THE ART OF LICENSING — FROM THE CONSULTANT'S POINT OF VIEW

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Much as diagnosis is to medicine, the analysis and ability to structure a licensing arrangement is one of the most critical aspects of the technology transfer process. In each situation, it is necessary to assess many factors, including the nature of the technology itself, the strengths and weaknesses of the parties, the market realities likely to be faced by licensees, and the surrounding legal and governmental environments. If the contemplated transaction is international in scope, a difficult new dimension is added to the problem.

The assets which a consultant, acting as a professional advisor, can bring to potential licensing negotiations may be grouped in three general areas. The first is a sense of objectivity, to temper the enthusiasm that originators invariably attach to their inventions; or the scepticism frequently manifested by potential licensees, usually known as the "not invented here" syndrome. The second is a thorough knowledge, based on experience, of the many ways in which industrial property can be protected and exploited. The last is a certain sophistication and imagination to select an approach which will provide favorable results to all parties, to what is usually a long term relationship. The combination of skills, stamina and sensitivity required for success in this field goes beyond mere competence, and may reasonably be described as an art.

When advising on the side of the licensor, it must first be determined that the market and profit potential are sufficiently attractive to warrant the considerable effort involved in the licensing process. Frequently, an equal amount of time and energy must be devoted to closing a small or narrow license as to one, involving some stunning new product or process, that can generate large royalties over a long term. Rigorous adherance to profit priorities is thus essential.

Other criteria are also relevant when deciding whether a certain item of technology is appropriate for licensing at that particular time. The primary question usually is: how promptly can potential licensees be in actual commercial operation, so that royalty income will be generated? The greater the lag time, the less attractive the opportunity, except in the relatively rare cases where the parties are in a position to be very patient, in anticipation of huge, long term gains.

The most favorable environment in which to grant licenses exists when the licensor is already actively exploiting the item in its home market. In these circumstances, potential licensees can evaluate more realistically the operating conditions they are likely to encounter. Assuming that the licensor in such situation would have already solved its manufacturing and marketing problems, the licensor would possess a body of know-how which could enable the licensee to get started promptly. This would include engineering drawings, plant layouts, shop manuals and sales strategies, as well as the availability of experienced personnel who can train their opposite numbers on the licensee's side.

While somewhat more difficult to consummate, successful licenses have frequently been concluded if the licensor merely has a pilot plant or a prototype to offer for demonstration purposes to licensees. The absence of actual commercial conditions may, however, be reflected in less satisfactory royalty terms for the licensor, since the licensee will probably require recognition of the risks and delays involved in pioneering. For the same reasons, a potential licensor is sometimes better advised to delay attempting to market a relatively naked bundle of patents until such time as he can simulate actual operating circumstances when negotiating with possible licensees.

If the licensor is not in a position to proceed further with development work, and if a licensee can be induced to carry this to completion, a technique is available that can protect both sides. This is for the potential licensee to take an option on a license, paying some reasonable sum to insure the exclusivity of its rights, and undertaking to carry forward with agreed research and development work. Attached to such option, as an exhibit, should be the actual license agreement between the parties, which automatically enters into force upon the exercise of the option, in accordance with its terms.

Timing can be crucial to the success of an envisaged licensing program for several reasons. It should be the responsibility of the consultant to recognize this, especially on the international plane where conditions may vary widely in different countries. If there happens to be a great deal of inventive activity in a particular area, the foregoing guidelines may not apply, since delay in presenting some new development for licensing may mean that potential licensees will make commitments to some other item. For instance, the audio-visual and cassette fields are now in such a foment: several inventions known to the author have not been taken up by potential licensees, who admitted the superiority of such inventions to items being readied by them for market, but who were already too deeply committed to scrap their investment.

By the same token, a new invention may be ahead of its time and require too much education for market acceptance. It is usually easier to license a "better mousetrap", whose merit is fairly readily discernable. This is particularly true of consumer products.

Another factor to be assessed when considering licensing is the existing industrial property protection of the item. Have patents been filed in the principal industrial countries? If not, has there been publication of the invention, or has the time for filing under the Paris Convention expired? Also, does the licensor have the resources to support a substantial portfolio of domestic and foreign patents?

It is obviously relevant to evaluate the strength of the patents when considering licensing. Frequently, however, the mere existence of patents is an important selling point when approaching a licensee, because it lends a certain official dignity to the technology involved. It is usually the corpus of know-how surrounding the use, manufacture and/or marketing of the item which is given greatest weight by a potential licensee, particularly if such know-how can be expected to be supplemented regularly by the licensor.

If the consultant is skilled in organizing such know-how into a meaningful package, the bargaining position of the licensor can be strengthened. The speed with which such know-how can be effectively transferred to licensees, following entry into force of license agreements, can also affect the early flow of royalties. If the transfer is property structured, there can also be important tax advantages to a licensor.

The adroit use of trademarks, particularly when consumer goods are involved, can enhance the position of a licensor in the long run. There is usually no legal objection to requiring a licensee to use a trademark belonging to the licensor in relation to the licensed products or processes, and such use will develop good will for the property belonging to the licensor, rather than to a mark belonging to the licensee. Thus, should it ever be necessary to change licensees, the identity of the licensor in that market, through its trademark, will already have been established.

The existence of a trademark license also provides the licensor with a legal justification to exercise close quality controls over a licensee, and enforcement of such procedures can have an important effect upon the success of the license. Technical expertise of a consultant on these questions, and their implementation, can thus be very valuable to all parties.

Once a decision has been made to proceed with a licensing program, the consultant must be prepared to outline strategy on several levels. This involves the type of licensees to be sought, the actual finding and contact techniques, and suggested structures of licensing arrangements.

It is frequently inadvisable to attempt to promote a license with a company presently marketing a competitive product, because this is likely to encounter internal resistance from those people who identify in some way with the item intended to be replaced. It is usually preferable to approach a company that is already selling other things to the same customers who would purchase the licensed product; for such a company, the licensed product would be an attractive diversification. Armed with an attractive "better mousetrap", such a licensee might be induced to enter the lists against the traditional companies in that market. A variation of this approach might be to offer a license to a relatively aggressive "Avis" in the market who is anxious to seize every opportunity to overtake the "Hertz".

Note that the focus is placed on the marketing rather than the manufacturing capabilities of the potential licensees. Royalties are almost always a function of sales. Thus, a licensee that possesses an apparatus capable of distributing the licensed products effectively and, where appropriate, handling servicing needs of customers, would satisfy the essential objectives of the licensor. If the same organization is also able to manufacture the product efficiently, so much the better.

If not, a competent manufacturing source can usually be located. Certainly, a company merely able to produce a product sought to be licensed, but who lacks adequate sales capacity, would be unsatisfactory, standing alone. Furthermore, the fact that a licensee candidate happens to have good manufacturing facilities is no guarantee that such company also possesses the requisite selling abilities.

Here could be an area for "positive thinking" by the licensor, who might set up its own subsidiary — or arrange some joint venture with the licensee or a third party — to manufacture the licensed products exclusively for a distributing licensee or, conversely, to sell the output of a licensee limited to producing the goods. The licensor could thus get an equity foothold in the licensed territory, which might be enlarged as the licensing relationship develops.

Another opportunity that might be available to the licensor, and which should always be considered, is whether the agreement can provide a market for sales by the licensor to the licensee of components, subassemblies, concentrates or intermediate compounds, or even certain models of the licensed products, to supplement the licensee's manufacturing operations.

The finding process, itself, is not an exact science, although there are various "tools of the trade". The first logical step is to understand the manner in which the relevant market presently operates, and to identify the principal companies in the field. The U.S. Department of Commerce, the equivalent government agencies in the license territory, trade directories, the editors of industrial periodicals, banks and brokerage house specialists can all be helpful in this connection. Frequently, however, the quickest and most effective intelligence route is through personal contacts, who can arrange introductions to executives active in the field.

Once the market is in focus, strategy in approaching potential licensing partners becomes crucial. Some people apparently prefer a "shotgun" method whereby form letters, usually covering a packet of material explaining the technology, are sent to the President or New Products Manager of each likely candidate. Those responding and indicating at least preliminary interest are explored further and the negotiating process is begun.

The author prefers another approach, which entails the shooting of a "rifle bullet", aimed as high as possible into the preferred candidate. Through a variety of approaches, many of which rely upon special contacts developed by the consultant, one can usually gain access to the President or senior responsible person in such companies. By writing to such "target" a carefully tailored letter, and then telephoning for a meeting the day on which the letter may be expected to be received, an effective penetration can often be made.

A variation of this technique is to approach first the second preferred choice and utilize these discussions, which will usually elicit the most pertinent issues and questions, as a "rehearsal" for the submission to the prime candidate.

If the imagination of a senior executive is excited by the possible license, he will be able to have the proposed transaction analyzed promptly by his subordinates. This process has obvious advantages over approaches to a company through the relatively junior channels of the legal or patent departments, since this requires a good deal of "swimming upstream" to the real decision makers. If the suggested technique is followed, the consultant need merely be sufficiently articulate to describe the available technology, without having a detailed knowledge of the scientific principles involved. Initial discussions proceed on the assumption that everything performs as specified; technicians from both sides are usually called in later to verify the claims made.

If the licensor and his consultant have done their homework, they will have a good notion about the attitudes which a seriously interested licensee will have about exclusivity, territory, term and royalties. In certain areas, particularly the European Common Market, there are antitrust provisions which can favor the licensor, and these should be familiar to the consultant. Such laws are intended to limit exclusive protection to licensees, and promote intra-brand competition. The ultimate structure of the deal should be such that it can be highly profitable to both sides, provided the licensee diligently promotes the new technology.

In this connection, a licensor can frequently improve the situation of all parties by permitting various licensees to help each other. For instance, suppose an American licensor has licensees in Japan and Sweden. Assuming the Japanese, because of their larger home market and lower labor costs, can produce the licensed products more cheaply than the Swedes, it would make sense to have the Japanese manufacture for both licensees.

The Japanese could fill the requirements of the Swedes without paying royalties to the licensor on such shipments. This would please both the Japanese licensee and the Government of Japan, because both business and exports would be expanded. The Swedes, who would pay royalties to the licensor on their sales, would be getting an excellent product more cheaply, with a lesser capital investment. The licensor would still have his royalties, based on the higher Swedish sales price, and the entire volume of activity might be expanded because of greater efficiency.

There are numerous ways to build incentives into a license. If a large initial fee is exacted, the licensee is induced to strive hard to recover such cost through profits. It is wise in certain circumstances to reduce the amount of such fee in favor of an obligation by the licensee to invest stipulated amounts in new plant and equipment. If the position of the licensor is relatively weak, and it needs an immediate cash infusion to prepare the technical know-how package for the licensee, it may be agreed to have a lump sum paid at the outset and treat this as prepaid royalties, to be credited against actual royalties subsequently accrued.

Minimum royalties can take several forms, e.g. (i) that the licensee must pay certain indicated amounts to keep the license alive, even if sales were insufficient to generate such royalties; or (ii) that the licensee may be required by the licensor to forfeit its rights if royalties based on sales fail to meet stipulated levels. Since the achievement of minimum royalties is usually not considered as a really satisfactory performance, the latter approach, which can automatically result in the replacement of an underachieving licensee, can usefully spur a licensee to greater efforts.

Royalties themselves can be calculated in a variety of ways. The most common is an agreed percentage of a defined "net invoice value", which usually encompasses f.o.b. billing, less sales taxes, returns and allowances. Depending on the circumstances, the royalty rate can decrease as certain volume levels are surpassed, or increase if it can be demonstrated that unit profits are likely to increase above indicated levels. Simple unit fees can be appropriate if prices are expected to be stable, or even decrease as efficiency improves. A formal procedure to re-evaluate the remuneration basis at regular intervals may also be provided where severe market uncertainties are anticipated by the parties.

Royalties ought to be considered as a direct function of the profitability of the arrangement to the licensee. A rule of thumb that royalties should be 25% of gross profits has been successfully argued, and has frequently resulted in the licensor obtaining a rate higher than the so-called "standard" 5%.

There is real scope for imagination on the whole question of remunerating the licensor. A consultant can therefore make some of his most valuable contributions, both to a licensor and a licensee, in this area. For example:

(a) In circumstances where the engineering and problem solving skills of a licensor of air pollution control equipment would be required for several years, a system of points was worked out to cover service fees of different levels of the licensor's personnel for furnishing this support. This resulted in significant income to the licensor, in addition to normal royalties, calculated as a percentage of net sales. This approach also enabled the licensee to build its own in-house staff slowly and carefully, since it did not immediately have to absorb this overhead.

(b) Different rates of royalty were charged if the licensed product was sold separately as a piece of original equipment or spare part; as a unit in a sub-assembly; or as a component in an entire system. The licensee marketed the item in all three ways.

(c) A licensee of packaging equipment was encouraged to offer the machines to customers on a lease basis with counters on the machine, rather than to offer the units merely for sale. This reduced capital expenditures of the customers, permitted more rapid introduction of the machines, and resulted in much greater return to both licensor and licensee over the long run.

The license on this packaging machinery was exclusive. The licensor also granted numerous non-exclusive licenses to make the proprietary packages. The competition among the licensees stimulated greater volume of utilization of the entire technology.

It is frequently desirable to have the licensor acquire equity in the licensee, since this enhances control and permits participation in the actual profits and growth of the operation. This may be accomplished by having all or part of the initial license payment made to the licensee in the form of stock of the licensee. Another way to achieve this is to have the licensee establish a new company to handle this technology and to give the licensor an agreed percentage of the equity in exchange for the input of the licensor's know-how. In either situation the licensor is sometimes also able to exact a royalty from the licensee in consideration for the privilege of using patents or trademarks registered by the licensor.

When negotiating either type of joint venture, the parties should always anticipate the expansion of the licensee's activities and financial needs. If the licensee should be unable or unwilling to match the licensor's ability to fund needed expansion, a procedure should be provided, based on some objective criteria, to enable the licensor, at its option, to make the added investment alone, and thereby increase his share in the business.

Licensors who own no equity in their licensees are at a disadvantage to large multi-national companies who can regulate the policies and actions of their controlled subsidiaries. A consultant can help reduce this gap between his client which owns no equity and the large corporate giants, if the consultant maintains facilities or has trusted associates in the licensed territory, by furnishing a regular liaison service between the parties. Supervision or observation of the licensee should essentially fall into three areas:

(i) research being conducted by the licensee with regard to the licensed products or processes; regular and detailed progress reports should be furnished to the licensor, who should have a royalty-free grantback license to any improvements developed by the licensee, with the right to grant sub-licenses thereunder;
(ii) the marketing program of the licensee should be assessed and suggestions made for improvements, either directly by the consultant or by his relaying comments of the licensor, where this could be helpful;
(iii) the accounts and records of the licensee relating to royalty payments to the licensor should be regularly audited.

This situation can be likened to a garden, requiring regular care and weeding. Failure to do this would probably result in a lesser return to the licensor's investment.

In international licensing, there is another important role which a consultant can usefully play. Perhaps the greatest reason for delays in the conclusion of international negotiations is the element of suspicion and incomplete understanding between parties of different nationalities. A sophisticated consultant can frequently dispose of certain national prejudices, and improve communication between the parties.

Thus, if an American consultant is retained by a Japanese company seeking to grant a license in the U.S., the parameters of the technology and the licensing proposals can be quickly defined by the consultant, acting as spokesman. Varying the facts, if the Japanese company would be the proposed licensee, and assuming it had confidence in its American consultant, the transaction is likely to be speeded because misunderstandings and fear of being cheated would be mitigated.

In the same vein, many lesser developed countries seeking to receive technology through the commercial licensing route have been well served by retaining licensing consultants who can maintain the trust and confidence of both sides to these negotiations. Indeed, it is known that many companies dealing with governments and individuals in lesser developed countries welcome the presence of such a professional advisor to the other side.

As the world-wide technological revolution continues to accelerate during the 1970s, and as the

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1971	**LES CALENDAR 1971**
October 19, 1971	Trustees Meeting – Puerto Rico
October 19-22, 1971	Seventh LES Annual Meeting – Puerto Rico Sheraton Hotel – San Juan, Puerto Rico – Harold Haidt, Chairman
October 30, 1971	Deadline–LES NOUVELLES material for November Issue
December 1, 1971	Deadline–LES NOUVELLES material for January issue

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1972-73	**1972-73**
April 1972 (tentative 3rd week)	LES West Coast U.S. Meeting
April 1972 (tentative 4th week)	LES Mid-West U.S. Meeting
May 8-10, 1972	LES/UN Meeting in New York – Licensing and Developing Nations – Len Mackey, Chairman
Mid-June, 1972	LES France Annual Meeting – Paris, France
End of August, 1972	LES Scandinavia Annual Meeting – Stockholm or Helsinki
September 1972	Japan Licensing Conference in Tokyo, Japan
October 25-27, 1972	U.S. Annual Meeting – San Antonio, Texas – Tom Copeland, Chairman

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April, 1973	International Licensing Conference in London, U.K.
Mid-October, 1973	U.S. Annual Meeting – San Francisco, California – Bill Poms, Chairman

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cost of research soars even further, the transfer of technology will become increasingly important. Licensing can provide significant income to originators and can help to defray the expenses of invention.

Both big and small business also increasingly recognize that new technology, indispensible to continued corporate health and growth, can be efficiently acquired under license. Moreover, many large companies have accumulated "surplus" technology relating both to products and processes. Some of these organizations have realized substantial supplemental income by licensing these assets, through in-house departments, outside consultants, or a combination of the two.

In his role as a conglomerate counsellor, finder, strategist, interpreter and guardian, the licensing consultant can fill a useful professional niche. These skills that do not readily lend themselves to standardization or automation, but they can nevertheless be highly productive. The elements of creativity involved in the art of licensing also make this an enjoyable and rewarding exercise for the practitioner.

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LICENSE/TRADE SECRET BATTLE

As LES NOUVELLES goes to press, one of our LES members sent the following clipping from the *European Chemical News* of July 16, 1971:

SIR AND RUMIANCA ACCUSED IN TRADE SECRETS BATTLE

A long-smouldering US-Italian dispute has again flared into life with the news of an action in New York by Dart Industries Inc., formally the Rexall Drug and Chemical Co., and the El Paso Products Co., against two Italian chemical companies, SIR, or Milan, and Rumianca SpA, of Turin.

Dart's Action, which is seeking to recover for misappropriation of trade secrets alleges that Rumianca entered into a patent license agreement and a process and product development agreement with Dart and El Paso for the production of high-pressure polyethylene. It is also contended that Rumianca obtained valuable trade secrets and confidential information under these agreements and passed on these trade secrets to SIR in breach of the agreement. SIR is alleged to be using the Dart-El Paso processes to produce high-pressure polyethylene at a 44,000 ton/year plant at Porto Torres, Sardinia.

The complaint alleges that Rumianca and SIR are under common control and that they conspired to make illegal use of the trade secrets which Rumianca obtained. Certain employees of the two defendants are alleged in a statement issued to Dart, to have been arrested by the Italian police some years ago and charged with the theft of trade secrets, including those of Dart-El Paso.

In its reply to the news of the action, SIR maintains that construction of the high-pressure polyethylene plant at Porto Torres commenced on January 9, 1963, and that production began on June 12, 1965. The company points out that it was not until March 1, 1968, that Nino Rovelli, president of SIR, joined the board of directors of Rumianca and was appointed vice-president of that company.

SIR rejects all these charges *in toto* and confirms its trust that competent courts will render full justice and request Dart to refund damages. Rumianca, which uses the Dart-El Paso processes to produce high-pressure polyethylene at its 25,000 ton/year plant at Assemini, near Cagliari, Sardinia, strenuously denies the charges also citing the date of SIR control.

Not to be outdone, Rumianca is also querying its payment of two different considerations to Dart-El Paso for the patent licence agreement and the process and product development agreement. Maintaining that the two agreements offer substantially the same things, Rumianca states that it has already paid $1.6m. to Dart-El Paso, of which $850,000 was for the now-terminated and fully-paid first agreement and $750,000 for the second agreement, which it now challenges. According to Rumianca, the first agreement grants the company the right to use all the patents on high-pressure polyethylene owned by Dart-El Paso until they expire.

The company maintains that it is still seeking clarification on the differing payments it has made for the two agreements, and expresses surprise that its recent request should have heralded the arrival of the Dart suit.

First news of this dispute materialized in June, 1969, when Dart Industries filed a patent infringement suit against Stiral SpA, the operator of the Porto Torres high-pressure polyethylene plant, in Court at Sassari, Sardinia. At that time, discussion was expected to centre around a number of Italian patents held by Dart which were alleged to concern the reaction and purification section of the Porto Torres plant. The process then in question involved the use of a tubular reactor.

SIR is believed to be a minority share-holder in Stiral, but the latter company has been widely referred to as being one of SIR's "satellites" in the Porto Torres area. The case in Sardinia is still pending, but amidst much to-ing and fro-ing of high-powered US and Italian Company personnel, the action now seems to have switched to New York.