3 Elements of a Successful, Long-term Licensing Agreement

Intellectual Property

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Cheat Sheet

- **Begin with the fundamentals.** Outline the key points using the basics like term sheets toward a win-win approach.
- **Identify potential disputes.** Figure out where interests don't align to be prepared for potential disputes early on.
- **State termination opportunities.** Market terms can be impossible to identify so in licenses such as service-level agreements, rather than offering credits, for example, if service is below par, allow the contractee to terminate.
- **Consider royalty law.** Royalties can become an issue when a company changes a product or service.

With US interest rates high and protectionism on the rise, traditional merger and acquisition (M&A) activity has been muted. Instead, licensing and intellectual property (IP) acquisition has become an increasingly desirable strategy for businesses to expand, especially those in high-tech industries.

Licensing is a niche area of law, requiring both IP and transactional expertise. However, licenses are typically incorporated as part of larger transactions, they're often handled by general in-house counsel or corporate attorneys without a technical or IP background.

Licenses take many different forms: ancillary agreements to larger transactions (like asset purchases); non-negotiable, click-through sets of terms in connection with off-the-shelf software solutions; and stand-alone strategic partnerships. The term “license” can be misunderstood by the business: it’s often used in connection with software as a service (SaaS) offerings (which actually involve a right of access, instead of a strict license to the underlying technology) or data (which may or may not be protected by intellectual property law).

The next time you find yourself in a licensing situation, consider these three tips before diving in:

1. Focus on fundamentals

Your first step should always involve meeting with the business team. License agreements are often strategic transactions for a business. Establishing a seat at the table early on allows you to shape the discussion, such as by negotiating approach, and even the initial set of terms. As many in-house counsel know all too well, there are two negotiations involved in licensing deals: negotiating with the other party and negotiating internally with your business team.

Business teams sometimes require significant coaching during licensing negotiations depending on their legal sophistication and comfort with negotiations. They tend to focus on short-term outcomes, like closing a deal while hitting their key performance indicators (KPIs). Your job involves considering long-term implications and their potential impact on the business.

In-house counsel should meet with the business team early on to manage license agreement negotiations effectively. PeopleImages.com - Yuri A / *Shutterstock.com*

During your initial kick-off meeting, you should have two immediate goals: First, encourage the business to create a term sheet for the deal that lists and outlines the needed and desired terms, and second, set and manage their expectations.

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While standard in other practice areas, term sheets are not always used for license agreements. And when they are, they tend to stick to the basic commercial deal points. Industry practice varies. In some industries like life sciences, an industry that heavily relies on extensive in- and out-licensing for drug development, term sheets can be incredibly robust and include some of the more hot-button legal provisions, like indemnification, limitation of liability, and diligence obligations (more on diligence obligations later).

Not only do term sheets establish the structure of the license, they create consensus on contentious terms at a time when trust and enthusiasm between parties is high and ensure a meeting of the minds on key points isn't lost during rounds of language modifications, they also identify deal breakers early on. Term sheets are especially valuable in negotiating complex licenses.

When drafting a term sheet, remember that it's intended to be non-binding between the parties (assuming that aligns with their intent) and consider including the following items:

- Definitions, including field of use, net sales, and licensed IP;
- License purpose (or description of the collaboration, project, or relationship of the parties);
- License grant (including exclusivity provisions);
- IP ownership of any improvements (and whether royalties must be made on improvements);
- Indemnification; and
- Limitation of liability.

When negotiating the core terms during the term sheet stage, it's important to remember that the parties' incentives are often misaligned, potentially leading to disputes and jeopardizing the project's success. Because the circumstances of licensing transactions can vary greatly, so can the parties' respective concerns. The first question to ask a client or business team at the initial kick-off meeting should be: "What are you most worried about?" The business is usually able to answer this question without hesitation – and their response should immediately inform your focus.

In the context of an exclusive license (e.g., an arrangement where the licensee is the only entity permitted to use the IP) the licensor is typically concerned with a licensee shelving the IP in exchange for promoting or developing the licensee's own products. In this context, licensors often doubt the licensee's commitment toward commercializing and marketing the product. The licensee, on the other hand, wants to minimize its risk of commercial failure.

One approach toward aligning incentives of both parties to make commercial success more likely is to ensure that both parties have "skin in the game," or at least have invested enough in the partnership to motivate them to generate a return on their investment. This can be achieved in a few ways: commercially, by restructuring the fees to include an upfront payment (in addition to royalties owed on future net sales), or legally, by imposing well-drafted diligence obligations on the licensee. In some industries, requiring licensees to exert commercially reasonable efforts to use licensed technology is commonplace, but can be appropriately adapted in many different contexts.

2. Recognize that chasing market terms is fruitless

As with other types of commercial transactions, you've probably heard from a client or business team that their goal for a given license agreement is simply to "make sure we get market terms." Defining "market" terms is particularly hard for license agreements (except for, maybe, off-the-shelf software licenses) because each transaction is typically highly negotiated and highly contextual. Terms vary based on the parties' bargaining power, technological capabilities, existing relationship, the strength of their IP rights, and market dynamics.

Moreover, focusing on what the "market" is places too much emphasis on the contractual outcomes, rather than the contractual process itself. Here is where it becomes critically important to manage the business's expectations: redlines, regardless of how extensive they appear, should not be taken personally by a receiving party nor should they be interpreted as an indication of an issue. Rather, a thorough negotiation process sets a licensing engagement up for success by identifying potential disputes at the outset when trust is high between the parties and investment is low, and attempts to mitigate the risk for dispute by removing potential ambiguity and setting clear expectations.

Take, for example, service-level agreements (SLAs) set forth in many software licenses. SLAs typically target software or software provider performance, focusing on support services and service availability. Oftentimes, they establish minimum or threshold performance levels that the software provider must provide to the user. For example, they might require a software system to be "available" or accessible to a user 99.5 percent of the time (referred to as an "availability" or "uptime" SLA). And in the context of software, SLAs are quantitative rather than qualitative, establishing a "minimum" performance standard rather than imposing performance standards upon software providers.

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SLAs are an often overlooked and underused tool. Unsophisticated business teams, especially those that infrequently purchase software rather than more sophisticated information technology (IT) procurement or sourcing individuals, are often unaware of their importance. When SLAs are missing from an agreement, as they often are (especially from less mature providers), they tend to shrug them off. "We tested the software," they say.

Educating the business team on this issue is key, as performance often becomes a source of dispute later on, and using real-world examples is always the best way to drive the issue home. A district court in New York in 2023 addressed SLAs in Walmart Inc., et. Al. v. Capital One. In this case, Walmart sought to terminate a partnership with Capital One on the grounds that Capital One breached their agreement by repeatedly violating SLAs set forth in the agreement. The agreement entitled Capital One to be the exclusive issuer of Walmart's private label and co-branded credit cards, but also included specific SLAs involving Capital One's customer service and support obligations.

Most standard, or what would be considered by some to be market SLA contract provisions, include language that limits the recipient's remedies in the event such SLAs are violated by the grantor, usually in the form of credits that the recipient can apply toward future payments. This example reiterates the problem with achieving market provisions: If the software, IP, or service is mission-critical to an organization or used in a novel context (like a co-branded or licensed product or service, as was the case with *Walmart v. Capital One*), performance is crucial to operational success. Forcing a licensee to live with compromised performance, even in the face of reduced fees, can be both unprofitable and commercially unacceptable.

Instead, consider adopting Walmart's approach and include language in the license agreement that entitles the licensee to terminate for multiple, recurring performance issues or SLA violations. Establishing SLA violations and calculating credits can be notoriously difficult to track and prove depending on how they are defined. Without the ability to terminate, the licensee often has very little leverage to enforce SLAs. Tying termination to SLAs is a powerful way to build in a real incentive for licensors and service providers to invest in, and commit to, an acceptable performance standard.

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3. Consider key IP concepts

Another common mistake in license agreements involves royalty calculations. Business teams tend to focus on the technology or product being licensed rather than the underlying intellectual property rights that form the basis for the royalty. It's not uncommon for royalty payments to be perpetually tied to net sales of the product.

In 1964, however, the Supreme Court held that a patent holder cannot charge royalties for post-expiration use of a patented invention in Brulotte v. Thys. Co., a seminal case on patent licensing. The rationale is simple: Because patent law gives a patent owner a limited monopoly, the right to make and use the invention should pass to the public when the patent expires. Essentially, *Brulotte* prohibits perpetual royalties for technology covered by patent rights.

This concept becomes complicated when licensed technology or products are not only protected by patent rights, but other IP rights too. These types of transactions are often called hybrid licensing arrangements. A common example involves pharmaceutical drug development, whereby a drug is protected by an array of different patent rights, but the manufacturing process relies on non-patented trade secrets and know-how. Does *Brulotte* prohibit perpetual royalties for licensed technology involving hybrid intellectual property rights, too?

This question was addressed by the US Court of Appeals for the Ninth Circuit in Kimble v. Marvel, which held that a license agreement covering inseparable patent and non-patent rights must provide a discounted royalty rate after the underlying patent's expiration date unless there is some other clear indication that the contested royalty is not subject to the patent. The plaintiff, Stephen Kimble, had invented a handheld web blaster, which allowed a child to pretend to be Spider-Man by mimicking his web-shooting abilities with foam string. He had approached Marvel about the idea, Marvel declined, and eventually launched their own version of a web blaster, causing Kimble to sue for infringement.

The parties eventually settled the dispute, entering into a settlement agreement that involved an upfront payment and 3 percent perpetual royalties on net sales of the web blaster. The web blaster met with enormous commercial success, leading to over US$6 million in royalties being paid to Kimble. Still, there was trouble in paradise. Kimble and Marvel again disputed, this time over the calculation of royalty payments involving improvements Marvel made to the web blaster, resulting in upgraded versions with additional functionalities.

Eventually, Marvel discovered *Brulotte* and filed a summary judgment motion declaring that it was no longer obligated to pay Kimble based on sales of the web blaster after the patent expired in 2010. And the Ninth Circuit agreed. If, the court noted, the definition of net sales had been tied to Marvel's use of ideas and know-how, the royalty might be enforceable indefinitely. But instead, the definition of net sales was tied to underlying patent rights, thereby contemplating one royalty rate for both patent and non-patent rights.

Marvel was later affirmed by the US Supreme Court in 2015, which upheld *Brulotte* and suggested a few ways for parties to work around it. One suggested approach involves deferring payments for pre-expiration use of a patent into the post-expiration period. For example, by setting a 10 percent royalty rate of sales during the 20-year patent term and amortizing that amount over 40 years.

The more common approach, which is standard in many technology-heavy industries like pharmaceuticals and life sciences, involves setting two distinct royalty rates: 1) a patent royalty rate for net sales, which runs until the latest-running patent covered in the agreement expires, and then, 2) a reduced step-down royalty rate kicks in for use of know-how and trade secrets. This approach can easily be adapted to any industry, so long as the definitions of licensed patents and know-how are clearly distinguished. This is commonly misunderstood by the business and non-IP attorneys who typically view the licensed product as a whole, when for licensing purposes, the product actually needs to be delineated into its component parts (the individual IP rights attaching to the product).

Marvel is an example of how even the most commercially successful licenses can give rise to dispute after dispute – even for the simplest (but very fun) products. Yet they remain a cost- and time-efficient way for companies to expand product lines and brands to extend into adjacent categories. The current licensing wave is likely here to stay. And while many may prove unsuccessful, it won't be attributable to your poor legal advising after reading this article.

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