Chapter 4

Royalties

§ 4:1 The Heart of the License

As with most agreements, the financial terms of a patent license are arguably the most important. Deciding how much royalty the licensor receives and the type of royalty (for example, net or gross revenue) often involves vigorous negotiations. After all, both parties wish to make money, and each feels its contribution is invaluable—the licensor for providing the patent, and the licensee for providing the means to exploit it.

Fortunately, there are ways to structure the royalties from which the parties can choose in order to find an agreeable compromise.

This chapter first discusses several types of royalties that are independent of actual sales of the licensed product: upfront royalties, research-funding royalties, milestone payments, and minimum royalties. It then discusses royalties based on the amount of sales (usually net receipts), also known as earned royalties. Finally, it deals with several general issues, including the enforcement of royalty obligations, royalties paid by licensees operating in foreign countries, and the effect on royalties of a failure to obtain an anticipated patent.

§ 4:2 Upfront or "Signing" Fees

An upfront or signing royalty is usually a one-time royalty due upon the signing of the license. It customarily consists of a single cash payment, unless the licensee is a promising but cash-poor upstart—in which case the licensor may take stock or stock warrants rather than immediate cash.

Sometimes upfront or signing royalties are credited against future running royalties. For instance, a licensee may pay a $1,000,000 signing royalty and have future royalty payments offset by that amount:

January 1, 2016	$1,000,000	Signing royalty paid
December 31, 2016	$3,000,000	Running royalties due
December 31, 2016	–$1,000,000	Credit for signing royalty payment
	$2,000,000	Amount due

The licensor may want to consider a time limit during which the signing royalty can offset running royalties.

For instance, if the licensor wants to motivate the licensee to act diligently in manufacturing, marketing, and selling licensed products, it can allow the offset for only the first six months of the license term. The period of time depends on how long it should take the licensee to ramp up and begin selling licensed products.

This serves as a disincentive for the licensee to sit on, or shelve, the technology.

The approach is not as effective for nonexclusive licenses. Why would a nonexclusive licensee diligently manufacture and market licensed products if another licensee can—without lifting a finger to develop the market—swoop in and compete? Worse, the second and subsequent licensees may enter the market without having incurred the expense of developing the market, and may thereby be able to compete at a lower price.

§ 4:2.1 Common Versus Preferred Stock

When licensors accept stock in lieu of cash royalty payments, they may seek common stock rather than preferred. Common stock offers advantages. The dividends paid on common stock, unlike preferred stock, can increase with a corporation's profits. If a licensee starts to reap enormous profits from sales of the licensed product, it may choose to have its common stock pay dividends that are much greater than those specified under the preferred stock. Holders of common stock also may vote for members of the board of directors and on company issues.

Perhaps even more importantly, the price of a company's common stock may increase much more than that set for its preferred stock.

Preferred stock can offer a guaranteed regular dividend unrelated to the company's performance. Because preferred pays a set dividend, the price of preferred stock is often pegged to interest rates, meaning it falls when interest rates rise and rises when interest rates fall.

Preferred stockholders do not get to vote for directors or company issues; however, two advantages that preferred stockholders enjoy are:

- priority over common stockholders in the payment of dividends, and
- getting paid before common stockholders in a corporate liquidation.

There can be different forms of preferred stock. Such stock can be convertible (converts to common upon a certain event, for example, sale); participating (dividend may increase if common dividend is higher than preferred); and adjustable-rate (adjusts with treasury rates).

This discussion is meant to give some idea of the types of stock available. Equity rights can be complicated and the intricacies are beyond the scope of this treatise.

§ 4:2.2 Stock Warrants

Stock warrants are securities entitling the holder to buy an amount of stock at a specified price by or at a future date. The price at which the warrant can be exercised is usually either a set price or, in the case of publicly traded companies, the market price on a certain date, for example, the date the license agreement is executed.

Stock warrants offer an attractive way for licensors to participate in a licensee's success. Warrants afford the licensor the opportunity—without the obligation—to buy the licensee's stock at a fixed price within a specific period of time. If the licensee is successful, the licensor shares in the prosperity by exercising the warrant at a low price and selling the stock at a profit. (Of course, if the market price is below the exercise price or "under water," the warrant is worthless, and in the worst case that might remain so until the warrant expires.)

An advantage of stock warrants is allowing the cash-poor licensee to finance royalties through the promise of future success. A group of software writers or geneticists may have little in the way of assets, but may possess great talent and may be best able to exploit the patent. While they may not be able to pay upfront royalties or any royalties in the first few years of the license, their ability to improve and devise ways to use the licensed technology may be unmatched. For a licensor to shun them because they cannot pay cash may be shortsighted. If the license proves profitable, the licensee's stock price could skyrocket and the licensor would gain much more from share appreciation than it would have from the payment of royalties alone.

In fact, stock warrants may prove more lucrative than the royalties based on sales. While the licensor under a percentage royalty may receive greater royalties from greater licensee sales, the royalty rate is capped, whereas there is no cap on the value of the licensee's stock; the licensor receives 100% of the stock's appreciation (less the cost of the exercise price).

Just the same, not all licensors like stock warrants, fearing that by the time the licensee turns a profit, a new or competing technology may appear and sweep the licensor's patent into obscurity. And licensors are often concerned that the licensee who is urging them to accept stock warrants is more skilled at wooing licensors (and maybe exploiting their avarice) than at performing under the license. After dealing with a fast-talking but later-defaulting licensee, street-smart licensors tend to prefer cash today over promises of stock appreciation tomorrow.

Still, warrants should not be rejected offhand. If a licensor finds itself questioning a licensee's ability to achieve success that will be reflected in an increase of stock value, it should reconsider whether the licensee can succeed at all: a company unable to increase its stock value by advantageously exploiting the license may be equally unable to generate the revenue from which royalties are paid.

For the licensee, a further advantage of warrants is to align the licensor's interests with their own, with the hope of influencing the licensor in its dealings with the licensee. The logic is that if the licensor is a stockholder of the licensee, it will, in its relations with the licensee, think more like an owner, rather than one who merely seeks the greatest amount of cash from a stranger. In other words, ownership may incline the licensor to grant advantageous terms and treatment to the licensee in the future.

The price at which the licensor may exercise the warrant and purchase the stock is usually either a fixed price ("100,000 shares of common stock at $10.00 per share") or the market price ("The per share exercise price of such Warrant shall be the average closing price of LICENSEE's common stock for the ten (10) trading days ending on and including the trading day immediately preceding the Effective Date"). The provision may recite the basic terms of the warrant, and refer the reader to a separate warrant agreement for the details:[1]

> Signing Fee. LICENSEE shall grant OWNER a Warrant to purchase 100,000 shares of LICENSEE common stock with an exercise price equal to the market price as of the Effective Date (the "Warrant"), which Warrant shall be substantially in the form of Exhibit B.

In addition to knowing at what price they may exercise the warrants, licensors may wish to avoid having their potential ownership interest diluted because of secondary offerings. Here is an example of a warrant provision with anti-dilution protections:[2]

> On the Effective Date, LICENSEE shall also immediately grant and deliver to OWNER, as an additional royalty payment, the warrant (the "Warrant") attached as Exhibit C, entitling the holder

1. This language is adopted from subsection N.2 of Example 4:8.
2. This language appears in Example 4:71.

> to purchase 100,000 shares of common stock of LICENSEE, which LICENSEE represents is equal to five percent (5%) of the total issued and outstanding common stock of LICENSEE as of the Effective Date. The per share exercise price of such Warrant shall be the average closing price of LICENSEE's common stock for the ten (10) trading days ending on and including the trading day immediately preceding the Effective Date. The Warrant shall be immediately exercisable and shall expire four (4) years from the Warrant's issuance. LICENSEE represents that the Warrant conforms to and complies with the specifications set forth in this Section.

To help assure they are receiving a minimum proportion of the company's stock, licensors can insert a representation as to the percentage of issued stock the warrant represents:

> . . . which [stock] LICENSEE represents is equal to five percent (5%) of the total issued and outstanding common stock of LICENSEE <u>as of the Effective Date</u>.

Warrants are time-sensitive. If not exercised within the defined period, they expire on their own terms. The time period can be stated by giving open and close dates:

> The Warrant shall be immediately exercisable and shall expire four (4) years from the Warrant's issuance.

To avoid large stock sales all at once, the exercise dates can be staggered:

> The first 50,000 of the 100,000 warrants shall expire on December 31, 2005 and the final 50,000 of such warrants shall expire on December 31, 2010.

Warrants can also be exercisable upon the achievement of certain development-related milestones, for example, for a drug, at the beginning of the first Phase III clinical trials.

Though beyond the scope of this discussion, there are other features available in warrants, such as nominal consideration or cashless exercise, and piggyback registration rights.[3]

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3. The term "piggyback registration rights" refers to the rights of existing shareholders to have their shares included in any registration statement filed by the company with respect to any proposed public offering of equity or debt securities by the company or by other shareholders.

§ 4:3 Research-Funding Royalties

Exploiting an invention can require much costly research. To help assure that licensors spend enough money on research towards bringing the licensed product to market, licensees may wish to insist that a portion of the royalties they pay are used to fund further research in developing the licensed technology. If the license includes improvements within its grant provisions, so that all improvements upon the technology or invention fall within the license grant,[4] it is in the licensee's interest to promote research that may lead to such improvements.

To foster such research by the licensor, the licensee may contractually require a specific amount of royalty revenues to be spent on experimentation and laboratory endeavor. The laboratory work may be conducted by the licensor or a third party, such as a university or hospital. This kind of provision assures that the licensor is committed to developing and improving the technology, rather than merely cashing royalty checks.

This type of research-committed royalty is analogous to the alternative of allowing the licensee to deduct research expenses from royalty payments. (This deduction can be provided in the net sales definition.) The difference is that a deduction is somewhat akin to a subsidy in that it allows licensee an option, but not an obligation, to conduct research. If under the net sales approach the licensor performs no research, it suffers no direct loss; whereas its failure to conduct research under a research royalty results in forfeiture of the research royalty.

§ 4:4 Milestone Payments

Royalties may be made payable upon the occurrence of certain events or milestones. An example is the regulatory approval procedures for pharmaceuticals. As the patented drug proceeds from test tube to market, certain payments become due. Typical examples of triggering events are pre-clinical tests, applications for clinical testing, and eventual approval. Each event triggers payments to the licensor, usually of varying, perhaps progressively larger, amounts.

Exacting payment from the licensee as it progresses towards marketing a patent may seem more a punishment than a reward for making progress. If the more a licensee does, the more he must pay, might a licensee be encouraged to drag its feet?

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4. *See* section 2:4 ("Improvements Included in Grant").

There are several reasons why this is not so. First, the patent monopoly is of limited duration. Time is not on the licensee's side; the licensee is under a deadline. Second, the licensee has already incurred expenses upon execution of the license, such as legal fees, engineering studies, business plans, consultancy expenses, and manufacturing and plant preparations, none of which will be recouped until customers can buy the licensed product. Thus, the sooner to market, the sooner to profits.

Third, minimum royalty payments are often also required under the license. With each year, more minimum royalties are incurred. Since most are creditable against percentage royalties, laggard licensees are not profitable licensees.

The following is an example of a milestone royalty scheme for a pharmaceutical:[5]

(a) As consideration for the licenses granted hereunder, LICENSEE shall pay OWNER the following amounts at the following times:

EVENT	**AMOUNT**
(i) Upon execution of this Agreement	$1,000,000
(ii) Upon completion of transfer of the Know-How described in Section [Definitions]	$750,000
(iii) Upon approval of the first clinical trial exemption or equivalent for a Product in the United States, Canada Japan or the European Community (*i.e.*, a filing such as an IND[6] that permits the commencement of Phase I Clinical Trials)	$1,550,000
(iv) Upon commencement of the first Phase III Clinical Trial of a Product	$1,500,000
(v) Upon acceptance of the first NDA[7] or similar filing in the United States, Canada, Japan or the European Community	$2,250,000

5. This language appears in Example 4:18.
6. Investigational New Drug Application.
7. New Drug Application.

EVENT	**AMOUNT**
(vi) Upon approval of the first marketing approval of a Product in the United States, Canada, Japan or the European Community (*e.g.*, approval by the FDA or similar governmental entity of an NDA or similar filing for a Product)	$3,000,000

(b) All payments described above shall be made within thirty (30) days of the relevant event (except for the payment provided in (a)(i), which shall be made upon signing of this Agreement).

§ 4:5 Minimum Royalty

Licenses often have minimum royalty requirements. Licensors seek such requirements to assure themselves of a certain amount of income, even if the licensee fails to diligently sell the licensed product.

Of course, as the licensee may argue, lack of sales can stem from lack of market appeal for the product rather than licensee laziness. The licensor may seek to avoid a future fight about whether the licensee's efforts are adequate and convince the licensee that in return for the license, the licensee should guarantee a certain degree of success in the form of minimum royalties.

Another reason to use minimum royalties is to force the hand of the licensee who is making overly optimistic sales projections. To court inventors, potential licensees sometimes paint rosy pictures of sales and royalty payments; it can be part of a licensee's strategy to lure inventors to sign exclusive licenses and keep the invention out of a competitor's hands. To cut through the puffery and assure a more honest assessment of future sales, licensors can insist that the sales projections be put into the contract as a minimum royalty condition.

Under the minimum royalty provision, even if the licensee does not sell enough licensed product to achieve the minimum royalty amount, it must still pay the licensor as if the sales had occurred. This is a risk some licensees are not willing to accept. But the licensor may point out that if the licensee does not have faith in its ability to sell the product, it is not an attractive licensing candidate to begin with.

Here is an example of a minimum royalty payment provision:[8]

> Minimum Royalty. Commencing with the 3rd Contract Year and each Contract Year thereafter, LICENSEE shall pay to OWNER a minimum royalty of $100,000 per Contract Year for the remaining Term of this License Agreement (the Minimum Royalty"), due and

8. This language appears in subsection N.5 of Example 4:8.

payable \$25,000 per quarter. The Minimum Royalty shall be credited against the Earned Royalty due and owing for the Contract Year in which said Minimum Payment is due. Minimum Royalties in excess of Earned Royalties for any Contract Year may be credited by LICENSEE against Earned Royalties due and payable to OWNER in subsequent Contract Years.

§ 4:6 Royalties Based on Sales (Earned Royalties)

§ 4:6.1 Generally

The licensee is customarily obligated to pay royalties on its sales revenue as well as a percentage of all revenues received from sublicenses relating to the patented technology. These royalties are customarily referred to as "earned" royalties. Here is an example of an earned royalty payment provision:

> Earned Royalties. LICENSEE shall pay to OWNER a royalty of 5% of Net Revenues until LICENSEE has realized cumulative Net Revenues of \$10 million; after LICENSEE has realized cumulative Net Revenues of \$10 million, LICENSEE shall pay to OWNER a royalty of 7% of all Net Revenues in excess of the cumulative \$10 million. The aforementioned royalties based on Net Revenues shall be called the "Earned Royalties."

Note that the royalty rate increases with increased sales. The premise is that once the licensee has established the market, it does not need the money as desperately to finance exploitation of the patent. Once the licensee is firmly on its feet, it is more readily able to pay royalties, and hence incurs a higher royalty percentage obligation.

§ 4:6.2 Valuation of Sales

An alternative to net-revenue-based royalties is royalties based on gross receipts. That is the simplest choice for accounting purposes, as no calculation is involved;[9] whatever amount of money is collected from sales of the patented product is the amount upon which royalties are calculated.

While gross sales is the simplest measurement of revenue for calculating royalties, most licensees are not willing to pay royalties on gross receipts. They want some deduction for the unavoidable

9. No calculation is involved unless the device consists of more than one patent, in which case it becomes, as discussed below in section 4:6.4, a combination product with sales apportioned between the contributing patents.

expenses incurred in making the sales, as well as for products returned by buyers. The deductions are customarily for specific items. Deductions are not necessarily unfair to licensors. Licenses are granted on the faith of a profit, and profits accrue from the balance remaining after deducting expenses from sales, the underlying assumption being that the operation will be economically run and the expenditures reasonable.

To elevate the assumption to an obligation, licensees can contractually specify which expenditures may be deducted from gross sales. It can prove dangerous not to do so; when presented with accountings laden with unexpected deductions, licensors are apt to feel deceived and disappointed, having expected greater royalties from their inventions.

The deductions that counsel may consider in calculating the net revenue include the following to the extent that any of the items are paid or incurred by the licensee:

(1) refunds, allowance or credits for recalls (other than recalls arising out of licensee negligence, misconduct or fraud), breakage, rejected or returned products,

(2) excise, use, value added, and sales taxes (other than income taxes),

(3) tariffs, import/export duties, customs duties, and other imposts,

(4) normal and customary quantity, trade, and cash discounts (other than cash discounts for early payment), and sales commissions,

(5) off invoice allowances other than co op advertising allowances,

(6) freight, shipping, and insurance charges specifically included in the billing amount, and

(7) rebates required by government rule, regulation, program, or fiat.

The deduction for taxes is discussed below.[10]

§ 4:6.3 Affiliate or Sublicensee Sales

Arm's-length sales to third parties usually present no difficulties in determining royalty payments. The price at which products are sold on the open market is rarely subject to question.

10. *See* section 4:6.7.

The question as to valuation arises in sales by the licensee to affiliated entities and sublicensees. Theoretically it is possible, though dishonest, to avoid or reduce royalty payments by transferring a licensed product to an affiliate at a favorable (low) price, after which the affiliate sells it at full market price. The licensor is paid a royalty only on the artificially low price paid by the affiliate, allowing the affiliate to keep the difference between the reduced royalty paid and the true royalty saved.

Another licensee tactic is to transfer the product to an affiliate for supposed resale, yet allow the affiliate to use the product royalty-free under the pretense that the product was sitting on the shelf unsold.

To avoid both tactics, licensors can include language that requires payment when the affiliate is an end-user, and also a provision that sets the price for non-third-party sales or transfers. The following provision is an example of such language:[11]

> Sales or transfers to Affiliates, or sublicensees, or interdivisional sales or transfers shall not be included in the payment calculation until the actual sale and shipment by such Affiliate, or sublicensee, to a third party except if such Affiliate or sublicensee is an end user of the Licensed Products. Under such circumstances, the license fee shall be based on the lowest sales price of Licensed Products charged to third parties for the calendar quarter in which the Licensed Product is shipped to such Affiliate or sublicensee which calendar quarter shall be the calendar quarter of payment; provided that such transactions with Affiliates shall be on prevailing market terms taking into account volumes of purchases, but for transactions with Affiliates, products may be offered at the maximum discounts available to any person. If no such shipment has occurred, such payment shall be based on the average sales price of the total quantity of the Licensed Products (separated as to category, if any) in the previous calendar quarter (exclusive of sales to Affiliates or sublicensees in which sales have occurred. If no such sales have occurred, such payment shall be based on the then prevailing market price.

§ 4:6.4 Combination Sales

Patented products are not always sold alone. They can be packaged or combined with other products or devices. The challenge is to apportion a value to the licensed product when it is sold as part of a package, or is integrated with nonlicensed products or products covered by licenses from a second or third licensor.

11. This language appears in subsection N.1(c) of Example 4:4.

For example, assume a patented meter with a fair market value (FMV) of $5,000 is integrated into a large industrial machine with a FMV of $450,000. It would not be fair for the licensor of the $5,000 meter to extract a royalty on the sale of the machine for $450,000. On the other hand, what if the machine's FMV, absent the meter, is $350,000, so that the $5,000 meter enhances the machine's value by $100,000? Is the licensor entitled to a royalty calculated on $5,000, or a share of the enhanced value?

Defining the agreed royalty formula can be a challenge. It can be a particular challenge with pharmaceutical licenses, where compounds are often mixed from many different ingredients. How do the parties determine royalties if multiple compounds are used, each licensed separately under various license agreements? One way is to apportion the values according to amounts invoiced:[12]

> In the event that a Licensed Product is sold in the form of a <u>combination product</u> containing one or more products or technologies which are themselves not a Licensed Product, the Net Sales for such combination product shall be calculated by multiplying the sales price of such combination product by the fraction A/(A+B) where A is the <u>invoice price</u> of the Licensed Product or the Fair Market Value of the Licensed Product if sold to an Affiliate and B is the total invoice price of the other products or technologies or the Fair Market Value of the other products or technologies if purchased from an Affiliate. In the case of a combination product which includes one or more Licensed Products, the Net Sales for such combination product upon which the royalty due to the OWNER is based shall not be less than the normal aggregate Net Sales for such Licensed Product.

An even simpler method is to limit the consideration to the number of different active compounds, regardless of the monetary value, weight, or volume of each of the ingredients. This is risky if the licensed compound is one of many ingredients, as royalties calculated under this method are apportioned according to the number of compounds, with no correlation to the efficacy or proportional value contributed by the licensed compound.

Here is an example of such a provision. Note the provision whereby royalties will never be reduced below 50%.[13]

> If any Product incorporates active compounds which are not covered by the Licensed Patent to form a combination product

12. This language appears in Example 4:45.
13. This language appears in Example 4:41.

> ("Combination Product"), then an adjusted royalty will be calculated based on multiplying the Net Sales of the Combination Product by the quotient 1/1+A, where A equals the total number of active compounds included in the Combined Product. In no event shall this adjustment cause the royalty to be less than 50% of the Net Sales of the Combined Product. "Active Compounds" means distinct proprietary products other than any covered by a Licensed Patent.

Attempting to measure value by the number of functions performed by the combination is another means of assessing relative contribution. All the functions performed by the combination are considered, without regard to the merit or contribution of each individual function. This total number of functions serves as the denominator in the valuation formula. While this method is simple, it ignores relative values of the various ingredients, which could result in a shortfall if the combination serves many functions of which the licensed product is the most operative or provides the most value (for example, is the function users want most). Section (b) in the below provision is an example of such a formula:[14]

> In the event that a Licensed Product is sold in a combination package containing other active products ("Combination Package"), then Net Sales for purposes of determining royalty payments on the Combination Package, shall be calculated using one of the following methods, but in no event shall the royalties payable to OWNER be reduced to less than 50% of that provided for in Section [Royalty Provisions for non-combination sales] above:
>
> (a) by multiplying the net selling price of that Combination Package by the fraction A/A+B, where A is the gross selling price, during the royalty period in question, of the Licensed Product sold separately, and B is the gross selling price during the royalty period in question, of the other active products sold separately; or
>
> (b) in the event that no such separate sales are made of the Licensed Product or any of the active products in such Combination Package during the royalty period in question, Net Sales for the purposes of determining royalty payments, shall be calculated by dividing the net selling price of the Combination Package by the number of functions performed by the Combination Package sold where such package contains active agents other than those licensed under this Agreement. The parties recognize that this

14. This language appears in Example 4:44.

> provision will require consultation and that in the event a Combination Package circumstance arises, the parties will negotiate in good faith to determine the calculation of Net Sales pursuant to this section.

§ 4:6.5 Government Sales

The U.S. government (and to a lesser extent the states) provides funding for research and development of medicines and technology. Often such government-funded developments become the subject of patents. In return for their funding, federal agencies may invoke federal law,[15] which requires royalty-free licenses to the government for any patents resulting from government-funded research.[16]

To avoid surprises or misunderstanding between licensor and licensee, a provision can be included in the license exempting royalty payments for such government sales.

Here is an example of appropriate language for such an exemption:[17]

> Federal Sales. To the extent that any invention claimed in the Patent Rights has been partially funded by the federal government, this Agreement and the grant of any rights in such Patent Rights are subject to and governed by federal law as set forth in 35 U.S.C. §§ 201–211, and the regulations promulgated thereunder, as amended, or any successor statutes or regulations. Licensee acknowledges that these statutes and regulations reserve to the federal government a royalty free, non exclusive, nontransferable license to practice any government funded invention claimed in any non transferable license to practice any government funded invention claimed in any Patent Rights.

If the parties desire further specificity in identifying government sales, precise conditions may be inserted. The advantage of such a list is the avoidance of ambiguity. The disadvantage, at least in the minds of suspicious licensors, is that it provides cagey licensees a list of assessed transactions to avoid or a target for loopholes.

§ 4:6.6 No Multiple Royalties

Sometimes a product sold under a license is made up of several licensed parts or is manufactured using more than one licensed technology or process, for example, combination patents. For instance,

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15. 35 U.S.C. §§ 201–11.
16. March-in rights are also granted the government pursuant to 35 U.S.C. § 203. These rights are usually addressed in the grant provisions of the license agreement, and are discussed in section 2:7.
17. This language appears in subsection N.4 of Example 4:2.

a device may contain a chip manufactured under one license and several other patented parts, each covered by its own license. Under the terms of each separate license, each patented part and process is covered by a royalty provision, and each license calls for a separate fee. Cumulatively, the applicable royalties can amount to an expensive assessment on the device, so expensive that the device becomes commercially unsalable.

To avoid the burden of multiple royalties, licensees may seek a provision capping the total royalties paid per product. The customary cap is one royalty rate per product, with the parties compromising if the royalty rates vary among applicable licenses. Here is a provision in which the licensor has been able to extract a royalty rate equal to the highest rate of any applicable license:[18]

> If a licensed product is covered by more than one license granted hereunder, LICENSEE shall be responsible for payment of only one royalty based on the Net Sales thereof, such royalty to be equal to the <u>highest applicable</u> royalty rate on a <u>product by product</u> and <u>country by country</u> basis.

§ 4:6.7 Deduction for Taxes

In calculating the net sales upon which they must pay royalties, licensees understandably wish to deduct all taxes incurred. The rationale is that taxes are a necessary evil paid to a taxing authority; neither licensee nor licensor has any control over the amounts, and hence, neither should gain or lose because of them.

While neither party has control over taxes, licensors should consider protecting themselves from inaccuracies by insisting upon verification. This is particularly important in foreign jurisdictions. If a licensee pays a bribe to a foreign official to reduce its taxes (even if that is considered an accepted cost of doing business in that country), the licensor may wish to assure that it is not considered an unwitting participant because it permitted deductions of such payments from royalty sales.

One means for the licensor to verify tax payments is to insist upon copies of tax receipts and tax declarations filed with foreign governments. This provides a further benefit of reducing creative accounting such as transferring nonqualifying fees and expenses into the deductible category to lessen royalty payments.

Here is an example of thorough reporting requirements:[19]

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18. This language appears in Example 4:32.
19. This language appears in Example 4:55.

Tax Withholding. If any taxes for OWNER's account, withholding or otherwise, are levied by any taxing authority in the TERRITORY in connection with the receipt by OWNER of any amounts payable under Article 4 of this Agreement according to any tax treaty or agreement between the United States and a country in the TERRITORY, then LICENSEE shall have the right to pay such taxes to the local tax authorities and pay to OWNER the net amount due after reduction by the amount of such taxes, together with:

(i) proof of payment of such taxes and a translation thereof into English,

(ii) evidence of the amount of such tax paid,

(iii) evidence of the country in the TERRITORY and the authority to whom it was paid,

(iv) any other documentation to satisfy compliance with LICENSEE's royalty reporting obligations under this License, and

(v) any other information OWNER may reasonably request regarding the payment of taxes.

§ 4:6.8 Volume Discounts

Just as "good" customers often receive incentive discounts, so "large" licensees may be prodded towards increased sales with the incentive of volume discount royalty rates. The reasoning is that with greater sales, licensors will receive greater royalties; hence both benefit. Of course, greater sales also mean (or should mean) greater profits for licensees. Nevertheless, it is sometimes in the licensor's interests to encourage greater licensee sales through the incentive of allowing the licensee to keep more money from what it sells.

One caveat: licensors should consider including a provision adjusting for inflation. Otherwise, in times of high inflation, the licensee will undeservedly pay lower royalties while selling no more licensed products.

The following clause provides for decreasing royalties if the increased sales are achieved in the particular year in question:[20]

Volume Discounts

N.1 Whenever during any calendar year the combined Net Sales upon which royalty payments are accrued by LICENSEE to OWNER under Section [Royalty payment provisions] shall

20. This language appears in subsection N.1 of Example 4:15.

exceed Thirty-Five Million Dollars ($35,000,000.00), then thereafter during that calendar year the royalty rate for all further Licensed Products sold or leased by LICENSEE in the United States shall be reduced to four percent (4%)[21] until said combined Net Sales exceeds Sixty-Five Million Dollars ($65,000,000.00).

N.2 Whenever during any calendar year the combined Net Sales upon which royalty payments are accrued by LICENSEE to OWNER under Section N.1 shall exceed Sixty-Five Million Dollars ($65,000,000.00), then thereafter during that calendar year the royalty rate for all further Licensed Products sold or leased by LICENSEE in the United States shall be reduced to three percent (3%).

N.3 In each calendar year after calendar year _______, the dollar sales amounts set forth in Sections N.1 and N.2 to establish royalty rate volume breakpoints, and the calendar year limits on royalty payments set forth in Sections N.1 and N.2, shall be adjusted upward for the next succeeding calendar year to reflect the cumulative Consumer Price Index for all Urban Consumers, U.S. City Coverage ("CPI") percentage increase for the preceding calendar year. In the event that there is no cumulative percentage increase in the CPI during any calendar year, the dollar sales amounts and the calendar year limits shall not change for the next succeeding calendar year from their value for the current calendar year.

§ 4:6.9 When Royalties Accrue

At what point do royalties become due and payable? That is to say, when does the licensee owe the royalty?

There are several possibilities, including (1) when products are shipped or received; (2) when the customer is invoiced; or (3) when the licensee receives payment from the licensor. For licensees, the most favorable time for royalties to become due is upon the licensee's receipt of its customer's payment. All the licensee need then do is take the royalty payment out of the money received from the customer. But what if the customer does not pay, or pays late?

Because of the risk of no payment or slow payment, licensors argue against letting the licensee's royalty payment await the licensee's receipt of the customer's payment. They insist that since the licensee alone chooses its customers, it is the licensee who is best able to determine, and therefore bear, the risk of nonpayment.

21. From an original higher royalty rate, *i.e.*, 6%.

A means of addressing the payment issue that is more favorable to licensors is to have royalties due upon the earliest of invoicing, collecting, or shipping. While this assumes that the licensee's customer will pay promptly, it is not overly onerous if there is a lag time between accrual and payment. Often royalties are due quarterly, with a forty-to-sixty-day lag time between the end of the quarter and when royalties are due in the licensor's hands. If the sale occurs early in the quarter and the customer's payment is received soon thereafter, the royalty may not be due for several months. To illustrate, here is a possible time line:

January 4	**January 7**	**February 10**	**March 31**	**May 15**
Order Placed	Order Shipped/ Invoice Mailed	Invoice Paid	Quarter Ends	Royalty Payment Due Licensor

Here is an example of language in which the licensor enjoys accrual of its royalties at the earliest possible event:[22]

> Running royalties and royalties upon Sublicense Income under this Agreement shall accrue hereunder upon the earliest of of the following:
>
> (a) when income from the sale or lease of Licensed Products shall have been received by LICENSEE,
>
> (b) when the sale or lease of Licensed Products shall have been invoiced by LICENSEE, or
>
> (c) if invoices are not issued, when Licensed Products shall have been shipped by LICENSEE.

§ 4:6.10 Double Royalties

The issue is probably best presented in the form of the following question: When a licensee buys a part (which it is licensed to sell) from a third party which is also a licensee of the licensor, does it owe the licensor a royalty on its sale? Here is the scenario. Licensee *A* and Licensee *B* are licensed by Licensor *C* to make, use and sell *C*'s patented Fast Chip. *A* can make Fast Chips more cheaply than *B*. *B* needs Fast Chips to make its Speedy PCs. When *B* buys a Fast Chip

22. This language appears in subsection N.9 of Example 4:2.

from *A*, *A* pays *C* a royalty. When *B* sells its Speedy PCs, must it pay *C* a royalty on the Fast Chip contained in the Speedy PC?

C has already been compensated by one royalty payment for the Fast Chip (from *A*). *B* will argue that just like any other customer of *A*, it has already paid *C* a royalty through its purchase price from *A*; it should not be penalized for being a licensee of the Fast Chip by having to pay twice. This makes sense. It is thus not unusual for licensees to insert language to that effect in their licenses. Here is language that avoids confusion of resale and combination royalty calculations:[23]

> Acquire and Resale. LICENSEE shall have the right to acquire and resell [describe devices similar to the Licensed Products] manufactured by others. If the [devices similar to the Licensed Products] are acquired from a vendor who is licensed by OWNER under all of the patents listed in Exhibit "B" applicable thereto and pays the requisite royalties or fees to OWNER, then LICENSEE need not pay royalties hereunder for the [devices similar to the Licensed Products] so acquired with respect to which royalties or fees have been previously paid. LICENSEE shall pay all applicable royalties required under Article [Royalty Payment provisions] hereof for whatever additional royalty items are combined with said acquired [devices similar to the Licensed Products]. Where LICENSEE combines additional royalty items with a Licensed Product, LICENSEE's payment of additional royalties for the additional royalty items shall be determined in accordance with the provisions of Article [Royalty Payment provisions].

§ 4:7 Government-Imposed Royalty Ceilings

Analogous to usury limitations on interest in lending rates, governments have occasionally placed caps on royalty rates, for example, no royalty rate may exceed 6% of net sales. Necessities such as life-saving pharmaceuticals are particularly susceptible to such restrictions. Having set a maximum rate, the laws may effectively substitute that rate for the parties' higher contract rate—or, more drastically, the laws may declare the parties' entire royalty provision void for having exceeded the maximum.

To avoid such a harsh result, licensors may insert savings language limiting the royalty rate to the maximum allowed by law. To learn when royalties are approaching the legal limit, licensors can require licensees to provide notice. Here is an example of a royalty savings clause with such warning provision:

23. This language appears in Example 4:21.

> In the event the royalties set forth herein are higher than the maximum royalties permitted by the law or regulations of a particular country, the royalty payable for sales in such country shall equal to the maximum permitted royalty under such law or regulations. Notice of said event shall be provided to OWNER. An authorized representative of LICENSEE shall notify OWNER, in writing, within thirty (30) days of discovering that such royalties are approaching or have reached the maximum amount, and shall provide OWNER with written documentation regarding the laws or regulations establishing such maximum.

§ 4:8 Royalties Paid by Licensees Outside the United States

§ 4:8.1 Currency Conversion Date

Currencies fluctuate, unpredictably and sometimes wildly. If royalties are payable in U.S. dollars (as they frequently are), then whether the local currency is strong or weak can be a blessing or a curse to the licensee. In any event, to avoid any attempts to take advantage of the fluctuations, the parties need to agree to a conversion date.

The time at which conversion is made is often the last day of the reporting period, for example, the last business day of the reporting quarter,[24] or the last day on which public currency trades occur.[25]

Another approach is to specify a period of trading days at the end of the quarter, and average out the conversion rates over that set number of days:[26]

> [A]ll amounts payable shall be converted into U.S. Dollars using the average of the daily exchange rates for such currency quoted by the Bank of America, N.A. for each of the last fifteen (15) banking days of each calendar quarter.

§ 4:8.2 Repatriation of Profits

Making money in a foreign country and getting it out are often two different things.

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24. "[C]onversion shall be made by using the exchange rate prevailing at the Chase Manhattan Bank (N.A.) on the last business day of the calendar month of the quarterly reporting period to which such royalty payments relate."
25. "LICENSEE shall convert such other currencies, for purposes of calculating Royalties, at currency conversion rates published by the Wall Street Journal, U.S. West Coast Edition, on the last day of publication in the quarter during which revenues accrue."
26. This language is adopted from Example 4:33.

Foremost on the licensor's mind is assuring that the licensee, often the party with the more extensive foreign contacts, will help rather than hinder the licensor's repatriation of its royalties. Adding the following sentence should help to assure licensee assistance in getting the money back to the United States:[27]

> If at any time legal restrictions prevent the prompt remittance of part or all of any royalties with respect to any country in the Territory where any Licensed Product is sold, payment shall be made through such lawful means or method as the parties reasonably shall determine, the parties agreeing to fully cooperate in effecting such remittance.

While the licensor is struggling to find a way to repatriate its royalties, it is best for the licensor to have custody of the funds, even if its possession is restricted to the foreign country. If the licensee is holding the money, it may be less diligent in releasing the funds to the licensor. Akin to the phrase "possession is nine-tenths of the law," taking custody of the royalties is often of paramount interest to licensors. The following sentence is an example of such a provision.[28]

> In the event that foreign moneys are not capable of export to the United States, LICENSEE shall cause the same to be deposited in a bank in such foreign country in an account which shall be established, owned and controlled exclusively by OWNER.

§ 4:9 Enforcing Payment Obligations

What does a licensor do if the licensee fails to pay? The most common immediate response is interest upon unpaid balances and termination if the unpaid balance remains unpaid after a specified period.

What does a licensor do to avoid an insolvent, judgment-proof licensee? One tactic is for the licensor to take a security interest in the licensed products. Here is an example of such a provision specifying both interest and a security interest.[29]

Remedies for Non-payment

4.1 **Interest.** Amounts due and payable hereunder but not paid by the date due hereunder will be subject to an interest charge from the date such payment was due until payment equal to the highest U.S. Prime Interest Rate per annum published in The Wall Street Journal on the first business day

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27. This language appears in subsection N.6 of Example 4:3.
28. This language appears in subsection N.6 of Example 4:2.
29. This language appears in Example 4:62.

after the payment first became due, plus _______ percentage points.

4.2 **Other.** Failure on the part of LICENSEE to timely pay for Licensed Products when such payment is due as provided herein shall give OWNER the right (without prejudice to any other remedies):

4.2.1 to enforce its security interest granted pursuant to Section 4.3; or

4.2.2 to give written notice to LICENSEE that LICENSEE shall not sell or part with possession of the Licensed Products until the transfer payments set forth in Section [Royalty Payment provisions] shall have been paid in full, with which LICENSEE shall comply.

§ 4:10 Royalty Payments If Patent Not Yet Issued

Sometimes the licensor will license an invention over which a patent application is still pending. While the parties usually proceed on the trusting conviction that a patent will issue, it may never do so. The effect on royalties in the event of eventual failure to achieve a patent on the invention is subject to negotiation.

The parties could agree that no royalties will be due in a jurisdiction in which there is no patent protection. The rationale is that anyone may make, use, and sell the licensed product in such a jurisdiction. If a licensee must pay a royalty there, it will be handicapped in competing with firms that are not saddled with a royalty payment. It may be discouraged from selling any licensed products there, which would gain the licensor nothing. On the assumption that a little of something is better than a lot of nothing, the licensor may seek a nominal royalty in such jurisdictions.

Here is an example of a provision in which the royalty is reduced in any jurisdiction in which no patent is issued by a certain time:[30]

> No Issuance of Patent. In the event that no patent within the OWNER's Patent Rights covering a Licensed Product has issued in any country within the Territory by the end of 3 years following the commencement of the commercial sale of such Licensed Product in said country, LICENSEE's obligation to pay further Earned Royalties on sales of such Licensed Product in said country shall be reduced by 50% from the rates described in Section [Earned Royalty provisions], and such obligation shall terminate 15 years following said commencement of commercial sales.

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30. This language appears in subsection N.7 of Example 4:8.

> However, if a patent shall subsequently issue in said country covering such Licensed Products, LICENSEE shall be obligated to pay the Earned Royalties on Net Sales at the standard rates described in Section [Earned Royalty provisions] from the date of such issuance.

§ 4:11 Expiration of the Patent

Licensees may insist that the obligation to pay royalties end upon the expiration or abandonment of the underlying patent. The logic is that the royalty is contingent upon the protection offered by the patent; without that protection, there is nothing of value conveyed to the licensee. The world may freely make, use, and sell the licensed product, so there is no reason for the licensee to pay for the right to do so.

Here is an example of such a provision:[31]

> Expiration of Patents. Upon expiration or abandonment of any patent or any claim included within the OWNER's Patent Rights, all obligation of LICENSEE to pay Earned Royalties to OWNER based on such patent or claim or any claim patentable indistinct therefrom shall cease as of the date of such expiration or abandonment.

§ 4:12 Royalties After Patent Expiration

§ 4:12.1 *Absolute Bar (*Brulotte v. Thys Co.*)*

Over forty years ago the Supreme Court held in *Brulotte v. Thys Co.*,[32] that "a patentee's use of a royalty agreement that projects beyond the expiration date of the patent is unlawful *per se*." In *Brulotte*, farm equipment was sold for a flat price accompanied by a license that required an annual royalty charged for use of the machine. The royalty was based on the amount of hops harvested with the machine. The licenses could not be assigned, nor could the equipment be removed from the purchaser's county. The patent license had expired but the licenses still required royalty payments nevertheless. The licensee refused to pay royalties.

The Supreme Court's rationale was that the licensor had abused the monopoly to project royalties beyond the expiration of the patent and that after expiration, the monopoly is "spent" and an attempt to extend it further under a license agreement is unenforceable.[33] The licensee argued that the post-expiration royalties were a means to

31. This language appears in subsection N.8 of Example 4:8.
32. Brulotte v. Thys Co., 379 U.S. 29 (1964) (emphasis by the court).
33. *Id.* at 33–34.

extend payment of the purchase price of the equipment, but the Court rejected the argument rationalizing that such was akin to a situation where nonpatented articles are sold at prices based on the amount of their use.[34] The court found it a "telltale sign" of patent misuse that the royalty was the same for pre-patent expiration as for post-patent expiration use and that the license prevented assignment of the machines or their removal from the county before as well as after expiration of the patents.

§ 4:12.2 *Absolute Bar Criticized (*Scheiber v. Dolby Laboratories*)*

Since 1964, *Brulotte* has served as a per se prohibition on the collection of patent royalties extending beyond the expiration of the licensed patent. *Brulotte* has been criticized as antiquated and inconsistent with the underlying purpose of U.S. patent law. *Brulotte* had its most blistering review in a decision written by Judge Posner in *Scheiber v. Dolby Laboratories*.[35]

Scheiber was a musician and inventor who held several patents covering the audio system known as "surround sound." He sued Dolby for patent infringement. The parties settled by agreeing that Scheiber would license his patents to Dolby. The last U.S. patent was scheduled to expire in May 1993. Dolby desired a lower royalty rate which it could pass on to its licensees. Dolby suggested and Scheiber agreed that in return for a lower royalty rate Dolby would continue to pay royalties even after the patents had expired.

Dolby nonetheless refused to pay royalties on any patent after it expired. Scheiber sued to enforce the license agreement. The district court granted Dolby summary judgment and dismissed the suit agreeing with Dolby's argument that the Supreme Court's *Brulotte* decision trumped the parties' agreement and precluded enforcement of royalty payment obligations on any patent after it has expired. Scheiber appealed to the Seventh Circuit Court of Appeals.

Judge Posner, who authored the opinion, felt duty-bound by *Brulotte* to rule for Dolby reasoning "that by extracting a promise to continue paying royalties after expiration of the patent, the patentee extends the patent beyond the term fixed in the patent statute and thereby in violation of the law."[36] While this was the letter of the law, Posner was not happy in enforcing it. His view was that "[t]he duration of the patent fixes the limit of the patentee's power to extract royalties;

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34. *Id.* at 31.
35. Scheiber v. Dolby Labs., 293 F.3d 1014 (7th Cir. 2002).
36. *Id.* at 1017.

it is a detail whether he extracts them at a higher rate over a shorter period of time or a lower rate over a longer period of time."[37]

Brulotte, according to Posner, was a "free-floating product of a misplaced fear of monopoly" emanating from the bygone days when every patent was assumed to create anticompetitive monopoly power.[38] Recognizing, however, that appellate courts had no authority to overrule Supreme Court precedent "no matter how dubious its reasoning" or "even how out of touch with the Supreme Court's current thinking," the trial court dismissal had to be affirmed.

§ 4:12.3 **Brulotte** ***Not Always Followed (But Must Be Followed)***[38.1]

The absolute bar of *Brulotte* against paying royalties after expiration of the licensed patent has not been universally followed. Despite the disgruntled adherence to *Brulotte* by Judge Posner in *Scheiber v. Dolby Laboratories*, at least one district court was not as strict in its obedience to *Brulotte*.

In *Bayer AG v. Housey Pharmaceuticals, Inc.*,[39] the district court held that various patent license terms, including a reach-through royalty which extended beyond the expiration date did not constitute patent misuse. The patents in *Housey* claimed research methods and tools utilized in drug discovery, not the resulting drugs. Housey offered Bayer a license. Bayer refused and brought a declaratory judgment action alleging, among other defenses to infringement, that Housey's licensing scheme constituted patent misuse.

The license offered by Housey entailed alternative payment options. Licensees could pay either (1) reach-through royalties based on sales of drugs discovered by practicing the patented discovery methods and materials or (2) a lump sum. Bayer alleged that the reach-through royalty violated the rule against obligations to pay royalties which extend beyond the patent's life in contravention of *Brulotte*. The court held that such provisions do not violate *Brulotte*, because the royalties would be based on the licensee's use of the patented invention during research which occurred prior to the patent's expiration. The court in dicta stated that collection of royalties after a patent expires is not per se patent misuse.

Is *Brulotte* good law after *Kimble v. Marvel Enterprises, Inc.*?[39.1] Likely. The royalty was incurred for use during the life of the patent.

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37. *Id.*
38. *Id.* at 1018.
38.1. *See* section 4:12.4.
39. Bayer AG v. Housey Pharm., Inc., 228 F. Supp. 2d 467 (D. Del. 2002), *aff'd on other grounds*, 340 F.3d 1367 (Fed. Cir. 2003).
39.1. Kimble v. Marvel Enters., Inc., 135 S. Ct. 2401 (2015).

That is allowed. It is the payment that is deferred. Does that situation fall within the exemptions cited by the *Kimble* Court's dicta? Probably.

What if a licensee cannot pay the royalties (which are incurred during the life of the patent) in cash? This is common. The licensee may need the cash to hire sales people to sell licensed products. The licensor wants the licensee to sell more licensed products. To do so, the licensee convinces the licensor that the licensor will make more money (royalties) if it allows the licensee to invest in hiring more sales people than if it insists on being paid in cash now. Instead of cash, the licensee offers a promissory note or stock.

After reciting how its decision did not preclude flexibility in licensing, it is doubtful the *Kimble* Court would quash such arrangements.

§ 4:12.4 *Supreme Court:* Brulotte *Must Be Followed (*Kimble v. Marvel Enterprises, Inc.*)*

Is *Brulotte* alive? Asked to overrule it, the Supreme Court declined to do so.[39.2]

In *Kimble v. Marvel Enterprises, Inc.*, "Marvel Entertainment's corporate predecessor agreed to purchase petitioner Stephen Kimble's patent for a Spider-Man toy in exchange for a lump sum plus a 3% royalty on future sales. The agreement set no end date for royalties. As the patent neared the end of its statutory 20-year term, Marvel discovered *Brulotte* . . . ."[39.3] Marvel then sought a declaratory judgment that it could stop paying Kimble royalties. The district court granted relief, and the Ninth Circuit affirmed, as did the Supreme Court.

But parties still have some flexibility, despite the Court's upholding of *Brulotte*.

Perhaps responding to widespread criticism that *Brulotte* was outdated, the Supreme Court tempered its *Kimble* decision with the observation that *Brulotte* did not kill flexibility; the parties are allowed some leeway in contracting for what they want.

According to the Court, the following options still exist in licensing patents:

1. Licensees may "defer payments for pre-expiration use of a patent into the post-expiration period."[39.4]

2. Licensees can amortize royalty payments. The Court gave the example of a licensee agreeing "to pay the licensor a sum

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39.2. *Id*.
39.3. *Id*. at 2403 (synopsis).
39.4. *Id*. at 2408.

equal to 10% of sales during the 20-year patent term, but to amortize that amount over 40 years. That arrangement would at least bring down early outlays, even if it would not do everything the parties might want to allocate risk over a long timeframe."[39.5]

3. The Court observed that there will be "still more options when a licensing agreement covers either multiple patents or additional non-patent rights."[39.6] "[P]ost-expiration royalties are allowable so long as tied to a non-patent right—even when closely related to a patent. That means, for example, that a license involving both a patent and a trade secret can set a 5% royalty during the patent period (as compensation for the two combined) and a 4% royalty afterward (as payment for the trade secret alone)."[39.7]

4. More broadly, the Court noted that "*Brulotte* poses no bar to business arrangements other than royalties—all kinds of joint ventures, for example—that enable parties to share the risks and rewards of commercializing an invention."[39.8]

§ 4:12.5 Practical Effects of Brulotte

It is not unusual for a potential licensee to desire a patent license but be unable to afford the market royalty the patent commands. The cash-poor potential licensee may propose various means of paying the royalties that often entail some form of extended payments. The patentee who is willing to entertain such offers is often amenable, as was the patentee in the *Scheiber v. Dolby Laboratories* case, to such financing. *Brulotte* has called into question the enforceability of such creative means of financing a patent license.

One way licensors and licensees have attempted to circumvent the harsh effect of *Brulotte* is by using deferred payments of royalties. Under such an arrangement, the royalties are considered paid up and described as such in the license agreement, but the payments are extended after the patents expire. This could be a risky approach. A court could reject such an attempt finding the payment, regardless of when made, to be a royalty. Because royalties under *Brulotte* may not be collected after the patent expires, when the obligation to pay is strung out or in installment payments it could be held to be invalid.

39.5. *Id.*
39.6. *Id.*
39.7. *Id.* (citation omitted).
39.8. *Id.*

Another method is to use promissory notes that state that the obligation is for past debts, that is, for past royalties. Yet another method is to have the licensee borrow from a third party and use the proceeds to pay the licensor. All of these methods are subject to the risk that the licensee will ultimately refuse to pay and will assert the *Brulotte* rule. A court asked to enforce such obligations may refuse on the basis that creative payment schemes should not be permitted to circumvent *Brulotte*.

Another technique to extend payments over the life of one patent is to license it with other patents. Under this technique, known as package licensing, the patentee licenses multiple patents with varying expiration dates. The obligation to pay royalties will continue until the last licensed patent expires. Some patentees will attempt what they consider a safer approach and have the royalties decrease as the patents expire. This is often referred to as step-down royalties. At least one court has held that no reduction in royalties is required as long as there was no coercion applied by the patentee when entering into the license.[40]

Patentees have also included in their license agreement recitations which are intended to support them in future challenges. Such recitations include statements that the parties have entered into the license of their own free will, that the terms were agreed upon in an arm's-length negotiation, that the royalties are a fair reflection of the agreed and perceived value of the patents to the parties, that specific royalty rates for each patent were not determinable at the time of the entering into the license, and that the royalties rates were determined, in part, as a matter of convenience to the parties.

§ 4:13 Hybrid Licensing: Split Royalty Rates for Patents and Trade Secrets

Royalties cannot be paid on expired patents. The Supreme Court affirmed this in *Kimble*. However, royalties can be paid indefinitely on trade secrets.

To allow this in one license agreement, there must be some separation between provisions covering patents and provisions covering trade secrets.

§ 4:13.1 Two Separate Royalties

Because royalties cannot be collected on expired patents, the royalties on patents and trade secrets need to be separate after the licensed patents expire. There are two approaches.

40. Sunrise Med. HHG, Inc. v. Airsep Corp., 95 F. Supp. 2d 348 (W.D. Pa. 2000).

Two Royalty Rates from Commencement. This approach entails two separate royalties from the beginning:

- A royalty on the licensed patents; and
- A separate royalty on the licensed technology.

Under this approach, the patent could be licensed at a rate of 3% and the trade secrets could be licensed at 4%. When the patent expires, the license on the patent would expire. The licensee no longer has an obligation to pay the 3% royalty. The licensee is still obligated to pay 4% on products covered by the trade secrets.

Step-Down Rates Upon Patent Expiration. Under this approach, there is one royalty at commencement of the license. Upon expiration of the licensed patent, the royalty steps down to a prenegotiated lower rate.

For instance, the royalty rate at the beginning of the license would be 7%. When the patent expires, the royalty rate would drop to 4%.

§ 4:13.2 Determining the Rates

A hotly negotiated aspect of hybrid licensing is determining the royalty rates for the licensed patents and the royalty rates of the licensed trade secrets. This is true for both approaches in section 4:13.1 above.

One aspect to consider is geography. Patents are limited to the country that issues the patent. Trade secrets are presumably valid wherever they remain secret.[40.1]

Licensors will likely wish to assert a higher royalty on the trade secrets. They are potentially more valuable for several reasons:

- They can last forever (assuming they remain secret).
- They are valid everywhere (where they qualify by law as trade secrets).
- There are fewer logistical and accounting issues (proving the quantity and where the products are sold).

§ 4:14 Determining Royalty Rates

Every patentee and company with a patent portfolio is first and foremost interested in the royalties that they will receive from their patents. Often patentees will consider what royalty rates their patents will command in the market before determining whether to embark on a licensing program.

40.1. Obviously, if the trade secret becomes public, the information is worthless.

The methodology used to calculate a proposed royalty rate for a proposed licensee is important; it can also vary by type of invention, industry (for example, pharmaceuticals command higher royalties than manufacturing equipment).

There are several approaches that can be used, the most appropriate one often dependent upon the potential licensee. For instance, royalty rates for comparable products are normally persuasive. Market royalty rates for a medical device performing similar functions can be a useful benchmark. If the client's patent offers better features, a higher royalty may be justified.

If the license scheme is to license numerous users under a mass licensing scheme, then a set or published royalty schedule will normally suffice. If the potential license fees are substantial, then flexibility is key to tailoring a license deal for large customers. We frequently use the following factors in negotiating patent royalty rates:

- Strength of the patent (ability to withstand declaratory judgment);
- Scope of the claims (narrow or broad);
- Exclusive or nonexclusive;
- Territorial extent;
- Degree of innovation;
- Susceptibility to design around;
- Competing technologies;
- Risks to licensee (ramp up costs, legacy issues);
- Strategic fit (new direction or close to present product line);
- Licensee finances;
- Motivation (for example, profitability, cost savings, keeping up with the competition);
- Deal structure flexibility (cash, equity, mixture);
- Royalty stacking.

§ 4:15 Definition of Sublicense Consideration

Perhaps uppermost in a licensor's mind is assuring that it is fully paid the royalties due under the agreement. This goes not just for payments due directly from the licensee but also for payments due indirectly from sublicensee's royalty payments to the licensee.

To avoid underpayments due to consideration received in a form other than cash, licensors may consider definitions that address the issue. The types of noncash consideration licensors may be concerned with are securities, equity, warrants for equity, and forgiveness of debt. While it may seem indefensible for a licensee to accept noncash consideration and not report it as royalties, licensors may include it in the definition of consideration.

Licensors may also include any value over and above the fair market value of equity received.

Here is an example of such a definition:[41]

> "Sublicense Consideration" shall mean consideration of any kind received by the Licensee from a sublicense for sales of Licensed Products or fees received, in whatever form (including, without limitation, <u>cash, securities, equity, warrants for equity, forgiveness of debt, or in kind consideration</u>), such as upfront fees or milestone fees and including any premium paid by the Sublicensee over Fair Market Value for stock of the Licensee received in consideration for such sublicense.

What happens if the sublicense is transferred or assigned as part of a change of control (such as a merger or acquisition) and money is paid for the value of the sublicense agreement? Should the licensor share in such consideration? To avoid ambiguity and a consequent dispute over whether the consideration should be shared, the licensor may include language like the following:[42]

> "Sublicense Consideration" means the <u>actual</u> cash income or <u>other forms of consideration actually</u> received by LICENSEE in exercising its rights under the License, including, but not limited to, cash income and other consideration received for <u>or consequent</u> to any sublicensing or permitted assignment of the sublicense.

41. This language is found in Example 4:74.
42. This language is found in Example 4:72.