7

Exclusive Licenses

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One of the fundamental attributes of any intellectual property (IP) license is whether it is exclusive or nonexclusive. The principal distinction between an exclusive and a nonexclusive license is the extent to which the licensor may grant third parties licenses covering the same scope as the original license. An exclusive licensor relinquishes the right to license its IP again, while a nonexclusive licensor retains it.

Exclusivity need not be absolute. Often, the scope of a licensee's exclusivity is limited to a particular field of use, territory or time period, and may include any number of qualifications and restrictions. Figure 7.1 illustrates the complex network of exclusive rights that can be granted with respect to subfields within a broadly applicable technology such as CRISPR-Cas9 gene editing.

In addition, if specified in an agreement, a licensor can expressly authorize one or more additional parties to operate in a manner that overlaps with the rights granted to its exclusive licensee (in which case the licensee is termed a "co-exclusive" licensee). In some situations, the licensor itself may wish to continue to operate under the rights granted to an exclusive licensee, though it commits not to grant licenses to others. In these cases, the licensee is often referred to as a "sole" licensee.

Finally, exclusivity need not last forever. In some cases, a limited exclusive "head start" period of six months, one year or some other term can be offered to a licensee. In other cases, exclusivity may be offered initially, but may convert to nonexclusivity if the licensee fails to meet specified "milestone" targets, such as annual sales volume or progress toward regulatory approval. In still other cases, the licensee may be required to make periodic payments to maintain exclusivity.

The samples that follow illustrate some of the permutations that can exist with respect to exclusive, co-exclusive and sole licenses. As you review these samples, consider the business motivations that would drive each party to push for, or resist, such structures.

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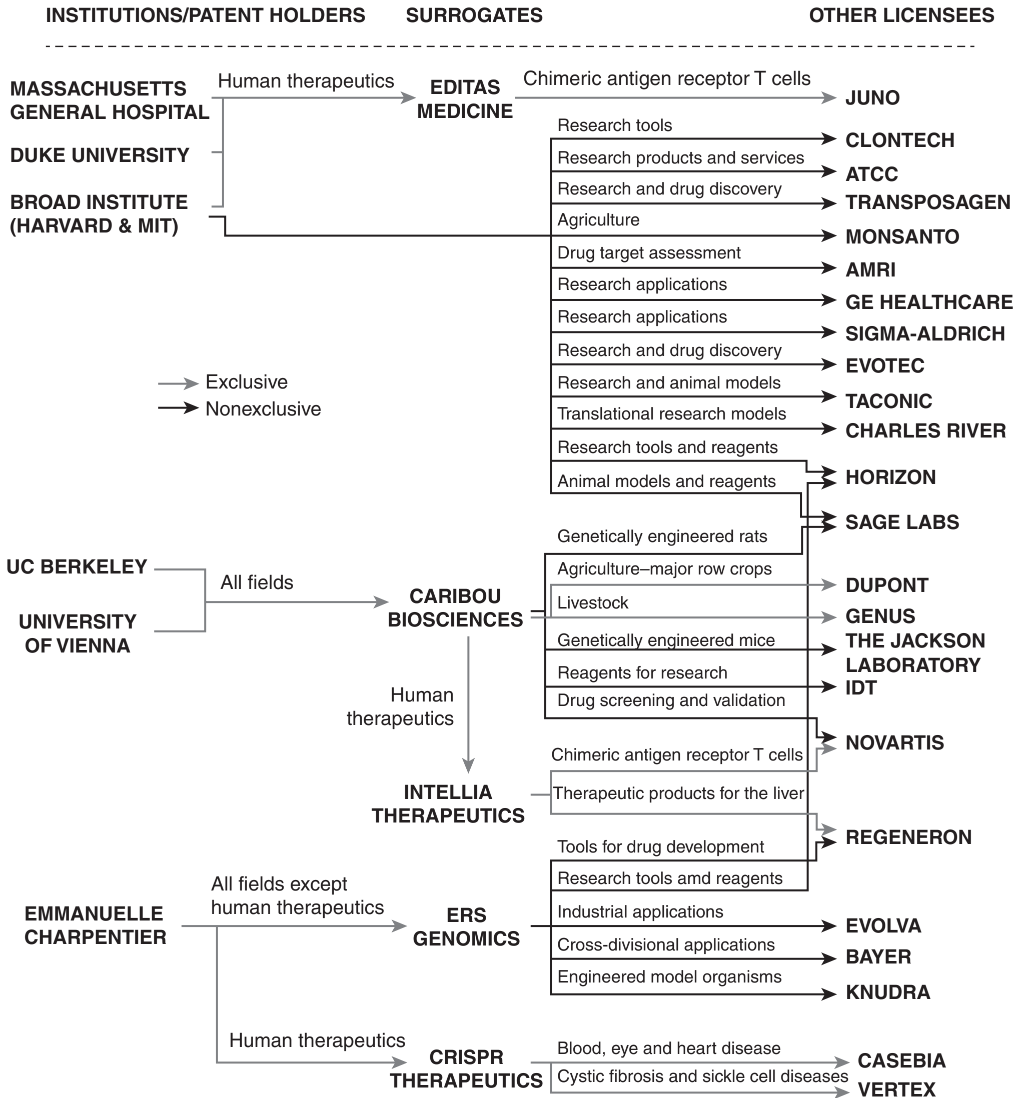

FIGURE 7.1 The complex, multi-tiered exclusive and nonexclusive licensing structure for CRISPR-Cas9 gene editing technology as it existed in early 2017.

SAMPLE EXCLUSIVE LICENSE GRANTS

Licensor hereby grants to Licensee the exclusive right and license:

a. to make, use, sell, have sold and import Licensed Products in the Territory;
b. to translate the Licensed Work into the Portuguese language and to reproduce and distribute such Portuguese translation in the Territory;

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c. to reproduce and display the Licensed Mark on Authorized Apparel Products for sale and distribution throughout the world, and in connection with their advertising and marketing;
d. to conduct research, develop and make therapeutic products targeting the XYZ Gene which are covered by the Licensed Patents, expressly excluding the right to sell, have sold or distribute such products on a commercial basis;
e. to operate one or more barbeque restaurants in Harris County, Texas under the Licensed Marks, which exclusivity shall be subject to Licensor's (or its assignee's) operation of its original barbeque restaurant on Kirby Drive under the Licensed Marks;
f. to make, have made, use, sell, have sold and import semiconductor chips covered by the Licensed Patents on a worldwide basis for a period of one year, after which such license shall remain exclusive only in countries in which Licensee's Net Revenues from the sale of such semiconductor chips exceeds $10 million in the immediately preceding calendar year.

7.1 EXCLUSIVITY: RATIONALES AND POLICY

Why would an IP owner grant a particular licensee exclusive rights with respect to that IP? After all, the IP owner is giving up a lot when it grants an exclusive license. What commercial factors make up for the loss of control ceded by the IP owner granting an exclusive license?

One set of reasons that an IP owner may wish to grant an exclusive license relates to the relationship that the licensor wishes to build with its licensee. A single exclusive licensee can be viewed as a privileged business partner with respect to a particular geographic market or product category, and the existence of only one licensee in this territory/category may enable closer cooperation and knowledge sharing between the licensor and licensees. For example, it is not uncommon for regional distribution relationships to be exclusive, so that an Italian wine producer may appoint different exclusive distributors of its products in the United States, the EU, Australia and South America. In each jurisdiction, a distributor would be chosen based on its skill, experience, commercial network, reputation and relationship with the manufacturer. Granting all rights in a particular jurisdiction to a single exclusive licensee enables that licensee to obtain necessary import clearances, develop distribution channels, produce advertising and the like. Were multiple distributors permitted in each territory, no single distributor would have as great an incentive to produce marketing or advertising to promote the products (as the others would benefit as "free riders").

Another important consideration in determining whether to grant an exclusive license arises in connection with what the licensee will be expected to do in order to bring the licensed product or technology to market. If the licensee will simply be reselling a packaged commodity product, such as a nationally recognized snack food or software application, then it must make relatively few investments in order to successfully exploit its license rights, and a nonexclusive license may be appropriate. But if the licensee will be expected to make significant investments either in product or market development, then it may be unwilling to make those investments unless it is guaranteed that it will not have competitors in the relevant market, at least for some time period (and at least not authorized by the same licensor). For example, exclusive licensing is common in the biopharmaceutical industry, where universities and biotech companies routinely license early-stage discoveries and technologies to pharmaceutical developers on an exclusive basis, with the understanding

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that the licensee will be required to devote significant additional effort and resources to finalizing any product suitable for commercial use, and will then be required to conduct costly and time-consuming clinical trials necessary to obtain regulatory approval for the product. Without the promise of exclusive rights to sell the resulting product, and the profit to be earned from being the only firm selling a breakthrough new drug or other product, few firms would invest the hundreds of millions of dollars required to develop a final product in these markets.

Finally, a licensee may simply wish to obtain exclusive rights in a market in which it feels that it can maximize its profits through exclusivity. In such cases, the licensor may be indifferent whether an exclusive or nonexclusive license is granted, and may allow a prospective exclusive licensee to pay some premium in order to obtain exclusive rights, at least for a specified period. From the licensor's perspective, the additional compensation that it can charge for an exclusive license may make this option attractive.

The granting of exclusive rights is not always a private matter to be negotiated between an IP owner and its licensee. Public policy issues can come into play when a licensed technology has a significant public health or other social benefit. Thus, in 1999, the US National Institutes of Health adopted a policy urging its grant recipients to license patented research tools (technologies that enable the discovery or development of multiple other technologies) on a nonexclusive basis to promote their greatest utilization (Fed. Reg. 64(246): 72090 (1999)). Likewise, in 2007, eleven major US research universities, including the University of California, Berkeley, Harvard, and MIT, committed to a set of core licensing values, known as the "Nine Points," one of which states that universities should make patented research tools as broadly available as possible through nonexclusive licensing (see Section 14.3.2).

The remainder of this chapter will address the obligations that exclusivity imposes on both licensors and licensees. But before moving to these topics, you should be aware that one of the most important attributes of an exclusive license agreement is the exclusive licensee's right to bring an action for infringement of the licensed IP rights against third parties. This critical right will be discussed at length in Section 11.2.

7.2 LICENSOR'S OBLIGATIONS

While actual agreements vary widely, the defining feature of an exclusive license is a commitment by the licensor that it will not grant further licenses covering the same subject matter and scope or exploit the licensed IP itself. There are, however, potentially significant drafting and policy issues that arise when applying exclusivity to the licensor's conduct.

7.2.1. *Granting Other Licenses in the Exclusive Field*

One of the key benefits that a licensee obtains from an exclusive license is the ability to occupy a field to the exclusion of competitors. But exclusivity may not always work out that way, as illustrated by the following case.

Donald F. Duncan, Inc. v. Royal Tops Manufacturing Co., Inc.

343 F.2d 655 (7th Cir. 1965)

MAJOR, CIRCUIT JUDGE

This action was brought by plaintiff [Duncan] against defendants [Royal] for alleged trademark infringement of its registered trademarks, "Yo-Yo," "Genuine Duncan Yo-Yo"

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and "Butterfly," unfair competition, false representation of goods and unauthorized use of plaintiff's trademarks. Defendants by answer denied all allegations of the complaint relevant to plaintiff's claim for relief.

Following a lengthy trial, the District Court entered its findings of fact, conclusions of law and a judgment order in favor of plaintiff, from which defendants appeal.

On July 23, 1948, [Duncan] entered into an agreement with Louis Marx & Company, Inc. and Charmore Company, whereby [Duncan] granted them a license to use the trademark "Yo-Yo." The agreement provided that "should Marx abandon the manufacture or/and sale of the bandalore types of toy spinning tops, manufactured and sold by it, then Duncan shall have the right to cancel the license granted herein upon thirty (30) days' notice in writing given to Marx."

In 1951, Royal's predecessor brought an action for declaratory judgment in the District Court for the Northern District of Illinois, by which it sought a cancellation of plaintiff's registration, "Yo-Yo," on the ground that it was the generic or a descriptive name of the article upon which it was used.

On September 14, 1955, plaintiff entered into a license agreement with Royal by which it granted to Royal "an exclusive and non-transferable right to use Licensor's trade-mark, 'Yo-Yo,' on or upon or in association with bandalore tops." This agreement provided, "The parties hereto agree that they will enter into appropriate papers in the United States District Court in the aforesaid litigation (referring to the action for declaratory judgment) wherein said trade-marks shall be held to be valid and existing."

On November 21, 1955, a consent judgment was entered which found plaintiff to be the owner of the trademark registrations for "Yo-Yo" and for "Genuine Duncan Yo-Yo." The judgment recited, "Each of the above trademarks is applied and used in connection with a disc-shaped top manipulated up and down on a string, more commonly known as a bandalore top or quiz." The judgment determined that the trademarks "are valid."

On September 6, 1961, plaintiff's attorney directed a letter of cancellation to the Marx and Charmore Companies, the licensees named in the 1948 license agreement stating, "Please consider this letter as the thirty-days' written notice." This notice was given as required by a provision contained in that agreement.

Royal contends that … plaintiff, as an inducement for the 1955 license agreement, fraudulently represented that there was no outstanding license agreement when as a matter of fact it knew or should have known the 1948 agreement with Louis Marx & Company, Inc. and Charmore Company was in force and effect. In any event, Royal argues that the [1955] license agreement was invalid because of a mutual mistake as to a material fact and that the consent decree was entered as a result of and as provided for in the license agreement and was, therefore, tainted with the same fraud or mutual mistake.

Plaintiff's response to these contentions is based upon a finding by the District Court. "This license (referring to the 1948 license to Marx and Charmore) was cancelled by mutual agreement in 1952," and "Correspondence between Marx and plaintiff indicates an acknowledgment of the cancellation of 1952." In our judgment, these findings as well as the argument predicated thereon are clearly erroneous and must be rejected.

Plaintiff in support of its cancellation theory relies upon the testimony of Donald Duncan, Sr., that the license was cancelled in 1952 by mutual agreement in a conversation with Marx. Admittedly he gave no thirty-day written notice of cancellation as required by the Duncan–Marx agreement. Nor was such a notice given until 1961, when it was given by plaintiff's attorney. Plaintiff attempts to bolster its contention on this score by

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inferences drawn from correspondence between Duncan and Marx following the alleged oral cancellation. An examination of this correspondence as a whole completely negates the inferences which plaintiff professes to discern. For instance, on July 14, 1961, the attorneys for Marx wrote plaintiff, stating, "Our client is licensed by you to use the name 'Yo-Yo' as provided in the 1948 agreement." On July 26, 1961, Marx wrote plaintiff, "We have an agreement to that effect (our right to use the name 'Yo-Yo') giving us full permission to use it." (This is the same Marx with whom Duncan claimed to have had the oral agreement of cancellation in 1952.)

Even after plaintiff's counsel gave written notice of cancellation in his letter of September 6, 1961, Marx was still contending that its 1948 agreement with plaintiff was in effect. In response to the written notice of cancellation, the attorneys for Marx wrote that they "… consider this attempted cancellation to be without validity or effect." It may be that when plaintiff's counsel gave written notice of cancellation in 1961, he was without knowledge of the alleged oral cancellation in 1952, or if he had such knowledge, recognized it as futile. In this connection it is pertinent to note that Donald F. Duncan, Jr., plaintiff's president, testified that to his knowledge the 1948 agreement with Marx and Charmore had not been cancelled and was still in full force and effect in 1955, when the license agreement was entered into between plaintiff and Royal.

Thus, the conclusion is inescapable that the 1948 license agreement between plaintiff and Marx and Charmore was in full force and effect at the time plaintiff entered into a license agreement with Royal and granted to it "an exclusive" right. Royal's president, Joseph T. Radovan, testified that he would not have settled Royal's suit against plaintiff for declaratory judgment if he had known there was an outstanding license agreement with some other company. The most charitable characterization which can be made of plaintiff's misrepresentation is that it was a mutual mistake, relied upon by Royal to its prejudice. The [1955] license agreement … is, therefore, invalid.

Notes and Questions

1. *When an exclusive licensee wants more*. Royal had an exclusive license from Duncan. Even if there was an additional (and presumably nonpracticing) licensee from 1955 to 1961, by the time this case was decided in 1965, Royal was Duncan's only licensee. Why would Royal argue that its exclusive license should be invalidated?
2. *Prior licenses*. Can an IP holder grant an "exclusive" license if prior existing licensees already exist in a field? In *Mechanical Ice Tray Corp. v. Gen. Motors Corp.*, 144 F.2d 720 (2d Cir. 1944), the holder of patents covering ice trays granted a license to General Motors (GM) which provided "that the defendant was exclusively licensed under the patents within the United States … with the sole exception of a non-exclusive license which had been granted to Westinghouse Electric & Manufacturing Company. It was agreed that if the Westinghouse license should be terminated the defendant should become the sole licensee." When the licensor claimed that GM breached the implied duty that an exclusive licensee has to exploit the licensed rights (see Section 7.3), GM argued that it was not an exclusive licensee due to the prior license that had been granted to Westinghouse. The court disagreed, reasoning as follows:

   We think this license made the defendant an exclusive licensee though it is true that the non-exclusive license to Westinghouse remained in effect. The argument that the

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> Westinghouse license prevented the defendant from becoming an exclusive licensee does not take wholly into account the legal meaning of that term. [An exclusive license] is not the equivalent of "sole licensee." A license can have the attributes which make it exclusive in the legal sense though it is not the only license. There may be one or more previous licenses which are non-exclusive and by contrast with the exclusive license are called bare. When this is so the exclusive license does not, of course, cover the entire field but it binds the licensor not to enlarge thereafter the scope of other licenses already granted or increase the number of licenses.

Do you agree with the court's reasoning? Should the outcome have been different if GM had been unaware of the Westinghouse license? What if the licensor had intentionally withheld the existence of the Westinghouse license from GM?

3. *Yo-yo history*. The following excerpt from the online Museum of Yo-Yo History (www.yoyomuseum.com) offers additional background:

> The modern story of the yo-yo starts with a young gentleman from the Philippines, named Pedro Flores. In the 1920s, he moved to the USA, and worked as a bellhop at a Santa Monica hotel. Carving and playing with wooden yo-yos was a traditional pastime in the Philippines, but Pedro found that his lunch break yo-yo playing drew a crowd at the hotel. He started a company to make the toys, calling it the Flores Yo-Yo Company. This was the first appearance of the name "yo-yo," which means "come-come" in the native Filipino language of Tagalog.
>
> Donald F. Duncan, an entrepreneur who had already introduced Good Humor Ice Cream and would later popularize the parking meter, first encountered the yo-yo during a business trip to California. A year later, in 1929, he returned and bought the company from Flores, acquiring not only a unique toy, but also the magic name "yo-yo." About this time, Duncan introduced the looped slip-string, which allows the yo-yo to sleep – a necessity for advanced tricks.
>
> Throughout the 1930s, 40s, and 50s, Duncan promoted yo-yos with innovative programs of demonstrations and contests. All of the classic tricks were developed during this period, as legendary players toured the country teaching kids and carving thousands of yo-yos with pictures of palm trees and birds. During the 1950s, Duncan introduced the first plastic yo-yos and the Butterfly® yo-yo, which is much easier to land on the string for complex tricks. Duncan also began marketing spin tops during this period.
>
> The biggest yo-yo boom in history (until 1995) hit in 1962, following Duncan's innovative use of TV advertising. Financial losses at the end of the boom, and a costly lawsuit to protect the yo-yo trademark from competitors forced the Duncan family out of business in the late 60s. Flambeau Products, who made Duncan's plastic models, bought the company and still owns it today.

4. *Licensees versus infringers*. In *Duncan* and *Mechanical Ice Tray*, an exclusive licensee alleged that the licensor had breached its obligation to grant it an exclusive license due to the existence of one or more other licensees. What if the licensor has not granted other licenses, but has instead permitted a third party to infringe an exclusively licensed IP right? Should this constitute a breach of the licensor's obligation to grant its licensee exclusivity? What if both the licensor and the licensee were aware of the infringement at the time the exclusive license was granted?

   Consider *Ryan Data Exchange v. Graco*, 913 F.3d 726 (8th Cir. 2019) (reproduced in Section 11.2). Rydex granted Graco an exclusive patent license in 2005. At that time, both Rydex and Graco were aware that a third party, Badger, was allegedly infringing the patent. Rydex sued Badger for infringement in 2011, but in 2012 settled with Badger in a manner

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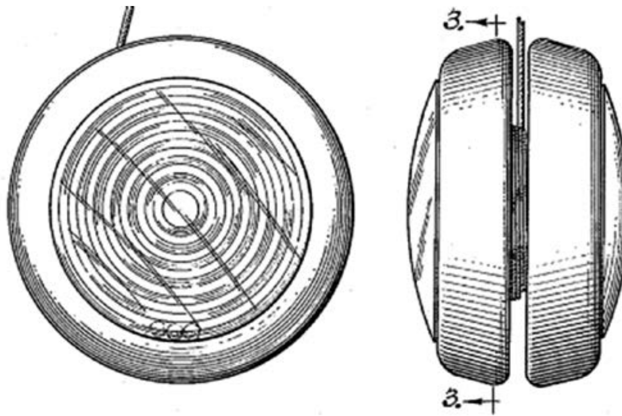

FIGURE 7.2 Illustration from one of Duncan's "Bandalore Toy" patents, U.S. Pat. No. D175,022 (June 28, 1955).

that did not end its infringement. The patent expired in 2015. Graco sued Rydex for breaching its obligation to grant an exclusive license. The district court held, as a matter of law, that Rydex breached its obligation to provide Graco with an exclusive license from 2012, when Rydex settled its suit with Badger, until 2015, when the patent expired. Yet the court allowed the jury to determine, as a question of fact, whether Rydex was in breach of that obligation from 2005, when Rydex granted the exclusive license, until 2011, when it sued Badger for infringement. The jury found that Rydex had not breached its obligation from 2005 to 2011. Why not?

5. *Semi-exclusive and sole licenses*. In some cases, a licensor will grant a license to more than one licensee, but will expressly limit the number of such licenses. These are called semi-exclusive licenses. Such arrangements sometimes occur when the owner of an IP right has granted a license that cannot be revoked, and a prospective new licensee wishes to be "exclusive" save for that prior license. In other cases, the licensor may wish to exploit the licensed IP itself, concurrently with a licensee, while at the same time committing that it will not grant further licenses to third parties. This is called a "sole license" (and is somewhat distinct from a licensor's "reserved rights" discussed in the next section, which are generally more limited). If you represented the licensee in these situations, what concerns might they raise?

Problem 7.1

Baker grants Mega an exclusive license to make, offer to sell, and sell patented bread-making machines throughout the United States. The license bears a royalty of 10 percent of Mega's net sales, with no up-front fee. Several months later, Mega discovers that Baker had previously granted a nonexclusive license to Texibake Corp. to make, offer to sell, and sell the same machines in the state of Texas. Texibake sells approximately 100 machines per year.

a. What remedy, if any, does Mega have?
b. Now suppose that, three years after Baker granted the exclusive license to Mega, Texibake expands its sales force and starts to sell machines throughout the United States in violation of its license. Does Mega's remedy change?

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7.2.2 *Licensor's Reserved Rights*

In some cases, a licensor may "reserve" certain rights to itself when granting exclusive rights to a licensee. The following case illustrates a fairly common set of licensor rights reservations for educational purposes.

Kepner-Tregoe, Inc. v. Vroom

186 F.3d 283 (2d Cir. 1999)

MOTLEY, DISTRICT JUDGE

This is an appeal of a civil judgment against Professor Victor H. Vroom for breach of contract and copyright infringement relating to an exclusive licensing agreement between Dr. Vroom and Kepner-Tregoe, Inc. (K-T). The licensing agreement provided K-T with the exclusive use of executive leadership training materials co-authored by Dr. Vroom in return for the payment of royalties to Dr. Vroom. The [issue] presented by this appeal [is] whether the district court's finding of liability against Dr. Vroom for intentional copyright infringement and breach of contract should be upheld. For the reasons discussed below, the decision of the district court is affirmed.

Background

In 1972, Dr. Vroom, a professor at Yale University's School of Organization and Management, entered into a licensing agreement with K-T, an international management training company. This agreement granted K-T the exclusive worldwide rights to specific copyrighted materials co-authored by Dr. Vroom. These materials, known as the Vroom–Yetton model, were used to teach managers how to make better decisions. In return, K-T agreed to pay Dr. Vroom and his co-author, Dr. Philip W. Yetton, royalties based on its exclusive use of the licensed materials. The licensing agreement also included a teaching clause that allowed Dr. Vroom to retain non-assignable rights to use the licensed materials for his "own teaching and private consultation work."

In the mid-1980s, Dr. Vroom created a more sophisticated software program, entitled "Managing Participation in Organizations" (MPO), which partially overlapped with the materials licensed to K-T. Dr. Vroom used the MPO program to conduct management training seminars for corporate executives at Yale University and other college campuses. Upon learning of Dr. Vroom's use of the copyrighted materials, K-T initiated this lawsuit in 1989.

K-T alleges that Dr. Vroom's use of the MPO program in his teaching of executives in the university setting infringes on its copyrights and constitutes a breach of the licensing agreement. It further alleges that Dr. Vroom breached the licensing agreement by assigning the rights to the MPO program, which infringed K-T's licensed materials, to Leadership Software Inc. (LSI), a Texas company founded by Dr. Vroom and his colleague, Dr. Arthur Jago. LSI was created to market the MPO program.

In 1990, K-T initiated a separate lawsuit against LSI and Dr. Jago in federal district court in Texas. Dr. Vroom was not a defendant in the suit because personal jurisdiction was unavailable. In that case, K-T alleged copyright infringement based on LSI's sales of the MPO program, which contained substantial similarities to the Vroom–Yetton model, the copyrighted materials exclusively licensed to K-T. The Texas district court found in favor of K-T and awarded it $46,000 in actual damages as well as injunctive relief.

After a five-day bench trial in April 1997, the district court in the present action held that Dr. Vroom's use of the licensed materials, including the infringing MPO program,

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in his teaching of executives in the university setting was not permitted under the teaching clause of the licensing agreement. The trial court found that the teaching clause was ambiguous as written and looked to other contemporaneous documentary evidence for clarification of the parties' intentions. The lower court interpreted the teaching clause to mean that Dr. Vroom was only allowed to use the copyrighted materials for his teaching of bona fide enrolled graduate and undergraduate students. Moreover, the district court found that Dr. Vroom willfully infringed the copyrighted material licensed to K-T and breached his contract with K-T when he taught the exclusively licensed materials to large groups of executives in the university setting.

Discussion

The central issue in this case involves the proper interpretation of the teaching clause of the licensing agreement, which allows Dr. Vroom to use the licensed materials in the course of his "own teaching and private consultation work." We find that the district court did not err in finding the teaching clause ambiguous. It properly looked to prior negotiations between the parties to determine the parties' intentions regarding the interpretation of the clause. Furthermore, credible evidence was presented at trial that supported the lower court's interpretation of the teaching clause so as to limit Dr. Vroom's teaching to only bona fide enrolled undergraduate and graduate students.

Dr. Vroom argues that the district court effectively rewrote the clear and unambiguous language of the licensing agreement by restricting his teaching of the licensed materials to only students. Dr. Vroom contends that the parties intended to allow him to retain broad and unlimited rights to use the licensed materials in his teaching, including his teaching of executives in the university setting. Dr. Vroom also claims that the trial court's decision will virtually deprive him of his right to earn a living because he is enjoined from using the MPO program in his courses for executives at Yale and other colleges.

We review the district court's construction of the text of the licensing contract *de novo*. To begin with, we agree with the district court that the teaching clause was ambiguous. K-T contends that this clause was only intended to allow the teaching of undergraduate and graduate students; Dr. Vroom argues that this clause, which also allowed "private consulting," also permitted him to teach classes to large groups of executives. We hold, as did the district court, that in the context of the agreement the word "teaching" was susceptible to the interpretation advanced by either Dr. Vroom or K-T. Accordingly, the district court was entitled to consider extrinsic evidence to interpret the contractual language.

We also affirm the district court's holding limiting the clause to the teaching of enrolled graduate and undergraduate students. The communications of the parties during the negotiation of the licensing agreement support this interpretation. K-T wrote a memorandum to Dr. Vroom in January of 1972, stating that it wanted to prevent "mass" teaching of the materials. Dr. Vroom produced no evidence at trial that he ever contradicted K-T's interpretation of the teaching clause in any communications with K-T throughout the remainder of the negotiations. The district court properly relied on this evidence to conclude that the teaching clause did not extend beyond the teaching of enrolled graduate and undergraduate students.

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Notes and Questions

1. *Licensor's reserved rights*. The dispute in *Vroom* centers around the reserved uses that an exclusive licensor retains for itself. There was no question that Dr. Vroom reserved some rights to use the Vroom–Yetton model for his own purposes. The question was how much Dr. Vroom could do. How might Dr. Vroom have improved his case by drafting his reservation of rights more carefully? How would you have advised him in 1972?
2. *Drafting of reservations*. Another good illustration of an exclusive licensor's reservation of rights can be found in *Macy's Inc. v Martha Stewart Living Omnimedia, Inc.*, 127 A.D.3d 48 (N.Y. Sup. 2015), which involved an exclusive licensing agreement between Martha Stewart Living Omnimedia (MSLO) and the Macy's department store chain, as well as MSLO's subsequent agreement with J.C. Penney Corp. (JCP).

> In 2006, Macy's and MSLO entered into a licensing agreement granting Macy's certain exclusive rights with respect to products designed by MSLO. These products were defined in the agreement as "Exclusive Product Categories" and included bedding, bathware, housewares and cookware. In conjunction with Macy's, MSLO would design goods in those categories, which were branded with the MSLO mark. Macy's would manufacture the goods and sell them in Macy's stores. The agreement further provided that Macy's would be the exclusive outlet for sales of these items and that MSLO would not, without Macy's consent, enter into any new agreement or extend any existing agreement "with any department store or manufacturer or other retailer of department store merchandise that promotes the sale of any items" in Macy's Exclusive Product Categories that are branded with a Martha Stewart mark. The agreement further provided that if MSLO ultimately contracted, with Macy's approval, tacit or otherwise, to sell goods in the Exclusive Product Categories through other outlets, such goods were to be manufactured solely by Macy's and could not be sold through a downscale retailer. The agreement was subject to several limitations, the key one being MSLO's reservation of the right to open its own retail stores. These stores were defined as "retail store[s] branded with Martha Stewart Marks or Stewart Property that [are] owned or operated by MSLO or an Affiliate of MSLO or that otherwise prominently feature Martha Stewart Marks or Stewart Property." Even with respect to those MSLO stores, however, only Macy's could manufacture and sell products in its Exclusive Product Categories at Macy's cost plus 20%. This arrangement was designed to prevent MSLO stores from undercutting Macy's prices on those goods.
>
> In 2011, MSLO [negotiated a retail partnership with JCP]. The evidence in the record clearly shows that JCP executives knew that, in order to obtain this retail partnership, they would have to "break" the exclusivity provisions in the Macy's contract. In order to evade those provisions, JCP viewed the exemption for MSLO stores as a means to attain its goals of creating a retail partnership with MSLO. It proposed creating a "store-within-a-store." Under this concept, MSLO retail stores would be set up as a separate "store" within already established JCP stores. Entry to the store would be located wholly within the confines of JCP stores, i.e., it would not be a freestanding store with a separate outside entrance; the MSLO store would only be accessible by entering through the JCP store. MSLO would help design the branded goods and receive a royalty, just as with Macy's. However, JCP would manufacture the goods, own the inventory, own the retail space, employ the salespeople, book the sales, set the prices, set the promotions and bear all risk of loss.

Macy's sued MSLO for breach of contract and JCP for tortious interference with contract. The lower court found that

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since JCP would manufacture the goods, own the inventory and, in short, control all aspects of the "store," this would run afoul of the clear language of the contract with MSLO and Macy's that requires Macy's to manufacture all MSLO goods in Exclusive Product Categories, even for MSLO stores. It also violated the prohibition on MSLO from entering into any agreement with any department store that promotes the design and sale of items within the Exclusive Product Categories, thus breaching, among other things, the exclusivity provisions of its contract with Macy's.

The court on appeal agreed, holding that "There are no exceptions to this exclusivity of manufacture, yet JCP's agreement with MSLO called for JCP to manufacture these products."

If you had represented MSLO in its negotiation with Macy's, how would you have drafted the exclusion from Macy's exclusive license to permit MSLO to enter into the desired arrangement with JCP?

7.2.3 *Licensor's Duties with Respect to the Licensed IP*

When a licensee obtains an exclusive license, it often pays a substantial sum to the licensor in advance and invests significant resources in creating complementary technology, building out physical manufacturing and distribution resources, developing a market for the licensed technology, training technical, sales and marketing personnel, and foregoing other business opportunities. As a result, licensees often expect that the licensor will "do its part" to maintain the value of the licensed IP, either by paying fees and taking routine steps at the Patent and Trademark Office to renew and otherwise maintain the licensed IP in force, or more assertively by enforcing the licensed IP against infringers in the licensee's exclusive field. Duties such as these can be imposed by contract, and often are (see Sections 9.5 and 11.2). But to what degree does the law impose such duties on an exclusive licensor?

The answer is: very little. Patent and trademark owners have significant latitude to protect, maintain and renew their registrations at their own discretion, and absent contractual requirements to the contrary, courts have been reluctant to recognize any duty that they do so. For example, in *Westowne Shoes, Inc. v. Brown Group, Inc.*, 104 F.3d 994, 997 (7th Cir. 1997), which involved an exclusive license of the Naturalizer trademark on footwear, Judge Richard Posner explained that

> The owner [of a trademark] can if he wants, unless contractually committed otherwise, abandon the trademark, dilute it, attach it to goods of inferior quality, attach it to completely different goods – can, in short, take whatever steps he wants to jeopardize or even completely destroy the trademark. When cases speak of the trademark owner's "duty to ensure the consistency of the trademarked good or service," they mean that it is a condition of the continued validity of the trademark, or a defense to a consumer's claim of having been fooled by the substitution of an inferior good, not that it is a ground for a licensee's being allowed to sue to force the trademark owner to take steps to assure the trademark's continued validity.
>
> We think that Westowne more or less understands all this, and is making solely a contract claim—that the trademark license obligated Brown to keep the Naturalizer mark up to snuff. A licensor might so promise, but this licensor did not. Westowne is asking us to make such a promise an implied term of every trademark licensing agreement, and that would be absurd. It would give licensees comprehensive power over the licensor's business … The office of implied contractual terms is to save contracting parties costs of negotiations by interpolating terms that they are pretty sure to have agreed to had they thought about the matter, not terms that they would

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FIGURE 7.3 Martha Stewart display inside a J.C. Penney's store.

be almost sure to reject; for the interpolation of such terms would increase rather than decrease the costs of contracting as parties busied themselves contracting around the interpolated terms.

Similar reasoning has been applied to an IP owner's failure to enforce its IP against infringers. More than 100 years ago, the court held in *Martin v. New Trinidad Lake Asphalt Co.*, 255 F. 93, 96–97 (D.N.J. 1919) that an exclusive licensee had no action against a licensor who allegedly failed to prevent others from infringing the licensed patents. The court reasoned that "[t]he license agreement [contains] no provision that the licensor would protect the licensee from infringements by others. In the absence of such a provision, there was no obligation upon the part of the [licensor] to do so."

In the end, if an exclusive licensee wishes to ensure that its licensor maintains the licensed IP or enforces it against infringers, it is well advised to insist upon contractual commitments that the licensor do so.

Notes and Questions

1. *Why so few licensor obligations?* Why don't courts impose implied obligations on licensors to maintain the value of exclusively licensed IP rights? Compare the unwillingness of courts to extend these obligations to licensors with the implied obligations imposed on licensees in Section 7.3. How do you account for this difference? What language should a licensee seek to include in an agreement if it is concerned about the licensor's willingness to maintain its IP?

Problem 7.2

Proggo and Curio enter into an agreement whereby Proggo will develop a software program to help Curio forecast global demand for antique furniture. The program will be based on templates that Proggo has created for clients in other industries (e.g., jewelry, paintings, rare books),

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but Proggo expects to add about 100,000 new lines of customized code (of a total of one million) for Curio. Curio does not want any of its competitors to have access to the functionality that it will receive. How would you draft an exclusive license provision for the software program? How would your result differ if you represented Proggo versus Curio?

7.3 LICENSEE'S OBLIGATIONS: DUTY TO EXPLOIT

7.3.1 *Milestone and Diligence Requirements*

Because the licensor of an IP right often depends on its licensees for revenue, and because the licensor seldom exercises direct control over its licensees' activities, license agreements often contain provisions that measure the licensee's progress against certain commercial or technological goals (milestones). Milestones, sometimes referred to as "diligence requirements," serve several purposes. First, the achievement of a milestone is often coupled with a payment by the licensee (see Section 8.5). This permits the licensee to stagger payments, usually of increasing size, based on its progress toward full commercialization of the licensed rights. As such, milestone payments align the licensee's payment obligations with its likelihood of achieving commercial success. From the licensor's standpoint, milestone payments can provide needed cash before a commercial product is approved and launched – a process that can often take years.

A final reason that diligence requirements appear in license agreements is unrelated to milestone payments. Under the Bayh–Dole Act of 1980 (discussed in Section 14.1), academic institutions that obtain federal funding may patent their federally funded inventions, but are subject to a number of requirements. Among these is the obligation to report to the federal funding agency "on the utilization or efforts at obtaining utilization that are being made" by the institution and its licensees with respect to each federally funded invention (35 U.S.C. § 202(c)(5)). As a result, many licenses in fields that are heavily funded by the federal government (biotechnology, aerospace, agriculture, computer encryption) contain measurable indicia of utilization of the licensed technology.

Milestones are intended to reflect the achievement of defined goals along the road to the full commercial exploitation of a licensed IP right. As such, milestones can reflect steps along the regulatory, technological or commercial pathway to commercialization. In drafting milestones, it is critical that these be specified clearly and based on objective criteria (e.g., not "satisfactory completion of product testing" and other subjective measures).

Common examples of **regulatory** milestones include:

- the licensee files an investigational new drug (IND) application for a licensed product with the FDA;
- the licensee administers first dosing of the licensed product to a patient in phase I/II/III clinical trials;
- the licensee receives FDA approval to market a licensed product in the United States;
- the licensee receives regulatory approval to market a licensed product in a specific country.

Common examples of **technological** milestones include:

- a working licensed product prototype is demonstrated to the licensor;
- a specified technical/scientific threshold is met;
- the licensed product is certified by a recognized international certification body;
- the licensed technology is submitted to a recognized international standards body;
- the licensed technology is adopted by a recognized international standards body as an industry standard;

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- a "beta" version of the licensed product is released.

Common examples of **commercial** milestones include:

- the licensed product is announced at a major trade show or event;
- the licensee enters into a manufacturing agreement for licensed products;
- the licensee completes construction of its manufacturing facility for the licensed products;
- the licensee appoints a distributor for the licensed product in a specific country or region;
- the licensee sells the first 100 units of the licensed product;
- the licensee's first sale of the licensed products in a specific country or region;
- the licensee earns $XXX from sales of the licensed products.

The licensee is often required to submit a periodic (often annual) report to the licensor indicating its progress toward achieving any as-yet-unmet milestones.

Milestones may be structured in a number of ways, and significant legal ramifications flow from the choices that are made:

- Milestones may be binding *commitments* – if the licensee does not achieve a milestone, it is in breach of the contract.
- Milestones may be *termination* triggers – if the licensee does not achieve a milestone, the licensor may have the right to terminate the agreement.
- Milestones may be *goals* – the licensee must expend some degree of effort to meet the milestones, but failing to meet them is not a breach.
- Milestones may be *payment* triggers – a payment is triggered when a milestone is achieved.
- Milestones may be requirements for maintaining *exclusivity* – if the licensee does not achieve a milestone, the licensor may convert some or all of the license (including specified fields of use) from exclusive to nonexclusive.

To make matters more complicated, the consequences of missed milestones are not mutually exclusive. For a discussion of the financial consequences of missed milestones, see *Law v. Bioheart, Inc.*, discussed in Section 8.5, and for a discussion of the licensor's right to terminate based on milestone failures, see Section 12.3, Note 1.

7.3.2 *Best Efforts*

Even without contractual milestones, courts often imply duties on exclusive licensees to use a degree of diligence in exploiting rights over which they have exclusive control. These implied obligations can range from duties to attempt to exploit the licensed rights in good faith, to more substantial obligations to employ "best efforts" in this pursuit. The case involving Lucy, Lady Duff Gordon, a classic of the contract law canon, introduces these issues, while *Permanence v. Kennametal* provides an overview of the recent case law addressing this topic.

Wood v. Lucy, Lady Duff Gordon

222 N.Y. 88 (N.Y. App. 1917)

CARDOZO, JUSTICE

The defendant styles herself "a creator of fashions." Her favor helps a sale. Manufacturers of dresses, millinery and like articles are glad to pay for a certificate of her approval. The things which she designs, fabrics, parasols and what not, have a new value in the public

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mind when issued in her name. She employed the plaintiff to help her to turn this vogue into money. He was to have the exclusive right, subject always to her approval, to place her indorsements on the designs of others. He was also to have the exclusive right to place her own designs on sale, or to license others to market them. In return, she was to have one-half of "all profits and revenues" derived from any contracts he might make. The exclusive right was to last at least one year from April 1, 1915, and thereafter from year to year unless terminated by notice of ninety days. The plaintiff says that he kept the contract on his part, and that the defendant broke it. She placed her indorsement on fabrics, dresses and millinery without his knowledge, and withheld the profits. He sues her for the damages, and the case comes here on demurrer.

The agreement of employment is signed by both parties. It has a wealth of recitals. The defendant insists, however, that it lacks the elements of a contract. She says that the plaintiff does not bind himself to anything. It is true that he does not promise in so many words that he will use reasonable efforts to place the defendant's indorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view to-day. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed. If that is so, there is a contract.

The implication of a promise here finds support in many circumstances. The defendant gave an exclusive privilege. She was to have no right for at least a year to place her own indorsements or market her own designs except through the agency of the plaintiff. The acceptance of the exclusive agency was an assumption of its duties. We are not to suppose that one party was to be placed at the mercy of the other. Many other terms of the agreement point the same way. We are told at the outset by way of recital that "the said Otis F. Wood possesses a business organization adapted to the placing of such indorsements as the said Lucy, Lady Duff-Gordon has approved." The implication is that the plaintiff's business organization will be used for the purpose for which it is adapted. But the terms of the defendant's compensation are even more significant. Her sole compensation for the grant of an exclusive agency is to be one-half of all the profits resulting from the plaintiff's efforts. Unless he gave his efforts, she could never get anything. Without an implied promise, the transaction cannot have such business "efficacy as both parties must have intended that at all events it should have". But the contract does not stop there. The plaintiff goes on to promise that he will account monthly for all moneys received by him, and that he will take out all such patents and copyrights and trademarks as may in his judgment be necessary to protect the rights and articles affected by the agreement. It is true, of course, as the Appellate Division has said, that if he was under no duty to try to market designs or to place certificates of indorsement, his promise to account for profits or take out copyrights would be valueless. But in determining the intention of the parties, the promise has a value. It helps to enforce the conclusion that the plaintiff had some duties. His promise to pay the defendant one-half of the profits and revenues resulting from the exclusive agency and to render accounts monthly, was a promise to use reasonable efforts to bring profits and revenues into existence. For this conclusion, the authorities are ample.

The judgment of the Appellate Division should be reversed, and the order of the Special Term affirmed, with costs in the Appellate Division and in this court.

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FIGURE 7.4 Lucy Christiana Lady Duff Gordon (1863–1935).

Permanence Corp. v. Kennametal, Inc.

725 F. Supp. 907 (E.D. Mich. 1989)

FREEMAN, JUSTICE

In this diversity action, plaintiff seeks damages for the breach of an implied obligation of a licensing agreement. [Defendant, Kennametal, Inc.] obtained a non-exclusive license to manufacture and sell products "made from and pursuant to" certain listed patents. Two years later, Kennametal exercised a contractual option to convert the license to an exclusive license to manufacture and sell. Plaintiff alleges that Kennametal breached and continues to breach to date, its obligations under the aforementioned written agreement between the parties [to exercise its best efforts]. Defendant argues that "[a] best efforts clause will not be implied in a patent license agreement where (i) the agreement is adequately supported by consideration, (ii) the plaintiff was represented by counsel, and (iii) the agreement is expressly an integrated agreement."

In *Vacuum Concrete Corp v. American Machine & Foundry Co.*, 321 F. Supp. 771, 772–73 (S.D.N.Y. 1971), the court adequately summarized the competing interests in determining whether to infer an obligation of best efforts:

> It is settled law that the court will imply a duty on the part of an exclusive licensee to exploit the subject matter of the license with due diligence, where such a covenant is essential as a matter of equity to give meaning and effect to the contract as a whole.
>
> The reasoning [is that] it would be unfair to place the productiveness of the licensed property solely within the control of the licensee, thereby putting the licensor at his mercy, without imposing an obligation to exploit upon the licensee. In effect the court is merely enforcing an obligation which the parties overlooked expressing in their contract or which they considered unnecessary to be expressed. In such circumstances the implied obligation "must conform to what the court may assume would have been the agreement

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of the parties, if the situation had been anticipated and provided for. Thus whatever obligation is sought to be raised by legal implication, must be of such a character as the court will assume would have been made by the parties if their attention had been called to the subject, and their conduct inspired by principles of justice."

A typical example of an implied covenant to exploit is found in a leading case in New York on the subject, *Wood v. Lucy, Lady Duff-Gordon*. There the defendant, a fashion designer, gave the plaintiff the exclusive privilege of marketing defendant's design. Although the plaintiff did not expressly agree to exploit the design, the court implied such an obligation, since defendant's sole revenue was to be derived from plaintiff's sale of clothes designed by defendant and defendant was thus at the plaintiff's mercy. In this and in similar cases the circumstances revealed that such an obligation was essential to give effect to the contract between the parties and was in accord with their intent. On the other hand, where the parties have considered the matter and deliberately omitted any such obligation, or where it is unnecessary to imply such an obligation in order to give effect to the terms of their contract, it will not be implied.

[Our] starting point, of course, must be the terms of the written contract between the parties. Although the Agreement purported to grant an exclusive license to AMF, obligating it to pay royalties to Vacuum, it is readily apparent that Vacuum, unlike the licensors in those cases where an obligation to exploit has been implied, did not depend for its revenue solely upon sales of the licensed devices (Octopus Lifters) by AMF. In the first place according to the terms of the Agreement Vacuum retained the right itself to manufacture and sell up to $300,000 annually of Octopus Lifters within the licensed territory. The significance of this reservation as a factor negating an implied covenant to exploit is apparent from the undisputed fact that up to the date of the Agreement between the parties Vacuum's maximum gross annual income from sales or licensing of the lifting device in the licensed territory (U.S.) was $63,771 received in 1964, of which $47,939 represented income from the sale of a total of eight machines, parts, and services.

The decision in each case in which a party asserts an implied obligation of best efforts turns upon the circumstances of each case, although certain factors can be distilled from an evaluation of the reported cases. In the *Wood* case, for example, the most important factor in the decision was that the fashion designer would not receive any revenue unless the plaintiff sold the designer's clothes. As a matter of equity, Justice Cardozo held that the contract was "instinct with obligation" on the plaintiff to use reasonable efforts to sell the clothes.

In *Havel v. Kelsey-Hayes Co.*, 83 A.D.2d 380 (N.Y. App. Div. 1981), the agreement in issue provided as follows:

By agreement dated January 30, 1973, plaintiff granted to defendant an exclusive license for the use and dissemination of the patented process. Defendant agreed to pay plaintiff a percentage of the cost of super alloy powders used in the process and further agreed that plaintiff would receive 25% of all lump sum payments and 40% of all royalties paid to defendant by sublicensees. The agreement also provided for payment by defendant of minimum royalties of $20,000 per year. The minimum payment was not guaranteed, however, because plaintiff's sole right was to terminate the license on defendant's failure to make up the deficiency if plaintiff's share of the lump sum payments and royalties did not amount to $20,000 in any calendar year.

The court held that the contract, when read as a whole, was instinct with an obligation to use reasonable efforts to exploit the process. Of primary importance to the court was the provision for an exclusive license; of further importance was that the minimum royalty provision was not guaranteed and that public policy supports the use of patents, not their suppression.

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In *Willis Bros., Inc. v. Ocean Scallops, Inc.*, 356 F. Supp. 1151 (E.D.N.C. 1972), the license agreement granted to the defendant,

> an exclusive, world wide right for the life of the patent to manufacture, use and sell a certain scallop shucking process on which plaintiffs had pending an application for letters patent. The plaintiffs agreed not to manufacture, use, or sell the equipment except as to commitments made prior to the agreement. In consideration for this exclusive licensing, the defendant agreed to pay plaintiffs an amount determined on a basis of three cents per net pound of product processed by use of the equipment and/or the processes. There is no minimum royalty provision in the contract. Although the Agency Agreement provides that Willis Brothers will serve as a nonexclusive agent for the defendant in the sale of scallop meat, there is no reservation of rights in the License Agreement permitting the plaintiffs to compete with the license. The Employment Contract provided that Willis was to receive consultant's fees. This agreement was cancelled by the defendant after one year. In order to enable the plaintiffs to pay the debts incurred by the development of the patent, the defendant loaned Willis Brothers seventy thousand dollars. Prepayment of the loan was to be made by application to the principal the royalties under the License Agreement and percentages of the amount payable to Willis Brothers under the Agency Agreement. The prepayment provision providing for payment of the loan from the royalties indicates that a "best efforts" provision is essential to give effect to the agreements between the parties.

Of importance to the court was that the agreement was for an exclusive license to work the patent and that the defendant must use due diligence in working the patent to allow plaintiff to repay the loan defendant made to it as part of the agreement.

In *Bellows v. E.R. Squibb & Sons, Inc.*, 184 U.S.P.Q. 473 (N.D. Ill. 1974), the agreement in issue provided in pertinent part:

> 4.01 Concurrently with the execution of this Agreement [Squibb] shall pay to [Bellows] the sum of … ($50,000.00), which shall represent a credit against future royalties, but shall not be refundable in whole or part in the event no royalties [accrue] to Bellows
>
> 8.02 [Squibb] may terminate this Agreement in its entirety … by giving [Bellows] written notice at least six (6) months prior to such termination.
>
> 8.03 In the event of any of the following, [Bellows] may, at his option, terminate this Agreement:
>
> a) [Squibb] elects not to exploit the license granted hereunder, … and [Squibb] shall have so notified [Bellows]…
>
> d) [Squibb] … has failed to market the Licensed Product … within eighteen (18) months of the date of this Agreement.
>
> e) [Squibb] does not pay to [Bellows] a minimum royalty of ($50,000) for each year after 1974 and during the life of this Agreement.

The court held as a matter of law that there could be no implied duty of best efforts in the exploitation of the invention. The crucial factors in the case are that the agreement specifically recognized that Squibb might decide not to exploit the patent and provided for that contingency. The court also noted that the agreement was the result of arm's length bargaining with both parties assisted by counsel and that "no obligation should be implied to merely cure an unsatisfactory bargain."

Looking at the agreement in this case, the court notes several important factors. First, the defendant exercised its option to obtain the exclusive rights to exploit plaintiff's patents.

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Second, plaintiff could only terminate the agreement upon a breach of the agreement by defendant; defendant, however, could terminate the agreement upon 90 days notice provided that it pay the royalties due up to the effective date of the cancellation. Unlike *Bellows*, this agreement does not contain any provision allowing plaintiff to terminate the agreement if best efforts were not used or if certain minimum royalties were not paid. This factor further supports plaintiff's position.

Third, the agreement contained an integration clause:

> This Agreement supersedes all other agreements, oral or written, heretofore made with respect to the subject matter hereof and the transactions contemplated hereby and contains the entire agreement of the parties.

Defendant relies upon this provision in arguing against any implied obligation of best efforts. In *Vacuum Concrete*, 321 F. Supp. at 773–74, the court stated:

> Other provisions of the Agreement which militate against implying a covenant to exploit with due diligence are … the stipulation that the Agreement constituted "the entire agreement between the parties." … For instance, the merger or integration clause …, by emphasizing that the formal contract, which contained no undertaking by AMF to exploit the device, constituted the "entire" Agreement between the parties, negates the thought that they intended to impose such a duty upon AMF.

Fourth, the parties have submitted contradictory affidavits regarding the drafting of the agreement and what was negotiated. *See* McKenna Affidavit para. 9 ("Kennametal responded in a letter dated March 11, 1985, pointing out that Permanence and Kennametal had discussed 'best efforts' during the negotiation and that the parties had agreed to prepaid royalties instead …"); Krass Affidavit para. 4 ("Neither the completed agreement nor any of the draft agreements contained a 'best efforts' clause and, to the best of my knowledge, there were not negotiations with respect to the inclusion of such a clause").

Fifth, on February 8, 1979, defendant pursuant to the agreement paid to plaintiff $250,000, $100,000 of which was an advance payment of royalties. On February 5, 1981, defendant paid plaintiff a second up-front fee of $250,000, $100,000 of which was an advance payment of royalties. The agreement also contained royalty rates on the net sales price of products made by defendant using processes that fall under valid claims of the patents. This factor sways decidedly in defendant's favor.

Finally, there is no dispute that the agreement has no express reference to "best efforts" with regard to the use of the patent, although the court notes that in another portion of the agreement the parties agreed that "Kennametal shall use reasonable efforts to guard against the unauthorized use or disclosure of such technology and technical assistance." The inclusion of the phrase "reasonable efforts" in paragraph 6.4 and the absence of that phrase in any other section of the agreement militates against inferring an implied promise to use best efforts to exploit the patents. This agreement was negotiated at arm's length by competent counsel.

After considering these factors, the court holds that there is no implied obligation of best efforts. Of primary importance is that the defendant paid up-front over $500,000 in fees and advance royalties. Thus, unlike the seminal *Wood* case, plaintiff's sole revenue was not subject to the whim of defendant in exploiting the patents – plaintiff had money in hand and was to receive further royalties under the agreement. While the *Masco* case upon which defendant relies can be distinguished because it involved a nonexclusive license, the Michigan Court of Appeals in that case stated:

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> There is no showing by the parties that Masco Corporation ordinarily supplied best effort clauses to licensing agreements. The circumstances surrounding this agreement also do not support the contention that the best efforts clause was so clearly within the contemplation of the parties that they deemed it unnecessary to expressly stipulate it. The record discloses a dispute between the parties as to whether a best efforts clause was considered during negotiation of this agreement. This is not a dispute of fact which would preclude summary judgment. This dispute shows that the parties did not feel that a best efforts clause was so clearly implied that it was unnecessary to include it in the contract.

Similarly, in the instant case, the only disputed factual issue is what occurred during the negotiation of the agreement. The court has carefully read the agreement and holds that no best efforts clause can be implied to it.

Notes and Questions

1. *What standard?* Although the *Kennametal* court states that *Vacuum Concrete* "adequately summarized" the law regarding "best efforts," the quoted language refers to a duty of "due diligence" rather than best efforts. Do these standards differ? A review of the case law quickly reveals that a range of different standards are used to describe the implied obligations of exclusive licensees. For example, courts refer to "reasonable efforts," "best efforts for a reasonable time," "good faith efforts," "active exploitation in good faith," and many other formulations of this concept. Are these courts all attempting to describe the same nebulous standard of conduct, or are there dozens of different shades of effort that may be imposed on a licensee depending on the circumstances?
2. *How good are best efforts?* Many transactional lawyers will tell you that "best efforts" is a very high standard of performance, requiring a party to take extreme measures, even risking financial ruin, to achieve the desired end. There is even an oft-repeated hierarchy of efforts, running from best efforts, at the top, to reasonable best efforts to reasonable efforts to commercially reasonable efforts to good-faith efforts, at the bottom.

   But the case law belies this folk wisdom. Clearly, "best efforts" require more than "mere" good faith, but cases routinely hold that "best efforts" do not require a licensee to take measures that are unreasonable or destructive. For example, in *Perma Research & Dev. Co. v. Singer Co.*, 402 F. Supp. 881, 896, aff'd, 542 F.2d 111, 113 (2d Cir. 1976), a party agreed to "use its best efforts for a reasonable time" to perfect a particular product for commercial purposes. The court held only that the party was required to undertake research and development necessary to bring the product to market without unreasonable effort. Thus, even under a "best efforts" requirement, the case law generally allows a licensee to make a reasoned business decision to take, or omit to take, actions dictated by reasonable judgment in light of market realities and circumstances. In other words, "best efforts" are "reasonable efforts."

   Parties that do not wish to throw the dice in court sometimes try to define the level of efforts required under an agreement with a greater degree of specificity. For example, in *Elorac, Inc. v. Sanofi-Aventis Can., Inc.*, 343 F. Supp. 3d 789, 794 (N.D. Ill. 2018), the license agreement defined "Commercially Reasonable Efforts" as:

   > efforts consistent with those generally utilized by companies of a similar size for their own internally developed pharmaceutical products of similar market potential, at a similar stage of their product life taking into account the existence of other competitive products in the marketplace or under development, the proprietary position of the product, the regulatory

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structure involved, the anticipated profitability of the product and other relevant factors. It is understood that such product potential may change from time to time based upon changing scientific, business and marketing and return on investment considerations.

Does this definition give the licensor more comfort than a simple obligation that the licensee use "reasonable efforts" to commercialize the product? Why? What specific aspects of this definition do you find the most helpful? To what degree is it still vulnerable to subjective interpretation?

3. *Good faith*. In general, an obligation of good faith is less stringent than a best efforts, negligence or reasonable care standard. Good faith is primarily concerned with whether conduct is fair and undertaken honestly, rather than the particular degree of care with which an act is performed. For example, UCC § 2-103(b) defines good faith as honesty in fact and conformance to commercial standards of fair dealing. In view of this distinction, what standard of conduct would you prefer to be held to as an exclusive licensee? What would you prefer as a licensor who has granted an exclusive license?
4. *Enumeration of obligations*. If a licensor wants to be sure that its exclusive licensee will take certain actions to promote a particular product or business, it can list those specific obligations in the agreement. For example, a licensee can be required to meet minimum annual sales or development milestones, achieve certain regulatory approvals, open a certain number of sales offices around the world, devote a certain number of full-time personnel to promotional activities, etc. Why don't all license agreement contain such specific lists of licensee actions? When might a general "best efforts" or "good faith" obligation be preferable? Absent a list of specific milestones or requirements, would you prefer that an exclusive licensing agreement state a general level of obligation such as "best efforts" or "good faith," or that it remain silent on this issue, allowing a court to determine the appropriate degree of effort depending on the facts and circumstances?
5. *Effect of advance payments*. Why does the court in *Permanence* emphasize the fact that the licensee made an advance payment to the licensor? What effect should advance payments have on an exclusive licensee's obligations?
6. *Merger clause*. The court in *Permanence* also gives weight to the presence of a "merger" or "integration" clause in the agreement between Permanence and Kennametal. This clause is typically considered part of the "boilerplate" that comes at the end of every agreement. Is it meaningful? Should the court give significant weight to standard clauses such as this, particularly if there is evidence that the parties had a different understanding? See Section 13.7 for a discussion of these standard clauses in licensing agreements.
7. *Remedies*. What is a licensor's remedy if its exclusive licensee fails to meet its standard of performance? If such a failure can be characterized as a breach of contract, then the licensor may have the right to terminate the agreement, either under the terms of the agreement or under the common law (see Chapter 12). But there are less severe remedies, as well. One of these is releasing the licensor from certain milestone or progress payments to the licensee (see Chapter 8.5). Another effective remedy is the licensor's ability to terminate the licensee's exclusivity, but otherwise to keep the license agreement in force. In effect, this remedy converts the exclusive license to a nonexclusive license. Depending on the agreement, such a conversion may also reduce the royalty rate payable by the licensee, eliminate further milestone payments by the licensor, and otherwise transform the financial profile of the agreement from an exclusive to a nonexclusive agreement. Both a release from payments and conversion to nonexclusivity are generally implemented through express contractual language rather than operation of law. Which remedy do you think is the most effective for

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an exclusive licensee's failure to meet its commercialization obligations? Does your answer depend on whether you represent the licensor or the licensee?

Problem 7.3

Kitchen Corp. grants Garden Italiano, a national restaurant chain, a five-year exclusive license under Kitchen Corp.'s patented process for sharpening kitchen knives. Under the agreement, Garden Italiano is required to make an up-front payment of $75,000 and to pay running royalties of 15 percent on income that it obtains from sublicensing the process to others, and 0.25 percent of net sales from all Garden Italiano restaurants. A year after the agreement is executed, Garden Italiano determines that it would be more economical to subscribe to a national knife rental program that delivers newly sharpened knives to its outlets every week. Garden Italiano discontinues use of Kitchen Corp.'s sharpening process and makes no further effort to market the process to others. Three months later, Kitchen Corp, notices that Garden Italiano has stopped making payments under the licensing agreement. What legal actions, if any, would you advise Kitchen Corp. to take in response?

Problem 7.4

Big Film USA is a major motion picture producer and distributor. Its inventory includes thousands of motion picture scripts, many of which were created by independent screenwriters. In most cases, the screenwriter has granted Big Film USA all rights to exploit the script under a worldwide, perpetual, exclusive license agreement in exchange for an advance payment of a few thousand dollars plus a 5 percent running royalty on net profits from any motion picture based on the script. Five years ago, Hank Toms licensed Big Film USA the script for a film titled *Citizen Jane*, a darkly comedic look at the rise of a plucky young newspaper reporter. Upon signing the licensing agreement, Big Film USA's acquisitions manager told Hank that the script was a "masterpiece of modern cinema." Nevertheless, during the past five years, Big Film USA has made no progress toward producing a film based on the script, though it has produced at least ten other motion pictures in the same genre as *Citizen Jane*. One of these other films won two Academy Awards, but the other nine ranged from modest commercial successes to flops. None of the other films infringes Hank's copyright in *Citizen Jane*. Does Hank have a legal claim against Big Film USA? What arguments might you make on behalf of Big Film USA to contest Hank's claims? How might you draft future exclusive script licenses to avoid such claims from other screenwriters?

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