Part II

Patent and Know-How License For Rustproof Widgets

With Annotations

Hot Topics in IP Licensing: 2009
Legal and Business Considerations
MNCLE Conference Center
Minneapolis, Minnesota
May 15, 2009

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Annotation protocol: The annotations throughout this annotated license will be provided in paragraphs having the format of the paragraph that you are reading now. Each annotation will refer to the clause or clause set immediately preceding the annotation unless otherwise expressly noted. Please feel free to address questions or comments concerning this annotated license to David Kagan at dkagan@kaganbinder.com.

NORM CONFIDENTIAL
April 16, 2009 (Revision prepared by NORM)

The header of the first agreement page, and optionally headers on the other pages as well, can bear a confidential legend and draft date like this. In this case, the legend says that the agreement is NORM CONFIDENTIAL ("NORM" is the nickname for the Norman Einstein Technical Institute.). This indicates that the draft originated with NORM. At some point during the negotiation process, both parties may have an interest in designating the license as confidential. In such a case, the legend can read "NORM AND ACME CONFIDENTIAL" or the like.

Note, too, that the draft bears a date. Each new draft should be dated so that a party can organize its files easier and can be assured that it is working from the most current draft. This also helps ensure that both parties are working from the same draft. In later drafts, particularly redlines that are exchanged, the date can be followed by a parenthetical indicating who prepared the redline, e.g., "April 14, 2009 (redline by ACME)" or the like. Without logistic clues like this, it can be difficult to track drafts that accumulate in your files throughout the course of negotiations.

Intellectual Property License Agreement for Rustproof Widgets

between NORMAN EINSTEIN TECHNICAL INSTITUTE and ACME CONGLOMERATE

The title block of this license includes both the subject matter of the license and also identifies the parties. While many license headers simply present "License Agreement" as the title block, a more informative title block eases license agreement administration. Discovery in related and unrelated litigation also is eased to some degree, because the person screening documents for a document production can see at a glance whether the license in hand is relevant or not to the document production.

This Intellectual Property License Agreement is made and effective this 15th day of May in the year 2009 (EFFECTIVE DATE) by and between NORMAN EINSTEIN TECHNICAL INSTITUTE having an office and place of business at One Quantum Plaza, 1023 Avogadros Number Way, Princeton, NJ 08542 (NORM), and ACME CONGLOMERATE as Licensee, having an office and place of business at 9876 Avenue of the Widgets, Burbank, CA 91505 (ACME).

Fundamentally, the full names and correct addresses of each party should be provided. It is surprising how many proffered licenses identify at least one of the parties incorrectly.

NORM represents that it is the owner of certain patent rights and know-how rights relating to RUSTPROOF WIDGETS and related products and services. ACME desires to obtain a license under such rights from NORM that will facilitate ACME's manufacture, marketing, and selling of RUSTPROOF WIDGETS and related products and services incorporating such rights. NORM is willing to grant ACME the right to use certain NORM patent and know-how rights in accordance with the terms and conditions of this Agreement.

Note that the term "know-how" instead of "trade secret" is used to refer to proprietary and/or confidential information that is not patented. This is purposeful, because contractually know-how can encompass more information than just trade secrets.

NOW, therefore, in order to provide ACME with such rights, the parties agree as follows:

Each clause in a patent/know-how license is important. After all, if a clause serves no purpose, the clause should not be in the agreement. Nonetheless, there are four clause sets that are the major stars. If an agreement lacks even one of these BIG FOUR, there is no agreement. Apart from naming the parties and including signatures, you can even have an agreement that includes only these four clause sets. Such an agreement might not be the best choice, but the deal essence will be captured.

The four major star clauses in any product patent license include the following:

- **The definition of the Licensed Product(s)**
- **The definition of the Licensed Patents and/or Know-how**
- **The granting of rights**
- **The payment of compensation**

Every other clause in the agreement supports these four clauses in one way or another.

Article 1
<u>DEFINITIONS</u>

1.1 "EFFECTIVE DATE" of this Agreement shall be May 15, 2009.

The license should make it clear when the license starts. The start date even can be retroactive or prospective relative to the date(s) on which the parties sign the agreement. Note the consistency between this definition and the date used in the opening paragraph that introduces the parties.

1.2 "PRODUCT(s)" shall mean all or a portion of any RUSTPROOF WIDGET as well as any article constituting all or a portion of any accessory, component, device, packaging, equipment, tool, marketing material, accessory or the like that is marketed and/or used in combination with a RUSTPROOF WIDGET.

The main definition of the Licensed Product actually appears in Paragraph 1.3 below. The present clause 1.2 establishes the right of the Licensee to sell related accessories as well as so-called kits and combinations with respect to the RUSTPROOF WIDGET, which are the base Licensed Products in this annotated agreement. What are kits and combinations? Let's explore these two concepts.

<u>A. Kits</u>:

A kit is a subset of the Licensed Product. A kit might include one or more components of a Licensed Product that the customer assembles into a finished product. Licensor patents independently might protect one or more of the kit components as well as the finished product, allowing the Licensor to control how these components are used.

Kits can be at issue in any market niche. The capital equipment and complex tooling markets are examples of markets where kits are sold. In these markets, the customer is typically a manufacturer that might not want to buy the finished Licensed Product itself, but still desires to buy a kit of components to incorporate into finished equipment or tooling lines of its own final designs.

<u>B. Combinations</u>:

Kits schematically can be viewed as a subset of the Licensed Product, which is the final product. A combination is the opposite of sorts. In a combination, the Licensed Product is a subset of the final product. The Licensed Product is only one part of the whole. Like the Licensed Product, the combination(s) incorporating the Licensed Product also may be protected by Licensor patents. In an exemplary context of a motor vehicle

engine, the engine's carburetor could be the Licensed Product, while the engine incorporating that carburetor is the combination. In an exemplary context of a chemical manufacturing process, a patented polyester polymer might be the Licensed Product, while an independently patented method of extruding that polyester polymer might be the combination.

C. Rights for kits and combinations:

The right to sell a Licensed Product generally does not carry with it the right to sell kits or combinations. This is particularly the case where one or more kit components or the combination, as the case may be, independently are protected by patent and/or know-how rights. If the Licensee wants these rights, or if the Licensor does not want to confer these rights (e.g., the Licensor wants to reserve kit and combination rights for itself), appropriate definitions, grant provisions, and/or reservations provisions can be provided in the license.

Clause 1.2 is a simple way to define kits and combinations relative to the baseline licensed product.

D. Repair, Upgrade, and Service:

If the Licensee's business plan contemplates that the Licensee will sell replacement parts, upgrade Licensed Products in some fashion to include additional features, and/or provide services to maintain or fix Licensed Products (or combinations that incorporate a Licensed Product), you need to keep kit and combination issues in mind, as well as related laws. Among these related laws, the repair v. reconstruction doctrine comes into play. The repair v. reconstruction doctrine states that a party can repair a patented product without needing to obtain any authorizations or permissions from the patentee. However, a party must have authorization from the patentee in order to reconstruct a patented product to avoid infringement.

Applying the repair v. reconstruction doctrine to a license context, the right to sell a Licensed Product without more generally does not include an express right to sell replacement parts or to service damaged, broken, or worn out Licensed Products if such activities constitute prohibited "reconstruction" rather than permissible "repair."

There are quite a number of situations that are clearly "repair" just as there are a lesser number of situations that are clearly "reconstruction." But, there still are a host of areas in which it is no so easy to decide whether conduct is repair or reconstruction. The case law is gray and does not clearly distinguish permissible repair from prohibited reconstruction in all

circumstances. Currently, there appears to be a bias in the cases to find repair more often than reconstruction. This bias is likely to continue under current policies for at least a handful of years.

Fortunately, parties to a license agreement have the opportunity to avoid any confusion under the repair v. reconstruction doctrine. Quite simply, the parties can expressly address rights with respect to replacement parts and associated services in the license via kit and combination clauses. If the Licensee wants these rights, or if the Licensor does not want to confer these rights (e.g., the Licensor wants to reserve replacement parts and associated services for itself), appropriate definitions, grant provisions, and/or reservations provisions can be provided in the license as appropriate.

For additional information relating to the repair v. reconstruction doctrine, please feel free to visit Kagan Binder on-line IP library. The website address is http://www.kaganbinder.com/library.html. Item #23 provides a summary of the repair v. reconstruction doctrine under recent cases.

1.3 "RUSTPROOF WIDGET" shall mean any widget covered by one or more valid, enforceable, pending or unexpired claims of the NORM PATENT RIGHTS and/or incorporating NORM INFORMATION.

Clause 1.3 defines the Licensed Product. Hence, this clause is one of the four major stars of this annotated Agreement.

Like all the major star clauses, the Licensed Product clause results from the clash of opposed perspectives. In many situations, a Licensor might want the scope of Licensed Products to be as narrow as possible, while the Licensee wants the scope to be as broad as possible. For instance, the key for the Licensee is to negotiate a definition of Licensed Product that fully authorizes the full scope of the Licensee's intended commercial activities. The Licensor, in contrast, does not want to authorize too much, either by a definition that is too broad or by inadvertently creating a situation in which implied licenses of unfortunate scope are accidentally granted.

Keep in mind, though, that there are some business situations in which the Licensor wants to grant, and the Licensee wants to receive, a license that is as broad as the underlying intellectual property will allow. Simple agreements often result when Licensor and Licensee perspectives are aligned like this.

A. Three main approaches to define Licensed Product:

There are three main approaches for defining Licensed Products:

1. The patent-wide clause.

In this approach, the Licensed Product is defined as broadly as the licensed patents and know-how allow. The Licensee gets free reign to do what it wants under the full scope of what is being licensed. Clause 1.3 above is an example of a definition that is patent-wide.

Another exemplary definition implementing this approach along with a Field restriction might be the following:

> **The term "Licensed Film(s)" shall mean extruded sheet and film comprising a polyvinylidene fluoride/polyester block copolymer for use in the Six-Layer Laminate Field and that are covered by one or more valid, enforceable unexpired claim(s) of the Licensed Patents and/or incorporate at least a portion of the Licensed Technology.**

Here is another example where the Licensed Patents include patent applications that have not yet issued:

> **"Licensed Product(s)" shall mean any and all water balancing confrigulators covered by one or more unexpired or pending claims of the Licensed Patent Rights. Licensed Products shall also include any and all laundry appliances incorporating a water balancing confrigulator covered by one or more unexpired or pending claims of the Licensed Patent Rights.**

Note that to appreciate the full scope of the definition of a Licensed Product and to appreciate the nature of the license agreement as a whole, you might also have to look at the definition of Licensed Product in the context of the corresponding grant clause. Sometimes, the license grant might include field restrictions or other terms that make the licensed subject matter more narrow than does the Licensed Product definition in isolation.

The lesson here is important. Clauses in an agreement work together and are best construed in context of each other. No license clause, particularly the major star clauses, is an island.

2. The hybrid clause.

In this approach, the definition of Licensed Product reaches only a subset of the full patent and know-how scope. The Licensee gets free reign to do what it wants, but only with respect to a limited range of Licensed Product subject matter. There are many ways in which a hybrid approach can be implemented. According to one approach, the scope of the Licensed Product is limited to products that incorporate certain technical features. The following example shows how a very broad patent-wide clause shown in Section 1.3 of this annotated license is transformed into a hybrid clause:

> **"RUSTPROOF WIDGET" shall mean any widget that includes a pair of opposed confrigulators driven by a voltage no greater than 75 volts and that is covered by one or more valid, enforceable, pending or unexpired claims of the NORM PATENT RIGHTS and/or incorporating NORM INFORMATION.**

There are various other ways to fashion a hybrid definition of Licensed Products.

One approach is to specify that the Licensed Product must conform to certain standards or specifications. Often, these are performance or form factor standards and specifications. So long as the Licensed Products meet these standards and specifications, the Licensee otherwise has free reign to design a Licensed Product to its own tastes. In some contexts, the applicable standards and specifications can be published industry specifications. In other contexts, the Licensor might craft its own confidential specifications to ensure that the Licensee can only make a certain class of Licensed Products of a certain quality.

An exemplary standards/specifications definition is as follows:

> **"RUSTPROOF WIDGET" shall mean any widget that is covered by one or more valid, enforceable, pending or unexpired claims of the NORM PATENT RIGHTS and/or incorporates NORM INFORMATION and that conforms to the Widget Specifications provided in Exhibit A as such are constituted from time to time under this Agreement.**

Here is another example:

> **"OPTICAL DISK DRIVE(s)" shall mean a drive for optically reading from and writing to continuously hyperbolic optical recording media that satisfy the Performance And Form Factor**

Specifications of Exhibit A and that incorporate all or a portion of the Licensed Intellectual Property Rights.

A hybrid definition can also be crafted that imposes branding limitations on the licensed subject matter. The scope of Licensed Product is limited to products that are branded in a particular way. For instance, the license might only authorize the Licensee to make, have made, use, sell, offer to sell, and import Licensed Products under only the Licensee's own trademark brands. This approach comes into play when the Licensor does not want the Licensor to make for others, etc.

An exemplary clause of this type is as follows:

> **"RUSTPROOF WIDGET" shall mean any ACME BRANDED widget that is covered by one or more valid, enforceable, pending or unexpired claims of the NORM PATENT RIGHTS and/or incorporates NORM INFORMATION and that conforms to the Widget Specifications provided in Exhibit A as such are constituted from time to time under this Agreement. An ACME BRANDED widget is a widget that is marketed and sold in connection with a trademark owned or controlled by ACME in a manner to indicate ACME as a source of the widget.**

A hybrid definition might also use exclusions to limit the scope of the licensed subject matter. In this approach, the scope of Licensed Product excludes products that incorporate certain features or characteristics. An example might include the following:

> **"RUSTPROOF WIDGET" shall mean any widget that is covered by one or more valid, enforceable, pending or unexpired claims of the NORM PATENT RIGHTS and/or incorporating NORM INFORMATION and that does not include either (a) two or more confrigulators or (b) one confrigulator that is driven by a voltage of 75 volts or more.**

3. The product specific clause.

In this approach, the definition of Licensed Product is limited to one or more specific embodiments. The Licensee is given limited or no opportunity to use the licensed intellectual property with respect to products of the Licensee's own designs.

In essence, the Licensee is obtaining rights with respect to a turnkey product when this kind of definition is used.

This approach can be used for a variety of reasons. For example, this approach allows the Licensor to control to some extent the differentiation between Licensor and Licensee products if both are selling into the same market. The Licensor also can ensure compatibility with related products sold by the Licensor and/or others.

Product specific definitions look a lot like hybrid definitions that recite specifications and standards, but the specifications and standards are detailed and focused on a particular product embodiment.

Note that these kinds of specifications define a particular embodiment whose form is largely controlled by the Licensor. In contrast, the specifications used in the context of a hybrid definition of Licensed Product might encompass a wide range of product choices whose selection and design is controlled by the Licensee.

B. Definition of Licensed Product impacts Agreement Structure Significantly:

Choosing a particular approach to define the Licensed Products has consequences. In particular, the choice will strongly influence the overall agreement architecture, including dictating other clauses that need to be in the agreement and the content of those clauses. For instance, choosing one kind of approach for defining the Licensed Product can make it highly desirable to use a substantial inventory of additional clauses that either are not needed with other definitional approaches or whose content would be strikingly different under other approaches. Again, clauses in an agreement work together, and no clause is an island.

The following table shows how the definition of Licensed Product impacts agreement architecture. In a pair of typical license deals, an exemplary agreement architecture accompanying a product specific definition is compared and contrasted to an exemplary agreement architecture accompanying a patent-wide definition:

	Definition of Licensed Product	
Agreement provisions:	Product Specific	Patent-wide
Product design details	The Licensor controls the nature of the licensed product and gives the Licensee very specific product details, including	The Licensee controls the development and nature of the licensed product.

	design drawings, etc. These are included as an exhibit to the license.	
Access to product samples and design information	**The Licensee grants this access to the Licensor so the Licensor can police agreement compliance by the Licensee**	**The Licensee might, but often does not, grant a limited access to this information for policing purposes.**
Grant	**Specifically limited to one particular embodiment. The grant also allows the Licensee to sell kits and combinations (discussed below). The Licensor reserves for itself the right to sell replacement parts.**	**The grant allows the Licensee to manufacture and market any product covered by one or more claims of the licensed patents and/or incorporating the licensed know-how.**
Know-how and show how	**The Licensor transfers substantial know-how and show how to the Licensee to enable the Licensee to manufacture and market the Licensed Product**	**No manufacture know-how is transferred, as the Licensee will be developing the product to be sold. However, the Licensor might transfer background data or prototype information**
Tooling	**The Licensor provides direct or indirect access to proprietary tooling needed to make the Licensed Product**	**Licensor provides no tooling.**
Authorized sources of supply	**Licensor sets up authorized sources to supply the Licensee with proprietary components of the Licensed Products**	**Licensee sets up its own sources and makes sure its rights under the agreement are broad enough to do this.**
Protection against infringement	**Since the Licensor controls and specifies the design of the**	**Since Licensee controls the product design and is in the**

	Licensed Products, the Licensor agrees to indemnify the Licensee if the Licensed Products infringes third party patent rights if the infringement is due to the product design as provided by Licensor	better position to avoid infringement problems, the Licensor offers no indemnity to the Licensee for third party infringement. However, the Licenser represents and warrants that it has no knowledge of any infringement or threats of infringement relating to the licensed intellectual property.
Limits on indemnity	The Licensor's indemnity contains limits so that the Licensor's risk is controlled to some degree	Not applicable
Agreement term	The agreement term is only 5 years, renewable with the consent of both parties. A short term like this is fair to Licensee, because Licensor, not Licensee, invested time and resources to develop the Licensed Product	Term extends for the life of the patents, but no less than ten years based upon the transferred know-how.
Royalty	The royalty rate can be higher in a turnkey Licensed Product like this. Optionally, the royalty stages down if the licensed patent rights are no longer applicable and only the know-how remains.	The royalty is less than a turnkey situation, because the Licensee is investing in product development. Optionally, the royalty stages down if the licensed patent rights are no longer applicable and only the know-how remains.
Confidentiality	Confidentiality terms must protect the significant bodies of transferred know-how	Confidentiality is also important, but the kind of information being protected is not as extensive.

	for the full life of that know-how	

Clearly, the structure of these two deals is quite different, with the product specific deal being the more complex of the two (as is commonly the case). The many differences between the two deals highlights the fact that the definition of Licensed Product that you choose for your deal will seriously impact the issues you must consider with your client when crafting the overall design of your deal and its corresponding agreement.

Choose your definition approach early to avoid having to completely re-design your deal and re-draft your agreement later in the negotiation process. You might already appreciate that the definition of the Licensed Products is an important clause, but perhaps it is a surprise that your approach to this clause impacts agreement structure so much.

<u>C. Enhancing readability</u>:

Very often, the generic terminology "Licensed Product" is used in a license. While there is nothing wrong with this approach, using a more descriptive label can enhance readability of a license. For instance, rather than use the label "Licensed Product" consider using a more concrete label such as "RUSTPROOF WIDGET" or "SINGLE WAFER SPIN COATER".

1.4 "NORM INFORMATION" shall mean any and all tangible technology, written materials, equipment, facilities, tooling, facilities design, product parts, processes, electronic media formulations, documentation, designs, plans, and policies relating to the PRODUCT that previously has been or will have be transferred to ACME by NORM hereunder. At a minimum, NORM INFORMATION shall include the items listed on **Schedule A**.

This defines the know-how that is going to be licensed. In this definition the term "NORM INFORMATION" is used, but alternative terminology such as "NORM KNOW-HOW" or the like also may be used. It is rare to see a term such as "NORM TRADE SECRETS" because contractually the scope of confidential and proprietary information can be broader than just trade secrets.

1.5 "NORM PATENT RIGHTS" shall mean any patent applications or patents owned or controlled by NORM as of the EFFECTIVE DATE and having one or more claims that relate to PRODUCTS. The NORM PATENT RIGHTS shall include United States patent application having United States Serial No. 77/777777, titled RUSTPROOF WIDGET, bearing Attorney Docket No. NORM0055US1 and filed January 1, 2008, in the names of Einstein et al., as well as any parent patent applications from which such application claims priority under 35 USC 119 or 120, continuations, continuations-in-part, divisions, additions, reissue applications, reexamined patent applications, any patents that may issue on any such applications, and foreign equivalents thereof. A listing of current NORM PATENT RIGHTS is shown in **Schedule B**. This list shall be updated by NORM from time to time upon request of ACME.

This defines the patent rights to be licensed. Note that the current U.S. rights include a pending application that has not yet issued as a US patent. This will impact language that is used in later clauses.

1.6 "NET SALES" shall mean the gross dollar amount collected by ACME from its customers, whether such customer is a distributor, wholesaler, retailer, end-user, or any other third party, for RUSTPROOF WIDGETS sold, leased, licensed or otherwise commercially transferred by ACME, less: (i) any discounts or rebates actually applied; (ii) any tax or governmental charge included in such gross dollar amount, which is imposed directly on, or measured by, the sale, lease or transfer, transportation, delivery or use of such items, other than any taxes or charges on the seller's net income, unless it is actually reimbursed; (iii) actual allowances for returned or defective RUSTPROOF WIDGETS; and (iv) any royalty paid to a third party for use of any technology incorporated in the RUSTPROOF WIDGETS.

Item (iv) is a clause that Licensees like to see as an offset against NET SALES. Importantly, this is a direct offset against NET SALES, not royalties. The difference is economically significant. To explain, consider a situation in which ACME has agreed to pay NORM a royalty of 7% of NET SALES, but ends up having to pay a third party a 5% royalty under the third party's intellectual property. With an offset against NET SALES, Acme still pays Norm 7% of 95% (100% less the 5% paid to the third party) of NET SALES. Norm only loses 7% of 5% of NET SALES with this offset approach. In contrast, if Acme were to get a direct offset against royalty, Norm would only get 2% (7% less 5% paid to the third party) of NET SALES.

A Licensor might not want to agree to any kind of offset up front. If the Licensee controls the design of the Licensed Products, then Licensee is in the best position to avoid the risk of infringement while Licensor should not have an obligation to provide an offset. That is not to say that the Licensor should not be amenable to discussing a potential offset were such a circumstance to arise.

On the other hand, if the Licensor designed the Licensed Product and the Licensee is only authorized to manufacture and market that Licensed Product, it seems more fair for the Licensor to provide some offset.

Article 2
LICENSE GRANTS, ROYALTY, AND REPORTS

2.1 NORM agrees to grant and does hereby grant to ACME a royalty bearing, worldwide, nonexclusive license under NORM INFORMATION and NORM PATENT RIGHTS to make, use, service, repair, reconstruct, sell, offer for sale, import, or otherwise distribute PRODUCTS and RUSTPROOF WIDGETS anywhere in the world.

This is a very serviceable, basic grant clause. Clauses like this have been used in thousands of license agreements with success. All the essential parts of a grant clause are present. The Licensor and Licensee are identified. The royalty bearing nature of the grant is recited. Other options might involve grants that are paid up and irrevocable if no running royalty is required. The nonexclusive nature of the grant is recited. Other common options include exclusive and sole licenses. The underlying intellectual property is clearly identified in the grant. The full litany of statutory rights (making, using, selling, offering to sell, and importing) are conveyed as well as the additional right to "otherwise distribute" such as by leasing or the like. Acme expressly gets the right to service, repair, and reconstruct. The products being licensed are clearly specified. The territory scope of the license also is recited. An optional field restriction is not included, but could be in many cases. For instance, perhaps the grant could be limited to the field of industrial producers of a certain class of product or the like.

Although acceptable, this basic clause can be enhanced. Also, additional features and supporting clauses can be added to handle more complex scenarios.

<u>A. Making, Having Made, and Making for Others</u>:

As one upgrade, it is helpful to realize that the "making" aspect of the granted rights can be viewed as a bundle of three different rights all relating to "making." This bundle includes the following rights:

- **<u>Making</u>: Under this right, the Licensee makes Licensed Products itself for the Licensee's own sales.**
- **<u>Having made</u>: Under this right, the Licensee hires another party, such as a contract or toll manufacturer, to make Licensed Products for the Licensee's own sales. The contract or toll manufacturer can only sell the Licensed Products it makes to the Licensee. The contract or toll manufacturer cannot otherwise use or sell Licensed Products.**
- **<u>Making for others</u>: Under this right, the Licensee manufactures Licensed Products for others for the others to sell under their own respective brands.**

If all three rights in the bundle are not expressly addressed in the grant clause, will have made and making for others rights be construed as aspects of the making right? The case law does not clearly indicate what

agreement construction might prevail. If the grant clause only refers to "making" without any reference to "having made" or "making for others", it is possible that "having made" or "making for others" rights will not be granted to the Licensee. This might cause consternation to a Licensee whose unexpressed, unilateral intent was to have such rights. It is just as possible that such rights might be construed as part of the "making" right. This might cause consternation to a Licensor whose unexpressed, unilateral intent was to reserve those rights and not grant them to the Licensee.

Good drafting practice suggests, therefore, that the entire bundle of making, having made, and making for others rights should be expressly addressed in the grant clause. If you are the Licensor and you do not want to convey the entire bundle of making rights, the following grant clause may be used:

> Licensor agrees to grant and does hereby grant to Licensee a royalty bearing, nonexclusive license under Licensed Patents and Licensed Know-how to make (but not to make for others and not to have made), use, sell, offer to sell, import, or otherwise commercially distribute Licensed Products in the Licensed Field throughout the Territory.

If you are the Licensee and you want the full bundle of making rights, the following grant clause may be used:

> Licensor agrees to grant and does hereby grant to Licensee a royalty bearing, nonexclusive license under Licensed Patents and Licensed Know-how to make, have made, make for others, use, sell, offer to sell, import, or otherwise commercially distribute Licensed Products in the Licensed Field throughout the Territory.

B. Authorized Sources:

As an alternative to granting "have made" rights, a Licensor instead may set up one or more authorized sources of Licensed Products or proprietary components of Licensed Products. Licensee will be authorized to purchase the items from the authorized sources but not elsewhere. This program might be desirable where the Licensor has crucial know-how that the Licensor does not want to transfer to the Licensee for one reason or another. Setting up authorized sources can give the Licensor more control over its know-how than if the know-how were transferred under license to the Licensee. This approach also ensures that a Licensee will not have access to key know-how upon the expiration or termination of the license. A Licensee might also favor this program. For instance, a Licensee might

not want to take in and be tainted by Licensor know-how if the Licensee is doing research in competitive technologies.

If a Licensor sets up authorized sources, the Licensor may wish to expressly state that the Licensor has no obligation to continue to authorize the sources to continue to be a source of supply after the agreement expires or terminates or perhaps after all the licensed patents are held invalid. Otherwise, an issue can arise as to whether the Licensee has an implied right to continue to patronize those authorized sources.

Authorized sources also have to be set up carefully to avoid accidentally conveying implied licenses that could frustrate the Licensor's ability to collect royalties.

<u>C. Exclusive grants</u>:

Consider a basic clause (<u>which is not adequate</u>) such as the following that grants an exclusive license:

> **Inadequate: Licensor agrees to grant and does hereby grant to Licensee a royalty bearing, exclusive license under Licensed Patents and Licensed Know-how to make, make for others, have made, use, sell, offer to sell, import, or otherwise commercially distribute Licensed Products in the Licensed Field throughout the Territory.**

This clause is very similar to the nonexclusive grant clause provided above, except that this one confers an exclusive grant. This basic approach might have been appropriate for a nonexclusive grant, but it is inadequate by itself in the exclusive setting. Too many exclusivity issues are unaddressed. A basic exclusivity grant clause like this one needs a supporting cast of related clauses to be adequate.

<u>1. Tax consequences</u>

First, the agreement architecture and overall approach must be carefully designed to accommodate whether the exclusive deal is really a license or an assignment under the auspices of the taxing authority. If the Licensee is not careful, an intended license can unintentionally be viewed as an assignment. This is a key concern, because tax consequences for an unintended assignment can significantly impact and undermine deal economics for the Licensee. Imagine, for instance, an exclusive license deal in which the Licensee pays the Licensor an initial fee of $1,000,000. Initial fees of this magnitude and even bigger are seen in deals involving medical device or pharmaceutical technologies. If the deal is truly a license for tax purposes, there should be no surprises. The initial fee paid

by the Licensee to the Licensor will be a deductible expense in the year the fee is paid to the Licensor. The Licensee can deduct the whole $1,000,000 payment as an expense.

The situation is quite different for an assignment. In this situation, the entire $1,000,000 is viewed as a capital expense. Even though the Licensee gave the money to the Licensor, the entire $1,000,000 payment will still be treated as Licensee income except for the minor portion of the payment that can be depreciated that year. The Licensee will pay taxes on the entire $1,000,000 payment less the depreciable amount. Imagine paying the Licensor $1,000,000 dollars for what you thought was a deductible expense only to find out you also owe the IRS and state taxing authority an additional $400,000 in taxes at the end of your fiscal year because really the payment was a capital expense and thus still income to you. This tax liability can come as quite a shock to an unsuspecting Licensee.

2. Can Licensee lose exclusivity?

Another issue concerns whether the Licensee is entitled to keep its exclusive license under all circumstances. In some deals, the Licensor is happy to convey the exclusive license rights and is not thereafter concerned if the Licensee works the patent rights or not. This might be the case if the Licensee received a lump sum payment for the license. In other deals, the Licensor remains very concerned that the Licensee work the patent rights appropriately or else the Licensor might want those rights back so the rights can be worked by someone else. This might be the case where the Licensor expects to receive a significant royalty stream under the license. Where the Licensor remains concerned that the exclusively granted rights are practiced adequately, the Licensor will want to make the exclusive grant subject to performance milestones. If the Licensee does not meet the milestones, the license might automatically convert to a nonexclusive license. Or the license might even terminate. In some deals, the conversion or termination might not happen automatically, but can be effected if the Licensor chooses to do so.

Examples of milestone provisions of this nature include the following:

> **The exclusive license granted herein is subject to LICENSEE achieving and maintaining certain performance milestones as follows (note the concept of SALES ACTIVITY which is introduced in section 2.3.1 of this clause set):**
>
> **2.3.1 If the cumulative SALES ACTIVITY for LICENSED PRODUCTS is below $750,000 as of December 31, 2009, then the exclusive grant automatically converts to a nonexclusive grant. As used herein,**

"SALES ACTIVITY" means the sum of (a) actual cumulative NET SALES of LICENSED PRODUCTS made by LICENSEE during the period from the EFFECTIVE DATE of this Agreement through the date on which SALES ACTIVITY is assessed, and (b) the prospective NET SALES for LICENSED PRODUCTS that LICENSEE reasonably could make within six (6) months with respect to any bona fide, good faith, active, pending written proposals submitted by LICENSEE to one or more third parties.

2.3.2 After December 31, 2010, if cumulative, actual NET SALES of LICENSED PRODUCTS by LICENSEE hereunder in any subsequent calendar year are less than $500,000, then the exclusive license grant shall automatically convert to a nonexclusive grant.

2.3.3 After December 31, 2010, if actual NET SALES of LICENSED PRODUCTS by LICENSEE hereunder are less than $40,000 in each of three (3) consecutive calendar years, then LICENSOR shall have the right to terminate this Agreement with ninety (90) days advance written notice to LICENSEE. In order for such termination to be effective, LICENSOR shall provide LICENSEE with such written notice no later than March 31 of the year following the end of the calendar year under scrutiny. In assessing the actual NET SALES of LICENSED PRODUCTS by LICENSEE with respect to such calendar years, LICENSOR need only consider those NET SALES timely reported in a written report of Section 2.8 and for which royalty has been timely paid.

Milestone provisions are an artifact of the Licensor's perspective to ensure that its patent rights are being worked. In some instances, a Licensee might even want to have the right in its discretion to convert an exclusive license to a nonexclusive one. The Licensee might want to do this to access a lower royalty rate or to release other burdens associated with an exclusive grant. A clause to do this is as follows:

2.3.5After December 31, 2009, and with thirty (30) days advance written notice to LICENSOR, LICENSEE shall have the right to convert its exclusive license grant to a nonexclusive license grant.

It is probably good practice that the royalty is reduced upon conversion of an exclusive grant to a nonexclusive grant. There are other circumstances that might also trigger a royalty reduction. If a package of patents is licensed, it may be desirable to reduce the royalty if one or more key patents of the package expire. If both patents and know-how are licensed, it may be desirable to reduce the royalty when all the patents expire and only the know-how remains in place. There is some case law suggesting

that potential misuse issues could be, but are not necessarily, raised if royalty reductions do not occur under circumstances such as these and the like.

3. Background Rights in the Exclusive grant context:

In addition to the directly licensed intellectual property rights, the parties to an exclusive license need to consider whether to expressly address the extent that a Licensee has authority to practice under the background rights of a Licensor. Background rights often can relate to the exclusively licensed intellectual property generally according to three scenarios. In one scenario, the background rights do not relate to the licensed intellectual property in any way. In a second scenario, the background rights are necessarily practiced when the Licensee practices the licensed intellectual property. In a third scenario, the background rights could be desirable, but are not necessary, to practice the licensed intellectual property.

In the first scenario, the background rights need not be addressed at all in the license.

Under the second scenario in which the background rights are necessary, background rights should be addressed expressly. If not expressly addressed, the Licensee very likely will be granted an implied license to practice the background rights. After all, if the background rights are necessary to practice the expressly licensed intellectual property, the license grant would be rendered meaningless if a license under the background rights is not implied.

This kind of implied license might not be a problem for a Licensor in a nonexclusive license setting. The implied license in a nonexclusive setting likely also would be a nonexclusive grant of an appropriate scope to allow the Licensee to practice the nonexclusive grant. But, the scope of such an implied license under background rights is not so clear in an exclusive setting. It is possible that the implied grant under the background rights might also be exclusive at least to some extent. This could surprise a Licensor who finds unexpectedly that it has no access to its background rights as a consequence of an exclusive, implied grant.

Consequently, any license, particularly an exclusive one, should expressly address what authority under Licensor background rights is being conveyed to the Licensee. If the Licensor desires to convey a right to practice to the Licensee but also wants to retain access to its background rights, the grant of background rights can be nonexclusive (which allows the Licensor not only to use the background rights but also to transfer

such rights to third parties in the Licensor's discretion) or sole (which allows the Licensor to continue to practice the background rights while prohibiting the Licensor from transferring background rights to third parties).

An exclusive license also should expressly address what authority to practice will be conveyed to the Licensee under the desirable background rights associated with the third scenario. If no right to practice under these desirable background rights will be granted to the Licensee, this should be expressly stated to avoid an inadvertent grant of an implied license. If optional background rights are to be conveyed to the Licensee in some fashion, this should be done expressly and not left to implication.

D. Sole grants:

Nonexclusive and exclusive licenses are terms of art. The meanings of these kinds of grants are well established. Consequently, it is not necessary to define what is meant by these kinds of grants. Sole license grants are possibly different, as some case law and commentators suggest that the meaning of a sole license is not settled. Consequently, if a license confers a sole license, it may be desirable to define what is meant by this kind of grant. An illustrative definition is as follows:

> "SOLE LICENSE" shall mean a license under which Licensor retains the full and unrestricted right under the Licensed Patents to continue to make, use, sell, make, have made, make for others, sell, offer to sell, import, or otherwise commercially distribute Licensed Products anywhere in the world in any field; provided, however, that Licensor agrees to refrain from granting further licenses to any other party during the term of this Agreement.

E. Avoid ambiguous grants:

Grant clauses, or any clause for that matter, should be clear. You want clauses to be clear not only for the parties who must operate under the agreement, but also for those who might end up enforcing the agreement in the future. Often, the personnel enforcing an agreement might not be the same personnel that drafted the agreement. Enforcement is confounded if the meaning of a clause or the corresponding intent of the parties is clouded by ambiguity. Ambiguities can also be the spark that ignites agreement disputes that could lead to expensive litigation. Ambiguities should always be dealt with at the drafting stage, if uncovered. Otherwise, ambiguities in these important clauses foster discord between the Licensor, license, and their permitted successors.

There are two common varieties of ambiguities that appear with some frequency. In one variety, the language of the clause is messed up and so jumbled that a definitive clause construction is quite difficult. The following clause from an actual agreement illustrates this foible:

> **<u>Ambiguous at best</u>: Licensor hereby grants to Licensee a worldwide FIELD OF USE license under Licensor Patent Rights to manufacture, make, have made, use, sell, offer for sale, import, lease or otherwise practice any act to practice any act to make, use or sell any practice or act under the Licensor Patent Rights on a nonexclusive basis in the FIELD OF USE.**

The rest of the license including this clause was pretty clear and easy to read. Therefore, this ambiguity likely resulted from a word processing error and careless proofreading of a draft revision rather than from poor drafting in the first instance. The meaning of the clause is vastly improved by this rewrite:

> **<u>Better</u>: Licensor agrees to grant and does hereby grant to Licensee a nonexclusive, royalty-bearing license under the Licensor Patent Rights to make, have made, use, sell, offer for sale, import, or otherwise commercially distribute Licensed Products in the Field of Use.**

In another variety of ambiguity, the grant clause is grammatically correct, but the legal meaning of the clause is unclear. The following clause illustrates this:

> **<u>Ambiguous</u>: Licensor grants to Licensee an exclusive, worldwide license to make, have made, use, and sell Licensed Products and to use Licensed Know-how within the Field.**

This clause is subject to multiple interpretations as shown by the following two illustrative options:

> **<u>Option A</u>: Licensor grants to Licensee an exclusive, worldwide, royalty bearing license under Licensed Patent Rights and Licensed Know-how to make, have made (but not make for others), use, sell, offer to sell, import, and otherwise commercially distribute Licensed Products in the Field.**

> **<u>Option B</u>: Licensor grants to Licensee an exclusive, worldwide, royalty bearing license under Licensed Patent Rights and Licensed Know-how to make, have made (but not make for others), use, sell, offer to sell, import, and otherwise**

commercially distribute Licensed Products. Licensor grants to Licensee an exclusive, worldwide, royalty bearing license under Licensed Know-how to make, have made (but not make for others), use, sell, offer to sell, import, and otherwise commercially distribute any products in any Field.

2.2 This grant shall further include the right of ACME to grant written sublicenses to any third party including Licensee Affiliates.

<u>A. General Sublicense concerns</u>:

Generally, if sublicensing is not expressly addressed, the Licensee has no rights to sublicense. However, this is only a general rule, and sublicense rights can still be implied. Sublicense rights should be expressly addressed and not left for implication or conjecture.

If sublicensing is prohibited, simple clauses such Clause 2.2 are acceptable (except possibly in an exclusive license for reasons noted below). If a have made right is granted, a prohibition on sublicensing might read as follows, inasmuch as a have made right can be viewed as a limited type of sublicense right.

> **Except for the right to have made, Licensee shall have no right to grant any sublicenses to any third parties.**

In contrast, if sublicensing is to be authorized, simple clauses such as the following are inadequate if used by themselves:

> **<u>Inadequate</u>: Licensee shall have the right to grant sublicenses to any third party.**

> **<u>Inadequate</u>: Licensee shall have the right to grant sublicenses to any Licensee Affiliates.**

These simple clauses are inadequate, because several issues relating to sublicense rights are not addressed at all. For example, should any sublicense continue or terminate when the main license expires or terminates? Can Licensor know-how be transferred to a subLicensee? If yes, under what conditions? Will the subLicensee pay the Licensee or the Licensor directly? If a subLicensee breaches, is the Licensee also in breach? Will the Licensor be able to sue a subLicensee directly in the event of a breach with or without the consent of the Licensee? A simple but reasonably complete clause might be as follows:

> ACME shall have the right to grant written sublicenses to others in the United States under Licensed Patents but not Licensed Know-how to make, use, sell, offer to sell, import, or otherwise commercially distribute the Licensed Products in North America; provided, however, that ACME shall give written notice to NORM of the grant of any sublicense(s) and shall provide NORM with a written copy of any sublicense and amendment thereto. ACME shall guarantee the performance of a subLicensee, including payment of royalties to NORM as required under this Agreement. ACME shall also secure from any subLicensee(s) an agreement similar to the audit and reporting provisions hereunder allowing NORM to audit the books and records of such subLicensee(s). NORM shall be named as a third party beneficiary of any such sublicense and shall be expressly be authorized to bring a direct action against the subLicensee in the event of a breach, either in NORM's own name or the name of ACME if required. Any such sublicense shall automatically terminate upon the expiration or termination of the present license agreement.

The Licensor and Licensee will need to address whether Licensee affiliates are to be licensed directly or only via a sublicense. If the Licensee is defined collectively as the Licensee and its Affiliates, the grant clause will confer a direct license on the Affiliates, too. In this situation, the Licensor may require an affiliate to sign the license in order for the license to be effective. If the definition of the Licensee does not include Licensee Affiliates, affiliates would need a sublicense. Many Licensees prefer the latter approach in order to control how license rights are made available to its affiliates.

B. Special sublicensing concerns in an exclusive license:

Some exclusive licenses might include a clause such as the following:

> Possibly improper: The Licensee shall have no right to grant any sublicenses to any third party unless advance written authorization is obtained from the Licensor.

The practical impact of this clause leads to an interesting legal issue. Because of this clause, the Licensee will not be able to convey any sublicenses without first obtaining the Licensor's approval. The Licensor also cannot act unilaterally to grant any further licenses, because an exclusive right was conveyed to the Licensee. The practical impact of this clause, therefore, is that neither party will be able to convey any kind of license rights to a third party without the Licensor and Licensee conferring and agreeing on the issue.

The fact that the parties will need to confer like this leads to the legal issue. There is a chance that a prohibition against sublicenses in an exclusive license constitutes patent misuse or a violation of the antitrust laws according to older cases on point. According to these cases, the exclusive Licensee must have sole discretion to grant sublicenses to others, because otherwise the parties have to collude or conspire to decide whether additional license rights will be made available.

If the sublicensing issue were to arise today in the context of an exclusive license, would modern courts continue to apply a per se standard? Maybe not. Under a totality of circumstances standard, if such a standard were to be applied, one can conceive of circumstances in which the parties could confer on sublicensing in a way in which the overall effect would be pro-competitive.

2.3 The license grant under NORM INFORMATION shall be deemed to be irrevocable and fully paid up as of midnight (CST), December 31, 2020.

This clause presents the Licensee perspective. It is very desirable from the Licensee perspective that a grant of rights under know-how become irrevocable and fully paid up at some point. This way, the Licensee is not obligated to continue to pay royalty for an indefinite period. Illustrative timeframes after which know-how becomes fully paid up and irrevocable can vary, but common ones include 5 years from the effective date, 10 years from the effective date, 15 years from the effective date, the life of the licensed patents, etc. The Licensor, in contrast, may have a very different perspective. If the know-how has a very long product life, the Licensor will want the Licensee to keep paying royalty or else stop using the know-how. An exemplary clause that protects the Licensor's perspective is as follows:

> **ACME'S right to use any NORM PATENT RIGHTS or NORM INFORMATION ends immediately upon any expiration or termination of this Agreement.**

In some instances the Licensee can be accorded a transition period:

> **Upon termination or expiration, Licensee's right to use any Technology, including Confidential Information, or any other proprietary right of Licensor, ends immediately upon any expiration or termination of this License Agreement. At the request of Licensor, Licensee will immediately return any and all materials related to the Technology to Licensor or destroy all documents and other writings supplied by Licensor, together with all copies of any such documents or other**

writings, and an officer of Licensee will certify to the return or destruction of all materials. Upon termination, Licensee will cease manufacture, sale or distribution of Products. Failure to comply with these obligations will be prima facie violation of the intellectual property rights of Licensor. Termination or expiration of this License Agreement through any means or for any reason shall not relieve any party of any obligation accrued prior to such termination (e.g. obligations of confidentiality or restrictions on use, obligations to pay accrued royalty) and shall be without prejudice to the rights and remedies of any other party with respect to default or breach of this License Agreement. Notwithstanding the foregoing, Licensee will have the right to fulfill orders that have been placed before the termination of this License Agreement if Licensee is not in material breach of this Agreement, has provided Licensor with notice of such pending orders following termination or expiration, and such orders will be fulfilled within 90 days of the termination date, and if royalty for these orders is paid in a timely manner.

2.4 As between NORM and ACME, NORM is and remains the exclusive owner of all right, title and interest in and to the NORM INFORMATION and the NORM PATENT RIGHTS, including IMPROVEMENTS. "IMPROVEMENTS" shall be included in the NORM PATENT RIGHTS and NORM INFORMATION, as the case may be, licensed to ACME hereunder. IMPROVEMENT shall mean any improvement or further invention made by ACME during the term of this Agreement (a) that relates to the RUSTRPROOF WIDGETS or the PRODUCTS, and (b) that is covered by one or more pending or unexpired claims of the NORM PATENT RIGHTS and/or for which a material portion of the improvement incorporates or is derived from NORM INFORMATION. ACME will execute any instruments and perform any acts reasonably requested by NORM to accomplish and confirm NORM's rights with respect to IMPROVEMENTS

<u>A. Improvement clauses must pass muster under misuse and antitrust laws</u>:

Improvement clauses, such as this grant back clause, usually are hotly negotiated. Either Licensor and/or Licensee improvements could be at issue. For instance, Licensor improvements might be conveyed to the Licensee via a grant forward clause. Any licensing strategy involving grant back and/or grant forward clauses must be scrutinized to make sure that the strategy on the table passes muster under misuse and antitrust principles.

The following improvement clause, for instance, very likely runs afoul of misuse and antitrust laws:

> **Possibly improper: NORM shall own all improvements relating to any kind of widgets that are made by ACME during the term of this Agreement.**

This is a grant back clause of patent rights under which title to a wide spectrum of Licensee improvements made during the license term is conveyed back to the Licensor. This improvement clause is potentially improper on several fronts. First, the clause is so broad, that the concern is raised that the patentee is enlarging the scope and extending the term of its patent rights to an unreasonable extent. There is also the concern that the Licensee loses any incentive to develop competing technologies, as these would have to be handed over to the Licensor.

The clause can be modified in several ways to arrive at a clause that has good chances of passing muster. Clause 2.4 above shows these modifications. The improvements subject to the grantback have a clear nexus to the licensed intellectual property. Other limitations could also be added to increase the chances of passing muster. For example, the obligation of ACME to grant back improvements could be limited to those improvements made in a relatively brief span of years from the Effective Date. Second, perhaps NORM does not get title, but rather gets a nonexclusive license.

There are a host of other approaches that might be used to handle improvements. The propriety of these other approaches is a gray area in many cases. This is one area where the applicable case law should be reviewed before one commits to an improvement strategy.

<u>B. Improvement clauses impact valuation</u>:

In some business situations, an improvement clause can undermine the valuation of a Licensor or Licensee that is obligated to convey improvements to the other party. For instance, consider a situation in which a party owns a patent that protects a key product line, and this party, the patent owner, granted a nonexclusive license under the patent to an industry colleague. Under the license, the patent owner obligated itself not only to license its patent but also to convey improvements of the patented technology to its Licensee for the term of the license. Now consider what happens if the patent owner/Licensor desires to sell its business to a potential buyer who views the product line and patent (and hence the impact of the license) as being crucial to the acquisition. The potential buyer will typically conduct a due diligence of the key technology and patents in order to validate the potential buyer's decision to close or walk away from the deal. This due diligence normally includes an assessment

of any applicable licenses and how they might impact the competitive posture of the buyer if it were to close the deal. The potential buyer often will have a myriad of questions concerning its due diligence of license agreements, but four key questions often are included in the extensive list of due diligence questions:

- **What is licensed?**
- **Does the Licensee have the right to transfer the licensed technology to others?**
- **Is the Licensor obligated to transfer rights for improvements to the Licensee?**
- **Does the license restrict Licensor's right to exploit the technology in any way?**

With these questions in mind, the hypothetical license is very problematic. If the buyer closes the deal, the buyer may now "inherit" the obligation under the license to convey improvements to the Licensee. The valuation of the business is undermined, because the buyer will not have a proprietary position, and any improvements it makes will be leaked away to a competitor. The problem is exacerbated if the Licensee not only has the right to use those improvements for itself, but also has the right to further transfer those improvements to its customers or even other subLicensees. The deal is not likely to close, or will close at a deep discount if the due diligence of the buyer uncovers a situation like this.

In other words, think twice before broadly agreeing to grant improvements to the other party to avoid undermining your business valuation.

There are ways to minimize this kind of valuation risk. First, before granting any license, a Licensor should always assess how the license will impact its valuation. If valuation is impaired too much, it may be best to forego granting the license. Second, the license deal can only be done if one party agrees to convey improvements to the other, the impact of such a clause upon of the valuation of the one party's business can be mitigated in certain ways. As one illustrative strategy, the obligation to convey improvements can terminate if the corresponding business or license, as the case may be, is conveyed to an independent third party. Another approach is to expressly provide that the obligation to convey improvements shall not bind or be applicable to any transferee of the license or of the business to which the license relates. The obligation to convey improvements can also be temporally limited, such as by providing that the obligation only extends to improvements made within a period of one year from the effective date of the agreement. Also, the agreement can prohibit the party receiving improvement rights from transferring those to any other party. Anything that minimizes the scope of the obligation,

minimizes the rights of the Improvement recipient, and/or that terminates the obligation if a third party steps into the picture, will be helpful.

2.5 ACME will use the NORM PATENT RIGHTS and the NORM INFORMATION only for the purpose of manufacturing, making, having made, marketing, selling, offering for sale, importing, or otherwise distributing RUSTPROOF WIDGETS and PRODUCTS and for no other purpose. This use restriction shall survive any expiration or termination of this Agreement.

This clause at its core prohibits the Licensee from using the licensed intellectual property to develop competitive products outside the scope of the license grant. If you couple tightly drafted improvements clauses with clauses that clearly limit how the Licensee can use the licensed IP, then the Licensor is well protected. Avoid grant forward improvement clauses and the Licensor is even better off.

Importantly, this restriction on developing competitive technology has a very strong, express link to the licensed intellectual property. In contrast, it is improper under misuse and antitrust principles to broadly block a Licensee (or Licensor) from developing any competitive technologies without regard to whether licensed intellectual property is being used or not. Thus, the following clause penned by an over-reaching Licensor is problematic:

> **<u>Likely Improper</u>: During the term of this Agreement, ACME shall not develop on its own or with others any widgets or related products that are competitive with the RUSTPROOF WIDGETS and the PRODUCTS.**

2.6 As part of the consideration for the license grants hereunder, ACME agrees to pay NORM a nonrefundable initial fee of $50,000.

This is a typical but incomplete initial fee clause. This clause can be improved in various ways.

First, from the perspective of the Licensor, the clause should clearly state when the initial fee should be paid. For instance, the fee can be due upon execution of the agreement or within a specified period of days from the signing. Also from the perspective of the Licensor, the initial fee clause can specify that the license grants and other rights of the Licensee are only effective upon Licensor's receipt of the initial fee. This gives the Licensee some motivation to pay the initial fee on time if the Licensee wants access to the license grants and other rights. From the Licensee perspective, all or a portion of the initial fee can be creditable against subsequent royalty payable by Licensee to Licensor. An exemplary initial fee clause and the

corresponding beginning of a corresponding grant clause that implement these concepts is the following:

> **As part of the consideration for the license grants of this Article, Licensee agrees to pay Licensor a nonrefundable initial fee of $50,000. This initial fee shall be paid in the form of immediately negotiable funds immediately upon the signing of this Agreement by Licensor and Licensee. This initial fee is creditable against royalty payable by Licensee to Licensor that accrues during the first 6, full calendar quarters of this agreement.**
>
> **Immediately upon Licensor's receipt of the initial fee and not before this receipt, Licensor agrees to grant and does hereby grant to Licensee . . .**

2.7 ACME shall pay NORM a royalty of 5% of the NET SALES PRICE for each unit of RUSTPROOF WIDGET and 6% of the NET SALES PRICE for each unit of PRODUCTS sold by or for ACME or an ACME Affiliate to an independent third party and whose making, using, servicing, repairing, reconstructing, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the NORM PATENT RIGHTS and/or that incorporates NORM INFORMATION.

A. Royalty Rates Generally:

This is a very conventional approach for setting the royalty as a percentage of net sales. A clever Licensee might think it can reduce its royalty burden by first selling to an affiliate or other non-independent party at a relatively low price, after which the affiliate (or other non-independent third party) sells to independent third parties at a higher price. The following can be added to the basic clause to guard against this royalty ploy:

> **If Licensee sells directly to an independent third party, the NET SALES PRICE to be used for purposes of computing royalty shall be the Licensee's NET SALES PRICE. If it is a Licensee Affiliate or other party under the control of Licensee that first transfers LICENSED PRODUCTS to an independent third party, then the NET SALES PRICE to be used for purposes of computing royalty shall be such Affiliate's or controlled party's NET SALES PRICE to such third party.**

As an alternative to expressing royalty rates as a percentage, flat royalty rates can also be used in a clause such as the following:

> **Licensee shall pay Licensor a royalty of $1.50 for each unit of Licensed Product sold by or for Licensee whose making, using, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the Licensed Patents and/or that incorporates Licensed Know-how.**

This simple clause can suffice for flat rate licenses, because guarding against Licensee royalty ploys is less of a concern with flat royalty rates. The royalty rate is the same regardless of the price at which a unit of Licensed Product is sold. This is one of the advantages of the flat rate.

But, there are disadvantages, too. If the NET SALES PRICE of the Licensed Products deflates, as can often happen over the course of the life of a product line, the royalty can become quite a burden to a Licensee. For example, the Licensee may find it acceptable to pay a flat royalty of $1.50 if the Net Sales Price is $30 or more, but the flat royalty of $1.50 can become irritating if the Net Sales Price falls to $10 or less. On the other hand, if the Net Sales Price increases over the life cycle of the Licensed Products, the effective royalty rate could be so low that the Licensor is leaving money on the table. Flat royalty rates are better, then, where price volatility is expected to be low or where volumes are so high that the Licensor will be happy no matter how high prices might climb. De minimis flat rates can also be used as an enticement to place licenses with otherwise recalcitrant Licensee candidates. Stated differently, if the royalty rate is low enough, a Licensee doing a cost benefit analysis might conclude it is cheaper to take a license at de minimis rates rather than invest in a patent litigation to challenge the patents. Lemelson used this approach to build his licensing empire.

<u>B. Royalty Schedules</u>:

It is common to use a royalty schedule that specifies royalty (either as a percentage or a flat rate) as a function of the number of units of Licensed Product sold in a specified timeframe to avoid ambiguity. It is important that a specified timeframe be provided whenever a schedule is used. For example, the following royalty clause expresses the royalty as a function of the number of units of Licensed Product sold, but no time reference is given:

> **Ambiguous: ACME shall pay NORM a royalty for all RUSTPROOF WIDGETS sold by or for ACME whose making, using, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the NORM PATENT RIGHTS or that incorporates NORM INFORMATION.**

The royalty rate shall be based upon a percentage of the NET SALES PRICE in accordance with the following table:

Number of units of Rustproof Widgets sold	Royalty as a percentage of Net Sales Price of each unit sold
1 to 10,000	7%
10,001 to 100,000	5.8%
over 100,000	4.9%

Without any time reference being specified, it is not clear if the schedule runs cumulatively through the entire agreement term, applies annually, applies quarterly, applies per shipment, or per some other reference. This is really one of the worst places to suffer from ambiguous terms. The royalty rate and payment of royalty is the essence of a license. This defines the money flow between the Licensee and Licensee. This is the bottom-line of a product license. Ambiguity about money can spark discord between the Licensee and Licensor. Avoid ambiguity by making sure that your royalty schedule uses a time reference.

A better clause would be the following, which expressly indicates that the schedule applies to the current calendar year and then re-sets as the next calendar year begins. The calendar year is the time reference in this clause:

Subject to Paragraph 2.4, ACME shall pay NORM a royalty for all RUSTPROOF WIDGETS sold by or for ACME to an independent third party and whose making, using, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the Licensed Patents. The royalty rate shall be based upon a percentage of the NET SALES PRICE in accordance with the following table:

Cumulative Number of units of Rustproof Widgets sold during the current calendar year through the end of the current royalty payment period	Royalty as a percentage of Net Sales Price of each unit sold
1 to 10,000	7%

10,001 to 100,000	5.8%
over 100,000	4.9%

The reference time period can even be a single transaction. For instance, the royalty can be specified as a function of the number of units of Licensed Products sold to a single customer in a single transaction:

> Licensee shall pay royalty to Licensor as a percentage of the NET SALES PRICE for LICENSED PRODUCTS sold by or for Licensee and whose making, using, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the Licensed Patents. The Royalty rate shall be based upon the quantity of LICENSED PRODUCTS sold per single sales transaction to a single customer in a single shipment. Individual orders may not be aggregated. Multiple shipments under a single supply contract may not be aggregated. Royalty shall be paid according to the following schedule:

[redacted]	
1 – 25,000	7%
25,001 – 100,000	6%
100,001 – 250,000	5%
250,001 – 500,000	4%
500,001 – 999,999	3%
1,000,000 and over	2%

If you do use a royalty schedule, the reference period should be at least as long as each payment period so that only a single rate applies to each payment period. For instance, if royalty is to be paid quarterly, it would be undesirable to use a royalty schedule in which the royalty rate is a function of units sold each month.

C. Aggregating sales under supply contracts:

When using a royalty schedule to define the royalty rate for single shipments, a question could arise as to how sales under long-term supply contracts should be treated. Should the sales made under the whole supply contract be aggregated to determine royalty rate, or does each shipment under the supply contract stand alone? For example, consider a deal in which a Licensee agrees to supply its customer with 1,000,000 units of the Licensed Products over a two-year period. During the term of the supply contract, the Licensee would ship 25,000 units for each shipment. Aggregation can make a real difference. Using the schedule provided above, the Licensee would pay a rate of 7% for each shipment if aggregation is prohibited, but would pay only 2% if aggregation is allowed.

In the clause shown above, aggregation is prohibited. But, in some deals, the Licensee has enough bargaining power to secure the right to aggregate shipments under a supply contract, thereby gaining access to reduced royalty rates. The Licensee might be happy with an aggregation right. The Licensor, on the other hand, has legitimate concerns. First, there is no guarantee that all the shipments contemplated by the supply contract would actually occur. Maybe only the first 3 shipments might occur in our example, while the last 5 are canceled. In other situations, more shipments might occur to meet expanding demand. Consequently, both underpayments and overpayments of royalty can occur if aggregation is permitted. As another concern, the Licensor will need to collect enough reported information from the Licensee to allow royalty payments to be accurately tracked for aggregated sales. Further, the Licensor may only wish to permit aggregation to occur for supply contracts for a minimum threshold volume. Consequently, an exemplary but detailed treatment of aggregation could be as follows:

> In some instances Licensee may enter into a supply contract with a particular customer that may extend over a period of time and under which the customer has contractually agreed to purchase a specified volume of LICENSED PRODUCTS during the term of the supply contract in one or more shipments. The total volume of LICENSED PRODUCTS to be shipped to a single customer under such a supply contract may be aggregated by Licensee for purposes of determining corresponding royalty payable to Licensor, subject to the following conditions:
>
> a) The supply contract shall specify a term of one year or less and shall specify that a minimum quantity of at least 1,000,001 LICENSED PRODUCTS must be purchased by the customer under the contract.
> b) Subject to subparagraphs c) and d) of this Section which apply a correction to the royalty paid at the end of a supply contract based upon actual performance under the contract, Licensee may

aggregate sales during the term of any qualifying supply contract and pay a corresponding royalty as if the sales volumes specified in the contract are being satisfied on a pro rata basis.

c) At the end of the supply contract, if the actual shipments to the single customer are less than the volume specified in the contract, then only the actual shipments to the customer can be aggregated for purposes of determining the royalty. Licensee shall promptly pay Licensor a royalty make up payment to cover the different royalty applicable to the shortfall in actual shipments under the contract in the next, corresponding royalty report.

d) At the end of the supply contract, if the actual shipments to the single customer are greater than the volume specified in the contract, then the actual shipments to the customer can be aggregated for purposes of determining the royalty. Licensee may apply any prior overpayment of royalty as a credit against future royalties payable to Licensor.

e) Licensee shall provide Licensor with a copy of the supply contract in advance, although Licensee may redact customer information from the copy provided to Licensor;

f) In the corresponding royalty report relating to each supply contract for which aggregation is used, Licensee shall expressly report the volume sales, the volume shipped, the NET SALES per unit for each shipment, the royalty rate applied to net sales, the aggregated sales under the current calendar quarter, the cumulative aggregated sales under the supply contract through the current calendar quarter, the contracted quantity of LICENSED PRODUCTS to be provided to the customer under the contract, and the starting and end date of the contract.

g) No supply contract shall have any terms with respect to LICENSED PRODUCTS that extend more than six months beyond the term of this Agreement unless approved in advance by Licensor. Thus, any shipments of LICENSED PRODUCTS under any such supply contract occurring after this six-month period shall constitute unlicensed sales under the LICENSED PATENTS and/or LICENSED KNOW-HOW, as applicable. (This clause assumes the term of the license is shorter than the life of the Licensed Patents.)

There is an even simpler approach for handling aggregation issues. Quite simply, the parties can simply specify that the royalty schedule is based upon the volume of units of Licensed Products sold to a particular customer during a relatively short time period, such as monthly or quarterly. If the annualized volumes are scaled down to such a quarterly or monthly schedule as shown in the following table, the Licensee can gain the benefits of aggregation without the complexity of additional, aggregation-specific clauses.

Up to $250,000 (US)	5% of the NET SALES
More than $250,000 (US) up to $1,250,000 (US)	3% of the NET SALES
Greater than $1,250,000	1% of the NET SALES

<u>D. Separate rates for know-how and patent rights</u>:

The present annotated license agreement between NORM and ACME involves both patent rights and know-how rights. The main royalty clause does not allocate the specified royalty between the patent and know-how rights, however. In some deals, separate clauses may be used to recite the royalty rates respectively applicable to patent rights on the one hand, and know-how rights on the other. This can be desirable for a variety of reasons. First, it provides an easy structure for royalty to automatically be reduced if one class of rights is inapplicable, if all of the Licensed Patents expire or are held to be invalid or unenforceable or if the know-how becomes fully paid up, etc. When using separate clauses, the Licensee should be careful to make sure that the sum of the two royalty rates is acceptable. This also provides some protection against a MedImmune style declaratory judgment action. An exemplary clause set might be as follows:

a) In addition to the royalty of Paragraph b), Licensee shall pay Licensor a royalty of 2.5% of the NET SALES PRICE for each unit of Licensed Product sold by or for Licensee or a Licensee Affiliate to an independent third party and whose making, using, selling, offering to sell, or importing is covered by one or more valid, enforceable, unexpired claims of the Licensed Patents.

b) In addition to the royalty of Paragraph a), Licensee shall pay Licensor a royalty of 3.5% of the NET SALES PRICE for each unit of Licensed Product sold by or for Licensee or a Licensee Affiliate to an independent third party and whose making, using, selling, offering to sell, or importing incorporates LICENSOR KNOW-HOW.

2.8 ACME shall have no obligation to pay royalty for any sales or other transfers of RUSTPROOF WIDGETS made to a third party for testing purposes. Only one royalty shall be payable for each RUSTPROOF WIDGET regardless of the number of times such RUSTPROOF WIDGET is commercially transferred by or for ACME.

2.9 Royalty payable by ACME hereunder shall be deemed to accrue and be payable to NORM on the date on which ACME is paid by its customers. Royalty shall accrue pro rata in each instance that ACME receives partial payment(s) from a customer until the full royalty payable hereunder has been paid for sales corresponding to such partial payments.

This clause is totally written from the perspective of the Licensee. Let's see why.

It is important to specify a trigger that makes it very clear when royalty accrues and becomes payable. (The trigger can be anything that defines a definite point in time.) Clause 2.8 specifies that royalty accrues and become payable when the Licensee gets <u>paid</u> by its customers. In this case, customer payments to Licensee are the trigger. According to an alternative approach that favors the Licensor, the following clause specifies that royalty accrues and becomes payable when the License ships Licensed Products:

Royalty payable by Licensee hereunder shall be deemed to accrue and be payable to Licensor on the date on which Licensee ships LICENSED PRODUCTS to its customer.

In this clause, <u>shipment</u> is the royalty trigger.

The trigger is a subject for which the Licensor and Licensee perspectives are at odds. The choice of trigger really is an allocation of the risk as to whether Licensee's customers pay their bills or not. From the Licensor perspective, the Licensor wants to get paid royalty as soon as possible. The Licensor most often wants royalty to accrue when Licensed Products are shipped or invoiced or even when a purchase order is accepted. Licensor does not want to wait to get paid until after Licensee gets paid. By using a trigger such as invoicing or shipment, Licensee pays royalty regardless of whether its customers pay or fail to pay for purchases of Licensed Products. Licensee bears all the risk of non-paying customers.

In contrast, Licensee prefers not to have to pay royalty until after Licensee is paid by its customers. This way, Licensee can pay royalty from its sales dollars and not have to float cash from other sources. Here, Licensor carries all the royalty risk if the Licensee customers do not pay. If Licensee customers do not pay Licensee, Licensor does not see any royalty payment even though Licensee used Licensor rights and had an opportunity to collect payment for the sales at issue. The Licensor is reduced to earning royalty on contingency. Alternatively stated, the Licensee is granted a free option to generate sales revenue and only has to pay Licensor a share of that revenue if and when the sales revenue is collected. Perhaps a Licensor accepting this kind of risk should charge a higher royalty rate. In any event, the relative bargaining strength of the parties often determines the choice of trigger and which party bears the risk of bad debts as far as royalty payments are concerned.

There are ways in which the risk of non-paying customers can be shared between Licensor and Licensee rather than foisted on one party or the other. A "bad debt" clause is one example of a clause that promotes risk sharing. With this approach, the royalty accrues when Licensed Products are shipped (favors Licensor), but Licensee can take a credit to some degree against future royalties if its customers fail to pay for Licensed Products after some specified time period (favors Licensee). Optionally, the credit can be conditioned upon the Licensee using reasonable efforts to collect delinquent payments. An example of a bad debt clause is the following:

> **In the event that Licensee has paid royalty on any shipment of LICENSED PRODUCTS but has not been paid by its customer on such shipment within 150 days of the payment date, Licensee may consider any such shipment to constitute a Bad Debt Shipment with written notice to Licensor. Licensee may credit any royalties paid for a Bad Debt Shipment to other royalties payable to Licensor that accrue in the present reporting period or within one year of the date the shipment is**

designated in writing as a Bad Debt Shipment. In the event that Licensee takes a credit for a Bad Debt Shipment and thereafter receives one or more payments or partial payments on such Bad Debt Shipment, Licensee shall pay royalty on the NET SALES PRICE corresponding pro rata to any such payment or such partial payment. Any such Bad Debt Shipments and credits shall be included in the written report hereunder. [*If an initial fee or other payment is creditable against payable royalties, the following clause can be used*:] If a credit for a Bad Debt Shipment is taken, only one of the originally paid royalty corresponding to the Bad Debt Shipment or the royalty for a subsequent shipment against which a Bad Debt Shipment royalty credit is applied may be credited toward the initial fee.

2.10 Beginning with calendar year 2011, ACME in the sole discretion of ACME shall pay NORM a minimum fee of $15,000 each year in order to keep this Agreement in full force and effect. Any royalty actually paid by ACME to NORM for each such calendar year shall be fully creditable toward this minimum fee. If there is a shortfall between royalties paid by ACME to NORM for such calendar year and the minimum fee (e.g., if royalties paid for the four calendar quarters total $8,500, then the shortfall is the difference between $15,000 and $8,500, or $6,500), and if ACME elects to continue the license beyond such calendar year, the shortfall is due and payable with the fourth calendar quarter report and payment (see Paragraph 2.7) for such calendar quarter. If there is no such shortfall, then no shortfall payment is due.

2.11 Within sixty (60) days after the end of each calendar quarter, ACME shall furnish NORM with a written report setting forth the computation of the royalties payable to NORM during such calendar quarter. Each report shall be accompanied by a certified check or money order payable to NORM in the amount due, less any taxes required by a governmental agency to be withheld with respect to royalties payable to NORM for that calendar quarter of that year.

2.12 The initial fee, royalties, and the minimum fee payment, if any, shall be paid to NORM in U.S. dollars.

In any agreement, but particularly when international commerce is involved, the base currency should always be specified. For instance, an agreement may specify that all payments are to be made in US dollars, euros, Japanese yen, or the like. Since exchange rates fluctuate with some velocity and volatility, the applicable currency exchange rate also should be specified for converting international sales into the base currency. The source of the currency exchange rate should also be specified, as the rate can vary with source. The following two clauses show possibilities:

<u>Option A</u>: Royalties shall be paid to Licensor in U.S. dollars. Sales occurring in another currency shall be

converted to US dollars using the currency exchange rate as reported by the Wall Street Journal for the New York Closing that was in effect on the last business day of the applicable royalty payment period. As of the Effective Date of this Agreement, such exchange rates are reported at http://online.wsj.com/mdc/public/page/2_3021-forex.html

Option B: Royalties shall be paid to Licensor in U.S. dollars. Sales occurring in another currency shall be converted to US dollars using a currency exchange rate that is the average of the currency exchange rates as reported by the Wall Street Journal for the New York Closing that were in effect on the first and the last business days of the applicable royalty payment period. As of the Effective Date of this Agreement, such exchange rates are reported at http://online.wsj.com/mdc/public/page/2_3021-forex.html

2.13 ACME shall keep accurate and complete records in sufficient detail to enable royalties payable to NORM hereunder to be verified. ACME shall permit such records to be inspected at the option of NORM once per calendar year upon written notice by NORM for the purpose of verifying the amount of royalties payable hereunder to NORM. Such inspection shall be made during reasonable business hours and shall be performed by an independent auditor, such as a certified public accountant or firm of certified public accountants, selected and appointed by NORM. NORM shall bear all the costs of retaining the independent auditor for such inspection. The independent auditors making such inspection shall report to NORM only the amount of royalties due and payable. Two (2) years after furnishing NORM with such written report, ACME shall have the right to destroy or discard the records that formed the basis for such written report, and the written report thereafter shall be deemed to be correct and accurate.

This is a typical version of an audit clause, but this typical version has quite a few holes in it. We can make improvements from the perspective of both the Licensor and the Licensee.

Before comparing and contrasting the Licensor and Licensee perspectives in this context, please keep in mind that this audit clause becomes very important if it becomes necessary for the Licensor to investigate Licensee malfeasance and/or to enforce the Agreement. One can say this clause becomes a fifth major star at that time.

From the perspective of the Licensor, unpaid royalties should bear interest. Also, if the amount of unpaid royalties exceeds a certain threshold amount, Licensor would want Licensee to bear at least a portion of the audit costs, keeping in mind that audits involve expenses relating to preparation,

collection, and analysis of the audit data. An express provision can be used that requires the Licensee to cooperate with the audit process so that the three audit phases (preparation, data collection, and analysis) can be carried out in a meaningful way. If Licensee does not cooperate with the audit, there is an express agreement clause that is being breached. The termination section of the agreement can mesh with this clause by specifying that breach of this cooperation clause is a material breach. The clause should also expressly survive termination or expiration of the agreement since license disputes can and do occur after a license ends.

Another issue for the Licensor concerns how many years of data can be accessed by the Licensor in the audit. For instance, if the Licensee had the right to discard royalty records after two years but did not do so such that the Licensee possesses royalty records for the life of the agreement, can the Licensor access all those records under the audit clause and prove corresponding damages for the extended period? A Licensee might assert that since it is only obligated to keep records for two years, the Licensor can only access two years worth of records to limit the amount of damages that can be proved. The Licensor might argue that there is a distinction between the Licensee's right to discard records after a period versus the right of the Licensor to access records in the Licensee's possession. In other words, the fact that the Licensee has a right to discard records does not necessarily mean that the Licensor's right to access records is similarly limited if the records are still being kept.

This is an important issue, because the scope of records accessible to an aggrieved Licensor is crucial to the amount of damages at play. Millions of dollars can turn on how this issue is resolved. To the best of my knowledge, the case law does not provide guidance. Fortunately, the issue can be expressly addressed to avoid any ambiguity. Quite simply, the audit clause can state that the Licensor can access records still in the possession of the Licensee even though the Licensee had a right to discard those records.

The Licensee will have very different perspectives. First, the Licensee will want to minimize or even avoid having to pay interest on unpaid royalties, particularly if the underpayment was a good faith mistake or if the applicability of the license to certain products was in good faith dispute. If the clause is to survive termination or expiration, the Licensee will want the survival period to be as short as possible. If the Licensee obligates itself to pay audit expenses if an underpayment is made, the Licensee will want to limit the circumstances as to when the obligation is triggered. The Licensee also will want to limit the maximum monetary exposure that may be involved, such as by limiting the audit reimbursement to the lesser of some percentage of the unpaid royalty amount or a dollar threshold. The

Licensee also will want to expressly limit the number of years of records that can be accessed by the Licensor. The Licensee also will want the audit clause to address what happens if the audit shows that the Licensee overpaid royalties. Perhaps the Licensee is entitled to a refund with interest. Alternatively, from a Licensor perspective, Licensee can take the overpayment as a credit against future royalties.

In view of these perspectives, the following is a more complete version of an audit clause that shows how a clash between the Licensor and Licensee perspectives might be resolved.

> **ACME shall keep accurate and complete records in sufficient detail to enable royalties payable to NORM hereunder to be verified. ACME shall permit such records to be inspected at the option of NORM once per calendar year upon written notice by NORM for the purpose of verifying the amount of royalties payable hereunder to NORM. ACME shall cooperate with NORM as reasonably required for NORM to prepare for, conduct, and analyze the collected data. Such inspection shall be made during reasonable business hours and shall be performed by an independent auditor, such as a certified public accountant or firm of certified public accountants, selected and appointed by NORM. The independent auditors making such inspection shall report to NORM only the amount of royalties and commissions due and payable. NORM shall bear all the costs of retaining the independent auditor for such inspection. However, if the independent auditor finds that the royalties and commissions paid to NORM have been deficient by seven percent (7%) or more when compared to the amount actually paid by ACME to NORM and the underpayment of royalty exceeds $15,000, then ACME shall be obligated to reimburse NORM up to a maximum of $10,000 for the actual, reasonable costs of the audit, including costs to prepare for, conduct, and analyze data relating to the audit. Unpaid royalties shall bear interest compounded at an annual rate of 7%. If the independent auditor finds that ACME overpaid royalties, ACME shall be entitled to apply the overpayment as a credit against an amount of future royalties that is equal to 1.07 times the overpayment. NORM shall have the right to inspect all records in the possession of ACME; provided, however, that three (3) years after furnishing NORM with the written report for a particular reporting period, ACME shall have the right to destroy or discard the records that formed the basis for such written report. This clause shall survive any termination or expiration of this Agreement.**

Article 3
<u>CONFIDENTIALITY</u>

3.1 During the term of this Agreement, ACME may find it desirable to share its confidential and proprietary business and technical information, e.g., royalty payments and reports, sales volumes, forecasts, business plans, vendors, customers, manufacturing information, test results, product development plans, etc. (CONFIDENTIAL INFORMATION) with NORM. ACME desires to protect the confidential and proprietary nature of such information as set forth herein.

3.2 NORM shall maintain, and will cause its employees, agents, and consultants to maintain, the confidentiality of all CONFIDENTIAL INFORMATION received from ACME under this Agreement using the same care and safeguards with respect to such CONFIDENTIAL INFORMATION as is used to maintain the confidentiality of its own information of like character, but in no event less than reasonable care.

3.3 CONFIDENTIAL INFORMATION received by NORM under this Agreement may be disclosed by NORM only to its employees, agents, and consultants to whom disclosure is necessary to fully use the license granted under this Agreement and to otherwise facilitate the purposes of this Agreement, and shall not be disclosed to any third party or commercially used by NORM for any purpose except as expressly authorized in the Agreement. NORM represents and warrants that all of its employees, agents, and consultants who shall have access to CONFIDENTIAL INFORMATION shall have been advised of their obligations under this Agreement. Further, NORM represents and warrants that all of its employees, agents, and consultants who shall have access to CONFIDENTIAL INFORMATION shall be bound by written agreements to maintain such information in confidence and not to use such information except as expressly permitted herein.

3.4 Except as expressly authorized in this Agreement, NORM shall not disclose CONFIDENTIAL INFORMATION to any third party without the advance written consent of ACME.

3.5 The obligations of confidentiality under this Agreement shall not apply to information which:

(a) is in the public domain without fault of NORM; or

(b) was known to NORM before receipt from ACME as demonstrated by written business records of NORM; or

(c) is independently developed by NORM; or

(d) is disclosed to NORM by a third party without restriction.

3.6 Except as otherwise expressly provided in this Agreement, the title to all CONFIDENTIAL INFORMATION provided to NORM by ACME shall remain vested in ACME.

3.7 The existence and terms of this Agreement shall be deemed to be subject to the confidentiality obligations of this Article 3. Written approval must be obtained from the other party if one party wishes to make any disclosure relating to the existence and/or content of the relationship between the parties hereunder.

3.8 NORM shall not be liable for disclosure of CONFIDENTIAL INFORMATION in compliance with any governmental statute, regulation, order, or decree of a court or other governmental body; provided, however, that NORM shall give reasonable notice to ACME before NORM's compliance with such statute, regulation, order, or decree.

3.9 NORM shall have a duty to protect only that CONFIDENTIAL INFORMATION which is (a) disclosed by ACME in writing and is marked as confidential, proprietary, or with a similar legend, at the time of disclosure, or which is (b) disclosed in any manner by ACME and is identified as confidential or proprietary at the time of the disclosure and is confirmed to be confidential by ACME to be confidential and provided to NORM within a period not to exceed one hundred eighty (180) days of initial disclosure.

Article 4
WARRANTIES, REPRESENTATIONS, AND INDEMNIFICATION

Representations, warranties, and Indemnification obligations lack the glamour of the major agreement clauses. But, pay attention to these clauses. They should never be glossed over. These are very important clauses from the perspectives of both Licensor and Licensee. If rights under a representation, warranty, or indemnification obligation are triggered, the financial implications for the party who must compensate the other can be huge and adverse. Bankruptcies can and have resulted. For the most part, these kinds of clauses impose burdens mostly on the Licensor. The Licensor should be careful only to provide representations, warranties, and indemnification of a fair and limited scope.

4.1 NORM warrants that it has no agreements with any third party or commitments or obligations which conflict in any way with its obligations under this Agreement.

This clause and the next two are pretty basic. These are found in most licenses.

4.2 NORM represents and warrants that it has full right and power to grant the rights set forth in this Agreement to ACME.

4.3 NORM represents and warrants that no claim by any third party contesting the validity, enforceability, use or ownership of any of the NORM INFORMATION previously has been made against NORM or, to the present knowledge of NORM, is threatened.

4.4 To the present knowledge of NORM, NORM represents and warrants that it has not received any written notices of, nor to the present knowledge of NORM, are there any facts which indicate to NORM a likelihood of any infringement or misappropriation by, or conflict with, any third party with respect to the NORM PATENT RIGHTS.

Sometimes, a Licensee advances a clause under which the Licensor would warrant the validity and enforceability of the Licensed intellectual property. A Licensor should never agree to such a broad-reaching obligation. However, it does seem fair, as shown in this clause, that a Licensor can comment whether a third party has in fact challenged the Licensed Patents. Also, a Licensor can make prior art in its file available to a License in a due diligence period so that a Licensee can decide for itself whether there are any validity or enforceability issues of concerns.

4.5 To the present knowledge of LICENSOR, LICENSOR has not received any written notice of any actual or threatened infringement or misappropriation by, or conflict with, any third party relating to the Licensed Patents.

Sometimes, a Licensee advances a clause under which the Licensor would warrant that the Licensed Products avoid infringement of any third party clauses. A Licensor should never agree to such a broad-reaching obligation. As discussed further below, there are some circumstances in which a Licensor might offer an infringement warranty of limited scope. Also as discussed below, there are other circumstances in which the Licensor should not warrant against infringement at all. It does seem fair, as shown in this clause, that a Licensor can comment whether a third party has in fact asserted infringement claims relating to the Licensed Patents or Licensed Products. Also, a Licensor can make prior art in its file available to a License in a due diligence period so that a Licensee can decide for itself whether there are any freedom to operate concerns.

4.6 IN NO EVENT WILL EITHER PARTY BE LIABLE FOR ANY INDIRECT, SPECIAL, INCIDENTAL, CONSEQUENTIAL OR PUNITIVE DAMAGES ARISING FROM, CONNECTED WITH OR RELATING TO THIS LICENSE AGREEMENT, THE PRODUCTS OR THE TECHNOLOGY, INCLUDING LOSS OF PROFITS OR OTHER ECONOMIC ADVANTAGE, WHETHER FOR NEGLIGENCE, STRICT LIABILITY, PRODUCT LIABILITY OR OTHERWISE, EVEN IF SUCH PARTY HAS BEEN PREVIOUSLY ADVISED OF THE POSSIBILITY OF SUCH DAMAGES.

This clause limits the liability exposure of both parties. Hence, it limits the damages available to one of the parties if the other breaches. One might say that the Licensee is most likely to be in breach. If the Licensee is most likely to be the breaching party, according to this line of thinking, one might further say that this limitation on liability favors the Licensee and disfavors the Licensor. This is not strictly true, however. The Licensor might have liability to the Licensee under many agreement aspects, including under warranty, representation, or indemnification clauses, breach of

confidentiality, products liability claims, and the like. Each deal is unique, but quite often both parties will benefit from a clause like this. Note the clause is written in all capital letters.

4.7 EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN THIS AGREEMENT, LICENSOR EXPRESSLY DISCLAIMS ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO (a) THE VALIDITY, ENFORCEABILITY OR SCOPE OF ANY LICENSED PATENTS OR ANY LICENSED KNOW-HOW; OR (b) WHETHER ANY LICENSED PRODUCTS INFRINGE OR MISAPPROPRIATE THE PATENT RIGHTS OR TRADE SECRET RIGHTS OF ANY THIRD PARTY. EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN THIS AGREEMENT, LICENSOR EXPRESSLY DISCLAIMS ANY EXPRESS OR IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE WITH RESPECT TO ANY AND ALL OF THE LICENSED PATENTS, LICENSED KNOW-HOW, AND THE LICENSED PRODUCTS.

To the extent that the Licensor gives any express representations or warranties, any others should be negated. This clause does that. Note the clause is written in all capital letters.

4.8 With respect to third party claims brought against one party during the term of this Agreement, or in the twelve-month period thereafter, the other party shall indemnify, defend and hold the one party and its Affiliates, representatives, employees, officers, directors, and agents harmless against all claims, suits, costs, damages, liabilities, losses, judgments, expenses (including attorneys' and other professional fees and expenses), and settlements arising out of, resulting from the fault of the other party, but only to the extent of such fault.

This is basic indemnification clause. Each party agrees to indemnify the other for exposure to problems, but only to the extent of fault. The fact that the obligation is limited to the extent of fault is important, but missing from many clauses that are seen.

The following series of indemnification clauses address a question that arises in many license negotiations. Should the Licensor indemnify the Licensee if the Licensed Products infringe third party patent rights? The answer depends to a large degree upon the nature of the Licensed Products. If only a specific product embodiment is licensed, then the Licensor very likely created and developed the design. It is fair from the Licensee perspective that the Licensor indemnifies the Licensee for infringement under such circumstances to an appropriate extent. Of course, this kind of indemnification is only as good as the financial integrity of the Licensor. A concerned Licensee could undertake its own freedom to operate analysis, rather than blindly rely only upon indemnification, to develop confidence that infringement risk is low.

On the other hand, if the Licensee is licensed under the full scope of the

Licensed Patents, then the Licensee likely controlled the creation and development of the Licensed Products. The Licensee is in the best position to avoid infringement, and indeed infringement likely is due to decisions made by the Licensee. From the Licensor perspective, it really is not fair to have to indemnify the Licensee for infringement in this context.

If the Licensor agrees to indemnify the Licensee for infringement of third party patent rights, the obligation should be limited to minimize risk to the Licensor. The following is a clause that is created to show many ways in which this kind of obligation can be limited in scope.

4.9 To the extent attributable to the fault of Licensor, Licensor will indemnify Licensee against any claim, liability, and expense, including reasonable attorneys' fees, arising out of and associated with a final judgment of literal infringement by Licensee of any third party, U.S. patents that results from Licensee's making, using, selling, offering to sell Products, provided that such indemnity ("Patent Indemnity") is subject to the following conditions:

4.9.1 The Patent Indemnity applies only to the infringement claims brought against Licensee for U.S. patents that were issued on or before the Effective Date and/or U.S. patent publications published on or before Effective Date;

4.9.2 The Patent Indemnity shall apply only if Licensee provides Licensor with written notice of the third party assertion of infringement within thirty (30) days of Licensee’s first becoming aware of the asserted infringement;

4.9.3 Licensor 's obligations under the Patent Indemnity applies only to the extent that the patent infringement by Licensee is attributable to the fault of Licensor with respect to the form of Products as specifically specified by Licensor in writing from time to time hereunder, and the Patent Indemnity shall not apply if the infringement arises from any use of the Products in combination with any other product, component, customization, process, enhancement, or add-on;

4.9.4 The Patent Indemnity only applies with respect to a particular Product if sold during the current term of this Agreement and if Licensee paid the royalty for that Product to Licensor in a timely manner;

4.9.5 The Patent Indemnity shall not apply to any Products sold after Licensee has notice of a third party patent or patent infringement claim unless Licensor agrees in writing to extend the Patent Indemnity to such Products;

4.9.6 The Patent Indemnity shall apply only to defenses against the claims of infringement and no other claims or defenses involved in any dispute with a third party;

4.9.7 The Patent Indemnity shall not apply if the third party asserting the claim of infringement against Licensee is an affiliate of Licensee or if Licensee directly or indirectly caused the third party to assert its patent rights against Licensee other than by Licensee's making, making for others, having made, using, selling, or offering to sell the Product;

4.10 Licensor shall have no obligation under the Patent Indemnity for any claims brought against Licensee more than three years after the Effective Date of this agreement.

4.11 In the event a claim that Licensee 's making, making for others, having made, using, offering for sale, or selling Products infringes a third party's patent commences in any court against Licensee and/or Licensor during the period of Licensor 's obligations under the Patent Indemnity, or Licensor has reason to believe such a claim may be asserted, Licensor may replace or arrange to modify the Licensor specifications for Products to make them non-infringing. Thereafter, the Patent Indemnity applies only to Products made according to such replaced or modified specifications.

4.12 In the event of a third party threat or assertion of a claim of patent infringement, Licensor may procure at its expense a license for Licensee to use the rights allegedly infringed.

4.13 Licensor may control Licensee 's defense of any patent infringement-related claim against Licensee in which the Patent Indemnity applies, and to employ counsel at Licensor 's expense to assist in the handling of such claims. Licensee shall cooperate with Licensor in taking any reasonable actions that would minimize Licensor 's liability associated with the Patent Indemnity (e.g., participation in settlement negotiations, etc.). Licensee will not compromise or settle any patent infringement-related claims in which the Patent Indemnity applies without the prior written consent of Licensor.

4.14 During the term of this agreement, Licensee shall promptly

notify Licensor in writing of any actual or potential patent infringement claims that arise or may be reasonably expected to arise in connection with Licensee 's use of Products.

Article 5
PATENT PROSECUTION, FILING, ISSUANCE, AND MAINTENANCE

5.1 During the term of this Agreement, the Parties shall cooperate to prepare, file, prosecute, issue, and maintain the NORM PATENT RIGHTS; provided, however, that no action may be taken with respect to the preparation, filing, prosecution, issuance, or maintenance of the NORM PATENT RIGHTS without the written consent of NORM. In addition to the specific United States Patent Application identified in Paragraph 1.5 above, the Parties shall confer and mutually agree as to whether to file and pursue additional patent applications in the U.S. and/or internationally constituting other NORM PATENT RIGHTS.

5.2 NORM shall have the right to select one or more patent counsel(s) ("Selected Counsel(s)) who will serve as the primary liaison between the Parties and the Patent Office in which any patent application constituting NORM PATENT RIGHTS is filed. The Parties shall obligate such patent counsel(s) to promptly provide both Parties with copies of any prosecution correspondence received directly or indirectly from a Patent Office or from local patent counsel(s) (e.g., EPO counsel or the like) assisting with patent prosecution of such applications. Both Parties must approve any and all substantive prosecution correspondence or other communication relating to any NORM PATENT RIGHTS before such correspondence or communication can be filed with the pertinent Patent Office and/or before such patent counsel(s) take other prosecution action on behalf of the Parties. Each party at its own expense shall provide the patent counsel(s) with assistance and documentation as reasonably required for the patent counsel(s) to operationally and administratively handle the preparation, filing, prosecution, issuance, and maintenance of patent properties constituting NORM PATENT RIGHTS.

Minnesota ethics rules come into play in a joint representation like this. On this joint matter, both parties are clients. Both have equal access to file contents and conversations. If a different stage is to be set, this should be done expressly.

5.3 ACME agrees that it shall bear all expenses and outside attorney's fees of the Selected Counsel(s) associated with the preparing, filing, prosecuting, issuing, and maintaining of any NORM PATENT RIGHTS during the term of this agreement. Otherwise, neither Party shall be responsible under this Agreement for paying or reimbursing the other Party for any fees or payments associated with other counsel representation, costs, or expenses unless approved by both Parties in advance in writing. ACME shall be entitled to credit up to 50% of such Selected Counsel(s) fees and expenses against any royalties, minimum fees, option payment, or any other payment obligations payable to NORM hereunder.

The last clause is very favorable to Licensee. Licensor might want to avoid this credit.

Article 6
<u>OWNERSHIP, ENFORCEMENT, AND COMMERCIALIZATION OF THE NORM PATENT RIGHTS</u>

6.1 During the term of this Agreement, ACME shall have the sole right and discretion to bring any action to enforce any patent(s) constituting the NORM PATENT RIGHTS and shall have the sole right and discretion to defend any declaratory judgment or other action in which a cause of action is asserted challenging the validity, enforceability, use, and/or claim construction of any patent(s) or patent application(s) constituting the NORM PATENT RIGHTS. In the event that NORM becomes aware of any infringement or possible infringement of any NORM Patent Rights, NORM shall promptly notify ACME in writing regarding such infringing activity.

6.2 Any action involving the NORM PATENT RIGHTS that is brought or defended by ACME (the "Acting Party") shall be at the sole expense of ACME, and any recoveries gained, or liabilities incurred in such action shall be entirely that of ACME. ACME shall retain control of any such action, including the sole right to select, retain, and direct counsel, and to make any and all decisions with respect to claims, defenses, counterclaims, settlement, and strategy. Further, ACME may initiate any such action in its own name and/or in the name of NORM if necessary and/or desirable under applicable law in order for ACME to initiate such action.

6.3 Upon request of ACME and at the expense of ACME, NORM shall have a duty to cooperate reasonably with ACME in any action involving The NORM PATENT RIGHTS that is brought or defended by ACME, including (if necessary) joinder as a party to such action. Such cooperation shall include cooperation to maximize the maintenance of all attorney-client, work product, and joint defense privileges, and the Parties shall each instruct their respective counsel(s) accordingly. As a condition of any participation, NORM shall agree to be signatory to and be bound by any protective order that might be entered by a court or stipulated to between ACME and the other party or parties. ACME shall, as is reasonable, provide NORM with the opportunity to comment and offer suggestions during the course of any such action and shall, as is reasonable, keep NORM informed of all developments in the action. NORM shall treat such information as Confidential Information and/or as privileged information in accordance with the provisions set forth in this Agreement.

Article 7
<u>TERM AND TERMINATION</u>

7.1 This Agreement shall commence on the EFFECTIVE DATE. Unless previously terminated in accordance with one or more of the other provisions hereunder, this Agreement shall expire five years from the Effective Date. The term shall be automatically renewed for one or more additional two-year periods thereafter. However, ACME shall need the advance written consent of NORM to renew for any successive two year term in the event that ACME is or has been in material breach of the agreement at the time the current term expires and/or if the average, annual royalty actually paid by ACME to NORM in the current term to be renewed is $250,000 or less. Payment information for a partial year may be annualized to determine the average annual payments hereunder in the event that the remainder of such partial year has not yet occurred and/or royalty payments for the remainder of the partial year are not yet due and payable at the time of the renewal determination. The initial fee after being paid to NORM may be considered royalty for purposes of this Paragraph.

The term of some licenses runs for the life of the Licensed Patents, but sometimes the term only runs for a shorter span of years such as is shown in this clause. When the term runs for only a span of years, a question that arises is whether one or more term renewals might be available. If yes, the next question is whether term renewal is automatic or whether renewal is conditioned upon some act, event, or consent. Perhaps renewal is conditioned upon the Licensee meeting milestones. Perhaps the Licensee must have been and currently must be in compliance with the license to obtain a renewal. Perhaps the Licensee can only renew with Licensor consent. Perhaps a combination of conditions are used. The present clause shows one option for handling renewals.

The renewal clause setting provides a potential instance in which two seemingly different clauses are actually the same from a practical perspective. For example, consider a clause that states that no renewals are available. This is functionally the same as a clause that states that a renewal is only available with Licensor consent. These clauses are practically equivalent because the conduct under each to secure a renewal is pretty much the same. The Licensee will request a renewal from the Licensor. The Licensor will then decide whether to agree to the extension. Notwithstanding the practical similarity between these two clauses and other equivalent clause pairs, I have seen deals in which the other party fights to convert one clause to an equivalent clause. In other words, the party burned up bargaining power to secure something that it already had. Good license practice recognizes the practical impact of clauses that so that precious bargaining power is not wasted like this.

7.2 Subject to Paragraph 2.2, this Agreement may be terminated by either party in the event of a material breach by the other party of the terms of this Agreement provided that the terminating party first gives the defaulting party written notice of termination, specifying the grounds therefor, and the defaulting party has had thirty (30) days after such notice is given to cure the breach. If not so cured, this Agreement shall terminate at the expiration of such thirty (30) days. Waiver by a party of a default by another party shall not deprive the first party of the right to terminate this Agreement due to any subsequent default of another party.

It is very common to give a breaching party a chance to cure its breach. According to a typical program, the aggrieved party must give notice of a

breach. The alleged breaching party is then given a period to cure the breach. If the breach is cured, the breaching party is back in compliance and the agreement continues. If the breach is not cured, the agreement could terminate. Most commonly, cure periods might be as short as 30 days or as long as 90 days. This clause provides a 30-day cure period.

Clauses like this are often invoked in combination with mediation clauses if also present in the agreement. For instance, if an aggrieved party sends a notice of breach to the other party, the other party might dispute whether a breach has occurred at all. Or, the other party might have grievances of its own. In such circumstances, the other party might initiate mediation. To give the parties time to mediate without risking loss of claims or defenses, the license can specify that any applicable statute of limitations or contract limitation clause is tolled during a mediation. Tolling is particularly important if mediation is mandatory or else the mediation clause and the applicable limitations clash in practice. An express limitations clause can go further and state that the cause of action also is tolled during a cure period.

If a breach is uncured at the end of an applicable cure period, the agreement should expressly specify whether termination is automatic or at the discretion of the aggrieved party. I would suggest that it is preferable if the termination is discretionary. This way, the aggrieved party maintains maximum flexibility and can choose among several options to respond to an uncured breach. Maintaining flexibility for as long as possible to maximize options is a principle of good license practice. Once you put a stake in the ground, such as mandating that uncured breach leads necessarily and automatically to termination, or if you issue inflexible ultimatums with hard deadlines, your flexibility diminishes and your options become more limited.

This termination clause is interesting because it provides that only material breaches provide the aggrieved party with a trigger to terminate a license. This approach protects the Licensee from losing a license for a breach that has no real impact. To minimize the potential for discord, examples of material breaches should be listed to make it more clear as to exemplary circumstances when a termination right arises. Failure to pay royalty or other monies due are classic examples of material breaches. But, there are many other materially improper acts under a license, including quality breaches, failure to achieve milestones, failure to submit accurate reports, failure to cooperate with an audit, inactivity, and the like.

7.3 Subject to Paragraph 2.2, ACME may terminate this Agreement with or without cause upon thirty (30) days written notice to NORM.

7.4 Any claim arising under or relating to this patent license, whether arising under contract, tort, or other theory, shall be instituted before the expiration of two years from the date that the claim accrued or else shall be thereafter forever and irrevocably barred. The two-year period shall be tolled during any (a) the cure period following any notice of breach according to Article VI; and (b) the period(s) extending from a written notice of mediation to the corresponding notice of termination of mediation as provided in Article XIV. This paragraph shall survive expiration or termination of this Agreement.

A. Limitation clauses:

Clause 7.4 or similar clauses have not found use in patent licenses prior to this annotated Agreement. Yet, a two-year contract limitation ("limitations clause") is very common in insurance contracts. Perhaps patent licenses should use this kind of limitations clause more frequently.

Notwithstanding being challenged in insurance disputes, these clauses have been upheld, surviving these challenges. Generally, if the limitations period is reasonable, the limitations clause is upheld. See Marrinson & Shugrue, Insurance Coverage Disputes, §2.202[5] (1996) (published by the Law Journal Press) and the many cites in the footnotes therein. Two-years often is deemed to be reasonable. In some instances, one-year limitations have been upheld except where the claims at issue take years to ripen by their very nature. See Lapham-Hickey Steel Corp. v. Protective Mutual Insurance Co., 633 N.E.2d 1235, 1240-1241 (Ill. App. 1994)(under MN law, one-year limitations clause too short for claims relating to long-term environmental damage), rev'd on other grounds, 655 N.E.2d 842 (Ill. 1995). Limitation clauses that are too long, e.g., the specified limitations period exceeds the applicable statute of limitations, also have been knocked down. See Shaw v. Aetna Life Ins. Co., 395 A.2d 384, 386-387 (Del. Super. 1978)(limitations clause that is too long violates public policy).

The enforceability of these clauses in the insurance setting indicates that limitations clauses could also be proper in a patent license. Note, though, that some states regulate these clauses by statute in the insurance settings, and statutory authority would be lacking in the patent context.

A typical statute of limitations for breach of contract claims under a patent license is six years. Why would parties to a license want to contractually trim this down to a shorter period such as two years, or even one year? There are several supporting reasons. First, the clause can offer peace of mind sooner, since an aggrieved party must assert claims promptly and not let claims fester. The shorter period also reduces exposure to risk. Shorter limitations periods also ease long-term business planning. Further, claims will be asserted when witness memories and other evidence are fresh.

If a limitations clause is used, the agreement should specify when the limitation period might be tolled. Also, the clause should survive expiration or termination.

B. Bankruptcy risk and protections:

Most product patent licenses are executory contracts for purposes of bankruptcy. Consequently, it is important to understand how a bankruptcy of the Licensor or Licensee can impact you if you are the other party. If the Licensee goes bankrupt, the Licensor retains a strong interest that its patent rights continue to be worked and that the Licensor be appropriately compensated. Faced by a bankrupt Licensee, the Licensor may want to immediately terminate a license or otherwise may be concerned that its stream of royalties will dry up.

Consequently, it is common to see a clause that specifies that the Licensor can terminate if the Licensee goes bankrupt or is otherwise seriously compromised financially. This clause is not enforceable in an executory license under 11 USC 365(e)(1). A Licensor who attempts to terminate a license upon Licensee bankruptcy could even be in contempt of court. Because of the present contempt of court risk, the clause perhaps should not be used in a patent license. Many licenses still use such a clause, though.

The Licensor is not entirely vulnerable, though. Section 365 of the bankruptcy code includes an exemption that allows a Licensor in an executory license to block an attempted assumption or assignment by withholding consent. See *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9th Cir. 1998) (cert. dismissed) (consent of the Licensor under a non-exclusive license of a U.S. patent is needed before a debtor/Licensee can assume or assign the license under Section 365). Compare *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), cert. denied, 117 S. Ct 2511 (1997)(non-exclusive patent license requires Licensor consent for assignment, but not for assumption).

One main concern of a Licensee facing Licensor bankruptcy might be a fear of losing its license. Fortunately, Section 365(n) gives a Licensee significant peace of mind. If the debtor or trustee rejects the license, then the debtor is excused from performing any of its obligations under the license. However, the Licensee can elect to keep its license in any event so long as the Licensee continues to pay the required royalty or other payments. The Licensee might not see any more performance from the Licensor, but at least the Licensee will retains its license rights.

Article 8
DISPUTE RESOLUTION

8.1 This article shall apply to any dispute arising out of the making or performance of or otherwise relating to this Agreement. The provisions of this article shall survive any termination or expiration of this Agreement.

Dispute resolution clauses that mandate negotiation, mediation and/or arbitration are widely used, particularly in international licenses. A common approach to mediation says that the parties can only arbitrate or litigate, as the case may be, if a reasonable attempt at mediation is unsuccessful. A mediation clause might be ambiguous to some degree by failing to provide any express guidance as to when mediation has reasonably run its course so that the parties can pursue arbitration or litigation, as the case may be. The mediation provisions can be written to provide express guidance on this issue. Also, a more detailed mediation clause might specify that any applicable statutes of limitations or the like for claims and defenses are tolled during the period of mediation. This way, the duty to mediate does not cause a party to lose rights due to expiration of a cause of action.

The arbitration clause at a minimum should expressly specify the applicable arbitration rules. Additionally, the arbitration clause can specify additional details such as the language of the arbitration (the parties almost always agree to use English when a United States party is involved, even in international deals), the number of arbitrators (one arbitrator often is the default, but it can be desirable to use three), the location of the arbitration, the choice of law, and the sharing of administrative costs. The clause may also specify whether the winner gets attorney fees.

Alternative dispute resolution procedures are not mandated in every agreement. In agreements that do not involve such a program, the choice of law and venue should still be specified.

The following clauses illustrate one illustrative dispute resolution approach involving a program of negotiation, mediation, and arbitration.

8.2 The Parties shall attempt in good faith to resolve any dispute arising out of the making or performance of or otherwise relating to this Agreement promptly by negotiations between persons who have authority to settle the controversy. Either Party may give the other Party written notice of any dispute not resolved in the normal course of business. Providing such a notice in good faith will toll the cure period of Paragraph 8.2 until the dispute resolution provisions of this article are exhausted. Within twenty (20) days after delivery of said notice, authorized person(s) of both Parties shall meet at a mutually acceptable time and place, and thereafter as often as they reasonably deem necessary, to exchange relevant information and to attempt to resolve the dispute. Three rounds of negotiation without material progress shall be deemed to be reasonable efforts sufficient to advance the dispute resolution process to mediation under Section 8.3 or if the parties fail to meet within 30 days pf a meeting request by the other. If a negotiator intends to be accompanied at a meeting by an attorney, the other negotiator shall be given at least seven (7) days advance notice of such intention and may also be accompanied by an attorney. All negotiations and mediation pursuant to this Article are confidential and shall be treated as compromise and settlement negotiations for purposes of the Federal Rules of Evidence 408 and any other comparable law provision. Any limitations period for bringing any claim or defense relating to any such dispute shall be tolled during the period of time that the parties carry out negotiation under this paragraph.

8.3 If the dispute has not been resolved by negotiation as above, the Parties shall endeavor to settle the dispute by mediation. Either Party may indicate a mediation proceeding by a request in writing to the other Party. Thereupon, both Parties will be obligated to engage in a mediation. The Parties regard the aforesaid obligation to mediate an essential provision of this Agreement and one that is legally binding on them. In case of a violation of such obligation by either Party, the other may bring an action to seek enforcement of such obligation in any court of law having jurisdiction thereof. Any limitations period for bringing any claim or defense relating to any such dispute shall be tolled during the period of time that the parties carry out mediation under this paragraph.

8.4 The mediator(s) shall be approved by each Party and shall have a background in the industry or subject matter of the dispute. The Parties shall share equally the costs and any administrative expenses of the mediator(s). Otherwise, each Party shall bear all of its own costs and expenses.

8.5 In the event that a dispute is not resolved within six (6) months of commencement of mediation of such dispute, the Parties agree to submit the dispute for binding arbitration in Minneapolis, MN, unless the Parties mutually agree to extend the term of mediation. Arbitration shall proceed in English under the rules of the American Arbitration Association before a panel of three arbitrators and shall be governed by the Federal Arbitration Act. Judgment on any award may be entered by any court in the State of Minnesota having jurisdiction. Each of the Parties may choose one arbitrator, respectively. The parties shall mutually choose an additional arbitrator. The arbitrators shall not limit, expand, or modify the terms of this Agreement nor award damages in excess of compensatory damages nor award damages contrary to express provisions of this Agreement, and each party waives any claim to any such excess damages. A request by a party to a court for interim protection shall not affect either party's obligation hereunder to negotiate, mediate, and arbitrate. The parties shall equally share the fees and expenses charged by the arbitrators and the arbitration authority but otherwise each will bear its own costs of arbitration. The content and result of arbitration shall be held in confidence by all participants, each of whom will be bound by an appropriate confidentiality agreement. The parties acknowledge that each has waived the right to a jury trial.

8.6 Nothing herein shall preclude either Party from taking whatever actions are necessary to prevent immediate, irreparable harm to its interests. Otherwise, these procedures are exclusive and shall be fully exhausted prior to the initiation of any litigation. However, if any such dispute cannot be resolved after the exhaustion of these procedures and after ninety (90) days from the termination of the mediation proceedings, each Party may pursue its remedies at law and equity through binding arbitration at a neutral location agreed upon by both Parties and in accordance with the rules then pertaining of the American Arbitration Association, and judgment or decree may be entered upon the award in any court having jurisdiction.

8.7 The validity, construction and performance of this Agreement shall be governed by and interpreted in accordance with the laws of the State of Minnesota, U.S.A. without giving effect to any choice of law or conflict of law rules or regulations that would cause the application of the laws of a jurisdiction other than Minnesota. Any action relating to this Agreement shall be brought in Hennepin County of the State of Minnesota.

It is important to specify both the choice of law and venue regardless of whether alternative dispute procedures such as negotiation, mediation, arbitration, and/or the like are specified. Parties often specify the choice of law, but fail to specify venue. This is ironic because specifying venue to get a home court advantage can be more important.

The choice of law must have a nexus to one of the parties. It is not proper to choose the laws of a state that has no connection to any party to a license agreement. This issue is governed by state law and the requisite facts to support a choice of law can vary somewhat among the jurisdictions. If you choose the law of a particular state and your parties do not have a plethora of contacts with the state, you may wish to consult that state's choice of law principles to see if your law choice will hold up under your facts. This issue surfaces, for instance, when the parties desire to pick a neutral state law as a compromise over choosing the indigenous state (or national) law of one of the parties.

International deals are a typical setting where selecting a neutral state law almost always works successfully as a compromise. Since the neutral state must have some nexus to one or both of the parties, one can choose the state law where the foreign party has a U.S. Affiliate inasmuch as most every foreign organization will do U.S. business through a U.S. affiliate for tax and other reasons. Often, one can find a neutral state that has connections to both parties. For instance, both the foreign and U.S. organizations might have U.S. affiliates and/or a manufacturing or marketing facility in a common state.

Article 9
ASSIGNABILITY

This Agreement shall inure to the benefit of and shall be binding upon the successors and permitted assigns of either party. Neither party shall have the right to assign or otherwise transfer this Agreement or any of the rights and obligations under this Agreement, in whole or in part, to any third party without first obtaining the advance written consent of the other party; provided, however, that Licensor and each permitted successor shall have the right to transfer this Agreement in its entirety only to a successor of the entirety of Licensor's (or permitted successor's) business to which this Agreement relates. Licensor (or any permitted successor) shall not disclose any Licensee Confidential Information to any such successor.

This is a basic, asymmetric assignment clause. The clause is asymmetric because it confers different assignment rights to the parties. The Licensor can assign to a successor, but the Licensee will need the Licensor's permission to make any assignment. Sometimes a Licensee will balk at the asymmetry of this form of an assignment clause, but the asymmetry can be justified. After all, it is the Licensor's intellectual property on the table. Asymetric assignment clauses can be used in any deal where one party has a legitimate interest in blocking the other party's assignment. For instance, the Licensor might have a legitimate interest in blocking assignment where significant know-how is licensed. In the flip side of this clause, the Licensee might have the right to assign to a successor while the Licensor would need the Licensee's permission to assign.

Symmetric clauses are more common. In these, both parties have the same assignment rights and obligations. Here is an example of a clause where both can assign to a successor:

> **Neither party shall have the right to assign or otherwise transfer this Agreement or any of the rights and obligations under this Agreement, in whole or in part, to any third party without first obtaining the advance written consent of the other party; provided, however, that a party and each permitted successor shall have the right to transfer this Agreement in its entirety only to a successor of the entirety of the transferor's business to which this Agreement relates. The transferor shall not disclose any Confidential Information of the other party to any such successor.**

Here is a clause where a party can only assign with the consent of the other party:

> **Neither party shall have the right to assign or otherwise transfer this Agreement or any of the rights and obligations under this Agreement, in whole or in part, to any third party**

> without first obtaining the advance written consent of the other party.

Under this clause, the non-transferring party has the sole discretion to give or withhold consent. Sometimes, a clause might condition assignment upon consent of the other party, but specifies that the consent cannot be unreasonably withheld:

> Neither party shall have the right to assign or otherwise transfer this Agreement or any of the rights and obligations under this Agreement, in whole or in part, to any third party without first obtaining the advance written consent of the other party, such consent not to be unreasonably.

This is a very common approach, but I do not favor it. The clause sets up a very gray area on an important issue. Under what scope of circumstances is it ever reasonable to withhold consent from the perspective of both parties? This is a recipe for discord. If one party wants to block an assignment desired by the other, the parties can end up in court. Alternatively stated, this might seem to be a seemingly innocuous clause in which a satisfying compromise is reached, but this compromise can have real impact on one party's ability to transfer all or a portion of its business to others. In other words, valuation is at risk. Because a business sale often is or becomes a key business objective, pay attention to this clause. If business liquidity is important to you, you need to allow assignment at least to a successor if the license relates to important aspects of your business. From the other perspective, if you want your consent to be a requisite for assignment by the other, give yourself the right to grant or withhold consent in your discretion. Avoid a clause in which consent withholding is subject to a reasonable standard

Assignment clauses that allow assignment only with the consent of the other party can impact your business valuation in other ways. In one exemplary context, if both the potential buyer and the other party to your license are competitors in the same market space, involving the other license party in your sale negotiations can be uncomfortable for many business and legal reasons. The problem is exacerbated if the license also proclaims, as is common, that the existence and terms of the license must be maintained in confidence by both parties. Now, not only do you have to get the permission of the other license party to allow the license to be sold with your business, you arguably have to get the permission of the other license party to allow the potential buyer to do its due diligence of the license before a buying decision has been made.

The selling party and its buyer are in a quandary of sorts. A buying decision cannot be made unless the license is reviewed under due diligence, but the due diligence cannot occur without the permission of the other license party. The selling party might not want the other license party to know the selling party business is for sale, and the non-selling license party might have a strong interest in not allowing the details of its license to be known to a potential industry competitor.

In the face of a clause set that prohibits assignment and also makes the agreement terms confidential, can the selling party show the license to a candidate buyer in the context of a due diligence? Unfortunately, the issue is unsettled and there are legal theories on both sides. Under some case law, the principle can be derived that both the candidate buyer and the selling party have liability to the non-selling license party. See Den-Tal-EZ Inc. v. Siemens Capital Corp., 9 USPQ2d 1932 (Pa. 1987); Smith v. Dravo Corp., 97 USPQ 98 (7th cir. 1953); but see Van Products Co. v. General Welding and Fabricating Co., 147 USPQ 221 (Pa. 1965). See also Hyde Corp. v. Huffiness, 117 USPQ 44 (Tex. 1958)(shows potency of confidential information protection in license context); Roton Barrier Inc. v. The Stanley Works, 37 USPQ2d 1816 (Fed. Cir. 1996) (another case that shows potency of confidential information protection in license context). The theory is that allowing an industry competitor, i.e., the potential buyer, to conduct a due diligence without the consent of the non-selling party is an act of unfair competition as it compromises the confidential information and the competitive business position of the non-selling party.

There also is at least one potential (please emphasize "potential" here) legal theory available to allow the due diligence to occur without have to first obtain consent from the non-selling party. While there is no case on point to my knowledge, the applicable principle possibly could be derived from cases such as Harvey Barnett Inc. v. Shidler, 67 USPQ2d 1641 (10th Cir. 2003), or the cases that mandate sublicense authority in an exclusive license context, discussed above. The theory proposes that a clause construction that prohibits the due diligence is a disguised covenant not to compete. Where the license is a significant business asset, neither party can market itself without seeking permission from the other. The parties have to collude to allow one party to sell itself.

A clause set such as the following might not be as problematic for a due diligence. This clause set is different from the more problematic one in that, even though term confidentiality is mandated, assignment to a successor is permitted. Although I am not aware of any case law on point, it is possible, but not certain, that the potential buyer can properly be allowed to do due diligence of the license without advance permission from the non-selling party. Even though the agreement includes a confidentiality

clause for the agreement terms, the assignment clause otherwise would be rendered meaningless from a practical perspective if the due diligence was not permitted by implication to allow the assignment right to be practiced.

To avoid the vagaries of the undeveloped case law, due diligence can be expressly authorized by a clause such as the following:

> **Each party shall treat the existence and terms of this Agreement as Confidential Information of the other party; provided, however, that one party may allow a potential, good faith buyer to study the terms of this agreement only if (1) the buyer undertakes written obligations to maintain the terms and existence of this Agreement in confidence until the terms and existence of this Agreement become publicly available without breach by such buyer or a party to this Agreement; (2) the buyer conducts its study only in the context of a due diligence in connection with an authorized assignment of this license from such one party to the buyer; (3) the potential buyer only studies the Agreement for purposes of conducting its due diligence and shall not otherwise use the Agreement for its own benefit or the benefit of any other party; (4) the buyer may only review the license at the legal offices or facilities of the one party; (5) the buyer shall not copy, retain, or otherwise possess a copy of this Agreement or any portion thereof; and (6) any notes relating to the study shall be returned to the one party at the end of the due diligence; provided however that the buyer may retain one copy of such notes in the offices of its legal counsel for archival purposes only.**

Article 10
NOTICE

10.1 Any notices or communications under this Agreement shall be in writing and shall be deemed to have been duly given by either party to the other on the date hand-delivered, or properly sent by facsimile, e-mail, or registered or certified mail, postage prepaid, to the following addresses of the respective parties as shown below:

To NORM: Attention: Dr. Marie Curie
NORMAN EINSTEIN TECHNICAL
INSTITUTE
[address]

Facsimile: __
E-Mail: __

To ACME: Attention: Bob Johnson
ACME CONGLOMERATE
[address]

Facsimile: ______________
E-Mail: _______________

10.2 Any changes of address of a party shall be communicated in writing to the other parties to be effective.

Article 11
MISCELLANEOUS

11.1 This Agreement sets forth the entire Agreement between the parties and supersedes all previous agreements and understandings, whether oral or written, between the parties with respect to the subject matter of this Agreement.

11.2 This Agreement may not be modified, amended, or discharged except by a written agreement signed by an authorized representative of each party.

11.3 The provisions of this Agreement shall be deemed separable. If any provision in this Agreement shall be found or be held to be invalid or unenforceable, then the meaning of that provision shall be construed, to the extent feasible, to render the provision enforceable, and if no feasible interpretation would save such provision, it shall be severed from the remainder of this Agreement which shall remain in full force and effect unless the provisions that are invalid or unenforceable substantially impair the value of the entire Agreement to any party. In such event, the parties shall use their respective reasonable efforts to negotiate a substitute, valid, and enforceable provision which most nearly effects the parties' intent in entering into this Agreement.

11.4 No waiver of any term, provision or condition of this Agreement whether by conduct or otherwise in any one or more instances shall be deemed to be or construed as a further or continuing waiver of any such term, provision or condition or of any other term, provision or condition of this Agreement.

11.5 This Agreement shall bind the parties, their successors, trustee in bankruptcy, and permitted assigns.

11.6 No party shall be considered in default or be liable to the other party for any delay in performance or non-performance caused by circumstances beyond the reasonable control of such party, including but not limited to acts of God, explosion, fire, flood, war, whether or not declared, accident, labor strike or labor disturbances, terrorist activities, inability to procure supplies from third party vendors, sabotage, order or decrees of any court, or action of government authority.

IN WITNESS WHEREOF, the parties, through their respective duly authorized officers, have executed this Agreement to be effective as of the EFFECTIVE DATE when signed and dated by both parties below.

ACME CONGLOMERATE

By: ______________________________

Printed Name: ______________________________

Title: ______________________________

Date: ______________________________

NORMAN EINSTEIN TECHNICAL INSTITUTE

By: ______________________________

Printed Name: ______________________________

Title: ______________________________

Date: ______________________________

The foregoing is intended to provide you with helpful suggestions in protecting your organization from avoidable liability concerns in intellectual property matters. Each matter is different, and the advice of competent counsel in each situation should be obtained.

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