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Licensing — A Basis for Strategic Alliances

ROBERT A. MYERS*



ABSTRACT

Strategic Alliances have become so common that a company with none to point to seems to be left out. Possibly for that reason, some companies have adopted the practice of referring to virtually any relationship with another company (or university, or government laboratory) as a “strategic alliance,” whether or not it is strategic (or even an “alliance”). Nevertheless, a true strategic alliance—one that advances the strategic direction of both parties—can be a very important element in modern business. In this paper we will consider some important types of alliances and a recommended process for establishing alliances that have good prospects for success. The closing section will review the elements of a partnership as they need to be embodied in a contract.

GOAL OF ALLIANCES— STRATEGIC ADVANTAGE

The purpose of an alliance, in global terms, is to gain some sort of strategic advantage from the partner that is either difficult or impossible for either of the parties to obtain independently. No enterprise should enter into discussions regarding the formation of an alliance without first having formulated in some detail the nature of the benefit to be derived from the alliance. This is only the first of several steps that need to be taken in advance. Sound preparation is one essential ingredient in preparing an alliance for success.

There are many potential “strate-

gic advantages” that can be conferred by an alliance. Fundamentally, the parties each contribute intellectual and physical capital to the alliance. The intellectual capital could be patents, copyrights, trade secrets and trademarks. Much of their respective intellectual capital is embodied in their people. When the parties have complementary reservoirs of skills, the alliance can do things that neither party could do alone. Other intellectual capital can also be shared, such as market access, customer relationships and so forth. The parties can of course share the cost and, thus, reduce their individual exposure to risk. Similarly, they can share physical assets such as plants, tools and inventories. Sometimes the payoff from an alliance may simply be mutual education, as, for example, when U.S. companies sought the secret of high-volume, low-cost manufacturing by forming alliances with Japanese and other Asian enterprises. The following is a list of some of the major strategic advantages to be obtained.

- additional revenue from existing assets
- avoid need to invest capital in capacity
- avoid need to add personnel
- build new business with partner’s know-how
- obtain exclusive access from supplier
- obtain additional talent from partner
- co-opt potential competition
- profitably divest unpromising business
- acquire complementary skills, know-how, channels, etc.

- solve patent problem
- get to market faster and better

An increasingly common type of strategic alliance arises from what has been called “supply chain management.” When done properly, this often reflects an intimate partnership between an end-product maker (such as a personal computer or automobile manufacturer) and the suppliers. This was exploited to a great extent by the Japanese automotive industry in their development of “lean manufacturing.” A counter to the traditional vertical integration in the U.S. auto industry, it transferred both responsibilities, such as for design and quality control, and financial burdens, such as carrying inventory and sharing cost savings to the suppliers. U.S. industry has adopted many of these practices, with some 70 percent of Chrysler’s value-add, for example, being provided by its suppliers. Even GM is rethinking Alfred E. Sloan’s legacy of total internal sourcing or vertical integration.

These alliances are based on intellectual property. The “systems house” and the supplier collaborate in design and development; risk and rewards are shared (possibly in proportion to respective market power). In considering the establishment of a strategic alliance with a supplier (or, if you are a supplier, with your customer), one must consider a variety of alternatives, starting with total internal

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control. Where the suppliers are limited to commodity parts, and all intellectual property is developed and controlled by the systems house, certain obvious benefits accrue. All the profits throughout the manufacturing process end up in one place. Control of trade secrets and other confidential information is easier. With a well-designed management structure, decisions can be made quickly, and (one hopes) better.

On the other hand, vertical integration is resource and asset intensive. More people, skills, money and buildings are needed. Unless care is taken, the final product design and execution can be sub-optimized. It may not be easy to guarantee (or even to verify) whether or not subassemblies and components are industry-best, or just “good enough.” Costs can get out of control. Especially important is the dilution of core competency. Although a very large enterprise might claim to be the industry leader in more than one aspect of its product line, it is hard to imagine that to be true of every sub-assembly and component. By assigning key parts of the final product to members of a supplier constellation, the end product can be the best of the best.

KINDS OF ALLIANCES

There is a wide range of alliance possibilities. These include joint development, joint manufacturing, partnering between a “channel” and a supplier, architecture and “platform” alliances, partnering with tool suppliers, and the semiconductor foundry model, among others. Each type of advantage suits a specific industry and enterprise situation, and generalization is of limited value. For this reason, I will focus in the following on “supplier” alliances, of which there are several different kinds.

When a supplier is one of the

partners, there are important choices to be considered. Traditionally, companies practiced (and many still do) “contract manufacturing.” Today, this is sometimes called “foundry” manufacturing, depending on the product in question. The supplier’s job is to build a widget that has been designed—often down to the bill of materials, manufacturing process and plant layout to be utilized—by the buyer. The supplier in such a relationship brings little IP to the table; most such alliances are driven by factors, such as cost of labor or tax structure and financial measurements, such as return on fixed assets. These are rarely describable as strategic alliances in the sense outlined above.

A step up from this approach is also traditional: the procurement of a part or subassembly from a supplier who is primarily using his own IP in the design and manufacture of the part. This enables the systems house to exploit a supplier’s competency, to seek out the best supplier of each portion of the product (which can, of course, include services such as distribution and billing—few companies today have their own trucking company or railroad!). In the IT industry, this is most definitely a two-way street. The buyer ordinarily must share many details of the final product with the supplier, often including some IP jewels, such as testing procedures, tools and programs. When the supplier has multiple customers in the industry, this process enables the supplier to build his own bank of know-how, with the resulting cross-pollination providing benefits to the buyer and, ultimately, to the end-users themselves.

In the hard disk drive (HDD) industry, for example, a supplier such as Nidec may provide 75 percent of all the spindle motors in the world, while Hutchinson Technologies, Inc. provides an equal proportion

of the head suspensions. At one time Sony supplied close to 80 percent of the CD player and optical storage industry’s laser pickups. Consumer electronics exhibits similar behavior. For example, there are only a half-dozen important suppliers of color cathode ray tubes, but even fewer suppliers of shadow masks and other critical components. The personal computer is the most extreme instance—indeed, it is often difficult to identify any significant IP that the final assembler provides (particularly when the “final assembler” assembles PCs for several different brands).

One might suggest that in this kind of world, the buyer is at a disadvantage. Faced with a limited number of competent suppliers, forced to volunteer know-how in order to realize a product, it is perhaps inevitable that the margins for the final products will be constrained.

This leads to a more balanced “strategic” partnership, in which the buyer recognizes the value of the intellectual property he brings to the table, and extracts a price for it from the supplier. A knowledgeable buyer might, for example, do much of the development, define and implement quality control processes and tests, and qualify—at no little expense—suppliers of components. Rather than simply handing that data over to a supplier (even with confidentiality provisions, leakage is likely in any culture, and approaches hemorrhaging in much of the world), the buyer can license the supplier his know-how—very likely including his patents.

In this situation, the buyer is providing great value simply by enabling the supplier to be in business. Still greater value is provided by overtly licensing the supplier to use this proprietary know-how in his entire product line—for a commensurate royalty. Where the

buyer has a valuable brand image, the license can include trademarks, such as “made for XYZ Company by us” or “made to the exacting testing demands of XYZ Company.” These can be exceedingly good deals for both parties, although many suppliers are still reluctant to (as they see it) “pay their customer for being his supplier.”

One additional aspect of the supplier partnership can occur when the “buyer” is also a supplier—which can be called OEM. That is, a final assembler—a systems house—may develop an industry-leading competency on one of the subsystems of its product. We often see that one automotive company, for example, is providing engines or transmissions to others. In consumer electronics, the CRT makers are also TV or PC monitor makers. IBM currently supplies HDD “heads” to the HDD makers, as well as providing finished drives to other PC makers. Most of the top 10 or so major Japanese electronics makers have semiconductor manufacturing facilities, and they buy and sell to one another while competing vigorously for end-product sales.

In such a situation, a strategic alliance between a buyer and supplier can be a delicate matter, usually requiring an ability to compartmentalize a complex enterprise’s different businesses while also maintaining an industry image that promotes trust. Still, such alliances are not precluded. Indeed, where the parties have complementary product lines, or are reciprocal suppliers, for example, a strategic alliance cutting across multiple businesses can be an excellent model. Such an alliance can be built on an exchange of intellectual assets, such as licenses or skills, or on reciprocal OEM dealings.

Although I have used supplier alliances for my paradigm, the usual steps that lead to the con-

summation of an alliance do apply—in general terms—to most kinds of alliances.

The process by which an enterprise sets in place a negotiation to form an alliance begins with the identification of the strategic objective of such an alliance, and the kind of alliance best suited to deliver that advantage.

It is critical at the outset to recognize the unavoidable fact that an alliance means a loss of independence. Although this is a truism, it is not always appreciated, and a company may well start a negotiation with the feeling that it will be “in charge.” There are, of course, many such “alliances” but the benefits they confer are limited and may not be worth calling an “alliance.” In a really good alliance—possibly like a really successful marriage?—decision-making power is shared; control is shared. Unless the objectives of the alliance, then, are shared, trouble is likely.

In a western culture, whatever the degree of trust and understanding, the actual embodiment of the alliance begins (and, sometimes, ends) with the contract. We shall later see what is ordinarily found in a good contract, but it is a general practice that “if it’s not in the contract, it’s optional at best.” This is sometimes ignored, to everyone’s later regret, particularly if the implicit understanding relates to unethical or even illegal activity (presumably by the other party than the one to whom this is addressed!). These are naturally not to be condoned, but it is almost as dangerous to trust an undocumented understanding if the issue in question is important. On the other hand, Asian contracts are often little more than a documented handshake, with the implementation of the deal utterly dependent on the trust (or clan relationship) that the partners have in each other. My experience is that the only such “contracts” that succeed

are those in which both parties have a strong interest in the success of the alliance, and neither party can succeed without the other.

PROCESS

Where the alliance is to be a “strategic” alliance, the assets that the enterprise has to put on the table—its “stake”—need to be inventoried. Although the amount of any capital to be invested in the alliance will need to be ascertained, that determination is closer to the end of this exercise than to the beginning. The first inventory challenge is intellectual assets, starting with your competitive standing in the business to be addressed by the alliance. Is this a startup industry? Are we a late entry in catch-up mode? Is it a horse race where we want to leverage the alliance to get a lead, or are we the trailblazers, looking for a path to maximize our return?

Although there are a variety of inputs to arriving at the answer here, at the bottom they all derive from intellectual property. Our company may have dominant patents, or the smartest developers in the world. We may have as customers everyone who will be a customer for the new product or service, or we may have some software or prototype systems that give us a head start. The assessment of the relative value of this portfolio of IP may require outside assistance. When dealing with an outside group, although a little puffery may help move the negotiation, a hard, objective assessment of what assets you actually have is vital if you are to enter the negotiation with the right valuation and pricing concepts. An internal supplier may not be the most objective assessor of his goods; even if he is objective, his culture may still be too parochial to enable arriving at the fairest value.

The valuation of internal assets

has multiple dimensions, starting with such "hard" intellectual assets as trademarks, patents and copy-right software. The highest value, from an alliance point of view, might be given to assets that make up an ongoing business or product, qualified by the nature and degree of maturity of the business in question. If the business is a mature, commodity-like business with heavy competition, it is probably less attractive as a rule than a recent start-up with a growing revenue stream and industry mind-share. As we shall later see, however, a mature, steady commodity-like business niche may well be very attractive to another company that is focused on that industry and needs added capacity, customers or skills. When a company today spins off or divests a manufacturing facility, it obviously does so to an interested buyer.

Even with a going business, one needs to consider its position on the industry's value chain, and the implications of that for margins and growth. A semiconductor commodity chip facility would look less attractive than a facility able to turn out custom chips, while the next level up, the "system on a chip" would be more attractive still. Whatever the industry and whatever the asset, a key value element is the degree to which the value of the asset can be multiplied through a well-chosen alliance or partnership.

The valuation process needs to be done from the viewpoint of the buyer, not the seller, of course. Technical people, in particular, are often terrible judges of the value of their work (sometimes too high, sometimes too low). For example, one small piece of proprietary software that was written in an evening might enable a multi-million dollar business. The writer (or, more to the point, the non-writer but technical assessor) can easily denigrate it because it looks like a

mere trifle. IBM's mobile hard disk drives have power-saving micro-code that is of the order of a few thousand bytes (millions of times smaller than Windows, to take an extreme contrast) written in a few weeks by a brilliant researcher. Yet this code improves the energy efficiency of the drive enough to make it the industry leader.

In contrast, as indicated above, there are also businesses that may be of low value to the current proprietor but look much more attractive to a prospective purchaser. A well-run business regularly carries out "portfolio management," the process of terminating or divesting businesses that do not meet the goals of the organization. If the enterprise's business model has a gross profit bar that is higher than the industry average, then even a business that doesn't make the cut might still raise the average margins of a different owner. A business highly dependent on supply of a scarce component might look very attractive to the supplier of the component. Often, a large enterprise will develop technologies, products and businesses that are not central to the enterprise's core competencies. Looking for growth or diversity, the business may be staffed and funded for some period of time, until it eventually looks like too much of a diversion. If it is someone else's core business, however, it (possibly packaged with the people and patents) might be very valuable.

From the very beginning, the proposer of a strategic alliance will have some idea, possibly a very detailed idea, of what the value of the proposed alliance will be to his business. The most straightforward value would naturally be in increased revenue or profit, or decreased costs. That is, financial benefits directly attributable to the anticipated alliance. Before any serious negotiation, however, this value needs to be quantified.

Balanced off against the value of the IP assets you are bringing to the deal, it represents the upper boundary of what you can pay (or ask) to join the partnership. Although back-of-the-envelope arithmetic is a good starting point, it is not asking too much to see a detailed business plan extending well into the future before deciding whether or not to invest the time and energy in putting a deal in place. This is time well spent, since it can be a deal "closer" to present the results of that analysis (possibly sanitized) to the other party in a negotiation.

The value of a partnership may be more complex than simply "added revenue," however. For example, a deal with the major customer of your main product, in which you work together on some new venture, may easily be categorized as an investment in customer satisfaction. Although also financial considerations, the cost of a plant not built, a facility not staffed, or a one-year delay in time to market can all be quantified, and they should be as well as they can.

Before proceeding too far into the "alliance" process, it will be helpful to list the major steps that need to be taken.

- Identify the strategic objective of the proposed alliance.
- Determine the value of the alliance to you.
- Identify your IP needed to make it go.
- Identify partner(s) with complementary IP.
- Obtain "buy-in" from "owners" of your IP.
- Determine the value of your IP to partner: "pricing."
- Determine the value of your partner's IP and the total alliance to you.
- Determine the value of your IP to you: the "walk-away price."
- Select a partner who can be trusted with your IP.
- Agree on reciprocal obligations

to protect IP.

- Analyze the value of IP if you go it alone.
- Develop a plan to maximize the value of shared IP.
- Develop a plan to maximize the value of IP developed during the partnership.
- Develop an exit plan.

At this point in the analysis, much of the work needed for the next step has already been done. This is the identification of one or more proposed partners, partners who have their own complementary IP—complementary in the sense of IP that is essential to realizing the goals of the contemplated partnership—and will also be likely to consider your own IP to have a high value. This is not a mechanical exercise, as it is equally, if not more, important to select a partner with whom you expect to be able to work—a partner where there is going to be mutual trust and respect.

It is easy enough to cull out companies with which you are “at war,” or are currently in litigation. This is not always a good test—sometimes an alliance can be the cure for an unfriendly relationship and it is a truism that business makes strange bedfellows. It is also necessary to understand the culture and ethical behavior of a proposed partner and no less important to develop, before serious negotiations, an understanding of the probability of maintaining good personal relationships at the executive and working levels. In some companies, for example, it is dangerous to base the expectation of a successful alliance on a good personal relationship between principals, because the company keeps moving people around—or out.

A potential alliance partner must naturally meet a variety of other requirements, beginning with the likelihood that he would be willing, or even interested, in exploring

an alliance. That might relate to the overall health of his business, to the financial situation in which he is found, or to his ability to take on new obligations, as much as it might to the risk of a culture (or even language) mismatch. This review should also be a factor in answering questions regarding trust. There could be candidates, for example, who are trustworthy and ethical, but where competitive factors are such that a partnership would be quite impossible. In some cultures, it has become clear that trade secrets and intellectual property rights in general are simply not protected, making a partnership with a company in some countries a very risky situation.

Would a particular choice of partner expose the alliance to legal risks? Are there antitrust or restraint of trade considerations? Legality is always a dominant consideration and one that can often only be answered with good legal advice.

When the analysis of a proposed deal has come this far, it is time to address seriously the question of going it alone. Again, objectivity is key. One needs to understand whether the value that the available partner candidates might bring to an alliance is large enough—whether, in fact, enough of the value of the proposed partnership might be realized without recourse to a partner. Even if key IP assets are lacking, possibly a simple patent or know-how license can be obtained. Are the resources that your company would have to put forward available? Is there organizational commitment to an alliance? Executive support? In the final analysis, although a decision to proceed with partnership negotiations may still be favorable, the go-it-alone scenario must be at the forefront of the determination of a walk-away price, the point at which the alliance ceases to be a good deal.

Before we turn to determining an actual price for a deal, we need to think further about internal organizational support. In a small company, or a company with clear hierarchical management structure, this may be trivial. The CEO wants to do it, or the head of the business unit wants to do it, and it's done. However, in many large organizations, particularly multinationals or organizations in which there is substantial organizational autonomy (glorified as “empowerment”), many deals cannot be executed by an individual. Indeed, the intellectual property involved may span multiple units or the organizational ownership of the IP may not even be clear. Unless these matters have been settled at the start, they carry a high risk of derailing an alliance, or of forcing upon it terms that will, in the end, run counter to the initial basis for the deal.

When a negotiation begins, both parties need to have developed their own evaluation of the “price”—either the price they are willing to pay or the price they are willing to accept. There is a vast literature in the licensing community for arriving at these numbers. With the caveat that much of the analysis in the literature is a complex way of saying “it's worth what the other party will pay,” the following list is one way to look at the value of your IP to a proposed partner.

- What was the cost to develop this asset?
- What would it cost the licensee to develop it today?
- How long would it take to develop the asset today?
- What is the real value of this time to market saving?
- What are the inherent advantages in your “design”(e.g., compatibility, serviceability, familiarity)?
- What will it cost to transfer the asset?
- What can the buyer afford?

- What is the buyer's business case?
- What is the impact on your business of transferring the asset?

This analysis is also a basis for determining your walk-away price, as well as for estimating the other party's walk-away. It is a rare negotiation of this type that succeeds in the absence of a well-justified walk-away. It is, of course, true that the walk-away may be based on financial factors completely unrelated to the deal in question. As only one example, the unit involved may have a choice between two deals, where there is a firm offer on the table for the "other" one and only one deal can be executed. In such a case, all other things being equal, the walk-away is the bird in the hand plus some additional factors. Nevertheless, unless the negotiating team or individual walks into the negotiation with a real, solid walk-away, a favorable outcome is not in the offing.

Clearly, there are both "hard" and "soft" elements in the walk-away price. If there is a technology transfer involved, for example, the direct costs of the transfer need to be taken into account—although it can be shortsighted to insist on cost recovery if there are other benefits at hand. When the alliance might entail a reduction in market share or margin by creating additional competition, that can often be quantified. Where the licensor has an extensive licensing program, it is often vital to maintain consistent pricing practices from deal to deal. Where a deal has already been made with one company in an industry, it may be unwise or even unethical to charge their competitor more—or less.

A few general rules hold about determining a walk-away price. First, a party has only one walk-away, determined either by a consensus among the interests on its

side of the deal, or else dictated by management. Second, the walk-away is a part of the preparation, not a work in progress. Third, there are no general rules. Insisting on recovering sunk cost, or on recovering transfer cost, or on achieving some fixed hurdle rate, among others, is a prescription for limiting one's opportunities, and profits.

When either of the parties is a complex organization, especially when fulfillment of the objectives of the alliance requires the participation of multiple units, it is absolutely necessary that advance buy-in from all of the affected parties be obtained. These parties could simply be finance, procurement, intellectual property law or some other staff function—or they could be the operating units that must participate in the partnership in order for it to succeed. As only one example, many alliances require that all of the relevant patents from both parties be cross-licensed. However, some companies endow their operating units with intellectual property autonomy. Thus, one holdout might completely preclude an alliance.

On the other hand, the requirement to secure this organizational consensus can have positive aspects as well. For example, the advocate of a deal may learn that another unit of his company has already established a relationship with a proposed partner, with that relationship (supplier, perhaps, or OEM customer) having considerable value to the proposed partner company. Use of such relationships can be instrumental in making an alliance more valuable to one or both potential allies.

This is only one instance of the importance of cross-organizational synergy. There are, in addition, many cases in which there can be extremely valuable synergy between different varieties of intellectual property. We've already seen that patents and patent licenses are

one example. Trademarks, too, can be immensely valuable. An alliance that at first seems to be little more than a procurement, contract manufacture or OEM deal can be converted into a multidimensional strategic alliance if the parties exchange technology licenses and trademark licenses with the hardware.

Many important alliances are based on one party licensing the other party to technology information or know-how. Examples might be software source code, or the design of a component or end product. The licensor in such a situation may feel secure about its ability to sell products to end users because it has obtained a broad portfolio of cross licenses, supplemented by an ability to gain any additional licenses by trading for a license with a strong patent portfolio. A licensee, however, may not have the same protection, or may feel a need for additional protection.

This can be a difficult challenge for both parties. Ordinarily, the licensee will ask for indemnities against infringing other's patents, copyrights or trade secrets. Although a licensor may be willing to provide some very limited indemnity, few will be willing or able to provide open-ended indemnities. Indemnities are even more problematical if a licensee requests indemnification against consequential damages, which can be huge in our litigious environment.

Where indemnification is sought, the licensor can, however, make certain representations. If the alliance includes sales from the licensee to the licensor, for example, the latter's licenses will normally provide protection. The licensor might be willing to provide the licensee with a list of the companies to whose patents it is licensed, possibly even to a list of the specific patents to which it is licensed. Under certain circumstances, the licensor may agree to

join its own licensee in seeking additional licenses. It is, however, unlikely that a licensor would be willing to provide any binding assurances that the licensee does not need any licenses.

The participants in an alliance will ordinarily start out with assets of intellectual property, which will include licenses to the IP of third parties. These licenses themselves can be very valuable if used properly. For example, many licenses can be transferred to subsidiaries, but only to those that are controlled by the parent licensee. When an alliance must have certain licenses to function—particularly if it involves the establishment of a joint venture or other separate entity—the assignment of ownership interests can be key. Similarly, the responsibility for some parts of an alliance may have to reside in the party with the needed enabling licenses such as, for example, the ability to function as a semiconductor foundry.

Finally, it is important, from the start of an alliance creation, for each party to have an exit strategy, and for this to be negotiated as part of the alliance contractual relationship. The following list summarizes some of the reasons:

- No alliance is forever.
- Both sides have to know what they own after the term of the agreement.
- Withdrawing a know-how license could end a business.
- Even after the agreement expires, there may be continuing transfer, secrecy or other obligations.
- Maintenance, royalties, indemnities.
- Neither side wants limits on personnel assignments.
- “Residual” information is forever.

In IBM alliance agreements, the termination sections are among the longest and most detailed, however unlikely it is that they will be exercised.

Whatever the nature of an alliance, and the substance of the underlying intellectual property that enables the alliance, two fundamental concepts stand out:

- The terms and conditions have to be such that both parties feel they are getting a good deal; and
- Whatever the “intrinsic” value of the deal, the final price is what the other party is willing to pay.

THE CONTRACT

It is hard to imagine an alliance in which there is no contract or, at the very least, a document of understanding. One alliance negotiation in which I was involved included a technology transfer agreement, a software license, a procurement agreement, a marketing agreement and an OEM component sale agreement—the parties already had a broad patent cross-license, or that would have been needed as well. Even when the parties have neither the intention nor the expectation of disagreeing, an alliance is based on certain assumptions and places obligations on the parties. Without an unambiguous documentation of these assumptions and obligations, misunderstandings or worse are inevitable. One who has never actively negotiated an intellectual property based alliance might think that negotiating the “deal” is the hard part; while the “contract” is a straightforward job of recording the agreement.

That just isn’t so. For only the most obvious example, if only the “price”—in whatever currency or commodity—is negotiated, then how is either party to deal with the fact that many of the terms and conditions also have associated costs. If the parties agree to a price without agreeing to all of the additional parts of the agreement, one or the other is paying too much, or giving up too much. The contract does not simply register the agree-

ment, it is the vehicle by which agreement is reached. Moreover, it is always the case that if something is not “non-negotiable,” it is negotiable. The ability to give and take on every clause of a contract is what enables willing parties eventually to reach a mutually satisfactory agreement.

The following is a list of the most important elements of a technology license such as would be the basis for an alliance:

- Specific IP asset(s) being transferred or licensed;
- Limitations, prior obligations, etc.;
- Confidentiality requirements;
- Specific physical deliverables involved;
- Specific work to be done, by whom, when, and who pays;
- Milestones and measurements;
- Who has what rights to the resulting work product, if any, subject to what limitations;
- Patents, copyrights, trade secrets, trademarks licensed or reserved;
- Rights to derivatives and enhancements;
- What obligations are placed on the parties, and for how long;
- Obligations for maintenance, updating and repairs;
- Indemnities, warranties and damages;
- How disagreements will be resolved;
- What the grounds for termination are;
- Sanctions for breach; and
- Specific payment terms and obligations.

When the contract is actually negotiated and finally drafted, there will be a wide range of somewhat less-substantive clauses. However, failure to pay adequate attention to these clauses, too, can in the long run result in undesirable consequences. Since most of these fall under the rubric of “legal boilerplate” from a business perspective, it will suffice at this point

to simply list some of them. On the other hand, the distinction between “substantive” matters and “boilerplate” is not a sharp one. “Term,” for example, affects such nontrivial matters as the period during which royalties might be due, while the detailed nature of the payments can have a very large impact both on how much tax is owed (and in what jurisdiction) and on how the parties can account for the deal on their financial statements.

- Term
- Termination
- Breach
- Governing law
- Jurisdiction
- Dispute resolution
- Confidentiality
- Taxes and other charges
- Force majeure
- Mergers and spin-offs
- Assignment
- Survival
- Language
- Severability

Since this paper’s focus is on arriving at a win-win alliance negotiation, it is out of place to take too much time to discuss the substance of the contracts themselves. However, one critical aspect, in my view, is that the contract is the embodiment of the negotiation—the one material object in which all of the agreements are recorded. It is, of course, the case that if either party commits some act that is counter to the letter of the contract, they risk invoking legal remedies, and this should be reason enough.

However, perhaps even more important, the alliance may survive well after all of the individuals on one or both sides have changed jobs or employers. Whatever understandings they may have taken to their management, whatever relationships they developed with individuals on the other side, sooner or later nothing is left but a piece of paper. Even if the individuals are still present, in their same roles, the world may well have

changed, or one or both of the alliance partners’ business may have changed—perhaps revolutionized. The contract has to anticipate as much of this uncertain future, both its positive and negative ramifications, as the negotiators can handle if the alliance is to have the best chances for long-term success.

Thus, there will be clauses and conditions that neither party, nor their management nor their attorneys seriously expect to be invoked, but the absence of which will cause serious problems for their successors. Moreover, these clauses should be as carefully thought out as the operational ones. Fortunately, many organizations that are in the alliance game have, over time, developed contract and license templates which, for the most part, suffice. When the organization has been developing partnerships over a long period of time, in fact, no one may even remember why a particular clause is non-negotiable—until it is needed.

Thus, my final prescription for a successful alliance is that the contracts and licenses be as complete and detailed as possible within whatever time limit is imposed. And they must be readable and understandable by people who had nothing to do with either the negotiation of the contracts or their drafting. Nothing short of clear, understandable English (or whatever language is operating) is acceptable.

A Primer on Benchmarking a Licensing Operation

* PATRICK H. SULLIVAN
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INTRODUCTION

The increasing value of intellectual property (IP) has produced many new IP management initiatives and activities designed to extract value from this form of intangible assets. Because the activities related to managing intellectual property are new, the managers whose job it is have little in the way of guides or textbooks on which to draw. As a result, many firms are using the experience of other companies to provide them with valuable information and lessons. Some companies have joined self-interest sharing groups and one-on-one benchmarking activities have increased significantly. (Although there are no hard data on the rise in benchmarking, heads of licensing groups in many leading companies say that they are increasingly receiving requests to be benchmarked.)

One group of companies that is frequently the target of benchmarking requests are those in the ICM Gathering, a collection of large, global corporations whose representatives meet regularly and who have been actively engaged in extracting value from their intellectual assets for an average of more than five years. As these companies have developed and become recognized for their relatively sophisticated knowledge, other companies, less sophisticated in IP management, often ask them to share their knowledge and experience through benchmarking arrangements. All of the ICM Gathering companies report that other companies' benchmarking activities are sometimes frustrating and not as effec-

tive as they might be. ICM Gathering companies attribute this, in part, to 1) a lack of adequate preparation for benchmarking and 2) poor execution.

Companies around the world have practiced benchmarking for decades. However, in the field of IP management, benchmarking (along with everything else) is new. In many companies, attorneys—a group whose training rarely includes courses on management or organization—are often the ones responsible for managing the firm's IP activities. For this reason, many IP attorneys turn to others—colleagues, other companies, consultants—for advice and to learn by example. But whether the people managing the firm's IP are attorneys, technology people, business people or scientists, all share an interest in learning how to benchmark their own operation against that of other companies.

This paper is intended to provide guidance and insight for companies that anticipate undertaking a benchmarking effort relating to licensing. This paper contains information designed to increase significantly the probability of successful benchmarking. Although the processes described herein refer to benchmarking activities related to licensing, they are applicable to virtually any functional area. This first paper provides some lessons about benchmarking in general and, in particular, describes how to increase the odds of a successful benchmarking endeavor through better preparation. Later papers will provide some examples of successful benchmarking efforts, specific guidelines and suggestions

about implementing a benchmarking effort, and key lessons.

WHAT IS BENCHMARKING?

We have noticed that people in the licensing field may use the same or similar terms and phrases but define them differently. When this happens, discussions can be confusing and fraught with well-intentioned misunderstandings. Thus, everyone reading this paper should understand that the authors define benchmarking as follows:

A benchmark is a point of reference or a standard by which others may be measured or judged. Thus, benchmarking consists of a controlled exchange of information between one company and carefully chosen other companies (benchmarks). Those companies may be inside or outside of the industry of the company doing the benchmarking, and may even include competitors. The subject matter has no limits, other than what a company wants to know and has the ability to interpret. A company may work to understand more about how others handle brand marketing, trademark protection around the globe, licensing, organizational structure and many other things.

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WHY FIRMS BENCHMARK

Companies that wish to justify or increase their budgets, companies contemplating a change in their licensing practices, or companies that want to better evaluate their licensing office's activities often turn to benchmarking to obtain helpful insights. Information about the operations of others always provides new perspectives and may present solutions to vexing issues.

Companies may have individual reasons for benchmarking the licensing practices of recognized leaders, but all companies grapple with two major issues: 1) justifying their current practices and 2) making changes.

To justify expenditures and practices. Companies seek information about the operations of others in order to substantiate or improve their own resource levels or practices. Justification is usually sought for:

- Resource levels—retaining current levels or seeking additional resources
- The organizational locus of activity (e.g., retaining licensing under the IP function or moving it to the business development function)
- The focus of activity (e.g., retaining licensing as a defensive activity through litigation avoidance, or changing the focus of licensing to an offensive activity such as revenue generation)

To determine how to make a change. Companies starting up or modifying a licensing activity often need guidance on aligning that activity with their strategy and goals, in particular:

- Setting objectives and monitoring performance. Many companies have questions about the strategic intent of a licensing activity and are interested in learning how other companies have developed objectives and performance metrics and then sold these to senior management.

- Improving processes. Most companies want to and even have a policy to steadily improve their processes. Benchmarking can help them gauge how good they are today and lead to the adoption of new best practices to help make desired improvements.
- Learning and retraining. Benchmarking can help teach new people or even retrain experts on the state-of-the-art of key business processes. Involving a new employee in a benchmarking exercise helps him learn about the licensing business based upon the information he provides to the other party, what he learns from them, and what information is exchanged during the benchmarking discussions.
- Teaching. Dow Chemical, for example, has used benchmarking to teach suppliers selected best practices related to key processes.
- Understanding the competition. Although both you and your competitors may place limits on the information you wish to exchange, this exercise will enable you to compare your capabilities with theirs in selected areas, determine where you have competitive advantages, and study whether these advantages are sustainable.

Your purpose for benchmarking affects several key aspects of the activity. As noted, companies normally benchmark with others in order to justify current or planned activity and resource levels, or to create new or improved operations or activities. These are very different goals, and those differences affect several key aspects of the benchmarking process, such as: the companies you select as your benchmarking targets or partners and the specific information or learning you seek (e.g., information about data, activities or operations).

WHEN YOUR PURPOSE IS JUSTIFICATION

When your purpose is justification, you should seek benchmarking partners that closely mirror your company's business. This means that you should benchmark either with competitors or with companies your firm's management perceives as important—or both.

- Compare your practices with those of competitors. After all, these are the companies you wish to surpass, so why not find out what they are doing, how they are doing it and how you stack up to them. When competitors are doing better than you are, and your resource levels are lower than theirs, this can be a good justification for expending more resources. Competitors are useful benchmarking targets when your objective is justification. When your objective is to emulate, competitors are usually poor benchmarking targets. This is because they often are not world-class best practice companies and, at best, all you may learn will be a set of "non-world-class" not-necessarily-best practice activities.
- Compare your practices with those of firms you admire. These are the companies, including best-in-class competitors, that, for whatever reason, you must include in your benchmarking because they are seen by your top management as increasing the credibility of your benchmarking results. Companies in this set are useful when your purpose is justification. If you wish to learn, however, these companies are usually not the best targets for comparison: they likely have different business strategies, different organizational dynamics and different goals and objectives for licensing.

WHEN YOUR PURPOSE IS LEARNING

When your purpose is learning, you should seek partners that are recognized as world-class best-

practice companies in the aspect, function or activity you seek to emulate. When you have identified the companies whose best practices you want to learn about, further reduce the list until it includes only the companies that most closely align with:

- Your licensing purpose and objectives. When your licensing purpose involves revenue generation, it may be unproductive to benchmark with a company whose licensing objective is litigation avoidance.
- Your philosophy of operation. When you are involved in active and offensive licensing, it may be unproductive to benchmark with a company whose philosophy involves passive and defensive licensing.
- Your degree of complexity. When you are a multi-office, multi-national organization involved with the licensing of a range of technologies, it may be unproductive to benchmark with a company that operates in one location and licenses a narrow range of technologies.

Firms that undertake benchmarking as a learning process usually already know which functions or activities they wish to learn about. If you know what functions or activities you want to improve, seek out world-class performers in that function or activity. This usually means they will not be competitors, nor will they be the companies your management perceives as ones to be emulated. They will, however, be the companies from whom you can learn the most. If you don't know with which functions or activities you should be concerned, then seek out benchmarking partners with two characteristics:

those whose licensing purposes and objectives are similar to yours (i.e., those companies that are the most likely to operate in ways that will help you achieve your licensing purpose and objectives); and those that are highly regarded within the licensing field. These are

companies whose approaches to the activities and functions related to licensing are probably to be trusted.

Perhaps as a final consideration, you should select companies that have a reputation for being willing to share information, and even for teaching.

PREPARATION IS KEY TO SUCCESSFUL BENCHMARKING

All important and meaningful studies require significant preparation, and benchmarking is no different. Perhaps the most important preparation is the internal establishment of your firm's objectives: 1) what you want to learn and 2) what you will do with the information once you have it. Let's deal with each of those in turn.

Define what you want to learn.

There are a number of dimensions to this issue, and they should all be discussed and defined. The following are the most often-mentioned items of interest among benchmarking companies:

- Functions. What functions are most common (e.g., the decision to patent; administering the IP portfolio; determining which innovations are licensable; negotiating the terms of the license, etc.)?
- Roles. Who performs each of the functions listed above?
- Organizational structure. Which activities are centralized and which are decentralized? To whom do the business units report within the organization? How and where is the staff recruited?
- Practices. What are the other companies' best practices and other practices of interest? What methods and procedures do they use? What is the sequence of activities?
- Data collection. What data do other companies gather about licensing inputs, processes and results? How are these things measured and in what context? How are the data compiled (e.g., manually, as part of a company MIS)? Do companies use the same definitions of terms and gather the same data?

- How have they secured management buy-in?

Create a "dummy" report of benchmarking results. Creating a "dummy" report—that is, an outline of what you would expect the report of results to contain—will help you identify the specific information you require from the benchmarking event. This is a project device often used by consultants to focus attention on the things that are important as opposed to the things that are merely interesting! The dummy report should contain, at the outset, the purposes for benchmarking and how the results are expected to be used. By placing this information in the front of your dummy report (and your actual report as well) you increase the odds that the benchmarking results will be consistent with your purpose as well as your intended uses of it.

Communicate with your benchmarking partners. Successful benchmarking projects are those where the participants work together to define their mutual needs and focus the discussion. Theo Grigoriou, executive vice president of licensing operations for Honeywell Intellectual Properties Inc., recommends that the benchmarking company and the target company determine the scope of the inquiry together. A narrow scope allows the participants to get into the details of selected processes rather than learn only about the proverbial 30,000-foot-high strategies.

Be sure your benchmark partner is willing to do the necessary preparation before the benchmarking session. Dennis Melton, director of patent and licensing management for Avaya, Inc., and formerly at Lucent, recommends that, after defining the scope of inquiry, the two companies develop a glossary that defines processes and key terms. This will ensure that they share information on an apples-to-apples basis and thus arrive at meaningful results.

Each party should prepare a list

of detailed questions and send the questions in advance of the session to the other party. Some companies go at least one step further, answering for themselves the questions to which they seek answers from their partners. This can lead to a refinement and clarification of those questions, making them more useful to the "benchmarker" and easier for the partner to respond.

The benchmarking participants should define the rules of engagement: Will both parties share all information about selected processes? Will confidential information be exchanged? If so, how may it be used? As important as the rules of engagement are to the success of benchmarking, nevertheless, the authors believe that the best benchmarking is achieved when the "rules" are held to a minimum. Both parties should indicate how willing they are to share information. Obviously, as Dennis Melton puts it, "open kimono" is best; however, this policy may be tempered if the benchmarking is between two competitors. And both parties need to indicate upfront that they are willing to give as well as take.

Finally, those present at the benchmarking session should be able to answer the other company's questions in the desired detail. Small groups work best. In large groups, participants tend to share information less freely.

MEASUREMENT AND THE BENCHMARKING PROCESS

There are two broad measurements related to benchmarking: 1) measurements of the activities and practices being benchmarked, and 2) measurement of the benchmarking effort itself.

The activities and practices being benchmarked are called the "measures of interest," of which there are three kinds: measures of success, measures of progress and measures of process.

Measures of success. The company doing the benchmarking is in a position to determine what it means by "success." Success in measurement means that one has measured the items of interest. Success in outcomes means that one has learned from the effort and made business progress. The most important measurement of success is whether anything changed as a result of the benchmarking project.

Measures of progress. These are, as the name implies, measures that are used to define and describe the degree of progress toward a goal or objective. For example, for a licensing office striving to achieve a targeted level of royalty payments, a measure of progress might be the current royalty stream amount, expressed in percentages of goal, or in terms of the distance remaining to achieve the goal.

Measures of process. It may be that an activity or process, though required, does not itself make progress toward a goal faster. In such a circumstance, one may measure the process itself. In our licensing example, the licensing office's activities—all of them necessary for reaching the targeted goal—are difficult to measure in progress terms. They are, however, measurable as processes that take place during the race. An example of a process measure might be the number of potential revenue-producing technologies considered for licensing, the number of licensing agreements drafted, or the number of licensing agreements executed.

SUMMARY AND CONCLUSIONS

Benchmarking is a widely used and accepted means of learning about and adopting best practices in a selected area. A successful benchmarking effort depends on the amount and quality of preparation and execution. Done well, the exercise can lead to new ways of doing business and enhance per-

sonal and corporate relationships. Professional societies are often a good source of target companies. The Licensing Executives Society offers all of its members networking opportunities with candidate companies and their employees.

Benchmarking is not a game. Participants must take the exercise seriously and be fully committed to working together to make the session worthwhile for the benchmarking company and those being benchmarked. If your vision of success and the scope are clearly and concisely defined, the experience will be positive and can result in important process changes at your company.

Selection and Application of Intellectual Property Valuation Methods In Portfolio Management and Value Extraction

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PAUL GERMERAAD *



INTRODUCTION

Valuation of intellectual property (IP) plays an important role to the portfolio management and value extraction activities of IP professionals. When valuing intellectual assets, there are many methods to choose from and these can vary widely in applicability and cost. In this paper, the distribution of expected values in a typical IP portfolio, and an appropriate range of value extraction options are discussed and provide a context for selecting and appropriately applying various valuation methods. A dozen or so of the most commonly used valuation methods are reviewed in detail and their range of applicability, advantages, biases and caveats are addressed.

The IP practitioner is presented with a practical approach to the selection and effective use of valuation methods in day to day IP portfolio

management, value generation and value extraction endeavors.

INTELLECTUAL PROPERTY PORTFOLIOS — VALUE DISTRIBUTION AND EXTRACTION METHODS

There are a wide variety of circumstances under which IP valuations are useful and essential to the normal operation of an IP licensing, management or commercialization professional. It is as important to know what tool to use—and when—as it is to know how to use the tool, or how and when to hire appropriate professional help.

Figure 1 shows the wide variety of IP assets with which today's IP professional routinely deals. In addition to the legally protected intellectual properties, such as patents and trademarks, there are a wide variety of know-how assets

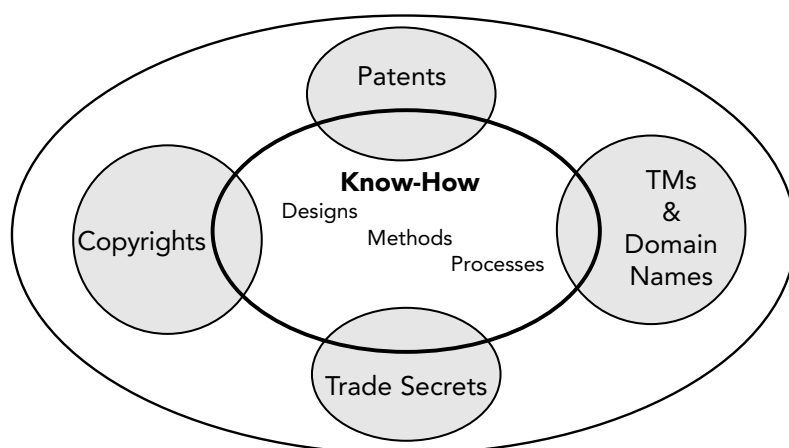
that are often the most valuable of the assets under consideration. These can require different preparation and approaches in their valuation and exploitation.

Know-how assets are characteristically different from legally protected IP in that they are embodied and closely held by individuals, and provide the positive enabling capability for producing a product or service. In contrast, patents, trademarks, etc., are primarily exclusionary vehicles and give their owner the right to prevent others from taking an action or producing and selling a product or service, thereby improving the competitive position or the margin of a product or service to the owner, but not actually enabling to the product.

Since know-how enables products or services, its valuation is usually dependent to a larger extent upon the specific context or business plan in which it is delivered. The specific individuals, and their skills and experience are of paramount importance. The know-how consideration comes strongly into play in situations of new business start-up, secondary sale or transfer.

In the valuation of private

FIGURE 1. INTELLECTUAL ASSETS



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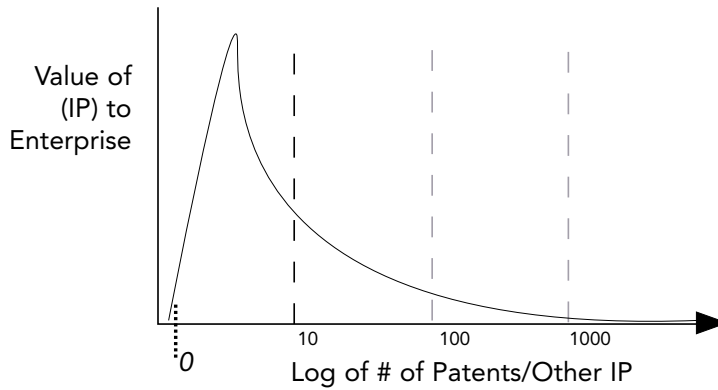
equity, know-how and the business plan and context is an area of special attention.

In addition to considering the different characteristics of various assets in an IP portfolio, it is important to understand that the individual and specific value of assets will vary widely. An understanding of how these specific values are statistically distributed greatly helps in planning and executing the management and extraction of value from them. Thus, in managing IP and technology commercialization, it is important to realize that the individual values of assets in a portfolio may not, and usually do not have a normal distribution. Experience with large portfolios tells us that there are usually a very few specific assets in any portfolio that contain most of the value and the remainder of the assets have much smaller values that may in aggregate amount to a small fraction of the overall value of the valuable few.

From practice, we would expect IP portfolios to have a distribution closer to log-normal than normal, with a sharp value peak around a few high-value assets and a long, broad lower value tail. This is illustrated in Figure 2. This understanding of the expected distribution of value among the specific assets in a portfolio is helpful in their management and value extraction. Clearly, any strategy to optimize value extraction must take care to not miss the few high-value assets, while at the same time provide for low-cost value extraction methods for the masses of much lower value assets.

Another related dimension of value extraction is the method used to extract value from assets in the various parts of the approximately log-normal distribution. Methods and commercialization cost need to match appropriately the expected underlying value. This value extraction method dimension is illustrated in Figure 3. In the tail of

FIGURE 2. HYPOTHESIZED LOG-NORMAL DISTRIBUTION OF AN IP PORTFOLIO—AN ENTERPRISE VIEW



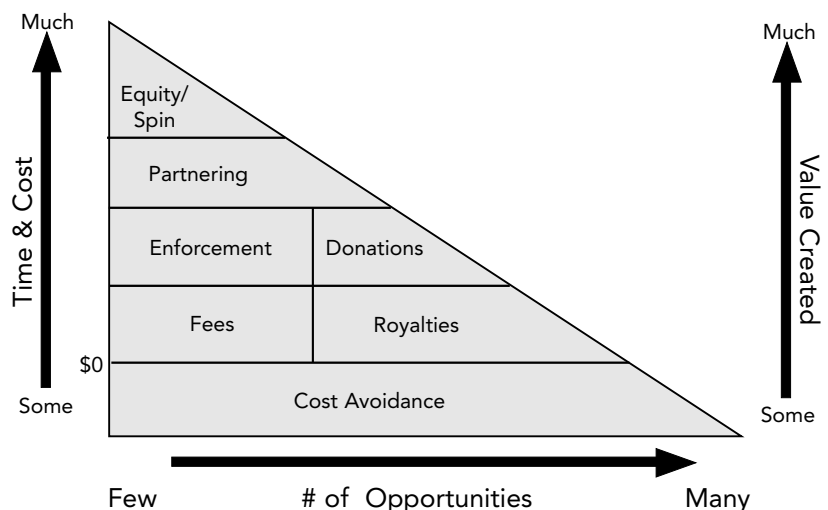
the log-normal distribution curve there are many lower value opportunities and lower cost approaches (in time and money), which are appropriate to value extraction from these assets. Moving up to the peak of the log-normal distribution curve, there are few high-value assets and here it is appropriate to spend much more time and money on a higher value extraction approach.

For lower value assets, value extraction can occur by cost avoidance or reduction, by low cost licensing, or by donation. Examples of cost avoidance and reduction are decisions to terminate R&D projects. As expected, these are frequent opportunities. Here, understanding the commercial potential, the marketplace and the competitive product space, and having a way to

develop quick relative valuations for various projects can result in substantial cost reduction, avoidance and savings. Similarly, periodically reviewing the assets in your patent and IP portfolio for those in the tail of this curve, and having a methodology for assessing relative value can greatly assist in choosing those assets appropriate for abandonment and discontinuation of maintenance fees, or donation.

At the next level up are opportunities for licensing of IP, and above this, there are even fewer opportunities for enforcement of patent rights and donation of the assets for tax reduction. As shown in Figure 3, the most valuable assets are at the same time the fewest and most costly from which to extract value. These are the assets that may involve some equity components

FIGURE 3. VALUE EXTRACTION METHODS



or arrangements. Equity arrangements can be in the form of partnerships, joint ventures, start-ups or spin-outs (or wholly owned subsidiaries). These equity opportunities are often moved from the technology / know-how / patent stage to the start-up stage through a process called "incubation."

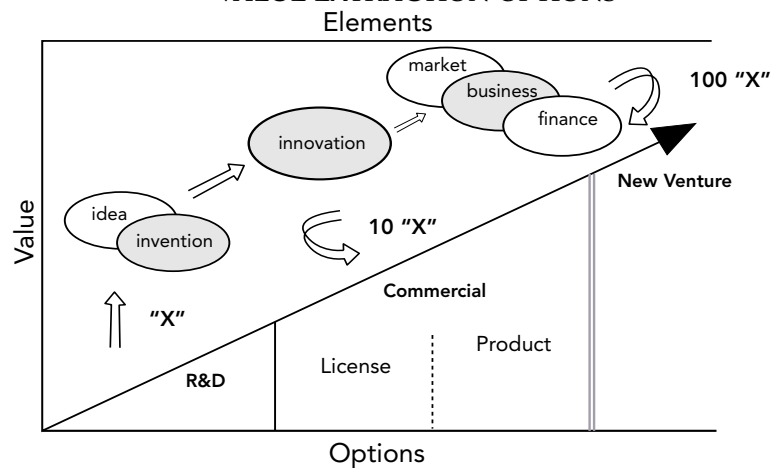
Incubation can be internal or external to the enterprise and either formal (as in a business "incubator") or informal (as carried out by an entrepreneurial leader with strategic and funding partners).

The latter half of the 1990s were an extraordinary time for technology-driven new business start-ups and new capital and value formation. The market valuation of going concerns and businesses can be very different for an equity-related instrument, in that multiples of revenue or other characteristics, along with comparisons to existing publicly traded businesses are often used in deriving value. This has resulted in the sort of valuation distribution shown in Figure 4, where the same technology is moved from an opportunity in R&D, to a license, to an equity possibility. The value available for extraction can increase one hundred fold. Thus, one should always be aware of those elements of the portfolio that might be applied to the right of the equity line and the effect of the revenue multiplier provided to aggregated and directed know-how of a "going concern."

VALUATION METHODS

In any discussion of valuation, it is important to note the clear distinction between value and price. Price is typically defined as what someone is actually willing to pay, in an arms-length transaction, for know-how or technology, based on its perceived value. Thus, price may vary from buyer to buyer. Value is an abstract, but deterministic quantity whose calculation is

FIGURE 4. COMMERCIAL CONTEXT FOR VALUE EXTRACTION OPTIONS



based upon an orderly, recognized and repeatable set of methods and rules. Here, the distinction between price and value will be set aside, and this paper will focus on a review and analysis of fundamental valuation methods.

Organization of Value Methods

At a high level, all valuation methodologies are based on cost, income, or market information. All other common valuation methods can be grouped under these three headings. Selecting which method to use for a specific business situation calls for an understanding of how these methodologies work and are

interrelated.

Segmentation criteria or patterns among these valuation methodologies can be found by looking at the array of elements that impact license or IP value. These are shown in Table 1. Two common underlying segmentation criteria are the maturity of the technology and business and the purpose to which the license or IP is to be applied. Figure 5 shows a graphic representation of the technology/business maturity curve over time.

As we will show, the appropriate valuation method is closely related to the technology/business maturity. For example, early in the technology/business cycle, before an idea

TABLE 1. ELEMENTS OF IP VALUE

<u>Legal Position</u>	<u>Markets served</u>	<u>Complementary Assets</u>
Patent or trade secret Other? Patent strength Claims Easy to work Dominating? Improvement?	Existing or new? High-tech, low-tech or no industry sector e.g., Chemical Semiconductor Healthcare Semiconductor Regulated?	Manufacturing capability Development capability Marketing & Sales capability Name & reputation History of successes Relationships Capital & access to capital
<u>Technology</u>	<u>License Terms</u>	<u>Risk</u>
Uniqueness/novelty Stage of development Industry sector Economic lifetime Anticipated economic benefit	Exclusivity Scope Geography Grantbacks? Know-how transfer? Infringement abatement Indemnification	Technical hurdles Market hurdles External uncertainties Economic Political Regulatory

has an associated business plan or business intent, cost-based methods are appropriate because at that point one doesn't yet know what products might result from an invention.

On the other hand, income methods are best when one knows what the idea will be used for. At this point in the maturity cycle, there is a business vision and plan. Thus, one can project what the total returns and the expected income might be over time. In this region of the curve, value rapidly increases with maturity, and it is here that income methods find their greatest utility.

At the top of the curve, in a maturing business, the value tends to flatten. Here, because of the increased amount of marketplace data of similar and comparable commercial products, market valuation methods offer the most precision for setting value. Since there are products in the market associated with these assets, one can obtain good market comparables. A number of private consulting companies have created—and made available—databases rich in the specific licensing terms of many products and services.

In Figure 6, the maturity concept is taken a step further. Identifying roughly a dozen commonly used valuation methods, it segments each into those that use cost, income, market, or income-based methods.

INDIVIDUAL VALUATION MODELS

Most discussions of the cost, income and market approaches to valuation usually cover only the high-level economic principles behind each method while the mechanics of the valuation are rarely discussed. Beginners trying to implement these approaches often are frustrated because the needed detail of the processes is not presented. When they are faced with the challenge of conducting a valuation in their daily work, they

FIGURE 5. TECHNOLOGY/BUSINESS MATURITY CURVE

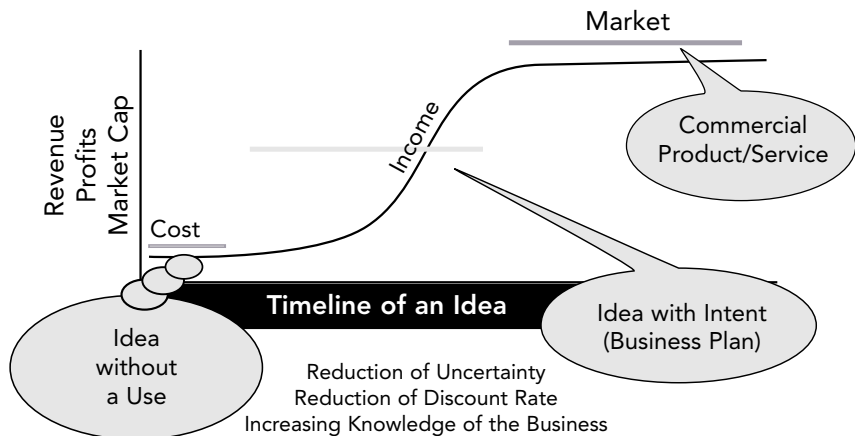
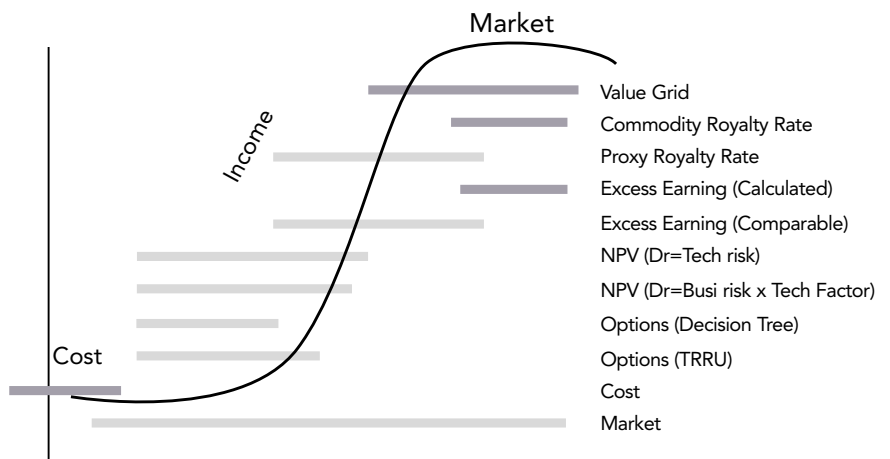


FIGURE 6. SPECIFIC VALUATION METHODS AS A FUNCTION OF TECHNOLOGY/BUSINESS MATURITY



usually do not have sufficient understanding of the step-by-step approach that needs to be followed to assign a reliable value to intangible assets.

Thus, it is critical to discuss each valuation method in enough detail to allow the reader to calculate the value of a technology that is protected by intellectual properties such as patents, trademarks, trade secrets and know-how. Here we present the specific valuation methods used by professional appraisers and review the strengths, weaknesses and applicability of each of these methods.

Cost Approach

As we have shown, the cost,

income, and market approaches¹ describe the general economic principles behind valuations. The cost approach is the least-used method because the cost to develop something is not usually directly related to its value. Even though it is simple to calculate using historic costs, the results can be misleading.

Rather, the appraiser needs to calculate the anticipated future costs to develop similar technologies, or the costs to design around existing protected inventions. This future cost calculation can be tricky and can require assumptions that are difficult to support.

¹ Gordon V. Smith and Russell L. Parr *Valuation of Intellectual Property and Intangible Assets*, John Wiley & Sons, Inc. Third Edition 2000.

Income and Market Approaches

The income and market approaches² are more commonly used. Three specific methodologies have emerged within these two approaches. These specific methods are the pure income approach, the pure market approach, and a blend of the two. For example, the pure income approach is carried out by discounting future anticipated revenues several years into the future. The applied discount rate includes the global economic risk, the country risk, the industry risk, the company risk and the technology risk. The strength of this method is based upon the availability of the information from the company that is practicing or developing the technology. Financial analysts and business managers within a company often use the income approach because they are familiar with the concept of discounting potential future revenues. If the company is producing current products from the technology then there is historic data on the revenue, costs and profit margins.

However, the income method has its weaknesses. These are apparent when trying to apply it to a new technology that has not yet reached the market and for which there are no sales or cost history to help predict the future. Another weakness to the pure income approach is related to the allocation of risk. Although we can calculate the business risk with relatively proven methods, it is difficult to allocate the risk of a new technology. Does one use the hurdle rates of comparable companies? Does one use the experience of the appraiser in the field of valuation of related intangible assets? Or, does one use the relatively high discount rates used by venture cap-

italists? An error in the assessment of the risk and assigning a too-low or too-high discount rate can result in a big range in the technology's computed value.

The pure market approach relates to finding exact, similar or comparable technologies to the technology being valued. This generally favored method requires finding sufficient detail about similar transactions to be sure the dollar value being assigned to the technology accurately reflects reality. The weakness of this method comes from the possible lack of documented prices for similar transactions and difficulty in obtaining details for the deals listed in the databases.

Hybrid Approaches

Appraisers have devised many other unique methods that blend the income and market valuation approaches so that one gets the benefits of both market comparability and the business community's familiarity with the income approach. These hybrid methods were shown in Figure 6. These methods can be grouped into the following categories: royalty rate, value grid, excess earnings, technology factor, and the Technology Risk-Reward Units (TRRU™) derived from the Black-Scholes options pricing method.

Royalty Rate Method

In the royalty approach, one needs to determine the past royalty rates that licensors and licensees have agreed to (this portion represents the market approach). This royalty rate is applied to the expected revenue stream that is anticipated in the future (income approach) as the licensee takes the technology into commercial production. In order to conduct this valuation, one first determines the royalty rate—for which there are

several sources. One often-overlooked source is the internal license deals that a company has concluded in the past. Other sources include consultants that sell royalty rate studies for their clients. Also, there are the 10-k and 10-Q filings with the Securities and Exchange Commission (SEC) of industry-related companies that may have listed recent licensing deals. Of course, there is no substitute for obtaining a real, full-fledged agreement that outlines in detail the specifics and the royalty rates that both parties agreed to. Sometimes personal contacts within a professional society will allow you to get a range or feel for industry-accepted royalty rates and terms. Finally, surveys regularly conducted by members of the Licensing Executive Society often help in the development of royalty rates.

Once an individual is comfortable with the royalty rate obtained from any of the sources outlined above, then the other variables needed to complete valuation of the technology include the future expected revenue, the risk associated with the revenue and the tax rate for the company. With those variables identified and estimated, one can calculate the value of the technology.

In some instances, the determination of the royalty rate is all that is needed. This is typical for a commodity product or a franchise licensing. In a commodity product, both parties know the manufacturing, sales and marketing risks for the product. The technology is proven and usually there are several licensing deals that have taken place in the past. So the licensing negotiation is based more on production volume or territory that the company is interested in licensing. Another situation where royalty rates are well known is in franchises. This is typical in the food industry, where the franchiser is

² Richard Razgaitis *Early-Stage Technologies: Risk Management, Valuation and Pricing*, John Wiley and Sons, Inc. 1999.

known to require a set royalty payment in exchange for site selection, management support and advertising.

Value Grid Method

In mergers and acquisitions, setting up holding companies, or measuring the contribution of R&D to a specific business, there is often a need for different royalty rates to capture the value of a large portfolio of intellectual properties. In such cases, it might be appropriate to use the value grid approach in determining appropriate royalty rates. The value grid is most appropriate for intra-company pricing of IP and for general business purposes where reasonableness of overall portfolio value is more critical than having one or two highly accurate data points.

In an example of this royalty rate selection process, Dr. Khoury, with the help of Arthur D. Little, developed the value grid for the chemical industry³. Here, he and his colleagues at DOW collected a large number of royalty rates within one industry, then organized a matrix that outlined the trends within that industry. For example, the chemical industry matrix of Table 2 was organized in terms of process, product and application or composition of matter patents as one axis, and the application of those patents into commodity, specialty or high per-

formance types of technology on the other axis. The total range for the chemical industry is 0.1–10 percent royalty.

Some chemicals that are applied into the pharmaceutical and agricultural areas demand higher royalty because of the high profit margins in those industries. This wide range is then narrowed based on where in the grid the specific technology resides; e.g., a specialty application protected by a product patent would have a royalty range of 2–5 percent. One could use this royalty range to determine the range of value. If a narrower range is needed, one can further refine the analysis such that a specific technology is on the low or the high end of the range. Those further refining attributes could include the stage of the technology, the breadth and the strength of the claims in the patent and the amount of know-how that is associated with the patent. In this way, the range may be further narrowed.

Excess Earnings, Formula or Residual Method

The excess earnings method or the formula method is a valuation approach used by some appraisers. (The Internal Revenue Service refers to the excess earnings method as the formula method.) It is for use in valuing the contribution of a technology to profitable on-going businesses.

IRS revenue ruling 68-609 describes in some detail the “formula” (excess earnings) approach to determine the fair market value of intangible assets. The IRS, knowing the limitations of the method⁴, suggests its use only if there is no better basis available for making a determination.

A short description of the formula method of valuation will reveal its limitations. The formula approach is defined as the capitalization of earnings in excess of a fair rate of return on net tangible assets. In practice, the appraiser assigns a percentage return on the average annual value of the *tangible* assets used in a business, as determined using a period of five or more years immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount, capitalized at a percentage of typically 15–20 percent, is the value of the intangible assets of the business determined under the formula approach.

Alan B. Simon⁵ wrote on the misconception of many appraisers in using the formula or residual method as the preferred method by the IRS.

To illustrate, in his article he outlined the example of Table 3.

The first flaw in the formula or residual method is the use of the capitalization approach to excess earnings. Capitalization is used when a business growth rate is constant and the intangible assets go to

3 LES Presentation – Annual Meeting 1998

Economic Impact	Process	Product	Application/COM
Compact	0.1 - 1%	1 - 2%	1 - 3%
Specialty	1 - 3%	2 - 5%	3 - 7%
High Performance	3 - 5%	5 - 7%	7 - 10%

4 IRS revenue ruling 68-609, www.equityvaluations.com/pubs/revenueruling68-609

5 Alan B. Simons, www.shbcpa.com/68-609.htm

TABLE 3. FORMULA OR RESIDUAL METHOD EXAMPLE

Average value of tangible assets:	\$400,000
Prevailing industry rate of return at the valuation date	12%
Earnings attributable to the average tangible assets	\$48,000
Total company average earnings	\$85,000
(Less) earnings attributable to the average value of tangible assets	(\$48,000)
Difference on excess earnings:	\$37,000
Capitalized at a rate related to the company's relative business risk	20%
Value of intangibles (\$37,000 ÷ 0.20)	\$185,000

perpetuity. Yet we know patents, trade secrets, know-how and copyrights may have a limited legal life and, in many cases, an even shorter business life. For example, a patent has a life of 20 years from the date of filing the patent. The technology could become obsolete in 10 years. Or the copyright of software could be protected for 50 years after the death of its creator, yet it could be obsolete in less than five years. So the capitalization approach can be the wrong approach to value the intangible assets.

The formula method was developed to value intangible assets by subtracting the return on cash and tangible assets from the value of the total enterprise. The result is assumed to be the return due to the intangibles for one year. The one-year value is capitalized to perpetuity to determine the total value of the intangibles. This method lumps the value of the total intangible assets into one number. The final value lumps the patents, trade secrets, trademarks, know-how, management team, etc., into one number. Thus, with this method, the value of one patented technol-

ogy cannot be extracted from the total value of the intangibles.

Nevertheless, the formula or residual method is accurate in valuing the total bundle of intangible assets of a profitable business that has been in existence for some number of years. It is especially well-suited to valuation of the intangibles of a company that has been conducting business for enough time that it can be calculated with relative accuracy the expected return on—and value of—the tangible assets.

The assumption that any excess earnings above and beyond the return on the tangible assets is solely attributed to the intangible asset bundle can lead to an error in valuation because it assumes that the business is maximizing the exploitation of all its intellectual properties. Various studies⁶ indicate that successful companies use 10–20 percent of their intangible assets within the enterprise that developed them. Moreover, if there are no excess earnings, it does not

⁶ Private benchmarking studies by companies during the implementation of intellectual asset, 1996

mean that the intangible assets have no value. Rather, it can simply mean that the company that owns those intangible assets is not exploiting them to their full potential. It is noteworthy that many companies do not fully exploit all the technologies that they develop because they do not have enough resources to exploit the existing technology or intangible assets in all fields of application. The billion-dollar licensing programs of IBM and Texas Instruments provide another illustration of intangible asset under-utilization within companies. If we were to value the intangible assets of those two companies before they started their licensing programs then we might have undervalued the intangible assets significantly.

Valuation of start-up companies is another area where the formula method is clearly inappropriate. Investors and venture capital groups pay large sums of money for e-commerce, software and small biotech companies. For these companies, the majority of the value is in the intangibles, and early investors usually buy them at a time when they are losing money. The formula method would suggest since there is no excess earning then the intangibles have no value. Still another shortcoming of the formula method is its inability to value the large number of intangible assets that are created by academic institutions or government labs. These institutions usually have no intention of starting a business, yet the marketplace pays significant amounts of money for the technology from academic research and government technical laboratories.

As we have illustrated, companies often commercially practice less than 20 percent of the technologies that their R&D departments create. That means that more than 80 percent of patented technologies have neither a real business plan nor any plans to turn this

technology into a business. Licensing executives, venture capitalists, the IRS or the SEC will have a tough time using the formula approach to assign value to these patented technologies. It is a clearly limited and inappropriate method for these applications. Thus, it should be apparent to the reader why the IRS, in its revenue ruling 68-609, suggests to the users that this method should be used only when there is no better basis available for determining value.

To manage the above shortcomings, some appraisal firms use a modification of the formula method on comparable established companies to figure out the return on the assets needed and assume that the hypothetical company would have similar assets and cash. Therefore, they derive a proxy valuation. If all the intangibles of the companies are due to a similar technology, without contribution from other intangible assets, then there may be an accurate valuation of the specific patents or technology. Unfortunately, in situations where all comparable companies are losing money the same problem raised earlier still exists.

Technology Factor Method⁷

The technology factor is defined as the incremental revenue that is contributing to the business enterprise. It is a modification of the income approach and addresses the shortcomings of the income and excess earnings approaches. It measures the contribution of the technology to the total revenue of the business directly. So even if the specific company using the technology is losing money, one can anticipate that this technology in the right company would contribute to the profitability of that

company. The technology factor method is sometimes used for companies that have filed for bankruptcy. In this case, appraisers are called upon to value the intangible assets so that the courts can pay creditors with the intellectual property that resides within the bankrupt company.

As discussed earlier, one shortcoming of the income approach is in the determination of the discount rate. The assignment of the risk associated with the technology and added to the discount rate to be used in the income approach is subjective and relies heavily on the experience of the appraiser. The technology factor calculates the net present value of the business by taking into consideration the risks associated with the business. The business risks are easy to calculate using well-established methods, such as Capital Asset Pricing Model (CAPM), the weighted average cost of capital (WACC), and the Arbitrage Pricing Theory (APT). Instead of raising the discount rate to include the additional risk for the technology (as in the income approach), the technology factor method accounts for the value of the technology by adjusting the final net present value of the industry risk by the amount that the intangible assets drive the business enterprise.

A further adjustment captures the specific risks associated with the technology being valued. A review of the utility and the competitive attributes of the technology result in capturing the risk that is unique to the specific technology. All these adjustments are summarized and captured as a percentage of value, which is always less than 100 percent. Since a business needs other tangible and complementary assets to generate revenues, the adjustment factor is always less than 100 percent. Studies by Carole Simon⁸ et al. show the percentage

of contribution of intangible assets to the market value of various tangible businesses. Also, proprietary studies on specific standard industry codes (SIC) have been calculated by Inavisis, Inc.

The technology factor method entails the following calculations: The appraiser determines the revenue generated by the business that employs the technology. For this example, we'll assume that the total revenue is \$8.5 million. Then we determine the net operating profit after tax (NOPAT), and we usually calculate that by comparing the profit margin for several companies that are in the same industry. In our example, we will assume that it is 10 percent. So multiplying \$8.5 million by 10 percent will give us the NOPAT for the business. Applying the market appreciation for intangibles for the industry, along with the specific technology risk derived from the utility and competitive attributes will give us a technology factor expressed as a percentage. In our example, we will assume it is 40 percent. So by multiplying the profitability of the business by 40 percent, we get the portion of the technology contribution to the profit of the business.

The technology factor approach can be used on one technology at a time, eliminating the limitations of the formula or excess earnings methods where the whole set of intangibles are valued and lumped together.

A shortcoming of the technology factor method is calculation of the percentages that are attributed to specific technology. These percentages have to be calculated for a large number of SIC codes and updated on a regular basis, and they require special industry knowledge. One of the strong ele-

⁷ Patrick H. Sullivan, *Profiting From Intellectual Capital*, John Wiley & Sons, Inc., pp 335-356, 1998.

⁸ Carole J. Simon and Mary W. Sullivan, *Marketing Science*, Volume 12, No.1 page 28-53

TABLE 4. TECHNOLOGY FACTOR EXAMPLE

Total NPV of the business revenue	\$8,500,000
Typical after-tax profitability of well-managed companies	$\times 10\%$
NOPAT	\$85,000
Technology factor (capturing industry and technology risk)	40%
Value of the specific technology	\$34,000

ments of the technology factor method is its wide adaptability to different types of technologies and various maturity stages. It can be used equally well for embryonic, early-stage technologies and fully commercialized technologies.

Options Pricing Method

In valuing early-stage technologies, some appraisers have applied the options pricing (or Black-Scholes method). The basic method entails the calculation of the value of the technology at a successful commercial stage and then calculating back the probability of being successful at the various stages that the technology has to pass through before it becomes fully commercial. Monte Carlo calculations are used to calculate the valuation probabilities, and software tools have been developed that allow the user to apply the option pricing approach within a manageable time frame. The option pricing method is popular in the pharmaceutical industry, where there are well-defined hurdles and stages that a technology has to go through. Also, in the pharmaceutical industry there are

significant statistical analyses of historical data that allow the appraiser to be comfortable with the assignment of the various probabilities of a technology to proceed from one stage to the other.

Technology Risk-Reward Units or the TRRU™ Method

Another options pricing approach is the TRRU™ method developed by PL-X and adapted from the formula of the Black-Scholes model to estimate the value of a specific technology. PL-X looks at technology as providing options for various future causes of business action. A significant effort went into the development of the TRRU™ valuation model. It uses the value of roughly comparable, technology-based businesses as a proxy for the value of patents and then subtracts from this the value of the cash that is needed to further develop the technology to a commercial stage.

The authors of the TRRU™ method mention in a recent article⁹ that this is an approximation of value, that it is used within the context of licensing a technology, and that the buyer should use it to calculate only an order of magnitude of value. One drawback of this method is the assumption that the value of technology-based companies solely reflects the value of the technology. It is well-known that in start-ups, a large fraction of the value (as reflected by venture capital investment) is dependent on the management team separate and independent of the technology. Venture capitalists invest significant sums of money based on the management team of the company and not just on the technology. Thus, the pool of companies that PL-X uses to find comparables within a specific field has signifi-

cant intangible value vested in the management team, independent of and in addition to the technology. Also, Black-Scholes was developed to value market-traded stock options, and although stocks may be normally distributed in value as the Black-Scholes formula assumes, it is not clear that intellectual property and technology are. As discussed earlier, most IP portfolios will be closer to log-normal, not normal distributions of value. It is hoped that future research will address the use and limitations of a simple application of the Black-Scholes formula to IP valuation. A validation or modification of the current formula and approach for IP valuation is recommended.

SUMMARY AND CONCLUSION

The hypothesized log-normal distribution of a corporation's intellectual assets demands that the process of valuation of each asset be conducted in the light of its likely value. As most assets will have low values, the importance of quickly selecting the appropriate valuation method is imperative. Time and money are best used on methods and consulting services most likely to expeditiously define an appropriate and correct value.

In the present paper, a dozen valuation methods were reviewed in detail, and their strengths, weaknesses and appropriate areas of applicability were discussed. With the IP practitioner in mind, a practical approach to the selection and use of valuation methods in day-to-day IP portfolio management, value generation and value extraction was developed and presented. The pros and cons of each method were explored so that each method's results can be appropriately weighted according to the sensitivity and quality of the needed inputs.

The technology/business matu-

⁹ Michael Stroud, *Invisible, Inc.*, Business 2.0, April 2000

rity approach to the selection and effective use of valuation methods provides a simple way to choose the best and most cost-effective method to compute IP asset value. Using the technology/business maturity as the determinant allows licensing professionals to quickly and efficiently select the most appropriate method to use for each case at hand. The licensing professional can also use this segmentation to determine which consulting organizations might best help with any particular valuation challenge.

Knowing which valuation method to use and which consultants or service companies are most familiar with each method can bring common understanding and resources to the licensing process, greatly speeding internal decision processes.

Getting people on the same wavelength is the key to success in licensing. Agreement and understanding in selecting the appropriate valuation methods up-front speeds and increases the success rate of licensing processes.

Valuing Intangibles? Consider the Technology Factor Method

SAM KHOURY, PH.D. *



IRS Revenue Ruling 68-609, also known as the “formula method” or “excess earnings method,” is believed by many to be the IRS’s preferred method of determining the fair market value of intangible assets¹. The appeal of the IRS 68-609 formula is its precise and entirely quantifiable approach.

A fundamental axiom of business, though, is that for every complex problem there is a solution that is simple, straightforward and wrong. The formula method can yield an answer precise to the second decimal place, but the underlying assumptions of the method are rarely met. For example, a start-up biotech company could invent a cure for cancer that tastes like chocolate and costs a nickel, but without a track record of earnings, the formula method would value this intangible asset at zero, or less than zero.

In the R&D and dotcom marketplace, many businesses with no history of earnings can be fervently sought acquisitions. And emerging technologies are frequently bartered and sold within the business community before the first product is released. The IRS itself acknowledges the limitation of 68-609 with the warning that, “...the formula approach may be used for determining the fair market value of intangible assets of a business *only if there is no better basis therefor available.*”

So what is a sound basis for determining fair market value? The technology factor (TF) method is

gaining ground in the valuation of intangible assets. This article explains the underlying assumptions of the older formula method and how the flexibility of the TF approach adapts it to situations where the formula method will fail. It also describes how individual expertise and group consensus contribute to the technology factor, and how this valuation task force can then provide momentum for carrying forward a business decision.

EVERY PROBLEM ISN'T A NAIL

All assets can be classified as either tangible or intangible, and the formula method exploits this principle. It values intangible assets by subtracting the return on tangible assets from the value of the total enterprise, to arrive by inference at the value of only the intangibles. The formula method was conceived during Prohibition, to compensate U.S. distilleries for lost income. To offer a simple example of the formula method, assume a distillery’s tangible assets (cash, plant and equipment) with the following valuation and earnings:

Value of Tangible Assets	\$1,000,000
Prevailing Industry Rate of Return	x 12 %
<hr/>	
Annual Earning Attributable To Tangible Assets	\$120,000

Now assume this distillery has average annual earnings not of \$120,000, which is to be expected

by industry standards, but of \$250,000. The difference between the \$250,000 and the \$120,000—\$130,000 in annual income—is called the “excess earnings.” These excess earnings can then be attributed to the intangible value of the product, perhaps in recognition of strong brand loyalty, a unique formula or a special aging process. This \$130,000 in excess earnings is then recapitalized at 12 percent to arrive at the intangible value of the product. In our example, this intangible value (also sometimes called “goodwill”) would be \$1,083,333, calculated by dividing \$130,000 by 12 percent. A fair market value for the distillery is thus determined. The total value of the distillery would be \$2.083 million: \$1 million for its tangible assets, and \$1.083 million for its brand name and goodwill.

But there is a saying, “when the only tool you have is a hammer, every problem looks like a nail.” The formula method is an effective valuation tool in situations where a product has an established history of earnings in a stable industry and has anticipated earnings consistent with past performance. But these caveats of past history and future earnings predictability, which were less of a concern in an industrial economy, assume crucial importance in the information age.

What is the value of a pharmaceutical that has earned \$2 million

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¹ <http://www.equityvaluations.com/pubs/revenueruling68-609.html>

annually for a decade, when its patent is due to expire in three years? Clearly, its value would be closer to \$6 million (\$2 MM per year for three years) rather than a recapitalization of \$2 million in annual earnings at 12 percent. Recapitalization based on past earnings would produce a precise but fallacious valuation of \$16.7 million (\$2 MM divided by 12%). As another example, what is the value of the human genome project, which has no track record of earnings after a decade of investment costing \$3 billion? The benefits of this intangible asset are so large, complex and far-reaching they are perhaps beyond calculation—but they would still be valued at zero by the formula method.

In general, companies commercially apply less than 20 percent of the technologies created by their R&D departments. So more than 80 percent of patented technologies have no real business plan. Licensing executives, venture capitalists, the IRS, or the SEC would have difficulty using the formula approach to assign value to these patented technologies.

For most new technologies, or new applications of existing technologies, or businesses that have failed because they have not yet found their market, a value can be found. However, the appropriate valuation method isn't the old, reliable hammer of the formula approach.

A TOOLKIT, NOT ONE TOOL

In general terms, all valuation methods are based on either cost, income or market information. The cost approach has the most limited applicability, since the value of an intangible property is rarely related to its cost of development. Under the cost method, the value of penicillin might be estimated at the cost of the wasted culture dish, accidentally contaminated by *Penicillium*

notatum in 1928 at St. Mary's Hospital in London. Like the formula method, the cost method can provide a very precise answer, which can also be quite wrong.

The most widely used valuation approach is the income method, which applies a discount factor to future anticipated revenues from a product. This discount factor may include global economic risk, country risk, industry risk, company risk and technology risk. The formula approach of IRS Revenue Ruling 68-609 is a very simple income method, based on a future projection of past earnings. However, there is no adjustment to the net present value (NPV) of expected cash flows in Ruling 68-609, other than a discount to reflect an expected rate of return such as 12 percent. This discount rate is used in the capitalization of the calculated excess earnings.

The market approach, unlike any version of the income method, can be considered a "valuation by proxy." The market approach considers technologies that are identical or similar to the intangible asset being valued. The difficulty of this approach is in finding an identical (or perhaps a similar) technology when none may even exist. Assuming a similar technology does exist, a second hurdle is gaining financial details, which may be private corporate data and unobtainable.

The technology factor² is a hybrid of the market and income methods and it minimizes their weaknesses by drawing on both market data and income data. The TF approach seeks the most specific market and income information available and places this information in a reasoned context. Information is considered within the framework of a specific company, a specific business and the current competitive

² Patrick H. Sullivan, *Profiting From Intellectual Capital*, John Wiley & Sons, Inc. pp 335-356, 1998

marketplace by using experts both inside and outside your organization. The TF method is best when it is considered a toolkit, rather than a specific tool. Or perhaps even better, consider it a single tool with a variety of features, like a Swiss army knife.

The TF method employs a consistent methodology from business to business. Also, the methodology is consistent for various stages of technology development, from novel technology to established global enterprises. It can be applied equally well to a single technology or product, or to a portfolio of products. The flexibility of the method allows one to consider a myriad of alternatives, such as the value of a technology to a company other than one's own, the value of a technology with no track record of performance, the value of an intangible asset near the end of its useful life or the value of a new application for an old technology. These situations, rather than being uncommon, are situations that typically prompt a need for valuation.

UTILITY AND COMPETITIVE ADVANTAGE

Valuation with the TF method can be presented as a simple formula: Value of Intangible = Technology Factor x Incremental Business NPV. NPV is the net present value of the income from products or processes that are directly tied to the technology being evaluated. This NPV is a preliminary figure, a cash flow that has only been discounted based on an expected rate of return, such as 12 percent. It has not yet been discounted by the technology factor to reflect a specific business situation and competitive environment.

The technology factor is always less than 100 percent and it is developed by considering all of the attributes of a technology that affect its potential for creating

value. What are these attributes? They fall into two categories: utility issues and competitive advantage issues. Utility issues include the technology's usefulness to your company, its usefulness to others, the capital required for implementation, the time required for implementation and the expected useful life of the technology. Competitive advantage issues include the differentiation of the technology, any available alternative technologies, legal strengths (such as the defensibility of a patent), the anticipated response from competitors, the teaching value of the patent and the owner's right to use the technology.

As shown in Exhibit 1, individuals from a variety of internal departments can best judge the impact of a specific competitive advantage issue or utility issue. These staff members, along with outside consultants and perhaps even representatives of a company negotiating a purchase of the technology, form the valuation task force. For each competitive advantage or utility issue identified, these individuals will determine whether the opportunities and concerns: add value (+), destroy value (-), or have no impact (0). An example chart is shown in Exhibit 2. It is important to note that a single issue that destroys value could outweigh all the other positive issues that create value. Through professional judgement, all issues, both positive and negative, are accumulated by individual opinion and group consensus into a single technology factor percentage.

FACTS AND EXPERTISE

The TF process is represented schematically in Exhibit 3. The technology factor is a detailed and systematic assessment of a technology and its potential role in a business, with a resulting figure that can be used in negotiating a purchase or a sale, a valuation for the

EXHIBIT 1: FUNCTION/ CONTRIBUTION CHART	
Function	Contribution
Business	Strategic fit of technology with long-term business plan
Attorney	Defines the exact boundaries of the protected intellectual property
R&D	Competitive R&D and its impact on the obsolescence of the technology being evaluated
Manufacturing	Scale-up hurdles and competitive manufacturing processes
Marketing	Product attributes, market applications, and competitive response
Business Analyst	Economic impact (profit/loss of market share of price). Calculates the incremental cash flow and the NPV of the products relevant to the technology
Technology Appraiser (if different from analyst)	Facilitates the generation of the technology factor and determines the value of the technology

EXHIBIT 2: EXAMPLE OF UTILITY AND COMPETITIVE ATTRIBUTES

Wt.	Utility Attributes	-2	-1	0	+1	+2
1	Usefulness to the Joint Ventures					X
2	Stage of the Technology				X	
1	Continued Research Support			X		
1	Acceptance in the Market		X			
2	Customer Willingness to Pay	X				
1	Marketing Effort Required		X			
1	Remaining Life of the Technology				X	
1	Time Required for Implementation					X
1	Capital Required for Implementation			X		

Wt.	Competitive Attributes	-2	-1	0	+1	+2
1	Alternative Technology		X			
2	Legal Strength				X	
1	Differentiation			X		
1	Strategic Positioning				X	
2	Anticipated Competitive Response	X				
1	Costs of Complementary Assets		X			
1	Displacement Potential				X	
1	Complexity of the Technology				X	

IRS, or in making an investment decision. The quality of the TF valuation is highly dependent on the quality of the assumptions and data. The greater the extent to which actual—rather than assumed or hypothetical—data is available, the more certain and supportable the inferences and the more accurate

and realistic the calculated value. The composition of the team and the expertise of the individuals are likewise crucial to the accuracy of the valuation.

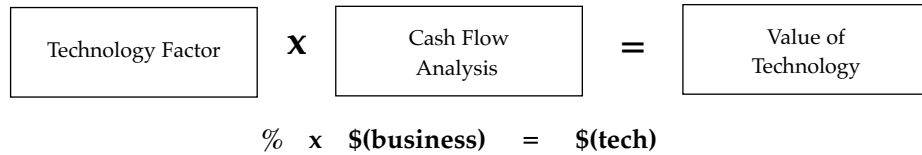
In addition to a quantitative numerical result, one of the benefits of TF method is the achievement of a consensus. This consensus can add

EXHIBIT 3: VALUATION PROCESS

Patent Summary (Claims)
(Legal Strength)

Technology Summary
(Impact of Technology)

Business Summary
(Economic Impact)



its own value, by accelerating speed-to-market momentum or by smoothing a purchase negotiation. The valuation task force can form the core of an implementation task force, with a personal relationship between departments and lines of communication and reporting already in place.

The American Society of Appraisers and outside consultants recommend that any valuation of a technology be done using more than one method. A second valuation approach, in addition to the TF method, will help establish and validate a price range

KNOW YOUR ASSUMPTIONS

Albert Einstein said, "Every problem should be made as simple as it can be, but not more so." The formula method and several other popular approaches often fail by making the valuation problem simpler than it is. Capitalization of excess earnings is appropriate only when a business growth rate is constant and the intangible assets go on into perpetuity. But we know that intellectual properties such as patents, trade secrets, know-how and copyrights have a limited legal life and perhaps even a shorter business life. And we know that any value achieved is only created in a specific business setting and in spite of competitive adversity.

The TF approach accepts the inherent complexities of valuing intellectual assets, deconstructs the problem into manageable issues and brings individual expertise to bear on each issue. This consider-

able professional expertise and the source data it employs are then reassembled into a single percentage, called the technology factor.

What is the first rule in valuing intangible assets? Understand your assumptions. Then, with these assumptions understood, know what situations lend themselves to a particular methodology. Also note the difference between facts that can be used as-is and facts that need to be qualified or interpreted. This will allow you to flag scenarios where the formula approach is clearly wrong, as well as identify how the TF method may apply.

Although elements of the TF approach (such as identifying discount factors for organizational fit and competitive environment) are subjective, it has emerged as one of the most accurate means for obtaining quantitative results from qualitative insights. This is especially true when valuations are required of individual assets using limited data. After 10 years of empirical validation, with follow-up studies performed to compare actual with projected results, what is the strongest argument for the TF approach? It works.

CONCLUSION

In conclusion, I would like to clarify the issues outlined above by differentiating the value of all intangibles to a business from the valuation of a specific technology. In determining the current market value of the total business, including the intangibles, then the for-

mula method could give an indication of the intangible value (assuming the business will maintain the same effort of research and advertising budgets to maintain its continuous contribution to the business into perpetuity). This statement indicates that any portion of an intangible bundle could lose its value, but the business will be able to generate new technology of similar or higher value. That might be a logical assumption in valuing a business, but it is not meaningful for the licensing executive who would like to license an individual technology. If an appraiser is valuing a technology protected by a patent or trade secret, then the formula method is inaccurate, and the TF method should be considered because it is designed to isolate the value of the technology from the business value and measure the risk associated with that unique patent. The analysis covers the life of the technology and does not overestimate the value of the technology by calculating its value into perpetuity. This analysis reflects real market analysis situations because the fact is that technology protection is a timed event and new innovations render many existing technologies obsolete, yet a business could continue well after the expiration of the any specific patent.

Valuing Intellectual Property: The Art, the Science and the Meaning of the Mean

DR. ALEX ARROW AND
DR. NIR KOSSOVSKY*



Determining the present value of intellectual property rights to a future technology or product is a daunting task to some and a source of livelihood for others. Licensing executives and their advisors disagree on the standard and most straightforward method to perform such calculations. A conversation overheard between three IP valuation players is indicative of the most recent thinking on this subject. Any similarities to actual people or institutions, past or present, are purely coincidental.

Edgar Jones, a veteran consultant for IP Valuations, LLP, a leading intellectual property consultancy specializing in litigation support services, was relaxing at a bar after finishing a long day of highly quantitative testifying and had just ordered a Knob Creek, “neat,” when the discussion between the two executives to his left caught his attention.

“Value is that which a willing buyer and seller have agreed upon as the basis for the exchange of money and intellectual property rights,” declared a man wearing a blue banker’s pinstripe suit.

“Yes, of course, that would be market value,” replied his female colleague in a British accent. “But with intellectual property, how often is value established through this market mechanism of yours?”

Jones, whose previous seven

hours were comprised of a grueling cross-examination, was responding quickly to the alcohol in the Knob Creek. “No more than 5 percent,” he volunteered, uninvited.

“How’s that?” asked the man.

“I’ve done some modeling in the past,” Jones continued to his two new conversation buddies, “and I estimate that the present value of the worldwide pool of useful intellectual property—and I refer mostly to patents, which is my area of expertise—is approximately \$5 trillion. Licensing and assignment revenue comprises no more than \$200 billion. That probably includes derivatives such as some of the more recent securitizations. In practice, therefore, we have to rely on expert appraisals of value for most intellectual property.”

“It seems to me you could extrapolate from the 4 percent you observe to derive market values for the remaining 96 percent,” said the man. “Statistically speaking, \$200 billion is a reasonable sampling.”

“In my opinion,” expert witness Jones pronounced, “the method of comparables is difficult to apply in practice because intellectual property is, by definition, unique. This uniqueness challenges the basic premise of the comparables technique—that the previous transaction and the present one are, in fact, comparable! The specific conditions under which the previous transaction occurred may have influenced the settlement price, and the background market conditions were most likely different.”

“Would you agree that value is market-sensitive?” asked the woman, intrigued by the opportunity to learn from someone other than her usual conversation companion.

“Yes.”

“Yet you suggest that ‘the specific conditions under which a previous transaction occurred’—the conditions of what one might call a market-based transaction—make it not a useful proxy. Is this not a contradiction?”

“Not at all,” replied Jones confidently. “The previous transaction is a singular event. Such an event may or may not be a ‘market event’ in the way your colleague described earlier. When I say ‘market conditions,’ I refer to broad economic indicators such as the performances of the global stock markets or interest rates. Broad public market data would be the ideal proxy, but, of course, are simply not practical to apply to intellectual property.”

The man, silent for the last minute, now turned fully to face Jones. “I am confused. You agree with me that transactional precedents would be ideal indicators of value, but you conclude that IP transactions of the past are inappropriate to be used as proxies. You propose that because each one is

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unique they are not sufficiently liquid to yield useful data; you agree with my colleague that market data would be an ideal indicator of value, but you conclude that you have no practical way to use those data. Are you advocating a subjective alternative?"

"Not at all. Subjectivity is a necessary impurity, of course, but any valuation authority must strive for objectivity at all times. Stochastic methods, to be exact, are the most objective method available today."

"Stochastic?"

"Probabilistic. Chance. Monte Carlo." Jones could sense from the confused look on the man's face that he would need to provide an explanation.

Patiently, Jones began, "The most commonly used valuation model is?"

"Discounted cash flows," replied the man.

"And the biggest problem with discounted cash flows?"

"The future cash flows of a piece of raw, undeveloped technology are uncertain," stated the man, conclusively.

"Exactly. But we know from past experience that with similar products arising from a previous intellectual property asset providing similar public benefits, the public is willing to pay a certain price—within limits. And the size of the public, or that portion of the public that purchased the previous similar products, is roughly the same," Jones went on. "We can therefore establish a mean estimate of cash flows and statistically model the range of cash flows that might be expected. We then use objective statistical modeling—effectively, a computer-simulated role of the dice—to generate an unbiased distribution of present values. Using further statistical tools, we then select the mean, or expected value, as the most reasonable estimate of present value."

The man was notably impressed.

"Yes, I can see how software simulations using a die roll to select an outcome from a statistical distribution removes much subjectivity. How do you set the boundary conditions for the die roll?"

"Observable data only," said Jones, pleased that his listeners clearly appreciated the objectivity of Jones' Monte Carlo methodology. "We look back over time, and see what cash flows have been associated with comparable technologies. We adjust for some of the differences between these previous technologies and the one we are valuing, of course, but as the public is basically paying for benefits, the cash flows can be reasonably expected to be similar in both distribution and mean value."

"I see how these many observations provide you with data that are more 'market-like,'" said the woman. "But as these dice-generated data are centered around historical, previous technologies, which are presumably susceptible to—how did you put it—'the specific conditions under which a previous transaction occurred', do they not suffer from what you argued was a lack of sensitivity to current market conditions?"

"A minor impurity," quipped Jones. The Monte Carlo method captures market activity by virtue of the range of values upon which the calculations are based. The fact that the data are not up-to-the-moment yields a small but acceptable error. If you were asking me what would be the ideal, it would be up-to-the-moment market data, of course. But I don't think such a thing is practical."

"Going back to your historical observations," said the man, "how does that differ from the 'comparables' that you argued were inappropriate?"

"There is a significant difference. The 'comparables,' as you say, were few in number. By contrast, the cash flow payments generated by

the Monte Carlo method represent a great many events. The increase in number corrects for idiosyncrasies that would be prominent in a small sampling."

"But are not the cash flows generated by each roll of the dice based on proxies—historical transaction proxies, that is—for the IP under consideration?" queried the woman. By now, both listeners were thoroughly engrossed in the unplanned lesson they were receiving from Jones.

"Another minor impurity," replied Jones. "The reality is that proxies are necessary evils. The art in valuation is in identifying appropriate proxies. The science of valuation is in using objective, repeatable, transparent methodologies. The objectivity and transparency of the Monte Carlo method is an obvious strength."

"It's been many years since I studied statistics," said the man. "I don't quite understand how this works. I understand how you set the boundary conditions for your die-roll-based estimates of future cash flows, but how many times do you roll the dice? For instance, if you rolled the dice once, you might get an extremely high or extremely low number. Would you accept that as your expected future cash flow? And if you rolled the dice twice, you might get one extreme and one fairly average value. Would you average the two?"

"As I said," replied Jones enjoying an opportunity to educate, "the method is objective. And being computer-based, repeat cycles represent no additional labor. Therefore, you run the simulation at least 30 times for statistical accuracy. In fact, with today's computational power, I often run it 300,000 times to achieve the greatest statistical significance." A bartender approached the trio looking to sell more drinks but was waved away by all three participants.

"Is it not true that the more frequently you run the model, the

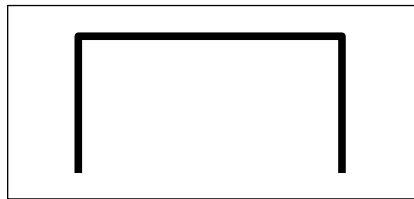
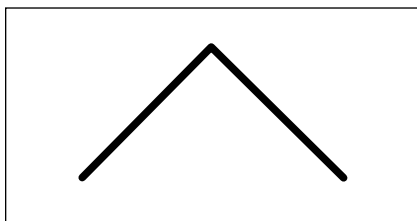
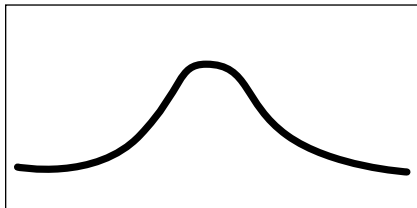
more likely the result will turn out equal to the mean value of the cash flows you defined when you set the boundary conditions based on your proxies?" asked the woman.

"Yes, of course," Jones replied.

"So therefore, is it not true that this model is both influenced by the cash flows you observed (and adjusted) from the previous technologies (the comparables), as well as the implicit assumption that the potential future cash flows for the current technology are normally distributed?" she queried.

"Yes to the first, but not to the latter," said Jones triumphantly, as he was starting to get concerned that the woman might be getting the better of him. "The software allows the user to define the shape of the curve. A normal distribution for future cash flows is just one of many distributions one can select when using the Monte Carlo method."

Conveniently, the filmy mess from spilt drinks on the bar counter-top allowed Jones room to trace out three curves of various shapes with his index finger. He used this makeshift chalkboard and drew the shapes carefully, as the man and the woman watched. Jones then pointed to each shape as examples of different distributions of future cash flows that could be used as inputs into a Monte Carlo simulation.



"Does this curve-picking process not adversely impact the objectivity we all seek as the ideal?" continued the woman. "In other words, if you pick one of these curves and tell the computer running your dice-rolling that the results should be distributed as such, aren't you inserting your own subjectivity into the simulation, since you are the one picking the curve?"

"An impurity," of course. "But the reality is that potential outcomes are often normally distributed and it is the goal of the valuation process to approximate reality," Jones concluded. For this reason, I often pick the first curve, the normal distribution, when creating the inputs to run a Monte Carlo simulation.

"I do remember one thing from my statistics course," the man interjected, "—that the normal distribution is symmetric and it extends infinitely in both directions."

"To be sure," agreed Jones. He pointed to the first of the three figures again. "I've tried to draw it symmetrically, and I've made the two tails extend very far in either direction." He pointed to the two ends. It was generally understood by the three of them that while the bar space allowed Jones to draw a fairly accurate representation of the normal curve, it did not allow him to make the two sides infinitely long.

"Yes, but does the range of potential future cash flows from a new technology run infinitely in both directions?" asked the man. "I mean, certainly, the potential is infinitely high—there's no telling how high future revenues could

be—but how could the potential run infinitely low? Cash flow cannot be less than zero. Put another way, your return on investment in new technology will never be less than negative 100 percent—a complete flop. The normal distribution is quite different from the reality in this way."

"Well, yes," admitted Jones, "but other than for that it's a pretty good approximation."

"Furthermore," now the man seemed to be working up momentum, "are future outcomes for new technologies symmetric about a mean? It would seem to me that they are not. Most technologies turn out to be nearly worthless, and a few of them are very valuable, right?"

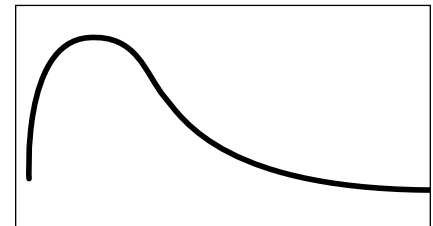
"Right," agreed Jones.

"So how is that symmetric?"

"Well.."

"Perhaps a better curve to model IP returns would look like this." Now it was the man's turn to push his finger along the countertop and draw a curve.

"This is a log-normal distribu-



tion," commented the man. "It reflects the fact that most technologies will turn out to have low values, a few of them will have very high values, and none of them will be worth less than zero. If we are talking about approximating reality, standards and objectivity, wouldn't a log-normal curve be the one to use?"

"An interesting point," conceded Jones. "I suppose a mathematical system using log-normal value distributions of observed data would increase objectivity."

"I think this has been helpful,

Mr..."

"Jones, Edgar Jones. IP Valuations, LLP," he offered, extending his business card.

"Thank you, Edgar. Jeremiah Bolton here," said the man. As the trio began their first actual introductions, they noticed that a small crowd had gathered around them at the bar, spectators of the heated discussion. "I'm the CFO of Large Bank out of Richmond. As I was saying, I think this has been helpful, but I want to recap. Recapping helps me remember things. If I heard you right, you believe that in the ideal, market-driven, up-to-the-moment data of artfully selected proxies of value distributed in a log-normal distribution and subjected to a Monte Carlo simulation of at least 30 cycles would yield a reasonable indication of value for IP?"

"That seems right, Jeremiah," answered Jones a bit bowled over by the banker's command of the subject.

"What about the discount rate?" Jeremiah continued. "If each roll of the dice is followed by a discounted cash flow calculation to obtain a present value, you need to tell the computer what discount rate to use. You don't do Monte Carlo simulations for that too, do you?"

"I don't think that would make sense," replied Jones. "Estimating risk through a probability function would be hard to justify. There are industry standard discount rates, or course, for different technology areas, and again, there is the art of valuation here. Many people take pride in picking the right discount rate for each assignment, and I am one of them."

"Edgar, my name is Amelia," said the woman. "What you say about discount rates intrigues me as well. In view of your other opinions, would not an observed market-driven measure of risk, adjusted up-to-the-moment, be the

ideal way to set the discount rate?"

"Yes, of course. But again, there is no practical way to measure this."

"So that I'm still on the same page with you two," said Jeremiah, "I'm hearing that you believe that in the absence of an actual transaction and price discovery, the ideal indication of value for an undeveloped intellectual property asset would be:

- an objective software-driven calculation, using
- artfully chosen, market-driven, up-to-the-minute proxies of technology value based on cash flows,
- distributed in a log-normal manner and discounted by
- observed market-based, up-to-the-minute estimators of risk."

Jeremiah counted off the points on his fingers to keep track of them.

"In the ideal, that's about right," replied Jones. "But in the absence of up-to-the minute market values, the discounted cash flow method incorporating Monte Carlo simulations is the most sophisticated solution available today."

"If you are looking for up-to-the-minute proxies of cash flow, it seems to me you would turn to what we all agreed is the most liquid market—the stock market," concluded Jeremiah. "Aren't data from the stock market more like the ideal cash flow proxy than cash flows from previous IP transactions, which you told us suffer as inputs to your Monte Carlo process because they are old, few in number and, of course, the result of 'the specific conditions under which a previous transaction occurred?'"

"Yes, but a stock price is not a proxy for technology cash flow," responded Jones. "And you would need a corresponding measure of risk." The eyes of the spectators darted back and forth between Edgar Jones and Jeremiah Bolton as if they were tracking the tennis ball in a Wimbledon match.

"But in a small company whose product pipeline is entirely in one specific niche field—a "pure play" company—enterprise value is an accepted proxy of technology value, and of course, market 'beta' is a financial standard," replied Jeremiah. "Remember that in a small company with minimal revenue, minimal history and a product pipeline that is specific to a single niche area, enterprise value—that is, market cap minus book value—is an excellent proxy for the value of a the average product in a specific niche area. It is an estimate determined by the collective wisdom of the world's markets. And it is updated every day, for every niche area. Beta is really a no-brainer, financially. It is a measure of risk based on actual, observed behavior, which would seem more reasonable than even the most artfully chosen discount rate."

"This is interesting from a theoretical perspective, of course," noted Jones. The alternative method you've hinted at, Jeremiah, sounds like an adaptation of the Black-Scholes options pricing model and I can see some merit in using financial market data. I'm bringing up the Black-Scholes formula because it is the result of deducing the present value of a right to an asset with highly uncertain future returns that are log-normally distributed. In fact, that's the way you derive the formula—from the log-normal distribution and the right to invest capital to obtain the underlying asset." Jones was extremely pleased with himself for remembering this derivation, and so, too, were a couple of the bar spectators.

"Ironically," Jones continued as if in an epiphany, "a patent is, financially speaking, a call option on the underlying technology to which its owner has rights. So there is, if you will, an innate attractiveness to the formula. But..." Jones stopped. "I

don't even know why I'm talking about this because the simple fact is that creating a system to calculate up-to-the-minute data for cash flow proxy value and risk is technically impossible today. Otherwise, you can be sure my colleagues at IP Valuations would have already done so."

"Interesting," said the woman. "Jeremiah and I must be off." As the trio broke up, the barroom conversation returned to more prototypical repartee. And the bar countertop ceased being used as a makeshift chalkboard, allowing the bartender to sell more drinks.

Overview of the Legal Treatment of Licenses and Technology Agreements in Brazil

LUIZ HENRIQUE DO
AMARAL *



In recent years, Brazil has experienced a series of changes and improvements in the laws and regulations concerning licensing and transfer of technology. Since the revocation of Normative Act 15 of 1975 by the Brazilian Patent and Trademark Office (BPTO) in the early '90s, there has been considerable relaxation of the rules and practices governing the examination and approval of licenses and know-how agreements.

However, Brazil continues to adopt the centralized exchange control regulation as far as the transfer of funds for trademark and patent licenses and transfer of technology agreements are concerned. Therefore, the recordation of the agreements with the BPTO and subsequent registration thereof with the Brazilian Central Bank continue to be required for remittance of payments abroad.

The new patent and trademark law that came into effect in Brazil as of May 15, 1997, eliminated all restriction on royalty-bearing trademark or patent licensing and has substantially reduced the discretionary powers of the BPTO to interfere with the conditions and terms of the transactions.

However, under the excuse of regulating the provision of the statute, the BPTO issued on May 15, 1997, Normative Ordinance 135 which, deviating substantially from the liberalization prescribed by the law, raised a number of questions as to whether the BPTO actually would follow more flexible rules for examination and approval of licenses and transfer of

technology agreements.

This Normative Act begins by establishing that the BPTO will approve the agreements taking into account the exchange control regulations, fiscal regulations, anti-trust and competition laws, the principles of defense of consumer, the franchise offering law and so forth.

The ordinance is rather laconic and simply states that the BPTO will record agreements concerning trademark or patent licenses, technical services, transfer of technology and franchises. The automatic approval if the BPTO fails to decide on the recordal within 30 days, which is in the new law, is not even mentioned in the ordinance.

The act expressly revokes the prior cost-sharing agreement and franchise acts that have proven to be very flexible and advantageous regulations.

From the requirements issued, one can easily perceive that license of unpatented know-how—as opposed to sale thereof—will not be admissible. Therefore, the actual implementation of the law seems to have deviated from the general principle set forth in the law. In fact, the BPTO continues to exercise a careful and detailed examination of the agreements applying rather restrictive interpretations of the laws.

TECHNOLOGY AGREEMENTS

Under the Normative Act 135, the BPTO has jurisdiction to review and approve the following agreements that are broadly defined as

technology agreements:

1. Acquisition of unpatented know-how
2. Patent or industrial design license
3. Trademark license
4. Franchise
5. Technical assistance services

RECORDAL OF CONTRACTS

The prior recordation of licenses and technology agreements with the BPTO is required for three specific purposes:

- to produce effect against third parties, thereby ensuring the licensee's exclusive rights in Brazil (if the agreement grants the exclusive license) and enabling the licensee to defend the involved marks and patents or to join the licensor in disputes involving the industrial property rights;
- to allow the payment and remittance of royalties overseas, relating to the licensing of industrial property rights and know-how; and
- to permit the local licensee to obtain the fiscal deduction of remitted values, as foreseen by Ministerial Ordinance No. 436/58.

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FISCAL DEDUCTION AND TAXATION

The payment of royalties by the local licensee or recipient of know-how is deductible provided that the agreement is recorded with the BPTO and that the ceiling for deductibility is observed. In fact, Law 4,131 of 1961 established that the payment for licenses and know-how are deductible by the local party to the extent that it does exceed altogether the limit of 5 percent of net sales of the licensed products.

Furthermore, the law sets forth that the fiscal authorities will set additional reduced ceilings based on the industrial segments involved. Ordinance 436 of 1958, still in force these days, lists the different segments and attributes a maximum ceiling for deduction for each industry, up to 5 percent.

For trademark licenses the limit is 1 percent of the net sales of the licensed product. For know-how and patent license the limit may vary from 1 percent up to 5 percent, depending on the area of activity.

No accumulation of ceilings for trademark with know-how or patent license is admissible.

As for taxation on the amounts to be paid, credited or remitted to a foreign entity, there is a 15 percent withholding tax levied upon the payments, which should in principle be paid by the foreign licensor or supplier. The fiscal burden may be contractually passed over to the local licensee.

In addition, a contribution on the economic domain of 10 percent of the amount to be paid, credited or remitted to a foreign entity has been introduced as of January 2001. Despite certain technical unconstitutionality, which may permit the judicial challenge of such tax, such taxation needs to be paid by the local entity before remittance. There is a credit of tax that may be applied to benefit the local party

and reduce the taxation in practice by 50 percent until 2003. The Financial Transaction Tax levied on remittance of royalties remains reduced to 0 percent.

LICENSE OF PATENTS AND INDUSTRIAL DESIGNS

Despite the flexibility foreseen in the 1996 legislation, certain conditions for the patents to generate remissible royalties stay in force. The most critical limitation in this connection requires that the titles have been regularly granted in Brazil for payments to be made overseas. In case of licenses during the pendency of the patent application, the payments may not be remitted abroad, but the licensor may be entitled to a credit for payments if the patent issues in the future.

The licensee may be invested by the patentee with all powers to act in defense of the patent. A license contract must be recorded at the BPTO to produce effect with regard to third parties. The recordal will produce effect with regard to third parties from the date of its publication. A license contract need not be recorded at the BPTO for it to have effect for validating proof of use, so that use by the licensee may inure to the patentee's benefit, regardless of recordal.

Any improvement to a licensed patent belongs to the person who made it, the other contracting party being guaranteed the right of preference with respect to a license.

LICENSE OF TRADEMARKS

The proprietor of a registration or the entity that has applied for a registration may enter into a license contract for use of the mark, without prejudice to his right to exercise effective control over the specifications, nature and quality of the respective products or services. Quality control is no longer an obli-

gation of the licensor but a contractual option.

The licensee may be invested by the registrant with full powers to act in defense of the mark, without prejudice to his own rights.

License contracts must be recorded at the BPTO in order to produce effect with respect to third parties. Recordals will produce effect with respect to third parties from the date of their publication. In order to validate proof of use, license contracts need not be recorded at the BPTO.

Royalties can only accrue as of the issuance of the registration of the marks and no payment will be credited or remitted for licensing in the pendency of the application.

TRANSFER OF KNOW-HOW

The policy of the BPTO is that unpatented technology (trade secrets and know-how) is not viewed as a proprietary right and, as a result, cannot truly be licensed to a Brazilian party. The agreement may be entitled a license agreement, but the BPTO makes sure to impose restrictions to characterize the agreements as sale or acquisition of technology. Thus, once transferred and duly paid, the technology shall be free for use by the recipient henceforth.

Therefore, transfer of unpatented technologies is viewed as outright acquisition of know-how and the periodic royalties, fees or other considerations receivable by the foreign supplier are, in essence, the purchase price. Based on this principle, the BPTO does not accept in the agreements covenants for return of know-how after expiration, perpetual confidentiality or discontinuance of use of know-how.

Thus, while it is generally possible to impose secrecy and restricted use of technology obligations on the Brazilian party applicable while the agreement is in force and up to

five years after expiration or termination, once the agreement expires or is terminated, the local party will be entitled to continue using the unpatented technology.

As a matter of policy, the BPTO does not approve contracts containing clauses prohibiting or restricting the Brazilian party's right to use or to disclose such technology after the contract comes to an end, nor does it approve clauses requiring the Brazilian recipient to return all documents and other physical property embodying such unpatented technology.

Based on a misinterpretation of the fiscal laws, the BPTO has taken the position that the recordal of the contracts may not exceed five years, so that even when the term of the contract exceeds the five years, the recordal will be limited to five years and renewals may be applied for to the extent that it is demonstrated to the examiner's satisfaction that there is justification for such extension of the recordal.

The BPTO considers that payments can only occur after the agreements have been filed for recordal, so that generally no retroactive payment will be admitted.

Exceptions to these policies are rarely made by the BPTO, although the agreements are presently dealt with on a case-by-case basis so that there are exemptions that may be exceptionally obtained depending on the details of the case and the benefits of the transaction to the Brazilian party.

PAYMENTS BETWEEN PARENT COMPANY AND SUBSIDIARY

In the case of agreements between independent companies without direct or indirect control, the examination by the BPTO, during the recordal proceedings, is based upon the assessment of the validity of the involved industrial property rights in Brazil as speci-

fied by Law No. 9279/96. There should be no limit as to the maximum royalty or payment acceptable. In this case, the BPTO should not question the price and the payment conditions under the agreement.

However, when the parties are parent and subsidiary or controlling and controlled companies, certain limitation as to the maximum royalty admissible apply.

Article 50 of Law 8,383 of 1991 sets forth that payments resulting from trademark or patent licensing or transfer of technology between the subsidiary and the parent company have become fiscally deductible and remissible in respect to agreements executed and recorded with BPTO from December 31, 1991, onwards.

Although the language in the law is not straightforward, the official interpretation has been that payment and remittance of royalties between subsidiaries or controlled companies and the parent company (not branches) should be admitted, as long as the technology has been introduced in Brazil after December 31, 1991, and the payments do not exceed the ceilings of fiscal deduction under Ordinance 436. Therefore, for a trademark license, the royalties cannot surpass 1 percent of the net sales price of the licensed products. For patents and know-how, the percentage allowed is based on the industrial segment involved but cannot overrun 5 percent of the net sale price or revenue of the products.

As regards payments, lump sums are, in principle, not permitted in agreements between a parent company and a local subsidiary. In fact, when the parties involved are controlling and controlled companies, the BPTO applies an extremely restrictive approach.

Nevertheless, when the technology is state-of-the-art, sophisticated and/or quite important for

the Brazilian economy, exceptions have been made. In any event, however, the BPTO will always insist that the lump-sum payments be treated as anticipation of royalties, so they must be deducted from the initial running royalties of the agreement. Also, the lump sum and the royalties together cannot exceed the maximum percentage fiscal deduction.

Furthermore, the BPTO views that, when the remuneration is already charged for patented or unpatented technology, the trademark license in relation to the same products has to be royalty-free, as the combination of the limits for know-how with trademark license cannot be accepted. In this sense, if the local party is already paying for the know-how, it is not permissible to add the fee for trademark license.

TERM AND RENEWAL

As far as know-how contracts are concerned, the BPTO limits the approval to a five-year period, regardless of the terms set by the parties in the contract, since Fiscal Law 4,131 only allows the deduction for five years.

At the end of this term, the parties need to apply for renewal and the BPTO reexamines whether to approve it for an additional five-year period.

However, the BPTO will not renew the agreement more than once, so that the maximum possible term of such agreements is 10 years for purposes of royalty payments to be made abroad in foreign currency.

In addition, it will not necessarily be easy to obtain approval by the BPTO of a five-year extension of an approved agreement. On the contrary, experience has shown that extension approval has been granted where the BPTO was convinced that the bulk of the technology or additional technology to be

transferred to the Brazilian party was yet to be accomplished, or that its application and implementation by the Brazilian party required continued assistance, know-how, etc. of the foreign party, or that completely new technology was to be supplied.

The parties seeking an extension should be sure to prepare and submit to the BPTO a detailed report setting forth the reasons why an extension should be granted. It should also be emphasized that a five-year extension is the maximum that the BPTO can grant.

BUNDLED AGREEMENT

The BPTO currently accepts bundled agreements combining patents, unpatented know-how, trade secrets and services, to the extent that the subject matters are clearly and separately defined and dealt with. Such exemption is narrowly applied and the likelihood of obtaining the recordal for bundled agreements will need to be addressed on a case-by-case basis.

COST SHARING AGREEMENT FOR RESEARCH AND DEVELOPMENT

The BPTO has revoked Normative Act No. 116/93 for the recordal of cost-sharing agreements.

Cost sharing was considered the co-financing of the cost for research and development (R & D) of new technologies. The BPTO will no longer record those agreements whereby the local party (recipient) will co-finance the costs of R & D by technology centers or companies (supplier) within the country or outside.

However, in special circumstances, the BPTO has been admitting similar contracts provided that they are presented as know-how agreements and relevant reasons for such format are consistently presented to the examiner's satisfaction.

FRANCHISE

Franchising is currently governed by two regulations in Brazil.

The first one is the Normative Act 135, which was designed to permit direct remittance of royalties from local franchisees to the foreign franchisors without need of other local subsidiaries or separate agreements.

Thus, international master or unit franchise agreements need to be recorded with the BPTO so that the franchisee may be able to pay the remuneration and royalties to the franchisor abroad. Indeed, in order to be officially recognized in Brazil, franchise agreements where one of the parties is a non-resident of Brazil shall only be enforceable after recordal.

In the past, due to the restrictive exchange control regulations, franchisors had to split the franchise agreement into several individual agreements (royalty-trademark license, service agreement, know-how agreement and so forth) and also set up local companies so as to be able to structure the business.

Currently, the legislation concerning the remittance of fees and royalties stemming out of master franchises is quite flexible.

According to this recordal practice, the agreement is admissible as long as the marks are filed in Brazil. There is no longer any requirement that the mark must be registered in Brazil under priority claim and during the first 10-year term. As long as the marks are already on file in Brazil, the parties are entitled to enter into the franchise agreement and record it with the proper Brazilian authorities.

Another requirement that franchisors must meet is that they must show evidence that they are franchisors in other jurisdictions. In the event Brazil is the first country where the franchise system is adopted, the BPTO will require evidence of a business format fran-

chise to allow recordation.

The second legislation is Law No. 8,955 of December 16, 1994, requiring that as of February 14, 1995, any prospective franchisees be presented a Franchise Offering Circular (FOC) 10 days before any agreement or payment.

Under the law, franchising is defined as the system by which a franchisor grants to a franchisee the right of trademark or patent use, associated with the right to exclusive or semi-exclusive distribution of products or services and, eventually, also the right of use of technology of implantation and administration of a business or operational system developed or retained by the franchisor against direct or indirect remuneration, however, without characterizing an employment relationship.

The FOC needs to be in clear and accessible terms and should contain the following information:

1. Background information on the franchisor and all companies directly linked to it;
2. Balance sheets and financial statements of the franchising enterprise relative to the last two fiscal years;
3. Precise indication of all litigation involving the franchisor, the controlling companies and trademarks, patents and copy rights owners relative to the operation and their subfranchisors challenging specifically the franchising system or those which may directly become a reason for the impossibility of functioning or franchising;
4. A detailed franchising description;
5. A profile of the "ideal franchisee;"
6. Requirements concerning the direct involvement of the franchisee in the operation and administration of the business;
7. The estimated total investment necessary, the initial fee royalties, publicity fees, insurance

TECHNICAL ASSISTANCE AGREEMENTS

- and other payments due to franchisor or to third parties linked to it;
8. A complete list of all franchisees, as well as of those who were terminated during the last twelve months;
 9. Territoriality considerations;
 10. Clear and detailed information on designated suppliers;
 11. An indication of what is effectively offered to the franchisee by the franchisor;
 12. Situation of the trademarks or patents, the use of which is being authorized by the franchisor;
 13. Situation of the franchisee after expiry of the franchising agreement regarding trade secrets and non-competition; and
 14. A copy of the agreement.

The Franchise Offering will be updated annually and should be delivered to the applicant at least 10 days before the signature of the franchise agreement or the payment of any kind of fees by the franchisee to the franchisor.

In the event of non-compliance with the provisions, the franchisee may argue the nullity of the agreement and require return of all amounts already paid to the franchisor or to third parties indicated by same, as initial fee and royalties, plus damages.

The franchise agreement must always be signed in the presence of two witnesses and shall be valid independently of being registered before a notary's office or a public agency.

For the purpose of recordation of the franchise agreement, the BPTO requires copies of the FOC or the acknowledgment of its receipt by the franchisee.

Technical assistance agreements are considered to be the rendering of specific engineering or technical services by technicians of a foreign company to a local one, be it locally or abroad. Remittances deriving therefrom may be effected on the basis of an umbrella agreement or specific invoices issued by the supplier. In cases where there will be a wide range of services, an umbrella agreement shall be required by the BPTO. The charges for the performance of the services must be a fixed amount based on the time spent for the service and the man-hour fee, to be detailed on a schedule or invoice based on a "time-sheet."

As presently defined by regulations, there are two sets of technical services that are treated substantially differently.

There are technical services with transfer of technology and technical services without transfer of technology. Those *with* transfer of technology are technical services directly related to the industrial or production area or where the local party is trained to render the services directly.

Those *without* transfer of technology are services relative to other areas not directly connected to industrialization or production, such as marketing, finance, distribution or commercialization, or when no training of a local technician takes place.

Prior recordal at the BPTO under Normative Act 135/97 and subsequent registration of the recordal certificate at the Central Bank are required for payments deriving from technical services involving technology transfer.

When this is the case, once the recordal and registration certificates are issued by the BPTO and the Central Bank (within 30 and 20 days, respectively) the local company will be allowed to start the remittances through a commercial bank using

the commercial exchange rate.

For technical services that do not imply know-how transfer, the transfer of funds to the parent company could be effected by directly presenting the agreement to the commercial bank without prior submission to the BPTO, and the remittance will occur under the provisions of Central Bank Ordinance 2.685/96 using the informal exchange rate.

In this instance, where the agreement is not recorded at the BPTO, Brazilian fiscal authorities may apply more stringent rules for fiscal deduction, such as proofs of the execution, demonstration of the necessity of the services, and assessment of fair market price of the service to allow fiscal deduction of the payments. This is, however, the most speedy manner in which to process remittances overseas.

In fact, the advantage of the recordal and registration at the BPTO is that such recordal and registration work as a guarantee as to the execution, necessity and fair market price of the agreement, ensuring the fiscal deduction of the amounts.

In case of doubt whether the services involve transfer of technology, the commercial bank will require submission of the agreement to the BPTO, which may issue a letter of exemption.

Recordation Formalities

Recordal with the BPTO must be decided within 30 days from filing of the contract. Before this time limit expires, the BPTO may issue office actions, which may defer any decision.

For filing, the agreement must bear signature by both sides along with two witnesses. The signatures collected abroad must be notarized and legalized by the Brazilian consulate. The local signature will need to be certified by a local notary. The agreement shall then

have to be translated into Portuguese. Furthermore, there are some forms and documents that will need to be completed by the local franchisee, licensee or purchaser for filing purposes.

The agreement can be entered into in the English language. In the case of bilingual agreements, one of the languages should be elected as the governing tongue.

An appeal may be filed against a decision rejecting the recordal of a license agreement.

There are some forms and documents that will need to be completed by the local franchisee for filing purposes.

The Central Bank usually registers the agreements electronically within approximately 10 days.

Preparing Patent Departments for the Intellectual Capital Era

LEX VAN WIJK *



Intellectual capital is likely to dominate everybody's professional life in the near future, since it is the new wave of interest in the business world. It is therefore prudent for in-house patent professionals to be aware of this development, especially since they will be among the first to be affected by it. The aim of this article is to explain why this will be the case and what can be done to prepare a patent department for this new era to come.

THE INTELLECTUAL CAPITAL CONCEPT

What is intellectual capital? In financial terms, it is the difference between the market value and the book value of a company; or, as some put it, it is the value of a company's intangible assets: that value of the company that is not found in its balance sheets, often referred to as "goodwill." If, however, intellectual capital is thought of as being the value of a company's intangible assets, it is important to note that this value is not just the sum of all the intangibles. It also includes the ability to transform the intangibles into financial gain. It is not without reason that intellectual capital is often referred to as "knowledge that can be converted into profits."¹

Nowadays, the intangible assets of a company often outdo its tangi-

¹ Patrick H Sullivan (1998). *Profiting from Intellectual Capital, Extracting Value from Innovation*, p. 5. New York: John Wiley & Sons, Inc.

ble assets, something that is reflected in the significant—and sometimes staggering—difference between the market and book value of a company.

However, since conventional accounting methods take only tangible assets into consideration, one can no longer rely on those methods alone for an accurate assessment of a company's total value. Therefore, new methods need to be developed to assess a company's intellectual capital in a useful, reliable and, therefore, acceptable manner. Reasons for the need for such methods have been well argued². However, methods that are widely accepted by all parties involved—investors, stock market governing bodies, and businesses themselves—are not yet available, let alone standardized methods.

A pioneer in this field has been Skandia, the Scandinavian insurance and finance company. In 1995, it was the first company to present a supplement on intellectual capital to its annual report³. Since then, Skandia's valuation has gone up considerably, one of the reasons being that investors believe in Skandia's ability to prosper from its intellectual capital in the future.

Measuring the value of a company's intangible assets and pro-

² Steven M H Wallman, "The Importance of Measuring Intangible Assets: Public Policy Implications". In *Capital for our Time, the Economic, Legal and Management Challenges of Intellectual Capital* edited by Nicholas Imperato. pp. 181-191. Stanford California: Hoover Institution Press.

³ Visualizing Intellectual Capital in Skandia. Supplement to Skandia's 1994 Annual Report. This and subsequent supplements (one every six months) are assessable via Internet. See www.skandia-afs.com/.

viding the related information to the financial world is just one way of creating a competitive advantage in the marketplace. Equally, if not more important, a reliable assessment of the value of the company's intangible assets enables the business to make better decisions in respect to these assets. For a company to be successful in the future, a committed effort will be required to ensure that value will be created for future commercialization and that as much value as possible will be extracted from a company's existing intangible assets.

MAJOR CHALLENGES: THE GOOD, AND THE POSSIBLE BAD NEWS

A major component of intellectual capital consists of intellectual assets, which include a company's codified competence, know-how, technology, databases, procedures and intellectual property rights, the latter of course including patents, which will be focused on in this article.

Since patent rights will become increasingly important to companies, patent professionals will be expected to provide a large contribution to the management of a company's intellectual assets to ensure that these rights will indeed provide a competitive advantage and add value to the company's bottom line. There are two major challenges that patent attorneys

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may have to face:

1) the measurement of the value of the company's patent portfolio in a reliable manner; and

2) the management of the patent portfolio with the view to creating value that can be leveraged in the future and to extract as much as possible value from the existing portfolio.

Some patent professionals may think that nothing will change in their work. Various reasons may apply. In some companies, for instance, intellectual asset management may already have been intrinsically present to some extent. Other patent professionals just may not believe in the concept of intellectual capital altogether.

For patent professionals belonging to the latter category and those who would not like to be involved in any change, there is bad news. Whether they like it or not, and despite some efforts to ridicule the concept⁴, intellectual asset management is here to stay.

The measurement of the value of patents as such is already a very complicated matter and so is the value extraction from one's patent portfolio. But that is not all. In addition, the relationship of patent professionals with their business colleagues is likely to change considerably.

DOW'S SUCCESS

Dow Chemical is one of the companies that are making an effort to manage its intellectual assets more effectively. In recent years, it pruned its patent portfolio considerably, thereby saving approximately \$40 million in patent maintenance costs over a 10-year period, while simultaneously increasing its licensing income from \$25 million in the mid-1990s to well over \$125 million currently⁵.

4 See note 2, Tim Draper, "Intellectual Capital Measurement for Start-ups: The Best of Intentions, the Worst of Outcomes", pp. 233-247.

5 See note 1, page 107.

Cynics will argue that Dow's patent department apparently did not have its act together for many years and that it was about time something was done about it. This is not likely to be the case. These cynics are advised to make an effort and find out what really has been established at Dow⁶ and to understand, for instance, what something called the technology factor method is all about⁷ It will be an eye-opener to them.

They will start to realize that intellectual asset management is not just a matter of pruning deadwood from a patent portfolio and making an extra licensing effort. Of course this helps, but there is much more to it. It involves a new way for patent professionals to look at their work, their relationships within the company and the competition. In order to be successful, a new culture will need to be established within a patent department, one with more emphasis on value creation and extraction.

CHANGING RELATIONSHIPS

Traditionally, patent professionals have considered the patent portfolio to be their "property." It is a matter exclusively dealt with and managed by patent professionals. Some are actually reluctant to share information about patents and related matters with their business colleagues, since they fear a situation may result where their colleagues themselves, and without proper consultation of the patent department, will decide on matters such as infringement and validity. Although that concern may be real, it is more likely to say something about a patent department's profile and the relationships and communication within a company than about anything else.

6 See note 1, Gordon Petrash, "Intellectual Asset Management at Dow Chemical", pp. 205-220.

7 See note 1, Sam Khoury, "Valuing Intellectual Properties", pp. 335-356; and pp. 87-90 of this Volume of *les Nouvelles*.

Patent rights and other intellectual property rights in general will become "shared" property within a company. Decisions regarding patent assets will be business decisions or, more accurately, informed business decisions reached in consultation with patent professionals—provided that patent professionals have positioned themselves to ensure that they give the most value possible to the company and that their contribution is recognized by the business. Otherwise, a situation could arise in which patent professionals would mainly be seen as draftsmen for patent applications.

It is also likely that business staff (including finance personnel and strategists) will want to take control of licensing activities, especially once these activities become increasingly successful and start to create considerable revenues for a company.

Without doubt, such developments could potentially be frustrating for patent professionals, because patents will become more important for their companies (and consequently their departments' profiles will rise), whereas at the same time, the work of patent professionals may become less interesting. This may especially apply to U.S. patent attorneys because they are traditionally more involved with licensing activities than their European colleagues. In view of changing relationships, a major and immediate challenge for patent departments will be to position themselves in such a way that they add maximum value to the business, while maintaining the level of job satisfaction within the department.

The good news is that a company like Dow has already proved to be up to it,⁸ so why should it not work for other companies and their

8 Conversation between the writer and Steve Grace, Dow Chemical's General Patent Counsel, during which it became clear that Dow's patent department's profile has risen, whilst at the same time work has become more interesting due to an increasing number of counseling and transactional activities.

patent professionals? But Dow is not the only successful company. Others like Du Pont, Xerox and Eastman Chemical, to name a few, are also making good progress, but then all these companies have the advantage that they are a member of the ICM Gathering.⁹

PREPARATION IS NEEDED

In order to prepare themselves, patent professionals should, of course, familiarize themselves with the concept of intellectual capital. This should not be too difficult since there is an abundance of excellent literature available these days.¹⁰ Additionally, they should start experimenting with the new insights that they will gain into this field, in order to find out what works for their companies and what doesn't.

It is further recommended that they look into and work on the following set of integrated preparation factors:

- vision,
- strategy,
- proactivity,
- transparency,
- flexibility and
- trust.

Of course, these factors can be considered to be self-evident, but then the problem with the self-evident is that it does not get the atten-

tion it deserves; it is taken for granted. It is believed that a committed effort to work on these preparation factors will provide patent professionals a new perspective and their patent departments the new culture needed to contribute to the future success of their companies.

The Preparation Factors

Vision. What is it that the patent department wishes to establish? What does it stand for? How does it fit within the company at present, and how will it fit within the company in the future? What role will it need to play to assist the company in establishing its business objectives? These are all very important questions, which are often easier to ask than to answer. Nonetheless, an effort should be made to answer these questions because it makes one understand the business context in which one has to work. An effective tool to use in such effort is the preparation of a mission statement, since it will focus the department's efforts and remind people what the role of their department is all about—what its objectives really are.

For a mission statement to be successful, all persons in the department should be actively involved in its development and all should buy into it once it has been established. To give an example, the mission statement of Burmah Castrol's patent department (before Burmah Castrol was taken over by BP Amoco last year) read as follows:

"Our aim is to be the automatic first contact for patent issues for all the Group Businesses by providing an expert, cost-effective, efficient and tailor-made patent service to each Business. This will ensure that the Businesses can take informed decisions regarding the protection and commercialization of their technologies and issues relating to Group owned patents and third party patents. In this way we will

add value by securing a competitive edge for the Group locally and globally."

Strategy. How can the patent department's objectives be established?

The first step is to look into each individual objective and to determine the fundamentals that are the key to success in establishing each objective or that are needed to move toward the realization of the objective in question. The resulting list of fundamentals will include a number of particular attitudes and abilities—for instance, proactivity and transparency—necessary for patent professionals and their departments to establish these objectives. In turn, these attitudes and abilities can, in practice, be manifested by activities.

The plan of action, the selected activities and the time to develop these activities will be the department's strategy to implement. To make the strategy work, everyone within the patent department needs to be committed to its implementation. One of the most important activities a patent department can develop is the establishment of a patent strategy for the company, or when applicable, for each individual strategic business unit within the company.¹¹

A patent strategy is a framework of decision-making processes and procedures that ensure that the patent activities of a business are consistent with both R&D and business strategy and its objectives. An appropriate patent strategy includes at least the following elements:

- education program
- confidentiality program
- monitoring patent activities of

¹¹ Although not a lot has been written on this subject, there exists some interesting literature. See for instance Stephen C. Glazier (1997), *Patent Strategies for Business*, Washington: LBI Law & Business Institute, for a useful discussion of patent strategies. See also, H. Jackson Knight (1996), *Patent Strategy for Researchers and Research Managers*. New York: John Wiley & Sons, Inc.

⁹ For more information on the ICM Gathering, see www.ICMGroup.com.

¹⁰ See notes 1, 2 and 3. Further examples, to name a few, include: Thomas A. Stewart (1999), *Intellectual Capital, the New Wealth of Organizations*. London: Nicholas Brealey Publishing; Johan Roos, Göran Roos, Nicola C. Dragonetti and Leif Edvinsson (1997), *Intellectual Capital, Navigating the New Business Landscape*. London: MacMillan Business; Karl Erik Sveiby (1997), *The New Organizational Wealth, Managing & Measuring Knowledge-based Assets*, San Francisco: Berrett-Koehler Publishers, Inc.; Leif Edvinsson and Michael Malone (1997), *Intellectual Capital, The Proven Way to Establish Your Company's Real Value by Measuring Its Hidden Brainpower*. London: Piatkus; Annie Brooking (1996), *Intellectual Capital, Core Asset for the Third Millennium Enterprise*, London: International Thomson Business Press.

third parties

- report of inventions
- review of inventions
- filing program
- enforcement function
- infringement of third party patents
- patent assets audits
- licensing
- due diligence

Proactivity. The role of a patent department traditionally has been a relatively reactive one. It is expected to take action in respect of a large number of requests or demands that are either dictated by the business or by national or regional patent authorities. In view of this and the increasing workload of patent departments in general, it is usually felt that there is no time left to do useful things on top of “daily work,” let alone to be genuinely proactive.

However, proactivity is one of the keys to a department’s future success because it can enable the department to make an effort in respect to things that really matter (i.e., add value to the business), but which are otherwise not addressed because of lack of time. These usually include the type of activities that would contribute to the realization of a patent department’s objectives.

Proactivity can be realized by improved time management¹² and more effective delegation.¹³

Activities that a proactive patent department could develop in order to establish its objectives could include:

- development of a patent strategy and its implementation;
- development of a program to

educate business and R&D personnel on patent matters;¹⁴

- development of a patent information database;¹⁵
- organization of annual patent assets audits;
- consideration of patent evaluation indices and measurement indicators;¹⁶ and
- transfer of best practices by benchmarking with other companies.

It is important to check with business management regarding whether these activities are aligned with their objectives before developing and implementing them—and to obtain their support. Additionally, each individual patent professional should be expected to have a proactive approach toward possible protection and commercialization of new technology.

Transparency. Businesses will need to have ready access to all sorts of patent information. Such

¹⁴ Business and R&D personnel should appreciate and understand what patents are, how they can be used to provide competitive advantage, and what the role of the patents department is within the company. It is therefore advisable to put an internal education program in place to bring all business and R&D personnel up to an acceptable base level of knowledge regarding patent rights and intellectual property rights in general. Such program could for instance be an integral part of the induction process for all new business and R&D personnel. Also a program of periodically reminder sessions for existing staff might prove useful.

¹⁵ A patents information database to which business and R&D personnel could have access may for instance include information on basic patent principles; list(s) of reported inventions; blank form to report electronically a new invention; patent portfolio survey(s); third party issues; patent awareness profiles. See note 1, Kelly Hale, *Creating the Portfolio Database*, pp.129-141, for a discussion on the development of a portfolio database. Interestingly, Hale seems to suggest that the development of such database should emanate from the business, not the patents department, since it may otherwise receive little support. This is not necessarily the case. In *Burmah Castrol* for instance the proactive approach to develop such a database has been successful.

¹⁶ See Leif Edvinsson and Michael Malone (1997), *Intellectual Capital, The Proven Way to Establish Your Company's Real Value by Measuring Its Hidden Brainpower*, pp. 80-85 and 177-188, London: Piatkus. See also note 2, Gordon P Petrush, “Intellectual Capital Accounting as a Management Tool”, pp. 202-208.

information will include the costs of every step in the patenting process, the costs to-date of a particular patent series and territorial coverage of a particular patent series.

In order to make this work, a patent department needs to be transparent to the business, and this can be realized by:

- having open lines of communication with the business;
- having a patent information database to which the business has access;
- informing the business about the department’s mission statement and its strategy;
- making sure the business knows the structure of the department;
- having clear decision-making processes in place that leave no doubt about responsibility and accountability;
- informing the business about the range of services the patent department can offer and the level of service it may expect to receive;
- explaining to the business its responsibilities towards the patent department; and
- developing a time-monitoring system that enables the business to understand the amounts of time spent on the various patent activities.

Flexibility. In times of continuous change, it seems quite obvious to expect a patent department to be flexible. But what does it mean in practice and what does it require?

It means that patent professionals need to learn how to adapt themselves successfully to change. This is important because many patent professionals’ work includes a lot of routine tasks—especially when one has been responsible for a particular part of the patent portfolio for a number of years. Any change of the role is therefore likely to be an unsettling experience.

¹² See Stephen R Covey (1992), *The Seven Habits of Highly Effective People*, London: Simon & Schuster Ltd., for effective time management teachings. See also Stephen R Covey, A Roger Merrill and Rebecca R Merrill (1994), *First Things First*, London: Simon & Schuster UK Ltd.

¹³ See David Oates (1993), *Leadership: The Art of Delegation*, London: Century Business, for a study of delegation in general.

Successful change can be realized by:¹⁷

- communicating the reasons for change, and pointing out opportunities;
- creating a sense of urgency;¹⁸
- involving all patent professionals in the change process, and ensuring they buy into it;
- attending external workshops on change;
- organizing internal workshops to discuss the activities that need to be developed, as well as various aspects of intellectual asset management;
- inviting a recognized authority in the field of intellectual capital to give a presentation followed by questions and a discussion;
- realizing and making effective use of the true potential of the people within the department;¹⁹
- encouraging teamwork in respect of the patent portfolio management and special projects;
- encouraging patent professionals to learn more about the needs and objectives of the business, and what it is that drives the business;
- generating short-term successes, for instance by organizing patent assets audits;
- creating an atmosphere of trust; and
- evaluating the change process and its progress.

Trust. Trust denotes honesty, fairness, openness and integrity; all essential ingredients that enable the creation of rich and lasting relationships within a patent department as

¹⁷ See Rosabeth Moss Kanter (1983), *The Change Masters*, London: George Allen & Unwin, for a study on change processes in general. See also John P Kotter (1996) , *Leading Change*, Boston: Harvard Business School Press.

¹⁸ This should not be too difficult in view of the potential change in relationships with the business, and the fact that many companies are seriously considering the possibility of outsourcing an increasing number of their corporate services.

¹⁹ Including the proactivity and creativity of people to look for new ways of doing things, i.e., to initiate further change.

well as between departments within a company. It is one of the most important components to establishing change in a successful manner, since it enlarges mutual understanding and common goals resulting in an increased commitment to a patent department 's success.

Additionally, trust enables effective teamwork and brings about a willingness to accept others' opinion and views. This is especially important to a patent department, as patent professionals are generally individualistic people. Trust can therefore ensure that a patent department can learn from the mistakes (and successes) of its individual patent attorneys, since it will encourage them to share experiences to the benefit of all involved. This does, of course, not only apply to a patent department internally; it should also be part of the relationship with the business.

WHY SHARE THIS?

We are entering the era in which the sharing of knowledge and technology will be crucial to companies.²⁰ The "not invented here" attitude will belong to the past. By sharing knowledge and technology, not only will the companies involved benefit, but so will society at large. The same principle applies to the sharing of knowledge regarding the management of patent assets, and that should not be too difficult to do for patent professionals, should it? After all, that is what patents are all about. They provide people a monopoly right for a limited period of time, and in turn ,those people share knowledge regarding an invention with the public, thus enabling society to benefit from the invention too.

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²⁰ See Russell L Parr and Patrick H Sullivan (1996), *Technology Licensing, Corporate Strategies for Maximizing Value*, pp. 3-9. New York: John Wiley & Sons, Inc.

Commentary: Experimental Use Exception – Clinical Trials in Germany

HEINZ GODDAR



In *les Nouvelles*, Volume XXXIV No. 1, March 1999, pages 1–2, this author had discussed the consequences of a landmark decision of the German Federal Supreme Court, keyword “Clinical Trials II,” published in 1997, relating to the extent of the experimental use exception according to Art. 11.2 of the German Patent Act, reading in translation essentially as: “The rights conferred by the Patent shall not extend to acts done for experimental purposes relating to the subject-matter of the patented invention.”

The German Federal Supreme Court (BGH) in the aforementioned decision had explicitly stated that clinical trials would be permitted in cases where one of the purposes was to obtain data for clinical approval, even if such trials would be conducted for the same indication as already known and protected, resp.

The author had expressed his opinion that, as a consequence of “Clinical Trials II,” during a patent’s lifetime, another party’s clinical trials for the same substance and the same indication as protected could be conducted, as long as the purpose of the trials would not mean a “use” of the substance in any patent-infringing manner during the patent’s lifetime (e. g. by distribution or manufacturing before the expiration of the patent in order to get early market entrance as soon as the patent expired).

This author’s opinion was heavily disputed and objected to, pointing to an appeal to the German Federal Constitutional Court still pending at the time of publication

of the article in *les Nouvelles* 1999. The decisions of this court, the highest court in Germany, are different from those of any other court in Germany in that they have the character and scope of legislative acts that are binding for everybody, not only “inter partes,” i.e., these decisions constitute laws.

In the meantime, the German Constitutional Court, by decision on May 10, 2001, published in GRUR 2001, pp. 43 ff., has confirmed Clinical Trials II, with the following results:

The decision of “Clinical Trials II” of the BGH is in full conformity with the German constitution. According to German law, the experimental use exception applies whenever tests relate to the subject matter of the patented invention as such and have the purpose of obtaining additional informations. The BGH and the Constitutional Court do not distinguish between different uses of the information that is obtained by clinical trials. The only prerequisite is that the experiments that are done with the matter as protected are directed towards the generation of information. Whether this information is further used for the registration of medicaments or for filing of use patents (new indications) does not matter. The limitations that occur for the proprietor of the patent during its lifetime have to be accepted by its owner in view of the development of both the state-of-the-art and public interest. Otherwise, according to the opinion of the Constitutional Court, a factual extension of a patent protection would occur which would not be

justified.

Only a “commercial use under disguise” of the patented matter would be prohibited according to German case law as it stands now, which, under normal circumstances clearly would be distinguishable from clinical trials in order to obtain information leading to market approval.

Because of the aforementioned case law in Germany, the country can be seen as being one of the most liberal in Europe, both with regard to the experimental use exception in general as well as in relation to clinical trials conducted either for the purpose of finding new indications or of getting market approval for patented indications that are still protected by the respective patents with the aim of entering the market immediately after the expiration of the patent (or protection certificate).

Open Book

A recurring feature

by John T. Ramsay, Q.C.



A review of current publications relating to the field of Intellectual Property licensing, transfer and tools therein.

THE NEW COMPANION TO LICENSING NEGOTIATIONS

Licensing Law Handbook
2000-2001 Edition

by Robert Goldscheider
(Copyright © 2000 West Group)

One of the core tools of the trade of licensing practitioners is a volume of precedents prepared by an experienced practitioner such as Bob Goldscheider. Goldscheider may be one of the most long-standing active members of the LES (USA and Canada) and LESI. His text, The New Companion to Licensing Negotiations is the fourth version of his "Companion" series and is the outcome of many other works that he has written.

The Companion provides 127 pages of commentary, 172 pages of sample forms, 162 pages of model clauses and an 82-page glossary of terms, with an additional three-page glossary of online terms. It is a solid, practical, one-volume text, easily carried as a "companion" when negotiating licenses. No disk is provided for the model clauses or the forms, and this is a deficiency that one might hope will be remedied in the next edition.

Goldscheider does not develop the law to any detailed extent; he assumes that the reader comes with the requisite legal knowledge but needs suggestions when drafting clauses. The *Companion* is not for the beginner; it will be more helpful to the intermediate and experienced practitioner.

The text is written in a user-friendly manner and does not suffer from dreadful drafting. The precedents do not use block capitals, which are intrusive to the reader, for defining phrases, although it may have in a previous version since there are leftovers of block capitals in some of the model clauses and the text. These could be removed in future editions. Goldscheider drives home the need for simplicity in §1.3 of his text, and the design of his clauses reflect that. Simplicity is not stupidity; it is

complex. It is usually harder to draft with simplicity rather than with verbosity and Goldscheider is to be commended for his drafting style. Perhaps he could stop using the word "said" even inside defined phrases as it is an unnecessary legal affectation.

I approached the *Companion* with a bias against form books on the basis that they provide the result of the drafter's thinking process but not the benefit of the process itself. I also have a problem dealing with model clauses because often they are out of context. Often model forms and model clauses do not apply to my facts and it is difficult to comprehend how the clauses interact and which ones I should use or adapt. Precedents by themselves are almost dangerous if the practical advice is not closely available or readily understandable. After reading Goldscheider's *Companion*, I may have to revise my biased position. It has attained a balance that I find impressive and the forms and model clauses define issues very well.

I chose three topics that I consistently struggle with to see how well Goldscheider provides the resources: grant clauses, warranties as to ownership and infringement issues.

GRANT CLAUSES

Chapter 7 sets the stage for the grant clauses, not by providing the requisite intellectual property law, but by discussing the different types of patent licenses. He informs us that the grant clause will be influenced by the licensing strategy: Is the license to resolve an infringement claim; is it part of a general cross-licensing strategy that may or may not be part of a corporate policy to avoid any suggestion of anti-trust activities; or is it for core or essential technology?

Goldscheider helpfully points out that the field of use definition might be more extensive than the scope of the license grant, but may be designed to cover automatic inclusions in the licensed subject matter as future tech-

**John Ramsay is the author of Technology Transfers and Licensing and Dreadful Drafting, The Do's and Don'ts of Licensing Agreements.*

nology is developed, as well as grant backs (see his §7.23). Forms 15 and 16 draw the distinction between a grant related to a product that is covered by a patent, and a perhaps more extensive grant related to all clauses in a specific patent. Goldscheider develops the scope of the claims in the licensed patents and gives helpful model clauses, even addressing the possibility of two courts issuing conflicting judgements on invalidity.

Goldscheider provides several model definitions of “licensed patents,” but has not discussed foreign equivalents as well as one might expect. Interestingly he picks up “clinical data” in one of the definitions of licensed patents, perhaps an inclusion that might later cause the drafter some problems since clinical data does not have an exclusionary characteristic but is the subject of the license, and inherently may have privacy or reuse limitations.

Goldscheider’s grant clause in §7.20 of the text properly separates the patent rights from copyrights, both of which are exclusionary in nature, and again from trade secrecy rights, which involve disclosure in exchange for restricted use and confidentiality obligations. That is an excellent clause but unfortunately it is buried inside the text in §7.20 rather than in one of the model clauses. Perhaps in a future edition, this excellent clause can be included in the model clauses to make the Companion that much more readily useable.

WARRANTY OF OWNERSHIP

The text does not directly develop the issue of ownership, an area that causes negotiators some difficulty since it is not clear what “own” means. Is it a warranty as to ownership, a warranty of title, a warranty of quiet enjoyment as that phrase is used in the real estate world, a warranty of exclusivity, a warranty of validity of patents, or a warranty against infringement? To some, each of those is included in the concept of ownership. The text could address this more extensively.

Goldscheider does provide in MCL 27-4 to 27-6 a list of negative warranties that may clarify what he means by “own” in model clause 27-9, which list should appear in every drafter’s checklist. He does not develop the issue of the possibility of joint ownership, which could be rectified in a future edition. The December 2000 issue of *les Nouvelles* has a series of excellent articles on joint ownership developing the law in United States, Canada and other countries.

Section 401 of the model Uniform Computer Information Transactions Act (UCITA) discusses a warranty of quiet enjoyment or what is called an “interference Warranty,” which also suggests a warranty that there is not, and will not be in the future, any action by

the licensor that will diminish the grant by the licensor to the licensee. UCITA suggests in section 401(b)(1) “A license or warrant (1) for the duration of the license, that no person holds a right to, or interest in, information [note that is a defined phrase] which arose from an act or omission of the licensor, other than a claim by way of infringement, which will interfere with the licensee’s enjoyment of its interest.” This clause might become popular if drafters can convince their clients that quiet enjoyment does not mean that there will be quiet, nor that the interest will be actually enjoyed! But for trade secrets, it does seem to be a better phrase than trying to deal with “possession” or such other phrases that may add little to the debate as to what is ownership.

Additionally, the discussion notes for section 401 of UCITA bring up the issue of exclusivity as to ownership: for a U.S. license to grant exclusive rights, the licensor has to have exclusive ownership. One joint owner could defeat another joint owner’s exclusive license by granting licenses under its partial ownership interest. Thus, section 401 would require a warranty that there are no other owners; a warranty of ownership by itself is not sufficient. In Canada, unless permitted by contract, the freedom of one joint owner to license without the consent of the joint owner in Canada would not be possible.

INFRINGEMENT

In §7:41, Goldscheider provides a checklist of the legitimate differences that the parties may have about infringement warranties and indemnities. For examples of warranties concerning third party infringers of the licensed technology, §7:41 tells us that, in some cases, the infringement is too minimal to warrant a suit, and the licensor may want to implement its own strategy choosing its own defendants. On the other hand, the licensee does not want to see competitors use the technology royalty-free when it has to pay a royalty.

The text in §7:42 gives an interesting twist to the warranties of quality of information: it disclaims a warranty “as to the ability of Licensee to understand and utilize the patents . . .” Perhaps we dreadful drafters should start using a disclaimer for our documents!

The model clause section provides 14 pages of clauses relating to infringement and related indemnities reflecting Goldscheider’s acknowledged focus on these issues. Model clause 9-1 to 9-5 and 9-7 to 9-15 contemplates suits against third party infringers. Model clause 9:6 contemplates a proceeding for the revocation of the licensed patents. Model clause 9:16 gets into infringement of third party rights and states that none of the technology infringes third party right. A purist might suggest that the technology—and certainly the related

intellectual property rights—cannot infringe; it is only the making, using or selling of the technology that causes the infringement.

I note that the warranty in § 9:16 is a no-knowledge warranty, which seems more reasonable than an absolute warranty. Model clauses 9-17 to 9-20 address reduced royalties in the event the exploitation of the licensed patents infringes the rights of others. For example, clause 9-18 talks about “substantial proof” of “significant quantities” of sales of infringing products, and the licensee being relieved of further payments if the licensor does not take action within six months of notice from the licensee. This is a clause written in a lucid way to bring out the issues. I expect drafters to have a debate as to what is “substantial” proof and what are “significant” qualities, but, in the end, they may do little to improve the quantification of those standards since it is unlikely that they can foresee the events that will qualify. Model clause 9-21 gets back to defending third party claims and model clauses 9-22 and 23 talk about infringement by a third party. Model clauses 9-24 to 9-26 address expiration and invalidity of patents. Model clauses 9-27 and 9-28 go to patent markings and then model clauses 9-29 to 9-31 address disclaimers of warranties. Model clauses 9-32 to 9-33 are sample indem-

nity clauses; perhaps these would be better consolidated into the category of model clauses illustrated in §28 that covers indemnification in more detail. The reader must read all of the sections on infringement and indemnification to get all the thoughts and some might seem to be structurally out of order; however, any logic chosen is unlikely to please every reader. The material is easy to read and therefore, a review of all the clauses is no great burden even when the reader is in a hurry.

CONCLUSION

I do not want to overstate the noted deficiencies; it is very easy to point these out, but it has to be acknowledged that thought, skill and effort that went into the preparation of this text. Goldscheider is to be commended for his contribution to our knowledge and for his valuable “toolbox” of knowledgeable, useful and well-communicated discussions both in the text and in the forms and model clauses, and codified knowledge that can be rapidly deployed by the busy licensing practitioner.

Andean Outlook

A recurring feature

by Natalia Tobón of Cavelier Abogados

A review and commentary on recent developments in the law of the Andean Community (Colombia, Venezuela, Ecuador, Perú and Bolivia) that relate to the field of licensing.



LICENSES IN THE ANDEAN COMMUNITY

Licenses are agreements applicable to patents and trademarks, whereby the licensor, being the proprietor of the patent or trademark enhances his production of goods or services and their distribution to new markets, while the licensee assumes consideration, namely payment of a royalty for benefiting from the trademark or working the patent.

In general terms, license contracts entered into in the Andean Community (Colombia, Venezuela, Ecuador, Perú and Bolivia) must abide by the community provisions on transfer of technology, foreign investment and industrial property, and national provisions on restrictive commercial practices on free competition.

Decision 291 of 1991 contains the Common Regime on Capital Investment and Transfer of Technology¹. In the Andean Community, Decision 486 of 2000 contains the Common Regime on Industrial Property and each member country has established its specific regulations on commercial practices restrictive of free competition.

I. COMMON REGIME ON CAPITAL INVESTMENT AND TRANSFER OF TECHNOLOGY: DECISION 291.

Decision 291 requires that contracts on technology import contain, at least, the following clauses:

- a) Identification of the parties, with express designation of their nationality and domicile;
- b) Identification of the mode of transfer of the technology being imported;
- c) Contractual value of each one of the elements involved in the transfer of technology; and
- d) Designation of the term of duration.

It prohibits, additionally, for purposes of registration of such contracts, that they contain the following clauses:

Finally, and except in extraordinary cases, duly qualified by the national competent body of the receiving

country, clauses shall not be admitted when prohibiting or limiting in any manner the export of products manufactured on the basis of the relevant technology.

II. Common Regime on Industrial Property: Decision 486

Decision 486 of 2000, applicable in Colombia, Venezuela, Ecuador, Perú and Bolivia since December 1, 2000, is the provision containing the Common Regime on Industrial Property in the Andean Community.

Some of the topics dealt with in the community provision may be summarized as follows:

a. Patent Licensing

Decision 486 of 2000 contemplates that the proprietor of a patent granted or in the application process grants a license to one or more third parties for working the relevant invention.

However, it requires that every license for actual work of a patent granted be registered with the respective national competent office, so as to ensure that the license may be enforceable against third parties.

In any event, the national competent authority will not register license agreements for actual working of patents when not adjusted to the legal provisions of the Common Regime for Treatment of Foreign Capitals and on Trademarks, Patents, Licenses and Royalties, or when not adjusted to community or national provisions on commercial restrictive practices of free competition.

b. Regime on Compulsory Licenses.

Decision 486 of 2000 introduced some modifications to the compulsory license regime previously regulated by Decision 344 of 1993.

Compulsory licenses are granted for industrial production of a product, subject matter of a patent or the integral use of the patented process when the term of three years (counted from the grant of the patent) or four years (counted from the application date thereof—whichever occurs later) has expired and no actual work

¹ Court of Justice of the Andean Community. Proceeding 2-IP-90, Sent. Sep. 20/90. Transfer of Technology

of the patent has been made in the member country where the license is applied for, or if the working of the invention has been suspended for more than one year.

A compulsory license shall not be granted when the proprietor may justify the lack of action through legitimate excuses, including force majeure or unpredictable event.

What is novel in the regulation of Decision 486 of 2000 on this aspect is that a compulsory license will solely be granted to whomever applies for one, would have previously tried to obtain a contractual license from the proprietor of the patent, under reasonable commercial terms and conditions, and such attempt would have not succeeded within a prudential period.

The community provision sets forth that the national competent office shall establish the scope or the extent of the license, the period of duration, the purpose of the license and the amount of consideration to be acknowledged to its proprietor.

It also seems relevant to point out that a prior declaration by a member country about the existence of reasons of public interest, emergency or national safety and solely while such reasons prevail, can at any time a patent be submitted to a compulsory license. Compulsory licenses granted in the Andean Community shall always be subject to the following limitations:

- They shall not be exclusive and no sub-licenses shall be granted;
- Licenses may solely be transferred with the portion of the enterprise or intangible equity that allows its being worked industrially, expressed in writing and registered with the national competent office. Otherwise they shall be legally ineffective;
- They may be revoked without prejudice to the adequate protection of the legitimate interest of the parties who obtained authorization for a license, if the circumstances that gave origin thereto have disappeared and are not likely to reappear;
- The scope and duration shall be limited by virtue of the purposes for which they were granted;
- For patents relating to protection of semiconductor technology, the compulsory license shall solely be authorized for non-commercial public use, or to remedy or rectify any practice that would have been declared contrary to free competition by the national competent authority;
- Adequate remuneration will be contemplated, according to the circumstances of each case; and
- g) That utilization be mainly for supplying the internal market.

c. Licenses for Integrated Circuits Layout Designs

Pursuant to Decision 486 of 2000, the proprietor of a registration of integrated circuits layout designs granted or in the process of being granted, may grant a license to one or more third parties for use of the relevant layout design. This constitutes a novelty vis-a-vis the prior community legislation, since no regulation existed for integrated circuits layout designs.

An integrated circuit layout design is, pursuant to the community provision, the three-dimensional arrangement, expressed in any manner of a product, in its final or intermediate form, whose elements, of which at least one is an active element, and any or all interconnections, form an integral part of the body or surface of a piece of material destined to perform an electronic function.

The decision establishes that a layout design will be protected when being novel, namely when resulting from the intellectual effort of its designer, and not being common in the integrated circuits industry.

In any event, the community provision establishes that every license granted for commercial use of the layout design shall be registered with the national competent office and the absence of registration shall render the license inefficacious vis-a-vis third parties. To such effect the license shall be in writing.

d. Trademark Licensing

The proprietor of a trademark registered or in the process of being registered, may grant a license to one or more third parties for the commercialization of the relevant trademark.

The license to use the trademark shall be registered with the national competent office and the lack of registration shall render the license inefficacious vis-a-vis third parties.

For purposes of registration, the license shall be in writing and any interested person may apply for registration of a license.

The national competent authority shall not register license agreements or transfers of trademark registrations when not adjusted to the Common Regime of Treatment of Foreign Capitals and on Trademarks, Patents, Licenses and Royalties, or to community and national provisions on commercial practices restrictive of free competition.

When a change occurs with respect to the name or address of the proprietor of a mark registration during the term of enforceability of the license, the proprietor of the registration should report it to the national competent office.

Otherwise, any notice sent pursuant to the data appearing on the registration shall be deemed valid.

e. Trade Name Licensing

Decision 486 of 2000, applicable in Colombia, Venezuela, Ecuador, Perú and Bolivia was quite generous when regulating the trade name and permitted explicitly its being the subject matter of a license.

It established additionally that licenses on trade names should solely be registered with the national competent office if national provisions so require.

The foregoing represents a change in connection with prior legislation—Decision 344 of 1993—that had provisions of a much more general character and made no mention of the possibility of granting licenses.

Decision 486 of 2000 defined the trade name as any sign identifying an economic activity, an enterprise or a commercial establishment.

It likewise determined that the exclusive right in a trade name is acquired through its first use in trade and terminates when use of the name ceases or when the activities of the enterprise or the establishment cease.

The community provision added that the proprietor of a trade name could prevent third parties from using in trade an identical or similar sign, when such use could cause confusion or the risk of association with the enterprise of the owner or with its/his/her products or services.

The registration of a trade name in the Andean Community is simply of a declarative character and each Andean country shall regulate the manner to do it.

The registration of a trade name shall be enforceable during 10 years renewable for similar periods, and no trade names shall be registered when falling under any of the following cases:

- a) when consisting, totally or partially in a sign contrary to morality or public order;
- b) when its use may cause confusion in trade circles or among the consumers with respect to the identification, nature, activities, commercial character or any other aspect of the enterprise or the establishment designated by such name;
- c) when its use may be liable for causing confusion in trade circles or among the public on the entrepreneurial source or other characteristics of the products or services of the enterprise; or
- d) when there exists a prior application or registration of a trade name.

Finally, Decision 486 establishes that the transfer of a registered or deposited trade name shall be recorded with the national competent office pursuant to the procedure applicable to trademark transfers.

III. PROVISIONS ON COMMERCIAL PRACTICES RESTRICTIVE OF FREE COMPETITION.

a. Columbia

Colombia is one of the countries most advanced in regulating restrictive commercial practices in the Andean area.

Its Political Constitution of 1991 states that, “The state, as provided by law, shall prevent any obstruction or restriction of economic freedom and shall avoid or control any abuse of their dominant position in the national market by persons or companies.”

Another article of the National Constitution establishes that, “The law shall regulate criminal proceedings to protect collective rights and interests related to public property, space, safety, and health or to administrative morality, the environment, free economic competition, and other matters of a similar nature as set forth in the law.”

The above-quoted provisions are determining, because the remaining development of the legislation (which is quite extensive on the subject matter) depends on them. We will emphasize only Law 155 of 1959 and Decree 2153 of 1992. \

1. Prohibited practices or agreements.

Pursuant to Law 155 of 1959, agreements or contracts are prohibited when their purpose is to directly or indirectly limit production, supply, distribution or consumption of national or foreign raw materials, products, commodities or services and in general all types of practices and procedures or systems tending to limit the free competition and to maintain or to determine inequitable prices.

However, the government may authorize the entering into of contracts or agreements that, notwithstanding the fact that they limit free competition, defend the stability of a basic sector for the production of goods or services of interest for the economy in general.

Contracts, agreements or transactions prohibited by law are absolutely null and void due to illicit purpose.

2. Agreements contrary to free competition.

Pursuant to Decree 2153 of 1992, among others, the following are deemed to be contrary to free competition:

- Those whose purpose or effect is the direct or indirect fixing of prices.
- Those whose purpose or effect is determining sale or commercialization conditions discriminating against third parties.
- Those whose purpose or effect is the distribution of markets among producers or distributors.
- Those whose purpose or effect is the allocation of production or supply quotas.
- Those whose purpose or effect is the distribution or

limitation of supply sources of productive inputs.

- Those whose purpose or effect is to limit technological developments.
- Those whose purpose or effect is to subordinate the supply of a product to acceptance of additional obligations that, due to their nature, would not constitute the subject matter of the business, without prejudice to what has been established in other provisions.
- Those whose purpose or effect is to refrain from producing a good or service or to affect their levels of production.
- Those whose purpose is an act of collusion in a public bid or offer or those whose effect is the distribution of contracts, offers or the establishment of bidding conditions.
- Those whose purpose or effect is to prevent third parties from having access to markets or to commercialization channels.

3. Acts contrary to free competition.

Pursuant to Decree 2153 of 1992, the following constitute acts contrary to free competition:

- Infringing provisions on advertising, contained in the regulations on consumer protection.
- Influencing upon an enterprise to attain a price increase of its products or services or so that it refrain from its intention to reduce prices.
- Refusing to sell or render services to an enterprise or discriminate against it when it may be understood as a retaliation against its price policy.

However, the following conducts will not be held as contrary to free competition:

- Those whose purpose is cooperation in research and development of new technology.
- Agreements on compliance with provisions on technical standards and measuring not adopted as compulsory by the competent body when not limiting the access of competitors into the market.
- Those referring to processes, methods, systems and manners of utilization when not limiting the access of competitors into the community market.

4. Abuse of dominant position.

The following conducts constitute abuse of dominant position:

- Reduction of prices below costs when aimed at eliminating one or several competitors or preventing their access or expansion.
- Application of discriminating conditions with regard to equivalent transactions that place consumers or suppliers in a disadvantageous situation vis-a-vis another consumer or supplier of analogous conditions.
- Those whose purpose or effect is subordinating the supply of a product to acceptance of additional obligations that, due to their nature, would not

constitute the corporate purpose of the business, without prejudice to other enforceable provisions.

- The sale to a purchaser under conditions different from those conditions offered to another purchaser when intended to diminish or eliminate competition in the market.
- The sale or provision of services somewhere within the Colombian territory, at a price different from that at which they are offered in another part of the Colombian territory, when the intention or effect of such practice is to diminish or eliminate competition in that part of the country and the price does not correspond to the structure of the costs of the transaction.

5. Control to economic concentrations.

Pursuant to Law 155 of 1959, enterprises engaged in the same productive, supplying, distributing or consuming activity concerning a specific article, raw material, product, commodity or service whose assets individually or jointly reach \$10,000 or more, shall be obliged to inform the national government about any transactions planned for the purpose of merging, consolidating or integrating into one another, whichever may be the juridical mode of consolidation, merger or integration.

The National Government shall object the transaction if it tends to produce an undue restriction of free competition.

It may be inferred that a juridical-economic concentration tends to produce undue restriction of free competition, whenever:

- It has been preceded by private agreements between the enterprises for the purpose of unifying and imposing prices upon raw material producers or consumers, or for distributing among themselves the markets, or for limiting the production, distribution or the rendering of the service; or
- When conditions of the corresponding products or services in the market are such that the merger, consolidation or integration of the enterprises that produce or distribute them may determine inequitable prices in prejudice of competitors or consumers.

6. Functions of the Superintendency of Industry and Commerce. Decree 2153, 1992.

The Superintendency of Industry and Commerce exercises the following functions:

- It monitors compliance with provisions on promotion of competition and restrictive commercial practices and takes cognizance of claims or complaints filed in connection with facts affecting competition within markets and duly processes those particularly significant.
- It imposes the relevant sanctions for infringement of provisions on restrictive commercial practices.
- It urges from natural and legal persons the supply

of data, reports, books and commercial documents required for the adequate development of its functions.

- It performs inspection visits for the purpose of verifying compliance with legal provisions whose control is under its jurisdiction and adopting the corresponding measures pursuant to law.

b. Perú

In Perú, the entity in charge of monitoring and enforcing free competition is the National Institute for Defense of Competition and of Protection to Intellectual Property (NDECOPI).

1. Principal provisions.

Legislative Decree No. 701 of 1991 provides for the elimination of monopolistic, controlling and practices restrictive of free competition.

Law No. 26876: Electrical Sector Anti-Trust Law.

Supreme Decree No. 017-98-ITINCI: Regulatory of the law that establishes control of entrepreneurial concentrations in the electrical sector: service of process.

2. Prohibited acts and conduct.

Acts and conduct relating to economic activities constituting abuse of a dominant position in the market are prohibited, as well as those limiting, restricting or distorting free competition in such a manner that they may generate damages for the general economic interest, within the national territory.

3. Abuse of the dominant position in the market.

It is deemed that abuse of the dominant position in the market exists when one or more dominant enterprises act in an undue manner for the purpose of obtaining benefits and damaging others in a manner that would not have been possible, had their dominant position not existed.

4. Practices restrictive of free competition.

Practices restrictive of free competition are understood to be agreements, decisions, recommendations, parallel performances or concerted practices among enterprises that produce or may produce the effect of restricting, preventing or deceiving competitors.

The following are practices restrictive of free competition:

- The distribution of markets or of supply sources;
- The distribution of production quotas;
- The concerted arrangement of product quality when not adjusted to national or international technical standards affecting consumers negatively; and
- Applying to commercial relationships inequitable conditions with respect to equivalent services, which may place some competitors in an unfavorable situation vis-a-vis others.

The grant of discounts and bonuses corresponding to generally accepted commercial practices is not deemed to constitute a practice restrictive of free competition if

it is granted due to specific compensating circumstances, such as advance payments, amounts, volumes of transactions or other reasons awarded on a general basis in all cases where similar conditions are present.

5. Procedure.

The related procedure is a unique one, divided into the following stages: The initiation of the investigation; terms and time for contesting and submission of evidence; a probationary period; appeal and proceedings at the Court; and, as the case may be, the criminal action.

Additionally, the Commission of Free Competition of INDECOPI may impose pecuniary sanctions on infringers, taking into account the following factors:

- The scope and extent of restriction of competition.
- The size of the market affected.
- The market quota of the relevant enterprise.
- The effect of the restriction of competition upon effective or potential competitors, upon other portions of the economic process and upon consumers and users.
- The duration of the restriction of competition.
- The reiteration in the performance of prohibited conducts.

c. Venezuela

Since 1992 there has been a provision in Venezuelan law intended to promote and protect the exercise of free competition (Official Gazette No. 34.88 of January 12, 1992), which is being submitted to study for amendment.

The entity in charge of controlling compliance with the law is the Superintendency for the Promotion and Protection of Free Competition.

1. Main provisions.

Constitution of the Republic of Venezuela. Amendments No. 1 and 2. Temporary Provisions.

Law to Promote and Protect the Exercise of Free Competition of January 13, 1992.

Guidelines for the Evaluation of Franchise Agreements. Extraordinary Official Gazette No. 5.431 of January 7, 2000.

Guidelines for the Evaluation of Transactions of Economic Concentration. Official Gazette No. 36.819 of November 1, 1999.

Internal Regulation of the Superintendency for the Promotion and Protection of Free Competition. Official Gazette No. 35.329 of November 7, 1997.

Regulation No. 2 of the Law for the Promotion and Protection of the Exercise of Free Competition. Official Gazette No. 35.963 of May 21, 1996.

2. Law for the promotion and protection of the exercise of free competition

This law pursues the promotion and protection of the exercise of free competition and efficiency to the benefit

of producers and consumers in Venezuela.

The Superintendency for the Promotion and Protection of Free Competition (Pro-Competencia) is the body created for controlling the fulfillment of the law and it is administratively attached to the Ministry of Industry and Commerce.

In general terms, the law establishes a general prohibition of the conducts and decisions that may prevent, restrict, deceive or limit free competition.

Additionally, there are specific prohibitions concerning practices restrictive of competition such as horizontal agreements, vertical practices, abuse of dominant position, boycotting and economic concentrations restrictive of free competition.

3. Horizontal agreements.

Horizontal agreements are regulated by law. They are defined as pacts entered into between competitors that end up weakening or restricting free competition between enterprises acting in similar markets.

Horizontal agreements may be manifested in the following manner:

- Fixing of prices: Economic agents or offerers fix their prices on mutual agreement instead of establishing prices independently and competing,
- Restriction of production: Economic agents share the market in such a manner that a group of consumers is serviced through one single supplier.
- Predatory pricing: One or more offerers set the price of a product or service below costs so as to induce other competitors to vacate the market.

4. Authorized vertical practices.

These are anti-competitive agreements between agents located at different levels of the commercialization chain (producers, distributors, wholesale vendors and retail vendors). Although they restrict competition, there exists the possibility of their being efficient. For that reason, they must be evaluated by Pro-Competencia prior to being approved pursuant to the provisions of Regulation No. 1 of the Law.

Vertical practices may be identified in the following manner:

- Agreements of exclusive distribution: Agreements established between the producer-distributor or distributor-retail vendor with the purpose of attaining exclusive rights to the sale of a product or service offered by the producer-distributor. These may be efficient and require the authorization of Pro-Competencia.
- Establishment of resale prices: When a distributor or retail vendor sells goods at the prices established by the supplier-distributor.
- Discriminating prices: When an offerer establishes several prices for a good offered to various clients under similar circumstances.
- Tied-up sales: When an offerer conditions the sale of

a good to the purchase of any other or to the rendering of a service.

5. Monopolies.

Law hinders the establishment of new monopolistic structures and monitors very closely those already existing prior to the enactment of the law, since it has already been determined that enterprises in this position are more likely to perform anti-competitive practices that turn into abuses of dominant positions.

Likewise, law prohibits and punishes specifically any abuse in which enterprises that enjoy a dominant position in a specific market impose prices, with absolute independence from their competitors, commercializing exceedingly competitive conditions to their clients and distributors. In this sense, law prohibits as being restrictive of free competition the following conduct:

- Imposition and fixing of prices, unjustified limitation of production or of distribution, unjustified refusal to sell, discriminating treatment and imposition of tied-up sales.
- Concerning mergers and acquisition of enterprises, making transactions of economic concentration (mergers and acquisitions) between agents engaged in a similar activity and that originate a restrictive effect upon free competition or increase a dominant situation on the whole or on part of the market (Article 11).

d. Ecuador

1. Provisions.

The Political Constitution of the Republic of Ecuador states:

Article 244. Within the system of socially oriented free market economy the state shall take upon itself to:

2. Promote the development of activities and competitive markets. Encourage the free competition and sanction according to law, monopolistic practices and any other that hinder and distort it;

Other laws on the subject matter are the following:

2. Law on modernization of the state.

Prohibits the existence of monopolies in any form and authorizes third parties to establish activities or render services of like or similar nature.

Without prejudice to the provision contained in the preceding paragraph, concessions, licenses or permits may be granted under conditions of regulated exclusiveness, only during a specified period, under the authorization of the president of the republic or of the competent body in the event of sectional governments. When the concession of a public service implies a dominant position in the market, the proprietor may not be the owner by himself nor through third parties, concerning collective communication media or financial institutions. Each of these activities shall be developed

in an exclusive manner by their managers or proprietors.

3. Structural legal organization for defense of consumers.

This law establishes in its article 51 that, "without prejudice to what in such respect criminal laws have established, speculation is absolutely prohibited. Likewise, any other unfair practice is prohibited which tends to, or causes indiscriminate rise in prices of goods and/or services."

It also determines that the following constitute abusive market practices, and are thoroughly prohibited for suppliers:

- To condition the sale of goods to the purchase of other goods or to the contracting of a service, except when for operation of the law the consumer must fulfill any requirement;
- Refusal to wait on consumers when stock permits;
- Sending to consumers any unsolicited service or product. Under such hypothesis, any goods or services so delivered shall be deemed "free of charge sample";
- Fraudulently take advantage of a consumer's age, health condition, level of instruction or capacity in order to sell him/her a good or service;
- Place in the market products or offer the rendering of services non-compliant with technical and quality standards issued by competent bodies;
- Apply readjustment formulas different from legal or contractual ones;
- Omit establishing terms for fulfillment of obligations, or leave it to his/her own criterion; and
- Round up terms for rendering effective the collection of interests, fines or other economic sanctions in credit cards, bank loans and other similar practices.

4. Intellectual property law.

The intellectual property law of Ecuador establishes that proprietors of industrial property rights and plant variety obtentors may grant licenses to third parties for their use and work through written contracts. Those contracts shall not contain clauses restrictive of commerce or create unfair competition.

Sub-licenses shall require express authorization from the proprietor of the rights.

Additionally, the law deems to be unfair competition any fact, act or practice contrary to honest use or custom in the development of economic activities.

For defining honest use, the criteria prevailing in the national commerce shall apply; notwithstanding, when relating to acts or practices performed in the context of international transactions, or having connection points with more than one country, the criteria on honest use prevailing in international trade shall apply.

5. Law of companies.

The establishment and operation of companies con-

trary to public order, mercantile laws and good habits is prohibited, as is the establishment and operation of those lacking a real purpose and a licit negotiation and those tending toward monopoly of supplies or of any branch of industry, through commercial practices oriented towards such ends.

Other provisions dealing with the subject matter are: Law for Economic Transformation of Ecuador (of the Amendments to the Special Telecommunications Law) and the Law for the Promotion of Investment and Citizenship Participation (of the amendments to the Hydrocarbon Law)

e. Bolivia

Of the entire group, Bolivia is the country with the fewest provisions on the subject matter. Only the Code of Commerce regulates, through articles 66 to 71, the topic of unfair competition.

In this sense, we find that restrictive commercial practices are analyzed from the point of view of prohibited uses, the acts that constitute unfair competition and the applicable procedure.

Utilization of trademarks, countermarks, signs, containers, drawings or indications that might induce the public to confusion about the quality, origin, or quantity of the goods offered or sold, constitutes a crime.

The author of unfair competition acts is deemed to be the person who infringes on trademarks, patents, trade names, signs or industrial secrets, who uses means or methods tending to discredit the products or services of a competitor or alters them for the purpose of deceiving, who utilizes a denomination of origin or imitates and takes advantage of the qualities of a third party product to its/his/her own benefit, utilizes praise or exaggeration that may induce the public to error.

Also, the author of acts of unfair competition is deemed to be whoever bribes employees of another enterprise in an attempt to drive away the clientele or maneuver to deprive their competitors from technicians and trustworthy employees, or uses fraudulent means or systems for disorganizing the trading market and puts into practice any other procedure in detriment of other entrepreneurs, being contrary to law and mercantile usage.

The damaged parties may resort to the competent court through summary proceedings seeking that the denounced act be suspended and the destruction of the physical material used and public rectification in the event of untrue or false representations.

The damaged party may also sue to claim payment of damages and the grant of guarantees to respond for unfair competition acts.

Non-compliance with the penalties may give way to fines.

IV. REGISTRATIONS

At least in Colombia, license agreements shall be approved and registered with two national authorities:

- With the Ministry of Foreign Trade for exchange and taxation purposes (even when not including payment of royalties).
- With the Superintendency of Industry and Commerce, for purposes of enforcement or advertisement against third parties from the perspective of industrial property.

Enforceability of license agreements is a critical topic due to the increasing number of filings in demand of trademark cancellation for non-use.

V. QUALITY OF THE PRODUCTS OFFERED.

It is worthwhile to point out that each one of the member countries of the Andean Community has established some specific requirements for protecting consumers in aspects relating to the quality of the goods offered, through license agreements.

In the Colombian case, for example, the Commercial Code establishes that the license agreement shall contain stipulations guaranteeing the quality of the products or services produced or rendered by the beneficiary of the license.

Similarly, the Colombian Commercial Code obliges the proprietor of the trademark to exercise effective control on quality and it/he/she shall be severally responsible vis-a-vis third parties for potential damages caused.

At the request of any person, or ex officio, the office in charge of controlling quality and standards shall take the appropriate steps to guarantee such quality and shall impose the required sanctions.

EU Review

A recurring feature

by Alec Burnside, Linklaters & Alliance, Brussels

A review and commentary on recent decisions relating to licensing in the European Union.



RECENT ANTI-TRUST CASES

European Commission Prohibits General Electric's Acquisition of Honeywell

Following an in-depth investigation into the markets for aero-engines, avionics and other aircraft components, the European Commission decided, in early July, to prohibit the GE/Honeywell merger on the grounds that it would create a dominant position in certain markets. The Commission considered that undertakings proposed by GE were insufficient to remove the competition problems.

GE's strong market position combined with its financial strength and vertical integration into aircraft leasing were among the factors that led to the finding of dominance. The investigation also showed that Honeywell is the leading supplier of avionics and non-avionics products, as well as of engines for corporate jets and of engine starters. The combination of the two companies' activities would have resulted in the creation of dominant positions in the markets for the supply of avionics, non-avionics and corporate jet engines, as well as to the strengthening of GE's existing dominant positions in jet engines for large commercial and large regional jets. The dominance would have been created or strengthened as a result of horizontal overlaps in some markets as well as through the extension of GE's financial power and vertical integration to Honeywell activities and of the combination of their respective complementary products. Such integration would enable the merged entity to leverage the respective market power of the two companies into the products of one another, thus foreclosing competitors, eliminating competition in these markets and ultimately affecting adversely product quality, service and consumers' prices.

European Commission Imposes Fines for Cartel Activity

The European Commission has fined Germany's SGL Carbon AG, UCAR International of the United States and six other companies a total of € 218.8 million for fixing the price and sharing the market for graphite

electrodes. A Commission investigation established that the eight producers, which together account for the quasi-totality of the production worldwide, operated a secret cartel during most of the '90s resulting in considerably higher prices than if the companies had competed against each other.

The companies held regular meetings at the chief executive level to agree upon concerted price increases and the Commission received evidence of secret meetings and illegal agreements. The companies were well aware that they were infringing antitrust law as they took great pains to conceal meetings, to avoid keeping any written evidence and, where documents did exist, using code names to refer to the cartel participants. In the period in which the cartel operated, prices of graphite electrodes increased by 50 percent.

The fines imposed varied among the companies depending on factors such as the duration of the infringement, the role of ringleader, continuation of the infringement after the Commission started its investigation and attempts to obstruct the Commission's investigation. As the driving forces behind the cartel, SGL and UCAR received the highest fines.

For the first time, the Commission granted a substantial reduction of a fine (70 percent) under the Leniency Notice to the company that was first to cooperate and provide decisive evidence of the cartel. UCAR, who also cooperated with the Commission at an early stage of the investigation, was granted a 40 percent reduction. In the United States, the major parties to the cartel pleaded guilty and paid substantial fines, including \$110 million for UCAR and \$135 million for SGL. Two former executives of the largest U.S. producer, UCAR, were jailed for several months.

DRAFT NEW LENIENCY RULES

The European Commission has adopted new draft rules aimed at better detection and eradication of price-fixing and other cartels. The proposed rules will replace the 1996 Leniency Notice and contain the following provisions:

Complete immunity from fines would be granted to

the first firm to inform the Commission of an undetected cartel. In order to qualify for immunity, the company will have to provide sufficient information to allow the Commission to launch a surprise inspection ("dawn-raid").

A company fulfilling the conditions for immunity would promptly receive a letter from the Commission confirming that immunity will be granted to the company if the conditions set out in the notice are observed.

The policy on reduction of fines would be modified to enable the Commission to give adequate rewards to companies that, following the immunity applicant and/or any inspections, provide "added value" evidence to the Commission.

In the proposed notice, the amount of any reduction of fines depends on the time at which evidence is provided and the quality of the evidence provided. A system of bands is proposed for each category of reduction beneficiary.

NEW COPYRIGHT DIRECTIVE

A new copyright directive establishing pan-EU rules on copyright and related rights in the Information Society has been adopted by the European Council and was published in the Official Journal of June 22, 2001. The directive will stimulate creativity and innovation by providing a secure environment for cross-border trade in copyright protected goods and services and will facilitate the development of electronic commerce in the field of new and multimedia products and services (both online and off-line, e.g., CDs). It aims to achieve this by harmonizing the rights of reproduction, distribution and communication to the public; the legal protection of anti-copying devices; and rights management systems. Particular novel features of the directive include a mandatory exception for technical copies on the Net for network operators in certain circumstances; an exhaustive, optional list of exceptions to copyright that includes private copying; the introduction of the concept of fair compensation for right holders; and a mechanism to secure for users the benefit of certain exceptions where anti-copying devices are in place.

The directive applies Community exhaustion and not international exhaustion for the distribution right. This is in line with previous directives in the field of copyright. Therefore, once a copyright protected product such as a CD or CD-ROM is marketed in the Community by or with the consent of the rightsholder, the distribution right is said to be "exhausted," i.e., there is no right to restrict further distribution in the Community. Parallel imports throughout the Community will therefore be permitted but the rightsholder will retain protection against parallel imports from third countries.

RESALE RIGHTS DIRECTIVE

The Council has adopted a directive on resale rights for the benefit of the author of an original work of art. The directive aims to ensure that the authors of graphic and plastic works of art share in the economic success of their work, regardless of where in the union their works are sold.

Resale rights will apply to any sale where the price exceeds € 3000. This means that some works of art that rarely attain such prices, e.g., sketches and photographs, are in practice unlikely to be covered by the directive. However, this restriction is tempered by the option given to member states of applying resale rights of not less than 4 percent of the selling price to sales of less than € 3000. In addition, the total amount of the royalty may not exceed € 12.500. However, in accordance with the principle of subsidiarity, member states will be allowed to establish lower national thresholds.

The deadline for the transposition of the directive will be four years (January 1, 2006). However, those member states that do not apply the resale right on the entry into force date of the directive shall not be required, for a period expiring no later than January 1, 2010, to apply the resale right for the benefit of those entitled under the artist after his death. A supplementary period of two more years is foreseen to enable economic operators in those member states to adapt gradually to the resale right system.

The Commission has issued a statement expressing its regret that the time limits for implementation are so long and stressing that such delays should be considered exceptional.

COMMUNITY PATENT

Despite recent parliamentary debates, ministers have not yet reached agreement on the proposed European Community Patent, but the issue features on the list of priorities of the new Belgian presidency. Currently, there are three ways of obtaining a patent in Europe: through the national patent offices, through the European Patent Office and via the Patent Co-operation Treaty. These different organizations have grown out of progressive attempts to try and simplify the application procedure. Within Europe, national patent law has become harmonized over time and in 1973, all EU member states signed the European Patent Convention (known as the EPC or Munich Convention), which established the European Patent Office (EPO) and a single procedure for granting patents. The Munich Convention, however, is not a community but an inter-governmental regime.

The aim of the Community Patent Regulation proposed by the Commission is to establish a community

patent system that would replace the current expensive and labyrinthine system and that would be valid throughout the EU at an affordable price and providing every guarantee of legal certainty. These patents, which would be issued by the European Patent Office in Munich, would exist alongside national and European patents so that inventors could choose the type of patent protection best suited to their needs. The current requirement that patents, in order to be legally valid in all member states, must be translated into all the official languages would be removed.

In the last month, the Commission has issued a statement proposing that there should be three working languages for the Community Patent—English, French and German—and that once granted and published, a patent would be valid without further translation. This reflects a balance between the need to keep costs for a community patent under control and access to patent information. The Internal Market Council, at its meeting set for September 27, will discuss the Community Patent, concentrating on the issues of language, the role of National Offices and costs.

COUNTERFEITING AND PIRACY

A conference on Counterfeiting and Piracy, organized by the Swedish presidency with the support of the Commission, took place in Stockholm on April 23. The aims of the conference were to create an understanding of the nature and breadth of the problem and the threat posed to economic growth in a knowledge-based society; and to find a basis for further measures to be taken in order to combat counterfeiting and piracy in an enlarged union.

In his closing speech, the Minister for Justice, Thomas Bodström, set out the main conclusions of the conference:

The legal structure for the protection of intellectual property rights was already strong. On an international level, the conventions administered by WIPO and the TRIPs agreement handled by WTO were working well. On a European level, the existing legal instruments such as the directives harmonizing intellectual property rights, the regulation on a unitary community trademark and the regulations on counterfeit and pirated goods all contained strong legal protections. In addition, the Commission's 1998 Green Paper "Combating Counterfeiting and Piracy in the Single Market" had given rise to an action plan, part of which is to be a directive, expected to be presented in early 2002, harmonizing the means of enforcing intellectual property rights and establishing a general framework of administrative co-operation.

There was strong evidence of the connection between counterfeiting and piracy and organized crime, which

showed that counterfeiting activities were being used to launder and recycle the proceeds of other criminal activities.

There was a real need to raise public awareness in the area of counterfeiting and piracy. The existence of a strong consumer demand for counterfeited and pirated products indicated that the public was not sufficiently aware of the fact that counterfeiting and piracy are not only illegal but also highly detrimental to intellectual creativity and to the economy as a whole.

Overall, the conclusion of the conference was that the focus, through the action plan, needed to be on practical enforcement aspects rather than on the legal framework and that, to this end, co-operation both between the competent authorities concerned on the one hand and between the authorities and the industry on the other was essential.

TRADEMARKS

Communitywide exhaustion of trademark rights

The European Parliament has issued a draft report on the problem of Communitywide exhaustion of trademark rights and the economic consequences thereof. As the legal situation currently stands, the legal effect of trademarks granted by the member states and the Community trademark are not yet exhausted within the Community if the trademark proprietor puts his product on the market outside the Community. Trademark proprietors can therefore bar parallel importers from importing the product into the Community and thus charge two different prices: a lower price outside the Community and a higher one within the Community itself. The report considers that international exhaustion (compared with Communitywide exhaustion) would be a great step toward combating this problem and attaining the goals of stimulating competition and obtaining the best prices for consumers.

In the field of product piracy, the report states that even with international exhaustion, trademark proprietors can still defend themselves against counterfeits by simply ascertaining their right to the trademark. The importer would then have to demonstrate the route by which he obtained the product from the original manufacturer. He would be unable to do so if the goods were counterfeit. Where the pirating of products can be prevented only by the trademark proprietor relying on other intellectual property rights, the burden of proof, which would normally be onerous for the rightsholder, should be revised in his favour. As in trademark law, the parallel importer should be obliged to demonstrate that the goods had not been pirated.

The issue of whether the EU should shift to the international exhaustion of trademark rights or maintain the

existing system of Communitywide exhaustion was most recently discussed at the Internal Market/Consumer Affairs Council in May but no agreement was reached. The council gave their support to further study of the issue and decided to return to the subject at a later date.

ADVOCATE GENERAL'S OPINIONS

Trademarks on non-EU Imports

The advocate general has given his opinion in two joined cases brought by the companies Davidoff and Levi Strauss to the effect that the interests of importers should be taken into account on trademarks of non-EU imports. The companies claimed that the importation of goods bearing their trademark into the Community and their sale there constituted an infringement of their registered trademarks. The questions that were submitted to the European Court of Justice concerned the conditions governing exhaustion under the Trademark Directive, in particular, the concept of "consent" by the trademark proprietor to the goods being put on the market in the EEA, as well as the question of what are "legitimate reasons" that can justify him in opposing further commercialization.

The advocate general stated that the principle of EEA-wide exhaustion is designed to prevent trade between member states from being restricted through the invocation of rights conferred by a trademark. In the case of parallel imports from non-member countries, however, the free movement of goods is not affected.

Regarding "consent," the advocate general pointed out that the focus cannot be on how that concept is construed in national legal systems, stating that the objective substance of that concept can be reached only by means of an autonomous Community interpretation.

The rights to exclusivity deriving from a trademark also include the right of the trademark proprietor freely to determine the conditions under which he wishes to market his product and control its distribution. However, this right to control the initial distribution of goods within the EEA, which may, for example, also take the form of sales bans or territorial restrictions on the right of the first purchaser to dispose of the goods, is not unlimited inasmuch as importers have interests that merit protection and that must be taken into account.

In regard to parallel imports from non-member countries, it is therefore a matter for the national court to examine whether, in the circumstances of the individual case, the conduct of the trademark proprietor can be construed as a waiver of his right to control distribution within the EEA. In such an examination, the national court must proceed on the basis of the principle of EEA-wide exhaustion.

Use of Trademark Rights to Stop Sale of Repackaged Trademarked Goods

Advocate General Jacobs has given his opinion on two cases that raise a number of questions concerning the circumstances in which a trademark owner may rely on his trademark rights to prevent the repackaging of his branded products by a parallel importer. The advocate general reached several conclusions:

EU trademark law does not entitle a trademark owner to oppose the marketing of a pharmaceutical product put on the market under his trademark where the importer has repackaged it and reaffixed the trademark and has complied with certain other requirements. (The product inside the packaging must not be affected, the manufacturer and origin must be clearly indicated, the reputation of the trademark or its owner must not be damaged as a consequence of poor packaging and the trademark owner must be given notice before the repackaged pharmaceutical product is put on sale).

However, opposition by the trademark owner is only precluded if the repackaging and reaffixing of the trademark are reasonably required to enable the importer to obtain effective access to the market of the importing member state and in so far as other, less intrusive, methods of repackaging will not enable him to obtain effective access to that market.

To determine whether repackaging is required, account must be taken not only of obstacles that exist in law—such as the regulatory requirements of the importing member state—but also of obstacles that exist in fact, including resistance of consumers, for example, to over-stickered boxes, which is such as to affect prescription or dispensing practice.

Further, a trademark owner may use his trademark rights to prevent the parallel importer of a pharmaceutical product from repackaging that product, but only if such use of his rights does not contribute to the artificial partitioning of the markets between member states or otherwise constitute a disguised restriction on trade between member states. A trademark owner who uses his trademark rights to prevent a parallel importer from necessary repackaging contributes to such artificial partitioning.

A parallel importer intending to market repackaged goods bearing a trademark must in all circumstances give the owner of the trademark reasonable advance notice. Three to four weeks' notice will normally be regarded as reasonable.

A European Commission proposal designed to clarify existing rules in order to facilitate access to life-saving drugs by needy countries was presented to WTO members at the Council on Trade-Related Intellectual Property Rights (TRIPs) on June 20. The EU's proposals concentrate on how to clarify TRIPs provisions and provide flexibility for countries to implement an intellectual property regime that serves wider policy objectives such as public health through, for example, the use of compulsory licensing in emergency situations. The EU believes Article 31 of TRIPS should be clarified so as to determine whether a developing country without pharmaceutical production capacity should be permitted to import medicines produced in another such country under a compulsory license.

These proposals follow on from the action plan on communicable diseases (HIV/AIDS, tuberculosis and malaria), adopted by the EU Council of Ministers in May, which seeks the support of the pharmaceutical industry for the implementation of a "tiered-pricing" system in order to make essential medicines available to developing countries at the lowest possible price. The EU also proposes enhanced technical co-operation and technology transfers to boost local production.

A number of recent events have illustrated the effects of the TRIPs agreement on public health policies. In this respect, one landmark case was the lawsuit brought by a pharmaceutical industry association and 39 of its affiliate pharmaceutical companies against the government of South Africa regarding provisions of its Medicines and Related Substances Control Amendment Act. The South African government's resolve on the correctness of its policy and serious weakness in the technical arguments of the plaintiffs together with strong pressure from domestic and international public opinion resulted in the withdrawal of these companies from the case. Following on from this case, a number of research and development-based pharmaceutical companies have come forward with interesting offers for developing countries in terms of affordable medicines to combat major diseases such as HIV/AIDS, malaria and tuberculosis. The discounts offered by the companies are impressive, but more still needs to be done given the dimension the diseases have reached in some countries. However, these individual initiatives fall short of constituting the global tiered-pricing scheme put forward to the TRIPS Council by the EU.

Licensing and Intellectual Property Organizations Meetings

<p>2001</p> <p>October 5 LES Benelux LES Meets the European Community Brussels, Belgium meetings@benelux.les-europe.org</p> <p>October 18-20 American Intellectual Property Law Association Annual Meeting Crystal Gateway Marriott Hotel Arlington, Virginia +1 703 415-0780</p> <p>October 28-31 LES (USA & Canada) Annual Meeting Marriott Desert Springs Palm Desert, California +1 703-836-3106 www.usa-canada.les.org</p> <p>November 1-3 LES International Delegates and Committees Meeting Marriott Desert Springs Palm Desert, California</p> <p>November 28 LES Benelux Trademark and Character Licensing Rotterdam, The Netherlands meetings@benelux.les-europe.org</p> <p>December 6-7 LES Pan-American Conference Renaissance Hotel Sao Paulo, Brazil +55 21-509-4080</p> <p>December 13-14 LES Benelux Two-day Licensing Course Leuven, Belgium meetings@benelux.les-europe.org</p>	<p>2002</p> <p>January 23-26 American Intellectual Property Law Association Mid-Winter Meeting La Pointe Hilton on South Mountain Phoenix, Arizona +1 703-415-0780</p> <p>February 14-16 LES (USA & Canada) Winter Meeting Las Vegas, Nevada +1-703-836-3160 www.usa-canada.les.org</p> <p>April 5-7 LESI Delegates and Committees Meeting The Rhiga Royal Hotel Osaka, Japan +81-3-3595-0578</p> <p>April 7-10 LES International Annual Conference The Osaka International Convention Center Osaka, Japan +81 3-3595-0578</p> <p>April 11-13 LES ANZ Annual Conference Melbourne, VIC, Australia www.lesanz.org.au</p> <p>April 18-20 American Intellectual Property Law Association Spring Meeting Waldorf Astoria Hotel New York, New York +1 703-415-0780</p> <p>April 20-24 International Trademark Association Pennsylvania Convention Center Philadelphia, Pennsylvania +1 212-768-9887</p>	<p>May 1-4 LES (USA & Canada) Summer Meeting Washington, DC +1 703-836-3106</p> <p>June 26-30 American Bar Association Intellectual Property Law Section Summer Conference Loews Philadelphia Hotel Philadelphia, Pennsylvania +1 312-988-5639</p> <p>August 8-14 American Bar Association Annual Meeting Washington, DC +1 312-988-5639</p> <p>September 8-11 LES Czech Republic LES Pan European Conference Prague Czech Republic</p> <p>September 29-October 2 LES (USA & Canada) Annual Meeting Sheraton Chicago Chicago, Illinois +1 703-836-3160 www.usa-canada.les.org</p> <p>October 3-5 LES International Delegates & Committees Meeting Sheraton Chicago Chicago, Illinois</p> <p>2003</p> <p>June 13-15 LES International Delegates and Committees Meeting Radisson SAS Plaza Hotel Oslo, Norway</p>	<p>June 16-18 LES International Annual Conference 2003 Radisson SAS Plaza Hotel Oslo, Norway</p> <p>September 21-25 LES (USA & Canada) Annual Meeting Hyatt Regency San Diego San Diego, California +1 703-836-3106 www.usa-canada.les.org</p> <p>2004</p> <p>May 7-12 LES Arab Countries LESI Delegates and Committees Meeting LESI Annual Conference Cairo, Egypt</p> <p>October 17-20 LES (USA & Canada) Annual Meeting Boston Copley Place Marriott Boston, Massachusetts +1 703-836-3106 www.usa-canada.les.org</p> <p>2005</p> <p>LESI Conference Munich, Germany</p> <p>September 25-28 LES (USA & Canada) Annual Meeting Phoenix, Arizona +1 703-836-3106 www.usa-canada.les.org</p>
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*For additions and revisions, please commu-
nicate with: Thomas G. Ryder editor@lesi.org*

*For the December 2001 issue, insertions
must be received prior to November 1, 2001.*

USA/Canada — Local Chapters

Meetings are held regularly in many locations. Call the chairperson in your area to attend a local meeting.

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