

Technology New Zealand

A Practical Guide to Licensing

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A Practical Guide to Licensing

Executive Summary

This guide offers helpful advice and tips in negotiating a licence agreement. It starts with some basic points such as determining whether a licence agreement is the best structure for you and comparing its strengths and weaknesses with other legal structures. It then goes on to emphasise the importance of doing a thorough due diligence on the prospective licensee since the best legal contract is only as strong as the ethics of the contracting parties.

Following these preliminaries, the guide mentions how important it is to give the licensee only what the licensee is capable of handling with its own resources. This can be accomplished by taking care in defining “licensed products”, imposing “field of use” restrictions and limiting the “licensed territory”.

The guide next considers the pros and cons of exclusive and non-exclusive licences. Most licensees seek exclusivity but this may not be in their best interest. A new technology needs more than one champion. Market expansion through healthy competition may achieve for the licensee what the licensee could never have achieved by itself. All things being equal, an exclusive licence should carry a higher price tag than a non-exclusive licence.

The obligations of both licensee and licensor should be spelled out in as much detail as possible. This is to avoid misunderstandings in the future.

The guide gives pointers on negotiating the consideration. Above all else, my advice to the licensor is: Don't be greedy. Don't kill the golden goose. Experience has proven that few licensors ever regret accepting too low consideration but they frequently regret accepting too low performance yardsticks. So worry less about what you will get paid and more about how the licensee will perform. Without performance, a high royalty is just words on a paper.

Setting minimum performance requirements is perhaps the most important issue that you will negotiate with a licensee. If the parties can reach agreement on that, everything else will fall into place.

The licensee should be willing to accept a restraint of trade, particularly if the licence is exclusive. The last thing you want is for the licensee to engage in parallel development activities unbeknownst to you. A strong restraint of trade, applicable not only during the term of the licence but, preferably, for one year thereafter, will discourage that sort of activity.

The guide gives pointers for negotiating patent infringement clauses. The bottom line is: Never warrant that your technology is unassailable. Also, products liability should be the licensee's responsibility.

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In this guide, I have used the masculine gender. I have nothing against women. Some of my best friends are women. It was simply for ease of expression.

Also, I have written this guide from the licensor's perspective. If you are the licensee, do the opposite of everything I say. If you are dyslexic, it will be easier for you.

To License or Not to License

This is a practical guide to licensing. As a threshold question, ask yourself: "Am I in the right place?" "Is licensing my technology the way to go?"

You deserve credit for asking these questions. They're pretty fundamental.

Conventional wisdom is that licensing allows an inventor to bring a product to market with limited resources. In that respect, licensing is a close cousin to franchising.

Most inventors know how hard it is to create a successful franchise. The commercial landscape is littered with failed franchises.

Would you be shocked if I told you that the success rate for technology licences is even lower than for franchises? Well, it's true.

Look at it from the perspective of a licensee evaluating your technology. First, you have to overcome the "not invented here syndrome".

You are a thorn in the side of the guy who is responsible for researching and developing whiz bang ideas for his company. You're all smiles and enthusiasm during the demonstration of your technology while he's there sitting, moping, fretting and thinking: "Why didn't I think of that. That's what the boss is paying me to do. This guy from New Zealand (wherever that is) thinks he knows more than I do. I'll show him a thing or two."

You'd better snuggle up to this guy, put on your best charm. Otherwise, be prepared to encounter resistance borne from political agendas.

You know the saying: "If you invent a better mouse trap, the world will beat a path to your door." That's true.....in Alice in Wonderland. In our alternate universe called planet earth, it may take you years and years to find a true champion for your better mouse trap.

Technology licences are notoriously difficult to conclude because of the very nature of "technology" itself.

With "technology", you are claiming ownership of something that is intangible. Technology does not appeal to any of your five senses. It is very hard to sell something that a buyer can't see, feel, taste, smell or hear. It requires an enormous leap of faith on his part, faith that your technology will create a product that will give him a significant competitive advantage.

Another problem with licence agreements is that they rarely go the distance. The term stated in the contract may be 10 or 15 years or the life of the last to expire patent. But the average life expectancy of a licence is usually much shorter than that.

Over time, the licensee has a tendency to forget your valuable contribution. As technology marches on, the licensee may have contributed more to the development of the product than you. He will become more and more resentful of paying any consideration to you for a product that he considers his own.

Because of these daunting challenges, I recommend to my clients that they pursue licensing only as a last resort. It is a low percentage gambit. There are easier ways to make a buck than selling intellectual property.

Perhaps the best way is to do it yourself. Make a product and sell it. Remember what I said: It is much easier to sell products than it is to sell intangible property.

Mankind has 50,000 years of experience under its belt selling products compared with just 100 years or so licensing technologies.

To manufacture and sell products requires hard work and capital. Licensing may seem so much easier, cleaner and cheaper. Don't believe it. You are trading a headache for an upset stomach.

So, then, do you really want to license your technology? Have you considered the other alternatives: Venture capital, joint venture, contract manufacturing or an out right sale, to name but a few alternatives?

If you are committed to licensing your technology, and nothing that I have said thus far has dissuaded you from that course of action, well read on.

This guide will tell you how to do it.

Know Thy Licensee

Few lawyers would ever make the confession that I am about to make: Try as I may, I have yet to draft an air tight licence agreement for a client.

An air tight licence agreement is as common as a perfect vacuum. Neither exists on this planet.

This is not because I made a drafting mistake, although I must confess, that happens too. More common is that my client accepted a commercial risk with full knowledge and awareness of what he was doing during the give and take of negotiations.

The sad truth is that even the strongest legal contract will not prevent an unethical and dishonourable person from ultimately revealing his true colours. That's why it is so vitally important to know as much as possible about the person with whom you are dealing.

Get credit checks. Get bank references. Check with his suppliers.

Ask him whether he has ever licensed a technology before. If he has, get references from the other licensors.

It is a very good sign if the prospect has had prior experience licensing technologies. He will have more realistic expectations.

First time licensees can be a real pain in the butt. They can be incredibly difficult to work with. They expect you to deliver everything on a silver platter. They

are not prepared to put in the resources and time that may be required to turn your prototype into a full scale production model.

So if licensing technologies is already part of a prospective licensee's corporate culture, that's encouraging news.

Here's another trap my clients fall into. They do their due diligence and everything about the licensee checks out.....until they realise that the name of the corporation in the legal papers is different from the name of the company upon which they performed the due diligence. This is the "corporate shell" game.

Don't accept assurances that "they" will provide the necessary support and financial backing for a new corporation that is the nominal licensee. Your agreement should be with the company upon which you did the due diligence. If this is not possible, at least get the company with the deep pockets and trading history to guarantee the performance of the licensee.

The Licensed Products

I guarantee it: The licensee's reach will exceed his grasp. He will seek to license your technology for every conceivable application under the sun, including ones you haven't even thought about.

Confine the licensee to what the licensee can do best. Do not give the licensee all applications of your technology.

It is in the licensee's own self interest for you to hold back applications of your technology so that you can give them to other licensees. That can lead to a mutually beneficial interaction with other licensees who can share technical know-how and technology advances free of any competitive worries.

Define "Licensed Products" with great precision. Only give the licensee what the licensee is able to do with his own resources.

Don't worry if that didn't sink in. You'll hear me say it again and again.

Sub-Licences

Remember what I said about how hard it is to make a licence agreement stick? Well, it is even harder still to derive any benefits from a sub-licence by the licensee.

Yet the right to sub-license is a deeply enshrined principle, is it not? It's an inalienable right of all licensees. Rubbish!

It is purely a lawyer's construct. In reality, sub-licenses are as rare as snow in Auckland.

I have been in this business for more than 25 years and I can count on one hand the number of times that a licensor has actually received a dollar from the relationship between the licensee and its sub-licensee.

The moral of this story is don't allow the licensee to sub-license. If the licensee needs to sub-license, it means that the licensee does not have the resources to do it himself. You might as well deal directly with the sub-licensee rather than through a middle man.

Field of Use Restrictions

Consider whether it is appropriate to limit the licensee to a specific class of customer. For example, one licensee may be strong in the do it yourself market while another is strong in the professional trade market.

You may license your technology to two licensees, each producing the same, or similar, product but for different markets.

The licensee will want the world. He will seek exclusive worldwide rights for all applications in all markets. You, in turn, will offer non-exclusive rights in a defined territory for defined applications.

You will end up striking a deal somewhere in between.

The Licensed Territory

In setting the territory, I follow the 80/20 rule. The Licensee's territory should be demarcated by where the licensee derives 80% of its sales.

Let's say that you are dealing with an American licensee who just happens to have a small customer in Germany. That would be a pretty flimsy reason to grant Germany to the American licensee. You can do much better by finding a licensee in Germany or in a neighbouring country.

Every licensee has a "home turf". The licensee knows what his home turf is as do his competitors. Confine the licensee's territory to his home turf and appoint other licensee's in their respective home turfs.

Never grant a territory based upon a licensee's mere expectation of sales there. You can do much better even if you do nothing.

There is nothing wrong with holding territories in reserve for future allocation. You don't have to give out the entire world in a single year.

Remember that American licensee with a German customer? You refused to give him Germany as part of his territory. What would you do if he asks you to give him non-exclusive rights in Germany? The answer is: Don't!

If you give the American licensee non-exclusive rights to Germany, it means that you will not be able to give any other licensee exclusive rights to Germany.

Don't fall into the trap of granting non-exclusive rights in territories well beyond the home turf of the licensee. It may seem a painless way to resolve the issue of territory but, take it from me, it is anything but painless. It effectively precludes you from granting exclusive rights to another licensee and that could frustrate your ability to license your technology there.

Take a case where the licensee demands a territory which you know is far greater than he needs or has the resources to supply. But the licensee digs in and threatens to walk unless he gets his way. You may have to make a concession here. If you do, condition the wider territory with performance yardsticks.

So you would say to the American manufacturer: "Okay, you can have Germany provided you sell not less than x dollars per annum there. If you fall below that sales volume, we can take Germany back from you."

In other words, give him Germany on a "use it or lose it" basis.

Rights of First Refusal

Sometimes a licensee will demand a "right of first refusal" to new products, new applications or new territories. Such a request may appear harmless but believe me, it isn't.

It is awkward in the extreme to negotiate with a keen licensee knowing that you will have to present the same terms to another licensee. For this reason, I discourage my clients from granting rights of first refusal.

Lawyers spend heaps of time drafting rights of first refusal but in the real world, they are rarely triggered and even more rarely exercised. In that respect, they fall into the same category of remote contingencies as sub-licensing income.

A right of first refusal is a lazy man's way of saying "no". Instead of saying: "You can't have this country", you say: "I'll give you a right of first refusal in that country".

A right of first refusal may seem like the easy way out but it may come back to haunt you.

Sometimes, the only appropriate answer to a licensee who is clawing and grasping for more territory, for more products, for more exclusivity than he deserves is, simply, "No".

Exclusivity vs Non-Exclusivity

Not once have I seen a licensee request non-exclusive rights. They will always demand exclusivity. Too often this is short sighted, borne by a deeply ingrained fear of competition.

As I explain to my clients, and to the licensees with whom they negotiate, not all competition is bad.

Competition can be quite good, particularly in respect to a new product or technology.

The two things that a new product needs most are market awareness and market acceptance. Healthy competition can help expand the market and generate market awareness. Market acceptance is fostered by giving buyers a choice.

Focus groups have borne out the wisdom of creating a “category”, not a “product”. Customers feel more comfortable in their buying decisions by buying from a category of products. They tend to avoid stand alone, orphan, products.

What your technology needs most is respectability. A sole licensee may not be able to achieve respectability for your product.

When you give a customer two choices, he may select one. But when you give him just one choice, he may feel uncomfortable and move on to a “tried and true” product instead.

From my experience, for a new product, particularly for a new product that does not fit within a pre-existent product category, competition is good, not evil.

Competitors will benefit from the market awareness created by each other’s promotional activity. Together, they will establish market acceptance and, with it, respectability.

The pie will expand so rapidly that neither competitor will be particularly concerned with what slice he is getting.

The more sinister effects of competition are most readily apparent with mature products in mature industries where price becomes paramount. For a new product, however, healthy competition may be just what the product needs to get it off the launch pad.

Admittedly, it is hard to persuade a licensee that competition is good for him. But at least have the discussion. All too often, it never occurs.

Finally, on the issue of exclusivity, bear in mind that there are different types. You can grant manufacturing exclusivity in a defined territory, meaning that you will not appoint any other licensee to manufacture the product within that territory.

Marketing exclusivity concerns where a licensee may sell the product. You may grant manufacturing exclusivity, marketing exclusivity, or both.

In the case of marketing exclusivity, beware of the anti-trust implications of confining the sales of a licensee to a specific territory. There are regulations in both the European Union and the United States governing territorial restrictions.

The Licensor’s Obligations

As a general rule, the more that a licensor must do in the relationship, the greater the consideration he will receive.

There is no free lunch. The more you give, the more you get. Therefore, it is incumbent upon you to “dress up” your role in the technology transfer.

At the very least, you will be providing technical support. That term covers lots of ground. Don’t forget to mention everything that you will do in terms of technical support. Don’t take anything for granted.

What then does a technology transfer entail? Are you simply transferring sheets of paper with drawings and words on them? What about prototypes or samples?

What are the “tangible” manifestations of the “intangible property”? Describe all of them.

Don't forget to mention further research and development that you plan to undertake to support the licensee. This is very important.

You must convince the licensee that while generation one is exciting enough, generations two, three and four will knock his socks off.

Try to convince the licensee that you, and you alone, have the vision (without sounding like a Sunday preacher!). You can see five and ten years out to where the technology is heading. You have products, either in your head or on the drawing board, to exploit your technology in the future.

Thus, the licensee is buying not only what you have already researched and developed but a “call” on your vision of the future. If you can impart this excitement to the licensee, you will be able to support a higher level of consideration.

Do you know what's the biggest turn-off to a licensee? It's a licensor who says, in effect: “Here's what I've done so far. Now you finish it.” Use that approach and brace yourself for a negative reception.

Listen to the licensee. Take your cues from him. Discover what his needs are. Cater to those needs. At the risk of sounding like a broken record (younger readers may not understand that idiom!), the more you give, the more you get.

Consider whether you can supply specific raw materials or components to the licensee. I have seen many relationships where the licensor made more money from supplying raw materials and components than from royalties on the technology itself.

Indeed, perhaps you should give away the razor just to sell the blades. Think about that. Give your technology away for free provided the licensee uses you, or your nominated supplier, for key components and raw materials.

There are several other areas where you, the licensor, can make an important contribution, such as: Training; designing and building plant and equipment; tooling; marketing support; trade show attendance and new product development. Each of these may fill a vital need of the licensee.

So remember: A licensee will have difficulty justifying substantial consideration for intangible property alone. But when you start to quantify your contribution in terms of the items above, the licensee will be right smack in his comfort zone. He will be able to put a price tag on those items.

It is much easier to pin your consideration on these items than it is to put a price tag on the raw technology itself.

The Licensee's Obligations

Most licence agreements fail because the licensee did not fully appreciate what was required to bring the technology to market.

The number one most common misunderstanding concerns the state of "market readiness" of the technology.

The licensee may believe that your technology is fully developed only to discover that this is not at all the case. The licensee may also underestimate what's required to manufacture the product. He may encounter unanticipated delays in start up.

Marketing miscalculations are less common although they, too, occur.

No purpose is served in failing to fully and candidly discuss these issues with the licensee at the outset. If you do not discuss them, you are simply postponing the disappointment and disillusionment that will inevitably occur.

The licence agreement should specifically detail the steps that the licensee needs to take to bring the product to market.

If further product development is needed, that fact should not be swept under the rug. Quite the opposite, it should be fleshed out in the licence agreement.

It may be necessary to attach a product development programme to the licence agreement indicating the specific activities and the relevant milestones for achieving them.

Your best defence to a licensee's claim that you misrepresented your technology is: "Don't say I didn't tell you."

So don't hold back. Be disarmingly honest about your technology's shortcomings, about where further product development is required. Detail them in the licence agreement. Put your cards on the table.

In terms of product development, you know more than the licensee does. It's your brainchild. You know what needs to be done. You know your technology's shortcomings. You know where you ran into difficulty. You know what you would have done if you had just a little more time and a lot more money.

So when it comes to product development, this is your opportunity to really negotiate with superior knowledge. Do not leave the licensee with any doubts as to the direction that you think product development should take. Place the onus upon him to follow that direction.

Product development is just one obligation. The licensee will have other obligations such as: Manufacturing; marketing and promotion; and distribution. As to these other obligations, your knowledge base will be weaker than his.

Do you know what I do when I know less than my adversary? I rely heavily upon my listening skills. That's what you should do.

Listen, carefully, to what the licensee says when you ask him how he intends to manufacture, market, promote and distribute the product. What you will hear, assuming that you are listening carefully, is the licensee's hopes and dreams in an ideal world.

It is his best case scenario. Make it yours!

Don't be content with generalisations. Take, for example, the issue of manufacturing. Ask the licensee what production resources he plans to deploy to the project.

Does he plan to use his current production resources? If so, how does he plan to allocate them as between your product and others?

Does he plan to buy any new plant and equipment? If so, what does it take to obtain approval for a capital expenditure?

Does he plan to take on more staff to handle this project? If so, how many and what types of staff?

You could really spend a good couple of hours just getting into the tin tacs of how he plans to manufacture your product. Do not short circuit these discussions. They are part of your due diligence. Just as the licensee will want to conduct a thorough due diligence of your technology, so too will you want to conduct a due diligence to confirm his ability to commercially exploit it.

Once you complete the segment of your discussion on manufacturing, move on to marketing and promotion, distribution, after sales service. Each of these latter topics is vitally important.

Without a good marketing and promotional plan, your product won't sell. Without a good distribution plan, your product won't get stocked.

Listen hard. Learn everything you can about what the licensee proposes to do.

Then give the information, chapter and verse, to your lawyer. Your lawyer should include these "to do's" as obligations of the licensee in the licence agreement.

They may not carry the same punch as an objective performance measure (eg. sales per annum), but when taken with everything else contained in the agreement, they give you awesome leverage against a non-performing licensee and, in the worst case, grounds for termination.

Promotion

The licensee should undertake to spend an agreed percentage of sales to advertise and promote the licensed products.

To cover the period before meaningful sales eventuate, the clause may state: "The licensee agrees to spend not less than x per cent of sales or y dollars per annum, whichever is greater, to advertise and promote the licensed products."

The licensee should provide proof of such advertising and promotional expenditures to you upon request.

Consideration

Think about this: For every dollar that the licensee pays you for your technology, that's one less dollar that he has to spend to bring your technology to market. So the moral of the story is: Don't be greedy!

Remember all those great things the licensee said that he would do. They all take money.

Now it's time for the licensee to put his money where his mouth is.

The licensee's enthusiasm, while important, is not what will drive your project. It's his resources.

Unless your technology is that very remote exception to the rule, chances are both you and he will underestimate the cost of bringing it to market.

To be forewarned is to be forearmed.

Get the licensee to allocate as much money as possible to the project. Request audit and inspection rights by an accountant to make sure that the licensee actually spends the money.

First worry about the project, then worry about yourself. If the project isn't adequately resourced, what good is a high royalty. They are only words on paper.

Once you have looked after the project, you have reached perhaps the most crucial stage of the negotiations: How much will the puppy cost.

I don't know what your puppy looks like but I have negotiated the sale of plenty of puppies in my time. Sad to say, some of them grew up to be dogs!

If you want to know what previous puppies have gone for, I have posted another document on this website. It's called "Indicative Financial Terms of Recently Concluded Licence Agreements".

Without mentioning names, I have indicated the financial consideration that the licensee paid the licensor for the technology. It should give you some feel for the range as well as for the variables. Let me mention some of those variables.

All things being equal, a product that carries a high gross margin can support a higher royalty, in the range of 5% plus. For a product with a low gross margin, such a royalty would not be feasible. Either the licensor would have to jack up the price to an uncompetitive level or his rewards would not be sufficient to sustain his interest.

The price of a product, in absolute terms, is not relevant. I have seen low priced products command a high royalty and high price products command a low royalty.

The only thing that is relevant is the gross margin.

Here's another truism. The more valuable the intellectual property, the higher the royalty.

When I refer to "intellectual property", I do not just mean patents. Secret know-how is just as important.

All things being equal, a patent licence will command a higher royalty than a know-how licence. But this is not always the case. For example, the licensor may possess very strong know-how in an industry where patent protection is not pervasive.

If you plan to supply things to the licensee, you can accept a lower royalty since you will be getting two bites at the apple. In an extreme case, you may transfer the technology, royalty free, in consideration for a long term supply contract.

As I said earlier, give the razor away for free but make a bundle selling the blades.

All things being equal, a licensee will generally pay more for an exclusive licence than he will for a non-exclusive licence. That doesn't necessarily mean that an exclusive licence is the way to go.

You may accept a lower royalty if there is some "contra" arrangement involved. Perhaps the licensee is giving you a cross licence to other technology or valuable distribution rights.

The royalty may also vary by region as some regions are more competitive than others. Although hard to generalise, the United States tends to be the most competitive region with extraordinarily high sales volumes but correspondingly low margins.

In cases where patent protection is very important, the royalty will reflect the life of the patent remaining.

In cases where you are providing extensive ongoing support, this may be reflected in a higher royalty or some other form of consideration.

Those are some of the variables. There are countless others as no two deals are alike.

The royalty can be expressed in a number of different ways, such as: A flat sum per unit sold; a flat percentage of net sales; a variable percentage at different levels of net sales; a flat sum per annum; a guaranteed minimum royalty; and a ceiling on annual royalties or aggregate royalties.

Caution: Whenever you express the royalty as a sum of money instead of as a percentage of net sales, make sure that you include an adjustment for changes in a relevant price index (eg. CPI) if not also for exchange rate fluctuations.

These are the most common ways to express royalties but don't let that limit your thinking. My clients have come up with some very ingenious royalty schemes, all perfectly fine.

Incidentally, the royalty should always be pegged to "net sales", never to "net profits" or, still worse, "manufacturing costs".

Net sales are objectively verifiable. The other two are terribly subjective and completely outside your control.

So the royalty must be based on sales for ease of calculation and to avoid future disputes. It is too easy for a licensor to "cook his books", to over state manufacturing costs, particularly overhead, or to understate profits.

What about an initial licence fee, sometimes referred to as an establishment fee or set up fee?

Undeniably, you will have a strong need for "up front money" to cover your legal fees and technology transfer obligations. But the licensee will have just as compelling a need not pay you any up front money and, instead, to spend that money to perform the licence agreement.

To be perfectly honest, I am not a fan of big up-front licence fees. Why take all that money out of circulation just to line your pockets when the licensee could spend that money bringing your technology to market. At least, that's how I look at it.

The worst end result would be for the licensee's first payment to be his last payment.

When it comes to negotiating initial licence fees, I usually keep quiet and let my clients carry the ball.

I have no problem with a small fee to cover your reasonable costs in transferring the technology. But when the fee takes on a proportion such that you are attempting to recoup part of your investment in the technology itself, that's going too far, in my opinion.

I aim to create win win relationships lasting 10 or 15 years, where sales chug along nicely and the licensor receives a fair royalty. An initial licence fee strikes me as inconsistent with that aim.

In negotiating the royalty, don't forget to consider withholding tax implications.

In many, if not most, countries, a royalty is subject to withholding tax or *ad valorem* taxes ("VAT"). That's no problem if the country in which you are located has a tax treaty with the country from which the payment originates. You can then claim a credit on your return.

Consult your tax adviser on this issue.

Performance

Next to royalties, the issue of performance will probably involve the most discussion during contract negotiations. It can even be a deal breaker.

Hang tough! If the deal falls over because the licensee won't commit to objective performance benchmarks, then the deal was never meant to be in the first place.

Let me cut right to the chase. You can't allow a licensee to "lock up" your technology for 10 or 15 years without agreeing to meet objective performance criteria.

Well, let me qualify what I just said. You can do that but if you did, you would be awfully stupid! Get my point?

Lawyers are a dismal bunch. We always see the worst side in people. Our clients always see the best. There's the rub.

Lawyers are brought in to fix problems. Our clients often think that we cause more problems than we fix.

Lawyers are paid to placate angry and disappointed clients. Divorces; custody fights; will contests; and, yes, non-performing licensees are our stock in trade.

If you had to do this every day of the week, you'd become cynical too. So don't begrudge our hourly rates. We earn them!

A client will come into my office. I will listen to his tale of woe about a non-performing licensee. He wants to terminate.

Unfortunately for my client, his licence agreement does not contain objective performance criteria. Instead, it contains some vague generalities about how the licensee will use all "reasonable endeavours" to manufacture and promote the licensed product. To terminate for breach of such a vague undertaking is very, very difficult.

To the client, it may seem like an open and shut case of non-performance. As with a marriage split-up, there are two sides to the story.

The licensee will show how hard he tried even though his efforts were to no avail.

I have seen judges rule in favour of the licensee, keeping the relationship in tact, even though the licensee did not make a single sale in five or six years and there was little likelihood of any such sale occurring over the balance of the 15 year licence!

The last thing a lawyer wants to do is to terminate an agreement for breach of subjective performance criteria.

The solution is so simple. Every licence agreement must impose objective performance criteria for the licensee to meet. Write that 100 times on the blackboard. (Younger readers may not know what a blackboard is!)

Spell out how much sales (whether in dollars or units) a licensee must make, or how much royalties a licensee must pay, for each year of the licence.

Spell out the consequences of failure to achieve those levels.

Usually, failure does not give rise to any liability by the licensee to the licensor. That is to say, if the licensee falls short of the minimum royalty by, say, US\$100,000, that does not mean that he is legally obligated to pay you that sum.

What it does mean is that you may then select from a range of remedies, including: Formal consultation; reduction in the size of his territory; putting him on a non-exclusive basis; or outright termination.

Do not confuse a minimum performance requirement with a guaranteed minimum royalty.

With the former, the licensee is not liable if he does not achieve a minimum performance requirement although you could select from a range of remedies as mentioned above.

With the latter, the licensee must pay the guaranteed minimum royalty. It's a legal liability.

Actual royalties would be credited against the guaranteed minimum with any short fall normally paid at the end of a year.

For example, if the guaranteed minimum was \$100,000 per annum, and the licensee paid royalties of \$75,000 during the relevant year, it would pay a "top up" of \$25,000, at the end of the year.

Some deals allow a licensee to "carry forward" any excess in the minimum performance level or guaranteed minimum royalty.

For example, if the minimum performance level or guaranteed minimum royalty is \$100,000, and the licensee actually paid \$110,000, he would be able to credit the \$10,000 excess against the minimum performance level or guaranteed minimum royalty, as the case may be, applicable to the subsequent year.

Don't set the minimum performance levels too high. If anything, set them so low that the licensee will think to himself: "Gosh, if I can't achieve that, I wouldn't want to continue with the relationship anyway".

My experience has taught me this. Performance issues most often arise when there is a near total absence of performance. Rarely do performance issues arise simply because a licensor thinks that the licensee should be able to "do better".

The reason is obvious.

If a licensee is performing to a certain level, you can almost rely upon his rational economic behaviour to ensure that he will seek to maximise his sales and profits.

The problem is getting the licensee to perform at all. That's where most relationships fall apart.

Thus, if a licensee hopes to sell US\$1,000,000 per annum, I would put the minimum performance level at just US\$500,000 per annum, maybe even less.

Remember: You are trying to protect yourself against near total non-performance. Don't worry about gradations of performance.

Suppose you are not quite sure where to set the performance levels. A good starting point would be to use the numbers in the licensee's own business plan and peg the performance levels at, perhaps, 50% of those numbers.

If you play your cards right, the licensee will reveal his business plan long before you will be negotiating performance levels with him. You will have the benefit of his rosy assessments as to sales before he even knows how such assessments may be used against him!

Performance levels should mirror the life cycle of the product. Thus, they may rise rather steeply over the first three to five years, then level off during the middle five years and gradually decline during the final years of the agreement.

By setting performance levels, a licensee will never be able to "lock up" your technology.

How would you feel if a licensee had an ulterior motive of putting your technology on ice for 10 or 15 years while he pursued his own technology or simply wanted to make sure that your technology did not get into the hands of his competitor? You would feel terrible, wouldn't you. Yet these lock up situations are more common than you may think.

By insisting upon minimum performance levels, it will be impossible for a licensee to lock up your technology for more than a year at most.

If your technology requires further development over an extended period of time, you still need performance requirements but such traditional measures as "sales" and "royalties" may be inappropriate.

Instead of such traditional measures, attach a project schedule to the licence agreement. The project schedule should identify critical milestones against which to measure the licensee's progress. If those milestones are not met within the time specified, either party should have the right to pull out.

Agree upon a budget for the development project. Get the licensee to commit to spend the money budgeted.

Spending money on product development is one way to guarantee performance before actual sales take place.

Incidentally, is there money for you in the budget? You should be compensated commensurate with your contribution to the development project. This should be spelled out too.

Make sure that the project schedule and budget form part of the licence agreement. They are usually attached as exhibits to it.

A licence that is preceded by a product development period must have a “drop dead date”.

That is to say, if the first sale of a licensed product does not occur by an agreed date, either party can terminate the relationship.

Upon termination, the licensor generally obtains the benefit of all product development work undertaken by the licensee.

Payment Terms

The issue of payment terms does not generally precipitate much debate.

The norm is for quarterly payments of royalties. With each royalty payment, the licensee should prepare a statement showing how it calculated the royalty.

You shouldn't really care in what currency the licensee pays the royalty, assuming that it isn't the Indonesian Rupiah, Polish Zloty or equivalent.

Nowadays, most royalty payments are made by telegraphic transfer to your nominated account. The statement showing how the royalty was computed is either faxed or e-mailed to you.

So much for payment terms.

Option to License

A licence agreement may be inappropriate where your technology is not fully developed. Instead of a licence agreement, you might consider a “technology development agreement” or a “collaboration agreement”. Such agreements may contain an “option to license” instead of a “licence” itself.

You, as the grantor of the option, may receive a sum of money in consideration for surrendering the right to negotiate a licence with another party. After all, an option does have value.

However, instead of paying you for the option, the beneficiary of the option may, instead, invest the sum in further developing your technology.

With an option to license, it is not necessary to spell out, in chapter and verse, every single clause that would appear in a licence agreement. However, you should definitely touch upon the key commercial terms, such as: Territory; exclusivity; minimum performance requirements; and consideration.

Grant Back Clauses

A grant back clause gives you, the licensor, the right to all modifications and improvements to your technology discovered by the licensee. The theory is that the licensee would not have discovered such modifications and improvements in the first place were it not your technology.

There are two variations to a grant back clause.

In the first variation, the stronger one, you would actually own the intellectual property in the modifications and improvements discovered by the licensee.

Beware that this variation is illegal in the European Union as an unlawful extension of your patents. So don't use it there. You can use it everywhere else, including the United States.

In the second variation, the weaker one, the licensee would "grant back" to you a perpetual, royalty free, licence to exploit the modification or improvement outside the licensee's territory.

This variation is legal in the European Union and everywhere else.

Incontestability Clauses

It is illegal in the European Union to impose an obligation upon the licensee not to challenge the validity of your intellectual property. However, there is a simple way around this problem.

It is perfectly okay to include a clause in the licence agreement giving you the right to terminate should the licensee ever challenge the validity of your intellectual property.

In other words, the licensee can't eat his cake and have it. The licensee may accept your intellectual property as valid. Otherwise, he may put his stake in the ground and challenge the validity of your intellectual property. But he can't have it both ways.

Thus, by challenging the validity of your intellectual property, the licensee runs the risk of losing all rights under the licence agreement. This could be a very serious miscalculation on his part and it will cause him to think twice, if not three times, before challenging your intellectual property rights.

Infringement by Third Parties

There are two types of infringement that you, the licensor, must be concerned with. The first type is where a third party infringes your intellectual property.

There are many different ways to deal with third party infringement. The simplest way is to give you the right to pursue a third party infringer in your sole and absolute discretion. If you decide to pursue the third party infringer, the licensee must reasonably co-operate with you, but at your cost.

Occasionally, a licensee will seek the right to pursue a third party infringer if you sit on your rights. In that case, you may offer to reasonably co-operate with a licensee, but at his cost.

You would also have to agree upon the division of any monetary recovery. Will the licensee keep it all (usually not) or will he share it with you?

Try to get the licensee to agree to a 50/50 split of any monetary recovery, perhaps after he reimburses himself for all prosecution costs. Your fall back position is to allow the licensee to recover all prosecution costs plus actual, provable damages. Whatever's left over, if anything, is then split 50/50.

Here's an important tip. Make sure your agreement includes a clause that the presence of competitors, whether or not they infringe your intellectual property, shall not cause any reduction or abatement in the royalty.

Never promise to confer a monopoly upon the licensee.

Infringement of Third Party Rights

You should never give the licensee a "warranty of non-infringement". Never warrant that your intellectual property does not infringe the rights of third parties.

Even with the most thorough patent search, it is not possible to state with absolute certainty that your technology does not infringe the rights of third parties.

From your perspective, it is best to gloss over this issue entirely. But if the licensee insists that it be addressed, a little finesse on your part is required.

The best outcome for you is to have a soft clause merely requiring mutual consultation in the event a third party threatens an action for infringement.

The licensee may argue that such a clause does not go far enough. The licensee may seek an indemnification from you.

You will have to determine whether or not to accept this commercial risk. It all depends upon your assessment of the strength of your intellectual property and the degree of confidence you have that your intellectual property does not infringe anyone else's intellectual property.

Under no circumstance should you make that assessment without having first received the results of a thorough patent search.

If you must give an indemnity, try to get an option to terminate the agreement if the licensee is sued. That may be a lower cost option than defending the licensee in an infringement action.

Finally, patent infringement insurance is obtainable although, at the time of writing this, the cost was quite high relative to the protection afforded.

If you must give an indemnity to the licensee, make sure that the indemnification clause contains the usual conditions involving full support and co-operation by the licensee in the defence, prohibiting the licensee from making any admis-

sions or otherwise communicating with the plaintiff, following your reasonable instructions, etc.

The more conditions you append to the indemnification obligation, the more traps you are setting for an unwary licensee. The licensee may unwittingly violate a condition thereby giving you the right to avoid the indemnification obligation.

It's the same trick the airlines play. Advertise a real cheapo fare but, in the small print, impose conditions that will ensure that no one ever qualifies for it.

It goes without saying that you should not be liable if the infringing aspect was due to changes in the product design or construction made by the licensee. Add that to the conditions too.

Invalidity of Licensed Patents

What happens if your patent is declared invalid or your patent application is not approved? Sure as the sun rises, the licensee will seek a reduction or even an abatement of the royalty.

Your best counter to that would be that the licensed know-how is far more important than the patent protection.

You may compromise by agreeing to a percentage reduction (usually 50%) in the royalty. However, if know-how is truly more important than patent protection, you should hold your ground.

Patent Filing, Prosecution and Maintenance

Patent costs can be a heavy burden. Sometimes, you can shift that burden to the licensee, requiring the licensee to pay all patent costs applicable within his territory.

I have no problem with shifting the cost burden but you should always retain control of your patent portfolio and pending applications. Never transfer responsibility for prosecuting patent applications to the licensee.

You may shift the cost but not the control.

Brand Ownership

Under what brand will the product be marketed, yours or theirs? This may seem like a trivial issue, particularly when the product has yet to be associated with any brand. Indeed, no brand may yet exist.

Believe me, brand ownership is not a trivial issue. The incremental value created by a strong brand will exceed the incremental value created by a weak patent.

Capture, if you can, that incremental value. In the agreement, include a clause giving you the brand but allowing the licensee to use it during the life of the agreement.

Whether or not you succeed in owning the brand, make sure that you have the right to use the brand outside the licensee's territory. Counter any possible objection by the licensee by explaining how a uniform brand, worldwide, will create greater product awareness.

The cost of registering a brand is inexpensive relative to the cost of registering a patent. Yet the protection afforded by a strong brand can not be overstated.

A strong brand can offset a weak patent.

Therefore, don't give up the brand without a fight.

Product Marking

You may require the licensee to mark or stamp products and promotional literature with a statement that they are manufactured pursuant to a licence that you have granted to him. Such a notation may confer certain marketing benefits let alone bragging rights.

However, you will have to weigh up those benefits against a possible detriment in terms of products liability. Obviously, such a notation would increase your visibility and, hence, your exposure to a products liability lawsuit.

Restraints of Trade

In exchange for the right to manufacture and market your product, the licensee should surrender any right to manufacture or market a competitive product.

Define a "competitive product" with precision. The key elements would be: A product with a similar design; a product with a similar function; a product intended for the same purpose; and a product marketed to the same customer.

If you can incorporate three or four of these elements in your definition of a "competitive product", you will have strong protection. Two elements will give you some protection and one element not enough protection.

The territory of the restraint of trade should be the same as the territory that is the subject of the licence agreement.

This issue does not usually engender much discussion. If it does, take a step back and ask yourself: "Does this guy have a hidden agenda?"

The real benefit of a restraint of trade comes into play once the relationship has broken off. After all, it is not likely that a licensee will manufacture and market a competitive product at the same time that he is manufacturing and marketing your product. That would be rather silly.

Therefore, make sure that the restraint of trade applies, not only during the term of the licence agreement, but for a specified time (usually one year) thereafter.

One year may seem like a short time to you but it will feel like forever to the licensee. It will discourage the licensee from re-entering the market when the restraint expires. If the licensee does re-enter the market, he will be back to square one.

If I shut down my law firm for a year, I would lose perhaps 90% of my clients. It would be tough as hell for me to start all over again. The same applies to any manufacturing or marketing enterprise. Shut them down for a year and you have shut them down forever.

Even if the licensee is willing to give you an ultra strong restraint of trade, beware of a Trojan horse. If the term of the restraint is too long, or the territory too expansive, it may be deemed invalid as violating anti-trust policy.

Confidentiality and Non-Disclosure

There are two major components of intellectual property: Patents and know-how. Each derives its value in a diametrically opposite way.

With a patent, you are hoisting a flag for all the world to see: "Look everyone....over here! Look what I've discovered. Here's how it works. Now that you've seen it, don't copy it!"

With know-how, you are doing the exact opposite. You are keeping your discovery a closely guarded secret.

Secrecy is the essence of know-how. If the cat gets out of the bag, it is no longer know-how and you have lost a valuable intellectual property right.

You thus have two choices. You may file a patent application and hoist that flag for all the world to see. You may disclose the know-how to recipients who undertake to keep it secret.

Patents are very costly but the protection afforded is generally stronger.

Know-how is harder to protect. You must put your faith in the honesty of the recipient of your know-how. Then, too, the recipient may be honest yet careless.

In practice, most intellectual property includes both patents and know-how.

Chances are, by the time you are ready to negotiate a licence agreement, the parties will have already signed a confidentiality agreement. Be careful.

The confidentiality agreement may have been entirely adequate for purposes of evaluating your technology but it may be quite deficient for purposes of a licence agreement.

In a licence agreement, you are entitled to strong protection for confidential information disclosed to the licensee. During the evaluation stage, you probably kept such disclosures to a minimum, just enough to pique the licensee's interest.

Once a licence agreement is signed, the disclosures will take on a different character. They will be far more meaty. This calls for more substantial confidentiality undertakings.

Therefore, a simple "merger" of your existing agreement into the licence agreement will probably not afford adequate protection. You need a new agreement, purpose built for a licence agreement, to replace the agreement that is presently in effect between you and the prospective licensee.

This new agreement will contain much stronger undertakings concerning non-disclosure, much narrower exceptions and stronger remedies for a breach, including injunctive relief.

The licensee is not likely to object. He may have been reticent, understandably so, to sign such an agreement during the evaluation stage. He should appreciate that a stronger agreement is in his own best interests.

Right to Assign or Sub-license

I have already expressed my opinion about granting a licensee the right to sub-license. Only rarely will you ever see income from a sub-licensee.

If the licensee can't do it himself, what value is he really adding that you couldn't add yourself? Is he truly in a better position to sub-license than you would be to license?

If a licensee needs the right to sub-license so desperately, this should set off alarm bells. What's he trying to promote?

The last thing you need is for a middle man to siphon off consideration that would otherwise flow completely to you. Don't delude yourself.

Remember what I said, and I will say it until the cows come home (this country may no longer have broken records and blackboards but it's still got them cows!): Licensors hardly ever make money from sub-licensees. It sounds great on paper but it doesn't work out in the real world.

If a licensee needs to sub-license, you have probably given the licensee more territory and more exclusivity than the licensee can reasonably handle with his own resources.

The fact that you may not have another keen party waiting in the wings is beside the point. There is no need to allocate the entire world based upon the one or more persons expressing interest at a given point in time.

Be patient. Allow for the possibility that opportunities might arise in the future....and believe me, they will. Don't foreclose those opportunities.

Having expressed my antipathy towards sub-licensing, you could imagine how I feel about assignments. I am dead set against them.

The only exception I would make is where a licensee undergoes some sort of internal corporate restructuring. Anything more than that, even, say, a material change in the ownership or control of the licensee, should be deemed a “constructive assignment” requiring your consent, not to be unreasonably withheld.

The same applies where a licensee sells its assets as a going concern. The licence agreement should not automatically go over to the buyer of the business.

In the case of “permitted” sub-licenses and assignments, make sure that the licensor guarantees and indemnifies you for the acts and omissions of the assignee or sub-licensee, as the case may be.

Quality Control and Plant Access

A licensor has a legitimate interest to ensure that all licensees manufacture to a uniform high standard of quality. Consequently, quality control is a valid concern of the licensor.

Do not take the approach: “Quality control isn’t my problem.” It is very much your problem. If the licensee stuffs up your product, where will you be.

The agreement should specify appropriate quality control procedures.

You should have the right to perform quality audits. Obviously, you should have the concomitant right to visit the facility in which the product is being manufactured.

You may also require plant access to show prospective licensees. If this is important, make sure it is in the licence agreement. Otherwise, the licensee may object to having your invitees waltz through his factory.

Sales Reports; Audit and Inspection Rights

The licensee should submit quarterly sales reports.

To avoid misunderstandings, attach a form of sales report to the agreement. In setting up the form, think about how you will use the information provided by the licensee.

If it is only to verify the royalty, the form can be quite simple. If it is for market intelligence, the form can be quite complicated.

Whatever your purpose is, make sure that it is known to the licensee beforehand. That’s why I recommend that you annex a form of sales report to the agreement.

You are also entitled to audit and inspection rights.

You will seek the broadest possible audit and inspection rights: All relevant books and records.

The licensee will seek the narrowest possible audit and inspection rights: No more frequently than once a year by an independent chartered accountant.

You will reach a compromise somewhere in between. Trust me, you will. This is never a deal breaker.

I would say that a fair compromise is that your accountant should have the right to audit and inspect for compliance purposes upon reasonable notice and at your cost and expense. However, if your representative should find an underpayment greater than 10%, the licensee should bear the cost of the audit as well as making good the underpayment.

The bottom line is that you must have audit and inspection rights to verify compliance by the licensee. If the licensee refuses to grant you audit and inspection rights, you may reasonably wonder what he's trying to hide.

Cross Licences and Supply Contracts

I have already mentioned the many different forms of consideration that may support a licence agreement: Royalties; initial licence fees; supply of components. One thing that I have not mentioned is the possible supply of licensed products by the licensee to you. This is quite common.

Under this scenario, the licensee will manufacture the products and market them in his territory. The licensee will supply the products to you for sale outside his territory.

If this type of relationship has any appeal, get hold of my distribution agreement checklist and make sure that the relevant points therein are incorporated within the licence agreement.

Another arrangement, a bit less common, is where you acquire distribution rights over unrelated products in consideration for the licence. The same principles apply here, namely, you must incorporate the distribution terms within the licence agreement.

The two relationships are dependent upon each other. If you lose your distribution rights, the licensee loses his rights to your technology, and, of course, *visa versa*.

Compliance with Laws and Regulations

The default situation is that compliance with laws and regulations is the licensee's responsibility. The licensee should also ensure that the licensed products meet or exceed all relevant standards.

Do you know all the laws and regulations that apply to products manufactured with your technology?

Products Liability

If possible, the licensee should give you a blanket indemnity against all products liability claims. The licensee should obtain appropriate insurance and the policy should name you as an additional insured party.

Sometimes, a licensee will seek to disclaim responsibility for products liability claims resulting from errors or omissions in the design of the product. The licensee may argue that product design is your responsibility.

You may have to wear this risk, unless the licensee will have significant input into the final design of the product.

Even though you may have to wear this risk, the licensee's insurance policy might still cover it. Check the policy terms. Make sure that there is a waiver of subrogation against you, the licensor.

Disputes

Today, most licence agreements provide an alternative dispute resolution procedure. The procedure may take many different forms.

If the issue in dispute is capable of a yes or no answer, the parties may appoint an independent "expert" to make the determination.

If the dispute involves more complex issues, including issues that are subjective in nature, the parties may employ the services of a professional mediator.

A professional mediator does not have any authority to decide a dispute. He may only cajole, coax and encourage the parties to work out a settlement themselves.

However, a professional mediator is a highly skilled problem solver using "tried and trued" problem solving methodology. The success rate of a professional mediator is generally quite high so don't underestimate the importance of professional mediation.

If professional mediation fails to resolve the dispute, the agreement may provide for binding arbitration or it may allow either party to pursue its remedies in court.

There are many different arbitration tribunals: LEADR (NZ); ACDC (Australia); Asia Pacific Centre for the Resolution of International Business Disputes (Asia Pacific Region); International Chamber of Commerce (Worldwide); UNCITRAL (United Nations); American Arbitration Association (United States); SIAC (Singapore); and JATAC (Japan).

Consult your lawyer for advice on a suitable arbitration tribunal.

Choice of Law

This can be a very emotive issue. Each party will seek the home court advantage.

You should argue that you are entitled to select the governing law since it is in the licensee's interest that all licensees operate with the same rule book.

If the licensee could choose the governing law, what's to stop other licensees from nominating the law of their countries as the governing law. This would lead to a patchwork quilt of governing laws and present nightmarish conflict of laws issues.

The bottom line is that a uniform governing law for all licensees is in the best interest of all licensees. The only uniform law that would apply would be the law nominated by you.

Fortunately, governing law is not as important as it used to be, thanks to international conventions, the tendency of laws throughout the world to converge around international legal norms and, most importantly, the use of alternative dispute resolution procedures.

Term of Agreement

Assuming the licensee performs, it shouldn't really matter to you how long the term of the agreement is. You could have a 10 or 15 year agreement. You could have an agreement that runs for the life of the last to expire patent.

Just make sure that, with these long term agreements, you have a clear cut right to terminate for non-performance. By clear cut, I mean some objective measure of performance as distinct from such subjective measures as "best endeavours" or, worse still, "reasonable endeavours".

Thus, if the licensee does not sell x number of widgets per annum, regardless of the reason, it's bye bye licensee.

If you do not have clear cut termination rights for non-performance, it's bye bye licensor!

If you can not agree upon objective performance measures, consider a short term agreement with an option to renew.

Make sure that the agreement spells out the rights and obligations of each party upon termination.

At a minimum, the licensee should return all confidential information to you. He should stop using your intellectual property. He should pay up all royalties accruing to the date of termination. He may continue to sell unsold stock of licensed products for a specified time after the termination date.

The obligations upon termination are fairly standard and not normally subject to negotiation.

The Final Word

Congratulations! If you've read this far, consider yourself an expert in licensing.

Now go out there and show the world what kiwi ingenuity can do.

Watch this web site for more of the "practical guide series" from Robert Auerbach.