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European Commission Proposes New Competition Rules for Technology Licensing

On 1st October 2003, the European Commission published a proposal for a revised EC Technology Transfer Block Exemption Regulation ("TTBER") and new explanatory guidelines (the "Guidelines").[1] As proposed, the TTBER and the Guidelines will dramatically change the European Competition law rules applying to intellectual property licensing agreements. Companies and other interested parties are invited to submit comments to the European Commission by 26 November 2003.

The proposed TTBER looks nothing like the current technology transfer block exemption.[2] The most important proposed changes are:

- **The proposed TTBER treats agreements between competitors fundamentally differently from agreements between non-competitors.**
- **In line with other modern block exemption regulations, the proposed TTBER's application will mainly depend (i) on the parties' market shares (combined share not exceeding 20% for competitors and individual shares not exceeding 30% for non-competitors) and (ii) the absence of specific "hardcore" restrictions; the current formalistic "white", "grey" and "black" list rules will be abolished.**
- **The proposed TTBER's scope will extend beyond patent and know-how licenses to include software copyright and design right licenses. Reproduction rights in respect of (non-software) copyright works are not covered by the proposed TTBER.)**

The proposed Commission Guidelines constitute a new approach to applying European competition law to intellectual property rights. On almost 40 pages, they contain notably:

- **Detailed explanations on the provisions of the proposed TTBER.**
- **Principles for the treatment under Article 81 of the EC Treaty ("EC") of technology licensing agreements not covered by the TTBER, including discussion of royalty obligations, exclusive licensing, sales restrictions, output restrictions, field of use restrictions, captive use restrictions, tying and non-compete obligations.**
- **Criteria for assessing technology pools, settlement agreements, and non-assertion agreements, which, by definition, fall outside the TTBER.**

The Commission aims to adopt the new TTBER and Guidelines in time for them to become applicable as of 1 May 2004. Licensing agreements that are already in force then would continue to benefit from the current technology transfer block exemption until the end of October 2005.

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1 Draft Commission Regulation on the application of Article 81(3) of the Treaty to categories of technology transfer agreements and Draft Guidelines on the application of Article 81 of the Treaty to technology transfer agreements, 2003 O.J. C235 of 1 October 2003, pp. 11-16 (draft TTBER) and pp. 17-54 (draft Guidelines).

2 Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article [85(3)] EC to certain categories of technology transfer agreements, 1996 O.J. L31/2.

While the proposed TTBER and Guidelines do not accommodate everybody's expectations, the proposal constitutes a major improvement to the current regime. It introduces a conceptually sounder, more economics-based approach to the competition law treatment of technology licensing agreements. The proposed TTBER will be easier to apply than the highly complex and rather formalistic technology transfer block exemption of 1996.

The Guidelines provide a significant degree of clarification at a time when European Competition law is imposing greater responsibility on companies to self-assess the legality of their contractual agreements. The reform will also bring the European Competition law rules closer to the US rules on technology licensing, although some important differences will remain, notably in respect of the treatment of intra-technology restraints.

For companies affected by licensing agreements, the reform will entail major changes:

- **A number of commercially important licensing provisions that are currently allowed (such as territorial restrictions on licensees in agreements between competitors) will constitute prohibited "hardcore" restrictions in the future, while other provisions will be treated more leniently than in the past; companies will have to adapt their licensing strategies to the new rules.**
- **The assessment of the legality of technology licensing agreements will become considerably more fact-specific. Contracting parties will have to initially establish and monitor during the lifetime of the agreement, their competitive relationship, their market shares and often the agreement's market effects. This will increase the compliance burden on companies and may lead to some uncertainty.**
- **Under the proposal, companies would have to review and potentially renegotiate existing licensing obligations in agreements that continue beyond October 2005.**

Interested parties now have until the end of November to submit comments.[3] While the Commission is unlikely to deviate from the general structure of the reform, there is understood to be scope for amendment on specific issues.

I. Background

The proposal was preceded by a lengthy evaluation period that included a public consultation on a Commission report published in December 2001.[4] The report characterized the present block exemption as too narrow and rigid and too focused on legal provisions rather than economic reasoning, and identified the overall need for greater legal clarity. Responses to the report largely shared that view and the need for a major reform.

The structure of the reform - adoption of a new block exemption regulation together with explanatory guidelines - follows the structure that the Commission implemented for horizontal agreements and vertical agreements.

The main benefit that the proposed TTBER confers is legal certainty. As is specified in the proposed Guidelines, no Member State court can find that an agreement covered by the TTBER violates Article 81 EC. In other cases, Member State courts and competition authorities can be expected to follow the Guidelines in practice.

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3 Comments can be e-mailed to COMP-TECHNOLOGY-TRANSFER@cec.eu.int.

4 Commission Evaluation Report on the Transfer of Technology Block Exemption Regulation No 240/96 - Technology Transfer Agreements under Article 81, adopted 21 December 2001. See "Upcoming reform of the Transfer of Technology Block Exemption" WCP Bulletin of 27 February 2003.

II. The proposed TTBER

The structure of the proposed TTBER differs radically from the current technology transfer block exemption. The latter "block-exempts" agreements depending on whether they contain specific types of provisions, but largely irrespective of the parties' competitive relationship, their market shares and the agreement's actual market effect. This "form-based" approach contrasts with the Commission's modern "effects-based" interpretation of Article 81 EC, which evaluates restrictive effects and potential justifications according to an agreement's market effects.

Fundamental to the new approach is the different treatment of licensing agreements between competitors and non-competitors, and the introduction of market share thresholds to determine the application of the proposed TTBER.

The proposed TTBER would block-exempt two-party technology transfer agreements that are for the manufacture or provision of goods (*see* below, Section 1), provided that the parties' market shares do not exceed certain thresholds, which are set differently for competitors and non-competitors (*see* below, Section 2).

However, if an agreement contains a restriction that the proposed TTBER defines as hardcore (again differently for agreements between competitors and non-competitors), the entire agreement loses the benefit of the block-exemption (*see* below, Section 3).

Even if it otherwise applies to an agreement, the proposed TTBER never covers a limited number of specific provisions (*see* below, Section 4). Finally, the TTBER can be withdrawn or disapplied in exceptional circumstances (*see* below, Section 5).

1. Technology transfer agreements between two companies for the manufacture or provision of goods or services

The general scope of the proposed TTBER (in terms of types of agreement covered) is not significantly different from the current technology transfer block exemption, with one major exception: the proposed TTBER is broadened beyond (pure or mixed) patent and know-how licensing agreements to include licensing agreements for computer software copyright and design rights. In addition to licenses, the proposal covers assignments of technology if the economic risk of exploiting the technology remains with the assignor. The proposed TTBER would also continue to apply to licensing of patent applications, utility models, applications for registration of utility models, topographies of semi-conductor products, supplementary protection certificates for medicinal products (or other products for which such supplementary protection certificates may be obtained) and plant breeder's certificates.

The proposed TTBER does <u>not</u> apply to:

- Agreements that predominantly concern the licensing of other intellectual property rights, such as (not computer related) copyright works and trade marks. However, the principles of the proposed TTBER and the Guidelines apply, by analogy, to licenses of copyright for the purpose of reproduction and distribution of the protected work. (There has been much controversy as to whether to include such licenses in the scope of the proposed TTBER.)

- Agreements that predominantly concern the purchase and sale of products.
- Agreements that predominantly concern joint research and development or specialization in production (including joint production).

- Multi-party licensing agreements. Agreements between more than two parties have to be individually assessed, but if they are of the same nature as two-party agreements that fall within the scope of the proposed TTBER, the Commission will apply by analogy the principles set out in the proposed TTBER.
- Master licensing agreements that allow the licensee to sub-license the technology. The principles of the proposed TTBER apply by analogy to such agreements.
- Technology pools (bilateral and multilateral), settlement agreements and non-assertion agreements. These are further discussed in the Guidelines (*see* below, Section 3).

2. Market share thresholds

The most significant change comes from the introduction of market share "thresholds" (in fact ceilings) to determine the application of the proposed TTBER. Under Article 3 of the proposed TTBER, agreements cannot benefit from block exemption if, on the relevant product or technology market affected by the agreement:

- The parties' combined market shares exceed 20% (if they are competitors).
- Or either party's individual market share exceeds 30% (if they are not competitors).

While the general rules for market share calculation apply to product markets, special rules apply to technology markets. For the purposes of the proposed TTBER, the parties will only be considered competitors on technology markets if they both actually license competing technology to third parties. Potential competition on technology markets does not create a competitive relationship under the proposed TTBER, but is relevant for an individual assessment outside the proposed TTBER. To calculate market shares on technology markets, the proposed TTBER asks, in essence, for the presence of the technology on the product market, rather than the share of the licensor's royalty income on the licensing market. For technology markets, these rules reduce the number of situations where the parties are considered competitors and in certain situations lead to lower market shares.

The proposed Guidelines accept that companies cannot be considered competitors on technology markets if they are in a one-way or two-way blocking position, *i.e.* where one or both parties cannot use its technology without infringing upon the intellectual property rights of the other. The Guidelines are more cautious with regard to situations of a so-called "sweeping technological break-through". When the parties have so far competed but one of them has succeeded in a drastic innovation that it now wants to license to the other, the parties will only be treated as non-competitors if strong evidence suggests that the licensee will no longer be able to compete with its old technology.

An agreement continues to benefit from the proposed TTBER for as long as all its requirements are met and the licensor's rights remain valid and in force. This requires companies to constantly monitor their competitive relationship and the development of market shares. If a new licensed technology is successful and the market share thresholds are exceeded, the agreement remains covered by the proposed TTBER for one additional year if the thresholds are exceeded by more than 5%, or two additional years if the thresholds are exceeded by 5% or less.

3. Hardcore restrictions

In line with the structure of other modern block exemption regulations, a technology licensing agreement loses the benefit of the TTBER in its entirety if it contains a hardcore restriction. Hardcore restrictions are licensing provisions which, directly or indirectly, in isolation or in combination with other factors under the control of the parties, have as their object the

achievement of certain anti-competitive market effects. Under this definition, which is also used in other block exemption regulations, not all hardcore restrictions can be detected by looking at the agreement alone. Individual market circumstances may also have to be taken into account.

Hardcore restrictions normally cannot be justified under Article 81(3) EC.

Hardcore restrictions in agreements between competitors. The hardcore list for competitors broadly reflects the hardcore lists of the block exemption on specialization agreements and the *de-minimis* Notice, but adds a fourth item. It covers provisions whose object is:

- Fixing of prices when selling to third parties.
- Limitation of output or sales (except output restrictions on the licensee in non-reciprocal agreements).
- Allocation of markets or customers (except "own-use" restrictions on the licensee and field of use restrictions on the licensee in non-reciprocal agreements).
- Restriction of the licensee's ability to exploit its own technology or either party's ability to carry out research and development, in the latter case unless such restriction is indispensable to prevent the disclosure of the licensed know-how to third parties.

This hardcore list entails very significant changes from the current technology transfer block exemption and considerably tightens the rules for licensing between competitors with, notably, the following implications:

- Several royalty mechanisms will be seen as hardcore price-fixing.
- Territorial or customer restrictions on the licensor or licensee will almost always be hardcore allocations of markets or customers. In contrast, the current block exemption allows territorial restrictions between competitors under relatively lenient conditions.
- It will also be a hardcore market allocation if the licensor undertakes not to exploit the technology itself. An undertaking not to give additional licenses is not hardcore.
- A number of, but not all, field of use restrictions are treated as hardcore, while the current technology transfer block exemption largely allows field of use restrictions between competitors.

Hardcore restrictions in agreements between non-competitors. Recognizing the similarity between licensing agreements between non-competitors and distribution agreements, the hardcore list for non-competitors is, broadly, a subset of the hardcore list of the block exemption on vertical agreements. A major change compared to the current technology transfer block exemption is that licensees can no longer be restricted from making unsolicited ("passive") sales into the territory of other licensees. The hardcore list for non-competitors covers:

- Resale price maintenance provisions other than for maximum and recommended prices.
- Territorial and customers sales restrictions *on the licensee*, <u>except</u>:
  - the restriction of active or passive sales into the exclusive territory or to an exclusive customer group reserved for sales by the licensor;
  - the restriction of active sales into the exclusive territory or to an exclusive customer group allocated by the licensor to another licensee;
  - own-use restrictions on the licensee;
  - the obligation on a wholesaler licensee not to sell to end-customers;
  - in case of selective distribution, the prohibition to sell to unauthorised distributors.
- Active or passive sales restrictions on a retail licensee in a selective distribution system concerning sales to end users (but unauthorised establishments can be prohibited).

4. Licensing provision that are never covered by the proposed TTBER ("conditions")

Article 5 of the proposed TTBER lists specific restrictions that are never block-exempted, even if the TTBER otherwise applies to an agreement. These restrictions include obligations on the licensee to license back and assign improvements, certain output restrictions, non-challenge clauses, and clauses limiting the parties' ability to carry out research and development. These provisions always have to be assessed in light of the specific market circumstances and the proposed Guidelines set a framework for that assessment.

5. Withdrawal and disapplication of the proposed TTBER

The Commission and national competition authorities will have the power to withdraw the benefits of the proposed TTBER for individual agreements that, while complying with the proposed TTBER, have particularly negative effects on competition. Withdrawal may, in particular, occur if several agreements of the same type existing on the market cumulatively produce anti-competitive effects. The proposed TTBER also authorizes the Commission to exclude ("disapply") from the scope of the proposed TTBER, by means of regulation, parallel networks of similar agreements where these cover more than 50% of a relevant market. Both withdrawal and disapplication should remain exceptional in practice and would not affect the legality of conduct that occurred before the withdrawal/disapplication.

III. The proposed Guidelines

1. General principles for the application of Article 81 EC to technology licensing agreements not covered by the proposed TTBER

If a technology licensing agreement is not covered by the proposed TTBER, an individual assessment in light of the market circumstances will establish whether the agreement restricts competition and is, therefore, caught by Article 81(1) EC. The only exceptions are hardcore provisions, which are considered to restrict competition by their very nature. There is no presumption of restrictive effect merely because an individual agreement falls outside of the proposed TTBER for exceeding the market share thresholds. Negative market effects may be on price, output, innovation, or the variety or quality of goods and services. The proposed Guidelines focus on three types of possible restriction:

- Inter-technology restrictions, *i.e.* restrictions (including the facilitation of explicit or tacit collusion) on actual or potential competition that would have existed had no license been granted, will normally be caught by Article 81(1) EC.
- Intra-technology restrictions, *i.e.* restrictions on competition that would have existed if the license had been granted without the allegedly restrictive provision are also normally caught by Article 81(1) EC, unless the provision is objectively necessary for the conclusion of the agreement. For example, territorial restraints between non-competitors may fall outside Article 81(1) EC if they are objectively necessary in order to penetrate a new market. The emphasis on intra-technology restrictions contrasts with the United States' approach to technology licensing, where intra-technology issues are rarely considered anticompetitive.
- Foreclosure of competitors can arise by raising their costs, restricting their access to essential inputs or otherwise raising barriers to entry.

Factors that the Commission will take into account when assessing restrictive effects include the nature of the agreement, the market position of the parties as well as of competitors and buyers of the licensed products, entry barriers and the maturity of the market.

If an agreement restricts competition, it is still legal (under the new Regulation 1/2003) if justified by its positive market effects under Article 81(3) EC. The proposed Guidelines explain the four conditions for application of Article 81(3) EC, which are resulting positive effects, the unavailability of less restrictive means, fair participation of customers in the benefit and the absence of elimination of competition.

In practice, exemption will often turn on whether parties with high market shares meet the fourth condition under Article 81(3) EC, *i.e.* they must not have the potential to eliminate competition. Interestingly, the proposed Guidelines explicitly move away from statements in the Commission's Guidelines on horizontal restraints and Guidelines on vertical agreements that dominance of the parties normally excludes the application of Article 81(3) EC. According to the Guidelines, an automatic bar to exemption only exists if the agreement amounts to an abuse of a dominant position under Article 82 EC.

The move away from a standard that automatically precludes restrictive agreements in cases of dominance widens the commercial possibilities for dominant companies and therefore should be welcome to many. However, the proposal may also leave companies and their advisers in some doubt about what they can do. Greater clarity in this part of the Guidelines would therefore be useful.[5]

2. Specific licensing provisions in agreements that fall outside the proposed TTBER

For technology licensing agreements that fall outside the scope of the proposed TTBER, the proposed Guidelines discuss how the following commercially important and commonly found licensing provisions should be assessed:

- Royalty payment obligation on the licensee.
- Exclusive licensing, *i.e.* an obligation on the licensor not to give other licenses.
- Sales restrictions on the licensee or licensor.
- Output restrictions.
- Field of use restrictions on the licensee.
- Captive use restrictions on the licensee.
- Tying obligations on the licensee.
- Non-compete obligations on the licensee.

The assessment of these provisions under the proposed Guidelines depends on whether or not the parties are competitors and, if they are, whether or not the restriction or obligation is reciprocal. Additional factual distinctions are made with regard to some of the provisions.

The proposed Guidelines' are too detailed to summarize usefully, but companies should carefully review them when assessing specific agreements. The following general remarks can be made.

As a general rule, these restrictions and obligations are least problematic if entered into by non-competitors, more problematic if entered into by competitors, and most problematic if entered into by competitors in reciprocal licensing agreements. In addition, restrictions in agreements between non-competitors preventing the licensee from using the licensed technology to compete against the licensor are generally looked upon favourably, on the premise that a

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5 The Draft Commission Guidelines on the application of Article 81(3), which have been published as part of the Commission's draft "modernization package" and are set to come into force on 1 May 2004 also, do not provide in their current form significant additional guidance on the issue.

technology owner would be likely to refrain from licensing if he cannot prevent such competition from his own technology.

Finally, the proposed Guidelines state that the following licensing provisions will not be considered to be restrictive of competition regardless of market circumstances: confidentiality obligations; obligations on the licensee not to sub-license; obligations not to use the licensed technology after the expiry of the agreement, provided that the licensed technology remains valid and in force; obligations to assist the licensor in enforcing the licensed intellectual property rights; obligations to pay minimum royalties or to produce a minimum quantity of products incorporating the licensed technology; and obligations on the licensee to use the licensor's trademark or indicate the name of the licensor on the product.

3. Assessment of technology pools

Long-awaited by many industries, the proposed Guidelines provide guidance on the assessment of technology pools. Technology pools are arrangements, regardless of their form, whereby two or more parties assemble a package of technology that is licensed not only to members of the pool, but also to third parties. Technology pools may set an industry standard, but can also support competing standards. Licenses granted by a pool to third parties fall within the scope of the proposed TTBER, but the pooling agreements themselves do not. They are assessed according to the following principles.

- Pools combining essential technologies will normally fall outside Article 81(1) EC. A technology is essential if there are no substitutes inside or outside the pool and the technology constitutes a necessary part of the package of pooled technologies.
- Pool agreements encompassing complementary technologies, where there are substitutes outside the pool for the included technologies, are likely to be caught by Article 81(1) EC if the pool has a significant market position on any relevant market. Relevant for the Commission's assessment are, notably, whether there are any pro-competitive reasons for including the technology in the pool, whether the licensors remain free to license their technologies independently, and whether licensees can limit the license to certain parts of the package and obtain a corresponding reduction of royalties. Technologies are complements rather than substitutes (the Guidelines recognize that the distinction is not always clear cut) when they are required from a technological point of view to produce the product or carry out the process to which the technologies relate.
- Pooling of substitute technologies will generally be considered to violate Article 81 EC.

The Guidelines also discuss additional considerations that are relevant in the assessment of technology pools. Companies should be aware of the following principles, in particular:

- Pools that hold a strong position on the market should be open and non-discriminatory.
- Pools should not unduly foreclose third party technologies or limit the creation of alternative pools.
- The risk of a pool violating Article 81 EC can be further reduced if participation in the process of setting up the pool is open to all interested parties, independent experts are involved in the creation and operation of the pool, the exchange of sensitive information among the parties is limited, and a dispute resolution mechanism exists.

4. Non-assertion and settlement agreements

Non-assertion and settlement agreements normally fall outside of 81(1) EC, but their terms and conditions may restrict competition. The Guidelines express caution towards restrictions on the use of the technology and royalty payments other than by a one-way lump sum payment.

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