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LES Annual Licensing Update Seminar

Important contract interpretation issues:-
English and US perspectives

11 February 2016

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Agenda

1. English and US approaches to contractual interpretation
2. Obligations to act in "good faith"
3. Liquidated damages clauses v penalties
4. Requirements for a valid assignment of IPRs
5. Endeavours obligations – what do they really mean?

Overview – English and US approach to contracts

Similarities and differences in US/UK approach

- Courts in the US and England adopt a similar approach:
 - both seek to give effect to a commercially reasonable interpretation of a contract provision that is in accordance with the objective intention of the parties and consistent with the terms and purpose of the contract as a whole.
- But there are important differences:
 - English courts may take into account the “matrix of facts” extrinsic to the written contract to determine the parties’ reasonable intention
 - Under US law, the court may only look to the “four corners” of the written contract – this is the “parol evidence rule”. State law governs how strict this is.
- This difference of approach informs the level of detail that should be included in a contract.

“Good faith”

English law: duty to act in good faith

- Common to see provisions in licence agreements requiring the parties to act in good faith in the performance of specific obligations or the exercise of specific rights.
- Typically these are obligations to co-operate, to negotiate or to grant approvals or consents. Less likely to see a general obligation that the parties will act in good faith in the performance of the contract as a whole.

“The Licensee shall submit samples for approval and the Licensor shall, acting in good faith, approve or reject the same.”

“The Licensor shall, in good faith, determine the fair market value of the Licensed Products in the relevant territory.”

- Number of cases over the past two years examining obligations to act in good faith.
- ***Yam Seng v. ITC, Medirest v. Mid Essex Hospital Services, IBM v. Fujitsu*** and, most recently, ***Portsmouth City Council v. Ensign Highways***.

English law: duty to act in good faith

- Two questions to consider:
 - can a general duty to act in good faith be implied in English law commercial contracts?
 - in the context of specific contractual obligations, what does “good faith” mean anyway?
- Position in English contract law is that there is no legal overriding principle of good faith and a duty to act in good faith is not generally recognised (except for certain types of contracts e.g. insurance, employment, partnership).
- Not the case in civil law systems (e.g. Germany, France, Italy) or certain common law countries (e.g. USA, Canada and Australia).
- Why is this?
 - English law emphasis on particular solutions for particular problems
 - ethos of individualism (free to pursue self interest)
 - general duty would create too much uncertainty
- In the last three years, the Courts have not followed Leggatt LJ’s comments in Yam Seng about “relational contracts”.

English law: duty to act in good faith

- ***Portsmouth City Council v Ensign Highways*** – specific clause required that the parties “*deal fairly, in good faith and in mutual co-operation with one another...*”
- Court held that this obligation did not create a general duty and did not apply to the contract as a whole for the following reasons:-
 - there was nothing in the language of the clause suggesting it did;
 - the agreement contained other clauses setting out specific narrow obligations of good faith suggesting the parties had carefully considered the situations where this duty should apply;
 - the implication of a term requiring good faith was not necessary to make the contract work; and
 - the termination rights could not be subject to a duty of good faith, they were clear termination rights triggered by specific events.
- Court, referring to *Medirest*, was mindful not to create a general obligation which could cut across specific provisions of the contract.

English law: duty to act in good faith

- Court also asked to consider whether PCC was subject to a specific implied duty to act in good faith when implementing the services points mechanism under the contract.
- Court followed the Court of Appeal in *Medirest*.
- Where one party has a discretion, a duty may be implied on that party to act honestly, on proper grounds and not in a manner that is arbitrary, irrational or capricious.
- Discretion existed in the level of service points to be awarded – not whether or not to claim the service points as this was a contractual entitlement.

English law: current position on “good faith”

- No overriding duty to act in good faith applies and will not be implied in the absence of an express term. Courts reluctant to expand a specific express term.
- Express obligation to act in good faith – what does this mean?
 - adhere to the spirit of the contract
 - observe reasonable commercial standards of honesty, transparency and fair dealing
 - be faithful to the agreed common purpose, consistent with other party’s expectations.
- In absence of an express obligation, parties free to pursue own self interest but beware “sharp” interpretations and consider other party’s interests. Specific obligations can be implied on the facts although less likely in fully formed contracts.
- Exercising a discretion: must not act in an arbitrary, capricious or irrational manner, even where there is no express obligation to exercise the discretion in good faith.
- Obligations to negotiate in good faith: position remains that an obligation to negotiate is generally too uncertain to be enforceable.

US law: obligations to act in "good faith"

Good faith and fair dealing

- Implied covenant of good faith and fair dealing in course of performance of executed contracts – UCC and common law
- Implied covenant that each party will not intentionally do anything to frustrate or undermine the purpose of the contract
- Implied covenant is violated when a party acts in a manner which, although not expressly forbidden by the express provisions of contract, would deprive other party of the right to receive benefits of the contract
- Many states prevent parties from contracting around the covenant (e.g. DE, NY and MN)

When does it arise?

- The implied covenant of good faith does not arise until an agreement is in existence
- During negotiation, US lawyers are bound by strict rules of professional conduct

Liquidated Damages & Penalty Clauses

"an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended"

English law: liquidated damages and penalties

- The general rule is that, if a clause is a liquidated damages clause, it is enforceable and the sum set out in the clause is recoverable. However, if it is a “penalty”, it will not be enforced beyond the actual loss of the claimant.
- Penalty was traditionally defined as *“a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.”*

Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915]

English law: liquidated damages and penalties

- The rule governing penalty clauses has now been reset and clarified following the Supreme Court case of ***Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis [2015] UKSC 67***.
- The penalty rule has now been “*set back on its proper course, as originally recognised in the equitable origins of the doctrine*”. Lords Neuberger and Sumption held in the above case that:

“The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.”

English law: liquidated damages and penalties

Key points from **Cavendish**:

- The real question is whether a clause is penal, not whether it represents a pre-estimate of loss. The fact that a clause is not a pre-estimate of loss does not on its own mean it is penal – the innocent party's legitimate interests may extend beyond recovery of compensation.
- Also, the fact that a clause acts as a deterrent does not mean it is inherently penal or contrary to public policy.
- The rule should only apply to secondary obligations – i.e. obligations which are triggered by a breach of contract – and not to primary obligations.
- The rule applies not only to clauses requiring payment but also to clauses providing for the withholding of payments or transfer of property.
- The enforceability of a clause will partly depend on whether it is unconscionable or (which will usually amount to the same thing) extravagant.

English law: liquidated damages and penalties

- Parties are broadly free to make their own bargains – in a negotiated contract where the parties are properly advised, the Supreme Court referred to a strong initial presumption that the parties themselves are the best judges of what are legitimate consequences of breach.
- In a licence agreement, could the following amount to penalties?
 - A licence becoming paid-up and irrevocable as a consequence of the licensor's breach, i.e. the licensee ends up with a free licence.
 - A breaching licensee being required to assign improvements and clinical data to a licensor for free (competition law issues aside).
- Will, of course, depend on the circumstances, including the “legitimate interests” of the innocent party.
- Almost certainly won't be a penalty where the contract has been negotiated and the parties have been legally advised.

US law: liquidated damages and penalties

- Treatment of liquidated damages varies among different jurisdictions within the US but the general position is the same as that of the UK. Enforceability is dependent on two elements:
 - uncertainty
 - reasonableness of the amount
- Failure to satisfy either will mean the clause is an unenforceable penalty
- This approach is illustrated as follows: “*[d]amages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty*”

Uniform Commercial Code, § 2-718

US law: practical pointers

- **Clearly state the breach:** e.g. the Seller fails to deliver the Products by [date]/[materially] breaches its obligations under clause [x] (the “Breach”)
- **State agreed damages:** the Seller shall pay to the Customer an amount equal to [x]% of the purchase price of the products/[\$] for each day the Breach continues (the “Liquidated Damages”)
- **Include “no penalty”:** The parties intend that the Liquidated Damages constitute compensation, and not a penalty. The parties acknowledge and agree that the harm caused to [Party A] by a Seller Breach would be impossible or very difficult to accurately estimate as of the Effective Date, and that the Liquidated Damages are a reasonable estimate of the anticipated or actual harm that might arise from a Seller Breach.
- **Clarify whether remedy is exclusive:** Are the liquidated damages meant to be the non-breaching party’s exclusive remedy for breach?
- **Severability clause:** If the liquidated damages clause is found to be unenforceable, should the rest of the contract survive?

Requirements for a valid assignment of IPRs

English law requirements for assignments of IPRs

- Wright Hassall LLP v Horton [2015] EWHC 3716 (QB) - professional negligence case
- One of the points which arose before the court was whether a purported assignment of patent rights should be held to be void for lack of consideration.
- The judge noted, *“there is no clear authority as to whether an assignment of a patent requires consideration or not. Neither counsel was able to refer to any statement on the point in any of the standard works on patents.”*
- *“...there seems to be no reason in principle why a legal assignment cannot be made without consideration, for instance by way of gift. Other types of property, both real and personal, may be transferred at law without consideration. No reason was suggested why patents should be different.”*

English law requirements for assignments of IPRs

Requirements for a valid assignment :-

- Assignment must be executed in writing by the assignor (e.g. see Patents Act 1977 s.30(6)).
- No requirement for the assignee to execute the assignment, except for CTMs and patent assignments pre 2005.
- No requirement for consideration, but assignments often include contractual obligations so will typically include consideration or be executed as a deed.
- No statutory requirements as to language needed to assign IPRs – “hereby assigns” will do.
- A failure to transfer legal title can nonetheless take effect as an equitable assignment.
- Cannot assign a patent in part, but can do so for copyright and trade marks.

Consideration requirements – US perspective

- Consideration needed to support a patent assignment, as with any other contract
- What constitutes sufficient consideration for the assignment of IPRs is a matter of state law, but the general rule is that nominal consideration will suffice to support the assignment of a patent
- So long as there is nominal consideration, the courts will not question its adequacy unless the amount is “*so grossly inadequate as to shock the conscience.*”
- In ***Memorylink Corp. v. Motorola Solutions, Inc. (ND Illinois 2014)***, consideration of one dollar was considered sufficient to render the assignment of a patent valid.

Endeavours Obligations

English law: endeavours obligations

- A spectrum of commonly used “endeavours” clauses under English contract law. Imposing varying degrees of obligation
 - “best endeavours/efforts”
 - “all reasonable endeavours/efforts”
 - “reasonable endeavours/efforts”
 - “all commercially reasonable endeavours”
- What is the distinction? What level of obligation do they each impose?

English law: endeavours obligations

- A matter of construction – assessed at the time the contract is formed, with reference to the contract as a whole and to the commercial context.
 - **Jet2.Com Ltd v Blackpool Airport Ltd [2011] EWHC 1529**
- This applies to both the level of effort required and the obligations which are qualified.
- For example, in ***Arsenal Football Club Plc v Reed [2014] EWHC 781***, Arsenal agreed to “*use its reasonable endeavours to supply goods to [Reed] ... at prices which are comparable to the lowest wholesale prices charged by [Arsenal] to other market traders*”. The court suggested the use of “reasonable endeavours” only related to matters such as delivery times, location, minimum quantities and would not excuse Arsenal from its underlying obligation to actually supply the goods.

English law: “best endeavours”

- *"means what the words say; they do not mean second-best endeavours" - **Sheffield District Railway Co v Great Central Railway Co [1911] 27 TLR 451***
- Requires the obligor, *"to take all those steps in their power which are capable of producing the desired results ... being steps which a prudent, determined and reasonable [obligee], acting in his own interests and desiring to achieve that result, would take"* - **IBM United Kingdom Limited v Rockware Glass Limited [1980] FSR 335**
- *"the next best thing to an absolute obligation or a guarantee" - **Midland Land Reclamation Limited v Warren Energy [1997] EWHC 375 (TCC)***
- In **Jet2.com**, the Court of Appeal found that Blackpool Airport's refusal to open outside of its normal operating hours was a breach of its obligation to use **best endeavours** to promote Jet2.com's low cost services.

English law: “reasonable endeavours”

- Not a certain, easily defined concept. Heavily fact dependent.
- The obligor must balance the *"the weight of their contractual obligation"* to the other party against *"all relevant commercial considerations"*. This may include matters such as the obligor's relationships with third parties, its reputation, the cost of that course of action, and the likelihood to the desired result.
- Does not require sacrifice of the obligor's own commercial interests.
- Case law suggests it may only require an obligor to take one reasonable course of action rather than many, although this is untested.

English law: “all reasonable endeavours”

- A compromise? - *"probably a middle position somewhere between the two, implying something more than reasonable endeavours but less than best endeavours"* – obiter ***UBH (Mechanical Services) Ltd v Standard Life Assurance Company, The Times, 13 November 1986***, although obiter statements suggest it may equate to best endeavours.
- Whether closer to “best” or “reasonable” will be fact specific.
- *“an obligation to use an all reasonable endeavours obligation does not always require the obligor to sacrifice its commercial interests”* - ***CPC Group Ltd v Qatari Diar Real Estate Investment Company [2010] EWHC 1535***.

English law endeavours obligations: a summary

Obligation	Requires Expenditure?	Overview
Best endeavours	May require significant expenditure by the obligor but not ruinously so. Obligor may have to sacrifice its commercial interests.	<p>Not an absolute obligation.</p> <p>Includes steps which a prudent, determined and reasonable obligee, acting in his own interests and desiring to achieve that result, would take. May be subject to countervailing duties on the obligor.</p>
All reasonable endeavours	May require expenditure. May or may not require the obligor to sacrifice its commercial interests.	Likely to exhibit characteristics of both best and reasonable endeavours.
Reasonable endeavours	May require limited expenditure, but does not require the obligor to sacrifice its commercial interests.	<p>Involves balancing the contractual obligation against all relevant commercial considerations.</p> <p>The chance of achieving the result is of prime importance.</p>

English law endeavours obligations: Practice pointers

- Consider framing the obligation by tying it to a standard, e.g. "*procured with all reasonable endeavours as would be expected of a normal prudent commercial developer experienced in developments of that nature*" indicates the obligor's particular circumstances may not be relevant when making this assessment - ***EDI Central Ltd v National Car Parks Ltd [2010] CSOH 141.***
- Little to no judicial interpretation of “commercially reasonable endeavours”, “reasonable commercial endeavours” or “utmost endeavours”.
- Ensure the objective is sufficiently clear.
- Consider explicitly referring in the contract to the required steps, or examples in order to clarify the obligations.
- Consider requirements for regular reports on progress or evidence of FTEs or spend to achieve the required objective.
- If the obligor, consider recording your endeavours to demonstrate compliance.

US law: efforts obligations

- State-by-state determination
- Generally little distinction between “best efforts”, “reasonable efforts” and “commercially reasonable efforts”
- Issue is one of fact – courts consider a party’s experience, expertise, financial status and other abilities
- General standard: work in good faith towards the object of the contract to the extent of the party’s individual capabilities

US law: efforts obligations

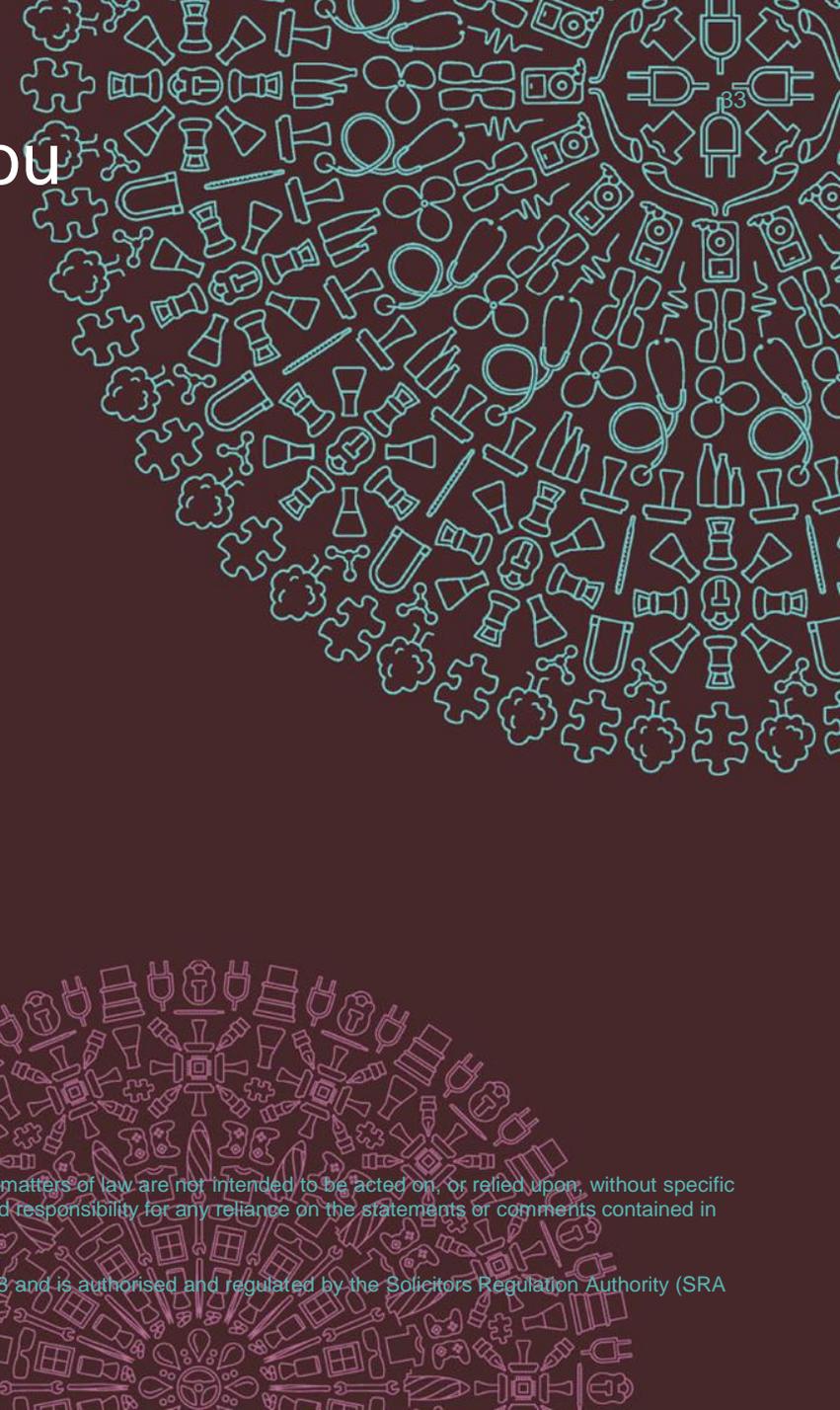
Efforts obligations do not require a party to:

- Take every conceivable effort
- Take unreasonable actions
- Sacrifice its own economic or business interests
- Incur substantial losses to perform its obligations

US law: practice pointers

- Define the meaning of whatever standard you include
- Use the term consistently throughout the contract
- Include known carve-outs
- Use objective criteria to describe the effort required

Thank you



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