as long as the licensee uses the trade secrets.

With respect to use and secrecy of trade secrets after termination of the license, appropriate provisions setting forth licensee's obligations are crucial. It is clear from the case law that a provision in the license which requires the licensee to return all tangible trade secrets to the licensor and to stop using the trade secrets, at least until they enter the public domain, will be enforced. In this respect, too, there is a need to identify and specify the trade secrets involved. As regards trade secrets developed and transferred during the life of the license, again a compilation and identification is needed. A set period for return should be specified.

Ken Payne gave some key interesting hints in this respect in his monumental article on "Trade Secret Licensing" in the June/July 1979 issue of "Licensing Law and Business Report":

> "Some licensors have found it advantageous to permit the licensee to retain and continue to utilize the technology after termination. In some instances, it may be impractical from an enforcement standpoint to prohibit further use. Where such licensors have continually supplied technolgy to the licensee over the life of the license, the licensor may not have been fully reimbursed for recently received technology."

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> "To alleviate this problem, the licensor provides for diminishing royalty over the years following termination. For example, the next year after termination, the licensee may still be required to pay 60 percent of his royalty, in the next year 30 percent and finally nothing in the third year. The reduction might also be 20 percent per year over a five year period."

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> "Of course, during this period of diminishing royalties, the licensor has no obligation to supply further know-how. This technique has the interesting effect of discouraging the licensee from terminating the agreement. He still pays royalties, but gets no additional technology."

III. Pre-Negotiation Secrecy Agreements

There is an important threshold problem, namely, maintenance of secrecy during negotiations. This is crucial for the licensor since, inasmuch as a potential licensee is most unlikely to buy a "pig in the poke", he will have no choice but to disclose confidential know-how to the licensee. This is the so-called "black box" problem or dilemma, which was vividly treated at length in two articles in "Licensing Law and Business Report" (December '79 and January/February '80). The second of these articles, by the way, ends with a useful "Model Agreement".

It is in both licensor's and licensee's interest to disclose and receive only as much confidential know-how as is needed for evaluation. In the event a license is not concluded, the licensee may decide to develop the trade secrets in question independently or license from an alternative source. In such a case, the licensee is less likely to risk a law suit if the disclosure was a limited one.

While an implied-in-fact or implied-in-law confidentiality obligation may adhere in a disclosure of trade secrets, it is of course best to have an express agreement, a written pre-negotiation secrecy agreement. The reasons are well summarized in the first of the "Licensing Law" article mentioned above:

> "There is less chance of an innocent misunderstanding between the parties if the terms and conditions of the exploratory disclosure are spelled out clearly. Through a written agreement the specific area of technology to be evaluated can usually be defined with clarity and precision. Moreover the relationship of the parties can be enunciated and the purpose and confidential nature of the disclosure documented. Finally the recipient's obligations with respect to confidentiality of the disclosed technology can be fully detailed, and the parties can provide a formal mechanism for resolving any post-disclosure problems.
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> "The primary attractiveness of a written pre-negotiation secrecy agreement is that its terms and conditions can be enforced by a court according to basic contract principles. Accordingly the intent of the parties as manifested in the agreement will normally be implemented by the court. By means of their written agreement the parties can establish rights and obligations between themselves which might otherwise not obtain."

Cases have come to light where negotiations were started and disclosures elicited by putative licensees as a ruse to ferret out a competitor's trade secrets. There is also quite a list of "black box" disclosure cases in the above-mentioned article. Thus, it is important, if not essential, from everybody's point of view to have a pre-negotiation secrecy agreement to settle the parties' rights and obligations and protect the parties.

In such an agreement it is important to carefully identify and delineate the technology involved and specify the methods of disclosure. The best method of disclosure is to provide documents with approporiate legends which signify their confidential nature and their restrictive purpose. Repro-duction should be explicity prohibited and return of the documents within a stated time period required if negotiationsbreak off. Documents prepared by the recipient during evaluation could also be included in this return obligation.

Furthermore, it is important to set forth the duration of the recipient's obligation to maintain the confidentiality of the disclosed know-how. It is usually possible to estimate the probable useful life of the trade secrets involved and propose a term that will adequately protect the owner and place a reasonable limitation on the recipient. However, the recipient must negotiate provisions that remove technology from confidentiality obligations if 1) already in the public domain, 2) already known to recipient, and 3) reaches the recipient subsequently legitimately through a third party.

And hereinlies an interesting point of burden of proof. Absent a specific contractual provision allocating this burden, the owner recessarily bears the burden of proof but it is reasonable for the recipient to bear this burden as a concession for the receipt of proprietary information. The recipient is obviously in a better position than the trade secret owner to prove, e.g., that he had possession of the information before the transfer. In this respect the agreement should provide for a limited period of time after disclosure for the recipient to come forward and challenge the trade secret status, if he can.

IV. Various Key Provisions

Confidentiality, Royalties, Warranties

A confidentiality clause is clearly the alpha and omega of every know-how license. This clause provides that the licensee accepts the information disclosed in confidence and acknowledges that he is receiving proprietary information. It should recite that the licensee will use and disclose information only as expressly permitted, that the licensee will inform all employees and others granted access of the confidential nature and the attendant obligation and that the licensee will take reasonable precautions to protect the information.

The royalty is obviously negotiable (what the "traffic will bear") and should preferably be a function of the number of items sold or product produced, etc. The fixed lump sum concept can be used as well as a minimum royalty concept. I prefer a royalty payment schedule up to a certain amount of product has been produced whereupon the license becomes a paid-up proposition. This approach eliminates difficulties and pitfalls as were discussed above.

Warranties and indemnifications obviously are also negotiable. And obviously, it is in the licensor's interest to provide as narrow a warranty as possible and in licensee's interest to get as much of a warranty as it can. One warranty which a licensee should seek is that licensor has the right to license the trade secrets as well as a warranty that licensor knows of no suits or claims to the effect that practice of the trade secrets constitutes violation of law. Licensor, on the other hand, should provide it makes no warranty that practice of trade secrets does not constitute infringement of any patent. I, as a licensee, was once able to include a provision, which I was able to successfully assert later, that no further payments apart from the downpayment would be due if the technology in question turned out to be covered by a dominant patent.

Similar considerations apply of course to indemnification provisions and need not be belabored. However, the ugly head of strict product liability seems to be lurking out there. There are no cases - yet - but more and more articles predict doom, the latest being by Goldman in the December '84 issue of the JPOS, entitled "Strict Liability and Intellectual Property Licensors - Keeping Closed a Can of Worms."

V. Mixed Know-How/Patent Licenses

While this Workshop addresses know-how rather than patent licensing, there is no denying the fact that not infrequently patent rights are involved and transferred concurrently. Mixed or hydrid licenses come into existence. As a general rule, when this happens it is advisable to state the consideration separately, otherwise the royalty obligation may be held to cease on expiration of the last-to-expire patents. Such a separate statement is also of value in case the patent is held invalid.

Again, "Licensing Law and Business Report" in its November/December 1984 issue, has ploughed this area very thoroughly in an article entited "Level Royalties in Hybrid Package Licenses" with chapters on "Post-Expiration Royalties in Packge Licenses", "Level Royalties in Hybrid Package Agreements" and "Allocation of Royalties Between Patents and Know-how". A couple of quotes therefrom will serve to emphasize the problem:

> "When multiple patent and know-how or trade secret rights are transferred the agreement must be carefully drafted to ensure its enforceability after expiration of the licensed patents. The legality of the hybrid agreement comes into question when level royalties are exacted for a period beyond the expiration not the licensed patents as payment for the licensee's continued use of the licensed know-how or trade secrets. The agreement will be enforceable after expiration of the licensed patents only if there is a basis for allocation of the royalites between use of the patents and use of the know-how or trade secret rights."
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> "In most cases holding a hybrid license unenforceable, one basis has been the inability to allocate level royalties between the expired patents and the licensed know-how. It is

> impossible for a hybrid patent and know-how license to continue after expiration of the patents if there is a basis for allocating royalites between the patents and know-how."

VI. Anti-Trust Considerations

A great deal has been said and written about antitrust law and trade secret protection. I have reread and scrutinized a number of articles on this subject in preparation for this Workshop and I fail to see any serious problems or pitfalls, provided of course bona fide secrets are involved, any restraints imposed are reasonable and ancillary and no nefarious anticompetitive scheme is attempted. Thus, for instance, the use to which the licensee may put the proprietary information may be limited by field-of-use restrictions. Similarly, the territory in which the trade secret is to be employed may be restricted. Furthermore, due to the inherent nature of a trade secret, it is permissible for the licensor to require the licensee to return all material and documentation disclosing it on terminaion of the license.

Of course, the anti-trust climate has changed considerably over the past few years. Years ago it was generally believed, based on statements by Department of Justice officials, that know-how license agreements were looked on very closely. In the words of a Justice Department spokesman: "Because know-how licensing lacks the protections and legislative mandate of the patent system ... know-how licenses will in general be subject to antitrust standards which, if anything, are stricter than those applied to patent licenses". Nowadays, the nine "no-nos" of general licensing restrictions propounded earlier by the Justice Department, have become "may-bes".

VII. Conclusion

This presentation was but a brief overview, merely highlighting some of the problematic areas in the field of know-how licensing. The principles and points discussed appear - after the fact - but applications of common sense and good business judgement. But they are based on an extensive body of case law generated by lack of agreements or agreements that left something to be desired. Thus, the need for care and vigilance in negotiating and drafting pre-negotiation secrecy agreements and know-how license agreements cannot be overemphasized.

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