



# Optimum Strategies for Patent License Negotiations

## Basic Terms and Conditions of a Patent License

Most high-tech ventures require the licensing of patents, trademarks, copyrights or trade secrets to or from third parties. Licensing is a specialty in which experience is the critical factor. Before entering into license negotiations, however, it is useful to know the basic terms and conditions of a patent license.

In general, all licenses fall into three categories, namely:

1. **Exclusive:** Only the licensee can exploit the license.
2. **Sole:** Both the licensee and licensor can exploit the license (this kind of license is relatively rare).
3. **Nonexclusive:** The licensor and an unlimited number of licensees can exploit the license.

Many entrepreneurs think of licenses in terms of patentable technology. While this is true, licensing can embrace a whole host of other property rights including, but not limited to: trademarks, cartoon characters, software, trade secrets, customer list, etc.

There is no such thing as a standard industry patent royalty rate. Royalty rates can run from less than one percent in the trucking industry to more than 20 percent in the pharmaceutical industry. *On the average*, royalty rates tend to run between four to six percent of “Net Sales.” An entrepreneur should not develop a fixation on a particular high royalty rate since other factors may also be important. Some of those other important features are the following:

1. **Minimum Royalties:** It is unwise to draft a license agreement, especially exclusive licensing agreements, unless there is a provision for minimum royalties. The primary purpose of minimum royalties is to give the licensee an incentive to exploit the license. If there is no incentive to exploit the license, the patent (or other property) may expire without producing royalties. There are numerous ways to draft minimum royalty provisions.

For example, if royalties over a particular period of time drop below a certain level, the consequence might be loss of exclusivity, loss of license or a modification of the royalty scheme.

Sometimes a shrewd negotiator will suggest employing “best efforts” in lieu of “minimum royalties.” Don’t accept that compromise. “Best efforts” is too vague for courts to enforce effectively. Insist on “minimum royalties” in all exclusive license negotiations.

2. **Advances Against Royalties:** Many licenses include a nonrefundable advance. The advance may or may not be recouped out of the future royalty stream. Generally, it is easier to negotiate for an advance in which at least part of the advance is paid back to the licensee from the royalty stream. Under such circumstances, it is preferable that the payback be applied against no more than 50 percent of the royalty stream so that the licensor can keep tabs on the progress of the license.
3. **Royalties Based on Net Sales:** Most common license agreements speak in terms of a royalty rate (e.g., five percent) based upon “Net Sales,” generally paid quarterly. “Net Sales” are usually defined as gross sales minus usual trade discounts, taxes, transportation and returns. Occasionally, you will see licenses drafted in terms of a fixed payment per unit or a percentage of savings. Sometimes, a licensee or licensor will seek a royalty based upon a percentage of “profits.” Royalty rates based upon “profits” should be avoided. It is not uncommon for a licensee to run a good business and yet charge a large amount of overhead against the “profit” of a particular project, thereby reducing the effective royalty base to zero. Any license in which the term “profits” is not defined with extreme care is likely to find its way to a court of law.

4. **Know How and Show How:** New technologies often require technical assistance in order to achieve full implementation. Therefore, most modern licensing agreements include a “Know How and Show How” provision that requires the inventors or other knowledgeable persons to devote specific amounts of time to the start-up phase of a new high tech project. For example, the inventor of a new process may be required to spend up to two days per month over the course of a year in order to make a new process work. Frequently, the inventor is paid a per diem in addition to his or her costs for the days during which work is performed.
5. **Reporting Requirements:** A licensee should report and render royalty payments quarterly. The licensor should have the right to have a CPA inspect the books of the licensee if reasonable advance notice is given.

If the entrepreneur is negotiating a first license, it is not uncommon for him or her to accept terms that are less favorable than those existing in the industry in order to establish a track record. The same is true of authors who sell the rights to their first work at a rate substantially less than they can command after they become established literary figures.

### Strategies for Negotiating a Strong Patent License

There have been many books written about the art and science of negotiations. Most of the basic rules apply to patent licensing negotiations as well. The following rules are not exhaustive but will be helpful in developing a solid license agreement:

1. **Know What You Want:** Do you want minimum royalties? If so, how much? What do you want to get as a royalty? Is this to be an exclusive, sole or nonexclusive license? It is strongly recommended that the negotiator review a checklist to be sure that nothing major is left out.
2. **Make Sure That Your Side Agrees on the Terms, Tactics and Strategy of the Negotiations:** Negotiators should understand that there are two sets of negotiations going on simultaneously. One is with the opponents. The other is with the people on the negotiator’s side of the table. Never forget it! Therefore, it is always important to spend quality time upfront and during negotiations to keep everyone on your side enthused and committed to the same goals.
3. **Size Up Your Opponents:** Are they college professors, Wall Street attorneys or sharks? What do they need and how soon do they need it? Are they in a superior or inferior bargaining position? If they have negotiated with others before, talk to those other parties. Try to obtain copies of their previous licensing agreements to get an idea of what they are willing to settle for.
4. **Initially Ask for More Than You Are Willing To Settle for and Offer Less Than You Are Ultimately Willing To Give:** This is just plain common sense. It is better to ask for too much and get turned down than to ask for too little and get it! The only exception to this rule is where you really know the other party’s goals or in certain take-it or leave-it circumstances where the negotiator doesn’t care about the outcome of the negotiations.
5. **Give Yourself Lots of Time To Negotiate – Never Rush Negotiations:** Almost all negotiators are turned down two, three, four, even 10 times or more before the license agreement is finalized. Typical license negotiations average about two to three months from beginning to signing. The Russians and Japanese are masters at using time to their advantage. Don’t expect instant gratification. A good license, like a good romance, takes time to develop into a solid relationship.
6. **Keep Good Notes of the Evolving Terms of the License and Volunteer To Draft Each New Version:** Take notes continuously! A spiral bound notebook is good for keeping notes as the negotiations play themselves out. The notes are helpful so that the negotiators can be reminded of the terms that they have actually agreed to. Since negotiations often take place over the space of many weeks or months and often under mind-numbing circumstances, the party with the best notes has a major advantage.
7. **Control the Preparation of the Draft After Each Session:** It may seem like extra work, but it helps to keep your opponents honest and the terms of the different versions consistent. If your opponents demand the same privilege, then it can be resolved by trading roles after each negotiating session.
8. **Keep the Atmosphere Cordial but Controlled:** A sense of humor helps in negotiations but the use of gimmicks such as overheated rooms or withholding food or drink is strictly juvenile. Remember that you will probably have to live with your opponents after the license is signed and you are better off having them respect you when you’re finished than to have them think that you are a mean-spirited manipulator.
9. **Be Prepared To Walk Away From Negotiations:** The worst kind of negotiations is where one of the two parties feels they must have a license. In that case, the party will be negotiating against him or herself. You can’t negotiate good terms unless you are objective about the value of the property to be licensed.
10. **Lastly, a License Should Be Relatively Fair to Both Sides:** If the license is loaded too heavily in favor of the licensee or licensor, it is likely that it will be hard to enforce.

There are many potential pitfalls in the licensing area. A poorly drafted license agreement is an invitation to future disagreements and litigation. A well-drafted license, at least, guarantees peace of mind – in addition to significant financial rewards.

### Sample Patent Licensing Checklist

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| <ol style="list-style-type: none"><li>1. Parties – Name and Addresses</li><li>2. Recitals</li><li>3. Definitions</li><li>4. Effective Date of the Agreement</li><li>5. Licensed Property<ol style="list-style-type: none"><li>a. Patents</li><li>b. Trademarks</li><li>c. Copyrights</li><li>d. Know How and Show How</li></ol></li><li>6. License Scope</li><li>7. Royalties<ol style="list-style-type: none"><li>a. Based upon:<ol style="list-style-type: none"><li>i. “Net Sales”</li><li>ii. Per Unit</li><li>iii. Profits</li><li>iv. Savings</li></ol></li><li>b. Payable<ol style="list-style-type: none"><li>i. Quarterly</li><li>ii. Yearly</li></ol></li><li>c. Right To Inspect Books by a Qualified Accountant</li><li>d. Portion Payable in Advance<ol style="list-style-type: none"><li>i. Credited Against Earned Royalties?</li></ol></li><li>e. Minimum Royalty?</li></ol></li><li>8. Term<ol style="list-style-type: none"><li>a. For a Specific Number of Years?</li><li>b. For the Life of Any Patent(s)?</li></ol></li></ol> | <ol style="list-style-type: none"><li>9. Improvements by Licensee<ol style="list-style-type: none"><li>a. Licensed Back to Licensor on a Nonexclusive Basis?</li></ol></li><li>10. Infringement<ol style="list-style-type: none"><li>a. Defended by Licensor</li><li>b. Defended by Licensee</li></ol></li><li>11. Technical Assistance<ol style="list-style-type: none"><li>a. Per Diem Paid to Inventor Until Technology Is Implemented</li></ol></li><li>12. Confidentiality Obligations<ol style="list-style-type: none"><li>a. On Licensee</li><li>b. On Licensor</li></ol></li><li>13. Boiler Plate<ol style="list-style-type: none"><li>a. Arbitration</li><li>b. Force Majeure</li><li>c. Assignments</li><li>d. Most Favored Licensee</li><li>e. Severability</li><li>f. Termination<ol style="list-style-type: none"><li>i. Bankruptcy</li></ol></li><li>g. Integrated Agreement – No Modifications Effective Unless in Writing and Signed by Both Parties</li><li>h. Applicable Law<ol style="list-style-type: none"><li>i. Notices and Addresses</li></ol></li></ol></li><li>14. Appendices – List of Patents, Trademarks, Copyrights, etc.</li></ol> |
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