

# Licensing: A Tool to Expand Business

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*Licensing of patents and know-how offers the potential to reduce time and expenditures and also to avoid risks.*

## LICENSING IS THE FAST TRACK

When one discovers a business opportunity, he must move quickly. But unless one has been investing in the R&D of the technology for a long period of time, spending a considerable sum of time and money, he may fail to capitalize on such opportunity. Even when the company has spent considerable time and effort to develop the required technology, whether it can be elevated into a commercially viable project remains another issue. For in order to be competitive in the real world, the quality of the product must be not only excellent but repeatedly so, its manufacturing process efficient and at low cost, and its marketing refined to target its intended customer.

Another aspect is whether the product or process would infringe third party patents. This is an area that can be surveyed, but not fully concluded, as there may be strong patents applications still in the examination period at the Patent Office, to which one has no way of having access.

So, one viable alternative is to receive a license to relevant IP from an existing producer. Looking back when I started on my career, Japan was still trying to recover from the defeat of WWII, and had virtually no advanced technology for civilian use. To survive and be able to

import food and fuel for its people to survive, Japan embarked on a route to modernize itself by industrialization. The approach taken was to catch up as quickly as possible, by adopting the most advanced technologies and systems then known to be in existence. This approach was enacted by entering into licensing arrangements with the leading firms in the developed countries.

## *License Agreements*

Licensing arrangements are concluded by entering into Licensing Agreements. Unless the Licensor is in such a dominant position that it has the power to dictate its terms so that the Licensee has no alternative but to acquiesce to the terms and conditions imposed by the Licensor, a serious negotiation ensues. Although some may say that such Agreements should ideally result in a "win-win" situation, the real world is somewhat different. Of course, if such a win-win situation can be achieved, it is highly commendable. But the interests of the parties to the License Agreement will necessarily differ, and in some cases be in opposing stances. How to reconcile such different positions are the substance of the License negotiations, and thus is the core of the License.

Not to sound too confrontational, I wish to remind that a License is really a beginning of a relationship between the Licensor and Licensee. It will go on for the duration of the License, and perhaps even thereafter. Even in the most heated discussions during the License

negotiations, this fact must not be overlooked or discarded.

## *License Negotiations*

In most cases, Licenses for IP, especially for those including know-how, are subjects of intense negotiations. This is because the circumstances surrounding the deal vary with each case.

While the items of a License are more or less standard, the conditions of the contents to be agreed upon can be quite different. In other words, Licenses and negotiations thereof can be said to be dramas without scenarios.

Rather than dwell on the theoretical aspects, some actual issues, which have a direct bearing on the business aspects, are explained hereunder based on my personal experience.

## *Licensed Territory*

As you all are well aware, the operations of companies, especially in manufacturing, are becoming global. In the past it used to be that the Licensee would be satisfied if he were granted exclusive or non-exclusive rights to practice the technology in his own country and/or in certain neighboring countries. Recently, manufacturers in both developed and developing countries are moving their manufacturing bases abroad. This means that a Licensee who is granted a

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license to manufacture a product, is inclined to have it made abroad by its affiliate or some third party under contract on an original equipment manufacturer (OEM) basis. One may argue when granted "the right to make" in a License, such right automatically includes the "right to have made (by others)," and no further clarification is required. But since the Licensor, as well as the Licensee, tends to have its products made abroad, and possibly in the same areas or countries, a possible conflict may arise, if the matter is not addressed in the License Agreement. Rather than wait until a problem occurs, and since a product being made (or having been made) in a country tends to be sold in such country where it is made, it is preferable to resolve such issues beforehand when still in the negotiating stage. This matter has repeatedly come up in recent cases, where the Licensor is a US concern and the Licensee is a Japanese concern, and also in the case where the roles of Licensor and Licensee are reversed. The solution is really to recognize such facts, and to allow such activity to take place, but to notify each other so that no overlapping occurs.

#### *Valuation*

This item is one of the key elements of a License from the business point of view. I have heard many theories on how it can be structured and calculated. They are all valid, I assume. But what is the value of a specific technology at a given time and place remains a big question mark. In the real world, this issue is probably the one that causes the most discussion and friction between the Licensor and Licensee. But it is an issue that no one can avoid. But how to arrive at a valuation that would satisfy, or be acceptable, to both the Licensor and Licensee is an issue, which has

no universally applicable formula and must be worked out on an individual case basis. In the following, I will list a few cases, on how the price of a License was arrived at.

**Case 1: Uncertainty of Business Outlook.** This is a recent case in which I was involved. The technology was developed by a relatively small company with limited resources. A rather large foreign corporation became aware of it and its business potential. License negotiations ensued. The technology is for considerably enhancing the performance of a certain novel material to be used in electronics materials. But as all revolutionary technologies go, it had certain weak points. The issue was whether this promising technology would bloom into a worldwide major success, which almost every producer in the field must use to meet the ever exacting requirements in the electronic industry, or would its weak points limit its use to an important but small niche market. No one could be certain at this moment, especially when the frantic pace of technical development of the electronics field is considered. The running royalty rate was agreed upon, but how to assess the initial lump sum payment remained the issue. The Licensor is a small company and needs funds to carry out further its R&D and support activities. So a lump sum is required. If the technology becomes a huge success, the amount of funds the Licensor must spend for support and for application development would be substantial. Thus the Licensor proposed a larger lump sum. The Licensee understandably was not willing to pay or commit to a large sum, so a deadlock was formed. After much discussion, a compromise was reached, which would satisfy at least part of the aims of both parties. A sales growth curve was drawn up. In fact two curves

were drawn, one showing the conservative "niche" curve, and the other representing the hugely successful scenario. If within an agreed time frame, the sales of the Licensed Product reached the upper curve, a large additional lump sum is to be paid by Licensee to Licensor. If the sales do not reach such optimistic point, but is above the niche curve, a lesser amount is to be paid. If the sales fail to reach the niche curve, then no additional payment is due. All recognize that this is not a perfect solution, but it goes halfway to be acceptable to both.

**Case 2: High Royalty Rates.** This is a case in which I was directly involved as the potential Licensee. The product was a plastic building material. The Licensor was a major leading US chemical company. All terms and conditions of the License were agreed upon; but there was one clause, which was still in controversy. The Licensor was asking for a tremendously high rate for the running royalty. While we were agreeable to paying some running royalty, the offered amount was so exorbitant that it would probably render the project unprofitable. After many negotiating sessions, we learned that the reason for such high rates was the report of their company economist's long-term forecast of the Japanese economy, in which he predicted that the Japanese yen would become much weaker. Since the Licensor had some total income as a goal to achieve, if the yen became weaker the running royalty which accrued in yen, would represent less income in dollars. In order to compensate for the erosion in income, the rates had been raised to very high levels. This negotiation took place in the mid-1980s, when the yen was about 200 yen to the dollar. I had faith in the future of the Japanese economy and believed that it would become much stronger and consequently the yen

would appreciate also. I proposed to the management that instead of a royalty rate, we propose a fixed amount of dollars per kilogram as the royalty, and absorb the risk of the fluctuations in the yen/dollar exchange rate. Such idea was accepted by Management and the Licensor. I am happy to say that thereafter the yen strengthened rapidly and settled at about approximately 100 yen per dollar basis. The Licensor obtained the amounts he anticipated, and the Licensee saw his effective royalty payment reduced by one half.

I have given this example to show that the License and the License Agreement are made up of terms and conditions, which are more or less standard, but the contents are to be determined on an individual basis.

#### *Strategic or Political Considerations*

When entering into a License, one must never forget that it marks the beginning of a new relationship. It is best to establish and maintain good relationships with the other party. It should be also remembered that the other party has to live and survive, and further it is important not to humiliate or embarrass him.

**Case 1:** A Japanese company had invented a novel way to make a speciality fiber, which was to replace an existing version. An American company had been the world leader of such fiber for many years, but had been caught napping and had not developed this new generation version. In order to protect its market and vested interests, the American company negotiated with the Japanese company for a License on the new generation fiber and was able to receive a License thereon. However, it did not wish to be known to the world that it had to rely on the Japanese company to stay in business. The Japanese side understood and

devised a way for the American company to save face. The formula was to use a cross-license format, in which the Japanese licensed the new version and the American licensed the old to each other, but the press release did not mention old or new. The payment fees were not disclosed, but in actuality, the new technology carried a high price, but the old one did not carry any price at all. The wording was that if and when the Japanese wanted to use the old technology, it would pay a nominal sum to the U.S. company. To the public, it appeared that the two were equals, exchanging rights, but the real situation was quite different.

**Case 2:** A Japanese company had developed a new oxidation process and catalysts therefor. It had filed in the U.S.A. for patent coverage and was granted patents thereon. In order to protect its technology, it had filed and been granted patents on many catalyst systems, which were useful in such process. Independently an American company had filed for patents in the same area, which were based on prior invention date, and issued after the Japanese patents had been granted. Some areas of the patents of the Japanese and American overlapped, and thus interference occurred. At the recommendation of the U.S. Patent Office formal proceedings were held at a lawyer's office. After some intense discussions and fervent research by the Japanese side, it was discovered that the U.S. side had not disclosed all prior art it had in its knowledge at the time of filing. This made the American position weak, and reversing its earlier stance agreed to settle. We had won, but since the Japanese company had other Licenses with this U.S. company, it decided not to take a confrontational stance. The settlement arrived by mutual agreement was that both parties would grant the

other a non-exclusive cross-license without payment, but that the U.S. company would modify and delete the part that overlapped with the claim of the patent of the Japanese. Again this may not seem to be such a major issue, but when conducting a business, it is better to end as friends, not bitter enemies, if a solution can provide satisfactory results.

#### MISCELLANEOUS

There are many many other aspects of Licenses that are important, but with a business orientation rather than legal or technical. It is my belief that in the Licensing activities, business considerations play a central role, which is not discussed very much. Yet the very objective of a License is to promote business, or to safeguard it.

#### *Failure in Licensing*

I would like to dwell a little on cases where the License was a failure. One does not really like to remember such incidents, but for the benefit of some, presented below are several cases where the License did not materialize into profitable businesses. The negotiations themselves were a success, but due to changes in the business environment, they did not bear fruit.

**Case 1:** A U.S. company developed a novel oxidation process to produce a speciality chemical. The conventional method was to go through an intermediate substance, and was costly. This new process was the first of its kind. A Japanese company found out such process had been successfully developed and was being tested in a pilot plant, and negotiated for a License. A License Agreement was concluded, but the Japanese under the advice of the U.S. Licensor, decided to wait until the Licensor had built

a commercial plant and had resolved all the bugs, which normally appear in such first-of-a-kind plant. About three years was required for the design and construction of the Licensor's plant. The Licensee had paid the initial payment and was waiting for the Design package to arrive. In the meanwhile, a third party announced that they had invented a new catalyst system, which they claimed gave a much higher yield and required less capital investment, relegating the Licensed Process to an inferior competitive position. After carefully gathering information on the third party's technology, the Japanese side concluded (and the Licensor agreed) that the press release was true, the Licensee discontinued its plans to commercialize the Licensed Technology. The initial payment, which had been paid, was not returned.

**Case 2:** A Japanese company had developed a specialty chemical for use in niche markets and had been exporting it to Europe. A major European oil company became interested in this chemical, as it had decided that the oil business was not profitable and wished to diversify into fine chemicals, which bear a higher margin. After intense and long negotiations, a License Agreement for the transfer of patent rights and know-how was concluded and a Joint Company formed to implement the Agreement. As the

Basic Design Package was delivered and detailed design work began, the European oil company suddenly announced that it had divested its Fine Chemical Group to a small company. Obviously the oil business had become profitable again, riding on an up cycle, and the appeal of a high margin but small business became less attractive to it. The Japanese side had the option of continuing on with the new small company, or aborting the License. Upon due deliberation, it was the conclusion of the Japanese side that the new small company did not have the resources nor organization to launch an aggressive marketing effort, so it terminated the License.

**Case 3:** A novel plastic was invented by an American company. It had excellent gas barrier properties, which made it ideal as bottles for packaging carbonated soft drinks and micro-filtered beer. A Japanese company found out about this development, and expressed its interests for a License. After negotiations, a License Agreement was signed, and since this happened in 1970, the approval of the Japanese Government was still mandatory. In unofficial consultation with the Health & Welfare Ministry, it was found that acceptable toxicity levels for soft drink bottles were extremely tough. The reasoning of the Ministry was that soft drinks are consumed by an

individual from his infant days, and continue to be consumed until his old age. So the possible cumulative effect is far greater than any other packaging. In order to be approved, and since the Licensor did not possess such data, the Licensee would have to collect such data by feed tests, which is time consuming and costly. Also the Ministry was concerned about the increasing amount of household waste, and did not wish to approve a project that would aggravate the situation. (Later with the advent of supermarkets and convenience stores, coupled with shortage of labor, making house-to-house delivery improbable, the one-way container has become widely used in Japan. On the other hand, the household garbage situation has become much worse.) In view of the attitude of the Government, the Japanese side abandoned the project.

## CONCLUSION

I have tried to touch upon some business aspects of Licensing, and to share with readers some of my past experience. Licenses can be beneficial to advancing one's business, but there are no set guidelines for one to follow. Each License is a new experience, and one must face License negotiations with fortitude, flexibility and creativity.