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### Financial Terms in License Agreements

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## CHAPTER 8 – FINANCIAL TERMS IN LICENSE AGREEMENTS

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While lawyers often obsess over the “legal” terms of an agreement, it is likely that the most important contractual language from the parties’ perspective – at least the business representatives of the parties – are those describing their financial obligations to one another. Attorneys often give far too little time and attention to these financial clauses, assuming that the parties and their accountants, bankers and financial advisors will work out the “numbers” to their satisfaction. This assumption, however, is grossly inaccurate. The financial clauses of an agreement are rife with legal details that can have an inordinate impact on the deal. Thus, while attorneys need not opine as to the market value of a particular technology, they must be prepared to draft and negotiate language that gives effect to the business and financial assumptions of their clients.

This being said, there is a virtually unlimited array of financial clauses that can be deployed in a licensing agreement. Save for limited antitrust considerations (see Chapter 25) and voluntary restraints (e.g., the FRAND licensing commitments described in Chapter 20), there are few legal constraints on the form or amount of compensation that an IP holder may charge for its IP. Accordingly, parties are relatively free to formulate whatever business arrangement they wish.

This Chapter summarizes the most common forms of financial clauses that appear in IP and technology licensing agreements and illustrates how they are used in typical transactions.

### A. ***FIXED PAYMENTS***

Fixed payments are amounts that are pre-determined and specified in a contract, usually without reference to the licensee’s revenue or use of the licensed rights. Such payments can be due upon contract signing (or within a short period thereafter), in which case they are called **up-front** payments.

#### 1. ***Up-Front and Lump Sum Payments***

Up-front payments are not uncommon in many types of license agreements. If an up-front payment represents the entire consideration for the license, then it is also referred to as a **lump sum** payment.

When you pay \$1.99 for a new app at the Apple AppStore, you have paid a lump sum fee for a non-exclusive license. Often, privately-held biotech companies require up-front payments from their licensees in order to fund their operations prior to the development, approval and marketing of a product. These up-front payments are often made in exchange for exclusive license rights in a particular field or fields of use and are often paid in addition to running royalties on products that are eventually created under the license.

### Example: Up-Front Fee

Licensee shall pay Licensor a non-refundable, up-front fee of \$1,000,000 within ten (10) business days from the Effective Date.

One of the best-known lump sum license fees was that paid by Microsoft to Spyglass, Inc., the start-up that licensed the original “Mosaic” web browser from the University of Illinois. In the early 1990s, Microsoft realized that the Worldwide Web had significant commercial potential, yet Marc Andressen’s Netscape Communications seemed to have a corner on the market for web browser technology with its then-ubiquitous Netscape Navigator program. To jump-start its own entry into the web browser market, Microsoft sought rights to distribute Mosaic from Spyglass. Microsoft’s first offer was \$100,000. As the CEO of Spyglass explained to the *New York Times*, “the first offer from Microsoft on licensing deals is always \$100,000.”<sup>1</sup> By December 1994, Spyglass negotiated Microsoft’s lump sum license fee up to \$2 million, which entitled Microsoft to distribute Mosaic with its Windows 95 operating system. Microsoft renamed the browser “Internet Explorer” and began to give it away for free, a business model with which Netscape simply could not compete.



*Spyglass, Inc. licensed its Mosaic Web browser code to Microsoft for \$2 million. Mosaic became the basis for Internet Explorer.*

<sup>1</sup> Steve Lohr, *Spyglass, a Pioneer, Learns Hard Lessons About Microsoft*, NY Times, Mar. 2, 1998, p. D1.

Depending on the industry, up-front fees in license agreements can be quite large. One recent study of more than 1,000 biopharmaceutical licenses entered into between 1998 and 2018 found that average up-front fees paid were \$11.5 million with a high of \$240 million (for a tumor therapeutic licensed by Exelixis to Bristol-Myers Squibb).<sup>2</sup>

## 2. *Option, License and Maintenance Fees*

Option fees are also typically one-time payments of a fixed amount. Thus, if a company – usually in the biotech industry – grants another company an option to acquire exclusive license rights to IP at some time in the future, the option fee will be paid as a one-time fixed fee, and the purchase price or license fee payable upon exercise of the option will be a (usually larger) fixed fee.

Fixed payments need not be made in a single installment. In many cases, such payments can be due periodically – monthly, quarterly, annually or on some other schedule. Fixed annual license fees are not uncommon in some industries, such as enterprise software. Likewise, such arrangements often include charges for related services, such as software maintenance, support and updating, which is charged periodically (often annually) as a percentage of the annual license fee (often in the range of 15% to 25% of the annual license fee).

### **Example: Periodic License Fee**

Licensee shall pay Licensor a non-refundable license fee of \$1,000,000 no later than sixty (60) days prior to the beginning of each Contract Year hereunder.

## 3. *Non-Refundable Fees*

One question that is often raised in the context of fixed fees is the degree to which such fees are refundable if some future event, such as regulatory approval of a drug, does not occur. In general, up-front fees are **non-refundable** (see above drafting examples). They thus represent a risk to the licensee, which must pay whether or not the acquired rights turn out to be as valuable as promised. Yet, absent outright fraud by the licensor, there is little that a licensee can do to recover non-refundable up-front fees once they have been paid.

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<sup>2</sup> Mark Edwards, *Biopharma Milestone Payments: Negotiating and Equitable Value Allocation*, BioSciBD (Jan. 6, 2019) (supporting data), <https://biosciibd.com/biopharma-milestone-payments/#2>.

### MYRIAD'S FLURIZAN WINDFALL<sup>3</sup>

In the summer of 2008, Myriad [Genetics, Inc.] announced the results of its 18-month clinical trial for Flurizan. It was a failure. The drug provided no significant benefit in treating Alzheimer's Disease over the standard treatment regimen. Without further ado, the company discontinued its Flurizan development program.

Despite this blow to Myriad, Flurizan represented a personal victory for [CEO Pete] Meldrum. A little over a month before the clinical trial results were released, Meldrum had negotiated a deal with the CEO of Danish pharmaceutical manufacturer Lundbeck. Myriad granted Lundbeck the exclusive European marketing rights for Flurizan in exchange for an up-front, non-refundable payment of \$100 million. Lundbeck made the payment promptly. Forty days later, the clinical trial announcement was made and Flurizan was dead. Lundbeck's CEO balked, but the contract was airtight -- the payment was non-refundable. Meldrum walked away from the Flurizan fiasco with a cool \$100 million and turned Lundbeck into an industry laughing stock. Biotech journalist Adam Feurstein called Meldrum's coup "one of the smartest drug licensing deals of all time." To recognize his achievement, TheStreet.com named Meldrum "Best Biotech CEO of the Year".

#### 4. *Advances and Applicable Fees*

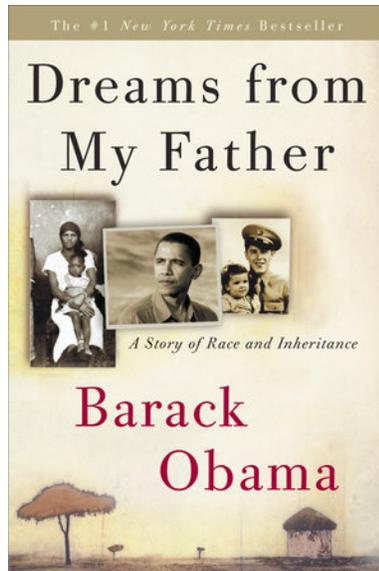
In some cases, up-front fees are characterized as advances against future payment obligations such as royalties. Such advances are common in the publishing, music and entertainment industries. In this model, authors and composers often receive an advance upon licensing their rights to a publisher. An advance can be paid before a work is delivered (common for non-fiction books) or upon the licensing of a manuscript (works of fiction) or sound recording.

The term "advance" indicates that such a payment is really a pre-payment of applicable royalties that may be due during the life of an agreement. Yet, in many cases, authors and other rights licensors receive only their advance, as earned royalties never exceed the amount of the advance.

In some cases, an up-front payment will be referred to not as an advance, but as "applicable" to a future payment obligation. This is sometimes the case with option fees. For example, a \$5,000 option fee may be described as "applicable to" the purchase price of the relevant right if the option is exercised. If the option fee is not applicable to the purchase price, then it is referred to as "non-applicable".

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<sup>3</sup> From Jorge L. Contreras, *How the Gene Was Won* (forthcoming) (citations omitted).



Former President Barack Obama received a \$20 million advance in 2017 for his memoir *Dreams from My Father*, the largest single-book advance on record, though some argue that Bill Clinton’s \$15 million advance for his 2001 memoir *My Life* was larger in inflation-adjusted dollars.

## B. ***RUNNING ROYALTIES – THE ROYALTY RATE***

For many types of intellectual property the most common form of payment is the royalty. A royalty is a periodic payment that is typically based on the licensee’s manufacture, use or sale of a licensed product or service, whether a new drug, a book or an action figure. These payments are often referred to as “running” royalties because they are paid over the course of the agreement term. The term “earned” royalty is commonly used to refer to royalties based on the licensee’s revenue, usually from sales of licensed products.

Royalties are typically calculated and paid periodically over the course of an agreement – monthly, quarterly, annually, or over some other fixed interval. Quarterly royalty payments are the norm in patent licensing agreements, though semi-annual payments are common in literary rights agreements. In general, royalties with respect to a particular period will be due and payable within some reasonable time after the end of the period (e.g., 30 days after the end of the relevant calendar quarter). A royalty report showing the basis for royalties paid is often required to accompany each royalty payment, and in Section I, below, we will discuss audit and other mechanisms used by licensors to check the accuracy of these reports.

Royalties are popular forms of compensation because they tend to align the interests of the licensor and licensee. That is, they typically increase in proportion to increases in the licensee’s own profits attributable to the licensed rights. Thus, if the licensee does well, so does the licensor. But while this general principle sounds straightforward, the calculation of royalties in licensing agreements can become devilishly complex, filled with room for interpretation and opportunistic behavior. This Section addresses some of the basic concepts necessary to understand royalty calculations, and Section C, which follows, addresses additional clauses used by parties when structuring their royalty arrangements.

## 1. *Per Unit Royalties*

### (a) *Flat Rate Royalties*

The simplest form of running royalty is one that sets a fixed charge for each unit of a licensed product sold or distributed by the licensee. An example of such a royalty provision is set forth below.

#### **Example: Per Unit Running Royalty**

In consideration for the licenses granted hereunder, Licensee shall pay to Licensor earned royalties at the rate of \$x.xx per unit of Licensed Product sold [*alternative*: manufactured].

Thus, if the royalty rate is \$0.10 per unit, and the licensee sells 500,000 units during a particular calendar quarter, then the licensee will owe the licensor a royalty of \$50,000 for that quarter. With a per unit royalty, it does not matter how much the licensee earns from its sale of licensed products, whether it offers discounts or even whether it makes a profit (or loss) on those sales.

Examples of per-unit royalties abound. As discussed in Chapter 16, the U.S. Copyright Royalty Board established a flat rate of 24¢ for every downloaded ringtone that includes a copyrighted musical work, whether composed by the *Rolling Stones* or your brother's weekend garage band. And, at its peak, the well-known DVDC6 patent pool charged disc manufacturers a flat rate of 7.5¢ per DVD disc. Because these per-unit rates are often denominated in cents on the dollar, they are sometimes referred to as "penny rates".

In some cases involving manufactured products, a licensor may not wish to wait to see whether a licensee sells the licensed products that it manufactures, and may require a per-unit royalty to be paid with respect to every licensed product that the licensee manufactures (or has manufactured on its behalf). This formulation tends to get the licensor paid earlier, and insulates the manufacturer from the vagaries of the licensee's sales efforts. Naturally, licensees will resist the manufacture of a product, rather than its sale, as the event triggering a royalty payment. After all, the licensee itself earns nothing when a product is manufactured but not sold, so the alignment of the parties' interests is weaker with such an arrangement. Nevertheless, licensors may find it easier to monitor or audit the output of a production line than dispersed sales across a wide geographic region, so there may be valid reasons that licensors insist on such provisions.

### (b) *Tiered Royalty Schedules*

Like percentage royalties (discussed below), per-unit royalties may be "flat" or "tiered". Flat royalties are the same no matter how many units of the licensed product are manufactured or sold, as illustrated in the example above. Tiered royalties, on the other hand, take volume into account, and usually decrease as the licensee's volume increases. For example, a tiered royalty schedule might look like this:

<i>Units sold during quarter</i>	<i>Royalty per unit</i>
0 – 5,000	\$1.00
5,001 – 50,000	\$0.85
50,001 – 100,000	\$0.75
100,000+	\$0.65

Using the above tiered royalty schedule, if, during the first quarter of the year, the licensee sold 60,000 units of the licensed product, it would owe the licensor \$1.00 for each of the first 5,000 units (or \$5,000), \$0.85 for the next 45,000 units (\$38,250) and \$0.75 for the next 10,000 units (\$7,500) for a total quarterly royalty payment of \$50,750. In the second quarter, the count would begin again from zero. Thus, if the licensee sold 100,000 units during the second quarter, it would owe \$5,000 + \$38,250 + \$37,500, or a total of \$80,750.

In some cases, the parties may not wish to reset the volume counter at the beginning of each royalty period, and may instead wish the licensee's volume tiers to continue to accumulate over the full year or the entire term of the agreement. For example, using the above example, suppose that the volume tiers continued to accumulate during the full term of the agreement instead of resetting each quarter. During the first quarter, the licensee would pay \$50,750, as above. However, if the licensee sold 100,000 units during the second quarter, it would begin with the benefit of the 3<sup>rd</sup> tier royalty. Its second quarter royalty payment would be \$0.75 for the first 40,000 units (\$30,000) and \$0.65 for the next 60,000 units (\$39,000), for a total of \$69,000, which is significantly less than what it would have paid had the tiers reset at the beginning of the second quarter.

## 2. *Percentage Royalties – The Royalty Rate*

For all of their advantages, per unit royalties do not closely link the licensee's royalty obligation to its actual revenue from licensed product sales. As a result, many parties to licensing agreements choose to specify royalties in terms of a *percentage* rather than a fixed rate per product.

### (a) *The Basics*

A percentage royalty has two key components: the royalty rate and the royalty base. The royalty *base* is the amount of licensee revenue that it multiplied by the royalty *rate* to yield the royalty owed. In other words,

$$\text{Royalty (\$)} = \text{Rate (\%)} \times \text{Base (\$)}$$

The royalty base is often expressed in terms of the licensee's "Net Sales" of licensed products. The definition of Net Sales is often one of the most complex and most contentious in a licensing agreement, and is discussed in greater detail in the next subsection.

### **Example: Percentage Royalty**

In consideration for the licenses granted hereunder, Licensee shall pay to Licensor, earned royalties at the rate of x% on Net Sales of Licensed Products.

#### *(b) Tiered Royalties*

Like per-unit royalties, percentage royalties may be flat or tiered. An example of a volume-based tiered percentage royalty schedule is below:

<i>Units sold during quarter</i>	<i>Royalty Rate</i>
0 – 5,000	2.5%
5,001 – 50,000	2.0%
50,001 – 100,000	1.5%
100,000+	1.0%

But tiered royalty schedules need not be based only on sales volume. For example, different royalty rates and rate schedules may be based on:

- the **geographic** market in which a licensed product is sold – e.g., many pharmaceutical products are priced differently in different geographic markets, with rates in low-income countries only a fraction of what they are in high-income countries;
- the **type** of licensed product sold – e.g., the DVD patent pools charged very different royalty rates depending on whether the licensee manufactured a DVD player or a DVD disc;
- the **date** on which the license is granted – e.g., licensors sometimes seek to incentivize early adoption of their technology by offering rates that are determined based on when the license agreement was signed.

Finally, tiered royalty schedules may combine all of these, as well as percentage and per-unit royalty rates, in any number of variations.

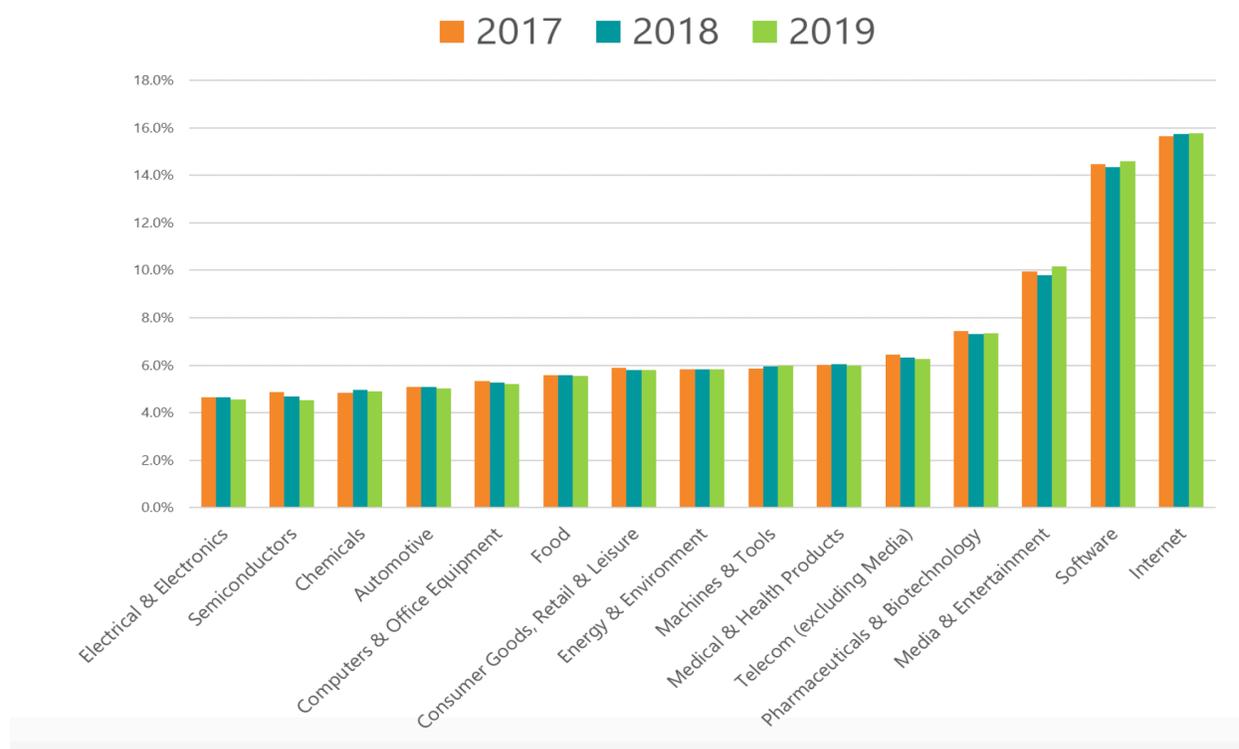
#### *(c) Royalty Rate Levels*

One thing that attorneys advising clients in licensing transactions are typically not called upon to do is determine the royalty rate at which the licensed rights will be licensed. The determination of royalty rates, just as the selling price of a product or service, is typically a decision left to business and financial experts. This being said, licensing attorneys should understand the general landscape of royalty rate determination, both to assist their clients during negotiations, and because

the framework for negotiating royalty rates often becomes a key factor in IP infringement litigation.<sup>4</sup>

In truth, the establishment of a royalty rate in a licensing agreement depends to a large degree on custom and practice in the relevant industry, as well as the negotiation leverage of the parties.<sup>5</sup> The following table illustrates average IP royalty rate ranges for various industries over three recent years.

### Average Royalty Rates by Industry Sector



Source: IPSCIO RoyaltySource, 2020 (royaltysource.com)

Within these general categories, there can be significant variation in royalty rates depending on the strength and desirability of the licensed IP, the size and reputation of the licensee, the type of licensed product being authorized, the exclusivity of the license, and numerous other factors. For example, according to one industry source, the average royalty rate for licensing a brand or

<sup>4</sup> For example, 35 U.S.C. § 284 establishes that a patent holder is entitled to minimum damages for patent infringement equivalent to a “reasonable royalty” for use of the invention, and the federal courts in assessing such reasonable royalties typically look to the 15-factor test established in *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970), which center on the royalty rate that would have been agreed by the parties in a “hypothetical negotiation”.

<sup>5</sup> This discussion assumes that there are no external constraints on the establishment of royalty rates, such as a patent holder’s commitment to grant licenses at rates that are “fair, reasonable and nondiscriminatory” (FRAND) – see Chapter 20.

character for use in toys and games is approximately 8%.<sup>6</sup> Yet it has also been reported that Disney charges Hasbro between 20% and 25% for its exclusive toy/merchandise license of Disney's *Star Wars* and *Marvel Comics* properties.<sup>7</sup>

## The WALT DISNEY Company



*The Walt Disney Company owns some of the world's most valuable brands and is reported to earn 15.5% of all IP licensing revenue in the U.S. (IBISWorld, Intell. Prop. Licensing in the US p.35 (Mar. 2020)).*

### ROYALTY RATES IN BOOK PUBLISHING

Book publishing agreements contain a range of royalty rates for different outlets and forms of publication. Below is a sample of the rates charged by a U.S. publisher for a novel by a non-celebrity author:

U.S. Hardcover retail sales	10-15% of retail price
Export hardcover sales	6% of retail price
U.S. Paperback retail sales	7.5% of retail price
Export paperback sales	5% of retail price
Foreign-language editions	75% of publisher's royalty received
Electronic editions	25% of publisher's royalty received
Serialization	50% of publisher's royalty received

<sup>6</sup> [www.thelicensingletter.com](http://www.thelicensingletter.com) (May 1, 2020).

<sup>7</sup> Leo Sun, *Disney's Pixar Could Become a New Growth Engine for Mattel*, The Motley Fool, May 2, 2019, <https://www.fool.com/investing/2019/05/02/disneys-pixar-could-become-a-new-growth-engine-for.aspx>

### RISE AND FALL OF THE 25% RULE

In an effort to analyze patent royalty rates more systematically, economists beginning in the 1970s postulated that a licensee should pay a royalty equivalent to 25% of its anticipated profit from sales of the licensed product. Thus, if the licensee's profit margin on sales of a licensed product were 16%, an appropriate royalty to the licensor would be 4%.



As explained by the rule's leading proponent, economist Robert Goldscheider, the 25% rule is based on the "assumption is that the licensee should retain a majority (i.e. 75 percent) of the profits, because it has undertaken substantial development, operational and commercialization risks, contributed other technology/IP and/or brought to bear its own development, operational and commercialization contributions."<sup>8</sup> Empirical work by Goldscheider and others seemed to corroborate the use of the 25% rule in a variety of licensing transactions.

Yet the 25% rule has its detractors, who charge that it fails to account for both the importance of the licensed patents to the product sold and the relationship of the parties. In 2011, the Federal Circuit rejected use of the 25% rule in reasonable royalty patent damages calculations, calling it "fundamentally flawed" and holding that "there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case. The 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy this fundamental requirement."<sup>9</sup> The court also held that evidence of the reasonableness of a royalty rate based on the 25% rule failed to satisfy the minimum threshold for admissible "scientific, technical, or other specialized knowledge" under Federal Rule of Evidence 702, as interpreted under *Daubert v. Merrell Dow*, 509 U.S. 589 (1993). To illustrate the absurdity of the 25% rule in practice, the court hypothesized that it "would predict that the same 25%/75% royalty split would begin royalty discussions between, for example, (a) TinyCo and IBM over a strong patent portfolio of twelve patents covering various aspects of a pioneering hard drive, and (b) Kodak and Fuji over a single patent to a tiny improvement in a specialty film emulsion." From the court's standpoint, the 25% rule was dead.

#### (d) Hybrid Royalty Rates

As we will discuss in greater detail in Chapter 24 (Intellectual Property Misuse), U.S. law does not permit a patent holder to charge a royalty with respect to a patent that is expired, or in a jurisdiction where the patent is not in force. Doing so is said to extend the temporal or geographic scope of the patent grant impermissibly, and is prohibited as patent misuse.

<sup>8</sup> Robert Goldscheider, John Jarosz and Carla Mulhern, *Use Of The 25 Per Cent Rule in Valuing IP*, 37 *Les Nouvelles* 123, 124 (2002).

<sup>9</sup> *Uniloc USA v. Microsoft Corp.*, 632 F.3d 1292, 1315 (Fed. Cir. 2011).

As a result, patent licensors often combine licenses of patents with licenses of know-how or trade secrets.<sup>10</sup> Because trade secret rights have no natural expiration, a trade secret license may technically last in perpetuity.<sup>11</sup> Under such a structure, one royalty is charged when and where patent claims remain in effect, and a lower royalty is charged when/where no patent claims are in effect (i.e., the royalty is consideration only for the know-how). As the Ninth Circuit held in *Chromalloy Am. Corp. v. Fischmann*, 716 F.2d 683 (9<sup>th</sup> Cir. 1983), when a licensed patent is found to be invalid,

while the licensor is not entitled to recover royalties as such under the patent license, compensation must be allowed to the extent that non-patent assets, such as know-how, are transferred to the licensee in the patent agreement.

But as the court went on to emphasize, it is important that the distinction between royalties for the patent rights and non-patent rights be clearly delineated in the agreement and not blended in a single rate.

The key question, then, becomes how to allocate royalty payments between patents and know-how. One common approach is to set the know-how-only royalty at 50% of the patent + know-how royalty, but there is no precise formula for making this determination. One leading treatise notes that “[t]he prospect of long or perpetual royalties may create the temptation to skew the allocation in favor of the trade secret component” in such a hybrid license.<sup>12</sup> The author warns, however, that such gamesmanship (e.g., allocating 75% of the royalty to trade secrets when they represent only 25% of the value of the combined patent plus trade secret package) could backfire on the licensor:

Suppose, for example, that a reasonable economic analysis of a bundle of patent and trade secret rights would require payment of 75% of the running royalty for the patents and only 25% for the trade secrets. Suppose further that a "clever" licensor, intent upon maximizing an entitlement to long term royalty and avoiding the risk of loss of royalty due to a finding of invalidity (or, for that matter, to expiration) of the patent, decides to shape the royalty allocation so that only 25% is allocated to the patents and 75% to the technology. The licensor may then, as a patentee, encounter a problem with other prospective licensees. Those licensees, interested in the patents, may not have any interest in the secret but unpatented technology, either because they have their own or believe they can develop it more cheaply than they can purchase it from the licensor. Legally, the licensor cannot condition the license of patents upon the requirement that the licensee take a license of related unpatented technology. Forcing unwilling prospective licensees to buy a patent plus trade secret package that they do not want risks suspending the enforceability of the patents by reason of misuse. And if the patent-only licensees insist upon most-

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<sup>10</sup> In addition to know-how, some biotechnology patent licenses seek to combine patent licenses with the provision of biomaterials such as cell lines, DNA samples or even modified organisms. See Patrick Gattari et al., *Beyond Hybrid Licenses—Strategies for Post Patent Expiration Payments in the United States*, 52 *Les Nouvelles* 31 (2017).

<sup>11</sup> See, e.g., *Warner-Lambert Pharm. Co. v. John J. Reynolds, Inc.*, 178 F. Supp. 655 (S.D.N.Y. 1959) (licensee’s obligation to pay royalties on sale of Listerine indefinitely upheld).

<sup>12</sup> 3-18 Milgrim on Licensing § 18.12 (2012).

avored licensee treatment, the prior license arrangement and its artificially low patent rate will haunt the licensor.

Another risk is that the licensor, by deflating the contractual consideration for the patent license may be creating an evidentiary pitfall for the future. Suppose the licensor must establish the value of those patents in patent infringement litigation against third parties. Say that the total "package" rate for licensed patented and trade secret technology is 5%, of which 4% would have been fairly attributable to the patent component, but the licensor has adopted the practice of charging only 1% for the patents and 4% for the trade secret technology. A third party claiming no rights under the licenses may practice the licensed patents and, as defendant in an infringement action, argue that the licensor's licensing practices have established the true value of the licensed patents and hence supply the "reasonable royalty" measure of damages to which the licensor is entitled if it prevails in the patent infringement action.<sup>13</sup>

### NOTES AND QUESTIONS

1. *Fixed Fees versus Running Royalties.* What are the comparative advantages and disadvantages of fixed fees versus running royalties? When would you advise a client to seek one over the other? Are there any circumstances under which you would advise your client to reject either of these options entirely?

2. *Royalty versus Royalty Share.* In the sample list of book publishing rates reproduced above, you will see that there are two ways in which a publisher calculates royalties due to an author: as a percentage of the retail price of the book, and as a percentage of the publisher's royalty received from a third party. What accounts for this difference in treatment? For additional thoughts on this approach, see Part D below relating to sublicensing income.

3. *More Rules of Thumb.* In addition to the 25% rule, parties litigating the reasonableness of patent royalty rates have also drawn upon the work of Nobel laureate John Nash, whose work predicted that parties bargaining over a matter would reach agreement when they evenly split the profits attributable to the patented technology.<sup>14</sup> This 50-50 profit split became known as the Nash Bargaining Solution, and was frequently introduced in royalty rate cases. But in *VirnetX, Inc. v. Cisco Systems, Inc.*, 767 F. 3d 1308, 1333 (Fed. Cir. 2014), the Federal Circuit rejected the Nash 50-50 rule of thumb as well, on grounds similar to those that it cited in the earlier *Uniloc* case. Though the Federal Circuit rejected both of these rules of thumb on evidentiary grounds, economists and damages experts continue to employ them when advising clients regarding royalty rates. Is this continuing reliance on these rejected rules of thumb justified? Why or why not?

4. *Not Too High.* Is it always in the licensor's interest to charge a royalty that is as high as possible? Consider the following assessment:

Perhaps counterintuitively, maximizing the royalty rate may not always be in the best interests of the licensor. If the royalty rate is exceptionally high, it may serve as a disincentive to the licensee because the profit associated with the commercial

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<sup>13</sup> Id. (citations omitted).

<sup>14</sup> John Nash, *The Bargaining Problem*, 18 *Econometrica* 155 (1950).

product will be negatively affected by the royalty. An exceptionally high royalty rate may also incentivize a licensee to develop technology that works around the IP defined in the license agreement.<sup>15</sup>

Do you agree? How might you advise your licensor client to approach the delicate issue of royalty rate determination?

### PROBLEM 8.1

Consider this clause from a license agreement between the University of Texas and IDEXX Laboratories for a veterinary (canine) diagnostic test reagent:

5.1.b [Upon University's receipt of a notice of allowance of the Patent, Licensee will pay University] a running royalty as follows:

- i. Four percent (4.0%) of Net Sales for all Licensed Products Sold to detect Lyme disease alone.
- ii. One percent (1.0%) of Net Sales of all License Products Sold to detect Lyme disease in combination with one other veterinary diagnostic test or service (for example, but not limited to, a canine heartworm diagnostic test or service). ...
- iii. Two and one-half percent (2.5%) of Net Sales for all Licensed Products Sold as a product or service to detect Lyme disease in combination with one or more veterinary diagnostic products or services to detect tick-borne disease(s).

IDEXX sells a combined canine diagnostic test that detects Lyme disease, heartworm and at least one other tick-borne disease. What royalty rate should IDEXX pay with respect to this test? Is there an ambiguity in the agreement? How would you resolve it?<sup>16</sup>

### PROBLEM 8.2

Suppose that you represent Sy Scientific, an inventor who has just filed a patent covering a new polymer-rubber compound that has amazing tensile properties that it retains even at ultra-high temperatures. Sy anticipates applications of this substance, which he has named "slubber", in markets from space exploration to nuclear power to cooking utensils. Sy has also developed a novel technique for determining the length of time that a batch of slubber must be heated in order to give it optimal tensile properties. How would you go about advising Sy to develop a royalty program for slubber?

### 3. *Percentage Royalties – Royalty Base*

As noted above, the amount that the licensee must pay when a percentage royalty is charged depends both on the royalty rate, discussed above, as well as the royalty base.

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<sup>15</sup> Michael A Reslinski & Bernhard S Wu, *The value of royalty*, 34 *Nature Biotechnology* 685, 689 (2016).

<sup>16</sup> For the court's not very illuminating conclusion, see *Bd. of Regents of the University of Texas System v. IDEXX Laboratories, Inc.*, Cause No. 2018-08064 (Dist. Ct. Harris Co., Tex., Sep. 29, 2020).

(a) *Net Sales*

In an agreement, the royalty base is often expressed in terms of the licensee's "Net Sales" of licensed products or services. Definitions of Net Sales are often highly contested and heavily negotiated. A highly simplified version might read as follows:

**Example – Net Sales (Licensee-favorable)**

"Net Sales" shall mean the actual amounts received by Licensee with respect to sales of Licensed Products.

As with many clauses involving payment, there are numerous variations on the themes set out above. For example, the licensee will generally favor defining Net Sales with reference to "actual amounts *received* by Licensee", as this is a reflection of the licensee's actual revenue from the Licensed Products. The licensor, on the other hand, may prefer a definition based on "amounts *invoiced* by Licensee", as this reflects the amounts that *should have been* paid for the Licensed Products, and is not dependent on the licensee's collection efforts or the compliance of the licensee's customers.

Likewise, it is not uncommon to define Net Sales with reference to amounts received or invoiced by "Licensee and its Affiliates", particularly if the licensee will be selling or distributing Licensed Products through its own foreign subsidiaries. Without this addition, Net Sales could be construed to mean the intercompany transfer prices that the licensee receives from its Affiliates, which could be far below market rates.

**Example – Net Sales (Licensor-favorable)**

"Net Sales" shall mean the actual amounts invoiced by Licensee and its Affiliates with respect to sales of Licensed Products.

(b) *Licensed Products*

Mathematically speaking, an infinite number of royalty rate and base combinations will yield the same per-unit royalty in any given situation. For example, a royalty rate of 1% charged on a \$100 base yields a royalty payment of \$1.00, as does a rate of 10% on a \$10 base and a rate of 0.01% on a base of \$10,000.

Yet for many reasons, it is important to get the royalty base "right", particularly when royalty rates are based on general benchmarks in the industry. Thus, if an apparel manufacturer licenses a popular cartoon character for use on children's pajamas at a royalty rate of 5%, and then prints the character only on the pajama tops, must it also pay the 5% royalty on the matching pajama bottoms that do not display the character? What about a smartphone manufacturer that licenses a patented film that eliminates scratches on a smartphone screen – must the manufacturer pay the agreed royalty only on the price of the film, or on the entire smartphone? This detail is critical to

define, either in the definition of Net Sales or, preferably, the definition of Licensed Products as to which Net Sales are calculated. Consider the following case in which this issue was raised.

**ALLEN ARCHERY, INC. V. PRECISION SHOOTING EQUIPMENT, INC.**

865 F.2d 896 (7th Cir. 1989)

WOOD, JR., CIRCUIT JUDGE

This is a contract case arising out of a patent license granted by plaintiff-appellee Allen Archery, Inc. (“Allen”) to defendant-appellant Precision Shooting Equipment (“Precision”) and defendant Paul E. Shepley. The parties dispute the amount of royalties due Allen for the use by Precision of Allen’s invention.

**I. FACTUAL BACKGROUND**

On December 30, 1969, United States patent No. 3,486,495 entitled “Archery Bow with Draw Force Multiplying Attachments” was issued to Holless W. Allen. The patent was assigned to plaintiff-appellant Allen Archery, Inc. in 1973 and it expired in 1986. The patent relates to an archery bow known commonly to archers and the archery industry as the “compound bow.”

The longbow or straight bow has been in existence for centuries and consists of a single piece of material with a single bowstring attached to the ends of the limbs. Another traditional bow, the recurve bow, is similar to the longbow, but its limbs curve forward at the tips where the bowstring is attached. The crossbow is a weapon having a short bow known as a “prod.” The prod is mounted crosswise at the end of a stock.

The compound bow system covered by Allen’s patent employs rotatable pulleys or cams and multiple-line lacing of the bowstring or cable to create compound leverage. The important advantage of the compound bow, as opposed to more conventional bows, is that the compound bow casts an arrow at greater speed with increased striking power while reducing the amount of force needed to draw the bow ... A compound bow comprises a handle section and a pair of limbs secured to the handle section. An eccentric wheel or cam is mounted on the end of each limb. A bowstring is trained around the wheels to present a central stretch and two end stretches. The central stretch includes a nocking point for receiving the nock or slotted tail of an arrow. The pulley wheels may be round or oval-shaped and are referred to as eccentrics since they are mounted off center in either case.



*H.W. Allen (1909-1979) with a prototype of his compound bow invention*

The compound bow quickly became popular in archery circles. Within eight years of obtaining a patent, Allen had licensed virtually the entire archery industry. When the compound bow first appeared, all of the compound bows built under the licenses were modifications of the longbow or straight bow. Not until 1982 was a crossbow developed that used a compound bow prod.

Pursuant to an agreement dated July 1, 1973, Shepley became a licensee under the patent. Precision ... is a sublicensee under the patent pursuant to a sublicensing agreement with Shepley dated November 1, 1975.

[The] disputes between Allen and Precision center on their differing interpretations of the licensing agreement. The agreement basically gives Precision a license to manufacture, use, and sell “bows embodying the inventions covered” by the compound bow patent held by Allen. Precision had to pay royalties to Allen during the life of the agreement on each bow sold and on replacement parts. The royalty schedule provided that Precision pay a royalty of 5 1/2 percent of the net selling price on the first 31,000 bows sold during a one-year period and a 5 percent royalty on any other bows sold during that same one-year period. The agreement stipulates that:

Licensor agrees that royalties are not to be paid on accessories such as stabilizers and sights and their mountings, bow quivers and fish reels, which are invoiced, billed or sold as separate items from the complete basic operable bow.

Precision began manufacturing crossbows embodying the compound bow principle in 1982. Allen contends that the “complete basic operable bow” described in the licensing agreement includes both the stock and the prod of the crossbow. The Crossfire, Foxfire, and Spitfire crossbows, all manufactured and sold by Precision, utilize the compound principle. Precision argues that the “complete basic operable bow” is provided by the prod alone and that Allen is entitled to no royalties on the value of the stock. Precision notes that when a crossbow is shipped, the prod is not attached to the stock. Precision claims that the prod of the crossbow could be used

as an operable bow. Precision values the prod alone at \$75, an amount arrived at through a comparison with its regular bow line and also based on the manufacturing cost of the product.

The parties also dispute the definition of accessories that are exempted from the royalty obligation. Allen contends that the overdraw mechanism which is standard equipment on the Mach II model bow is not an accessory. An overdraw is a device that enables a bow to shoot a shorter-than-normal arrow. The overdraw uses a ledge mounted on the side of the bow handle to support the tip of the arrow. The tip of the arrow can then be supported behind the handle of the bow and does not need to project forward from the front of the bow as is usually the case. Precision claims that the overdraw is an accessory since the Mach II could be a “complete basic operable bow” without it. Allen also asserts that the special camouflage paint applied to some bows is part of the basic bow since it is invoiced and billed as part of the basic bow price. Precision states that the special paint is in reality sold separately and the royalty obligation does not apply.

## II. DISCUSSION

[The issues] revolve around the proper construction of the licensing agreement as it relates to crossbows and “accessories.” *Richards v. Liquid Controls Corp.*, 26 Ill. App. 3d 111, 325 N.E.2d 775 (1975), sets out the method for construing contracts in Illinois:

The primary objective is to give effect to the intention of the parties. This is to be determined solely from the language used in the executed agreement when there is not ambiguity, but a strict construction which reaches a different result from that intended by the parties should not be adopted. Previous agreements, negotiations and circumstances may be considered in finding the meaning of the words used and when there is an ambiguity, or when the language used is susceptible of more than one meaning, extrinsic evidence is admissible to show the meaning of the words used.

Precision asserts that the language of the licensing agreement is ambiguous and it disputes the meaning of such terms as “complete basic operable bow,” “bows embodying the inventions covered by said patent,” and “accessories . . . invoiced, billed, or sold as separate items.” The district court found that the language used in the agreement was not ambiguous. The court stated that there was no evidence before it concerning prior negotiations or agreements that could be considered in determining the meaning of the terms.

Examining the issue of how crossbows fit under the term “complete basic operable bow,” the district court found that Precision was obligated to pay royalties on the full sale price of any crossbow embodying the Allen compound bow invention. The court rejected Precision’s contention that the prod and the stock could be separated for the purposes of computing royalties. Finding that the agreement was meant to cover all bows embodying the inventions, the court stated that the stock of a crossbow was an integral part of the bow, not a mere accessory.

A review of the record indicates that the district court was correct in its determination that the entire sale price of a crossbow was subject to the royalty payment set forth in the licensing agreement. Precision, in paying royalties to Allen on its compound crossbow sales, had only paid royalties on the supposed value of the prod minus the stock. It unilaterally set this price at \$75 per compound crossbow. Precision sold a large number of these compound crossbows, far more than

its sales of conventional or noncompound crossbows. Each of these compound bows sold is marked with the Allen patent number.

It is strained logic to argue that because the prod can be separated from the stock, it can qualify as a “complete basic operable bow.” In attempting to define those terms, we must find the “ordinary and usual connotation attributable to those words.” While it may be possible for some people to fire an arrow from the prod minus the stock, it is clear that an ordinary user would not consider the prod on its own to be a complete bow. The owner’s manual shipped with every crossbow clearly explains how the prod is to be mounted on the stock and drawn and shot only after it has been secured to the stock; nowhere is it suggested that the prod is operable as a separate unit. It is of no consequence that Precision did not manufacture crossbows at the time it obtained the license, since the agreement covers all bows embodying the patented principles, including those bows not yet designed or built. The district court’s conclusion that royalties must be paid on the full sale price of the crossbows was correct.

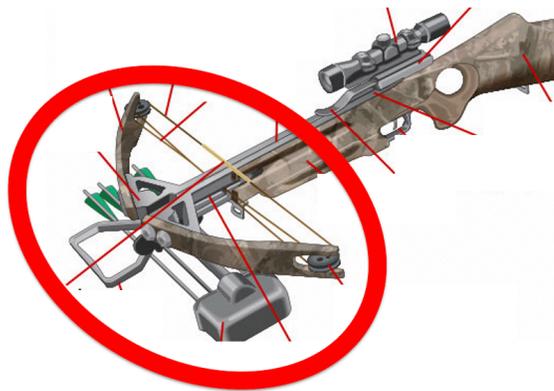
The case of *Richards v. Liquid Controls* presents a very similar fact situation. Richards was an inventor who developed equipment to improve the control of fluids for industry. Richards assigned his patents to AMMCO Tools, which agreed to pay 5 percent of the net selling price of every Air Eliminator sold embodying the inventions acquired from Richards and 2½ percent of other devices embodying those inventions. There was to be one payment on each complete device sold and no payments for repair or replacement parts. The dispute there, as here, centered on what constituted a complete device. The assignee argued that the royalty did not apply to any device attached to parts actually embodying the invention. In *Richards*, the court found that the term “complete device” meant the invention plus all other parts attached to it. The court refused to restrict royalty payments solely to the patented portion of the complete devices sold. Payments were due on the price of any complete device so long as the device contained or embodied one of the inventions.

Precision ... argues that since the licensing agreement does not specifically detail how royalties should be apportioned for crossbows, overdraw mechanisms, and paint, the court should not include nonpatented elements in the determination of royalty obligations. Precision points to the case of *Velsicol Chemical Corp. v. Hooker Chemical Corp.*, 230 F. Supp. 998 (N.D. Ill. 1964), for the proposition that royalties should be computed in proportion to the use of the patented device. However, the *Velsicol* case involves a situation that in many ways is unique to the chemical industry. In *Velsicol*, the defendant’s patented end product used the plaintiff’s patented chlorendic as an ingredient. Unlike the present case, *Velsicol* concerns products where both the component and the end product are patented by the respective parties. The proportionate use argument does not apply here where there is no issue of relative contribution between the parties. Precision also attempts to distinguish the *Richards* case by pointing out that it involved the assignment of a patent rather than the granting of a license, but this distinction does not change the *Richards* case’s applicability to the present fact situation.

The lesson offered by the *Richards* case becomes more useful when we consider the question of whether the overdraw mechanism on the Mach II bow and the camouflage paint found on some bows qualify as accessories under the agreement. The district court found that they were not accessories within the meaning of the agreement and ordered that royalty payments be made on the full sale price of the bow including the overdraw and the camouflage paint. The district court emphasized the testimony of a Precision manager who stated that no accessories are attached to a bow when a bow is shipped. Working from that premise, the court determined that, since the

overdraw mechanism and the camouflage paint were both attached to the bow when shipped, they could not be accessories.

While this proposition at first may seem to be an over-simplification, by looking closely at the licensing agreement, we conclude that the district court's finding that items attached to a bow cannot be accessories is correct. The licensing agreement provides that accessories will be excluded from royalty calculations if they are invoiced separately. Precision did not choose to invoice the paint jobs or the overdraw devices separately. It included them, as well as the crossbow stocks, in the invoice prices of the respective bows. This leads to the conclusion that they are part of the complete bow. Also, the agreement names items that it considers accessories, such as "stabilizers, sights, and their mountings, bow quivers, and fish reels." These items are all clearly separable from the "complete basic operable bow." Camouflage paint and overdraw mechanisms are not separable items and should not be considered as accessories.



*The court in Allen Archery held that a crossbow's stock, overdraw mechanism and camouflage paint were not "accessories" excluded from the royalty calculation, even if they were not covered by the patent claims and could be purchased separately.*

## NOTES AND QUESTIONS

1. *EMVR versus SSPPU*. The dispute in *Allen Archery* required the court to interpret the scope of the royalty base defined in the licensing agreement between Allen and Shepley. A similar analysis is often conducted in patent infringement cases in which no agreement exists between the patent holder and the infringer. In these cases, if infringement is proven, the court must determine both an appropriate royalty rate and a royalty base. When patents cover a single component of a multi-component product, such as the crossbow in *Allen Archery*, a smartphone or a computer, the court must decide whether the royalty base should be the price of the component covered by the patent or the larger product in which the component is used.

The court considered this issue in *Cornell University v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009). In that case, Cornell obtained a patent covering one component of an instruction buffer that could be embodied in a computer processor chip used in computer servers and workstations. Cornell sued Hewlett-Packard for infringement and was awarded damages at a royalty rate of 0.8%. The court then had to determine the base to which this royalty should be applied: H-P's sales of computer servers and workstations, CPU "bricks" including processors,

coolant, external memory and power converters, or processors alone. Cornell argued that it was entitled to royalties on the \$23 billion that H-P would have made if it had sold the infringing processors as bricks. The court disagreed, holding that Cornell was entitled to royalties only on a base that represented the “smallest salable patent practicing unit” or SSPPU. Though H-P primarily sold computer servers and workstations, it had in the past sold individual processors. Thus, the processor, and not the CPU brick, was the SSPPU that formed the base on which Cornell was entitled to royalties (still a substantial \$8 billion sum).

The court in *Cornell* also held that in order for the holder of a patent covering a component of an end product to receive royalties on the basis of the sale price of an end product (the so-called “entire market value rule” or EMVR), three conditions must be met: (1) the infringing component must be the basis for customer demand for the entire product, (2) individual infringing and non-infringing components must be sold together to form a functional unit, and (3) individual infringing and non-infringing components must be analogous to a single functioning unit, not sold together for mere business advantage.

2. *Process Royalties.* Not all patents relate to products that can be sold. Some patents cover processes or methods for performing services, for manufacturing other goods, for improving efficiency, and for many other purposes. In these cases, the royalty base is often expressed in terms of the licensee’s revenue from use of the patented process. For example, a license of an automated system for operating a customer service call center might bear royalties based on a percentage of the licensee’s call center revenue, and a patented process for improving the efficiency of an assembly line might bear royalties based on the licensee’s sales of products manufactured on that line. While such arrangements are not uncommon, they require significant analysis and negotiation in order to give the licensor a fair share of revenue derived from its licensed process without allowing it to capture value associated with the licensee’s other operations, techniques and licensed technology.

3. *Reach Through Royalties.* If a patent covers a research method or tool, it may not be practical for the patent holder to charge a royalty on the “sale” of products covered by that patent. Indeed, there may be no products sold at all. Rather, the research tool may be used to discover new compounds or drug targets, to locate subterranean oil reserves, or to predict stock market movements. In each of these cases, use of the tool could result in the discovery or development of something hugely profitable – a new drug, an oil reservoir, or a market windfall. On what basis should the patent holder charge a user for the use of the patented research tool? Traditionally, the developer of such a research tool – say, a microscope, chemical reagent or DNA sequencing technique – would charge a one-time fee for the use the tool, either through the sale of a product such as a microscope or reagent, or as an up-front license fee for the use of a patented method. Some developers of research tools, however, have sought to collect royalties not only on the sale or use of their patented tool, but on the licensee’s revenue derived from products discovered or developed *using* the research tool.<sup>17</sup> These royalties on downstream products are referred to as “reach-through” royalties.

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<sup>17</sup> In some cases, a tool developer’s patents claim not only the tool itself, but products resulting from the use of that tool. Yet it is not strictly necessary for the tool developer to have patent claims covering the products discovered using the research tool to charge a royalty on those products. We will consider this issue further in Chapter 24 relating to IP misuse.

Reach-through royalties have been highly controversial. The National Institutes of Health discourages the use of reach-through royalties with respect to federally-funded discoveries, stating that:

[NIH grant] Recipients are expected to ensure that unique research resources arising from NIH-funded research are made available to the scientific research community. ... If the materials are patented or licensed to an exclusive provider, ... royalty reach-through, or product reach-through rights back to the provider are inappropriate.<sup>18</sup>

In addition, many corporations disfavor the use of reach-through royalties by their potential licensors.<sup>19</sup> What justification can you see for charging reach-through royalties? Why might a licensee object to the payment of such royalties?<sup>20</sup>

4. *Including Unlicensed Products in the Royalty Base.* In *Automatic Radio Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950), Automatic Radio licensed a portfolio of more than 500 radio broadcasting patents from Hazeltine (an early patent assertion entity) in exchange for a royalty based on Automatic Radio's total sales of radio broadcasting receivers, whether or not they practiced the licensed patents. Four years into the agreement, Automatic Radio objected to paying the minimum royalty required under the license agreement, arguing that none of its products infringed the patents and that requiring it to pay a royalty amounted to patent misuse (discussed in greater detail in Chapter 24). The Court disagreed, holding that the royalty base established under the agreement was "a convenient mode of operation designed by the parties to avoid the necessity of determining whether each type of petitioner's product embodies any of the numerous Hazeltine patents", *id.* at 833. How does the Court's reasoning in *Automatic Radio* compare to that of *Allen Archery*, in which the licensor was permitted to include the price of unpatented crossbow components in its royalty base?

(c) *Exclusions from Net Sales*

As most percentage-based running royalties are expressed in terms of the licensee's "Net Sales" of Licensed Products, the definition of Net Sales is often negotiated heavily. In addition to the scoping described above, there are a range of exclusions from Net Sales that often appear in licensing agreements. An example of these is shown below.

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<sup>18</sup> Natl. Inst. Health, Principles and Guidelines for Recipients of NIH Research Grants and Contracts on Obtaining and Disseminating Biomedical Research Resources: Final Notice, 64 Fed. Reg. 72,090, 72,094 (1999).

<sup>19</sup> See Gattari et al., *supra* note **Error! Bookmark not defined.**

<sup>20</sup> For a comprehensive discussion of reach-through royalties in the biopharmaceutical sector, see Alfred C. Server, Nader Mousavi & Jane M. Love, *Reach-Through Rights and the Patentability, Enforcement, and Licensing of Patents on Drug Discovery Tools*, 1 Hastings Sci. Tech. L.J. 21 (2009).

### Example – Net Sales (with exclusions)

"Net Sales" shall mean the actual amounts [invoiced/received] by Licensee and its Affiliates with respect to sales of Licensed Products, less (a) shipping, packaging, delivery and freight insurance costs to the extent separately stated on the invoice; (b) standard quantity discounts, rebates and credits for returned goods; (c) applicable taxes and other duties assessed directly on sales of the Licensed Products; and (d) amounts received for training, technical assistance, maintenance, service and support.



*Shipping and Packaging* – fees received by the licensee for shipping, packaging and delivery are often excluded from Net Sales because these fees are usually paid by the licensee to third party fulfillment and shipping firms without markup and do not represent actual revenue to the licensee. If licensee handles its own fulfillment, then this provision may be less appropriate.

*Discounts* – this exclusion is important if Net Sales are based on the amounts that the licensee invoices for Licensed Products. If the licensee invoices the customer \$100 for a product but then extends a \$10 discount to the customer, so that the licensee only receives \$90, then it is fair for the licensee's royalty to be based on the invoiced price less the discount. Even so, the licensor may insist that Net Sales be reduced only for discounts that are "standard" and which relate to the quantity of products ordered, as the licensee should not be permitted to reduce its royalty base

*Rebates* – in some cases, the licensee will receive payment for a Licensed Product and then refund part of that payment to its customer in the form of a rebate. As the licensee does not retain those funds, it will often seek to exclude rebates paid from Net Sales. The licensor's response to this request could be that rebates should be considered promotional expenses paid by the licensee, similar to advertising, which are not appropriate reductions to the royalty due.

*Returns* – if the licensee sells 100 products but 5 are returned by customers for a refund, then the licensee may argue that its royalty obligation should only be with respect to the 95 products that were not returned. The licensor may respond that its royalties should not be reduced on account of the licensee's poor product quality. Depending on the industry, this exclusion can be heavily negotiated and may allow deductions from Net Sales up to an expected return rate (say 5%) or may simply adjust the royalty rate to take that return rate into account.

*Taxes* – if the licensee collects sales, use or value-added taxes from its customers in connection with the sale of Licensed Products or Services (as it is often legally required to do), and then remits those amounts to the appropriate taxing authority, then it is customary to allow the licensee to deduct those amounts from the definition of Net Sales.

*Licensee Services* – if the licensee charges its customers for services (training, maintenance, etc.) as part of its sale of Licensed Products, then the licensee will often argue that such amounts (which are not paid with respect to the Licensed Products themselves) should not be used to calculate the royalty payable to the licensor. Licensors may disagree, arguing that such

add-on services are enabled only because the Licensed Products are being sold, and may wish to prevent the licensee from shifting large amounts of revenue from the Licensed Product price to these services simply to reduce the royalty owed.

## NOTES AND QUESTIONS

1. *In-Kind Compensation.* The typical percentage royalty arrangement is based on the licensee's Net Sales of Licensed Products or Services. But what if some or all of the licensee's compensation is in the form of non-cash consideration? Some non-cash consideration -- equity securities, marketed products, commodity services and even advertising space/time -- is relatively easy to value and a Net Sales definition can be adjusted to reflect the cash-equivalent market value of such consideration on the date paid. Other non-cash compensation -- intellectual property licenses, non-competition covenants, technical assistance -- may be more difficult to value, and the licensor will seek to ensure that the licensee is not circumventing its royalty obligations by accepting unreported non-cash compensation in exchange for Licensed Products or Services. By the same token, agreements normally contain a range of obligations in addition to payment (confidentiality, indemnification, etc.), and it would be unreasonable for a licensor to insist that each of these obligations be converted to a cash value for purposes of royalty calculation. If you were a licensor, how might you seek to prevent your licensee from avoiding its royalty obligations through accepting non-cash consideration?

### C. ***RUNNING ROYALTIES – ADJUSTMENTS AND LIMITATIONS***

Section B above discusses the basic framework for defining and calculating running royalties. In this Section C, we will discuss some additional provisions that are used in licensing agreements to modify and limit running royalties.

#### 1. ***Minimum Royalties***

It is sometimes the case that a licensor will require its licensee to pay a minimum level of royalties, whether or not those royalties are actually earned under the applicable royalty calculation formulas. Royalty minimums are often required if (a) the licensor has fixed cost commitments, such as facility and personnel costs, and few sources of income other than royalties and (b) the licensee's income is seasonal, with significant variation among calendar quarters (e.g., toys, retail, vacation travel, etc.)

Minimum royalties may be structured in a variety of ways. The most straightforward method is to specify a minimum dollar amount that the licensee will pay during defined periods (e.g., every calendar quarter or year) during the term of the agreement.

**Example – Quarterly Minimum Royalties (without crediting)**

In the event that the total earned royalties payable by Licensee to Licensor hereunder during any calendar quarter during the Term of this Agreement is less than \$250,000 (the “Quarterly Minimum”), then concurrently with Licensee’s payment of earned royalties to Licensor hereunder for such quarter, Licensee shall, in addition, pay to Licensor an amount (the “Make-Up Amount”) equal to the difference between the Quarterly Minimum and the amount of earned royalties payable with respect to such quarter, such that the total amount payable by Licensee with respect to such quarter is the Quarterly Minimum.

If minimum royalties will be due on an annual basis instead of a quarterly basis, then the relevant provision must speak to the total earned royalties paid and payable over the course of the year, with the Make-Up Payment being made with the fourth quarterly payment for the year.

But what happens if the licensee exceeds the Quarterly (or Annual) Minimum during a particular calendar quarter (or year), but then falls short in a future quarter (or year)? May the licensee credit its overage against satisfaction of the minimum in a future period? This is often a topic of some negotiation. A licensor that is looking for an assured quarterly or annual payment is unlikely to wish to agree to crediting of prior overages against future minimum royalty commitments, even though it will, over the course of both periods in question, satisfy the minimum. If crediting of overages is allowed, another question to be answered is how long such credits can be applied: in the next quarter, the next x quarters, or any time during the term of the agreement.

The following language addresses some of the issues arising from crediting overages against prior period minimums.

**Example – Quarterly Minimum Royalties (with crediting)**

In the event that the total earned royalties payable by Licensee to Licensor hereunder during any calendar quarter during the Term of this Agreement is less than \$250,000 (the “Quarterly Minimum”), then concurrently with Licensee’s payment of earned royalties to Licensor hereunder for such quarter, Licensee shall, in addition, pay to Licensor an amount (the “Make-Up Amount”) equal to the difference between the Quarterly Minimum and the amount of earned royalties payable with respect to such quarter, such that the total amount payable by Licensee with respect to such quarter is the Quarterly Minimum. Licensee **[shall/shall not] have the right to credit any overage of earned Royalties above the Quarterly Minimum in a given calendar quarter against any shortfall of earned Royalties below the calendar quarter Minimum during [any future/the next] calendar quarter.**

## 2. *Royalty Caps*

The converse of a minimum royalty is a maximum royalty or royalty “cap”. Royalty caps may be applied to any given period under the agreement (e.g., quarter or year), or may be aggregated over the entire term of the agreement.

### Examples – Royalty Cap

*Example 1:* In no event shall Licensee be required to pay earned royalties hereunder during any calendar quarter in excess of \$1,000,000.

*Example 2:* In no event shall Licensee be required to pay earned royalties hereunder in excess of a total of \$10,000,000 during the Term of this Agreement.

In the case of a royalty cap that applies across the entire term of the Agreement (Example 2 above), once the licensee pays earned royalties equal to the cap, the license is typically considered to be paid-up.

### PROBLEM 8.3

LocCo has licensed FashO’s famous “WOOSH” brand for use on apparel in the United States for a period of 3 years. The licensing agreement contains the following provision:

LocCo will pay minimum earned royalties of \$500,000 during each calendar quarter hereunder, with any overage carried forward one calendar quarter and no more, and provided that under no circumstances shall LocCo be required to pay earned royalties during the term of this Agreement in excess of \$7,000,000.

Earned royalties under the Agreement are calculated at the following levels during each year:

Year	Q1	Q2	Q3	Q4
<b>1</b>	\$350,000	\$450,000	\$500,000	\$650,000
<b>2</b>	\$400,000	\$450,000	\$550,000	\$600,000
<b>3</b>	\$650,000	\$750,000	\$850,000	\$1,000,000

What payments is LocCo required to make with respect to each quarter during the term of the Agreement?

### 3. *Royalty Buyouts*

Some license agreements permit the licensee to pay a lump sum in order to “buy out” its remaining running royalty obligation. This buyout option usually becomes available at some defined point during the term of the agreement, often when some milestone is achieved.

The buyout price should fairly compensate the licensor for its lost potential royalty revenue, though some licensors may accept a discount from the projected present value of the remaining royalty stream given the certainty of the lump sum payment versus the inherent uncertainty of royalty income. The amount of the buyout can be specified in absolute terms (i.e., a fixed dollar

figure) or, more often, as a multiple of prior quarterly royalty payments (assuming that royalty payments have commenced at the time of exercise).

From the licensee's standpoint, a one-time cash payment, even if greater than the expected royalty stream, may be more desirable from a revenue reporting and profitability perspective than a running royalty that must be paid every quarter.

#### 4. *Royalty Escalation Clauses*

Generally, the payment provisions of licensing agreements are not subject to change unless changes are expressly provided for. Thus, even in the presence of changed circumstances or incorrect assumptions, unless there was fraud on the part of one of the parties or events rise to the level of force majeure (see Chapter 13), the parties must live with the deal that they have made.

Nevertheless, some agreements do permit changes to royalty rates and other financial terms under certain conditions. The following case illustrates these issues.

### **ARBITRON, INC. V. TRALYN BROADCASTING, INC.**

400 F.3d 130 (2d Cir. 2005)

CALABRESI, Circuit Judge.

This breach of contract dispute raises the question of whether, under New York law, two parties entering into a licensing agreement for radio ratings and data may authorize one party to adjust the price of that data unilaterally at some point in the future. [W]e conclude that the contract before us delegated, with unmistakable clarity, price-setting authority to a single party, and that New York law does not invalidate such contracts. We therefore vacate the district court's order of summary judgment and remand for reconsideration.

#### I. BACKGROUND

Plaintiff-appellant Arbitron, Inc. ("Arbitron"), a Delaware corporation, is a popular listener-demographics data provider for North American radio stations. Arbitron licenses its copyrighted listener data to regional AM and FM stations, which then use the demographic profiles of station listeners to attract advertisers. In 1997, Arbitron entered into one such license — a "Station License Agreement to Receive and Use Arbitron Radio Listening Estimates" (the "License Agreement") with defendant Tralyn Broadcasting, Inc. ("Tralyn"), a Mississippi corporation. The License Agreement permitted Tralyn's only radio station (WLUN-FM in the Gulfport, Mississippi area, later known as WLNF-FM) to use Arbitron listening data reports. Over its five-year term, the License Agreement charged Tralyn a monthly rate of \$1,729.57 for the use of Arbitron's listening data reports by this single station.

Were this monthly license fee the only pricing portion of the License Agreement, this case would present an extremely simple contract dispute. But another clause of the agreement — which we shall call the "escalation clause" — provided that, were Tralyn or its successor to acquire

additional radio stations in the same or adjacent regional markets, a new license fee would be charged. Upon acquiring such stations, Tralyn was required to notify Arbitron so that Arbitron could determine a new license fee, and, if necessary, approve the assignment of the licensing agreement to a new party in interest. Any new licensing fee would be set, according to the escalation clause, at Arbitron's discretion. The clause provided:

In the event that Arbitron consents to the assignment of this Agreement, Arbitron reserves the right to redetermine the rate to be charged to the assignee. . . . Station agrees that . . . if it is or was purchased or controlled by an entity owning or otherwise controlling other radio stations in this Market or an adjacent Market . . . Station . . . will report the change and the effective date thereof to Arbitron within 30 days of such change. In the event of such occurrence, Station further agrees that Arbitron may redetermine its Gross Annual Rate for the Data, Reports and Services licensed hereunder, as well as any Supplementary Services, effective the first month following the date of the occurrence. Notwithstanding Station's failure to notify Arbitron, pursuant to provisions of this paragraph, Arbitron may redetermine the Station's Gross Annual Rate for all Data, Reports and Services, as well as any Supplementary Services, based on the foregoing, effective the first month following the date of the occurrence.

Pursuant to this "escalation clause," Arbitron was given the right to increase the license fee as Tralyn purchased additional stations (or as entities owning additional stations purchased Tralyn). Thus, the escalation clause assumed that, as Tralyn acquired additional regional stations, it would share listener data among each of these stations, and, by allowing Arbitron to increase Tralyn's fees, the clause provided Arbitron with a mechanism to reflect this additional use.

On October 31, 1999, Tralyn was purchased by defendant-appellant JMD, Inc. ("JMD") a Mississippi corporation. At the time JMD acquired Tralyn and WLNF-FM, JMD also controlled at least four other stations in the Gulfport, Mississippi market (WROA-AM, WZKX-FM, WGCM-AM, and WGCM-FM). The purchase agreement between JMD and Tralyn assigned to JMD the License Agreement; JMD thereby assumed responsibility for paying Arbitron, and implicitly, for notifying Arbitron of the additional radio stations now operated by Tralyn's successor. But in violation of Paragraph 11 of the License Agreement, neither JMD nor Tralyn obtained Arbitron's prior written consent to the License Agreement's assignment. Nor did they provide Arbitron with notice of a change in ownership of WLNF-FM. Instead, from November 1999 until June 2002, JMD simply paid the original single-station monthly license fee (\$1,729.57) directly to Arbitron. In return, Arbitron provided WLNF-FM with updated listening data (specifically, the Fall 1999 Ratings Book and Research Data — referred to by the parties as the "Fall Book" — which was published in February 2000).

In June 2000, Arbitron discovered, through its own diligence, that JMD had purchased Tralyn and that the terms of the License Agreement had been breached. Arbitron thereupon notified JMD by letter that it was exercising its right to increase the monthly licensing fee under the escalation clause of the License Agreement. Arbitron determined JMD's new annual license fee by multiplying the single-station license fee (\$1,779.57) by five (\$8,897.85) to reflect the five JMD stations that could now share Arbitron's listener data. It then reduced that figure by 35% to reflect the typical volume discount for licenses covering five or more stations. The result was a revised monthly charge of \$5,784.93. Based on this new licensing fee, which Arbitron claimed should have been paid since the October 1999 purchase, Arbitron sent JMD an invoice for "incomplete"

payments made between October 1999 and June 2000. It also sent an invoice indicating the additional payments that would be due for the next quarter's listening reports.

JMD never paid these invoices, and subsequently refused to pay anything — even the \$1,779.57 due each month under the original one-station License Agreement. Arbitron therefore stopped sending JMD its listening data reports, as it was permitted to do under the License Agreement upon the licensee's nonpayment of the monthly licensing fee.

Arbitron filed the instant suit against Tralyn and JMD on November 1, 2001. Its complaint for breach of contract sought \$172,394.22, representing all moneys due under the Licensing Agreement (plus interest) from June 1999 to the end of the contract's five-year term.

On June 5, 2003, the district court (Sweet, J.) ... granted summary judgment — but not monetary damages — to JMD. The district court concluded that because "[n]either the escalation clause in ¶ 11, nor any other section of the Agreement, contains any basis for determining the new rate to be paid Arbitron in the event changes in ownership occur," the License Agreement's escalation clause was unenforceably vague under New York law.

In concluding that the escalation clause (but not the rest of the License Agreement) was void for vagueness, the district court emphasized the following passage from *Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher*, 52 N.Y.2d 105, 417 N.E.2d 541 (1981):

[B]efore the power of law can be invoked to enforce a promise, it must be sufficiently certain and specific so that what was promised can be ascertained. Otherwise, a court, in intervening would be imposing its own conception of what the parties should or might have undertaken, rather than confining itself to the implementation of a bargain to which they have mutually committed themselves. Thus, definitiveness as to material matters is of the very essence of contract law. Impenetrable vagueness and uncertainty will not do.

Because the district court considered the escalation clause to be "impenetrabl[y] vague" for want of a missing term, it deemed that portion of the License Agreement unenforceable under New York law, and therefore awarded summary judgment to JMD. Arbitron now challenges the district court's decision.

### Arbitron ratings for Bend

The ratings list the percentage of radio listeners ages 12 and older who are listening to the station during any 15-minute period from 6 a.m. to midnight through the week.

Station	Format	Fall 2007	Spring 2008
KBND-AM	News Talk Information	7.6%	8.8%
KQAK-FM	Oldies	7.6	7.9
KXIX-FM	Pop Contemporary Hit Radio	6.6	7.9
KSJJ-FM	Country	9.5	7.4
KTWS-FM	Classic Rock	7.1	7.0
KWPK-FM	Hot Adult Contemporary	4.3	6.0
KRXF-FM	Alternative	6.6	5.6
KLTW-FM	Soft Adult Contemporary	5.2	5.1
KMTK-FM	Country	4.7	4.7
KLRR-FM	Album Adult Alternative	2.8	2.8
KMGX-FM	Adult Contemporary	2.4	2.8
KRCO-AM	Classic Country	3.3	2.8
KWLZ-FM	Classic Rock	2.8	2.3
KICE-AM	All Sports	1.9	1.9
KNLR-FM	Contemporary Christian	1.9	1.9
KRDM-AM	Mexican Regional	1.9	1.9

Source: 2008 Arbitron Inc.

An Arbitron radio market report from 2008

## II. DISCUSSION

The district court based its decision on three New York cases, each dealing with contracts for the sale or lease of real property. Upon review of these same cases, we conclude that the escalation clause is enforceable under the common law of New York. This is so because the clause before us is not an "agreement to agree," under which future negotiations between the parties must occur, but is instead an acknowledgment that, if certain conditions arise in the future, no new agreement is required before Arbitron may set new license terms. Such an agreement is not unenforceably vague under New York's common law.

The seminal New York precedent on unenforceably indefinite contracts is *Delicatessen*. There, the Court of Appeals was faced with an agreement between a landlord and a tenant to lease a commercial space for five years at a monthly rate beginning at \$500 and escalating over five years to \$650, with the option to renew the lease for another five-year term at a rent to be determined by the parties. At the close of the lease's five-year term, the landlord sought to increase the rent from \$650 to \$900 monthly. Surprised, the tenant employed an assessor, who appraised the market value of the premises at no more than \$550 per month. The tenant sued for specific performance, seeking a new five-year lease at the fair market rate of \$550. In resolving the case, the *Delicatessen* majority recognized that the U.C.C., as implemented by the New York legislature, counseled in favor of supplying missing price terms to save and enforce the agreement, and that the terms supplied by a court under the U.C.C. would correspond to a good's fair market value. Nevertheless, because the New York statute's terms made clear that leases or contracts for the sale of real property were not covered by the U.C.C., the Court of Appeals refused to enforce the agreement. It concluded that

it is rightfully well settled in the common law of contracts in this State that a mere agreement to agree, in which a material term is left for future negotiations, is unenforceable. This is especially true of the amount to be paid for the sale or lease of real property. The rule applies all the more, and not the less, when, as here, the extraordinary remedy of specific performance is sought.

We note that, despite its "seminal" status, *Delicatessen* is of limited precedential value in this case. The majority opinion emphasized that its conclusion was "especially true" in relation to the subject matter at hand (real property), and "all the more, and not the less" true for the requested remedy (specific performance). Those qualifications undermine *Delicatessen's* applicability in contractual disputes related to the subject matter ("licenses" for listener data reports), and the requested remedy (monetary damages), before us.

In *Cobble Hill Nursing Home v. Henry Warren Corp.*, 74 N.Y.2d 475, 548 N.E.2d 203 (1989), the Court of Appeals again faced the question of unspecified price terms. The contract in *Cobble Hill* gave the plaintiff a purchase option for a nursing home, but did not provide a specific price for the property. The agreement instead permitted plaintiff to buy the property "at a price determined by the Department [of Health] in accordance with the Public Health Law and all applicable rules and regulations of the Department." When the plaintiff exercised that option and attempted to buy the nursing home at the price set by the Department of Health, defendants refused to honor the option, citing a perceived discrepancy between the property's fair market value and the Department of Health's assessment. Plaintiff filed suit for breach of contract, seeking specific performance at the price set by the Department. Defendants claimed that the agreement was unenforceably vague because its four corners did not include a definite price term. Evaluating these arguments, the Court of Appeals emphasized that "[f]ew principles are better settled in the law of contracts than the requirement of definiteness," and that under New York law "[i]f an agreement is not reasonably certain in its material terms, there can be no legally enforceable contract." But it also noted that

a price term is not necessarily indefinite because the agreement fails to specify a dollar figure, or leaves fixing the amount for the future, or contains no computational formula. Where at the time of agreement the parties have manifested their intent to be bound, a price term may be sufficiently definite if the amount can be determined objectively without the need for new expressions by the parties; a method for reducing uncertainty to certainty might, for example, be found within the agreement or ascertained by reference to an extrinsic event, commercial practice or trade usage. A price so arrived at would have been the end product of agreement between the parties themselves.

Applying that reasoning to the option contract, the Court concluded that, because it was "apparent from the agreement that these parties reposed discretion in the Department to make the price determination, limited only by the requirement that it apply provisions that were suitable, pertinent and appropriate for the task at hand," and because "[t]he terms of agreement and the appropriate remedy can be readily determined, and it is plain that the parties intended this to be a complete and binding contract," there was "no legal justification for voiding this agreement."

Most recently, in *In Re Express Indus. Terminal Corp.*, 93 N.Y.2d 584, 715 N.E.2d 1050 (1999), the Court of Appeals refused to enforce a lease agreement whose material terms, including the price term, were simply left blank by the parties. A unanimous Court concluded that because the lease agreement's terms — including the date on which an option would expire, and the amount of rent reduction that would correspond to the exercise of that option — were represented by blank spaces, and because there was "no objective evidence that the parties [to the lease agreement] intended that [the lessor] be allowed to fill in these blanks with any reasonable terms [it] chose," the contract was not enforceable under New York law. But the Court also suggested that, in the face of sufficient evidence demonstrating that both parties intended to give one party the power to

select "any reasonable terms [it] chose," a similar contract for the sale or lease of real property might be enforceable.

Upon review of *Delicatessen*, *Cobble Hill*, and *Express Industries*, we conclude that the License Agreement's escalation clause is indeed enforceable under the common law of New York. The escalation clause, unlike the promise to set a future rent rate collectively in *Delicatessen*, does not require the parties to reach an "agreement" on price at some point in the future. That is, the escalation clause is not an "agreement to agree." Instead, like the contract in *Cobble Hill*, it is a mechanism for objectively setting material terms in the future without further negotiations between both parties. It does so, moreover, with "sufficient evidence that both parties intended that [pricing] arrangement." *Express Indus.*, 93 N.Y.2d at 590, 715 N.E.2d at 1050. The escalation clause clearly and unambiguously states that, in the event that Tralyn or its successors acquired new radio stations in the same (or an adjacent) geographic market, "Arbitron may redetermine its Gross Annual Rate for the Data, Reports and Services licensed hereunder . . . effective the first of the month following [the acquisition]." The escalation clause further provides, in unambiguous language, that Arbitron may exercise this power to "redetermine" the license fee "[n]otwithstanding Station's failure to notify Arbitron" that an acquisition had occurred.

The intent of the parties is manifest in the language of the agreement. Both Arbitron and Tralyn explicitly agreed that Arbitron was authorized to adjust the license fee in the event that Tralyn or its successors began to operate additional stations. This fact makes the instant case very different from those disputes in which courts are faced with "no objective evidence" of a shared intent to permit one party to set prices in the future. And it in no way leads a court enforcing the contract to "impos[e] its own conception of what the parties should or might have undertaken." Accordingly, we conclude that the district court erred in holding the License Agreement's escalation clause "impenetrably vague" under New York law.

In reaching this conclusion, we note that the cases discussed above are not the only New York precedents on the issue of missing contract terms. Under New York's implementation of the Uniform Commercial Code, there is a strong presumption that agreements are enforceable even if their price terms are not definite. N.Y.U.C.C. § 2-305 provides that:

- (1) The parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price at the time for delivery if (a) nothing is said as to price; or (b) the price is left to be agreed by the parties and they fail to agree; or (c) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.
- (2) A price to be fixed by the seller or by the buyer means a price for him to fix in good faith.

The commentary to this section of New York's commercial code makes clear that "[t]his Article rejects in these instances the formula that 'an agreement to agree is unenforceable' . . . and rejects also defeating such agreements on the ground of 'indefiniteness.' Instead this Article recognizes the dominant intention of the parties to have the deal continue to be binding upon both." N.Y.U.C.C. § 2-305, Purposes of Changes, cmt. 1 (emphasis added).

It is not clear whether, under New York law, a license agreement of the sort at issue in this case constitutes a contract for the sale of goods, or is otherwise governed by the U.C.C. We note,

however, that were this section of New York's commercial code applied to the License Agreement, then the escalation clause would undoubtedly be a valid contract term under New York law; it would simply establish "[a] price to be fixed by the seller," and would be enforceable so long as that price was fixed "in good faith." N.Y.U.C.C. § 2-305. But the applicability of the U.C.C. to the license agreement before is not something we need to decide today.

Because we believe that the License Agreement's escalation clause is not inconsistent with New York law, we conclude that the district court erred in granting summary judgment to JMD. We therefore vacate the district court's order and remand the case for further proceedings.

## NOTES AND QUESTIONS

1. *The Sky's The Limit?* The Second Circuit in *Arbitron* holds that ¶ 11 of the License Agreement gives Arbitron the right to increase the royalty payable by JMD following an assignment of the agreement. As court explains,

Arbitron determined JMD's new annual license fee by multiplying the single-station license fee (\$1,779.57) by five (\$8,897.85) to reflect the five JMD stations that could now share Arbitron's listener data. It then reduced that figure by 35% to reflect the typical volume discount for licenses covering five or more stations. The result was a revised monthly charge of \$5,784.93.

Arbitron's recalculation seems reasonable, or at least grounded in the facts of the case. But the Court says that Arbitron has "complete discretion" to increase its rates. Does that mean that Arbitron, if it so chose, could have raised its rate to \$10,000? \$100,000? \$1,000,000? Is there any cap on Arbitron's seemingly unfettered discretion?

2. *A Drafting Lapse?* As we will discuss in Chapter 17 (Consumer and Online Licenses), an increasing number of online license agreements give the licensor the unilateral right to amend the agreement, subject only to contractual limitations on unconscionable behavior. Usually, consumers acceding to these terms have little knowledge or understanding of what they are agreeing to. But what about a commercial entity such as Tralyn? Why would it agree to give Arbitron seemingly unfettered discretion to raise its rates? Do you think that Tralyn and JMD made any mistakes in handling this transaction?

3. *A Trade Secret License.* Arbitron's license agreement covers "radio ratings and data" – factual information that is not covered by copyright, but which may qualify as a trade secret. Do trade secret licensors need to be particularly careful about the parties that are entitled to access licensed data – more so than licensors of other forms of IP? Why or why not?

4. *Back to the U.C.C.* In *Arbitron*, the Second Circuit notes that "It is not clear whether, under New York law, a license agreement of the sort at issue in this case constitutes a contract for the sale of goods." The First Circuit in *ProCD v. Zeidenberg* (discussed in Chapter 17) similarly punts this question, stating "Whether there are legal differences between "contracts" and "licenses" (which may matter under the copyright doctrine of first sale) is a subject for another day". Yet, as we saw in *Systems Unlimited v. Cisco* (discussed in Chapter 2), the Eleventh Circuit has held somewhat definitively that the U.C.C. does not apply to licensing transactions, which led to the abortive effort to create U.C.C. Article 2B that eventually became UCITA (see Note 1, Ch. 2). What do you think? Should an IP license agreement be subject to U.C.C. provisions addressing sales of goods?

## 5. *Royalty Stacking and Bundling*

### (a) *Royalty Stacking Clauses*

Many products are covered by multiple IP rights. One industry group estimated in 2011 that a typical smartphone was covered by approximately 250,000 different patents.<sup>21</sup> A motion picture or video game often embodies rights from an adapted book, personal rights of publicity, fictional characters, original artwork and set designs, multiple musical works, the film's cinematography and choreography, as well as distinctive buildings, product designs and logos that are shown. Even biotechnology products can be subject to multiple patent claims – one analysis estimated that the Vitamin A-rich genetically engineered product known as *Golden Rice* was covered by 45 patents or patent families held by more than 20 different entities.<sup>22</sup> New vaccine products may be subject to patents covering research tools, recombinant techniques, cell lines, DNA sequences, transformation vectors, adjuvants, and delivery means.



*The genetically-modified golden rice product was covered by 45 patents held by more than 20 entities [photo: International Rice Research Institute 2011, CC-BY]*

As a result of the proliferation of IP in many fields, a licensee seeking to commercialize such a product or work must obtain licenses from a number of separate rights holders. And if each, or some portion, of these rights holders demands a royalty, then the royalties will add up, possibly to a sizeable sum. This phenomenon is known as royalty “stacking”.

In most cases, royalty stacking is simply a cost of doing business in a rights-centric world. While there have been some attempts in particularly patent-heavy industries to coordinate and limit aggregate royalties charged by patent holders for a single product (see Chapter 20 relating to so-

<sup>21</sup> See RPX Corp., Registration Statement on Form S-1, p.55 (Sept. 2, 2011).

<sup>22</sup> R. David Kryder, Stanley P. Kowalski & Anatole F. Krattiger, *The Intellectual and Technical Property-Components of proVitamin A Rice (Golden Rice): A Preliminary Freedom-to-Operate Review*. ISAAA Briefs No 20 (2000), <http://www.isaaa.org/resources/Publications/briefs/20/download/isaaa-brief-20-2000.pdf>.

called FRAND licensing commitments for standardized products), and to aggregate both patents and copyrights in pools (see Chapter 26), such industry-wide efforts are uncommon.

As noted in Chapter 26.A, Note 6, patent pools are rare in the biopharmaceutical field. However, licensing practices have developed in the industry to account, at least partially, for royalty stacking concerns.

### **Example – Royalty Stacking Clause**

In the event that Licensee, in connection with exercising the rights licensed to it under Section x, is required to pay license fees, royalties or similar amounts to a third party in addition to Licensor in respect of patents covering the manufacture, use or sale of the Licensed Products in any country solely by reason of the incorporation of Licensed Technology therein or the implementation of any of the claims of the Patent Rights ("Third Party Payments"), and such Third Party Payments exceed [25% of the Royalties payable to Licensor hereunder,] then the Royalties payable hereunder shall be reduced by [50% of] the amount of such Third Party Payments actually paid by Licensee with respect to Net Sales of Licensed Products during the same calendar quarter [, provided, however, that the amount of such reduction shall in no event exceed fifty percent (50%) of the Royalties otherwise due hereunder].

The above clause allows the licensee to reduce its royalty payments to the licensor if it is required to make patent-related payments to another party. In response, the licensor may seek various limitations, including (a) a threshold that must be met before any adjustment is made, (b) a discount on the amount of the Third Party Payment to be applied against Royalties due to the licensor, and (c) a limit on the overall reduction of such Royalties.

Royalty stacking clauses are most common in the biotechnology sector, though they do appear occasionally in licenses relating to semiconductors and other patented technologies. They are not widely used in connection with copyright licenses.

#### *(b) Royalties for Bundled Rights*

A licensor will sometimes license a bundle of IP rights as a single package. In these cases, it usually charges a single royalty that does not differentiate among the multiple rights included in the bundle. In these arrangements, the royalty typically remains constant, whether or not individual rights (typically patents or copyrights) are added or subtracted from the bundle.

As discussed in Part B.3 above (Note 4), bundled royalty arrangements were validated by the Supreme Court in *Automatic Radio Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950) where a fixed royalty was charged with respect to a portfolio of more than 500 patents, some of which would expire during the term of the agreement. The Court held that the bundled royalty was “a convenient mode of operation designed by the parties to avoid the necessity of determining whether each type of petitioner's product embodies any of the numerous Hazeltine patents”, *id.* at 833.

Since *Automatic Radio*, the pricing of bundled rights at a fixed rate has been further validated, including by a national review committee convened by the Attorney General in 1955:

Package licensing should be prohibited only where there is refusal, after a request, to license less than a complete package. Additionally, the licensor should not be required to justify on any proportional basis the royalty rate for less than the complete package, so long as the rate set is not so disproportionate as to amount to a refusal to license less than the complete package. For example, where a substantial group of patents are offered at a flat royalty rate, the deletion of one or several specified patents need not affect the rate.<sup>23</sup>

Nevertheless, the Supreme Court's 1964 decision in *Brulotte v. Thys*, 379 U.S. 29 (1964) (reproduced in Chapter 24), established that post-expiration royalties are not permissible and constitute a form of patent misuse. However, *Brulotte* involved a portfolio of 12 patents, all of which had expired by the time of the royalty dispute. Cases following *Brulotte* indicate that so long as a single patent in a licensed portfolio remains in effect, the licensor need not decrease the portfolio royalty.<sup>24</sup>

This being said, some licensors have adopted the practice of adjusting bundled royalty rates downward as patents in the bundle begin to expire. One of the most notable of these was the DVD6C patent pool, which decreased its royalty for DVD players and discs every two years as patents in the portfolio began to expire.<sup>25</sup>

## NOTES AND QUESTIONS

1. *The Licensor's Perspective.* It is clear why a licensee would wish to reduce the royalty payable to a licensor based on royalties payable to third parties, but why would a licensor accept a royalty stacking clause? In other words, why should a licensor of a valid IP right be penalized because the licensee's product will include IP owned by others?

2. *Bundling for Convenience.* In *Automatic Radio*, the Supreme Court held that charging a single rate for a bundle of IP rights does not constitute patent misuse if agreed for the parties' mutual convenience. Conversely, in *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100 (1969), the Court held that patent use may be found when "the patentee directly or indirectly "conditions" his license upon the payment of royalties on unpatented products — that is, where the patentee refuses to license on any other basis and leaves the licensee with the choice between a license so providing and no license at all." How should a patentee thread the needle between these two cases? May it offer a "standard" licensing program for its portfolio which includes all patents for a single rate, or must it honor every licensee's request for a more limited license at a reduced rate?

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<sup>23</sup> Report of the Attorney General's National Committee to Study the Antitrust Laws 39-40 (March 31, 1955).

<sup>24</sup> See, e.g., *McCullough Tool Co. v. Well Surveys, Inc.*, 43 F.2d 381, 410 (10th Cir. 1965), *cert. denied* 383 U.S. 933 (1966) (distinguishing *Brulotte*, in which the licensor "attempted to extend the period for paying royalties beyond the date of expiration of the last of the patents covered by the agreement"). But see *Rocform Corp. v. Acitelli-Standard Concrete Wall, Inc.*, 67 F.2d 678 (6th Cir. 1966) (licensor misused its patents by failing to reduce package royalty rate after the most important patent in the package had expired).

<sup>25</sup> DVD6C Licensing Group, Royalty Rates Under the DVD6C Licensing Program, <http://www.dvd6cla.com/royaltyrate.html>.

#### D. ***SUBLICENSING INCOME***

Running royalties are based on the licensee's (and its Affiliates') revenue earned from the sale of Licensed Products. But what if the licensee does not itself sell Licensed Products, but instead sublicenses its rights to another party who manufactures and sells those products? Such arrangements are common in a number of industries including biotechnology, branded goods, and literary works. If a sublicensee is in the picture, what should the licensee be required to pay the licensor? The answer to this question can have significant financial implications for the parties.

There are three general options that can be used to allocate sublicensing income between the licensor and the licensee:

1. *Include Sublicensee's Revenue in Licensee's Net Sales* -- "Net Sales" on which the licensee's royalty is based can include revenue received by the Licensee, its Affiliates, and their Sublicensees.
2. *Include Licensee's Sublicensing Income in Licensee's Net Sales* -- "Net Sales" on which the licensee's royalty is based can include all amounts that the Licensee receives from its Sublicensees, including sublicensing fees, royalties and milestone payments.
3. *Share Licensee's Sublicensing Income* -- The licensee can pay the licensor a specified percentage of all amounts that the licensee receives from its sublicensees, including sublicensing fees, royalties and milestone payments, which is at a different (and usually higher) rate than the Running Royalties that the licensee pays on its own Net Sales (e.g., 50%).<sup>26</sup>

The financial effects of these different payment structures can be illustrated by the below example.

- a. Brand Owner grants a U.S. manufacturer (USM) the worldwide right to use a particular brand on apparel at a royalty rate of 25%.
- b. USM grants a Korean manufacturer (KM) the right to use the brand on apparel in South Korea.
- c. USM, knowing that profit margins on Korean branded apparel are very high, charges KM a royalty of 40%.
- d. During a particular quarter, USM earns \$100,000 from sales of branded shirts, and KM earns \$500,000.

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<sup>26</sup> Cf., *B.J. Thomas v. Gusto Records, Inc.*, 939 F.2d 395 (6th Cir. 1991) (according to industry custom, "the musician receives half of the fees received from licensing the masters to unaffiliated third parties").



USM's royalty obligation to Owner for its U.S. sales is 25% of \$100,000 or \$25,000.

KM's royalty obligation to USM is 40% of \$500,000 or \$200,000.

What, then, must USM pay Owner with respect to KM's sales? This depends on the payment structure agreed by Owner and USM.

If they used Option 1, in which USM's Net Sales are deemed to include KM's sales revenue, then KM's entire \$500,000 revenue is counted in USM's Net Sales, and USM must pay 25% to Owner, a royalty of **\$125,000**.

If they chose Option 2, in which the royalty income received by USM from KM is included in USM's Net Sales, then USM must pay Owner 25% of the \$200,000 royalty paid by KM to USM, or a royalty of **\$50,000**.

If they chose Option 3, assuming that USM and Owner have agreed to split USM's sublicensing revenue 50-50, then USM must pay Owner 50% of the \$200,000 royalty paid by KM to USM, or **\$100,000**.

The above example demonstrates the significant financial effect that the treatment of sublicensing income can have. But the effect can be even more stark. Suppose that Korean margins on apparel are much lower than they are in the U.S., and KM can only pay USM a royalty of 10%. In this case, KM pays USM a royalty of \$50,000 on its revenue of \$500,000, and USM's payment to Owner is:

Option 1:  $25\% \times \$500,000 = \mathbf{\$125,000}$

Option 2:  $25\% \times \$50,000 = \mathbf{\$12,500}$

Option 3:  $50\% \times \$50,000 = \mathbf{\$25,000}$

Note that under Option 1, USM earns only \$50,000 from KM but pays \$125,000 to Owner resulting in a net loss to USM of \$75,000. Under this scenario, the individual who drafted the Owner-USM license agreement would likely be out of a job.

In reality, Option 3 is the most common method for handling sublicensing income, with a split negotiated at, above or below the 50-50 level. However, attorneys should be vigilant to ensure that definitions of Net Sales do not inadvertently include sublicensing income in a manner that would distort the financial deal reached by the parties.

## E. *MILESTONE PAYMENTS*

### 1. *Milestone and Diligence Requirements*

Because the licensor of an IP right often depends on its licensees for revenue, and because the licensor seldom exercises direct control over its licensees' activities, license agreements often contain provisions that measure the licensee's progress against certain commercial or technological goals (milestones). Often, the licensee's achievement of a milestone triggers a payment by the licensor, though this is not always the case.<sup>27</sup>

Milestones, sometimes referred to as "diligence requirements", serve several purposes in an agreement. First, if the achievement of a milestone is coupled with a payment obligation by the licensor, it rewards the licensee for achieving a substantial step toward the ultimate commercial goal of the agreement and incentivizes the licensee to achieve that milestone. Milestone payments also permit the licensor to stagger payments of increasing size to the licensee based on its demonstrated progress toward full commercialization of the licensed rights. As such, milestone payments align the licensor's payment obligations with the licensee's likelihood of achieving commercial success than, say, periodic lump sum payments.



From the licensee's standpoint, milestone payments can provide needed cash to fund increasingly costly operations associated with its commercialization program. Many milestone schedules relate to the period before commercial launch of a product, such that milestone payments are made before the licensee begins to sell products and earn royalty income.

A final reason that milestones appear in license agreements is statutory. Under the Bayh-Dole Act of 1980 (discussed in Chapter 14), academic institutions that obtain federal funding may patent their federally-funded inventions, but are subject to a number of requirements. Among these is the obligation to report to the federal funding agency "on the utilization or efforts at obtaining utilization that are being made" by the institution and its licensees with respect to each federally-funded invention. 35 U.S.C. § 202(c)(5). As a result, many licenses in fields that are heavily funded by the federal

<sup>27</sup> Separately from triggering any payment obligation of the licensor, a licensee's milestone or diligence requirements under an agreement may be viewed as affirmative obligations of the licensee, the failure to achieve which could constitute breach of contract.

government (biotechnology, aerospace, agriculture, computer encryption) contain measurable indicia of utilization of the licensed technology.

## 2. *Types of Milestones*

Milestones are intended to reflect the achievement of defined goals along the road to the full commercial exploitation of a licensed IP right. As such, milestones can reflect steps along the regulatory, technological or commercial pathway to commercialization.

Common examples of **regulatory** milestones include:

- The Licensee files an Investigational New Drug (IND) application for a Licensed Product with the FDA
- The Licensee [begins/completes] Phase I/II/III clinical trials of a Licensed Product
- The Licensee receives FDA approval to market a Licensed Product in the United States
- The Licensee receives regulatory approval to market a Licensed Product in [country]

Common examples of **technological** milestones include:

- A working Licensed Product prototype is demonstrated to Licensor
- A specified technical/scientific threshold is met
- The Licensed Product is certified by a recognized international certification body
- The Licensed Technology is submitted to a recognized international standards body
- The Licensed Technology is adopted by a recognized international standards body as an industry standard
- A “beta” version of the Licensed Product is released

Common examples of **commercial** milestones include:

- The Licensed Product is announced at a major trade show or event
- The Licensee enters into a manufacturing agreement for Licensed Products
- Licensee completes construction of its manufacturing facility for Licensed Products
- The Licensee appoints a distributor for the Licensed Product in [country/region]
- The Licensee sells the first 100 units of Licensed Product
- The Licensee’s first sale of Licensed Products in [country/region]
- Licensee earns \$XXX from sales of Licensed Products

The licensee is often required to submit a periodic (often annual) report to the licensor indicating its progress toward achieving any as-yet unmet milestones.

### 3. *Size of Milestone Payments*

Just as with up-front payments and royalties, there is no uniform methodology for determining the size of milestone payments. To some degree, these payments can be dictated by the licensee's anticipated cash needs as its commercialization program for the licensed IP progresses. For example, as a drug candidate advances along the development pathway, the scope and cost of human clinical trials increases dramatically.

Despite this variation, one thing that can generally be said about milestone payments is that the achievement of successive milestones usually triggers increasingly large payments. The following example illustrates this principle.

#### **Example – Due Diligence Milestones and Payments**

As further consideration for the rights granted under this Agreement, Licensee will pay Licensors a non-refundable, non-creditable milestone payment upon the satisfaction of the following diligence milestones within thirty (30) days following Licensee's written certification thereof, provided that such diligence milestone is achieved by the corresponding date specified below:

<b>Diligence Milestone</b>	<b>Milestone Payment</b>	<b>To be Achieved by</b>
Licensee begins U.S. Phase II clinical trial of Licensed Product	\$15,000,000	Mar. 1, 2022
Licensee begins U.S. Phase III clinical trial of Licensed Product	\$25,000,000	Jan. 1, 2024
U.S. FDA grants marketing approval of Licensed Product	\$50,000,000	Jan. 1, 2026
First U.S. sales of Licensed Product	\$100,000,000	June 30, 2026

One study of more than 1,000 biopharma licensing deals signed between 1998 and 2018 found that average total milestone payments were approximately \$31 million, with a high of \$800 million (in a 2001 deal between Eli Lilly/ImClone and Bristol-Myers Squibb for the tumor drug Erbitux).<sup>28</sup>

<sup>28</sup> Edwards, *supra* note 2.

### “BIOBUCKS”

In the biopharmaceutical sector, licensing and development deals valued in excess of \$1 billion are regularly announced in the press. But upon closer inspection, it turns out that few of these deals actually result in the advertised payments being made. For example, in 2016, Novartis and Xencor announced a \$2.4 billion deal for two drugs targeted at acute myeloid leukemia and B-cell malignancies. But only \$150 million was paid up-front, with the rest payable upon the achievement of regulatory and commercial milestones.<sup>29</sup> In an analysis of 700 biotech deals, STAT found that on average, only 14% of the announced deal value was paid upon signing.<sup>30</sup> Another recent study of 100 biotech deals found that, on average, only about one-third of potential milestone payments were actually paid out over the term of the agreement.<sup>31</sup> So how can companies announce billion dollar deals when only a fraction of the stated amount is likely to be paid? Behold the magic of “BioBucks” – inflated dollar amounts that are useful for press releases, but little else.

#### 4. *Consequences of Missed Milestones*

Milestones may be structured in a number of ways, and significant legal ramifications flow from the choices that are made:

- Milestones may be binding *commitments* -- if the licensee does not achieve a milestone, it is in breach the contract,
- Milestones may be *termination* triggers -- if the licensee does not achieve a milestone, the licensor may have the right to terminate the agreement,
- Milestones may be *goals* -- the licensee must expend some degree of effort to meet the milestones, but failing to meet the is not a breach,
- Milestones may be *payment* triggers -- a payment is triggered when a milestone is achieved, and
- Milestones may be requirements for maintaining *exclusivity* -- if the licensee does not achieve a milestone, the licensor may convert some or all of the license from exclusive to non-exclusive.

To make matters more complicated, these consequences of missed milestones are not mutually exclusive. An agreement may give rise to multiple remedies for a licensee’s failure to meet a

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<sup>29</sup> See Amy Reeves, *Novartis, Xencor Ink \$2.4 Billion Licensing Deal In Blood Cancer*, Investor’s Business Daily, Jun. 28, 2016, <https://www.investors.com/news/technology/novartis-xencor-ink-2-4-billion-licensing-deal-in-blood-cancer/>

<sup>30</sup> Damian Garde, *What’s behind those billion-dollar biotech deals? Often, a whole lot of hype*, STAT, Nov. 18, 2016, <https://www.statnews.com/2016/11/28/biotech-biobuck-deals/>

<sup>31</sup> Philip Gregg, *Biotechs receive one-third of the milestone payments provided for in licensing agreements*, Born.to.Invest, Jan. 2, 2020 (translated from French original), <https://born2invest.com/articles/biotechs-receive-one-third-of-the-milestone-payments-provided-for-in-licensing-agreements/>

milestone. Consider the following case, which concerns a dispute over compliance with a milestone requirement.

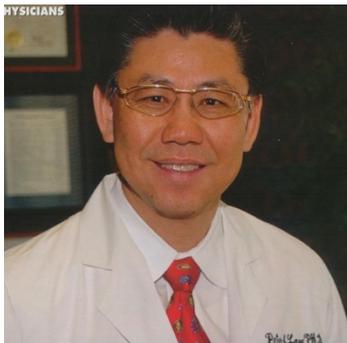
### **LAW V. BIOHEART, INC.**

2009 U.S. Dist. LEXIS 21464 (W.D. Tenn. 2009)

DONALD, DISTRICT JUDGE.

#### FINDINGS OF FACT

In 1991, Dr. [Peter K.] Law resigned his professorship at the University of Tennessee to launch the Cell Therapy Research Foundation ("CTRF"), a non-profit organization dedicated to developing cellular treatments for muscular dystrophy, particularly Duchenne muscular dystrophy. At the time Dr. Law separated from employment with the University of Tennessee, the University of Tennessee Research Foundation--the owner of patents developed by Dr. Law while in the university's employ--granted to Dr. Law ... rights to the patent application that eventually, through Dr. Law's efforts, became U.S. Patent No. 5,130,141 ("141 patent"). In addition to the '141 patent, Dr. Law has also developed other technologies that have been patented.



*Dr. Peter K. Law*

Beginning in 1991 with the founding of CTRF, Dr. Law concentrated his scientific work on treating sufferers of muscular dystrophy both in the United States and abroad by means of "Myoblast Transfer Therapy" ("MTT"). MTT involves the transfer of a normal human genome to a genetically abnormal patient through the injection of cultured myoblasts. A myoblast, sometimes called a satellite cell, is an immature skeletal muscle cell. In the treatment of muscular dystrophy by MTT, a small number of cells are taken from a genetically normal donor. Those cells are then cultivated into billions of additional cells over several weeks, and the cultivated cells are injected into the patient. The implanting of cells from one person into another, such as in MTT, is known as an allogenic process. By contrast, in an autologous process, the cells implanted are derived from cells extracted from the patient's own body.

[In 1997], Dr. Law formed Cell Transplants International, LLC ("CTI"), a Tennessee limited liability company, in order to commercialize his patents. In 2004, Dr. Law allowed the Tennessee Secretary of State to administratively dissolve CTI. CTI had become financially unsound and left numerous creditors at its dissolution.

In 1999, Dr. Law and CTRF became the subject of an investigation by the Food and Drug Administration ("FDA") after an inspection of CTRF's laboratory revealed a number of deficiencies. The FDA placed the MTT program, which at the time was in trials pursuant to an "investigational new drug" application ("IND application"), on clinical hold in October 1999, thereby precluding further trials and treatment. In the summer of 2000, the FDA seized Dr. Law's supply of myoblasts and notified Dr. Law that he had been disqualified as an FDA-approved clinical researcher. Dr. Law's myoblasts were destroyed by the FDA in February 2001. In November 2002, the FDA notified him that it intended to conduct a hearing on his qualifications.

Dr. Law failed to appear at the FDA's hearing and did not otherwise contest the charges against him. Finally, in October 2006, the FDA officially disqualified Dr. Law from serving as an investigator in clinical trials.

### B. Bioheart

Bioheart, a Florida corporation, maintains its principal place of business in Sunrise, Florida. In 1999, Howard Leonhardt, a businessman with many years of experience in the biotechnology sector, formed Bioheart with the goal of developing and commercializing cellular therapies designed to repair or regenerate damaged human heart muscle. After some initial research, Bioheart decided that it would utilize myoblasts, as opposed to other types of cells, in this process.

"MyoCell" is the trade name of the product Bioheart ultimately developed. MyoCell treatment involves first taking a skeletal muscle biopsy from the thigh of a patient who has suffered heart failure. Myoblasts are then removed from the biopsied muscle tissue. These myoblasts are isolated and cultured in a proprietary growth media, which causes the myoblasts to grow into millions or even billions of cells. Finally, the cultured myoblasts are implanted into the damaged heart muscle by means of a catheter. Bioheart's original plan did not call for Bioheart to culture myoblasts itself. Bioheart instead planned to contract this responsibility to outside manufacturers--namely Dr. Law and his facility.

As part of developing MyoCell, Bioheart sought out and acquired patents and other intellectual property that potentially possessed utility for its purposes. ... Mr. Leonhardt concluded that Dr. Law's '141 patent might cover at least part of the process being developed by Bioheart. Bioheart, therefore, decided to contact Dr. Law in order to obtain rights to his '141 patent.

### C. The License Agreement

In early 2000, Dr. Law and Bioheart exchanged draft proposals for an agreement by which Bioheart would acquire a license to practice the '141 patent. At this time, Bioheart and Mr. Leonhardt were operating under the impression that Dr. Law's procedures were FDA-compliant and that he was in the process of conducting human clinical trials; in reality, this was precisely when Dr. Law's problems with the FDA were escalating. Dr. Law represented that he could greatly assist Bioheart in the development of its product, including by becoming Bioheart's supplier of cultured myoblasts. Reliance upon Dr. Law would, Bioheart believed, enable it to progress quickly into clinical studies and then to commercialization of MyoCell. Ultimately, both sides reached an agreement, producing the first contract ("License Agreement") at issue in this case.

Mr. Leonhardt executed the License Agreement on behalf of Bioheart on February 7, 2000, and Dr. Law executed the License Agreement on February 9, 2000. Dr. Law repeatedly made representations to Mr. Leonhardt that he and CTI/CTAL could be Bioheart's supplier of cultured myoblasts, and Bioheart anticipated that they would act as its supplier.

### D. The Addendum

Shortly after execution of the License Agreement, the parties recognized the need for revisions and modifications to its terms as well as the need to enter into additional agreements. The parties

also appeared to be unclear on ... exactly what events would cause the \$3 million milestone payment to become due.

Consequently, the parties undertook discussions lasting from approximately February to July 2000 aimed at altering their original agreement. [O]n July 21, 2000, Dr. Law executed the Addendum ("Addendum") amending the License Agreement.

The Court summarizes the terms of the Addendum as follows:

Section 1. Dr. Law and CTI agree to sign four separate agreements along with the Addendum: (a) a Scientific Advisory Board Consultation Agreement ("Advisory Board Agreement"); (b) a Supply Agreement ("Supply Agreement") related to supplying cultured myoblasts; (c) an Inventions and Proprietary Rights Assignment and Confidentiality Agreement ("Inventions and Proprietary Rights Agreement"); and (d) a Warrant Certificate ("Warrant Certificate") related to obtaining stock in Bioheart. ...

Section 2(a). ... Dr. Law and/or CTI shall provide Bioheart with "all pertinent and critical information" needed to obtain FDA approval of an IND application for the processes being developed by Bioheart.

Section 2(c). Bioheart agrees to make a \$ 3 million milestone payment to CTI upon commencement of a "bona fide Phase II human clinical trial study that utilizes technology claimed under [the '141 patent] with [FDA] approval in the United States[.]" ...

...

#### E. Subsequent Relations Between Plaintiffs and Bioheart

In the period following execution of the Addendum, Bioheart was still preparing for the filing of its initial IND application with the FDA, but Dr. Law's operations in Memphis were already the subject of an ongoing FDA investigation into his practices. The parties had entered into the Supply Agreement on the premise that CTI would be Bioheart's primary, if not sole, supplier of cultured myoblast, but CTI was never able to perform the Supply Agreement in spite of Bioheart's repeated insistence that its performance was needed. Ultimately, Bioheart began seeking other suppliers, which had the effect of delaying its IND application.

As indicated above, Section 2(a) of the Addendum obligated Dr. Law and/or CTI to provide Bioheart with "all pertinent and critical information" needed "to file an IND with the FDA and to have [the IND application] approved by the FDA." Providing this information was a vital part of facilitating Bioheart's submission of an IND application. Dr. Law, however, never discharged this obligation as Bioheart had envisioned. Dr. Law failed to provide Bioheart with his complete standard operating procedures ("SOP's") for culturing myoblasts even though Bioheart needed them in order to file its IND application, and the SOP's Dr. Law did provide were either redacted or so vague as to be unhelpful. Declaring it to be proprietary information, Dr. Law also withheld information from Bioheart regarding the formulation of the culturing media employed in his processes, which was likewise required for the IND application. Similarly, Dr. Law never gave Bioheart all the information needed regarding the source of his media's ingredients, nor did he ever furnish the necessary certificates of analysis for these ingredients. Although Bioheart requested it, Dr. Law and CTI also refused Bioheart even limited access to their "drug master file" in relation

to certifying the safety of Dr. Law's cell culturing media. Additionally, Dr. Law did not make available to Bioheart information on shipping and transporting cultured myoblasts.

Determining that Dr. Law's SOP's did not comply with the FDA's cGMP standards and facing a lack of necessary information about Dr. Law's processes and media, Bioheart elected to develop its own SOP's and culturing media rather than rely upon Dr. Law and CTI. Dr. Law insisted at trial that he only withheld the SOP's for yielding the billions of cells that he would produce in MTT because that number of cells would be too great for Bioheart's needs. The Court finds, however, that Dr. Law's failure to provide information was not as harmless as he contends.

After developing its own SOP's and culturing media, Bioheart filed an IND application in 2002. Bioheart also built a cGMP-compliant cell culturing facility. Subsequent attempts to consult with Dr. Law did not result in meaningful assistance, and Dr. Law continued to withhold information. At trial, Bioheart submitted that Dr. Law's failures severely hindered its IND application and forced it to develop SOP's and culturing media at a cost of \$3,737,657.19.

MyoCell now depends upon processes and media that differ substantially in several significant ways from those developed by Dr. Law. Bioheart's first trial of MyoCell in the United States occurred in April 2003. The next significant step in the development process, FDA-approved Phase II/III human clinical trials, commenced in October 2007. No commercialization of MyoCell has yet occurred, although Bioheart has received partial reimbursement of certain expenses in relation to its clinical trials.

## CONCLUSIONS OF LAW

### *Plaintiffs' Claim for the \$ 3 Million Milestone Payment*

In Count Four of their amended complaint Plaintiffs sue for damages under Section 11 of the License Agreement, the provision obligating Bioheart to make a \$3 million milestone payment to CTI/CTAL upon the occurrence of certain events. Section 2(c) of the Addendum contains language superseding Section 11 of the License Agreement. Because the Court has found that the Addendum validly supplants parts of the License Agreement, any claim to the milestone payment under the terms of License Agreement is moot. Nevertheless, Plaintiffs contend that they are also entitled to the milestone payment under the Addendum because the conditions described in Section 2(c) of the Addendum have now occurred. Specifically, Plaintiffs argue that Bioheart has commenced a bona fide Phase II human clinical trial study in the United States utilizing technology claimed under the '141 patent with FDA approval. Bioheart makes several independent arguments in response. The Court concludes that Bioheart is entitled to judgment on Count Four of Plaintiffs' amended complaint.

### *Existence and Satisfaction of Condition Precedent*

Bioheart [argues] that the milestone payment under Section 2(c) is subject to a condition precedent which neither Dr. Law nor CTI has satisfied. According to Bioheart's interpretation, Section 2 of the Addendum creates a condition precedent when it prefaces the terms of the new agreement with a recital stating that the contract is "[i]n consideration of Dr. Law's and CTI's execution, delivery and performance of the above-identified agreements [i.e., the Advisory Board Agreement, Supply Agreement, Inventions and Proprietary Rights Agreement, and Warrant Certificate] as well as the [License] Agreement, as amended and supplemented hereby[.]"In the provisions that followed, Bioheart agreed, among other things, to make the milestone payment

upon "commencement of a bona fide Phase II human clinical trial study that utilizes technology claimed under [the '141 patent] with [FDA] approval in the United States." Bioheart now cites four ways in which, it says, the condition precedent has not been satisfied: (1) CTI never performed and never was able to perform the Supply Agreement under which CTI was to furnish Bioheart with FDA-quality myoblasts; (2) Dr. Law failed to comply with his obligation under the Inventions and Proprietary Rights Agreement to give Bioheart access to his information--including his formulae, processes, manufacturing techniques, and trade secrets--related to heart muscle regeneration and angiogenesis; (3) Dr. Law did not conduct research of "mutual interest" in exchange for receiving the \$500,000 payment; and (4) Dr. Law did not provide Bioheart "with all pertinent and critical information in order to file an IND with the FDA and to have it approved by the FDA" as he was obligated to do by Section 2(a) of the Addendum. Plaintiffs' principal argument in response is that these are not part of a condition precedent to the milestone payment. Rather, they urge that the only condition to payment of the milestone is Bioheart's initiation of the Phase II human clinical study, an event that has occurred.

"A condition precedent generally is defined as 'an act or event, other than a lapse of time, which must exist or occur before a duty of immediate performance of a promise arises.'" (citation omitted) A condition precedent may be a prerequisite to the coming into existence of a binding contract, or it may be what causes a duty in an existing contract to arise. If it is subject to a condition precedent, a duty need not be performed until the condition occurs or the nonoccurrence of the condition is excused.

Plaintiffs correctly note that Tennessee law, like the law in other jurisdictions, does not favor contractual conditions precedent. Generally, where it is fairly debatable whether particular language in a contract creates a condition precedent, the language will be interpreted in favor of creating only a covenant or promise. Where, however, it is the parties' intention, as gleaned from the language of the contract and the surrounding circumstances, to create a condition precedent, it will be upheld. Although it does not require the use of any particular language, "[t]he presence of a condition is usually signaled by a conditional word or phrase such as 'if,' 'provided that,' 'when,' 'after,' 'as soon as,' and 'subject to.'"

Considering the Addendum as a whole, the Court concludes that the preface in Section 2 does not create a condition precedent to the \$3 million milestone payment. First, Section 2 does not employ any of the terms or phrases usually associated with creation of a condition precedent. While the specific language of Section 2(c) does signal a condition by making Bioheart's payment due only "upon commencement" of a Phase II human clinical study "utilizing technology claimed" under the '141 patent, no reference is made within Section 2(c) to any other condition. And, as Plaintiffs note, in Section 1 of the Addendum, the parties indisputably set up a condition precedent to the Addendum's becoming an enforceable contract. There the Addendum reads, "It shall be an express condition precedent to the effectiveness of this Addendum that . . . [the four described agreements] . . . be executed and delivered by the parties hereto." Thus, Section 1 is compelling evidence to indicate that, when these parties unmistakably intended a condition precedent, they knew how to express their wish clearly. Presumably then, if the parties had intended Section 2 to also contain a condition precedent, they would have been just as explicit. Furthermore, Bioheart's argument puts too great an emphasis on use in Section 2 of the word "performance"--a term whose inclusion can fairly well be characterized as referring to the mutual promises (detailed in the subparts to Section 2) which serve as the Addendum's consideration. Taking all of these factors along with the legal presumption against finding conditions precedent, the Court finds that

Bioheart's \$3 million milestone payment is not subject to a condition precedent other than commencement of the clinical study described in Section 2(c). A party's failure to perform the duties Bioheart references could constitute a breach and be the basis of an independent claim for damages, but it would not amount to a failure of a condition precedent.

### *Failure of Consideration*

Bioheart's post-trial filings also suggest that the \$3 million milestone payment is not due because Dr. Law has not followed through on all of his obligations under the Addendum, which would amount to a failure of consideration. A "failure of consideration" refers to an uncured material failure by one party to perform its promised obligations under a contract. This excuses the performance of the party which did not breach.

[T]he Court concludes that Dr. Law did breach his duty under the Addendum to provide "all pertinent and critical information" necessary for Bioheart to file its IND application with the FDA. The Court, though, does not find that Dr. Law has totally failed to fulfill any of his obligations under the Addendum, nor did Bioheart seek to prove that he did. Dr. Law's breaches constitute no more than a partial failure of consideration, which can give rise to the remedy of rescission only if "the failure defeats the very object or purpose of the contract or renders that object impossible to accomplish." Given that Bioheart chooses to embrace the Addendum rather than to have the Addendum rescinded, Bioheart's remedy for Dr. Law's breach is to pursue a claim for money damages, not to have its own performance excused.

### *Utilization of Technology Claimed under the '141 Patent*

Finally, Bioheart argues that the milestone payment is not due because MyoCell does not "utilize[] technology claimed under" the '141 patent. The Court agrees. CTI is entitled to no milestone payment if the Phase II human clinical study does not utilize technology claimed under the '141 patent, and the evidence at trial established that the MyoCell process does not. MyoCell is an autologous process, whereas the process described in '141 patent is allogenic. MyoCell also uses pure myoblasts, but the '141 patent describes the use of a mixture of myoblasts, myotubes, and young muscle fibers. Further, MyoCell utilizes a culturing media different from that developed by Dr. Law as well as a different method for storing and transferring cultured cells. In light of these substantial differences, the Court finds that Bioheart's MyoCell process does not utilize technology claimed under the '141 patent. The Court thus dismisses Count Four of Plaintiffs' amended complaint.

## **NOTES AND QUESTIONS**

1. *Rationales for Milestones.* What rationale do licensors typically have for including milestones in licensing agreements? What about licensees? What do you think are the typical points of contention in formulating milestones?

2. *Satisfaction of Milestones.* In *Law v. Bioheart*, Dr. Law failed to fulfill several of his contractual obligations, yet the court was still willing to uphold his right to receive the \$3 million milestone payment. On what ground did the court eventually reject his claim to the milestone?

3. *Election of Remedies.* The court notes that despite Dr. Law's breaches, "Bioheart chooses to embrace the Addendum rather than to have the Addendum rescinded". Why do you think Bioheart made this choice? What would have been the effect on the parties' obligations of rescinding the Addendum?

4. *The Rest of the Story.* Bioheart's business is commonly referred to as "stem cell therapy", a controversial and largely unregulated process that one Harvard stem cell biologist refers to as "the modern equivalent of snake oil".<sup>32</sup> Bioheart, whose investors included Dan Marino, former quarterback of the Miami Dolphins, changed its name to US Stem Cell in 2016. As noted by the court, beginning in 1999 the FDA investigated Dr. Law, seized and destroyed his stock of myoblasts, and disqualified him as a clinical investigator in 2006. In 2017, Dr. Law, writing from his position at the Cell Therapy Institute in Wuhan, China, struck back. He published an article in which he accused the FDA of "character assassination", "non-scientific, unjust and possibly illegal practices" and "crime[s] against humanity".<sup>33</sup> He insists that his myoblast therapy for Duchenne Muscular Dystrophy is both safe and effective.

#### PROBLEM 8.4

You represent Western University, which has patented a promising new process for curing cheese. You are negotiating an exclusive license agreement with Cheesy Co., a small, local company that produces artisanal cheeses. The parties have agreed that Cheesy will pay up to \$5 million in milestone payments to WU. Draft a "Milestones" section of the agreement that includes five reasonable milestones and accompanying payments and that describes the schedule for milestone achievement and the consequences for non-achievement of milestones.

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<sup>32</sup> Sharon Begley, *Three patients blinded by stem cell procedure, physicians say*, STAT, Mar. 15, 2017 (quoting Dr. George Daley, dean of Harvard Medical School).

<sup>33</sup> Peter K. Law, *Crime against Humanity—Uncovering Two Decades of Corruption in the FDA Regarding DMD Treatment*, 6 Open J. Regenerative Med. 35 (2017).



*Stanford University is reported to have earned \$336 million by selling shares of Google stock in the company's 2004 IPO and subsequent offerings.*

#### F. ***EQUITY COMPENSATION***

When a licensee is a start-up company without substantial financial resources, a licensor may accept shares of the licensee's capital stock as full or partial compensation for a license. While this arrangement is most common in university spin-out licenses (see Chapter 14), it occurs elsewhere as well.

The issuance of stock involves corporate and securities laws that are beyond the scope of this book. However, even non-corporate attorneys should be familiar with the basic contractual terms surrounding the issuance of equity securities in licensing agreements.<sup>34</sup>

#### **Example – Equity Compensation**

Licensee will grant to Licensor \_\_\_\_\_ shares of the Licensee's common stock (the "Shares"), which represents \_\_\_ percent (\_\_\_\_%) of the issued and outstanding equity securities of Licensee, calculated on a fully diluted, as converted basis, as of the Effective Date, after giving effect to the issuance of the Shares.

The Shares are fully paid as partial consideration for the license of certain intellectual property rights granted by Licensor to Licensee under this Agreement.

Such Shares shall be issued to Licensor and evidenced by a stock certificate, registered in the name of Licensor, that is delivered to Licensor within thirty (30) days following the Effective Date.

U.S. universities generally seek equity compensation from start-up licensees in the range of 5-10% of the company shares. UK universities are known to seek higher equity shares, in the range of 50%.

<sup>34</sup> Further details can be found in Bryce Pilz, *Modern Intellectual Property Valuation in the Academic Technology Transfer Setting* in Research Handbook on Intellectual Property and Technology Transfer 166, 184-89 (Jacob Rooksby, ed., Edward Elgar: 2020).

But what does this percentage actually mean? Usually, it refers to a percentage of the total outstanding company stock, including both common and preferred stock,<sup>35</sup> as of the Effective Date of the agreement. Unexercised options and warrants to acquire shares of the licensee's stock are usually not included in this calculation.

For example, suppose that the licensor wants equity compensation equal to 5% of the licensee's equity. Suppose that the licensee has a total of 50,000 shares of common stock issued to its founders, and 10,000 shares of preferred stock, which converts to common stock at a ratio of 1:5. The total outstanding shares, on an as-converted basis, at the Effective Date is thus 100,000. The licensor's share will be 5% of the total, taking into account the issuance of the licensor's shares. Thus, the licensor will receive 5,263 shares, as this equals 5% of 105,263.<sup>36</sup>

The term "fully-diluted" in the above example refers to so-called "anti-dilution" provisions that are often contained in preferred stock terms. In short, these provisions result in the issuance of more shares of preferred stock if additional stock is issued to someone else. So the issuance of stock to the licensor itself could trigger an anti-dilution adjustment for the preferred stockholders, which would result in their having more stock, which would result in the licensor's share having to increase to reach the required level, and so on. The calculation can be done, but it is a bit complex.

These days, university licensors can ask for a range of additional equity-based protections and rights, including anti-dilution, the right to participate in future stock issuances, board observer rights, and the like. The provisions are beyond the scope of most typical licensing agreements and generally require the involvement of attorneys familiar with capital markets and equity issuance laws.

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<sup>35</sup> The term "as converted" means that shares of preferred stock are treated as though they have been converted to common stock, as most preferred stock can be, though sometimes on a basis greater than 1:1.

<sup>36</sup> A discussion of the mechanics of such transactions can be found in Mark Edwards, Fiona Murray & Robert Yu, *Gold in the ivory tower: equity rewards of outlicensing*, 24 *Nature Biotechnology* 509 (2006).

**Table 1 Benefits and risks associated with primary compensation mechanisms used in license agreements**

Type of compensation		Licensor	Licensee
Equity <sup>a</sup>	Benefits	Captures some future value regardless of product's stage of development Probability of a liquidity event is higher as equity can be cashed in before a company has a commercially successful product	Enables preservation of cash
	Risks	Equity can be illiquid and difficult to value Institutions with equity in licensees that are university startups/spinouts will be diluted in subsequent financing rounds unless the investment is upsized	Equity issuances are dilutive and the value of licensed IP contributing to the value of equity may be difficult to ascertain
Upfront payment <sup>b</sup>	Benefits	Payment received at earliest stage of development that captures immediate value	May enable reduction in other downstream economics by offering more upfront and/or guaranteed compensation
	Risks	Downstream economics such as milestones and royalties may be much more meaningful Securing more upfront and/or guaranteed compensation typically reduces long-term compensation, such as royalties	Cash payout is challenging if licensee is a small company/startup needing to conserve cash Risk of overpayment given challenge of successfully developing and commercializing a pharmaceutical product
Milestone payment <sup>c</sup>	Benefits	Yields economic benefits as clinical, regulatory or commercial milestones are met Can be monetized to accelerate payments and mitigate some clinical, regulatory and commercial risk	Enables preservation of cash until de-risking events occur
	Risks	Milestone payouts are binary in nature and are difficult to design, negotiate, and forecast	Requires company to reserve cash for milestone payouts, which can be difficult to predict
Royalties <sup>d</sup>	Benefits	Aligns long-term interests of licensor and licensee If based on a proportion of product sales, is not subject to inflation Can be monetized to accelerate payments and mitigate some clinical, regulatory, and commercial risk	Mitigates risk of initial overpayment and enables preservation of cash until product is commercialized
	Risks	Typically used under assumption that product will be commercialized within IP term	Ongoing royalty payments to licensor will have negative impact on profitability of product

<sup>a</sup>Equity includes transfer or issue of company shares from the licensee to the licensor. <sup>b</sup>Upfront payments include consideration paid by the licensee to the licensor following execution of the license agreement, and may include reimbursements for costs incurred. <sup>c</sup>Milestone payments are lump sum payments triggered by specific clinical, legal, regulatory, or commercial events paid by the licensee to the licensor. They may also be tied to the issuance of patents or other legal outcomes. <sup>d</sup>Royalty payments are regular, recurring payments, typically based on product sales, paid by the licensee to the licensor.

*In this table, Michael Reslinski & Bernhard Wu of DRI Capital compare the risks and benefits of different types of license compensation from the standpoint of the licensor and licensee.<sup>37</sup>*

## G. COST REIMBURSEMENT

When universities and small companies license patents, they often require that the licensee reimburse them for patent prosecution costs that they incurred prior to the execution of the agreement. If a license is exclusive, then the licensee often covers the entirety of these costs. If the license is co-exclusive, or if it is exclusive only in a particular field, then the cost is often split among licensees. Non-exclusive licensees typically do not reimburse the licensor for prosecution costs.

The level of patent prosecution costs will vary depending on the complexity of the technology, the development stage of the technology, the stage of prosecution (e.g., provisional application, utility application, examination, issuance, post-grant opposition), how many applications and patents have been filed, whether foreign protection has been sought, and whether competitors have, or are likely to, oppose the patent(s) at the Patent Trial and Appeals Board (PTAB). For “mature”

<sup>37</sup> Reslinski & Wu, *supra* note 15, at 686.

patents, maintenance fees may also have been paid to the PTO. These costs can thus range from as little as \$10,000 to several hundred thousand dollars or more.

Of course, patent prosecution often continues after a license agreement is signed, and maintenance fees will continue to become due with respect to issued patents. If the licensee has agreed to assume responsibility for prosecution matters (see Chapter 9), then the licensee will usually cover ongoing prosecution and maintenance costs. If the licensor retains this responsibility (e.g., if it has granted several exclusive licenses in different fields and has not granted prosecution responsibility to any one licensee), then the licensor may seek periodic reimbursement of at least a portion of its prosecution and maintenance costs. In some cases, these costs may be split by the licensor evenly among all licensees.

#### H. ***MOST-FAVORED CLAUSES***

“Most-Favored” licensee clauses find their roots in the world of international statecraft, in which the most favorable trade status that can be afforded to another country is that of a “most-favored nation” or MFN. Most-favored clauses are not uncommon in licensing agreements, and often retain the label “MFN” even when used in this private law context.

Most-favored clauses protect the licensee against competitive disadvantage arising from the licensor’s later grant of more favorable contractual terms to a competitor of the licensee. But with this type of clause, more than many others, the devil is in the details. Two examples of MFN clauses are provided below.

### Examples – Most Favored Licensee

#### Example 1

If during the term of the Agreement the Licensor grants to any unaffiliated third party licensee (“Third Party”) [that is of a similar size and geographic focus as Licensee] a license to the Licensed Patent in the Field of Use on financial terms that are [substantially] more favorable than those granted herein [for similar quantity and kind of Licensed Products], then Licensor shall promptly notify Licensee of such license, describing the Third Party’s more favorable terms in reasonable detail, though the identity of the Third Party need not be revealed.

Licensee shall then have a period of [60 days] in which to consider whether to exercise its rights under this Section. If it so elects, it shall notify Licensor in writing, and thereupon this Agreement shall automatically be amended to provide for such more favorable terms. Such amendment shall be retroactively effective to the date on which the more favorable terms were granted to the Third Party. In the event that such amendment requires the parties to make any adjusting payments, these shall be made within sixty (60) days following Licensee’s exercise of its rights hereunder.

#### Example 2

The aggregate Fees charged to Customer for [the Services/Software] during the term of this Agreement shall not exceed [ninety-five percent (95%) of] the aggregate fees contemporaneously charged by Licensor to any other [non-Affiliate customer / Competitor of Customer] for comparable services and software (taking into account product mix, term of use, number of seats/copies, and corresponding non-monetary benefits received by Licensor). Licensor shall adjust the Fees charged to Customer on a going-forward basis so that such Fees do not exceed such threshold; provided that if Licensor reduces the Fees charged to Customer to comply with such requirement and then subsequently ceases to charge Licensor’s [other customers/such Competitor] at or above the price that triggered such reduction, Licensor shall thereafter be entitled to increase the Fees charged to Customer to levels consistent with such pricing requirement, but in no case to levels above those originally charged under this Agreement. Notwithstanding the foregoing, under no circumstances shall Licensor be required to provide any refund, rebate or credit to Customer in respect of Fees paid prior to the charging of such lower fees to such other customer/Competitor.

The first question to ask when drafting (and negotiating) an MFN clause is how broad its scope should be in terms of *agreement coverage*. That is, what types of later agreements will need to be compared to the agreement with MFN treatment to determine whether their terms are more favorable? Should a patent license agreement be compared only to other patent license agreements? Or should other types of agreements, such as merger agreements, supply agreements and settlement agreements, also be subject to MFN comparison? This issue, which parties often fail to address in their drafting, is the subject of the *Kohle* case excerpted below.

The second issue of this nature concerns which future *licensees and fields of use* are subject to comparison under an MFN clause. That is, should the first licensee be entitled to terms as favorable as those granted by the licensor to entities of all descriptions or only entities that can reasonably be viewed as competing with the first licensee (it is generally accepted that MFN clauses do not apply to intercompany transactions between a licensor and its affiliated companies)?

For example, suppose that a patent covers a method for rapidly recharging a lithium-ion battery, and it is licensed to an electric vehicle manufacturer at a flat rate of \$7.50 per car. If the licensee has MFN protection, should that protection extend to licenses that the patent holder grants to manufacturers of smartphones at \$1.00 per phone? Considering that the price of a smartphone is far less than that of a car, it might seem unreasonable to compare these two licenses. Likewise, a pharmaceutical manufacturer that is licensed to sell a patented drug in the United States should probably not be automatically entitled to the same rates as a manufacturer distributing the drug in the developing world. Finally, a trademark licensor might be reluctant to grant a small, specialty business – say a producer of hand-crafted porcelain dolls -- MFN protection against lower rates that it extends to a large multinational toy manufacturer that will produce far larger quantities of licensed goods at lower price points.

Once these initial scoping questions are decided, the parties must agree *which contractual terms* are subject to MFN treatment. Suppose that the first licensee pays a running royalty rate of 5% to manufacture and sell widgets covered by the licensor's patents. If the licensor grants a license to a second licensee at a royalty rate of 3%, the first licensee's MFN clause would be triggered. But what if the second licensee pays a large up-front fee in order to secure this lower royalty rate (like pre-paying "points" on a mortgage in order to secure a lower monthly interest rate)? Should the first licensee be entitled to the benefit of the 3% rate if it made no up-front payment? Or should it be given the option to make a similar up-front payment in order to gain the advantage of the lower running royalty rate? Likewise, what if one licensee purchases equity of the licensor? Should the first licensee be required to make such a purchase in order to enjoy the lower royalty rates enjoyed by the second?

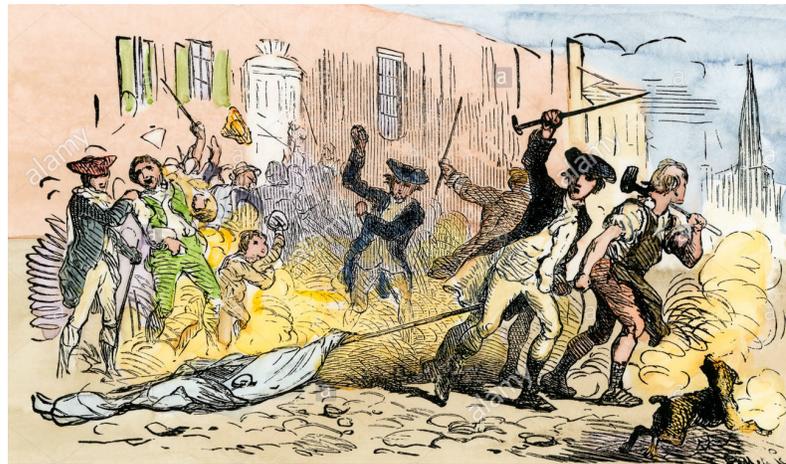
With respect to the comparison of financial terms, some MFN clauses contain a materiality or substantiality qualifier. Licensors will argue that an MFN adjustment should not be triggered based on trivial differences among licenses (e.g., slightly different interest rates for late payments, payment terms or foreign exchange rates). But once such a qualifier is introduced, there will always be an issue of what constitutes a "material" difference. When large amounts are at stake, the parties are well-advised to be as specific as possible in this regard, perhaps specifying that any difference in royalty rates or total compensation of more than x% will trigger an MFN adjustment.

Most MFN protection is limited to protection against more favorable *financial* terms, as there are hundreds of other contractual provisions – notice periods, warranties, indemnities, etc. – that will vary from agreement to agreement. If a later agreement gives a second licensee 45 days to cure a breach rather than 30 days, should the first licensee's MFN clause give it the benefit of that longer cure period? What if the second license also has a less favorable confidentiality clause? Must the first licensee accept the bad terms of the second agreement in addition to the good? And what if some terms in the second license are entirely inapplicable to the first license – how would the electric vehicle manufacturer's license for battery charging technology be adjusted if a smartphone manufacturer received a large milestone payment upon approval by the Federal Communications Commission? The above example contains some possible limitations on the type, size and field of use of later licenses that are subject to MFN treatment, but additional language may be necessary depending on the specifics of the parties' transaction.

Once these terms are decided, the process for implementing MFN treatment must be specified in some detail. This necessarily includes a notification by the licensor of the more favorable terms, a period during which the licensee may consider them, and some mechanism for the licensee to gain the benefit of the more favorable terms. In some cases, an agreement may specify that more

favorable terms are automatically extended to the licensee. However, if the licensee would be required to make an up-front payment or the licensor would be required to refund amounts previously paid by the licensee, the parties should have a reasonable period of time in which to calculate and effect such reconciliation. This being said, some MFN clauses (such as Example 2 above) specifically exclude any refund of prior amounts paid by the licensee.

Finally, the retroactive effect of an MFN adjustment must be considered. One approach is to make the more favorable terms apply retroactively to the date on which they were first granted to the second licensee. This eliminates any advantage that the licensor may gain by delaying its notification to the licensee. However, retroactive adjustments can have significant accounting and financial implications, which should encourage the licensor to notify the licensee as promptly as possible of the more favorable terms.



*Protests erupted in response to John Jay's 1794 trade treaty between the United States and Britain, under which Britain granted "most favored" trading status to its former colonies*

### **STUDIENGESELLSCHAFT KOHLE M.B.H. V. HERCULES INC.**

105 F.3d 629 (Fed. Cir. 1997)

MAYER, J.

In 1986, Studiengesellschaft Kohle m.b.H. (SGK) sued Hercules, Inc.; Himont U.S.A., Inc.; and Himont, Inc. (collectively "Hercules") for patent infringement. Hercules counterclaimed, alleging that SGK had breached the most favored licensee provision of their license agreement by failing to offer Hercules a license with the same terms it offered other licensees. But for the breach, Hercules argued, it would have been licensed under the patents at issue during the period in question, thereby insulating it from infringement. The district court agreed and entered judgment for Hercules. Because SGK has not established that the court made any clearly erroneous findings of fact or error of law, we affirm.

## Background

SGK is the licensing arm of the Max Planck Institute for Coal Research in Germany and the successor-in-interest to Professor Karl Ziegler, the Institute's former head, who died in 1973. Hercules manufactured and sold plastics from the 1950s through 1983, when it sold its polypropylene business to Himont U.S.A., Inc.

In the early 1950s, SGK invented a catalyst that could be used to make plastics, such as polyethylene and polypropylene. In 1954, SGK and Hercules entered a "polyolefin contract" (the "1954 contract") granting Hercules a nonexclusive license under SGK's "Patent Applications and Patents Issued Thereon." Although the United States had not issued SGK any patents at that time, the contract contemplated that Hercules would be licensed under any SGK patent issued in the future in the plastics field. The contract included a most favored licensee provision, set forth in pertinent part:

If a license shall hereafter be granted by [SGK] to any other licensee in the United States or Canada to practice the Process or to use and sell the products of the Process under [SGK's] inventions, Patent Applications or Patents or any of them, then [SGK] shall notify Hercules promptly of the terms of such other license and if so requested by Hercules, shall make available to Hercules a copy of such other license and Hercules shall be entitled, upon demand if made three (3) months after receiving the aforementioned notice, to the benefit of any lower royalty rate or rates for its operations hereunder in the country or countries (US and Canada) in which such rates are effective, as of and after the date such more favorable rate or rates became effective under such other license but only for so long as and to the same extent and subject to the same conditions that such . . . lower royalty rate or rates shall be available to such other licensee; provided, however, that Hercules shall not be entitled to such more favorable rate or rates without accepting any less favorable terms that may have accompanied such more favorable rate or rates.

The contract also contained a termination clause, which granted SGK the right to terminate the agreement and the licenses upon sixty days written notice if Hercules failed to make royalty payments when due. However, Hercules had the right to cure its default by paying SGK "all sums then due under [the] Agreement," in which case the licenses would remain in full force and effect.

The parties amended the contract [in 1972] by granting Hercules "a fully paid-up" license through December 3, 1980, the date the '115 patent expired, under SGK's "U.S. Patent rights with respect to polypropylene . . . up to a limit of six hundred million pounds (600,000,000) per year sales." For sales exceeding that amount, Hercules was obligated to pay SGK royalties of one percent of its "Net Sales Price." As to SGK's patents expiring after December 3, 1980, Hercules possessed the right, upon request, to obtain "a license on terms no worse than the most favored other paying licensee of [SGK]." SGK concedes that this provision granted Hercules the "right to the most favored paying licensee's terms regardless of whether those terms had been granted before or after 1972." The amendment also provided that the terms and conditions of the 1954 contract remained in "full force and effect except as modified by, or inconsistent with, this amendment." SGK concedes that "the notice provision, indeed the whole [most-favored licensee] clause, 'survived the 1972 Agreement.'"

*The SKG-Hercules agreement concerned patent rights in polypropylene, a plastic used to make a wide range of products from tic-tac containers to furniture.*

*[photo: Alex Rio Brazil CC BY-SA 3.0]*



On November 14, 1978, SGK was issued U.S. Patent No. 4,125,698 ('698 patent) for the "Polymerization of Ethylenically Unsaturated Hydrocarbons." The parties agree that under the 1972 amendment Hercules was licensed under the '698 patent, without any additional payment, through December 3, 1980. It is also undisputed that this patent is covered by the 1954 agreement, as amended.

In March 1979, SGK sent Hercules a letter terminating the 1954 contract and the licenses granted under it "for failure to account and make royalty payments" when due. In accordance with the agreement, the letter stated that the termination would become effective in sixty days unless the "breach" had been corrected and the payments made. Hercules paid SGK \$339,032 within the sixty-day period, which SGK accepted. Although SGK possessed the right to question any royalty statement made by Hercules, and to have a certified public accountant audit Hercules' books to verify or determine royalties paid or payable, it did not do so.

On May 1, 1980, more than seven months before the expiration of Hercules' "paid-up" license, SGK granted Amoco Chemicals Corporation (Amoco) a nonexclusive "paid-up" license to make, use, and sell products covered by SGK's polypropylene patents in the United States. In exchange, Amoco paid SGK \$1.2 million. SGK does not dispute that the '698 patent is covered by this license or that it failed to apprise Hercules of the license at the time it was granted. Hercules first learned of Amoco's license in 1987, after SGK commenced this action. It demanded an equivalent license retroactive to December 3, 1980. SGK refused, contending that (1) Amoco was not a "paying licensee," as contemplated by the 1972 amendment; (2) Hercules' request was too late; and (3) Amoco's license was granted as part of a settlement agreement.

On December 3, 1986, SGK filed suit in the United States District Court for the District of Delaware, charging Hercules with infringement of the '698 patent. Hercules counterclaimed, alleging that the 1954 license, as amended, required SGK to notify it of the Amoco agreement in 1980, the terms of which it was entitled to obtain via the most favored licensee provision of the 1954 contract, as amended. Hercules argued that it would have exercised its right to obtain a license

on Amoco's terms had SGK not breached that provision. It claimed, therefore, that it was entitled to such license, retroactive to December 3, 1980, upon paying SGK \$1.2 million. The court agreed and entered judgment for Hercules. This appeal followed.

### Discussion

SGK concedes that the notice provision was effective but argues that it was only obligated to provide Hercules with notice of any license with terms more favorable than Hercules' license. In 1972, Hercules obtained a "paid-up" license under SGK's patents through December 3, 1980. In 1978, the '698 patent issued. Hercules was licensed under that patent, without additional cost, by virtue of the 1972 license. Because Hercules obtained a "free" license under the '698 patent for the first 600 million pounds, no terms could be more favorable, according to SGK. So, it had no duty to apprise Hercules of the Amoco license.

SGK's interpretation does violence to the plain language of the 1954 contract. The notice clause did not condition SGK's obligation to inform Hercules of other licenses on whether such licenses were more favorable. It required SGK to notify Hercules promptly of the terms of a license granted "to any other licensee." Under SGK's construction, the power to determine whether another license was more favorable resided not with Hercules, but with SGK. That simply was not what the agreement provided. It is true that the 1954 contract granted Hercules the right, upon demand, to the benefit of any "more favorable rate or rates." However, that clause signified nothing more than the commercial reality that Hercules would opt only for a license whose terms it thought were more favorable than its own. It did not divest Hercules of the right to decide which terms were more favorable. Indeed, such a decision will not always be apparent when one considers the myriad combinations of royalty payments, lump-sum payments, and technology transfers a license can effect. Consequently, the court was correct that SGK's failure to provide notice constituted a breach of the license agreement.

SGK next says that it had no obligation to grant Hercules a license with terms equivalent to those in the Amoco license because Amoco was not a "paying licensee" within the meaning of the 1972 amendment. Again, we turn to the plain language of the license and interpret it anew. The 1972 amendment provided that for any of SGK's patents expiring after December 3, 1980, including the '698 patent, SGK would "grant Hercules, upon request, a license on terms no worse than the most favored other paying licensee of [SGK]." SGK contends that Amoco was not a "paying licensee" because it made just one lump-sum payment and no royalty payments; only licensees that make ongoing royalty payments are "paying licensee[s]."

In construing the term "paying licensee," we must give the words their ordinary meaning unless a contrary intent appears. The ordinary meaning of the term "paying licensee" is one who gives money for a license. See Webster's II New Riverside University Dictionary 863 (1984) (defining "pay" as "[t]o give money to in return for goods or services rendered"). SGK has not established that the parties intended that the term should mean something else. We see no distinction between one who makes an up-front, lump-sum payment and one who makes continuing royalty payments. Indeed, such a distinction would be doubly doubtful because a "paid-up" license presumably includes potential future royalty payments discounted to their net present value.

SGK also argues that the \$1.2 million payment was in settlement of litigation; Amoco was not intended to be a "paying licensee." But the court found that Amoco paid SGK \$1.2 million for a

paid-up license for unlimited production under, inter alia, the '698 patent. SGK has not shown how this finding is clearly erroneous: Amoco was a “paying licensee.”

Even were we to accept SGK’s interpretation as reasonable, however, the provision would be ambiguous because Hercules’ construction is also reasonable. Under such circumstances, and in the absence of any extrinsic evidence clearly establishing the parties’ intent, we construe the term “paying licensee” against the drafter of the language — SGK — under the doctrine of *contra proferentem*. So, Hercules’ interpretation would still prevail.

According to SGK, even if Hercules is entitled to terms equivalent to those in the Amoco license, it exercised its option too late to be effective. This argument fails because the only requirement in the 1954 contract or its amendments that limits the time in which Hercules must request a license is that it be within three months of receiving the required notice. Because SGK failed to notify Hercules of the Amoco license, that time limitation never began. The court found that Hercules first became aware of the Amoco license in 1987 through discovery in this case. Hercules demanded an equivalent license on or about March 16, 1987, so even if constructive notice could trigger the three-month limitation, Hercules met it.

SGK also contends that the court erred in concluding that Hercules was entitled to a license retroactive to December 3, 1980. It argues that for six years Hercules intentionally manufactured products covered by the '698 patent, which it thought was invalid, without a license. Only after this court ruled that the patent had not been proven invalid, did Hercules become interested in obtaining a license. It requested a license retroactive to the date its allegedly infringing activities began, thereby insulating itself from any infringement claim. SGK argues that “nothing in Hercules’ option provides for such a right.”

To be sure, neither we nor the parties can know with certainty whether Hercules would have exercised its right to a license on Amoco’s terms in 1980, had it received the required notice. To that extent the prospect of absolving six years of alleged infringement via a retroactive license is troubling. But the uncertainty was caused by SGK’s breach, the consequences of which it must bear. The 1954 contract expressly and unambiguously provides Hercules with the right to obtain the terms of another license “effective, as of and after the date such more favorable rate or rates became effective under such other license.” The agreement must stand as written. Hercules is entitled to the terms of the Amoco license effective May 1980, when the Amoco license became effective.

## NOTES AND QUESTIONS

1. *Different Approaches to MFN*. Compare the Example MFN clauses provided above. How do they differ? Which would you prefer if you were the licensee? The licensor?

2. *Dispute Resolutions*. A surprising number of litigated cases in addition to *Kohle* involve disputes over the applicability of MFN clauses to settlement agreements, arbitral awards and other agreements arising from the resolution of disputes between the licensor and other licensees.<sup>38</sup> How

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<sup>38</sup> See, e.g., *Wang Laboratories v. OKI Electric Industry Co.*, 15 F. Supp. 2d 166 (D. Mass. 1998) (“Monies received as a settlement for past tortious use of patents are not the equivalent of royalties”), *Willemijn Houdstermaatschappij BV v. Standard Microsystems Corp.*, 925 F. Supp. 193 (S.D.N.Y. 1996) (issues arising from arbitral dispute resolution).

might you draft an MFN clause to avoid this potential issue? What factors might complicate any blanket exclusion of dispute resolution agreements from MFN comparisons?

3. *Exclusivity and MFN.* MFN clauses are typically granted in non-exclusive license agreements. Do you see why? What protection does an exclusive licensee have against future competitive licenses by the licensor?

4. *Favorable Terms.* In *Kohle*, the MFN clause in the 1972 amendment required SKG to grant Hercules a license on terms no worse than the most favored other paying licensee. Amoco, which paid SKG \$1.2 million, was found to be a paying licensee. But Hercules paid nothing for the right to operate under the patent through December 1980. Was Amoco's license truly "more favorable" than Hercules's?



*A royalty audit involves an inspection of the licensee's books and records.  
[photo: Orange County Archives, CC BY 2.0]*

## I. **AUDIT CLAUSES**

In many licensing agreements, the licensee's payments are based on information solely in the licensee's possession: its revenue and sales figures, its achievement of certain technical and commercial milestones, and the like. As a result, the licensee is usually required to submit periodic reports to the licensor informing it of the facts underlying payments due during the period. These are often referred to as royalty reports or statements.

In most agreements, the licensor has the right to "audit" the licensee's records in order to verify the information stated in its royalty reports. Such audit provisions are complex to negotiate, however, as the information that they seek is often confidential to the licensee, and of significant commercial and competitive value. Below are two examples of financial audit clauses, illustrating provisions that are favorable to the licensor and the licensee, respectively.

### Examples – Audit Clauses

**[Licensor-favorable]** Licensor may cause an audit to be made of the applicable Licensee records and facilities (including those of Licensee's Affiliates) in order to verify statements issued by Licensee and Licensee's compliance with the terms of this Agreement. Any such audit may be conducted by Licensor or its independent accountants or consultants during regular business hours at Licensee and/or Customer's facilities, with one (1) week's notice, unless Licensor has reason to believe that Section x or y has been breached, in which case Licensor may audit Licensee and/or Customer's activities upon 24 hours notice. Licensee agrees to provide Licensor's designated audit team prompt access to the relevant records and facilities. Licensor will pay for any such audit, unless the amount of any underpayment is greater than [5%] of the amount due, or if the audit reveals a material breach of any provision of this Agreement. In this case, Licensee shall reimburse Licensor for such audit costs in addition to the underpaid amounts and applicable interest charges. Licensor reserves the right to disclose the results of any audit conducted under this Section x to its own licensors that have a need to know.

**[Licensee favorable]** Licensor will have the right, no more than once during any twelve month period, to engage an independent certified public accounting firm reasonably acceptable to Licensee to audit the books and records of Licensee for the sole purpose of confirming the accuracy of Royalty Statements provided hereunder. The auditor shall be required to enter into a nondisclosure agreement with Licensee covering all information learned or derived during such audit, and shall not be permitted to disclose to Licensor any such information other than its determination that an underpayment may have occurred, and in what amount. All costs and expenses of such audit shall be borne by Licensor unless such audit reveals any previously undisclosed underpayment in excess of [10%] of the total amount due during any calendar year and such underpayment is confirmed in writing by Licensee or by a court of competent jurisdiction in a final judgment from which no appeal may be taken, in which case Licensee shall reimburse Licensor for the reasonable and customary fees of its external auditing firm.

As you can see, audit provisions can vary substantially based on which party drafts them. Below are some of the more contentious issues that are usually negotiated in such clauses:

*Who Conducts the Audit?* – Perhaps the most controversial issue in an audit clause is who is authorized to conduct the audit. The licensor will prefer to inspect the licensee's book and records itself – this is cheaper than hiring an external firm and will also give the licensor insight into the licensee's internal accounting practices, sales figures, and the like. The licensor's personnel may also be more attuned to the industry and be better able to recognize inconsistencies or suspicious entries. The licensee, on the other hand, will be concerned about the disclosure of its confidential business records to the licensor, which may compete with the licensee or deal with the licensee's competitors. As a result, the licensee usually prefers that the audit be conducted by an external auditing firm and that records disclosed to the auditor be subject to a confidentiality agreement. Using an external auditor increases the cost and hassle for the licensor, making an audit less likely, and also makes it easier for the licensee to conceal information that the auditors may not know to ask for. If the licensor agrees to hire an external audit firm, it may also insist that its own financial

personnel be permitted to participate in the audit, or at least to view the records provided to the auditors.

*What Records are Subject to Audit?* -- In an audit, the licensor will seek access to as many records of the licensee as possible – computer files, databases, sales receipts, invoices and the like. The licensee will seek to confine the subject of the audit to specific records supporting its royalty reports. A key question is whether the licensee will give the auditor the right to search records as it wishes, or whether records for review will be provided by the licensee.

*Cost Shifting* – Usually the licensor is responsible for the costs of conducting the audit, though there is a trigger for shifting that cost to the licensee. The trigger is usually an underpayment by the licensee, though the amount of the triggering underpayment can range from 0 to upwards of 10%. There is also a question of which costs are shifted – should licensee cover only the licensor’s out-of-pocket fees paid to an external audit firm, or should it also pay for the time and effort expended by licensor’s internal personnel?

*Disputing Audit Results* – It is inevitable that in some cases, the licensee will dispute the findings of the audit. If this happens, a path for resolution must be specified. If the agreement contains a general dispute resolution clause (see Chapter 13), then that mechanism may be used. If a dispute resolution clause is not included in the agreement, then the audit clause should include language specifying the mechanisms used to resolve disputes over the audit results (e.g., mediation and arbitration). If such mechanisms are not specified, then the licensee’s only option may be to refuse to pay the underpayment detected by the auditor and allow the licensor to sue for breach (nonpayment), at which time a court will resolve the dispute.