



INTELLECTUAL PROPERTY LICENSING

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THE
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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. In the past decade, as innovative activity grows increasingly collaborative and transnational, there has been a shift away from traditional focus on ownership of IP to securing right to use through licensing.

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. Naturally, 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 define precisely the exact scope of its warranties as to title (including non-infringement) and perhaps effectiveness	To be as wide as possible to cover everything that is needed with title, efficacy and non-infringement assurances for a successful product or service
Scope of Licence	To define precisely 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 cannibalism amongst Licensees and to allow better control over pricing, consumer expectation, customer satisfaction and market demand

Trade Channels, Territories & Duration

Trade or Distribution Channels	To allow only specific channels and reserve 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

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 or guarantee

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)

Tax

Licensee to handle local taxes for overseas Licensor without any deduction or set-off

Licensor to be responsible for its own tax except where applicable law imposes withholding tax to be paid by Licensee on Licensor's behalf

Audit Right

Licensee to 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 or liquidated damages (usually in the form of default interest or surcharge) 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

Control & Rights Maintenance

Licensor's preference



Licensee's preference

Quality Control

No contractual obligation to exercise quality control but may do so 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, testing, 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 recordal of licences

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 to take all steps to maintain and enforce the exclusive rights to such IPs



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 with right to sub-license to other Licensees

Belongs solely to Licensee with rights to apply for registration protection if appropriate

If use of improvements shall be granted to Licensor, such use to be personal and not further licensable to other Licensees

Right 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

Where the IP rights are registered without substantive examination and the law requires such examination be carried out to confirm validity before enforcement, Licensor shall undertake to do so

Cost to be borne by Licensor to be reimbursed from any financial compensation with remaining balance to be shared 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 the least warranties and disclaim all implied warranties to the maximum extent permissible under the applicable law

To effect the most extensive disclaimers and limitation as to liability

To be responsible for any invalidity or infringement of third party rights of the licensed IP only upon final judgment

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 arising from Licensee's breach

Licensee's 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 of any advanced royalties paid

Warranties as to Licensor's right to license; title, validity and non-infringement; the IP rights (especially technology IP) are accurate, complete and sufficient for the licensed purposes; 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

Basic warranties to comply with the material terms of the licence and all applicable laws, especially product merchantability and safety, all subject to Licensee's reasonable commercial efforts

Licensor's warranty as to title and non-infringement to be absolute and Licensor's liability should not be limited

Insurance, Force Majeure & Confidentiality

Licensor's preference



Licensee's preference

Insurance	Product liability and non- infringement insurance with Licensor as a named insured	Insurance not exceeding customary scope and premium
Force majeure	Flexibility to decide what constitutes a force majeure event and to suspend, terminate or vary the licence	To know precisely when Licensee's performance of contract may be excused, suspended or terminated and the exact consequences
Confidentiality	Licensee to keep everything and all information about the licensed IP (whether or not already in public domain) 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, Sell-off, Sub-contracting & Assignment

Termination	Licensor to have wide discretion to terminate in the event of any actual, threatened or anticipatory breach	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	<p>To be approved at Licensor's discretion</p> <p>Licensee to impose all applicable terms and conditions of the licence mutatis mutandis upon its manufacturer or sub-licensee</p> <p>Licensee to be obliged to enforce against its sub-licensee or subcontractor for any breach, default or failure to comply</p> <p>Any breach of sub-licensee or subcontractor shall be deemed breach on the part of Licensee</p>	<p>Licensee to have either full right to appoint sub-licensee or subcontractor or Licensor's approval shall not be unreasonably withheld</p> <p>Licensee to exercise reasonable commercial efforts to procure compliance by approved manufacturers or sub- licensees</p>
Assignment	<p>Licensee not allowed to assign unless with Licensor's approval</p>	<p>Flexibility to assign freely within own group of companies or upon merger or amalgamation or Licensor's approval not to be unreasonably withheld</p>

Governing Law

Licensor's preference



Licensee's preference

& Dispute Resolution - - - - -

Governing Law	<p>Licensor's choice</p>	<p>Licensee's choice or a third (neutral) country</p>
Dispute Resolution	<p>Licensor's choice</p>	<p>Claimant's choice</p>

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

PRE-LICENCE DUE DILIGENCE

From a Licensee's perspective, it is fundamental to make sure that the Licensor can provide what is needed 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 must do more to satisfy itself that the licensed rights are indeed valid and belong exclusively to the Licensor. Where rights are under application, depending on the nature of such rights, they may or may not be searchable from public sources yet. The Licensee may have to rely more heavily on the Licensor's (or their legal advisors') representations, warranties and filing information. 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 the IP 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. Naturally, a Licensor expects 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 the calculation is 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 can 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 may 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 granted from the same Licensor. On the other hand, the Licensor may refuse cross-collateralisation and demand minimum guarantee in respect of each licensed IP, each product/service, territory and channel of distribution to maximise its royalty income.

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, quality and the law 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 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 the Licensor or the 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 the Licensor declines, then the Licensee, depending on the law, may take action in its own name (in many countries, the exclusive Licensee will have such right) or may commence action in the name of Licensor or by adding Licensor as a party. Often, in such situations, the Licensee is expected to bear all the legal costs incurred but may keep the 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. Where IP rights are granted registration without substantive examination, the law may require such examination be carried out and the registered IP rights be confirmed valid before enforcement can be carried out (for example, short-term patents in Hong Kong). Naturally, the Licensor is expected to take whatever action to confirm the validity of the IP rights to allow enforcement.

GOVERNING LAW & DISPUTE RESOLUTION

If the parties are situated or operating principally in different jurisdictions, understandably each prefers to apply its own domestic law. 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 between the respective jurisdiction where the Licensor and Licensee resides, 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. In Hong Kong, a Licensor and a Licensee can use arbitration to resolve their dispute over the licence or the licensed IP (validity, ownership, scope, duration, infringement or any other aspect) irrespective of whether the IP is protectible by registration and whether it is registered, or subsists, in Hong Kong or other jurisdictions. It should be borne in mind that arbitral proceedings and arbitral awards are confidential unless the parties otherwise agree and an arbitral award is not binding on other persons, including other Licensees, who are not parties to the arbitration.

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