INTRODUCTION TO Technology Licensing

By Harold J. Evans

In this volatile, Internet-driven economy, the lifeblood of many commercial firms is their technology. This technology, or the intellectual property which embodies it, may be developed in-house or externally acquired but is usually jealously guarded yet often traded like rare baseball cards. A business lawyer may easily find himself or herself representing either the owner of the intellectual property or the recipient of the right to use the intellectual property. Thus, the attorney must be knowledgeable about the types of agreements which effectuate these transfers of technology. The purpose of this article is to familiarize such a lawyer with the key provisions of a technology license agreement and with some of the issues which arise out of licensing transactions.

WHAT IS A TECHNOLOGY LICENSE AGREEMENT?

A technology license agreement is a contract which transfers technology and associated legal rights between parties primarily for the purpose of fostering an ongoing business relationship. The owner of the technology (or the party with authority to control its use) is the "licensor". The party that is granted the right or license to use the technology according to the terms of the contract is the "licensee". The grant of a license is not an outright assignment of the technology but is actually more in the form of a lease since the licensor retains ultimate ownership of the intellectual property. Once the license expires, the rights granted to the licensee revert back to the licensor.

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WHY LICENSE TECHNOLOGY?

The reasons for licensing technology are myriad but a few predominate. For example, a small, start-up company or a research university may have developed an innovative method for the distribution of widgets over the Internet but lacks the financial resources to take the technology to the marketplace. It may make good economic sense to partner with a large company that has the capital and manufacturing and marketing capabilities to commercialize the technology. For the large commercial firm, the license may constitute a cost-effective means for acquiring new or existing technology needed to augment or continue its own development and product sales efforts. Also, with respect to the licensor, granting a license may be the best way of generating royalties and fees from the technology. In other instances, a license may act as a defense to, or a settlement of, the conflicting intellectual property rights of other companies.[1]

DRAFTING THE LICENSE

Since a license agreement may remain in effect for a number of years, it is important that the terms of the agreement fully reflect the understandings of the parties and accurately describe their rights and obligations under the agreement. A significant objective should be to state the terms in a clear, precise manner to avoid future misunderstandings. An added consideration is that the writing style be easily understood by non-lawyers since, most of the time, it is the business and technical personnel who handle license administration and implementation.

KEY CLAUSES OF THE LICENSE

Granting clause. The importance of the clause granting the licensee various legal rights to commercialize the licensed technology cannot be overemphasized. This "granting clause" must articulate the rights given to the licensee and the parameters of the authorized uses of the technology. In drafting such a granting clause, the attorney must carefully delineate: (1) the actual legal rights which are the subject of the license; (2) the authorized uses of such rights; (3) whether the license is exclusive or nonexclusive; and (4) whether the licensee may grant further licenses (i.e., sublicenses) to the licensed rights to third parties.

Definition of licensed technology. In any license agreement, the current and anticipated subject matter of the license should be clearly and unambiguously defined.[2] For patents, copyrights and trademarks, this includes each element of the statutory rights. In the case of trade secrets, there should be a description of the "know-how" to be transferred.

The grant of a license to patent rights should reference all patents issued in every country where the licensee will engage in activities contemplated by the licensing transaction. Usually, the definition of "patent rights" incorporates a reference to an exhibit which recites the title, the patent number and, sometimes, the issue date for each patent. Generally, the license will cover all of the claims in the referenced patents; however, the license grant may be limited only to those claims necessary for the licensee to perform its obligations or satisfy its own commercialization requirements. The license agreement should also include all patent applications pending at the time of the granting of the license and, in some instances, future patent applications relating to other facets of the licensed technology. This latter component of the patent rights may be appropriate for inclusion if it consists of technology which is originally licensed to the licensee as know-how. The definition of patent rights should encompass all rights covered by a pending patent application if a patent issues from such application. Since, in the United States, a patent application is maintained in confidence by the U.S. Patent and Trademark Office until a patent issues,[3] the license agreement should permit disclosure of the pending application to the licensee and grant the licensee a license to use the know-how described in the application.

In the case of trademarks, the license agreement should carefully define the goods or services covered by the agreement and with which the trademarks may be used. Where a trademark is used and registered for different categories of products or services, the agreement should specify whether the license applies to some or all of those uses and should expressly reserve the right to use, and license others to use, the mark in connection with other products or services.[4]

If textual or graphic materials constitute or provide a significant aspect of the technology being transferred, a grant of rights to copyrights will usually be included in the license agreement. Copyrights will also be a part of any software license since copyright law protects many of the integral components of the software package – although software patents are becoming more and more common, particularly those relating to the Internet.[5] If copyrights are included in the license, it is advisable to reference such copyrighted work by listing the title of the work, the name of the author, a brief description of the subject matter and, if registered with the U.S. Copyright Office, the registration number.

Trade secrets or "know-how" is often licensed in conjunction with patents. Such confidential and proprietary information may be essential in order for the licensee fully to commercialize the licensed technology. Indeed, many patent licenses will also include a mechanism to identify and license all trade secrets of the licensor necessary for the licensee to fulfill the purposes of the license. Also, the licensor may have chosen not to or was unable to obtain patent protection for certain aspects of the technology, but substantial value may nonetheless exist in the trade secrets. To address these possibilities, the granting clause of the license agreement might include a transfer of all technical information needed for the licensee to make, use and sell the products embodying the licensed technology.

Exclusive or nonexclusive license. As mentioned previously, a license may be exclusive or nonexclusive. If it is exclusive, the license agreement should clearly state whether or not the right to commercialize the licensed technology precludes competition from the licensor as well as any other party. The scope of the exclusive license may be restricted by limiting its duration, the field of use for the licensed technology, or the marketing area for product sales. Continued exclusivity may also depend upon the licensee's due diligence in meeting certain performance goals (see the *Due Diligence* section of this article).

Sublicenses and assignments. A licensor may authorize a licensee to grant to third parties all or a portion of the licensee's rights to use the licensed technology. Absent such an express authorization, the licensee has no right to sublicense or assign the technology to others.[6] Sublicensing may be appropriate where the licensor and licensee have agreed that products based upon the licensed technology will be marketed, manufactured or sold through third parties. On the other hand, since an assignment of a license constitutes a more fundamental change in the original business relationship, nonassignment clauses are common in license agreements. Indeed, a licensor will be reluctant to agree in advance to substitute an unknown third party for the licensee. An exception to the nonassignment provision is sometimes allowed in circumstances where the ownership of the licensee has changed.

Improvements. During the term of a license agreement, either the licensor or the licensee may make improvements to the licensed technology. Improvements are generally defined as certain modifications, enhancements or changes to the licensed technology. Such changes normally do not alter the identity of the invention and, where patents are involved, may be specifically limited to modifications which, if unlicensed, would infringe one or more claims of the patents included in the licensed patent rights.[7] These minor improvements or enhancements are often licensed to the licensee for little or no additional consideration. Occasionally, the licensee is granted rights in the improvements developed by the licensee under a grant-back provision. However, grant-back provisions require careful drafting so as not to run afoul of the anti-trust laws.[8]

Territory. The geographical area in which the licensee is authorized to make use of the licensed technology should be specifically described. The marketing and commercialization plans of both parties as well as the nature of the legal rights which will be covered by the license agreement will be relevant factors in determining the territory. In some cases, especially where there are multiple licenses, there will be a specific allocation of territory to a specific licensee. In other cases, it will be sufficient simply to state the territory as "the world" even though applications for patents or trademarks may have been filed only in certain countries. Such a designation takes into consideration any future expansion of sales or distribution of the licensed technology into other countries and also where an essential component of the technology is protected as a trade secret.

Compensation. There are nearly as many ways to structure the compensation for a technology license as there are forms of technology to protect. The type of compensation may vary widely with the terms of the particular transaction. Such types include: a fixed payment; a royalty calculated as a percentage of the licensee's sales or income derived from the licensed technology; or a fixed payment upon execution of the agreement followed by a periodic payment of royalties.[9]

If the compensation is based upon a royalty percentage of "net sales", as is common in many licensing transactions, that term must be clearly defined. A standard definition consists of the gross sales, royalties or fees received by the licensee for product sales, whether invoiced or not, less the following: returns and allowances actually granted; packing, insurance, freight out, taxes or excise duties imposed on the transaction (if separately invoiced); and wholesaler and cash discounts.[10]

The licensor often wants assurances that the licensing arrangement will enable it to recover research and development costs associated with the licensed technology. In such instances, the licensee may be required to pay the licensor a specified minimum royalty amount, usually on an annual basis, during the license term regardless of whether royalties have actually been earned. If the licensee fails to make the minimum royalty payments, the licensor may terminate the agreement or sue for damages. On the other hand, the licensee may seek to limit its obligation to make royalty payments to the licensor. In that regard, the parties may agree to a "cap" on royalties paid to the licensor, presumably on the basis that the licensee has completed its obligation to commercialize the technology and the licensor has recovered its development costs.

Periodic royalty payments may be replaced or supplemented by a simple fixed amount, payable once upon execution of the license agreement or in installments over the term of the license. Such lump sum payments may be appropriate in instances where (1) the technology has a relatively short lifespan; (2) the licensor wants to recover quickly the costs of developing the licensed technology; or (3) the licensor wishes to provide an incentive for the licensee to commercialize the technology.

Accounting and payment procedures. The license agreement should provide a means for determining and verifying the compensation owed to the licensor by the licensee. Among the most common provisions are the following:

(1) a statement of the number of payments and the dates on which such payments will be made and imposing a penalty for any late payments;
(2) designation of the currency in which payments will be made and, if applicable, the authority by which currency conversions will be made;
(3) a requirement that the licensee provide regular statements to the licensor setting forth the method of calculating royalty payments; and
(4) a requirement that the licensee keep complete and accurate records of all transactions involving the licensed technology and that the licensee allow the licensor or the licensor's independent auditor to examine such records (usually during normal business hours upon reasonable notice to the licensee and limited to once or twice each year during the term of the license) with the cost of such examination being borne by the licensee if the records indicate a significant underpayment of royalties.[11]

Due diligence. The license agreement should impose certain performance requirements on the licensee for continuation of the license. At the very minimum, the license should contain a covenant by the licensee to use its "best efforts" to commercialize the licensed technology in a manner agreed upon by the parties. In the case of an exclusive license, failure to meet a particular performance milestone might result in the conversion of such a license to a nonexclusive one or a complete termination of the entire license. These "milestones" might consist of the development of a prototype of the licensed technology by a specified date or obtaining approval from the appropriate regulatory authority for the manufacture and sale of a product based on the licensed technology. Exclusivity might also be conditioned upon the licensee's expenditure of a minimum amount of research and development funds or the receipt of a threshold level of investment capital. Of course, however, the licensee should be allowed to use reasonable business judgment and practices to exploit the licensed technology and not be required to meet unreasonable commercial standards.

Protection of licensed technology. The license agreement should contain provisions which obligate both parties to cooperate to protect the licensed technology from infringement or, in the case of trade secrets and technical information, misappropriation by third parties. If the agreement includes statutory technology rights (patents, trademarks or copyrights), the procedures should be clear for establishing and maintaining the rights in the United States and in each foreign jurisdiction where the licensed rights are to be commercialized. In particular, the license agreement should specify which party will be responsible for filing the patent, trademark or copyright application and paying the costs associated with such filings.

A risk inherent in any technology-based relationship is that the licensed technology may be legally challenged by third parties or there may be a need to institute an action against infringers. In that regard, both the licensor and the licensee usually agree to notify the other of possible infringement of the licensed rights and of any pending or threatened infringement claims by third parties. The parties normally will agree upon which party will have the right to institute and control any litigation, how the costs and expenses of litigation will be allocated between the parties, and how any money judgments will be distributed. When a third party files suit either challenging the validity of the licensed rights or accusing the licensee and/or licensor of infringing the third party's intellectual property rights, there should be a similar understanding regarding the defense of such an action.

Confidentiality. The licensor will want to insure that any trade secret information contained in the licensed technology is maintained as confidential by the licensee and all authorized sublicensees. Thus, the licensor of a trade secret will usually require the licensee to assure that (1) internal use of the trade secrets will be limited to those employees with a "need to know";(2) employees with access to the trade secrets will, either as a matter of contract or law, be bound to maintain the information in confidence; and (3) reasonable steps will be taken to insure that the trade secrets are not misappropriated by third parties.

Representations and warranties. There are certain types of representations and warranties which are relatively unique to technology license agreements. For example, the licensee often seeks assurances that:

(1) the licensed technology does not infringe any legal rights of third parties;
(2) the licensor is the sole owner of the licensed technology which is free and clear of any encumbrances;
(3) the licensor is free to enter into the license agreement and has the right, power and authority to grant the licensee the rights contained therein; and
(4) the licensed technology is not invalid or unenforceable.

The above provisions are usually the subject of intense negotiations between the licensor and the licensee. The licensor may be particularly resistant to an agreement to warrant that the licensed technology is non-infringing. However, such resistance may depend upon the legal nature of the technology rights granted. Copyrights and trade secrets all can be independently created without infringing upon the rights of any prior users. Thus, a representation covering such licensed rights would only have to stipulate that the licensor has not copied, or otherwise obtained by improper means, the licensed technologies and that such technologies were developed through the lawful and independent efforts of the licensor. Patents, however, present a riskier scenario for the licensor. This is because a third-party patent owner can bring a viable infringement action even if the alleged infringer created the technology independently and without reference to the third party's work.

Product liability. A patent licensor who is not also a manufacturer of the licensed technology is probably at minimal risk for liability from product liability claims.[12] It is nevertheless prudent to require that the licensee maintain adequate liability insurance coverage with respect to products manufactured using the licensed technology. For the trademark licensor, such protection should be mandatory since control over the nature and quality of goods sold bearing the licensed trademark is essential to a valid trademark license. Indeed, inadequate quality control may result in a loss of trademark rights.[13] Such quality control, however, increases the licensee's exposure to the risk of a direct product liability. claim.[14] The risk may be further minimized by requiring the licensee to indemnify the licensor against the licensee's negligence or failure to meet reasonable standards of manufacturing and production.

Term and termination. In all license agreements, it is important to establish the anticipated life of the agreement and the procedures for terminating the agreement either before or at the end of its normal term. For a patent license, the term should generally extend until the last of the patent rights expire. In the case of trade secrets, the term is typically fixed at five, ten or fifteen years (the longer terms where patents are also licensed). The agreement should further state any options the licensee has either to renew or to extend the agreement and should specifically set forth how these options may be exercised. The types of termination provisions common to commercial transactions generally (such as the right to terminate upon bankruptcy, insolvency or a material breach of the agreement) should be included in the license agreement. In addition, both parties may have the right to terminate or modify the agreement upon the occurrence of certain events, such as the licensee's failure to commercialize the technology in the product or market area designated in the license or the licensee's desire to forego further expenditures necessary to commercialize the technology.

Miscellaneous provisions. Other provisions which are customary in commercial transactions should also be included, such as governing law, dispute resolution and notices. Additionally, because certain transfers of technology may constitute an export of technical data, a clause specifically requiring the licensee to comply with the United States export regulations is advisable.[15]

CONCLUSION

The economic risks to a licensor or licensee of technology that are inherent in a licensing agreement can be substantial. A poorly drafted license may poison the potential of a mutually beneficial and long-term business relationship between the parties. This article was intended to provide an introduction and guide to technology license agreements and, hopefully, help the business lawyer make decisions which lessen those risks.◆

ENDNOTES

1. *See, e.g., Phillip Morris v. Brown & Williams*, 641 F.Supp. 1438 (M.D. Ga. 1986).
2. *See, e.g., Lemelson Medical, Education & Research Foundation L.P. v. Intel Corp.*, 1999 WL 81394 (D. Ariz. Aug. 18, 1999).
3. 35 U.S.C.A. § 122 (1984).
4. *See* Epstein, Michael A. & Frank L. Politano, *Drafting License Agreements* 275 (1992 Supp.).
5. *See, e.g., State Street Bank & Trust Co. v. Signature Financial Group Inc.*, 149 F.3d 1368 (Fed. Civ. 1998); "Trying to Issue Better Net Patents," 16 No. 3 Computer L. Strategist 8; and U.S. Patent and Trademark Office, *Examination Guidelines for Computer-related Inventions* (Feb. 1996).
6. *See Rock-Ola Mfg. Corp. v. Filben Mfg. Co.*, 168 F.2d 919 (8th Cir.), cert. denied, 335 U.S. 892 (1948).
7. Brian G. Brunsvold & Dennis P. O'Reilley, *Drafting Patent License Agreements* § 9.00 (4th ed. 1998).
8. *See* 1995 Antitrust Guidelines for the Licensing of Intellectual Property, adopted on April 6, 1995.
9. *See* Epstein et al., at 279.
10. This language or a variation thereof is the definition for "net sales" used by the University of Arkansas in many of its patent licensing agreements.
11. *See* Epstein et al., at 279-280.
12. In my research, I have yet to find a single case in which a patent licensor, who is not a manufacturer of the licensed technology, has been held liable for product liability claims.
13. *See Stansfield v. Osborne Indus.*, 52 F.3d 867 (10th Cir. 1995), *cert. denied*, 516 U.S. 920 (1995).
14. *See, e.g., Gizzi v. Texaco Inc.*, 437 F.2d 308 (3rd Cir. 1971), *cert. denied*, 404 U.S. 829 (1971); *but see Ditri v. Coldwell Bankers Residential Affiliates*, 954 F.2d 869 (3rd Cir. 1992).
15. The export regulations may be found at 15 C.F.R. Parts 768-799.