

Your First Licensing Deal: The Ins and Outs of Licensing Agreements — Part Two

by Billie Audia, Attorney, Zermatt Legal Group

This is the second article in a DEN newsletter two-part series on negotiating your first licensing deal. The first article reviewed license grant terms, including intellectual property ownership and grant restrictions, encouraging entrepreneurs to strategically negotiate the grant provision so it meets their business objectives. This article looks at two additional key facets of an entrepreneur's first licensing deal: publicity and payment terms.

Publicity Terms

As the entrepreneur negotiating a commercial licensing agreement with Big Company licensee, you will be focusing on the aspects of the deal that are well-known to be critically important to your emerging business such as protecting your IP, mitigating risks and earning licensing revenue. However, it may be beneficial to devote attention to other deal terms as well, such as the often-overlooked publicity provision. Many Big Company standard licensing agreements will not include any mention of marketing, publicity, or press release – because they do not need it to bolster their business. But, imagine, for example, the benefits that an emerging software company may derive when a press release hits the industry trade journals announcing the deal they just inked with Cisco: instant industry credibility, VC and investor attention and the start of a win/win track record.

Dave DeLucia, CEO of ImmuRx, a DEN-incubated bio-tech start-up based in the Upper Valley negotiated one of the company's first licensing deals with a Big Pharma company and he purposefully included a press release provision in the deal terms. He remarks, *"Successfully launching a new company requires that you create expectations of success. A deal with a large company confers credibility to your effort - if and only if you have permission to publicize the relationship. Therefore, getting a provision that you can publicize the relationship is very valuable to the start-up."*

The beauty of requesting such a provision from the Big Company licensee is that neither party incurs any costs, but the start-up may glean enormous benefits. Generally, the licensee will want to review and pre-approve the press release prior to it being issued, which is fine as long as the entrepreneur drafts it shortly after the deal is signed and the licensee's approval is not unreasonably withheld.

Payment Terms

Let's turn our attention to a critically-important term in any licensing deal – the revenue and payment provisions. What type of payment structure or combination thereof best suits your business model? Does your business need an immediate cash infusion? If so, then an up-front payment structure may work best. Or, perhaps you are after a steady income stream over time. If so, then a guaranteed minimum royalty payment may be most appropriate. Generally, licensing agreements include one of three types of payment arrangements: royalties based on sales, up-front payment or usage-based fees. While there are other ways to structure licensing fee payments, these three structures are the most common. This article provides an overview of each.



Billie Audia is a commercial lawyer with over 15 years experience advising emerging and Fortune 100 companies on IP strategy, licensing agreements, royalty arrangements, and international legal matters.

 continued on next page

The Ins and Outs of Licensing Agreements — Part Two

- continued from page 18

Royalty based on sales. Royalties based on “net sales” is the most common payment arrangement in any type of licensing deal. Ideally, the licensor is paid a percentage of the licensee’s gross sales revenue minus returns that are actually credited. Assuming the definition of net sales is reasonable, licensors generally favor this payment type because it affords them an opportunity to be paid over the lifetime of the product or service.

The key is honing in on the definition of “net sales”. As the entrepreneur-licensor you want a straightforward definition of net sales (e.g., gross sales revenue less credited returns), so your royalty percentage will be based on the highest possible sales number. The licensee, however, likely will strive for a comprehensive net sales definition. For example, the licensee may want it to include not only credited returns, but also marketing costs, postage, office space lease, packaging and investments, so that the royalty percentage owed will be calculated on as small of a sales number as possible. If this is the case, the licensor may want to suggest that these are simply the costs of the licensee doing business and should not be considered as a licensor expense.

“As the licensor if you are granting sublicensing rights to the licensee, then the net sales definition should also include “sales by sub-licensees”, as Alla Kan, the Director of the Technology Transfer Office at Dartmouth College, points out, “This will allow the licensor to share in any revenue the licensee may derive from such sublicensing rights, which is often called “pass through royalties”.

You may also want to consider structuring the deal so that you have a guaranteed minimum royalty payment each quarter with any additional royalties being paid when net sales exceed a certain threshold. In addition to the net sales definition, you should consider how the royalties are calculated – on an accrual or cash basis. Lastly, you will want to ensure the licensee’s reporting obligations have enforcement teeth and that you have a right to audit. It is wise to scrutinize the royalty provisions and seek advice from an industry-expert business lawyer before agreeing to terms.

Up-front payment. Up-front payment terms mean the licensee pays you – the licensor – at the start of the deal for the right to license your product or service. Obviously, this puts money in your hands quickly and if your business needs an immediate cash infusion this could be the desired model – that is, assuming the terms are straightforward and the license scope is limited. On the other hand, if your product becomes wildly successful and the license was perpetual, then you may think your up-front payment was not ample compensation for the licensee’s perpetual use of your product or service.

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From the entrepreneur’s perspective, the cleanest up-front payment provision ensures that the licensee pays you, in full, upon execution of the agreement with no refund capabilities. The licensee, however, may desire to delay – or possibly incrementally stage – the up-front payment until he/she sees that the software is performing as specified or when sales hit a certain minimum threshold. You may, in addition to your up-front payment, want to include a future royalty based on sales when and if the sales reach a certain threshold, so you are sharing in the ongoing revenue stream. Likely, the licensee may want a full or partial refund option, for example, if the product does not perform properly.

Usage-based or unit-based license fee. A usage-based or unit-based license fee means the licensee pays you a fee for each use they make of your licensed product or service. For example, if you patented the process for coating glass for halogen lights, your process may be used in the halogen light manufacturing operation and you would charge a fee based upon the number of glass units produced using your process. Or, if you are licensing software, you may charge a fee for each person accessing your technology or for each server on which your software is installed. If you plan to include a user-based fee structure, be sure to require that the licensee use a usage tracking system and accurately report all usage, which should be reinforced contractually with omission penalties. Oftentimes, software vendors will embed tracking mechanisms in their software to ensure accurate usage reporting and to avoid confrontations with licensees over reporting and payment errors.

There are numerous ways to negotiate a licensing payment provision, so consider the aspects that are critical to your business and consult with your business lawyer accordingly.

This two-part series is intended to provide you with an overview of licensing terminology and offer for your consideration strategic ways to structure your first licensing deal. Before entering any licensing arrangement, you should consult with your business lawyer to ensure it protects your company’s interests and meets business objectives. While the content of this 2-part series should not be considered legal advice, we hope it provides guidance on getting the most out of your first licensing deal.