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INTERNATIONAL LICENSING

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I. Licensing What

In discussions of licensing, whether international or domestic, we must first decide what are we licensing. In nearly all cases the licensed material may be classified as a proprietary asset, which includes patents and patent applications, trademarks, trade secrets, know-how and copyrights.

It must be kept in mind when discussing licensing, and particularly international licensing, that a United States patent is only effective in the United States and gives you no right in any other country directly. There are techniques whereby you can get a patent of confirmation or importation or some similar right in another country by registering the U. S. patent but, by and large, these are not available in the important foreign countries.

A patent does not give you the right to do anything. In other words it is not, strictly speaking, a monopoly, although it is often referred to as such. A patent gives you the right to keep someone else from doing something, specifically to keep someone else from making, using or selling a product or from practicing a process covered by the patent. Thus, if you have the basic patent on the telephone it does not necessarily mean that you or your licensee can make or sell a dial telephone, which is better than a non-dial telephone, particularly if someone else has a patent on the dial telephone. On the other hand the owner of the dial telephone patent, or his licensee, cannot make or sell the dial telephone because it would infringe the basic telephone patent. Thus, neither party can make or sell a dial telephone unless he gets a license from the other.

Thus, when you license a patent to someone else, you are really telling them you will not sue them for infringing your patent. Therefore, you must be careful when negotiating with others that both parties clearly understand what is the effect of patents owned by third parties. The rights of the parties should be set forth in the license agreement so that either the licensee understands that you are not responsible for the patents of others, or there is a royalty sharing arrangement of some sort whereby if the licensee is required to pay a royalty to a third party he is permitted to deduct part or all of that third party royalty from the royalties he pays to the licensor.

Often patents are involved in the license; however, it is comparatively rare that the license will be only a patent license. Usually trade secrets or know-how may be just as important, and in some cases more important, as the patent rights and you usually license the package of patents and know-how to the other party.

Another item that is frequently licensed is a trademark. Again, this may be licensed with a package of know-how. For example, many of the shirt companies, such as Manhattan or Arrow, have licensees in many countries of the world that make shirts in accordance with the technology of the licensor and are permitted to use the trademark on the shirt. Thus, Manhattan is a well-known name in many foreign countries in the shirt business and the fact that the trademark is on the shirt tells the customer that it meets certain quality standards.

II. Alternatives to Licensing

Licensing, which can take place in a variety of forms, is still only one way to operate in the international field. There are a number of other alternatives available. Of course, you can export your own products and either market them yourself in the foreign country or market them through others. You can also expand your own operations to establish your own manufacturing and marketing activities overseas which you control. Another alternative is investing in an established company to get partial ownership or, if desired, a majority or even total ownership. There are a variety of joint venture arrangements where your company and

one or more other companies jointly make arrangements. At one end of the spectrum the companies can establish a separate entity in which the companies each own a portion of the venture. At the other end of the spectrum the companies merely cooperate with each other and share the profits or losses in some fashion.

II. A. EXPORT--ADVANTAGES AND DISADVANTAGES

Each of these alternative methods of international operation has advantages and disadvantages. For example, in a direct export of items to the foreign markets you are in complete control of the manufacture yourself, you can make the product to your own specifications and quality, the labor is a known factor and you do not have to take into account foreign laws, regulations or customs in your manufacturing operation. If you are marketing yourself you again are in complete charge of your operation. You can make the decisions yourself and need not be concerned with convincing others that your way is the way things should be done.

On the other hand there are certain disadvantages in the export market. The products may be made in a comparatively high labor area, such as the United States, and you will be competing in the foreign country with either products made in that country or imports from other countries where labor rates are substantially lower. In some cases it is an advantage to have the product made in the United States because of reputation for quality but in other instances anti-American bias may be a detriment. The export market is also difficult because of certain trade restrictions imposed by foreign governments, by exchange shortages causing difficulty in bringing money back to the United States, the competition in the local country to which you are exporting often has increased substantially and the feeling of nationalism that many of the countries have which makes it difficult to import products, particularly products which the local government may control.

II. B. FOREIGN SUBSIDIARIES--ADVANTAGES AND DISADVANTAGES

Establishing your own foreign operation does, of course, involve substantial commitment of company funds in a foreign country. In some instances, of course, facilities have been nationalized by the local government and the American company has had difficulty in recovering its investment. There are certain U. S. Government agencies which will assist an American manufacturer in granting insurance against this, but it is still a messy situation. Often the establishment of a foreign branch will take substantially more management time and investment than is regarded as desirable for the potential return. Also, operating in a foreign country requires an understanding of the local laws, regulations and customs and an American may make important blunders without realizing it. It may also be that the present foreign market is initially too limited to warrant establishment of a manufacturing or marketing arm overseas and that thus substantial investments will have to be made for a number of years before the market develops sufficiently to provide a reasonable return.

Many foreign governments will not permit the establishment of a local subsidiary operation which is controlled by foreigners. This may be an absolute bar to establishing your own operation in these countries.

The establishment of a minority interest in a foreign firm, often by direct investment, is an alternative which does not require the substantial investment that the establishment of a wholly-owned subsidiary requires but still involves problems with local partners, the control of the operation, the government regulation involved in control of joint venturs, etc. While a joint venture to some may seem to be a reasonable method of entering a country initially others feel strongly that it is not a vehicle for a long-term operation as both your management and the management of the other party changes from time to time and it is often difficult to accomplish your objectives through a subsidiary which is partially owned if control of management is in the local people. It is, of course, possible to establish a company in which you own a minority interest with the remaining interest owned by the local public. This does

give you the advantage of practical control but still does not return the complete profit to you and often will require a substantial investment in capital and management time.

III. LICENSING--ADVANTAGES AND DISADVANTAGES

To some licensing has been regarded as the middle approach because it does involve more risk and commitment to the foreign market than merely exporting from the United States but certainly involves less risk and commitment than owning and managing your own manufacturing and distribution facilities. One way to look at licensing is by referring to it as the export of proprietary assets rather than proprietary products. It is a form of investment without the use of dollars and may provide a substantial return for the proprietary asset invested.

In a license the licensor cannot expect to receive the lion's share of the profit for the proprietary asset as the licensee is taking the larger risks of investment, commitment, etc. and should, therefore, retain the major portion of the profit. The licensor, however, has no risk of loss and gets his royalty whether the licensee makes a profit or not in any particular period.

Licensing, of course, is not limited to a direct financial return in the form of royalties. It may very well be that in return for rights in your proprietary asset you will obtain an equity position in the licensee and on occasion even a majority equity position. In addition to the equity position and its share of the profits you may also get royalties on sales of the licensee. The equity position, of course, has the same disadvantages that a joint venture may have in that you often are at the mercy of another party if you are in a minority position but this risk may be well worth taking, Of course, you can often use your royalties to increase your holdings in the licensee by reinvesting the royalty earnings. Also, you can accumulate your royalties overseas and invest them in other foreign markets.

Thus, a major reason for licensing often is obtaining extra income from proprietary assets. It may help in getting income to partially support the cost of the company research and development programs, or to maximize the returns from these research results.

There are a number of other possible reasons for licensing. It may permit you to retain established markets that may have been closed or threatened by import or other trade restrictions or permit you to reach new markets which are not accessible by export from your existing facilities. It is one way to enter or expand foreign markets quickly with a minimum effort or risk as a number of licensees may be selected in a variety of countries and expansion of sales of the licensed product may take place with a minimum of time. It is a way to gain cost or other advantages of local manufacture without committing your capital abroad and it may be used to augment your limited domestic capacity and management resources for serving the foreign markets.

On occasion licensing is useful to provide services and supplies for important domestic customers who want the services and supplies available overseas for use with their export products. For example, if you are a component manufacturer and your customer does a substantial amount of foreign business he may want ready access to replacement components available overseas and the service that goes with them.

Licensing may be a way to accommodate the military needs of foreign governments. As you are aware, many United States defense firms license foreigners to make defense products for the foreign governments. This often occurs in a situation where the foreign government will not purchase the product from the United States and will not permit the product to be imported to the country involved.

A licensing program may be used to develop the goodwill and reputation and acceptance of your company name, particularly if a trademark license is involved. The acceptance of the trademark may be capitalized upon later on by other licensing arrangements or by your own direct manufacturing or export.

An important fact is that licensing is a two-way street which may permit the American company to get access to a foreign company's technology and expertise and to acquire a new product line for a comparatively small amount of money and in a short time. The American company does not have to establish a research program with the attendant difficulties

and need not spend years in developing the expertise and the product line which may be available immediately from a competent foreign company.

Of course, there are reasons for not licensing in the foreign market. One is a limited interest in foreign markets and a feeling that the American company has all it can handle in the United States and does not wish to get involved in the complexities of international licensing. Another reason is that the company may have its own methods of operating in the international field and these may not involve licensing. The company may be perfectly happy with its export operation and is able to compete very well in this manner. On the other hand the company may have decided to operate in the overseas market by the use of wholly-owned subsidiaries and has no need for licensing.

Some companies, particularly those with a strong trademark, feel they cannot adequately control the quality of a licensee's operations and feel that if an inferior product were made, particularly a food product for example, their trademark and their reputation would be damaged overseas and they do not wish to take this risk. They prefer to operate either by exporting their products or by establishing wholly-owned subsidiaries where they have complete control over the operation. In either case the company exercises control over the quality of the goods.

Of course, it may be that a company's overseas operations may involve a variety of different forms depending on the particular situation. The company may have established subsidiaries for certain product lines in certain parts of the world. It may export in other areas and may license in still others.

IV. LICENSING ORGANIZATION

If you do decide to establish a licensing program, how should you go about it? How should you organize internally? It depends a lot on the particular company, the amount and quality of licensable items, the size of the company, the variety of products, the sophistication of the technology, etc.

In recent years many corporations have established a licensing group within the company. These license groups may be found in a variety of places within the company. Sometimes they are part of the overseas or international group, such as at Westinghouse, where the international group handles all international licensing. At Itek, however, we have a small licensing operation within the Patents and Licensing Department. This licensing group is not composed of patent attorneys but includes businessmen with a technical and/or marketing background. The licensing people work closely with the patent attorneys.

Other companies have the licensing done by their Patent Department or by a separate licensing group which may report to the same or different people to whom the patent operation reports. In other companies the licensing may be done by the divisions with little or no coordination between the different parts of the company.

There are people and organizations who are available to license your products to others by finding potential licensees or, if desired, they will find product lines and technology which are available from others in areas in which you might be interested.

Licensing, like many other things in today's world, can be quite complex and really should not be undertaken without expert consultation and assistance. I am sure that many of you as managers feel that the expertise of the financial community is a vital necessity to management and that important decisions must take financial considerations into account before steps are taken. I think it is similar in the licensing field. Decisions about licensing should not be taken without consulting the appropriate licensing experts and arrangements should not be negotiated without such prior consultation. Usually the negotiations themselves should be handled by licensing people either with or without direct participation by management.

V. LICENSING--GENERAL COMMENTS

Assuming that you decide to investigate licensing, I would like to make a few comments on some of the different types of licenses. It may

be that a suitable license for your situation may involve exclusive rights where the licensee is the only person who is permitted to practice under your proprietary assets in a particular territory. For example, you could have an exclusive licensee in France which would mean you could not grant a license to another company in France. You could have a semi-exclusive license which would permit your licensee and one other party, often yourself, to practice under the proprietary asset. In some cases a non-exclusive license is suitable.

You may, of course, have combinations where a license is exclusive for manufacturing in a country, such as France, with a non-exclusive right to sell in other countries, for example, in the common market.

In many countries, such as Japan, the government enters into the licensing situation by requiring government approvals. Japan often requires that the Japanese licensee shall have the right of export anywhere in the world. Also, many governments of developing nations, such as Mexico and Brazil require government approvals of technology transfer agreements. These governments will not approve many clauses which have been used regularly in the past. In addition, the U.N. is working on a proposed Code of Conduct for Technology Transfer which, if adopted, would prohibit the use of certain clauses in technology transfer agreements.

The United States does not require government approval, but many of you may have noted, the United States Department of Justice is attacking a license between Westinghouse Electric and Mitsubishi in Japan which the Justice Department feels prevents Westinghouse from using its technology in Japan and prevents Mitsubishi from using its technology in the United States.

In many instances, it may be advantageous to obtain rights under the improvements of the licensee. In the past, many licensors obtained title to these improvements by a grantback of rights from the licensee. More recently, because the Department of Justice does not like such arrangements, many licensors have merely taken a non-exclusive right under licensee's improvements which permits them to practice the inventions but also permit the licensee to license others under the improvements if it so desires.

The license may be directed to a particular product, a product line, or a whole area of technology. These are all things which must be evaluated.

It is usually much easier and more profitable to license an item which is actually produced by the licensor so that he has complete information available and the licensee is able to buy the rights to manufacture an established and tested product or use a tested and established process. This does not mean that there may not be occasions in which concepts or items which have only reached prototype stage may not be licensed; but, this is much more difficult. In concept licensing it is not easy to obtain a substantial down payment for this type of license inasmuch as the licensee is required to make substantial investments himself in order to get the product ready for the marketplace.

Often there may be an exchange of technology such as the previously mentioned Mitsubishi/Westinghouse arrangement where each party makes available to the other his technology in certain areas and this is provided on a continuing basis including access to the technology, use of patent rights and if appropriate, use of trademarks.

There are many other factors which must be considered in licensing and I will do nothing more than mention a few of them. As I indicated before the United States Department of Justice is taking a much closer look at international licensing today because the Constitution gives the Federal Government the right to regulate commerce with foreign nations. It is the feeling of the Department of Justice that international licensing arrangements are involved in commerce with foreign nations and on occasion may even have bearing on interstate commerce, particularly when a foreign licensee is excluded from importing its products into the United States. Also, of course, if a number of United States' companies or companies in foreign countries act together to regulate commerce, the Department of Justice will be involved. Thus, there are many restrictions which either are not permitted or are risky to put in a license.

For example, it would not be wise to include clauses fixing the prices at which the product may be sold. If the license involves only the use of know-how, the Department of Justice feels that the licensee should have the right to export the product made by the use of this know-how anywhere in the world. The views of the Department of Justice change from time to time and there are no laws or regulations covering many of these arrangements. The Government proceeds on a case by case basis and something that may have been common in the past may be overturned

by a case in the near future. This is what gives licensing people gray hair but you do the best you can with the situation.

Often a U. S. company may not appreciate the value of a trademark. One difference between a trademark and a patent is that a trademark, with proper use and care, can be renewed and may last forever, whereas a patent has a definite life and once its life is over the patentable item is available to all. For example, the Coca-Cola trademark will last forever if the Coca-Cola Company has its say about the matter. While I might be interested in learning the Coca-Cola formula, which is a trade secret, I would much rather have rights under the trademark. If I could sell a soft drink which tasted like Coca-Cola but had to be called Blair's Cola it would not sell nearly as well as another soft drink which may not be quite identical to Coca-Cola, but which I could call Coca-Cola.

Thus, a properly handled trademark can support a licensing program indefinitely. If, for example, you have a licensee under your trademark for making shirts, styles can come and go, new techniques can come and go, manufacturing processes are changed, but the trademark goes on forever and thus the royalty goes on forever.

VI. FINANCIAL ASPECTS OF LICENSING

As managers, you are interested in returns from a license arrangement. There is no definite rule for returns on licenses as the royalty amounts depend on a variety of factors. Factors to be considered are the quality of the know-how, the strength of the patent or trademark, the size of the market, the profitability of the market, the capability of the licensee, the amount of investment required by the licensee, etc.

A rule of thumb which may be useful is that the licensor should expect something between fifteen and thirty-five percent of the profits of the licensee. For a number of reasons you do not structure the license so that the licensee pays you a percentage of his profits. First, if the license makes no profits you would get no returns. Second,

determining profits, as you financial people can appreciate, is often very complex, depends on the accounting practices of the company, the laws of the particular country involved, and a number of other factors. You can understand that many licensees do not want the licensor to have available to him all the cost figures of the licensee in order to determine the actual profitability. So what you do is estimate the profitability of the item in the hands of the licensee, often using figures furnished by him, then calculate for yourself the percentage of his profits you feel is appropriate because of the quality of the patent rights, trademarks, etc. and ask for a percentage of the net sales, a readily determinable figure, which will give you the amount you want. For example, if you have a strong patent position, your know-how is quite good and the licensee does not have a large investment to make a start to penetrate the market, a return of twenty-five or thirty percent of the licensee's profits is not unreasonable. Thus, if a licensee makes a profit before taxes of twenty percent, it is not unreasonable to request for yourself a five percent royalty.

However, if the license agreement calls for a five percent royalty it does not mean that you will actually receive a five percent royalty, because the foreign country in which the licensee is located may very well tax royalties or not permit the export of dollars to the licensor country. These situations can be handled in the license agreement in a variety of ways which you should consult your licensing experts about.

For example, many countries have tax treaties with the United States so that if the foreign government requires that a percentage of the royalty, fifteen or twenty percent for example, must be withheld by the foreign company for the foreign government, the United States will give the licensor credit for that in the payment of his United States taxes. Thus, if you get a copy of the tax certificate showing the amount withheld for the foreign government, you may file this paper with the United States Government and get full credit. In other cases the United States does not give credit for particular taxes and you may wish to have the

licensee pay you a net five percent royalty with taxes being his responsibility.

Often the financial return may involve an initial down payment, particularly when substantial know-how is available and is to be furnished to the licensee. This down payment may be made in one lump sum or it may be a commitment that the licensee must pay the down payment over a period. For example, if you get a down payment of $200,000, it may be payable at $50,000 per year. The down payment may or may not be creditable in whole or in part against future royalties. This is a negotiable item and depends on the fact situation and the positions of the parties.

As I mentioned previously, it may be more appropriate to receive equity rather than cash or part equity and part cash in payment for the license. This is something that must be evaluated in each instance.

One advantage of royalty income is that when the money is received by the licensor, it is nearly all profit not sales. Occasionally, the licensor will have to do certain work for the licensee or do extra research but these amounts are usually quite small compared to the income. Thus, if you receive $1,000,000 in royalties from your foreign licensees, nearly all of that will be profit with the cost of the licensing operation usually being minimal. How large do yoursales have to be to make an equivalent amount of profits?

Of course, the royalty income may be in place of the licensor's ability to use his plants, expand his sales, etc. but in many instances profit is the name of the game and a profit with no risk of investment or management time may be very effective.

There are a number of other ways in which the return is controlled. For example, if the licensee receives an exclusive license, he may be required to make certain annual minimum payments in order to retain his exclusivity. If his royalties do not get to this level, he may be permitted to make direct payments to reach the level; but if he does not do so, the licensor should have the right to look elsewhere for a licensee to give him his desired returns.

It should be kept in mind that if "all substantial rights" relating to the patent or know-how are granted to the licensee, the royalties may be capital gains rather than ordinary income. For example, if the licensee is given an exclusive license to make, use or sell under the proprietary asset in a particular country for the life of the asset, this would qualify as a capital gain. For this reason, as in many other areas of business commerce, your tax people should be fully consulted when considering licensing arrangements.

Licensing is, in many respects, like marriage. In choosing your partner you can never tell what the real facts are going to be until it is too late. You do the best you can in your investigation and you should retain as much freedom as possible to correct the situation if it is not working satisfactorily. The licensee, of course, may need the same protection if the technology does not prove to be useful.

Of course, after you have your license agreement executed do not forget it and put it in a drawer. Your licensing people should continue the contact with the other party. There may be necessary technical information that can be provided. There may be problems which may appear to be insurmountable to the licensee but which the licensor can easily solve. I have found that continuing contacts are essential to a good return. Thus, a properly organized licensing program will provide for this continuing contact and will give the licensee the service he needs to be an effective operator and to return maximum amounts to the licensor.

A few years ago a group called the Licensing Executives Society was formed in the United States limited to those who had specific responsibilities in licensing. The people involved in the formation thought that the Society might, as time went on, grow to the size of 100 members, or possibly 150. The Society has grown to over 3,000 members located throughout the world and still is experiencing substantial growth, particularly in overseas areas. The Society now has 1,300 members in the United States with nearly all substantial corporations being represented. I am Past President of the Licensing Executives Society (U.S.A.), Inc. and I would be happy to give any of you or your associates further information about the Society and how to become a member.

Of course, a subject as complex as licensing is impossible to cover in a short time but I feel I have hit some of the highlights. In any particular situation experts should be consulted. The normal foreign license is usually between fifteen and twenty pages in length and, while some of the clauses may be fairly standard, I have never run across a standard license agreement. Each one must be designed for its particular situation. Thus, each one involves a complex negotiation and drafting situation in which it is well advised to invest the time and effort to do it properly so that the maximum return may be realized.