INSIDE THE MINDS

Intellectual Property Licensing Strategies

Leading Lawyers on Analyzing Trends in IP Licensing and Drafting Effective Agreements

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Incorporating the Appropriate Balance of Licensee and Licensor Protection in an IP License Agreement

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Introduction

My clients span a wide range of industries. My educational background is in electrical engineering and software, and I often represent clients in those areas. However, I just as often represent clients in the chemical, pharmaceutical, and biotech industries. I also frequently represent clients in the defense, manufacturing, and automotive industries. The mix has not changed substantially in the past year or two. It *has* changed from when I first started practicing because I focused first on software and high-technology clients based upon my educational background, but have over time expanded my practice to include the full range I now counsel.

Each industry certainly has its own set of challenges, driven by the conventions and needs of that industry. It is difficult to summarize those challenges, but there are two standouts: the software industry faces many challenges due to rapidly-evolving technology and industry conditions, as well as much uncertainty around software patents. The pharmaceutical industry faces many challenges due to the high stakes and extraordinary dollars often at issue with each license.

In my experience, there are more similarities than differences across industries when dealing with licensing. The challenges within each industry tend to be variations of common themes, rather than completely new themes.

Evolving Protection for Trademark Licensees in Bankruptcy

During the past few years, there have been some interesting cases coming out of the various circuit courts addressing the rights of a trademark licensee when the licensor goes into bankruptcy, with the most recent case being an *en banc* decision from the Eighth Circuit in *Lewis Brothers Bakeries Inc v. Interstate Brands Corp.*[1]

This has been a troubling issue for trademark licensees for some time. Section 365(n) of the US Bankruptcy Code[2] provides certain protections to licensees when the licensor goes into bankruptcy, but Section 365(n)

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[1] *Lewis Brothers Bakeries Inc v. Interstate Brands Corp.*, 751 F.3d 955 (8th Cir. 2014).
[2] 11 U.S.C. § 365(n).

infamously does not apply to trademarks. This has created much uncertainty for trademark licensees, who fear making a substantial investment in a trademark license only to have it lost as a result of the licensor's bankruptcy, which is out of the licensee's control. Complicated license structures have evolved to address this risk by, for example, having the trademark rights owned and licensed by a bankruptcy-remote special purpose vehicle; however, none of these structures are perfect, and they often create separate problems that can be difficult to address.

In the absence of Congress taking any action to provide protection to trademark licensees, there have been several court decisions over the past few years that have found alternative means of protecting trademark licensees. For example, in the *Lewis Brothers* decision, the court found the trademark license in question to be "non-executory." In doing so, it effectively eliminated the trademark owner's ability to terminate the license in the bankruptcy proceedings because that termination right is generally limited to termination of "executory" contracts. Prior to the *Lewis Brothers* decision and other similar recent decisions, it was generally assumed by practitioners that IP licenses were "executory," and therefore terminable in bankruptcy, unless protected by Section 365(n), which applies only to "executory" contracts. Other court decisions have taken different approaches to achieve the same result—protection of the trademark licensee.

The court decisions on these issues are not universally binding across all circuits, and have been the subject of much debate. Accordingly, trademark licensees cannot yet rely upon them when drafting agreements; however, they represent an evolving area of law relevant to trademark licenses that should be watched closely.

Supreme Court Active in Patent Arena

The Supreme Court has been active in the patent area during the past several few years, with numerous cases potentially affecting the scope of existing patent rights. These decisions have a direct impact on license agreements, whether already existing or currently being negotiated.

In particular, the Supreme Court's recent decision in *Alice Corp v. CLS Bank International*[3] has called into question the validity of many so-called "software patents," at least to some degree, depending upon how the decision is interpreted and applied by the district courts and the Federal Circuit.

Another standout is the Supreme Court's 2007 decision in *MedImmune, Inc. v. Genentech, Inc.*,[4] which created a fundamental shift in patent law by allowing a patent licensee to bring a declaratory judgment action to challenge the validity or enforceability of a licensed patent, while still maintaining its rights under the license agreement. Because licensees have this right, each new court decision that deals with patent enforceability or validity issues now may have a significant impact on existing licenses. Accordingly, both licensors and licensees in patent licenses must pay close attention to Federal Circuit and Supreme Court cases addressing these issues. The Supreme Court's activity in this area could continue, and, in any case, there likely will be additional Federal Circuit cases related to the Supreme Court's recent decisions.

Ensuring the Contract Language Matches the Client's Intent

During my initial meeting with a client, I learn as much as I can about the client's objectives and concerns. I try to do this before getting into the details of the license terms. Understanding the client's objectives and concerns helps me to better understand the license terms, because I can put them into context. It also helps me to identify potential conflicts between the proposed license terms and the client's overall objectives or concerns.

The attorney's main role in drafting a license agreement is to ensure the contract language matches the client's intent. This goes well beyond simply having the client read the language and confirm it is correct. It requires the attorney to truly understand the client's intent and then ensure that intent is reflected in the contract language. Going the other way—asking the client to read the contract language and confirm it is correct—can lead to disastrous consequences. A client who is unfamiliar with the nuances of contract drafting may not read

[3] *Alice Corp. v. CLS Bank Int'l*, 134 S. Ct. 2347 (2014).
[4] *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118 (2007).

the contract language critically, and may approve any language that is not obviously inconsistent with his or her intent. There can be a wide gap between contract language that is unambiguously correct and contract language that is not obviously inconsistent.

The Client's Role in Entering into a Successful License Agreement

I encourage clients to conduct as much due diligence as they can on the counterparty, and in the case of the licensee, on the IP to be licensed. This includes both legal and business due diligence.

While many of the risks that are the subject of due diligence will be addressed in the contract terms (for example, through warranties), the contract terms often are not able to completely address or eliminate all risks. Even if a risk is capable of being completely addressed in the contract terms, it can often be better to identify and address those risks before entering into the license, rather than having to address a breach of warranty claim or other claim under the agreement. For example, if there is a fundamental problem with the title to a patent to be licensed, it is likely better for the licensee to uncover and address that issue before entering into a license with a large upfront payment, which may or may not be recoverable under a warranty claim.

Preventing Superficial Drafting Mistakes

During the initial client meeting, I also try to learn as much as I can about the IP being licensed and the scope of intended use. In doing so, I push for a fair amount of detail and ask questions about terminology. My goal in doing so is to avoid what I call "superficial drafting" mistakes, which are mistakes many attorneys make. Superficial drafting refers to contract language that appears to be precise and unambiguous—but only if examined at a superficial level, or with only a superficial understanding of the relevant subject matter. A little extra time spent doing this upfront can prevent significant problems down the road.

The most important elements of a license agreement are scope, duration, and consideration. "Scope" refers to both the scope of IP being licensed and the scope of how that IP can be used. While these may seem obvious to anyone familiar with licenses, it amazes me how little attention attorneys sometimes pay to these key issues. I am frequently involved in license disputes, and these disputes are often the result of "superficial drafting." Disputes often arise later when the seemingly clear contract language is put to the test against a real-life situation involving nuances and details that are simply not addressed in the contract language.

A simple example is a license that refers to "licensee's products" without defining what it means for a product to belong to the licensee. Is this limited to products designed, manufactured, and sold by the licensee under its own brand? Or can it include products designed and manufactured by a third party and merely resold by the licensee? Despite the obvious ambiguity in this construct, and several resulting court cases, it still frequently appears in licenses today.

It is essential for attorneys for both sides to develop a somewhat granular understanding of the relevant IP and the intended uses under the license. They should then tailor the contract language to be as precise as reasonably possible. They should also critically assess the contract language to identify potential ambiguities. One way to do this is to make a list of things that should either be allowed (in the case of the licensee) or disallowed (in the case of the licensor). They should then test each item on the list against the contract language, to see if the contract language can be interpreted (within reason) to allow or disallow something that it should not allow or disallow.

Ensuring Licensor Protection in License Agreements

It is important for licensors to identify the types of records that must be kept to enable the licensor to protect its rights. The license agreement should have clear provisions requiring the licensee to keep those records, and, as appropriate, provide them to the licensor. The licensor should also consider having meaningful audit rights to allow it to both confirm the required records are being kept and verify their accuracy.

Licensors also should consider the consequences of a licensee's failure to keep records. This is a subject that is often unaddressed in licenses, but failing to address it can leave the licensor without a meaningful way to enforce its rights. For example, if royalty payments are tied to the licensee's sales of a particular product model, but the licensee fails to keep adequate records on those sales, the licensor may never be able to recover the full amount of royalties it is owed. Licensors should consider appropriate provisions to remedy this type of situation or to provide sufficient disincentives against them occurring.

Ensuring the Licensor's Fair Compensation

Licensors also must be careful about entering into an exclusivity arrangement. They must ensure they are being fairly compensated for giving up their rights in the area of exclusivity. If that compensation will depend upon the licensee's activities under the license (for example, royalties based upon the licensee's sales), then the licensor must ensure the license agreement includes appropriate incentives for the licensee to engage in the activities that will generate compensation for the licensor, or at least provides relief to the licensor in the event the licensee performs below the licensor's expectations.

One common approach for licensors is to establish minimum royalties, where the licensor has the right to terminate the license if the licensee does not pay at least the amount of the minimum royalty. Minimum royalties are a useful tool for addressing this issue, but licensors often view them as being a "floor" to protect against a worst-case situation. However, licensors should also consider that, depending on how the agreement is structured, a minimum royalty could instead serve as a "ceiling"—once the licensee has paid the minimum amount necessary to retain its exclusivity, it may no longer be incentivized to undertake activities to increase the licensor's compensation. In fact, if the minimum is set too low, a licensee might consider paying the minimum without actually using the licensed IP, just to keep the licensed IP out of the market. Minimum royalties should be used in combination with other contract provisions to avoid this type of situation.

Prohibiting or Limiting License Rights to Third Parties

Licensors must carefully consider all ways in which a licensee can extend its license rights to third parties, and prohibit or limit them as appropriate.

Licensors typically insist upon prohibiting any assignment of the license agreement, but often allow for exceptions, such as in the case of a sale of the licensee's business or transfer of the license to an affiliate. When doing so, however, licensors often fail to consider the full impact of those exceptions. In the case of an assignment to an affiliate, the licensor should consider that the licensee's affiliates may change over time and it may not want the license assigned to these future affiliates, depending upon who they are or their businesses. In the case of an assignment with the sale of a business, the licensor should consider whether there are any purchasers to which it does not want the license assigned. In all cases, the licensor should consider how the assignment will affect other provisions in the agreement that may have been tailored to the licensee. For example, the new entity may be substantially larger or smaller, both of which could have unintended consequences on the scope of the license granted and other key terms.

If a license has assignment restrictions in it, licensors should also consider corresponding change of control provisions. This is especially important if the license agreement allows for sublicenses to affiliates or otherwise allows the licensee's affiliates to benefit from the license agreement.

Finally, the licensor also should consider these same issues when allowing for sublicenses to be granted to affiliates. The universe of a licensee's affiliates may change, without triggering an anti-assignment or change of control provision, but can have many of the same consequences as previously discussed.

Protecting Licensees in License Agreements

Licensees must carefully consider all of the circumstances under which they can lose any of their license rights, especially any circumstances giving rise to termination of the agreement. This becomes increasingly important as the licensee's start-up costs rise, whether in the form of direct payments to the licensor or the licensee's own costs. Equally important to consider are the licensee's exit costs (for example, the costs of removing the licensed IP from its products). One area in particular for licensees to consider is the consequences of the licensor's bankruptcy.

Ensuring Flexibility in Reassigning the License

As previously discussed, licensors typically seek to limit a licensee's ability to assign a license agreement to third parties; however, licensees should carefully consider the circumstances under which they may need or want to transfer the license. This is especially important if the licensee (or its parent company) anticipates any acquisitions or divestitures that would require a transfer of its license rights. Otherwise, the acquisition or divestiture could become contingent upon the licensee later being able to obtain the licensor's consent to the transfer, which may make the acquisition or divestiture unpalatable due to the risk of the licensor denying consent. It may also allow the licensor to demand significant payment for its consent, given its ability to hold up the acquisition or divestiture.

Drafting Licenses in Challenging Circumstances

It can be challenging for attorneys to draft licenses when the body of IP to be licensed cannot be identified with specificity. This issue can arise any time the body of IP to be licensed includes anything other than registered IP (including patents) identified by a list of registration or application numbers. If the licensed IP must be described in any way other than by referencing such a list, it can be difficult to do so in a way that is neither over-inclusive nor under-inclusive. This often comes up in broad-based technology licenses, where the licensor may own many different types of IP that are relevant, including know-how and trade secrets, or where the licensor may own a large patent portfolio that has not been fully analyzed for its application to the technology in question.

It is important for both parties to carefully consider how the relevant body of IP is described. Licensors need to consider whether the description can be construed more broadly than they intend, and licensees need to consider the converse. For example, consider a license that covers all IP necessary for making a certain widget (which is a common approach to this type of description). A licensor that owns both IP for the widget itself and IP for components or materials used in the widget may intend for the license to be limited to the former but risks it being interpreted to also cover the latter, and vice versa for the licensee.

Both sides can also mitigate the risk of this approach by identifying specific IP or categories (descriptions) of IP to be included (in the case of the licensee) or excluded (in the case of the licensor). When doing so, it is obviously better to identify specific IP whenever possible. But identifying categories of IP, or even multiple categories of IP, to be included or excluded can help avoid unintended results, especially if the categories are selected to address the most likely areas of uncertainty or overlap.

Another challenging situation for attorneys stems from licenses arising out of the settlement of a dispute. These are often highly contentious negotiations where the parties' interests are exceedingly unaligned. There is often mistrust, and possibly resentment, between the parties. All of this can make a license negotiation significantly more challenging for the attorneys involved, when compared to negotiating a voluntary license of the same type and scope. There is no magic bullet for dealing with this situation. They are typically exercises in good judgment—knowing which battles to pick—and persistence—fighting the battles long enough to win them.

Consequences of Failing to Comply with a License

The possible consequences for licensees that fail to comply with the terms of a license, and the possible remedies for IP owners if their licensees fail to comply with the terms of a license, is often a point of contention in license agreements. Licensors typically seek to have termination of the license as the primary remedy for breach of the agreement. Licensees often push back against a termination remedy, either eliminating it altogether or limiting it to narrow circumstances with plenty of opportunity to avoid termination (for example, by having a long cure period).

This issue is most hotly debated when addressing a licensee's use of licensed IP outside the scope of the license grant. Licensors argue this is a clear violation of a fundamental limitation in the agreement and should give rise to their right to terminate the license. They may allow for licensees to have some opportunity to cure the violation, as long as they ultimately have the right to terminate. Licensees argue termination is an unfair and draconian remedy, which gives too much leverage to licensors for what could be an unintentional violation of the license terms. They point to the fact that use of the licensed IP outside of the scope of the license grant amounts to infringement, and licensors have separate remedies available to them for infringement (including injunctive relief and damages), although those remedies can be costly to obtain.

As with any negotiation, the resolution of this debate is generally driven by leverage; however, there are many contexts in which a licensor can maximize its own value by providing more protection to the licensee. For example, a licensee may pay a premium for technology that will be deeply integrated into the licensee's business, but may be reluctant to do so if the license can be terminated easily or at all. Even in situations in which the licensee is not offering to pay a premium, a licensee may be more cautious in its use of licensed technology subject to termination rights, which could result in lower royalties for the licensor, or the licensee choosing a different technology altogether.

A licensee's failure to pay royalties is another big area of contention for this issue. Licensees argue that, as long as the licensor ultimately has the right to collect the full amount of royalties, there should not be any need for termination (except maybe if the licensee refuses to pay undisputed royalties). Conversely, licensors want the threat of termination to serve as an incentive for the licensee to pay the correct royalty amount the first time. It can be difficult and time-consuming for a licensor to discover a royalty underpayment; thus, licensors want a strong disincentive for underpayment.

Both sides of the royalty debate have merit, but a termination right is not the only available disincentive. License agreements often have other disincentives for underpayment. These are usually tied to the licensor having audit rights. If the audit uncovers an underpayment, the licensee can be required to pay for the cost of the audit plus a higher royalty rate for the period in question. The higher royalty rate could be applied to royalties other than those that were underpaid, either on a retroactive or prospective basis. Even in these situations, there is often some form of termination right for egregious violations of the royalty provisions.

Conclusion

IP licenses play an important role in most companies' business, both at the strategic and operational level, and will continue to do so for the foreseeable future. The volume of patent licenses driven by actual or threatened litigation will likely diminish substantially due to the Supreme Court decision in *Alice* and to ongoing legislative efforts to curtail perceived abuses in the patent system. Nevertheless, patents and other IP rights will continue to have significant value and licenses will remain a useful way for monetizing or otherwise obtaining value from IP rights.

Attorneys working with IP licenses can add tremendous value to their clients' businesses by having an ongoing desire to learn—not just learning about developments in the law but also learning about their clients' IP and how that IP fits into their clients' businesses and products. Attorneys who do so will enable their clients to maximize the value of any licensed IP and avoid costly mistakes.

Key Takeaways

- Truly understand your client's intent and ensure that intent is reflected in the contract language. Going the other way—asking the client to read the contract language and confirm it is correct—can lead to disastrous consequences. Understand the relevant IP and intended activities under the license well enough to critically assess the contract language.
- When working with the licensor, consider the consequences of a licensee's failure to keep records, ensure the license agreement includes appropriate incentives for the licensee to engage in the activities that will generate compensation for the licensor, and prohibit or limit the ways a licensee can extend its license rights to third parties.
- When working with a licensee, carefully consider all of the circumstances under which it can lose any of its license rights (especially any circumstances giving rise to termination of the agreement), the licensee's exit costs, and the possible consequences of the licensor's bankruptcy.
- Be aware that negotiating licenses arising out of the settlement of a dispute may be challenging. These are often highly contentious negotiations where the parties' interests are exceedingly unaligned.
- Recognize that a termination right is not the only available disincentive for failure to pay royalties; your client can exercise audit rights that

require the licensee to pay for the cost of the audit plus a higher royalty rate for any underpayment for the period in question.

Adam Petravicius, a partner at Jenner & Block LLP, is the chair of the firm's IP Transactions Practice, and focuses on transactions driven by IP and technology. He regularly advises clients on IP and technology issues that impact their businesses. Mr. Petravicius also advises clients on disputes related to IP and technology, often helping to resolve these disputes through a negotiated agreement.

Mr. Petravicius has worked on a wide range of IP and technology transactions, including: licenses of all types, including for software, data, patents, know-how, and trademarks; IP portfolio sales and acquisitions; research and development agreements; distribution, supply and other commercialization agreements; joint ventures and strategic alliances; I/T outsourcing and services agreements. He also regularly advises clients on current developments in IP and technology, and has advised clients on issues such as IP risk allocation in transactions; open source software; cloud computing; data privacy and security; and standards organizations.

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