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# Foreign Licensing and Joint Venture Arrangements

by Vincent D. Travaglini\*

Licensing and joint venture arrangements are methods of developing and serving foreign markets in lieu of or in addition to exporting or direct foreign investment. Exporting is the most obvious method of penetrating a market, but is not always feasible for a number of reasons, such as tariff and nontariff trade barriers, transportation costs, product design differences or distribution problems. Direct investment, on the other hand, involves a commitment of capital and management that a company may not be able or willing to make.

Licensing under commercial arrangements comprises any or all of the following:

- (1) Legally protected inventions and other forms of industrial property;
- (2) Know-how and technical expertise in the form of feasibility studies, plans, diagrams, models, instructions, and technical advice and services;
- (3) Architectural and engineering designs.

## I. Pros and Cons of Licensing

Companies have given the following reasons for entering into foreign licensing agreements:

- (1) Licensing permits entry into foreign markets without large capital outlays. It is, therefore, a favorite device for small and medium-sized companies.
- (2) Returns are apt to be more rapidly realized than in the case of manufacturing ventures.
- (3) The income from foreign licensing helps to underwrite costly research programs.
- (4) Licensing enables a firm to retain markets otherwise lost by import restrictions or because it is being outpriced.
- (5) Licensing can be used to test a foreign market and then to service it without costly additions to production or detracting from the supply available for local customers.
- (6) Licensing permits a company to develop outlets for components or other products and to build goodwill for other company products.
- (7) Licensing enables a company to establish an operation in countries

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that will not permit the establishment of a local subsidiary controlled by foreigners.

(8) Licensing is a two-way street which may permit the American company to get access to a foreign company's technology and even acquire a whole new product line without the delay and expense of development.

There are also drawbacks to the licensing and joint venture approach. Lack of management control is often cited, although some American corporations do not find it causes them difficulties. There are other disadvantages:

(1) Every licensee is a potential competitor. If the arrangement continues over time to be of mutual benefit, both parties will want to perpetuate it and continue to exchange know-how and product improvements. However, once a licensee has acquired technical proficiency and a good market, pressure can build up to terminate the license or at least revise it to the licensor's detriment.

(2) Licensor control over the licensee's manufacturing and marketing operations is rarely completely satisfactory. This can result in damage to trademarks and company reputation. The technique for averting this problem lies in careful investigation before selecting a licensee and maintaining quality control whenever a trademark or trade name is licensed.

(3) Licensing is probably the least profitable way of exploiting a foreign market. On the other hand, the risks and headaches are usually less than those experienced with investing, at least in the short run, although perhaps more than those experienced with exporting. Moreover, licensing may represent the only way to enter certain markets.

## II. The Licensing Contract<sup>1</sup>

The typical foreign licensing agreement used to be a simple contract extending to the licensee the bare legal right to use the licensor's patent, trademark or other industrial property. However, since World War II the simple patent or trademark license has given way to comprehensive contractual arrangements that often involve the licensor as a partner or co-venturer. The uses and services encompassed in the various types of contractual arrangements may be categorized as follows:

(1) Licensing of patents, trademarks and copyrights.

(2) Furnishing of know-how, consisting of processes, techniques, designs, patterns, blueprints, plant layouts, specifications and similar industrial and intellectual property rights.

(3) Providing technical and managerial services in engineering, design, supervision of construction and installation, and production layout. Supplying engineering and technical personnel to initiate the industrial undertaking and training for foreign managerial, engineering, technical and other skilled personnel.

These uses and services will usually be referred to in the preamble to the contract, which will also identify the contracting parties and state

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<sup>1</sup> See also L. ECKSTROM, LICENSING IN FOREIGN AND DOMESTIC OPERATIONS (3d ed. 1977); PRACTICING LAW INSTITUTE, CURRENT TRENDS IN DOMESTIC AND INTERNATIONAL LICENSING (R. Goldsneider & M. Finnegan eds. 1975); G. POLLZIEN & E. LANGEN, INTERNATIONAL LICENSING AGREEMENTS (2d ed. 1973); A. WISE, TRADE SECRETS AND KNOW-HOW THROUGHOUT THE WORLD (rev. ed. 1977); WORLD INTELLECTUAL PROPERTY ORGANIZATION, LICENSING GUIDE FOR DEVELOPING COUNTRIES (1977).

their mutual agreement to the contract terms. The basic elements of the license contract are discussed below.

### *A. Product Coverage*

The definition of licensed rights and products should be broad enough to take in all the items, processes and apparatus upon which the licensor expects to collect royalties. Sometimes the products are listed in a separate schedule annexed to the contract. It should be made clear whether new products or designs are covered.

### *B. Rights Licensed Under the Contract*

Foreign patents and trademarks, know-how and copyrights constitute the main licensed rights.

1. *Patents.*—Patents should be fully identified by number, date of issue and other pertinent detail. Patent applications are also an appropriate subject for licensing.

2. *Trademarks.*—Trademarks and service marks are often licensed when they have a reputation or recognition by the public or an industry outside the United States. Trademarks, like patents, are usually licensed with know-how. Many U.S. consumer goods producers have licensees in other countries who make the product utilizing the licensor's technology and are permitted to use the trademark. Trademarks are granted for a specific term but, unlike patents, are renewable.

3. *Know-how.*—This should be defined in the contract since it can cover a varied assortment of rights, trade secrets, plans, photographs, blueprints, specifications, manuals and technical assistance provided by the licensor's personnel.

4. *Copyrights.*—These are exclusive rights in creative works. In the context of technology licensing, copyrighted material may include advertising and promotional literature, shop manuals and other technical documents made available to the licensee.

### *C. Territorial Coverage*

The licensee is usually granted manufacturing, use and distribution rights for his country. Such rights may be extended to selected adjacent countries, to the regional or continental area of his location or to broader worldwide activities. The territorial rights granted to the foreign company may be exclusive or nonexclusive. The licensor generally retains the right to limit or extend, during the course of the agreement, the licensee's assigned territory or to convert it from an exclusive to a nonexclusive status, or vice versa, depending on the latter's performance and ability to give proper coverage and service to the territory concerned.

The territorial scope of the manufacturing right may be different from that of the distribution right.

#### *D. Tenure or Term of Contract*

Licensing agreements based primarily on the use of patents are usually concluded for periods effective for the duration of the patent rights that are licensed (*i.e.*, last-to-expire patent), but may also have fixed durations not dependent on the life of the patents.

Agreements concerned primarily with technical assistance, licensing of know-how, trade secrets or other unpatented technology, and in which patents play a minor role, are generally concluded for fixed periods ranging from a minimum of five to a maximum of twenty years from the agreement's execution date. When a trademark agreement expires or is terminated, the licensee is required to discontinue use of the trademark.

#### *E. Extension and Renewal Clauses*

Agreements with duration based on "last-to-expire" patents generally have no clauses pertaining to extension or renewal of any further basis. Technical assistance and licensing agreements concluded for fixed periods usually have provisions specifying that, if prior to the end of the term, the licensor acquires a patent on the subject matter, he may extend the agreement for the patent's duration, including rights to the licensee thereunder.

Agreements primarily licensing trademark rights generally provide for renewal after the initial licensing term. The renewal periods may continue for so long as the licensor's trademark registration is in force in the licensed territory.

#### *F. Protection of Rights Subject to License*

It is usual for the licensor to agree that he will, at his own expense, apply for and acquire patents, as appropriate, to be included in the arrangement and that he will maintain, enforce and protect all patents subject to the license. When any such patent is reportedly being infringed, the licensor usually assumes the responsibility and expense of an infringement action. Where an infringement action is left to the licensee, it may take proceedings in its own name to restrain such infringement at its own expense and for its own benefit.

Licensors ordinarily do not indemnify their licensee against the possibility that activities conducted under the license might infringe patents or other rights of third parties. However, cases of indemnification do arise when circumstances known in advance tend to fix the licensee's design and when the payments likely to be made by the licensee are so large as to make the risks of indemnification reasonable. Such losses may include awards, recoveries and damages assessed against the licensee. The amount indemnified generally is not to exceed the royalties anticipated

by the licensor. The licensor retains sole discretion to defend, settle, adjust or compromise any infringement suit involving the licensed rights; there is, however, the understanding that he will impose no money damages on the licensee beyond that already incurred by the latter and reimbursed by the licensor.

The licensor also undertakes specific commitments, subject to his right to grant other licenses, to safeguard the secrecy of the licensed inventions and technology and to guard them against unauthorized disclosure and use.

Registrations and renewals of licensed trademarks are usually conducted at the licensor's expense. The licensor reserves the right to use the mark in the licensee's territory. When the licensor agrees not to sell his similarly trademarked goods in the licensed territory, he assumes no obligations for the sale of such products in that territory by a third party. The licensor usually requires that he be notified by the licensee of possible infringements and assumes responsibility for initiating the infringement action in his or the licensee's name.

#### *G. Future Rights and Options*

The licensor generally specifies to the licensee that he will not grant a license under the same subject matter to another party at a royalty rate lower than that granted to the licensee, without lowering the latter's rate to the same level.

The licensor may also agree to include within the scope of the licensing agreement all new inventions, improvements and innovations that he may develop in the future, regardless of whether they are patented. Under such technology, the licensee usually has the same manufacturing, use and sales rights in the same territories as in the basic agreement.

#### *H. Merchandising and Management Assistance*

It is common for the licensor to provide such assistance where the agreement involves sales and distribution. In this connection, the licensor may make available to the licensee members his sales, production and technical staffs on an "as needed" basis. Such personnel provide advice and instruction on the licensor's marketing experience, advertising and use of samples. The licensor may also assist the licensee in setting up and operating displays at trade shows, as well as provide other marketing and management assistance.

#### *I. Quality Control*

Where the agreement involves licensing of trademarks, maintenance of the licensor's quality standards for products using his mark is an integral feature. Certain countries (*e.g.*, the United Kingdom) have so-called "registered user" requirements wherein a trademark licensing agreement must be registered with the government so that the licensor's product

quality standards for the mark can be enforced by the government against the licensee.<sup>2</sup>

Even if the licensing agreement does not involve trademarks, but only patents and technical assistance, the licensor, desiring to protect his product reputation, will usually impose commitments on the licensee that all products made under the agreement are to meet his standards of quality and performance. In this connection, the agreement will require the licensee to accord the licensor's representatives full access, test and inspection rights at his facilities to see that the standards are being met. The licensee may also be required to provide the licensor with a prototype or sample of the product proposed for manufacture for the licensor's approval or modification, before undertaking full production.

### *J. Grantback and Cross Licensing*

Licensors may require their licensees to grant return licenses on inventions or technology processed by the licensee. This may cover new advances on the licensed technology or may apply to a broader field. On the other hand, instead of an absolute assignment the provision might bind the licensee to grant a nonexclusive, royalty-free license on the advances, which the licensor would then have the right to exploit or sublicense.

Until a few years ago, the return flow of rights and information under grantback provisions was disappointingly small for many companies. That company was the exception that could point to a significant return of technology in a given field. The fault was not always with the foreign licensee, since most grantback arrangements involve procedures whereby the licensor must ask for certain developments made by the licensee. For the latter to send all developments to the licensor for examination was considered to be too time-consuming a procedure. U.S. licensors have generally not taken the initiative for grantbacks, being generally more interested in money returns than in any flow of techniques or improvements. This lack of interest is explained partly by the fact that, until a few years ago, most U.S. companies viewed foreign technical developments skeptically. In recent years, however, the situation has changed considerably as foreign managements in industrialized countries are taking the initiative in pushing introduction of their own technologies into the United States. American firms, in turn, have become more interested in taking licenses for foreign technology in a variety of fields offering promising marketing opportunities in this country. Examples of such technical flow backs to the United States include the Norwegian "Sloderberg System" for aluminum production, the British Pilkington process for producing plate glass, the German Wankel rotary

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<sup>2</sup> U.S. TRADEMARK ASSOCIATION, TRADEMARK LICENSING: DOMESTIC-FOREIGN 59 (1962).

combustion engine, the Czechoslovak contact lens technology and varied electronic technology from Western Europe.

### *K. Royalty Rate and Structure*

In most licensing agreements, the parties agree to a royalty rate that is relatively easy to police, calculate and handle in accounting. The rate is usually calculated as a fixed percentage of the licensee's net or gross sales proceeds from products made under the license. A frequently used royalty base is Net Sales Price, defined as invoice price less trade discounts, returns from licensee's customers, sales, use and excise taxes, packing charges, customs duties, and transportation and insurance costs. Some licenses assess the royalty as a charge per number of units made or sold, or per weight, size or capacity measurement of each unit. If the license is for a mining process, the royalty may be based on tons extracted and/or delivered. Depending on the products, other examples of royalty bases include cents per liquid or linear measurement, per square foot, per dozen pairs, per specified performance of a particular equipment's operation or per minute playing time of the product (*e.g.*, films and records).

Although royalty rates may range from a fraction of one percent to as high as fifty percent, five to six percent is generally considered an average rate for licensing agreements. This average may be lower or higher depending on how much the licensor values his patents, know-how and trademarks subject to the agreement and how extensively he licenses such rights to others. Other factors usually considered in fixing rates are royalty patterns in the particular industries, value of the rights to the licensee, territorial scope of the agreement and the strength of the licensor's patent rights in terms of their legal validity and scope. There is a growing tendency for the governments of licensee companies to become involved in the royalty negotiation process and to attempt to influence the rate; intervention of this type is encountered in India, Japan, France and other countries.

Some agreements provide for renegotiation of the royalty and fee rate structure during their life to take into account changing market conditions. Also, it may be necessary to reduce the royalties and fees during the later life of licensed patents when they are perhaps not as valuable for commercial exploitation as they were in their earlier periods. Further, if a licensor, under substantially identical conditions, grants to a licensee a lower royalty rate than that in a preexisting agreement with another licensee, he may be required under the latter agreement to give that party the same lower rate.

### *L. Service Charges*

Where technical, engineering and manufacturing assistance is to be rendered by the licensor, in connection with his patent, trademark



and/or know-how license, this is considered a service for which specific payments are required. Such services and payments may be spelled out in a separate Technical Aid and Assistance Contract with the licensor or the overall contract itself may include this feature in a combination licensing and assistance agreement. The most common services generally include supplying plant and equipment layouts, installing equipment, giving architectural and purchasing assistance, training key personnel, starting up new equipment, providing advice on use of equipment in assemblies and end products, and supplying information on new developments in the industry.

Other services of a nontechnical nature may include management assistance and help with governmental administrative procedures. In marketing, information may be provided on advertising and sales promotion and on other operational experience in selling the licensed products. In many agreements, services of a personalized and nontechnical nature are provided without extra payment. Where a licensing agreement includes equipment leasing or other provisions for the licensor's equipment to be used by the licensee, services are also required for taking care of and supplying parts for the equipment. If the licensee is to pay for the above described nontechnical services, payment terms may also be set out in the basic contract or in a separate service contract.

#### *M. Royalty-Free Licenses*

Patents and technology are licensed in many cases for reasons other than monetary compensation. Royalty-free licenses are generally used when the parties conclude a cross licensing agreement for the main purpose of exchanging complete rights and infringement immunities under their patents and technology in specified territories; where they primarily wish to promote, through a licensing agreement, an active two-way flow of know-how and technical data; or where they primarily wish to obtain the services of each other's key technicians on the subject matter of the license.

#### *N. Terms and Conditions of Payment*

Licenses often provide for initial lump sum payments. This may include an initial payment of the anticipated total royalties for the first year of the agreement, plus a sum to cover the licensor's out-of-pocket expenses in establishing the working arrangement with the licensee. Whenever a new product is added to a licensed product line, an initial down payment may also be required covering a year's royalty and out-of-pocket negotiating expenses. The licensee then makes his royalty or other required payments based on contract performances to the licensor monthly, quarterly or semiannually. At the end of the fiscal year, the licensee must supplement these payments to reach the minimum required annual payment, if this level has not been reached. The licensee

may also be required to maintain a security deposit against which the licensor may draw to meet payment defaults. The licensee must replenish this deposit to maintain it at the prescribed level.

The licensee is also required in most agreements to reimburse the licensor, upon his billing, for out-of-pocket expenses in providing the various services and assistance required, including the licensor's personal travel and living expenses.

Where the licensor is a U.S. firm, payments are often required in U.S. dollars. Since exchange rates may vary considerably, some contracts provide for the use of a calculated average rate for the royalty period; others take the effective exchange rate on the last day of the royalty period.

#### *O. Reporting and Auditing Requirements*

Licensees are required in their agreements to keep complete and accurate accounts of all particulars necessary to show the amounts payable to their licensors. This includes accounts and records of licensed articles made, used and sold, and net or gross sales price or other bases upon which royalty payments are calculated. The licensee's books and accounting data are to be open for inspection for a specified period of years (usually five), following the end of the fiscal year to which they pertain by the licensor's auditors.

Within ten to thirty days after the end of each quarter or other royalty payment period, the licensee must submit a report to the licensor containing details on the royalties due and simultaneously pay such royalties.

#### *P. Equity Participations*

Some licensors may prefer, or be asked to accept, stock in the licensee's company or in a newly-formed joint venture as a condition of concluding the licensing agreement and as a form of payment. A recent study indicates that it is now quite usual for a licensor to accept or seek some equity share in the licensed firm as a down payment or as partial compensation for the rights and services extended under the contract.<sup>3</sup>

Where the licensor may participate in formation of a new joint company, equity shares may be accepted as the entire payment for the contribution of patents, trademarks and/or know-how of the licensor partner. In the joint venture, in which the parties have invested and of which their licensing agreement is an integral part, one side, generally, will supply the above technical property rights and working capital, and the other side will provide the land, buildings, personnel and markets, for equity participation.

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<sup>3</sup> Feldman, *Coping with New Challenges to Investment Ventures Abroad*, COM. AMERICA, July 17, 1978, at 10.

*Q. Currency Control*

Many governments maintain controls on the payment of foreign exchange and these apply to royalty payments in the same way that they apply to goods and services. Whether payments will be authorized may depend on prior official approval of the licensing contract. Even then, unforeseen events may produce an exchange shortage so that even though the contract has been authorized, payments cannot be remitted. It is therefore advisable to provide in the contract for mandatory deposits in local currency in the name of the licensor and in the event remittances to the United States cannot be made.

*R. Choice of Law*

There are several possibilities regarding which jurisdiction's law shall control. Many, perhaps most, license contracts stipulate as controlling the law of the state of the American licensor's incorporation, that being the jurisdiction where the judicial precedents are best known to the licensor's attorneys. Another possibility is to stipulate the laws of the host country, but to combine this with a reciprocal venue provision requiring the U.S. party to sue in the host country and foreign party to sue in the United States. The matter is left open in many contracts since most foreign courts would apply U.S. law anyway if the contract is made in the United States.

*S. Know-how and Trade Secret Protection*

In a know-how license it is important to provide specifically that all the relevant data and materials remain the licensor's property and shall be kept confidential by the licensee, his employees and independent contractors, if any. In addition, the licensee should be asked to observe the U.S. export control regulations relating to exported know-how.

*T. Plant Visits*

The contract should make appropriate provisions for visits of the licensor's employees to the licensee's plant (or vice versa) on such matters as compensation, observance of plant rules and indemnification of property damage or personal injury.

*U. Commercial Arbitration*

In view of the difficulty, delay and expense of litigation across national boundaries, inclusion of a clause stipulating arbitration in case of disputes may be desirable. There are many experienced and reputable arbitration bodies around the world, including the American Arbitration Association, The International Chamber of Commerce and the London Court of Arbitration. Enforcement of agreements to arbitrate and of awards has been strengthened by the widespread adoption of the United

Nations Convention of 1958 on International Commercial Arbitration.<sup>4</sup>

### *V. Taxes*

The parties should agree on how taxes shall be borne. There may be withholding taxes in the foreign country on payments remitted to the licensor. If so, the contract may require the licensee to pay such taxes on behalf of the licensor to the extent that the latter can obtain a foreign tax credit. The licensee is usually responsible for other taxes imposed by his country and arising from the contract. Before this clause is prepared, a thorough review of the tax status should be made, including tax treaties, if any.

### *W. Termination Provisions*

A separate clause for early termination based on failure or neglect by either party to fulfill the agreement's obligations is common in licensing agreements. The party usually gives written notice of any considerable default to the other and, if after thirty days, the other party is still in default or has not fulfilled the obligations, the first party has the right to terminate the agreement. Major causes for early termination include:

- (1) disputing or impairing the value of patents and trademarks,
- (2) failure to make payments,
- (3) failure to provide reports or access to records,
- (4) failure to meet quality and production requirements,
- (5) bankruptcy, insolvency or receivership, or governmental action forcing curtailment,
- (6) fire, flood, embargoes, riots or other force majeure,
- (7) unauthorized disclosures of licensed data and
- (8) invalidation of patents.

### *X. Terminal Rights and Obligations*

Licensing agreements generally impose on licensees, at the time of termination, obligations to return all of the licensor's technical property (drawing samples, models, blueprints, manuals, etc.) and to pay all royalties accrued to the date of termination. Obligations are also imposed on the licensee to return any products, parts and materials delivered by the licensor for use in the agreement.

Some agreements have a so-called "momentum clause" which recognizes that manufacturing schedules and inventions developed under the agreement will continue after termination to generate some income due the licensor. Usually, the licensee, under this clause, is required to pay certain fees specified in the agreement for six months after its termination. The licensor is generally under no obligation to the licensee if the agreement is terminated by force majeure or other causes beyond the licensor's control.

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<sup>4</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2571, T.I.A.S. 6997, 330 U.N.T.S. 3.

### III. Antitrust Considerations

Licenses invariably include limitations on the nature and scope of the rights granted. Among the limitations which have raised antitrust questions are restrictions on price, field of use, territory, resale, tie-in requirements and patent pools.

The former chief of the U.S. Department of Justice Antitrust Division has said:

We view license arrangements among independent companies preventing one or both from selling in U.S. foreign commerce in competition with the other as being highly suspect under the antitrust laws. Our analysis of a patent licensing arrangement will usually involve consideration of its economic significance, of the actual and potential competitive strength of the contracting parties and the extent to which the restrictive provisions are necessary to assure commercial development of the patented product or process.<sup>5</sup>

A recent antitrust suit charged Westinghouse Electric Corporation and two Japanese companies with conspiring to restrain trade between the United States and Japan through restrictive patent and technology licensing agreements.<sup>6</sup> The agreements provided for:

- (1) a grant to Mitsubishi of a license to use the transferred technology for the manufacture of products within the fields of the agreement in Japan and the right to sell products so manufactured anywhere "except the United States and Canada";
- (2) a grant to Westinghouse of a license to use the transferred technology for the manufacture of products within the fields of the agreement and the right to sell products so manufactured anywhere "except Japan";
- (3) royalty payments to each other irrespective of whether the products on which royalties were payable were patented or were produced by using the licensed technology.

The suit requested termination of the agreements. In addition it asked that defendants be ordered to grant reasonable royalty licenses under their respective U.S. and Japanese patents in order to permit Westinghouse to sell the licensed products in the United States. In this case, however, the court found that the alleged unlawful conspiracy not to compete was not supported by the weight of the evidence<sup>7</sup> and the case was dismissed.<sup>8</sup> Nevertheless, this case illustrates that there are restrictions that will be challenged and remain risky to insert in a license. In addition to export restraints, clauses fixing the prices at which the product may be sold are in this category.

Tying clauses in patent licenses which require the licensee to purchase from the patentee articles not within the scope of the licensed patent have been condemned. An agreement with a foreigner prohibit-

<sup>5</sup> Davidow, *Antitrust and International Patent Licensing*, 43 ANTITRUST L. J. 530, 535 (1974).

<sup>6</sup> *United States v. Westinghouse Elec. Corp.*, No. C-70-852 (N.D. Cal., Oct. 20, 1978) (dismissed pursuant to FED. R. CIV. P. 41(b)).

<sup>7</sup> *Id.* at 4.

<sup>8</sup> *Id.* at 18.

ing him from challenging the validity of an American patent will raise very serious questions under U.S. antitrust law. In the same vein, American courts have consistently held that a patent holder violates our antitrust laws if he attempts to enforce the patent or collect a royalty on it beyond its term of years.<sup>9</sup> The restrictions in this paragraph are per se violations on the antitrust laws, which means that a court will consider them illegal without examining their actual anticompetitive effect. Other acts may also be illegal but an evaluation of anticompetitive effects is essential to a finding of illegality.

Also, it will likely be held illegal to require a licensee to agree in advance to grant back to the licensor an exclusive license on any new patents the licensee may obtain related to the licensed invention. The reasoning is that a nonexclusive grantback clause should meet all the legitimate needs of the licensor, while an exclusive grantback may perpetuate a monopoly and retard invention by the licensee. Fortunately for the uncertain practitioner, the Justice Department's *Antitrust Guide for International Operations* contains several illustrative cases which will be helpful in a licensing context.<sup>10</sup>

#### IV. Foreign Controls on Licensing

In drafting international licensing contracts we should, of course, be mindful of the possible application of foreign laws. For example, the antitrust rules of the European Communities have a clear impact on licensing in the Common Market.

Some governments are imposing limitations on the royalty payments which a foreign licensor can assess on his domestic licensee. The reasons for this policy include a desire to conserve foreign exchange and to minimize what they believe to be abuses by international business.

In many developing countries, the royalty limitation is usually imposed either on a percentage basis or as a gross payment limit. Industrialized countries tend to impose their restraints indirectly through governmental approval procedures, exchange controls on remittances or tax deductibility rules. The effect is the same in that the amount that can be charged for transferred technology is limited and controlled.

It is important to stress that success in licensing depends ultimately on sound commercial considerations. Careful legal draftsmanship is important but other vital factors should not be overlooked, such as market surveys, a fair royalty structure which reflects the realities of the market and an equitable apportionment of responsibilities among the parties.

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<sup>9</sup> *Brulotte v. Thys Co.*, 379 U.S. 29, 32 (1964).

<sup>10</sup> ANTITRUST DIVISION, U.S. DEP'T OF JUSTICE, *ANTITRUST GUIDE FOR INTERNATIONAL OPERATIONS* (1977). See cases A, D, E, F, G, H, I AND J.

## V. Joint Business Ventures<sup>11</sup>

Joint ventures have much in common with licensing arrangements and often arise from them, as when a licensor accepts equity in return for patent or know-how rights. They are also directly and indirectly encouraged by the refusal of some countries to permit wholly-owned foreign subsidiaries. For these and other reasons, the international joint venture is becoming increasingly important as a method for U.S. companies to invest and operate abroad.

The joint venture approach has several advantages: it minimizes the capital commitment, enlists knowledgeable local talent in the business, facilitates relations with local government, affords broader access to local supplies of goods and services, and offers a deterrent against expropriations. Many investors resist joint participation, however, principally because of difficulties which arise from divided management or from reluctance to share valuable industrial technology with others.

Obviously, joint ventures require careful legal planning. Here we can do no more than touch on the question of organization and some tax and antitrust aspects.

### A. Corporate Organization

Ventures involving local interests and a foreign investor are usually organized under one of the corporate devices available under the law of the country where the business will operate. Most jurisdictions have at least two types of corporation.

In civil law countries there are the so-called "formal" corporation (*e.g.*, *société anonyme* or *sociedad anonima*) and the limited liability company or "informal" corporation (*société à responsabilité limitée* or *sociedad de responsabilidad limitada*). The English counterparts are the ordinary public company and the more limited private company. Any of these forms is usually suitable for a joint venture arrangement. In many situations the "informal" corporations are more suitable for joint venture companies because the law itself provides for a limited ability to transfer shares. Shares can usually be transferred to a nonmember only after consent and after other members have declined to exercise a prior option to purchase. The "informal" company is usually subject to less regulation than the corporation and may also bear a lower tax burden.

In any case, where the law is silent or ambiguous any terms and conditions desired by the parties can be included in a contract. This guards against any change or uncertainty in the corporate law, and in some countries a contractual right is more easily enforceable than one based on corporate law.

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<sup>11</sup> See also G. BEETH, INTERNATIONAL MANAGEMENT PRACTICE, 44-56 (1973); Berens, *Foreign Ventures - A Legal Anatomy*, 26 BUS. LAW. 1527 (1971); JOINT INTERNATIONAL BUSINESS VENTURES (W. Friedman & G. Kalmanoff eds. 1961); NATIONAL INDUSTRIAL CONFERENCE BOARD, JOINT VENTURES WITH FOREIGN PARTNERS (1966).

### B. Tax Aspects

The place where the joint venture is incorporated is often crucial for tax purposes. Corporations created in the United States are taxed here on their worldwide income. Corporations created in a foreign country are generally taxed here only on income earned in the United States,<sup>12</sup> while income earned abroad becomes subject to U.S. taxation only upon repatriation.<sup>13</sup> Because the deferral of U.S. taxes turns upon an artificial factor—whether a foreign corporate charter has been interposed between foreign income and the U.S. taxpayer<sup>14</sup>—the Administration's 1978 tax program calls for ending deferral of foreign earnings and imposing U.S. tax currently, unless a tax treaty providing otherwise is in force.

The foreign corporation, in most cases, will pay some foreign income tax. This payment may be credited against U.S. income tax.<sup>15</sup> If the foreign tax rate is lower than the U.S. rate, a tax is paid to the United States on foreign source income at a rate equal to the excess of the U.S. over foreign rate.<sup>16</sup> When the foreign rate equals or exceeds the U.S. rate, the credit cancels the U.S. tax of foreign source income. The policy behind the foreign tax credit is to provide neutrality as between domestic and foreign economic activity.

Whether foreign taxes are creditable depends in part on the U.S. taxpayer's accounting method, but generally the foreign tax credit is available only after foreign taxes have been paid or accrued.<sup>17</sup> Suppose our joint venture is operating in a country which allows it a five-year tax holiday. In that case the joint venture will pay full U.S. income taxes at such time as it distributes dividends. The tax holiday will then have been nullified to a large extent.

This circumstance causes loud complaints from capital-importing countries. Tax incentives designed to attract new industries, especially those that will manufacture export products or replace imports, are quite common in the less developed areas. At one time the United States included on its tax treaties a so-called "tax-sparing" provision which in

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<sup>12</sup> See I.R.C. §§ 881(a), 882(a)(1), which distinguish between rates applicable to income earned "effectively connected with the conduct of a trade or business within the U.S." and income not so "effectively connected."

<sup>13</sup> This is because the U.S. recipient shareholder is taxed only when earnings are received, *e.g.*, in the form of a dividend; the foreign corporation's income is subject to U.S. taxation in general, only to the extent (1) the amount is "received from sources within the U.S." (I.R.C. § 881(a)) or (2) the income is "effectively connected with the conduct of a trade or business within the U.S." (I.R.C. § 882 (a)(1)). Exceptions to this latter rule arise if, *e.g.*, the foreign subsidiary of a U.S. corporation produces primarily "passive income" and becomes subject to I.R.C. §§ 952, 954.

<sup>14</sup> For what constitutes a foreign corporation, see 153-4th TAX MANAGEMENT, FOREIGN CORPORATIONS-U.S. INCOME A-10 (1977).

<sup>15</sup> I.R.C. § 906.

<sup>16</sup> See *id.* §§ 902, 904 and Treas. Reg. § 1.902 for information and examples on computation and limitations of the foreign tax credit.

<sup>17</sup> I.R.C. § 902(a); but see *id.* § 905 concerning the possibility of taking a tax credit for foreign taxes accrued; see also Treas. Reg. §§ 1.901-2, 1.905-1, 1.902-3.



effect gave recognition to LDC investment incentives by granting U.S. tax credits for the foreign tax which would have been paid. However, the U.S. Senate refused confirmation to treaties containing such provisions and their use was discontinued.

When "all substantial rights" in property, including patents and know-how, are transferred, the amounts realized may be capital gains rather than ordinary income. In general, a transfer of "all substantial rights" in property means a transfer of the exclusive right to make use or vend the property for all purposes throughout the life of the property, even if limited geographically.

Transfers of know-how rights, in order to qualify as "property", must be granted in perpetuity and the recipient country must afford legal protection for the know-how transferred. Otherwise capital gains treatment may be disallowed and the value of any stock received will be taxed at ordinary income rates. Also, under section 1249 of the Internal Revenue Code,<sup>18</sup> proceeds from the sale of technological property by a domestic company to a controlled foreign corporation do not qualify for capital gains treatment but are taxed as ordinary income.

When an investment overseas is not solely in cash, and property—including patents, designs, models, trade secrets, technological information and know-how—is contributed in exchange for stock of a foreign corporation, the tax problems are magnified.

Under section 351 of the Internal Revenue Code, property of one corporation may be transferred free of tax to another corporation in exchange for stock, provided the transferor of the property owns at least eighty percent of the voting stock of the recipient corporation after the exchange. If the transferee is a foreign corporation, however, it is necessary to obtain a favorable ruling from the IRS; otherwise, the transaction may be taxed as ordinary income. Under section 367 of the tax code, as modified by the Tax Reform Act of 1976, the taxpayer need only file a request for a ruling within 183 days after the beginning of the exchange. To be granted tax-free treatment, the taxpayer must then establish to the satisfaction of the Internal Revenue Service that the exchange did not have as one of its principal purposes the avoidance of federal income taxes.<sup>19</sup>

If, however, the transfer of property is to a foreign corporation in which the transferor holds less than eighty percent interest, the tax consequences of exchanging patents and know-how for stock will be that the income will be taxed as ordinary income. In this one respect, then, U.S. tax treatment is such as to favor a direct investment approach over joint venture and minority interest investment. At one time the United States sought to eliminate this distinction by including in its tax treaties with several less developed countries a provision allowing deferral of U.S.

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<sup>18</sup> I.R.C. § 1249.

<sup>19</sup> *Id.* at § 367(b)(1).

taxes payable for technical assistance. However, the Senate refused to approve the new provision and the United States now has no treaties in force containing this provision.

### *C. Export Controls*

The exportation of technology from the United States is subject to the export controls and licensing provisions established to implement the Export Administration Act of 1969, as amended.<sup>20</sup> Export Administration regulations are in Title 15 of the Code of Federal Regulations.<sup>21</sup>

As a general rule, exports of technical data must be made under a U.S. Department of Commerce "general" license or "validated" export license. A "general" license is defined as one which permits export without the necessity of making an application to the Department. There are now two general licenses. General license GTDA authorizes the export to all destinations of (1) data that have been made generally available to the public in any form; (2) scientific or educational data not directly and significantly related to design or production; and (3) data contained in an application for the foreign filing of a patent, provided that the patent application has been filed abroad in an "earlier publication country". A second general license designated GTDR authorizes the export of technical data not exportable under the provisions of general license GTDA, subject to specific restrictions depending on the destination. Exports that do not meet the conditions of either general license GTDA or GTDR require a validated license.

## **VI. Conclusion**

This discussion of the legal aspects of foreign licensing and joint ventures has dwelled principally on the elements of the contract or agreement, with note taken of tax, antitrust and export control factors. Several final points should be made.

First, a full treatment of the subject would include a description of the international regime governing the acquisition and use of industrial property in a foreign country. This regime is a complex of international treaties headed by the Paris Convention of 1883, which was last revised at Stockholm in 1967.<sup>22</sup> The Paris Convention, which is administered by the World Intellectual Property Organization (WIPO), is important chiefly because it sets an international standard of nondiscrimination ("national treatment") in patent and trademark matters.

Efforts to reduce the costs and administrative complexities of patent and trademark protection are beginning to bear fruit. A Patent Coop-

<sup>20</sup> Export Administration Act of 1969, 50 U.S.C.A. App. §§ 2401-2413 (1970).

<sup>21</sup> 15 C.F.R. §§ 368-399 (1978).

<sup>22</sup> Stockholm Convention Revising the Paris Convention for the Protection of Industrial Property of March 20, 1883, July 14, 1967, U.S.T. 1583, T.I.A.S. No. 6923, — U.N.T.S. —; 24 U.S.T. 2140, T.I.A.S. No. 7727, — U.N.T.S. —.

oration Treaty (PCT) came into effect on January 24, 1978 which should simplify international filing for patents.<sup>23</sup> Under the PCT, U.S. citizens may file an international patent application at the U.S. Patent and Trademark Office with the same effect as if applications have been filed separately in several foreign countries. A Trademark Registration Treaty with similar objectives has been negotiated and is awaiting ratification.<sup>24</sup>

Second, the developing nations as a group are actively seeking international agreement on terms of technology transfer which would drastically alter existing commercial practice. Their efforts have been most prominent in the United Nations Conference on Trade and Development (UNCTAD) where the objective of the LDCs is a compulsory code of conduct for the international transfer of technology. Current negotiations toward a Law of the Sea Convention also include a demand by the LDCs for inclusion of the concept of mandatory technology transfer in connection with deepsea mining.

Finally, it is important to understand that the success of a license or joint venture depends less on the drafting of an agreement than on the clear understanding of its terms and effective performance by the parties. Even companies whose contracts are always comprehensive in scope stress the importance of choosing the right partner and of mutual understanding when differences occur.

### Question and Answer

*Question:* Suppose a U.S. licensor has license back rights from overseas licensees in countries having laws protecting the ownership of inventions made by employees of the licensee. Should the U.S. licensor require the employee to approve of or be a party to any agreement to license back an invention of that employee?

*Mr. Travaglini:* Without referring to specific laws, I think it is fairly clear that if you are licensing into a country where employees have statutory rights in the inventions they have developed, you should require that his rights be observed. This will be essential to preserving your license back provisions of the original license agreement. The answer to this question may be slightly different with regard to Eastern European countries which ordinarily do not give patents. Those governments give certificates of invention which entitle the originator, who, of course, is a state employee in all cases, to certain emoluments in kind, such as a new

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<sup>23</sup> Patent Cooperation Treaty of Washington, June 19, 1978, — U.S.T. —, T.I.A.S. No. 8733, — U.N.T.S. —.

<sup>24</sup> Trademark Registration Treaty of Vienna, June 12, 1973, — U.S.T. —, T.I.A.S. No. —, — U.N.T.S. —, *reprinted in* 5 E.D. OFFNER, OFFNER'S INTERNATIONAL TRADEMARK SERVICE NO. 14 (1975).

dacha, two months at the Black Sea, a larger flat or an automobile. The government takes over all rights to the invention.

*Question:* Does a detailed discussion with a foreign national of a technology otherwise under export control violate any U.S. regulations?

*Mr. Travaglini:* That is probably a technical violation, but I have never heard of any claim filed on the basis of an oral declaration. The violation would be difficult to document and prove if all that is done is an exchange of information. The Export Control Law consistently uses terms such as data and publication.

*Question:* Is there any trend with regard to U.S. university generated technology being licensed outside the United States? Can the Department of Commerce help in this regard?

*Mr. Travaglini:* There has been much licensing of university generated inventions and technology both in this country and abroad. The University of Illinois has been particularly successful in this endeavor. They have set up separate institutions in which to vest ownership of inventions discovered by university people. Licensing these inventions has generated substantial income for the university. The Department of Commerce can help because it often secures licensing opportunities through the Foreign Service. Foreign nationals will inform U.S. embassies abroad that they are interested in licensing a particular process and the Commerce Department will publish the opportunity in its magazine. American firms can then read and respond to them.

*Question:* When granting patent, trademark and know-how rights, is it best to combine all grants in one agreement or to draft separate contracts for each right?

*Mr. Travaglini:* Different lawyers would give a different response to this question, because there is no standard rule on this. If the patent, trademark and know-how all refer to the same general field, they are unified and probably should be included in one agreement. On the other hand, if they are disassociated, there may be some virtue in separating them, especially if you are dealing with a country whose governmental authorities become involved in licensing agreements. There may also be tax considerations in deciding how many agreements to draft. You will almost always want to put technical services in a separate agreement, because services tend to be taxed as ordinary income whereas other property rights in the agreement may be taxed differently.

*Question:* Are mandatory purchases of component parts by the licensee from the licensor subject to U.S. antitrust prohibitions against tying clauses?

*Mr. Travaglini:* Tying clauses in license contracts are invalid if the purchases of components are outside the scope of the rights being licensed. On the other hand, if they are necessary to manufacture the product which is the subject of the patent, then there would be no objection.

