Reform of the technology licensing rules

David W Hull and Amy L Toro
Covington & Burling

In December 2001, the European Commission issued a report on the Technology Transfer Block Exemption Regulation (TTBER), Regulation 240/96, in which it gave the TTBER low grades in many areas and concluded that a fundamental revision was in order. This revision is underway. The Commission has circulated an initial draft of the revised TTBER to the EU Member States, and a revised proposal should be available for public review this autumn. Review of the initial draft reveals the likely direction of a new TTBER and associated guidelines (the ‘Guidelines’). As expected, the proposed TTBER is less formalistic and more focused on economic analysis than the existing one. Major changes include basing the exemption on market share thresholds keyed to whether the parties are competitors, and replacement of the black, white, and grey clause lists with a shorter list of hard-core restrictions. Because the TTBER serves as a virtual template for intellectual property licence agreements, these proposed changes have practical significance for companies doing business in the EU, particularly those in industries that rely heavily on intellectual property licensing such as pharmaceuticals, biotech, software, and hardware.

Kinds of intellectual property rights covered

The proposed TTBER covers technology transfer agreements entered into between two companies for the manufacture or provision of licensed products. It would continue to cover patent and know-how licences and would expand its coverage to include software copyright licences. Licences of other types of intellectual property (IP), including copyrights other than those for software and trademarks, would continue to be covered if ancillary to a covered licence. The Guidelines point out that the Commission would rely on the principles laid down in the Guidelines by analogy for certain forms of excluded IP (eg, mechanical reproduction copyright licences), but not for others (eg, performance copyright and trademark licences), depending on the nature and purpose of the licence.

Unfortunately, certain basic IP licences will still fall outside the scope of the TTBER. For example, although the Commission states that trademark licences should be treated as analogous to distribution agreements, basic trademark licences are not covered by any block exemption. The Commission may be correct that such licences have more in common with distribution agreements than with technology transfer agreements, and that the modernisation of the competition rules brought about by Regulation 1/2003 will improve the situation by allowing the national courts to provide individual exemptions under Article 81(3) for such licences. Yet, leaving trademark licences out in the cold remains an unfortunate gap that unnecessarily reduces the certainty afforded to trademark licensors.

Finally, the Commission has adjusted its approach to know-how licences to parallel the treatment of other IP rights. Instead of allowing exemption of such licences only for a specified time period, the proposed TTBER would allow exemption until the licensed know-how is no longer secret, or, in the event that secrecy has been compromised by the licensee, the length of the agreement.

Distinguishing between competitors and non-competitors

The proposed TTBER puts forth a new definition of competitors, which has significant consequences because the proposed TTBER treats agreements between non-competitors much more leniently than those between competitors on the grounds that the former raise fewer competition concerns than the latter. In particular, the market share threshold is lower, and the list of impermissible hard-core restrictions is longer in the case of agreements between competitors. Under the proposed TTBER, competitors are those companies that compete either in the relevant technology or product markets. For technology markets, parties are considered competitors only if they actually compete against one another. As discussed below, however, the Commission states, without explanation, that, although potential competitors are not considered competitors in technology markets for purposes of the block exemption, the Commission would consider potential competition in evaluating an agreement under Article 81(3).

In contrast to the approach to technology markets, for product markets, ‘competitors’ would include both actual and potential competitors. ‘Potential competitors’ are those that ‘would, on realistic grounds, undertake the necessary additional investments or other necessary switching costs so that they could enter the [relevant market] in response to a small and permanent increase in relative prices’. This definition is similar to the one used in the Commission’s Horizontal Guidelines, but lacks any reference to the relevant time period for entry. The Horizontal Guidelines provide that market entry needs to occur sufficiently fast so that the threat of potential entry is a constraint on market behaviour, noting that a period of one year provides an adjustable yardstick and that particular reference would be made to how long it would take for active market participants to readjust their capacities. It would be helpful if the Commission would clarify whether any factors specific to intellectual property would alter the analysis. The Guidelines make it clear that a party is not a potential or actual competitor if, absent a licence to the licensed technology, it would not be able to participate in the market without infringing the licensed IP.

Finally, the Guidelines suggest that the parties may not be considered to be competitors if the licensed technology ‘represents such a drastic innovation that the technology of the licensee has become obsolete or uncompetitive’. As the Guidelines go on to suggest, it is rarely possible to make this determination at the time that the parties enter into their agreement. If this is indeed the case, the entire discussion of the issue would not seem to be particularly useful because it seems to be little more than an extension of the general principle that the market definition may change over time.
Market share thresholds

As anticipated, the proposed TTBER includes market share thresholds, which, if exceeded, render the exemption inapplicable. For agreements between competitors, the exemption applies only if the combined market share of the parties does not exceed 20 per cent in the relevant technology and product markets. For other agreements, the exemption applies only if neither party has a market share over 30 per cent in a relevant market. The market share analysis is dynamic. For technology markets for which there are no sales of products, a zero market share is assigned, but, when sales commence, the technology will start accumulating market share. This dynamic reveals the uncertainty that will result from the use of market share thresholds. In the case of an increase in market share, a short grace period of one to two years applies to allow the parties to renegotiate the agreement as necessary. However, this protection will provide little comfort to companies licensing their intellectual property through long-term development and commercialisation arrangements.

The proposed TTBER calculates market share on the technology market based on the presence of the licensed technology on the relevant product market(s), meaning the market share in the relevant product market(s) of the contract products manufactured or provided by the licensor and its licensees. This method, as the Commission recognises, has the benefit of capturing the vertically-integrated portion of the market by including entities that are using their own technologies in their products and are therefore neither licensors nor licensees in the technology market (although such entities may enter the technology market as licensors in the event of a small but permanent increase in price for licences in such market). This methodology also makes it easier for the parties to calculate market shares than, for example, one based on a technology's total share of licensing income from royalties as sales figures are likely to be more readily available than royalty figures.

The Guidelines indicate that, outside the block exemption safe harbour, the Commission will apply the same product sales method for calculating market share in the technology market, but may also rely on a calculation based on each technology's share of total licensing income from royalties in order to obtain an accurate picture of the licensor's position in the market. Unfortunately, this dual approach may create uncertainty outside the block exemption, particularly when combined with the possible 're-qualification' of competitor status described below.

Potential competitors revisited

As discussed above, the proposed TTBER does not include potential competitors in the definition of 'competitors' in a technology market for purposes of establishing which market share threshold and list of hard-core restrictions applies. In contrast, the Guidelines provide that potential competition would be considered in cases falling outside the safe harbour, which could, according to the Commission, lead to a re-qualification of the competitive relationship between the parties. The Commission provides no reasoning for switching its approach to potential competition midstream. Apart from the logical inconsistency in applying different standards, it would seem inconsistent with the Commission's overall approach to subject agreements falling outside of the block exemption safe harbour to a stricter standard than those falling within the safe harbour.

Appropriate use of market share analysis?

While the use of blanket market share thresholds combined with a shorter list of hardcore restrictions is preferable to a long list of hardcore restrictions, market share thresholds are a blunt regulatory tool. Under the proposed TTBER, any licence to which a company with a high market share entity is a party, whether as licensee or licensor, is not exempted. This outcome is consistent with the Commission's view that it is inappropriate to exempt a licence agreement involving a dominant company. While this approach may be justifiable with respect to certain markets, it may be overly restrictive in the IP context where many licensors may be deemed 'dominant' (or may have high market shares) in a technology market simply because they possess IP rights designed to compensate them for their innovative efforts. Moreover, in rapidly-evolving technology markets, dominance can be a fleeting concept. The refusal to exempt agreements involving companies with high market shares, regardless of their content, combined with the vague and sometimes imprecise language of the Guidelines, forces dominant (or other high-market-share) companies to live with far less certainty than that afforded to companies with lower market shares.

With respect to firms with high market shares in a technology market, the analysis could benefit from analogy to the enforcement safe harbour established in the US antitrust authorities' IP Guidelines, a discussion of which the Commission included in its report. The US approach recognises some of the difficulties that may arise in applying market share analysis with respect to technology markets. Therefore, in determining whether an agreement is eligible for the safe harbour, the US antitrust agencies analyse market share only with reference to product markets (unless such analysis would inadequately address the effects of the licensing arrangement on competition among technologies or in research and development). As the US IP Guidelines explain, licensing arrangements raise concerns under the antitrust laws only if they are likely to affect adversely the prices, quantities, qualities, or varieties of goods and services either currently or potentially available, and often the competitive effects of licensing arrangements can be adequately assessed within the relevant markets for the goods affected by the licensing arrangements. In such instances, the US agencies will delineate and analyse only goods markets.

Even if analysis of a technology market is required, the US IP Guidelines allow for an alternative method of assessment in cases where market share may not accurately reflect competitive significance. This test provides that the agencies will not challenge a restraint in an IP licensing arrangement that may affect competition in a technology market if (i) the restraint is not facially anticompetitive, and (ii) there are four or more independently-controlled technologies in addition to the technologies controlled by the parties to the licensing arrangement that may be substitutable for the licensed technology at a comparable cost to the user. Thus, for example, a party with a 60 per cent market share in the technology market could still obtain the benefit of a safe harbour exemption if there were four substitute technologies available, each of which had 10 per cent of the market. As noted above, the need for this type of alternative analysis is particularly important for technology transfer agreements, where particular entities may have very high market share for a limited time period as a result of their IP protection. In addition, such an approach would not necessarily benefit only large multinational corporations. Small technology companies, which in many industries are viewed as the engines of innovation and growth, may possess IP rights desirable in particular product markets in which they do not even compete, but may have high market shares in the technology market and would therefore exceed the market share threshold. Large companies may find that conducting in-depth antitrust analyses is simply a cost of doing business, but, for smaller companies, the need to navigate the vague Guidelines in search of a template for their licence agreements may be overly burdensome.

It is likely that, as in mid-1990s, the last time the Commission proposed a TTBER based on market share thresholds, industry will complain vociferously that such thresholds would result in an unde-
IP: TECHNOLOGY LICENSING

sirable degree of uncertainty. However, in light of the Commission’s efforts to harmonise the TTBER with its other block exemptions, it is unclear whether industry will be able to hold off the Commission the second time around. To do so, the industry may have to emphasise the uniquely negative consequences of such an approach in high-tech industries.

Hard-core restrictions
As anticipated, the proposed TTBER abandons the use of the black, white, and grey lists to divide acceptable restraints from unacceptable restraints in favour of two relatively short lists of hard-core restrictions, one for agreements between competitors and the other for agreements between non-competitors. This change is welcome because it gives companies much greater freedom to structure their agreements in ways that make the most commercial sense. In some instances, however, the Commission’s approach remains stricter than economic analysis would dictate.

Agreements between competitors

Price coordination
Price fixing between competitors is hard-core and the Guidelines make clear that the Commission interprets price fixing broadly. First, any agreement between competitors that provides for cross-licensing and reciprocal royalty payments based on the sales of final products will be considered price fixing unless the agreement results in a significant integration of complementary technologies. Second, even where sufficient integration provides a justification for the cross-licence, a two-way royalty will be deemed to constitute price fixing if the parties could reasonably have chosen a less restrictive payment scheme such as a lump sum payment or a one-way payment of net royalties (unless the amount of the royalty is small enough so that it is unlikely to have a significant impact on prices). Finally, the Commission categorises as price fixing any agreement between competitors that calculates royalties on the basis of all product sales whether or not the licensed technology is used.

Output or sales restrictions
Restrictions on output and sales are also considered hard-core except that a non-reciprocal limitation on a licensee’s output is neither hard-core nor block-exempted. Rather than leaving such a limitation out in the cold so that its legal status is uncertain, it would seem preferable to exempt it if the licence agreement is within the market share safe harbour.

Market allocation
The proposed TTBER deems hard-core any ‘allocation of markets or customers’. The Guidelines make clear that the Commission will strictly interpret this requirement and apply it to (i) a cross-licence granting each party an exclusive territory to exploit the licensed technology; (ii) a non-reciprocal licence where the licensee is granted an exclusive territory and the licensor reserves another territory for itself; and (iii) an exclusive licence including a commitment from the licensor not to exploit the licensed technology itself. The Commission intends for apply these principles to apply even if the licensee remains free to use his own technology.

The Guidelines also include as a form of market allocation ‘any licence that restricts the licensee as to where ... he may sell’, but then elsewhere states that market allocation does not include a licence where ‘the licensor undertakes not to license other third parties within a particular territory’, which seems to envision licences limited to particular territories. Hopefully, the Commission will clarify this point. Finally, according to the Guidelines, a field-of-use restriction between competitors is a form of impermissible market allocation.

Exploitation of technology; limits on research and development
The licensee must have the right to use its own competing technology, and such use may not be subject to price or output restrictions or royalty obligations. In addition, the licensee must retain the right to license its own technology to third parties. Finally, both parties must be free to continue independent research and development.

Agreements between non-competitors

Price restrictions
Minimum resale price maintenance is considered hard-core, but maximum sale prices and recommended sale prices are acceptable unless they amount to fixed or minimum sale prices as a result of pressure or incentives.

Territorial, customer and field-of-use restrictions
The proposed TTBER would expand the types of territorial, customer and field-of-use restrictions eligible for block exemption. However, even in the case of non-competitors, territorial and customer restrictions are hard-core unless listed as one of the following exceptions:

- restricting a licensee’s territory to preserve an exclusive territory or customer group for the licensor;
- restricting active sales (but not passive sales) with respect to the exclusive territory or customer group allocated to another licensee;
- limiting production to products for the licensee’s own use and spare parts;
- limiting a wholesale licensee’s (but not a retail licensee’s) sales to end users; and
- restricting sales to unauthorised distributors by the members of a selective distribution system.

In addition, preventing licensees that belong to a selective distribution system and that operate at the retail level from making active or passive sales to end users is considered hard-core, although such licensees may be prevented from operating out of an unauthorised place of business.

Field-of-use restrictions between non-competitors are not hard-core, although the Guidelines note that a restriction styled as a ‘field-of-use’ restriction may in fact be a hard-core customer restriction if the restriction relates to the use made by the buyer of the product (rather than use of the technology by the licensee).

Research and development
As in the case of agreements between competitors, any restriction on engaging in research and development is hard-core unless such restriction is indispensable to prevent the disclosure of licensed knowledge to third parties. The Commission should clarify that this hard-core ban relates only to restrictions on independent research and development within the field of use, and that a licensor is free to restrict a licensee from using the licensed technology outside the licensed field of use, and in the case of subcontracting, to limit the subcontractor from using the licensor’s technology for research and development purposes.

Grantbacks of improvements
In the proposed TTBER, the Commission has largely retained a restrictive approach to grantbacks. The rules would only be loosened to the extent that non-exclusive grantbacks of improvements would no longer need to be reciprocal in order to be covered by the block exemption. The Commission’s restrictive approach to grantbacks decreases a licensor’s incentive to grant a licence in the first place because it makes it difficult for the licensor to control its tech-
Technology once it gets out of its hands. Under the current rules, a large pharmaceutical company that enters into a subcontracting agreement with a small biotech company whereby the biotech company is supposed to manufacture the product would find that, if the biotech company discovers a promising application, the pharmaceutical company can only acquire a non-exclusive licence to this application. Such outsourcing arrangements are increasingly common in the pharmaceutical and biotech industries, but, unfortunately, the proposed TTBER discourages them by threatening the licensor with the prospect of not being able to reap the full returns on its investment in its technology if it involves third parties in any phase of the development of the technology or manufacture of the products incorporating the technology.

The proposed TTBER would deny exemption to (i) assignments to the licensor of any improvements or new applications of the licensed technology; and (ii) exclusive grantbacks of severable improvements and new applications. This is similar to the approach of the existing TTBER, which lacks clarity in this area. It would be desirable for the Guidelines to define the term ‘severable’ and to explain whether the language ‘new application of the licensed technology’ has any independent meaning distinct from ‘severable improvements’. If ‘new applications’ does not add anything, the Commission should consider dropping this reference and relying solely on the language of improvements, which is grounded in IP law. Finally, it is difficult to see a justification for distinguishing between ‘severable improvements’ in the case of exclusive grantbacks and ‘improvements’ in the case of assignments because, as the Commission recognises, there may be no economic difference between an exclusive licence and an assignment.

Finally, the Commission should allow the exemption of exclusive grantbacks below the market share thresholds. This approach would be more consistent with that taken in the US IP Guidelines, which do not exclude grantbacks from the benefit of the safe harbour. In addition, more closely following the US approach in applying Article 81(3) would greatly assist high-tech industries by providing greater certainty. In particular, the Guidelines could specify the conditions under which grantbacks are most problematic. The US IP Guidelines provide more helpful guidance by focusing on the harms that may arise with respect to the licensee’s incentives to engage in research and development and thereby limit rivalry in innovation markets, noting that a particularly relevant factor is the licensor’s market power in the relevant technology or innovation market. In addition, the US IP Guidelines acknowledge the importance of considering the pro-competitive effects that may result from allowing a licensor to include exclusive grantback provisions. These include (i) promoting dissemination of licensees’ improvements to the licensed technology, (ii) increasing licensors’ incentives to disseminate the licensed technology, (iii) otherwise increasing competition and output in a relevant technology or innovation market, and (iv) increasing licensors’ incentives to innovate in the first place. All of these factors are important, particularly in the biotechnology and pharmaceutical industries, where exclusive licensing of technologies along with careful allocation of subsequently developed technologies between the parties provides the engine that drives the development and commercialisation of new products.

**Tying**

Tying is block-exempted if it falls within the market share safe harbour, with the Commission noting that the market share thresholds apply to any relevant technology or product market including the market for the tied product. The Guidelines explain that, absent market power in the tying market, the licensor cannot use its technology for the anti-competitive purpose of foreclosing suppliers of the tied product, and the tie must cover a certain proportion of the market for the tied product for foreclosure to occur. In addition, the Guidelines recognise potential efficiency gains from tying, including enforcing quality standards and achieving technically satisfactory exploitation of the licensed technology.

**Non-compete obligations**

Within the market share safe harbour, non-compete obligations (defined by the Commission as an obligation on the licensee not to use third-party technologies) are also exempted. The Commission acknowledges various pro-competitive effects of non-competes, including promoting the dissemination of technology by reducing the risk of misappropriation of know-how, ensuring that the licensee has an incentive to invest in and exploit the licensed technology effectively, and compensating a licensor that has made client-specific investments in training and tailoring its technology. The Guidelines note, however, that minimum output or royalty obligations or upfront lump sum payments (alternatives that will need to be considered by parties ineligible for the block exemption) may be equally pro-competitive yet create less risk of foreclosure. In addition, the Guidelines warn that non-compete obligations relating to de facto industry standards may prevent the development of new and improved technologies and standards.

**Blocking patents, patent settlements and patent challenges**

In a world of interlocking patents, a party may find that it is unable to use its technology without infringing upon the patent of another party (a one-way blocking position), or in some cases, two parties may have patents that block each other from using their respective technologies (a two-way blocking position). The Commission is sympathetic to the difficulties that such overlapping intellectual property can pose. Nonetheless, it expresses great concern that, if such relationships were given special status under competition laws, the parties would feign a blocking relationship in order to engage in anti-competitive practices. Thus, the Commission will give careful scrutiny to determine whether a blocking relationship in fact exists, relying on objective factors and independent experts.

In theory, if a blocking position is established, the parties are not considered competitors. However, the Commission takes a strict approach to the cross-licensing of blocking patents. First, the Commission applies the hard-core restrictions applicable to competitor agreements to any patent settlement of blocking patents without consideration of the actual competitive position of the parties. This approach seems unduly harsh. Even parties that do not compete against one another would be prevented from including standard vertical restraints such as territorial and field-of-use limitations.

Second, the Commission assumes that ‘simple cross-licensing without any restraints’, either royalty-free or with a one-way royalty, is sufficient to end a patent dispute relating to blocking patents. However, if parties do not compete, they should be free to use a two-way royalty, which can better capture the value and use of the technologies over time.

**Multiparty licences**

The Commission opted not to include multi-party licences, such as patent pools, in the TTBER (which would have required a revision of Council Regulation No. 19/65). According to the Guidelines, however, the TTBER covers licences between a patent pool and individual licensees, which should provide some comfort. In addition, the Guidelines discuss patent pools, albeit in a somewhat confusing manner. The Guidelines put forth two important principles: (i) pools of ‘essential’ patents (each of which is necessary to implement a de facto or de jure industry standard) fall outside of Article 81(1); and (ii) pools of competing patented technologies
The European Antitrust Review 2004

The European Antitrust Review 2004

Notes


Conclusion

Overall, the proposed TTBER is a vast improvement over the existing TTBER. It will make life easier for companies with market shares below the applicable thresholds. To qualify for the block exemption, such companies will need only to avoid certain prohibited clauses. In contrast, companies with significant market shares will need to undertake their own competition law review of their agreements.

Clear guidelines would assist all companies, particularly small companies that may be less familiar with competition law principles, in applying Article 81(3) to their IP agreements. Thus, the proposed Guidelines could become an important tool for antitrust counsellors and national courts and competition authorities (which, in light of the recent modernisation programme aimed at decentralising enforcement of the EU competition rules, will become increasingly responsible for the day-to-day application of these rules). As presently drafted, however, the Guidelines lack clarity in a number of areas, which creates the risk of uncertainty for businesses, a risk that could be compounded by fragmented application at the national level.

Notes