Acquisition and Licensing of Intellectual Property

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A. Introduction

Advancements in technology are continuously occurring throughout the world as firms seek to develop new ideas for their products, services and markets. Companies wishing to expand into the international arena are finding that licensing or transferring their technology provides a low risk and highly profitable alternative to direct export, establishing a foreign branch, subsidiary or joint venture. A license is a contract which authorizes the *use* or *exploitation* of the subject matter of the license for a specified purpose and period of time, with all other rights maintained by the owner of the technology. Alternatively these rights may be transferred outright to a new owner.

The decision to license their technology to an established firm that can sell their technology or products is often motivated by a desire to penetrate markets which the licensing company might not otherwise be able to penetrate through export or direct investment. This is because the licensor does not have the resources to achieve full commercial exploitation of their intellectual property on their own. For instance, a computer software developer might license a computer manufacturer to distribute the developer's software to take advantage of the manufacturer's greater resources for marketing and product distribution. By adding the licensee's resources for specified business operations to its own, the licensor can serve markets it would otherwise not be able to enter. For example, IBM selected Microsoft's MS-DOS operating system software to build the PC-DOS operating system for IBM personal computers enabling Microsoft to obtain the benefit of IBM's extensive marketing and distribution system.

Also, few firms have the personnel or resources to market their product worldwide because of the need to deal with foreign language issues, customs and physical modifications of the products as required under local law. The use of a foreign concern with the necessary resources and familiarity with the foreign market, customs and needs often provide the licensor with the fastest route to the foreign market.

Licensing also presents certain risks. There may be loss of control over further exploitation of one's intellectual property, e.g. under a manufacturing license, the licensor surrenders direct control over the details of the manufacturing process and quality of the products. With regard to a marketing and distribution license, the licensor surrenders control over advertising, promotion, distribution and pricing policies.

It is obvious that licensing requires confidence and trust in the licensee. The licensor must be satisfied that the licensee has the technical and business ability to commercialize the subject matter of the license. In addition, there is always the risk that the licensed intellectual property will be used or disclosed without authorization, either wilfully or inadvertently. This risk of "piracy" increases because licensing reduces licensor's control over the manner in which the intellectual property is exploited and the precautions used to prevent unauthorized use and disclosure. For example, the agreement often permits the licensee to provide intellectual property to its employees, consultants, customers and suppliers. Further the licensee may market products and services that are similar to but not the same as the subject matter of the license agreement. Defining precisely what changes and improvements belong to the licensor and at what point they become a "new product" not covered by the agreement often is the subject of intense negotiations and may provoke disputes over who gets credit for improvements, whether and when royalties are due, and the scope of the licensing long after the agreement is signed.

Since the licensor depends on the licensee's efforts to generate income from the licensed activities, this revenue and the licensor's business can be adversely affected if the licensee has other interests, does not have the capability or personnel for effective marketing and distribution or simply makes bad business decisions.

Finally, licensing may create a potential competitor during and after the licensing term or any applicable statutory period. This risk and the others mentioned above can be minimized by a well drafted license agreement containing restrictions designed to limit the licensee's sales to certain geographical areas and prevent disclosure to others as well as the careful selection of the propective licensee.[1]

B. Subject Matter of the License

Licensing agreements may extend to any type of experience or knowledge that may be useful in the invention, manufacture, sale or maintenance of a product or in the organization, provision and marketing of a service. Such knowledge or experience is commonly referred to as intellectual property and generally involves statutory rights such as patents, trademarks and copyrights or non-statutory rights generally referred to as trade secrets and know-how. Each type of intellectual property provides its own "bundle of rights" which may be licensed separately or withheld by the agreement.

A patent is a governmental grant which entitles an inventor to exclude others from exploitation of the invention for a certain period of time, i.e. a legal monopoly to manufacture, use and sell his invention. While the underlying concept of a patent is uniformly understood world-wide, variations occur in the kinds of patents issued, the manner in which they are applied for and maintained and the length of time during which they remain in effect. These variations must be considered in any licensing program.[2]

A trademark is any word, name, symbol, device or combination thereof adopted and used by a manufacturer or merchant to identify its goods and to distinguish them from those sold by others. Trademark registrations may be renewable indefinitely but failure to use a trademark will usually result in its loss. In most common law jurisdictions trademarks are created by their use, not by registration. In most civil jurisdictions, however, trademarks are similar to patents since ownership itself is determined by registration. Some countries prohibit local entities from paying license fees for trademarks but allow licensing of patent rights.[3]

A copyright entitles an author of certain literary or artistic works the exclusive right of copying, publishing and selling copies for a certain limited time. Its function in licensing generally covers rights in advertising and other literature of the licensor such as manuals, specification sheets and other documentation respecting the technology.

Trade secret and know-how are the most common subject matter of technology transfer agreements. They encompass all knowledge, expertise and information useful in accomplishing the subject matter of the agreement. It may include models, designs, drawings, in tangible form or consist of engineering or technical assistance. Trade secrets and know-how are the most difficult subject matter of licensing agreements. They are generally not patented and legal protection in most countries is based upon trade secret law which generally limits enforcement to contractual obligations not to disclose the know-how.[4]

Worldwide, national intellectual property laws generally have little or no effect beyond the borders of the nations that enact them. International licensing depends upon varying and inconsistent national laws, including the laws of supranational organizations, such as the European Union and NAFTA. Various international conventions attempt to prohibit discrimination against foreign nationals and provides priority for certain foreign filings and harmonizes a few substantive norms of protection.

However, the level of substantive harmonization is low although substantial progress is being made under the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) as part of the restructuring of the General Agreement on Tariffs & Trade (GATT). GATT TRIPS provides minimum standards for protection of copyrights, trademarks, designations of geographic origins, industrial designs, patents, semiconductor chip designs and confidential information as well as requiring both national and most favored nation treatment for the nationals of all member nations.[5]

While different nations intellectual property laws vary in detail they do have similar features, e.g. patents and copyrights give the creator exclusive rights for limited terms and trademarks and trade secrets, while having potentially unlimited duration, provide less protection against copying and imitation. In any event licensing in the international marketplace requires consideration of local variations in intellectual property law and practice. Further local tax and exchange controls as well as possible antitrust violations must also be addressed in the agreement between the parties.[6]

C. The Licensing Agreement

Once the decision to license or transfer the technology has been made, the agreement between the parties must be carefully drafted to clearly express the intent of the parties so as to avoid or minimize any future disputes. It will be assumed that the licensor owns the relevant intellectual property or has authority from the owner to grant the license. Its major provisions are discussed below.

1. *Defining the Subject Matter of the License*

License agreements seldom cover only one type of intellectual property and for each type of intellectual property, the licensing agreement must specify what rights in the "bundle of rights" are licensed to the licensee and what rights are reserved to the licensor. For example, in a license to manufacture and market a new computer system, it may include patent provisions if the particular circuits in the computer are patentable. If the computer uses soft-ware, the license may also cover copyrights in the software. If software uses trade secrets or if the process used to manufacture the computer system involves trade secrets not disclosed by the system itself, then the trade secrets will be licensed and protected. Also if the licensor has a trademark, the agreement may grant the right to use the trademark to promote and market the computer systems. Thus the nature of the rights covered by the license must be clearly defined.[7]

Patents and trademarks should be referenced by name, number and date of issue. A more difficult problem is describing trade secrets and know-how and the manner of transfer to the licensee. Licensees prefer the broadest possible description. In general it should be described as all knowledge, information and experience possessed by the licensor in connection with the manufacture, production, marketing, maintenance and repair of the products which are the subject matter of the agreement. It may be desirable to also provide a list of the kinds of documents embodying the trade secrets or know-how.[8]

The agreement should provide whether improvements made by the licensor during the term of the agreement are to be included within the scope of the license grant. Licensees are concerned with having access to licensors' continuing technical development especially if the licensee is to incur an ongoing royalty obligation. Also to avoid disputes, the agreement should specify in great detail what changes the licensee may and may not make in the licensed intellectual property.

2. *Technical Assistance Provisions*

If know-how is to be transmitted, the agreement will provide that the licensor furnish technical assistance. On the job training and observance of manufacturing techniques is often necessary for the effective transfer of know-how. The licensor however will want to limit the extent of its commitment to furnish training. Typically the agreement will provide for a limited period of training at cost. Thereafter any additional assitance may be based on a *per diem* or other rate of payment. The agreement should provide any employees sent from one company to the other should remain employees of the sending company with all responsibilities that an employer-employee relationship entails.

Where appropriate the licensee may desire or licensor require that the licensed products be made using parts and components supplied by the licensor. The terms and conditions of purchase and any discounts should be included in the agreement.

3. *Scope of License*

The precise scope of the license granted should be specified. Does it extend to manufacturing and/or sales, is it on an exclusive or non-exclusive basis? Is it limited to a specific territory?

The licensee will want an exclusive grant especially if the contemplated royalty payments are substantial. The licensor may prefer a non-exclusive license or a sole license where the licensor will not appoint othe licensees but may sell into the market directly.

Granting an exclusive patent license would not seem to involve an antitrust violation assuming that the exclusive is not part of a cross-license program or patent pool arrangement under which competitors have agreed on a market division or allocation. Likewise territorily restricted manufacturing licenses appear lawful if reasonable, taking into account the main purpose of the agreement, the scope of the license technology and the duration of the restrictions.[9]

With respect to sublicenses and assignments, in the absence of an agreement to the contrary, a license is generally not assignable and the licensee may not grant sub-licenses. The agreement should be specific in this regard.

4. *Royalty Compensation*

In addition to technical assistance charges, the license agreement usually provides for some form of royalty payments. Many agreements provide for a fixed or lump sum royalty to the licensor which may be paid in advance or in instalments. If paid in advance it may be treated as advances against future royalties if earned. A lump sum payment is usually exacted where statutory rights have limited strength or life, or where technology can be transferred at one time and quickly absorbed by the licensee, or where licensor has incurred substantial research and development and may be unwilling to share its knowledge without some assurance in advance it will receive appropriate reimbursement for a share of the development costs or where licensor fee restrictions in developing countries may limit future ability to recapture or remit royalties. Many laws of developing countries control payment of lump sum amounts and must be consulted.[10]

The most common form of compensation is periodic royalties measured by standards such as sale of products, units of production or profits. United States firms tend to base royalties on net sales.[11] Royalty rates are often reduced or increased with the volume of product sold or produced. The royalties may be less in the early years of the license as an incentive to the licensee.

Whatever method is used to measure royalties, the licensor's intent is to obtain royalties measured by as broad a base as possible, e.g. by asserting a royalty for all products which in any way utilize or take advantage of the technology transferred while the licensee has an interest in narrowing the base upon which royalties are paid.

The most frequent method used to calculate royalties is based upon licensee's net selling price of the royalty products. The licensor should be certain that royalties on inter-company transfers between the licensee and related parties will be computed on an arms length basis. Otherwise the taxing authorities, especially the United States Internal Revenue Service, may reallocate income, deductions, credits, and the like to clearly reflect income.

In computing net sales price, it is customary to subtract from the invoice price the items on which royalties will not be based such as transportation and insurance expenses, duties, tariffs and sales and value added taxes, discounts and returns, installation charges, fees for maintenance of patents and amounts charged for service, maintenance and spare parts.

Minimum royalties may be required whether they are earned or not. They are often provided as a performance standard which the parties have set to reflect their expectations as to which the licensee would reasonably be expected to achieve. As stated above a failure to meet the minimum may cause the license to terminate or change the license from exclusive to non-exclusive. It should be noted some countries will not allow minimum royalties.[12]

In any case, the agreement should also provide for periodic accounting and payments of royalties as well as right to inspect the books and records of the licensee to verify the accuracy of such statements. If royalties are based on sales, it is necessary to determine when a sale is made, e.g. when a product has been shipped and the invoice sent to licensee's customer or when the invoice is paid by the licensee's customer. The agreement should provide which currency remittances are to be made. Usually they are made in the currency of the licensor and the agreement should fix the exchange rate.

Finally if income taxes are withheld at the source at a fixed rate, or at the rate reduced by treaty between the countries involved or if royalties are subject to value added taxes in the country of the licensee, the agreement should provide who bears the taxes imposed on the transaction. If royalties are paid net or free of taxes this may increase licensee's royalty burden. If licensor pays the taxes, it may be able to benefit from tax credits in its country. In any event the respective tax laws of the parties must be considered in structuring the royalties to be paid.[13]

5. *Quality Standards and Warranties*

A licensor may wish to impose quality standards upon the licensee to protect the licensor's reputation or guard against exposure to products liability claims. This is especially important for the preservation of any trade-mark rights, i.e. if control is not adequately maintained, the owner faces possible abandonment of his trademark. The more control the licensor exercises over the licensee's manufacturing process the greater the risk of liability to the licensor in the event of injury to third parties. Therefore, it is important that licensor obtain adequate indemnities from licensee along with provisions for satisfactory certificates of insurance.[14]

There is no implied warranty under United States law that the invention has commercial utility, that the patent is valid or that there will be no infringement of other patents. In other countries the license implies granting a right to use the patent and imposing upon licensor the duty to make such use possible.[15] There fore the applicable law with respect to implied warranties must be ascertained and the warranties either limited, disclaimed or made express depending upon the negotiations of the parties.

With regard to an exclusive grant, an obligation to use its best efforts to exploit the license may be implied under the circumstances. Where intended, a best efforts clause should be specifically provided. It should be noted that in some countries a patent right may be lost or subject to compulsory licensing to third parties if the patent is not worked.[16]

6. *Infringement of Licensed Rights*

In many countries the licensor may have an implied obligation to take action against infringers in certain circumstances whereas under United States law no such implied obligation exists, although an exclusive licensee may commence such litigation and join the owner.

The Agreement should provide what rights and obligations the parties have in the event of infringement. If the licensee is unable to take action against an infringer, a provision for optional termination of the agreement or reduction in royalties may be provided. Likewise if the licensed rights are adjudged invalid, the agreement should specify what continuing obigations, if any, the licensee will have.

7. *Duration and Termination*

Generally the Agreement is often designed to continue for a term that is equivalent to the expected life of the underlying know-how or actual life of the patent. With regard to know-how the term is more complicated to arrange. The licensor wants the longest period possible or as long as licensee manufactures the product, while the licensee takes the position that the know-how should be deemed fully paid after some period of time. Generally in practice such agreements do not continue for a period beyond five years.[17]

In certain countries the term of a licensing agreement is regulated, i.e. the term may not exceed a period of time substantially less than the life of the licensed patent. Regarding non-patented technology local law may prohibit imposition of royalty payments beyond the time necessary for licensee to master the technology or beyond the time when the technology remains secret.[18]

Termination of the agreement is normally based upon an event of default, bankruptcy or insolvency. In addition the licensor may have the right to terminate or convert from an exclusive to a non-exclusive grant if royalties are not maintained at certain levels. The licensee may seek an option to terminate if the licensed technology is no longer useful or competing technology is readily available.

The termination should not alter the rights and obligations to pay amounts due or obligations that have accrued to the date of termination. Further the licensor will want to bind the licensee to preserve the confidentiality of information that remains secret even after expiration of the agreement. This can be accomplished by covenants by the licensee to keep the confidential information secret and prohibit it from using or disclosing the same except in accordance with the agreement.

A well drafted agreement should protect the licensee by excluding from any obligation of confidentiality information which was known to the licensee prior to its transfer by the licensor, information which was independently developed by licensee, information which has been acquired lawfully by license from a third party and information which has entered the public domain through no fault or breach by the licensee.

8. *Miscellaneous Provisions*

The agreement should provide for certain other provisions commonly included in international commercial agreements. With regard to dispute resolutions, a United States licensor may prefer that the agreement be governed by the United States law but this may be prohibited under certain transfer of technology laws. The use of arbitration or some alternative method of dispute resolution is often desirable although the licensor may prefer to exclude licensee's payment and non-disclosure obligations from such arbitration.

Provision is often made for excused performance for such reasons as force majeure, restrictions on assignments or transfer of the rights under the agreement and compliance with various local law and regulations that affect licensing of technology.

D. Antitrust Considerations

In addition to the antitrust concerns discussed above other antitrust issues must be considered in the structuring of the license agreement. Antitrust laws may vary considerably depending upon the countries involved although in the European Union community, doctrines similar to those in the United States have been applied to licensing practices deemed objectionable.[19]

Potential illegal antitrust activity in technology licensing include 1) no contest clauses under which a licensee is precluded from challenging the validity of the licensed patent, 2) grant back clauses whereby the licensee agrees to extend to the licensor any improvements it makes in the licensed technology especially if the licensee is required to assign to the licensor inventions which go beyond licensor's patent, 3) field of use restrictions whereby the licensor licenses certain products for use in e.g. the private or home field, but excludes the licensee from use in the commercial field especially if used to allocate or divide markets or to prevent resales, 4) any form of price fixing, 5) discriminatory or exorbitant and oppressive royalty rates, 6) tying arrangements where the party with market power is selling a product only on condition that the purchaser agrees to purchase a different or tied product, 7) where a party is restricted from dealing in competitive products especially when its effect is to prevent the licensee from manufacturing competing unpatented goods 8) cross-licensing or patent pools especially where competitors are involved and 9) agreement not to license a competitor without the consent of the first licensee.[20]

E. Tax Aspects of Licensing

No licensing transaction should be completed without first consulting the respective tax laws and considering their tax consequences upon the parties involved. In the United States a licensor's concern is frequently whether income will qualify for capital gain treatment or be taxed at the higher ordinary income rates. The licensee's concern is to make currently deductible payments or to take appropriate depreciation deductions. Where foreign taxes are paid to a foreign taxing authority, the paying company will want any applicable foreign tax credit and that no more tax is paid than is due, keeping in mind treaties between the country of the payer and the country of the income recipient.

In the United States income received by the licensor from *licensing* technology is treated as ordinary income. Whereas a complete transfer, i.e. an assignment, of all the intellectual property rights may qualify for capital gain treatment.[21]

If the licensor renders technical assistance or training the amount received that is properly allocated to services is considered compensation and not royalties. This may have consequences under laws which provide for withholding of taxes on royalties but not on services. These withholding taxes may be reduced by bilateral treaties or eliminated altogether. Under United States law such taxes qualify for applicable foreign tax credits. In general the rule for withholding differs where the U.S. licensor maintains a permanent establishment in the country of the licensee wherein the benefits of tax treaties are not extended to the licensor.

In other countries there may be other taxes applicable to royalty income or licensing agreements such as registration fees, property taxes or value added taxes. These taxes will not qualify for the foreign tax credit although they may be deducted for United States purposes. Further, foreign countries may impose tax on compensation paid for technical assistance as being source income where the services are rendered.

In the United States royalty payments to foreign licensors are subject to withholding at the source at a flat rate of 30% unless the rate has been reduced or elininated by applicable treaty. The withholding does not apply in cases where the licensor maintains a permanent establishment in the U.S. or the royalty income is effectively connected with the conduct of a U.S. trade or business by a foreign licensor.

Assuming no transfer pricing allocations by the U.S. Internal Revenue Service when the licensing is between affiliates, royalty payments by a U.S. licensee who uses the license rights in its business will be deductible as an ordinary and necessary business expense.[22]

Summary & Conclusion

There are many important issues that must be addressed in the planning and drafting of an international license and technology transfer agreement. The major legal issues to be considered include a clear definition of the technology licensed, any provision for technical assistance and training, a clear delineation of the scope and extent of the rights licensed, its duration and termination, provisions to maintain quality control and any warranties and infringement provisions with respect to the licensed technology, provisions for royalties and fee payments, antitrust issues and tax considerations.[23]

These issues must be considered in light of the respective laws of the countries of the parties involved. The terms and conditions of the agreement depend on the respective bargaining positions of the parties and left to negotiation. In any event, careful consideration of these issues will enable the parties to have a clear understanding of their respective rights and obligations so as to minimize any potential dispute.

Endnotes

1. On the advantages and disadvantages of licensing, see generally I L. Eckstrom, *Licensing in Foreign and Domestic Operations* Section 1.07 (Clark Boardman 1986)

2. See J. Baxter, *World Patent Law & Practice* (Matthew Bender 1968) (Vol 2 & 2A of Patent Law & Practice) (J. Sinnott, Revising author from 1979)

3. J. Dratler, *Intellectual Property Law: Commercial, Creative & Industrial Property,* Chapter 4, (Law Journal Seminars Press, 1991)

4. A. Wise, *Trade Secrets & Know-How Throughout the World* (Clark Boardman Co. 1981)

5. Annex IC. Agreement on Trade Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, ARTS.1(3)(Members Obligations), 2(1)(National Treatment), 4(Most Favored Nation), MTN/FA Special Distribution (UR-93-0246) (December 15, 1993), 33 *International Legal Materials* 9, 83, 84-86 (Jan. 1994)

6. For summary of the most important conventions, treaties and agreements relevant to licensing, see J. Dratler, *Licensing of Intellectual Property,* Chap. 1 (Law Journal Seminars Press 1997)

7. M. Epstein and F. Politano, *Drafting License Agreements,*Chapter 2 (Prentice Hall 1991)

8. Siegel & Gross, Licensing from a Licensee's Perspective in *Drafting Licensing Agreements,* Practicing Law Institute Handbook, 1994

9. S. Meyer, "Exploring Intellectual Property Assets through Licensing; Strategic Consideration" in *Protecting your Intellectual Property,* Practicing Law Institute Handbook 1997.

10. World Intellectual Property Organization, *Licensing Guide for Developing Countries,* paragraph 580 *et. seq.,* (1987)

11. S. Phillips, Identifying & Evaluating Royalty License Clauses in *Drafting Licensing Agreements,* Practicing Law Institute 1994

12. See *supra* note 10, paragraph 441

13. See *supra* note 10, paragraph 456

14. See Goldstein, "Products Liability & the Trademark Owner When a Trademark is a Warranty", 67 TM Rep 587 (1977)

15. See *Supra* note 6, Chap. 2

16. Henry, "Multi-National Practice in Determining Provisions in Compulsory Patent Licenses" II J Intl L & Econ 325(1977)

17. L. Eckstom, *Licensing in Foreign and Domestic Operations,* Section 10.08 (Clark Boardman 1972) See also Kantor, Licensing Restrictions in Latin America in *4 The Law & Business of Licensing* (M. Finnegan & R. Gold Scheir eds., 1978)

18. See *supra* note 6, Chap. 3

19. See Article 30-36, 85 & 86 of the Treaty of Rome, see Davis, "The EEC & Transfer of Technology", 59 J Pat Off Socy 424, 462 (1977)

20. See *supra* note 6, Chap. 5

21. United States Internal Revenue Code, Sections 1221, 1231,1235

22. United States Internal Revenue Code, Section 482, Section 1441(a),(b) and 1442(a). See also J. Bischel, *Taxation of Patents, Trademarks, Copyrights as Know-How,* paragraph 4, 36 (Warren, Gorham & Lamont 1994 Supp)

23. See Melville, L. *Forms and Agreements on IntellectualProperty & International Licensing,* (1987) and Clasen,Thomas, *Foreign Trade & Investment,* (Callaghan & Company 1987)