European Commission publishes draft new technology transfer rules: A comment on policy directions

This Article presents a policy opinion on the European Commission’s proposals for a new technology transfer block exemption issued in September 2003.

Marc Hansen and Omar Shah, Latham & Watkins, Brussels/London.

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On 25 September 2003, the European Commission issued for public consultation a draft set of technology transfer rules (published in the Official Journal of the European Union on 1 October 2003 (OJ 2003 C235/10)). The proposals consist of a new technology transfer agreements block exemption regulation (TTBE) to replace Regulation 240/96 (OJ 1996 L31/2) with a set of draft guidelines (Guidelines) (see Legal update: Commission issues draft Regulation on technology transfer agreements). The TTBE and Guidelines are intended to enter into force on 1 May 2004, coinciding with the accession of the new member states to the European Union and entry into force of the so-called...
‘modernisation Regulation’ (Regulation 1/2003 OJ 2003L1/1). The Commission has invited comments on the TTBE and Guidelines, with a deadline for submitting comments of 26 November 2003.

Overall, the TTBE and Guidelines represent a welcome modernisation of the law inspired by the less formalistic and more effects-based approach previously taken by the Commission in relation to vertical and horizontal agreements. This involves a safe harbour approach based on market share thresholds together with relatively short “black” and “grey” lists of per se restrictions and non-exempted (but not per se restrictive) provisions, respectively.

However, on many issues in the TTBE and Guidelines, the Commission seems to opt for consistency with its approach to other types of agreements without due consideration of the particular characteristics of technology transfer agreements and the economic context in which they operate. For instance, the TTBE and the Guidelines often make a clear distinction in their treatment of agreements between competitors and non-competitors without obvious economic justification. One example is the treatment of territorial restrictions in agreements between competitors as hard core when equivalent restrictions between non-competitors may be exempted (see Territorial restrictions). In addition, the Commission adopts a number of positions that may discourage rather than stimulate pro-competitive technology licensing in the future, for example, in relation to cross-licenses (see Cross-licences, below).

Finally, the Commission includes in the Guidelines a discussion of multiparty licensing (which falls outside the scope of the TTBE), that could be improved to encourage the possibility of joint disclosure and negotiation of technology licensing terms by prospective licensors and licensees before the setting of an industry standard (see Joint ex ante disclosure and negotiation of licensing terms in multiparty licensing).

This Article provides an overview of the major changes introduced by the TTBE and Guidelines, together with an analysis of certain provisions of the draft that cause concerns.

**Principal changes from Regulation 240/96**

**Broadening the scope of the block exemption**

**Safe harbour approach.** The previous formalistic white list of exempted clauses is replaced with a broadly-defined safe harbour based on market share thresholds (Article 2). Unless certain hardcore restrictions are present (for example, price-fixing, market sharing; see Article 4), bilateral technology transfer agreements (where a licensor permits a licensee to exploit licensed technology for the manufacture of goods or provision of
services) will be exempted under Article 81(3) up to certain market share thresholds:

- **30%** of the relevant technology or product markets (the market share of each party to the agreement must not exceed 30%) in the case of **non-competitors;** and

- **20%** (combined share of the parties) of either a relevant technology or a relevant product market for **competitors.** (*Article 3.*)

Given this clear difference in the treatment of competitors and non-competitors, the definition of a competitor takes on greater significance. The TTBE defines competing undertakings as undertakings that compete on the relevant technology market and/or relevant product market (*Article 1(1)(h)).* The Guidelines provide detailed guidance on the distinction between competitors and non-competitors (*see paragraphs 23-26, Guidelines*). One area of difficulty with the definition contained in the Guidelines is that in relation to blocking patent positions. A one-way blocking position exists when a technology cannot be exploited without infringing upon another technology. A two-way blocking position exists where neither technology can be exploited without infringing upon the other technology and the holders thus need to obtain a licence or waiver from each other. If the parties to an agreement own technologies that are in either a one-way or two-way blocking position, the Commission will consider the parties to be non-competitors on the technology market. However, the difficulty arises because the Commission requires “convincing” evidence of a blocking patent position before it will accept that the holders of the patents are non-competitors. In the case of a two-way blocking position, only a final court judgment or the opinion of an independent expert would appear to suffice (*paragraph 25, Guidelines*).

**Inclusion of software copyright licensing agreements.** Software copyright as well as patent and know-how licensing agreements are now covered (*Article 1(b)).* Trade mark and other copyright licensing agreements will therefore continue to be excluded from its scope unless they are ancillary to a covered agreement. The Guidelines also cover mechanical reproduction copyright (but not performance copyright or trade mark) licensing agreements (*paragraph 48, Guidelines*).

**Customer allocation restrictions.** In the case of non-competitors, the TTBE aligns its treatment of customer allocation restrictions with its approach to vertical agreements containing such restrictions. Thus the licensor may lawfully prevent active or passive sales to exclusive customer groups reserved to itself (*Article 4(2)(b)).*
Exemption of non-compete and tying clauses.
Obligations imposed on the licensee to take a licence of another technology or purchase another product from the licensor or someone designated by him (tying) and not to use third-party technology (non-compete) are exempted (paragraphs 182-195, Guidelines). The Commission has thus ensured consistency between its treatment of such provisions in vertical agreements and in technology transfer agreements.

Exemption of grant-back obligations. Non-exclusive grant-back obligations are exempted even where they are non-reciprocal, that is, they are only imposed on the licensee and where under the agreement the licensor is entitled to feed on the improvements to other licensees. In addition, exclusive grant-back obligations are exempted where they relate to non-severable improvements (where they relate to severable improvements, grant-backs are excluded from the scope of the exemption) (Article 5(1)). This change should give greater incentives to licensors to license their technology as they will have access to their licensees’ improvements to their technology without having to reciprocate.

Exemption of output restrictions between non-competitors. Output restrictions in license agreements between non-competitors are block exempted up to the market share threshold of 30%, provided that the licensor is not obliged to limit the output of other licensees or the total output of all licensees (Article 4(2) (b); paragraph 165, Guidelines). This change recognises the pro-competitive effect of allowing a licensor to restrict a non-competitor licensee’s output to ensure that the total output of the product in question does not exceed the licensor’s profit maximising level.

Narrowing the scope of the block exemption
As compared with Regulation 240/96, the draft TTBE narrows the scope of application of the exemption in several ways.

Market share thresholds. The safe harbour approach introduces market share thresholds above which the block exemption will no longer apply and under which an individual analysis of any agreement under Article 81(3) must be undertaken, taking into account relevant market circumstances (Article 3).

Second sourcing. The TTBE no longer exempts quantitative limitations imposed on the licensee in licences granted to provide a customer with a second source of supply within the licensed territory.

Cross licences and field of use restrictions. The Commission proposes to take a strict approach to asymmetrical field of use restrictions (that is, covering distinct product markets or technical fields of application) in reciprocal cross-licensing agreements between
competitors under the TTBE (Article 4(1)(c)). For example, where A and B cross-license competing technologies and A limits his licence to product market X, and B limits his licence to product market Y, the agreement will be regarded as hardcore market sharing (paragraph 83, Guidelines). In addition, the Guidelines take a strict approach to cross licences that are used as part of settlement and non-assertion agreements (the Commission suggests that such licences should be royalty free and without restraints (paragraphs 196-201, Guidelines) (see further Cross licences).

Narrower definition of “know-how.” In order to be regarded as “substantial” (and thus fall within the TTBE), know-how must now be indispensable for the manufacture of the contract products, whereas previously it merely had to be useful to the competitive position of the licensee (Article 4(1)(g)).

Possibility of withdrawal in case of cumulative effect. Where the access of third parties’ technology is restricted, for example, by the cumulative effect of parallel networks of similar restrictive agreements prohibiting licensees from using third parties’ technologies, the Commission may withdraw the benefit of the TTBE from those agreements. Similarly, the benefit of the TTBE may be withdrawn where access of potential licensees to the market is restricted by parallel networks of restrictive agreements prohibiting licensors from licensing to other licensees (Article 6(1)).

Policy issues raised by the draft TTBE and Guidelines

Calculation of market shares

Market definition in the context of technology transfer agreements encompasses both technology markets and markets for products incorporating the licensed technology, and is already fraught with difficulty due to the fast-moving, rapidly changing nature of innovation, technology and product markets. Added to this difficulty in definition is now the proposed requirement under the TTBE to calculate market shares by reference to existing product markets (paragraph 69, Guidelines). This approach is likely to result in a distorted picture of market power of the parties to an agreement as it captures historical market share rather than focusing on the contestability of the market. It also does not take potential competition into account. Although the Commission does allow for an alternative approach for technology markets in the Guidelines (based on each technology’s share of licensing income from royalties) (Article 3(3); paragraph 21, Guidelines), even this method would be difficult for the parties, still less courts or competition authorities, to calculate. A possibly better method of measuring market power in technology
markets consists of identifying competing R&D poles (alternate technology centres) in order to determine whether there is sufficient actual or potential inter-technology competition. Although this method is currently reserved by the Commission only for a limited number of cases (paragraph 22, Guidelines), it is more practical than market share analysis and is likely to give a more accurate picture of the contestability of the relevant technology markets.

Territorial restrictions

In the TTBE and Guidelines, the Commission has harmonised its treatment of territorial restrictions in technology transfer agreements with its approach to horizontal and vertical agreements.

Thus, in agreements between competitors, all restrictions on active or passive sales between territories within the EU are prohibited (Article 4(1)(c)). Furthermore, in agreements between non-competitors, restrictions on active sales will only be exempted if they are to protect territories exclusively reserved for another licensee (Article 4(2)(b)(i)). Although this approach is slightly more liberal than Regulation 240/96 in its exemption of active and passive sales restrictions that protect territories reserved for the licensor, (and in its lifting of time limits on territorial restrictions in know-how licences), the proposed approach appears to take insufficient account of the economic context in which technology transfer agreements operate.

This is apparent in the Commission’s emphasis on market integration and fostering intra-technology competition in the licensor’s technology, even in cases where, but for the licence, the parties would not have been actual or potential competitors. In such cases, the Guidelines require that the territorial restriction (and indeed any restraint on the parties in a technology transfer agreement) be objectively necessary for the conclusion of the agreement, that is, given the nature of the agreement and the characteristics of the market, a less restrictive agreement would not have been concluded by undertakings in a similar setting (paragraph 14(b), Guidelines). This test is significantly different from that applied by other major antitrust jurisdictions and may prove impracticable due to its inherent subjective element. Such a test could in particular be interpreted in such a way as to make it very hard to be satisfied by courts and national competition authorities. Furthermore such restrictions increase the incentives to licence and thus foster inter-technology competition. A preferable approach would therefore be to remove the presumption of illegality under Article 81(1) in respect to such restrictions with a proviso that they can be prohibited if they lead to collusion (foreclosure due to cumulative effect can already be addressed using the withdrawal provisions).
Cross licences

Similar concerns to those expressed in relation to territorial restrictions above also apply in relation to asymmetrical field of use restrictions in reciprocal cross licences (paragraph 83, Guidelines). While there may be legitimate concerns as to anti-competitive arrangements such as market sharing arising from the use of such provisions in cross licences, there are very few actual cases in which such concerns have come to light. This is primarily due to the fact that such arrangements are generally used in fast-innovating, highly competitive industries to allow firms to lower their transaction costs and increase their focus on R&D. Cross licences of patent portfolios allow firms to pierce through the patent thicket, gain access to a wider range of technology and secure their design freedom. In the case of smaller firms, reciprocal cross licences containing asymmetrical field of use restrictions are often their only method of accessing the market to build on their existing research and compete with their larger rivals. Given that in many cases asymmetrical field of use restrictions in reciprocal cross licences can produce significant pro-competitive effects, it would appear to be incorrect to presume that they are almost always anti-competitive. It would also appear incorrect as a matter of competition policy to treat such restrictions as hardcore restrictions that naturally fall within Article 81(1) and only in exceptional circumstances satisfy the criteria in Article 81(3). A preferable approach may be to remove the presumption of illegality under Article 81(1) in respect to such agreements with the same proviso relating to collusion as in the case of territorial restrictions (see Territorial restrictions, above). Alternatively, the presumption of illegality could be retained but only in relation to agreements which provide for a restriction on either party’s ability to use its own technology.

Settlement agreements

The prohibition of asymmetrical field of use restrictions in reciprocal cross licences between competitors is also problematic in the context of cross licences used to settle patent disputes (paragraphs 196-201, Guidelines). In such cases there is often an imbalance in the respective patent portfolios of the parties in terms of scope and value. As asymmetrical field of use restrictions are often used to redress this imbalance, this would mean that such settlements would no longer be possible, reducing the level of technology licensing and thus the level of inter-technology competition. Accordingly, it may be preferable to remove the presumption of illegality under Article 81(1) in respect to asymmetrical field of use restrictions in patent settlement agreements. In addition, it may be desirable to allow parties to settlement agreements to be more flexible in agreeing royalty obligations in order to account for uncertainty in the value of their respective portfolios over time.

Reduction of royalties in multiparty licensing
In the Guidelines, the Commission suggests that licensees be allowed to obtain packages of patents essential for a particular product or process from the parties to a patent pool at a reduced rate where such packages do not contain all essential patents that have been pooled (that is, to the exclusion of patents that are either not worked by a particular licensee or the licensee otherwise would not infringe the patent) (paragraph 215, Guidelines). The Commission believes that in order to offer such partial packages at correspondingly reduced royalty rates, the parties to the pool need to assign a share of the overall royalty to each technology in the pool. This appears to be a reflection of the Commission’s concern that substitute technologies could be developed subsequent to the formation of a pool and that the absence of partial packages at reduced royalty rates would mean that pool licensees would be foreclosed from licensing such substitute technologies.

The problem with this proposal is that the value of a pool of essential patents is greater than the sum of its parts. Attacking unitary pricing goes to the heart of the benefits of pools: complements pricing is lower than the aggregate sum of individual patent prices (eliminating horizontal double marginalisation problems and increased transaction costs). Requiring individual pricing of the component patents thus runs contrary to the pro-competitive rationale of pools (that is, pools operating as a solution to the complements and hold up problems). Whereas the Commission has, on occasion, required pools to be adjusted to reflect a particular application (containing only patents needed for that application), one may question whether there is a basis in law for intervening in the pricing of the pool as suggested. Such a requirement is particularly difficult to understand as the Guidelines already provide a remedy for potential licensees that wish to receive only part of the technology since they provide that direct licenses from pool members for each patent must remain available at all times. If an additional provision were to be deemed justified, the Commission could consider a requirement to conduct an additional essentiality review at the instance of a licensee alleging that a substitute technology had been developed subsequent to the formation of the pool.

Joint ex ante disclosure and negotiation of licensing terms in multiparty licensing

Currently, licensors set the terms at which they are prepared to license prospective licensees with the technology that is essential to the implementation of a particular industry standard after that standard has already been set (ex post), i.e., at a point when those licensors have already effectively been granted market power by the standard-setting body. This has encouraged licensors to engage in strategic behaviour (for example, patent ambushes) as each licensor tries to leverage its increased ex post market power as much as possible. In many cases, this has resulted in severe delays in the implementation of a standardised technology and/or
supra-competitive royalties with the resultant loss of competition at inter-technology level and on downstream markets. Consequently, the Guidelines (which currently do not address this issue) could with some benefit allow, and indeed encourage joint negotiation (in standards development organisations) on pricing and other terms of the intellectual property rights that are essential for compliance with an industry standard, prior to that standard being adopted (ex ante).

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