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Even Good Deals Go Bad: Minimizing Unintended Consequences in Patent Licensing

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We've all seen a seemingly happy technology marriage end in acrimonious divorce. Often those things can be avoided by careful advance planning, and proper cultivation of the nascent and the resulting product, and a carefully articulated plan for alliance management. This article focuses on problematic clauses that often are overlooked or given short shrift, the importance of clarity and thoroughness of communication, the necessity of building an effective relationship, and the proper cultivation of that relationship for the long term after the deal is "done." The first section deals with an essential foundation for licensing—a system of laws that recognizes that intellectual property has all the attributes of other forms of property. The second section deals with select elements of a license agreement that are given short shrift, are difficult to draft, or are rife with risk. The third section deals with the importance of alliance management, and continuing engagement to ensure the relationship realizes its potential.

Ruminations on Licensing, and IP as a Property Right

In his seminal work *On War*, Karl Von Clausewitz described war as the continuation of politics by other

means. In the same spirit, we might think of litigation as a continuation of licensing by other means. Ultimately, the same result is achieved. There is a dispute over certain rights, a contest of ideas and/or arms in resolution of the dispute, and, ultimately, resolution in the form of an agreement. Now, it might be that the agreement reached is in the form of an implied license and peaceful co-existence; or it might be a more formal "treaty" whereby the contestants specify anew their respective rights and responsibilities; or it might be a complete vanquishing whereby one side achieves total victory. Rarely, however, and especially in today's highly complex and interdependent markets, is this latter scenario observed. Nonetheless, in each case, there is a settlement of sorts, and usually in the form of a license agreement.

In similar fashion, and of greater benefit to society, is the scenario in which a party has a certain property right, duly conferred by an authorized and competent arm of the state, and that property right is respected by the market. In reliance on that property right, the owner affords others the right of access to that property, and to derive revenue from its use. In turn, the owner is compensated for the conveyance of that right. Both parties derive benefit, and both parties are better off than they would have been otherwise. As such, the exchange of the right conferred and the right received is a mechanism for mutual enrichment, and the classic win-win scenario is observed.

The philosopher John Locke wrote of the Commons—those resources that abound and are available to all, in rough and unrefined form—that are commonly available to the public in general, and of the notion that a property right is properly recognized in those who employ their labor and creative faculties in converting the raw material of the Commons into useful articles. The Commons are acknowledged as rich in potential, but in their native form of minimal utility. But, by applying one's labor to those commonly available resources, we promote the individual inclination toward useful endeavors, and we reward the successful and diligent application

of those skills toward the production of goods and services of general benefit to society.

Many of the Founding Fathers read extensively of Locke's work, and were influenced by his philosophy. Thus, the notion of intellectual property as a personal property right is found in our Constitution. Article I, Section 8, clause 8 reads:

The Congress shall have Power To... promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries....

This clause is notable for the fact that it is the only provision of our Constitution associated with a particular and express purpose. In the case of patents, it is the purpose of promoting progress of the useful arts.

Locke's philosophy is particularly important as we look at licensing, and the ability to freely use the property right that resides in a patent (or other forms of intellectual property). Locke wrote extensively about the value that derives from government recognition of private property rights, and how that recognition can be useful for society as a whole. For one thing, it provides the incentive of a reward for the application of skill and industry to the bounty that surrounds us, including the use of one's own skills and talents.

By rewarding individuals with a property right in the fruits of their labor, we create a broad array of assets that can be bought and sold, and thereby stimulate commerce. But, more importantly, and particularly as applied to intellectual property, we reward creativity, the development of the intellect, and expand on the store of basic knowledge, as well as the knowledge and creativity that is employed in the creation of useful articles and services.

So, if we start with the notion that society benefits from a system of laws that recognizes property rights, and we likewise recognize the alienability of those property rights, then we must also acknowledge, as the Founding Fathers did, that intellectual property is a form of property like any other, and thus, should be equally recognized under the law and equally alienable. Only then do we have a robust and reliable legal regime whereby one's livelihood may be sustained by the industrious application of one's intellect and creativity.

We must further recognize that it is the application of one's intellect and creativity that results in the property right; not how one chooses to ultimately exploit the results. The notion that a property right might properly be confined to specific endeavors in the exploitation of the right cannot properly take hold

in a system that values property rights, in general, and the merits of the free market, in particular. Imagine a system where a toolmaker is afforded a property right in its tools only insofar as it uses those tools itself rather than by selling them to craftsmen skilled in the use, rather than the manufacture, of those tools. It is the same with intellectual property. Inventors must be free to invent, knowing they may convey to others the right to use those inventions in commerce for the benefit of all.

Further, we cannot let go of the notion of intellectual property as property without also addressing a characteristic attribute that the Founding Fathers determined so fundamental as to expressly include it in the Constitution—exclusivity. The Constitution gives Congress the power to grant Authors and Inventors the *exclusive* Right to their respective Writings and Discoveries. An exclusive right is more than a mere right of remuneration, it is the right to control the use and disposition of one's property, and to deny others access to it. Without the fundamental attribute of exclusivity, we lurch toward a system of compulsory licensing, or a private right of individuals to take another's property on the mere promise of compensation. Under our Constitution, and particularly the Fifth Amendment, or the Takings Clause, even the government does not possess that right except that it be for some demonstrable public rather than private use. Thus, to be true to the express language of our Constitution, and respectful of the limits imposed on the Fifth Amendment, the rights inherent in intellectual property necessarily must include a right to exclude others from the enjoyment of that property.

So, having now established that intellectual property rights are property rights that reside in the individual responsible for creating that property, and thus, that these are personal property rights having all the attributes of personal property, including alienability of those rights, we may now consider how one may use those rights to properly sustain a livelihood, and at the same time fulfill a civic obligation as a useful and contributing member of society.

Licensing and the Art of Preventive Negotiation

The art of preventive negotiation in a license agreement is not practiced solely by means of pen and paper (or word processor); but instead, starts much earlier. The care and attention devoted to the earliest stages of a deal are highly worthwhile. A friend and fellow Licensing Executives Society (LES) member is fond of

saying: “No deal without a meal.” This is emblematic of the fact that a license agreement is no more than an attempt to put in writing what the parties have agreed they are desirous of achieving, and how they propose allocating rights and responsibilities to achieve those ends. Trust is an essential component, and this is built up over time, and only by abiding by basic principles of fairness, responsible business behavior, and ethical conduct and appropriate transparency.

There are many books written about licensing, negotiating, deal-making, and the drafting of agreements. That’s not my purpose. Here, I offer a few humble observations and reflections on aspects of the licensing process that I have observed often are overlooked or underappreciated. It is by no means a comprehensive review, nor will all of these recommendations work in all situations; but, I hope they will offer some insight, and help you expedite your next deal, and avoid unforeseen challenges.

Memorandums of Understanding and Term Sheets

The earliest stages of licensing are marked by certain practices designed to facilitate early assessment as to whether a deal is in the parties’ respective best interests, and, if so, how to go about getting there. Thus, the normal attributes of courtship in the context of licensing are observed: development of a memorandum of understanding and/or a term sheet; due diligence; good faith negotiations; responsible and attentive consummation and execution of the deal; and well-resourced alliance management.

At the early stage of a memorandum of understanding (MOU) or a term sheet, the parties have a good opportunity to discern whether their interests and objectives are aligned sufficiently that they can and should invest further in exploring a deal; and to outline the general contours of that deal.

The term sheet should be focused only on the major terms of consequence. It should not descend to tactics and operations or else it runs the risk of invading the rightful province of detailed negotiation and drafting of the agreement itself, and a needless redundancy. Tactical details are for later, when the investment is clearly justified. Likewise, premature focus on the tactical raises the risk that negotiation of the ultimate agreement becomes a rehash of the term sheet, which risks not only duplication of effort, but inconsistency, misunderstanding, and deviation from the strategic objectives underlying the alliance.

Recitals

What I refer to as the neglected stepchild of licensing, recitals have an under-appreciated, and

often underutilized, role to play. Although technically without legal significance, the recitals provide an opportunity to explain in plain English the underlying purpose of the agreement. Here, the parties can explain to the reader what it is that brought them together, and what they hope to achieve, in succinct, simple prose. This can be of enormous benefit when the agreement comes to be interpreted by a third party (*e.g.*, a judge) who is well informed in the law, but not at all informed as to the nuances of business dealings in a particular industry, and much less so as to the technological advantages that are occasioned by the exchange of intellectual property rights that is being effected by operation of the agreement. Thus, it is worthy of more than mere passing attention, and might well be spelled out with substantial particularity. You must take care, however, that the recitals do not go so far as to intrude into the tactical elements of the agreement, and thereby create inconsistency within the agreement.

Here is where I invoke what I call the “Aunt Matilda” rule. If your agreement, and particularly the recitals, are not written such that your hypothetical Aunt Matilda—bright, articulate, but not informed in the ways of your particular business—could understand your purpose in setting forth in such excruciating detail what the two parties are agreeing to do and hoping to achieve, then you may well have done yourself a grave disservice.

Definitions

Bear in mind that a license agreement is a legal contract entered into by two or more parties intending to be legally bound. As such, basic principles of contract law apply. There must be a bona fide offer and an acceptance of that offer, and there must be an exchange of consideration.

The contract is the meeting of the minds between the parties. The written agreement is the always imperfect memorialization of that common understanding. As such, the written agreement forever suffers from the deficiencies of language; and, perhaps more importantly, from the inaccuracies derived of our often unartful attempts to use the written word to express that common understanding. The unpleasant task of the judge called on to settle a dispute often is to discern, many years hence, and from the four corners of a complicated and arcane legal instrument what precisely was the common understanding, and to do so notwithstanding those deficiencies and inaccuracies.

The definitions in an agreement often are hampered by inattention to detail, reliance on a peculiar lexicon that is familiar only to the parties, and by a

tendency to use shortcuts and jargon. Often, they are an artifact of an ill-informed notion that somehow, a lack of clarity or specificity will somehow inure to a party's interest. Here one should reach for Strunk & White's, *The Elements of Style*. Most notably, heed their admonitions to use definite, specific, concrete language; omit needless words; make definite assertions; and to avoid tame, colorless, hesitating, non-committal language. As professionals engaged in one of the most complicated tasks of the writing world, licensing professionals should, above all, strive to write clearly. No small feat, but a worthy aspiration among those practicing the noble profession of licensing.

Most commonly, I find deficiencies of definitions in those terms that are of most consequence to the deal. For example, at the core of any license agreement is the "Licensed Technology," the "Licensed Products," the "Field of Use," and the "Consideration" or "Royalty." Also of importance are subordinate, but nonetheless important, terms, such as "Improvements" and "Confidential Information," and what constitutes the royalty base, for example, "Net Sales." Too often, terms such as Licensed Technology and Licensed Product are defined by shorthand recitation of such things as patent applications, and trade names. Both are somewhat indeterminate, and neither is durable. Patent applications are indefinite in what is covered (if anything); and trade names readily and frequently are changed according to the vicissitudes of commerce and the whims of marketing professionals.

Seek to define the terms in your agreement according to concrete and enduring characteristics that are discernable and understandable to the lay person. For example, define the Licensed IP or Licensed Technology just as you would define the invention in a patent claim. It matters not that an examiner has not yet agreed with you as to the patentability of that subject matter. The freedom of contract that underpins a license agreement permits the parties to define amongst themselves what is being conveyed, and the corresponding consideration. This is especially true when the agreement is a hybrid involving patent rights, trade secrets, know how, and other forms of IP. Under that scenario, the parties may characterize their respective rights and responsibilities without regard to the legal basis for those rights, and if the Licensed IP or Licensed Technology goes beyond the bounds of what ultimately is determined to be patentable, it is of no moment, at least as between the parties to this particular transaction.¹

Finally, carefully crafted and detailed definitions are critical to the proper purpose and function of a license agreement; but, as with all good writing,

definitions must balance particularity and relevance. We can readily envision a definition section so detailed that any modification of the agreement necessitates revisiting and rewriting one or more definitions, thereby hampering negotiation and consummation of the agreement. Similarly, the use of nested definitions can create unforeseen complications, and prolong the drafting process. By defining terms based on definitions of other terms, we risk a hazardous cycle of needing to revise terms that are buried within other terms that are somehow dependent on still more terms. Finding each, and revisiting how it is used in the agreement, can be a burdensome and time consuming task.

The Grant

The Grant is that which is conveyed through the execution of the license agreement. These are the rights or acts being licensed, and can be: the authorized uses; an identification of specific markets; territorial restrictions; and/or sublicense rights. Indeed, the Grant can be any parcel of rights to which the licensor is itself entitled to enjoy, and to convey.

As with the definitions, the Grant clause is a challenge to write, if only because it is the very crux of the agreement. The Grant clause should be structured to allocate the various rights according to the specific type of IP that is being conveyed.

Rights to inventions in the form of patents should be conveyed in accordance with the statutory language specifying the rights inherent in a patent. In the United States, that is the right to make (and have made), use, sell, offer for sale, and import the invention.

The rights inherent in copyright are the rights to reproduce the work; prepare derivative works; distribute copies to the public by sale or other transfer of ownership.

The statutory (and common law) right in a trademark is the right to use the mark in commerce to identify and distinguish goods or services, and to indicate the source of the goods.

When conveying rights in trade secrets, first determine whether there is any significant difference between what constitutes a trade secret, know-how, and confidential information. Often, courts and practitioners use the terms interchangeably. That alone, is not necessarily a bad thing, but permitting confusion among the terms and as a default without assessing the rights and resources intended to be exchanged, can indeed be problematic. In the United States it is best to use the trade secret definition of the Uniform Trade Secret Act: "Trade secret" means information, including a formula, pattern, compilation, program,

device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Generally, those various intellectual property rights may be parsed and conveyed in any way that the parties deem fruitful. It may be by geography, by time, by market, by field of use, or any other split that makes sense to the parties.

It is worth noting that the peculiar attributes of intellectual property mean that those rights may be conveyed in a way that commodities may not. As property rights, they may be allocated and conveyed in a manner that commodities cannot. For example, antitrust law, or competition law, would proscribe an agreement whereby competitors agree to divide up markets, regardless whether it is by geography, field of use, or market. However, if one of those competitors has a legitimate intellectual property right, the corresponding technology can be allocated in almost any manner that the parties choose.

The distinction must be made between a license and an assignment. A license is a transfer of a subset of the rights possessed by the owner. An assignment is more akin to a sale. Regardless of how it is characterized, a transfer will be assessed by a court based on the nature and extent of the rights transferred. An agreement that conveys from one party to another the totality of the rights possessed by the owner, is more likely than not an assignment. A conveyance that transfers only a portion of those rights, and reserves to the licensor any substantial right, or bundle of rights, is more likely than not a license. The difference can be significant. The two transactions often are taxed differently, and the difference can be highly consequential as to the parties' respective rights in the event of a breach. Similarly, the difference can be highly significant in terms of how the consideration is structured.

Two Types of Grant

Fundamentally, there are two types of grants. One focuses on the technology or embodiments that are contemplated as the conveyance. The other type focuses on the intellectual property. Thus, the grant can be structured according to licensed products and fields of use; or it can be broadly based on anything that comes within the scope of the specified intellectual property.

If, however, the scope of the specified intellectual property is indeterminate, as where patent

applications remain pending, then there is reason to carefully consider whether a grant based on the intellectual property suits the purpose. Perhaps better to specify what may be made of the technology, as where the licensed products are defined in detail. Here, the parties are in effect agreeing as to what constitutes the property rights that are being exchanged, without regard to whether one or more examiners, in one or more patent offices, agree.

In the standards world, parties might find it helpful to limit the grant to only those patents, or perhaps claims, that are "necessary" or "essential" to the use or further development of the technology.

Term of the Grant

In the United States, it is especially important to ensure any grant of patent rights, or prospective patent rights, do not exceed the statutory term of the licensed patents. The *Brulotte* rule² proscribes the grant of patent rights exceeding the statutory term as contrary to public policy, rendering the patents themselves, and the agreement unenforceable. Although the unenforceability of the patents can be purged, it requires cooperation of the parties, and approval by the court. The combination of events may not be easy to achieve, particularly if there is ill will amongst the parties.

If constructing a hybrid license, be sure to differentiate royalty payments according to the rights conveyed. The consideration for patent rights should expire according to the term of the patents. Residual non-patent rights may remain beyond that term, and royalties may properly accrue, but they should be distinguishable from the consideration specific to the patent rights.

Implied Licenses

The Grant clause also should address implied licenses, and particularly where international rights are conveyed. In many countries, there are a host of implied or imputed licenses that operate by statute. While this has the effect of simplifying licenses in some jurisdictions, it can be a trap for the unwary. Choose a hospitable jurisdiction for interpretation of the contract, expressly address or disclaim implied or imputed licenses in plain and unambiguous terms, and ensure the parties have a mutual understanding as to whether such disclaimers are recognized and effective in that jurisdiction.

Specify Beneficiaries

Aside from exclusive versus nonexclusive licenses, there is frequently a desire to extend the rights and privileges of a license agreement to others *via*

sublicense and/or to one or more affiliates. This brings us back to the importance of definitions. If a sublicense is contemplated, then the parameters of that right are set forth, usually within the Grant clause, and a simple and straightforward grant is uncomplicated. However, a license agreement that expressly denies the licensee the right to sublicense might nonetheless include a right to transfer rights to “affiliates.” Unless the term “affiliate” is carefully defined, that right can be the exception that swallows the rule. Know what’s intended and express it plainly.

Risk Shifting Provisions

Risk shifting provisions usually are found in the Representations and Warranties, and the Indemnification clauses. Whole books have been written about the pitfalls of inattention to those provisions. A detailed treatment is beyond the scope of this article. However, a few highlights, and general principles, are worth noting.

These provisions afford considerable opportunity for the parties to allocate risk in a manner that suits their respective strengths, desires, risk tolerance, and ultimately the rewards likely to be derived of the transaction. As such, these provisions are inextricably tied to the consideration and/or the balance of remuneration for the successful exploitation of the licensed rights. The assumption of greater risk usually translates into greater reward. Know what risks you are assuming, and ensure you have a good and thorough understanding as to how that is likely to play out in commercialization, and resulting sales. This might require a comprehensive valuation of the technology, and corresponding market evaluation.

From a relationship standpoint, it is important to bear in mind that the implications of the risk shifting provisions survive long after consummation of the deal, and indeed, beyond the expiry or termination of the contract. Thus, the risk that a deal might blow up, and impose substantial and unexpected costs, will survive long after those crafting the deal have left the scene. Don’t let the goodwill and optimism attendant on the last stages of concluding a promising deal be a barrier to a careful and thorough articulation of the rights and responsibilities should things turn out not to be so.

There is a tendency in many organizations to leave the seemingly dry and arcane details of the risk shifting provisions to the lawyers. This is a risky proposition. It is best that those intimately familiar with the business remain thoroughly engaged in this process. These provisions can dramatically alter the revenue derived of a deal, and can impose substantial liabilities or penalties that might well exceed the revenue

derived of a deal. What’s more, they usually are influenced by the peculiarities of specific industries and markets. The lawyers, even in-house lawyers, might be familiar with the general contours of a given industry, but it is unlikely that they will possess the same expertise as the business executive as to where the real risks lie in product development, manufacturing, and sales and marketing. That skill set is the stock in trade for the business executive. Make sure that the deal team exploits that skill set.

Alliance Management

The field of alliance management as a discrete professional discipline is a relatively new phenomenon. Coming out of the pharmaceutical industry, the practice of alliance management is now being recognized as an increasingly important part of the licensing process. The Association of Strategic Alliance Professionals (ASAP) is a great resource for best practices in strategic alliance management. Among other things, what this phenomenon, and the growth of this field as a discipline, tells us is that the conduct and management of the relationship following the execution of the deal is every bit as important as what came before. In many respects, it is more important.

It is worthwhile, throughout the licensing process, to bear in mind how the relationship will be implemented, and to specify early how the alliance will be managed. As with any obligation of the agreement that will be performed over time following execution, it is prudent to spell out within the agreement itself, how performance is to be conducted, and what resources the respective parties will bring to bear. This exceeds the historic practice of committing to vague terms such as best efforts; but instead often is far more tactical, and indeed may contemplate specific budgets, personnel, and benchmarks or timelines.

Without a dedicated alliance management plan, it too often is the case that the deal is concluded, the deal team moves on to the next deal, and the agreement is locked away with other important commercial documents. The deal usually isn’t revisited unless and until there is a problem, a change in circumstances, or a concern that one or the other of the parties is not enjoying the revenue it is due. In most circumstances, when the parties find a need to go back to the specific terms and conditions of the deal, whether it is to assess a party’s performance or to conduct an audit, the result is foreordained. An erosion of trust has likely occurred, and the parties are not quite as rosy about the relationship as they were at signing. This can all be avoided with a well-planned

and resourced, and a carefully articulated, alliance management plan.

Through frequent touch-points, and deliberative transparency, the parties will be better suited to identify problems early, and to address them in a spirit that preserves trust and aligns with the mutual interest that the parties shared during negotiation. Thus, alliance management might be seen as a continuation of the negotiation process, albeit one informed and constrained by the original agreement.

It is perhaps a bit cliché, but licensing and alliance management is a marriage. The deal is the pre-nuptial agreement, but the relationship must be expected to deviate and exceed our limited capacity to contemplate the myriad situations and scenarios likely to unfold. The relationship must be nurtured, and there must be an appropriate level of flexibility and give and take. Only then will deals reach their full potential.

Conclusion

The true art of licensing resides in the art of managing relationships. These include identifying interests, equitably exchanging rights and responsibilities, devising a plan to discharge those responsibilities and exploit those rights, and to cultivate the relationship over time. This requires a deft hand that far exceeds intimate familiarity with a particular industry, the rights available, the legal implications, or indeed the ability to draft a detailed agreement. For this reason, licensing is best conducted as a team sport, drawing on many diverse talents, experiences, and perspectives. But, above all it demands respect for your counterpart, and a healthy recognition that mutual sacrifice in service of the enterprise is essential to any durable relationship.

Good luck!

1. There, of course, are terms and conditions that may be included in a license agreement that violate public policy, and impair the contract and enforceability of the underlying IP, but that's beyond the scope of this article.

2. *Brulotte v. Thys Co.*, 379 U.S. 29 (1964). See also *Kimble v. Marvel Entm't, LLC*, 135 S. Ct. 2401 (2015).

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