Memorandum

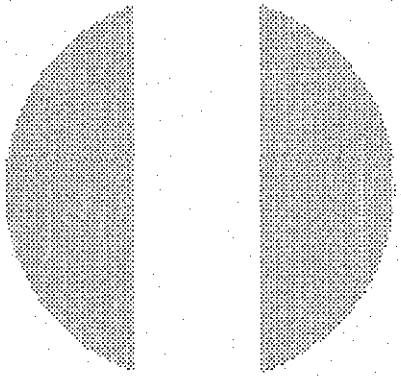
To: All Attorneys/agents

From: Norman J. Latker

Date: June 5, 2003

Re: The Basics of Licensing

Attached is a very good guide on licensing for your files.



CONFIDENTIAL



The Basics of Licensing

Including International License Negotiating Thesaurus

Licensing Executives Society
U.S.A. and Canada

FORWARD

This pamphlet has been prepared for general use by individual inventors and managers of small business. Although it contains a broad overview of current (considerations) laws, regulations, other issues related to licensing and technology transfer, readers should understand these matters change over time. This pamphlet is **not** a substitute for the services of a licensing professional. You should consult a licensing specialist to discuss specific questions and issues. Before retaining a professional, be sure to verify his or her past experience and qualifications.

Prepared by the Licensing Executives Society (U.S.A. and Canada), Inc., Small Business Committee.

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INTRODUCTION

The Licensing Executives Society (U.S.A. and Canada), Inc. hereinafter called LES, is a non-profit, professional society of over 3,700 members—executives who engage in technology transfer on a regular basis. Its members are business people, technology transfer personnel, attorneys, engineers, consultants, and scientists. A primary LES goal is to educate its members and the public about techniques and substantive issues associated with licensing and technology transfer.

This pamphlet discusses licensing, or contractual business relationships between a seller (licensor) and a buyer (licensee) who contracts to use the seller's invention, technology, know-how, patent, trademark, copyright, trade secrets, or other intellectual property for compensation (e.g., cash, equity). Licensing is primarily a business activity. The final written record of this activity forms a legal document called a license agreement which is simply a special kind of contract.

Negotiating a "win-win" agreement is more important than the language in which the agreement is embodied. A licensor, with the makings of a profitable license, can easily locate an individual who can help write a satisfactory license agreement. Licensors have more difficulty finding an individual who will help identify a potential licensee and negotiate an equitable agreement.

Licensing can be very complex. Indeed, the very process of locating and negotiating with potential licensees constitutes a very difficult task. There is no "standard license." License negotiating and writing should be customized to fit each specific business situation, technology, intellectual property, and existing laws/regulations. Having thus cautioned you, we urge you to study this pamphlet carefully.

THE VOCABULARY OF LICENSING

License: A license is the granting of permission or rights to make, use and/or sell a certain product, design, or process or to perform certain other actions, the granting being done by a party who has the right to do so. There is generally no intent on the part of the licensor to convey ownership or on the part of the licensee to purchase ownership in the property being licensed. The intent of the parties in a license is only to authorize the licensee to use the intellectual property which is the subject of the license.

Licensor: The seller/granter of a license. While in most cases a licensor owns the licensed intellectual property, in some cases a licensor only has a legal right to license that which is owned by a third party. For example, Manufacturing Company A grants Engineering Contractor B the right to grant licenses and build plants for others, such as Buyer C, in all cases utilizing intellectual property of A in return for compensation which typically will flow from C to B to A. What B has is "sub-licensing" rights from A, and B thus is a "sub-licensor" to C.

Licensee: The buyer. In the previous example Buyer C is a "Sub-Licensee."

Technology: The word "technology" often is used as a generic word to cover the intellectual property which is licensed. Typically, lawyers draft a precise definition of the "technology" or intellectual property which may include inventions, patents, trademarks, copyrights, and various types of trade secrets or know-how (e.g., methods, formulas, blueprints, customer lists, manuals, or know-how and show-how such as operations manuals).

Technology Transfer: This phrase often refers to moving technology from a licensor to a licensee via a license. Classroom teaching, aviation simulation instruction, in-plant training—all can be technology transfers. More often though, a typical technology transfer involves "technology" protected by a patent, trademark, copyright, or trade secret.

Know-how: Expertise or knowledge of how to perform a useful function in a proven and efficient way. Know-how can be available in the public domain (no need for one to license) or can be classed as a trade secret (defined below).

Trade Secret: This word is used by licensing professionals to denote information or technology which is used in a business, and which creates an advantage over competitors who do not know or use it. It is protected only as long as it remains secret, and is not generally known by competitors. Examples of trade secrets are: a formula for a chemical compound; a manufacturing process; and an industrial technique.

Government Approvals: In some countries a license is not valid (legally enforceable) until a government department reviews and approves it. Foreign government approval may be required because the foreign government wants to control outflow of its currency, keep track of technology transfers, and limit competitive restrictions.

Grant-back: The initial act of technology transfer, from a licensor to a licensee, is the grant. The later transfer of rights in any improved or subsequently invented technology by the licensee back to the licensor is a grant-back. Many license agreements have a grant-back clause.

Royalty: Royalty is the payment made by a licensee to a licensor. Royalties can be paid in a "lump sum" or a "front end" payment, a fixed sum per year, a percentage of sales (the percent can change with volume), or a fixed amount per article sold (the latter two are called "running royalties"). If a licensor sets a floor or lower limit for payment, it is called a "minimum royalty."

Negotiation: This is the bargaining process between a prospective licensee and a licensor that occurs before a license agreement is signed. The objective of this negotiation is to arrive at settled, fixed terms for the license agreement. Negotiations often are face to face, but also can be conducted in writing, by telephone, or through intermediaries.

HOW IS LICENSING DIFFERENT FROM OTHER TRANSACTIONS?

A sales agreement transfers all rights to the property sold from a seller to a buyer; licensing grants only limited property rights to a licensee and usually for a fixed length of time. Generally speaking, you can sell an item only once. However, many licenses can operate simultaneously.

To locate licensing properly relative to other transactions such as direct sales, distributorships, and assembly operations, consider a typical business growth pattern. At the start, Company A retains Mr./Ms. X as its sales agent. X takes orders and sends them to A's home office where the order is filled and shipped, and a fee is paid to X. A distributorship is slightly more complex. Sales agent X rents a warehouse, maintains a stock of goods by purchasing them from A, and fills orders from a warehouse. Then a partial assembly operation may be

established, perhaps in the unused portion of X's warehouse; then X may begin packaging and delivering product, and integrating other business activities. Many businesses never grow beyond this point. Others, however, grow by licensing. Company A may transfer its technology to X who makes some or all of the items in a product line, and who pays a royalty to Company A. In some cases, X may be short of capital so X participates in a joint venture that is licensed by A. Company A then receives royalties plus dividends.

WHAT CAN BE LICENSED?

Almost anything can be licensed if it contains a protectable property right. The most familiar licensed items are industrial processes, industrial or consumer products, software, characters (e.g., cartoons, famous individuals, artwork), and business ideas.

In defining the word "technology" above, we noted this word often is used generically to include anything licensed (i.e., patents, trademarks, copyrights, trade secrets, and know-how). In each of these cases there is some form of legal right. In the case of a patent, a property right is granted by a national Government to a patentee when the legal requirements and property rights for a patent are fulfilled. For instance, in the case of a trademark and a trade secret, Coca-Cola maintains property rights in both its trademark and the secret formula for the Coca-Cola syrup. If there is no legal right, there is no protection. Thus, any person or firm wishing to practice the process or produce the product can do so with impunity—all competitive advantage is lost.

Some of mankind's greatest discoveries have been judged not patentable, and therefore may be freely used by anyone. Ether, the first widely used, safe anesthetic, was judged not patentable because small amounts are found in nature. This allowed all who wished to do so to distribute and use it without payment to the "discoverer."

SOME ADVANTAGES AND DISADVANTAGES OF LICENSING

Licensing requires a licensor to assume less risk and make less commitment than when a firm manufactures and sells its own goods. A licensor should not expect to receive the major portion of any profit from the sale of a licensed product because the licensee typically assumes the greatest risk (e.g., raising capital, building a sales force, equipping a manufacturing facility, establishing advertising campaigns). Thus, the lesser risk of a licensor usually equates to a smaller share of potential profits.

There are benefits to licensing in addition to royalty payments. In some cases, a licensor can transfer his technology in return for an equity position in a joint venture. Also, it may be possible to obtain a "grant-back" of improvement technology from the licensee. In any business, large or small, the financial success of a licensing program has the added benefit of encouraging managers to license more frequently, and to continue research and development programs which lead to additional licensable subject matter.

Another advantage of licensing is that it can provide a licensor with a way to continue gathering competitive information about technology as practiced by licensees and others. Although it is often difficult to quantify this advantage, it can be very valuable to a licensor who also uses the technology. To a small business, licensing has an additional advantage of permitting the firm to enter domestic and foreign markets otherwise closed by trade restrictions, quotas, tax, freight or other legal considerations. Licensing can be a method for quickly entering and expanding foreign markets with a minimum of risk. It also can be a method for increasing production of some parts of a complex mechanism, which then are sold to the licensee for inclusion in licensed assemblies. And, a licensing program can increase the goodwill and reputation of a firm. Further, licensing can be a first step in establishing relationships in foreign countries that could lead,

at a later stage, to joint ventures, other kinds of alliances, and eventually acquisition of one partner by another. Licensing may be required in industries needing many suppliers (e.g. automotive industry). At the same time, licensing technology broadly in foreign countries may lead to the domestic government negotiating restricted market share.

Transferring technology that covers part of a business' current manufacturing operation may ultimately create a competitor. Even if that licensee is in a foreign country, the licensor should be aware that, in a time of expanding foreign markets and more rapid transportation, today's non-competitor in a foreign country may become a future competitor. Licensors also should recognize that protection for technology may be very limited in certain countries.

Some corporations discourage outside inventors from submitting or disclosing their ideas. This can be disheartening and frustrating. Such a corporation may have an extensive research and development program in the same field the independent inventor wishes to license. Firms fear becoming "technically contaminated." A corporation often will not tell an inventor this, but merely will say it has no interest in the invention. This helps avoid litigation by an independent inventor when the corporation later produces a similar product. Other corporations encourage outside inventor disclosures and use a multi-stage secrecy agreement process to avoid the technical contamination problem and subsequent litigation.

WHEN SHOULD YOU LICENSE?

A patentable idea increases in value as the following events take place (not all events are present in all invention development cycles).

1. A raw idea is formed (the idea has low value).
2. A domestic patent application is filed to cover the idea.
3. A working model or other demonstration of the viability of the idea is made, and a preliminary market analysis is completed.
4. Foreign counterpart patents are filed; the domestic patent issues (now the invention has moderate value).

5. The invention is commercially marketed.
6. One or more prudent businesses accept licenses under the patent (the invention now has very high value).

Another way to look at the question of when to license is to consider the buyer's or the licensee's needs. A company seeking new products and processes to complement its current range of products or processes is a good potential licensee. A company without research and development facilities, and there are many, will have to acquire technology for new products from outside the company. Similarly, in order to diversify activities and enter a new field, companies must obtain technology somewhere and licensing is one common method.

The simple answer to the question of when to license is: when a licensee believes it will be rewarding to accept a license, and when a licensor has secured sufficient protection so that licensing does not jeopardize ownership in the idea or invention. Other factors (e.g., balancing risks and rewards) also play a role in the timing decision and should be carefully considered.

HOW DO I FIND A LICENSEE?

There are a number of steps an independent inventor or a small business can take to find a licensee. First, a search for prospective licensees should be undertaken. Prospects can be located through directories such as *The Thomas Register* which you can find at your local library; they can be located by using keyword database searching available on-line at libraries or through other sources; and they can be located through trade associations in the technology field concerned. If you are a member of LES, you may find members are potential licensees. Suggestions for potential licensees may be made by business colleagues; commercial banks and stockbrokers sometimes are sources of information; and even trade shows and exhibitions will furnish leads.

Your objective is to compile a list of potential licensees and then narrow the list to the best prospects. With only a list of names and

addresses of firms that might be interested, you will need more information to narrow the list. For example, what is the financial strength of each company in terms of annual sales and profits? What types of products and processes does each prospective licensee now manufacture and sell? Does the prospect conduct research and development in its own laboratories (or through contract)? Is there a history of "licensing in" for a potential licensee?

Once you have narrowed the list, your next task is to prepare a prospectus which describes your invention as accurately and informatively as possible without giving away any secrets. This prospectus should describe, in broad terms, functions and results, rather than setting forth the details of construction or operation. Be completely factual in this endeavor. Then you are ready to begin a mail campaign or making direct personal contacts.

HOW CAN I GET HELP IN LICENSING?

If you have protected your idea well, you can get help finding licensees, determining the value of your idea, and negotiating the license. Experienced licensing attorneys, LES colleagues, or consultants are the best sources of help. Be sure to ask any attorney or consultant to provide you with references and information concerning the extent of his or her licensing experience before you retain him or her. You should ask the consultant/broker how and how much he or she expects to be paid. The Licensing Executives Society (U.S.A. and Canada) Inc. publishes a *Consultants and Brokers List.* This list contains information about licensing professionals who specialize in working with independent inventors and small businesses.

Other, but usually less informed sources of licensing help are those which are wholly or partially funded by the Small Business Administration or the U. S. Department of Commerce (e.g., Small Business Development Centers, Small Business Institutes, the Service Corps of Retired Executives (SCORE)), and the Energy-Related Inventions Program funded jointly by the U. S. Department of Commerce and

the U. S. Department of Energy. Some universities have established offices to help independent inventors and small businessmen. Inventor organizations which can help you locate licensing help can be found in major cities. Such groups are listed in a document titled "How To Protect and Benefit From Your Ideas" published by the American Intellectual Property Law Association. Copies of this pamphlet and other information about the pamphlet and licensing help are available from:

American Intellectual Property Law Association
2001 Jefferson Davis Highway, Suite 203
Arlington, VA 22202

HOW DO I DETERMINE THE VALUE OF MY INVENTION OR IDEA?

This is one of the most difficult questions in licensing, and only general guidelines can be utilized until the parties actually have negotiated. In general, a license royalty should not be so high that it reduces the profit margin of a licensee below the traditional level. Many licensing executives use a rule of thumb to begin negotiating: 1/4 to 1/3 of the saving of a new process, or 1/4 to 1/3 of the profits of a new product should go to the licensor. This split recognizes that a licensee typically assumes greater financial risk in commercializing the technology, and takes into consideration the level of effort made by both parties.

Royalties commonly are expressed as a percentage of the "net sales price" of a licensed product. Other times they are expressed as an equivalent thereto, such as $2 per ton of paper product under a license on a paper machine. Recognize that $2 per ton today may be good, but 15 years from now, particularly in high inflation economics, may not be worth much.

Factors influencing a royalty rate include the strength and scope of the protected intellectual property, the expenses necessary for a licensee to reach full production, the cost of any additional research and development required, the exclusivity or non-exclusivity of the

license agreement, the geographic scope of the license, the competitive product, processes, and technology available to the prospective licensee (sometimes called the "next best alternative"), the total market and its estimated growth, industry common or standard license rates, and whether the license covers all or part of a process or product.

A WORD OF CAUTION

First, licensing is not the key to the United States Mint, even if you have a very good invention. Statistics indicate that if you write to 100 firms offering to sell or license your idea or invention to them, only about 30% will ever answer, and your chances of making an actual deal are less than 1%. This is due to the nature of the new product business.

Second, there are fraudulent invention development companies in the United States. These companies offer services such as marketing, patenting, developing and presenting inventions to industry. Their existence in part results from the fact that most inventors place a high value on their inventions. Fraudulent invention development companies thrive on this tendency. They realize an inventor wants to hear that his or her invention is the greatest, and so they provide an inventor with the desired response. They usually try to secure a large front-end payment from an inventor, because they realize that their chances of successfully marketing the idea or invention are very low.

A FINAL THOUGHT

The name of the game in licensing is markets. For any licensing transaction to succeed, any technology must have an appropriately large market to attract a potential licensee. As you proceed in developing your technology, be sure to develop market information and protect your intellectual property.