Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Pros And Cons Of Licensing Technology

By **Toni Hickey, William Barrow and Charles Harris** (August 3, 2018, 12:57 PM EDT)

Toni Hickey

William Barrow

Charles Harris

Businesses must continually adopt new technologies to remain profitable, innovative and competitive in today's global market. Many companies are choosing to achieve these goals by collaborating with others through licensing programs, outsourcing, joint ventures, acquisitions or other strategic partnerships. Each of these affiliations almost always requires the inbound or outbound licensing of intellectual property.

Statistics show that licensing activity is at an all-time high. In 2017, global revenues attributable to trademark licensing alone were over $271 billion, representing a 12.5 percent increase over three years.[1] Still, companies should carefully consider whether and how to license technology, as licensing arrangements can present a conundrum for both IP owners and licensees. Indeed, while the outbound licensing of technology offers a practical approach for businesses to generate new revenue streams, IP owners must balance this benefit against a myriad of possible pitfalls. Likewise, inbound licensing can be a valuable tool to accelerate innovation cost-effectively, but potential licensees often face uncertainty as to the financial outlay required to exploit inbound technology.

The question becomes: How does a company approach granting or procuring licensed IP in a disciplined and diligent way that maximizes rewards and minimizes risks? This article begins with a discussion, from both the licensee's and licensor's perspectives, about the pros and cons of licensing IP and the difficulties they face in pricing IP for licenses, and then concludes with tips for safely and effectively licensing technology.

A Corporate IP Owner's Viewpoint

The Pros

Many businesses own extensive IP portfolios that include patents, patentable inventions, know-how and copyrights, as well as trade secrets, trademarks and domain names. The most common reason companies license IP is that outbound licensing (also referred to as “licensing out” or “out-licensing”) can be a useful and simple way to monetize underutilized technology. However, there are many other potential advantages to licensing out IP that may be less evident. For instance, outbound licensing can:

- strengthen relationships and reinforce a company’s value with its existing customers and others;
- facilitate penetration into new markets and distribution channels that may have been inaccessible (without an increase in capital expenditures or ongoing expenses);
- allow a business to rely on the expertise, capacity and skill of a licensee to commercialize IP, which is especially valuable when a company lacks the infrastructure, financial resources and know-how to bring a product to market independently;
- provide access to improvements a licensee made to its licensed technology without the related research and development costs (i.e., through “grant-back” clauses in licenses);
- provide a company with access to new technology or neutralize blocking technology through cross-licensing;
- give a business some control over the technical standards set by national and international standard-setting organizations, which typically require that patentees grant licenses for technology adopted in the standard-setting framework under fair, reasonable and nondiscriminatory terms, or that the license be royalty-free;
- enhance the company’s brand recognition in new markets; and
- convert an infringer or competitor into a collaborator by avoiding or settling IP litigation, and reduce the risks of future litigation or licensing demands.

The Cons

As noted above, there are also potential drawbacks to licensing out IP. Businesses should understand and assess these disadvantages, as they can easily outpace the benefits described above. For instance, the considerable resources required to create a licensing program may be a potential downside for businesses. Launching a sophisticated program requires many time-consuming steps, such as: auditing the company’s existing IP, identifying the IP to license out and creating a licensing strategy, pursuing potential licensees, negotiating and drafting license agreements, and subsequently monitoring the licensed IP. Accomplishing these tasks can require a significant investment of time from corporate stakeholders, in-house and outside legal counsel, and other outside consultants.

There are other potential dangers regardless of whether a company is considering establishing a licensing program or ad hoc outbound licensing. For example:

- Creating a Competitor. A significant downside to outbound licensing is that a licensee could become a competitor. For example, a licensee may have a more effective go-to-market strategy than the licensor, or customers may prefer the licensee’s product. The ultimate effect of creating a competitor is that the licensor may make less in royalties than it foregoes in lost sales to the licensee or, even worse, that the licensor yields market share to the licensee.

- Depending on a Lousy Licensee. A licensor may have to rely on the skill, ability and know-how of a licensee to fulfill its revenue goals, such as where the licensor grants an exclusive license and its only source of revenue is royalties generated by the licensee. When a licensee is inept, the licensor could fail to recover its investment in technology or lose a potentially profitable market opportunity it could have exploited itself.

- Exploitation of the Licensed Technology. A licensee may attempt to exploit a licensor's IP once statutory rights have expired (such as for patents) or upon termination of the license if the agreement does not include terms preventing such abuse.

- Loss of Control Over Technology. Licensors have to surrender control over their technology to licensees and in doing so, can lose some degree of control over their IP. This concern is most prevalent when a licensee is based overseas in a remote region.

- Diminution in the Value. Businesses that license out trademarks must invest resources in quality control measures to ensure that the licensee's use is compatible with brand standards and maintains the quality of the licensed products and technology. A decline in the performance or brand standards of a licensor's technology by a licensee may damage the goodwill previously obtained by the licensor.

- Litigation Risks. Several different litigation risks arise when a company licenses out technology. For instance, if license negotiations break down, a licensee may commence legal action in court or through an administrative agency to invalidate the IP in question. Also, licensing trademarks may expose the licensor to product liability suits. While the law in many jurisdictions is unsettled, some courts have held that a licensor may be liable to a plaintiff for injuries caused by a product manufactured by the licensee that bore the licensor's mark.

Many companies avoid outbound licensing due to the disadvantages outlined above.

A Potential Licensee's Viewpoint

The Pros

Inbound licensing (also referred to as "licensing in" or "in-licensing") can provide a licensee with cost-effective means to gain immediate access to new innovative technologies without the associated R&D expenditures. Many companies, especially small ones, don't have the necessary resources or capacity in-house to conduct their own R&D for technology advances. Inbound licensing can also:

- allow licensees to rapidly enter new markets or distribution channels, which may have otherwise been unavailable, with proven technologies or brands;

- allow licensees access to advanced technology to produce better quality or new products, or to use established trademarks to market their products;

- allow licensees early access to evolving technologies through FRAND licenses;

- help a licensee stay competitive and maintain market position in the highly competitive technology markets; and

- mitigate the risks of litigation for licensees and their downstream customers that might have incorporated their technologies into connected devices.

The Cons

The disadvantages to inbound licensing are less clear, but potential detriments include:

- Financial Commitment. A licensee may have to pay the licensor significant upfront costs and royalties to use and exploit licensed technology, mainly when the licensee is using the technology to expand its existing product or service offerings or to increase its market penetration.

- Licensing Immature Technology. If a licensee is not careful, it may in-license technology that requires significant enhancements before the technology can be commercially exploited in the way that the licensee intended.

- Dependence or Restrictions. A business could become too reliant on external technology to accomplish its business goals. The company may also limit its growth potential by agreeing to constrictive terms that frustrate its ability to expand into new markets or to fully exploit the licensed technology to create new products or services.

Licensees and licensors should also consider that the U.S. Department of Justice and Federal Trade Commission could find a license arrangement to be anti-competitive. These agencies have published guidelines to help businesses evaluate what practices might violate antitrust laws.[2]

The Difficulty of Pricing Technology for Licensing

Licensors and licensees often reach a stalemate during pricing discussions in license negotiations because each party places a different value on the subject IP and there is no established rule for valuing technology. Valuation in this context is inherently uncertain because IP assets are often unique, and license terms can vary widely and are typically confidential. Nevertheless, valuation analysts and IP professionals often use one or more of the following accepted methodologies to value and price technology:

- A cost-based approach is probably the easiest method to value technology, but it is also the least popular. Licensors particularly dislike this method because it fails to consider the future commercial value of IP. Rather, the value of technology rests on the costs to develop or replace the IP. This cost dimension can include direct costs such as materials and manufacturing, or indirect costs, such as development time and overhead.[3]

- A market-based approach is perhaps the most straightforward and logical method for valuing IP, but it is only useful when comparable market transactions exist. In a nutshell, this method treats IP like real estate and establishes its value based on pricing in comparable transactions. The difficulty with IP, as noted above, is the lack of historical data for comparable products bought and sold under publicly available license terms. Then again, a number of businesses are now selling spreadsheets created from aggregated survey data that catalog licensing royalty rates for products in various industries.[4]

- The income approach, perhaps the most commonly used IP valuation method, values technology by estimating past and future economic benefits. There are many metrics that parties can consider to arrive at an estimate of financial gain for an asset, including historical profitability, gross profit deferential, a rate of return, or the amount the licensor can afford or is willing to pay for the technology.[5] Commonly applied derivatives of the income approach are addressed directly below.

- The 25 percent rule (or "rule of thumb") for valuation can have several different indications, but usually means that either (1) the royalties will be one-fourth of the licensee's cost savings from using the licensed technology, or (2) the royalty is one-fourth of the licensee's net profits generated from selling products or services that incorporate the licensed technology.[6]

- The discounted cash-flow analysis approach calculates a present value of potential cash flows. Said differently, using this method, a party estimates future cash flows and adjusts them to their current value by applying a discount rate. The discount rate typically includes compensation for risks and anticipated rate of inflation.[7]

When valuing IP, parties should remember that compensation for licensed technology can come in many different forms, including royalties, cash, stock, R&D outlays, equipment, consulting agreements, grant-backs and access to technology. Notwithstanding any potential disadvantage to licensors, using royalties as the sole form of payment can avoid many of the aforementioned valuation issues. Instead, the parties simply rely on the wherewithal of the licensee to exploit the technology, though identifying a fair royalty rate may still be an area of disagreement.

Tips for Companies Looking to License In or License Out Technology

Keeping in mind the matters discussed above, there are several things licensors and licensees should do to get the most from a licensing arrangement and avoid difficulties:

1. Opportunity Cost

At the outset, prospective licensors and licensees should conduct a thorough assessment of the costs and benefits of licensing, including: identifying opportunities for strategic partnership, the impact of licensing on third-party business relationships, the tolerance in the company's industry for inbound and outbound licensing, the identification of subject matter areas in which the company can maximize return, and the potential costs associated with administering a licensing program.

2. Due Diligence

Licensors and licensees should perform extensive due diligence on each other. For licensors, this should include: a background check on the licensee, an assessment of its ability to achieve expected profits, consideration of whether the licensee could become a competitor or whether conflicts of interest may arise, and a review of the IP in question to affirm its validity. Due diligence by licensees should include some of the same actions. Also, licensees should ensure that the IP is still enforceable and protected in relevant jurisdictions and that their ability to exploit the IP is not constrained by any laws or regulations.

3. Comprehensive Valuation

Licensors and licensees should undertake a comprehensive assessment of all valuation options, including: identifying which valuation methods place them in the best bargaining position, how those methods comport with prior licenses and negotiations or any perceived standard royalty rates, and assessing creative means of consideration, including cross licenses, running royalties, issuance of stock or R&D funding. This may necessitate hiring outside consultants or counsel, but the upfront cost will be worth it in the long run.

4. Licensing Terms

Licensors and licensees should exercise extreme care in the preparation of the license agreement. Among other things, both parties should ensure that any desired provisions or protections are expressly spelled out in the agreement and checked against controlling precedent, implicated business partners are protected, and payment, duration, geographical scope, and subject matter coverage are as transparent as possible. Licensees may want to include provisions capping the amount of the licensor's royalties. Conversely, licensors may wish to preserve their right to terminate the license should the licensee not meet expected revenue targets.

5. Monitoring of Licensees

Licensors should monitor licensees' use of the IP to ensure compliance with the terms of the agreement as well as their financial and reputational expectations, including: monitoring royalties generated by the licensed IP, the quality of products sold under the licensed brand, and whether the licensee is doing anything to undermine the licensor's ability to collect damages from infringers in future litigation.

6. Litigation Preparedness

Licensors and licensees should be prepared for litigation, which may occur if: licensing negotiations are unsuccessful, disagreements over licensing terms arise, the licensor or licensee later decides to assert the IP against third parties, and third-party business partners are targeted as a result of their manufacture, sale or use of products related to the subject IP.

7. Enforcement Terms

The parties should also carefully consider the appropriate dispute resolution procedures when entering into a license. For instance, they might consider a multi-tiered dispute resolution clause that prevents the parties from commencing with a lawsuit or arbitration until they have either made several attempts to resolve the dispute amongst themselves or attempted mediation.

Toni Y. Hickey is chief IP counsel for Cummins Inc.

William J. Barrow is an associate and Charles E. Harris II is a partner at Mayer Brown LLP.

[1] Global Revenue From Licensed Goods and Services Grows to US$271.6 Billion, Licensing Industry Merchandiser's Association (May 22, 2018), https://www.licensing.org/news/global-revenue-from-

licensed-goods-and-services-grows-to-us271-6-billion/ (last visited Jul. 18, 2018); Lima Global Licensing Industry Survey 2015 Report, Brandar Consulting LLC, http://www.licensing.org/wordpress/wp-content/uploads/2013/11/LIMA-Global-Licensing-Report-2015-FINAL.pdf.

[2] U.S. Dep't of Justice and FTC, Antitrust Guidelines for the Licensing of Intellectual Property (Jan. 2017), https://www.justice.gov/atr/IPguidelines/download (last visited June 14, 2018).

[3] Robert F. Reilly, Intellectual Property Valuation Approaches and Methods, 46 les Nouvelles 198 (Sept. 2011).

[4] See, e.g., Gregory J. Battersby et al., Licensing Royalty Rates (2018).

[5] See Reilly, supra note 2.

[6] See Robert Goldscheider, The Classic 25% Rule and the Art of Intellectual Property Licensing, 2011 Duke L. & Tech. Rev 006 (May 2011).

[7] Kelvin King, The Value of Intellectual Property, Intangible Assets and Goodwill (June 2003), http://www.wipo.int/sme/en/documents/value_ip_intangible_assets_fulltext.html (last visited June 14, 2018).