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OF

LICENSING

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ROBERT GOLDSCHEIDER - BIOGRAPHICAL NOTE

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The Art of Licensing Out

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Introduction

As with all other aspects of the licensing process, success in finding one or more appropriate licensees for a body of technology requires detailed preparation. This includes understanding the strengths and weaknesses of the corpus of intellectual property being offered, careful research about qualified candidates and the relevant market, and, then, thorough implementation of the initiatives actually undertaken.

It is more usual than not that a prospective licensor must fight an uphill battle: It must gain the attention of target companies who are attractive for some realistic reason and then persuade the decision makers of these potential licensees to invest and launch a serious, well financed effort to introduce the substance of the licensed technology as a marketable product, or to use process technology in its production activities.

It will be appreciated that the licensor is usually requesting its licensee to assume a significant, and sometime unsought, risk. As the suitor in this relationship, it therefore behooves the licensor to effectively provide "comfort" in the form of accurate, businesslike, and useful information to the prospective licensing partner. If this can be accomplished successfully, deliberations about the feasibility of the technology transfer tend to be shortened, and the chances of a positive decision are enhanced.

Preparations by a Prospective Licensor

As the originator of the technology intended to be transferred, the licensor can be presumed to consider its proprietary technology as possessing certain competitive advantages over the traditional products or processes in the same field. It is probably because some weaknesses in the existing situation were perceived that the innovation was made in the first place. Even where the status quo ante was essentially satisfactory, some new technological phenomenon may have been revealed which motivated the inventor to undertake the effort, and make the necessary investment in time and money, to create the new development.

For instance, mechanical calculating and adding machines worked with efficiency and satisfactorily served the needs of business offices as they were perceived. The same could be said of the engineering slide rule. The advent of solid

state electronics, however, opened new horizons that made it possible within a very few years to replace these widely utilized products with calculators, and eventually, personal computers, lap tops and other multi-purpose devices, which revolutionized the entire environment in which they operated.

Although the advantages of a new invention are frequently readily appreciated by its innovator, lack of objectivity may obscure certain of its disadvantages or limitations to its universal application. When presenting a licensing opportunity to a third party, it is important for the selling party (that is, the prospective licensor), to project credibility and thereby remove initial skepticism and other negative impulses of the target licensee. If claims regarding the invention are overstated, or misstated in any way, the licensee is likely to be turned off, and could reject the entire proposal. Furthermore, it is far better for the proprietor to reveal any shortcomings of its technology than for that information to be learned by the prospective license from other sources. Experience has shown that an initial refusal by a potential licensee is very rarely reversed as a result of subsequent submissions to the same recipient.

Thus, it is incumbent upon a technology proprietor who seeks to conclude licenses to appreciate realistically the competitive advantages and disadvantages of the items proposed to be licensed. This type of analysis, in relation to alternatives, should address:

- the efficiency, utility, and effectiveness of the technology;
- if a product, the near term, and projected long term costs of production and anticipated selling prices, thereby indicating potential rates of profitability, especially when the parties have gained experience from the learning curve;
- if a process, costs of energy and materials in relation to throughput efficiency, as compared with known methods;
- environmental "friendliness" of the process is also deemed increasingly important;
- the size of the potential market in the contemplated national or international licensed territory, together with a conservative projection of the market share that the technology, properly managed, can reasonably be expected to capture;

- the size of anticipated investments in further research and development, production equipment, marketing and distribution organization, plus delay before it can begin to realize profitable returns from the contemplated licensing initiative;

- the novelty of the invention, including a professional evaluation of the breadth and enforceability of any patents involved; the extent to which the licensor has trade secrets or acquired know-how relating to the technology, as well as the existence of momentum to develop additional proprietary information; the existence of any trademarks relating to the product or process planned to be licensed as well as any goodwill attaching thereto; whether or not there are relevant computer software programs, and if copyright protection has been secured;

- the estimated economic life of the technology to be licensed;

- existing competitive technology that is currently available in the relevant market, as well as additional developments by others that reasonably can be envisaged;

- economic forecasts of the national and global economies that could affect the commercial success of the licensed technology, as well as political factors that might have an impact.

If a prospective licensor can soberly evaluate its technology and conclude that there is some quantifiable advantage available to potential licensees, an important milestone is achieved. The existing strengths of the prospective licensee, in combination with the intellectual property and other contributions of the proprietor may be able to magnify the over-all profitability of the deal; if so, this possibility should be highlighted.

Of course, business executives may differ as to the assessed valuation of a given body of technology, or of the methodology employed. Assuming the exercise was skillfully performed, however, such values are meaningful, and can help provide the foundation of a realistic technology transfer. The prospective licensor should highlight this in a customized "executive summary" of this evaluation of perceived advantages to each targeted licensee. This should be at the beginning of the licensing memorandum, and should rarely be longer than one page.

Licensing Memoranda

As already mentioned, a technology proprietor seeking one or more licensees is frequently making unsolicited contacts with the target companies. It should also be realized that the decision makers who will evaluate these licensing submissions do not often have a highly technical background, because they may have risen through the financial, marketing, or even legal sectors of their company. One must also assume that the executives of recipients of licensing offers have existing priorities and preoccupations of their own. Furthermore, they are probably very pressured, possibly lazy, and are also being approached by other would-be licensors—or a combination of all of these realities.

It is thus logical to provide these people with a succinct, accurate, and clearly written description of the pertinent aspects of the technology transaction that the licensor is seeking to consummate. These documents should be customized as much as possible with the target company in view. If effectively and attractively done, licensing memoranda can convey positive impressions of the prospective licensor and its technology and can thus facilitate the commencement of a dialogue, hopefully leading to a positive decision on the part of the target licensee.

Licensing memoranda usually include the following sections:

(1) *Introduction or Executive Summary:* As already noted, this should present a brief overview of the licensor's position and provide initial focus on the points which have persuaded the prospective licensor that this recipient is an appropriate licensee candidate.

(2) *Description and Brief History of the Licensor:* Here the credentials of the licensor and other factors which led up to the invention or development sought to be licensed should be explained. Since licensing transactions usually involve ongoing and interactive relationships, an effort should be made here to persuade the licensee that his licensor is a capable and congenial collaborator company with which to conduct the business contemplated by the license, which may continue over an extended time period.

(3) *Summary of Technology*: This should be a short, nontechnical description which emphasizes the operating and business advantages to the potential licensee, without ignoring possible weakness, problems, or further development work that may be required before the technology can be expected to generate profits. Technical analyses and illustrations can be provided in annexes to the memorandum. If it is feasible to provide photos

or actual samples of the licensed products, that is also helpful. In recent years, prospective licensors have also prepared video cassettes and CD ROMS as effective ways to demonstrate or illustrate the operations of certain inventions.

(4) *Reference to Intellectual Property Portfolio*:

(a) The existence of patents or pending patent applications in all or part of the proposed licensed territory can be very important to the recipient company. Copies of any issued patents proposed to be licensed can be annexed to the memorandum for prompt analysis by the patent department of the prospective licensee, thus helping to shorten the time of deliberation. Since the patentee has presumably paid substantial fees to its patent agent or attorney, there should be no reluctance in requesting a professional opinion from that advisor regarding the presumed breadth or enforceability of the patents concerned.

(b) Assuming the advisor's opinion is positive, reference thereto should be made in the memorandum. It can be expected, however, that any serious prospective licensee will also independently have the proffered patents evaluated. If the possibility exists for a dialogue between the patent advisors, this can help reduce the chance of misunderstandings, and perhaps accelerate the discussions between the parties. In some cases, a well financed proprietor might commission a renowned patent law firm, which had not been involved in the prosecution of the original patents, to render an independent opinion, following a free-handed study, of the proprietor's patent portfolio. If this turns out to be a favorable, the opinion can be made available to prospective licensees as an exhibit, possibly serving to accelerate deliberations.

(c) Descriptions of the types of know-how possessed by the proprietor, as well as the means of making this known to the licensees, should be explained here. The availability of trouble-shooting and consulting services, including the extend to which this can be offered without special charges, should also be discussed.

(d) If trademark licensing is expected to be part of the deal, the conditions desired by the licensor should be discussed here. If the mark already possesses goodwill, or is particularly apt or attractive, that should be emphasized, with illustrations provided.

(e) Appropriate software packages to implement the licensor's technology is not routinely provided. The proprietor's ability to update regularly such software, as well as its willingness to enforce special sensitive features of such software from unauthorized use, should also be mentioned. It might also be indicated whether it is intended to made available source code as part of the licensing package.

(5) *Economics of Business from Licensed Technology*: In the spirit of assisting the recipient of the memorandum to grasp and appreciate the dimensions of the licensing opportunity, it is useful to provide a cash flow and profitability analysis of the anticipated business. This might even be hypothecated in three tracks—optimistic, pessimistic and realistic. If these figures take into account actual performance of the technology elsewhere in the world, that can contribute to the credibility of the picture painted, that can be helpful. In all events, the figures set forth can provide a logical basis for the proposal by the technology proprietor concerning requested payments and other expectations from the licensee.

(6) *Suggested Transaction:* This is the "bottom line" of the licensing proposal. It should outline a suggested business framework for the transaction, including the basic form , e.g. exclusive or non-exclusive license, joint venture, strategic partnership, etc... This might also provide for an initial test period, under an option, or else indicate that the potential licensee might sell the products as an agent or a distributor before making the more significant commitment to manufacture. The licensor should also indicate terms under which it is prepared to sell to the licensee certain ingredients, components, subassemblies, or models, particularly since this can constitute sources of remuneration to the licensor from the over-all relationship, in addition to royalties, while also reducing the costs or investment needs of the licensee.

If the proposed form and price of the transaction is carefully thought out, and is well calculated to be profitable to both parties, this contributes to a positive negotiating environment. Of course, the opposite is also true regarding unrealistic or greedy suggestions. The licensor should give the impression that it has thoughtfully worked out the format and that it is not merely "highballing" as a first offer. Nevertheless, it is usually advisable to signal that there is a certain amount of "flexibility" for counter-proposals and alternate ideas.

Licensing memoranda should be attractively printed and bound. They should also include good quality color photographs, art work and charts, if

appropriate. If a "shotgun" rather a "rifle shot" approach is favored in a given situation, the licensing memorandum can be featured on the proprietor's web page. The availability of laser printers, copy shops and ready web access made all of this available even to individual or small ambitious potential licensees, with modest means.

Selecting Licensee Candidates

This is one of the most crucial stages in the licensing process. As already mentioned, the analogy of oil well drilling is pertinent here. A proprietor can have the most sophisticated drilling rig, and employ the best trained crew in sinking a well but, unless oil or gas are found and brought to the surface, the entire exercise is worth zero. Indeed, the effort will have generated a substantial loss in time and employment of people, equipment, and capital. Thus, extreme care is to be exercised.

Marketing

One of the initial decisions to be made by the technology proprietor is the preferred profile of the potential licensees. Usually, the ability to market the product in question is the most significant criterion, even more important than possession of suitable manufacturing facilities; production capability can be contracted out to a third party who could make the licensed products for the licensee under contract. The possession of a marketing organization that is equipped and qualified to introduce the products promptly, widely, and effectively, however, is an asset that is not easily and cheaply acquired. A company capable of addressing the various relevant markets for products sought to be licensed is a very desirable potential candidate.

In some cases a highly skilled sales force can only be achieved after years of expensive training. This is the case with ethical pharmaceuticals, where a network of "detailing" people, who are qualified to call on physicians in order to interest then in new drugs, is virtually indispensable to success. These people are valuable corporate assets, whose time should be productively occupied. This reality has led to the negotiating of "co-marketing" deals where the detailing force of company A agrees to market and sell selected ethical drugs of company B, which is smaller and lacks an adequate detailing force of its own.

Marketing and Manufacturing

Of course, a company that combines the requisite manufacturing and marketing strengths is an even more attractive possibility. Its utilization of existing productions facilities, which presumably have available capacity, means that it

could have goods available for sale to third parties at a lower cost than would be available if those goods were to be purchased for resale from an outside production source. This cost effectiveness could be translated into greater profitability to the licensee which should, in turn, mean that the licensor ought to be able to benefit from better margins with a comparatively high royalty rate.

Inappropriateness

Even though a potential licensee possesses the requisite marketing and/or manufacturing qualifications, it would be an inappropriate candidate if there are existing reasons why it might lack motivation to give this licensing project highest priority. A market leader in a particular field that has had a long standing commitment to a different technology might not be the best firm to approach.

To illustrate, a new type of plastic conveyor chain was developed and patented several years ago which simulated the action of metal roller chain. Injection-molded from polycarbonate, this new chain had excellent lubricity and was much lighter in weight than steel chain, thus requiring much lower power to operate. It had several other advantages in that it was less noisy, and the individual links could easily be replaced, if damaged, with a hand tool.

There were several excellent companies producing a range of mild steel and stainless steel chains that were being marketed to exactly the same list of intended customers of the new plastic chain. Each of these companies was well financed and industrially capable of handling the plastic chain—although they might initially have the individual links made outside by a custom injection molder.

Nevertheless, the proprietor made a strategic decision *not* to offer a license to any of these traditional chain companies, although several expressed serious interest. It was felt that they would each have an internal conflict of interest between metal and plastic chain, and might push sales of the plastic chain only when customers expressly specified this over metal chain. This theory made sense to the proprietor because each of these potential licensees had already made large capital investments in tooling and metal fabricating machinery, and thus had a need to operate these plants. Furthermore, the sales forces were metal chain oriented because they had always previously concentrated their efforts on promoting metal chain in preference to those made of other materials.

The license was therefore concluded with a smaller company that had successfully pioneered the introduction of plastic rollers for use as part of conveyor systems; these products were being offered as alternatives to, and replacements for, metal rollers. These people possessed an existing sales organization addressing the

exact market that was relevant to the injected molded chain. They had a strong institutional bias favoring plastics over metal. They also had no other chain in their product line and were thus without a product conflict of interest. They turned out to be a perfect choice, and this license proved successful to all concerned.

Joint Ventures and Strategic Partnerships

Sometimes, an attractive alternative to the producer and seller of a competitive product does not exist, or the various corporate strengths of the traditional market leader are so superior that it would be counterproductive in the long run to grant a license to anyone else. In these cases, an effort should be made to insulate the activity of a new license from the licensee's main line activities, in order that the transferred technology can be treated with focus and high priority.

One way to accomplish this is by establishing a joint venture between the technology proprietor and the market leader, to be headed by a mutually approved chief executive and other key personnel, who would devote 100 percent of their effort to the new technology, and whose remuneration would be geared to the success of the new venture. At the same time, this venture should be eligible to take advantage of existing marketing and production facilities (e.g. tooling sources, manufacturing and assembly of equipment, warehousing, delivery vehicles, computerized billing and banking credibility) of the market leader, so long as these provide comparative advantages and do not dilute the strategy of launching and maintaining the new project on target.

The joint venture can be particularly valuable to a proprietor whose patents will expire in the relatively near future. As an equity holder in an ongoing company, the proprietor can expect to receive income from this business beyond the life of such patents. This form might nevertheless be acceptable to the purchaser of the technology if the purchaser had been anxious to become active in the business, i.e., to get a "running start", before patent expiration, and also if the patentee still possesses the ability to generate improvements, whether or not patented, to its body of technology. Licensing to the joint venture by the proprietor of a valuable trademark can also help cement a relationship in the long run.

Strategic partnerships constitute a relatively new approach to technology transfers that are gaining in popularity. They provide considerable flexibility because they are based on the principle that companies should interact in whatever way makes sense to the parties, and that these relationships should evolve in sensitive reaction to the development of the underlying intellectual property and the business itself. One of the most common types of strategic partnerships between large and small companies reflect from the fact that each party recognizes mutual

advantages resulting from their respective sizes.

Thus, both parties wish to preserve the advantages of smallness of one party ("S"), which can result in greater creativity and speed of development, without bureaucratic inefficiencies. At the same time, the parties recognize the need for the financial resources and marketing abilities of the larger party ("L"), as well as certain disciplines and experience it can bring to the project. This combination of factors offer results in relationships whereby:

- L makes a substantial, but usually minority investment in S, thereby contributing to S's financial stability;

- L and S agree on a multi-year research program, with milestones, calculated to utilize as fully as reasonably possible S's creative abilities. L usually reserves the right to monitor these activities at regular intervals and to provide support to S by calling into play various existing strengths or facilities of L; this program would be generously funded by L so as to permit S to proceed with a *minimum* of unnecessary delays;

- If S's research efforts are successful, L will have reserved exclusive worldwide licensing rights, (with the right to sublicense, if necessary) under realistic royalty rates and other terms.

Ambition Motivating Potential Licensee

Another factor that can affect the choice of a licensee candidate might be termed the "AVIS phenomenon." If there are several viable potential licensees, it might be better to opt in favor of someone ambitiously attempting to overtake the leader, rather than to license the leader itself. That candidate might "try harder," in the words of the famous slogan, or else might be willing to accept somewhat more expensive licensing terms in order to obtain this opportunity.

Research Tools

It follows from the foregoing discussion that the importance of research by the proprietor in identifying specific licensee candidates cannot be overemphasized. Any and all of the following tools can be utilized:

- The advent of the Internet provides a powerful new tool to locate potential licensees, who can then be rapidly and anonymously investigated further by visiting their web sites.

- Interrogate, via key words, selected computer data bases, which include recent scientific publications and references to issued patents. This technique can be especially valuable in attempting to locate relatively small or unobvious companies in certain area of high technology.

- Traditional desk research in checking basic business directories, industry publications, and trade association rosters remains valuable, particularly after initial computerized searches.

- Attend trade shows where an effort should be made to obtain personal contacts in all of the various companies of potential interest. The potential licensor might bring copies of the one page executive summary of its licensing memorandum, together with business cards, to leave as "door openers" with personnel of possible target licensees at the trade show.

- Sample existing products in retail outlets or contact dealers or distributors of products in the industry, in order to evaluate items with which the licensed technology will be competitive, and also to obtain intelligence about companies who are either potential licensees or competitors.

- Retain consultants, including recently retired executives, who may have extensive personal contacts in the industry. They may have valuable insights about the true state of affairs concerning the various "players". Furthermore, they could conduct investigations on behalf of the technology proprietor without necessarily revealing its identity.

There is no single magic formula for conducting market research in the licensing field, although experience has shown that personal discussions with persons active in the targeted industry can rapidly provide valuable insights about trends and the reputations of particular companies.

The adroit use of the telephone can help accomplish this—a technique facilitated by the accelerated introduction of advanced telephone equipment in the United States and elsewhere in the world. Someone who has acquired long experience in a particular field is usually willing, in the course of a non-threatening telephone conversation, to share their expertise on the marketing level, provided

one does not seek to elicit business secrets. These people will often comment about the relative merits of several companies, including their competitors in the industry, and also supply the names of others deemed knowledgeable.

By comparing and cross-checking a variety of opinions—which can be obtained by a skilled investigator in a relatively short time—a meaningful picture usually emerges. Tact, friendliness with respect, attentiveness and gratitude are traits that are important to the success of these exercises in telecommunications.

Plan of Action

If the potential licensor has (1) already prepared a licensing memorandum, (2) considered various viable licensee profiles, and (3) worked out priorities, the input of market intelligence acquired through employment of the described techniques should make it possible to formulate a realistic plan of action. This should include decisions about (a) whether exclusive or nonexclusive license grants would be most appropriate, (b) whether to consider including field of use restrictions, and (c) how to define the authorized operating territories of licensees, and (d) other strategic alternatives, including "creative" forms for the transaction.

Another decision to be made at this point is whether customized "rifle bullets" should be sent to specifically selected potential licensees, or whether the availability of the license should be made known to the industry in some broadcast fashion. The writer usually favor a "rifle shot" over a "shotgun" blast. Sometime, however, even this amount of background information fails to reveal a clearly preferred course of action to the proprietor. The relevant industry may be so diverse, without any really obvious targets, or there may be numerous potential applications of the technology in question. If so, a shotgun approach may be more appropriate.

This can be accomplished by placing an announcement of the availability of the license on the Internet or by publishing a description of the technology offered for license as an article or advertisement in relevant trade journals, briefly describing the opportunity and indicating the names and addresses of persons to contact for further details. It can also be done by sending out a series of licensing memoranda to each of those companies falling within the selected general profile. The extent to which specific individuals in the latter class of companies can be identified by name and title can influence the degree of success of this approach, because it adds a useful personal touch. Existing PC software makes such customization easily possible.

Care must always be taken in choosing the point of entry to a target

company. If the technology proprietor has previously done the requisite homework, he or she will understand something about the internal organization of each potential licensee, including the location of the senior person to whom the first approach ought best be made. Implementing this can avoid unnecessary delay; indeed it can prevent having the project pigeonholed or rejected because the essence of the offer was misunderstood, or beyond the clout of the person contacted.

As a general proposition, the higher the level at which attempts to penetrate a target company are made, the more likely the proprietor is to gain the attention of the true decision maker. It is also usually a fact of life that the difficulty of penetration is usually directly proportional to the seniority of the selected point of entry. It is here that a truly excellent licensing memorandum proves its value as an "ambassador." If this document can reach the consciousness of the right people in the target company, and if genuine interest is thereby stimulated, one of the most serious hurdles to successful licensing will have been overcome.

Here again, the telephone can provide useful assistance. It is believed that initial licensing proposals—usually in the form of the memorandum, hopefully accompanied by illustrations or samples—should never arrive unheralded. A telephone call to the secretary of the targeted executive, or a fax sent the day before, announcing the imminent arrival of an important licensing opportunity, is frequently helpful. An overnight courier should also be used to be certain of delivery when expected. Furthermore , once his memorandum is received, the proprietor should promptly follow up with a telephone call to be certain that the mailing was indeed received by the intended person.

It should also be indicated at the same time that a follow up (to answer questions and to learn any preliminary reactions) can be expected at a particular point in time. This should be no later than one week following receipt of the disclosure, and probably should be sooner.

A willingness on the part of the licensor to comply with any reasonable disclosure procedure maintained by the licensee might be indicated at the same time. Indeed, this might be obviated at this stage if the licensing memorandum expressly provides that it is limited to nonconfidential disclosure, and/or that the proprietor is relying solely on its patent rights in making this submission. Readiness to enter into legally protected confidential discussions as the dialogue proceeds should also be made known at the outset.

Questions

Once initial contact has successfully been made with one or more potential licensees who express interest, it behooves the proprietor to help provide meaningful answers to the extensive range of questions which can be expected to be raised by serious prospective licensees. After all, each potential licensee is contemplating making and investment which can create an extension, and perhaps even an important change, in its business. This involves risks as well as capital outlay. The skill and speed with which the proprietor makes it possible for the potential licensee to appreciate the true potential of the technology, and to obtain reassuring answers to its legitimate questions, is of crucial importance to the outcome of the dialogue.

Several factors are deemed relevant in this connection:

(1) The licensor should arrange a well-rehearsed demonstration of the technology to representatives of the licensing target company as promptly as possible after an expression of interest. If this can occur at the premises of the licensor, and if these facilities are likely to create a favorable impression on members of the visiting delegation, so much the better.

Otherwise the licensor should indicate its readiness to visit an appropriate facility of the licensee provided this does not create undue hardship. One advantage of this is that it can afford the licensor an opportunity to inspect such facility and thereby improve its knowledge of the licensee's capabilities.

If successfully executed, this exercise serves two indispensable purposes:

(a) It provides evidence of the accuracy of the claims made by the proprietor in its licensing memorandum, thereby contributing to credibility; and

(b) it advances the personal relationships between representatives of the respective parties. The spirit of confidence and mutual trust that may be developed between the parties can serve as a useful catalyst when the parties eventually get down to serious bargaining.

(2) Each party should nominate a principal spokesperson, plus an

alternate, through whom communications from the other party are to be addressed. By thus focussing the dialogue, irrelevancies and misunderstandings can be minimized.

(3) Questions and concerns of the potential licensee should be identified as early as possible, and the best qualified people on each side should thoroughly address each issue. These might include:

(a) Technical queries about the operation and effectiveness of the technology, both on its own and in comparison with alternatives;

(b) Financial and cost matters that can have an impact on the ultimate profitability, or degree of risk to the licensee, in the envisaged technology transfer;

(c) Environmental problems and other regulatory issues that are relevant to the contemplated activity;

(d) Evaluation of the coverage and enforceability of the patents being offered for license, including an analysis of their prosecution history at various patent offices;

(e) Understanding the extent to which the licensor possesses valuable trade secrets, operating and marketing know-how, and the likelihood that further developments of this sort may be expected; and

(f) The availability to the licensee of initial consultations to get the project started, as well as providing troubleshooting aid in later years.

(4) The potential licensee will usually prefer to take the lead in deciding about certain other issues, particularly those relating to the suitability of the licensed technology in the territory reserved for the license. The willingness and generosity of the licensor in providing data, based on its own experience, can nevertheless make a favorable impression and prove valuable.

Promoting Understanding

Because licensing arrangements usually entail continuing relationships,

extending over many years, a certain gestation period is almost always necessary. In addition to the need to obtain answers to the logical questions listed above, and also to perform their own market research, licensees are frequently seeking a degree of confidence in balancing the risks against the scope of the opportunity being offered. This is particularly true in international licensing, in which the parties may be products of very different cultural backgrounds.

The general comportment of the technology proprietor can be important here. If he, she or it demonstrate efficiency and thoroughness in furnishing information, this can tend to overcome the inherent caution of the prospective licensee. If the licensor appears overanxious or pushy, however, suspicions may be aroused. Thus, sensitivity in interpersonal relations can be a significant factor. Again, this is particularly true on the international level where the initial threshold to achieving understanding is higher because of cultural and language differences.

Suppose, however, the licensee displays a degree of indifference, or appears to be employing delaying tactics as part of a negotiating strategy. The proprietor's best defense against this is to have alternative licensing candidates and to indicate this fact frankly to the prime target company. A powerful potential licensee may sometimes state that it will not subject itself to "horse races" or other forms of pressure. Unless the licensor is intent on delaying with that particular candidate, however, it would be counterproductive for the licensor to abandon the element of competition as an aid to the licensing of its technology.

Licensing Agreements

As the proprietor of the technology in question, the licensor should be in a position to suggest that it be the one to furnish the initial draft of the written agreements. Lawyers argue that this can entail risks, because courts tend to interpret against the draftsman when ambiguities arise in contractual language. It is my view, however, that the advantages in framing the first text greatly outweigh this potential negative factor. This is because the first draftsman can set the entire tone of an agreement and can easily insert many reasonable procedural elements in the first instance that otherwise might have to be bargained for later, requiring possible unnecessary concessions to the other side, if they are omitted from the initial draft. Furthermore, the initial draft might contain provisions which the proprietor might be willing to reduce or eliminate during negotiations, for which it might obtain some reciprocal concession.

In the context of this chapter, there are two portions of the licensing agreement that call for comment. One concerns the provisions governing the license grant and actual technology transfer; the other relates to reporting by the

licensee.

License Grant and Technology Transfer

The parameters of the licensed technology should be precisely defined. Imagine, for example, a license in the 1950s with respect to calculating machines, at a time when this type of product was entirely electromechanical in nature. If the agreement provided, as many do, that improvements by the licensor to the licensed technology will be automatically communicated tithe licensee, the quantum change to solid state electronic calculators would automatically be available at no additional charge to the licensee, assuming the licensor had succeeded in making this innovation. Had the original definition been tightly confined to "electromechanical calculating machines," however, this problem would be avoided, and the licensor would be eligible to make a new deal, probably on more favorable terms, given the important impact to be expected from the new technology.

The actual technology transfer should be carefully focussed, yet be accomplished expeditiously, because the major portion of royalties anticipated under the agreement will not begin to flow until the licensee is actively exploiting the subject of the license. This can be accomplished pursuant to these guidelines:

- A complete written description of the technology, with requisite engineering drawings, should be made available to the licensee in the form of a manual. Often, only one copy of the comprehensive manual is provided, in loose leaf form, with strict requirements that this be under the control of certain named persons, who undertake to maintain the complete body of information confidential.

- Copies of portions of the manual should then be provided to specialized employees of the licensee who have "a need to know." Such personnel should also be bound to appropriate obligations of secrecy concerning the information revealed to them, and their identity should be made known to the licensor. Much of this information can now be transferred via CD-ROMS, which may also require special confidentiality safeguards.

- Qualified employees of the licensor should present the subject matter of the technology transfer to the licensee, and spend sufficient time doing so to be certain that the information is properly understood. The expense of this exercise to the licensor can be covered by initial license fees and/or by preset per diem charges if a defined amount of

time intended for the initial technology transfer is exceeded.

- Selected delegations of employees of the licensee may be afforded an opportunity to visit, and even spend substantial periods of time, if appropriate, at designated facilities of the licensor, if this can accelerate or improve their comprehension of the essence of the technology transfer.

- Machinery should be provided for effective communications between the parties in order to answer questions or solve problems that may arise, with a minimum of delay. Teleconferencing and state-of-the-art graphics techniques can prove helpful here. The parties should never lose sight of the fact that inoperative licensees do not generate running royalties, and it therefore behooves the licensor to do everything possible to be certain that the licensee "gets it".

Reporting by Licensee

Periodic reports (usually quarterly) by the licensee should cover three areas:

(1) the level of business activity of the licensee on the basis of which running royalties are calculated;

(2) the marketing strategies that have been formulated by the licensee and details of the manner in which these programs have been implemented; and

(3) research projects underway by the licensee, or for which it may have contracted, relevant to the licensed technology, particularly progress made that may be subject to a grantback to the licensor.

The licensor should be actively responsive to the information obtain through these reports. It should be prepared to have the royalty calculations audited; indeed, regular auditing, particularly at the outset of a licensing relationship, has been known to instill a healthy sense of discipline into the accounting procedures of the licensee. If weaknesses in the licensee's marketing program are perceived, the licensor should comment, suggesting improvements. With regard to technical innovations, measures should be taken to insure appropriate intellectual property protection, and also to integrate useful innovations into the licensor's technology portfolio.

These three areas of interchange between parties to licensing agreements are sometimes defined as "post-licensing liaison." They constitute an aspect of the technology transfer process that is frequently given insufficient emphasis. An analogy to vegetable gardening is not inappropriate: weeding is usually somewhat tedious and tiring, but it tends to improve the size and quality of the crop.

Conclusion

Success in finding and nurturing new licensing relationships can be enhanced if practitioners approach this difficult assignment with discipline. The many considerations involved have been described as constituting "10 percent inspiration and 90 percent perspiration." Logic and attention to detail are obviously important to this, as they are to most fields of industrial activity. Before undertaking the investments in time and expense involved in the licensing process, the proprietor should also carefully evaluate whether the innovation sought to be licensed is of sufficient merit and dimension to justify the considerable effort required.

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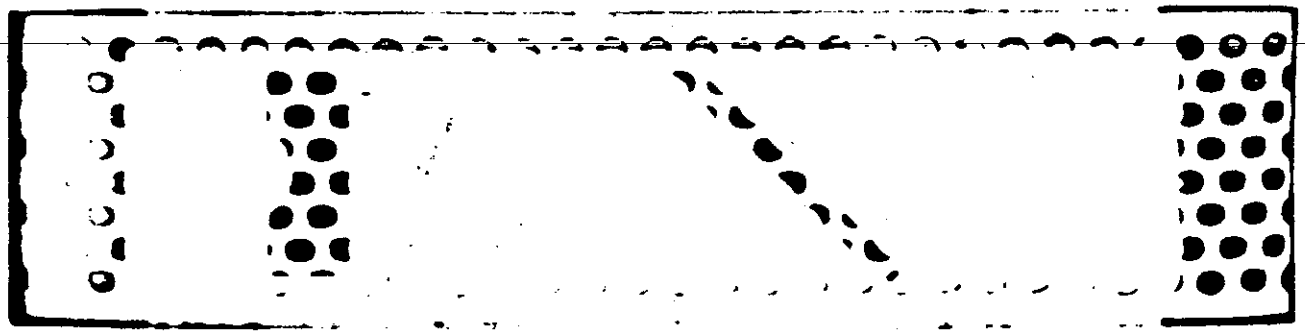
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Robert Goldscheider 1





THE NEGOTIATION OF ROYALTIES AND OTHER SOURCES OF INCOME FROM LICENSING

BY ROBERT GOLDSCHEIDER*

I. INTRODUCTION

Technology transfer agreements involving long-term relationships should be creative in both organization and structure. In fact, long-term profitability is often achieved by subtle and indirect forms of consideration. Accordingly, skilled practitioners of licensing should not be slaves to a "plain vanilla" approach. Rather, by combining resources from several aspects of various intra-party business dealings, practitioners can frequently generate greater income for both parties to a negotiation.

Without the prospect of substantial benefits, there is no point in making a deal. Thus, when valuing a prospective transfer of technology, one should first quantify the total possible profit. This valuation should include the effect of combining the rights and resources which each party is expected to contribute. Only after making this determination may parties logically negotiate their portion of the profit. If the preliminary apportionment is realistic and equitable, the parties may achieve the ultimate goal of licensing professionals: the "win-win" relationship.

The above approach may seem strange to newcomers to the licensing field who are only familiar with licenses based on royalty rates, which are often a simple percentage of the licensee's net sales of the licensed product. Indeed, the thought of basing a license upon a profitability analysis is distasteful to many in the licensing field. But royalty rates are merely expressions, or mechanical forms of calculation, employed by parties when making decisions or assumptions based upon profitability. Thus, many people make decisions based on profitability without even realizing it.

Parties to potential licensing transactions should remember that a technology transfer may have broad, corporate implications. Transac-

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tions susceptible to these implications may include: licensing in technology to complement existing core technologies; licensing out technology to a larger company to fund further research; or, for a small proprietor, generating capital funds for growth by selling a minority equity interest to the licensee. Later, the licensee might also consider acquiring the proprietor.

License creations are often important transactions in their own right. However, they may also be integrated into multi-faceted arrangements to meet both the short and long-term objectives of the parties. Furthermore, licenses are not the only way to realize returns on investments made during discovery, creation, and development of the subject technology; many alternatives exist. This article exposes and discusses many profit-generating alternative methods for achieving a mutually-satisfactory bottom line.

II. PARAMETERS OF OPPORTUNITIES

There are several questions which help quantify the profit potential of a specific license. Some of these questions include the following:

A. *Size of Relevant Market*

Is this item widely utilized by the general public, or is it a relatively specialized item that is important to only a narrow sector of the population, or to only a limited geographical region? Additionally, does the deal have wider implications for the proprietor or the licensee?

B. *Dynamism of Market*

Is this a rapidly expanding sector of the economy that is expected to continue growing? Is this optimism a reaction to the novelty of the technology involved in this particular transaction, which may be supported by a patent or trade secret protection or both? Is the relevant market stagnant or declining? Indicators of market stagnation are excess production capacity, too many competitors, changes in consumer tastes, and general technological obsolescence.

C. *Special Characteristics of Technology Intended to be Licensed*

Is the technology a unique breakthrough which is creating a new market? Is a "pioneer" patent involved? Has a validity search of the patent(s) been conducted by competent persons? Is the subject invention an improvement that is easily discernible over other, widely-known products or processes? Alternatively, is it an evolutionary refinement of something relatively standard? Is it a key component of a larger system? Can it stimulate additional sales of ancillary products or services?

D. *Quality of Contribution by the Proprietor*

Does the proprietor enjoy a well-recognized reputation as an innovator and a continuing source of useful ideas and improvements? Is the proprietor known to vigorously defend its rights against infringers? Is there goodwill attached to being associated with this company, person, or group?

E. *Expected Asset Contributions From the Technology Recipient*

Is the recipient financially powerful and an efficient manufacturer, or does it possess an effective marketing organization, or both? If properly motivated, is it likely to maximize the potential of the relevant technology? Does the recipient require, ancillary to the patent, know-how from the proprietor, or does it already possess such knowledge?

F. *General State of the Economy*

Does the economy show signs of expansion, recession, or recovery? Are there economic indicators, existing or proposed laws, or tax incentives which could affect the licensing parties' contemplated business?

These criteria, interpreted individually and in combination, should help parties assess the financial outlook of a given license. These tools may generate a forecast that will help proprietors and licensees avoid disappointing relationships.

III. CONCEPT OF INHERENT VALUE

When attempting to license an invention, a proprietor will sometimes justify a high royalty rate by noting that it has expended enormous time, effort, and money to create and develop the subject technology. To counter this argument, astute licensees should characterize those expenditures as the proprietor's "sunk-costs." As such, they are irrelevant to the licensee, who is only interested in the technology's future profitability.

Fortunately for the licensor, there is a way to trump this "sunk-costs" theory. Consider, for example, a pharmaceutical company which, with very little out-of-pocket expense, discovers a new application or use for an existing drug. Assume further, that the licensor has existing, fully-depreciated production facilities to satisfy the large and urgent need for this new use. In such a case, the proprietor might alternatively choose to exploit the opportunity directly. This extra option provides the proprietor with enough leverage to demand a high royalty rate; thus, the proprietor can afford not to make a deal.

The element of risk is also important in determining which party should realize the lion's share of the return from a licensing relationship. The licensor typically bears the principal risk, since that party usually makes the initial investment required to introduce the subject technology. When the subject of the license is a process, however, licensees may have to make investments as well. Often, their existing production facilities must be reorganized, and sometimes, completely new facilities are needed in order to exploit the license. In situations where no such licensee capital outlays are needed, a high royalty rate would be justified. A high rate will serve to compensate the proprietor for the risks associated with its initial investment.

IV. RELATIVE CONTRIBUTIONS OF PARTIES

After reaching a consensus about the overall profit potential, the parties should establish a profit-sharing ratio. This apportionment of future profit rarely occurs on a conscious level, but it is nevertheless important.

It is here that the so-called "25 percent rule" can be put to useful effect. The rule compares the licensee's expected pre-tax profitability rate from the combined resources of the parties to the expected profitability of a similarly-situated, model license. It cannot be overemphasized that this technique merely provides a starting point from which the parties can often gain a better perspective on their relative contributions.

Although helpful, the "25 percent rule" is not universally applicable. If it were, there would be no point in applying it in the first place.[1]

Apparently, the "25 percent rule" was utilized by practitioners even prior to 1971. The late Worth Wade, citing Albert S. Davis, Jr.,[2] listed three basic patent licensing considerations: "(1) scope of patents, (2) validity of the patents, and (3) profitability of the patents' use. If the patents protect the licensee from competition and appear to be valid, the royalty should represent about 25% of the anticipated profit for the use of the patents."[3]

Accordingly, if the existing factors correspond closely to the model, the parties should seriously consider adopting a 25 percent to 75 percent profit split between the licensor and licensee. But where the circumstances differ from those in the ideal model, the ratio should be adjusted accordingly. The author's recent experience demonstrates that the ratio can successfully be adjusted to reflect pertinent factors, like varying levels of party participation.

The author suggests basing calculation upon pre-tax profitability because pre-tax profitability is one of two figures (the other being "net invoice value" or "net invoiced sales,"[4] the most common basis for the calculation of royalty payments) which are least subject to differing interpretations by accountants. When developing a strategy that will work in a variety of settings, this type of consistency is important.[5]

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[1] The author first discussed the "25 percent rule" in print in 1971 in Goldscheider & Marshall, *The Art of Licensing from the Consultant's Point of View*, 6 LES NOUVELLES 4 (1971), *reprinted in* FINNEGAN & GOLDSCHEIDER, THE LAW AND BUSINESS OF LICENSING 645 (1980). This concept arose from a world-wide series of successful licenses. Beginning in 1959, the author negotiated a series of licenses that were based upon a 20 percent pre-tax profit and a 5 percent royalty on net sales (i.e., a 25 percent of total profit). This rate satisfied both licensees and licensors. While the rule has been refined, it is now widely employed by licensing executives and has been mentioned frequently in licensing literature.

[2] The late "Sam" Davis, formerly General Counsel of Research Corporation, is a fondly remembered and highly regarded American pioneer in the licensing profession.

[3] WORTH WADE, HOW TO PROFIT FROM LICENSING 1 (1969).

[4] This is usually specifically defined in the agreement as gross sales less cost of freight, insurance, returns and allowances, and sales or use taxes, but not income taxes.

[5] In some situations, it may be preferable to refine pre-tax profitability to the concept of Income Before Income and Taxes (IBIT), or Earning Before Income and Taxes (EBIT), where the former is sometimes referred to by accountants. This refinement can remove anomalies in the earnings of particular companies that are carrying a heavy debt burden from some past, unrelated, transactions. A company's projected operating profits from the specific licensing transaction might be equal to those of another potential or actual licensee that is debt free, but the requirement to make interest payments on such debts [illegible]

Licensors with a relatively strong arsenal of assets should begin licensing negotiations by requesting a 25 percent royalty rate. With this as a starting point, the involved parties may adjust that rate to account for mitigating circumstances.

Elements that increase the strength of a prospective licensor's assets include the following:

(1) the existence of relevant, assumable, and enforceable patents;

(2) the existence of trade secrets and know-how that are related to the subject technology;

(3) the existence of ancillary trade secrets and know-how, including marketing insights and contacts;

(4) one or more established product trademarks, house marks, or logos that could promptly contribute goodwill and credibility to the licensee;

(5) software programs, advertising support and other expressions of creative work, whether or not protected by copyright;

(6) an active, well-financed and historically-productive R&D facility that could reinforce the licensed technology on a regular basis;

(7) a pattern of successful licenses between the licensor and similar or current licensees;

(8) a reputation for diligence in pursuing infringers of its rights; and

(9) a reputation for protecting its licensees from independent actions initiated by third parties.

Licensee risk assumption is probably the most contested factor in the entire profit-apportionment equation. Prospective licensees who assume unusual risks should expect to adjust their portion of the profit up from the standard 75 percent. For instance, licensees may need to make substantial investments in new plants and staffing. They may also face

serious competition in the relevant market. From the licensee's perspective, other risk-related factors exist and may include:

(1) the possession of a pre-existing manufacturing plant and the capacity to produce the licensed product or process;

(2) the possession of a skilled marketing force that can effectively reach the licensed technology's intended market; and

(3) the availability of critical raw materials, local government approvals, or financial grants that can have an impact on both short and long-term success.

To the extent that the licensee and licensor have overlapping resources, the licensor's leverage is reduced. However, the contemplated technology transfer may enable the licensee to make better use of under-employed resources. When this is the case, the licensee's overall risk is reduced, and the licensor's leverage is increased.

The 25 percent rule is not actually a rule, in the formal sense. It is merely a rough guideline that should be refined to fit a given situation. While licensing professionals sometimes follow other royalty setting approaches, careful presentation of licensing terms based on the 25 percent rule is usually well-received. Because it was originally conceived in the real world, this rule has a ring of common sense and is becoming widely accepted.

In a recent negotiation, the parties reached a consensus on several projections: the costs of production, including raw materials to the licensee; the selling prices obtainable; the levels of sales; and the expected market share. This data, along with predicted inflation rates and expected market demand, made it possible for the potential licensor to construct a ten year spreadsheet.

During the following negotiating session, the potential licensee offered to pay a 5 percent royalty rate on the mutually agreed royalty base. The licensor then presented its spreadsheet. The spreadsheet illustrated that the licensee could expect a weighted pre-tax profitability of more than 40 percent over the next ten years. Based on the value of the intellectual property offered, the proprietor requested a minimum of 25 percent of this revenue, which was actually a 12 percent royalty rate. The spreadsheet's numbers were indisputable and the 12 percent royalty was adopted. Additionally, since the "bottom line" achieved in the negotiation was supported by credible figures, the contracting parties' boards of directors accepted it as well.

V. SETTING RATES

Quite often, parties will agree that the division of profits will be manifested in practice as a percentage royalty of the licensor's net invoiced sales. This mechanism is frequently chosen for two basic reasons:

(1) licensees operating at "arm's length" with their licensors often prefer to release raw sales figures over actual profit margins; and

(2) this approach compensates for inflation.

Although commonly used, a "percentage of sales" approach actually disfavors licensees. This is because it regularly generates royalties to the licensor, regardless of the actual future profit performance of the licensee. Consider the following situation:

(1) suppose, at the outset, a licensee is able to sell the licensed products at $100 and has total material labor and overhead costs of $70. This yields a pre-tax net profit of $30. Accepting the 25 percent rule, the licensor is entitled to 25 percent of the pre-tax net profit. Therefore, the parties should agree to a 7.5% royalty rate, because: 25% of pre-tax profit = (.25 x (100-70)) = 7.5%; and

(2) if conditions change, and costs increase from $70 to $94, without a corresponding increase in licensee prices above $100, the pre-tax net profit would be only $6. If the parties previously agreed to a royalty of 7.5% of the licensee's net invoiced sales, the licensor would be entitled to the same royalty rate, but the licensee would actually be incurring a loss. (100-94 = 6% pre-tax net profit; a 7.5% royalty would mean a 1.5% loss to the licensee).

This "heads I win, tails you lose" aspect of royalty calculations based on a percentage of sales can provide licensees with an argument to fix the royalty rate lower than the 25 percent guideline. An increased likelihood of substantial market fluctuations may also aid the licensee in arguing for a lower rate when applying the 25 percent rule.

VI. ROYALTIES AS A PARTICIPATION IN SUCCESS

Licensors who have confidence in the future performance of their licensees may maintain a high royalty rate by offering to share in the fortunes of the licensee, good or bad. This approach is often useful in licenses for processes designed to improve efficiency or lower costs. For example, a confident licensor might set royalties at 25 percent of the savings the licensee realizes from the improved process. The danger here is that the licensor must forgo royalties if the licensed technology fails to achieve its predictions.

Indeed, by assuming this added element of risk, the licensor might even attempt to negotiate a bonus for exceptional performance attributable to the licensed process. This bonus is a logical request, because even marginal increases in efficiency often produce increases in profit.

When the above "cost savings" approach is used, the parties must agree upon exactly how the "cost savings" will be calculated. This type of planning reduces the likelihood of disputes related to royalty amounts later on, and therefore, helps maintain long-term business relationships.

Even where product licensing is concerned, licensors sometimes offer to share the licensee's risk by accepting royalties calculated as a given percentage of profit. If royalties are based upon an objectively-determined profit calculation formula that allows for verification, this method is an effective way to license products.

VII. OTHER FORMS AND APPROACHES TO LICENSING REMUNERATION

Although running royalties account for most of the remuneration received by licensors, additional approaches exist. These include the following:

A. *Lump-Sum Payments*

A would-be licensor (now called the proprietor) can simply sell its technology for a so-called "lump-sum payment." This approach is useful for technology that licensors no longer need. It is often used when a given technology falls outside the proprietor's business or when, as is common after a policy shift, the proprietor abandons activities relating to the subject technology. Care should be exercised before choosing this method because it may elicit capital gains tax treatment if the technology's cost basis can be established.

After quantifying the payment, the proprietor's minimum acceptable amount should, at least, account for the disposal costs and any risk arising from the purchaser's possession of the technology. The proprietor may also justify a higher selling price by pointing out the benefits the sale will bring to the purchaser.

The upper boundary of lump-sum payments is the purchaser's cost to duplicate or "invent around" the technology. If the technology is patented, the remaining patent life should be considered. Similarly, a body of know-how or trade secrets can also be transferred, with the cost and time needed for duplication accounting for its purchase price.

The same 25 percent rule which is useful in setting periodic royalties may also be used to set lump-sum payment prices. To apply the rule to lump-sum payments requires the following steps:

(1) perform a 25 percent rule analysis and arrive at a royalty rate;

(2) project the economic life of the technology in question;

(3) project a royalty base for the technology, taking into account the significance of such technology to the product, process, or service being transferred; and

(4) multiply the rate by the base and perform a discounted cash flow analysis on the product of such multiplication, using the interest rate for borrowing available to the technology purchaser.

Of course the sum reached by the foregoing method is subject to final adjustments. Often these adjustments reflect the parties' need to complete the transfer.

B. *Periodic Lump-Sum Payments*

Sometimes it is onerous for parties to calculate royalties on the use of a particular invention because it is a component of a complicated piece of equipment or system. In these cases, an annual lump sum may be a more practical approach.

For instance, suppose an auto manufacturer licenses technology that improves its current technology. Assume further that the invention is incorporated into each of the millions of vehicles produced by such licensee each year. If an annual lump sum of $1 million were fixed as a

"paid-up royalty" for that year, it would represent a very narrow slice of the profit generated by the total sales of the vehicles concerned. Nevertheless, the actual payment may well be reasonable to the parties concerned. Because the auto market's and the licensee's gigantic proportions are not attributable to the licensor or its invention, a more "normal," heavily discounted royalty rate is appropriate.

An alternate approach involves charging a fixed royalty per item sold or used by a licensee. This method is favored because it affords easy royalty calculation. Whatever method is used, it is advisable to key the lump-sum royalty to a recognized economic indicator. This link will facilitate later increases in the payments, consistent with inflation or other economic events.

C. *Initial Payments*

The availability of initial payments is very important in the negotiation of licenses. It is also important during the calculation of the parties' relative profit entitlement. Initial payments are popular because they provide front-end cash to a licensor, which can immediately be applied to recover the costs associated with developing the licensed technology. Additionally, because the costs must be recouped before a licensee can begin to realize profit, these payments are strong evidence of licensee commitment. The licensee's maximum payment should correspond to the reasonable amount of working capital earmarked by the licensee for the license.

D. *Prepaid Royalties*

Sometimes a licensor is financially weaker than the licensee, but is required to further develop the licensed technology. The licensee may provide these needed funds. The amount paid in excess of the reasonable initial payment can sometimes be applied against future running royalties, depending on how they are calculated.

In a current negotiation, this device is being cleverly employed by a start-up licensor who has patented a significant invention, for which there are several powerful licensees. The licensor requires significant working capital to grow its business and to further develop its technology. However, the entrepreneurs who founded the business do not currently wish to dilute their equity holdings by bringing in equity funding. So each licensee is required to pay, in lieu of an initial fee, a pre-paid royalty of $250,000 in U.S. currency. This sum is then recovered by the licensee at

In other words, if a licensee sells $5,000,000 of the licensed products at a 10% royalty rate, then $500,000 in royalties would accrue. The licensee would pay $250,000 in running royalties to the licensor and would credit the remaining $250,000 to the prepaid royalty previously advanced to the licensor. This device provides the licensor with funding, while helping the licensor maintain its ownership position.

E. *Minimum Royalties*

Minimum royalties are another device which can ensure commitment and adequate licensee performance. The word "adequate" is used advisedly because the level set is usually less than excellent performance. Instead, it reflects results which are at the low end of the licensor's acceptable range. It has been said that "minimum royalties are the handmaiden of exclusive licenses." This is because the minimum amounts must be paid in order to assure the continued exclusivity of the licensees.

Minimum royalties can also be employed when non-exclusive licenses are involved. They can improve a licensor's cash flow, especially in times of high interest rates, by requiring each licensee to pay the greater of the minimum or the accrued royalties at the end of each calendar quarter, with the possibility of a final adjustment at the end of each reporting year. Minimum royalties may also be used to eliminate licensees who cannot perform adequately by providing a mechanism to "weed out" the unsuccessful licensees.

The licensor has three recourses to enforce the minimum royalty, which vary in severity. In ascending order of impact, they are as follows:

(1) if the activity level of a licensee is insufficient to generate enough accrued royalties to exceed the minimum level, a licensee may merely pay the difference;

(2) on the same facts, even if a licensee pays cash to cover its shortfall, a licensor has the discretionary right to reduce the rights of the licensee (e.g., by retracting exclusivity, by reducing the scope of the products licensed, or by narrowing the territory covered by the license); and

(3) on the same facts, a licensor has the discretionary right to cancel a license.

The agreement may provide that remedies (2) or (3) would only be available to a licensor if a licensee had failed to accrue sufficient royalties

to meet or exceed the minimum level in more than a set number of years or consecutive reporting periods.

Minimum royalty levels usually increase from zero, during the initial year of a license, up to a maximum level during later years. For instance, a license which starts on February 1, 1995, might provide the following royalty payments:

Until 12/31/95	10,000	U.S. Dollars
From 1/1/96 to 12/31/96	25,000	
From 1/1/97 to 12/31/97	50,000	
From 1/1/98 to 12/31/98	75,000	
Every calendar year thereafter	100,000	

In some instances, parties can also provide that minimum royalty requirements will decrease over time to reflect the maturity of the licensed technology. Providing for inflation by tying minimum royalty figures to some recognized index (e.g., the Producer's Price Index of the U.S. Department of Labor) is a useful device that is frequently employed.

F. *Sale of Key Ingredients, Components, or Special Items by Licensor to Licensee*

A licensee may purchase a key component from a licensor at a price sufficient to eliminate the licensor's need to exact royalties in any form. Provided the purchased item is truly proprietary to the licensor, these arrangements need not run afoul of tying prohibitions under the antitrust laws.

Frequently, it is cheaper for a licensee to purchase certain components from a licensor who is prepared to make the components and can take advantage of long production runs. By exploiting their production ability, some licensors may offer a price and royalty combination that makes the subject technology cheaper than if the licensee produced it. Licensors who do this can sell the component at a price that includes incremental profit; they can also charge running royalties.

Sales also occur when licensed products are available in a range of sizes or models, with some being much more in demand in a licensee's territory than others. In these cases, it may be more economical for a licensee to purchase the less popular sizes or models from a licensor. Royalty payments may or may not attach to resales by the licensee of those items, depending on the circumstances, including the relative bargaining strengths of the parties.

G. *Barter and Payments in Kind*

Barter and payments in kind are common when licensing to third world countries and to the People's Republic of China because these countries have insufficient hard currency available to fund their licensing interests. A barter system frequently utilizes specialized intermediaries who arrange the trade of goods offered as payment by the licensees.

Alternatively, licensees may offer to sell goods made under the license back to the licensor, at attractive prices. This system works when the licensor makes a resale profit that is sufficient to compensate the licensor for granting the license. However, arrangements of this sort are not frequently of interest to licensors because there are often ample supplies of the subject goods available.

H. *Receipt of Equity*

Skeptics of the licensing process claim that these transactions educate future competitors. To reduce this risk, licensors should require interested potential licensees to form a new corporate entity for the purpose of executing the substance of a proposed license. As total or partial consideration for a license grant, the licensor should receive a mutually agreed percentage of the voting stock of the new corporate licensee, usually with the right to veto decisions that are considered important to the continued viability of the venture.

There are many possible variations on this theme, including provisions for royalty payments to the licensor or potential dividends from the licensor's holdings in the licensee corporation. Also, the licensor might sell or increase its holdings, in accordance with some express formula.

I. *Sublicensing*

By granting licensees the right to appoint one or more sublicensee, a proprietor can increase its earning potential. To do so, the licensor should require that sublicensors remit a pre-agreed percentage of the income from sublicensees, e.g., from 5 to 95 percent, depending upon the role of the licensee. Another approach is to require the licensee to remit to the licensor the same sum per licensed product . . . the licensee pays on its direct sales, with the understanding that the sublicensees will pay a somewhat higher royalty; the difference being retained by the principal licensee

VIII. SUPPLEMENTAL FORMS OF REMUNERATION TO LICENSORS

By performing special, additional services for its licensees, technology proprietors can often increase the profitability of licenses. Proprietors often provide consulting or trouble-shooting services. Profits from these services can come from annual retainers or per diem charges. To encourage licensees to utilize these licensor-operated services, a certain (usually modest) amount of the service may be offered free of charge, with fees only attaching to the excess.

Licensors can also increase their profitability by retaining marketing rights to products produced by licensees outside the licensed territory. This clearing house function can enable licensors to earn commissions on sales from a licensee, who is a very efficient producer, to other licensees, who may be less efficient or not manufacturing a full line. Moreover, such an arrangement may allow a licensor to better protect and serve its home market. For example, if the licensor has a highly proficient Japanese licensee, the licensor may be able to make some high quality and cost-effective purchases from its Japanese licensee, while also protecting its home market from competition by the same Japanese licensee.

IX. FAIRNESS DOCTRINE

One overall consideration applicable to licensors' management of licensees is the "fairness doctrine." Its basic concept is that although an unaffiliated licensee is an independent party, a licensee is somehow part of the licensor's family. There exists an underlying, and often unspoken, critical bond between a licensor and a licensee; they are collaborating on a business venture in which, in effect, they are sharing profits.

The sharing may be spelled out in black and white terms, *e.g.*, five percent of net sales. Yet, in key ways, a licensing agreement is more involved for both sides than is a straight arm's length sale. First, the relationship is long term. Second, it usually involves an exchange of know-how, personnel, and management techniques; it is not merely a sale of goods. If one side is too demanding, the other may simply find the venture unprofitable and either abrogate the agreement or treat it in such a haphazard manner that both sides lose potential profits.

Perhaps more of the responsibility for maintaining a fair relationship rests with the licensor than with the licensee, if only because the licensor has more to give. Ultimately, both must share in making the relationship work. However, if the licensor demands too much, the deal will not be mutually profitable and will fail. By comparison, it is less

likely that a licensee who is realizing an unforeseen windfall will voluntarily offer a corresponding increase in its royalty rates. Such an initiative would not be counterproductive, however, because it could inspire the licensor to be more active in supplying improvements and other services back to the licensee.

X. STANDARD INDUSTRY LICENSING RATES

Negotiators or so-called "licensing experts" often suggest that standard, industry-specific royalty rates exist and that it is very difficult to depart from them. Indeed, there have been efforts to publish standard rates as guidelines to practitioners. However, since the author feels that royalties are essentially an expression of underlying contemplated profitability, he disapproves of royalty rate standardization.

For example, third-party licenses are rare in the agricultural chemical industry. Instead, they are kept within the immediate corporate "family," and are usually handled by close affiliates. Only less important technology is licensed. Therefore, if negotiated royalties were to be tabulated and averaged in the agricultural chemical business, the results would be unrealistically low.

It is believed that the same considerations hold true for many other industries, particularly those in which multi-national companies are active. If industry trends indicate low royalties, they could merely be a reflection of the general level of profitability in that industry. To limit innovation in that industry to an artificially low royalty standard would be inappropriate. The licensing process should not be subject to the pressures of Gresham's law.[6]

XI. CONCLUSION

The various approaches and examples described in this article are intended to be illustrative, not exhaustive. Any informed description of ways to obtain income from licensing must highlight the scope for creativity provided by the technology transfer process. This is perhaps the touchstone of the art of licensing. Moreover, such a description requires discipline and an appreciation of a methodology intended to

[6] "Gresham's law" is an economic principle observed by Thomas Gresham, an English financier and economist in the 1570s. The economic observation is that "bad money [over-valued] drives out good." By analogy, a "bad" royalty standard drives out innovation in industry. *See* 5 THE NEW ENCYCLOPAEDIA BRITANNICA 391 (15th ed.

locate solutions that will motivate both parties to work diligently toward mutually-profitable goals.