INTELLECTUAL PROPERTY LICENSING

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Fundamentals of an IP Licence

WHAT IS IP LICENSING?

Licensing is one of the most common IP activities and enables a third party to use the IP asset in return for rewards. Licensors benefit from the extended reach and increased exposure of their IP assets thereby generating goodwill, market recognition and demand. Licensors may also benefit from additional cash flow in the form of deposits or advances, guaranteed income by way of minimum guarantees, and increased revenues with royalty payments. Licensees benefit from sparing the costs and risks in creating the Licensors' IP assets and from utilising a method or system which has proven to enjoy certain success.

LICENSOR & LICENSEE



There is general freedom for the parties to negotiate and finalise their terms of licence. Surely, Licensors and Licensees have different expectations. Licensors hope for the maximum royalty return and the least liability exposure while Licensees expect as much success assurance and flexibility in using the licensed rights as possible.

Many court cases have demonstrated how a loose or poorly drafted licence caused uncertainties and led to differences and legal disputes. The following discussion aims to provide an understanding of the general contents of an IP licence and the preferences of Licensors and Licensees from their different perspectives. Of course, the finalised terms of a licence agreement is a matter of commercial negotiation reflecting the respective bargaining power and skills of the parties.



Description of IP Rights

	Licensor's preference	Licensee's preference
Description of IP Rights	To be precise as this affects the scope of its warranties as to title (including non-infringement) and perhaps effectiveness	To be general to cover everything that is needed with title and non-infringement assurances for a successful product or service based on what is licensed
Scope of Licence	To be precise as to how the licensed IP may be used and exploited	To be as flexible and wide as possible
Sole, Exclusive or Non-exclusive	To grant non-exclusive licences as more Licensees means potentially more income (unless the market is saturated) and competition amongst Licensees may improve quality and stimulate sales and market demand resulting in the survival of the fittest Licensees	An exclusive licence to avoid cannabalism amongst Licensees and to allow better control over consumer expectation, customer satisfaction and market demand

Trade, Territories & Duration

Trade or Distribution Channels	To grant rights only for specific channels and reserving other channels for other Licensees	The whole market to allow exploitation in all channels, to include also new channels subsequently invented or made possible
Territories	Specific territories with provisions to prohibit a Licensee from selling products to others knowing that those products will be resold outside the licensed territory	The wider the better and in any event, freedom to sell to anyone within the licensed territory
Duration	A short term with no automatic renewals; extension usually only upon Licensee's full compliance and achieving certain performance targets (such as minimum sales, minimum royalties, certain market penetration rate or market share etc)	Automatic renewals upon same terms and conditions unless the Licensee serves notice to terminate; or an option to renew

Royalties & Audit Rights

	Licensor's preference	Licensee's preference
Royalties	An advance minimum guarantee Royalty payment at regular intervals, weekly/monthly/quarterly etc. as may be appropriate with proper financial statements and performance reports Percentage to be based on sales turnover or gross profits	No advance payment Royalties to be paid in arrears and at less intervals – biannually or annually with minimal reporting and administrative requirements A fixed lump sum if possible or a percentage based on net profits to allow deduction of certain costs and operation expenses (and sometimes sharing of risks such as bad debts)
Audit Rights	Licensee must maintain proper books and records for an agreed number of years, usually longer than statutory requirements for tax purposes Freedom to audit any time especially when the Licensee is off-guard (and within a certain period after termination of licence) with full access to all related books and records and co-operation from Licensee Penalty (usually in the form of default interest) if the audit reveals discrepancy in favour of Licensor in addition to Licensee's payment of the audit fees	To restrict the exercise of such right by Licensor to be confined to at most once every year during normal business hours upon reasonable notice with confidentiality pledge from those conducting the audit Payment of Licensor's audit fees only if discrepancy exceeds a certain percentage

Quality Control & Maintenance

	Licensor's preference	Licensee's preference
Quality Control	To be exercised at Licensor's complete discretion and Licensor to have freedom to implement or change any quality approval and control procedures and technical specifications Licensee to fully comply with all of Licensor's specifications; Licensee to ensure its products are in absolute conformity with approved samples Licensor's right of control or approval over all aspects from creation, development, production, packaging, transportation, storage, marketing and display; Licensor's right to inspect Licensee's production and storage facilities and shops to ensure compliance Licensor's right to withdraw approval and demand a recall from the market if products are found to be defective or have safety issues	Least intervention from Licensor provided that Licensee materially meets Licensor's specifications No right of Licensor to demand a product recall subject to Licensee's reasonable commercial endeavours to take remedial actions
Seconds; Overruns	Licensee cannot sell seconds (products with defects but still merchantable) or overruns (excess production) except with Licensor's approval and strict control over where, when and how those may be disposed of	Flexibility to dispose provided all trade marks or identifying labels are cut off or the products are off-season or are sold to less important markets or preapproved channels
Registration and Maintenance of IP Rights	At Licensor's absolute discretion Licensee to agree to enter into simple user agreements for recordal where relevant laws require such recordal	Licensor's commitment to diligently prosecute all applications to ensure the licensed IPs are secured and maintained by registration if capable of being registered; if not capable of registration, Licensor should take all steps to maintain and enforce the exclusive rights to such IPs

Improvements & Enforcement

	Licensor's preference	Licensee's preference
Improvements	If made by Licensee, Licensee should immediately notify Licensor with full and complete disclosure Improvements to belong to Licensor solely and absolutely or be of joint ownership with Licensor's unfettered rights to use and exploit or Licensee to provide Licensor with at least a worldwide, perpetual, royalty-free licence to use without restrictions	Belongs solely to Licensee with rights to apply for registration protection if appropriate
Rights to Modify	Licensor may do so anytime and Licensee shall have to adopt such modification Licensee may only modify upon Licensor's approval at Licensor's sole discretion	Licensee to have say in whether to adopt any Licensor's modification to the licensed IP or Licensee to be allowed a reasonable time for transition before implementing the change Licensor's approval of Licensee's modification not to be unreasonably withheld
Enforcement of IP Rights	Licensee must notify Licensor of any suspected, threatened or actual infringement Enforcement to be at Licensor's full discretion Where Licensee is an exclusive Licensee with right to enforce in its own name, Licensee shall provide an indemnity to hold Licensor harmless against any counterclaim or challenge as to the validity of the IP rights Enforcement to be at Licensee's costs with compensation recovered to be shared between Licensor and Licensee	Licensor's commitment to enforce if the challenge or infringement prejudices Licensee's business Cost to be borne by Licensor to be reimbursed from any financial compensation or cost incurred and amount recovered to be shared at an agreed percentage

Warranties & Remedies

	Licensor's preference	Licensee's preference
Licensor's Warranties	To give an "as is" warranty with Licensee using at risk To give only limited warranties with extensive disclaimers and limitation as to liability No express warranties but Licensor to be responsible for any invalidity or infringement of third party rights of the licensed IP only upon final judgment	Warranties as to Licensor's right to license; title and non-infringement; the IP rights (especially technology IP) are sufficient for the licensed purposes, accurate and complete; effectiveness of technology or patent licensed; efficiency and efficacy of licensed process, business structure, methods or mode of operation No limitation as to Licensor's liability for breach of warranty
Licensee's Warranties & Indemnities	Licensee to assume all product liability, all liabilities arising from use of the licensed IP rights outside the agreed scope, and from use of the licensed IP rights in conjunction with the Licensees' own or other third party component Licensee to strictly comply or exercise best endeavours to comply with the licence Licensee to indemnify Licensor against all loss and damages suffered from Licensee's breach	Basic warranties as to compliance with the material terms of the licence and all applicable laws, especially product merchantability and safety, all subject to Licensee's reasonable commercial efforts
Remedies	Licensee's sole remedy to be limited to replacement or substitution of the licensed IP or Licensor perfecting the licence; or to return of royalties paid (either all or according to an agreed formula depending on the gravity of the issue and the remaining duration of the licence) or pro rata refund if any advanced royalties paid	Licensor's warranty as to title and non-infringement to be absolute and Licensor's liability should not be limited
Insurance	Product liability and non-infringement insurance with Licensor as a named beneficiary	Insurance not exceeding customary scope and premium
Confidentiality	Licensee to keep everything and all information about the licensed IP (whether or not already public information) strictly confidential during and after termination of licence	Licensor to keep all information about Licensee, without limitation its business projects and financial performances, confidential at all times even after termination of licence

Termination & Sub-contracting

	Licensor's preference	Licensee's preference
Termination	Licensor to have wide discretion to terminate in the event of any breach whether actual, threatened or anticipatory	Licensor may only terminate if there is a material breach not capable of being remedied or not remedied within an agreed time
Sell-off	Licensee may only have a limited sell-off period upon expiry of licence provided that there was no breach and there will be full royalty accounting; following expiry of sell-off period the products are to be destroyed or surrendered to Licensor or Licensor has discretion to acquire at cost or an agreed price	Licensee shall be free to dispose provided that the quality of the products is up to standard
Sub-licensing/ Sub-contracting	To be approved at Licensor's discretion Licensee to impose all applicable terms and conditions of the licence mutatis mutandis upon its manufacturer or sub-licensee Licensee to be obliged to enforce against its sub-licensee or subcontractor for any breach, default or failure to comply Any breach of sub-licensee or subcontractor shall be deemed breach on the part of Licensee	Licensee to have either full right to appoint sub-licensee or subcontractor or Licensor's approval shall not be unreasonably withheld Licensee to exercise reasonable commercial efforts to procure compliance by approved manufacturers or sub-licensees
Assignment	Licensee not allowed to assign unless with Licensor's approval	Flexibility to assign freely within own group of companies or upon merger or amalgamation or Licensor's approval not to be unreasonably withheld
Governing Law	Licensor's choice	Licensee's choice or a third (neutral) country
Dispute Resolution	Licensor's choice	Claimant's choice

The above table should be easy to understand but the following issues require some elaboration:

Pre-licence Due Diligence

From the Licensee's perspective, it is fundamental to make sure that the Licensor can provide what it needs for the licence and the Licensor has the capacity to license. Where rights are registered, this can be searched from public sources but for unregistered rights, the Licensee has to do more to satisfy itself that the licensed rights are indeed valid and belong exclusively to the Licensor. As for the Licensor, probably it needs to find out the financial stability and capacity of the Licensee to perform.

Exclusivity

When an exclusive licence is granted, even the Licensor is excluded and only the exclusive Licensee can use the licensed IP. If it is a sole licence, the Licensor and the Licensee may each use it but there shall be no other licensee. If the licence is non-exclusive, the Licensor may itself and license others to use the granted rights.

Often if it is an exclusive licence and the Licensee failed to achieve certain performance target, the Licensor will have the options of not renewing the licence, terminating the licence or converting it into a non-exclusive licence. It is also possible for the parties to negotiate a non-exclusive licence which can be a de facto exclusive licence if the Licensee meets certain targets.

Royalties

The amount, the interval of payments and how royalties should be paid are purely driven by business considerations. Licensor should however note and stipulate that where the Licensee may have intra-group sale, prices and terms must be at arm's length. Often, a Licensor requires a Licensee to maximise sales and income (hence royalties). Parties should negotiate and agree what sort of deductions may be allowed in the calculation of royalties. If based on sales turnover, it is customary to allow deduction of returns and trade/cash discounts. If based on gross profits, then cost of goods sold shall be deducted and the parties should agree on what will be included in the costs of goods sold, e.g. material and direct labour cost, cost of shipment and insurance. If based on net profits, then all business expenses shall be deducted and typically this refers to profits before tax. Certain expenditure such as provisions for bad debts may require special attention as an exceptional high level of bad debts may not be agreeable with the Licensor. Sometimes, Licensor imposes a limit on the maximum percentage of all allowable deductions.

Also, if the Licensee deals with other products or operations, how its overheads should be apportioned should be discussed and agreed. If there is a minimum guarantee, the Licensee would like to be able to cross-collateralise a better year against a poor year or one product against another if different IP rights may be involved from the same Licensor. On the other hand, the Licensor may refuse cross-collaterialisation and demand minimum guarantee in respect of each licensed IP, each product/service, territory and channel of distribution in order to maximum its royalty income.

Royalties

If income may be in different currencies and royalties will be collected in one currency, given the volatile currency market, the parties shall have to agree whether the applicable conversion rate shall be that on the date of payment, or be averaged over a period of time or a fixed rate. Special attention should also be given to territories where there is foreign remittance control and how this should be handled.

Quality Control

Licensors may choose to rely on Licensees' warranties as to conformity with specifications and quality and may not be too keen to assert stringent quality control. Sometimes, a Licensor may not even provide any quality or technical specifications. This certainly depends on the Licensee's expectations and requirements but Licensors should be careful whether notwithstanding the Licensee's warranties and indemnities, the applicable local law may impose liability over the Licensor for lack of due supervision. For example, in some countries, a Licensor must supervise and ensure the quality of licensed trade mark products otherwise the lack of quality control may constitute abandonment of the trade mark rights.

Enforcement

Whether actions shall be taken by a Licensor or Licensee, the parties' cooperation is paramount. It is however understandable that the parties may not always agree on the type of action required, the cost and risk involved. Invariably, the Licensor shall have the first say whether to commence legal proceedings. If Licensor declines, then Licensee may take action in its own name (as the exclusive Licensee) or to use the name of Licensor or to add Licensor as a party in order to commence proceedings. Often, in such situations, the Licensee is expected to bear all the legal costs incurred but shall have the right to keep all sums (cost and damages) recovered. The Licensor will ask the Licensee to indemnify the Licensor against any claim or counterclaim or any challenge as to the validity of the licensed IP. If the licensed IP rights are challenged, it is invariably the case (and the Licensee expects) that the Licensor shall defend and uphold its IP rights.

Governing Law & Dispute Resolution

If the parties are situated or operating principally in different jurisdictions, understandably each prefers to apply the law it is most familiar with. Often, as the Licensor is in a stronger bargaining position, the law where the Licensor resides becomes the governing law and the courts there have exclusive jurisdiction. It is suggested that a foreign licensor should think twice whether to insist using the law where it resides considering that if enforcement is to take place, this will be in the jurisdiction where the Licensee is situated. Also unless there is arrangement for reciprocal enforcement of judgment, the parties should consider if arbitration may be a better option given the wide adoption to The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

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