

THE NEW EU TECHNOLOGY LICENSING RULES

EXECUTIVE SUMMARY

On 1 May 2004 the EU competition law reform package came into force, thus marking the end of the era where companies could notify restrictive agreements to the European Commission for clearance, granting them immunity from fines and protection from assertions of nullity of contract and other claims in litigation. In addition, as from that date the national competition authorities and courts of the EU Member States have full competence to apply Article 81 of the EC Treaty directly in its entirety, including Article 81(3).

Businesses themselves have now become responsible for ensuring full compliance with the EU competition rules, at the risk of being faced with fines, nullity of contract or damage claims before the courts. In the event of an agreement that restricts competition, parties to the agreement will now have to ensure that their agreement will qualify for individual exemption pursuant to Article 81(3) of the EC Treaty and thus withstand challenges from other parties.

Certain categories of agreements will nevertheless continue to benefit from so-called block exemptions. These provide shelter from antitrust claims, provided the conditions of the block exemption concerned are fully met.

On 1 May 2004, for example, the new Technology Transfer Block Exemption Regulation (Commission Regulation (EC) No 772/2004 of 27 April 2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements, OJ No 123, 27.04.2004, p. 11; hereinafter 'TTBER') came into force. It lays down new rules for the licensing of patents, know-how and software copyright, thereby replacing the old TTBER of 1996 (Regulation No 240/96). Businesses have until 31 March 2006 to bring their existing agreements in line with these new requirements. Failing to do so may lead to nullity of contract, claims for damages and fines.

Alongside the new TTBER, a set of accompanying Technology Transfer Guidelines (OJ No C 101, 27.04.2004, p.2; hereinafter 'TT Guidelines') came into effect. They explain the application of the TTBER and provide a framework for analysing technology licence agreements that fall outside the scope of the TTBER. Licence agreements which fulfil the conditions laid down in the TTBER benefit from a safe harbour, i.e. they are automatically legally valid and enforceable. Licence agreements which fall outside the scope of the TTBER are not, however, presumed to be illegal and could still qualify for individual exemption on the basis of Article 81(3) of the EC Treaty. Such agreements must therefore be analysed on the basis of the TT Guidelines.

I. INTRODUCTION: THE EC COMPETITION RULES

Article 81(1) of the EC Treaty contains a general prohibition on agreements which restrict competition and affect trade between Member States. Such restrictive agreements are unenforceable. In addition, parties entering into such agreements risk fines as high as 10% of their worldwide turnover and claims for damages.

However, **Article 81(3) of the EC Treaty** provides for an exception to the prohibition laid down in Article 81(1). It 'exempts' restrictive agreements which confer sufficient benefits (so-called 'pro-competitive effects') to outweigh their anti-competitive effect.

These rules also apply to technology licence agreements. Technology licence agreements are in general believed to affect competition between companies. As such, they would risk infringing Article 81(1) of the EC Treaty. On balance, however, the advantages realized by these agreements may outweigh the anti-competitive drawbacks. In such situations, the agreement could qualify for an exemption under Article 81(3) EC.

Since 1 May 2004, the implementation of Article 81(3) has drastically changed.

Until that date, the European Commission had exclusive competence to apply this provision and to grant exemptions. Parties wishing to obtain an exemption had to notify their restrictive agreements to the Commission. If the Commission was unwilling to grant an exemption, the parties could enter into negotiations with the Commission concerning the required amendments to qualify for exemption. This system was rather bureaucratic, and in order to avoid an overload of notifications, the Commission over the years adopted a number of 'block exemptions', e.g. concerning vertical agreements (distribution agreements), horizontal agreements (i.e. co-operation between competitors), etc. Agreements that fulfilled the conditions set out in these block exemptions were automatically exempted and no longer required notification.

As from 1 May 2004, the notification system has been abolished completely. Companies no longer have the possibility of notifying agreements to the Commission in order to obtain an exemption. The Commission's exclusive competence to grant an exemption has been abolished as well; the competition authorities and the courts of the EU Member States can now also apply Article 81(3) EC. The parties to an agreement have to carry out a so-called 'self-analysis' and assess whether their agreement restricts competition and if so, whether it is 'exemptible'. If the agreement fulfils the conditions of one of the block exemptions (e.g. the new TTBER), then it will be automatically legally valid and enforceable. If not, the parties will have to ensure that they have good arguments to defend their agreement on the basis of Article 81(3), should it be challenged. For technology licence agreements, guidance on the application of Article 81(3) can be found in the TT Guidelines.

II. THE NEW TTBER: MAIN FEATURES

The configuration of the new TTBER strongly resembles the structure of other recently adopted Block Exemption Regulations in other areas (e.g. concerning vertical agreements), thus moving away from a legalistic, clause-by-clause approach to one that is more focused on economic analysis.

Its main features can be summarised as follows:

Scope:

The TTBER applies to technology licence agreements between two undertakings for the manufacture or provision of goods or services incorporating the licensed technology (“contract products”). The TTBER also applies to agreements whereby the licensee must carry out development work before obtaining a product or process that is ready for commercial exploitation, provided that a contract product has been identified.

The new TTBER only applies to patent (including design rights), know-how and software copyright licensing or mixed patent, know-how or software copyright licensing. Its scope is thus broader than the old TTBER of 1996, which did not cover software. Trademarks and copyright licensing are covered only if they are licensed as ancillary to patent, know-how or software copyright licence agreements. In practice, however, the TT Guidelines will in effect also serve in the assessment of copyright licences.

Agreements whereby a company licenses technology to a licensee to manufacture products and supply them only to the licensor in a subcontracting arrangement now also fall under the scope of the TTBER.

Duration:

The safe harbour provided for by the TTBER applies as long as the licensed intellectual property right (IPR) has not expired, lapsed or been declared invalid. In the case of know-how, it applies as long as the licensed know-how remains secret.

Distinction between competitors vs. non-competitors:

A new important feature in the TTBER is the differentiated treatment of competitors and non-competitors (e.g. separate market share caps and separate hardcore list). In order to determine the competitive relationship between the parties, it is necessary to examine whether the parties would have been actual or potential competitors in the absence of the agreement.

For agreements between competitors, the TTBER makes an important distinction between reciprocal and non-reciprocal agreements. A reciprocal agreement is defined as a technology transfer agreement where two undertakings grant each other, in the same or separate contract, a licence and where these licences concern competing technologies or can be used for the production of competing products.

Safe harbour:

The TTBER provides a safe harbour for certain technology licence agreements: they are block exempted from the prohibition rule laid down in Article 81(1) EC and are thus automatically legally valid and enforceable.

The safe harbour is available to licence agreements falling within the scope of the TTBER and which satisfy the following conditions:

1. Market share caps

A set of market share thresholds are the principal entrance keys to the benefits of the TTBER. This constitutes a radical change compared to the old TTBER of 1996.

The exemption contained in the new TTBER covers agreements between:

- Competitors: provided that their combined market share does not exceed 20% on the affected relevant technology and product market; and
- Non-competitors: provided that neither party's individual market share exceeds 30% on the affected relevant technology and product market.

If the applicable market share threshold is exceeded on an affected relevant market, the TTBER does not apply to the agreement for that relevant market. In the event that the licence agreement concerns two separate product markets or two separate geographic markets, for example, the TTBER may apply to one of the markets and not to the other.

Relevant markets:

Market share on the relevant technology market is to be calculated on the basis of sales of products incorporating the licensed technology on downstream product markets. A licensor's market share on the relevant technology market(s) shall be calculated on the basis of all sales by the licensor, the licensee and other licensees of products incorporating the licensor's technology. Where the parties are competitors on the technology market, sales of products incorporating the licensee's own technology must be added to the sales of the products incorporating the licensed technology.

In the case of new technologies that have not yet generated any sales, a zero market share will be assigned and the technology will accumulate market share once sales begin. If a technology is highly innovative, it is likely that the owner's market share will quickly exceed the thresholds and will not benefit from the safe harbour of the TTBER. New technologies may create their own markets (with 100% market share).

As for the relevant product markets, the licensee's market share is to be calculated on the basis of the licensee's sales of products incorporating the licensed technology and competing products, i.e. the total sales of the licensee on the product market in question. Where the licensor is also a supplier of products on the relevant market, the licensor's sales are also taken into account. Sales made by other licensees will not be taken into account when calculating the licensee's and/or licensor's product market share.

Market shares: a moving target

Companies benefiting from the new TTBER will need to continuously review their market position in order to establish whether the new TTBER still applies. The introduction of market share thresholds may therefore create legal uncertainty. The definition of the relevant product market can be a complicated exercise when the licences concern high-level innovative technologies. Innovation markets change often and rapidly; market share data may therefore quickly become outdated and may not be a true reflection of current market power. Objective economic analysis - in particular with regard to market share - may, therefore, be required in order to reach solid conclusions on the applicability of the new TTBER.

However, if the market share of the parties rises above the thresholds during the course of the agreement, then the TTBER shall continue to apply for a period of two calendar years following the year in which the threshold was first exceeded.

2. Hardcore restrictions

The TTBER contains a series of so-called ‘hardcore restrictions’. In the event that the licence agreement contains any such clause, the entire agreement will lose the benefit of the block exemption, regardless of whether or not the market share thresholds are met. Such agreement will normally not qualify for individual exemption either.

There is a separate hardcore list for agreements between competitors and agreements between non-competitors.

Licence agreements between **competitors**:

- Restrictions on the parties’ ability to freely set prices when selling products to third parties;
- Reciprocal output limitations on the parties;
- Allocation of markets or customers, except for:
 - (i) an obligation on the licensee to produce only within one or more technical fields of use or one or more product markets;
 - (ii) an obligation on the licensor not to license the technology to another licensee in a particular territory (sole licensing);
 - (iii) an obligation on the licensee to produce the contract goods only for his own use;
 - (iv) in a non-reciprocal agreement:
 - (a) an obligation on the licensor and/or the licensee not to produce within one or more technical fields of use/product markets or one or more exclusive territories reserved for the other party;
 - (b) a restriction of active and/or passive sales by the licensee and/or the licensor within the exclusive territory/customer group reserved for the other party;
 - (c) a restriction of active sales by the licensee within the exclusive territory/customer group allocated to another licensee;
 - (d) an obligation on the licensee to produce the contract products only for a particular customer, where the licence was granted to create an alternative source of supply for that customer (‘second sourcing’).
- Restrictions on the licensee’s ability to exploit his own technology or restrictions on the parties’ ability to carry out R&D.

Licence agreements between **non-competitors**:

- Restrictions on price-setting (maximum or recommended sale prices are, however, allowed);
- Restrictions on the territory in which, or of the customers to whom, the licensee may passively sell, except for:
 - (i) a restriction of passive sales within an exclusive territory/customer group reserved for the licensor;
 - (ii) a restriction of passive sales within an exclusive territory/customer group allocated to another licensee during the first two years that this other licensee is selling the contract products;
 - (iii) an obligation on the licensee to produce the contract goods only for his own use;
 - (iv) an obligation on the licensee to produce the contract products only for a particular customer, where the licence was granted to create an alternative source of supply for that customer ('second sourcing');
 - (v) a restriction of sales to end-users by a licensee operating at the wholesale level;
 - (vi) a restriction of sales to unauthorised distributors by the members of a selective distribution system.
- Restriction of active or passive sales to end users by a licensee who is a member of a selective distribution system and who operates at the retail level.

Remark: non-competitors becoming competitors...

Where the parties to a licence agreement are not competitors at the time of conclusion of the agreement, but become competitors afterwards, the black list for non-competitors remains applicable, unless the agreement is subsequently amended in any material aspect.

3. Excluded restrictions

The TTBER also lists a number of restrictions which do not benefit from the safe harbour (not automatically exempted), and require individual assessment on the basis of the TT Guidelines as to whether they merit exemption because their pro-competitive effects outweigh their restrictive effects.

Inclusion in a licence agreement of any of these restrictions does not, however, prevent the application of the block exemption to the rest of the agreement, provided that the market share thresholds are met and the agreement contains no hardcore restrictions.

The restrictions concerned are the following:

- Exclusive grant-back obligations (either through a licence or assignment) in respect of a licensee's own 'severable' improvements to (or his own new applications of) the licensed technology (a severable improvement means 'an improvement that can be exploited without infringing the licensed technology');
- No-challenge clauses in respect of the validity of the intellectual property rights held by the licensor, without prejudice to the possibility of providing for termination of the licence agreement in the event of a challenge;
- In case of non-competitors: restrictions on the licensee's ability to exploit his own technology or on the parties' ability to carry out R&D.

III. OUTSIDE THE TTBER: NO PRESUMPTION OF ILLEGALITY

It is clear from the above that, if the market share thresholds are not exceeded, all clauses that do not amount to hardcore or excluded restrictions are legally valid (safe harbour).

If the market share thresholds are exceeded or one of the other conditions laid down in the TTBER is not met (e.g. agreements that involve more than two parties), there is no presumption of illegality. In such case, the agreement will require an individual analysis by the parties concerned on the basis of the TT Guidelines in order to assess whether it restricts competition and therefore falls within the prohibition laid down in Article 81(1), and if so, whether its pro-competitive effects outweigh its anti-competitive effects, therefore fulfilling the conditions for exemption under Article 81(3) EC. In this respect, the TT Guidelines provide guidance on royalty obligations, exclusivity and sales restrictions, output restrictions, field of use restrictions, captive use restrictions, tying, non-compete obligations, settlement and non-assertion agreements and technology pools.

Agreements containing a hardcore restriction will normally be prohibited, irrespective of the market share of the parties.

IV. TECHNOLOGY POOLS

The new TTBER does not cover technology pools, i.e. arrangements where two or more parties assemble a package of technology that is not only licensed to members of the pool but also to third parties. Such arrangements have to be assessed on the basis of the TT Guidelines.

Technology pools may restrict competition. However, the TT Guidelines acknowledge that patent pools may also have pro-competitive effects (e.g. one-stop licensing and reduction of transaction costs), particularly if:

- the patents concerned are essential, complementary and not substitutable;
- the license-in and license-out arrangements are non-exclusive;
- access to the technology is non-discriminatory;
- the technology is licensed on terms that are fair and reasonable.

The anti-competitive risks and the efficiency-enhancing potential of technology pools depend to a large extent on the relationship between the pooled technologies and their relationship with technologies outside the pool. In this respect it is important to distinguish between technological complements and substitutes, and between essential and non-essential technologies.

As a general rule, the inclusion of substitute technologies in a pool will be considered to restrict competition to an extent that would not allow for an exemption. One of the negative effects could be that royalties are higher because licensees do not benefit from rivalry between the technologies in question. Where the predominant part of the pool is composed of substitute technologies, the arrangement effectively amounts to an unlawful price-fixing cartel between competitors.

When a pool is composed only of technologies that are essential and therefore by necessity also complementary, the creation of the pool as such generally falls outside the scope of Article 81(1). However, the conditions on which licences are granted may fall under the scope of Article 81(1) EC.

Where non-essential but complementary patents are included in the pool, there is a risk of foreclosure of third-party technologies, in particular where the pool has significant market power.

In the event of non-essential technologies, parties will have to assess whether there are pro-competitive reasons for including the non-essential technologies in the pool, to what extent licensors remain free to license their respective technologies independently and whether licensees may exclude certain parts of the package from the licence and receive a corresponding reduction of royalties.

Remark:

Individual licences granted by the pool to third-party licensees are treated in the same manner as any other licence agreement, i.e. they benefit from a safe harbour if the conditions laid down in the TTBER are met.

V. CONCLUSION

Companies need to be aware of the anti-trust angle when dealing with their IP. They will have to assess whether and how the new rules will impact upon their existing licence agreements. Most likely quite a number of licence agreements will have to be adapted and possibly renegotiated in order to align them to the new rules.

In many respects, the new TTBER is more permissive than the old TTBER of 1996. The old TTBER was based on a formalistic approach with its long and rigid list of acceptable and non-acceptable clauses. The new TTBER, on the contrary, is characterised by an economics-based approach assessing the impact of licence agreements on relevant markets. However, the increased flexibility of the new TTBER also has a price. The market share caps introduce significant legal uncertainty. In addition, self-assessment becomes the rule (it is no longer possible to notify licence agreements to obtain immunity) and might in practice result to be very complex, involving a mix of legal and economic arguments, particularly in respect of the definition of markets, the calculation of market shares, the determination as to whether technologies are essential, complementary, substitutable, etc., which is particularly difficult in technologically complex and innovative sectors.

A proper self-assessment process is essential to guarantee that agreements are not declared null and void and that parties do not expose themselves to claims for damages or even fines.

ANY FURTHER QUERIES?

Please contact:

Wilko van Weert, Partner / **Filip Ragolle**, Associate

Bird & Bird, Brussels

EU & Competition Department

Rue de la Loi, 15

B- 1040 Brussels (Belgium)

Tel : +32 2 282 6000

Fax: + 32 2 282 6011

E-mail: wilko.van.weert@twobirds.com / filip.ragolle@twobirds.com