

Managing punitive damages risks in licensing transactions

Even the simplest of licensing transactions can come unstuck in the event of a dispute further down the line. The recent *City of Hope v Genentech* litigation illustrates some of the potential hazards that can arise

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The negotiation of technology and patent licensing agreements is not ordinarily considered to be the type of business transaction likely to involve a punitive damages award in the event of a future dispute. However, depending on the nature of the deal and the parties involved, this is actually a very real possibility in the event that a disagreement arises over the terms of the licence and the parties' obligations under such a contract.

The recent litigation between City of Hope National Medical Center in Los Angeles, California and Genentech is one example of the potential business risk that can be involved in an otherwise straightforward licensing transaction. The case also illustrates the need for a focus on the possibility of such a dispute and potential claims for punitive damages as part of a breach of contract lawsuit, and the management of that risk, both at the time the terms and conditions are being negotiated and when drafting the licensing agreement.

City of Hope v Genentech

In June 2002, after a jury trial, the City of Hope National Medical Center in Los Angeles, California obtained a judgment against Genentech, Inc in a lawsuit for breach of a licensing agreement. The jury awarded City of Hope more than \$500 million in damages, including \$200 million in punitive damages on the theory that the licensing agreement created a fiduciary relationship between City of Hope and Genentech.

The judgment was entered after a second trial; a first jury trial ended with the jury deadlocked by a seven-to-five vote favouring Genentech. At the retrial, the jury found that Genentech had breached the contract with City of Hope, breached its fiduciary duty to City of Hope and acted with fraud and malice, and awarded compensatory damages of \$300,164,030 (the amount City of Hope had claimed as unpaid royalties) and \$200 million in punitive damages, which the California State Court of Appeal affirmed.

Genentech appealed to the Supreme Court of California, which affirmed the compensatory damages award but set aside the punitive damages award. That court found that because punitive damages cannot be awarded for breach of a contract under California law, and because no fiduciary relationship was created between the City of Hope Medical Center and Genentech, the court was required to set aside the jury's award of \$200 million in punitive damages to City of Hope. The court found that the primary issue was whether, as the jury found, a fiduciary relationship necessarily arose when City of Hope, in return for royalties, entrusted its confidential technology to Genentech to be developed, patented and commercially exploited. Since the court concluded that no such relationship had been created, that conclusion invalidated the jury's punitive damages award, which was based on City of Hope's tort claim for breach of fiduciary duty.

The licensing negotiations

In the mid-1970s two City of Hope scientists, Dr Arthur Riggs and Dr Keichi

Itakura, developed a process for genetically engineering human proteins. By 1976 they had prepared a confidential National Institutes of Health grant application. At that time, Dr Herbert Boyer, a genetic engineering scientist who had previously worked with Riggs and Itakura, contacted Riggs and learned of the Riggs-Itakura process. At about the same time, Boyer and venture capitalist Robert Swanson incorporated Genentech to commercially exploit biotechnology. Swanson became Genentech's president and in May 1976 he sent City of Hope a funding proposal that would allow Genentech to use the Riggs-Itakura process to synthesise somatostatin and insulin, and to secure any patents that would be necessary for commercialisation. Discussions then followed between Swanson and City of Hope's patent attorney concerning a possible licensing agreement.

In June 1976 City of Hope sent Swanson and Genentech's patent lawyer a summary of an agreement. They later met to discuss contract issues and in July Genentech sent City of Hope a draft of an agreement that Genentech had prepared. A cover letter sent with the agreement explained that in Article 6.01 of the draft, the royalty rate to be paid to City of Hope had been intentionally left blank because Genentech was considering City of Hope's proposal of a 2% flat royalty rate. After the parties discussed this draft, Genentech sent City of Hope a second draft agreement with a cover letter stating that Article 6.01 now included sales by Genentech's affiliates and provided for the payment of a 2% royalty to City of Hope. In both drafts, Article 6.09 stated that if Genentech granted any licences, it would pay to City of Hope the same royalty that City of Hope would receive if Genentech itself were to carry out the licensed activities.

The licence agreement

In August 1976 Genentech and City of Hope executed an agreement. The signed contract stated as follows:

- Genentech was to manufacture and sell polypeptides.
- To do so, it required synthetic DNA which coded for the production of a particular polypeptide when incorporated in a bacterial or other plasmid.
- City of Hope had laboratory facilities with personnel qualified to synthesise DNA for selected polypeptides.

- Genentech would provide funding for that process and would use the resulting DNA in the manufacture of polypeptides.
- Genentech would secure and hold patents that might result from that work.

The signed contract also stated, as agreed during the negotiations, that for five years Genentech would pay City of Hope a royalty of 2% of its sales of polypeptides using DNA synthesised by City of Hope, whether or not Genentech obtained any patents on the work. After that, Genentech was obligated to pay royalties only if the manufacture, use or sale would infringe an issued Genentech patent. The contract also specified that if Genentech licensed the patents or recovered damages for infringement, then it would collect and pay the same royalties to City of Hope. In an October 1980 prospectus for a public stock offering, Genentech confirmed its obligations to pay royalties to City of Hope "contingent upon the existence of one or more patents arising from the funded research which would, but for Genentech's ownership of the patent(s), be infringed by the activities underlying the royalty payment". The contract also expressly stated that it did not create an agency, joint venture or partnership relationship between City of Hope and Genentech; in contrast, the parties agreed that City of Hope's relationship was that of an independent contractor.

The dispute

The collaboration between Genentech and City of Hope was a success, and Genentech obtained a significant number of patents and granted licences to various companies, including Eli Lilly, Hoffman-La Roche, Monsanto and Boehringer-Ingelheim. Genentech advised City of Hope about the Lilly licence, but did not tell City of Hope about the other licences it had granted. City of Hope received more than \$300 million in royalties on the sales by Genentech and its licensees of somatostatin, insulin and another hormone that used DNA synthesised by City of Hope, but received no royalties on sales of other products based on the Riggs-Itakura process that did not use DNA synthesised by City of Hope.

In October 1986 City of Hope requested a list of all products that Genentech produced using any methods of genetic engineering or replication of DNA provided

to Genentech by City of Hope, as well as a list of companies that Genentech had licensed. Genentech eventually sued Lilly for patent infringement and in December 1994 the parties settled the lawsuit, with Lilly agreeing to pay Genentech about \$145 million and a 6% royalty on future sales of human growth hormone. City of Hope then asserted that under its contract with Genentech, it was entitled to 2% of Genentech's \$145 million patent infringement settlement with Lilly, as well as a 2% royalty on Lilly's future sales of human growth hormone. After initially rejecting City of Hope's claim, Genentech agreed to pay \$3 million and a 1.75% royalty on Lilly's future sales of human growth hormone.

In 1998 Genentech settled a lawsuit it had brought against Novo Nordisk for infringing the Riggs-Itakura patents for \$20 million. In August 1999, after Genentech rejected City of Hope's claim for a share of that settlement, City of Hope brought its suit against Genentech.

City of Hope's breach of fiduciary relationship claim

On appeal to the California Supreme Court, Genentech argued that no basis existed for the jury's punitive damages award because no fiduciary relationship arose from its contract with City of Hope. The court agreed, noting that there was no indication in the agreement between City of Hope and Genentech that Genentech had entered into the relationship with the view of acting primarily for the benefit of City of Hope.

The court specifically noted the following:

- The agreement envisioned a mutually beneficial relationship between the parties, expressing Genentech's desire to acquire synthetic DNA from City of Hope for the purpose of manufacturing and selling certain polypeptides.
- City of Hope would receive funding from Genentech to conduct the DNA synthesis

work and would earn royalties from Genentech's sales.

- Genentech would have exclusive ownership of patents and other proprietary property stemming from City of Hope's work under the contract.
- Genentech had the right to assign and transfer its contractual rights, including patents and patent licences.

The court found these statements in the parties' contract to be an indication that the common goal was to achieve an equally valuable affiliation, not that Genentech had undertaken a fiduciary obligation to act on behalf of and for the benefit of City of Hope. The court further noted that nothing in the contract indicated that Genentech was to subordinate its interests to those of City of Hope or that Genentech knowingly undertook the obligations of a fiduciary.

Licensing strategies

What lessons can be learned from *City of Hope v Genentech* that can be applied to technology and patent licensing transactions?

The California Supreme Court's opinion notes that under California law, an agreement to develop, patent and commercially exploit confidential technology in exchange for the payment of royalties did not, without more, impose a fiduciary obligation on one party to act on behalf of and for the benefit of another party. The court noted that under California law, the only relationships imposing that obligation are joint ventures, partnerships and agencies. The City of Hope-Genentech licence clearly stated that the parties' relationship was none of these – it rather confirmed that City of Hope was an independent contractor.

The court also pointed out that factors significant to the determination that no fiduciary relationship had been created under California law were that both City of Hope and Genentech were sophisticated



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parties, had substantial bargaining power and had been represented by counsel. In addition, the contract stated that in return for the payment of royalties to City of Hope, Genentech was to be the sole owner of patents it would obtain for City of Hope's discovery of synthetic DNA, and that Genentech could assign and transfer its contractual rights and the patents.

At the very least, one observation that can be drawn from the *City of Hope* dispute is that attention should be paid to licence agreement provisions addressing issues such as the particular state law that will be applied to contract interpretation and that will govern the resolution of disputes under a licensing contract. Equally important are terms and conditions that specify the venue in which disputes will be litigated,

that acknowledge the parties retained and were represented and advised by legal counsel before entering into the agreement, and that define the relationship between the parties. Very often most attention is directed to the specific business and licensing provisions involved, and issues such as those that arose in *City of Hope* become secondary and even tertiary considerations during negotiations and when drafting the licensing contracts.

Parties to licensing transactions need to focus on and consider issues that might arise out of future disputes before entering into such relationships, during the negotiation of terms and conditions extending beyond the specific business and licensing provisions, and before finalising contracts that involve the licensing of technology developed by others.