June, 1981, Vol. 63, No. 6

A BRIEF LOOK AT THE LEGALITY OF COMPETITIVE RESTRICTIONS IMPOSED ON TRADE SECRET LICENSEES BY TRADE SECRET LICENSORS

*Peter L. Michaelson**

In contemporary industrial America, hundreds of billions of dollars are spent annually on corporate research and development. For a variety of reasons[1] trade secret protection is quickly becoming and has become, to a great extent, the major means of legally protecting the fruits of this investment.

Trade secret owners often license the use of their secret. Once having put the secret on the "block", the licensor, much to his chagrin, quickly learns that the only interested taker turns out to be, not unexpectedly, his competitor. Faced with this, the licensor then asks himself "Is the license worth the risk? For all that I might gain from it, will my competitor ruin my business by turning the trade secret against me and eliminate my competitive advantage?" To remedy this impasse a compromise, in the form of a restrictive license, often emerges. This conflict was recognized quite early by the Supreme Court. Take, for example, the following from 1874:

> Suppose the case of two persons [who are] associated in business as partners, and engaged in a manufacture by which they supply the country with a certain article, but the process of manufacture is a secret, and they agree to separate, and one of the terms of their separation is that one of the parties shall not sell the manufactured article in Massachusetts, where the other resides and carries on business; and that the latter shall not sell the article in New York, where his associate is to reside and carry on business. Can there be

---

© 1981, P. L. Michaelson.

* Member of the Legal and Patent Staff, Bell Laboratories, Incorporated.
Member, Pennsylvania and New Jersey Bars.

The views expressed herein are soley those of the author and are not to be construed in any way as being those of his employer.

This paper was written in partial satisfaction of the requirements of the LLM degree in Trade Regulation at the New York University School of Law.

1 Note the limited reach of statutory patentable subject matter under 35 U.S.C. 101. For an interesting examination into the patentability of computer software and physical systems employing programmed computers, see a fascinating although confusing series of Supreme Court cases: Diamond v. Diehr, ____ U.S. ____, 209 U.S.P.Q. 1 (1981); Diamond v. Bradley, ____ U.S. ____, 209 U.S.P.Q. 97 (1981); Parker v. Flook, 437 U.S. 584 (1978); and Gottschalk v. Benson, 409 U.S. 63 (1972). Also see the numerous CCPA cases citing *Parker* and *Gottschalk*. For a different perspective, see Diamond v. Chakrabarty, 447 U.S. 303 (1980) which discusses the patentability of micro-organisms.

any doubt that such an agreement would be valid and binding?[2]

The answer to this question is - no, as long as the restriction is "ancillary" to the grant to use a bona fide trade secret. If it is not, a Sherman Act violation will almost certainly be found. But what does ancillary mean and what are its boundaries? Over the past fifty years a clear judicial trend has emerged and it is the subject of this paper.

Since the major portion of the relevant law concerns territorial restraints, particular emphasis will be paid to them from a trade secret perspective. However, where appropriate, comparisons will be made from a patent perspective.[3]

General--

The trade secret owner has the right to exclusively use his secret technology and he may exercise that right in such time, place and manner as he may choose. This exclusivity is lost once the trade secret becomes widely known.[4] Nonetheless, until this condition occurs, the trade secret owner may license the use of the secret to others and condition its grant as to time, place or manner of use. The license operates as a partial release of his exclusive rights rather than the imposition of any restraints on trade in products made using the trade secret.[5]

A patent owner, on the other hand, is clothed with statutory exclusivity, i.e., the right to exclude others from making,

---

2 Oregon Steam Navigation Co. v. Windsor, 87 U.S. (20 Wall) 315, 318 (1874). Also see U.S. v. Addyston Pipe and Steel Co., 85 Fed. 271 (6th Cir. 1898), aff'd 175 U.S. 211 (1899), wherein the Court noted "...[W]hen one in business sold property with which the buyer might set up a rival business, it was certainly reasonable that the seller shall be able to restrain the buyer from doing him an injury which, but for the sale, the buyer would be unable to inflict. This was not reducing competition, but was only securing the seller against an increase of competition of his own creating. Such an exception was necessary to promote the free purchase and sale of property. ..." Id at 280-281.

3 See Milgrim, *Trade Secrets* §6.05(2) (1980 printing) (hereinafter cited as Milgrim). For further in-depth study in this area, the reader is referred to MacDonald, *Know-How Licensing and the Antitrust Laws*, 62 Mich. L.R. 351 (1964)--a somewhat dated but nonetheless excellent article. An updated version is reproduced in Milgrim, Appendix H.

4 Milgrim, §2.03

5 The Court in John D. Park and Sons v. Hartman, 153 Fed. 24 (6th Cir. 1907) noted "so long as the owner of such a secret can preserve its secrecy, he has necessarily a monopoly in its use, and there is no illegal restraint because he refuses to make it public. Neither is the public interest affected whether the process or formula is used by A or B or by both, for there can be no restraint of trade in respect of a method or formula which is known only to the discoverer and those to whom he chooses to communicate it under restrictions. ..." Id at 30.

using or selling the patented invention[6] and to grant an exclusive right under his patent to another operative either within the entire or within any specified part of the United States.[7] Since a patent license is a waiver of the right to sue for infringement, the licensor can limit his waiver to something less than all the exclusive rights. This can encompass the manner of use of the products to be produced, the length of time in which these products can be produced (if less than the term of the patent) and the area in which the patent can be utilized by the licensee.[8]

The Early Law of Competitive Restraints --

To appreciate the law as it exists today, one must begin in the past; that point is 1888.

During that year, the Supreme Court decided the case of *Fowle v. Park.*[9] There, a licensee under a secret formula for "Wistar's Balsam of Wild Cherry" agreed with a number of other licensees to stay out of their sales territories. In challenging this restraint, the licensee argued that the territorial restraint operated as a common law restraint of trade and thus rendered the license void. Even though this restraint was for an unlimited amount of time, the Court upheld it as being reasonable and ancillary to the license of the secret formula.[10] The court recognized that the policy of the law is to encourage useful discoveries by securing the fruits to those who make them. Furthermore, since the restraint did not disadvantageously affect the public welfare, and the territorial restraint upon the licensee was not greater than the protection from undue competition of his own creation which the licensor requires, the restraint was sufficiently con-

---

6 "Every patent shall contain...a grant to the patentee...for the term of seventeen years...of the right to exclude others from making, using or selling the invention throughout the United States. ..." 35 U.S.C. §154.

7 "...The applicant, patentee or his assigns or legal representatives may in like manner grant and convey an exclusive right under the application for patent, or patents, to the whole or any specified part of the United States. ..." 35 U.S.C. §261.

8 MacDonald, supra at p. 358.

9 131 U.S. 88 (1888).

10 Id at 97.

nected to the grant of the trade secret as to be reasonable.[11] After noting the particular circumstances involved, the Court said:

> Relating as these contracts did to a compound involving a secret in its preparation, based as they were upon a valuable consideration, and limited as to the space within which, though unlimited as to the time for which, the restraint was to operate, we are unable to perceive how they could be regarded as so unreasonable to justify the court in declining to enforce them.
>
> The vendors [licensors] were entitled to sell to the best advantage, and in so doing to exercise the right to preclude themselves from entering into competition with those who purchased [licensees], and to prevent competition between purchasers, and the purchasers were entitled to such protection as was reasonably necessary for their benefit.[12]

In 1911, the Supreme Court again addressed the area of competitive constraints by a trade secret licensor in *Dr. Miles Medical Co. v. John D. Park and Sons Co.*[13] [hereafter referred to as *Dr. Miles*]. In this case, the plaintiff engaged in the

---

11 Ibid citing Oregon Steam Ship Navigation Co. v. Windsor. In that case, the plaintiff sold a steamer to the defendant for $75,000.00 subject to the covenant that the defendant will not run the steamship in the waters of California and the Columbia River. Defendants used the steamer to transport passengers and freight in California waters. Plaintiff sued for breach of contract. The Supreme Court upheld the validity of the covenant. The Court held that the covenant is unobjectionable on the basis of public policy as long as the public is not deprived of the restricted party's industry and that the party so restricted is not precluded from pursuing his occupation and thereby supporting himself and his family. If neither of these conditions occur, and if the contract is founded on valid consideration and a reasonable ground of benefit to the restricted party, it is free from objection and will be upheld. Id at 318. Here, prior to the sale, the defendant did not operate in either California or Oregon so that the public was not, by virtue of the covenant, deprived of defendant's industry. Nor was defendant's existing business adversely affected. Cf. Gibbs v. Consolidated Gas Co., 130 U.S. 979 (1889) wherein the adverse effects to the public welfare led to the invalidation of an agreement between two natural gas companies. In particular, one company agreed to abandon its statutory public function of laying additional gas pipe and mains for the supply of gas to the City of Baltimore. In addition, it agreed to fix prices for the sale of gas at a rate which could not be lowered below a fixed price without the consent of the other party. The Court said that "the supplying of gas is a business of a public nature to meet a public necessity. It is not a business like that of an ordinary corporation engaged in the manufacture of articles that may be furnished with individual effort." Thus "in the instance of business of such character, it cannot be restrained to any extent whatsoever without prejudice to the public interest." Consequently "courts decline to enforce or restrain contracts imposing such restraint, however recited, because in contravention of public policy." Id at 984.

12 131 U.S. at 74.

13 220 U.S. 373 (1911).

manufacture and sale of proprietary medicines prepared by means of secret methods and formulas. These proprietary processes and formulas were not discoverable from the medicines themselves. To eliminate price cutting, the plaintiff, by contract with its wholesalers, jobbers and retailers, fixed the minimum price at which its proprietary medicines could be sold at every level of distribution. To uphold these restraints, the plaintiff argued that they related to a proprietary medicine manufactured under a secret process.[14] While the Court upheld territorial restraints placed upon a trade secret licensee noting "the secret process may be the subject of confidential communications and of sale or license to use with restrictions as to territory and prices...,"[15] the Court noted that what is at issue is not so much the proprietary process of manufacture but the manufactured product itself. Since the trade secret remained safe regardless of what happened to the products, no competitive restraints were necessary to protect the trade secret. So viewed, these constraints were not sufficiently ancillary to the grant of the right to use the trade secret formula, and instead caused an illegal combination to fix prices under the Sherman Act.[16]

Dr. Miles was shortly followed in 1926 by *U.S. v. General Electric*.[17] General Electric (G.E.) owned three patents on electric light bulbs. G.E. licensed Westinghouse to manufacture and sell the bulbs embodying the patented technology to the public at prices set by G.E. In upholding the legality of the price restraint, the Court noted:[18]

> ...Conveying less than title to the patent or part of it, the patentee may grant a license to make, use and vend articles of the specifications of his patent for any royalty or upon any condition the performance of which is reasonably within the reward which the patentee by the grant of the patent is entitled to secure. ...[W]here a patentee makes the patented article and sells it, he can exercise no

14 Id at 401-402.

15 Ibid.

16 For an earlier case dealing with essentially the same set of facts but reaching an opposite result, see Wells & Richardson v. Abraham, 146 Fed. 190 (1906). For a further examination of vertical resale agreements, see U.S. v. Colgate, 250 U.S. 992 (1918), U.S. v. A. Schrader's Son, Inc., 252 U.S. 471 (1919), and cases citing the same.

17 272 U.S. 476 (1926).

18 A use restriction imposed upon a patent licensee was upheld in General Talking Pictures Corp. v. Western Electric Co., 305 U.S. 124 (1938), citing with approval U.S. v. General Electric.

future control over what the purchaser may wish to do with the article after purchase. It has passed beyond the scope of the patentee's rights....[B]ut the question is a different one which arises when we consider what a patentee who grants a license to one to make and vend the patented article may do in limiting the licensee in the exercise of the right to sell. The patentee may make and grant a license to another to make and use the patented articles but withhold his right to sell them. The licensee in such a case acquires an interest in the articles sold...but if he sells them he infringes the right of the patentee, and may be held for damages and enjoined. If the patentee goes further and licenses the selling of the articles, may he limit the method of sale and the price? We think he may do so provided the conditions of sale are normally and reasonably adapted to secure pecuniary reward for the patentee's monopoly.[19]

In essence, the Court thought that, since a patent licensor can establish the prices at which he sells the patented good so as to secure the pecuniary reward, he should at least be able to control the licensee's prices of those same goods in order to achieve the same ends.[20] In that light, the price restraint was viewed as being sufficiently ancillary to the grant of the right to make and sell the patented technology that it was upheld.

In *Thomas v. Sutherland*[21] a seller of a business involving a secret process to make photographic paper imposed a four-country territorial restraint on the purchaser's competitive activities. The restraint was needed to adequately protect the seller's remaining business since both the purchaser and seller had equal access to the trade secret. Thus, the Court upheld the territorial restraint as being ancillary to the sale of the business, even though it went beyond the use of the secret process.[22]

From these cases emerges a judicial recognition of the legality of competitive restrictions on trade secret licensors provided that (1) a bona fide grant of know-how is involved, and (2) the restrictions are no greater than those necessary to safeguard the licensor's remaining business from ruinous competition from the licensee.

---

19 Id at 489-490.

20 Implicitly, one could suggest, that since the patentee is not under any duty to license anyone and thus could exploit the market at prices of his own choosing, he is, by licensing another at fixed prices, not removing any goods or purchasing choices from the public. Rather, by allowing a certain amount of competition which he could exclude altogether, he is thereby providing the public with an increased choice of suppliers of the patented goods. However, this view has a limited reach. See U.S. v. Masonite, Corp., 316 U.S. 265 (1942) and Motion Picture Patents Co. v. Universal Film Manu. Co., 243 U.S. 502 (1917).

21 52 F.2d 592 (3rd Cir. 1931).

22 Id at 595, 596.

The Extremity

Between approximately 1930 and 1950, a line of cases, notably *National Lead, Line Material, General Electric Carboloy,* and *Imperial Chemical,* dealt with gross abuses of patent and trade secret licensing. Out of these cases emerged a simple common thread: if the intent of the parties to any license is to restrain competition and not to establish a bona fide grant of know-how and/or patented technology, then the restrictions are, without further inquiry, illegal restraints of trade.

While *National Lead*[23] is solely concerned with patent license restrictions, its fundamentals have been accepted as a basic bench mark for judging the legality of restrictions in trade secret licensing.

In 1920, Titanium Pigment Co., a National Lead subsidiary, and Titan Co. A/S, held patents from a number of industrialized countries covering the production of titanium dioxide. At that time, the titanium dioxide industry was in its infancy. These companies intended first to eliminate competition and, second, through an exchange of technology, to advance the state of the art in titanium dioxide production. Moreover, they felt that any advances in the art resulting by such an exchange should remain, as far as possible, property of the parties.[24]

To accomplish these ends, they entered into an agreement in 1920. It provided that each company agreed to grant licenses to the other to "manufacture, use and sell each and every invention, improvement or subject matter in the licensed field"[25] which was "defined to include all substances consisting of or containing above 2% of titanium dioxide ... and all apparatus, methods, and processes useful in the obtainment or manufacture or use of said substances."[26]

Pursuant to this agreement, the license given to each party was restricted to certain territories: Titan Co. A/S obtained exclusive rights in all areas outside North and South America and Titanium Pigment Co. received exclusive rights in North and Central America. Each party granted non-

23 U.S. v. National Lead Co., 63 F.Supp. 513, 66 U.S.P.Q. 141 (S.D.N.Y. 1945), aff'd 332 U.S. 319 (1947).

24 63 F.Supp. at 517.

25 Ibid.

26 Ibid.

exclusive rights to the other in South America. In addition, each party was permitted to import certain titanium goods into the territory of the other provided its sales would not substantially interfere with the sales of the others. In addition, each party appointed the other its exclusive agent for sales and distribution of its goods in the territory of the other.

Furthermore, each party agreed never to question the validity of the patents of the others, and each agreed to make its patent applications available to the other. Detailed provisions existed as to prosecution of patent applications and for the maintenance of patents by each company within its particular territory. According to the agreement, each party could grant sublicenses provided that the sublicensees agreed both to adhere to the 1920 agreement and to convey to other parties to that agreement exclusive rights in all patents that they might have outside the territory of the sublicensor.[27]

Thus, by the terms of the 1920 agreement, the parties had divided the world into two territories. Each party agreed not to trepass into the territory allocated to the other; and all commerce between the territories in titanium products proceeded only by the grace of their mutual consent. The suspension of commerce was not limited to patented articles but extended to all products within the "licensed field."[28] Numerous sublicenses were granted and the objectives of the 1920 agreement were perpetuated and expanded on a worldwide scale by several similar but more encompassing subsequent agreements with additional parties.

The district court struck down these territorial licenses as a violation of section 1 of the Sherman Act:[29] any agreement which divides the world into exclusive trade areas and suppresses all competition among the parties to the agreement is per se illegal. These territorial restrictions, the Court held, could not be viewed as being ancillary to the patent grant because they covered conduct not within the provisions of the limitations of the patent grant. In particular, they applied to patents not yet issued, and to inventors not yet imagined. They covered commerce beyond the scope of any patent, and restrained conduct beyond the term of any then-existing pa-

27 Ibid.

28 63 F.Supp. at 518.

29 "Every contract, combination...or conspiracy in restraint of trade or commerce among the several states...is illegal. ..." 15 U.S.C. §1.

tent.[30] They embraced an acknowledgment of patent validity with respect to patents not yet issued nor applied for, and concerned inventions not yet conceived. Moreover, the license restrictions extended to countries such as China, where no system of patent protection existed.[31] Since the conduct at issue, having the purpose and effect of suppressing competition, went far beyond that accorded a patentee, it was held to be illegal under Section 1 of the Sherman Act.

In *U.S. v. Line Material Company*,[32] Line Material Co. owned a dominant patent on a certain type of electric fuse cut-out. Another manufacturer, Southern States Equipment Corp., owned a blocking improvement patent. In separate hands, these patents produced a deadlock. To exploit these patents, each party agreed to give the other a royalty-free cross-license. They further agreed that one manufacturer was authorized to grant sub-licenses to other manufacturers, if the sub-licensees agreed to adhere to prices set by the sub-licensor. This combination was viewed by the Court as an il-

---

30 63 F.Supp. at 524. The Court cited Ethyl Gasoline Corp. v. U.S., 309 U.S. 436, 44 U.S.P.Q. 614 (1940) wherein a patent license restriction prevented the sale of patented leaded gasoline by licensee refiners to jobbers and retail dealers not licensed by the patent owners. The license also established price differentials between unleaded and leaded gasoline which were to be charged not only by the licensee to the jobbers but also by the jobbers to the retail dealers. The Court, in invalidating these licenses, generally stated the law concerning patent license restrictions. It held "[t]he patent law confers on the patentee a limited monopoly, the right or power to exclude all others from manufacturing, using or selling his invention. ...The extent of that right is limited by the definition of his invention, as its boundaries are marked by the specifications and claims of the patent....He may grant licenses to make, use or vend, restricted in point of space or time or with any other restriction upon the exercise of the granted privilege, save only that by attaching a condition to his license he may not enlarge his monopoly and thus acquire some other which the statute and the patent together did not give. He may not, by virtue of his patent, condition his license so as to tie to the use of the patented device or process the use of other devices, processes or materials which lie outside of the monopoly of the patent licensed...or condition the license so as to control conduct by the licensee not embraced in the patent monopoly, or [upon] the maintenance of resale prices by the purchaser of the patented article." Id at 457. Looking at the leverage available to the licensor by licensing 11,000 jobbers (out of a total of 12,000 in the country), the Court viewed the patent license restrictions and the parties thereto as a combination resting on the "fulcrum of its patents" which controlled jobber prices and suppressed competition among them. Id at 457-458. Holding that contracts or combination which are used to obstruct the free flow of interstate trade, even in a patented article after it is sold by the patentee or his licensee, are violations of the Sherman Act, *ibid,* the Court struck down these license restrictions.

31 Ibid.

32 333 U.S. 287 (1947).

legal attempt by licensees to fix the prices at which patented articles were sold. In making this determination, the Court said:

> Even if a patentee has a right in the absence of a purpose to restrain or monopolize trade, to fix prices on a licensed sale of the patented product in order to exploit properly his invention or inventions, when patentees join in an agreement as here to maintain prices on their several products, that agreement, however advantageous it may be to stimulate the broader use of patents is unlawful per se under the Sherman Act.[33]

Thus, the bilateral nature of the agreement to fix prices, in the Court's eyes, proved fatal.

Shortly after *Line Material,* the *General Electric Carboloy*[34] case occurred. As in *National Lead* this case involved a division of territories. Pursuant to the terms of a patent license agreement between General Electric and its subsidiaries (G.E.) and a German competitor, Krupp A.G., G.E. received exclusive rights in the United States and Canada to sell cemented carbides. G.E. further agreed to refrain from exporting elsewhere. Because the restriction encompassed not only articles made under the patented process but extended to all cemented carbide articles made by the patentee, this license was viewed as merely a naked division of markets among two former competitors.[35] Thus, the territorial

---

33 Id at 314.

34 U.S. v. General Electric Co. et al, 80 F.Supp. 989, 79 U.S.P.Q. 124 (1948).

35 80 F.Supp. at 1009. See U.S. v. Sealy, 388 U.S. 350 (1967) in which the Supreme Court invalidated a horizontal agreement by which the users of the Sealy trademark attempted to allocate exclusive market territories among themselves. Also see Timken Roller Bearing Co. v. U.S., 342 U.S. 593 (1950) in which an American company, Timken, agreed with two associated companies (British and French Timken) to divide world markets. When the legality of this was challenged, Timken aruged that the market division was ancillary to the right to license the use of its trademark. The Court held that a horizontal territorial agreement could not form the basis of a valid trademark licensing system. When coupled with an intent to suppress competion, it is per se illegal under Section 1 of the Sherman Act. With respect to vertical territorial restraints, the Court has opted for a rule of reason approach, rather than per se illegality. See Continental T.V. Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), overruling U.S. v. Arnold Schwinn & Co., 388 U.S. 365 (1967). Under such an approach, all facts and circumstances underlying the restriction are considered as the framework for assessing the reasonableness of a competitive restriction. In *Continental,* a franchise case, a vertical territorial restraint on intra-brand competition was upheld since its purpose was to increase inter-brand competition. However, under ancillarity principles, this result is hardly surprising since the interest of the party imposing the restraint was not to restrain trade in an inter-brand sense but rather to further his business by increasing inter-brand competition.

restraint was prohibited under Section 1 of the Sherman Act.

Territorial restraints were again at issue, a few years later, in *U.S. v. Imperial Chemical Industries, Ltd.*[36] There, Imperial Chemical Ltd., DuPont and various other companies were concerned with the manufacture under patents and trade secrets of dynamite based explosives. The parties, in imposing worldwide territorial sales restraints, argued that these restrictions were legal by-products of a legitimate exploitation of valid patents and trade secrets. Again the Court predicated its decision on the intent of the parties. It felt that the territorial restrictions were not motivated by an exchange of technology. Instead they exhibited an intent and objective to divide and allocate world markets. Thus, the territorial restrictions at issue were held to be per se illegal[37] under the Sherman Act.

It is thus apparent that Courts have not hesitated to strike down territorial restraints as being per se illegal where the clear intent of the parties has been to restrain competition. However, there are instances where the intent is either not clear or simply not anticompetitive. In these instances, the result is not so clear-cut.

A case in point is *Foundry Service Inc. v. Beneflux Corp.*[38] where an exclusive, territorially restricted license was granted by a trade secret owner-licensor to a licensee permitting the latter to manufacture products using the trade secret process and sell those products only in the United States and Canada. The defendant asserted that the license was invalid because it divided the market into competitive areas within which competition was prevented--possibly forever[39]--thereby creating an illegal restraint of trade. However, since the parties were not competitors before they entered into the license, the case was remanded for a factual hearing as to the particular facts and circumstances involved to determine legality.

In the *DuPont Cellophane*[40] case, a territorial restraint was upheld as being reasonable and ancillary to the grant of trade secret know-how. In particular, LaCellophane, a French concern, had developed a secret and valid process for

---

36 100 F.Supp. 504. 91 U.S.P.Q. 78 (S.D.N.Y. 1951).
37 Id at 592.
38 206 F.2d 214 (1953).
39 Id at 215.
40 U.S. v. E. I. DuPont de Nemours & Co., 188 F.Supp. 41, 44 U.S.P.Q. 462 (D. Del. 1953), aff'd 351 U.S. 377 (1955).

the commercial production of cellophane. At that time, no one could economically produce cellophane in commercial quantities without use of this technology. To tap the American market--which was up to this point totally unexploited--a joint venture was created by DuPont and LaCellophane. It was granted an exclusive territorial license to manufacture and sell cellophane in North and Central America using LaCellophane's trade secret technology.[41] However, the cellophane produced from this technology did not meet the needs of the American market. DuPont, in response to this, invented and patented moistureproof cellophane. The Government, having charged DuPont with monopolization, argued that the territorially limited license under LaCellophane's trade secret process was per se illegal. The Court, in rejecting this argument, said:

> It is not the purpose of the Sherman Act or the common law of restraints of trade to discourage establishment of a new business in a new territory. Trade secrets have always been considered in the nature of a property right. ...Among the ancillary restraints which are considered reasonable, both under common law and the Sherman Act, are those which limit territory in which the contracting parties may use the trade secret. ...
>
> The reasonableness of ancillary restraints on competition--here at the most potential competition since the participants were not in fact competitors--is enforced by the inherent legality of imposing a territorial limitation on an assignment of a secret process. The result of the agreement, in the case at bar, was the creation of the American cellophane industry.[42]

Since the intent was clearly not one of limiting competition, the Court had no trouble in upholding the territorial restraint as being reasonable and ancillary to DuPont's use under license of LaCellophane's trade secret.

Thus, the intent-based test functioned superbly in eliminating gross abuses--those which are clearly illegal without any elaborate inquiry, and in validating clearly competitive conduct, such as the development of new markets. However, between these extremes lie the vast majority of business dealings and license restrictions. In this middle ground, unfortunately, the Courts have not provided adequate guidance. Since every competitive restriction is the product of an anti-

41 118 F.Supp. at 219.
42 Ibid.

competitive intent, which is at best difficult to ascertain, it would be necessary in each instance, as in *Beneflux*, to undergo a protracted and exhaustive case-by-case analysis to determine legality. This result renders little comfort to a businessman who cannot afford the time and expense of litigation.

The Middle Ground

In 1968, the Ninth Circuit Court of Appeals addressed the legality of a competitive restriction imposed on a trade secret licensee in *A. & E. Plastic Pac Co.* (AE) *v. Monsanto Company.*[43] Monsanto granted AE a license to use its trade secret for the production of "OPS" (biaxially oriented polystyrene) plastic sheet, subject to the restriction that Monsanto could purchase from AE five million pounds over the first three years. Without this license, AE would have been unable to enter this market. Sometime later, AE notified Monsanto that it was ready to deliver the sheet plastic. Monsanto repudiated the agreement. The agreement contained a provision calling for arbitration of all issues and Monsanto served notice of demand for arbitration. AE countered with a law suit claiming that the agreement violated the Sherman Act as an attempt to monopolize and restrain trade in the OPS market.[44]

The Court viewed the license *not* as one to restrain competition, but as a license of technology to which restraints of competition were attached as conditions of the license. The key element inherent in this finding is that, absent the license, AE was in *no* position to compete with Monsanto.[45] The Court noted the following with respect to trade secrets in general:

> The holder of a patent can validly license it to others on the condition that they use it only for certain purposes. ...To a certain extent the same is true of the licensing of trade secrets or know-how. ...[46]

With respect to the legality of competitive restrictions imposed on a trade secret licensee, the test is whether:

> ...[T]he restriction may be fairly said to be ancillary to a *commer-*

43 396 F.2d 710 (1968).
44 Id at 712-713.
45 Id at 715.
46 Ibid.

cially supportable licensing arrangement, or whether the licensing scheme is a *sham* set up *for* the purpose of controlling competition while avoiding the consequences of the antitrust laws.[47] [Emphasis added.]

The Court distinguished both *Imperial Chemical* and *G.E. Carboloy* by noting that each case lacked any true trade secrets and that whatever secrets did exist did not justify worldwide territorial restraints. Thus, the cross-licensing agreements in those cases were invalidated as "subterfuges enabling the participants to divide markets and fix prices while avoiding the antitrust laws."[48]

Thus with respect to the AE-Monsanto agreement, its legality in the Court's mind depended upon the existence and extent of know-how exclusively possessed by Monsanto and whether the *substance* of that technology may fairly be said to support ancillary restraints of the kind imposed[49]--a test reminiscent of the analysis used in *Fowle v. Park* and *Dr. Miles*.

In *Shin Nippon Koki Co., Ltd.* (SNK) *v. Irvin Industries Inc.,*[50] Irvin granted to SNK an exclusive license to both manufacture and sell in Japan three machines using Irvin's trade secret technology. As in *A&E Plastic Pac,* no competition existed between the parties prior to the license and the technology transfer was substantial. The Court began its analysis with the premise established in *Fowle v. Park*, that territorial restraints upon the licensee's sales of products made with the licensor's secret technology are valid if reasonably ancillary to the grant of the technology itself. Justification for this rule lies in, as the Court noted, providing an incentive, i.e., a sufficient reward, to a trade secret owner--who can use the secret or not as he chooses with impunity from the antitrust laws--to make the secret available to the public at large. Thus, the trade secret owner should be allowed to place reasonable competitive restraints upon those to whom he has granted the license and who, but for the license to use the secret, would be unable to compete.[51] Rather than restraining existing competition, the license will have the effect of fostering competition, albeit on a limited

47 Ibid.
48 Ibid.
49 Ibid.
50 1975 CCF Trade Cases No. 66,438, ¶ 60347.
51 Id at No. 66,440.

basis, where none had previously existed.

In identical fashion to what the Court had done in *A&E Plastic Pac*, the Court in *Shin Nippon* distinguished *National Lead* and *G.E. Carboloy* on the ground that in each of those cases the competitive restraint went far beyond that needed to safeguard the licensor from an increase in competition resulting from the grant of valuable technology. In those cases the justification, favoring the allowance of a reward in the form of allowing the licensor to impose competitive restraints, was clearly inapplicable,[52] and the restraints in each case were found to be illegal.

To provide adequate guidance to the business community, the Court delineated boundaries of what it considered to be legally acceptable restrictions. In particular, it enunciated the following three-prong test to determine whether a competitive restraint upon a know-how licensee is sufficiently "ancillary" to grant of the technology and thus legal.

(1) Is the subject matter of the license substantial, valuable secret know-how?

(2) Is such restraint limited to the "life" of the know-how, i.e., the period during which it retains its secrecy?

(3) Is such restraint limited to only those products which are made by use of the know-how?[53]

An affirmative answer to all three questions signals legality.

Conclusion--

Limited competitive restraints on bona fide transfers of substantial trade secret technology are legal. However, these restraints are illegal where little or no technology is transferred and their sole overriding purpose is to suppress competition. Between these extremes, the ancillary doctrine articulated in *Fowle v. Park* and *Dr. Miles* and further clarified in *Shin Nippon* should within the framework of the rule of reason provide adequate guidance for the business and legal practitioner alike in assessing the validity of competitive restraints attached to know-how transfers.

---

52 Id at No. 66,441-66,442.

53 Id. at No. 66,440.