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SPECIAL CONSIDERATIONS IN TECHNOLOGY TRANSFER CONTRACTS

(Basic Legal Structure of Licensing Agreements)

Introduction

The legal nature of the transfer of technology arrangements is that of a "contract". Such arrangements are, therefore, in all of their legal aspects subject to the laws of contracts. That applies equally to their formation, as well as to their termination, settlement of disputes and all other matters regulated by their substance such as defaults, warranties and guarantees, remuneration, rights and obligations of contracting parties, etc.

Legal classification of transfer of technology contracts is very difficult since their existence in practice shows a great variety of forms, which contain many discrepancies, incongruities and inconsistencies. Maybe, the simplest way to distinguish these contracts is to classify them according to the substance of their subject matter. On the one hand, we have contracts which cede a certain acquired "right" (like a patent, trademark, service mark, copyright, franchise, and even unprotected "know-how"). In principle, transfer of technology is the main and principal objective of these contracts. On the other hand, we have all the other contracts which perform a certain other function which classifies them as "work" or "sales" contracts (like, supply of equipment, supply and installation of equipment, turn-key, etc.). These contracts have the transfer of technology not as the main objective of the contract but only as an incidence or as an ancillary function. However, as we pointed out earlier, classification is difficult to make, because a "work" contract may have also as an ancillary function the ceding of certain rights (like, for example supply of basic engineering in connection with construction of a plant).

Nevertheless, whatever classification we adopt, all the transfer of technology contracts will have in common the purely legal matters, such as the question of when a contract was formed,

penalties for defaults, how can it be rescinded or terminated, what will be the jurisdiction and the procedure for the settlement of disputes, and similar matters.

Formation of contracts

The pre-contractual phase of the transfer of technology negotiations will be subject to the same formation of contract rules as any other contract. Parties to such negotiations will be likely to issue letters of intent, letters of comfort, and will in all probability make protocols, minutes of meetings, heads of agreement in anticipation of concluding the true contract sometimes in the future. The substance and the possible contractual character of all these documents will be judged according with the same rules as are applicable to all other contracts. In this area we are, therefore, directing the interested readers to our other, already published materials.

There is one aspect of the pre-contractual phase of the transfer of technology agreements which is very specific for them. It is, namely, the so called "secrecy agreement" which the parties are likely to sign in the pre-contractual phase. The "secrecy agreements" are necessary because the parties may reveal during negotiations one to another certain legally unprotected data. If such data are revealed and no contractual undertaking is in place to oblige the other party to keep them secret and not to reveal them to other parties, the proprietor of the secrecy will lose it. Legally unprotected data are often various data connected with a legally protected right. Thus, for example, a patent, which is of course legally protected, may have certain secret data which are not revealed in the patent itself, but which are essential for the working of the patent. The unprotected data are particularly essential in a know-how negotiations, since know-how is by definition legally unprotected unless there is a contractual obligation to keep it secret.

A secrecy agreement will often spread the secrecy obligation to employees of the negotiating parties and to their outside collaborators. Such an obligation will basically make the signatories of the document liable one to another if the secrecy is not kept. A difficulty may also come about if one of the negotiating parties already has the knowledge and know-how revealed in the negotiating phase and the other side does not know about it. The other side may be under the wrong impression that the knowledge was obtained during negotiations and a dispute may arise.

As an example of a secrecy agreement we are enclosing a sample

document as published in TIES Newsletter, No. 43/1991.

Warranties, conditions and guarantees

Warranties, conditions and guarantees are terms which are often used in connection with the obligations of contractual parties to perform their contractual obligations. There is a certain difference in various legal systems in the use of this terminology and a few words should be said about it.

The term "warranty" has been taken from the Common law. It means an obligation to perform a promise collateral to the main purpose of the contract. However, this promise is of less significance than a "condition". A condition is a contractual term to which the parties attribute such importance that it can truly be described as being of the essence of the contract. ^{1/} In case of a breach of a warranty in a contract of sale, for example, the buyer is not entitled to reject the goods, although he may claim damages. Since a "condition" is of a higher legal quality than a "warranty", the buyer is entitled to reject the goods if a condition was broken (for example, if the goods are not in accordance with their description in the contract, if they are unsuitable for a particular use, if they do not correspond with the sample, etc.). Since every condition, being of a higher legal quality, contains a warranty, the buyer would be entitled to treat a broken condition only as a broken warranty and accept the goods and claim damages. ^{2/}

A "guarantee" in Common law is usually applied to suretyship. It usually is a reference to a "guarantor" who undertakes to be liable to the creditor if the principal debtor fails to discharge his obligation, while a "guarantee" or suretyship is an arrangement involving three parties (the creditor, the principal debtor and the guarantor). This arrangement between the creditor and the guarantor is called the "guarantee". ^{3/}

In Civil law countries, a "guarantee" is often referred to in the similar meaning as the Common law "warranty", although it is also used in the same meaning as the Common law "guarantee". For the purposes of this paper, "warranties" and "guarantees" will be used in reference to obligation to perform a certain promise contained in the transfer of technology arrangement.

In this context, the license agreements have a specific place because other types of agreements cannot be treated in the same way. Namely, license agreements have an intangible character where it is not always easy to ascertain the cause of a certain non-

performance. Obligations of a licensor are not the same as the obligations of a supplier of tangible goods. Nevertheless, licensors do take over certain obligations in the license agreements and they are liable for the fulfillment of these obligations.

The first warranty or guarantee of the licensor is in relation to the technical feasibility and technical usability (in German "technische Ausführbarkeit und Brauchbarkeit") of the subject of the license. Of course, legal systems of nations play a significant role, since they may contain specific provisions in this area. In German law, this guarantee does not include the commercial viability of the license subject. Even the terms "technical feasibility and usability" are controversial, since their true meaning is not always clear. Generally speaking, it seems that the licensor is responsible that the license can be industrially repeated by average technically equipped experts, but unless he has expressly guaranteed it, he is not liable neither for its commercial viability nor for its commercial "maturity".

The second warranty or guarantee of the licensor is directed toward the harmful effects of the license subject matter. Harmful effect may be of two kinds: (a) the application of the technology itself (acting in accordance with technical rules) is harmful for the environment, or (b) the results of the application are harmful to the consumers or to third parties and make the technology therefore unusable. These warranties are closely connected with the technical "feasibility and usability". Some technologies may be technically "feasible" but, due to harmful effects, "unusable". Of course, for all the expressly agreed guarantees or for the ones prescribed by the applicable law, the licensor shall be liable.

The third area of liability of licensor is in regard to the profitability of the license. The prevailing opinion is that the licensor, unless he has explicitly or by implication, taken over obligations in this respect, will not be liable for the commercial failure of the license.

For the true shortcomings of the technology the licensor should warrant in the same way as supplier of goods warrants for the quality of his goods. In this spirit, the recipient of a technology has the duty to examine the technology at the first genuine opportunity and to intimate to the licensor that he refuses to accept it. How long is the terms for rejection, depends on the applicable legal system as well as on the character of the license relationship. For example, the Law of Obligations of former Yugoslavia (article 486/2) provides a term of six months for examination and rejection of goods. Nevertheless, it is considered that this term is far too short for a license contract, since it is

by its nature of a long duration. It is thought that other rules, like the ones applicable to lease, should be applicable to a license contract. In a lease, lessor is entitled to intimate deficiencies all through the duration of the lease.

Liability for legal deficiencies of the license includes in the first place the obligation of the licensor to secure undisturbed use of the license to the licensee. Therefore, the liability for legal deficiencies of the license continue throughout the duration of the license agreement. Here, we understand, in the first place, the non-existence of the patent or the declaration of the nullity or invalidity of the patent and also the expiry of the patent. Furthermore, a patent may have certain limitation in its use in favor of a third party and the licensor guarantees that the patent is free of such burdens.

Licensee is entitled to request the licensor to remove the obstacles of legal deficiencies of the patent. If the deficiencies may not be removed, licensor have certain remedies at their disposal. They may either request the termination of the agreement, reduction of royalties and damages.

Penalties

Contracting parties in their agreements often provide penalties for non-fulfillment of various obligations. Obligations may relate to contractual dates (delivery or completion by a certain date) or to certain contracted parameters (consumption of fuel, electric power, tons of cement per hour, etc.). By providing penalties in advance, parties avoid the lengthy and sometimes difficult procedure of proving the exact amount of damages and claiming damages through a court or arbitration procedure. If the parties agree on what the penalty for a specific default will be, they may deduct the amount of the penalty from amounts due from the other party even without going to an arbitration or a court.

In common law countries, penalties are differentiated between "penalties" and "liquidated damages", while in the Civil law countries we speak only about "penalties. The difference between "penalties" and "liquidated damages" in Common law is that the "liquidated damages" represent a "genuine estimate of damage". This means that the parties have genuinely assessed the possible damage in advance and have agreed what will be the penalty for that specific default. If the default really occurs, the party entitled to "liquidated damages" may get only the amount agreed, regardless whether the actual damages were higher or lower. Since they have in advance agreed on the estimate of damages, they cannot claim more

and the obligor (defaulting party) cannot claim a reduction of the estimated amount.

In Civil law countries, "penalties" are also an advance estimate of damages but, if the actual damages were higher than the estimate, the party entitled to damages may claim before an arbitration or before a court to be paid the difference until the full amount of actual damages. Similarly, if there was a delay or a default, but there was no damage or the damage was considerably lower than the agreed penalties, in Civil law the party liable to pay damages may ask the court or the arbitration to lower the amount or to nullify its obligation to pay the agreed penalty.

Sometimes, licensor will agree to pay penalties or liquidated damages if their technologies do not have the agreed performance. However, such obligations of licensor are not the rule in transfer of technology contracts because licensor, in principle, do not have the possibility to oversee the application of a specific technology. If penalties are agreed, it is important that contracting parties know what is the difference between the terms most often used in such cases.

Duration of transfer of technology agreements

In some developing countries, the duration of transfer of technology agreements is limited to a certain period of time. In some jurisdictions, the time limit is not explicitly prescribed but it is stated that transfer of technology either have to have a time limit or that they may not be concluded for an excessively long period of time. Of course, duration of transfer of technology agreements is directly related to the total amount of the royalty the licensees have to pay to licensor because the longer the duration of the contract the higher will be the collected license fees. However, such provision should be carefully drafted in order to allow the licensees full absorption of the licensed technology on the one side, and a continuing support of the licensor for as long as it may be beneficial for the licensees. However, it has been noted in some countries which had time limit indications in their legislation (for example, Mexico), that there is nothing in the law which would prevent the approving authority to accept a new agreement after the expiration of the first one. ' /

Impediments for performance

One of the basic principles of contract law is that the contracts and contractual obligations have to be performed. Once

the parties have concluded a contract, they may free themselves from undertaken obligations only under certain conditions. Legal systems usually recognize which impediments will be treated as justifiable excuses for non-performance of contractual obligations.

The best known and legally recognized excuse for non-performance of contractual obligations are the cases of "force majeure", as known in national legislation. In the French Code Civil (as well as in other legislation) "force majeure" is defined as an absolute impossibility to perform. According to this notion, the obligor is actually prevented from fulfilling his obligations due to causes for which he is not responsible.

In today's contractual practices, the notion of "force majeure" is sometimes used in such a way that it does not assume an absolute impossibility to perform, but only an occurrence of events which make the performance more difficult or onerous. If a clause is phrased in such a way, we do not have a classical "force majeure" clause, but a modern "hardship" clause. Such clauses provide for non-performance if the conditions have changed in such a manner to have made the performance for one party more difficult or more costly than it was envisaged at the time the contract was concluded.

In contracts which stand under the influence of English law, the term used for excusable impediments is the term "frustration". Frustration is very similar to "force majeure", since it also requires an absolute impossibility of performance. However, frustration is different in another important aspect. Namely, under a "force majeure" civil-law concept, in the case of an occurrence of an event of "force majeure", the performance may be temporarily suspended. Once the impeding event has ceased to influence the performance, parties may continue with the performance of the contract. Under this concept, "force majeure" is cause for only a temporary suspension of performance of contractual obligations.

The concept of "frustration" is different because under English law, an event which "frustrates" the performance destroys the very foundation on which the contract was made. In such a case, the parties do not have a choice, either to wait for the cessation of the impediment or to terminate the contract, as it is often the case in "force majeure" clauses. In cases of frustration a contract is automatically considered as canceled once a "frustrating" event has occurred.

In transfer of technology agreements it is usual to provide either for a "force majeure" clause or for a "hardship" or a

"frustration" clause. At the same time, one has to bear in mind that transfer of technology agreements are contracts for a long duration and, in principle, the parties do not consider it feasible to provide for an "easy" way out. Parties to such agreements undertake long-term responsibilities and the very possibility that one of the parties may abandon the project if the performance becomes more costly than originally planned, may leave the other partner in a very awkward position. If a licensee has invested large amounts of money in order to be able to absorb the transferred technology, he will not agree to have such a "force majeure" clause which will enable the licensor to walk away without a truly serious reason.

Similarly, parties may be reluctant to agree on a "frustration" clause, since that would mean an automatic termination of the contract. If they do agree on such a clause, they will most probably see to it that the grounds for termination of the contract are truly serious. Therefore, the "force majeure" concept, with its flexibility of resuming the performance after the cause for interruption has ceased to exist, may be better suited for transfer of technology contracts and for joint ventures than a "hardship" clause. In such arrangements the impeded party will be allowed to suspend the performance of its obligations while the impediment lasts, but it will have to continue with the performance once the impediment has stopped.

However, in such cases parties may agree on a limit to the duration of the suspension. If, for example, the impeding event lasts more than six months or a similar period, parties are then free to terminate the contract. Otherwise, they are only allowed to suspend its performance as long as the impeding event actually prevents them to perform. As a concluding remark, one should point out that "force majeure", "frustration" and "hardship" clauses may also be under the influence of the applicable law which have a abound with rules and judicial experience with such clauses.

Termination

Termination of a transfer of technology agreement is possible through the usual legal instruments applicable to termination of other contracts, such as "force majeure", duration, suspension, etc.

However, there is an important difference between a transfer of technology agreement and other contracts. Namely, the ground for termination of a transfer of technology agreement may have as its causes circumstances that are very specific to the nature of

such agreements and which are not usual or are entirely unknown in other contracts.

In a patent license agreement, for example, there may be numerous causes for its termination due to some legal deficiencies of the patent - causes which are entirely unknown in other contractual forms. Similarly, in a know-how agreement, if licensees discover after the conclusion of the agreement that the know-how is not secret or that it has ceased to be a secret during the validity of the agreement they may be entitled to a termination of the agreement.

The very notion of "secrecy" itself may also be quite controversial. Is know-how "secret" only because it is difficult to collect it or to find out in the literature what it is or should it be under absolute control of the licensor in order to be considered as "secret" ? Sometimes, the parties may provide for "secrecy" to be a constitutive (absolute) element of the agreement or may provide for it to be only a "relative secrecy". Whether the parties have agreed on a "relative" or on an "absolute" secrecy will sometimes depend on the test whether the recipient would conclude the agreement had he known that the secrecy is only relative.

Settlement of disputes

It is an accepted fact that parties to international commercial transactions and consequently the parties to international transfer of technology agreements, are free to agree on the forum which shall have the jurisdiction to solve the disputes arising out of their contracts. The parties also have the freedom to choose the applicable law. The situation is the same in the transfer of technology agreement as in all other international commercial agreements.

Consequently, parties to a transfer of technology agreement may agree that their disputes shall be solved either by the courts of the host country, or by arbitration which they chose. Furthermore, they can agree on the application of any legal system they like, even the one which is totally unrelated to their contractual relations. The only exception may be in regard to the mandatory laws of the host country regulating the existence of the undertaking as such. As a result of this freedom to make their own choice, international arbitrations are more and more frequently used in international commercial contracts.

Arbitrations are distinguished as "institutional" or "ad hoc". Institutional arbitrations are the ones which are attached and

administered by an "institution" like a chamber of commerce or similar permanent arbitration institution. "Ad hoc" arbitrations are such which are formed for each case separately. Such arbitrations are mostly initiated by the parties themselves and their administration is then taken over by the arbitrators, once they are nominated.

There are today many "institutional" arbitrations, namely, such which are attached to some institutions. A good example is the Arbitration Court of the International Chamber of Commerce (ICC) in Paris. Another example is the Arbitration Center established under the auspices of the Afro-Asian Legal Consultative Committee in Kuala Lumpur (Malaysia) and its Regional Arbitration Center in Cairo. There are also many national Chambers of Commerce which have standing arbitration courts and which are ready and willing to arbitrate and offer arbitration facilities if the parties so agree.

The World Bank has been instrumental in creating the Convention for the Settlement of Investment Disputes. Until the end of 1991, there were 106 countries which have signed the Convention and 95 countries which have ratified the Convention (the last were Grenada and Mongolia). The Convention provides for an arbitration facility which is administered by the International Center on Settlement of Investment Disputes (ICSID) within the World Bank in Washington. ICSID is available in cases of disputes which have their origin in "investments". This term usually encompasses foreign investment but can also be used for disputes connected with long term construction contracts. Another feature of ICSID arbitration is that at least one of the parties involved in the dispute must be a Government or a governmental authority. In all, 26 disputes have already been submitted to ICSID for settlement, out of which 14 have come to a conclusion through amicable settlement and 8 have ended in final awards. Further 4 cases are pending before the Center. As of the end of fiscal 1991, Czech and Slovak Republic has signed the Convention ((May 13, 1991) but has not yet ratified it. In an ICSID procedure, one of the parties has to be a Government or a governmental organization and the dispute has to come "out of an investment".

If the parties opt for an ad hoc arbitration and not for an institutional arbitration, they will usually provide in their contract that each party will nominate its own arbitrator, and these two arbitrators will nominate the third one. The difficulty of such ad hoc arbitrations is that one of the parties has the possibility not to co-operate diligently in the nomination process and may thereby destroy the efficiency of the dispute settlement procedure. Even if the parties do co-operate, the administration of

an arbitration is much slower and less efficient if carried out by arbitrators themselves, instead by an institution.

For such cases and in order to mitigate the slowness and inefficiency of ad-hoc arbitrations, UNCITRAL in Vienna has devised the so-called UNCITRAL Arbitration Rules. If the parties wish to provide for an ad hoc arbitration procedure, it may be advisable that they provide in the arbitration clause that the dispute shall be settled in accordance with the UNCITRAL Arbitration Rules. By helping this Rules to come into effect, UNCITRAL did not establish a court of arbitration or a forum for settlement of disputes, as it is sometimes erroneously thought. UNCITRAL only helped the Rules to come into force (1977) and that is the reason why the Rules are known as the UNCITRAL Arbitration Rules. UNCITRAL has also helped in the creation of the Conciliation Rules (1981).

In order to facilitate the nomination of arbitrators in and "ad hoc" arbitration, the parties may also wish to provide in the arbitration clause an "appointing authority" which shall appoint arbitrators, if one of the parties does not co-operate in the nomination procedure. However, even if no appointing authority has been named by the parties, UNCITRAL Arbitration Rules have a solution and this is, maybe, the biggest advantage of these Rules. In such cases, the Secretary-General of the Permanent Court of Arbitration at The Hague shall designate the appointing authority. This part of the Arbitration Rules (Article 6) is the core of these Rules because they help the appointment of arbitrators.

Such a procedure has not been provided in the UNCITRAL Conciliation Rules. "Conciliation" is a procedure of amicable settlement to which the parties agree to be held with some outside help. This help may be either of an institution or again "ad hoc". The parties are entirely free to conciliate or to arbitrate and it is up to them to decide what they wish to do. According to UNCITRAL Conciliation Rules on the procedure or on the nomination of the conciliators, there is no "appointing authority" to help them. If they do not agree to conciliate, they are free to resort to arbitration.

Applicable law

As stated hereinabove, parties may also freely choose the applicable law according to which their contract shall be interpreted and which shall be applicable to their contract in case of a dispute. Their choice may relate to the procedural law and/or to the substantive (material) laws alike.

Parties to international business contracts are free to select the law they wish to apply to their contract and in making this choice they are, in principle, free. Namely, parties may select any applicable law they wish as long as their domestic law allows them to do so. Legal systems in most countries of the world allow their merchants to select any law they wish, provided that there are some mandatory rules of their laws which they request their citizens (including legal persons) to obey. Therefore, parties are not allowed to deviate from the "mandatory" laws of their own countries. For example, if a national legal system provides that a certain type of contract has to be approved by a national authority before it enters into force, it is almost certain that the contract will be void and will have no effect in the country where such conditions are imposed if not approved in accordance with the procedure prescribed by law. Therefore, even when the parties have made a choice of another legal system, they still are bound by the mandatory rules of their own national legal systems. The lawyers, judges and arbitrators will know which of the laws or legal rules are of a mandatory or of a non-mandatory character from the laws themselves or from prior judgments or from legal literature.

International transfer of technology agreements, like many other international business arrangements, often provide for international arbitration as a way for settlement of disputes.

Execution and enforcement of arbitral awards

When parties to a contract agree on a dispute settlement procedure by either agreeing on an arbitration or on jurisdiction of foreign courts, they will, once they obtain the arbitral award or a final court judgment, be faced with the problem of execution of such a decision in the national courts of the country where the losing party has its seat.

Foreign arbitral awards or court judgments can be enforced only through local courts in the same way as judgments of local courts. In most countries of the World, local codes of procedure or similar codes, contain rules for enforcement of foreign arbitral awards and judgments of foreign courts. That means, that parties who won their disputes abroad will have to apply to local courts to enforce such decisions in the country where the losing party has its seat and that such enforcement will have to be carried out in accordance with the procedure for such enforcement as contained in national codes.

In order to unify the principles and conditions under which a

foreign award or a judgment may be enforced in local courts, the so-called New York Convention of 1958 has been signed and ratified by more than 70 countries. This Convention provides only a few grounds on which enforcement of a foreign arbitral award may be refused by local courts. Such reasons are few and explicitly enumerated.

Recently (1985), UNCITRAL has worked out a Model Law on International Commercial Arbitration which was aimed to serve as a model to national legislators when drafting provisions of their own codes providing for such arbitration. The Model Law repeats the grounds on which recognition or enforcement of a foreign arbitral award may be refused under the New York Convention. In this way, if many countries would incorporate the Model Law into their national legal systems, even a greater degree of unification could be achieved than it exists today through the New York Convention.

1. Schmitthoff, C. *The Law and Practice of International Trade*, Eight Ed. 1986, p. 115.
2. *Ibid.*, p. 115-116.
3. *Ibid.*, p. 379 et seq.
4. See, *National Approaches to the Acquisition of Technology*, UNIDO, No. 1, N.Y. 1977, p. 44.

SECRECY AGREEMENT

The Editor of the *Newsletter* felt that some readers may find the following sample of a secrecy agreement useful, especially in view of its relevance to the foregoing article.

Secrecy agreement

This day of199., BY AND BETWEEN

A:

and

B:

WITNESSETH

Whereas A has developed and owns technical data and know-how in the field of oil extraction and distillation from aromatic plants;

Whereas B is a multinational company which is, in particular, specialized in the production of oil and other by-products deriving from the distillation of oil from aromatic plants;

Whereas B is interested in the technical knowledge held by A and is willing to collaborate with A in order to develop this technical knowledge and produce products deriving therefrom;

Whereas A is willing to collaborate with B, that such collaboration will be the subject of a detailed agreement to be entered into after a more detailed examination of the knowledge held by each of the parties;

NOW THEREFORE, IN CONSEQUENCE OF THESE PREMISES, IT IS HEREBY AGREED AS FOLLOW:

ARTICLE 1 – SECRECY

The parties reciprocally undertake to keep all technical knowledge they will exchange during this stage of preliminary work strictly confidential.

They will extend this obligation to all members of their staff, internal and external collaborators and sub-contractors, and will take care that the information covered by the present agreement will only be disclosed to the extent necessary for the work to be carried out.

To the extent copies of documents have to be made and circulated, the parties will organize such circulation and set up rules which will prohibit further copying and handing over of the documents to persons not concerned and that any such documents and their copies will be restored after use for return to the owning party or for destruction. At any moment during this collaboration, each of the parties will be entitled to check that the above regulations

of confidentiality are applied and that the persons concerned abide by them.

ARTICLE 2 – VALIDITY

The present agreement will be effective when signed by both parties for the entire period of the preliminary work concerned and until it is either replaced by a collaboration agreement or, should no further collaboration be achieved, until the documents handed over are restored and their copies destroyed.

ARTICLE 3 – LIMITS TO CONFIDENTIALITY

The above regulations and undertakings of confidentiality will not apply

- in case the information disclosed is in the public domain
- in case the information disclosed falls in the public domain during the validity of the present agreement
- in case the information becomes held by the party concerned through other means than by the present agreement and provided it is lawfully obtained by the said party.

In witness whereof the parties have signed the present agreement on the day and year stated hereabove, in two original copies in the English language, each party receiving one of the original copies,

.....AB
