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Embracing the Arm's-Length Licensor: Closer Than You Think

Technology disclosure and licensing arrangements are common arm's-length business deals, usually thought to involve no fiduciary relationship, i.e., one having special trust and confidence and heightened duties of fairness toward the other.

Frequently, inventors disclose their idea to others, who then invest money to commercially exploit it, with one side or both having or obtaining legal protection, e.g., patents, trade secrets, trademarks or copyrights. The inventors/licensors are usually compensated by a royalty scheme — some percentage of the developers/licensees' revenues or profits.

While oral contracts occasionally exist, usually the parties memorialize their arrangement in a written contract, carefully spelling out the obligations of each side, and governing any later disagreements. Normally, even if there are unforeseen circumstances or contractual ambiguities, the parties will be limited to their rights and remedies under the contract.

But not so fast! A recent California case suggests that in some circumstances the exploiting party, the developer, may be treated as a fiduciary, owing a heightened duty to the inventor, and subjecting itself to heightened damages, including punitive damages.

'City of Hope v. Genentech'

In *City of Hope National Medical Center v. Genentech Inc.*, 2004 WL 2361763 (Cal.App. Oct. 21, 2004), a California appellate court held that Genentech, a prominent biotechnology company, owed a fiduciary duty to an inventor — a research medical center named City of Hope. Interestingly, the medical center is a prominent research facility that, at least today, appears to be quite sophisticated about intellectual property and its protection and licensing. Its Web site, www.cityofhope.org, boasts of a 550-person research facility, some 26 issued or pending patents in the last three years and a licensing staff that is responsible for licensing patented technology in 14 different areas of bio- and biomedical technology. It should be noted, however, that the licensing agreement at issue was consummated in 1976, when intellectual property management was a relatively new issue for most institutions in that field.

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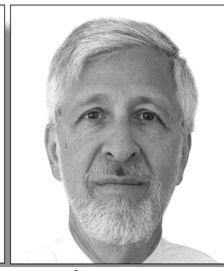
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In the mid-1970s, the medical center had developed technology related to genetic engineering of human proteins. The technology was licensed to Genentech, which obtained the patent for it, developed it further and then exploited it through a series of both licensing agreements and litigation against asserted infringers. City of Hope was granted a 2 percent royalty on sales and licenses. Later, disputes arose over "ambiguous provisions" as to what royalty licenses this applied, as well as whether it applied to proceeds from infringement litigation. A jury found for the medial center and awarded more than $300 million in royalties due under the medical center's interpretation of the contract.

But, the jury also awarded, and the appellate court upheld, an additional $200 million award in punitive damages. This extra-contractual award was permitted because the court found that Genentech owed the medical center not only contractual, but also fiduciary duties. Relying on a 1956 California Appellate precedent, *Stevens v. Marco*, 147 CalApp2d 357, 373, 305 P.2d 669 (1956), the court quoted the following as rule of law:

> Where an inventor entrusts his secret idea or device to another under an arrangement whereby the other party agrees to develop, patent and commercially exploit the idea in return for royalties, there arises a confidential or fiduciary relationship between the parties.

The *City of Hope* court then wrote an extended discussion explaining why the 1956 case is still good law and good public policy, and distinguishing other California precedents. From this discussion, the critical fact creating the fiduciary duty appears to be that the inventor entrusted its secrets to the developer; that confidences created a confidential or fiduciary relationship: "There is a history in this state and others of viewing the relationship between inventors and those they entrust their secrets to as confidential or fiduciary in nature."

City of Hope should be contrasted with *Wolf v. Superior Court*, 107 Cal.App.4th 25, 130 Cal.Rptr. 860 (2003), a recent California appellate decision that it cited and distinguished. In *Wolf*, an author assigned the rights to his novel and its characters to Walt Disney Pictures and Television in exchange for a percentage of net profits from a motion picture based on the novel, and additional, contingent compensation. The *Wolf* court held that "a contingent entitlement to future compensation within the exclusive control of one party does *not* make that party a fiduciary in the absence of other indicia of a confidential relationship[.]" (emphasis added). The *Wolf* court distinguished the 1956 *Stevens* case on the grounds that the author had not alleged a relationship akin to a joint venture.

The *City of Hope* court rejected Genentech's efforts to bring the facts of its case within the *Wolf* holding:

> According to Genentech, *Wolf* applies rather than *Stevens* because the facts of this case and *Wolf* are indistinguishable. This claim is tenuous and we dispense with it summarily. *Wolf* involved an assignment of literary rights, not the entrustment of a secret idea for patenting, manufacturing and exploiting. This distinction is dispositive. Genentech likens this case to *Wolf* on the premise that they are both devoid of a relationship that is akin to a joint venture. … But Genentech ignores that the entrustment of a secret device was a separate basis for the *Stevens* court to find a fiduciary duty. It is that holding in *Stevens* which governs.

The *City of Hope* court then rejected Genentech's arguments that (1) the fiduciary duty only extended to maintaining the secrecy of the device and not the management of its commercial exploitation and (2) the fact that Genentech had an option, but not an obligation, to exploit the technology relieved it of a fiduciary duty.

One of many possible criticisms of the *City of Hope* case is that it conflates disclosure of "confidential" information with a relationship of "confidence," the latter being the same as a fiduciary relationship. Genentech itself touched on this point when it argued that the only fiduciary duty imposed by *Stevens* is the duty to protect the confidentiality of a secret idea; that argument was rejected as ipse dixit by the court. However, there are many situations where one party agrees to maintain information provided by a party as "confidential"; that does not necessarily mean that the entire relationship is a fiduciary one. For example, query whether, under the *City of Hope* analysis, every trade secret license (which by its very nature will contain confidentiality provisions) automatically creates a fiduciary relationship between the licensor and licensee.

Decisions in other jurisdictions have been mixed. In one Texas case, an appellate court sustained a finding of breach of fiduciary duties and a verdict of punitive damages, where the inventor disclosed secrets in confidence, which were later patented and exploited by the defendant, who then failed to pay certain royalties due under the contract.[1] In contrast, a federal district court in Texas rejected a similar claim where the inventor failed to obtain an agreement of confidentiality from the manufacturer and failed to establish that the parties had entered into a "joint venture" under Texas law.[2]

In one New York case, the Supreme Court held that the defendants owed the inventor fiduciary duties. The plaintiff went to work for the defendants to develop new products in the telephone interconnect devices field. However, the plaintiff was not a mere employee; there was an understanding that some form of partnership, corporation or joint venture would be created, but the details were never clearly spelled out. This arrangement, though vague and undefined, created a "kind of fiduciary relationship" among the parties. On this basis, the court enjoined use of the trade secrets and ordered an accounting of profits.[3]

Imposing a Fiduciary Duty

As illustrated by the cases above, one result of the imposition of fiduciary duties is that it exposes the parties to extra-contractual damages, including punitive damages. But that is not all: a fiduciary duty has always meant far more than an arm's-length relationship implied by a contract. The fundamental rule of a fiduciary obligation is loyalty.[4] While a fiduciary need not necessarily put the beneficiary's interests ahead of its own, it must at least treat them as equal, and cannot sacrifice those interests to advance its own.[5] In then-Chief Judge Benjamin N. Cardozo's famous formulation:

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> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[6]

Consider the following scenario: inventor (I) discloses a revolutionary design for widgets to manufacturer (M) under a confidentiality agreement. Suitably impressed, M enters into a licensing agreement whereby M will develop the idea, protect the intellectual property by patenting it and exploit it commercially (either through sales or licensing), paying I a 5 percent royalty on gross receipts. At this point, M and I's interests are aligned; the more widgets sold, the more profits for both.

Suppose, however, at the same time, M manufactures a number of other items besides widgets. In fact, besides I's patent, M has an impressive portfolio of patents and exploits them in several fields. Customer (C) is interested in a variety of M's products and intellectual property. Indeed, C is, potentially, a very large customer for all of M's products. As a trial run, C is considering ordering 1,000 widgets from M; if the price and quality are right, a much larger order for many other products may well follow.

In this situation, can M lower the price on this order of widgets in the hope of obtaining more lucrative contracts in the future? If, as some cases hold, a fiduciary duty is owed, then M may be precluded from doing so.

Avoiding Fiduciary Duties

Drafters of agreements between inventors and exploiters of inventions need to be alert to the fact that a fiduciary relationship may be implied, particularly where there is disclosure of a "secret" idea. One possible solution is to simply disclaim the creation of any such relationship. However, courts have held that such disclaimer must be clear and unambiguous, and, because such a disclaimer essentially relieves the party from tort-law duties, courts often find an ambiguity. See, for example, *Anderson v. Century Prods. Co.*, 943 FSupp 137, 150-52 (D.N.H. 1996). That court held that a clause in an invention disclosure agreement which stated that "no confidential relationship is being established [between the parties]" was ambiguous (and hence did not relieve the party of fiduciary duties) in that it might relate only to the relationship between the parties during the invention review process, not thereafter if the manufacturer decided to exploit the idea.

Alternatively, one might consider imposing a limitation of remedies clause — for example, disallowing punitive damages, providing for an audit procedure, etc. In any event, negotiators of disclosure/licensing agreements need to be aware that, apart from contractual duties, they may be accepting heightened, fiduciary duties in such situations.

Addendum

The California Supreme Court granted review in the *City of Hope* case on Feb. 2, 2005, No. S 129463.

1. *Crutcher-Rolf-Cummings, Inc. v. Ballard*, 540 S.W.2d 380 (Tex.Civ.App. 1976).
2. *Holloman v. O. Mustad and Sons*, 196 F.Supp.2d 450 (E.D.Tex. 2002).
3. *Ewen v. Gerofsky*, 86 Misc.2d 913, 917-18, 382 N.Y.S.2d 651, 654 (Sup.Ct. 1976).
4. Scallen, Eillenn, "Promises Broken vs. Promises Betrayed: Metaphor, Analogy and the New Fiduciary Principle," 1993 U.Ill.L.Rev. 897, 909 (1993).
5. Id. at 908-09.
6. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545 (1928).