

TECHNOLOGY LICENSING GUIDEBOOK

LICENSE AGREEMENT

This Agreement ("Agreement") is entered into effective as of the last date set forth on the signature page of this Agreement ("Effective Date") by and between XXX, a Delaware corporation having its principal place of business at ("XXX"), and YYY, a New York corporation having a principal place of business at ("YYYY").

WHEREAS, XXX owns Licensed Patents and technology relating to methods and apparatus for [description of use] ("Certain Uses"); and

WHEREAS, YYY desires to obtain a license from XXX to make, use, offer for sale, and sell apparatus for Certain Uses incorporating technology disclosed in the Licensed Patents and Licensed Technology.

NOW, THEREFORE, in consideration of the mutual covenants and agreements hereafter set forth, the parties hereto agree to be bound by the terms and conditions set forth hereinbelow:

NYS SCIENCE+TECHNOLOGY
LAW CENTER

AT SYRACUSE UNIVERSITY COLLEGE OF LAW



Division of
Science, Technology
& Innovation

About the Licensing Guidebook:

This guidebook was compiled by the New York State Science & Technology Law Center to help answer questions about licensing technology. The invention and protection of new technology are the first steps, but licensing is the way to grant permission to others to use the technology in exchange for a share of the profits. For example, an entrepreneur may seek to license a university-owned technology as the basis of a new business or to enhance the products it currently produces, or an inventor may seek to license their own invention to someone else to produce and distribute, and take a share of the profits in return.

This guidebook provides an overview of how licensing works to acquaint the user with the process and decision points they are likely to encounter. Sample licensing agreements are also included.

About the New York State Science & Technology Law Center:

The New York State Science & Technology Law Center (NYS STLC) has been a leading resource in technology commercialization for nearly a decade. Since its inception, the NYS STLC has assisted with hundreds of commercialization projects across New York State. It was established at the Syracuse University College of Law by Empire State Development's Division of Science, Technology and Innovation (NYSTAR) to facilitate New York State's economic development by leveraging the experience and expertise of law faculty and SU College of Law students to assist New York businesses and institutions in delivering new and emerging technologies to the marketplace.

Advisement:

The information contained in this pamphlet is intended to be an introductory guide. No part of the guidebook, attachments, or related discussions constitutes legal advice or written opinion of counsel. For legal advice, please consult with an attorney.

Any opinions, findings, conclusions, or recommendations expressed are those of the author and do not necessarily reflect the views of the New York State Department of Economic Development.

© 2017 Technology Commercialization Law Program, All Rights Reserved
Research by Chris Horacek, Esq.

Table of Contents

1 Types of Licenses	5
1.1 Types of Technology Licenses	5
1.1.1 Intellectual Property Rights Licenses	5
1.1.2 Product Design Licenses	5
1.2.1 Trademark Licenses	6
1.3 General Software Licenses.....	6
2 Scope of a Technology License	7
2.1 Geographic Scope	7
2.2 Exclusivity	7
2.3 Field of Use	8
2.3.1 Purpose	8
2.3.2 Examples of Fields of Use	8
2.4 Sublicensing	9
3 Consideration	11
3.1 License Fees	11
3.2 Earned Royalties	11
3.3 Consideration for Sublicensing.....	13
4 Determining Royalty Rates.....	16
4.1 Profit	16
4.2 Other Assets	17
4.3 Profit Allocated to Total Technology IP that is Contributed by the Licensing Technology	18
4.4 Purpose	19
5 Clauses Related to Exclusivity	21
5.1 Diligence in Commercializing Licensed Technology	21
5.2 Minimum Royalties.....	22
5.3 Cost of Obtaining and Maintaining IP Rights	22
5.4 Enforcement of IP Rights.....	23
6 Other Contract Clauses in Technology Licenses	25
6.1 Indemnification	25
6.2 Term and Termination.....	28
6.3 Confidentiality	28

Basics of Technology Licenses

1 Types of Licenses

This guidebook focuses on licenses of intellectual property rights and technology that enable commercialization of a specific product (technology licenses). There are different types of technology licenses, and technology licenses as a group are one of several larger classes of licenses. The following classification of some common types of licenses puts technology licenses into context.

1.1 Types of Technology Licenses

Technology licenses can be separated into two groups, licenses of intellectual property rights and licenses of product designs.

1.1.1 Intellectual property rights licenses (IP rights licenses) consist of licenses of patents, copyrights of software source code, and trade secrets, which are capable of enabling broad functionalities and different embodiments in multiple types of products or different applications. The licensee of the IP rights will do the research and development necessary to develop a specific product application, and the licensee will bear the product development costs. The output of basic research may be protected by a patent, copyright, or trade secret, and Technology licenses from universities typically are IP rights licenses to a company that will develop a product design based on the IP rights and make and sell product based on the design.

1.1.2 Product design licenses consist of a complete or partially completed design and specification for a product, or a functional subassembly of a product, plus all of the intellectual property rights that are necessary to make and sell the product or subassembly that is made from the design (design licenses). The licensor of the design has done some, or all, of the research and development necessary to develop the specific product application, and the licensee will save these costs. The output of research and development activities by a company typically is directed to the design

of a particular product, and design licenses are typically granted by a for-profit company to another company that will manufacture products based on the licensed design.

1.2 Other Types of Licenses Used in Commercializing a Product

1.2.1 Trademark licenses grant the right to use a brand for a product and can be important to successful commercialization, but they do not involve any technology.

1.2.2 Object code software. Many types of object code software are licensed to manufacturers to be incorporated into their products, for example an operating system for microprocessors in the product or software to run the display of the product. These are often referred to as original equipment manufacturer (OEM) software licenses. They can be essential to commercialization but are not specific to a particular product.

1.3 General Software Licenses

Licenses of software for use on a computing device (end user software licenses) and licenses of software to an organization for use on all of its computing devices (enterprise software licenses) are not related to commercializing a product, although they contain some of the same types of clauses that are used in technology licenses.

1.4 Overview

This guidebook provides an introduction to some of the key considerations and provisions of technology licenses.

2 Scope of a Technology License

Technology licenses enable the licensee to make and sell products that embody the licensed IP rights or product design (licensed technology), in other words to make and sell licensed products. Licensed products are defined as any product that has features which embody the licensed technology, or alternatively, as any product that would infringe the licensed technology in the absence of the technology license. The scope provisions of a technology license are used to define any limits on the licensee's authorization to make and sell licensed products. There are four main scope provisions of a technology license relating to 1) geographic scope, 2) exclusivity, 3) field of use, and 4) sublicensing.

2.1 Geographic Scope

The geographic scope of a technology license is addressed in a clause that defines the geographic territories in which licensed products can be sold. If no territory is specified, the licensee would be authorized to sell the licensed product in all territories, meaning anywhere in the world. Territories typically are defined by the countries in which the licensee is authorized to sell licensed product.

2.2 Exclusivity

Technology licenses can be either non-exclusive or exclusive. If a technology license is non-exclusive, the licensor can grant multiple licenses of the IP rights or product design within the scope of the license to any number of companies, all of which will sell licensed products with features based on the licensed technology. The licensee obtains no protection against competition from sales of other licensed products. If a technology license is exclusive, the licensor can grant only one license of the IP rights or product design within the scope of the license. The licensee does obtain protection against competition from sales of other licensed products.

2.3 Field of Use

The field of use provision limits the scope of a technology license by limiting the authorization to make and sell licensed products only to situations in which the licensed products are within a specified product market (broad field of use) or a defined type or class of products within a product market (narrow field of use). If a field of use is not specified in a technology license, the licensee has the right to make and sell any and all types of licensed product in all product markets. A field of use definition should be based on recognized and well defined product market segments or a set of objective characteristics of the types or classes of products that the licensee is entitled to make and sell, so that determinations of whether a licensed product is, or is not, within the field of use can be made consistently and without ambiguity.

2.3.1 Field of use clauses typically are used in exclusive licenses when the licensor wants to allocate licensed technology among a number of separate product markets which do not significantly compete with each other for sales. The licensee in each product market (field of use) will have exclusivity and therefore not face competition from sales of other products in the market segment that have features based on the licensed technology.

2.3.2 Examples of fields of use illustrating alternative broad to narrow ranges: 1) motor vehicles, 2) cars or trucks, or 3) a specific type of car or truck based on weight or some other set of characteristics; and 1) medical devices, 2) prescription/professional use medical devices, or 3) over-the-counter medical devices.

2.3.3 Fields of use based on customers to whom products can be sold should be avoided because of problematic enforcement of exclusivity. To illustrate the problem, assume a licensor grants exclusive technology licenses to two licensees for the same territory, with different fields of use based on the type of customer instead of the type of licensed product. The same licensed product can be used by customers in both groups, and customers in both groups have the right to resell products to each other because they are not

bound by the field of use restriction. Exclusivity between the two licensees may be difficult to enforce because of the likelihood of secondary resales by customers.

2.3.4 Fields of use are most important in IP rights licenses because IP rights licenses are capable of multiple embodiments or applications, and the licensor often wants to license the IP rights to the most capable company in each relevant market segment. Fields of use would be less important in design licenses, because design licenses are typically limited to a specific product. However, a Field of use can be relevant if the design license covers a subassembly or a partially complete design that is adaptable to more than one application.

2.4 Sublicensing

The Sublicensing scope provision relates to whether or not the licensee under a technology license can further license the IP rights or product design to third parties for the purpose of authorizing the third parties to independently make and sell licensed products. Sublicensing is different from two similar legal relationships, assignments and contract manufacturing.

2.4.1 An assignment transfers a technology license from one licensee to another licensee. After the transfer, the first licensee does not retain any rights to use the licensed technology and only the second licensee will make and sell licensed products under the technology license. Conversely, under a sublicense the first licensee retains its rights under the technology license (either all rights or some part of the rights) to make and sell licensed products, and creates a duplicate license (for all or some of the rights) to the licensed technology that authorizes the second licensee to independently make and sell licensed products.

2.4.2 A contract manufacturing arrangement is one in which the licensee under the technology license extends its rights under the technology license to a second licensee for the sole purpose of

making licensed products for the first licensee. The contract manufacturer obtains no right to independently sell the licensed products to anyone other than the first licensee.

2.4.3 As described in section 2.4.1, if a technology license permits sublicensing, the duplicate licenses granted by the first licensee to sub-licensees may cover all or only some of the rights under the original, main technology license. A common sublicensing scenario is a case in which the main technology license covers all fields of use or a broad field of use, such as an entire product market, and the licensee under the main technology license elects to grant a sublicense of rights under the licensed technology to make and sell licensed products within a narrower field of use within the broader field of use, which the licensee does not intend to exploit.

2.4.4 If sublicensing is permitted under the main technology license, it may require that the licensor approve the sublicense, or that the licensor and licensee agree, before execution of the sublicense, on the allocation between them of any license fees and earned royalties that will be generated under the sublicense (to the extent that the allocation is not completely addressed in the main technology license).

3 Consideration – License Fees and Royalties

The consideration payable under a technology license will be divided into two types for purposes of this guidebook, license fees and earned royalties. License fees are not based on the quantity of licensed product sold by the licensee, whereas earned royalties are based on the quantity of licensed product sold by the licensee.

3.1 License Fees

License fees are fixed amounts of money that are payable by the licensee to the licensor as full or partial consideration for use of the licensed technology. License fees may be in the form of a single payment that covers the entire term of the license, or they may be payable for defined periods of time during the term of the license, for example an annual, quarterly, or monthly fee.

3.1.1 License fees can be difficult to use in technology licenses, because they require that the lifetime sales demand for the licensed product (sales during the time the licensed product is offered for sale in the market) be estimated to determine the amount of the fee. In general, the amount of the fee represents the value of the licensed technology, which in turn depends on the profit that the licensee will generate from the quantity of licensed product that will be sold during the entire term of the license. A license fee will be either too high or too low, to the extent that the actual sales of licensed product vary significantly from the assumptions about profit from the licensed product that are used to estimate the license fee.

3.2 Earned Royalties

Earned royalties are paid based on the actual quantity of licensed products sold and therefore eliminate the uncertainty of estimating sales demand and profit for licensed products that make it difficult to determine the fair value of a fixed license fee. There are two main types of earned royalties, one based on the revenue generated

from sales of licensed product, and one based on the number of units of licensed product sold.

3.2.1 Earned royalties based on revenue are specified as a royalty rate in the form of a percentage, multiplied by a royalty base in the form of the net sales revenue realized by the licensee from sales of licensed product during a defined period of time, usually a 12-month contract year. Net sales revenue typically is defined as the sum of the prices charged by the licensee for all units of licensed product sold during the period, minus credits for the price of units returned for a refund of the price paid, shipping costs, and the price of units provided as samples to customers without charge (subject to some maximum). The formula is $\text{Royalty Rate} \times \text{Royalty Base}$. For example, if a technology license provides for a 5 percent royalty rate, the amount payable to the licensor for a license period would be the net sales revenue from licensed product for the period multiplied by 0.05. Assume the licensee sold 100 units of licensed product during the period at \$100 per unit, charged customers for shipping fees as a separate item on invoices, and had no units returned for refunds and no units provided as free samples. The net sales revenue would be \$10,000 and the earned royalty would be \$500 ($0.05 \times \$10,000$).

3.2.2 Earned royalties based on units of licensed product sold are specified as a royalty rate in the form of a fixed dollar amount per unit, multiplied by a royalty base in the form of the net unit sales of licensed product sold during the 12-month contract year. Net unit sales typically is defined as the total number of units of licensed product sold, minus the number of units returned for a refund and the number of units provided as samples to customers without charge (subject to some maximum). Again, the formula is $\text{Royalty Rate} \times \text{Royalty Base}$. Unlike the revenue based earned royalty, the unit based earned royalty will not vary based on increases or decreases in the price of the licensed product. It may be attractive to a licensor in cases where the licensed product may be sold by the licensee as part of a bundle of products, and there is risk that the price of the licensed product can be artificially lowered to reduce

the earned royalty in combination with a compensating increase in price of the other products in the bundle, such that the bundle price remains the same.

3.2.3 Earned royalties may sometimes vary by territory, especially if the licensed technology is based mainly on patents, which provide protection from competition only in countries in which a patent has been issued. In such cases, the earned royalty would be higher in territories comprised of countries in which patents had been issued.

3.2.4 Earned royalties are paid periodically—typically quarterly, semiannually, or annually—and payments are accompanied by a report in which the licensee provides the licensor with information on the calculation of the royalty base for the period—either net sales revenue or net unit sales—and the amount of the earned royalty that is being paid. The clause on reporting and payment of earned royalties will provide that the licensor has the right to audit the licensee’s business records to verify that net sales revenue or net unit sales have been accurately reported.

3.2.5 In some cases, earned royalties may be limited to a maximum total amount, and if the maximum amount is paid before expiration of the term of the technology license, it becomes fully paid up and no further consideration is required to be paid for the remainder of the term.

3.3 Consideration for Sublicensing

If a technology license permits sublicensing as described above, there will be one or more sublicenses, pursuant to which the licensee under the main technology license becomes the licensor to a secondary licensee. The licensed product will be sold by both the licensee under the main technology license and the secondary licensee(s) under the sublicense(s). The licensor of the main technology license is not a party to a sublicense between the original licensee and the secondary licensee but is a third party beneficiary

of the sublicense. The licensed product is being sold by the secondary licensee, and such sales would violate the main technology license if consideration is not paid to the original licensor.

3.3.1 If the main technology license provides for no earned royalties and the licensor is compensated solely by negotiated fixed license fees, then it may not be necessary to provide for any additional compensation for the licensor based on sublicensing within the scope of the main technology license. The rationale for this is that the fixed fee is not dependent on the quantity of sales of licensed product, whether the quantity of sales is generated by the original licensee alone or by secondary licensees. However, if the main technology license provides for earned royalties, it must include a clause that provides for how consideration will be paid by the original licensee to the original licensor with respect to sales of licensed product under sublicenses.

3.3.2 The most straightforward way to handle sublicensing consideration with respect to earned royalties is to provide that net sales revenue or net unit sales under all sublicenses will be reported as sublicense net sales revenue or sublicense net unit sales under the main technology license. The original licensee is required to pay earned royalties on the sublicense royalty base (either sublicense net sales revenue or sublicense net unit sales) at some sublicense royalty rate, which may be the same as or different from the royalty rate applied to direct sales of licensed product by the original licensee. To operate profitably, the royalty rate under a sublicense will be higher than the sublicense royalty rate under the main technology license, and the original licensee will retain the excess. For example, assume a main technology license provides for a sublicense royalty rate of 5 percent on sublicense net sales revenue and the original licensee sublicenses the licensed technology for particular field of use for an earned royalty based on 7 percent of net sales revenue. The original licensee will report the sublicense net sales revenue and pay a 5 percent royalty on it, retaining the excess 2 percent of net sales revenue that it received from the secondary licensee.

3.3.3 If the main technology license permits sublicensing, it will also be necessary to agree on how fixed license fees collected from secondary licensees under sublicenses (sublicensing fees) will be allocated between the original licensor and licensee. Allocation of sublicensing fees is more complex than allocating earned royalties and depends on the situation. In general, if the sublicensing fee represents a prepaid earned royalty, the original licensee should get a portion, because it is equivalent to an earned royalty, but, if the sublicensing fee represents compensation or cost reimbursement for putting the sublicense into effect, the original licensee should not get a portion. The main technology license may address allocation of sublicensing fees in several ways, including 1) an agreed-upon percentage split, such as 50 percent for each, 2) a ratio equal to the ratio of the sublicense royalty rate used for earned royalties under the main technology license divided by the royalty rate used for earned royalties under sublicenses (based on the example in 3.3.2 above, the ratio would be 5/7 or 71 percent to the original licensor), or 3) requiring agreement by the licensor and licensee on a case-by-case basis before a sublicense is executed.

4 Determining Royalty Rates

Determining the royalty rate to use for earned royalties requires valuing the licensed technology. Valuation of intellectual property is a complex subject, and many methods are used in valuation. This section provides a summary of one simple method for estimating the value of licensed technology. The method is based on three assumptions. First, the value of licensed technology is a portion of the profit on the revenue stream that is generated from sales of licensed product. Second, the profit results from the deployment of all classes of assets that are used in the business of the seller of the licensed product, and it is reasonable to allocate profit among the various classes of deployed business assets in proportion to the relative cost ratio of each class of assets. One of the classes of deployed business assets consists of all technology intellectual property developed or licensed by the seller (total technology IP) and its share of profit is determined by a relative cost ratio. Third, the value of licensed technology is some part of the profit allocated to total technology IP, which can be estimated by the incremental sales of licensed product as compared to sales of a substitute product without the features based on the licensed IP (licensed IP contribution). The formula for valuing licensed technology, using the terms defined above, is $\text{Royalty Rate} = \text{Profit} \times \text{Cost of Total Technology IP} / \text{Cost of All Assets} \times \text{Licensed IP Contribution}$. Each element of the valuation formula and its associated assumption is explained in more detail in the following sections.

4.1 Profit

Profit is the starting point for valuation because if sales of licensed product generate no profit there is no value to the seller. The financial information necessary to calculate profit is obtained from a pro forma income statement for the business based on selling the licensed product. (Pro forma statements are used in budgeting and planning and are based on estimated revenue and cost instead of actual revenue and cost.) Profit is defined by the following general formula: $\text{Profit} = \text{Revenue} - \text{Production Costs} - \text{Non-Produced}$

tion Costs. Production costs include materials and manufacturing labor consumed in making licensed product; non-production costs comprise all other business operating costs of the seller of licensed product. The pro forma income statement will set out in spreadsheet form the revenue, production costs, and non-production costs for the product line of the licensed product. Most pro forma income statements will show all entries as both dollar amounts and as percentages of sales revenue. Profit stated as a percentage of net sales revenue can therefore be taken directly from the pro forma income statement for the licensed product business. The profit estimated by this method can be evaluated for legitimacy by comparison of the pro forma income statement for the licensed product with published information on operating profits for public companies that sell product similar to the licensed product. (This information can be found on a company's investor relations page or the Securities and Exchange Commission's EDGAR database.)

4.2 Other Assets

A seller will deploy several different types or classes of assets to operate the business that sells the licensed product, and the annual cost of these classes of assets also are shown on the pro forma income statement as the non-production costs. A typical income statement will show non-production costs for the following asset classes: 1) brand IP assets, represented by marketing and advertising expenses, 2) business intangible assets, represented by expenses for sales, administrative and support business functions, and management (the sales, general, and administrative [SGA] expense), 3) technology IP assets, represented by research and development and technology licensing costs, and 4) physical assets, represented by depreciation of buildings and equipment. It is assumed that in a successful business, the relative cost of each asset class is a good proxy for estimating the contribution of each asset class to generating profit.

4.2.1 The following illustrates use of the first two elements of the formula for determining the portion of profit that is allocated to

all technology IP assets. Assume that the pro forma income statement for a licensed product shows estimated profit to be 40 percent of net sales revenue, production costs of 25 percent of net sales revenue, and non-production costs of 35 percent of net sales revenue. Further assume that the pro forma income statement shows the non-production costs allocated among the four assets classes described above as the following percentages of net sales revenue: marketing/brand IP 10 percent, R&D/technology IP 12 percent, SGA/business intangibles 8 percent, and depreciation/physical assets 5 percent (total 35 percent). As a reminder, the valuation formula is: $\text{Royalty Rate} = \text{Profit} \times \text{Cost Total Technology IP} / \text{Cost All Assets} \times \text{Licensed IP Contribution}$. The ratio of the cost of technology IP as compared to cost of total deployed business assets is 12 divided by 35 or 0.34, and the formula becomes: $\text{Royalty Rate} = 40\% \times 0.34 \times \text{Licensed IP Contribution}$. (At this intermediate stage of valuation, the share of profit allocated to total technology IP is about 14 percent of net sales revenue, or $40\% \times 0.34$.)

4.3 Profit Allocated to Total Technology IP that Is Contributed by the Licensed Technology

The last element of this valuation formula estimates the portion of the profit allocated to total technology IP that is contributed by the licensed technology. A licensed product is likely to incorporate several technologies, only one of which is the licensed technology. This valuation method assumes that the relative value of the licensed technology as compared to the other technologies in the licensed product can be determined by comparing 1) estimated sales of licensed product, which has the feature(s) based on the licensed technology, and 2) estimated sales of a product that is identical to the licensed product, except that it does not have the feature(s) based on the licensed technology (substitute product). The value of the licensed technology is represented by the excess of net sales of licensed product as compared to net sales of substitute product, which will be referred to as incremental sales. Incremental sales are equal to the net sales of licensed product minus the net sales of substitute product. The licensed technology's contribution to profit allocated to total technology IP is defined as incremental

sales divided by net sales of licensed product. For example, assume estimated net sales of a licensed product for its life cycle is \$10 million and estimated net sales of substitute product for the same period of time is \$5 million. The licensed IP contribution is 0.5, or 50 percent (incremental sales of \$5 million divided by \$10 million net sales of licensed product). In other words, the licensed IP contribution is incremental sales stated as a fraction of total net sales of licensed product.

4.3.1 Building on the example in section 4.2.1, the share of profit allocated to total technology IP was 14 percent of net sales revenue, and if we now assume that the licensed technology drives incremental sales of 50 percent, as in the immediately preceding discussion, the valuation formula becomes $\text{Royalty Rate} = 40\% \times 0.34 \times 0.5 = 7\%$ of Net Sales Revenue.

4.3.2 The information necessary to estimate incremental sales and the licensed IP contribution factor in the valuation formula cannot be obtained from a pro forma income statement, unlike the profit and cost ratio factors in the formula. The information would typically be developed by the marketing function, based on surveys and focus group activities with potential customers to learn how they would value a hypothetical licensed product as compared to a baseline substitute product. The substitute product will either be one already in the market or similar to a product in the market, and baseline sales can be estimated from market research. The surveys and focus groups are used to assess the extent to which customers would prefer the licensed product and to estimate incremental sales. Estimation of incremental sales is the most difficult and uncertain part of valuation of licensed technology.

4.4 Purpose

The most important use of the valuation formula is not necessarily to calculate a royalty rate with precision, but to focus attention of the parties negotiating the royalty rate on the factors that drive its valuation: profit on licensed product, cost ratio of technology IP to all business assets deployed in selling licensed product, and

incremental sales that are likely to be driven by the licensed technology. The profit and cost ratio factors tend to be characteristic of the relevant product market segment, while the incremental sales are unique to the specific licensed technology and the most difficult to estimate. It is often helpful to use the formula to see what level of incremental sales are necessary to justify a given royalty rate, in light of the better-understood profit and cost ratio factors.

5 Clauses Related to Exclusivity

A number of clauses are typically included in exclusive technology licenses, relating to 1) diligence in commercializing licensed technology, 2) minimum royalties, 3) cost of obtaining and maintaining IP rights, and 4) rights to enforce IP rights that protect licensed technology. The first three benefit or protect the licensor; the last one benefits or protects the licensee.

5.1 Diligence in Commercializing Licensed Technology

In an exclusive technology license with consideration based on earned royalties, the licensor relies solely on the licensee to generate sales of licensed product that will in turn generate earned royalties. The diligence clause requires the licensee to demonstrate satisfactory progress toward commercialization—to prevent locking up the licensor’s technology—and provides the licensor with contractual recourse if the licensee fails to satisfy the commercialization schedule.

5.1.1 Diligence clauses typically provide for a sequence of milestones that the licensee agrees to achieve by dates scheduled for each milestone. Examples of types of milestones include 1) producing specified types of prototypes, 2) finishing various testing of prototypes, including clinical testing, 3) obtaining regulatory approval or completing various stages of application for such approval, 4) offering licensed product for sale, and 5) spending minimum amounts on marketing and advertising the licensed product. Different sets of milestones may be set for various territories.

5.1.2 Remedies for failure to satisfy the diligence clause may require payment of financial penalties for delay in achieving milestones and typically permit the licensor to terminate the license if the delay extends beyond an agreed-upon date.

5.2 Minimum Royalties

The minimum royalty clause typically assigns minimum amounts of earned royalties that must be paid per annual period during the term of an exclusive technology license. The first annual period, or contract year, that will be subject to a minimum royalty is specified, and the amounts of minimum royalties for succeeding contract years typically will increase up to some maximum amount. For any year in which earned royalties do not equal the minimum, the licensee must pay the licensor the difference between the amount of the minimum royalty and the earned royalty generated or default on performance of the technology license.

5.2.1 The remedy for breach of the minimum royalty clause can vary between termination of the technology license or conversion of the technology license from exclusive to non-exclusive. The licensor will prefer termination if the licensee has not generated significant sales of licensed product or if the technology license does not have enough potential in the market to support a group of non-exclusive licensees.

5.3 Cost of Obtaining and Maintaining IP Rights

It is not unusual for an exclusive technology license to require the licensee to reimburse the licensor for the cost of obtaining and maintaining the IP rights. The rationale for this is that the business that sells the licensed product should bear the cost of IP protection, because it directly benefits from the IP protection due to the competitive advantage that results from the product features that are based on the licensed technology. Under an exclusive technology license, the exclusive licensee's business is the only one authorized to sell the licensed product, and so these costs are passed on to the licensee. This clause would be unusual in a non-exclusive license, because in that situation, several licensee businesses could be selling the licensed product and the individual licensees do not get the competitive advantage from product features that are based on the licensed technology.

5.4 Enforcement of IP Rights

Enforcement of IP rights refers to preventing third parties from selling products that infringe the IP rights, e.g., selling products with features based on the IP rights without a license. The licensee under an exclusive technology license expects a competitive advantage, based on exclusive use of the licensed technology, and wants to ensure that the licensed IP rights are enforced to prevent infringement and to preserve the expected competitive advantage of exclusivity. IP rights are enforced by the owner, and therefore the licensor has the legal right to enforce the IP rights' underlying licensed technology. However, enforcement of IP rights is expensive, and the licensor may be reluctant to pursue enforcement as aggressively as the exclusive licensee believes is necessary. Many exclusive technology licenses address this potential problem with a contractual clause that typically has the following characteristics:

5.4.1 The licensor has the option to enforce the IP rights against infringers that have been identified, either by the licensor or licensee. In this scenario, the licensor typically pays the cost of enforcement and is entitled to any damages or settlement recovered through enforcement.

5.4.2 If the licensor declines to pursue a potential infringement that the licensee has identified, the licensee has the right to enforce the IP rights against the potential infringer. In this scenario, the licensee pays the cost of enforcement, and any damages or settlement that are recovered may be retained by the licensee or allocated between the licensee and licensor according to an agreed-upon formula. A common formula provides that any recovery is allocated first to reimburse the licensee for all costs of enforcement, and the remainder is allocated between the licensee and licensor using an agreed-upon percentage.

5.4.3 A good way to set the percentage allocation for enforcement recoveries is to translate the royalty rate, which is based on net sales revenue or net unit sales, into an equivalent rate of profit.

This is appropriate because an enforcement recovery will be based on the infringer's profit. The rate of profit that is equivalent to the royalty rate can be taken directly from the previously discussed formula used to determine the royalty rate. Referring to the example in section 4.3.1, the royalty rate of 7 percent of net sales revenue was calculated as $40\% \text{ Profit} \times 0.34 \text{ Total IP Technology Cost Ratio} \times 0.5 \text{ Licensed IP Contribution}$. The 7 percent royalty rate is equal to 17 percent of profit ($0.34 \text{ Cost Ratio} \times 0.5 \text{ Licensed IP Contribution} = 0.17 \times 40\% \text{ Profit}$). Using this method, the allocation of enforcement recoveries would be 17 percent to the licensor and the balance to the licensee.

5.4.4 In many jurisdictions, an exclusive licensee does not have standing to bring an infringement action by itself because it is not the owner of the IP rights. The enforcement clause, therefore, requires the licensor to join the exclusive licensee as a co-plaintiff in any enforcement action undertaken by the exclusive licensee.

6 Other Contract Clauses in Technology Licenses

This section summarizes a few of the many other clauses that are commonly found in technology licenses.

6.1 Indemnification

Indemnification means that one party to a contract undertakes to protect the other party from liability for certain types of claims. Protection requires defense of the claim and payment of any judgment on, or settlement of, the claim. Two common types of claims covered by indemnification clauses are third-party claims and claims for consequential damages caused by a breach of contract.

6.1.1 Indemnification for third-party claims is used in cases in which both parties to a contract could be liable for the claim, but one party is primarily responsible for causing the claim, while the other party would be secondarily responsible only because of the contractual relationship. The party with primary responsibility agrees to indemnify and protect the other party from the secondary liability. Two key types of third-party claims that usually are subject to indemnification in technology licenses are 1) claims by an owner of intellectual property rights which assert that the licensed product infringes the owner's IP rights (infringement claim), and 2) claims by customers who purchased the licensed product and assert that it was defective and caused injury or damage (product liability claim).

6.1.2 Infringement claims arise because the design of the licensed product was not adequately vetted against the claims of issued patents (or registered copyrights). In principle, the party to a technology license who has primary responsibility for designing the licensed product and conducting the freedom-to-operate analysis would indemnify the other party against infringement claims.

6.1.2.1 In the case of an IP rights license, the licensee designs the licensed product and is responsible to obtain the freedom to oper-

ate the business of selling the licensed product (which will occur after the license has been executed). The licensee almost always will indemnify the licensor against infringement claims under an IP rights license.

6.1.2.2 In the case of a design license, the licensor has done some, or all, of the design for the licensed product and should have done a freedom-to-operate analysis before the license is executed. Based on this consideration, the licensor should indemnify the licensee for infringement claims. However, the design license may be offered by the licensor expressly on an as-is basis, meaning that the licensee assumes all infringement risk for the design. The licensee is permitted to perform due diligence and/or freedom-to-operate analysis on the design before deciding whether or not to take the design license. In this case, there may be no indemnification for infringement claims.

6.1.3 Product liability claims arise because of design defects or manufacturing defects, and the party to a technology license who has primary responsibility for preventing design defects and manufacturing defects would indemnify the other party for product liability claims.

6.1.3.1 In the case of an IP rights license, the licensee is responsible for both designing and manufacturing the licensed product, and generally will indemnify the licensor against product liability claims.

6.1.3.2 In the case of a design license, the licensee is responsible for manufacturing the licensed product and generally would indemnify the licensor against product liability claims based on manufacturing defects. On the other hand, the licensor has done some, or all, of the design for the licensed product, which suggests that the licensor should indemnify the licensee for product liability claims based on design defects. However, as mentioned above, if the design license is offered as is, the licensee may assume the risk of design defects, and there would be no indemnification for product liability claims based on design defects. In this case, the

licensee would perform due diligence on the integrity of the design before deciding whether or not to take the design license.

6.1.4 Indemnification for consequential damages caused by breach of contract is used because of the common practice of including in contracts a damages clause that limits the liability of both parties for breach of contract to direct damages and excludes liability for consequential damages. Direct damages essentially are the costs of fixing the breach of contract. For example, in a contract under which a manufacturer buys parts for a product that it produces, if the seller delivers a batch of defective parts, the direct damages are the cost of replacing the defective parts with good ones. Consequential damages are losses suffered by the non-breaching party to a contract that are caused by the breach in addition to the cost of fixing the breach itself. For example, in the contract under which a manufacturer buys parts for a product that it produces, if the seller delivers a batch of defective parts that are used to make the product, consequential damages would include reworking the products to replace the defective part, perhaps the cost of a recall to retrieve the product to perform the rework, and profit lost on any decreased sales caused by bad publicity relating to the recall.

6.1.4.1 Indemnification for consequential damages is used for situations in which direct damages are too small to adequately motivate a party to use best efforts to avoid a breach and the other party will face significant consequential damages as a result of the breach. For example, in a technology license, the breach of a confidentiality provision covering a trade secret used in licensed product could result in small direct damages but large consequential damages. Direct damages may be limited to the cost of improving security to prevent further disclosures and of recovering the trade secret from anyone that was involved in its misappropriation or theft. However, if the trade secret is discovered by innocent third parties because of the breach and it is used to increase sales of a competitive product, the consequential damages would be the profit lost on decreased sales of licensed product due to the competitive product.

6.1.4.2 Indemnification for consequential damages must be carefully negotiated to clearly define the types of claims that must be indemnified and to provide for appropriate limits of liability for indemnified claims based on the financial capability of the party providing the indemnity.

6.2 Term and Termination

The term of a technology license often will be the lesser of the life of the licensed product or the life of the licensed IP rights. In other words, the license will continue in effect until either the licensed product is no longer offered for sale or the IP rights that are licensed expire.

6.2.1 A technology license should define the events that will be deemed to be a default and permit either party to terminate the technology license for cause if the other party defaults. For-cause termination clauses often require that a written notice of default be sent to the party in default and provide an opportunity to cure the default within some agreed-upon period of time.

6.2.2 Termination of a technology license without cause typically is permitted only by the licensee—for example, if the licensee decides to stop selling the licensed product in favor of an alternative. Termination without cause by the licensor is usually not permitted because the licensee will have committed resources to commercialize the licensed product and is entitled to realize the value from the committed resources so long as it satisfies its performance obligations under the technology license.

6.3 Confidentiality

A technology license will contain standard confidentiality provisions, which will not be discussed in detail. However, it should be noted that if the technology license includes trade secret IP rights that are used in making the licensed product, the duration of the confidentiality provisions with respect to the trade secrets should be the life of the trade secret. The life of a trade secret continues

for an indefinite period that will end only if and when: 1) the trade secret is independently discovered by another person or entity and made public, or 2) the products in which the trade secret can be used are no longer offered for sale (e.g., due to obsolescence) and therefore the trade secret no longer has value by virtue of providing a competitive advantage.

6.3.1 Standard confidentiality provisions often limit the duration of the confidentiality obligation to some specified time period, such as five years. The fixed period of time may be appropriate for information that is only temporarily confidential, such as business plans or product development plans, because this type of information either becomes public when the plans are implemented or become irrelevant due to being abandoned. The fixed period duration is not appropriate for trade secrets and other information with a lifetime longer than the fixed period, such as that dealing with private information for individuals. To the extent that it is necessary to limit the duration of a party's obligation to keep confidential information secret, it can be done by providing that the obligation continues for specified time, such as two years, which does not begin to run until the date on which the party returns or certifies the destruction of all records that contain the confidential information. The total period of the confidentiality obligation is the sum of the time that the party has possession of records containing the confidential information plus the specified tail period.

If you are looking to work with the NYS STLC or have a specific request for assistance please contact us at:

Molly Zimmermann
315.443.8943
nysstlc@law.syr.edu

NYS Science + Technology Law Center
Syracuse University College of Law
310 Dineen Hall
Syracuse, NY 13244
nysstlc.syr.edu
32