ment of consideration for the present Agreement."

In closing, I would like to refer again to the concept of the interface between the antitrust laws and the patent laws, the erosion of proprietary rights over the past few years, and the anlogy with the Pacific Palisades. As a general principle, I suggest that License Agreements should be written to stay at least one big step back from the precipice, or the borderline between the antitrust and the patent laws. Further, this should be determined by reviewing the entire License Agreement, rather than looking at the Agreement on a section-by-section basis. If, for commercial reasons, you must edge up very close to this precipice separating sound licensing law from the forbidden antitrust violations in one section of the License Agreement, you should then maintain a greater distance from the interface with regard to the other provisions which you include in your agreement. Just as the owner of Pacific Palisades property must be careful not to load the edge too heavily, with his house, swimming pool and barbecue pit all at the brink; so the license draftsman should draft a License Agreement which does not cross antitrust lines and adversely affect competition to a significant extent, from an over-all standpoint.

Finally, it is strongly suggested that old so-called standard License Agreement forms be carefully reviewed, and that new language be included to accommodate at least some of the recent developments in the law which I have noted above.

By following these precautions it is hoped that you can license your "Package" lawfully, and avoid the precipice of antitrust "unenforceability" of your License Agreements.

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THE SMALL COMPANIES' VIEW OF LICENSING

by
*Norman A. Jacobs**

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All companies have the same objective when they license technology: *to render better service and develop profit by extending resources most rapidly at minimum risk.* What factors then are unique in the smaller companies that make their stance on licensing different from their larger brothers? By definition, the small firm has fewer tangible resources — dollars, installed capacity, and warm bodies. But again, almost by definition, the smaller firm also has less inertia, more flexibility, both in internal and external relationships. Often, also, a greater fraction of the people have the entrepreneurial spirit and/or creative talent. These factors — flexibility, drive and creativity — underlie the behavior pattern of the small organization in licensing and elsewhere.

The small company often has need to supplement its manufacturing capability. It can, thus, be an aggressive licensee when technology is available. More often, however, the small company is THE expert in its field of concentration and cannot fill its needs from outside. Most often, then, the small company is licensor and/or joint partner in developing ideas of its own. Small companies generate at least their share of ideas, but many lack the resources, both financial and human, to bring them to commercial fruition. Thus, one significant characteristic in the viewpoint of a small company is that we frequently seek to license technology at an early stage of development, with the result that the licensing agreement often includes provisions for us to perform additional laboratory work on behalf of our licensee. Let us, therefore, examine how this combination licensing and research activity is handled. Then, I would like to describe some ways we have used licensing apart from our research activities to complement and accelerate the marketing of our products, and finally, I shall exemplify the flexibility of our approach in determining royalty rates and defining the technology which we license.

Joint development programs

We have often found ourselves with a product of process idea that does not fit into our established businesses. The concept might require research effort that is clearly beyond our financial resources, or it might be a commodity-type product that requires a major manufacturing investment in order to achieve economical production, or the market might be so different from the ones we now serve as to require investment in a separate marketing organization. If further analysis confirms these circumstances, then instead of simply putting the idea on the shelf in the hope of being able to exploit it sometime in the future, we will try to license it even at this early stage.

The first step is to identify companies who might be interested in exploiting the idea. The potential licensee might be either a company which is making and selling similar products, or a company which could use the idea in its own manufacturing activities. As an example of this latter approach we worked on development of novel battery separators with a manufacturer of batteries, rather than with a company that sells separators. We also licensed protective coatings for food processing equipment to a manufacturer of such equipment, rather than to a paint company.

In selecting a particular company within an industry, we have found that the largest companies, while receptive to licensing fully developed products, would generally prefer to rely on their own research departments rather than take a license to a product that requires extensive additional research. Smaller companies, on the other hand, often cannot afford R&D costs for the new idea. As a result, we most often license technology at this "idea" stage to medium-to-large companies who can afford the cost to commercialize the product, *and* who are willing to consider ideas from outside.

One problem that we face immediately in licensing is finding a way to disclose the idea so that it can be considered by a prospective licensee, but not giving it away. In order to protect his proprietary information, the licensor would like to execute a secrecy agreement under which the prospect agrees to keep the idea confidential if he does not elect to take a license. Unfortunately, one of the results of accepting information in confidence is to bar the recipient from ever being able to invent the same idea himself, and many prospective licensees are unwilling to restrict their future activities to this extent. If the licensor discloses his idea without this protection, however, he may be limiting the value of his idea to the value of the patent protection he can obtain; and if the idea is at an early stage of development where the degree of potential patent coverage is largely unknown, reliance upon patents may be quite dangerous.

We try to get around this problem by first freely disclosing expected *performance* data for the product, and general information about its composition and method of manufacture, which should allow the prospective licensee to determine whether there is in fact any conflict with his own research activities. If the company then refuses to accept additional information in confidence, we simply go elsewhere. In most cases, when this initial disclosure establishes that there is no real conflict, we proceed to execute a secrecy agreement under which we fully disclose our idea under the assurance that the prospective licensee will not further disclose or use the idea for some reasonable time, usually about five years.

Once past this disclosure hurdle, the prospective licensee can determine whether he is seriously interested, and if so, the parties can hopefully define royalty and other license terms that are satisfactory to both. Often the licensee would prefer to have the originator of the idea perform the additional research or development work until the product reaches the pilot plant or other stage where it becomes logical for the licensee to assume full responsibility. We are often willing to perform such work at cost, or even to assume part of the cost ourselves, in return for higher royalty rates or other license terms more favorable than the idea itself might command at an early stage of development. In such joint development programs the agreement covers both this research work and the licensing arrangements.

In most cases, the licensee is only interested in, or capable of, commercializing a portion of the potential uses which the idea may have. As a result, we often grant licenses limited to certain fields of use. We reserve the right to commercialize or license other uses that may be developed, subject to a "reverse royalty" payable to the original licensee in proportion to the extent that we utilize technology we have developed in the course of the research program he has supported. As a small company actively seeking such licensing arrangements, we are often in a better position to exploit these fringe applications than our licensee, and we have been able to convince many larger companies of this fact. Based on our experience, these field-of-use licenses clearly result in commercialization of spin-off technology, and the resulting flow of new products to the public, that would otherwise be overlooked by our licensees.

Two subjective comments based on our experiences with these joint development programs may be of value. First, we have found that the most critical element to consider in selecting a licensee is the strength of his marketing organization, and particularly his ability to define and capture markets for new products. Too many marketing groups have difficulty adjusting their strategies and techniques to exploit a product that does not fit their established patterns, or even recognizing that a new product requires a change in marketing approach. Second, the licensor should be prepared for what seem like great delays between the signing of the license agreement and ultimate commercialization of the product. With a licensed product, the usually long period between test tube and market is further extended by the inevitable "Not-Invented-Here" attitudes of the licensee's technical, manufacturing, and marketing organization, which we have learned to minimize but not to eliminiate.

Licensing flexibility

In addition to the "joint development programs" we are increasingly active in granting straightforward licenses to use relatively well-established technology that does not require a major research program. These licenses are more typical of licenses granted by larger companies, but there are several types of agreements that are perhaps unique to a smaller company.

In one case we developed a protective coating that provided unusually valuable properties. But it was used in thin coatings so the quantity of coating material was small. We initially planned to market this coating as a specialty product, but found that the projected return was too small since, despite its unique properties, customers would not pay much more than the per pound price for similar coating resins. We finally located a major potential user of the coating who, based on the unique properties provided by the coating, was willing to base a royalty payment on the *area* coated, which amounted to more than the per pound selling price we had projected for the coating material. This case was perhaps unique, but I believe fitting the royalty base to each situation merits exploration whenever you are considering the introduction of a product whose value to the customer is out of proportion to the usual selling price of comparable products.

We have also found licensing valuable as an adjunct to the production and marketing of our own products. We have, for example, worked closely with a major customer who was making a significant investment in order to utilize a proprietary product of ours in his manufacturing operation. He was justifably concerned that his investment might be lost if we did not supply our products to him. We therefore offered this customer a license to produce the product himself in the event we were unable or unwilling to continue to supply his requirements. This "distress license," as we call it, avoids the necessity of setting

up a second source of supply, while still providing the customer with assurance of a continuing source of a critical product. Of course, we plan our activities to minimize the likelihood of our customer exercising his license rights, since our objective in these cases is to sell products, not to collect royalties.

In another situation, we found that there was a major application for a new product which required marketing capability in a specific industry that would have been too expensive for us to develop for this single product. In addition, the market for this product, if we were successful, would be 10-50 times our production capacity. We therefore appointed a major chemical company who was servicing this industry to be our distributor, and granted him licenses to manufacture the product himself to the extent that the demand exceeded our production capacity.

Royalty

I am often asked by companies considering licensing for the first time, "how do I determine how high a royalty to charge?" A number of writers have suggested that a "fair" royalty is one which would provide that the licensor receives about 25% of the profit earned by the licensee from practice of the invention. I believe this is a valid guideline, since it recognizes that the licensee, who will be making the significant capital investment and taking the major risks in commercializing the invention, should receive the major portion of the profit produced. Although the inventor often believes he is entitled to the lion's share of the profit, most license negotiators recognize the contributions of engineering, manufacturing, and marketing plus the investment in plant and working capital as meriting something like 75% of the profit produced.

There are cases, though they are rare in my experience, where the royalty is stated just this way, i.e., 25% of profit. In most cases, however, the licensee is unwilling to disclose the profit he earns, and even if he could, expressing a royalty in terms of profit could lead to innumerable problems in determining the actual profit earned by one product out of many being sold. We most commonly express the royalty as a percentage of sales, and attempt to approximate 25% or more of the profit we think the licensee will earn. Where our technology is used to reduce the licensee's manufacturing cost rather than increase his sales, we have expressed the royalty as a percentage of the projected cost savings, although this still poses problems in agreeing in advance on the elements of manufacturing cost to be considered.

In addition to earned or running royalties measured by the extent of usage of the invention, we insist on minimum annual royalty payments so long as the license is outstanding. These minimum payments generally ascend from year to year, and are calculated at 25-50% of the earned royalties that will be generated if the forecast sales are achieved. The purpose of minimum royalties is to ensure that the licensee diligently exploits the technology, or if not, that he will at least terminate the license and allow us to try to find another licensee.

The request for minimum royalties often provokes the response that the licensee is about to spend a significant sum of money to develop and introduce the product, and that this investment alone ensures he will not "sit on" the product in the future. The licensor should recognize, however, that, once spent, these costs are "sunk costs" and really do not ensure future diligence. An obligation to pay $5,000 of minimum royalties this year is much more effective in prompting action than $100,000 spent three years ago.

Another critical element for the small company as licensor is the definition of the technology on which royalties will be paid. The manufacture of chemical or plastic products often involves significant secret art or know-how, which cannot be determined by "reverse engineering" of the end product. This know-how is at least as valuable as any patent protection that may be obtained, and often even more valuable. In such cases, we believe that royalties should be payable so long as the licensee is operating either under valid patents or under any valuable know-how that is neither public knowledge nor known to competitors. In either case, the licensee is operating at an advantage over his competitors, and should pay a royalty for that privilege.

As I stated at the outset, in most respects a small company looks at licensing no differently than a larger organization. Because of limited resources, however, a smaller company may seek to license technology at an earlier stage of development, and should be prepared to conduct further research for the benefit of the licensee as a part of the license agreement. The small company may also be able to use licensing, or at least an option to license, as a marketing tool with the large customer who is concerned about the reliability of his source of supply. Finally, the small company must be alert in negotiating license terms such as earned and minimum royalties, and even the description of the technology to be licensed, if he is to ensure a successful licensing program.

**About the Author: Norman A. Jacobs is President of Amicon Corporation, 25 Hartwell Ave., Lexington, Massachusettes 02173. He was one of the founders of Amicon in 1962, and served as Vice President and Treasurer until his election as President last year. He holds an M.B.A. from Harvard, and M.S. and B.E. degrees from M.I.T. and Yale, respectively. He has been Treasurer and a member of the Board of the Licensing Executives Society since 1969.*

NOTICE

Secretaries of all LES Chapters are reminded that a copy of the minutes of each LES Chapter and Director's meetings should be sent in English to all other LES Chapters. This allows all Chapters to coordinate their activities and to be aware of the activities of other Chapters.