

When Agreements Fail

An examination of reasons licensing agreements do not succeed; what to do when they fail

BY CRISPIN MARSH*

I believe that there is a major gap in the licensing literature. One can find in *Les Nouvelles*, in the growing number of textbooks on licensing and in the commercially produced journals a vast amount written about the subject of licensing. There is, however, very little about the causes of licensing failures.

Where among the articles on trade practices, negotiations, taxation, patent laws, and doing business with the Chinese do you find stories of failures? Success stories are there aplenty, but failures are as rare as hens' teeth.

I believe that an examination of licensing deals that have failed shows many of the major pitfalls in licensing. An examination of these failures should help us all in future dealings.

Now, what is it that we can regard as a "licensing failure"? The object of licensing is to transfer technology from a licensor to a licensee. The purpose of the transfer is to benefit the provider of the technology and to benefit the receiver of the technology. It is of the essence that there be, as the saying goes, "something in it for everyone." I therefore regard a licensing failure as a license which fails to benefit both of the parties to the license. Unless both parties benefit from entering into the arrangement, the arrangement cannot last, it cannot bear fruit, it cannot be regarded as a success.

Some of you might think that this definition is unduly narrow or too limiting. Surely, you might say, if I license another to make my patented widget and he pays his royalty regularly why should I worry about whether he makes a profit. The answer to this is quite simple. It is the thing which distinguishes the licensing of technology from many other contractual relationships. Unlike the sale of a car or the purchase of a house, licensing is not over and done with when the papers are signed. A license is necessarily designed to last. It is an ongoing relationship.

If your new car is a lemon or if the house you bought has a leak in the roof you can but grit your teeth and determine not to buy again from that vendor. In a license agreement, by contrast, you may well be dealing regularly with the same licensor or licensee for years. If the license does not yield a benefit for you

both, then as surely as night follows day that license will fail.

The benefit will normally be monetary, a royalty for the licensor and a manufacturer's profit for the licensee. There are other benefits which may be substituted and sometimes these may be more valuable, for tax reasons, than cash. Payment may be in kind.

Caterpillar sold a tractor plant and manufacturing technology to the Soviets in return for a proportion of the output of that factory. The benefit may be even less tangible—such as shares in the licensee or the settlement of litigation. It may be a cross-license or access to complementary know-how. Many a license has been turned from failure to success by an innovative and flexible approach to finding mutually acceptable benefits from the relationship.

Categories

I have found one can categorize the reasons for licensing failures into five groups. They are:

1. Failures in the evaluation of the technology.
2. Failures in the selection of the partners.
3. Failures in the conduct of the negotiations.
4. Failures in the agreement itself.
5. Failures in the implementation and servicing of the license.

Another topic I shall touch on is the termination of the agreement when failure occurs. If the parties disengage cleanly the way may be open for a fresh attempt.

By way of introduction to these matters I shall tell you a cautionary tale which illustrates them all.

As with many good stories the events I relate did not occur and the people I speak about do not exist. The tale relates to the establishment of a joint venture between an American individual and a merchant bank and the subsequent grant of a license by the joint venture to a Korean company.

The individual had stumbled on a useful chemical formulation. Let's call it "Superglop." With little or no capital of his own the inventor went knocking on doors and eventually came upon an English-based merchant bank which had just established a venture capital division run by an energetic and enthusiastic young man with absolutely no experience in the field of technology transfer or licensing.

The merchant bankers were not taken in completely. They indicated that if the inventor could get a marketing company interested who was prepared to guarantee to buy minimum quantities of "Superglop" or to pay minimum royalties then they, the merchant

*F.B. Rice & Co., Balmain, Australia.

bankers, would capitalize a joint venture, would manage the licensing, and would fund further research.

The inventor went to Korea where he had considerable success. He had success in obtaining access to Korean companies and more importantly success in finding a company sufficiently interested to agree to send its managing director to the states for discussions. The inventor's success was, I suspect, due at least in part to the fact that the name of the merchant bankers, who I might say were very well known and respected in Korea, was more freely used than was warranted by the commitment that had in fact been made.

Mistake

By this stage the first major mistake had been made. Neither party, it seems, bothered to look seriously at the technology or the market for it. The merchant bankers assumed that if the Koreans were in, it must be good and the Koreans took the view that if a prestigious merchant banker would back it then they wanted to be in too.

The managing director of the Korean company was soon in the states steamed up to do business. This was the signal for the joint venture to be established and for the money to start flowing. This was also the moment for the second major mistake.

Little thought seems to have been given to the qualities, the strengths and the weaknesses, of the proposed licensee. It was assumed that if someone was prepared to fly from Korea to the states his company would make a "right fine licensee." Who bothered to wonder about that company's abilities as a manufacturer or a marketer? How much did they know about warehousing and distribution? What was their record for quality control? Now the answers to these questions turned out to be nobody and nothing.

The proposed licensee was in most respects a mirror image of the merchant bankers. A venture-capital outfit set up by a large investment company in Korea and run by a capable and energetic Korean finance man who knew nothing, or less, about bacterial spoilage, the penetration properties of U.V. light or the latent heat of vaporization of water, all of which were more or less relevant to an understanding and marketing of the invention.

The joint venture was not unprepared for the Korean visit. By careful arrangements, the Korean was "entertained" at breakfast, lunch and dinner by the inventor and the merchant bankers. Great care was taken to ensure that he ate only at European restaurants and particularly those that didn't serve rice. The inventor later told me with great pride that he had devised this tactic when in Korea after having been told by one of his hosts that every Korean must eat rice at least once a day. The tactic in a sense worked. The Korean later admitted he was in great distress during the week of negotiation due to a very upset tummy.

Isolation

After a week of strenuous negotiations, lots of late nights, and no rice, our poor unfortunate Korean was sent off to an island resort in the Carribean as a guest of the joint venture. This was to give him time to think

over the deal, to relax and reflect, and was stated to be a sign of good faith to show the joint venture was not trying to push him into something which was not in the interests of his company. It was of course fortuitous that the particular island resort selected had no telex or telephone facilities, a deficiency which prevented the Korean communicating with his colleagues in Korea!

On his return to the states the Korean negotiator was presented with an ultimatum, "Sign now or the deal is off." In these circumstances the Korean capitulated and signed the agreement. The irony of the situation was that he had no authority from his board to do so, a point which was to cause much anguish later.

The elation of the joint venturers at this event was as misplaced as a rock band at a funeral. The joint venturers had bumbled their way into their third major mistake. They had unfairly taken advantage of the managing director and chief negotiator of the company with which they were supposedly entering into a long-term relationship. They had destroyed whatever trust had ever existed between the parties.

What was this agreement into which our Korean friend had been coerced? While having many good points, the agreement had some glaring defects. First, what was being licensed? There was the exclusive right, in Korea, to use an undisclosed formula for an unpatented product and the right to use an unregistered, and possibly unregistrable, trademark. There was the supply of unspecified know-how from a technologically barren source. Not what you would call a very prepossessing basis for a license!

The licensed product was defined as:

"Comprising a variety of defined types of compounds with 'any variation, exclusion or inclusion'."

This definition was so wide as to include a bottle of washing-up detergent or a packet of jelly crystals, both of which clearly did not have the desirable qualities of "Superglop."

Obligations

And what were the obligations of the lucky recipient of these goodies? They were required to buy significant quantities of "Superglop" concentrate and certain other goods from the joint venturer over a number of years. They moreover acquired the right to put a million dollars into a joint venture to be set up between the Koreans and the merchant banker/inventor to market the licensed products throughout the world with the exception of the U.K. and Korea.

The agreement contained a range of other boilerplate clauses but interestingly enough only a very loosely written termination clause. It was a very one sided agreement with clauses defining the licensee's obligations outnumbering those defining the licensor's obligations five to one.

Here was the fourth mistake. The agreement did not provide a fair and reasonable balance of benefits and obligations. The minimum purchase obligations were seemingly plucked from the air with little thought for the ability of the licensee to perform. There was no room for the licensee to maneuver. There was little or

no time for the licensee to get geared up to produce or sell before he was swamped with the concentrate he was committed to buy. There was no serious obligation on the licensor to perform. There was no guarantee that the manufacturing plant to be designed by the licensor would work. The list of detailed deficiencies is almost endless. The essential problem with the agreement was that it did not try to set out the framework or ground rules of a lasting, mutually beneficial, relationship.

In the background to the agreement lay the seeds of the fifth major mistake. The implementation of the agreement was from a practical point of view impossible. "Superglop" concentrate was shipped to Korea and a manufacturing plant was set up in Seoul to the specification and plans supplied by the licensor. This plant was designed to produce "Superglop" from the concentrate supplied by the joint venture. The product rapidly showed bacterial spoilage which wrecked a test marketing exercise. This led to a serious loss of confidence in the product.

From this point on the mistakes that had been made snowballed. Sales were nothing like those expected, the licensee didn't know how to deal with its manufacturing and marketing problems. The Korean managing director was under fire from his board for entering into an agreement without authority. The agreement did not have approval from the Korean Central Bank which meant that funds could not be remitted—or so the Koreans maintained.

There we have it—a license that failed at the level of the evaluation of the technology; which failed at the level of the selection of the parties; which failed in the conduct of the negotiations; which failed in the agreement to define a long-term workable arrangement; and which failed in its implementation.

Trust

The agreement drifted on in rancor and bitterness for some years. The lack of clear termination provisions and the inability of the parties to trust and work with one another defeated even attempts to disengage the parties and allow a fresh start.

I shall now turn to look at these five areas of potential failure in a little more depth.

First, the evaluation of technology.

I don't intend to delve into this fascinating subject other than to say that it is clear that many licenses fail purely because the licensed product or process did not come up to the market expectation of the parties. If it happens to you or your clients console yourself with the fact that you are not alone.

The big Australian, B.H.P., entered into a license agreement with a small building company for whom we acted. Under this agreement B.H.P. was to develop and market building cells which had been invented by the building company. The idea was that these cells would be manufactured and finished internally in a factory and trucked to a site where they would be assembled into a house, a block of flats or an office building.

The novelty lay in having a structure so designed that the weight of the cell was sufficiently low that it could be handled by conventional trucks and cranes

while still having the required strength. Large sums were spent developing the system to a high degree of sophistication but in the end analysis the cost savings just didn't justify the capital cost of setting up a factory.

C.S.I.R.O. some years ago developed a method for producing polyunsaturated food products such as meat, milk, yogurt and cheese from cows and other ruminant animals. In this case everything that could have been done to ensure success seems to have been done by both C.S.I.R.O. and the licensee Dalgety Agri-Lines Pty. Limited.

Production techniques had been refined by C.S.I.R.O., market surveys had been done, sophisticated efficiency trials had been conducted and advertising gurus had been consulted. When the products came on the market, however, people just did not buy, presumably the price increment over the normal product outweighed the perceived advantages in the public mind.

Marsh Law

My involvement in that project on behalf of Dalgety Agri-Lines led me to the postulation of Marsh's First Law of Market Research. This law says that answers given to market researchers' questions will more truly reflect what the answerer thinks the questioner wants to hear than any real intention on the part of the answerer to act in a particular way. Let's fact it, if asked whether we would buy our dear old granddad polyunsaturated steak so that he wouldn't have another heart attack, how many of us would say "NO." Our resolve becomes less definite when we find it costs \$5 per kg more, can only be obtained two suburbs away, and is only 20% polyunsaturated, anyway!

I now turn to the selection of a licensing partner. Failure occurs here primarily because of a desire by an eager licensor to have a licensee at all costs. The first prospect through the door is often seen as being too good an opportunity to lose without any real attempt to analyze the licensee's suitability. Put crudely, taking what is immediately available might be fine on a one-night basis, but for marriage it spells disaster. Licensing like marriage is a long-term proposition.

Partner selection clearly starts with an analysis of one's own strengths and weaknesses. Do I have a product but no manufacturing or marketing skills? Do I have money looking for a venture? Do I have a leading product in a declining market? It is not until this analysis is complete that one can begin to look for a partner. The partner must be able to provide what you are lacking. As we saw in the "Superglop" case, two financiers don't make a manufacturer or a marketer.

The negotiation process has been written about probably more than any other aspect of licensing. However, I know of no better overview of negotiations than the paper presented to LES Australia's annual meeting in 1976 by Pete Horgan. LES Australia and New Zealand has a videotape of this speech. If you haven't seen it you certainly should.

There are some aspects of the negotiation process which are rarely mentioned and which I have observed as being the cause of negotiation breakdown. A

client of mine was negotiating with an Australian milk company to sell a license to use a patented process for production of a hydrolyzed milk product. The milk company was in a distant city. To save cost it was decided by the parties to use the milk company's local solicitor to draw up the contract. The parties duly met, discussed the situation, reached what appeared to be agreement, and left it to the solicitor to draw up a contract reflecting what had been agreed.

You can imagine my client's consternation when the written contract differed markedly from what had been agreed, either by a failure to transcribe correctly the points agreed to or by the inclusion of conditions which had not been discussed at all. This process was repeated two or three times. It ultimately led to such a degree of frustration and mistrust between the parties that they both packed up and walked away from the arrangement. They had worked amicably together for more than a year on a technical level.

Opportunities

It is essential that all of us who are involved as advisers and middlemen in the licensing process avoid by our carelessness, thoughtlessness or obstinacy, spoiling our clients' opportunities.

Dudley Smith, a founder of LES, tells of a similar situation with a happier ending. The respective presidents of Cluett-Peabody and Westvaco, both large American companies, had agreed in a general way that a license should be granted by one company to the other for a process relating to the manufacture of Kraft Paper. Apparently the lawyers of the two companies then proceeded to argue for something like a year without coming to an agreement. Fortunately, there was good rapport between the respective presidents and a degree of mutual trust. The voluminous agreements over which the lawyers were still arguing were torn up and a letter passed from one company president to the other saying something along the lines: "You can use our process and we will split the profit 50/50." Thus was born the spectacularly successful 50/50 joint venture known as Clupak Inc.

The agreement itself is of course vital to licensing success. It must define the rules of the game and while there are successful licenses based on one paragraph as in the Clupak case, these are the exception and cannot be recommended as a routine procedure.

In negotiating and drafting an agreement there are those who advocate the preparation and agreement of a "Heads of Agreement" to precede the agreement itself. I think John Stonier has advocated this approach. Personally, I have found this works admirably where the parties are negotiating face to face and want a framework to take away with them and within which further developments can take place.

It is not a procedure I favor in the situation in which there has been only very general contact between parties who cannot readily get together face to face and one party is asked to send the other a draft agreement. I have found in these circumstances that the two-step approach merely doubles the complexity of the case. It unnecessarily increases the time and cost of the negotiation. A fully prepared agreement, while it does introduce detail into the discussion at an early stage,

does ensure that when the parties do agree they know what they are agreeing to and there is no possibility of the deal fouling up because of nasty surprises in the fine detail.

Encourages

The essence of a well structured license agreement is that it encourages the parties to make the license a success. This is an approach that an American friend of mine strongly advocates. I would like to tell you a little about this approach as I believe it lessens the likelihood of failure. I should perhaps note here that my friend is in the happy position of never having had to seek a licensee.

Companies come to my friend's company asking for licenses and there is no need for them to chase licensees. He sits down with the prospective licensee and asks what they intend to do if they are given a license. The licensee will then generally put forward the best plans he can formulate—maybe a new plant here and a sales office there, five new salesmen and an advertising campaign. My friend notes all this down and writes it into the agreement. It will take the place of the traditional best-efforts clause. If that factory is not built or the sales offices are not opened at the time nominated, the agreement terminates or becomes nonexclusive or whatever. The beauty of this approach is that often nothing goes into the agreement that the licensee has not offered. It also gives the licensee a positive implementation plan to work to.

As an incentive to the licensee to perform you might provide, instead of a minimum royalty clause, a minimum advertising budget with any shortfall going to the licensor by default. If the licensee fails to spend his advertising budget in any particular year the balance is paid to the licensor. A licensee will often be more willing to make a commitment that he sees as directly benefiting both parties than he would if he sees it as benefiting only the licensor.

Another tactic is, if you are the licensor, always to write the licensor's obligations first. Your licensees thus first see what they are getting and only then find out what it will cost. A minor matter, you might think, but it is a technique used by good salesmen since selling began.

One encounters special problems when selling "know-how." I take the view that you can never, in practice, stop a licensee from continuing to use know-how after a license expires. So, instead of saying, "When the license terminates you must stop using the know-how," one can provide that a license is for, say, 10 years. After, say, seven years you can either agree to extend or you stop getting new know-how, but you may continue to use the knowledge we gave you beyond the term of the license. Thus, upon the expiry of the license the know-how still being used is at least mature if not outdated.

Implementation

The implementation and servicing of a license is an often overlooked area for failure. The transfer of knowledge and the implementation of a new process or the manufacture and marketing of a new product is

always fraught with difficulty. Unexpected obstacles block the road to innovation.

Successful licensing projects are often characterized by meticulous care and attention by the licensor to ensure a smooth startup. This initial implementation can have unexpected problems for the licensor. A colleague recently related a situation in which his company found itself. It had granted a know-how license which provided that a royalty would be payable once the licensee's plant had run continuously for eight hours producing a product having tightly specified characteristics. It is now found that, while the process runs satisfactorily for long periods the product fails to meet the specification due to the melting point of the product being a degree or so lower than that specified.

I understand this situation has persisted for some time and the licensee refuses to pay a royalty which would run into six figures per year. This might be a fault in the license agreement, someone was perhaps just too optimistic in writing the agreement, or it might be an implementation fault. Perhaps the licensee was not taught the amount of tender loving care he had to exert to get the product to come out to specification.

It is amazing how rapidly a licensee of a successful product or process will forget the benefit he has received from the licensor. In the first year or two he will pay his royalty quite willingly. Toward the end of the 20-year life of a patent, however, it can be a very different matter. It helps tremendously and is a positive deterrent to failure of a license late in its life for the licensor to be seen regularly by the licensee and for the licensee to be perceived as continuing to help the licensee throughout the life of the agreement.

The Australian company Rocla, which has a worldwide network of licenses using the Rocla concrete pipe technology, hold regular conferences for their licensees. At these meetings they bring the licensees up to date on the latest research and developments and discuss the licensees' problems. I expect that these activities have had a lot to do with many Rocla licensees renewing their licenses two or three times.

Now, for a little about termination. I like to write in specific performance criteria to allow termination if the criteria are not met. Traditional best-efforts clauses can work. However, I strongly favor defined limits. If they are not met the license can be cleanly terminated. A traditional best-efforts clause was written into the Arlo Pole license. Arlo successfully sued Transfield and recovered some hundreds of thousands of dollars. However, that was a slightly special case because Transfield was so blatant. Arlo had given a license to Transfield to make and sell Arlo's patented power transmission pole. While telling Arlo it was tendering to the N.S.W. Electricity Commission, Transfield in fact tendered with its own design of a non-infringing

pole. The situation where a licensee does little or nothing is more difficult than the Arlo and Transfield case.

Arbitration

A subject which perennially comes up when one talks of termination is arbitration. I admit to being very much of two minds on the subject. I can see many theoretical advantages in going for arbitration. In the one case in which I had to consider the question I came to the conclusion that my decision to write in an arbitration clause was wrong, although in the end it probably didn't make much difference.

I had drafted a license agreement for an Australian individual client granting a license to a Hong Kong company. This, just incidentally, has a quite fantastic tax effect for Australian residents. The license specified performance criteria and provided that in the event the licensee did not sell a defined amount of product, the license could be terminated and the dies used to make the licensed product would be turned over to the licensor. The sales did not exceed the minimum after the third year and the license was terminated. We then experienced great difficulty in getting the dies back.

I would have liked to have gone for an interlocutory injunction to prevent continued use of the dies and to have the dies placed in protective custody. The reason for haste was that I didn't want the dies damaged or worse still to end up at the bottom of Victoria Harbor. This need for speed was thwarted by a provision in the agreement specifying arbitration before court. Fortunately, the matter resolved itself when a new licensee agreed to pay a token amount to the old licensee for the dies.

The points to remember are:

- A successful licensing relationship is a long-term one.
- Analyze the technology in great detail before going into it. Talk to people in the industry. Take the journals in the field. Investigate and probe.
- Apply the same analysis to your proposed partner. Can he provide what you lack. Is there a synergism between the parties?
- Negotiate fairly. Don't screw your proposed partner for short-term gain. Don't destroy the trust. Do ensure that what has been verbally agreed gets put on paper accurately.
- Seek an agreement that has positive incentives to achieve the desired results.
- Take care with the implementation and ensure your licensee continues to value your license throughout its life.

Last, but not least, structure the license so that if it does fail the parties may disengage cleanly.