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A Few Problems in Licenses and How to Avoid Them

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It's said that those who don't learn from their mistakes are bound to repeat them. Over the author's years of practice in negotiating license agreements and mediating, arbitrating, or litigating disputes involving them, the same types of provisions seem to cause a disproportionate amount of the trouble. This article identifies a few that not all readers have likely experienced and presents some ideas for avoiding them, in the hope that those who learn from the mistakes of others won't have to learn from their own.

Division of Sublicensing Revenue: In a Complex Transaction, What Is the Base That Is Subject to Division?

License agreements negotiated at an early stage of technology development (many years before a commercial product would reach the market) commonly provide for sharing of revenues obtained by the licensee for the grant of sublicenses. Such provisions are especially common in licenses between universities and start-ups: The start-up doesn't have the funds to pay a large upfront license fee, and the university wants a piece of the action when and if the licensee

flips the licensed technology to a bigger company. These licenses often are encountered in due diligence on a former start-up, whether by potential investors, an acquirer, or a prospective marketing/development partner.

In the biotechnology and pharmaceutical field, for example, there is an expectation that the university's small (often start-up) licensee will partner with an established pharmaceutical company at some point in the development process to fund clinical trials and obtain sufficient sales and marketing capabilities. Such transactions often include substantial upfront payments and milestones paid upon reaching certain development points, e.g., initiation of phase III clinical trials, submission of a New Drug Application or Biological License Application, and receipt of marketing approval in a major market country. Because the total consideration flowing to the university's licensee may consist in large part of such payments—or entirely so if the product does not ultimately obtain regulatory approval and reach the market—the university will often negotiate for a share of them.

Here is an example drawn in large part from an actual agreement that resulted in a contentious dispute over what categories of payments to the licensee were subject to division. Although this example is based on a university licensor, the issue is not confined to that context:

Licensee shall pay University ten percent (10%) of all license fees, advances (other than research funding) and other payments received by Licensee in consideration for any sublicense granted by Licensee to Licensed Products.

The language is simple enough. But when the transaction between the licensee and its big-pharma marketing partner is complex—involving different types and categories of payments—how do the parties determine if any given sum was “in consideration for” the grant of a sublicense?

For example, if a license to the licensee's own patents is included in the transaction, must an

allocation be made to determine what payments are attributable to those patents as opposed to the university's patents, with the university entitled to division only of the latter part of the total payment? If so, does a stated allocation in the agreement between the licensee and its marketing partner control, thus giving rise to the potential for subterfuge (from the university's perspective) or permissible structuring (from the licensee's perspective) to reduce the amount of money attributable to the university's patents and thus divisible with the university?

If the transaction does not (and need not) include a sublicense of the university's patents because the licensee will manufacture and sell product to its marketing partner, is there still a sublicense of the "Licensed Products" that triggers the obligation to divide payments? And if the sublicensee pays a large sum to acquire a stake in the licensee's equity or debt as part of the transaction, are such payments "in consideration for any sublicense" if the purchase occurs in the same transaction as the sublicense?

Identifying possible ambiguities, anticipating potential problems, and settling on the intended business terms guide the appropriate solution. For example, if the goal from the licensor's perspective is to make sure that *all* consideration, no matter how characterized or allocated in the agreements, is subject to division, the above-quoted provision could be redrafted along the following lines:

Licensee shall pay Licensor ten percent (10%) of all payments and consideration received by Licensee from a sublicensee of the Licensed Patents or Licensed Technology.

or

Licensee shall pay Licensor seven percent (7%) of all consideration received by Licensee or its Affiliates in any transaction or series of transactions that include the grant of a sublicense of the Licensed Patents or Licensed Technology.

A different approach is to confront the valuation problem head-on. One way is to deem a minimum share of value attributable to a sublicense of the licensor's patents:

Licensee shall pay Licensor ten percent (10%) of all payments and consideration received by Licensee in consideration for any sublicense

granted by Licensee to the Licensed Patents or Licensed Technology. If such any such sublicense is granted as part of a transaction or series of transactions which include the grant or transfer of other licenses, rights, or property, no less than ___ percent (___%) of the total of all payments and consideration received by Licensee in such transaction or series of transactions shall be deemed to be consideration for the grant of such sublicense.

Of course, using the deemed minimum approach virtually guarantees that the minimum will also be the maximum, at least in the eyes of the licensee.

Yet another approach is to recognize that questions of valuation in a complex transaction are likely to be subject to dispute and, therefore, establish a mechanism to resolve them short of litigation or arbitration. For example, each side could select a qualified valuation expert to determine what part of a deal is attributable to the sublicense of the university's rights, with the two experts selecting a neutral expert to pick one valuation if the two sides' experts are more than 10 percent apart. Such mechanisms, however, are costly to employ because of the fees that must be paid to the valuation experts.

Finally, another problem that often arises in these situations is informational, *i.e.*, refusal by the licensee to give the university the entire agreement (or group of agreements) with its sublicensee or marketing partner. The licensee sometimes justifies its refusal by claiming that the agreements contain confidentiality provisions that forbid it from giving the university copies of the agreements. Such claims are readily dealt with by including a provision along the following lines in the license agreement:

As a condition of granting sublicenses or in the event of any merger, acquisition, or reorganization that results in a Change of Control of Licensee or a new Affiliate of Licensee, Licensee shall provide Licensor with full and complete copies of all contracts and agreements between it and any sublicensee within five (5) business days after execution of same, including agreements that do not include the grant of a sublicense. Licensor shall maintain such copies and their terms in confidence pursuant to Section ___ of this Agreement. No grant of a sublicense shall be valid if any agreement between Licensee and such sublicensee prohibits, restricts, or conditions Licensee's

provision of such copies to University as required by this paragraph.

Provisions of this sort make clear that the transaction will be subject to scrutiny by the licensor/university with respect to the division of “sublicense” payments.

When conducting due diligence, consideration should be given to whether the target will be asked to address how it proposes to divide payments with the licensor/university. In the case of a straight sublicense (as opposed to an acquisition), the prospective sublicensee might reasonably take the position that this is none of its business and that it does not want to be involved (other than to obtain a warranty that the licensee has the right to grant the sublicense and will take all actions required under the license to keep the license in force and avoid termination). This approach may be thought to minimize the sublicensee’s risk of being drawn too deeply into a dispute between the licensee and licensor.

But ignorance isn’t necessarily bliss. In the case of an acquisition, problems between the licensee and licensor immediately become problems of the acquirer. But even in the case of a straight sublicense, the sublicensee’s investment and stake may be greater than those of the licensee, and assets may not remain in the licensee to cure an alleged breach of the prime license. And while a well-negotiated sublicense agreement will grant the sublicensee the right to cure any alleged breaches of the prime license at the licensee’s expense, the cost of doing so may be high and recoupment from the licensee may not be easy.

The *de facto* Sublicense in a Merger or Acquisition

Related to the above discussion is the acquisition of a licensee in a transaction that does not expressly grant a sublicense. For example, the licensee could continue as a wholly owned subsidiary of the acquirer and continue to conduct the licensed activities, obviating the need for a sublicense. If the licensee/subsidiary sells licensed product to its parent, this is a “first sale” that exhausts the licensed patent rights and the parent does not itself require a license to resell the licensed products, or in the case of pharmaceuticals that are governed by the safe-harbor provision of 35 U.S.C. § 271(e)(1), the licensee and acquirer may take the position that no sublicense is required because the activities are within the safe harbor and would not infringe even absent grant of a license. Finally, if the license grant in the prime

license runs (as is common) to the licensee “and Affiliates,” the licensee/acquirer may contend that no sublicense has occurred because the parent is now a direct licensee.

A potential acquirer conducting due diligence should not expect its target’s licensor to readily accept the position that no part of the acquisition payment is subject to division with it as sublicense income. Rather, the licensor will contend that regardless of form, the economic reality of the transaction includes the grant of a *de facto* sublicense that triggers the division of payment. Even if the licensee and acquirer consider this position to be unjustified, they must recognize both its substantial equitable appeal (especially if discovery will show that the transaction was structured in part with the intent of avoiding a sublicense payment) and the substantial leverage that the licensor may have if it has the right to terminate in the event of breach.

Circular Definitions Leading to Never-Ending Improvements

The grant of a license often is part of a larger agreement providing for sponsored research. In agreements of such type, there is a definition of Licensed Technology or Licensed Know-How that usually embraces inventions that have not yet been made but which are expected to be made in the course of the licensor’s ongoing research. Also common to such agreements are provisions that future “improvements” made by the licensor also are subject to the license. Indeed, some license agreements that do not provide for sponsored research nevertheless include such improvements provisions.

Drafting definitions that clearly distinguish between those as-yet-unmade inventions that will qualify as licensed improvements and those that will not is a challenging exercise. An entire book chapter could be devoted to just this topic, but one type of problem should be easy to avoid. This is the problem of circular or never-ending improvements.

Consider the following improvements language adapted from a litigated contract between two major pharmaceutical companies:

If Licensor improves the Licensed Know-How or Licensed Products, or makes improvements to the Licensed Process, all such improvements shall become part of the Licensed Know-How and shall be promptly transferred and/or communicated to Licensee, and by the provisions hereof shall be deemed to be a part

of the Licensed Patents or Licensed Know-How as the case may be.

As can be seen, “improvements” become part of the licensed technology and thus are subject to their *own* improvements being made and included as well, resulting in a potentially never-ending cycle of technology transfer.

Few clients would like to hear from their corporate counsel that the company that participated or supported some research several years ago has the potential to claim rights in work that is now viewed as new or different. In the case of a university license, an equally bad conversation would be telling an influential faculty member who has made great advances in what is to her a new field that an agreement reached with a company based on work done in someone else’s lab has the potential to encumber her own independent work.

With the problems identified, several possible solutions are obvious. First, avoid circularity by providing that Improvements are licensed without adding them back to the previously defined Licensed Technology. Second, set time limits such that only improvements made within a limited period of time are included in the license. Third, restrict improvements to those made by the same group, lab, faculty member, or research team involved in creating the original technology.

Using Overblown Claims of Patent Misuse to Negotiate Reduced or Limited Royalties

Broadly speaking, patent misuse occurs when a patentee uses the power of its patents to obtain an agreement that requires a licensee to pay royalties on unpatented products or beyond the expiration of the licensed patents. The effect is that the misused patents are unenforceable until the misuse is purged.

Potential licensees sometimes raise (in this author’s opinion) unjustified concerns about misuse to influence license terms in the negotiation process. For example, when licenses are being negotiated before patents have issued and the license is to both know-how and patents that are expected (or at least hoped) to issue in the future, the potential licensees may contend that charging full royalties if the patents do not issue (or do not cover the product) would be patent misuse, and that the royalties need to be separately allocated and charged on know-how and issued patents.

Because meaningful claims of patent misuse are quite uncommon (and rarely litigated to a judicial decision), licensing personnel may lack sufficient familiarity with this doctrine to confidently dismiss questions about patent misuse when it is raised by a potential licensee in negotiations. The result may be agreement to the licensee’s demand for reduced royalties, especially because this is not uncommon as a business model even without questions of misuse.

A complete discussion of patent misuse is beyond the scope of this article, but in most cases such expressions of concern by potential licensees are either feigned or uninformed. Remember that in many cases the licensee will have an exclusive license with at least some rights to enforce against third-party infringers. In those cases, the licensee would be shooting itself in the foot if it were to contend in a dispute with the licensor that the licensed patents are unenforceable for misuse. And if raised by a third-party in defense of an infringement suit, a misuse defense is unlikely to get much traction if the licensor and licensee present a unified front in explaining that (i) the transaction was entirely rational from a business perspective, (ii) any value received outside the scope patent rights was negotiated in good faith at a time of uncertainty over what patent claims would issue, and (iii) there was a meaningful transfer of know-how and technology outside the four corners of the patents and patent applications themselves.

Reserved Rights That Preclude Sufficient Exclusivity for Licensee to Sue

As a general rule, only exclusive licensees have standing to sue for patent infringement. Depending on the circumstances, an exclusive licensee may be able to on its own or may be able to sue only if the patentee joins as a coplaintiff.

A license that reserves to the licensor the right to grant additional licenses for research purposes that are otherwise within the licensee’s exclusive field may not support suit by the licensee without joining the patentee.

Transactions by Companies That Already Have a License

What happens if one existing licensee (Le1) is acquired by another existing licensee (Le2) that has a

more licensee-friendly (cheaper) license agreement? Depending on how the agreements are written, Le2 may claim that Le1's products are subject to the lower royalties of the Le2 license because Le1 is now Affiliate otherwise. If successful, this would diminish the revenue received by Licensor from sales of the Le1 products, and possibly deprive it of the benefit of its bargain, especially if there was a good business

reason to charge and receive a higher royalty rate on Le1 products.

A possible remedy is to include in all license agreements a provision aimed at preventing this by providing that in the case of such a transaction, the different product lines will continue to be subject to the royalties in effect immediately prior to the acquisition.

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