

The treatment of know-how licensing under the competition rules

1. Importance of know-how transfer in the context of the Community's policies in the technological field

The transfer of know-how is an important complement to all the Community's policies in the technological field (e.g. ESPRIT, RACE, BRITE). These policies are based on the need to improve substantially cross-frontier transfers of technology within Europe by means of research and development cooperation and the subsequent dissemination of the results through patent and know-how licences to other Community companies and sectors. The development of European-sourced technology from the Community's vast technological potential will also help to reduce technological dependency on third countries.

It should be borne in mind that the transfer of technology, irrespective of whether or not it is protected by patents, is a highly complex process of assimilation and adaptation of know-how which requires close mutual understanding between the companies involved. These characteristics peculiar to know-how transfer have to be taken into account when assessing the agreements in question under Article 85.

Competition stimulates the innovative capacity of Community industry. On the other hand, competition policy should facilitate cooperation aimed at the development and dissemination of new technologies, to the extent that this opens up new markets, creates new competitors and products and thus strengthens competition. For this purpose, it is indispensable to define which forms of contractual arrangements are compatible with the competition rules, so as to provide the necessary legal certainty.

The Commission has already shown a favourable attitude to technology transfer in the Research and Development and Patent Licensing Regulations.

2. Definition of know-how

The term know-how is generally employed in business to denote any knowledge relating to the use of a method of manufacture or to the use or application of an industrial process, or any experience in technical, commercial, administrative, financial or other sectors that is applied in business practice. Council Regulation 19/65 refers in less broad terms to "a method of manufacture or knowledge relating to the use or to the application of industrial processes." This document however is concerned with industrial know-how which, for the purpose of discussion, may broadly be described as substantial technological information relating to the whole or a part of a manufacturing process or a product, or to the development thereof, which is not in the public domain and therefore justifies efforts to maintain its secrecy and which is valuable to the prospective licensee.

The term "substantial" is intended to exclude information that is trivial, or obvious. The notion "not in the public domain" does not mean that the know-how must be totally unobtainable. It may even be the case that each individual component of the know-how package is known to qualified engineers in the sector but that the precise configuration and assembly of components and features which make the technology work is not readily available. The notion "efforts to maintain its secrecy" means that the know-how possessor must take steps which are reasonable under the circumstances to ensure that this knowledge does not become generally known to the public. The term "valuable" is taken to mean that the know-how is of decisive importance to the licensee in starting up production rapidly using a working technology for which he is therefore willing to pay royalties.

Know-how which relates not to technology as such but to other matters indispensable to the proper exploitation of the technology may in this context be treated in the same way. For example, it may be necessary in certain circumstances to provide the licensee with essential information concerning the characteristics of raw materials, the storage and conservation of the final product, etc.

Pure marketing know-how and know-how communicated under subcontracts or commercial franchising arrangements should be excluded from the scope of a regulation or guidelines. Know-how licences connected with other agreements or practices between the contracting parties such as research and development cooperation, joint ventures, patent pools and other cross-licensing arrangements should also be outside the scope of such an instrument. Any regulation should apply to simple one-way agreements, covering all or a part of the common market, whether exclusive or not, which disclose the know-how to the other party for use in production; agreements regarding selling alone would be excluded, except in cases where the licensor undertakes to supply the contract products to the licensee for a preliminary period before the licensee himself commences production.

3. Need for comparable treatment of patent licences and know-how agreements under the competition rules

The patent system is generally recognised as being the best legal means available for the promotion of technical progress in the public interest. Given the stringent requirements of the patent system itself (public disclosure and examination of patentability) it can generally be assumed that a patent involves technical knowledge of an objectively high quality. In contrast to patents, know-how may involve elements which are not worthy of patent protection, its novelty and substantial value have not been tested by a public authority and there is a danger that cartel-minded firms could make irrelevant technical data the subject of spurious know-how licences, their main objective being to obtain official approval for disguised market-sharing agreements and other restrictive practices.

However, whether there is real substance or subterfuge in know-how licence restraints can be ascertained by requiring that, to comply with competition rules, the know-how granted must satisfy sufficiently high standards. Both patents and substantial, not publicly known and valuable know-how are, notwithstanding their substantial differences of legal status, essential factors in technological progress and competitiveness and both know-how agreements and patent licences should enjoy comparable favourable treatment under the competition rules. This is apparent from the following :

- a) Know-how can, and often does, have an economic value equal to or greater than that of patents; its development and exploitation on an industrial scale can be extremely costly and complicated.

The large sums spent by industry on research and development are not necessarily directed at or likely to lead to patentable inventions. Research and development effort is mostly directed at problem-solving, and examples from several industrial sectors suggest that only about a quarter of research and development results end up in patent applications. Non-patented results can be a major determinant of firms' competitive advantage. With the pace of technological change, the possession of or immediate access to the latest technology is the key to success in the market. This is especially the case in high-technology sectors.

- b) In line with its importance as a determinant of competitive advantage, know-how plays an indispensable role in technology licensing. This applies not only to pure know-how agreements, which generally account for a third of all licensing agreements, but also to mixed agreements in which a patent licence is granted along with the transfer of know-how. In practice, the boundary between the two types of agreements is fluid: This is for example the case where a patent licensed with the know-how has only been applied for at the time of licensing and is subsequently not granted, or where the licensed patent expires, is declared invalid or is lost for any other reason while the transfer of the know-how continues. Such conversions of mixed into pure know-how agreements are not uncommon.

These considerations alone make it clear that a generally less favourable treatment of know-how than patent licences under the competition rules would be unjustified and would lead to unwarranted distinctions between different constitutive elements of a given technology being licensed.

Indeed, there are considerations that could arguably support a less restrictive approach under the competition rules to know-how than to patent licences. On the one hand, whereas patented technology is, by definition, fully disclosed and subject to compulsory licences, in the event of inadequate exploitation, and to unlimited use once the patent expires, know-how may be hoarded for ever from the public unless its possessor is willing to license. Whilst the hoarding of know-how may only occur infrequently, the danger of hoarding makes it in the public interest to have a positive climate for know-how licences. Furthermore, whereas secret know-how does not have the beneficial effects of publication as in the case of patents, the absence of patent protection minimizes the effect of restrictive clauses in know-how licences, as the know-how possessor has no absolute right to exclude third parties from independently discovering and exploiting the same technology and has to rely only on secrecy.

In the light of the above consideration, this paper suggests that contractual restrictions on competition between licensors and licensees /and between licensees inter se/ in know-how licences, in particular territorial restrictions, should be approached in the same way as in patent licences under the Patent Licensing Regulation, due regard being had to their particular features. The reasons, relating to the protection of investment and the wider dissemination of technology, for allowing varying degrees of territorial protection as between the licensor and the licensee /and as between licensees inter se/ that have been acknowledged in the Patent Licensing Regulation do not become less valid only because the know-how possessor enjoys less extensive legal protection than the patent-holder.

It is most important in this context that know-how can be protected only by contract when licensed. A prohibition of indispensable contractual provisions in know-how licences could impede or inhibit the license of know-how.

4. Response of policy to economic realities

The Commission considers that such an approach would respond to the following competitive purposes and objective needs of industry without coming into conflict with the general aims of the patent system :

- From the competition policy point of view, the license of know-how has a direct pro-competitive effect: a know-how licence creates new or increased competition because with the licensed technology the licensee is able to market a product which competes with existing comparable products even in the areas of non-patentable improvements. An indirect pro-competitive effect will also come about, as after the expiration of any temporary contractual limitations, competition between licensor, licensee and other licensees will occur. The know-how licence may also increase the number of production facilities and the quantity of goods produced in the common market. Furthermore, it facilitates the penetration of new markets, since the licensing of a firm in another country offers an attractive middle ground between exporting and the risks of direct foreign investment and marketing. In particular, licensing may help to overcome problems related to non-tariff barriers and national public procurement policies. Also, know-how licensing usually leads to an even greater transfer or exchange of technology, as the licensee mostly receives a complete package of the licensor's knowledge.

- A licensor transferring his technology creates a competitor capable of producing identical products of the same quality and technological standard. In economic reality therefore, a company cannot be expected to act against its own business interests by granting a know-how licence without providing for reasonable protection from competition by the licensee in its own market. For his part, the licensee will normally only agree to take the licence and to undertake the necessary investment if reasonable protection from the licensor /and other licensees/ is provided for in the contract.

Provisions for such protection only relate to the use of the licenced technology or the products made from such technology. Thus, they do not impose restraints in existing markets but only limit the competition created by the licence.

- Allowing the possessors of know-how to protect their legitimate business interests within reasonable limits should not substantially influence the propensity of companies to make their inventions public by applying for patents.

Developers of a patentable invention may in particular cases have serious reasons for not applying for patents, for example when the life cycle of the technology concerned is so short that it is not appropriate to seek protection for every technological development or when they might not have the financial means at their disposal or might not wish to obtain and maintain patent protection in every Member State. In these cases the decision not to obtain patent protection does not mean that the processor of know-how is seeking to circumvent the patent laws. However, given a straight choice between statutory protection and the very fragile protection afforded to know-how, which is vulnerable to outside discovery and publication, they might continue to seek patent coverage.

5. Provisions frequently contained in know-how licensing agreements

The following analysis deals with the contractual clauses usually included in know-how agreements. The Commission should state how it would assess these clauses in relation to Article 85.

Some of these clauses will not normally fall under Article 85(1); others may fall under Article 85(1) but may be exempted under Article 85(3) in individual decisions or by a future block exemption regulation, in so far and as long as the know-how has not entered into the public domain. If a block exemption regulation were adopted, its structure could follow closely the Patent Licensing Regulation in giving a list of obligations

normally caught by Article 85(1) which would be exempted by the Regulation, a list setting forth those obligations not normally deemed to involve restrictions of competition, and a "blacklist" of provisions or restrictions whose presence will make the exemption unavailable. An opposition procedure could also be provided for.

6. Obligations which are normally considered not to fall under Article 85 (1)

i) Obligation to preserve secrecy

All obligations imposed on the licensee to take any steps necessary to protect the know-how from losing its secrecy can be regarded as inherent in the transfer and thus not falling under Article 85. The obligation not to divulge the know-how can also be extended beyond the expiry of the agreement as long as the know-how has not entered the public domain.

ii) Obligations not to sub-license

Obligations on the licensee not to grant sub-licences without the consent of the licensor are related to the secrecy obligation. They are justified in the context of the licensee's obligation to preserve the possession and the secrecy of the licensed know-how. This obligation can also be extended beyond the term of the licence as long as the know-how has not entered the public domain.

iii) Obligations relating to improvements in the know-how

Arrangements for the reciprocal non-exclusive communication of improvements between licensor and licensee (non-exclusive grant-back), on a royalty-free basis or otherwise, are generally not restrictive of competition. The relevant question in this context is the extent to which the licensee can freely exploit his own improvements of the know-how initially transferred.

Firstly, it should be provided that the licensee may not be prevented from using them, at least during the validity of the contract/ or from licensing them to third parties as long as such licensing does not disclose the original know-how of the licensor that is still secret.

Secondly, the question whether the licensee must also be free to sub-license to third parties the original know-how where that know-how is indispensable for the exploitation of the licensee's own improvements may give rise to difficult issues.

Different interests are involved here : from the public interest standpoint it appears desirable to secure the largest possible dissemination of any new ideas, including improvements by the licensee. On the other hand, the fact cannot be ignored that such sub-licensing to possibly a large number of third parties poses a much greater danger that the secrets become known and the licensor loses everything. To refuse the licensor the right to prevent such sub-licensing would constitute a major exception to the permissibility of obligations designed to preserve the confidentiality of received know-how. As, but for the licence, the licensee would not have the confidential know-how to build upon in future development activities, it is therefore suggested that such refusal is not justified. Furthermore, it is likely that no substantial hindrance to subsequent transfers of technology will result from allowing the former licensor discretion over sub-licensing, for a licensee who has developed improvements will be in a strong bargaining position to obtain the licensor's consent for sub-licensing. Not only will such sub-licensing increase the flow of royalties to the licensor, but the licensee may be able to obtain the licensor's consent for sub-licensing in return for a grant-back of substantial improvements which will enable the licensor to exploit the very latest technology.

iv) Obligations concerning quality standards and specifications

Obligations imposed on the licensee to meet certain minimum specifications and quality standards in the production of the licensed products should not be regarded as restrictive of competition provided that they serve to maintain the technological and quality image of the licensor. This will only be the case when the product bears the licensor's trade mark or identifies the licensor in some other way.

v) Royalties

In principle, the contracting parties should be left free to negotiate the level of royalties and initial down-payments and the distribution of royalties over time. Normally the licensor will be interested in receiving high initial lump sums and royalties during the first few years of the licence. The licensee, on the other hand, will be interested in minimizing initial costs until production and marketing of the licensed product have reached full scale. As a compromise between these two positions, arrangements designed to spread payments of a fixed sum over a given period which may even extend beyond the entry of the know-how into the public domain are in the nature of an installment plan and therefore need not be considered restrictive of competition.

One of the more controversial aspects of know-how licensing, however, is whether a licensee can be forced to pay royalties in the form of percentages of turnover after the technology has become public knowledge and is being used royalty-free by competitors. It is clear that in a patent licence royalties cannot be charged after expiry of the patent (unless by payment in instalments over time). In a mixed patent and know-how agreement there may be a danger that the know-how is simply used as a pretext to require royalties on the expired patents, in which case payment of royalties cannot legitimately be required. However, in pure know-how licences there would be no improper extension of a legal monopoly and the fact that the know-how had become public should not in itself be governed by the rule on patents, i.e. the prevention of continuation of the licensee's obligation to pay royalties.

The following solutions appear possible : Firstly, the parties can agree that entry into the public domain terminates the licence or otherwise eliminates the necessity to pay royalties. Secondly, where the parties have not so agreed, it could be envisaged that an obligation on the licensee to keep paying royalties until the end of the contract should not be considered restrictive of competition, if parties have agreed a reasonably limited duration with the option at the end of the contract either to renew the licence, should the

technology still be secret, or to continue to use the licensed technology on a royalty-free basis should it no longer be secret. The same would apply if, irrespective of the duration of the agreement, parties agree that payments are still due for a limited period after the entry of the technology into the public domain. Such a period should generally not exceed three years as an obligation to keep on paying for a longer or indefinite period would ultimately place the licensee at a disadvantage with competitors freely using the technology.

The reasoning behind this solution is as follows: The licensor should not be obliged to assume all the risk of a premature entry of his know-how into the public domain, i.e., either litigation costs to prove that it is still secret or has entered the public domain through the fault or even by a deliberate act of the licensee, or the loss of a substantial part of the agreed royalties in the event of disclosure of the know-how by third parties. If he were obliged to run this risk, he would either prefer not to license at all or would insist on heavy down-payments and high initial royalties. This would discourage the licensee from taking the licence. When a licence is freely negotiated, the price agreed reflects the risks which the parties are prepared to share, including the risk that the know-how might enter the public domain during the life of the contract. The value of the licensed know-how consists in giving the licensee a lead-time over his competitors to whom the same or equivalent technology is not available. By the time he could develop the know-how himself, the technology might be out of date. He is therefore paying primarily a negotiated price for this lead time.

However, if the know-how has fallen in the public domain through the action of the licensor, the licensee should be freed from his obligation to pay royalties.

Furthermore, the contract may frequently not only cover the communication of know-how not in the public domain, but the know-how possessor may have also supplied other non-secret information or work over and above it, which continues to be important for the licensee (e.g. technical assistance). In these cases, whilst other competitive restraints on the licensee should no longer be covered by a block exemption from the time the know-how has entered the public domain, royalty payments could still be lawfully agreed for a limited period of time.

vi) Minimum quantity

An obligation on the licensee to produce a reasonable minimum quantity of products derived from the licensed know-how serves to ensure an effective exploitation of the know-how and meets a legitimate interest of the licensor.

7. Clauses which may normally be considered to fall within Article 85(1)

i) Field of use

Modern technology is strongly characterized by its interdisciplinary and intersectorial application. Allowing a restriction on the licensee to use the know-how only in certain technical fields of application gives an incentive to the licensor to disseminate technology in other sectors. This will result in new applications and products. Meanwhile, the licensor can reserve for himself the fields in which he is primarily interested. In particular, field-of-use restrictions allow smaller firms to license their technology to large companies for applications in other fields while keeping for themselves the areas in which they can apply their own technology without the threat of competition which the greater financial resources of their licensees would otherwise make possible.

Such restrictions can fall under Article 85(1) as they prevent the licensee from using the know-how in the excluded fields of use and thus from manufacturing and selling the products incorporating the licensed technology, but they can normally be exempted under Article 85(3). An obligation on the licensor not to exploit the know-how within the field of use granted to the licensee may be examined in the general context of exclusivity obligations dealt with in point (v) below.

Field-of-use restrictions which amount to de facto customer restrictions fall to be considered under (ii) below.

ii) Customer restrictions

Restrictions in respect of sharing customers within the same technological field of use, either by an actual prohibition on supplying certain classes of customer or an obligation with an equivalent effect, cannot be exempted under a block exemption. An exception might be allowed where a second supplier is needed either to provide a second source of supply at the customer's insistence or because the first supplier cannot satisfy the totality of the customer's demand. Such cases should be examined on a case-by-case basis.

iii) Price restrictions

Restrictions on the price at which the licensee can sell the licensed products are normally unacceptable. They should be blacklisted in a future block exemption regulation.

iv) Quantity restrictions

Quantity restrictions are normally unacceptable and should be blacklisted. However, an exemption might be envisaged when the licensee wants to produce only enough of the product to cover his own needs, or when the licence is granted for the purpose of creating a second source of supply as mentioned in (ii) above.

v) Automatic extension of the agreement by the licensor to cover improvements not originally licensed

The exemption will be unavailable if the agreement provides for the automatic extension of the licence beyond its original term by inclusion of any improvement obtained by the licensor, unless each party has the right to terminate the agreement at least annually after expiry of the original term.

vi) Exclusivity of use and territorial restrictions

- Economic reasons for exclusivity and territorial restrictions

The licensor may find it difficult to transfer his know-how if he is unable to promise a licensee that he will not encounter competition from other licensees or the licensor himself in the allotted territory. The licensee will be unwilling to undertake the risk of the investment and marketing costs involved in the introduction of the licensed product in the market if exclusivity of manufacturing and sale for a given territory is not guaranteed by the licensor.

The same is true from the point of view of the licensor, who would be acting against his business interests if by licensing his technology he created a direct competitor in his reserved territory.

Several arguments in favour of territorial restrictions put forward in the recitals of the Patent Licensing Regulation are also valid for know-how licences; for example :

- Protection of the licensee's investment and marketing efforts;
- Territorial restrictions encourage the licensor to grant licences and make the licensees more inclined to undertake the investment required to manufacture and market a new product;
- The resulting increase in the number of production facilities and in the quantity and quality of goods produced in the common market;

- Consumers are as a rule allowed a fair share of the benefit resulting from the improvement in the supply of goods incorporating the latest technology;
- Competition at the distribution level is safeguarded by the possibility of parallel imports.

- Territorial exclusivity

Exclusive licensing agreements, i.e. agreements whereby the licensor undertakes not to exploit the licensed know-how in the licensed territory himself or to grant further licences there, do not in themselves fall within Article 85(1) where they are concerned with the protection of new technology in the licensed territory. This is because, in such cases, the competition eliminated would not have existed at all without the licensing agreement.

Where, in other circumstances, exclusivity provisions do fall within Article 85(1), they should be exemptable under Article 85(3). The Commission would, as in the Patent Licensing Regulation, permit varying degrees of territorial protection as between the licensor and the licensee and as between licensees inter se and make exemption subject to the following conditions :

- The period during which the licensor undertakes not to grant further licences in the licensed territory or to manufacture in and export directly to the licensed territory himself should generally not exceed ten years from the date when the product is first placed on the market within the EEC, as this period is generally considered in industry to be the normal life of know-how agreements.
- The agreement should enable the licensor to terminate the exclusivity on the expiry of a period of five years from the date of the agreement if, without legitimate reason, the licensee fails to exploit the technology adequately.

- Territorial restrictions on the licensee

Know-how licence agreements may provide for territorial restrictions on the licensee. Obligations on the licensee not to manufacture or sell products derived from the licensed technology in territories reserved for the licensor and not to manufacture or make active /and passive/ sales of such products in the territories of other licensees should be exemptable under Article 85(3). The Commission would make exemption subject to the following conditions:

- The duration of obligations on the licensee not to manufacture in or export products derived from the licensed technology to the territory of the licensor should generally not exceed /ten/ years from the date when the products concerned were first placed on the market within the EEC.
- The duration of obligations on the licensee not to make active /and passive/ sales of products derived from the licensed technology in the territories of other licensees should generally not exceed five years from the date when the products concerned were first placed on the market within the EEC.
- An obligation on the licensee not to use the know-how for manufacture in the territories of the other licensees should generally not exceed /ten/ years. Such a restriction has acceptable anti-competitive effects, since the licensee would be free to sell the products in the territories of other licensees after five years.

These cut-off dates should give the licensee sufficient time to recoup the cost of his investment in development, full-scale production and introduction of the product on to the market and would also be considered by the licensor as being a sufficiently long period in which he would not be exposed to competition from his licensee. Longer-lasting territorial restrictions could mean that a substantial part of the benefit connected with the licence would not occur or would be neutralized by anti-competitive effects.

A specific problem arises in licences covering a continuous stream of improvements of know-how. It is proposed that the addition of improvements to the licensed technology should not entail an extension of the period of protection. To allow an additional period of territorial protection every time a further transfer of improvements takes place would result in an open-ended restriction.

In no event can any prevention or hindrance of parallel imports be allowed. Since competition at the distribution stage is ensured by the possibility of parallel imports, know-how agreements will not normally afford any possibility of eliminating competition in respect of a substantial part of the products in question. This is also true of agreements that allocate to the licensee a contract territory covering the whole of the common market. However, in this case intermediaries or users should not be prevented by the parties from obtaining the contract goods from outside the common market. In relation to services, in which there is no parallel trade, it is essential to provide that requiring the licensee, after any initial period in which a territorial restraint would be permitted, not to provide a service in territories licensed to other licensees within the common market would preclude application of the block exemption.

vii). Non-competition clause

Obligations which restrict the licensee's freedom to compete with the licensor in respect of research and development, manufacture, and use or sale of products based on technologies other than those licensed normally fall under the prohibition of Article 85 because of their tendency to exclude competing technologies. The prohibition of such restrictions must however be reconciled with the legitimate interest of the licensor in having his know-how exploited to the full. Accordingly, the licensor may require the licensee to use his best endeavours to manufacture and market the licensed product. Such a requirement does not restrict competition within the meaning of Article 85(1).

viii) Post-term prohibition on licensee's use of know-how

Another of the more controversial aspects of know-how licensing is whether a licensee may be required to return at the expiry of the agreement all tangible know-how to the licensor and to stop using all the know-how received, at least as long as it remains secret. This clause can be found in almost all agreements which have been notified to the Commission.

Two different views are generally taken on this question :

It can be argued that it acts as a strong disincentive to prospective licensees and consequently cannot be exempted under Article 85(3). The reasoning behind this view is that by taking a licence to the know-how the licensee has lost for ever the possibility of developing, i.e. "rediscovering", the know-how himself.

It can also be argued that such clause is acceptable. This follows from the recognition of the know-how licensor's right to dispose of the know-how under contractual arrangements. Parties should be free to decide whether to regard the communication of the know-how as a final, irrevocable act akin to a sale or as a leasing relationship limited in time.

The following solutions are here suggested :

Firstly, parties should be allowed to include such a clause in an agreement providing for use of technology for a specific project (e.g. a large-scale construction contract). Refusal to allow a post-term prohibition on the licensee's use of the licensed know-how where either party would be reluctant to enter into an agreement providing for a transfer of technology for a longer duration would inhibit the dissemination of technology.

Apart from these specific cases a post-term use ban could be generally accepted where all the following conditions apply :

- The prohibition on the licensee's use is limited to /three/ years from the expiry of the agreement. It could be argued that this period corresponds in general to the time it would have taken the licensee to develop the know-how himself.

- The licensor is required to identify and describe in as much detail as possible the confidential information in the agreement and to maintain a record which reflects an accurate compilation of subsequent confidential information transferred during the course of the agreement. That would prevent the licensee from being unduly restricted in the utilization of his own technology or of that which is freely available elsewhere and would generally alleviate the problem of improvements added by the licensee.

- It is clearly stated that such a clause is no longer allowed as soon as the licensee can prove that the know-how has become public knowledge or that he has acquired know-how of identical content from a third party.

In all other cases the clause should be subject to individual examination.