Getting the **best deal**

When drafting licensing agreements, there are many issues that patent owners should consider in order to avoid any nasty surprises, says **Paul J Sutton** of Sutton Magidoff.

Owners of intellectual property such as patents will often consider granting licensing rights to one or more third parties. The motivation for doing so will vary, with the hope of realising revenues from IP being at, or near, the top of the list of considerations. The extraordinary value of patent licences can be historically witnessed in companies whose patent and other IP rights are of such consequence that their income from the grant of licences far exceeds the revenues they realise from operations.

A patent licence can be equated to a grant of the right to infringe. In the absence of a licence, infringers may face lawsuits involving millions of dollars of attorneys' fees, litigation costs, exposure to a permanent injunction, damages which may be tripled, and/or the other side's attorneys' fees if wilful infringement is found. To this can be added the considerable management time that must be devoted to patent infringement litigation. Avoiding such litigation is usually a priority.

A chief executive officer's excitement about the possibility of generating huge patent licensing revenues will sometimes get in the way of proceeding in a deliberate and cautious manner. The decision of whether to grant a patent licence should involve the participation of more individuals than merely the top one or two company executives. There may be a considerable impact on the efforts of a company's research and development (R&D), engineering, and sales and marketing teams. For this reason it is highly recommended that the leaders of all such teams play some role in the decision on whether to license IP, as well as the type and scope of any licence to be granted.

It goes without saying that one should always have an experienced attorney prepare a patent licensing agreement. And in some circumstances it may be desirable to have a licensing expert negotiate the basic terms of the agreement. In each case, there is a role for such individuals from start to finish.

It is highly recommended that one does not attempt to use a form of precedent agreement as the basis for the new agreement. The terms of licensing agreements usually tend to favour either the licensor or licensee, and this fact

will not be obvious from a quick reading of a previously executed agreement.

Before even beginning to draft a licensing agreement's language, it is recommended that the parties negotiate and reach agreement on a 'term sheet' in which the basic deal is outlined in more or less detail. This will avoid the potential for a party's changing of its previously agreed position, and will also provide enormous benefits and a road map to the person drafting the language of the final agreement.

Let us examine here some of the basic terms that will be included in typical patent licensing agreements. Most agreements, after the usual 'whereas' clauses that acknowledge the consideration being exchanged by the parties, will include a 'definitions' section in which contractual terms used in the agreement are carefully and clearly defined.

Parties

It is important to identify the specific individuals or legal entities who will be a party to the agreement. In the case of corporations, there may be a parent company with subsidiaries and/or affiliates, one or more of which could conceivably be a direct or indirect competitor of the other party. In most cases, one should involve a corporate parent as a signatory to minimise changes in the parties' respective responsibilities.

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Effective date

When does the agreement legally begin? Ideally, it is recommended that the very opening sentence recites the effective date. This date takes on significance as defining the commencement of the parties' respective obligations. The duration of the licensing agreement is also usually measured from this effective date.

Technical information

Apart from patent rights being licensed, there may be an obligation on the licensor to provide supporting technical information to the licensee. There is often know-how that may be of considerable assistance to a licensee's efforts to bring a licensed product to market. This may reside in manufacturing techniques not at all obvious from the face of the patents being licensed.

Care should be taken on the part of a licensor not to underestimate the financial and manpower resources that may fall within the scope of technical information assistance. A limit on the man hours for any given time period can be an effective way to avoid runaway costs.

Type of licence

A patent licence may be exclusive or non-exclusive or shades of grey between them. An exclusive licence transfers to a single entity all the rights to make, use, offer for sale, sell, and import products that come within the lawful scope of the patent rights being licensed. A non-exclusive licence transfers these rights, but also reserves the right to grant the same rights to others. In some instances a licensor may reserve the right to market licensed products in competition with the licensee. Such a reservation is rare since it will convert an exclusive licence into a non-exclusive one by virtue of the licensor's presence in the marketplace.

Some agreements provide for territorial limitations for the parties. There is a natural tendency on the part of licensees to want to acquire exclusive licence rights in order to lawfully minimise or eliminate competition.

Licence duration

How long do the parties want the licence to last? Typically, it will extend for the life of the licensed patents. That said, if an exclusive licensee does not experience expected sales of licensed products, and the agreement includes an obligation to pay minimum guaranteed royalties, such a licensee may find itself in a financially untenable position.

Some agreements provide for the right of a licensee to convert an exclusive licence to non-exclusivity, in order to escape from or minimise mandatory payments. This will be a major issue in negotiating the terms of the agreement.

Right to sub-license

Giving a licensee the right to grant sub-licences will permit others to practise the patented invention(s). Licensors will often allow this right so long as they achieve the same remuneration from sub-licensees and the principal licensee remains on the hook.

Licensed patents

While the identity of specific patents and patent applications being licensed will be defined, it is essential that the issue of improvements and modifications by either party is addressed in the agreement. One approach may be to have such post-ground (after the licence) developments jointly owned by the licensor and licensee, subject to the licence grant. An advantage to this approach is that each of the parties will in effect have a freedom to operate under any patents that result from these efforts.

Licensed products or processes

Licensees will not want to pay royalties or other remuneration to a licensor on the sales of products that are not covered by the licensed patents. A licensor's demand that a licensee does so may run afoul of US competition laws. For this reason, the definition of licensed products should clearly recite that they come within the scope of the issued claims of patents. The same may be recited for patented methods and processes.

Net sales price

Great care should be taken by a licensor not to have royalties payable on profits, as opposed to the net sales price of licensed products sold. Accountants can 'play' with expenses attributable to sales, thereby raising the potential for unfair deductions used to arrive at profits. By including a definition of net sales price, which should comprise gross revenues minus agreed reasonable deductions, such problems will be avoided. It is also important to a licensee that it does not have to pay royalties on sales for which the licensee has not been paid. For this reason, a definition of 'sold' is often included in the agreement.

Background IP

In licensing agreements where there will be R&D collaboration between the parties, there may be four distinct forms of IP assets: background, foreground, sideground and post-ground IP. Background IP is generated before the R&D collaboration. Foreground IP is generated during the collaboration. Post-ground IP is generated during a period after the collaboration. And sideground IP is generated during the collaboration but in non-project-related activities. An agreement should carefully define the scope of each of these forms of IP to avoid unnecessary adversarial confrontations.

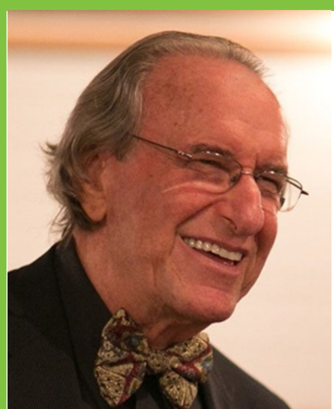
Licensed territory

A licensor is entitled to limit the grant of patent rights to a geographical licensed territory. This will permit the licensor to grant rights to parties with marketing strengths within such territories. Provision should be made to prevent multiple licensees from poaching sales within the territorial rights of others.

Patent marking

Under 35 USC 287(a), in the absence of proof of notice of infringement, a patent owner will not be able to recover damages in a patent infringement litigation unless the product is marked with the US patent number. For this reason, a licensor will often ask in an agreement that the licensee marks its products with appropriate patent numbers.

The issues discussed here are just samples of the many considerations that will go into a successful agreement and relationship between the parties. Other issues will include indemnification for infringement of third-party rights, enforcement against infringers, minimum guaranteed remuneration, and more. ■



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