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BRIEFING

New rules on technology licensing

Executive summary

The European Commission has proposed major changes to the rules on licensing patents, knowhow and software. The changes will be particularly relevant to those in the technology sector, but all businesses should consider their impact and decide whether to get involved in the EU lobbying process.

Introduction

The European Commission has proposed important changes to the technology licensing rules in the 1996 Technology Transfer Block Exemption (TTBE). While the changes will not come into force until early next year, all businesses depending on technology licensing need to be aware of them now. They should take particular note of the changes when negotiating new licences and ought to review their current agreements for compliance. The proposals are likely to cause controversy in some quarters and businesses may wish to lobby the Commission. The proposals are open to consultation until 26 November 2003.

Background

Article 81(1) of the EC Treaty prohibits agreements that prevent, restrict or distort competition. Such agreements are void and the parties may face damages claims and fines of up to 10 per cent of worldwide turnover. Article 81(3) provides a system whereby certain agreements may fall outside article 81(1) if they meet certain criteria: broadly, if their technical and economic benefits outweigh their anticompetitive effects.

Currently, in order to be certain that an agreement benefits from article 81(3), the parties to it may seek individual exemption from the European Commission, or else draft the agreement to fall within one of the block exemptions. In addition to the TTBE, there are block exemptions for vertical, R&D and specialisation agreements. Also, some agreements between parties with a low market share may be exempted under the Commission's Notice on Agreements of Minor Importance (Naomi).

A modernised competition law regime will come into force on 1 May 2004 and, as part of this, the Commission will no longer give individual exemptions. The parties themselves will have to determine if an agreement falls within article 81(3). Therefore, in order to obtain maximum certainty, companies will increasingly rely on the block exemptions.

History of the Proposals

In December 2001, the European Commission issued a report evaluating the TTBE. Before adopting the report, the Commission carried out a preliminary fact-finding exercise, which showed that industry favoured a review and simplification of the TTBE. The report found that the TTBE assessed the form of agreements, rather than their effects on the market, and invited comments on whether it should be reviewed. In July 2002, the Commission published the 33 responses received, and concluded that a review was necessary.

On 1 October 2003, the Commission published a draft block exemption regulation and related guidelines (the Proposals) to replace the TTBE, and invited comments by 26 November 2003.

Scheme of the Proposals

The proposed regulation is significantly simpler and less formalistic than the TTBE and follows the more economic approach of the recently reformed rules on vertical and horizontal agreements. It treats agreements between competitors differently from those between non-competitors, but exempts all agreements between parties that fall under certain market share thresholds – subject to a short list of banned provisions.

The proposed guidelines advise on how the regulation should be interpreted and how article 81 will apply to technology transfer agreements that do not come within the block exemption.

Technology transfer agreements

The draft regulation will apply to technology licences entered into between two undertakings for the manufacture or provision of goods or services incorporating the licensed technology ('contract products' is defined to include both products and services). It is wider than the TTBE in that it applies not only to patent and knowhow licences but also to licences of copyright in software and of design rights.

Among other things, the draft regulation will apply to subcontracting arrangements; namely, where a company licenses technology to a licensee to make products and supply them to the licensor only. The Proposals will replace the Commission's 1978 notice on the application of article 81(1) to subcontracting agreements. The guidelines note that subcontracting agreements usually fall outside article 81(1) if the licensed technology is necessary to manufacture the products. They may, however, fall foul of article 81(1) if they reduce the ability or incentive of the subcontractor to innovate, foreclose third parties, or facilitate collusion on the market.

The regulation will not cover R&D subcontracting arrangements, where the licensee carries out R&D in the field covered by the licensed technology and then hands back an improved technology package to the licensor.

Further, it will not deal with licensing agreements for the purposes of setting up patent pools (although it will apply to licences granted by a technology pool to third parties). The draft guidelines do give extensive and useful guidance on how the Commission will view patent pooling arrangements; this is dealt with below.

Competitors and non-competitors

A major shift introduced by the Proposals is their relatively strict treatment of agreements between competitors, on the basis that these pose a greater risk to competition than agreements between non-competitors. The draft regulation defines competitors as undertakings that compete on the relevant technology and/or product markets. Companies compete on the relevant technology market if they license competing technologies. They compete on the relevant product market if they are both active on the product and geographic markets where the products are sold (actual competitors), or if they would realistically enter those markets in response to a small and permanent increase in prices (potential competitors).

The draft guidelines suggest that where an undertaking owns patented technology, but requires a licence from a second undertaking in order to exploit that technology, a licensor and licensee in that context will not be considered to be competitors on the technology market. However, in assessing whether the licence is required in order for the undertaking to exploit its own technology (called a blocking position), the Commission will consider objective evidence, such as final judgment in an infringement case, or expert evidence, rather than the subjective views of the parties.

The Commission may be unrealistic in requesting final judgment as evidence. Patent infringement cases rarely reach final judgment because an alleged infringer is unlikely to risk an order granting a permanent injunction against it. Where the Commission is provided with expert evidence, it will review how an expert was selected when considering how much weight to place on his evidence.

It is worth noting that, although two companies might be competitors at the start of their agreement, the licensor's technology may prove to be such a radical innovation that it renders the licensee's technology obsolete, putting the parties into the position of non-competitors. It might therefore benefit both parties to keep their relationship under review.

Market share

Probably the regulation's most controversial element is its introduction of a market share test. It will exempt agreements between competitors if they have a combined market share not exceeding 20 per cent of the relevant technology and product markets. For agreements between non-competitors, neither party's market share can exceed 30 per cent.

If the parties initially fall under the market share thresholds but later exceed them, they retain the benefit of the exemption for two years, provided the relevant market share does not exceed 25 per cent or 35 per cent respectively. Where these higher thresholds are exceeded, the exemption continues to apply for only one year.

A party's share of the relevant technology market is defined in terms of the presence of the licensed technology on the relevant product market. A licensor's market share is the combined market share on the relevant product market of the contract products manufactured or provided by the licensor and its licensees. Market shares must be calculated on the basis of market sales value data for the preceding calendar year. If this information is not available, estimates may be based on other reliable market information, including market sales volumes.

The introduction of the market share tests will inevitably cause difficulties for companies seeking to define relevant markets and to establish their exact market share at any given time. The issue is particularly sensitive for those dealing with new technologies. Where a new technology has not yet generated any sales, a zero market share will be assigned, with the technology accumulating market share as sales begin. If the technology is particularly innovative, its owner's market share may soon exceed the relevant threshold, taking any licensing agreement outside of the regulation's safe harbour. In some cases a radical new technology will create its own market, automatically taking a 100 per cent market share.

When the TTBE was last reviewed, the Commission significantly watered down its initial proposal for market share caps following criticism that this would lead to uncertainty (the market share test was consigned to the withdrawal section of the TTBE). However, it seems likely that the Commission will retain the test in some form this time around, in particular because similar thresholds have been introduced for vertical and horizontal agreements (as well as the *de minimis* thresholds in Naomi.)

Restrictions

Assuming the parties fall below the market share thresholds, they must also avoid imposing any of the regulation's hardcore restrictions in order to benefit from the block exemption. Inclusion of any of these restrictions will invalidate the agreement. Again, competitors and non-competitors are treated differently. For competitors, the banned provisions are as follows.

- Restrictions on prices. According to the guidelines, royalty-bearing cross licences between competitors can potentially be regarded as price-fixing. Enormous care is needed when entering into such agreements.
- Limitations on output or sales, other than a limitation on output imposed on the licensee in a non-reciprocal agreement.
- Allocation of markets or customers, other than (a) an obligation on the licensee in a non-reciprocal agreement to exploit the licensed technology only within one or more technical fields of use or one or more product markets or (b) a restriction to manufacture or provide products for use by the licensee only. The guidelines interpret this as prohibiting any reciprocal field of use restrictions and field of use restrictions on the licensor in a non-reciprocal agreement. This interpretation is surprising and not in line with any existing authority. It is likely to be the focus of heavy lobbying as it will make it almost impossible for competitors to enter into licensing agreements.
- Restrictions on the licensee exploiting its own technology, or on the parties carrying out R&D, except where necessary to prevent disclosure of knowhow to third parties.

For non-competitors, the prohibited terms are as follows.

- Restrictions on prices, other than imposing a maximum price or a recommended resale price.
- Restrictions on the territory into which, or on the customers to whom, the licensee may sell, except:
  - where the territory/customer group is reserved to the licensor;

– restrictions on active sales to a territory/customer group reserved to another licensee;
– limiting manufacture or provision of products for use by the licensee only;
– restrictions on sales to end users by a licensee at the wholesale level; or
– restrictions on sales to unauthorised distributors by the members of a selective distribution system.

- Restrictions of sales to end users by licensees which are members of a selective distribution system operating at the retail level (other than a prohibition on operating out of an unauthorised place of establishment).

The draft regulation also states that the following provisions are not block exempted, and therefore require individual assessment as to whether they infringe article 81(1):

- any requirement on the licensee to exclusively license-back any severable improvements or new applications of the technology;
- any requirement on the licensee to assign to the licensor any improvements or new applications of the technology;
- no-challenge clauses, although the licensor may terminate on challenge;
- any limitation on output by the licensee in a non-reciprocal agreement between competitors; and
- in an agreement between non-competitors, any limitation on the licensee exploiting its own technology or on the parties carrying out R&D, except where necessary to prevent disclosure of knowhow.

Those familiar with the black, white and grey lists of the current TTBE will immediately appreciate the relative simplicity of the draft regulation's list of banned clauses. Particular changes include the following.

- Licensors will no longer be able to restrict licensees making passive sales, other than in an agreement between non-competitors where the licensor has reserved a territory to itself. Under the current TTBE, licensors may prohibit passive sales subject to a five year time limit.
- The current 10 year limit for pure knowhow licences will be removed. The proposed block exemption would apply for as long as the licensed right has not expired or been declared invalid or, in the case of knowhow, remains secret.
- Licensors no longer need to license their own improvements to the technology in return for a licence-back from the licensee of its improvements or new applications.
- Licensors may no longer require an exclusive licence-back of new applications of the licensed technology. This new constraint is likely to be particularly relevant to the pharmaceutical sector.
- The prohibition on field of use restrictions noted above.

Two particular issues of concern to those in the technology industries are cross licensing and technology pools.

Cross licensing

The guidelines provide a useful commentary on cross licences, particularly where these are 'exclusive'. (The guidelines use the word 'exclusive' to describe a licence in which the licensor agrees not to grant the same rights to other licensees, but reserves the licensor's right to use or exploit the licensed technology. Strictly speaking therefore, the Commission's guidance is directed at sole cross licences, which in practice are quite rare.) Exclusive licensing between competitors is block exempted up to the market share threshold of 20 per cent. Above the threshold, exclusive cross licences are likely to be caught by article 81(1) and are unlikely to fulfil the conditions of article 81(3). Such licences should be available to third parties on reasonable terms.

In the case of non-competitors, exclusive licensing is block exempted up to the market share threshold of 30 per cent. Above this threshold, it is unlikely to give rise to appreciable foreclosure effects unless there are only a limited number of viable technologies available.

The guidelines state that in the context of settling a patent dispute, where the parties agree to cross-license their patented technology, such agreements are not as such restrictive of competition. However, if the terms of any such cross licence restrict the ability of either undertaking to exploit its own technology, it could fall foul of article 81(1) and is unlikely to benefit from the exemption in article 81(3).

Technology pools

Although not covered by the regulation, the guidelines set out the Commission's views on agreements establishing technology pools – views that appear to have been heavily influenced by those of the US Department of Justice. The guidelines note that the competitive risks and efficiency enhancing potential of technology pools depend on the relationship between the pooled technologies and on their relationship with technologies outside the pool.

The Commission uses the following terminology to analyse the positive and negative effects of technology pools. Two technologies *complement* each other where they are both required in order to produce a product or carry out a process. Two technologies will be *substitutes* where an undertaking could use either of the technologies to produce a product or carry out a process. A technology is *essential* if there are no substitutes for it inside or outside the pool, and the technology is required to produce the product or carry out the process to which the pool relates. Technologies that are essential are by necessity also complements.

As a general rule, the Commission considers that the inclusion of substitute technologies in a pool constitutes a violation of article 81(1), and that the conditions of article 81(3) are unlikely to apply. The effect is to restrict inter-technology competition and will amount to collective tying. Where the predominant part of the pool is composed of substitute technologies, the arrangement will also amount to price-fixing between competitors.

Where a pool is composed only of technologies that are essential and therefore by definition complements, the creation of the pool will generally fall outside article 81(1) irrespective of the market position of the parties. However, the conditions on which the pool grants licences to third parties may be caught by this article.

Where non-essential but complementary patents are included in a pool, there is a risk of foreclosure of third party technologies. Licensees will have little incentive to purchase a competing technology if they are already paying a royalty for a package of technology which includes a substitute. The inclusion of non-essential complementary patents may also amount to collective tying, and is likely to be caught by article 81(1) where the pool has a significant position on any relevant market.

Going forward

The Commission has asked for comments from interested parties by 26 November 2003. The aim is that the regulation will come into force on 1 May 2004, the same date as EU enlargement and the introduction of the modernised competition law regime.

Companies entering new technology transfer agreements now should bear in mind the provisions of the draft regulation, particularly its hardcore restrictions. Businesses will also need to consider whether any current agreements will comply with the new block exemption when it comes into force. The regulation will provide a grace period for non-compliant agreements that fell within the old TTBE – but only until 31 October 2005. Special care is required when entering into cross licences and patent pooling arrangements.

At a time when the assessment burden is to fall on industry, the simplification of the notoriously byzantine TTBE is to be welcomed. However, the introduction of problematic market share tests, and the failure to extend the exemption to other IP rights, is perhaps regrettable. Those wishing to participate in the debate should act now.

The Proposals are at *http://europa.eu.int/comm/competition/antitrust/legislation/entente3_en.html#technology*.

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