



Licensing in the Boardroom 2007

Patent sub-licensing developments: implications for patent licence drafting
Kelley Drye & Warren

A supplement to *Intellectual Asset Management* magazine
www.iam-magazine.com

iam

Patent sub-licensing developments: implications for patent licence drafting

By **David R Yohannan, Thomas Gilbertsen, Joanna Baden-Mayer** and **Stephen Freeland**, Kelley Drye & Warren, Washington DC

Over the past few decades, businesses have come to regard intellectual property not only as protection for their own products and manufacturing methods, but also as a powerful tool to secure competitive advantages in the marketplace and as an income-generating asset in its own right. For smaller research and development firms, licensing intellectual property is often the company's sole source of meaningful revenue. Even for larger manufacturers, patent licences can be lucrative and are frequently used to gain access to competitive technology via cross-licensing arrangements. Lawyers drafting these licences are charged with carefully defining their scope and vigorously policing those boundaries thereafter.

This article deals with a phenomenon that may become prevalent as access to intellectual property becomes more critical to market entry and survival: licence work-around arrangements. Assume that Acme Intellectual Property Partners develops valuable patents for the next generation of widgets, and thereafter enters a non-exclusive licence with Ted's Widget Company to make, use, sell or have made widgets utilising this new patented technology. It later emerges that Ted's Widget is unable to make the most of Acme's patented technology. When other widget manufacturers express interest in the new technology, the creative managers at Ted's Widget realise that they may instead serve as a second, lower-cost source for the intellectual property necessary to produce the new products.

But there is one problem: a non-exclusive

patent licence may prohibit the licensee from granting sub-licences to others as a matter of law. By granting only a non-exclusive licence, the licensor is expressing its intent to license the same technology to others in the future – a right that would be destroyed if the licensee were allowed to sub-license the same patents to others. So Ted's Widget Company cannot simply sell and extend sub-licences to Acme's patents; something more nuanced is required for the Ted's Widget managers to realise their questionable goals.

In an increasing number of cases, creative licensees are becoming adept at crafting arrangements to try to circumvent patent licence prohibitions against sub-licensing. The motivation for doing so is usually the licensee's desire to capture rents that are otherwise unavailable due to the licensee's own production constraints, or a simple inability to practise the licensed technology.

In one case, a non-exclusive licensee was already operating at capacity when a prospective customer approached it with an offer to buy substantial requirements for the patented product. Unable to fill the order, the licensee tried to avoid a sub-licensing prohibition by entering a toll conversion/buy-back arrangement whereby the unlicensed customer made the patented product and sold it to the licensee, only to buy the same product back again once it had been baptised by the licensee's right to have a third party make the licensed product for the licensee. In another case, a licensee was simply unable to capitalise on the licensed technology and was approached by somebody that could. Through a series of complicated consulting, supply and distribution agreements, the two worked out pass-through arrangements that attempted to put a licensed glaze on the end-products. In both situations, federal courts ruled that the arrangements constituted unlawful sub-

licences that warranted termination for material breach.

In a case earlier this year, in which the authors participated, a non-exclusive licensee attempted to extend its licence to its joint venture partner by crafting the joint venture entity to look like a subsidiary of the licensee, all the while operating like a 50-50 joint venture. Like other federal courts faced with similar work-around arrangements, the Western District of Texas rejected the joint venture's corporate fiction. The court ruled that the attempted pass-through constituted an unlawful sub-licence, justifying the patent licensor's termination of what had previously been a perpetual and fully paid-up licence. That judgment is now on appeal before the Fifth Circuit.

The Dupont case: selling what could not be bought

In *E I DuPont de Nemours and Co v Shell Oil Co*, Shell had taken a non-exclusive licence from DuPont to manufacture and sell a patented insecticide, methomyl (the DuPont licence). The DuPont licence expressly prohibited Shell from sub-licensing the patents. A few years after that licence was executed, Union Carbide was looking for a ready supply of methomyl for a new product it had developed; it approached Shell about a licence to manufacture the chemical. When Shell told Union Carbide that it did not have the right to sub-licence, Union Carbide investigated the possibility of buying its methomyl requirements from Shell, but concluded that Shell lacked sufficient production to meet those needs. Shell then proposed a toll conversion/buy-back arrangement whereby Union Carbide would make methomyl for Shell under the latter's have-made rights in the DuPont licence; Shell would then immediately sell the methomyl back to Union Carbide under the DuPont licence's sell for use or resale rights. When Union Carbide ultimately agreed to that arrangement, DuPont swiftly reacted with a suit to bar it.

At trial, DuPont presented undisputed facts that the Shell/Carbide arrangement was drafted with the specific intent to avoid the DuPont licence prohibition on sub-licensing and "to withstand scrutiny of a court" while mimicking a "good faith exercise" of Shell's rights. However, the trial court found that the Shell/Union Carbide arrangement did not constitute a sub-licence violating the DuPont licence. On appeal, the Supreme Court of Delaware reversed the trial court and directed entry of partial

judgment in favour of DuPont, recognising that "[a] nonexclusive patent license conveys certain indivisible rights under the patent, which are personal to the licensee", and that by operation of well-accepted contract principles, "these rights are not susceptible to sublicensing, unless specific permission is given". The court found that the DuPont licence provision expressly preventing Shell from sub-licensing its rights "underscored" the importance to the parties of what the law already prohibited.

The Delaware Supreme Court then considered and decided the key issue: "Whether the toll conversion/sale-back arrangement between Shell and Carbide, in effect, amounted to a 'sublicense.'" In our view, such arrangement did constitute a sublicense in violation of the License Agreement." The court held that: "It is the overall effect of such Agreements, rather than their precise label, which will determine whether such an arrangement amounts to a sublicense." Recognising that the touchstone of a sub-licence is "whether the production is by or for the use of the original licensee or for the sublicensee himself or for someone else", the court found that the Shell/Carbide arrangement "did amount to a sublicense because, ultimately, Carbide was producing methomyl, not for Shell, but rather for itself".

The Delaware Supreme Court concluded: "What we have here is a situation wherein Shell is assuming the posture of a middleman solely to by-pass the prohibition against sublicensing by virtue of some neatly tailored drafting. We cannot countenance such legerdemain whereby Shell sought to free itself from the contract language by which it agreed to be bound under the License Agreement with DuPont."

The *Dupont* case was one of the first cases of this type of which the authors are aware; however, it is not the lone case controlling this issue in the law. The increasing importance of patent licensing has resulted in more licensees attempting to circumvent sub-licensing restrictions through more and more inventive means.

The Boston Scientific case: a sub-licence disguised in pass-through clothing

Another case involving similar facts is *Cook Inc v Boston Scientific Corp*. Here, a Canadian corporation called Angiotech entered into an exclusive licensing agreement with Cook and Boston Scientific, granting co-exclusive rights for both companies to "use, manufacture, have

manufactured, distribute and sell” certain patented stent products and endoluminal delivery devices (the Angiotech licence). None of the parties were permitted to assign rights under the Angiotech licence without prior written consent of the other two. Four years after entering the licence, Cook executed a complex series of supply and distribution agreements with Advanced Cardiovascular Systems Inc (ACS) that effectively sub-licensed Angiotech’s patents to ACS.

The first of these agreements provided that ACS would act as the exclusive distributor for the patented stent product manufactured by Cook. ACS and Cook also executed a supply agreement, under which ACS would supply Cook with certain components that were necessary to make the patented stent products. A development agreement required ACS and Cook to collaborate on testing, clinical trials and regulatory approval of the patented product. Indeed, Cook, in breach of the Angiotech agreement, illegally delegated to ACS its obligation under the agreement to obtain regulatory approval for the stents. A separate distribution agreement provided that Cook would act as a non-exclusive distributor for stent delivery systems manufactured by ACS. Finally, the parties cross-licensed patents that each held.

Boston Scientific learned about Cook’s arrangements and sent a letter charging that the Cook-ACS association violated the Angiotech licence. Cook immediately filed suit for a declaratory judgment that it was not in breach of the Angiotech licence and Boston Scientific counterclaimed for breach of contract, and breach of the covenant of good faith and fair dealing. On cross motions for summary judgment, the Northern District of Illinois relied extensively on the *DuPont* decision in ruling that the Cook/ACS arrangements were: “A transparent attempt to draft around the limitations clearly expressed within the Angiotech Agreement.” The court stated: “Although the pass-through nature of the ACS deal is more skillfully hidden than was the case in *DuPont*, the arrangement is no less of a sham.” The court found that the “five agreements, like the two contracts in *DuPont*, combine into an attempt to circumvent the restrictions of the original license from Angiotech.” The court also recognised that: “For ACS to step into Cook’s shoes and distribute the licensed applications ... does not involve an exercise of Cook’s rights under the license; rather it would necessitate a grant of those rights to ACS, which could only take the form of a prohibited assignment.”

Granting summary judgment to Boston Scientific, the court held that Cook’s conduct constituted a breach of contract at the point of the unauthorised assignment: “What Cook has attempted to do here is to grant a *de facto* sublicense to ACS or assign to it substantial rights it enjoys under the Angiotech Agreement. These attempts are neither authorized, permitted, nor lawful. Cook’s attempts to separate various functions between it and ACS ... are nothing more than a sham. As such, its actions cannot be countenanced.”

The Nano-Proprietary case: a third attempt

In the most recent case of this type, *Nano-Proprietary Inc v Canon Inc*, the well-known Japanese camera and copier manufacturer took a non-exclusive licence to certain of Nano-Proprietary’s patents in field emission display (FED) technology. Thereafter, Canon entered a joint development agreement with Toshiba to research whether FED technology could be used in a new generation of flat panel display televisions.

In 2004, Canon and Toshiba created a joint venture called SED Inc to begin manufacturing the new televisions. In an attempt to qualify SED Inc as a Canon subsidiary entitled to practise under the patent licence at issue, Canon and Toshiba agreed that Canon would own one additional share in the joint venture, ostensibly to have control over it. It was discovered, however, that Canon and Toshiba had agreed separately that Canon would not exercise the control that would have normally flowed from its ownership of a majority of the shares in the joint venture. The US District Court for the Western District of Texas found that SED Inc, with one additional share being held by Canon combined with a surrender of the control attendant to that share, was not a subsidiary of Canon and thus was not licensed. The attempt to disguise SED Inc as a licensed subsidiary was held to amount to an effective sub-licence from Canon to the joint venture in violation of the patent licence with Nano-Proprietary. The violation was severe enough to qualify as a material breach of the patent licence which resulted in Nano-Proprietary terminating Canon’s licence, thereby leaving both Canon and the joint venture, SED Inc, unlicensed.

A few lessons

These cases present a cautionary tale for those who draft non-exclusive patent licences and those who become dissatisfied with their constraints. It is important to

realise the fundamental purpose of a non-exclusive licence: the licensor's intent to provide a limited right only to the licensee, while retaining the right to license all others under the same patents. In most of these matters, so-called have-made rights were exploited to circumvent prohibitions against sub-licensing. In the more recent *Nano-Proprietary* case, a joint venture's structure was manipulated to bring the entity within the patent licence's subsidiary definition. One hallmark of each case: a product

covered by the licence was being made and sold by an unlicensed entity under the auspices of the non-exclusive licensee.

As these types of arrangements become "more skillfully hidden", to use the words of the Northern District of Illinois, the burden falls on drafters to emphasise the non-exclusive licence being granted and provide that the manipulation of have-made rights or other stream-of-commerce provisions will not defeat the fundamental purpose of the licence: no other producers shall be licensed.



Kelley Drye partner David Yohannan represents a wide variety of clients, ranging from Fortune 50 companies to small start-ups. He counsels and represents clients in connection with state, federal and administrative litigation, involving patent, trademark and consumer protection issues. He provides clients with opinions of counsel regarding the validity and infringement of patents and trademarks. He also advises clients in structuring patent licensing programmes, including the negotiation and drafting of licence agreements and establishing royalty structures.

David R Yohannan

Partner

Email: DYohannan@KelleyDrye.com

Tel: +1 202 342 8616

Kelley Drye & Warren LLP

USA

www.kelleydrye.com



Thomas Gilbertsen is a partner with Kelley Drye's Litigation Practice Group. He serves as lead counsel to major consumer product and service companies in intellectual property, antitrust, false advertising and consumer class action litigation. Mr Gilbertsen has appeared in over 40 federal and state courts across the nation, as well as before the Federal Trade Commission and International Trade Commission. He earned his JD from Cornell.

Thomas Gilbertsen

Partner

Email: TGilbertsen@KelleyDrye.com

Tel: +1 202 342 8505

Kelley Drye & Warren LLP

USA

www.kelleydrye.com



Joanna Baden-Mayer is an associate with Kelley Drye's Litigation Practice Group. Ms Baden-Mayer's practice focuses on civil litigation and consumer product safety matters. She has extensive experience counselling clients concerning compliance with the Consumer Product Safety Act and other statutes regulated by the US Consumer Product Safety Commission. Ms Baden-Mayer earned her JD from Washington University.

Joanna Baden-Mayer

Associate

Email: JBaden-Mayer@KelleyDrye.com

Tel: +1 202 342 8548

Kelley Drye & Warren LLP

USA

www.kelleydrye.com



Steve Freeland is an associate with Kelley Drye's Litigation Practice. He has experience preparing direct and cross-examination outlines, assisting in the preparation of opening and closing arguments, preparing witnesses, and designing and presenting electronic trial presentations. He earned his JD from George Mason University in 2006, where he graduated with the distinction of magna cum laude.

Stephen Freeland

Associate

Email: SFreeland@KelleyDrye.com

Tel: +1 202 342 8635

Kelley Drye & Warren LLP

USA

www.kelleydrye.com

Kelley Drye & Warren LLP

Washington Harbour, Suite 400
3050 K Street, NW,
Washington DC 20007-5108, USA

Tel +1 202 342 8400

Fax +1 202 342 8451

Web www.kelleydrye.com

Other offices New York, Chicago, Stamford, Parsippany, Tysons
Corner, Brussels, Mumbai (affiliate – independent office)