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The way in which a licence agreement is described on paper could have a significant bearing on its effectiveness further down the line. Lack of precision, for example, may end up being very costly

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One of the most important tasks of anyone faced with the licensing of intellectual property is to make sure that they first and foremost fully understand the business deal. Once this is done, they can proceed with allocating the risks and benefits for both parties and capture the business deal in a clear and unambiguous licensing agreement. This fundamental objective of clarity is guided by the principle of the freedom to contract and the ability of two parties to negotiate in good faith a fair and reasonable agreement. However, while clarity is essential, other aspects of intellectual property may trump the axiom of freedom to contract in creating an enforceable agreement.

The true test of clarity is for a person unrelated to the transaction to be able to discern the rights and obligations of the parties easily. It is wise to avoid the legal and technical jargon which frequently appears in intellectual property licences unless such terms are clearly defined in the agreement. Many US states even have plain language statutes that require agreements to be written in a form of English that is easily understood.

Generally speaking, courts will enforce clear and unambiguous agreements that have been reached by two parties of equal bargaining strength and are reluctant to interfere or introduce new terms. Rarely will a court negate or void an agreement or contract term so long as the contract or term is not unconscionable and was freely negotiated and agreed upon by both parties. Unfortunately, when licensing intellectual property, it may not be sufficient to just have a clear and unambiguous agreement that was negotiated in good faith. If you are not careful, these laws might supersede even the most clearly written and unambiguous agreement. This article explores two cases that demonstrate the importance of clarity and the need to understand the laws governing intellectual property

Scheiber v Dolby Laboratories Inc

Back in the early 1980s, Peter Scheiber was a musician turned inventor who held United States and Canadian patents on the audio technology know as surround sound. In 1983, Scheiber sued Dolby for patent infringement and the parties agreed to settle their dispute through a licence agreement. Scheiber's United States patents were scheduled to expire in May 1993 and his Canadian patents were to expire in September 1995.

Dolby suggested, in the course of negotiating the licence agreement, that in exchange for a lower royalty rate payable to Scheiber it would be willing to pay royalties that would continue for a longer period of time beyond expiration of the United States patents. Remember – it was Dolby, the licensee, not Scheiber, the patent owner, who suggested that the payment of royalties be extended beyond the expiration of the patent. Scheiber agreed to Dolby's payment plan and the licence agreement was drafted accordingly to allow for royalty payments to extend beyond the term of the patent. Imagine Scheiber's surprise when Dolby notified him that it was no longer going to pay him any royalties as soon as the first United State's patent expired. So much for fairness and equity.

Dolby took the position that, regardless of what the contract provided, its duty to pay royalties on any patent covered by the licence

ended as soon as the patent expired. Since royalties were based on Dolby's sales of equipment that were within the scope of the patent, once the Scheiber patent expired there were no longer sales of equipment covered by any patent claims.

Dolby relied upon the United States Supreme Court 1964 decision in *Brulotte v Thys Company* that a patent owner may not enforce a contract for payment of patent royalties beyond the expiration of the patent. *Brulotte*, which has never been overruled but has been criticised, also involved a licence agreement covering patents that expired on different dates. According to the Supreme Court in *Brulotte*, by extracting a promise to continue paying royalties beyond expiration, the owner of the patent is essentially extending the patent beyond the term fixed by statute which is a form of patent misuse in violation of the law.

The *Scheiber* court criticised the Supreme Court reasoning in *Brulotte* and suggested that, upon expiration of the patent, anyone can use the patented process or product without infringing, so that the ongoing payment of royalties by a licensee beyond the term of the patent does not, in fact, extend the patent term at all. According to the *Scheiber* court, whether the royalties are paid at a higher rate over a shorter period of time or a lower rate over a longer period of time should not matter. In its view, charging royalties beyond the term of the patent does not lengthen the patent owner's monopoly, but merely alters the timing of the royalty payments. Despite the *Scheiber* court's criticism of *Brulotte*, it still found that it had no authority to override a United States Supreme Court decision "no matter how dubious its reasoning strikes us".

The *Scheiber* court also cited another United States Supreme Court case, *Aronson v Quick Point Pencil Company*, which was decided several years after *Brulotte*. In 1979, *Aronson* upheld a licence agreement with payment provisions similar to those used in both *Brulotte* and *Scheiber*. The *Aronson* case, however, involved a licence agreement for a patent application. The licensee was granted a licence for an as yet unissued patent with royalties payable to the licensor for as long as the licensee continued to sell products embodying the invention. Since no patent was ever granted, the doctrine of patent misuse invoked in *Brulotte* did not invalidate the licence involved in the *Aronson* case. The leverage that a patent owner exercised in *Brulotte* to extract royalties beyond the patent term was, according to the Supreme Court, absent in *Aronson*.

Scheiber, the inventor, faced a double-edged sword. He could not sue Dolby for patent infringement since his patents had already expired. He could only sue Dolby to enforce the licence, which according to the court was invalid based upon *Brulotte*. In this situation, where does the freedom to contract and the notion of fairness and equity come into play? Scheiber unsuccessfully argued that Dolby had unclean hands as it was Dolby that had asked him to stretch out the payments beyond the patent term and it was also Dolby who, following that agreement, now sought to get out of its contractual obligation. The court, however, found that the doctrine of unclean hands would apply only if Dolby were seeking equitable relief. Dolby simply did not want to pay on the grounds that its duty to pay on the licence was unlawful and therefore unenforceable. In its decision the *Scheiber* court seemed to try its best to find a way around the Supreme Court decision in *Brulotte*, but reluctantly affirmed the summary judgment in favour of Dolby.

Several important lessons in licensing can be learned from this case. It is not always sufficient to capture the bargain negotiated in good faith between two parties who reach a reasonable accommodation and agreement concerning the payment of royalties and other business terms. When drafting the licence agreement you must make sure that you not only clearly capture the intent of the parties without any ambiguities, but that you also are aware of the laws governing intellectual property and how they might impact any terms of the agreement. Just as you never want a court to try and interpret the meaning and intent of an agreement, you do not want a contract provision deemed unenforceable as a matter of law. In the case of intellectual property licences, clarity is not always enough.

Warner-Lambert Pharmaceutical Company v John J Reynolds Inc

Whenever I gargle in the morning using my favourite brand of mouthwash, Listerine, I am reminded of a valuable lesson for all attorneys, like myself, who spend much of their practice negotiating intellectual property licences. My new mantra is: "Simple is sometimes best."

In the late 19th century, Dr J J Lawrence devised a formula for an antiseptic compound which was known as Listerine. Dr Lawrence agreed to make available his formula to Jordan Lambert in 1881. While in today's times we may consider the number of pages in a licence agreement as indicative of the skills and value brought by the attorney, the

simple two-sentence agreement that was used to transfer the formula for Listerine for use by Mr Lambert read as follows:

"Know all men by these presents, that for and in consideration of the fact, that Dr. J.J. Lawrence of the City of St. Louis Missouri has furnished me with the formula of a medicine called Listerine to be manufactured by me, that I Jordan W. Lambert, also of the City of St. Louis Missouri, hereby agree for myself, my heirs, executors and assigns to pay monthly to the said Dr. J.J. Lawrence his heirs, executors or assigns, the sum of $20.00 for each and every gross of said Listerine hereafter sold by myself, my heirs, my executors or assigns. In testimony whereof, I hereunto set my hand and seal, Done at St. Louis, Missouri this the twentieth day of April 1881 Jordan W. Lambert."

A few years later Dr Lawrence agreed in another short agreement to reduce the royalty from US$20 to US$6 per gross. In 1885, Mr Lambert assigned his rights to the Listerine formula as set forth in these simple agreements to the Lambert Pharmaceutical Company, the predecessor to the Warner-Lambert Pharmaceutical Company. Warner-Lambert and its predecessors continued to make payments to Dr Lawrence and his heirs and assigns based upon these agreements for at least 75 years. So long as Listerine was manufactured or sold by the company the payment stream continued. By 1956, payments based upon the Lawrence-Lambert agreement reached more than US$22 million with annual payments of over US$1.5 million.

Warner-Lambert must have finally grown tired of making such payments because they initiated this declaratory judgment action to stop further royalty payments. The main argument of Warner-Lambert was that the formula for Listerine was no longer a trade secret and was readily used by other companies including their competitors. There was, for example, already a public disclosure of the Listerine formula in an article that appeared in the *Journal of the American Medical Association* in 1931. They also argued that the agreement was not enforceable since it lacked a definite term and violated the rule against perpetual agreements.

The judge identified the issue before him as follows: "The plaintiff claims that its obligation to make payments to the defendants under the Lawrence-Lambert agreements was terminated by the public disclosure of the Listerine formula in various medical publications. The defendants assert that the obligation continued and has not been terminated."

The judge also ruled that, despite the plaintiff's claim that the Lawrence-Lambert Agreement was indefinite and unclear at least as to the length of time during which payments would continue, the agreement was "plain and unambiguous", stating: "There is no ambiguity or uncertainty in this language. Nor can I ascertain any alternative or hidden meanings lurking within it."

According to the judge, the parties were free to contract with respect to use of such a formula in any manner they chose and, unlike a copyright or patent, a secret formula or trade secret may remain secret and protected indefinitely as a matter of law: "If they desire that the payments or royalties should continue only until the secret is disclosed to the public it is easy enough for them to say so. But there is no justification for implying such a provision if the parties do not include it in their contract, particularly where the language which they use by fair intendment provides otherwise."

Since the agreement for Listerine did not involve an issued patent, the judge was not as restricted as the court was in the *Scheiber* case previously mentioned. The judge also noted that the acquisition by Warner-Lambert of the formula pursuant to the licence agreement provided the company with a significant advantage in the marketplace by giving it a "head start in the field of liquid anti-septics even after the formula had been disclosed". In fact, the judge identified that no mention of trade secret or secrecy appeared anywhere in the Lawrence-Lambert Agreement and all that was required for payment was that the formula be used in the manufacture of a product.

What do we learn from the *Listerine* case? An agreement should be no longer than necessary to accomplish its specific purpose. To this end, the person who drafted the simple agreement for Dr Lawrence in 1881 did a masterful job. The counsel for Mr Lambert and the successor corporation Warner-Lambert would, however, have been wiser if they had added at least a few more sentences to this agreement that anticipated the future availability of the Listerine formula and included a specific term or duration for payments.

Most licence agreements today are not as simple and concise as the Listerine agreement. Indeed, it is rare today that you find even a two-page agreement. Licence agreements cover more issues than just the amount of royalty payable. At a minimum, trade secret licence agreements require that the information remain secret and include the standard exceptions such as if the trade secret ever comes into the public domain or

otherwise loses its legal status as a trade secret. The addition of such exceptions to the Listerine agreement would most likely have allowed Warner-Lambert to terminate its obligations to pay any further royalties under the 1881 Agreement once the article appeared in the *Journal of the American Medical Association* in 1931. Without such an exception the payments will continue indefinitely so long as the formula is used by Warner-Lambert in the manufacture of products.

Hybrid licences

A final important lesson can be learned from both the *Scheiber* and *Listerine* cases. That is, if both parties to an agreement truly desire to extend payments beyond the patent term, they should consider a hybrid licence that includes patent rights as well as know-how and trade secrets. This can avoid the early termination of payments as occurred in *Scheiber* and allow continued payments for use of the know-how or trade secrets as permitted under the *Listerine* case. To avoid any issues, separate royalties must be identified and payable for the patent and for the know-how or trade secrets. While royalties may end for the patent, royalties can continue indefinitely at least for the know-how or trade secret portion of the licence.

Clarity is essential to any licence agreement for intellectual property, but do not forget the laws governing intellectual property when memorialising the agreement. The freedom to contract may not be enough.

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For over 20 years Mr Cohen has negotiated licence agreements and contracts related to computer software and related technology, polymers, collectible dolls, plastic couplings, adhesives, fibre optics, earth-moving machinery, music, literary works, food products, medical devices, pharmaceuticals, boat technology, film, ringtones, the Tinkerbell fairy from Peter Pan and a variety of other industries and products. He is an adjunct faculty member at the University of St Thomas and is currently working on a treatise on entertainment law for spring 2006 publication.