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OUTSIDE COUNSEL

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California Slows Usage of Fiduciary Duties in Licensing

We discussed in the New York Law Journal a few years ago, a California appellate decision holding that a technology licensing relationship created fiduciary duties between the inventor who disclosed confidential technology and the licensee who agreed to exploit the technology in exchange for a royalty.[1] The California Supreme Court has now reversed that ruling, holding that no fiduciary duty had been established and that punitive damages awarded could not stand. A $300 million breach-of-contract judgment was, however, upheld. *City of Hope Natl. Medical Ctr. v. Genentech Inc.*, 43 Cal. 4th 375, No. S129463 (Cal. April 24, 2008).

As we previously wrote, technology disclosure and licensing arrangements are commonly arm's-length business deals. The *City of Hope* opinion provides guidance to licensing practitioners seeking to avoid creating a fiduciary relationship between the parties—a relationship that imposes heightened duties and can result in tort damages, including punitive damages.

Facts

Genentech had a licensing arrangement with the City of Hope research medical center. Interestingly, the medical center is a prominent research facility that, at least today, appears to be quite sophisticated about intellectual property and its protection and licensing. Its Web site, www.cityofhope.org, boasts of a 550-person research facility, some 26 issued or pending patents in the last three years, and a licensing staff that is responsible for licensing patented technology in 14 different areas of bio and biomedical technology.

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

'City of Hope' gives guidance to licensing practitioners seeking to avoid a fiduciary relationship between the parties—a relationship that could impose greater duties and result in tort damages, including punitive damages.

Moreover, the jury awarded an additional $200 million dollars in punitive damages. This extracontractual award was permitted because the trial court found that Genentech owed the medical center not only contractual, but also fiduciary duties. The failure to pay constituted a breach of these duties and was a basis to award punitive damages.

Appellate Court Upholds Award

Relying on a 1956 California Appellate precedent, *Stevens v. Marco*, 147 Cal. App.2d 357, 373, 305 P.2d 669 (1956), the intermediate appellate court quoted the following as rule of law:

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

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

California High Court Reverses

The California Supreme Court held, as a matter of law, that no fiduciary duties had

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been imposed on Genentech.

1. No Knowing Acceptance of Fiduciary Duties. First the Supreme Court noted that fiduciary duties are either knowingly undertaken or imposed as a matter of law on certain types of relationships. "[B]efore a person can be charged with a fiduciary obligation, he must either knowingly undertake to act on behalf and for the benefit of another, or must enter into a relationship which imposes that undertaking as a matter of law." There was no record of evidence that Genentech had intended to undertake a relationship with the view of acting primarily for the benefit of City of Hope; to the contrary, the contract evidenced an intent to enter into a relationship for the mutual benefit of both parties.

2. No Imposition of Fiduciary Duties as a Matter of Law. That left the question whether such duties should be imposed as a matter of law. "The remaining question then is whether an agreement to develop, patent, and commercially exploit a secret scientific discovery in exchange for the payment of royalties is the type of relationship which imposes that undertaking [fiduciary obligation to act on behalf of and for the benefit of another] as a matter of law." This question was answered in the negative.

First, the relationship was not one of the classic relationships, such as a joint venture, partnership or agency, for which the law has traditionally imposed fiduciary duties. Second, and most importantly, the court rejected the notion that the mere entrusting of secret information by one party to another creates fiduciary duties. "[A] fiduciary relationship is not necessarily created simply when one party, in exchange for royalty payments, entrusts a secret invention to another party to develop, patent, and market the eventual product."

The Supreme Court, quite properly in our view, fixed the lower court's confusion of two separate concepts: (1) sharing of secret or "confidential" information and (2) a repose of trust and "confidence" which creates a fiduciary relationship. The mere fact that a commercial arrangement involves a "confidence" of the type does not necessarily mean it involves one of the second type.

3. Rejection of Four-Part Test. Third, the court rejected City of Hope's proffered four-part test for imposing fiduciary duties. City of Hope argued that where the following four factors are present, a fiduciary duty should be imposed:

(1) one party entrusts its affairs, interests or property to another;

(2) there is a grant of broad discretion to another, generally because of a disparity in expertise or knowledge;

(3) the two parties have an "asymmetrical access to information," meaning one party has little ability to monitor the other and must rely on the truth of the other party's representations; and

(4) one party is vulnerable and dependent upon the other.

Rejecting that test, the court noted that it was a common one in contractual relationships:

> [T]he four characteristics articulated by City of Hope…are common in many a contractual arrangement, yet do not necessarily give rise to a fiduciary relationship. For example, a person who takes a car to a garage for repairs has entrusted property to another (factor 1 of City of Hope's test). Because the garage operator has expertise in the field of automotive repair but the car owner does not, the car owner must grant the garage operator broad discretion to carry out the necessary work (factor 2) and must rely on the truth of the garage operator's representations about what repairs are needed and how they should be done (factor 3), leaving the car owner vulnerable and dependent on the garage operator (factor 4). Notwithstanding the presence of all these four factors, no court has ever held or suggested, as far as we know, that in this situation the garage operator owes fiduciary duties to the car owner.

For similar reasons, neither vulnerability nor repose of confidence lead to imposition of fiduciary duties. As to the latter, "every contract requires one party to repose an element of trust and confidence in the other to perform," yet no one has ever thought the mere entry into a contractual relationship creates fiduciary duties.

As to vulnerability, the court noted that many contractual relationships involve some level of superior skill or knowledge:

> Was City of Hope vulnerable because it had to rely on Genentech's superior ability in obtaining patents and in marketing products based on the secret scientific discovery of City of Hope scientists…? Yes, but not to the extent that would necessarily warrant recognition of a fiduciary duty. It is not at all unusual for a party to enter into a contract for the very purpose of obtaining the superior knowledge or expertise of the other party. Standing alone, that circumstance would not necessarily create fiduciary obligations, which generally come into play when one party's vulnerability is so substantial as to give rise to equitable concerns underlying the protection afforded by the law governing fiduciaries. Here, City of Hope has not made such a showing.

Given that the "[licensing] contract was between two sophisticated parties of substantial bargaining power," City of Hope stood little chance of meeting its burden of proof.

4. Possible Ways of Avoiding Fiduciary Duties. The latest *City of Hope* decision permits us to suggest a road map to make avoidances of fiduciary duties much easier for future contracts and licensing arrangements.

- First, the agreement should make clear that it is for mutual benefit and that the licensee is not undertaking special or fiduciary duties towards the licensor.
- Second, as in the *City of Hope* case, it is important to disclaim any of the classic relationships as to which the law imposes fiduciary duties, i.e., joint venture, partnership or agency.
- Third, one has to ensure that thew licensor is not later construed to be in a particularly vulnerable position. It appears that the fact that City of Hope was a "sophisticated part[y] of substantial bargaining power" was important in determining that no fiduciary duties would be imposed. One could conceive of a situation where the licensor was an individual inventor operating out of his garage with little experience in the ways of licensing inventions, rather than a sophisticated medical research center. It appears that the Supreme Court left the door ajar slightly to impose fiduciary duties in such circumstances.
- Finally, licensing counsel might still wish to consider incorporating a limitation of remedies clause: for example, disallowing punitive damages, providing for an audit procedure, etc.

1. "Embracing the Arm's-Length Licensor: Closer Than You Think," NYLJ 233:54 (March 22, 2005).