City of London Law Society
Joint submission by Intellectual Property and Competition Law Committees

Response to European Commission Consultation on Draft Proposal for a Revised Block Exemption for Technology Transfer Agreements and for Revised Guidelines

1. Introduction

This response is submitted jointly by the Intellectual Property and Competition Law Committees of the City of London Law Society ("CLLS") in response to the European Commission's Consultation on the draft proposal for a revised block exemption for technology transfer agreements ("TTBER") and for revised guidelines initiated on 20 February 2013 ("Consultation").

The CLLS is made up of approximately 15,000 lawyers based in the City of London through both individual and corporate membership including some of the largest international law firms in the world. These law firms advised a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through 19 specialist committees.
The CLLS is registered on the European Commission's Transparency Register, and its registration number is ***24418535037-82****.*

2. General Views

The CLLS welcomes the fact that the Commission has taken the step of proposing that the existing regulation and guidelines be retained, albeit with amendments. The CLLS had argued in favour of retention of a block exemption in its earlier response of 3 February 2012 to the Commission's initial review of the regime. The experience of the CLLS is that the majority of clients support the relative legal certainty that a block exemption regulation brings to the self-assessment process.

However, legal certainty must not be gained at the cost of creating a legal straitjacket by introducing too narrow conditions for exemption or automatically blacklisting certain clauses where the perceived risk to competition is not clear. If the block exemption is to fulfil any function at all and be of practical use it must be commercially practicable for licensors and licensees to avail themselves of the safe harbour provided rather than having each time to carry out bespoke, and potentially expensive, individual self-assessments.

However, the CLLS would like to emphasise two points:

- the best way to ensure that markets are competitive is to create a framework that fosters innovation and encourages investment in developing and improving technology;
- there should be a presumption that competition is fostered whenever technology is being licensed and equally a presumption in favour of the licensor and licensee's freedom to contract with the party of their choice and on the terms of their choice except where there is a clear anti-competitive objective.

We note, however, a subtle change in wording between the current and the revised Guidelines that may indicate that the Commission has shifted its ground and no longer views licensing restrictions in the proper commercial context.

Paragraph 8 of the revised Guidelines correctly recognises the commercial risk taken by the licensor where it states:

> "*[T]he creation of intellectual property rights often entails substantial investment and [….] it is often a risky endeavour. In order not to reduce dynamic competition and to maintain the incentive to innovate, the innovator must not be unduly restricted in the exploitation of intellectual property rights that turn out to be valuable*."

Seen in this light many licensing restrictions may not be restrictive at all but merely necessary commercial conditions without which the licensor would never grant a third party licence in the first place and competition would in fact be reduced.

Paragraph 9 of the revised Guidelines goes on to say:

> "*There is no presumption that intellectual property rights and licence agreements as such give rise to competition concerns. Most licence agreements do not restrict competition and create pro-competitive efficiencies. Indeed, licensing as such is pro-competitive as it leads to dissemination of technology and promotes (follow on) innovation*."

The CLLS nevertheless detects a reluctance to acknowledge sufficiently the investment and commercial risk undertaken by licensors and a more grudging attitude to the benefits of licensing than previously. The CLLS therefore fails to see any cogent reason behind this more cautious line.

It is of course very welcome that the Commission recognises the two fundamental principles set out in paragraphs 8 and 9 and cited above. However, the CLLS detects that the Commission may be prepared to lose sight of this starting point when it gets into the detail of the TTBER, where essentially licensing arrangements are being shaped so that they would be compliant – *i.e.* exemptible – if in fact they did prevent, restrict or distort competition.

This does not only go to the question of setting the appropriate level of market shares below which the TTBER applies in full and above which it does not. The guidelines should perhaps reinforce the message that where licensor and licensee have limited market shares in any relevant markets it is unlikely that their agreement will need exemption at all.

More fundamentally, the Commission's approach to the revision of the TTBER, notwithstanding the starting principles, is to view technology licensing with suspicion, especially where it involves competitors. The CLLS regrets this. The experience of members of the CLLS in advising clients who are competitors on licensing arrangements is that those clients would not, either explicitly or implicitly, seek to collude with respect to technology or contract products. Their primary concern will be all about exploiting technology.

In the light of those preliminary remarks, we comment below in more detail on the main changes that the Commission proposes to make to the existing regulation and guidelines, which again betray a more cautious approach, the need for which the CLLS would tend to question.

3. Draft Commission Regulation

3.1 Explicit rule for determining which BER applies

The new draft makes it explicit at recital 7 that the TTBER applies only on condition that the block exemption on R&D agreements or the block exemption on specialisation agreements are not applicable, effectively giving priority to the rules on horizontal cooperation. This seems helpful in terms of improved legal clarity and is consistent with the approach taken in the Commission's guidelines on horizontal cooperation agreements.

Changed test for when purchase of raw material or equipment is covered by the safe harbour of the TTBER

A new test, which looks only at whether the provisions are "directly and *exclusively* related" to what the licensee produces with the licensed technology, is proposed to determine whether certain provisions surrounding a technology transfer agreement, in particular concerning purchases of material or equipment from a licensor or the use of the licensor's trade mark, are automatically exempted. This means in practice that even if the input bought from the licensor is worth more than the licensed technology, the provisions relating to the purchase are still covered by the TTBER.

On the face of it this seems a helpful broadening of the scope of the block exemption to cover provisions which add value to the technology and do not appear to raise anti-competitive concerns. However, the CLLS would on balance not support such a change, partly because it does not seem commercially appropriate or easy to apply in practice and partly because, the way it is currently drafted, it raises problems of interpretation.

Commercial considerations
When the terms of a licence are being negotiated the licensor is likely to offer the basic technology and the related products and consumables and any trade marks and other IP rights as part of an overall package. The royalties will tend to bear a relation to the whole package.

In the case of tied product sales the only criterion in our view should be whether they are technically necessary or otherwise add value to the technology package.

As for related licences, the revised wording, for instance, causes potential difficulties where a licensor's technology is part of a family of technology for making a range of products under a common trade mark, which is often the case. The new definition would exclude the application of the TTBER to the related trade mark licence simply because it would not be exclusive to that licensed product.

Drafting
In terms of clarity of drafting, there appears to be confusion about whether the test requires the products and/or the IP rights to be directly and exclusively related. Literally the wording requires the "provisions" to be so related, but that does not immediately make sense as a legal or indeed competition-based test.

The same could apply to products which are related to and necessary in the production process or for the production of the contract products but have other uses. In our view it is sufficient for Article 1(1)(c) merely to require the provisions to be "directly related to and necessary for" the production of the contract products.

3.2 Lower market share threshold for certain licensing agreements between non-competitors

The CLLS accepts the need for market share thresholds. It is understood that market share tests are the price that has to be paid for an economics-based approach to competition law and that they do in principle allow a more permissive approach than the old black-list, white-list type of block exemption regulations. That, however, comes with the caveat that they make block exemptions far harder to apply and require a degree of self-assessment by the parties that is potentially disproportionate in terms of automatic safe harbours which are simple for clients themselves to apply. For this reason it would be wrong to introduce any further complexity into the market share thresholds in the TTBER.

The loss in terms of legal certainty as a result of having market share tests is particularly acute for technology licensing. The plain fact is that most clients most of the time do not have the resources or even the ability to carry out the work necessary to define the relevant markets. Of course, there are some licensing deals where a full market evaluation is done – typically involving major multinational businesses with the money and the sophistication to carry out this exercise.

Often, however, a fairly rough and ready estimation of what ways a market might be defined and what kinds of market shares might be relevant is all that is feasible.

But there is a genuine complexity in technology markets, especially for new technologies that may have 1% or 100% of the market depending on the definition of the market adopted. The Commission is proposing to extend the market share threshold of 20%, up to which agreements between competitors are deemed *unproblematic*, to the situation where, in an agreement between non-competitors, the licensee owns a technology which it only uses for in-house production and which is substitutable for the licensed technology. The stated object of this change is to capture the higher potential for anti-competitive effects of this type of agreement on the downstream product market or the upstream innovation market (as compared to a technology transfer agreement between non-competitors where the licensee does not own a technology used in-house).

The Commission appears concerned about the risk under the current regime of licensees foreclosing potential entrants to the downstream market by entering into exclusive licences with the only company licensing out technology, but still benefiting from the higher, 30%, market share threshold because the current regime does not treat them as competitors.

As stated, relevant technology markets are often difficult to determine. This will be even more difficult if undertakings need to consider whether any technology used only for in-house production could be used to produce competing products. Use of technology by an undertaking for its in-house production is very different from an undertaking engaging in the business of manufacturing for external use or of licensing that technology, and so its substitutability is very unlikely to have been analysed previously. This is therefore a barrier to applying the TBBER.

It also seems inconsistent with the usual practice of taking into account only contestable sales in assessing market share. And if the licensor is the only licensor of the relevant type of technology, how could the TTBER apply anyway – its market share will surely exceed 30%.

And finally, in the Commission's current consultation on revising the simplified procedure for merger notifications a simplified procedure is suggested in circumstances where competitors have a combined market share of up to 50% if the increment to market share is low. The CLLS would propose that a similar approach be taken in the TTBER.

The CLLS consider that this part of the Commission's proposals raises some major practical difficulties in terms of calculating market shares. It goes against the practice of the Commission in mergers cases, where captive sales are excluded. It is unnecessary and should be abandoned. Consideration should instead be given to extending the block exemption to the situation where a licensing arrangement leads to only a marginal increase in market share so that the aggregate share does not exceed, say, 50%.

Passive sales restrictions between licensees no longer covered by the safe harbour of the TTBER

The current TTBER differs from the BER for vertical restraints (Regulation 330/2010) in that there is a carve-out in Article 4 that exempts passive sales restrictions protecting a licensee from passive sales from other licensees into its exclusive territory during the first two years of an agreement between non-competitors. This was always justified on the basis that it provided a necessary commercial incentive for a licensee to assume the risk of taking on the licence and investing in exploiting the new technology in its reserved territory.

The proposal now is that the carve-out should be removed, so that passive sales restrictions would always be treated as hardcore restrictions and not capable of benefiting from automatic exemption under the TTBER.

In the view of the CLLS there is no justification for aligning the TTBER with the BER for vertical restraints as they deal with very different commercial and economic situations.

The CLLS notes that the revised Guidelines would expressly acknowledge that this type of passive sales restriction can be individually exempted if the restraints are objectively necessary for the licensee to penetrate a new market. But this puts the onus on the parties to assess on a case-by-case basis.

The CLLS has no specific information from clients on how often parties avail themselves of the right to insert a two-year restriction on passive sales to other licensed territories and so how much practical difference it would make to remove this exemption. However, the CLLS believes it is not a very common kind of restriction in licensing agreements, but it can be useful. The change also gives an incentive for licensors to reserve territories to themselves rather than licensing out, as the licensor can restrict passive sales to its own territories.

In summary, the CLLS considers that the treatment of passive sales in the current TTBER represents a sensible compromise and there is no compelling reason to change it.

3.3 All exclusive grant-backs fall outside of the safe harbour of TTBER

The proposal is to remove the current distinction between so-called severable and non-severable improvements and exclude from the safe harbour all exclusive grant-back obligations concerning all improvements made by a licensee. All exclusive grant-backs would require an individual assessment. This change will ensure that there are sufficient incentives for follow-on inventions. All non-exclusive grant-backs are still covered by the TTBER.

This seems to the CLLS to be an unnecessary change to the current regime. The CLLS is not aware of any disputes about the severability of improvements having reached the courts and it can be assumed that in practice the distinction is being applied without problems. Licensors have a genuine interest in ensuring their technology is exploited to the maximum extent. The TTBER should encourage new developments and improvements to be shared within the licensed network and grant-back clauses serve a very useful function in that respect.

The CLLS recognises the need for the TTBER to encourage the dissemination of new technology, including improvements to existing technology, as widely as possible. However, this should not be at the cost of the careful balance of commercial interests that led the licensor to make the licensed technology available in the first place to one or more external licensees rather than keeping it to itself to develop, in all likelihood more slowly and less effectively. Restrictions on the ability of the licensor subsequently to control that technology and any technology spawned by its underlying technology should be applied with caution as they risk having the counterproductive effect of deterring the technology being disseminated in the first place.

A restriction on the exclusive grant-back of improvements (whether back to the licensor for own use and/or sharing with other licensees in the same network) has to be viewed differently from a restriction on an entirely new piece of technology. The improvement probably would not have been made but for the licence in the first place and if such restrictions are imposed in could have a chilling effect on licensing as a viable commercial option for owners of IP.

The CLLS certainly recognises the need for the TTBER to encourage and open up competition by encouraging it to be made available within the immediate circle of the licensor and licensee and other licensees in the same network.

The CLLS also recognises the sense in applying the same logic to improvements made by a licensee that are stand-alone and severable by excluding the TTBER if the licensor attempts to limit them being made available outside the immediate circle of the licensor and licensee and other licensees in the same network.

However, if a licensee makes a significant development for improving a licensed product or process but its technology cannot stand alone (is non-severable), the ultimate decision whether to license third parties to exploit that improvement technology should not be the licensee's but the licensor's. If the licensee's development has substantial value then the licensee can charge royalties for it and its endeavours are sufficiently rewarded. Market forces will dictate whether it can be licensed to the wider world if the licensor sees it as in its interests to allow this as a means of generating more sales and revenues.

Many licence agreements contain grant-back clauses making this established distinction between severable and non-severable improvements. For the Commission to revisit this arrangement at this stage, would cause uncertainty and unnecessary expense in potentially requiring parties to re-open commercial arrangements, without there being any real justification as a matter of competition policy to do so.

3.4 Termination clauses also to fall outside of the safe harbour of the TTBER

The proposal to remove the carve-out for licensors to terminate technology transfer agreements in the event of a challenge to the validity of the licensed IP rights (no-challenge clauses) is not supported by the CLLS. They would in future require individual assessment by the parties, although their invalidity would not prevent the rest of the agreement from benefiting from the safe harbour of the TTBER.

The Commission's stated rationale for the change is that, in particular in cases where the licensee has made substantial investments, no-challenge clauses can have very similar effects to exclusive grant-back clauses. It also claims that licensees are usually in the best position to know when particular IP rights have been invalidly granted.

The CLLS does not share the Commission's view that such clauses are particularly problematical from a competition law point of view.

However, the CLLS views this change as an unnecessary interference with the system of intellectual property right protection and with the parties' commercial freedom to contract. In any event the recent *Astra Zeneca* decision and subsequent appeals confirm that parties who unjustifiably apply for doubtful patents are at risk under Article 102 TFEU and face the risk of fines.

Most licensing is between a willing licensor and a willing licensee, for a licensee to gain access to technology to exploit a new market, whether a new product market or new geographical market, which is not being exploited by the licensor. The Commission seems to view this from the starting point that all licence negotiations are inherently forced or one-sided and therefore anti-competitive. That is simply not the case in our experience.

In any event, the commercial reality is that it would be odd for a licensor to be obliged to continue to license and deal with a licensee who was suing the licensor on the basis that it did not in fact need a licence. At the same time the licensee will find it unattractive to have to continue paying royalties under the licence agreement whilst the patent challenge takes its course and may prefer to terminate and take the risk of losing the challenge. Meanwhile the licensee gets the benefit of a product that is still technically patented and licensed to it on an exclusive basis and which third parties are not authorised to market. And licensors may in future insist on having short general termination provisions that allows termination of the licence at any time without cause which from a licensee's point of view is worse.

The Commission's analysis fails to appreciate that the licensor may be providing tangible material under the licence, such as secret know-how, through handover of instruction or process manuals, access to improvements and technical assistance or training, which the licensor would see no basis to continue, where the licensee demonstrates an intention not to be bound by the terms of the licence by challenging the licensor's patents. Most licence agreements are more complex than simply being a bare legal licence of intellectual property rights, but involve the licensee being given access to material that would never be made available publicly.

The Commission's proposed reversal of the risk onto the licensor can only increase the risk of gamesmanship in litigation. There is clearly a debate to be had about the extent to which no challenge clauses generally should be treated as anti-competitive but the CLLS is not convinced by the Commission's reasons for shifting the commercial risk from the licensee to the licensor in this way.

4. Draft Guidelines for Technology Transfer Agreements

The only two sections in which there have been important changes in substance (not reflected in the TTBER) are in the section on settlement agreements and in the section on technology pools.

4.1 Settlement agreements

The Commission proposes to clarify that settlement agreements involving a licence may infringe Article 101(1) TFEU, in particular where a licensee agrees, against a value transfer from the licensor, to more restrictive terms than the licensee would have accepted solely on the strength of the licensor's technology. This type of agreement is commonly referred to as a "pay-for-delay" agreement or "reverse payment patent settlement". The term "reverse payment" refers to the fact that the payment is in the opposite direction of what would ordinarily be expected in patent law.

Furthermore, the Commission believes that clauses in settlement agreements not to challenge the patent in the future are in particular problematic if the patent holder knows or should have known that the patent does not meet the patentability criteria, for example because the patent was granted following the provision of incorrect, misleading or incomplete information.

While the CLLS has no reason to doubt that in some cases the above may be the correct analysis under competition law, it questions whether it is yet right to include this thinking as if they were decided principles in a set of formal guidelines that will be widely used by parties and by national regulators and judiciaries

There has been more extensive litigation in the US on the antitrust implications of this sort of settlement agreement, and thus far relatively few cases have come before the courts in the EU. That would tend to indicate that for the most part the current regime works well enough. Only in a few well-publicised instances have the Commission or national competition authorities become involved, including investigations in the pharmaceutical sector.

However, the CLLS questions the extent to which the pharmaceutical sector should be seen as typical. Businesses do not on the whole engage in expensive litigation with a view to reaching a settlement involving allegedly collusive licensing, but reach a deal which is a genuine compromise of legal proceedings. If they do, then one can be sure that any collusion will have been evident before litigation was ever contemplated.

While it is useful to have a record of the European Commission's thinking on the subject, it seems to the CLLS premature for the Commission to have set out its views in guidelines in language that appears quite so rigid and prescriptive without first having had sufficient experience, in particular outside one specific industry.

4.2 Technology pools

The CLLS supports the fact that the Commission's guidelines will contain a comprehensive safe harbour for pools covering not only the creation of the pool but also its subsequent licensing out. Clearly it is important that it should give further incentives to the creation of pro-competitive pools, as the Commission has stated is the case.

We do not have any additional comments at this time other than the views expressed above.

The CLLS would, however, welcome the opportunity to participate further in the consultation process, including attending any public hearings, and would ask to be consulted.

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