



**TILBURG LAW SCHOOL**

Master's Thesis

# Audit Clause in Intellectual Property Licensing Agreements

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## ABSTRACT

One of the forms of commercializing intellectual property (IP) assets, i.e. trade secrets, patents, copyrights, trademarks, among others, is through licensing agreements, where the owner of the IP asset (licensor) grants permission for the use of its IP rights to a third party (licensee) who is interested in commercially exploiting them. As a contract, under English contract law, a licensing agreement has to comply with the obligatory elements of offer and acceptance, formalities, intent to create legal relations, and consideration. While licensing agreements do not transfer ownership of the IP asset from the licensor to the licensee, the former may wish to exercise some form of control of its IP asset in a way that it does not lose its validity and value while in the “hands” of the licensee, but also in regard to the financial returns he expects to obtain from such IP asset.

The Directive 2004 / 48 / EC (Enforcement Directive) and the cases 118 Data Resource Limited v IDS Data Services Limited and others, Transport for Greater Manchester v Thales Transport & Security Ltd, and Orion Publishing Group Ltd v Novel Entertainment Ltd provide the licensor and licensee, as well as contract drafters with the valuable and necessary guidance as to the avoidance of troubles while negotiating, drafting and agreeing upon an audit clause in licensing agreements, with a view of preserving its enforceability efficiency.

**KEYWORDS:** Intellectual Property; Licensing Agreement; Audit Clause; 118 Data Resource Limited; Orion Publishing Group Ltd.

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## INTRODUCTION

Intellectual Property (IP) may be understood as “the creations of the mind: inventions; literary and artistic works; and symbols, names and images used in commerce.”<sup>1</sup> In the increasingly knowledge-driven economy, IP plays a vital role for innovation in the pursuit of progress and the wellbeing of humanity. Intellectual Property Rights (IPR’s) are like any other property rights, allowing their owners to financially benefit from their own work and investments. And such work and investments ought to be protected globally and regionally so that they turn into new creations and inventions in technology, culture and so on. The legal protection of IPR’s also “encourages the commitment of additional resources for further innovation...”<sup>2</sup>, and “... spurs economic growth, creates new jobs and industries and enhances the quality and enjoyment of life.”<sup>3</sup>

Establishing the IP, such as trade secret, patent, copyright, trademarks, among others, means that the new creation/invention has become an intangible asset<sup>4</sup>. And such asset may be commercially explored internally, i.e., via the own resources of its owner, and/or by third parties through a licensing agreement. This IP licensing agreement will cover several aspects of the parties’ relationship, with particular consideration of the limits of the exploration of the intangible asset by the licensee and its financial return to its owner, the licensor.

Special attention to a specific clause in the IP licensing agreement is called in this academic research: the Audit Clause. Virtually present in all IP licensing agreements, the audit clause requires careful attention to contract drafters and negotiators, not only in respect

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<sup>1</sup> WIPO Publication No. 450(E). ISBN 978-92-805-1555-0. Retrieved from [http://www.wipo.int/edocs/pubdocs/en/intproperty/450/wipo\\_pub\\_450.pdf](http://www.wipo.int/edocs/pubdocs/en/intproperty/450/wipo_pub_450.pdf)

<sup>2</sup> *Supra*, Note 1

<sup>3</sup> *Supra*, Note 1

<sup>4</sup> An asset that is not physical in nature. Corporate intellectual property (items such as patents, trademarks, copyrights, business methodologies), goodwill and brand recognition are all common intangible assets in today’s marketplace. Retrieved from <http://www.investopedia.com/terms/i/intangibleasset.asp> - accessed on 23 February, 2015

to the contract management field, but most importantly to its enforcement and eventual need to challenge it before courts. In brief terms, the audit clause gives the licensor the right to have access to the licensee's premises and documents in order to assess/audit the compliance of the provisions of the licensing agreement. It is one of the tools the licensor may make use of in order to audit the exploration of the licensed IPR in respect to, among other issues, the limits of its exploration and the correctness of the agreed payment terms.

In the case *118 Data Resource Limited v IDS Data Services Limited and others* [2014] EWHC 3629 CH<sup>5</sup>, though still pending final judgment, Deputy Judge David Halpern QC, England and Wales High Court, due to the uncertainties of the wordings of the audit clause agreed upon by the parties, decided to restrain the licensor from enforcing its audit rights as he, in an interim way, found the audit clause to be bad drafted so as it gave broadened and unlimited access to the licensor in regard to the licensee's premises and information while performing the audit. It undoubtedly puts contract drafters and lawyers to learn such lessons as to avoid disputes, which might ultimately cause early termination of the envisaged business relationship of the parties.

Based on such case, this academic research will look to provide contract drafters, negotiators and lawyers with key resources for the drafting of a model audit clause in IP license agreements so as it is legally effective and enforceable, and passes efficiently before courts if challenged by any of the parties. It will basically focus in avoiding the use of implied terms, which will ultimately require the court to decide what the rights and the obligations of the contracting parties are, leaving room for the ineffective exercise of the audit clause.

A general overview of IP Licensing agreements will be dealt with in Chapter I. It will mostly analyze the general and specific aspects of licensing agreements, its main

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<sup>5</sup> *118 Data Resource Limited v IDS Data Services Limited and others* [2014] EWHC 3629 CH. Retrieved from <http://www.bailii.org/ew/cases/EWHC/Ch/2014/3629.html> - accessed on 23 February, 2015

clauses and some keynotes in regard to different types of licensing agreements, i.e., the licensing agreements of distinct intellectual property rights. In Chapter [II](#), the audit clause in IP license agreements will be explained in [more](#) details, particularly in respect to its particularities and objectives, with examples of [common](#) used [audit](#) clauses. Chapter [III](#) will deal with [the relevant legal rules for licensing agreements, limited to the analysis of English Contract Law and its general principles for contract formation and the intent of the parties.](#) [Special attention will be also given to the Directive 2004/48/EC, the Enforcement Directive, as it specifically deals with the enforcement of intellectual property rights.](#) In Chapter [IV](#), the case [118 Data Resource Limited v IDS Data Services Limited and others](#) [will be dealt with in details, along with two other relevant cases, which are of support to address the matters of an audit clause in depth.](#) Chapter [IV](#) will end up with critical reflections about the presented audit clause case law, with detailed recommendations as to better negotiate and draft an audit clause in a licensing agreement.



## CHAPTER I

### LICENSING AGREEMENTS

#### I.1. Licensing Agreements

Intellectual Property (IP) assets, such as, patents, copyright, industrial design, and trademarks, when not commercially exploited by the owner, may be so by third parties through the acquisition of such assets or the right to exploit them.

Though it is not our intention to discuss the sale and purchase of IP rights herein, it is important to mention that such transactions play an important role in today's economic development. Owners of IP assets usually opt to sell out their assets so that the purchaser may exercise all the exclusive rights in regard to such assets. In the contractual relationship of an assignment, the seller, also called "assignor", transfers all the exclusive rights he has acquired through his invention to the "assignee", or the buyer, and will not have any rights whatsoever in his invention from that time on.

In the event the owner of the IP asset is not interested and/or capable of exploiting its invention/creation, he might opt to permit others to do so. This is when the "licensing agreements" come into place.

Third parties, with the permission of the owner, may commercially explore IP assets. In this scenario, "license" implies the permission granted by the owner of the intellectual property right (IPR's) to another to use it on agreed terms and conditions, for a defined purpose, in a defined territory and for an agreed period of time.<sup>6</sup>

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<sup>6</sup> WIPO Publication No. 906(E). ISBN 92-805-1247-7. *Exchanging value: negotiating technology licensing agreements*. Retrieved from [http://www.wipo.int/export/sites/www/sme/en/documents/pdf/technology\\_licensing.pdf](http://www.wipo.int/export/sites/www/sme/en/documents/pdf/technology_licensing.pdf) - accessed on 23 February, 2015

A licensing agreement may be defined as:

...a form of contractual arrangement between the holder of an IP right (the licensor) to another party (the licensee) who wishes to obtain a legal permission from the licensor, either to operate within the bounds of the licensor's monopoly IP right or perhaps to exploit the licensor's technological innovation which is protected by the licensor's IP.<sup>7</sup>

In more simple words, a licensing agreement may also be defined as:

...simply a permission given by the owner of the relevant intellectual property rights (licensor) to a user (licensee) to do something which the owner could otherwise prevent. At all times, the licensor remains the owner of the licensed intellectual property.<sup>8</sup>

Such a license shall be vested into a contractual relationship, with varied terms and conditions. In some countries, the IP law will prescribe the legal form of the document evidencing a license contract, such as the requirement for the licensor and licensee to sign the contract. It may be also required that a license contract is presented at the IP Office. Yet, in cases where the intellectual property asset are to be licensed is abroad, central bank and/or other governmental authorities may have to review and/or examine the provisions of the licensing agreement for payments in foreign exchange must be made.<sup>9</sup>

## **I.2. Licensing Agreement in More Details**

Every license agreement is unique, reflecting the particular needs and expectations of the licensor and licensee. An infinite variety of agreements are

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<sup>7</sup> Curley, D. (2013). *Intellectual property licenses and technology transfer: A practical guide to the new European licensing regime*, 1<sup>st</sup> ed. Oxford [etc]: Chandos Publishing

<sup>8</sup> Bristows. *IP licensing handbook*. May 2013 ed. Retrieved from <http://np.netpublicator.com/netpublication/n74852309>

<sup>9</sup> WIPO Publication No. 489(E). ISBN 978-92-805-1291-5. *Intellectual property handbook*. 2<sup>nd</sup> ed., pg. 174. Retrieved from [http://www.wipo.int/edocs/pubdocs/en/intproperty/489/wipo\\_pub\\_489.pdf](http://www.wipo.int/edocs/pubdocs/en/intproperty/489/wipo_pub_489.pdf)

possible, limited only by the needs of the parties and by the parameters of the relevant laws and regulations.<sup>10</sup>

The licensing agreement is a contract. As such, legal requirements for a binding and enforceable contract are necessary. For instance, parties must have the legal capacity and intention to enter into the contract. Yet, there has to be an offer and acceptance, among other requirements. [In Chapter III, English Contract Law will be dealt with in more details.](#)

The key aspect in a license agreement is the IPR to be licensed, in which the licensor will grant the licensee the right to use. Depending on the parties' intention, such license may be exclusive, sole or non-exclusive. Sub-licensing the IPR is also possible should the parties wish so.

It is common practice that a licensing agreement involves more than one IP asset. Two or more interrelated patents, for instance, may be the objects of a licensing agreement. Yet, patent or industrial design assets, among others, are usually licensed along with trademark rights.

However, in most countries, IP law is codified specifically to an IP asset – patent, industrial design, copyright, trademark etc. Thus, such licensing agreements with more than one IP assets require specific care and compliance to the several and specific legal diplomas and regimes.

The specifics and limitations of the licensed right are also of relevant importance. If the licensing agreement grants the licensee with exclusive rights, not even will the licensor be able to exploit its own IPR's. If, however, the licensee and the licensor enter into a sole licensing agreement, then, both the licensee and the licensor may exploit the IPR. Yet, if licensing agreements are on the basis of non-exclusiveness of the IPR's, then, besides

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<sup>10</sup> *Supra*, note 6

licensing its IPR's to one licensee, the licensor is still free to license its IPR's to any other interested parties.

The licensee may also have the possibility to sub-license the licensed IPR's to third parties. If this is the case, sub-licensing terms must be agreed upon with the licensor. It is for the benefit of the licensor to agree upon terms that must be prescribed in the future sub-licensing agreement. Because the sub-licensing contractual relationship will be between the licensee and the sub-licensee, the licensor will have little, if any, power in such relationship. Thus, determining what the minimum terms for the sub-licensing agreement must be in the licensing agreement may prevent unwanted use of its IPR's in case of sub-licensing agreements.

In joint ventures and/or merger and acquisitions of the licensee's business, it may be the case that the licensed IPR will be assigned to a third party. Such transaction is also made possible in licensing agreements, as long as licensor and licensee have dully agreed upon. It is common practice, however, that the licensor will prevent the assignment of its licensed IPR for he shall have no control over the assignment terms.

Improvements of the licensed IP asset, if possible, also play an important role in the licensing agreement. Are such improvements allowed? If so, to what extent? Are third parties allowed to jointly work on such improvements? Who will own the IP in the improvements?

The aforementioned aspects of licensing agreements do not aim to explore such topic in depth, though they are relevant in virtually in all licensing agreements. The aim is to provide the reader with insights and to call his/her attention as to the very importance of avoiding simple licensing agreements, which will ultimately lack precise and specific terms to the envisaged contractual relationship of the owner of a specific IP asset, the licensor, and his interested licensee.

### **I.2.1. Main Clauses of a Licensing Agreement**

Generally speaking, a licensing agreement will prescribe what and to whom is licensed, the payment terms, the purpose, in what territory and for how long, and under what conditions, such as warranties, disclaimers, indemnification, the IPR may be exercised.

Some of the main clauses in a licensing agreement would be the following:

- Identification of parties
- Grant or terms of use (extent of rights; limitations)
- Payment terms: fees, royalties, minimum annual payments
- Life of the agreement and termination
- Representations and warranties; disclaimers
- Intellectual property protection; conduct of prosecution
- Audit
- Applicable law; choice of jurisdiction; arbitration/mediation
- Infringement; right to sue
- Indemnity; liability; insurance
- Assignment
- Confidentiality/secretcy
- Miscellaneous: *force majeure*, maintenance, survival on termination, amendments etc.

The aforementioned list of the clauses of a licensing agreement is not complete, nor is it exhaustive. As each and every licensing agreement is unique, parties must manage to add as many clauses as they find fit for the envisaged business relationship.

Nevertheless, it is this author's view that one of the most important clauses in a licensing agreement is the one that prescribes the grant or terms of use (extent of rights and limitations). Thus, such a clause is explained in more details below, without the commitment to explore each and every aspects of this clause, which could be dealt with in a broader and specific research thesis. Yet, special attention will be given to the audit clause in Chapter II, as it is the main research topic of this present thesis.

### **I.2.1.1 Grant or terms of use (extent of rights; limitations)**

This clause seems to be one of the most relevant clauses in a licensing agreement for the scope and the extension of the intellectual property right must be fully prescribed therein, aiming to leave no gaps, which could lead to misinterpretation and/or need to the recourse of court interpretation.

The type of the IP asset of the licensing agreement will guide the parties and contract drafters as to the extension and limits of the IPR, which is being licensed. For instance, if a patent is being licensed, the full and official text of the patent should be annexed to the licensing agreement, with clear and proper mention of the existence of such patent in the grant clause. Yet, the licensor may decide to only grant rights to the licensee in respect to some of the claims contained in the patent, but not to all of them. In such a scenario, the licensor would be exercising his right to limit the licensee's right of use of the patented technology.

The licensed IPR may also be determined in regard to its nature. Will the licensed IPR be of use in personal/private nature? Teaching and/or academic purposes? Non-profit or for-profit organizations? This determination may allow the licensor to enter into other licensing agreements in regard to the same IPR, as long as the nature of its use is different from the one(s) contained in the previous licensing agreements.

Another way of limiting the extension of the IP asset is by agreeing upon a specific length of time and/or geographical restrictions. Not to mention the possibility of limiting the extension of the IPR via determining that the goods manufactured under the IPR has to be made at only one factory, or by imposing quantity restrictions.

In a software licensing agreement, for instance, the licensor may want to limit the licensed rights in a way that the licensee has the right to only use the licensed software, but not to modify it, nor to reverse engineer it. The number of workspaces where the software is to be installed may be also limited by the licensor.

The very quantity and type of limitations of the IPR to be agreed upon the parties will greatly depend on the type of the IP asset to be licensed, the envisaged business relationship and the bargain power of the parties.

### **I.3. Specific Licensing Agreements**

As explained above, if the licensing agreement is related to a patent or a group of patents, parties will need to pay special attention to the very specific requirements to such license. The same is true for Copyright, Trademark, and Know-how and Trade Secret. Specifics to some of these licensing agreements will follow.

#### **I.3.1. Know-how and Trade Secret Licenses**

The first point of precaution in regard to know-how and trade secret licensing agreements is related to the ability of its owner to keep the secrecy of such information. Alexander Poltorak and Paul Lerner argue that the value in this type of intellectual property asset lies in its secrecy and not in the underlying information. “If the secrecy is lost, so too is the value”.<sup>11</sup> Although such statement is arguable at a certain extent, it shows how important keeping the secrecy at all times by its owner is so that the trade secret may be regarded as a valuable asset. One might remind of Coca-Cola’s secret formulation, which has been a

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<sup>11</sup> Poltorak, A. I.; Lerner, P. J. (2004) *Essentials of licensing intellectual property*. Hoboken [etc]: Wiley, pg. 69

successful case of keeping it secret. It may be argued, however, that Coca-Cola would still benefit of its secret formulation after it is revealed, but that certainly would diminish its competitive advantage towards competitors and new entrants.

The secrecy, then, prompts both the licensor and the licensee to agree upon specific and detailed provisions of confidentiality so that the licensed know-how and/or trade secret does not become available to any third parties, nor to the public. Yet, it is for the benefit of the licensor that provisions are agreed upon should the know-how and/or the trade secret become publicly available. The parties should, for instance, carefully consider if the public availability of the know-how and trade secret is a cause for the termination of the licensing agreement, without the prejudice for any of the parties to seek for further damages compensation.

If this is the case for the negotiated licensing agreement, then, parties should start by agreeing upon a clear definition what “public availability” means with the aim of avoiding further misinterpretations and the need to recourse for court’s interpretation.

It is for the benefit of the licensor that the parties shall, then, agree upon certain conditions in which the public availability of the know-how and trade secret will not cause the licensing agreement to terminate and, thus, the licensee must still keep on paying royalties for the licensed rights. For instance, in case the cause for such public availability originated from the licensee in a breach of his confidentiality obligation, besides damages it may cause to the licensor which he may decide to seek for compensation, he will still keep the contractual right to keep on receiving royalties for he was not the one responsible for making such secrets publicly available.

Deriving from the importance of the secrecy aspect of know-how and trade secret licensing agreements, detailed provisions on confidentiality must be present in such a licensing agreement. The licensor shall want the licensed know-how and trade secret to not be



disclosed to anyone else, except to the persons who will directly need such information to commercially benefit from the licensed rights. Such “need-to-know” persons may include the main manufacturing engineer, but not the whole manufacturing team, if the licensed technology is related to a manufacturing process, for instance. Yet, such confidentiality obligations shall survive the termination of the agreement once know-how and trade secrets do not expire in their legal protection validity, as long as secrecy is maintained at all times.

Prescriptions in regard to confidentiality clause shall include, among other things, the minimum necessary measures so that confidentiality of the know-how and trade secret are maintained at all times by the licensee. One might think of confidentiality clause in employment agreements as one of such measures. Yet, documents that contain the know-how and trade secret or related information shall be marked as “confidential” and/or “classified”. It follows that such documents shall be kept at specific locations only, with special protection, whether physical or electronic, such as firewalls and others.

Another important aspect of know-how and trade secret licensing agreements is the capacity of the licensor and the licensee to properly describe the contents of such IP asset, since it is not vested in an official document, such as a patent or trademark register. It is the duty of the licensee to make sure the know-how and trade secret allow him to commercially benefit from the licensed right, whether it is only consolidated through a description document and/or with the support of related materials, such as plans, drawings, specifications, formulas etc.

### **I.3.2. Copyright Licenses**

*It is not an idea but merely a particular expression of the idea that is protected by copyright.<sup>12</sup>*

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<sup>12</sup> *Supra*, note 5

Some types of original expressions that may be protected under copyright law include literary works; musical works; dramatic works, pantomimes and choreographic works; pictorial, graphic and sculptural works; computer software, motion pictures and other audiovisual works; sound recordings; and architectural works.<sup>13</sup>

The first aspect one should keep in mind in regard to copyright licensing agreements is that copyright laws are national in scope. Thus, it is mandatory to check the specifics of the national law pertaining to the envisaged licensed copyright so as to address the appropriate issues and procedures prescribed in such laws.

Yet, it is important to mention that some copyright laws allow the so-called “fair use” of, or “fair dealing” in, copyright works. The “fair use” of, or “fair dealing” in, copyright works relate to purposes such as criticism, comment, news reporting, scholarship or research. Although the “fair use” of, or “fair dealing” in, copyright works may be assessed in a case-by-case way, it will usually involve the analysis as to the purpose and character of use; the nature of the copyright work; the amount and substantiality of the portion used; and the effect of the use on the value of, or potential market for, the copyright work.<sup>14</sup>

The licensing of a copyright work will commonly present certain features, such as the clear and concise definition of the copyright work and rights, the territories in which the license applies, the term of the licensing agreement and the payment terms and conditions (royalty).

The subject matter of the copyright licensing agreement must take into account the full description of the copyright work to be licensed. In such description, limits may or may not play a vital role in exploiting such licensed copyright work. For instance, the copyright work of a motion picture may be licensed only for personal/private use and not to

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<sup>13</sup> WIPO Publication No. 897(E), ISBN978-92-805-1271-7. *WIPO guide on the licensing of copyright and related rights*. Retrieved from [http://www.wipo.int/edocs/pubdocs/en/copyright/897/wipo\\_pub\\_897.pdf](http://www.wipo.int/edocs/pubdocs/en/copyright/897/wipo_pub_897.pdf)

<sup>14</sup> *Supra*, note 7

the public, such as in the cinema. If this is the case, parties should prescribe such limitation in the subject matter of the copyright licensing agreement.

### **I.3.2.1. Publishing Licenses**

A publishing agreement is a license granted to the publisher by the owner of the copyright work. It usually involves the right for the publisher to reproduce and publish the copyright work concerned. It also sometimes involves the reproduction and publication of the translation of the original copyright work.<sup>15</sup>

As far as the translation of the copyright work is concerned, the licensor and the licensee shall agree upon the language or languages of the authorized edition or editions. Yet, parties must agree on the quality issues of the translations, as well as which party will bear the costs of such translation. The licensor may also want to prior approve not only the translation of the entire copyright work, but mainly the translated title.

The distribution of the copyright work is also of importance in publishing agreements. It is for the benefit of the licensor that the licensee bears all costs in regard to the promotion of the publication, as well as makes it continuously available to the public, even if it requires new editions to be printed. [In The Netherlands, by the way, there is a bill pending, which aims at giving higher protection to authors, once they are considered to be the weaker party in publishing agreements. Often, the publisher has the obligation, and not a merely task, to do enough to promote the copyright work and, if failing to do so, author shall seek compensation, without prejudice to other dispute measures.](#)

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<sup>15</sup> *Supra*, note 9

### **I.3.2.2. Computer Software Licenses**

Although some countries' laws allow for computer software to be patented, the discussion here is not about the computer software *per se*, but its use and distribution.

The option to license computer software, rather than selling it, allows the computer software owner to keep ownership of it. And such ownership implies that further licenses of the same computer software may be possible, generating more and more turnover to the owner. Yet, it keeps exclusive ownership of the computer software code and is able to improve it as it wishes.

The growth of the use of computer software and the internet over the law years brought about what is called "Shrink-wrap license agreements" and the "Web-wrap/Click-wrap license agreements", although typical software licensing agreements are still in place, for instance, when businesses are in need of computer software, which is specific to its needs, as well as to the place of use and the number of users.

In the latter case, important issues have to be considered in the software licensing agreement, such as hardware specifications to run the computer software, the grace period after termination of the licensing agreement and warranties for the licensor's responsibility should the software fail.

The "Shrink-wrap license agreements" are the ones where the end-users accept the terms of the licensing agreement by opening the shrink-wrap packaging of the software box or other form of packing of the software. They are very common in retail sales of computer software. Recent trend has also been to display the license in electronic form on the computer before installation of the software.<sup>16</sup>

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<sup>16</sup> *Supra*, note 7

The “Web-wrap/Click-wrap license agreements” are the ones entered into electronically over the internet. Before the software is downloaded or paid, the software licensing agreement is shown and the end-user/licensee has to click on the button “Accept” or “Don’t Accept”.

Following the lessons of the case UsedSoft GmbH v Oracle International Corp C-128/11<sup>17</sup> of the European Court of Justice, it is important to mention that the reselling of software is allowed, as long as the reseller is not using the software at the time of resale. In other words, the reseller has to delete the software copy before it resells it. Thus, the licensor, in a software licensing agreement, is not allowed to restrict resale of its software. The licensor, however, may impose certain prescriptions in the licensing agreement, for instance, that the deletion of the software has to be expressly proven by the licensee in case it wishes to resell the licensed software.

### **I.3.3. Trademark Licenses**

*“A trademark is a distinctive sign, which identifies certain goods or services as those produced or provided by specific person or enterprise. It helps consumers identify and purchase a product or service because its nature and quality, indicated by its unique trademark, meets their needs.”<sup>18</sup>*

The licensee of a trademark right is commonly in pursuit of the commercial and financial benefits in commerce the nature and the quality attached to the specific trademark possesses. As such, the licensor must make sure that he exercises control over the trademark used by the licensee, such as trademark usage and quality control monitoring.

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<sup>17</sup> [UsedSoft GmbH v Oracle International Corp C-128/11](http://curia.europa.eu/juris/document/document.jsf?text=&docid=124564&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=142703). Retrieved from <http://curia.europa.eu/juris/document/document.jsf?text=&docid=124564&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=142703> - accessed on 22 June, 2015

<sup>18</sup> *Supra*, note 4

By trademark usage, one should bear in mind that the licensor may specify the manner in which the trademark will be used on or in connection with the goods and services of the licensee.<sup>19</sup> Yet, special attention must be placed on the advertising and promotional materials. It is common practice that the licensor needs to approve such materials before they are released to the public.

The quality control monitoring is related to provisions that allow the licensor to have access to the licensee's facilities, raw materials, finished products, personnel and records in order to monitor the adherence of the licensee to the licensor's quality standards.<sup>20</sup>

In case the licensing agreement is terminated because of the licensee's inability to maintain the licensor's quality standards, it is for the benefit of the licensor to prescribe that the affected remaining inventory shall not be sold and has to be put away. If the licensing agreement expires due to the regular course of the agreed timing, the licensee may benefit of [clauses, which](#) shall allow him to sell the remaining inventory. It should be of special attention to the licensor, however, that no discounted prices or other similar practices should be applied in those sales as they might adversely affect the nature and the quality of the trademarked products as perceived by the public.

Finally, the licensor must be sure to negotiate and agree upon indemnification clauses from any suits brought by consumers, whether individually or in a class action, originated from injury by a licensed product or service. Sufficient assets must be present in the licensing agreement in specific regard to the indemnification clause. It is also of great importance to insist on clauses for product or service liability insurance policy.

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<sup>19</sup> Trademark licensing. Retrieved from <http://www.inta.org/TrademarkBasics/FactSheets/Pages/TrademarkLicensing.aspx> - accessed on 02 Mar, 2015

<sup>20</sup> *Supra*, note 12

## CHAPTER II

### AUDIT CLAUSE IN LICENSING AGREEMENTS

#### II.1. Audit

Besides financial audit being the most known one, nowadays, several other audits are present in the corporate world. There are IP audits, environmental audits, management audits, forensic audits, data audits, medical audits, technology audits and many others.<sup>21</sup>

Michael Power in *The Explosion of Audit*, brings an interesting thought about audit:

... Audits are needed when accountability can no longer be sustained by informal relations of trust alone but must be formalized, made visible and subject to independent validation.<sup>22</sup>

Yet, as audits seem to be surrounded by fear and skepticism by most professionals, Russell Parr in *Royalties Rates for Licensing Intellectual Property* brilliantly states:

... It must be understood that the use of a royalty audit is not an accusation of fraud, but rather an acceptance of the potential for human error.<sup>23</sup>

#### II.2. Definition of Audit

The Merriam-Webster defines “audit” as:

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<sup>21</sup> Power, M. (2004). *The audit explosion*. London: Demos, pg. 1

<sup>22</sup> *Supra*, note 21

<sup>23</sup> Parr, R. (2007). *Royalties rates for licensing intellectual property*. New Jersey: Wiley

1. a formal examination of an organization's or individual's accounts or financial situation; the final report of an audit – 2. a methodical examination and review.<sup>24</sup>

The noun “audit” is further defined according to [Longman Dictionary of Contemporary English](#) as:

[1. an official examination of a company's financial records in order to check that they are correct; 2. \(formal\) a detailed examination of something in order to check if it is good enough.](#)<sup>25</sup>

[The Oxford English Dictionary](#) also brings a definition of “audit”, in which we find it to be more complete and detailed, as follows:

[... An evaluation \(esp. by formal, systematic review\) of the effectiveness of the management, working practices, and procedures of a company or other professional body, usually conducted by independent auditors or external consultants. Also: the practice of carrying out such investigations at regular intervals or as part of a continuous process.](#)<sup>26</sup>

[It may be inferred from the definitions above that there will be always an examination or review during an audit. Examining and reviewing take into consideration only the contents that are already established. There are no creations and/or modifications in the audited contents while examining or reviewing them.](#)

[As per the audit object, the average person usually thinks of it to be related to financial statements and/or books. This might hold true because the setup of financial statements has long been regulated and subject to government approval. Yet, such statements are the main documents in which tax authorities will look into for tax compliance purposes.](#)

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<sup>24</sup> Britannica dictionary. Retrieved from <http://academic.eb.com/bps/dictionary?query=audit> - accessed on 12 May, 2015

<sup>25</sup> Longman dictionary of contemporary English. Retrieved from [http://www.ldoceonline.com/dictionary/audit\\_1](http://www.ldoceonline.com/dictionary/audit_1) - accessed on 21 June, 2015

<sup>26</sup> Oxford English dictionary. Retrieved from <http://www.oed.com/view/Entry/13035?rskey=qrkBkq&result=1&isAdvanced=false#eid> - accessed on 22 June, 2015



Thus, even before having them strictly examined and reviewed by the tax authorities, many companies have them examined and reviewed by external auditors, not to mention the cases where such external audit is demanded by law.

The purpose of an audit in a contract, however, may not relate only to financial statements or records, though it is of no surprise if it is. The obligations contained in a contract may be the object of an audit as to assess whether they are being complied with or not, either in whole or in part. And the rationale behind this performance audit lays in the fact that late findings that a party is in default with one or more obligations may bring out consequences which are hard to reverse and/or already irreversible. This is the case for the confidentiality obligation, for instance, where once not complied with may cause irreversible consequences to the owner of the confidential information.

It may be concluded, thus that the aim of an audit is to examine or review information and records in order to form a view on whether the information presented reflects the true facts. Credibility on the true facts and/or operations of the organization is what is ultimately sought with an audit.

### **II.3. Intellectual Property Audit**

The IP audit is known as a systematic review of the IP assets owned, used or acquired by a business.<sup>27</sup> Although it is not the subject of this research work, it is important to mention such an audit in a way to differentiate it from the IP Audit brought out by a clause in an IP Licensing Agreement, which will be dealt with in more details below.

An IP audit will help companies assess, preserve, and enhance their IP assets through the systematic review of such assets and related risks and opportunities. An IP audit

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<sup>27</sup> Cockburn, I. *IP audit – A “how to” guide*. Retrieved from [http://www.wipo.int/sme/en/documents/ip\\_audit\\_fulltext.html](http://www.wipo.int/sme/en/documents/ip_audit_fulltext.html) - accessed on 18 May, 2015

may also help correct defects in IPR's, put unused IP to work, identify risks that a company's products or services infringe another's IP, and also help implement best practices for IP asset management. The company's IP-related agreements, policies and procedures, and the competitor's IP may also be part of an IP audit.<sup>28</sup>

The primary goal of an IP audit is to identify what IP assets are owned by the business. If IP assets are not known by the business, it will not manage nor will it protect their IP assets. Such awareness will help the business make decisions as to the IP's protection, development, and eventually licensing and exploitation. Yet, it is also a primary goal to identify innovations, which shall turn out to be a new IP asset.

An IP audit also helps preserve and enhance the value of an existing IPR. When the business becomes aware of their IP assets, they avoid missteps that diminish or destroy them. For instance, to protect inventions by patents or product design, a formal application must be filed. If a patent application for an invention is not filed and/or is filed incorrectly, such invention might not be protected by patent and competitors will have access to it. Yet, chances are that the IP audit also reveals IP assets that the business needs and/or should have so that it can further develop its business or prevent litigation of an alleged infringement of others' IP assets.

Preventing costly disputes may also be an objective of an IP audit. Because IP litigation is usually complex and expensive, an IP audit may help a business anticipate possible disputes and plan successful avoidance and resolution strategies. If it is found during an IP audit that the business' IP assets are conflicting with their competitors, decisions can be made as to options such as designing around, licensing or challenging the competitor's right.

Yet, business transactions may be facilitated and optimized after an IP audit. As an IP audit will provide the business with a current understanding of its IP assets and their

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<sup>28</sup> McCann, C. *IP audits: what are they? why are they important? what do they cost?* Retrieved from <http://www.corporatecomplianceinsights.com/ip-audits-what-are-they-why-are-they-important-what-do-they-cost/> - accessed on 18 May, 2015

estimated value, better decisions can be made in regard to the sale of the company and/or licensing of its IP assets. It is also possible to look for funding for further expansion of the business by way of securing such funding with the IP assets.

In the IP Audit Evaluation Report prepared for the United Kingdom Intellectual Property Office, in which research was conducted among businesses participating in the IP Audit program between November 2011 and March 2013, 95% of the businesses indicated that they received an IP Audit report with recommendations on protecting or capitalizing on the IP.<sup>29</sup>

Some of the summarized findings are worth transcribing, as follows:

- Most businesses (82%) have acted or are acting on recommendations outlined in their reports.
- Actions taken as a result of the IP Audit range from registering trade marks (19%), filing for patents (17%) to introducing non-disclosure agreements (15%).
- Three out of ten (31%) businesses reported that their recommendations identified new business opportunities.
- Furthermore, over four in ten (43%) have identified new opportunities to exploit their IP through initiatives like licensing and franchising.
- While one in six (17%) have been able to secure more business as a result of their IP assets.
- Encouragingly, some businesses are reporting some financial benefits as a direct result of the IP Audit, with around three in ten (28%) indicating that they have seen some financial gain as a result.
- Some businesses also report that funding streams like equity funding (23%) and grant funding (30%) have opened up to their business as a result.<sup>30</sup>

In summary, [the IP audit is a valuable process and may](#) help companies protect, [enhance](#) and/or capitalize on their IP assets.

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<sup>29</sup> Mhonda, J.; Dalziel, D. (2014). *IP audit evaluation*. London: Intellectual Property Office.

<sup>30</sup> *Supra*, note 29

## II.4. Audit Clause in Licensing Agreements

Regardless of the simplicity or complexity of a licensing agreement, an audit clause is not a mandatory one by law and, if present, will fall under the autonomy of the parties.<sup>31</sup>

A licensing agreement, in which no audit clause is present or, when present, is not enforced by the licensor, may be deemed to be a self-reporting agreement as to the obligation of the licensee to report on the amount of royalties to be paid. In other words, it means that the licensor will need to rely upon the licensee's report on the payment of the royalties, without the possibility to challenge such report due to the inexistence of an audit clause.

And it is no surprise that such reports may present unintentional or intentional errors, which will end up in loss of royalties by the licensor, as mistakes frequently happen in the real corporate world.

Yet, it may be the case that the licensee is unable to capture the necessary information to correctly report the due royalties as, for instance, in a large corporation where several departments must be involved in such a reporting process.

Another aspect to be considered, among others, is the poor drafting techniques of the licensing agreement, mainly in terms of the payment of royalties' clauses, where there might be room for misinterpretation or dual and conflicting interpretation. It may be the case that the licensee will report the payment of royalties improperly, unintentionally or intentionally, covered by such bad drafted clauses.

It is, thus for the benefit of the licensor and, ultimately, for the best business relationship of the parties in a licensing agreement that an audit clause should be always

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<sup>31</sup> Private law in general, and contract law in particular, are thought to be the domain of party autonomy. *Mandatory rules in contract law - the draft directive on consumer rights*. Retrieved from <http://www.law.ox.ac.uk/event=10102> - accessed on 18 May, 2015

present, as to enable the licensor to properly and fairly assess whether the licensee is complying with the agreed terms or not.

#### II.4.1 The Audit Clause

A simple audit clause in a Licensing Agreement may read as follows:

Upon reasonable notice, Licensor may examine the Licensee's books, records, and supporting information during Licensee's normal business hours to ensure compliance with this Agreement.<sup>32</sup>

The licensor, owner of the IP asset, based on this audit clause, is primarily looking to assess whether or not his royalties are being duly paid by the licensee under the agreed licensing agreement provisions.

Yet, the licensor may want to assess if the licensee is complying with all the agreed terms in the licensing agreement via an audit clause, as follows:

10.2. Audit and Compliance: ... may audit (using its own employees and those of an independent auditing firm that is subject to appropriate confidentiality obligations) your use of the Licensed Products and Documentation to verify your compliance with this agreement. You agree to give ... (or the auditing firm) reasonable access to your facilities and records for purposes of conducting these audits. ... will give you at least five days advance notice before conducting an audit. Audits will be conducted during normal business hours and no more than once per year, unless ... has a good-faith basis for believing that more frequent audits are warranted. ... will bear all the costs it incurs (including the fees and expenses of the auditing firm, if any) in conducting an audit, unless the audit reveals that you have failed to comply with this agreement in a material way, in which case you agree to reimburse ... for these costs.<sup>33</sup>

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<sup>32</sup> Kirkpatrick, B. *Disguised software audit clauses*. Retrieved from [http://www.scottandscottllp.com/main/disquished\\_software\\_audit\\_clauses.aspx?blogid=154&utm\\_source=Mondaq&utm\\_medium=syndication&utm\\_campaign=View-Original](http://www.scottandscottllp.com/main/disquished_software_audit_clauses.aspx?blogid=154&utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original) - accessed on 18 May, 2015

<sup>33</sup> *End-User software license and maintenance agreement*. Retrieved from <http://www.synopsys.com/Tools/Pages/SoftwareLicenseAgreement.aspx> - accessed on 22 June, 2015

As it may be inferred from the clause above, the licensor aims, via such audit clause, to assess whether or not the licensee is in full compliance with all material provisions of the agreed licensing agreement, including, but not only, the royalties payment.

Both parties go even further as to set details of the audit, such as who will perform the auditing, i.e. the licensor's own employees or an auditing firm, the need for an advanced notice, and who will bear the costs of the audit, even in the case that non-compliance by the licensee is found out during the audit.

It is interesting to note that the parties agree that the audit may be performed by the licensor's own employees and those of an independent auditing firm, with respect to confidentiality obligations of the latter. Such prescription might aim at establishing an independent party in the audit since it may be expected that the licensor's own employees shall perform the audit in a biased way. Yet, audit firms shall bring specialization to the auditing process and both the licensor and the licensee may benefit from it.

The need of an advanced notice also plays an important role in the audit process for the licensee shall need to prepare the access to the facilities and make available documents and records. The licensee's employees may also need to be available for clarifications and/or interviews. Thus, such an advanced notice shall be regarded as an important mechanism for the success of the audit.

Yet, the parties agreed that the licensor would bear the audit costs. An exception is made in case the audit reveal that the licensee has failed to comply with the agreement terms in a material way. The regrettable aspect here is that "material way" is not defined, which may give cause to misinterpretations and misunderstandings among the contracting parties. Will the licensee have to bear the audit costs even if the material incompliance was of minor or even inexistent consequences to the licensee? In what extent will the material incompliance be regarded as to shift the obligation to bear the audit costs?

As a final important note in regard to the above audit clause, the parties should have defined the nature of the documents/records to be made available by the licensee during the audit. In other words, are the confidential, non-confidential or both types of documents/records to be made available during the audit? The contracting parties should have addressed these issues in a way of more detailed express terms in order to try avoiding future disputes.

In another software licensing agreement, one may also find an audit clause as follows:

9.7 Audits. Licensee agrees that ... has the right to require an audit (electronic or otherwise) of the ... Materials and the Installation thereof and Access thereto. As part of any such audit, ... or its authorized representative will have the right, on fifteen (15) days' prior notice to Licensee, to inspect Licensee's records, systems and facilities, including machine IDs, serial numbers and related information, to verify Licensee's Installation of and Access to the ... Materials. Additionally, within fifteen (15) days of the audit request, Licensee will provide to ... all records and information requested by ... in order to verify Licensee's Installation of and Access to the ... Materials. Licensee will provide full cooperation to enable any such audit. If ... determines that Licensee's Installation of or Access to the ... Materials is not in conformity with the applicable agreements or terms of service, Licensee will obtain immediately and pay for valid license(s) to bring Licensee's Installation and Access into compliance and pay the reasonable costs of the audit. In addition to such payment rights, ... reserves the right to seek any other remedies available at law or in equity.<sup>34</sup>

As noted above, an audit clause may be a simple or a complex one. It will ultimately fall upon the parties' will as per their envisaged business relationship and its nature, which will or will not require complex terms for the licensing agreement. The bargaining power of the contracting parties may also define how simple or complex an audit clause will be.

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<sup>34</sup> *License and services agreement*. Retrieved from <http://download.autodesk.com/us/FY16/Suites/LSA/en-US/lsa.html> - accessed on 19 May, 2015

In Chapter [IV](#), the peculiarities of the audit clause in a licensing agreement will be discussed in more details, having as a reference the interim decision of the case 118 Data Resource Limited v IDS Data Services Limited and others<sup>35</sup>.

#### **II.4.2 The Audit of the Licensee**

Dependent upon the wording of the audit clause, the audit of the licensee will generally focus to establish that the licensee is complying in full with the agreed terms of the licensing agreement. It may be the case, however, that only the correct payment of royalties will be audited, if this was the intention of the contracting parties.

Although an audit in a licensing agreement may result in a report which is negative for the licensee, such as in the case that it becomes clear that royalties were underreported, the licensee may also harvest the benefits of an audit, should the case be that the report show that he is complying properly and in full with the terms of the licensing agreement. In such a scenario, both the licensor and licensee will have shown that they have been working towards fair collaboration to strengthen their business relationship.

For the licensor, seeking to constantly maximize the value of the licensed IPR's is mostly made possible via the audit of the licensing agreement. Yet, he may also bring comfort and protection internally that the IP assets of the company are being properly taken care of and protected. External stakeholders may also show comfort by realizing that the company proactively seeks to protect its IP assets, not to mention that, via the audit, the company is also sending a message to all its licensees that it takes its IP assets and their income very seriously.

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<sup>35</sup> *Supra*, note 5



Methodologically speaking, the audit of the licensee may be of a proactive or reactive nature. As the words suggest, a proactive audit is the one that is initiated by the licensor, under the terms of the audit clause, without any suspicion of any faults committed by the licensee. On the other hand, the reactive audit is the one, which is also initiated by the licensor, but based on a suspicion and/or the confirmation that any of the agreed terms of the licensing agreement is not being complied with. Such reactive audit will focus on the alleged and/or confirmed suspicion and, depending on the wording of the audit clause, may also be a reason for further and more detailed examination of the licensing agreement in general by the licensor.<sup>36</sup>

While ancillary rights of the licensor shall also be the focus of an audit clause, such as the proper use of its trademark and copyrights, confidentiality obligations and others, issues related to the correct payment of royalties shall also be present in such a clause. And, as noted above, the incorrect payment of royalties may be a result of an intentional act, but also of an unintentional one. As such, regular audits in licensing agreements shall help licensors to capture eventual royalty losses generated by incorrect royalty reports.

The example below makes it clear how important a licensing agreement audit is for both the licensor and the licensee:

Working together with our client, a Fortune 500 corporate brand owner, we conducted a royalty audit of its licensee, an international toy manufacturer, to ensure the licensee was performing and reporting according to the terms of its license agreement. Beanstalk determined that the licensee had not complied with certain terms of the license agreement. We worked closely with the licensee to manage the negotiation of the settlement amount and terms, and executed an audit settlement agreement that benefited both parties involved and helped improve communication between the brand owner and the licensee. Audits findings included:

- Underreported sales for certain SKUs<sup>37</sup> on royalty reports

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<sup>36</sup> Wright, J. T.; Bone, J. R. *Auditing self-reporting agreements*. Retrieved from <http://www.srr.com/article/auditing-self-reporting-agreements> - accessed on 20 May, 2015

<sup>37</sup> [SKU is a warehousing item that is unique because of some characteristic \(such as brand, size, color, model\) and must be stored and accounted for separate from other items. Every SKU is assigned a unique identification](#)

- Application of incorrect contractual exchange rate resulting in underpaid royalties
- Delinquent royalty payments
- Sale of products in unlicensed territories
- **Total Audit Findings: \$1.7 million.**<sup>38</sup>

It is virtually impossible to think of a complete list of findings in an audit report due to the very unique nature of IP assets and the business relationship of the parties. It is, however, possible, to address some of the most common ones, such as: misinterpretation of the agreement, clerical errors, improper deductions from gross sales, unaccounted for returns, unapproved discounts, incorrect royalty rates, misallocation of sales price among bundle products, missing inventory, untimely reports and more, many more.<sup>39</sup>

In order to understand how a license audit is usually performed, we will not consider any specific audit clauses, but deal with a general overview of the necessary steps in auditing the licensee as per its compliance to the terms of the licensing agreement.

Ideally speaking, an audit executed on the basis of a licensing agreement should start with a planning. What are the IP assets involved in the license? How does their nature, such as patented product or process, trademark, database rights etc, affect the audit? Who will perform the audit? Will it be performed by the licensor employees or by third parties? What documents and records must be made available? What sites shall be visited? Who must be interviewed? And so on.

By properly answering those questions, an audit plan will be in place as to guide the necessary steps in order to perform the audit at its best result possible.

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number (inventory or stock number). Retrieved from <http://www.businessdictionary.com/definition/stock-keeping-unit-SKU.html#ixzz3dpdZSOQE> - accessed on 22 June, 2015

<sup>38</sup> *Implementing an auditing program that not only improves cash flow, but also enhances the relationship between brand owner and licensee.* Retrieved from <http://www.beanstalk.com/brands/brand-extension-examples/licensee-audit-case-study/> - accessed on May 22, 2015

<sup>39</sup> *Supra*, note 36

Following the planning, the licensor and the licensee shall coordinate the details of the audit by way of communicating to one another, aiming for a smooth and fair audit process from the start to the end.

The development of the audit *per se* will involve the representatives of both the licensor and the licensee and, usually and if allowed by the audit clause, third parties who are specialist in such audits. Depending on the very nature of the licensing agreement and the IP asset, documents pertaining to the business operations of the licensee will be [assessed](#), as well as sites, either office or manufacturing plant, as the case may be. In certain circumstances, even interviewing employees of the licensee will be needed in order to better cover the relevant facts of the license.

It may also be necessary to inspect the premises of third parties related to the licensee, as well as to interview its employees, as it is in the case, for instance, when the licensee has outsourced its obligations under the licensing agreement.

The result of the fieldwork of the audit will be the audit report. The final audit report will detail the assessment of the licensing terms in the perspective of the licensee's obligations and shall a) render a conclusion that the licensee is in full and/or partial compliance with the licensing agreement terms; b) recommend adjustments to the terms of the licensing agreement in case inaccuracies were found to be a result of misinterpretation of the said terms; and eventually c) propose amicable settlement terms if it was found that the licensee was in partial compliance or non-compliant at all to the licensing agreement terms.

As the audit of the licensing agreement is mostly [a right of](#) the licensor, the licensee, while negotiating the licensing agreement, will seek to impose to the licensor the obligations to cover the overall costs of the audit. Although it is open for the parties to negotiate, such audit costs, which are even higher if an auditing firm and/or professional is involved, may place an extra cost to the licensor, which will ultimately diminish its profits for

the licensing agreement. Here, the bargaining power of the parties will play an important role as to who must bear the audit costs.

In the event that the licensor must bear the costs of the audit, the licensor usually imposes to the licensee the obligation to pay for it should the audit reveal that the licensee's report of payment of royalties is inaccurate and has caused losses to the licensor. Again, the bargaining power of the parties will play an important role as to whether thresholds of inaccuracies will be present in such audit clause in a way that the obligation to cover the overall costs of the audit will shift from the licensor to the licensee. For instance, a 5% (five per cent) underreporting payment of royalties may not be a cause for the shifting of the obligation to pay for the audit costs. However, parties may still agree that, even in the event of a low rate of inaccuracy, such as the 5% (five per cent) one, the licensee will bear the overall costs of the audit in case of repeated underreporting.

To better understand the issue of bearing the costs of the audit and its eventual shifting in obligation, the part of the audit clause that refers to its costs shall read as follows:

“If any examination or audit by licensor discloses that amounts due for the period exceeded those reported by more than (–) percent, licensee shall pay the cost of such examination in addition to the amounts due disclosed by the examination or audit.”<sup>40</sup>

Following, in Chapter [III](#), will turn to the analysis of the legal aspects of the IP licensing agreements, in the perspective of [English](#) Contract Law and the Directive 2004/48/EC, as to build the minimum grounds for the assessment of the case 118 Data Resource Limited v IDS Data Services Limited and others<sup>41</sup> in Chapter [IV](#).

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<sup>40</sup> Bower, D. *Your licensor contractual audit rights*. Retrieved from <http://www.rbz.com/news-category/the-bottom-line/your-licensor-contractual-audit-rights/> - accessed on 23 May, 2015

<sup>41</sup> *Supra*, note 5

## CHAPTER III

### LEGAL RULES IN LICENSING AGREEMENTS

#### III.1. Legal Overview

As mentioned in Chapter I, licensing agreements are contracts, in which the owner of the IP asset (licensor) grants rights to the party interested in exploiting such asset (licensee). As such, it is important to have a brief understanding of the law applicable to the licensing agreements, i.e., contract law so that they are valid and ultimately enforceable, if necessary.

English<sup>42</sup> Contract Law is the one to be looked upon in this research work due to its relevance for the analysis of the case *118 Data Resource Limited v IDS Data Services Limited and others*<sup>43</sup> in Chapter IV, which is being handled by UK court. [Moreover, English Law is often the law of choice between international contracting parties.](#)<sup>44</sup> It is not, however, our intention to provide the reader with a deep analysis of UK Contract Law, but with the minimum contract law principles and general rules so as the executed licensing agreement does not encounter validity issues when challenged at UK courts. [In other words, an invalid contract and/or clause shall preclude a party seeking to enforce or rely on it from doing so in whole or in part.](#)<sup>45</sup>

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<sup>42</sup> “English law” is the law of the jurisdiction of England and Wales.... . in relation to private law one should not speak of “British” law of contract, or the law of the United Kingdom. Cartwright, John. *Contract Law: An Introduction to the English Law of Contract for the Civil Lawyer*. Oxford: Hart Publishing Ltd, 2<sup>nd</sup> ed., pg. 3

<sup>43</sup> *Supra*, note 5

<sup>44</sup> [In a 2010 international arbitration study by The School of International Arbitration, Queen Mary, University of London, 40% of 136 respondents used English law most frequently, followed by New York law 17% \(22% if combined with other non-specific US law\), and Swiss law 8%: 2010 International Arbitration Survey: Choices in International Arbitration.](#)

<sup>45</sup> [International and comparative law quarterly. Volume 23. Issue 01. January 1974.](#) Retrieved from <http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=1498208> - accessed on 22 June, 2015

It is also important and relevant to look upon the Directive 2004 / 48/ EC (Enforcement Directive), as it pertains to the enforcement of IPR's within the European Union. If a license agreement is valid, but one of the parties does not comply with its terms and is not willing to amicably do so, the other party will have as its only resource to seek enforcement at court.

The preamble of the Enforcement Directive states that:

...without effective means of enforcing intellectual property rights, innovation and creativity are discouraged and investment diminished. It is therefore necessary to ensure that the substantive law on intellectual property, which is nowadays largely part of the *acquis communautaire*<sup>46</sup>, is applied effectively in the Community. In this respect, the means of enforcing intellectual property rights are of paramount importance for the success of the internal market.<sup>47</sup>

Special attention will be given to Articles 6 and 7, as they may be of paramount support in obtaining evidence, which is ultimately the aim of the audit clause, before courts in the United Kingdom.

Yet, according to the Article 2(1) of the Enforcement Directive, it is important to mention that the Directive shall be applicable to any cases of (alleged) infringement, regardless if the (alleged) infringer has or does not have a license.<sup>48</sup> Thus, its broad application for IP matters justifies the importance to look more closely into it in respect of the audit clause.

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<sup>46</sup> Also known as The Community *acquis*, it is the body of common rights and obligations, which bind all the Member States together within the European Union. Applicant countries have to accept the Community *acquis* before they can join the Union. To integrate into the European Union, applicant countries will have to transpose the *acquis* into their national legislation and implement it from the moment of their accession.

<sup>47</sup> Directive 2004 / 48 / EC on the enforcement of intellectual property rights, Preamble (3).

<sup>48</sup> Without prejudice to the means which are or may be provided for in Community or national legislation, in so far as those means may be more favorable for rightholders, the measures, procedures and remedies provided for by this Directive shall apply, in accordance with Article 3, to any infringement of intellectual property rights as provided for by Community law and/or by the national law of the Member State concerned. Article 2(1) of the Directive 2004 / 48 / EC on the enforcement of intellectual property rights.

## III.2. English Contract Law

Contract law is related to the enforcement/execution of promises made by the contracting parties. As a contracting party and/or a lawyer, you must [know and be able to apply](#) the obligatory elements [of a contract so](#) that an agreement/contract [will be](#) ultimately enforceable at courts, [if needed be](#).

[In case](#) one or more obligatory elements [of a contract](#) are missing, a court may find the promises made by the contracting parties not enforceable. [Thus](#), the parties [shall be left](#) without any further [alternatives, but to have to accept](#) the [potential negative](#) consequences suffered by the non-performed promises.<sup>49</sup>

The obligatory elements of a contract under English Contract Law are: Offer and Acceptance (Contract Formation), Formalities, Intent to Create Legal Relations (Contractual Intention), and Consideration.<sup>50</sup>

Yet, a brief look into the legal aspects of the content of contracts is also of relevance, considered the scope of this research work. While negotiating, drafting and interpreting an audit clause in licensing agreements, special attention has to be given to the Express and Implied Terms, as it will be discussed below.

### III.2.1. Contract Formation: Offer and Acceptance

#### III.2.1.1. Offer

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<sup>49</sup> MacMillan, C.; Stone, R. *Elements of the law of contract*. Retrieved from [http://www.londoninternational.ac.uk/sites/default/files/programme\\_resources/laws/ug\\_subject\\_guides/elements\\_law\\_contract-subjectguide4chapters.pdf](http://www.londoninternational.ac.uk/sites/default/files/programme_resources/laws/ug_subject_guides/elements_law_contract-subjectguide4chapters.pdf) - accessed 27 May, 2015

<sup>50</sup> McKendrick, E. (2012). *Contract law: Text, cases, and materials*. Oxford: University Press, 5<sup>th</sup> ed.

An offer is a manifestation of will to contract on indicated terms, made with the intention that it is to be binding once accepted by the person to whom it is addressed.<sup>51</sup> There must be an objective manifestation of intent by the offeror to be bound by the offer if accepted by the other party. Therefore, the offeror will be bound if his/her words or conduct are such as to induce a reasonable third party observer to believe that he intends to be bound, even if in fact he has no such intention.<sup>52</sup>

Besides expressing a willingness to be bound, an offer must also describe what the parties to the agreement are meant to do or not do. Before a court can make an order of specific performance or an order to pay damages, for instance, it must be able to determine what it is that the defendant agreed to do.<sup>53</sup>

An offer must be distinguished from an invitation to negotiate, by which a person does not make an offer *per se* but invites another party to start discussions with the aim of an eventual future agreement among them. Whether a statement is an offer or an invitation to negotiate depends predominantly on the intention with which it is made. An invitation to negotiate is not made with the intention that it is to be binding as soon as the person to whom it is addressed communicates his assent to its terms. For instance, displays of goods on a shelf in a self-service store are deemed to not be an offer. The customer will ultimately make an offer to buy the goods and the trader will decide if he will accept the offer or not.

The death of the offeror or of the offeree, as well as the lapse of time are causes in which the offer may be deemed terminated. It should be noted, however, that, if not explicit expressed in the offer, the circumstances shall determine what a reasonable time period is.

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<sup>51</sup> Stover v Manchester City Council [1974] 1 WRL 1403

<sup>52</sup> Moran v University College Salford (No 2), The Times, November 23, 1993

<sup>53</sup> Smith, S. A. (2005). *Atiyah's introduction to the law of contract*. Oxford: Clarendon Press, 6<sup>th</sup> ed., pg. 42



The termination of the offer may also take place if the offeror revokes the offer before the offeree accepts it or if the offeree responds to an offer by making an offer on different terms, i.e. a counteroffer. This is to say that by counter-offering on different terms, the offeree is no longer in the position to accept the original offer and he becomes the offeror.

### **III.2.1.2. Acceptance**

An acceptance is a final and unqualified expression of consent to the terms of an offer. As it is the case for an offer, there must be an objective manifestation, by the recipient of the offer, of his intention to be bound by its terms. The offeree must accept the offer in its identical terms if it is to form an agreement. To be valid, an acceptance must be communicated to the offeror.

Anything that shows to the offeror the offeree's unequivocal assent is sufficient: it can be words or conduct, including starting to perform the contract in circumstances the offeror can reasonably infer that it is on the basis of the proposed terms. Courts will not, however, infer acceptance from silence, nor from words or conduct of the offeree, which are not communicated to the offeror.<sup>54</sup>

An acceptance is also made possible by post. Postal acceptance takes effect when the letter of acceptance is posted.<sup>55</sup> This is also the case even if the post is destroyed, lost or delayed.<sup>56</sup> It must be noted, however, that if the offer stipulates the way the acceptance has to be communicated, acceptance may only be accepted for its legal effects in that way.

A communication will not take effect as an acceptance if it attempts to vary the terms of an offer. In such cases it will be deemed as a counter-offer, which the original offeror may either accept or reject. Making a counteroffer is regarded as a rejection of the original

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<sup>54</sup> *Supra*, note 50

<sup>55</sup> *Henthorn v Fraser* [1892], 2 CH 27

<sup>56</sup> *Adams v Lindsell* [1818] 1 B & Ald 681

offer, which cannot afterwards be reestablished or accepted (unless the parties agree so). Yet, a mere request for further information regarding the original offer is not a counter-offer.

Considered an offer has been duly accepted, the parties have an agreement, which is the basis for a contract. However, such agreement is not sufficient to create legal obligations, as it still lacks the other obligatory elements of a contract.

### **III.2.2. Formalities**

The general rule is that no formalities are required for the creation of a contract in English Law. In other words, a contract may be created through writing, verbally, through conduct, via electronic communication<sup>57</sup>, or by a combination of these.<sup>58</sup>

Some exceptions apply to this general rule, such as: real state sales, agreements to pay someone else's debts, real state leases for longer than one year, among others.

It is always wise, however, to have a contract in writing to ensure that parties understand their obligations. Yet, if court enforcement is required, a written contract may better indicate the parties' obligations and possibly avoid the judge having to solely rely on oral allegations of the contending parties.

### **III.2.3. Intent to Create Legal Relations (Contractual Intention)**

In order to create a valid and binding contract, the parties must have had an intention to create legal relations. This rule, however, does not generally give rise to any difficulties in the context of commercial transactions, because the courts presume that the

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<sup>57</sup> Electronic communications are valid as any other type of communication. This was confirmed by the EU Directive on Electronic Commerce, which requires Member States to allow contracts to be made by electronic means and which was implemented in the UK by the Electronic Communication Act 2000.

<sup>58</sup> *Supra*, note 50

parties to a commercial agreement do intend to create legal relations. Such presumption is not an irrefutable one, but it is not an easy one to invalidate. Clear evidence is required in order to do so (*Edwards v. Skyways Ltd* [1964] 1 WLR 349, 355).<sup>59</sup>

This doctrine of intention to create legal relations plays its most important role in the context of domestic and social agreements. As they are not the objects of this research work, no further analysis will be made in this regard.

### **III.2.4. Consideration**

Consideration is an indispensable element of a legally binding contract. In order to enforce a contract under English law, courts will assess the bargain reached between the parties in regard to their exchange of promises, which must have economic value, and has to be exchanged by each of the parties. In other words, it is a thing, which has value in the eyes of the law or a promise to do something. This reciprocity is essential to contracts in English law. Thus, there is an advantage to and an encumbrance for each party entering into a binding contract. The advantage of the contract for one party is the encumbrance of the other.<sup>60</sup>

Where this reciprocity is not present, a legally binding contract may not be formed. Yet, contracts may be supported by small consideration, such as € 1.00. In such a circumstance, courts shall look for consideration for a promise, instead of assessing the commercial merits of the contract<sup>61</sup>. Nominal consideration is sufficient.

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<sup>59</sup> *Supra*, note 49

<sup>60</sup> *Contractual consideration*. Retrieved from <http://www.drukker.co.uk/publications/reference/contractual-consideration/#.VWx-NIyeDGc> - accessed on 01 June, 2015

<sup>61</sup> There are a few exceptions, for example, where certain terms of a contract are void either by statute (for example, tenancy agreement) or where common law holds the terms to be so unreasonable that they cannot be enforced and/or are varied by the courts.

Consideration may be classified as executed or executory. The later is related to made promises, which were not yet performed. The former is a consideration, which has been already provided by the party promising it.

The element of consideration cannot be found in a past consideration. Consequently, a consideration is only valid if it is fresh, i.e. at the time the contract is formed. Nor is an existing obligation or duty a consideration. In other words, if the promisor is already obliged to do something, such as an existing obligation, it is not deemed to be a consideration. Yet, the lack of economic value, such as gratuitous promises, charitable gifts, or promises of sentimental or moral value is not consideration. It has to be real or sufficient in the sense that it has economic value. And finally, except from some particular exceptions, part payment of debts are not consideration under English Law either.

### **III.2.5. Express and Implied Terms**

Contracts, in general, contain both express and implied terms. The express terms are the words that are used by the parties in order to record what their agreement is. The implied terms are the ones that are implied by fact, by law or by custom or usage.

Stephen A. Smith in Atiyah's Introduction to the Law of the Contract states that:

“... in the conventional understanding, the law of implied terms deals with those aspects of contracting parties' basic or primary obligations that cannot be directly explained by the contract's express terms. Thus, a vendor's obligation to provide goods of 'satisfactory' quality is explained on the ground that section 14(2) of the Sale of Goods Act 1979 implies such a term into all contracts of sale...”.<sup>62</sup>

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<sup>62</sup> *Supra*, note 53

One of the important issues to consider in express terms is related to the words the parties used and their proper meaning. Courts usually assess the meaning of the words taking into consideration how a reasonable person would have understood them.<sup>63</sup>

Most importantly, however, are the issues related to the express terms of another document, in which reference is made to in a contract. For instance, parties may expressly refer that the rules of any given standards are applicable to their business relationship. In such an event, the standard rules may conflict with the express terms agreed upon by the parties in the contract. If that is the case, courts will usually, and where possible, give primacy to the terms actually drawn up by the parties for they represent their predominant intention.<sup>64</sup>

A term implied in fact is the one that was not expressly used by the parties, but which the parties must have intended to include, as per the court's view. They are usually referred as "so obvious that it goes without saying". The implied term in fact, however, has to be obvious to both parties. Yet, such implied term is often said that it must be "necessary to give the transaction such business efficacy as the parties must have intended".<sup>65</sup>

The contract terms may also be implied by law or legislation. Clear examples of those are the implied terms related to minimum wage, holidays etc, in employment contract legislation. Even if parties decide to not include them as express terms, courts will apply them while enforcing the employment contract. The same is true for consumer contracts, sales of goods, among many other legal disciplines.

The terms implied by customs or usages rely on the fact that a local custom exists and is generally regarded as being associated with such contracts. It is important to highlight that such custom or usage has to be reasonable, certain and notorious. In *Hutton v*

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<sup>63</sup> *Eyre v Measday* [1986] 1 All ER 488; *Thake v Maurice* [1986] QB 644

<sup>64</sup> *Adamastos Shipping Co Ltd v Anglo-Saxon Petroleum Co Ltd* [1959] AC 133

<sup>65</sup> Treitel, G. H. (2004). *An outline of the law of contract*. Oxford: University Press, 6<sup>th</sup> ed., pg. 71

*Warren* 1836, a term that was not expressly stated in the contract was held to be implied to exist because of the well-known agricultural custom in the area.<sup>66</sup>

As a closing and important remark in regard to express and implied terms, if there is an implied term which conflicts with an express term, the express term will normally override the implied term. However, if the term is implied by statute, law or court decision in common law, the implied term will override the express term agreed by the parties.<sup>67</sup>

In Annex 1, a summary with definitions and examples of express and implied terms of a contract are shown through a flowchart.

### **III.3. Directive 2004 / 48/ EC - Enforcement of Intellectual Property Rights**

The scope of the Directive 2004 / 48 / EC (Enforcement Directive) is of broader procedural application and applies to all intellectual property litigation. It aims to increase the position of IPR holders when they need to enforce their rights in civil proceedings, and to obtain a minimum level of harmonization between the civil procedures available in the Member States of the European Union. The Enforcement Directive applies only to civil proceedings; enforcement of criminal proceedings and penal sanctions are left to the individual Member States.<sup>68</sup>

Articles 6 and 7 of the Enforcement Directive are of specific importance to the IPR holders and for parties in a license agreement. These Articles address the issue of proof/evidence and introduce measures for obtaining and preserving them.

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<sup>66</sup> *Contract law – Express and implied terms*. Retrieved from <https://quizlet.com/11739781/contract-law-express-and-implied-terms-flash-cards/> - accessed on 02 June, 2015

<sup>67</sup> *Supra*, note 65

<sup>68</sup> Coulson, N.; Paris, C. M.; Schlötter, R. *The impact of the European enforcement directive: A new regime for gathering and preserving evidence?* Retrieved from [http://www.jonesday.com/files/Publication/6fc58417-8bc7-4b51-a761-5bae370d3a45/Presentation/PublicationAttachment/bda093f9-cb3c-45d1-9d3e-6a5131958a96/European\\_Enforcement.pdf](http://www.jonesday.com/files/Publication/6fc58417-8bc7-4b51-a761-5bae370d3a45/Presentation/PublicationAttachment/bda093f9-cb3c-45d1-9d3e-6a5131958a96/European_Enforcement.pdf) - accessed on 02 June, 2015

It has to be noted, however, that [the implementation of the key aspects of Articles 6 and 7 of the Enforcement Directive by the UK was actually not necessary](#) due to the fact that English procedural law already has a general disclosure process, and particular procedures in intellectual property lawsuits, as follows.

The UK Civil Procedure Rules (“CPR”), in Part 31, obliges the plaintiff and/or the defendant to disclose documents, which are relevant to the lawsuit and are in their possession. It means that the main elements of Article 6 of the Enforcement Directive are already accounted for in the UK. Thus, the obligation to disclose documents in UK IP lawsuits continues broader than the one prescribed by the Enforcement Directive and is a normal and compulsory practice as a matter of course in each lawsuit.

In order to illustrate the above, it is important to refer to CPR, Rule 31.6:

Standard disclosure – what documents are to be disclosed

31.6 Standard disclosure requires a party to disclose only–

- (a) the documents on which he relies; and
- (b) the documents which –
  - (i) adversely affect his own case;
  - (ii) adversely affect another party’s case; or
  - (iii) support another party’s case; and
- (c) the documents which he is required to disclose by a relevant practice direction.

Yet, the plaintiff is able to obtain pre-lawsuit disclosure in case he can demonstrate it is appropriate for fairly disposing of anticipated proceedings (CPR, Rule 31.16). Moreover, disclosure is also possible against a third party not involved in the lawsuit, as established in the case *Norwich Pharmacal Co. v The Commissioners of Customs and Excise* [1974] RPC 101 and present in the CPR, Rule 31.17.<sup>69</sup>

In regard to IP cases, UK law brings further specific rules that define the scope of disclosure, and present a more established and accessible structure for a party to access key

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<sup>69</sup> *Supra*, note 68

documents than that prescribed by the Enforcement Directive. CPR, Part 63 PD, para. 5.1 provide patentees, for instance, with really advantageous rules in infringement cases. To start with, the alleged infringer may be ordered to provide a full product and/or process description of the alleged infringement, which has to be accompanied by a representative who is made available for cross-examination.<sup>70</sup>

In process claims, i.e., when the patent is related to a product process, but not to the product itself, the court may immediately order an inspection at a defendant's premises (or other appropriate venue), and usually accompanied by the judge. Further, according to CPR, Rule 31.12, there is the possibility, also present in Article 6 of the Enforcement Directive, to seek a court order for specific disclosure of any documents that the petitioning party supposes to be in a party's control that would contribute [to the merit of the pending case](#) and that have not been disclosed yet.

In regard to Article 7 of the Enforcement Directive, which contemplates the possibility to safeguard evidence, the case *Anton Piller KG v Manufacturing Processes Ltd* [1976] Ch 55 in the UK has long provided parties with the ability to seek a court order for search-and-seizure. It has to be noted, however, that a legitimate concern that the evidence may be destroyed is a pre-requisite for such an order to be granted.

Yet, section 37 of the Supreme Court Act 1981; section 38 of the County Courts Act 1984; and CPR, Part 25 provide the courts with the general power to grant an injunction in order to preserve evidence. The other requirements of Article 7 of the Enforcement Directive relating to, for instance, *ex parte* hearings and notifications are also present into CPR, Parts 23 and 25 (including PD).<sup>71</sup>

It may be concluded then, that UK law and case law have long implemented Articles 6 and 7 of the Enforcement Directive. And not only that, but as explained above, UK

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<sup>70</sup> Technip France SA's Patents [2004] RPC 46

<sup>71</sup> *Supra*, note 68



law is relatively broader in scope than Articles 6 and 7 of the Enforcement Directive, and provides extensive possibilities for obtaining, protecting, and preserving documents and/or other evidences, which may be of important relevance to IP lawsuits.

## CHAPTER IV

### 118 DATA RESOURCE LIMITED V IDS DATA SERVICES LIMITED<sup>72</sup>

#### IV.1. Summary of the Dispute

The Claimant (“118”) applied for summary judgment for specific performance of clause 4.7 of an agreement with the First Defendant (“IDS”). 118 and IDS are business competitors who entered into an agreement for sharing information and have now ceased to be dealing with one another on friendly terms. 118’s business includes the sale and licensing of its database of contact details of businesses in the UK (“the Database”). IDS’s business also includes the sale and licensing of contact details of businesses in the UK. The Second Defendant, Mrs. Macfarlane, is a director of IDS. The Third Defendant is an employee or former employee of IDS who is not a party to the current application.<sup>73</sup>

118 granted a written license to IDS for limited use of the Database, including a limited right to grant sublicenses (“the Agreement”) on 1st April 2009. Except as to the original fee, the Agreement was renewed for three more years on the same terms as previously on 22 February 2012.

It seems that 118 wanted to guarantee that IDS as a business competitor did not surpass the terms of the limited license. In order to do so, 118 aimed to have some form of policing of IDS’s business by way of an audit clause. IDS, on the other hand, wanted to be sure that 118 did not act unrestrictedly while gaining access to its knowhow while monitoring the Agreement performance.

Clause 4.7 prescribes as follows:

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<sup>72</sup> [Supra, note 5](#)

<sup>73</sup> *Supra*, note 5

"[IDS] undertakes and agrees with [118] that it will ... permit any duly authorized representative of [118] on reasonable prior notice to enter into any of its premises where any copies of [the Database] are used, for the purpose of ascertaining that the provisions of this Agreement are being complied with."

The issues before the court are as follows:

1. On its true construction, what rights are conferred by clause 4.7?
2. Is the construction sufficiently clear for summary judgment?
3. If clause 4.7 is construed as 118 submits, should 118 be granted specific performance?
4. If clause 4.7 is construed as 118 submits but an order for specific performance would cause hardship, should the court instead make an order for early disclosure?
5. The form of any order.<sup>74</sup>

118 is seeking a mandatory injunction by way of interim relief in the alternative. 118 is also claiming copyright and database rights, but only the matter of contract law is considered.<sup>75</sup>

This case is still ongoing and seems to be complex as it involves alleged infringement of several IPR's, such as database rights, copyright and confidential information, as well as issues related to breaches of the terms of the IP license.

## **IV.2. The Disputed Audit Clause**

The Audit Clause in the License Agreement between 118 and IDS reads as follows:

"[IDS] undertakes and agrees with [118] that it will ... permit any duly authorized representative of [118] on reasonable prior notice to enter into any of

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<sup>74</sup> *Supra*, note 5

<sup>75</sup> *Supra*, note 5

its premises where any copies of [the Database] are used, for the purpose of ascertaining that the provisions of this Agreement are being complied with.”

First, it is important to mention that none of the parties in the dispute alleged issues in regard to the construction of the agreement, i.e., originated from the Offer and Acceptance (Contract Formation), Formalities, Intent to Create Legal Relations (Contractual Intention), and Consideration.

As a brief note, however, the judge Mr. D Halpern QC stated that:

“Where commercial entities enter into an agreement, the court will strive to give it a meaning and not hold it void for uncertainty. This application of the maxim *ut res magis valeat quam pereat*<sup>76</sup> applies with particular force where the agreement is a detailed written agreement between two commercial entities that was plainly intended to have binding effect.”<sup>77</sup>

As 118 and IDS had divergent interpretation in regard to the audit clause, express and implied terms also play an important role in this case.

In the case *Liverpool City Council v Irwin* [1977] AC 239 at 254A, Lord Wilberforce clarified that “the court here is simply concerned to establish what the contract is, the parties not having themselves fully stated the terms. In this sense the court is searching for what must be implied.”<sup>78</sup>

Based on this last point, it is the obligation of the court to seek means of interpretation into a contract in order to make it useful. As it may be inferred from the case *Sudbrook Trading Estate Ltd v. Eggleton* [1983] 2 AC 444 at 479, such interpretation is usually achieved by constructing on an express or implied duty to act reasonably.<sup>79</sup>

After having looked at the Agreement as a whole, judge Mr. D Halpern QC turned to construe clause 4.7, taking into consideration the following issues:

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<sup>76</sup> It means that “*the thing may rather have effect than be destroyed; in order that the thing may be valid rather than invalid*”.

<sup>77</sup> *Supra*, note 5

<sup>78</sup> *Supra*, note 5

<sup>79</sup> *Supra*, note 5

1. IDS agrees to permit access to “any duly authorized representative” of 118. Who is to be given access?
2. Access is to be given to “any of its premises where copies of [the Database] are used”. Which premises are meant?
3. Access is to be given “for the purpose of ascertaining that the provisions of this Agreement are being complied with”. What does this mean?
4. Clause 4.7 merely refers to access but does not say what 118 is permitted to do once it has gained access.<sup>80</sup>

In responding to the first questions, judge Mr. D Halpern QC stated that, although Clause 4.7 prescribes “authorized representative” in the singular, Clause 1.3 stipulates that the singular should include the plural, indicating, thus that such expression does not limit to one person. The lack of limitation, however, requires that 118 has to act reasonably. Yet, regardless of the potential risk that 118’s own employee or employees might discover something to 118’s commercial benefit, judge Mr. D Halpern QC concluded that there is nothing in the express language of the audit clause, which prevents 118 from assigning its own employee.<sup>81</sup>

In regard to the second and third questions, judge Mr. D Halpern QC clearly concluded that 118 has right to gain access to the main office of IDS. However, he could not see any good reasons for allowing “a search of the place where its licensed Database is stored if that gives 118 carte blanche to search for anything which happens to be on those premises, whether or not connected with the storage or use of the Database”. He continued saying that “it seems to me to be more likely that those words limit the nature of what may be inspected as well as defining the location”.<sup>82</sup>

Finally, it is possible to conclude that the intention of the parties was to enable 118 to police the Agreement, as long as it is limited to policing the use of the Database, clearly imposing some kind of duty on IDS to allow access to the computer/server so that 118

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<sup>80</sup> *Supra*, note 5

<sup>81</sup> *Supra*, note 5

<sup>82</sup> *Supra*, note 5

is able to carry out the legitimate examination. Such permitted access, however, did not result in the granting of the order for specific performance by IDS due to the lack of provisions in regard to the material scope of the audit, among other details.

As such, judge Mr. D Halpern QC finally states as follows:

“There must be some restriction to ensure that 118 searches only for material relating to the use of the Database, that it does not search for commercially sensitive information relating to IDS’s customers, that it does not search for any material relating to the use of the Database which is protected by legal professional privilege, and that 118 is prevented from using the material for other purposes. There is no mechanism to deal with any of this. Further, if 118 carries out a search and discovers (or considers that it has discovered) a breach, the Agreement is silent as to what steps 118 is permitted to take thereafter. Is 118 permitted to remove data and, if so, what may it do with the data? ... this will involve substantially rewriting the parties’ bargain.”<sup>83</sup>

The application for a summary judgment for specific performance of clause 4.7 was then dismissed.

As a final and important remark, Judge Mr. D Halpern QC did not aim to render a final [opinion](#) of enforceability of the audit provision and what relief, if any, 118 shall be entitled to for non-compliance. At an interim stage, however, he was of the opinion that the clause lacked sufficient detail to permit the court to formulate a clear order for specific performance.

### **IV.3. Audit Clause – Case Law**

It is imperative to further look at two other specific cases that deal with disputes in relation to the rights and obligations of the audit clause as they are of support to highlight the essential lessons for businessmen, lawyers and draftsmen while working on license agreements, more specifically on the audit clause.

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<sup>83</sup> *Supra*, note 5

#### IV.3.1. Orion Publishing Group Ltd v Novel Entertainment Ltd<sup>84</sup>

Orion Publishing Group Ltd (O) is a publisher company, which had assigned all worldwide television, film, radio and audio-visual rights to Novel Entertainment Ltd (N) under the assignment contract. Under Sch.3, para.3.4 to that contract, O had the right to designate a chartered accountant to review N's books of account with a view to verify the truthfulness of statements that related to television programs and ancillary rights within the preceding 12 months.

The conflict between the parties arose in regard to the definition of "relevant books of account", as well as to the express limitation of the 12-month-old data to be made available for the audit.

In the view of the court, thus, the central controversies were (a) the scope of the term "relevant books of account" and whether review of data was restricted to data relating to the preceding 12 months; (b) whether para.3.4 allowed for review of data that did not relate particularly to exploiting television programs and ancillary rights regarding children's fictional character; (c) whether review of data that were not strictly financial was allowed; and (d) whether para.3.4 included an implied right to make scanned copies or photocopies of documents.

The court concluded that the meaning or definition of "books of account" required to simply ascertaining what the reasonable person in the position of the parties would have taken the parties to mean in the words that they used.<sup>85</sup> In regard to whether the contract allowed for examination of data that did not fall within the previous 12 months was unequivocal and straight, considered that the contract used the express words "in respect of

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<sup>84</sup> Orion Publishing Group Ltd v Novel Entertainment Ltd [2012] EWHC 1951 (Ch)

<sup>85</sup> Investors Compensation Scheme Ltd v West Bromwich Building Society (No.1) [1998] 1 W.L.R. 896

the previous 12 month period”. Therefore, review was restrained to data pertinent to the preceding 12 months.

The court went on concluding that O could only examine data in regard to television programs and ancillary rights of the children’s fictional character. O could not examine data relating to children’s fictional character’s films, or data that was not related to the children’s fictional character, unless a document was also comprised of data relating to television programs and ancillary rights relating to the children’s fictional character. In such a case, however, N was able to censor the non-children’s fictional character television data by redacting them.

In regard to the nature of data, the documents available to O under para.3.4 were not restricted to only those for accounting purposes, but were restricted to receipts and documents which backed up, vouched for, or verified the accurateness of the significant figures in the royalty reports. The paragraph did not consider the inclusion of ancillary materials. Paragraph 3.4 did not aim at an audit in the proper sense of the word. Thus, O did not have the right to examine many categories of data that it wanted and a wide-ranging audit was rejected, by way of limiting access to examination of limited categories of data (receipts and back-up documents of the previous 12 months for the examination of the royalty statements). The court found that the rationality of “relevant books of account” fit reasonably to the wording of para.3.4.

Finally, the court also found that not to permit copies of documents under para.3.4 would lay down a definition of the prescription that is not commercial. There were no express words in para.3.4 that copies were prohibited in order to determine the accurateness of the data. A special remark was made, however, due to the confidentiality obligation of the parties. In other words, O would be in breach of the contract if it made use of the copied material for obscured purposes. Thus, a contractual obligation of confidentiality between the



chartered accountant and the contracting parties should be in place and, under para.3.4, scanned or photocopied copies of data was allowed while conducting the data review.

#### **IV.3.2. Transport for Greater Manchester v Thales Transport & Security Ltd<sup>86</sup>**

Transport for Greater Manchester (TGM) and Thales Transport & Security Ltd (Thales) entered into a contract for the supply of a new tram operating system. The contract provided TGM and others with the right to perform an audit of Thales' documents and data with the aim of assessing Thales compliance with the contract terms.

Under clause 27, Thales was obliged to keep all data relating to the performance of its obligations under the Contract for a period of at least 12 years. In addition, clause 28.1 provided that upon a reasonable request, Thales was obliged to disclose other information, records or documents in its possession or control, or in the possession or control of its auditors, agents or subcontractors, that related to the data prescribed in clause 27. Yet, clause 28.2 read that under reasonable notice, TGM, the Secretary of State for Transport and any Auditor would have the right to review and make copies of the data or any other documents in Thales' possession or control which related to the carrying out of any of Thales's obligations under the contract.<sup>87</sup>

After the failure of Thales to provide TGM with requested documents (Thales agreed to provide 33 of the 53 categories requested by TMG), TGM commenced Part 8

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<sup>86</sup> Transport for Greater Manchester v Thales Transport & Security Ltd [2012] EWHC 3717 (TCC)

<sup>87</sup> *Audit clauses: reasonable requests for documents*. Construction Industry Law Letter. Retrieved from <http://www.constructionindustrylaw.com/contract/audit-clauses--reasonable-requests-for-documents-62969.htm> - accessed on 06 June, 2015

proceedings<sup>88</sup> seeking an order for specific performance. TGM required Thales to disclose several categories of documents and data.

In a nutshell, the court's findings were as follows<sup>89</sup>:

1. Clauses 27 and 28 clearly cover "records relating to [Thales'] obligations under this Agreement ... relating to the performance of its obligation" as well as any failure to perform the obligations. The use of the general words "relating to" suggests that this is or in given circumstances may well be broader than if words such as "limited to" were used.
2. Under clause 28.1, Thales has to provide other information, records or documents "... which relate[s] to the" information prescribed in clause 27. Therefore other documentation relating to the information in clause 27 has to be provided.
3. In clause 28.2 (b), it is clear that, for access to be given by Thales, the "other information, records or documents" have to relate to "the supply of the Deliverables or carrying out of" Thales' obligations. In the judge's view, "*the parties were agreeing on the provision not only of source or basic records relating to performance and supply but also of other documents which relate in a broad sense to performance and supply*".
4. Yet, the judge concluded that "*the context of the word "auditing" is that of auditing "any information supplied" to TGM*". Such conclusion was brought about from the overall terms of clauses 27 and 28. The judge went on concluding that "*...the overall context of the word is such as to suggest that an equivalent meaning is "vetting" or "checking"*".

It may be inferred from this case that the wording of the audit clause is of paramount importance so that it becomes enforceable, if needed be. Yet, any and all confidentiality obligations agreed upon by the parties have to be respected, mainly and specially in regard to the audit disclosures. The possibility of TGM to have access to a broad variety of documents and data does not entitle it to do whatever it wants to, but only to assessing whether Thales had performed its contractual obligations.

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<sup>88</sup> Part 8 proceedings may be issued where a party is seeking a declaration of rights under a contract; a declaration relating to the law (where there is an issue regarding the interpretation of a statute); and a declaration of non-liability.

<sup>89</sup> [Supra, note 87](#)

#### IV.4. Critical Reflections on Audit Clause Case Law

In the case 118 Data Resource Limited v IDS Data Services Limited and others<sup>90</sup>, the contracting parties had agreed upon a quite simple, but broad in scope audit clause, theoretically giving the licensor full rights of entering the premises where the licensed IP assets were stored for the assessment of the terms of the licensing agreement.

However, such “full audit rights” did not prove to be enforceable to the licensor, since the contracting parties are competitors and the confidential information of the licensee would be at risk.

In other words, the court, in its discretion, seemed to offer higher legal protection to the competing party, in which confidential and, thus privileged information could be accessed during the audit by his competitor, but without any further agreed mechanisms as to how the later should treat such information.

Such decision prompts contracting parties and lawyers to the necessary need of not only understanding the nature of the each of the contracting parties, but also their business characteristics and peculiarities, which shall be of support to more detailed and definite terms in the audit clause.

Yet, it is highly possible that the above court’s rationale shall be applied where one of the contracting parties, i.e. either the licensor or the licensee, is much powerful and the other is a small business, or a consumer. In our view, the right to audit in such circumstances shall not overcome the right of keeping one’s own information confidential, mainly where no further and detailed prescriptions were agreed upon, in which protection is to be found for the weaker party. And where the law does not provide such higher level of protection to weaker parties, courts usually do so.

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<sup>90</sup> Supra, note 5

In the case *Transport for Greater Manchester v Thales Transport & Security Ltd*, the court found, in the express terms of the audit clause, the confidentiality obligation of TGM in regard to its access to records and documents of Thales. Thus, Thales was obliged to give access to TGM of its records and documents, considered they were relevant to the assessment of Thales' compliance of the license terms.

Yet, in our view, besides the more elaborate audit clause present in this case, it is reasonable to infer that TGM's business is of public interest and, thus its right to properly audit the supply contract no matter how must be preserved.

Finally, in the *Orion Publishing Group Ltd v Novel Entertainment Ltd* case, the court sought to apply its best efforts in order to give the express terms of the license its original and intended meanings. The court also made it clear that the audit should not be understood as the assessment of only financial records and documents, but also other data, which could eventually back up the review of the accurateness of the royalty reports. As such, Novel Entertainment Ltd was allowed to redact documents and records so that its confidential information was not released if contained therein. Again, the court brought to attention that confidential information should not be automatically revealed for the purposes of the audit clause.

#### **IV.5. Audit Clause Case Law – Key Lessons Forward**

The aforementioned case law summarizes the importance of ensuring that audit provisions in licensing agreements are to be drafted in precise terms in order to reduce the risk that they cannot be relied upon and to ensure that the party being scrutinized can know clearly what is required.

The parties must define clearly the terms of their agreement, avoiding broad, and vague audit clauses that may not be enforceable if needed be.

In order to adequately protect the licensor's rights to check out that the licensee is not in breach of the licensing agreement and that the licensee's rights are adequately protected, the audit clause must be drafted with sufficient particularity to the individual circumstances of the agreement in question.

Moreover, it is of paramount importance that the peculiarity of the contracting parties, as well as their businesses' characteristics are taken into consideration while drafting the rights and the obligations under the audit clause.

Special attention is also highly important in regard to the licensee's confidential information, which might be at risk during the audit. Whether the audit is to be performed by the licensor's representatives and/or by a third party, confidentiality obligation has to be agreed upon, with clear prescriptions in respect of how to deal with such information, should they be revealed.

Yet, although the word "audit" may mainly have financial significance, information that shall be disclosed under an audit clause is inclined to go far beyond documentation that contains only financial information or financial accounts. It is important to consider that even if the information is "confidential" or "commercially sensitive", or contains "personal data" (as defined by the Data Protection Act 1998<sup>91</sup>), will not necessarily be legitimate reasons for failing to disclose it under an audit clause.

In our view, the enforceability success of an audit clause shall find its best chances if negotiated and drafted in a way that its outcome focuses on the use of express terms, avoiding the use of general wording. Yet, the audit clause wording must estipulate the

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<sup>91</sup> The Data Protection Act 1998 (DPA 1998) is an act of the United Kingdom (UK) Parliament defining the ways in which information about living people may be legally used and handled. The main intent is to protect individuals against misuse or abuse of information about them. The DPA was first composed in 1984 and was updated in 1998.

purpose/scope for which the audit may be carried out and set out the circumstances in which disclosure of information may be requested. This will certainly make the parties intention clearer and help the court properly interpret its terms.

As per the information to be accessed during the audit, the contracting parties and drafters must specify the categories of information the other party is entitled to request and clearly restrict specific categories of information that will not be disclosed, if this is the intention of the parties. Additionally, it is important to expressly consider the circumstances when information may be redacted before it is disclosed and specify what use can be made of the information obtained as a result of the audit. The obligation to keep relevant information for a certain amount of time is also of importance, mainly in long term licensing agreements.

The contracting parties and drafters must also agree upon and state who may carry out the audit and in what premises (where) the audit may be carried out. It may be the case that the use of a third party shall bring an unbiased audit report and also present less concern, if any, to the licensee in regard to its confidential information.

Setting out the frequency which audits may be carried out is also important. Such frequency may take into consideration the nature of the licensed IP asset, as well as the singular characteristics of the business relationship of the parties. It must be noted, however, that the frequency of the right may not serve as a watchdog of the licensee. The contracting parties and drafters must set the audit frequency in a reasonable way, in which we believe may be expressed as once a year

Prescriptions in regard to the costs of the audit also play an important role in the audit clause. Common practice shows that the licensor must bear the audit costs, except if a breach is discovered by the audit. Needless to say, the bargaining power of the contracting parties will most probably determine who will bear the audit costs. If prescriptions are agreed upon in case of a breach is discovered by the audit, special attention has to be given as to

clearly define what a breach is for the purpose of the audit. Yet, the contracting parties and drafters may want to determine the extent and/or level of a breach, so that it shifts the obligation to bear the audit costs. In other words, the contracting parties and drafter may agree upon that a breach, which does not bring a direct financial loss to the licensor shall not be regarded as one not able to shift the obligation of the audit costs.

Last, but not least, the contracting parties and drafters must set out the following steps after the audit. For instance, they may want to prescribe if the parties are obliged to meet to discuss a remedial plan if a breach is identified and/or whether additional audits are allowed to examine the implementation of the remedial actions.

In conclusion, the enforceability of a contractual audit clause will mostly depend upon its precise wording, the careful consideration of confidential information and the bargaining power of the contracting parties. As with any other contractual terms, but especially with an audit clause, unclear and inadequate wording shall be more difficult to enforce.

#### **IV.6. Audit Clause – Alternatives**

Regardless of the potential aforementioned benefits an audit might offer the licensee in a licensing agreement, it is our view that the audit benefits the licensor the most. As such, the audit creates a real risk that the licensee's business information, whether confidential or not, is revealed and used by the licensor against the licensee. For instance, the licensor may learn during the audit that the licensee's profit margin is extremely high, and thus might want to review its royalty fees. Yet, the licensor may have access to other licensing agreements in which the licensee has obtained IPR's in regard to other IP assets and, even if such licensing does not confront directly with the licensor's ones, the licensor might,

for instance, want to argue about the licensee's investments on its licensed IPR's in comparison with the other licensed IPR's.

Based on the theory that contracts are never perfect and thus always incomplete<sup>92</sup>, even though a high level of precautions are exercised while negotiating and drafting the audit clause, it might be the case that a potential incompleteness of the licensing agreement and/or the audit clause *per se* may result in an unintended outcome for either the licensor or the licensee and the business relationship shall be jeopardized.

The affinity of the contracting parties of the licensing agreement, as well as their past and current market reputations may be a reason to support that an audit clause is not necessary in the licensing agreement. In other words, the business practices of the potential licensee may be already established in the market at such fair and loyal levels that the aforementioned risks posed by an audit is not justifiable. In addition to that, the nature of the IP asset may also be a supportive reason for the absence of the audit clause. For example, the licensing of a trade secret in which the licensor is the exclusive supplier of the raw material related to such trade secret, theoretically, does not justify the need of an audit clause once the licensor might be remunerated as per raw material sales and not on the basis of royalties of the sales of the manufactured product.

In conclusion, the use of the audit clause in a licensing agreement is not always necessary, and even if so, must not be an automatic decision as to insert it in the licensing agreement. The aforementioned lessons provide the contracting parties and contract drafters with good light to as to better assess the negotiation and drafting of an audit clause. However, the contracting parties should exercise deep and detailed evaluation about the real need of an audit clause before entering into a licensing agreement, as their main intention is the business

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<sup>92</sup> Schmidt, D. (2014). *Entrepreneurs choice between venture capitalist and business angel for start-up financing*. Hamburg: Anchor Academic Publishing.



growth and financial return on the IP asset, rather than the review and examination of each others' business throughout their business relationship.

## CONCLUSION

Licensing agreements are contracts where the owner of an IP asset (licensor) grants permission for the use of its IPR's to a third person (licensee), i.e. an individual or a business. Such permission may be of exclusive or non-exclusive natures, and yet may be restricted or unrestricted as to the right of the licensee to sublicense them.

By licensing its IPR's, the licensor keeps ownership of its IP assets, and thus will seek to exercise some form of control over them so that, among other things, they do not lose validity and keep on providing the licensor with reasonable financial returns. And one of the ways to exercise such control is by negotiating and agreeing upon an audit clause, which shall, in theory, prescribe the rights and obligations of the licensor and the licensee in regard to the audit, i.e. the examination and review, of the licensing agreement terms.

Being this research work based under English contract law, the parties of the licensing agreement must comply with the obligatory elements of offer and acceptance, formalities, intent to create legal relations, and consideration, so that their licensing agreement does not face validity issues if challenged at courts.

The use of an audit clause in the licensing agreement shall only focus the royalty payment report prepared by the licensee. It may, however, also seek to assess the licensee's compliance of the terms of the licensing agreement, either in whole or in part. It is the intention of the parties, the peculiarities of their business relationship, the characteristics of the IP asset involved in the licensing agreement, or even the bargaining power of the parties, among other things, that will ultimately determine how broad the scope of the audit clause will be.

In any event, this research work sought to show via case law how important it is to master the use of express terms in the audit clause so that the initial intended intentions

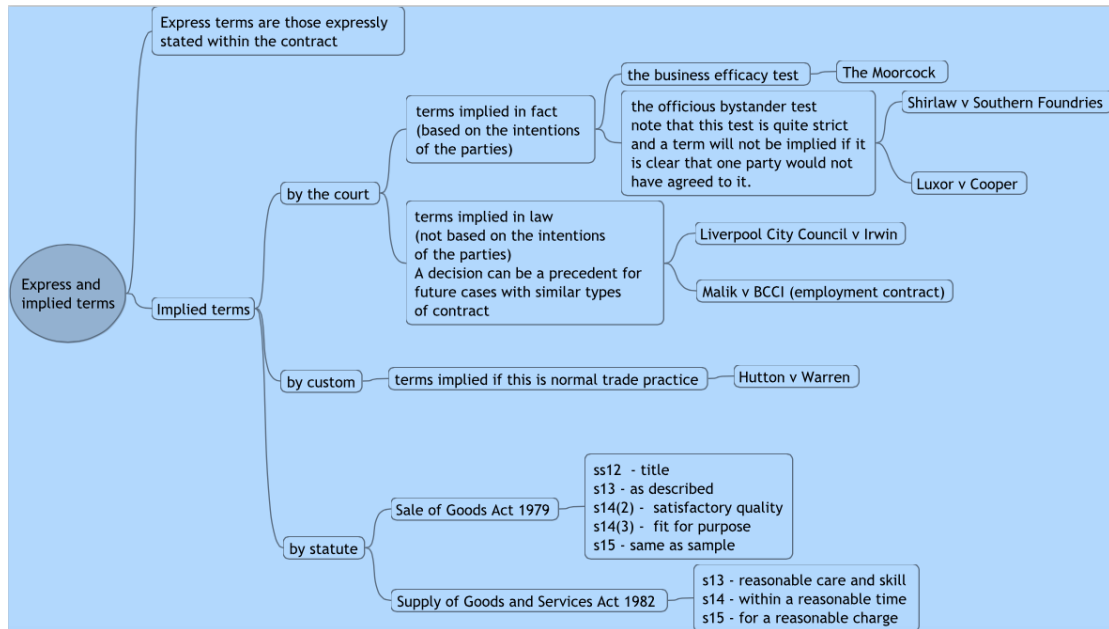
of the contracting parties are not amended, if the audit clause is challenged at courts. Case law also showed that the contracting parties must keep careful attention to the prescription of request, release and disposing of confidential information during and after the audit, as it is inherently vested with a high level protection. Yet, if it is the intention of the parties that the audit shall focus in the compliance, in whole or in part, of the terms of the licensing agreement, and not only on the royalty payment report, they must be aware that the term “audit” will not be regarded as to only financial records and documents, but also as to a broader category of records and documents, in which the assessment of the compliance of the licensing agreement terms may be achieved by the auditing party.

The interim decision of the case 118 Data Resource Limited v IDS Data Services Limited and others is a highly valuable tool for contracting parties and drafters of audit clause in licensing agreements, and as such and with the support of the cases Transport for Greater Manchester v Thales Transport & Security Ltd and Orion Publishing Group Ltd v Novel Entertainment Ltd, audit clauses may be better negotiated, drafted and agreed upon so that their enforceability matters at courts, if needed be, are not at risk.

As a concluding remark, however, audit clauses are not necessary in all licensing agreements. Its use must be well thought about prior to the licensing negotiation as to not overlap the main intention of the contracting parties, which is business growth and financial return on the IP asset.

# ANNEX 1

## Express and Implied Contract Terms<sup>93</sup>



<sup>93</sup> Retrieved from [http://www.lawschoolonline.co.uk/mindmaps/Contract/Express% 20and% 20% 20implied% 20terms.pdf](http://www.lawschoolonline.co.uk/mindmaps/Contract/Express%20and%20%20implied%20terms.pdf) - accessed on 02 June, 2015

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