COMPETITION AND ROYALTY ISSUES IN TECHNOLOGY LICENSING

By Kam W. Li, Esq.
Procopio, Cory, Hargreaves & Savitch LLP

INTRODUCTION - ROLE OF TECHNOLOGY LICENSE

Without question, technology licenses play a major role in the modern technology-based economy. A small company may want to obtain access to acquire critical technological platforms, patented products and processes, and installed base of compatible products. In a joint venture or strategic alliance, complementary and supplemental resources can enable the parties to achieve faster, more control and flexibility in the execution of their business plans than if they were to do it alone. Blending complementary strengths to pursue a defined market, in a structure that aligns the economic interests, these parties can develop, build and move their products faster to a broader market. Resources such as financial, human, technology, know-how, market, distribution, manufacture capacity can be juxtaposed yet blended in alignment to translate a business proposition from model into reality. Properly structured, a technology license can achieve many desirable results.

A technology license agreement enables the parties to define their relationship in economic terms and primes the intangible intellectual property for exploitation under a contractual framework for achieving an economic return. Defining issues such as the technology subject matter, research and development obligations and intellectual property rights to improvements, the parties can develop the technological platform on which they operate. Negotiating exclusivity, field of use, product mix, territory and/or distribution channels, the parties bring market reality into the relationship, which directly affects the success of the relationship and ultimately the parties respective economic interests. Over time, the alignment of interests of the parties promotes their cooperation, raising the barrier to entry by third parties and reducing the business risks to the parties if each were to pursue the business interests alone. In that sense, the technology license is truly an adaptive means to enable strategic intellectual property management, which maximizes the value of IP assets, a means that is demanded by the changing markets in a modern economy.

COMPETITIVE BUFFER ZONE AND ROYALTY

A technology license agreement can cover as many issues as the parties may wish. To achieve a "win-win" deal, the agreement must work for the benefit of both the licensor and licensee. At the same time, it should ensure that the parties' interests do not compete. While exclusivity, royalty, (rate and amount, payment schedule), territory, rights to improvements, representation and warranty, and indemnification, are among the many tough issues that are considered, a willingness to be flexible and the ability to find alternatives in a possible stalemate will go a long way to achieve a enduring, mutually satisfying and profitable relationship.

In the technology license, the mechanism for risk allocation has to be clearly defined, measurable and acceptable to the parties in order to minimize future disputes, which increases uncertainties and reduces the present worth of the licensing relationship. In addition, the balance of technology exchange and license rights has to be viewed as fair to both companies. The hard part is that no two companies are alike. Even for two companies of comparable revenue and size in the same industry sector, their business models, operating assumptions and resource limitations can differ substantially. A rewarding challenge is to architect a licensing relationship that supports the common cooperative goals of the parties while protecting their respective competitive positions. This relationship will require resolving the allocation of financial risk between the parties while recognizing that market conditions and technological landscape will be uncertain. At the same time, the parties will need to develop the necessary contractual framework to effect open technology exchange to drive the exploitation of the technology while drawing the appropriate boundaries or the competitive buffer zone around the technical relationship. Key drivers to enable the parties to deal with these issues are exclusivity and royalty.

EXCLUSIVITY – A COMPETITIVE BUFFER

A licensee would prefer exclusivity in order to gain a competitive edge over unlicensed third parties. With an exclusive license, the licensee can develop a certain comfort zone that the licensor cannot use the licensed technology to compete against the licensee within the domain of use. In fact, a licensee should strive to make sure that a license agreement is designed to achieve this result. From the licensor's perspective, the efficiency in dealing with a single licensee, particularly where the latter has the resources, technical platform and the distribution network to exploit the technology under the license, can be a compelling justification for the licensor to grant such an exclusivity.

However, exclusivity is such a popular term in licensing arrangements that often it is forgotten that it compasses many variables that can directly affect the competitive buffer zone as between the parties. On one hand, it is important to achieve alignment of the parties' interests in the licensing relationship. On the other hand, a good relationship must also be reinforced by the elimination of conflicting interests outside it. Therefore, exclusivity must be well defined to ensure this buffer zone is meaningful and sustainable.

Exclusivity appears in many forms. In the traditional brick and mortar economy, many parties would incorporate territorial exclusivity to ensure that movements of their goods do not cross path in any single geographical territory. But the commercial reality of the market place is that goods and services can easily be transported beyond geographic confines. In addition to prohibiting each party from intruding into the other's territory, the parties should consider the possibility of transshipment by third parties.

Field of use exclusivity is also a common tool to prevent the potential competitive conflicts between the parties. Therefore, the parties should make sure that the licensed and retained fields are truly non-fungible in functionality. Or functional elasticity of the products could encourage third parties to arbitrage the licensors' and licensee's products on the basis of price to create unintended competition. In addition, the license agreement should prevent any portion of the licensed (patented) technology to be used to provide direct or indirect assistance to the party's competitors.

When defining the field of use, the parties should specify physical embodiments as the intended licensed use. The licensor should avoid a field of use that is defined in functional terms. Generally, the functional attribute of technology is too amorphous to provide any precise definition of the field of use. Obviously, in a mature industry, the field of use can be readily defined in terms of physical embodiments such as certain kinds of finished products. For a new technology, however, defining the field of use can be demanding. To reduce the uncertainty that the field of use could be unexpectedly broadened due to the evolving change of the technological landscape, one could begin with a narrow scope and build in a mechanism for future expansion, such as first right of refusal or options.

Exclusivity can also be specified for a particular marketing channel. An identical product can be promoted under different trademarks, which are sold to different classes of customers, an approach commonly employed where the possibility of customer crossover is not significant. In that situation, the licensor must make sure that the license agreement does not allow the licensee to leverage on the licensed product in order to build a market for a functionally similar product, with potentially devastating results.

In many situations, the competitive buffer between the licensor and the licensee-venture is usually redlined with a non-compete obligation on the parties. To prevent future competition from unexpected parties, the licensor should consider restricting transfer of the license itself, including transfers as a result of merger and acquisition activity.

OBLIGATION TO EXPLOIT

An exclusive license should include a reciprocating obligation to exploit, a provision regardless of the strength or weakness of the parties' negotiating position. This is to prevent abandonment of the licensed technology, which could lead to the erosion or evaporation of royalty. The obligation to exploit can be instituted in many forms: minimum royalties, minimum unit sales, commitment to bundle technology with other products, defined marketing efforts or promotional budgets, or "best efforts."

The obligation to exploit can also be enforced with remedies such as termination of the license, loss of exclusivity, transfer of control, or even ownership of the business to the other party. This latter remedy may be more appropriate in some circumstances especially when the technology is new and its market uncertain.

On the other hand, to motivate the licensee to achieve a better-than expected result, the licensor may offer incentives such as expansion of license scopes, territory, access to additional technology, extension of license term, and declining royalty rates.

ROYALTY STRUCTURES

Without question, royalties are an easily identifiable and measurable success of the licensor in the extraction of value from his intellectual assets. However, royalty should not be viewed only as the end game in a licensing relationship. Beyond the numbers, the royalty structure actually serves as a mechanism to allocate risk and reward, considering both the present and future market and legal uncertainties. Further, royalty can function to effectively drive the deal and change the parties' behaviors in the licensing relationship well after the deal is signed, sealed and delivered.

In general, there are two royalty kinds: fixed sum and running royalties. Where the effects of uncertainties about future sales volume, market price, and the effect of competition are perceived as insignificant, a fixed sum royalty would carry no risks to the licensor. In real life, a fixed sum royalty imposes all the market risk on the licensee in exchange for all the upside potentials.

With running royalty, the parties share the risks and rewards of the uncertainties. And market reality plays into the relationship. If the technology proves more valuable than anticipated, the licensor receives more. If the technology stagnates, the licensee pays less. The shared risks approach harmonizes the parties' interest, and it increases the dimensions of market outcomes acceptable to the parties. Two general types of running royalty formulas are commonly encountered: Fixed amount per unit and percentage of sale.

The fixed amount per unit royalty divides risks and rewards as a function of unit sales volume. If the sales volume is predictable, licensing revenue and expenditures can be well quantified. However, market conditions can assert a significant influence on the sale price. So a fixed amount per unit royalty arrangement would place all risks of a low sales price to the licensee. Conversely, if the market conditions favor the licensed product, such an arrangement could reward licensee with a high sales price.

In licensing negotiations, this arrangement is commonly encountered where the IP (or technology) represents a small portion of the end product. A high unit rate gives the licensee an incentive to maximize the sales price at the expense of volume.

A percentage of sales royalty approach takes into consideration both unit sales volume and the selling price and allocates the risks and rewards to the parties accordingly. This type of royalty is commonly encountered when the technology represents a significant part of the value of the end product or when its value is uncertain, as well as in joint venture situations.

Revenue-based structure requires specific consideration of the present and future market conditions. It also requires detailed attention to the business model, which directly affects the return to the parties' business. Some of the factors that should be considered are the way in which the IP is capability and capacity of the licensee, the distribution network and the pricing structure in moving the product incorporating the IP downstream of the licensee, and technological platform and the packaging of the products on which the royalty is calculated.

Once the basic royalty parameters are cast, the parties can use the payment structure to achieve particular behavioral changes. For example, a licensor can require minimum royalties to encourage aggressive marketing. Conversely, where the product sales are stagnant, the licensor could consider making royalty concessions to jump start a marketing campaign. Further, the licensor can make royalty concessions as its contribution to licensee's equity, as in a case of a joint venture. Still, when R&D represents a significant part of the IP, a declining royalty arrangement that is expressed as a function of total sales would give preferential return to the licensor until R&D costs are recovered. This could motivate the licensee to maximize sales volume in order to increase margin. Royalty payment structure can also be adapted to reflect contingent legal

issues and future market conditions. Adjustments to royalties due to contingencies such as failure of a patent to issue or its invalidation, infringement claims, publication of trade secrets, and technological obsolescence.

IMPROVEMENTS AND JOINT DEVELOPMENT

Incorporating a competitiveness dimension, a technology license agreement should address the issue of technology improvements, by either one or both parties. For technology companies, this aspect of a license agreement can be most challenging and have broad implications in maintaining the competitive buffer between the licensor and the licensee, as well as their respective competitive edge in the market place.

At the outset, one should avoid joint ownership of the improvements, which directly affects the exclusivity attributes and the relative competitiveness of the licensor and licensee. This negative impact can further be complicated when dealing with the particular IP such as patents, copyrights vs. trademarks. Further, it could significantly alter the balance in the allocation of risks and reward. Additionally, in some countries, the consent of all owners may be necessary to grant a licensee. In others, all joint owners may be necessary parties to an infringement claim.

From the licensee's perspective, considerations of how new technologies can be acquired, and whether they are covered by the original license (and the agreed royalty, field of use and geographical exclusivity, etc.) are important. The licensee should be prepared to address how the new technologies are distinguished as "new products" that are more appropriate for a new license. In addition to the right to use the new technologies, the licensee should be concerned about how the new technologies are to be priced. In the case of new technologies developed by the licensee, ownership rights and right to use of the new technology are critical elements for the license to consider.

The licensor should also take into consideration of how he would acquire new technologies in the context of the licensing relationship. Where a licensor's platform technology is to be leveraged on the licensee's R&D for further refinement and application, a critical concern is the possibility of being shut-out of the future by the licensee's improved intellectual property. To attenuate such a concern, most modern technology licenses would incorporate a certain form of grant-back of improvements, derivations and enhancements achieved by the licensee. Negotiations of a grant-back is perhaps the most challenging aspect in the development of the licensing relationship because various technological, business and economic factors are not susceptible to easy evaluation even within the immediate business cycle. Grant-back and ownership issues are extremely challenging at the intersection of the technologies for both the licensor and the licensee, especially when there is a joint development effort. Irrespective of these challenges, by establishing forward-looking views on the method and direction of ongoing technology development and to address these issues in advance, the parties are likely to find themselves engaged in a much more meaningful relationship, reducing the potential of disputes and the uncertainties accompanying the competitive strengths of each party.

Kam W. Li is a partner at Procopio, Cory, Hargreaves & Savitch LLP. He focuses his practice on litigation and transactional work in the areas of banking and financial institutions, intellectual property, unfair competition laws, international transactions, Native American issues and related litigation. He assists a wide range of U.S. and international clients with due diligence in property transactions, as well as intellectual property strategies, protection and licensing, commercial transactions, deployment of intellectual capital and strategic partnering relationships. Kam can be reached at 619.515.3253 or kwl@procopio.com.