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The Manager's Guide to Intellectual Property

SECOND EDITION

JEFFREY G. SHELDON, ESQ.

Second Edition: July 2018
Printed in the United States of America
ISBN: 978-1-64254-561-6

CHAPTER 7

Licensing[1]

Introduction

This chapter presents the basics of monetizing intellectual property by licensing the intellectual property to a third party. The party granting the license is referred to as the "licensor" and the party receiving the license is referred to as the "licensee."

The first question for the executive to answer with regard to licensing is "Does a license make business sense?" Once a decision is made to explore license opportunities, then it is necessary to negotiate the business terms. Later in this chapter is a checklist of common business terms that need to be negotiated when entering into a license. These are frequently negotiated without the assistance of an attorney. Until these basic business terms are negotiated, it makes no sense to prepare a license agreement with all of its legalese.

Next, the details of a license agreement are discussed, including distinguishing a license from an assignment, recognizing terms that are found in most license agreements for intellectual property, and understanding terms that are specific to different

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[1] Based on Chapter 5 of "Intellectual Property Licensing," written by Jeffrey Sheldon, from the book *Intellectual Property Business Transactions,* published by Continuing Education of the Bar, State Bar of California, with their permission.

types of license agreements (e.g., terms specific to trademark licenses are not used for patent licenses).

The executive need not know the specific legal language used for a license agreement. It is the job of the executive to negotiate the key business terms. It is the job of the attorney to put the business terms into an enforceable agreement. Exemplary language for a license agreement is available in Chapter 5 of *Intellectual Property in Business Transactions,* published by the State Bar of California and written by the author, Jeffrey Sheldon.

Does a License Make Business Sense?

Licensing makes business sense when more money can be made from licensing than not licensing. The following are typical scenarios where licensing is a viable option.

A. The owner of the intellectual property lacks one or more of the marketing, distribution, management, capital, and manufacturing capabilities needed to monetize the intellectual property. Common examples of this situation include the following:

- A manufacturer of fasteners without marketing in Europe licenses the technology for a new fastener to a manufacturer in Europe.
- An individual inventor develops a better windshield wiper system and licenses it to car manufacturers.
- Marvel licenses its comic book characters to a movie studio.

- Disney licenses the Mickey Mouse trademark to toy and apparel manufacturers.
- A manufacturer of rivets develops a new material useful for nails and licenses the material to nail manufacturers.
- A software developer does not have marketing channels in Asia and enters an exclusive distributorship agreement for that market.

B. Tax advantages are available from licensing:

- An owner of a closely held company licenses his new invention to his closely held company in exchange for royalties. Royalties generally are not considered to be disguised dividends as can occur if the payments were for salary. In contrast to royalties, if a portion of a salary is considered by the IRS to be disguised dividends, it can be subject to double taxation—taxed to the corporation as profits and to the owner as dividend income.
- A U.S. company transfers technology to an overseas, related company located in a country with lower taxes than the U.S., and licenses the technology back to the U.S. company for royalties, thereby transferring profits to the other country where they will be taxed, if at all, at a lower rate.

C. Licensing can generate additional revenue:

- A new cost-saving technology for a manufacturing process is licensed to competitors. This provides an opportunity to maximize the profits to be made from the process by creating revenue from other sources, rather than just settling for the cost savings produced by the new technology.

- A manufacturer of adhesives licenses its technology to an OEM (original equipment manufacturer) producing computers in China.

Negotiating the License

It is the executive that negotiates the key business license terms, sometimes with the assistance of a licensing expert such as a licensing attorney. This is usually done before the formal license agreement is drafted. It makes no sense to spend money on attorneys before the parties agree to the basic business terms. Many times, a negotiated deal falls apart when the licensing contract is prepared because agreement was not reached as to a key business term.

The checklist in Exhibit 7-1 identifies those terms that should be negotiated before drafting a license agreement. If any of the key terms is not resolved, the deal can fall apart.

Exhibit 7-1: Negotiation Checklist for Licensing

1. What rights are received? (to make, have made, sell, export, import, sublicense)
2. What products/processes are licensed?
3. What is the field of use?
4. Is the license an exclusive or nonexclusive license?
5. Geographic territory
6. Royalty base
7. Royalty rate
8. Minimum royalties
9. What happens if minimums are not paid?
10. Any upfront payments?
11. Are upfront payments an advance against royalties or in addition to royalties?
12. Who enforces the intellectual property rights assigned against an infringer?
13. What happens if practice of the licensed rights results in infringement? Who is responsible?

License vs. Assignment

Licenses and assignments are different. Using the lease of a building as an example, the lessee has rights in the building, but does not own the building. Similarly, a licensee has rights in a patent, but does not own the patent. In the case of an assignment, the assignee owns the patent, just as if the purchaser of a building owns the building.

Common Provisions of License Agreements

This section discusses provisions found in most license agreements, independent of the intellectual property being licensed. The executive should make sure that a license agreement includes these provisions or consciously decide not to include them.

Definitions

Typically, key terms are defined in a definition section. Including definitions allows the parties to focus on key terms during their negotiations.

Licensed Intellectual Property
The licensed intellectual property needs to be clearly defined so there is no question about exactly what the licensee receives. The licensed intellectual property can be patents and patent applications, U.S. and foreign; trademarks, including trademark registrations, both U.S. and foreign; copyrightable subject matter, including copyright registrations; and/or trade secrets.

Geographic Territory

The rights granted under the license agreement can be any defined geographic territory ranging from the entire universe, to a specific group of countries such as Europe, or to a particular portion of a state. For trademark licenses, the territory may be a very specific location. For example, McDonald's licenses its franchisees for specific locations.

Field of Use

Some licenses may be limited to a particular field of use. For example, a new light-weight composite material may be licensed to one manufacturer for airplanes and to another manufacturer for helicopters. Disney has different licensees for clothing than it does for toys.

Sales; Net Sales

If the license includes a royalty payment, often the royalty is based on sales of particular products or net sales of the product. The difference between sales and net sales is the exclusion of certain revenue received from net sales. For example, freight, returns, sales taxes, and the value of free samples are deducted from total sales to yield net sales.

Licensed Product

The definition of licensed product defines exactly what the licensee can sell under the licensed rights.

Grant of Rights

The Grant

The grant of rights is a key term of every license agreement. The parties need to understand exactly what rights are granted, and that sufficient rights are granted for the licensee's business purposes. The grant provision generally defines whether the rights granted are exclusive or nonexclusive. And if the rights granted are exclusive, clarity is needed to determine whether the term *exclusive* excludes the licensor as well as third parties from exercising any of the rights granted. The grant also defines exactly what the licensee can do with the rights granted. Examples of what rights that can be granted include the following:

- make
- have made
- sell
- use
- import
- export
- offer to sell
- distribute;
- publish
- display
- copy
- perform
- create derivative works

Limitations on the Grant

Often, there are limitations on the rights granted. The limitations may include such terms as:

- **Quantity.** Are there any limits on the amount of licensed product the licensee is allowed to manufacture?
- **Price.** Is there a minimum price or a fixed price for the licensed product? A licensor often wants such a provision when the licensor is also in the

marketplace. (It is prudent to consider whether such restrictions raise antitrust concerns.)

- **Term.** How long does the license last? For a patent, the license term may be until the patent expires.
- **Channels of commerce.** Are there any limits on the channels of commerce that the licensee can use? The channels of commerce can be divided up in a way that makes business sense, such as retail sales versus industrial sales, or direct-to-consumer sales versus retail outlet sales.

Royalty

A royalty may take many different forms.

Fixed Payment Versus Ongoing Royalty

The royalty can be a fixed payment or a payment on an ongoing periodic basis. If a fixed payment, it can be payable over time. An ongoing royalty can be based on measurable parameters such as the licensee's sales, profits, cost savings, or the like.

Upfront Payments

Even when there is an ongoing royalty, there can be an upfront payment. Licensors want an upfront payment to show the good faith of the licensee, to guarantee there is some return from the license, and to cover the costs of obtaining the license, such as attorney fees.

An issue to resolve is whether the upfront payment is in addition to an ongoing license fee or an advance against ongoing royalty payments.

Usually, any upfront payments are nonrefundable, i.e., if the licensee decides not to use the rights granted, the licensee is not entitled to a refund of the payment made.

Minimum Performance Requirements

It is important to include minimum performance requirements for the licensee, particularly when the license is exclusive. Typically, the minimum is expressed as minimum royalties or minimum sales. The licensor wants to set a minimum such that if the licensee only performs up to the minimum, the licensor is satisfied with the deal.

In an exclusive license arrangement, what happens if the minimum is not reached? One option is termination of the license. Another option is to convert the license to a nonexclusive license. Sometimes a two-tier approach is used, e.g., if a first minimum is not satisfied, the license becomes nonexclusive, and if a second lower minimum is not satisfied, the license is terminated.

Usually the licensee is given the option of making up any deficiency between the minimum and an actual earned royalty with a cash payment to keep the license in place.

Should there be a minimum amount of royalties for a nonexclusive license? Since a nonexclusive license prevents the grant of an exclusive license, the licensor generally wants a minimum. If there is a minimum requirement in a nonexclusive license, generally the consequence of a licensee failing to meet the minimum is termination of the license. This allows the owner of the intellectual property to grant an exclusive license.

Royalty Base

"Royalty base" needs to be distinguished from "royalty rate." The royalty base is what the royalty rate is applied to in order to determine the royalty payment. For example, if the royalty rate is 5% and the royalty base is net sales, the royalty due is calculated by multiplying net sales by 5%.

What is used as a base for calculating royalties is whatever makes business sense and what can easily be calculated. Examples of royalty bases are

- cost savings;
- sales or net sales;
- profits;
- sales or profit increases.

It is best to use an easily determined number to avoid disputes over the royalty base. Thus, using profits as a royalty base is asking for trouble, in that exactly how profits are determined, including allocation of costs, can lead to disputes between the licensee and the licensor. Likewise, cost savings can be difficult to determine.

To minimize disputes, the royalty base can be based on a preapproved price to be determined yearly. This avoids the problem of the licensee gaming the deal by bundling licensed goods with nonlicensed goods, and discounting the licensed goods while getting full price for the nonlicensed goods.

Royalty Rates

Guidelines for Determining Royalty Rates

Royalties can be a fixed amount based on the royalty base, such as $1 per unit sold, or a percentage, such as 3% of net sales. What should that royalty rate be? To bring a rational approach to royalty rates, it is useful to recognize that the profits of a business result from the 5 “M’s,” namely:

- **M**anagement;
- **M**anufacturing;
- **M**arketing;
- **M**oney (capital); and
- **M**ind (the intellectual property licensed).

Thus, licensed intellectual property is only one of many factors that can lead to a profit. With these factors in mind, a recommended approach to determine a royalty rate includes the following steps:

Step 1: Calculate the profits expected from use of the intellectual property. A licensee will not willingly pay a royalty greater than what is generated in profits or realized in cost savings.

Step 2: Determine the relative contributions of the various components of the business to its success, i.e., how important is the intellectual property compared to the other "M's"? For some products, such as a new therapeutic drug, intellectual property is a very important component. For other products, such as mass-produced consumer items, the intellectual property may be only a very small component of the success of the product.

Step 3: Pick the royalty rate based on the relative apportionment between these two steps. If a profit margin of 25% is assumed and all five factors above contribute equally to the success of the business, the result is a royalty rate of about 5%, a number often used as a starting point for negotiations. However, when licensing drugs and computer software—both of which may have very high profit margins where intellectual property is an important factor in their success—royalty rates may exceed 5%. When licensing mass-produced consumer products, which may have lower profit margins and for which marketing is usually an important factor of success, royalty rates less than 5% are not unusual.

When developing the appropriate royalty rate, the following factors need to be considered:

1. Will the royalty rate vary with increases or decreases in the royalty base? It is common for a licensee to contend that, as sales of a licensed product increase, the royalty rate should decrease because the licensor is receiving more royalty payments. But the licensor often contends that as sales increase, the royalty rate should increase, because the licensee's profits increase since the licensee's fixed costs remain relatively steady.

2. Are the royalties capped, either on a yearly basis or over the entire term of the license agreement? Licensees like such a provision.

3. Should the royalties change with inflation? An inflation factor can be included when the royalty rate is a fixed amount per unit sale.

4. What effect does issuance or nonissuance of patent have on royalty rates? For example, for a licensed invention for which no patent has issued, there may be a provision for an increase in royalty rates if the patent does issue. Alternatively, there may be a provision for a decrease in royalty rates on the unpatented invention if a patent does not issue within a certain amount of time.

5. Does the royalty rate vary across territories or the channels of commerce? Developed countries may support higher profit margins and thus higher royalty rates than developing countries. Likewise, some channels of commerce may be more profitable than others and thus justify higher royalty payments.

6. What if the licensee challenges the rights of the licensor? Under U.S. law, a licensee can challenge the validity, enforceability, and scope of a licensed patent in court and keep the license by continuing to make royalty payments. This is a favorable situation for the licensee, because if it loses the court challenge, it is no worse off than it was without the challenge, because it keeps the license. And if the licensee wins the challenge, it may not have to pay royalties. Thus, the licensor may want to include a disincentive for the licensee to bring a court challenge. One technique is to have a high royalty rate with a discount that applies as long as the licensee does not bring such a lawsuit. An advantage of this technique is that it establishes a higher base rate to use in litigation against an infringer who does challenge the patent validity. (Whether or not this approach will survive a court challenge has not been determined.)

Royalty Term

For how long are royalties payable? It is unusual for the term of royalty payments to be longer than the term of the agreement, but it is not uncommon for the payment term to be shorter than the term of the agreement. For example, a patent license may have a term that expires when the licensed patents expire, but may provide for royalty payments for a shorter term.

Payment Date
The license agreement needs to specify when royalty payments are due. For example, they can be payable quarterly, on the last day of the month following the close of each calendar quarter.

Important Business Provisions

License agreements typically include many important business terms. These should be distinguished from the so-called "boilerplate" terms that a competent licensing attorney knows to include. These important business terms, all of which can be negotiated, include:

Enforcement of Intellectual Property Rights
There are three principal contractual issues with regard to enforcement of the licensed intellectual property rights against third party infringers:

1. Who has the right or duty to enforce the intellectual property rights?

2. Who pays the costs of the enforcement proceedings?

3. If there is any recovery against an infringer, how is it divided?

The answers to these questions need to be negotiated and included in the license agreement.

Generally, the licensor wants to control the enforcement efforts since it is the licensor's intellectual property at risk in the dispute. Intellectual property litigation is unique because the owner of the intellectual property can emerge from a lawsuit with less than it went in with; the intellectual property may be declared invalid. In a typical civil lawsuit, such as over a traffic accident, the plaintiff may come out with nothing, but not less than he/she started with.

Duty to Exploit

Should there be a duty on the licensee to exploit the intellectual property, in addition to payment of minimum royalties? Licensors want such a duty in order to be sure the licensee is not just sitting on the license. This can be particularly important if a minimum royalty requirement does not take effect until many years into the license. Provisions intended to make certain that the licensee exploits the rights granted beyond minimum payment requirements include:

- Accomplishment of benchmarks tied to specific dates, such as due dates for a prototype, a marketing plan, test market introduction, granting of sublicenses, submission to FDA for approval, and FDA approval.
- Financial benchmarks, such as a specified amount to be spent on research and development.
- A best efforts clause. This is a risky approach, because it is difficult to measure "best efforts." It may turn out the licensee uses its best efforts,

but is incompetent, and thus the licensee's best efforts are inadequate.

Is There a Warranty of Noninfringement?

The licensee usually requests a warranty of noninfringement against third parties accusing the licensee of infringement. The licensee also wants to be indemnified and defended against such a claim. The scope of that warranty should be considered carefully. For example, a warranty of noninfringement of a third party's copyrights is generally acceptable to a licensor, because the licensor should know whether he or she copied someone else's work. By contrast, a warranty of noninfringement of patent rights is very difficult to give, because without doing a worldwide search, it is impossible to know of all patents that may exist. Moreover, there may be unpublished pending patent applications that could create infringement problems when and if patents issue. Thus, a warranty with regard to noninfringement of patent rights is generally drafted to state that there is no "known" infringement of any third-party rights. A warranty regarding noninfringement of a trademark can sometimes be given, but generally only after a comprehensive trademark search.

Indemnification

The licensor generally requests that the licensee will defend and hold the licensor harmless in the event that the licensor is sued because of the actions of the licensee. For example, if the licensee infringes a third party's trademark, or uses a third party's trade secrets, or infringes a third party's patent, or causes personal injury or property damage, and the licensor is named in a suit, the licensor wants to be made whole.

Marking

It is important to include a marking provision in a license agreement to protect the licensor's rights and its ability to collect damages in case of infringement. Such a provision can include a requirement to use ® in a trademark license or a copyright notice in a copyright license, or to comply with the patent marking statute in a patent license.

Reporting and Audits

With an ongoing royalty obligation, it is important that the license agreement specify the licensee's reporting requirements and the licensor's audit rights. It has been reported that licensees under-report royalty payments about 70% of the time. The key issues regarding audits are how often they can occur, who conducts them, who pays for them, what information will be made available, and what happens if there is a shortfall in payment.

Assignability

The right to assign the duties and rights of the license agreement should be specified. Unless the licensor has ongoing duties, such as continued research and development efforts, it is common for the licensor to have an unlimited right to assign its rights and duties under the agreement.

For good business reasons, the licensor may not want the licensee to have any assignment rights. For example, if a small competitor is nonexclusively licensed, the licensor may not want that license to be transferred to a larger and more aggressive competitor that could sell into the licensor's markets.

In addition, the licensor's willingness to grant a license and the royalty rate may be dependent on the quality of the licensee.

A compromise that is often reached is that the licensee can assign the rights along with a sale of the portion of the licensee's business to which the license is applicable.

Sublicensing

Should the licensee have the right to grant sublicenses? For a nonexclusive license, usually the answer is no, because the licensor wants to retain the right to grant additional licenses. For an exclusive license, the licensor may be willing to grant the licensee the ability to grant sublicenses if the licensee is well positioned to find additional licensees.

How are the sublicense revenues divided? The licensor typically wants to receive at least the same amount that it would have received if the licensee had made the sales, but that may not provide any incentive for the licensee to grant sublicenses. A possible compromise is a 50/50 split, with a minimum payment to be received by the licensor.

Term and Termination

> ***Term:*** How long does the license last? For patent licenses, the term is often the life of the last patent to expire. For trademark, trade secret, and copyright licenses, the term of the license agreement is usually shorter than the life of the licensed rights, because trademarks and trade secrets can last forever, and copyrights have a very long life. The term may be a specific amount of time with an automatic extension if neither party gives the other a notice of termination

within a specified period before the end of the term.

Voluntary or Involuntary Termination: Provisions for termination of the license, voluntary and involuntary, before the end of the stated term should be specified. License agreements commonly provide that a material breach, such as nonpayment of royalties, gives the licensor a right to terminate, sometimes with a period during which the license can fix the breach after notice to the licensee of the breach. Other events that can cause termination may include a bankruptcy filing.

Defense of Infringement Suits
What if the licensee is sued for infringement as a result of exercise of the rights granted by the licensor? The license agreement should include a provision addressing who has control of the defense and who pays for it.

Special Provisions

Certain provisions of license agreements are specific to the type of intellectual property rights licensed. This section discusses these provisions.

Patents and Patent Applications

Prosecution and Maintenance Fees
A provision specifying who is responsible for the prosecution of any pending patent applications and payment of the associated costs, including maintenance fees, should be included in the agreement.

Improvements

The parties should include provisions in the license agreement dealing with two types of potential improvements to the licensed inventions: improvements made by the licensor and improvements made by the licensee. The issues concerning how the improvements are to be handled are:

(1) Who owns the improvements if made by the licensee?

(2) Are the improvements automatically included in the license if made by the licensor?

(3) Do the improvements, if included in the license, have any effect on term, royalty base, and royalty rate?

(4) Who has the right to seek patents on the improvements, and who pays for the patents?

(5) Who pays the maintenance fees for patented improvements?

Trade Secrets

Steps to Control Secrecy

Trade secrets by definition exist only as long as they are maintained secret. Therefore, the licensor wants provisions in the license agreement regarding how the licensee will maintain secrecy of the trade secrets.

Transfer of Trade Secrets

A trade secret license agreement should include provisions for transfer of the licensed trade secrets and know-how. For example, trade secrets may be provided in documents marked “confidential.”

Trademarks

Quality Control
A trademark license must include quality control provisions because, if it does not, the licensed mark may be deemed abandoned. Quality control provisions may include:

- right of the licensor to randomly inspect the licensed product or services;
- requirement that the licensee provide representative sample products to the licensor; and
- requirement that the quality of the licensee's products or services be at least as good as those of the licensor.

Franchise agreements, which generally include trademark license provisions, typically have detailed quality control provisions.

Franchise Avoidance
Both the federal government, through the Federal Trade Commission, and many states have laws and rules regulating franchises. It is expensive to comply with these provisions since generally the franchise terms need approval by each state where there is a franchisee. Thus, a license agreement should be drafted to avoid creating a situation where the franchise laws apply, unless the parties are prepared to comply with them.

California law is typical of the franchise laws of various states. Under California law, one of the elements necessary for an agreement to constitute a "franchise" is:

> The right must be granted to engage in the business under a marketing plan or system prescribed in substantial part by the franchisor.

Thus, the license agreement needs to be drafted to not include this element; namely not to provide a marketing plan or system dictated by the licensor to the licensee.

Copyrights

Rights Granted

A copyright consists of multiple rights, such as the rights of reproducing and distributing the copyrighted work, preparing derivative works based on the copyrighted work, and, in specified instances, publicly performing and publicly displaying the copyrighted work. These rights can be subdivided. Copyright licenses are commonly limited to cover only certain specified rights, with other rights subject to different licenses with other licensees.

Software Licenses

A software license normally includes a license of copyright. It may also include a license of trade secrets and patent rights.

Source Code Escrow

What happens to a software licensee if the licensor goes out of business or no longer supports the software provided? Software licenses can include an escrow term, under which the source code is escrowed with a third-party escrow holder. In certain specified circumstances, the licensee receives access to the source code.

Maintenance, Modifications, Enhancements, and Updates

Software often contains errors and can be modified, enhanced, and updated. License agreements typically specify the licensee's right to have the software maintained by the licensor, as well as the right to any modifications, enhancements, or updates. The agreement should specify the cost, if any, associated with updates.