

Assessing Licensing Ventures

Licensors' criteria for deciding whether to conclude licensing agreement often depends on facts and circumstances

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My subject deals with the criteria operative in the decision of a potential licensor whether to conclude a given venture in a given situation. As I am employed in a major company, the point of view of such a company will make its mark on the assessment in my paper. My personal experience is essentially limited to the field of electrical engineering. My reflections on the topic may therefore not lay claim to general validity. I would even assume that the issue may have quite different aspects in other fields, such as chemical engineering.

I shall exclude from my discussion licenses within a group of companies. I will concentrate on licensing ventures between partners without capital participation of either of the parties in the other.

Now, to list and examine the individual factors to be taken into account in technology transfer ventures.

Licensing Laws and Antitrust Law

The question under what conditions a licensing venture can be concluded with a partner in a given country is not only to be assessed on technical, financial and marketing criteria, but also to a great extent on purely legal criteria. In drafting of licensing ventures we are constricted legally from two sides. It must first be painstakingly established whether that which is desirable from the point of view of business policy may also be bindingly agreed on in the light of antitrust law. Licensing ventures frequently fail on account of problems of antitrust law. A German company with business activities in the whole EC which receives a request for a license from a French company is not in the position to place limitations on the French company's marketing of the licensed product within the EC to any considerable extent.

It is a matter of course that such deliberations lead to many ventures not being concluded within the EC. If one were to follow the opinion of the Commission in Brussels as represented in the Raymond Nogoya case, one would, as a European company granting licenses to Comecon countries or any other countries outside

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the EC in many cases have to give such licensees the possibility of delivering the products under license to all territories of the EC. Such decisions have no considerable influence on the evaluation of licensing ventures.

Mandatory Approval

But we are not only limited by antitrust law considerations in our decision-making scope. The same effect occurs on account of mandatory approval of license agreements in most countries in the world. The conditions under which license agreements are approved in the respective country are partially in the form of laws, partially in the form of regulations but also partially in simple guidelines, as in India.

The limitations to which the parties are subjected during negotiation on license conditions are so decisive that they must be taken into account from the outset and may well often lead to abandonment of the respective venture. In my experience, this is one of the main problems in the assessment of licensing ventures. The laws, regulations and guidelines leave the authorities such scope for discretion that it is frequently most difficult to make a qualified statement as to what conditions the authorities will approve in a concrete case. Considerable uncertainty on the legal situation is hereby caused and is often used by potential licensees to their advantage.

Personnel Problems

In assessing licensing ventures, especially in threshold or developing countries, the personnel problem must be carefully examined. By this I mean the commitment of one's own personnel as also the fact that employees of the potential licensee must be trained in manufacture as also that the licensor will frequently have to deploy his own personnel to a considerable extent in support of the licensee. Whether sufficient personnel is available in the individual case must be checked.

Rights of Use

The question of which rights of use under the technical knowledge to be transferred to the partner are to be granted is frequently one of the central points in the assessment of such a venture.

Rights of Manufacture: The rights of manufacture to be granted are, as a rule, not problematical because they are nearly always limited to the country in which the potential licensing partner is registered.

Sales Rights: As regards sales rights to be granted, legal problems as also problems of marketing policy

are to be considered. You are familiar with the antitrust law problem in the question of which sales rights are to be granted to a partner. The license regulation laws generally require comprehensive sales rights for the domestic licensees. Unlimited worldwide sales rights may even be required in some cases. Careful deliberation is required, whether a licensing venture is still of interest for the company assessing the same if the potential licensee is in a position to compete with the licensor on a worldwide or at least considerable scale.

Those companies with worldwide activities are particularly hard-hit by this problem. The reaction to this problem in such companies is manifold. Some of those involved point out that the potential licensee in a threshold or developing country is not a serious competitor outside his own country because of the nonexistence of a marketing or service network. Others tend to the opposite extreme. They fear that even few offers from such a country on important markets of the licensor could lead to an alteration of the price-and-supply structure.

Of course it depends on the specific situation of the company assessing the venture whether the sales rights demanded by the potential licensee are acceptable. A Japanese licensor, for example, finds it considerably easier than a licensor from the EC to grant to a licensee in the Comecon states sales rights for the EC. I assume that the requirement of the EC Commission for essentially unlimited sales rights in the EC has led to European companies only granting a very limited number of licenses to partners within the EC.

Exclusive Licenses: It is my observation that exclusive licenses are mainly demanded nowadays by companies in the threshold or developing countries. Major companies with worldwide activities are not interested in granting exclusive licenses for self-evident reasons. If readiness to conclude an exclusive license is expressed in an individual case, practical implementation is generally hindered in such countries because the financial consideration required, e.g. as a minimum royalty payment will frequently not be approved by the authorities.

Sublicenses: The demand that sublicenses may be granted by potential licensees may often be heard, but as a rule will be refused. I remember very few cases where this question has been a crucial point in a decision on a licensing venture.

Financial Consideration

The question whether adequate financial consideration may be obtained for a licensing venture is, of course, a central point if not the central point of the assessment.

Let me start with one observation I frequently make. Companies granting licenses are relatively generous as regards consideration for the technology to be transferred when considerable supply business is expected within the framework of such a licensing venture. There appears to be a relatively high level of willingness on the part of the company granting the license to transfer the technology in the interest of the supply business at financial conditions which would surely not be regarded as adequate in a purely licensing venture (i.e. one in which no supplies are involved).

I have gained the general impression in the electrical field that there has been a sort of price collapse in recent years in the licensing field. Companies are more and more frequently encountered that are prepared to grant licenses at conditions which would not have been regarded as reasonable a few years ago.

Costs of Transfer and Participation in Development Costs: The potential licensor is first confronted with the task of working out the costs incurred in the course of the licensing venture. Such costs may be easily determined and the minimum requirement of a potential licensor must be to ensure that such costs are borne by the licensee. The motive for granting licenses, is not, however, to cover such costs but to earn from the licensing venture. It would appear to me to be immaterial whether such earnings are characterized as a participation in the development costs of the company granting the license or as compensation for giving up sales territories.

Consideration Paid by the Licensee for Commercial Use of the Know-How: The financial consideration which the licensor intends to receive may be in the form of lump-sum payment made by the licensee. It can also be in the form of a participation in licensee's turnover by means of royalties. These are the two extremes between which various combinations are possible. An advanced payment may be agreed on and the royalties correspondingly reduced. A minimum annual payment set off against royalties may be agreed on, etc. All these theoretically available alternatives for determining consideration paid by the licensee are, however, only practicable to a limited extent. The reason for this is that only a few of these alternatives are approved by the authorities. Before the question of consideration is discussed in detail as to the magnitude of such consideration it is absolutely necessary to first determine which consideration may be approved in the respective country.

Lump-Sum Settlement

For the potential licensor there are frequently good reasons for a lump-sum settlement for the technical know-how to be transferred. In the case of partners in threshold or developing countries there is frequently a considerable discrepancy in assessment of turnover to be expected between the licensor and the licensee. The licensee tends to an optimistic assessment. In such situations it is often advisable to agree on lump-sum settlement. There are, of course, also countries in which a lump-sum settlement may be specified because the partners in these countries are not prepared to pay consideration in any other form.

The question is only how such consideration is to be calculated. Of course, calculation of such lump-sum payment may be based on market estimates and a commensurate royalty calculated for estimated production. These may well be interesting considerations and may also provide a basis for determining the lump-sum payment.

But what happens then? Based on these calculations you offer at 100 and the competition offers at 90, 85, 80 and 70. What action do you take then? For a while you will play the game but then will begin to think over where your limit is. I would maintain that this limit at

which you are awarded the venture or at which you drop out is extremely difficult to define. The decision remains one of business policy in which all the factors indicated must be duly considered.

Royalties on Turnover

The same factors which have to be taken into account while calculating a lump-sum payment are also valid for determining royalties related to turnover. In a given case you regard a royalty of 5% for 10 years as being commensurate. Your competition offers 4% for 8 years. With which arguments would you then substantiate your drawing equal with the offer of the competition or even underbidding the competition?

When I sell a product I work out my costs for manufacture and marketing of this product and thus have a secure basis for my decision at which price I can sell the product at a given profit. Other factors may even cause me to be prepared to sell this product under my own costs in individual cases. In any case, I will know exactly whether I earn on the transaction or not.

The situation in licensing ventures is utterly different. I can work out the costs incurred in the course of venture. Therefore, if I ensure in a licensing venture that all costs incurred in the transfer are covered I will not make a loss. The venture will be profitable with turnover-related royalties if the licensee has a large turnover and I may earn nothing if he makes no turnover. To put this in a provocative manner: how much must I earn for the venture to be of interest to me? There is no objectively verifiable answer to this question.

Supplies

Many licensing ventures are linked with the expectation of supply business. If such supply business is bindingly agreed on it is a reliable basis for assessment of the licensing venture and therefore also for the question of how good the financial consideration for the technology transfer must be so that this venture remains of interest.

If supply business cannot be bindingly agreed on—and this is most often the case—it is a matter of speculation with which probability supply business may be expected. These expectations will be nurtured by the potential licensee in order to obtain a considerable reduction of the financial consideration for the technology transfer.

Goodwill

A further point often raised by the potential licensor is also within the realm of speculation. A positive light is shed on the conclusion of a licensing agreement by representation that the licensor will create goodwill in the respective country or—a formulation I have often encountered—will establish his technology in the country. I leave it to your discretion to judge what significance such factors have in your assessment of a licensing venture.

Patents

Frequently, or even as a rule, the product for which licenses are to be granted is protected by patents to a more or less wide extent. My colleagues from the

patent department are of the conviction that such protection of the product to be manufactured under license must be reflected in calculation of consideration to be paid by the licensee.

Legal Question

I would finally wish to deal briefly with the question as to what extent other problems of the licensing agreement are of significance for the decision. I am thinking of questions of liability of the licensor, applicable law, *force-majeure* and similar. The scope available to the negotiating parties in dealing with these questions are regulated by the laws of the developing and threshold countries to the effect that there is hardly any scope at all.

Many countries require a comprehensive assumption of liability by the licensor and it is required, as a rule, that the law of the country of the licensee is applicable for the agreement, and the question as to whether strike is a *force-majeure* case is an object of contention.

Without wishing to unnecessarily denigrate these questions, I would still wish to maintain that licensing ventures have hardly failed on account of these questions.

LICENSING VENTURES AND RELATED ACTIVITIES

When assessing licensing problems two questions which have occurred more frequently in recent years in the context of licensing ventures should not be overlooked.

Companies in developing countries intending to take licenses are more frequently demanding that the potential licensor should participate in the company in the country which is to manufacture the licensed product. Such companies apparently work on the assumption that a licensor with participation in a company will make greater efforts to effect a smooth and successful technology transfer. Therefore potential licensors who are really only interested in a license agreement and, possibly, in the associated supply business are being confronted more and more frequently with the question of whether they should go so far as to take up a minority participation in a company in the developing country in the interest of the licensing venture and in the interest of supply business.

In such cases it is practically only a question of minority participation by licensors, as a majority participation or a 50% participation is prevented as a rule in such joint ventures by the laws of the developing countries. In many cases additional restrictions are placed on the influence of the licensor holding a minority participation on the business of the joint venture by the laws of the respective developing country. The influence of the licensor is mostly limited at the wish of the partner in the developing country to the technical aspects of the joint venture.

I do not intend to go into further detail on this topic, but would wish to draw your attention to one aspect of the assessment of such ventures. The license agreement concluded with a minority holding company in the developing country must, of course, be approved by the authorities of this country. Experience has shown that such companies require further technical

support by the licensor for a long period of time after termination of the license agreement. If you wish to receive commensurate consideration for such further technical support from the minority holding, a new license agreement must be concluded to provide title to such payment. In many cases difficulties will be encountered in convincing the authorities that the minority holding requires further technical support after termination of the first license agreement and that commensurate consideration therefore must be approved.

Factory Planning

A further point has come to my notice in recent years with reference to license agreements concluded with companies in developing countries. If the licensees are new-founded companies taking up manufacture of a given product for the first time, the licensor is often expected to undertake the planning of the factory in which the product is to be manufactured under license. This factory planning work poses a problem for the licensor. The licensee will, as a rule, wish to limit the planning work of the licensor to those tasks for which a competent contractor can not be found on the domestic market in order to limit the foreign exchange requirements to a minimum.

The interaction of the planning work of the licensor and the complementary work done in the licensee's country often gives rise to difficulties. In the context of such interaction of planning done by two different parties, the licensor will hardly be in a position to accept liability for his planning work.

Difficulties will also be frequently encountered as to the question of what consideration is commensurate for such planning work. In the assessment of a licensing venture involving planning work required by the licensee, attention must be paid whether this aspect of the venture can be satisfactorily provided for.

SUMMARY

These are my observations on the topic. I have not been able to offer you a patent solution for the assessment of licensing ventures. On the contrary. The multiplicity of aspects to be taken into account in each individual case makes it impossible to list generally valid assessment criteria. Even in the case of one product to be licensed in two different countries—such as Germany and India—completely different criteria must be taken into account. Moreover, most of these criteria are not tangible entities. It is therefore not a surprise that many licensing ventures by no means lead to the success hoped for by the licensor.