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Confidentiality and Pre-license Negotiations

SUMMARY CONTENTS

Before a commercial agreement of any significance is entered, the parties generally engage in discussions and negotiations. Depending on the size and complexity of the transaction, negotiations can sometimes take weeks, months or even years to complete. Often, the parties will exchange one or more pre-transaction documents that set the stage for the negotiations and a framework for the final, or "definitive" agreement(s). This chapter considers several of the most common forms of such preliminary documents: (1) invitations to license, (2) confidentiality and nondisclosure agreements and (3) term sheets, letters of intent and memoranda of understanding.

5.1 INITIAL OVERTURES AND DECLARATORY JUDGMENTS

Often, licensing and other transactions are effected between parties that know one another through their respective employees or consultants or their reputations in the market. In these cases, the discussions leading to a transaction can be initiated through a simple phone call, email message or meeting. But in other cases, the parties may not have a pre-existing relationship and will need to query potential business partners "cold." For example, a neophyte author will generally send out dozens or hundreds of query letters to publishers and literary agents before finding one who is interested in her great American novel. This process for authors, journalists, toy designers, visual artists, film makers, freelance photographers and other holders of copyrights can be time consuming and frustrating, but generally not fraught with legal issues.

The situation is somewhat different, however, when patents are involved. As discussed in Chapter 1, an individual who invents a new type of widget may not have the resources, expertise or business network to embark on full-scale production and marketing of the device. Likewise, the widget may simply be one component of a more complex product such as a smartphone, automobile or geosynchronous satellite that is manufactured by other, much larger, companies. In all of these cases, the inventor may need to approach different market players about potential licensing arrangements.

But how will a large company react to a licensing overture by an inventor who holds a patent that is potentially relevant to some aspect of its business? In the best case, the company will

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invite the inventor to discuss the proposal, which may eventually lead to an agreement. Less good, but far more common, the large company may ignore the inventor's unsolicited proposal. But most risky for the inventor, the company, once it is alerted to the existence of his patent, might view it as a potential threat. If that is the case, the company could seek to challenge the patent preemptively by bringing a *declaratory judgment action* against the inventor seeking to invalidate the patent.[1]

DECLARATORY JUDGMENT ACT (28 U.S.C. § 2201)

In a case of actual controversy … any court of the United States … may declare the rights and other legal relations of any interested party seeking such a declaration.

Thus, when there is an "actual controversy," a party may avail itself of the Act by seeking a declaration of its rights in federal court. For example, if the holder of an intellectual property right threatens to sue a party for infringement of that right, the threatened party may seek a declaration either that it does not infringe or that the asserted right is invalid or unenforceable.

In *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007), the Supreme Court established the current standard for assessing the existence of an "actual controversy" in IP cases:

> Whether the facts alleged, under all circumstances, show that there is a substantial controversy between parties having adverse legal interests of sufficient immediacy and reality to warrant the issuance of a declaratory judgment.[2]

The Federal Circuit's most extensive analysis of declaratory judgment jurisdiction in patent licensing cases can be found in *SanDisk Corp. v. STMicroelectronics, Inc.*, decided two months after the Supreme Court's decision in *MedImmune*.

Sandisk Corp. v. STMicroelectronics, Inc.

480 F.3d 1372 (Fed. Cir. 2007)

LINN, CIRCUIT JUDGE

SanDisk Corporation ("SanDisk") appeals from a decision of the U.S. District Court for the Northern District of California granting STMicroelectronics' ("ST's") motion to dismiss SanDisk's … claims relating to declaratory judgment of noninfringement and invalidity for failure to present an actual controversy. Because the district court erred in dismissing the declaratory judgment claims for lack of subject matter jurisdiction, we vacate the judgment and remand the case to the district court.

I. Background

SanDisk is in the flash memory storage market and owns several patents related to flash memory storage products. ST, traditionally in the market of semiconductor integrated

[1] Patents may be invalidated on a variety of grounds, including anticipation, obviousness, non-enablement, unclean hands and others. A patent that has been invalidated can no longer be enforced by its owner.

[2] Discussed in greater detail in Section 22.3.

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circuits, more recently entered the flash memory market and has a sizeable portfolio of patents related to flash memory storage products. On April 16, 2004, ST's vice president of intellectual property and licensing, Lisa Jorgenson ("Jorgenson"), sent a letter to SanDisk's chief executive officer requesting a meeting to discuss a cross-license agreement. The letter listed eight patents owned by ST that Jorgenson believed "may be of interest" to SanDisk. On April 28, 2004, SanDisk responded that it would need time to review the listed patents and would be in touch in several weeks to discuss the possibility of meeting in June.

On July 12, 2004, having heard nothing further from SanDisk, Jorgenson sent a letter to SanDisk reiterating her request to meet in July to discuss a cross-license agreement and listing four additional ST patents that "may also be of interest" to SanDisk. On July 21, 2004, SanDisk's chief intellectual property counsel and senior director, E. Earle Thompson ("Thompson"), responded to ST's letter by informing Jorgenson of his "understanding that both sides wish to continue … friendly discussions" such as those between the business representatives in May and June. The discussions of May and June that Thompson referred to were discussions among managers and vice presidents of SanDisk and ST at business meetings held on May 18, 2004, and June 9, 2004, to explore the possibility of ST's selling flash memory products to SanDisk. The business meetings were unrelated to any patents.

On August 5, 2004, when the business representatives next met, SanDisk presented an analysis of three of its patents and orally offered ST a license. ST declined to present an analysis of any of its patents, stating instead that any patent and licensing issues should be discussed in a separate meeting with Jorgenson. Later that same day, Thompson wrote a letter to Jorgenson objecting to separating business and intellectual property issues and stating that "[i]t has been SanDisk's hope and desire to enter into a mutually beneficial discussion without the rattling of sabers." On August 11, 2004, Jorgenson replied, stating that it was her understanding that the parties were going to have a licensing/intellectual property meeting later that month "to discuss the possibility for a patent cross-license." She said that SanDisk should come to that meeting prepared to present an analysis of the three SanDisk patents it identified during the August 5th business meeting, as well as "any infringement analyses of an ST device or need for ST to have a license to these patents." She also said that ST would be prepared at that meeting to discuss the twelve patents identified in her prior letters. In closing, Jorgenson said that ST was "look[ing] forward to open and frank discussions with SanDisk concerning fair and reasonable terms for a broad cross-license agreement."

On August 27, 2004, the licensing meeting was held. Jorgenson, two ST licensing attorneys, and three technical experts retained by ST to perform the infringement analyses of SanDisk's products, attended on behalf of ST. Thompson and an engineer attended on behalf of SanDisk. At the meeting, Jorgenson requested that the parties' discussions be treated as "settlement discussions" under Federal Rule of Evidence 408. ST then presented a slide show which compared statistics regarding SanDisk's and ST's patent portfolios, revenue, and research and development expenses, and listed SanDisk's various "unlicensed activities." This slide show was followed by a four- to five-hour presentation by ST's technical experts, during which they identified and discussed the specific claims of each patent and alleged that they were infringed by SanDisk. According to Thompson, the presentation by ST's technical experts included "mapp[ing] the elements of each of the allegedly infringed claims to the aspects of the accused SanDisk products alleged to practice the elements." Thompson declares that "the experts liberally referred to SanDisk's (alleged) infringement of [ST's] products." SanDisk's engineer then made a presentation, describing several of SanDisk's patents and analyzing how a semiconductor chip product sold by ST infringes.

At the end of the meeting, Jorgenson handed Thompson a packet of materials containing, for each of ST's fourteen patents under discussion, a copy of the patent, reverse engineering reports for certain of SanDisk's products, and diagrams showing how elements of ST's patent claims cover SanDisk's products. According to SanDisk, Jorgenson indicated (in words to this effect):

> I know that this is material that would allow SanDisk to DJ [ST] on. We have had some internal discussions on whether I should be giving you a copy of these materials in light of that fact. But I have decided that I will go ahead and give you these materials.

Jorgenson further told Thompson that "ST has absolutely no plan whatsoever to sue SanDisk." Thompson responded to Jorgenson that "SanDisk is not going to sue you on Monday" and that another meeting might be appropriate.

On September 1, 2004, Jorgenson wrote to Thompson, enclosing copies of ST's general slide presentation from the August meeting and also enclosing a hard copy booklet containing each of the engineering reports "for each claim on all products where ST demonstrated coverage by the 14 ST patents to-date [sic]." Jorgenson requested that SanDisk provide ST with a copy of SanDisk's presentation and information about the three SanDisk patents presented. On September 8, 2004, Thompson replied by e-mail, confirming receipt of the package from ST, attaching a copy of SanDisk's presentation, indicating it was his "personal feeling … that we have got to trust one another during these negotiations," and seeking a non-disclosure agreement. Thompson also wrote "I still owe you the rates quoted."

On October 15, 2004, after several further e-mails and phone calls between the business representatives trying to establish another meeting, SanDisk filed the instant lawsuit. SanDisk alleged infringement of one of its patents and sought a declaratory judgment of noninfringement and invalidity of the fourteen ST patents that had been discussed during the cross-licensing negotiations. On December 3, 2004, ST filed a motion to dismiss

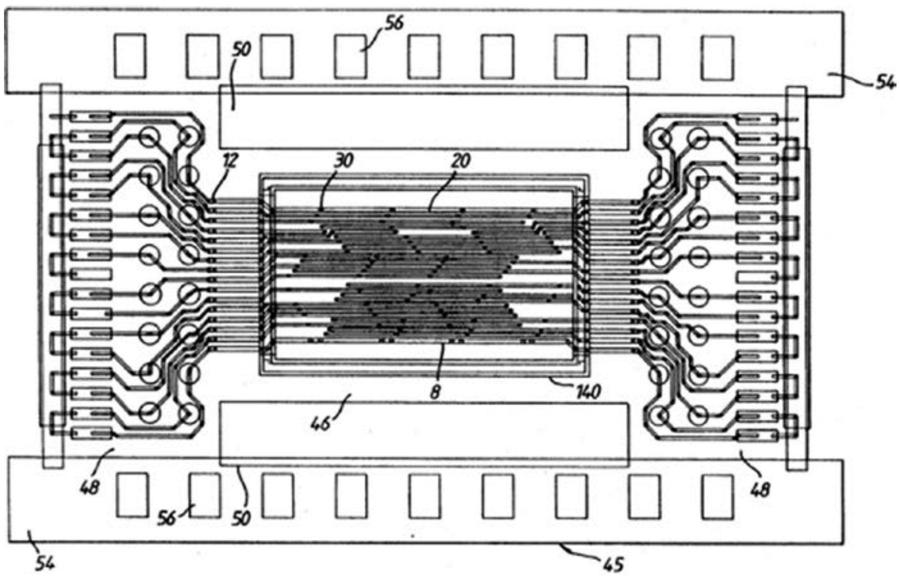

FIGURE 5.1 Figure from US Patent No. 5,073,816, "Packaging semiconductor chips," which ST claimed that SanDisk infringed.

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SanDisk's declaratory judgment claims for lack of subject matter jurisdiction, maintaining that there was no actual controversy at the time SanDisk filed its complaint.

The district court granted ST's motion to dismiss, holding that no actual controversy existed for purposes of the Declaratory Judgment Act because SanDisk did not have an objectively reasonable apprehension of suit, even though it may have subjectively believed that ST would bring an infringement suit. The district court reasoned that "SanDisk has presented no evidence that ST threatened it with litigation at any time during the parties' negotiations, nor has SanDisk shown other conduct by ST rising to a level sufficient to indicate an intent on the part of ST to initiate an infringement action." The district court found that the studied and determined infringement analyses that ST presented to SanDisk did not constitute the requisite "express charges [of infringement] carrying with them the threat of enforcement." The district court also found that the totality of the circumstances did not evince an actual controversy because ST told SanDisk that it did not intend to sue SanDisk for infringement. In a footnote, the court indicated that, as an alternative basis for its ruling, even if it did have jurisdiction, it would exercise its discretion and decline to hear the case.

SanDisk appealed the dismissal to this court.

II. Discussion

SanDisk argues that the district court erred as a matter of law by requiring an express accusation of patent infringement coupled with an explicit threat of judicial enforcement to support declaratory judgment jurisdiction, and that, under the correct legal standard articulated by this court in *Arrowhead*, the facts of this case illustrate that SanDisk's apprehension of an infringement suit was objectively reasonable. SanDisk asserts that the infringement analysis presented by ST and its experts at the August 27, 2004 licensing meeting constituted an allegation of infringement and that the totality of the circumstances shows that ST's conduct gave rise to an actual case or controversy. SanDisk further points out that negotiations regarding licensing had ceased by the time SanDisk filed its claims for declaratory judgment.

ST counters that the district court applied the correct legal standard and argues that SanDisk ignores the line of cases that have followed and interpreted [*Arrowhead Indus. Water, Inc. v. Ecolochem, Inc.*, 846 F.2d 731 (Fed. Cir. 1988)]. ST asserts that the cases following *Arrowhead* reveal that the bare mention of infringement, particularly during license negotiations, is not sufficient to meet the standard set forth in *Arrowhead*. ST asserts that its conduct at the August 27, 2004 licensing meeting was to strengthen its position during licensing negotiations and that, under the totality of the circumstances, SanDisk has not shown that ST's conduct gave rise to declaratory judgment jurisdiction …

1. Case or Controversy

The first question we address is whether the facts alleged in this case show that there is a case or controversy within the meaning of the Declaratory Judgment Act, 28 U.S.C. § 2201(a).

The Declaratory Judgment Act provides, in relevant part, that

> [i]n a case of actual controversy within its jurisdiction … any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought.

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The "actual controversy" requirement of the Declaratory Judgment Act is rooted in Article III of the Constitution, which provides for federal jurisdiction over only "cases and controversies." Thus, our jurisdiction extends only to matters that are Article III cases or controversies.

The Supreme Court, in the context of a patent license dispute, recently examined Article III's case or controversy requirement as it relates to the Declaratory Judgment Act. See *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007). In *MedImmune*, the Supreme Court considered "whether Article III's limitation of federal courts' jurisdiction to 'Cases' and 'Controversies,' reflected in the 'actual controversy' requirement of the Declaratory Judgment Act requires a patent licensee to terminate or be in breach of its license agreement before it can seek a declaratory judgment that the underlying patent is invalid, unenforceable, or not infringed."

The Supreme Court began its analysis

> with the recognition that, where threatened action by government is concerned, [the Court] do[es] not require a plaintiff to expose himself to liability before bringing suit to challenge the basis for the threat—for example, the constitutionality of a law threatened to be enforced. The plaintiff's own action (or inaction) in failing to violate the law eliminates the imminent threat of prosecution, but nonetheless does not eliminate Article III jurisdiction.

The Supreme Court quoted its earlier decision in *Maryland Casualty Co. v. Pacific Coal & Oil Co.*, 312 U.S. 270, 273 (1941), where the Court stated that "the question in each case is whether the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment." The Supreme Court emphasized that Article III requires that the dispute at issue be "'definite and concrete, touching the legal relations of parties having adverse legal interests'; and that it be 'real and substantial' and 'admi[t] of specific relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts.'" *Id*. The Supreme Court stated that, when faced with a genuine threat of enforcement that the government will penalize a certain private action, Article III "d[oes] not require, as a prerequisite to testing the validity of the law in a suit for injunction, that the plaintiff bet the farm, so to speak, by taking the violative action." As the Supreme Court noted, "the declaratory judgment procedure is an alternative to pursuit of the arguably illegal activity." The Supreme Court clarified that, although a declaratory judgment plaintiff may eliminate an "imminent threat of harm by simply not doing what he claimed the right to do[,] … [t]hat did not preclude subject-matter jurisdiction [where] the threat-eliminating behavior was effectively coerced." *Id*. "The dilemma posed by that coercion—putting the challenger to the choice between abandoning his rights or risking prosecution—is a dilemma that it was the very purpose of the Declaratory Judgment Act to ameliorate."

The Supreme Court then applied these principles to the facts of the case and remarked that "the requirements of [a] case or controversy are met where payment of a claim is demanded as of right and where payment is made, but where the involuntary or coercive nature of the exaction preserves the right to recover the sums paid or to challenge the legality of the claim." *Id*. The Supreme Court held that "[t]he rule that a plaintiff must destroy a large building, bet the farm, or (as here) risk treble damages and the loss of 80 percent of its business, before seeking a declaration of its actively contested legal rights finds no support in Article III."

With regard to patent disputes, prior to *MedImmune*, this court articulated a two-part test that first considers whether conduct by the patentee creates a reasonable apprehension on the part of the declaratory judgment plaintiff that it will face an infringement suit, and second examines whether conduct by the declaratory judgment plaintiff amounts to infringing activity or demonstrates concrete steps taken with the intent to conduct such activity. *See Arrowhead*, 846 F.2d at 736.

The Supreme Court's opinion in *MedImmune* represents a rejection of our reasonable apprehension of suit test. The Court first noted that "the continuation of royalty payments makes what would otherwise be an imminent threat at least remote, if not nonexistent … Petitioner's own acts, in other words, eliminate the imminent threat of harm." The Court nonetheless concluded that declaratory judgment jurisdiction existed relying in particular on its earlier decision in *Altvater v. Freeman*, 319 U.S. 359 (1943). There, the patentee brought suit to enjoin patent infringement, and the accused infringer filed declaratory judgment counterclaims of invalidity. The district court found that there was no infringement and that the patent was invalid. The appellate court affirmed the finding of noninfringement but vacated the finding of invalidity as moot. The Supreme Court held that the declaratory judgment counterclaims were not mooted by the finding of noninfringement. In finding declaratory judgment jurisdiction in *MedImmune*, the Court specifically addressed and rejected our reasonable apprehension test:

> [e]ven if *Altvater* could be distinguished as an "injunction" case, it would still contradict the Federal Circuit's "reasonable apprehension of suit" test. A licensee who pays royalties under compulsion of an injunction has no more apprehension of imminent harm than a licensee who pays royalties for fear of treble damages and an injunction fatal to his business. The reasonable-apprehension-of-suit test also conflicts with our decisions in *Maryland Casualty*, where jurisdiction obtained even though the collision-victim defendant could not have sued the declaratory-judgment plaintiff-insurer without first obtaining a judgment against the insured; and *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 239 (1937), where jurisdiction obtained even though the very reason the insurer sought declaratory relief was that the insured had given no indication that he would file suit. It is also in tension with *Cardinal Chemical Co. v. Morton Int'l, Inc.*, 508 U.S. 83, 98 (1993), which held that appellate affirmance of a judgment of noninfringement, eliminating any apprehension of suit, does not moot a declaratory judgment counterclaim of patent invalidity.
>
> *MedImmune*, 127 S. Ct. at 774 n.11.

The Supreme Court in *MedImmune* addressed declaratory judgment jurisdiction in the context of a signed license. In the context of conduct prior to the existence of a license, declaratory judgment jurisdiction generally will not arise merely on the basis that a party learns of the existence of a patent owned by another or even perceives such a patent to pose a risk of infringement, without some affirmative act by the patentee. But Article III jurisdiction may be met where the patentee takes a position that puts the declaratory judgment plaintiff in the position of either pursuing arguably illegal behavior or abandoning that which he claims a right to do. We need not define the outer boundaries of declaratory judgment jurisdiction, which will depend on the application of the principles of declaratory judgment jurisdiction to the facts and circumstances of each case. We hold only that where a patentee asserts rights under a patent based on certain identified ongoing or planned activity of another party, and where that party contends that it has the right to

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engage in the accused activity without license, an Article III case or controversy will arise and the party need not risk a suit for infringement by engaging in the identified activity before seeking a declaration of its legal rights.

…

Under the facts alleged in this case, SanDisk has established an Article III case or controversy that gives rise to declaratory judgment jurisdiction. ST sought a right to a royalty under its patents based on specific, identified activity by SanDisk. For example, at the August 27, 2004 licensing meeting, ST presented, as part of the "license negotiations," a thorough infringement analysis presented by seasoned litigation experts, detailing that one or more claims of its patents read on one or more of SanDisk's identified products. At that meeting, ST presented SanDisk with a detailed presentation which identified, on an element-by-element basis, the manner in which ST believed each of SanDisk's products infringed the specific claims of each of ST's patents. During discussions, the experts liberally referred to SanDisk's present, ongoing infringement of ST's patents and the need for SanDisk to license those patents. ST also gave SanDisk a packet of materials, over 300 pages in length, containing, for each of ST's fourteen patents under discussion, a copy of the patent, reverse engineering reports for certain of SanDisk's products, and diagrams showing a detailed infringement analysis of SanDisk's products. ST communicated to SanDisk that it had made a studied and determined infringement determination and asserted the right to a royalty based on this determination. SanDisk, on the other hand, maintained that it could proceed in its conduct without the payment of royalties to ST. These facts evince that the conditions of creating a substantial controversy, between parties having adverse legal interest, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment were fulfilled. SanDisk need not "bet the farm," so to speak, and risk a suit for infringement by cutting off licensing discussions and continuing in the identified activity before seeking a declaration of its legal rights.

2. Promise Not to Sue

We next address whether Jorgenson's direct and unequivocal statement that "ST has absolutely no plan whatsoever to sue SanDisk" eliminates any actual controversy and renders SanDisk's declaratory judgment claims moot.

We decline to hold that Jorgenson's statement that ST would not sue SanDisk eliminates the justiciable controversy created by ST's actions, because ST has engaged in a course of conduct that shows a preparedness and willingness to enforce its patent rights despite Jorgenson's statement. Having approached SanDisk, having made a studied and considered determination of infringement by SanDisk, having communicated that determination to SanDisk, and then saying that it does not intend to sue, ST is engaging in the kinds of "extra-judicial patent enforcement with scare-the-customer-and-run tactics" that the Declaratory Judgment Act was intended to obviate. ST's statement that it does not intend to sue does not moot the actual controversy created by its acts.

Conclusion

For the above reasons, we conclude that the dismissal was improperly granted. The dismissal is vacated, and the case is remanded for further proceedings consistent with this opinion.

FIGURE 5.2 The dispute in *MedImmune v. Genentech* involved a Genentech patent claiming antibody technology. Because MedImmune's allegedly infringing drug Synagis generated 80 percent of its revenue, MedImmune accepted a license from Genentech and paid royalties "under protest," then sought to invalidate the patent.

Notes and Questions

1. *Declaratory judgment actions*. Why would a potential licensee bring a declaratory judgment action seeking to invalidate a patent offered to it for license? If the potential licensee does not wish to enter into a license, why not simply wait until the patent holder sues for infringement, and then raise any available defenses of invalidity?
2. *FRE 408 settlement negotiations*. Federal Rule of Evidence 408 states that:

   > Evidence of the following is not admissible – on behalf of any party – either to prove or disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or a contradiction:
   > (1) furnishing, promising, or offering – or accepting, promising to accept, or offering to accept – a valuable consideration in compromising or attempting to compromise the claim; and
   > (2) conduct or a statement made during compromise negotiations about the claim – except when offered in a criminal case and when the negotiations related to a claim by a public office in the exercise of its regulatory, investigative, or enforcement authority.

   In *SanDisk*, the parties seemingly agreed to conduct their August 27 meeting under FRE 408. What is the significance of this decision? Why should it be relevant to declaratory judgment jurisdiction?
3. *No reasonable apprehension of suit*. In *MedImmune*, the Supreme Court explicitly rejected the Federal Circuit's "reasonable apprehension of suit" test for declaratory judgment jurisdiction. How do you think SanDisk's action would have fared under that test? Is ST's representation that it had no intention to sue still relevant under *MedImmune*?
4. *MedImmune's impact*. In his concurring opinion in *SanDisk*, Judge Bryson predicted that the Supreme Court's decision in *MedImmune*, which the Federal Circuit was bound to follow, would cause "a sweeping change in our law regarding declaratory judgment jurisdiction." Why? Do you think that such a sweeping change was justified? Would Judge Bryson, as the majority suggests, require SanDisk to "bet the farm" before bringing a declaratory judgment action? What impact is *MedImmune* likely to have on licensing negotiations?

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5. *Patent applications*. In addition to issued patents, licenses are often granted with respect to patent applications (see Section 6.1). How might the presence of patent applications in a portfolio offered for license affect the declaratory judgment analysis under *MedImmune* and *SanDisk*? What other risks might exist for a potential licensor in offering patent applications for license?
6. *Invitations to license*. Following the decisions in *MedImmune* and *SanDisk*, patent holders must thread a particularly thin needle when approaching potential licensees. If they are too aggressive in arguing that the potential licensee is infringing, they may trigger a declaratory judgment action by the potential licensee in the court of its choice. If, on the other hand, they are too vague regarding the scope of their patents and the potential infringement, they may not persuade potential licensees that a license is necessary. Compare the two models of licensing "inquiry letters" below and consider what approach you might advise a client to use in crafting a licensing invitation that is not likely to lead the potential licensee to bring a declaratory judgment action.
Letter A is a traditional pre-*MedImmune* licensing invitation. But is the patentee better off with the informal and nonspecific approach in Letter B?

LICENSE INQUIRY LETTER A: DIRECT APPROACH

To: Company CEO
From: General Counsel, Patentee

You are hereby notified that Company's XYZ product infringes U.S. Patent No. x,xxx,xxx owned by Patentee. Unless you return a signed copy of the attached license agreement to Patentee within 10 days of this letter, Patentee will initiate litigation against Company in the Eastern District of Texas.

LICENSE INQUIRY LETTER B: INDIRECT APPROACH

Hey Joe [CEO of Company Y] –

I heard the XYZ product got great press at ComDex! ☺

Let's grab sushi next time you're in Cupertino. My treat – we can catch up and maybe do some biz. I have a great idea for how our companies might be able to cooperate on a terrific new idea.

Ciao!
Jim

7. *Demand letter statutes*. More than thirty states have enacted statutes intended to curb abusive litigation by patent "trolls" by imposing fines for sending misleading or abusive letters that allege infringement and demand payment from recipients. In May 2021, the attorney general of Washington enforced such a law against a company that allegedly sent identical demand letters to 1,200 small businesses in forty-eight states over an eighteen-month period, all demanding $65,000 to license a patent covering financial transaction processing.[3] Do

[3] *State of Wash. v. Landmark Technology A LLC*, No. 21-2-06348-5 (King Co. Sup. Ct., filed May 13, 2021).

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such laws make legitimate licensing overtures even more risky? How can patent owners address these risks?

8. *Demand letters and personal jurisdiction*. Does sending a patent demand letter to a potential licensee give the federal or state courts in the recipient's state personal jurisdiction over the sender? This controversial issue is addressed in Section 22.3, Note 4.

Problem 5.1

You represent I.C.E., the holder of a portfolio of US patents covering machines used in the packaging of ice cream for consumer resale. Draft a proposed licensing inquiry letter to the CEO of MechanIce, a long-time competitor in the manufacture of ice cream packaging machines.

Now assume that MechanIce refuses to respond, and you wish to bring it to the negotiating table by making its customers aware of your patents. Draft a licensing inquiry letter that can be sent to more than 3,000 supermarkets and grocery store chains in the United States that sell ice cream packaged using MechanIce machines (assume that the packaging itself is covered by the claims of one of your patents). How advisable is it to send this letter? What risks are involved?

5.2 CONFIDENTIALITY AND NONDISCLOSURE AGREEMENTS

During the proposal and negotiation of a licensing or other business transaction, it is often the case that one or both parties will be required to disclose information to the other that is not generally known to the public. Depending on the type of transaction that is contemplated, this information could include technical product details, input costs, names of existing and potential customers, details of unpublished patent applications, and much more.

In the United States, trade secrets are protected under both federal and state law. The Uniform Trade Secrets Act (UTSA), which has been adopted in most states, defines a trade secret as:

> information, including a formula, pattern, compilation, program, device, method, technique or process, that:
>
> 1. Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by other persons who can obtain economic value from its disclosure, and
> 2. Is the subject of efforts that are reasonable under the circumstance to maintain its secrecy.[4]

Thus, much of the information that the parties are likely to disclose to one another would fall under this definition. But part 2 of the definition requires the party claiming a piece of information as a trade secret to take reasonable efforts to "maintain its secrecy." An unrestricted disclosure of even the most valuable information will result in the loss of its status as a trade secret, and the receiving party will be under no obligation to limit its use or disclosure of that information.

For this reason, it is often critical that parties enter into a written nondisclosure agreement (NDA) (also known as a confidentiality agreement) before any confidential information is disclosed. One of the most common agreements that a junior attorney will be given to draft and negotiate is an NDA. Below is a relatively customary form of NDA that is used in transactions like these.

[4] UTSA § 1(3). In 2016, Congress enacted the Defend Trade Secrets Act (DTSA) (18 U.S.C. § 1836), which provides a federal cause of action for trade secret misappropriation. The DTSA definition of trade secrets does not differ significantly from that of the UTSA.

EXAMPLE: MUTUAL NONDISCLOSURE AGREEMENT

Agreement dated ____________ (the "Effective Date"), between ________________, and ______________________ (each a "Party" and together the "Parties").

1. *Background*. The Parties intend to engage in discussions and negotiations concerning a possible business relationship. In the course of such discussions and negotiations, [and in the course of any such business relationship], it is anticipated that each party will disclose or deliver to the other party and to the other party's directors, officers, employees, agents or advisors (including attorneys, accountants, consultants, bankers, financial advisors and members of advisory boards) (collectively, "Representatives") certain of its trade secrets or confidential or proprietary information for the purposes of enabling the other party to evaluate the feasibility of such business relationship [and to perform its obligations and exercise its rights under any such business relationship] (the "Purpose") [1]. As used in this Agreement, the party disclosing Confidential Information (as defined below) is referred to as the "Disclosing Party"; the party receiving such Confidential Information is referred to as the "Recipient."
2. *Confidential information*. [2] As used in this Agreement, the term "Confidential Information" means all information that is disclosed by the Disclosing Party or its Representatives to the Recipient [and which is designated as such in writing, whether by letter or by the use of an appropriate proprietary stamp or legend], [*or*] [which by its nature is of a type which is considered to be confidential and/or proprietary]. In addition, the term "Confidential Information" shall be deemed to include: (a) any notes, analyses, compilations, studies, interpretations, memoranda or other documents prepared by the Recipient or its Representatives which contain, reflect or are based upon, in whole or in part, any Confidential Information; and (b) the existence or status of, and any information concerning, the discussions between the parties concerning the Purpose.
3. *Duration*. This Agreement shall apply to all Confidential Information disclosed between the parties hereto from the Effective Date until [the first anniversary of the Effective Date] [3]. The obligations imposed by this Agreement shall continue with respect to a particular item of Confidential Information until the [fifth anniversary] of the disclosure of such Confidential Information to Recipient pursuant to this Agreement; provided, however, that the confidentiality obligations imposed by this Agreement with respect to [_________] included in the Confidential Information shall continue [in perpetuity/for a period of [__] years/for the duration of applicable trade secret protection under the law].
4. *Use and disclosure*. [4] The Recipient shall use the Confidential Information of the Disclosing Party only for the Purposes. The Recipient shall hold the Confidential Information in confidence with at least the same degree of care as it uses to keep its own proprietary information confidential, which shall in no event be less than reasonable care, and shall not intentionally disclose or publicly release any Confidential Information of the Disclosing Party.
5. *Limitations*. The obligations of the Recipient specified in section 4 shall not apply, and the Recipient shall have no further obligations, with respect to any Confidential Information to the extent that the Recipient can prove that such Confidential Information: (a) is

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generally known to the public at the time of disclosure or becomes generally known without the Recipient violating this Agreement; (b) is in the Recipient's possession at the time of disclosure; (c) becomes known to the Recipient through disclosure by sources other than the Disclosing Party without such sources violating any confidentiality obligations to the Disclosing Party; or (d) is independently developed by the Recipient without access or reference to the Disclosing Party's Confidential Information [5]. Moreover, this Agreement shall not prohibit the Recipient from disclosing Confidential Information of the Disclosing Party to the extent required in order for the Recipient to comply with applicable laws, regulations, court orders and stock exchange rules, provided that the Recipient provides prior written notice of such required disclosure to the Disclosing Party, takes reasonable and lawful precautions to avoid and/or minimize the extent of such disclosure and cooperates with the Disclosing Party to obtain confidential treatment for such Confidential Information from the relevant authority.

6. *Ownership*. The Recipient agrees that it shall not receive any right, title or interest in, or any license or right to use, the Disclosing Party's Confidential Information or any patent, copyright, trade secret, trademark or other intellectual property rights therein, by implication or otherwise. Each of the parties hereto represents, warrants and covenants that the trade secrets which it discloses to the other party pursuant to this Agreement have not been stolen, appropriated, obtained or converted without authorization. [A prohibition on reverse engineering is sometimes included here, as well. [8]]
7. *Return of Confidential Information*. The Recipient shall, upon the written request of the Disclosing Party, return to the Disclosing Party, or destroy, all Confidential Information received by the Recipient from the Disclosing Party and all copies and reproductions thereof, including any notes, reports or other documents prepared by the Recipient which contain Confidential Information of the Disclosing Party [provided, however, that the Recipient shall not be required to locate or delete copies of Confidential Information that are stored on its internal or external computer backup media as part of its standard system backup and disaster recovery processes, so long as such Confidential Information is accessible only to the relevant computer operations personnel]. Notwithstanding the return or destruction of the Confidential Information, the Recipient will continue to be bound by its obligations of confidentiality and other obligations hereunder.

[8. OPTIONAL: *Residuals*. Notwithstanding anything to the contrary contained in this Agreement, either party shall be free to use any information disclosed hereunder to the extent that it is retained in the unaided memory of its employees.] [9]

9. *Representatives*. Recipient shall be permitted to disclose Confidential Information received from the Disclosing Party to those of its Representatives who have a need to know such Confidential Information for the Purposes, provided that such Representatives are legally bound to maintain the confidentiality of such Proprietary Information at least to the degree that Recipient is so bound hereunder. Any breach of any obligation of confidentiality by a Representative shall constitute a breach by Recipient hereunder, and Recipient shall be jointly and severally liable with all such Representatives for such breaches. Recipient shall maintain a written log of Representatives to whom the Confidential Information is disclosed and shall share such log with the Disclosing Party upon its request. [6]

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10. *Injunctive relief*. The provisions of this Agreement are necessary for the protection of the business and goodwill of the parties and are considered by the parties to be reasonable for such purpose. The Recipient agrees that any breach of this Agreement [will/may] [7] cause the Disclosing Party substantial and irreparable injury which cannot be remedied by monetary damages alone, and, therefore, in addition to other remedies which may be available, the Disclosing Party shall have the right to [seek] [7] specific performance and other injunctive and equitable relief to prevent any such breach or its continuation without the necessity of posting a bond.

DRAFTING NOTES

[1] *Purpose* – Each NDA should define the purpose for which information is exchanged. Sometimes the purpose is narrowly limited to a specific potential transaction (often an acquisition), and sometimes it broadly covers any business transaction between the parties.

[2] *Confidential Information* – some NDAs use the term "Proprietary Information" instead of "Confidential Information." The intent is largely the same, though "Proprietary" connotes ownership as opposed to simple confidentiality (e.g., a party may hold third-party information that it does not "own," but which it is obligated to keep confidential).

[3] *Time of disclosure* – in some cases, the parties may have exchanged information before the NDA is signed, in which case retroactive effect should be considered.

[4] *Use and nondisclosure* – section 4 contains the two principal obligations that should be included in every NDA: the recipient's obligation not to use the disclosing party's confidential information for any purpose other than the purpose, and not to disclose or release that confidential information to others. Many NDAs inadvertently omit one of these key obligations – don't let this happen to you!

[5] *Independent development* – this exception generally becomes relevant in two contexts: (1) When the recipient is a large enterprise with multiple independent groups conducting research and development on potentially related topics, often in different geographical locations; if confidential information is disclosed to a group in the Austin, Texas office, but similar information is created by the recipient's Moscow office, the information should not be protected. (2) If the recipient knows that its developers are "contaminated" with confidential information, it can form a new development group with individuals who are assured to have no access to the confidential information and ask them to develop similar information independently. This is called a "clean room" approach, and has been upheld by the courts if conducted carefully. See *NEC Corp. v. Intel Corp.*, 1989 WL 67434 (N.D. Cal.).[5]

[6] *Recipient personnel* – in some cases, the disclosing party may wish to limit the recipient's personnel that are authorized to access and use its confidential information. Such

[5] Note that independent development is not a defense to patent infringement, which is a strict liability tort that requires neither intent nor knowledge, though it may rebut a claim for enhanced damages for "willful" infringement under 35 U.S.C. § 284.

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limitations can be structured to list the names and/or titles of such personnel, or the groups or departments in which they are based (e.g., "Confidential Information shall be made accessible only to attorneys who are members of Recipient's Office of General Counsel"). Alternately, certain groups can be expressly excluded from access to confidential information (e.g., "No Confidential Information shall be provided or made accessible to the members of Recipient's Mark V development team").

[7] *Injunctive relief* – this clause is intended to enable the disclosing party to obtain an injunction to prevent disclosure (or further disclosure) of its confidential information without proving every element typically required to obtain injunctive relief. As such, the recipient sacrifices significant legal protections by agreeing to this language in its "strong" form. The [alternative] language represents a recipient's standard push-back against this clause.

[8] *No reverse engineering* – if confidential information includes proprietary materials, chemical compounds, circuitry, software or other items from which other trade secrets may be derived, the disclosing party should consider the inclusion of a "no reverse engineering" clause, discussed in detail in Section 18.2.5.

[9] *Residuals* – section 8 is a "residuals" clause, which permits the recipient to continue to use any confidential information retained in the "unaided memory" of its personnel. Such a clause is almost always controversial, and its use and acceptance are generally industry-dependent. IBM is reputed to have "invented" this clause to enable its engineers to think freely, even after they had been exposed to competitors' confidential information. While a residuals clause does not permit the recipient to use any written, electronic or other artificial means to preserve confidential information that it is no longer permitted to use, it is certainly possible that some individuals may have exceptional (or even photographic) memories, which could enable them to use the disclosing party's confidential information long after a proposed transaction has failed to materialize.

Notes and Questions

1. *Purpose*. One of the most heavily litigated issues arising under an NDA is whether the recipient used confidential information for some purpose beyond the stated "purpose" of the disclosure. For example, in *Le Tote Inc. v. Urban Outfitters Inc.*, (E.D. Pa. 2021), Le Tote described its mail-order fashion rental business model to Urban Outfitters under an NDA for the purpose of enabling Urban Outfitters to evaluate a potential acquisition of Le Tote. Urban Outfitters did not acquire Le Tote, but did start its own mail-order fashion rental business. Le Tote alleged that it did so using Le Tote's confidential information. If you had represented Urban Outfitters, what language might you have drafted to protect your client from such allegations? For a sense of just how large the stakes can be in such matters, see *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072 (Del. Ch. 2012), aff 'd, 68 A.3d 1208 (Del. 2012) (injunction of a $5.5 billion hostile takeover on the basis of the interpretation of the word "between" in a confidentiality agreement).
2. *NDA versus definitive agreement*. In section 1 of the sample NDA, what is the purpose of the language in the definition of "Purposes" that reads "and to perform its obligations and exercise its rights under any such business relationship that is formalized between the parties"?

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Is it advisable to allow a pre-agreement NDA to continue to cover information disclosed after a definitive license or other agreement is signed? Another approach is to limit the NDA to pre-agreement discussions, and then to include a comprehensive confidentiality clause in the "definitive" agreement between the parties. Or the parties may draft the confidentiality clause in the definitive agreement broadly enough to encompass information disclosed under the NDA and then supersede and cancel the NDA in the definitive agreement. What are the advantages and drawbacks of each of these approaches?

3. *Marking*. In section 2, the [bracketed] language shows that the central definition of "Confidential Information" can be cast in two ways: either as all information that the disclosing party marks as confidential (e.g., with a "CONFIDENTIAL" legend) or as *all* information that the disclosing party discloses to the recipient. What is the significance of including a marking obligation on the disclosing party? Which form of this definition would you choose if you were representing the disclosing party? The recipient?
4. *Confidential information versus trade secrets*. Why do NDAs go to such lengths to define confidential information, rather than simply relying on existing statutory and common law definitions of trade secrets? Are there significant differences between proprietary/confidential information and trade secrets? Why require any terms in an NDA beyond a simple acknowledgment that certain information is a trade secret?
5. *Timing and duration*. Section 3 of the NDA addresses timing and duration issues. The first sentence limits the obligations under the NDA to information disclosed prior to a particular cutoff date. Why would such a cutoff be advisable? If a cutoff is used, the parties must be careful to remember that the NDA is no longer in place after that date, as information disclosed afterwards will not be covered. An alternative is to eliminate the cutoff entirely. Under what circumstances would this approach be advisable?

   The next sentence describes how long the obligations under the NDA last with respect to information disclosed under it. Sometimes this duration has two tiers, a shorter term for most information (e.g., a five-year term) and a perpetual or longer term for highly sensitive or valuable information (e.g., the formula for Coca-Cola, key computer source code, etc.). Why should obligations of confidentiality ever expire? What other kinds of information might merit perpetual protection?

   Note the final drafting "option" in this sentence. It provides that all confidential information that constitutes a "trade secret" will remain protected for the duration of its trade secret status. Does this provision introduce some circularity to the duration of protection for this information?
6. *Residuals*. As noted in Drafting Note [9], residuals clauses are almost always controversial. If you represented the disclosing party in a transaction, how would you respond to the recipient's request for a residuals clause in an NDA? When might such a clause be reasonable? Could a residuals clause be interpreted as granting the recipient an implied license under the disclosing party's patents? How might this implication be avoided? How would a residuals clause have helped Urban Outfitters in the case discussed in Note 1?
7. *Exceptions*. Section 5 of the NDA provides several exceptions to the recipient's obligations of confidentiality. Which of these, if any, would you wish to eliminate or modify if you represented the disclosing party? How? The *Celeritas* case discussed below addresses one of the most common of these exceptions, that concerning information that is in the public domain. What is the purpose of the exception at the end of this section pertaining to the disclosing party's compliance with law and regulations? Why isn't this exception included with the other exceptions listed in Section 5?

FIGURE 5.3 The formula for Coca-Cola, which is allegedly stored in this imposing vault in Atlanta, has been a trade secret since 1886.

Celeritas Technologies, Ltd. v. Rockwell International Corp.

150 F.3d 1354 (Fed. Cir. 1998)

LOURIE, CIRCUIT JUDGE

Rockwell International Corporation appeals from the decision of the United States District Court for the Central District of California denying Rockwell's motions for judgment as a matter of law and for a new trial following a jury verdict that Rockwell willfully infringed Celeritas Technologies, Ltd.'s patent, misappropriated its trade secrets, and breached a non-disclosure agreement relating to the protected subject matter. [We affirm.]

On July 28, 1993, Michael Dolan filed a patent application for an apparatus for increasing the rate of data transmission over analog cellular telephone networks [using "de-emphasis" technology]. The resulting patent, U.S. Patent 5,386,590, assigned to Celeritas, was issued on January 31, 1995.

[In] September 1993, Dolan and other officials of Celeritas met with representatives from Rockwell to demonstrate their proprietary de-emphasis technology. Rockwell is the leading manufacturer of modem "chip sets" which contain the core functions of commercial modems, including the modulation function where de-emphasis is performed. The parties entered into a non-disclosure agreement (NDA), which covered the subject matter of the meeting and provided in pertinent part that Rockwell "shall not disclose or use any Proprietary Information (or any derivative thereof) except for the purpose of evaluating the prospective business arrangements between Celeritas and Rockwell."

The agreement provided that proprietary information "shall not include information which … was in the public domain on the date hereof or comes into the public domain other than through the fault or negligence of [Rockwell]." [In] March 1994, AT&T Paradyne began to sell a modem that incorporated de-emphasis technology. In that same month, Rockwell informed Celeritas that it would not license the use of Celeritas's proprietary technology, and concurrently began a development project to incorporate de-emphasis technology into its modem chip sets. Significantly, Rockwell did not independently develop its own de-emphasis technology, but instead assigned the same engineers who had learned of Celeritas's technology under the NDA to work on the de-emphasis development project. In January 1995, Rockwell began shipping its first prototype chip sets that contained de-emphasis technology. By the time of trial in 1997, Rockwell's sales were surpassing its projections.

On September 22, 1995, Celeritas sued Rockwell, alleging breach of contract, misappropriation of trade secrets, and patent infringement. The jury returned a verdict for Celeritas on each of the three theories, awarding Celeritas $57,658,000 each on the patent infringement and breach of contract claims, and $26,850,000 each in compensatory and exemplary damages on the trade secret misappropriation claim. [Rockwell] moved for JMOL on liability and for a new trial on damages.

Rockwell first argues that the district court erred by denying its motion for JMOL on the breach of contract claim. Citing the prior art submitted to the United States Patent and Trademark Office (PTO) by Celeritas, Rockwell argues that the evidence at trial clearly demonstrates that the de-emphasis technology disclosed to Rockwell was already in the public domain. Even if the technology were proprietary at the time of disclosure, Rockwell argues, the technology had entered the public domain before Rockwell used it, concededly no later than March 1994. Specifically, Rockwell asserts that AT&T Paradyne had already placed the technology in the public domain through the sale of a modem incorporating de-emphasis technology ("the modem"). Rockwell asserts that the technology was "readily ascertainable" because any competent engineer could have reverse engineered the modem. Rockwell further argues that any confidentiality obligation under the NDA regarding de-emphasis technology was extinguished once the '590 patent issued in January 1995.

FIGURE 5.4 A Rockwell 33.6 K analog modem, *c.*1990s.

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Celeritas responds that substantial evidence supports the jury's verdict that Rockwell used its proprietary information. Celeritas argues that in order for a trade secret to enter the public domain in California, it must actually have been ascertained by proper means, and not merely have been ascertainable. Celeritas maintains that, in any event, the only evidence at trial supports the jury's implicit finding that the information was not readily ascertainable from inspection of the modem. Celeritas also argues that the issuance of its patent in 1995 is immaterial because Rockwell had already breached the agreement by using its proprietary information in 1994.

We agree with Celeritas that substantial evidence supports the jury's conclusion that Rockwell breached the NDA. The jury implicitly found that the information given to Rockwell by Celeritas was proprietary. Unrebutted testimony established that Celeritas disclosed to Rockwell implementation details and techniques that went beyond the information disclosed in the patent. Thus, even if every detail disclosed in the patent were in the prior art, a fact never alleged by Rockwell, that fact would not undermine the jury's conclusion that Celeritas revealed proprietary information to Rockwell which it then used in developing its modem chip sets. Accordingly, Rockwell's reliance on the prosecution history of the '590 patent and the prior art submitted to the PTO is misplaced.

The jury also implicitly found that the technology had not been placed in the public domain by the sale of the modem. California law appears somewhat unsettled regarding whether a trade secret enters the public domain when it is "readily ascertainable" or whether it must also be "actually ascertained" by the public. Because the judgment is supportable under either standard, we need not attempt to resolve this issue of state law. Suffice it to say that substantial evidence supports a finding that the technology implementing the de-emphasis function in the modem was not "readily ascertainable." In fact, Dolan's testimony, the only evidence cited by Rockwell, belies its contentions. [Dolan] stated that (1) a spectrum analyzer would be needed to discover the de-emphasis technology, (2) most engineers that he talked to did not have spectrum analyzers, and (3) only if an engineer had a spectrum analyzer and knew what to look for could the engineer discover that the modem had de-emphasis technology. His express caveat that the use of de-emphasis could have been discovered if it was being affirmatively pursued is not an admission that the technology would be "readily ascertainable." Because substantial evidence supports the conclusion that the information disclosed to Rockwell had not entered the public domain before its unauthorized use by Rockwell, the court did not err in denying Rockwell's motion for JMOL regarding its breach of the NDA.

Notes and Questions

1. *Public domain information*. In *Celeritas*, the NDA did not apply to "information which [was] in the public domain on the date hereof or comes into the public domain other than through the fault or negligence of [Rockwell]." Why is such information excluded? Given the result in *Celeritas*, how might you adjust this language for future transactions?
2. *Patent applications*. Beginning in 2000, US patent applications have been published by the Patent and Trademark Office eighteen months after filing, unless the applicant chooses to waive foreign filing rights (35 U.S.C. § 122). The patent application in the *Celeritas* case, which was filed prior to 2000, was not subject to this requirement. What effect is the publication of patent applications likely to have on the information that they contain? How might this affect the recipient's obligations under a typical NDA?

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3. *Issued patent*. Rockwell also argued that the issuance of Celeritas' patent in 1995 eliminated any obligation of confidentiality that Rockwell may have had. Is this correct? Why doesn't the court discuss this argument? What would the result have been if Rockwell had waited to begin development of its de-emphasis modem technology until Celeritas' patent had issued (disregarding the potential need for a patent license)?
4. *Contract versus trade secret*. Are there any advantages in bringing an action for contractual breach of an NDA as opposed to an action for misappropriation of trade secrets under either state law and/or the federal DTSA? When might you bring *both* a contractual and a trade secret misappropriation action?

Problem 5.2

Referring to the sample mutual NDA above, what are the top ten terms that you would seek to negotiate if you represented the party most likely to be the disclosing party? The recipient? What if you are not sure, at the outset, which party will be likely to disclose more proprietary information during discussions? Draft a mutual NDA that would be both reasonable but favorable to each of these negotiation positions.

5.3 PRELIMINARY DOCUMENTS

In addition to confidentiality agreements, parties negotiating licensing and other transactions often exchange, and sometimes sign, preliminary documents that summarize the terms of an anticipated transaction, as well as the premises under which negotiations are anticipated to occur. These preliminary documents are variously called term sheets, letters of intent, heads of agreement, memoranda of understanding, and a host of similar designations. In almost all cases, with a few notable exceptions, they are intended to be nonbinding.

In a recent article, Professor Cathy Hwang points out the high stakes that can ride on such preliminary documents and explores why they are used:

> In 2015, the Delaware Supreme Court awarded $113 million in expectation damages when a sophisticated party did not honor the terms of an unsigned, two-page preliminary agreement marked "non-binding." Over a ten-year battle, the Delaware courts' four decisions in *SIGA Technologies Inc. v. PharmAthene Inc.* stirred up a storm of interest from deal lawyers. They also brought to light a long-standing and puzzling practice in dealmaking: the use of non-binding agreements. Why do parties use non-binding agreements to memorialize high-stakes deals, especially when they have the option to use formal, binding contracts?
>
> This inquiry reveals that parties primarily use non-binding agreements to add formality to an otherwise murky pre-contractual deal process. Preliminary agreements mark the moment when deal parties have resolved most deal uncertainty and are likely to do a deal together, whether or not they sign a preliminary agreement. Instead of causing parties to behave well, preliminary agreements merely mark the moment when parties were already primed to behave well, with or without an agreement.[6]

Cynthia Cannady discourages the use of such preliminary documents whenever possible:

> Letters of intent and Memoranda of Understanding (MOUs) are quasi-agreements and are a risky practice with few benefits. Unlike interim agreements, they are often phrased in such a

[6] Cathy Hwang, *Deal Momentum*, 65 UCLA L. Rev. 376, 378–79 (2018). The term sheet in *PharmAthene* was not a standalone document, but set forth terms over which other (binding) agreement required the parties to negotiate in good faith.

way that it is unclear if they record a binding agreement. The parties may create a similarly confusing document by signing term sheets or other documents that do not express agreements on material terms. These types of documents are often entered into because the parties have not reached agreement on material terms that have proven intractable in negotiation, however, the parties still wish to proceed with a development project or a public announcement.

For example, the parties may enter into a letter of intent to avoid the risks of negotiation failure on the question of which party will own foreground IP in a development agreement, and the additional time pressure that delay places on the engineering teams when they begin work. Expressions like "good faith" and "best efforts" are often used in such agreements to describe the efforts of the parties to agree and/or produce a deliverable. However, after six months of joint engineering work, with no agreement on IP ownership, the parties are still likely to find it hard to agree. They may also rest on the comfort of a signed MOU and devote themselves to the engineering tasks at hand.[7]

Notes and Questions

1. *Value of preliminary documents*. As the above excerpts from Hwang and Cannady demonstrate, there is some disagreement regarding the value, or even advisability, of preliminary documents. Which of these viewpoints do you find more persuasive? How would you advise a client who came to you with a request to prepare a nonbinding letter of intent for a transaction?
2. *Texaco v. Pennzoil*. One of the most notorious pre-transaction documents in history involved three oil industry giants. In early January 1984, Pennzoil negotiated and signed a "Memorandum of Agreement" with certain large shareholders of Getty Oil whereby Pennzoil would acquire the outstanding shares of Getty at a price of $110 per share. The Memorandum of Agreement was subject to approval of Getty's Board of Directors, which rejected the offer as too low. Following further negotiations, the Board counter-proposed a price $5 above Pennzoil's original offer. Pennzoil accepted the counteroffer and both parties issued press releases announcing the deal. The next day, however, Texaco offered $125 per share to acquire all outstanding shares of Getty. Getty's Board voted to withdraw its previous counterproposal to Pennzoil and to accept Texaco's higher offer instead. Getty and Texaco signed a definitive merger agreement two days later. Pennzoil then sued Texaco for tortious interference and was awarded $7.53 billion in compensatory and $3 billion in punitive damages by a jury in Houston, Texas – the largest civil verdict in history. *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App. 1987).
3. *Nonbinding language*. In the wake of *Texaco v. Pennzoil*, lawyers became keenly aware of the need to be very clear when they did not intend preliminary documents to be binding. Robert Lloyd, reflecting on the judgment in that case, recommends language along the following lines:

   > Although the parties may exchange proposals (written or oral), term sheets, draft agreements or other materials, neither party will have any obligations or liability to the other party unless and until both parties' authorized representatives sign definitive written agreements. Exchanged terms are non-binding to the extent they are not included in such definitive written agreements. Either party can end these discussions at any time, for any reason (or for no

[7] Cynthia Cannady, The Three No's: Letters of Intent, Memoranda of Understanding, and Standstill Agreements, in Technology Licensing and Development Agreements 469–70 (Oxford Univ. Press, 2013).

FIGURE 5.5 The record-breaking verdict in *Texaco v. Pennzoil* reinvigorated the popular notion that a handshake is a binding commitment.

reason at all), and without liability to the other party. Each party remains free to negotiate and to enter into contracts with others.[8]

Do you think this language is necessary to demonstrate that no contract is being formed by preliminary documents? What about merely including the word "nonbinding" in the document header?

4. *Binding terms – confidentiality, exclusivity, break-up fees*. Though most provisions of preliminary documents are nonbinding, a few provisions sometimes do bind the parties. First, and most commonly, confidentiality terms are often included in preliminary documents and are generally drafted to be binding on the parties. Beyond these are two less conventional forms of binding terms: exclusivity and so-called break-up fees. Exclusivity provisions require that the parties negotiate exclusively with each other for a specified period, which could be days, weeks or months. Break-up fee (also referred to as "bust-up" or "walk-away") provisions require that one party pay the other a specified amount if the parties fail to reach a binding agreement within a certain period of time. Why would parties agree to exclusivity and break-up fees before they have executed a definitive agreement?
5. *The term sheet*. Some forms of preliminary documentation look very much like contracts and are signed by the parties (as they were in *Texaco v. Pennzoil*). However, in many cases these documents are not signed, further bolstering arguments as to their nonbinding nature. The simplest form of preliminary documentation is probably the term sheet: a list of key terms that the parties anticipate including in a definitive agreement, assuming that they can get the details ironed out. Well-drafted term sheets may also include pointers to important but unresolved issues that need to be ironed out in the definitive agreement. Do you see value in such a nonbinding document?

[8] Robert M. Lloyd, *Pennzoil v. Texaco, Twenty Years After: Lessons for Business Lawyers*, 6 Transactions: Tenn. J. Bus. L. 321, 352 (2005).

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NONBINDING TERM SHEET: SUBJECT TO NEGOTIATION AND DEFINITIVE AGREEMENT	
Licensor	ElectroBev Co., a Delaware corporation
Licensee	Sunbelt, SA de CV, a Mexican corporation
Licensed Rights	Proprietary formula for ElectroBev soft drinks ElectroBev word and design marks in the Territory (Licensed Marks)
Licensed Products	Canned and bottled ElectroBev soft drinks for sale in consumer retail stores, convenience stores, restaurants, kiosks and vending machines. Excludes fountain drinks.
Territory	South and Central America (including Caribbean)
Rights Granted	Manufacture, promote and sell Licensed Products in the Territory under the Licensed Marks
Exclusivity	Exclusive (other than Electro's Brazilian subsidiary – which will retain rights in a manner to be agreed)
Up-Front Fee	$100,000
Royalty	5% of Net Sales up to $10,000,000 3% above $10,000,000
Term	5 years, with 1-year automatic renewals
Target execution date	Jan. 30, 2020

6. *Term sheet terms*. How do you decide which terms to reflect in a term sheet? How might such terms differ from those in the above sample trademark license term sheet if the transaction involved (a) a feature-length film to be based on a popular foreign-language book; (b) a new lightweight silicone-based coating with high heat resistance; (c) a chemical compound with medicinal properties that has recently been extracted from a rare tropical insect; and (d) the lyrics to twenty Broadway musicals composed by a recently deceased songwriter?
7. *Interim agreements*. Lying somewhere between nonbinding preliminary documents and definitive transaction agreements are short-term "interim" agreements that parties sometimes enter while they are considering whether a longer-term arrangement is advisable. Cannady explains the rationale for such agreements in the technology sector:

> Evaluation is part of the negotiation process. An evaluation agreement permits the parties to work together for a period of time and exchange information, and develop new information and ideas for the purpose of testing collaboration opportunities. It is like an NDA but permits a closer cooperation between the parties and may also specify which information will be exchanged.
>
> A prototype agreement goes further than evaluation and commits the parties to make one or more prototypes by a certain date. The agreement's material terms relate to the allocation of costs and duties, payment of expenses, and IP ownership and rights. Prototype agreements are mini-development agreements, but with a reduced [statement of work] and a shortened time frame.
>
> Interim agreements are used to permit the parties to work together for a period of time pending negotiation of the agreement. These agreements clarify which party will bear what costs, IP ownership and rights, and other critical issues. They provide that the agreement

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will terminate by a certain date, usually a matter of a month or two. These agreements are risky because they tend to "let the horse out of the barn"; the parties rely on them as if they had successfully negotiated the full agreement. Just like development agreements, interim agreements require resolution of IP ownership and other difficult issues, but within a short time frame. In some cases, they are useful in helping parties find an interim solution pending negotiation.[9]

Do you agree with Cannady's assessment of the risks and benefits of interim agreements? How would you protect your client's interests if they wished to enter into such an agreement?

8. *Beta testing agreements*. One type of interim agreement that is sometimes used in the software industry is called a "beta testing" or "early release" agreement. This is essentially a license agreement that permits the use of a pre-release version of a software program. Because the software is not ready for commercial release, it is usually provided "as is" without warranties of any kind and at no or low cost to the user. In addition, the vendor often requires the user to report all bugs and errors in the software and to provide feedback on its features and functionality, which the vendor is then permitted to build into subsequent versions of the software (i.e., through a form of "grantback" license – see Section 9.1.2). What do you think happens under a typical beta agreement if a user conceives a patentable improvement to the software that she has been licensed to use? What risks might the assignment of improvements to the vendor pose for a beta user?

Problem 5.3

Your client, Cook E. Mawnster, has developed an innovative and delicious new recipe for chocolate-chip cookies. Until now she has been baking cookies and selling them at local bake sales and farmers' markets with resounding success. Now, she would like to enter into an agreement with a commercial baked goods company to produce and sell her cookies on a national basis. Draft the pre-transaction documents that you would recommend she use when approaching these companies.

[9] Cynthia Cannady, Technology Licensing and Development Agreements 470 (Oxford Univ. Press, 2013).