

Drafting Heads of Terms for License Agreements

By Colm Mackernan

The first step in any licensing strategy is to establish why you are licensing and what are the basic outlines of the licenses you plan to offer. Licenses are not identical; rather they are situational, reflecting the technology on offer and the commercial and business objectives of the licensor and the licensee, and each party's need to protect itself. Moreover, licenses and heads of terms are not something that 'legal' should just throw together – rather what should be in the license terms depends on facts and information that needs to be supplied typically by the finance, marketing, operations and technology functions within a licensor's business. The note below is designed to try to get these functions to think about the factors that need to be applied to a licensing decision and contribute their knowledge to working out what should be in the heads of terms.

1. Should we do it and if so to who?

A.

First, do we have a technology that we are either not exploiting, or for which we are failing to recognize the full economic potential?

transfer or can we acquire those resources?

- iv. What will the technology transfer cost us to execute for the classes of potential licensees at B(ii)?

B. Is this technology transferable, i.e.,

- i. What does it consist of - patents, teachable know-how?

- a. If it is know-how is there a confidentiality agreement for what has already shown to the licensee - can it be kept confidential or is it's a technology to which 'inevitable disclosure' applies (i.e., once on sale it can be reverse engineered and if so – is there 'lead-time-advantage' for the first-to-market)?

C. Where is the profit found?

- i. How and where do exploiters of the technology find their profits?

- ii. What levels of market are the main profits made at?

- iii. Are there licensees that we identified at B at those levels of the market?

- iv. Applying a DCF or other Net Present Value analysis, and a 25% of licensee's margins rule, can we realize more from licensing than the profits from our sole exploitation of it without competition and the cost of technology transfer? What is the cash flow impact for us until revenue is realized (impacts whether to charge license fee (see below))?

- ii. Are there potential licensees with the skills to receive the technology - who?

- are there substantial variations in technological level among likely licensees?

- iii. Do we have, or can we find the resources to carry out the technology

D. What do we know about potential licensees:

- i. What are their economic goals? Can we make a proposal that meets them?
 - a. What is the typical Rate of Return (RoR) and/or Gross Margin in their sector;
 - b. What is the sector leading RoR and Gross Margin?
 - c. Can we determine from reviewing their annual reports, and if US listed, their SEC forms 10-K and 10-Q what their current RoR and Gross Margin is and if their management has made any statements about targets for RoR and Gross Margin?

- ii. Have they expressed an interest in the market that this technology would give them access to?
 - a. Do they already have skills in this area?
 - b. Are they a 'have not' with respect to a technology where their competitors already have something to offer?
 - c. Would there be internal competition for the licensed technology and a risk of 'not-invented-here'?

- iii. What markets can the potential licensees effectively address? Do they have a channel to market?
 - a. Geographically?
 - b. Fields of use?

- iv. How do they play with others?
 This is a crucial issue, so ask among friends and colleagues. Companies have business cultures and some business cultures will greatly support a technology transfer model and business relationship, while others will severely undermine one. However, short of massive management changes and substantial departures "leopards rarely change their spots" and thus a company will tend to behave in fairly consistent ways. Some types of partners are:
 - a. The demanding partner that keeps its promises and has a thought through strategy, values business relationships and understands that its business partners need to profit from a deal as much as it does. This is the ideal business partner. Most successful technology companies will tend to exhibit this type of approach – but it is also how bad partners will present themselves. Moreover, even the best companies will often show aspects of the negative behaviors described below.
 - b. The indifferent partner, that simply fails to consider the damage that its actions or more often inaction and indecision are causing its business partner. Such a partner will inexplicably 'dither' on issues ranging from signing the contract to launching the product. It is usually a bad idea to give this type of partner any exclusive rights.
 - c. The "all your margins are ours" partner. This type of partner is often volume driven with a "pile 'em high, sell 'em cheap" mentality which means that any profits its business partners enjoy undermine its business model. Generally not a good business partner for the long term - royalty floors are pretty essential with this type of partner.
 - d. The partner that will insert language into their agreements that

allow them under certain, almost inevitable circumstances, to take your technology for free – this type of partner is fairly rare, but one very large company does use this tactic, so be careful.

- e. The ‘scorpion’ – who, like the character in Aesop’s fable, will sooner or later ‘sting’ its partner, even though it too may be damaged by this act. With such a partner it is only a matter of time before it will turn on you. Generally you should avoid this partner – but if you have to, make sure the contract is very carefully drafted and never accept the suggestion “but we would not do that!”
- f. “The negotiate now, argue and litigate later” partner. This type of partner will often try to reopen the deal later in the relationship and, with a smaller partner, will use its greater financial strength to force it to make further concessions, resorting sometimes to litigation to attain this objective. Careful drafting of dispute resolution provisions is crucial with this type of partner.
- g. The ‘re bargainer.’ The best way to describe this partner is like someone, who, after having enjoyed a fine meal in a restaurant, demands discounts on the price when the check appears. Re-bargainers will often from a position of financial strength, use their control of the payment due to demand further price concessions from a financially weaker partner – so re-bargainers will often be large companies dealing with smaller ones. A re-bargainer will commonly use a small dispute on

a minor issue as a pretext to withhold all payments due while arguing for a discount. Very careful drafting of credit terms is important to deal with this issue.

- h. The “give us a very favourable license or we will make our own, undercut you (or even give it away for free)” partner. Look to your intellectual property rights, patents etc. to be able to counter threaten and any technical disclosures for evaluation requires a ‘bulletproof’ confidentiality and non-use agreement, backed by careful recording of all technical disclosures to the partner.

To all of this needs to be added a caveat. Business is uncertain and technology agreement will often need revision. This is not a bad thing, and too much rigidity should be avoided.

2. Basic Terms

A. What are we licensing

- i. Patents
- ii. Patent Applications
- iii. Know-how
- iv. Copyright
If Software?
Source code
Object code
- v. Trademarks

B. Exclusive or Non-Exclusive

Licensing has risks for the licensor and the licensee. For the licensee the risk is that in a non-exclusive situation the licensee will invest effort and funds in acquiring a technology to find that it is entering a more competitive market place than anticipated - this risk is exacerbated if the licensor can establish other competitors to the licensee. Thus licensees almost always seek some sort of

protection from this risk, and exclusivity is one form of protection. The licensee's need for protection increases as the investment associated with exploiting the transferred technology increase.

However, a licensor is taking a risk that the licensee will:

- not properly exploit the technology,
- take too long to come to market
- be unable to address key markets
- be just bad at the business.

Especially if the licensor expects to be compensated by means of a royalty, these risks are acute for the licensee. The other issue driving exclusivity is that the licensor may be planning to itself exploit the technology and is wary of setting up the licensee as a competitor - and so the licensor may choose to grant the licensee a license that reserves certain markets for the licensor. Another factor influencing the question of exclusivity is already existing licensees and business arrangements, and the existence of other likely licensees. Based on these weighing these risks there are various solutions on the issue of exclusivity:

i. No exclusivity at all

This arrangement is actually rather rare in technology transfer agreements, other than for 'commodity technologies', e.g., ARM processor cores, where widespread use and ubiquity is part of the product value. Such arrangements are often associated with multilateral standards or unilateral (single company) standards.

ii. Complete Exclusivity

This type of arrangement is also very rare - it amounts to an effective sale of the technology to the licensee. As such it is associated with high up front payments or licensee fees and high royalties with

severe restrictions on how low in cash terms the per unit royalties can be (minimum \$ per unit plus annual/quarterly minimums.) The licensor must absolutely trust the licensee, the licensee must be financially strong, and the licensor should still build in numerous safeguards.

iii. Limited Exclusivity

The most common form of exclusivity. In such an arrangement exclusivity is limited in various ways. Exclusivity arrangements can be sensitive under competition/antitrust law but they are not generally prohibited. It is common for specious competition/antitrust arguments to be raised in negotiation ("that clause is illegal") so always ask for this legal objection to be shown with reference to licensing guidelines.

a. Performance and exploitation/use conditions

The license provides that the licensee must meet certain performance conditions to retain exclusivity. These conditions can be temporal, i.e., the licensee must have achieved certain things by certain dates - e.g., prototype built, first sale, specific markets addressed, etc. To explain in clearer terms, if the licensee is not using the exclusive rights, it loses them.

There are two types of performance/use consequence. One is termination of the license – used in situations where any replacement licensee would likely need exclusivity, the other is ending of the exclusivity. In any event, for legal safety, the conditions for invoking such a termination need to be very 'bright

line' and there should also normally be a pre-termination notice period (e.g., 30/60/90 days pre-termination the licensor shall warn the licensee that the clause is going to be invoked absent a 'cure.')

Such a combination of 'bright line' plus 'notice' makes it difficult for the licensee to complain successfully.

b. Field-of-Use limitations

A field of use clause is a provision that limits either the licensee or the licensor to a particular use for the product. In general this is common when the licensee and licensor have asymmetric marketing strengths. Thus to take the example of a silicon device - the licensor might reserve standalone sales to itself, but grant rights to incorporate or embed the component in a certain class of devices to a licensee with strong marketing capabilities or other factors that make it more effective in that market place. One of the benefits of such a provision is that it reduces the risk of channel conflict. Field of use restrictions that are poorly drafted can raise serious antitrust/competition issues.

c. Territorial Limitations Territorial restrictions are used for various reasons, e.g.:

- One party is better able to address certain national markets than others, e.g., one has a US distribution network, the other a European;
- The investment to address the entire world market is too much for a single licensee and so each

licensee is given a market of a size it can support;

- The licensor wants to keep one market for itself or there is already a licensee in one of the territories with an exclusive license.

Territorial restrictions within the EU can be complicated to draft under applicable EU competition law. If you plan a territorial restriction it is advisable to review the EU competition guidelines. Some sorts of restrictions can only be for a limited time.

d. Limited Time/Term

Exclusivity for a limited time has advantages for both the licensor and licensee. For the licensor, it has the opportunity to add additional licensees at a later date plus it knows that the first licensee will have a strong incentive to maximise its market position while it enjoys the exclusive rights, which means that the progress of the technology may be faster – this is particularly the case the licensee has paid non-refundable fees and charges upfront to the licensor. From the licensee perspective, it has a period in which it enjoys a lack of competition that will allow it to recoup investment in adopting the technology.

C. For how long – perpetual or limited term

Limited terms sometimes arise – i.e., the license is for 5 years. They are however unusual without some sort of renewal or extension clause. The reason is that a licensee who has invested a lot in exploiting a license, has dedicated facilities that cannot

be used for other purposes, or cannot be redeployed without cost, and may have long-term customers, will be very much a hostage of the licensor at the end of the term. When licensors seek limited terms it is because of an uncertainty about the price at which they are licensing the technology – the licensor is worried that it will have given too favourable a deal to the licensee and wants to reserve the opportunity to re-price the technology at a later date. Licenses where the bulk of the compensation in the transaction is mostly a license fee or that have low running royalties tend to result in the licensor seeking a limited term.

- Renewable

From time to time a fixed term license will have a provision that allows the licensee to renew the license. Such a provision will often have a formula for calculating financial terms. However, the actual application of these clauses are unusual, since usually the licensor will have written them on terms that causes the licensee to want to renegotiate. However, even if onerous, they do provide a “safety net” for the licensee.

- Post term use

Limited term licenses will typically need to deal with post-term use issues such as warranty replacements, stock-in-hand, components-runoff, existing orders, etc.

- Goodwill provisions

Particularly where a licensee has built up substantial goodwill in the business associated with the license, that licensee may want some mechanism to allow it to recapture some or all of that goodwill if the license is not renewed, while the licensor may want some mechanism to ensure that goodwill is successfully transferred in practical terms. These can be very difficult clauses to balance.

3. Payment Basis

There is very little point in being ‘coy’ about financial terms. Both the licensor and licensee are going to invest time and management/legal resources in negotiations. If the licensor’s financial terms are going to be ‘dead on arrival,’ it is better that this is apparent before the resources of both licensor and licensee are expended. It is for this reason that section 1 of this note contains so many questions designed to establish a priori whether what the licensor needs for the license to be an economically viable proposition and to establish a clear view with respect to potential licensees of what they will want for the transaction to make sense to them.

In terms of how payment works there is a basic principle to understand – ‘money certain’ is worth more and costs more than ‘money uncertain’ which is to say that to the extent that a licensor seeks certain payment upfront, this reduces what can be sought in the uncertain royalties ‘down the road.’ However, another driving factor, which may lead to seemingly economically irrational outcomes, is the accounting treatment of the license by the licensee and licensor, how it is treated on company balance sheets and the effect of revenue recognition rules.

i. License Fee

A license fee is a fixed fee that is payable on signing the license. A large license will tend to lower royalties payable. However, there are advantages to such a large license fee. First, it tends to put pressure on the licensee’s management to exploit the technology, so as to justify the amount paid for it. Second, the license fee can often be treated as capital expenditure (CapEx) on the licensee’s bal-

ance sheet and so it is more attractive from an accounting perspective than royalties. Third, depending on the basis for payment of the license fee, a licensor may be able to recognize it as revenue immediately. Generally a large public company prefers to pay a license fee to a royalty.

ii. Royalty

A high royalty will tend to detract from the amount of any license fee. The benefit of royalties is that if the technology proves very successful, the licensor will earn more, while the licensee avoids a large initial outlay and the licensor gets a guaranteed payment. However, for the licensee the main disadvantage is that royalties are accounted for as a cost/expense item, and so look less attractive on the balance sheet and in the annual report. In setting any royalty you need to consider how it will be charged. There are two basic types of royalty:

- a. ad valorem, i.e., the royalty is charged as a percentage of the selling price. There are advantages and disadvantages to this type of royalty. The advantage is that the royalty can track the value of the technology more closely, so that the royalty can more effectively avoid being uneconomically low or high in terms of the actual monetary amounts paid in Dollars, Euros and Pounds. The problems are that it can be very difficult to determine the point at which the royalty should be charged – i.e.,
 - what sale attracts the royalty and is this an ‘arms-length-sale’ with a fair selling price?
 - What happens if the sale is a ‘related party transaction’, a ‘loss-leader’ or a tax driven ‘transfer price’ for the licensee and the price is therefore below its proper level?
- How do you deal with situations where the transferred technology is embedded by the licensee in a much larger component – what proportion of value is attributed to the licensed technology?
- b. Fixed royalties – i.e., a fixed monetary amount per unit. The problem with fixed royalties is that they can be too low, or commonly can become too high. Again some solution to the problem that the royalty may be so high as to render the technology uneconomic has to be found – but from the licensor perspective, the licensee’s solution, a very low royalty may result in selling the technology too cheaply.
- c. Mixed royalty systems – ad valorem with a fixed floor. This is a common solution where the rate is set at a percentage of the sales price, but a minimum amount is also fixed on a unit basis and the licensor is paid the ‘higher of.’ It is also common to also provide that for related party transactions a royalty floor can be set by reference to unrelated ‘arms length’ and non-sham transactions.
- d. Minimum amounts – royalty clauses where there is exclusivity will often contain provisions requiring a minimum amount of royalties to be paid per quarter, half or annually, usually starting at a specified date and rising for a series of early quarters to a ceiling. This protects the licensor against

lack of exploitation or bad exploitation by the licensee.

- iii. Sometimes prepaying an amount of royalties is proposed as a license term. Pre-payment may be helpful for the licensee depending on its accounting treatment but it can raise major revenue recognition problems for the licensor.
- iv. Metering
It is particularly useful in a royalty situation to look for some metering proxy. The term metering is used in licensing to describe methods for trying to work out the extent of the licensee's use of the licensed technology, by, for example, looking at the number of unique components purchased. Running royalties should usually be tied to something that can be metered easily and reliably.

4. Grant-Back Clauses

Grant-back clauses require a licensee to grant the licensor a license to anything the licensee develops that the licensor, or other licensees will find essential to exploiting the technology. They are common where the licensor will work closely with the licensee in implementing the technology, which can create problems in identifying who owns technological improvements developed during this process and also where development of the technology is not totally complete. Grant-backs are also used when the licensor has developed a standard technology and need to ensure that all licensees adhere to that standard for the full value of the technology to be realized. Exclusive grant-back provisions are prohibited under EU, Japanese and Korean competition rules and are at least legally suspect under US antitrust law.

5. Termination

There are two reasons a license may terminate – either it is a term license and it has simply expired, or the licensee has breached the terms of the license. A license will usually need to specify grounds for termination of the license which typically are major breaches of the terms of the license or minor breaches is left un-fixed after notice and the elapse of a certain period of time. A real risk of litigation exists when a license is terminated. For the licensor to protect its legal position it needs to be able to show that a termination was fair. Thus immediate summary termination of a license should only be for exceptionally grave breaches of the license agreement, while other breaches should have cure clauses that allow the licensee to a certain period of time to cure the breach after a notice letter.

There usually need to be provisions that deal with what happens in the event of such a termination – for example return of confidential materials, destruction of moulds, maskworks and jigs, deletion of source code, databases, etc. It is not usual to include these provisions in initial heads of terms, but the licensor should have a good idea of what the termination provisions are likely to be early in the technology transfer process.

One issue that should be considered early though is reservation of title clauses – these are provisions that for example provide that documents, diagrams, semiconductor masks, etc. remain at all times the property of the licensee.

6. Expenses

The question of how expenses associated with technology transfer and technology maintenance will be allocated needs to be settled early on. If the licensor intends to

recover this cost, the daily rates for licensor staff involved in the transfer will usually have to be addressed. Other minor issues such as travel policies, insurance etc., should also be considered.

7. Audit

It may be cynical to note that a time-honoured technique for licensors needing to raise revenue quickly is to carry out a few licensee audits. Although one might in principle expect that inadvertent errors in royalty reporting would tend to divide equally between under payment and over payment, the ratio is typically 95% underpayment and 5% overpayment.

Typical audit clauses limit the licensor to performing audits at a maximum frequency, e.g., no more than every two or three years and provide that the licensor will pay for the audit unless a certain magnitude of underpayment is identified (e.g., 2%, 3%, 5% underpayment) at which point the licensee must pay for the audit. There is normally also a provision that in the event of a significant underpayment being found the licensor can audit again in a shorter period, e.g., 12 months. Typically the audit is performed by an independent large accounting firm. Finally, there are normally provisions that require the licensee to preserve certain records to allow for an effective audit. It is particularly useful to find some metering proxy – that is to say some thing, such as component, the use or purchases of which by the licensee can easily be counted, that the licensor can use to track the licensee's use of the licensed technology.

8. Taxes and Withholding

This can prove to be a very contentious issue since a number of countries impose withholding taxes on royalties and may require evidence under a tax treaty that such

taxes should not be withheld. The usual approach is to specify that all royalties are set net of taxes and withholding – i.e., the licensee deals with the taxes, but to require the licensor to provide any reasonable documentation and materials the licensee requires to lower the amount of the withholding or eliminate it under relevant tax treaties.

9. Branding

If the licensee will be expected to show the licensor's brand on products containing the technology this needs to be addressed early – preferably in the heads of terms. The definitive agreement will usually contain branding guidelines for how the brand or brands should be presented.

10. Internal Marketing

It is hard to understate the importance to a licensor of examining how 'internal marketing' at the licensee will operate. Licensees frequently take in technology, but fail to have any plan to promote the technology to their own sales force and internal customers. Moreover, technology companies are very prone to the 'not invented here' syndrome, especially when there was an internal rival for the technology acquired. Thus one of the biggest reasons technologies post transfer fail to thrive is because there is no internal marketing effort at the licensee. A licensor needs to address this issue proactively from the outset of any license discussion.

11. Choice of Law and Dispute Resolution

The most desirable solution is to avoid any litigation. Thus it is wise to put escalation clauses into agreements, which require the parties to refer disputes first to uninvolved managers for resolution, then to the CEOs or Chairmen and only if they cannot resolve the matter after a fixed period of time to

allow litigation. Pre-litigation mediation may also be advisable if it is required to be completed on a strict timetable. In such escalation clauses it is important to force the resolution procedure along – because of the risk that one party will simply use the provision as a way to just ‘stall’ legal proceedings and not honestly seek a resolution.

The general tendency of parties to international commercial agreements is to seek to use their own domestic law and courts – thus a licensor will often suggest its law and courts, the licensee the opposite. This is somewhat of a ‘knee-jerk’ approach when it may be that the other party’s law is more favorable. Thus for example, in agency agreements a US agent should seriously consider an offer of a European law since the European Commercial Agent’s Directive is generally more favorable than the law of the various US states. However, there may be substantial drawbacks to agreeing to a foreign law – your lawyer for example may need to seek legal advice from that jurisdiction at some cost, and some states have legal provisions, such as unfair business practices laws or unfair competition laws that create unexpected problems in the event of a dispute. It may well be that the best solution is a compromise law such as New York, English or Swiss – all of which allow for their law to be selected even with minimal contacts with that forum, or none at all.

Dispute resolution is another complex problem – the courts of certain countries and indeed in certain US states are notoriously chauvinistic and will tend to heavily favor the domestic party. In other legal systems, the judiciary is often corrupt or open to political pressure. The solution is usually a forum selection clause where a relatively neutral venue is selected – or alternately an

arbitration provision with one or three arbitrators (and sometimes clauses that provide for one arbitrator for small disputes and three for large.) An arbitration provision usually allows a choice of the city in which the arbitration will be held and this can have a substantial impact on costs. Sometimes home-field advantage clauses provide that the arbitration hearings will be in the respondent’s home city.

11. Special License Situations

Licenses have a wide number of variations each driven by its own special circumstances. However, a few common variations can be addressed:

- A. Supplier licenses are licenses that a licensor grants the licensee so that it can supply the licensor with an item that it needs. The advantage of such a license is closer control over the licensor’s technology and if it wants the ability to restrict the licensee from supplying a competitor.
- B. Off-take provisions are clauses that allow the licensor to off-take a proportion of the licensee’s production for the licensor’s own purposes. These are often combined with filed of use exclusivity clauses and will have provisions to ensure that the licensor gets a favorable price.
- C. Dual sourcing licenses arise when a licensor’s customer insists that for security of supply it wants to ensure that there is a second source for that licensor’s products. While the security of supply argument may be legitimate, the licensor/supplier should be wary of a provision whose real objective is to lower the licensor’s prices by establishing a competitor and in such a situation would be

wise to demand a substantially higher than typical royalty.

- D. Export controls. Certain sensitive technologies, for example weapons related technology, can be subject to export controls. In such a situation the licensor may need to insert clauses requiring licensee compliance with export controls.
- E. Marking. The US Patent statute at 35 USC §287 requires that a patented product be marked with the patent numbers applicable to that product. This used to cause very significant difficulties as it was simply impracticable to mark many products with what was often a long list of patent numbers. The act was recently amended to allow for virtual marking – i.e., the marking of the product with “Pat” or “Patent” followed by a url which linked on the Internet to a list of applicable patents.

clear plan of why you are licensing, what you hope to gain and what you need to offer a likely licensor. Moreover, many of the key issues to resolve in a license, the things that form the Heads of Agreement are not ‘boolean’ questions, but rather involve weighing the facts of that particular license so as to come up with a deal that forwards both the licensor and licensee’s interest. You are looking for that old cliché – a ‘win-win’ arrangement. It is because each license is sui generis that you cannot simply dust off a standard ‘boiler plate’ license agreement, or dig up one from a past deal involving different technology and different partners and expect it to work. Moreover, effective licensing does benefit from a ‘joined up’ management approach to gathering the information to craft an effective deal.

Conclusion

Licensing is not a dangerous unless you stumble into a licensing strategy without a

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