IP bits

April 2014

Rights of first refusal and options to negotiate – their legal status

The hard questions about rights of first refusal and options to negotiate

Rights of first refusal and options to negotiate a license are commonly employed tech transfer tools. The hard questions about them are:

1. What do they actually mean?
2. Are they legally binding?
3. Is a party in breach if it declines to negotiate?
4. Is a party in breach if it participates in a negotiation but does not agree with the other party's proposals?
5. Is a party in breach if it breaks off negotiations?
6. If a party is in breach, is it liable to pay damages to the other?
7. If it is liable to pay damages, how are damages assessed?

What do these rights mean?

A right of first refusal to be granted a license and an option to negotiate a license can both be described as first in line rights. That is, when these rights are granted by an owner of intellectual property to a prospective licensee, the parties:

1. wish to defer the negotiation of a license to a later time
2. agree that the prospective licensee stands in a preferential position to be granted a license, before anyone else.

A right of first refusal to be granted a license and an option to negotiate a license are essentially the same.

They are commonly employed in a research agreement. A company may financially support research at a university, and seeks these first in line rights. It is too early to devote significant time and resources and cost to negotiating the license, and to do so might delay the research. Instead, the parties prefer to proceed with the research, and defer the negotiation for a license to a later date, if a license should be sought at all.

They are also commonly employed in a Material Transfer Agreement. A company may provide its biological material to a university for research purposes, and seeks the opportunity to negotiate a license with the university for any of the university's research outcomes that relate to the company's material.

Obligation to negotiate or obligation to reach agreement?

Sometimes it is thought that an obligation to negotiate also creates an obligation to reach agreement. But that is not so.

The obligation is an obligation to participate in the negotiation process to explore where common ground and consensus can be found. But it is not an obligation upon either party to actually agree with the other party's proposals.

Status of these first in line rights: UK, Singapore, Malaysia, India, Hong Kong etc

In the UK, and countries whose legal systems are based on the UK's legal system, the law has always regarded an agreement to negotiate as an agreement to agree, which is void and unenforceable.

Suppose Person A states to Person B: "I agree to sell you my car for a price that we will negotiate in good faith next week"

If Person A reneges and the following week refuses to sell the car, has Person A breached obligations to Person B?

In the UK the law has always taken the approach that a binding contract, to be binding, must not leave anything essential to be agreed upon later.

If a contract left something essential unaddressed, to be agreed upon later, such as the price of the car in this example, then it must follow that there was no agreement yet.

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In the UK, this is described as an agreement to agree, and in the United Kingdom, an agreement to agree is void.

Amongst the reasons that in these countries this is void, is because of the difficulty of assessing or quantifying damages for breach, if it was not void. How can a court assess the probability of whether two parties negotiating would have reached common ground and consensus? Were they so close that the probability was high? Or were they so far apart that the probability was low? Should the assessment of damages assume that the contract would have lasted a long time, or a short time?

United States and Europe

In the United States and Europe however, quite a different view is taken. In these countries, if two parties submit to an obligation to negotiate in good faith, the law can judge whether the parties have conducted themselves in a manner that is consistent with discharging that obligation.

In the United States the obligation to negotiate imports the obligation to inform the other party about competing negotiations to enable it to at least make a matching proposal. As well, there is the obligation upon the parties to continue their negotiation until they reach consensus, or have definitely reached an impasse.

If the obligation to negotiate is breached in the United States, courts can award reliance damages, or expectation damages.

Reliance damages compensates a party for the expenses it incurred in reliance upon the obligation to negotiate being discharged. It will compensate for legal expenses and travel expenses for example. It will also compensate for any opportunity cost associated with missed opportunities. But it will not compensate for the loss of profit. Expectation damages on the other hand compensate for lost profits. Courts in the United States infrequently award expectation damages, given the uncertainties of assessing the probability of whether the negotiation would have resulted in a concluded agreement. But where a court is persuaded that this was probable, expectation damages can be substantial.

Countries whose laws are evolving

In some countries, the law is evolving. Australia for example consistently followed the UK approach. In more recent decades, its law has evolved so that it now follows the US approach.

In other countries, such as Singapore and Hong Kong, recent court decisions demonstrate consideration to similarly move away from the UK approach to the US approach.

Legal risk

If an obligation to negotiate a license, arising either under a right of first refusal, or an option to negotiate, is subject to the laws of a country where it is legally enforceable, important legal risks arise if the obligation to negotiate in good faith is not discharged. There is the risk of reliance damages described above, or expectation damages described above.

Commercial risk

Where one of the parties is a risk averse university or research organisation, it can be particularly sensitive to these legal risks. In turn, this makes the risk averse university or research organisation able to be intimidated by the suggestion that it is not discharging its obligation to negotiate in good faith, and intimidated by the inferred threat of a legal dispute. Sometimes that intimidation is subtle. Sometimes it does not exist at all, but is perceived to be there. And sometimes the intimidation can be direct.

In each case, the university or research organisation might as a result compromise on a commercial issue more than it might have wished to. The commercial risk to a university or research organisation is therefore that it might settle on less than optimal license terms.

Managing these risks

Mechanisms can be employed to lessen or minimise these risks. None wholly eliminate these risks, and some of have their own inherent risks.

1. Framing the obligation to negotiate within parameters:

   For example, the parties may have a term sheet that records the parameters of their discussions at a particular point of time, and commit to each other to negotiate within these parameters. This exposes each party to the risk of an assertion that it is not negotiating in good faith should it need to negotiate outside these parameters, or to introduce new parameters. As sometimes happens in a negotiation, as it progresses, discussions or intervening events result in a genuine need to seek to negotiate outside previously agreed parameters.

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It might be argued that a party that needs to negotiate outside previously agreed parameters acts in contravention of the obligation to negotiate in good faith. But it might also be argued that the party that refuses to recognise the other's need to go outside previously agreed parameters is the one that acts in contravention of the obligation to negotiate in good faith.

2. Recording a royalty range.

   The parties might record that they agree that when they negotiate the financial terms of a license the royalty range that they will discuss will be between 5% and 8%.

   This exposes the licensor to the risk of being unable to secure any more than the lowest rate in that range.

3. Placing a time limit on negotiations.

   Sometimes the parties provide for a time limit, stating that if a negotiation has not resulted in a concluded agreement within an agreed period, such as three months, then the parties have no further obligation to negotiate. However, this does not address the question whether one of the parties failed to negotiate in good faith during the period of three months.

Option with license attached

An alternative is not to defer the negotiation at all, but to negotiate all the terms of a license at the outset. Here, at the same time as negotiating a research agreement, the parties also fully negotiate the terms of the license, including all financial terms, with nothing to be negotiated later.

Typically, the research agreement then contains a provision that confers on the company the choice to be granted a license on the agreed terms. If the company makes that choice, or exercises that option, the parties become obliged to execute a license on those agreed terms, without deviation.

Pragmatically, this alternative is only available to the parties where:

1. the amount of research monies being invested into research justifies the time and expense of fully negotiating a license at the outset, and

2. there is sufficient certainly about the research outcomes anticipated to be able to confidently assess the value of those outcomes to negotiate the financial terms of the license.

Concluding comments

As with all commercial matters, there are always risks to each party, and these risks cannot always be eliminated.

Obligations to negotiate arising from rights of first refusal and options to negotiate are no different to any other type of commercial risk that needs to be assessed.

The obligation to negotiate arising from rights of first refusal and options to negotiate serves an important facilitating role.

Without them, there would be an impediment to material transfer agreements and research agreements, and in turn, there would be an impediment to undertaking the research that each type of agreement enables.

In each case therefore, the risks of the occasion need to be assessed against the potential benefits of the occasion.