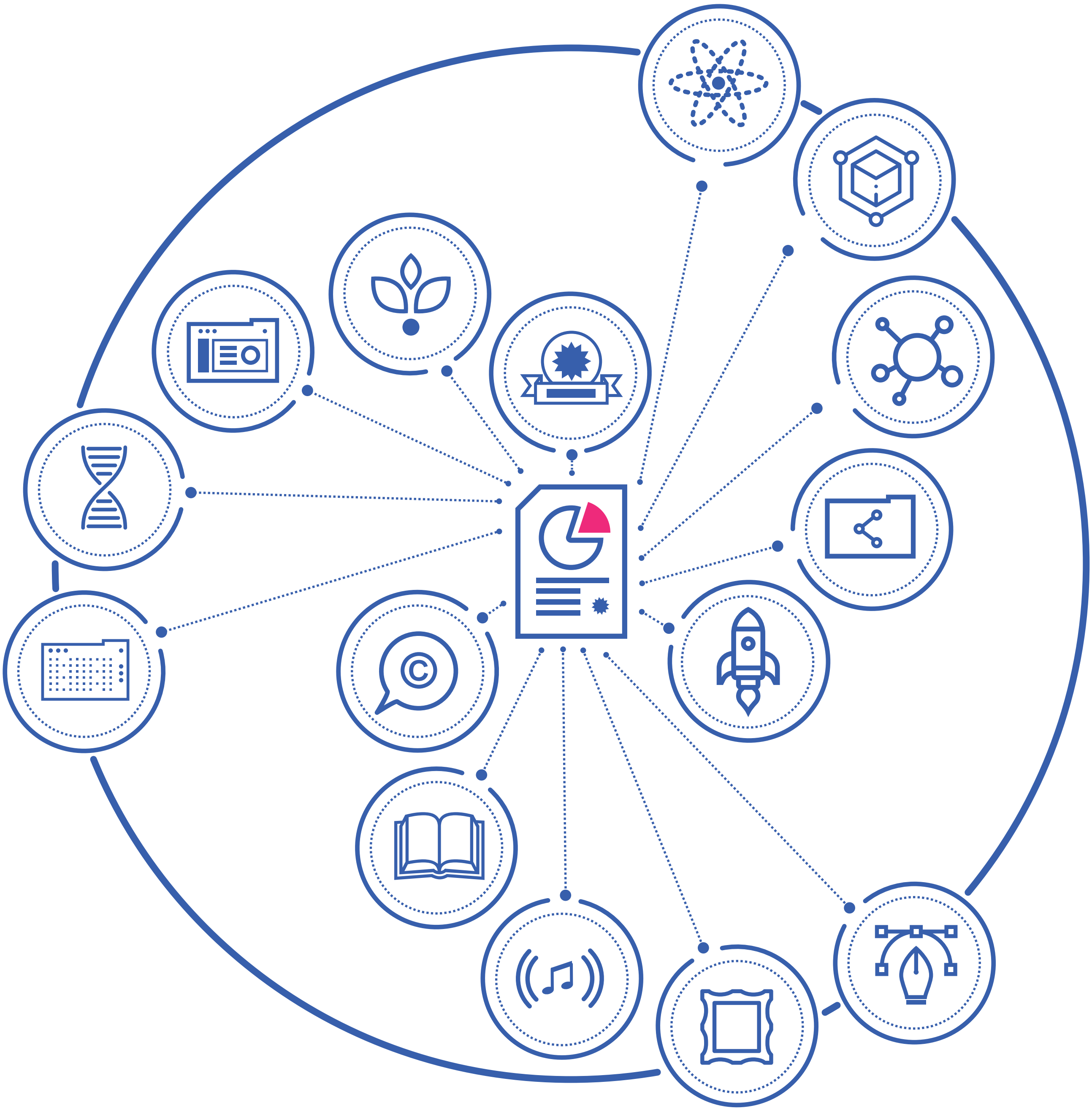


We can cherish our business innovation and expect it to soar. But we might wish to fulfil the potential and capabilities more rapidly by allowing others to use our Intellectual Property. So how do you protect and share this with interested parties? This third LESI Briefing for Business explores how you can effectively ...

LICENSE YOUR VALUABLE ASSETS

LES
LICENSING EXECUTIVES SOCIETY INTERNATIONAL

INTRODUCTION
TO THE LESI BUSINESS BRIEFINGS

Fiona Nicolson
President - LESI

Hello and welcome to this Business Briefing, the third of three published in part works by the Licensing Executives Society International ('LESI').

LESI is the world's leading membership organisation for professionals and business people involved in the business of IP — indeed our LESI tag line is 'Advancing the business of IP globally'. We have 33 member societies and more than 8,000 members in over 90 countries worldwide.

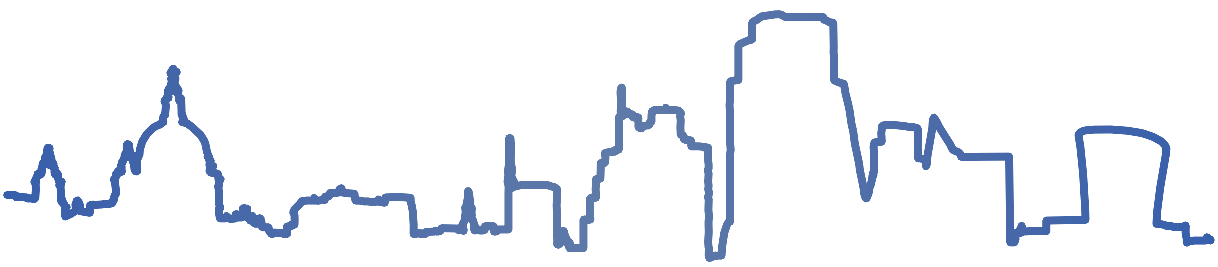
As President of LESI, I have made it our mission this year to provide useful tools for our members and for companies that rely on licensing technology to grow and further their businesses.

For those involved in the business of IP for the first time, these briefings provide critical information that may help your efforts to be successful. I hope you find this Business Briefing — as well as the others in this series — useful.

They have all been written by LES members who are experts in their subject and active in licensing in various markets throughout the world. Our LES members have an incredible amount of experience and expertise on IP matters. During the course of the year, LES Societies provide a variety of educational and networking opportunities both locally and internationally. The back page provides more information on the authors, how to join LES and more information on this specific topic.

A special thanks to the **leaders of the LESI Committee** who have led this initiative, working tirelessly during the last year to produce these Business Briefings, namely **Karin Hofmann of Vienna University of Technology, Don Drinkwater, Director of Licensing at Bose Corporation, and Danie Dohmen, a partner of Adams & Adams in South Africa.**

London, May 2020



CONTENTS

YOUR VALUABLE ASSETS ARE DEFINING THE 21ST CENTURY

Intellectual Property ('IP') is one of the most valuable assets in the 21st century global economy.

While it is at the core of many global biotech, healthcare, engineering and hi-tech companies, as well as international consumer and luxury brands in the retail sector, it also exists to be exploited in innovative small and medium size enterprises (SMEs). Even micro-businesses with very few people can develop their own IP. Size is not a barrier.

IP can be harnessed in various ways. It can be used pro-actively to prevent a competitor that is infringing your IP, or it can be licensed by your business to generate new revenue streams. It may also be used defensively to reach settlement and cross license agreements.

> *An IP license is the permission or the right by a licensee to use a specified intangible asset from a licensor under agreed conditions.*

Every year significant license[1] incomes are generated in many industrial fields for patents, know how, trademarks, data and other intangible assets. For example, companies such as IBM®, Microsoft®, SAS® and Qualcomm® generate billions of dollars for recurring income through patent licensing. So IP has intrinsic financial value helping to protect a business, create cash flows and generate new streams of businesses.

1 In these Business Briefings, we use the American English term: license for the noun, which is licence in UK English

In many cases, IP can also create or increase cash flows for other users who do not own the IP. This is what we aim to discuss in this Business Briefing.

In such cases, the IP can be 'leased' or licensed to another party. For usage of the protected IP, the licensee usually pays a fee and/or a royalty following certain rules. Thus, the use of the IP by another party has to be set up legally on a solid basis. A license contract will regulate the use of the IP, the role and obligations of each party, the financial terms, and how the protection of the IP is secured.

This Briefing does not offer formal professional or legal advice, but will give a practical insight into why licensing makes economic sense and the principles you should consider when setting up a licensing agreement.

WHAT IS A LICENSE – AND WHY DO WE NEED THEM?

An IP license is the permission or the right to use a specified intangible asset, the IP or part of the IP, from a licensor (usually the IP owner) to one or several user licenses under agreed conditions.

Licensing can cover a range of IP such as:

- PATENTS
- TRADEMARKS
- COPYRIGHTS
- REGISTERED DESIGNS

But licensing could include more than that, such as:

- UTILITY MODELS
- KNOW HOW
- UNREGISTERED DESIGN RIGHTS
- PLANT BREEDER RIGHTS
- DATABASE RIGHTS

In practice, the parties often agree to a 'bundle' of what is covered by a license. This might be a single patent or a 'family' of patents, related know how and also additional relevant intangibles which might be relevant drawings, results from laboratory tests, and specific documentation. The bundling of related assets is important as the IP can more often be fully exploited when combined with its value drivers.

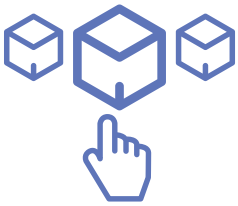
Why bother with a license?

The advantages and disadvantages of licensing IP have to be viewed from both the perspective of a licensor and the licensee.

Pros for You, as the Licensor	Cons for You, as the Licensor of out-licensing
It can generate cash flow or improve the profitability of your products and services.	It could create competitors.
It can expand a geographical market if you have limited capacities to expand.	It might cost money and time to monitor the licensee.
It can create and build a joint venture for R&D.	There could be abuse or non-compliance with the terms of the contract by the licensee.
It will enable a business partner to manufacture or sell goods.	There are risks of negative effects on your own IP, particularly in the case of trademarks.
There is no need for you to invest in new and expensive manufacturing infrastructure.	There are risks to your reputation and brand, if the licensee uses the IP in an unacceptable way.
It can be attractive to a potential suitor who wishes to buy a stake or all of your company.	There could be a loss of control in the use of your IP.
	It could diminish your potential to use your own IP.

Pros for You, as the Licensor	Cons for You, as the Licensor of out-licensing
It saves you time and money in developing your own IP.	There are risks of sunken costs through fixed payments if your sales do not follow the expected plan.
It increases your chance of entering new markets.	You will be dependent on the terms and duration of the license contract, especially in the case of a successful usage of the licensed IP.
It avoids the risk of developing your own technology, which could infringe the licensor’s patents.	You could be harmed by the activities of the licensor in case of infringements.
A successful use of the licensed IP can generate substantial cash flows.	There might be an effect on your enterprise value, especially if the licensed IP is a major value driver.
	Any legal suits over potential infringements may impact on investments from third parties into your company.

HOW DO YOU PREPARE? IDENTIFYING YOUR IP



From the outset, it is important to have a clear idea of what your IP is. Moreover, you should be able to clearly identify each IP asset and easily explain its use and benefits to a prospective licensee. In particular, the use of written technical documents will help to determine and evidence your IP. There are many helpful materials available to assist you in this process including the LESI Business Briefing on IP Valuation.

You should also be sure that you have the right to license the IP in the first place. Where IP is created and produced by employees in a company, it is customary that the company will own it and can license it, rather than the individual employee.

> *You should be sure that you have the right to license the IP in the first place.*

However, this default position may be altered contractually or indeed the IP may have been previously transferred or changed hands over time. It is therefore important to conduct regular audits of your IP portfolio to ensure that you have the necessary rights. This will avoid future costs and legal complications, particularly when it comes to licensing the IP to third parties.

Defend or Attack: an opportunity or enforcement?

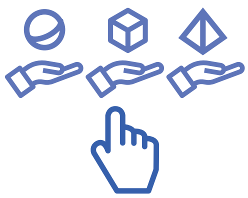
As we have explained, IP might be used proactively by the granting of licenses, or defensively to prevent some unauthorized party from infringing your license.

If you are interested in licensing your IP to a third party, there are two methods of finding and securing licensees.

Firstly, you can actively seek suitable potential licensees. In principle, the licensee should benefit from the use of your IP and you should benefit from the revenue or business relationship that the license creates. The arrangement should be collaborative and beneficial to both parties.

Secondly, if someone is already using your IP without your permission, you can seek to actively enforce your IP and offer the potentially infringing party a license, known as a settlement license. This is an alternative to enforcing your rights against them in a court of law. This may be attractive to them, and you, given the cost and time burden of litigation.

This 'carrot or stick' decision will affect how you approach the license terms and negotiations.



FIND THE RIGHT PARTNER: CHOOSING A LICENSEE

You should consider the advantages and disadvantages of each potential licensee.

This requires researching the market and understanding who the key players are, and how your IP could add value and be attractive to potential licensees.

Conversely, you also need to consider which licensee is likely to be the best partner to use and exploit your IP.

When choosing licensees, you should consider their market power and expertise.

Ask yourself key questions:

- What assets do they already have?
- How can our IP complement their existing products and markets?
- Do we need to create new IP?

The location of the potential licensee and their geographical scope could also allow you to expand your business into new territories.

Other factors, such as their size and extent of resources, can help you to distinguish between different potential licensees. Your preferences on such factors will vary depending on what your IP asset is and what you seek to achieve from the license.

You should also conduct due diligence on the potential licensee. Once you are in a licensing relationship, you will be exposed to the risk that the licensee may not have sufficient funds to cover all of the licensee's obligations. This could be damaging for your company in the event of insolvency or the collapse into administration of the licensee's business.

It is therefore important to look at the potential licensee's background and financial status.

Moreover, it may also be helpful to research their relationships and track record with other market players and licensing partners.

Due diligence should also include research on the management of the potential licensee and, in the case of larger companies, its corporate structure.

> *Licensing is a long-term game, based on relationships, so you should consider individuals with decision-making power and authority.'*

Licensing is a long-term game, based on relationships, so you should consider individuals with decision-making power and authority, and how committed they are likely to be to you (and the use of your IP).

Being aware of the company's group structure is also essential to determine whether the whole group, or a specific company, is to acquire the license rights.

There may be risks associated with licensing your IP to a competitor, and you should also consider the possibility of creating your own competitor by allowing a third party to use your IP rights.

SELLER BEWARE: PROTECT YOUR CONFIDENTIAL INFORMATION

Once you have identified a potential licensee, you will need to establish whether they would be interested in taking a license.

To decide, they will clearly need to understand what your IP is and how it can benefit them. Here you must be extremely cautious about disclosing information about your IP to the potential licensee.

It is vital that you have a signed confidentiality agreement in place with them. If there is no confidentiality agreement, you cannot be sure that they will not use the details of your IP and the information you give them in dealings with others, or even in developing their own IP.

Confidentiality agreements are essential where your IP asset is an invention for which you have not yet filed a patent application. Disclosure of the invention to a third party with no confidentiality agreement in place is dangerous. It can nullify its novelty and prevent you from obtaining patent protection.

Where a potential licensee is unwilling to sign a confidentiality agreement before an initial meeting, which can be common for some larger companies with greater bargaining power, you should be careful not to explain how your IP works in detail or disclose any sensitive information.

Confidential information should only be provided after you have a signed confidentiality agreement and, even then, only to the extent required.

A key stepping stone: the Heads of Terms agreement

For complex transactions, you may consider using 'Heads of Terms' before going straight into the negotiation of the license. Heads of Terms set out, in a short and simple way, the main points of a proposed license so the parties can seek to agree, in principle, what the terms of the final binding license will look like.

Heads of Terms can be helpful as a starting point in negotiations as they can provide clarity and potentially save money and time during negotiations. However, Heads of Terms are generally not legally binding and therefore you may not be able to rely on them during the license negotiation if the licensee subsequently changes its mind.

THE NUTS AND BOLTS OF YOUR LICENSE AGREEMENT

Licensed Rights

Any IP license agreement will need to clearly identify the IP that is subject to the agreement. There are numerous types of IP that can be licensed. "Licensed Rights" is commonly used as an umbrella term in a license agreement, under which each sub-category of IP is identified. For example, in a patent and know how license, the relevant know how and details of the patents will usually be identified in a schedule to the license agreement and will together be defined as the 'Licensed Rights'.

Patents and know how

A patent is a registered IP right which covers a particular invention, usually a product or process. Know how is harder to define, it is best thought of as commercially sensitive information that a party has gathered carrying out certain activities over a period of time that is not generally known by a third party. It is often the case that a licensee will wish to obtain a license for both the patent and the requisite know how, in order to have both the right and the knowledge to make a product or carry out a certain activity.

Trademarks

Trademarks are registered IP rights and tend to be symbols, words or shapes that can be used to identify a particular company or brand (i.e. Nike®, Adidas®, Coca-Cola® or Google®). A licensor may seek to license a trademark to third parties in situations where they lack the capacity or resources to manufacture, market or sell products in certain territories or markets; such an arrangement would enable the licensor to build, and continue to leverage, its brand and goodwill.

Copyright

Copyright can be either a registered or un-registered IP right and is automatically vested during the creation of a particular 'work' that satisfies the legal requirements. It can be thought of as the protection of the form of an expression of ideas, rather than the protection of the ideas themselves, and in this way, it differs from a patent. For example, copyright may protect a piece of written music, being the written sequence of musical notes. As with trademarks, copyright may be extensively licensed and is another effective way of entering new markets.

'The patenting of software is particularly complex and there are some restrictions on when a patent may actually be granted.

Software

Although not actually an IP right, software can be protected using either patents or copyright. Copyright may arise from the creation of original source code for a particular piece of software. On the other hand, a patent protects the way in which a piece of software functions, i.e. the algorithm. The patenting of software is particularly complex and there are some restrictions on when a patent may actually be granted.

Parties

Any commercial agreement requires at least two parties. The parties must be legal entities in order to contract with one another.

Each party may be a company or an individual. However, in the majority of cases, the parties are companies so that they may make use of their limited liability status.

The parties should correctly identify the legal entity that they will be contracting with. When entering into a license agreement with a company which is part of a wider corporate group, it is important that the company named in the license agreement is the appropriate party. Put simply, the licensor should have the relevant rights to license the IP and the licensee should have sufficient assets and be capable of exploiting the IP. If the licensor is going to contract with a smaller subsidiary in a particular group of companies, then it should consider asking for a parent company guarantee, under which the ultimate parent company takes on responsibility for the performance of the license agreement.

Make it crystal clear: what needs to be defined

It is vital that the definitions used in the license agreement are absolutely clear, as they will directly affect the operation and scope of the agreement.

For example, defining the 'Territory' in which the licensee can operate under the agreement is of particular importance. This is because, for example, if an agreement defines 'Territory' as the 'European Union' and something, such as Britain's exit from the European Union, occurs, a dispute may arise over the operation of the license agreement in the United Kingdom.

The main purpose of the definitions is to allow for succinct drafting that makes the agreement as user friendly as possible and thus avoids future disputes.

WHAT TYPE OF LICENSE DO YOU REQUIRE?

A license comes in a multitude of different forms, but there are three main types:

- **Sole license** — the licensor can also continue to use the licensed rights in the territories set out in the license agreement. By entering into this agreement, the licensor will be forfeiting its right to enter into further licenses with third parties in the territories in which the license agreement has effect.

- **Exclusive license** — only the licensee can use the licensed rights in the manner provided for under the agreement. The licensor, in addition to being prevented from entering into further agreements with third parties, may also itself be unable to use the licensed rights in the territories in which the license agreement has effect. Therefore, the licensee will truly have the exclusive use of the licensed rights in such territories. Licenses in the field of life sciences are often exclusive.

- **Non-exclusive license** — this license allows the licensor to grant further licenses to third parties, in addition to the one granted to the licensee. Most licenses in the Information and Communication Technologies sector are often non-exclusive. A licensor may only want the licensee to use the IP for particular purposes and could restrict the licensee to using the IP for a defined area or application.

  The licensor can do so by restricting the use of the IP to certain 'Fields', for example, academic research purposes or the treatment of cancer. Restricting the use of the IP to a particular 'Field' is usually a feature of exclusive licenses, where the licensor retains the right to use or license its IP in all fields other than the 'Field' designated in the license agreement, which the licensee then has the exclusive rights to.

> *There is often a tension for licensors between granting broad enough rights to ensure they receive significant royalties but not too broad to exclude the licensor from exploiting its own IP.*

Therefore, it is important to consider factors such as territories and Fields when considering whether a license is exclusive or non-exclusive. Often a license is quasi-exclusive, being exclusive to the licensee but only in a certain agreed territory or Field.

Licensed Products

The license needs a clear definition of the 'Licensed Products' for which the IP may be used to create or be applied to.

This allows the licensor to control the scope of the license agreement, which could be important in retaining the ability to exploit their own IP in certain products if desired. In such cases, there is often a tension for licensors between granting broad enough rights to ensure they receive significant royalties but not too broad to exclude the licensor from exploiting its own IP. Payments

Payment conditions between the parties must be clearly set out so that each party knows what it can expect to receive or pay under the agreement.

In this part of the license agreement the economic conditions have to be agreed with the parties, that should also consider the duration or term of the agreement. For details of how to determine the economic terms of a license, please see below.

IP Infringement and Enforcement

Most IP license agreements contain clauses that require the licensee to notify the licensor of any potential infringement of the licensed rights by third parties. The obligation will set out in detail the procedure that the licensee must follow if they become aware of such activities. Furthermore, the provision will likely set out the role of the parties if the licensed rights need to be enforced against potentially infringing third parties as well as the financial responsibility of the parties in those situations.

The licensor will typically, especially in cases where the license is non-exclusive, want to retain control over such matters. Universities interested in commercialising their know how and technology usually want to involve licensees in such activities.

Sub-licensing

Consideration should be given as to whether the IP can be further licensed by the licensee to another party, a practice which is known as sub-licensing, which is quite common in life sciences for example.

Typically, sub-licensing rights are only granted in cases where the licensee has an exclusive license. When granting sub-licensing rights a licensor should seek to restrict sub-licensing by the licensee without the express written consent of the licensor.

The main reason for including this restriction is that the licensor will have carried out extensive due diligence on the licensee (as detailed above) and therefore would not want the license to its IP being sub-licensed to a party who they have little or no knowledge of.

Nevertheless, sub-licensing provides benefits to both the licensee and licensor. For example, a licensee who does not have a worldwide geographical reach may wish to enter into sub-licenses with third parties in such countries. This would ensure that the products using the IP may be sold all over the world, which would of course result in increased royalties for the licensor.

THE LEGAL STUFF YOU NEED TO CONSIDER

Compliance

Certain products or areas under a license agreement may be governed by legislation and regulatory guidance; pharmaceuticals are a good example of this. Therefore, the license agreement will set out certain obligations that the licensee will need to comply with when exercising their rights under the license agreement. Such obligations will include compliance with the appropriate laws and regulations, as well as meeting agreed specifications for the manufacturing of any licensed products.

Diligence Obligations

A licensor must make sure the licensee does their best to successfully exploit the IP. Therefore, particularly in the case of exclusive licenses, licensors should seek to impose obligations on a licensee to ensure that they use 'commercially reasonable efforts' (a term which is often defined in detail in the license agreement) to develop, market and sell the licensed product or impose an obligation of minimum royalty payment on the licensee. This provides some comfort to the licensor that the licensee will be compelled to use the IP in the manner described in the license agreement, and as a result, generate monetary income for the licensor.

Additionally, such diligence terms will provide recourse in the event a licensee does not adequately meet such their obligations. This will allow the licensor to terminate the license and give it to another partner or seek to exploit the IP itself.

Improvements

> *If you are the licensee you may require access to the licensor's improvements, otherwise you risk the possibility that your technology will lose its competitive edge.*

Often the technology licensed will be further developed by either the licensee or the licensor during the term of their relationship. If you are the licensee you may require access to the licensor's improvements, otherwise you risk the possibility that your technology will lose its competitive edge, while as the licensor you may also want to have access to improvements made by the licensee but enabled by the licensed technology in the first place.

At the start it is important to precisely define the technology that is covered by the license agreement at the date of execution, what are considered as improvements, and what changes or modifications are not regarded as improvements. It is advisable to try to define improvements to the extent possible by objective criteria such as certain technical features (for example, speed, and solvability) or decrease of cost if the improvement results in cheaper use or production.

It is also advisable to establish a notice mechanism for both parties to mutually disclose the improvements made.

Another issue here is who will own the improvements and does the other party have access to its use and under what conditions, which may mean further payments. Often parties grant mirror rights, mutually allowing the other to exploit future improvements. There are other options, including granting the option to the other party to use the improvement and whether the improvement can be sub-licensed. Resolution of these issues depends on the technology, the market and the bargaining position of each party.

Finally, you may want to include clear provisions governing the rights to improvements following the termination of the license agreement. Importantly, the provisions on improvements shall be subject to a review from the point of view of antitrust considerations particularly regarding the licensee's obligation to grant exclusive license to the licensor on improvements.

Warranties

Most licensors and licensees request warranties and/or representations from each other. The party giving a warranty promises that certain facts and positions are true and undertakes legal liabilities for them, hence it is a tool for managing risks arising from IP usage and claims by third parties. The breach of such warranties may result in the termination of the agreement.

The most commonly included warranties include:

- **Ownership:** the licensor warrants that it is the exclusive legal owner of the licensed IP and is entitled to enter the license agreement. In some jurisdictions joint IP cannot be licensed without the consent of all IP owners.
- **Non-infringement:** the licensor warrants that the use by the licensee of the licensed IP does not infringe any third party IP.
- By **granting a warranty,** you bear the risk of legal and business expenses should there be a question about the ownership of the product or technology. Warranties on the validity of the right, particularly patents and other technology rights, are to be treated with caution since many facts resulting in invalidity lie outside the control of the licensor.

Indemnities

A license will also typically include indemnity clauses, for example, managing the financial obligations of the licensor towards the licensee if the licensee becomes exposed to third party IP claims. In this case the licensor may agree to compensate the licensee for any losses related to the claim resulting from use of the licensed technology.

Since the granting of an indemnity imposes significant financial risk to the licensor, it is advised that you spell out in the agreement the conditions, limitations and exemptions related to the licensor's obligation. For example, you should include a notice mechanism the licensee has to follow ensuring that it only receives indemnification if it timeously notifies the licensor of the third party claims. Also the cooperation of the licensee in the lawsuit may be required as a precondition of indemnification. The indemnity should be considered vis-a-vis improvements or changes of design, e.g. if the infringement or ownership claim of a third party arises in connection with an improvement the licensee made. You should define which losses of the licensee do and do not fall into the scope of the indemnity, particularly if certain losses are excluded as well as whether there should be a cap on the amount paid by the licensor under the indemnity, such as X % of the total royalties received by the licensor.

The licensor may also want indemnities against third party claims arising from the sales of the products manufactured by the licensee, such as a consumer claim.

Moreover, a licensor may want to be indemnified against third party claims if the licensee uses the technology outside the scope of the license. You may also require your contracting partner to obtain indemnity insurance so that their ability to pay is ensured.

It is important that you specifically define the term of the agreement. The duration of the intellectual property right being licensed should be noted, since the period of the license cannot exceed the term of the right.

How long is the license in place? Term and termination

It is important that you specifically define the term of the agreement. The duration of the IP right being licensed should be noted, since the period of the license cannot exceed the term of the right (this can get complex when different types of IP are licensed in the same agreement).

Typically, there can be patent and know how licensing at the same time and parties may wish to maintain the know how license following the expiry of the patent – in which case a special contractual regime is needed for ensuring the necessary adjustments of the contract provisions. Keep in mind the respective rules of the governing law as they may contain a provision on the term of the agreement in the absence of the parties' specific stipulation. When the term is shorter than the term of the licensed rights, a licensee may prefer to have the option to automatically extend the license period.

You should have an agreement on the terms on which both parties can terminate the agreement. Further, it is important to define clearly the notice and any cure period of the termination. You shall also consider if legal succession on either side (e.g. transfer of the licensed right or acquisition of the other party) is a ground for termination.

There may also be situations that give rise to an immediate termination of the agreement. These include the non-payment of royalties, insolvency, or acts of a party that are detrimental to the other party's reputation. You should determine which obligations are so essential in their relationship that the breach of those should give rise to immediate termination.

Consideration should be given to what will happen following the termination of the license agreement. Typically, the process for paying outstanding royalties is covered here, as well as the return of equipment or assets of the licensor or the sale of the licensee's existing stocks. At this point it is important to settle the fate of improvements and decide who has access to improvements in the future. Also, certain rights or obligations may survive the license agreement such as confidentiality obligations.

In the event of termination, you should also bear in mind the existence of potential sub-licenses. The sub-licenses should terminate together with the main license but, in any case, it may be advisable to mitigate risks of claims posed by the sub-licensee by including respective provisions in the main license according to which it is ensured that sub-licensees are aware of the dependant situation. The licensor may also add a provision allowing it to take over certain sub-licenses in case of termination.

Don’t break the law: Anti-trust considerations

Anti-trust and anti-competitive considerations may prohibit certain clauses of a license agreement.

It is very important to check the agreement from the point of view of anti-trust or unfair competition prohibitions in all jurisdictions where the market is affected by the agreement bearing in mind that legal provisions may have national or regional specialties.

Importantly, anti-trust prohibitions of any jurisdiction cannot be precluded by choice of governing law.

Clauses that require special attention related to anti-trust law include (but are not limited to) those which:

- require the licensee to pay royalties after the expiry/revocation of the IP right;
- fix the prices (even indirectly) of products sold by a licensee to third parties;
- limit the number of products a party may produce or sell;
- require the licensee to pay royalties for other IP, products or services without regard to the relation of such IP/products/services and the licensed IP;
- require the licensee not to challenge the licensed IP right.

Keeping the date safe: Privacy and Data Considerations

Many agreements, especially those that deal with content licensing, require that personal identifiable (PI) information is exchanged among the parties.

When this is the case, clauses identifying which entity is in charge of the data (known as the Data Controller) and which party merely processes the data (known as the Data Processor) must be determined. Clauses must be added to the agreement to restrict how the data can be used based upon the privacy policies of the parties.

The agreement should spell out the nature and requirements for both parties’ privacy policies. The GDPR recently enacted by the European Union and other governmental regulations regarding data policy should be followed under the agreement.

SO WHAT ARE THE TAX IMPLICATIONS FOR YOU …

Your considerations

You should consider tax issues when license terms are agreed. Here, it is advisable to seek professional advice. You may have to disclose tax considerations to your contracting partner during the negotiations as this may influence the basic terms of the agreement (even the amount of the license fee) and help the other party understand a certain position and save unnecessary costs and disputes. Factors that are typically relevant from a taxation point of view are the form of payment of royalties, which might be a lump sum or running royalty, the type of IP licensed, in cross border transactions of unrelated parties, the double tax treaty provisions which may exist between each party's country and between related parties the transfer pricing. In cross border transactions, the domestic tax laws of both the licensee's and the licensor's country tax laws shall be taken into consideration. Issues to be checked particularly include whether there is withholding tax on royalty payments, VAT/sales tax regulations, the deductibility of the royalty payments paid by the licensee and the income tax rules of royalty revenues on the licensor's side.

… AND HOW YOU DETERMINE THE BEST FINANCIAL OUTCOME?

Types of license fees

Consideration for the granting of IP rights usually includes a license fee or royalty, which is the 'rent' for the intangible asset for a particular use.

License fees can basically be structured differently:

- fixed fees where the amount is stipulated;
- royalty rates, where a percentage of net or gross sales is agreed (running royalty); or
- a combination of a one-time or periodic fee, such as an annual fee, and a relative amount royalty.

The agreed nature of the license fee depends on the asset involved in the agreement for use and how the risks and opportunities are split between licensor and licensee. Fixed royalty amounts can be one-time payments, such as upfront fees, or be due at regular intervals, usually annual.

With fixed royalty amounts, the licensee has the risk that the initial investment in the form of the fixed royalty might not be amortized (so-called sunk costs) during the use. Nevertheless, if the usage of the IP is successful the licensee can keep his profits. Thus, after the upfront payment is amortized the licensee has the chance to earn high profits. The licensor receives the repay of his initial investment (and a possible surplus) but does not participate in future economic benefits.

> *Royalty payments are usually calculated as a percentage of the revenues that have been obtained by, or on behalf of, the licensee from exploiting the IP under the license agreement.*

Royalty rates can be stipulated as a fixed amount per unit (for example, one dollar per unit) or a percentage license in terms of a price/quantity component (for example, one per cent of net sales). With royalty rates, the licensor benefits from the success, since he receives a portion of the value of the intangible asset in relation to defined financial key performance indicators.

Very common is a sales royalty, since it can be easily determined and well controlled.

If the licensed object is the major value driver for the business model of the licensee, sales is economically the best basis for the value component to be apportioned to the licensor.

In other words: the closer the causal relation between the licensed object and the development of the licensee's business, the greater the participation of the licensor in the success of the business.

Often royalties are also stipulated as combination models. The licensor at first participates through the fixed royalty and is not solely dependent on the marketing success of the licensee.

At the same time, the pressure increases on the licensee to use the license as efficiently as possible in order to redistribute the fixed costs already incurred.

ROYALTY RATES: WHAT IS A REASONABLE REWARD?

A common method for calculating payments under a license agreement is by way of a royalty mechanism, rather than a fixed amount. Royalty payments are usually calculated as a percentage of the revenues that have been obtained by, or on behalf of, the licensee from exploiting the licensor's IP under the license agreement.

A central economic principle is that licenses and especially royalty rates are only informative in connection with the royalty base (e.g. net sales, gross sales, sales of the final product or a component). Thus, a reasonable royalty rate can only be determined in this context.

The amount of a royalty rate without a corresponding royalty base says nothing about the order of magnitude (royalty rate is 'high' or 'low').

Furthermore, net sales as a royalty base must be specified precisely in the contract. Usually, net sales are stipulated as the royalty base. Net sales are gross sales minus returns and rebates as well as shipping costs.

Thus, the net sales represent the sales which a company makes with its customers with the sale of the products. The net sales are generally stated as such in the financial data of the financially reporting company and thus are easily auditable.

This will become more complex when the royalty shall be based on a smaller unit, that is part of another end product, also called 'royalty-bearing-portion'. In this case the relevant revenues can only be extracted from the financials of the licensee. In order to assure that the royalty payments are made correctly a licensor usually requests for regular license audits carried out by an independent advisor, who reviews the royalty base and the correctness of the license payments.

In addition to royalty payments, a licensor may also seek to receive 'milestone' payments when pre defined events are achieved by the licensee. For example, in addition to the royalty payments, a fixed sum could be payable to the licensor if sales of the licensed product meet a certain pre-defined target.

Sources for License Payments or Royalty Rates

The economic payment terms are one of the most critical part when a license agreement is drafted. The general question is what is the value of the licensed IP? What shall we agree as royalty?

Very often an 'industry typical royalty' is searched and placed quickly in a license agreement. But each license agreement is quite different, the risks and chances between the parties are agreed individually and the economic terms vary significantly from case to case. Therefore, a typical industry specific royalty does not exist.

Rather, each license agreement has to be analyzed for its benefits for licensor and licensee individually. Usually, the economic ratio of a license shall consider the business case of the licensee who intends to use the IP.

Therefore, the licensor has to simulate (or try to find out) how the licensee plans to use the IP. The licensee has to set up his business plan and calculate, which royalty might be affordable to develop a marketable product.

Certain royalty databases with license agreements can be used as a benchmark for the agreement on royalty rates. There is for example the annual LES royalty rate survey. Hereby it is necessary to analyze carefully the economic terms in the different benchmark cases. As it might not be possible to find an exact comparable case to the license agreement in question, amendments shall be made to the benchmark figures.

Also the economic frame can differ because of the market, competition, regulations, technological developments, product calculations, strategic partnerships or legal restraints. The economic terms also depend on the status and maturity of the IP. This means that also legal terms (especially for patents) are important for the business case of a licensee.

Thus, a reasonable royalty requires an in-depth analytical work of comparable and the license situation for the usage of the IP. We explored this in more detail in our in our second LESI Business Briefing ***"The Value of Intangible Assets"***.

Case of Standard Essential Patents and FRAND Commitments

Licensing Standard Essential Patents (SEP) require special consideration as their use is unavoidable for the realization of a standardized technology. Holders of SEPs are required to provide a license to their patents on fair, reasonable and non-discriminatory terms (FRAND).

Following legal disputes worldwide on the subject, the United States Department of Justice, the European Commission, the High People's Court of Guangdong, People's Republic of China and the Japanese Patent Office have all published guidance regarding FRAND terms of license agreements for SEPs.

These help the parties better comprehend and apply FRAND terms in view also of the regional differences.

ABOUT THIS LESI BRIEFING

We hope you have enjoyed reading License Your Valuable Assets and that it has provided you with some useful information on the topic. This briefing is one of a series on business related topics. Please see the other titles which include ***The Value of Intangible Assets*** and ***Managing Your Intellectual Property (IP).***

This Business Briefing has been written by experts from all over the world who are members of the Licensing Executives Society (**lesi.org**).

As a member of LES you will be welcome to participate in our educational programmes, receive our highly rated quarterly journal 'Les Nouvelles', access our membership database and participate in local and international meetings – see **lesi.org** for our meeting calendar.

Our local LES Societies would be pleased to provide more information on the topic of this guide and put you in touch with LES members who may be able to advise in more depth on this topic if required.

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→ Information about local LES societies and how to join can be found on our website or please contact admin@lesi.org.

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