

Patent Licenses: Key Provisions

Go to: Framing the License Agreement | Identifying Patents Subject to the License | The Patent License Grant Clause | Exclusive vs. Non-exclusive Patent Licenses | Rights Granted to a Patent Licensee | Patent License Payment & Royalty Provisions | Representations and Warranties in Patent Licenses | Patent License Provisions That Protect Against Risk and Govern Future Disputes | Term & Termination of Patent Licenses | Assignability of Patent Licenses
Current as of: 09/10/2019

by Michael J. Kasdan, Wiggin and Dana LLP

This practice note details the key patent license agreement provisions and terms, namely:

- 1 Framing the License Agreement
- 2 Identifying Patents Subject to the License
- 3 The Patent License Grant Clause
- 4 Exclusive vs. Non-exclusive Patent Licenses
- 5 Rights Granted to a Patent Licensee
- 6 Patent License Payment & Royalty Provisions
- 7 Representations and Warranties in Patent Licenses
- 8 Patent License Provisions That Protect Against Risk and Govern Future Disputes
- 9 Term & Termination of Patent Licenses
- 10 Assignability of Patent Licenses

Framing the License Agreement

Identifying the Parties

Typically the opening paragraph of a license agreement states the parties to the agreement, as well its effective date. The parties should provide the complete legal name of each entity, as well as its place of incorporation and the address of its principal places of business. The identification of the parties to the agreement serves the obvious purpose of identifying each side of the transaction, both licensor and licensee, thus identifying the specific entities making the promises and receiving the benefits set forth in the agreement. Additional identifying details help to avoid potential confusion over other entities with similar names and to provide a basis for determining parent companies, subsidiaries, and related corporate entities.

Though it may seem obvious, identifying the proper parties to the agreement is an extremely important consideration. Getting the parties right, on both the sides of the agreement, is crucial, and to do so requires careful analysis. To ensure that the proper party or parties are identified as the licensor (i.e., the party licensing the intellectual property), the drafter must understand who owns and controls the subject IP. It is important to carefully consider all relevant entities that should be made a party to the agreement. For example, as it relates to patents, in the case of non-practicing entities or individual inventors, intellectual property may be owned and assigned through a network of legally unrelated - but commonly owned - holding companies. Sometimes, in the event that there are multiple inventors or co-owners, multiple parties may hold rights to the IP. In these cases, where possible, the licensee should consider directly including individuals, such as inventors and principals, as parties to the

Patent Licenses: Key Provisions

agreement. As discussed herein, representations and warranties in a license agreement may provide additional protection that the parties to the agreement are the right parties such that the rights flow from and to the proper parties. See Representations and Warranties in Patent Licenses.

As for identifying the proper licensee(s) (i.e., the party receiving the license rights), the drafter must carefully consider which entity will be making, using, selling, offering to sell, or importing the products/services covered by the agreement during the term of the agreement. Failure to do so may result in a situation where the entity that requires the protection of the license is not covered by the agreement. Parties should also pay careful attention to the definition of the term "subsidiaries," which is often defined to include all relevant related companies who may require rights. The licenses under the agreement are then granted not only to the licensee, but also its defined subsidiaries.

Preamble/Recitals

The first section of a license agreement is generally the "Preamble" (or "Recitals") section. In addition to identifying both parties and the effective date of the license agreement, this section is used to provide context for the agreement. The Preamble typically includes clauses that describe the circumstances that led to the agreement (e.g., settlement of litigation, desire to use the licensed IP, etc.), the relationship between the parties, and the existence of prior or related agreements between the parties. This explains the background of the agreement and, in general terms, the intentions of the parties. The explanation can be very useful to those reading the agreement years down the road, and to those interpreting the agreement at a later date.

Traditionally, the Preamble statements recited a series of so-called "WHEREAS clauses," in which each statement is preceded by the term "WHEREAS." For example, a first WHEREAS clause may state "WHEREAS, Corporation A is the owner of the trademarks listed in Appendix A," and the following clause may state "WHEREAS, Corporation B desires a non-exclusive license to use those trademarks and Corporation A is willing to grant such license to Corporation B." This series of WHEREAS clauses is followed by a transition sentence to the body of the agreement, generally "NOW, THEREFORE, in consideration of the promises and mutual covenants herein contained, IT IS HEREBY AGREED by and between the parties as follows." Though the traditional "WHEREAS clause" formulation is still used by many, others simply use prose statements without the older English term "WHEREAS." No matter how the phrases are formulated, the key is that as a matter of substance, the Preamble be as specific about the circumstances of the agreement as possible.

Specificity about the circumstances leading to the agreement, and any prior agreements, is both important to ensure a good understanding of the transactions between the parties and valuable to interpretation of the scope of the license in the case of a future dispute. For example, a recital such as "WHEREAS, X and Y had entered into a License Agreement on January 1, 2013, which is now expired," immediately informs the reader of a prior licensing relationship and a course of conduct that may be relevant to a proper interpretation of the license. Similarly, an end-of-litigation recital (e.g., "X has denied any infringement of the asserted IP, and the parties desire to amicably resolve their differences,") places the agreement in an adversarial context.

These recitals may also provide insight on the value of the licenses as a valuation tool. For example, a high royalty rate in a license between two market participants may be more probative of the value of the IP than that same royalty in an agreement that settles a litigation.

Identifying Patents Subject to the License

A key provision in any patent license is the designation of the patents or patent rights that are licensed. A patent license agreement should clearly identify the patent rights subject to the license, including whether they encompass foreign counterparts to U.S. patents, patents that might issue in the future covering inventions described in pending applications, and patents resulting from related applications, such as continuation applications, divisionals, and continuation-in-part applications. The license agreement also may identify related patents necessary to practice the licensed technology, as well as any other IP rights included in the license grant, such as copyright, trademark, trade secret and proprietary know how.

Patent Licenses: Key Provisions

Although a licensor may plan to license a single issued patent, in many cases the licensee will be interested in obtaining rights to practice multiple related patents owned by the same licensor. A single patent application frequently results in several patents, each with claims directed to different aspects of the technology described in the original application. These related patents or patent applications must be analyzed to determine whether they claim technology that should be covered by the license.

- Some applications, known as continuations or divisionals, generally share the same priority date as the original application. Continuations and divisionals have the same disclosure as the original patent application, but usually claim some aspect of the invention, or class of invention, not claimed in the original patent.
- Some applications, such as continuation-in-part applications, often do not enjoy the same priority date as the original application, because the claims are based on information first disclosed in a later application. As a result, these applications may include an improvement or other subject matter that was not described in the original application.

In order to define the patents subject to a license, two basic approaches are common. First, the license may define the affected patent rights by enumerating specific patents or applications, or by defining the licensed patents as all patents and applications owned by the patentee that claim the benefit of one or more specific effective filing dates. When negotiating a license agreement using this approach, the licensee should make every effort to verify all relevant patent applications filed by the licensor. You can accomplish this through careful due diligence, or by requesting a representation that the licensor has disclosed all relevant applications. Alternatively, the license may define the affected patents by subject matter, rather than specific patent or application number. In this approach, the license identifies a technology, such as a process or a product embodying certain features, and describes the licensed subject matter as including all patents and applications owned by the patentee that are related to that process or product. The approach that is taken depends on the parameters of the underlying business transaction and the leverage by licensors (who generally prefer the first alternative) and licensees (who generally prefer the second alternative) so long as it is clearly defined. Frequently, a combination approach is used in which the license provides that the licensed patents are listed in an attached Exhibit, provides that the Exhibit may be amended from time to time as appropriate when new continuations, divisionals, etc. are filed, and further provides that additional intellectual property related to the subject field shall be included should the licensor possess or later acquire same.

The Patent License Grant Clause

The central provision in a patent license agreement is the grant clause. At its essence, the grant clause provides the licensee with authority to practice the licensed patents during the license term. In addition, however, the grant clause typically includes other important limitations on that right. The grant clause usually indicates whether the parties consider the license to be exclusive or non-exclusive, although, as noted above, that characterization may be at odds with the substance of the license terms. The following are key limitations commonly found in grant clauses.

Scope of Use

The grant clause may provide the licensee with a broad grant of rights to practice the licensed patents, including the right to make, use, offer for sale, sell, and import any products covered by the patents, or use any covered processes. Alternatively, the grant may limit the licensee to some, but not all, conduct that otherwise would infringe the licensed patents. For example, the license may permit the licensee to "sell" and "offer for sale," but not include the right to "make" or "import" articles covered by the licensed patent.

Territory

In non-exclusive licenses, grants may be limited to specific geographic territories or markets. For example, a license may be limited to a region defined in the agreement. The license also may be limited to market segments, such as the retail consumer market. If the licensee is the sole licensee in a particular region or market, the parties may refer to the license as "exclusive," although the license may technically not be considered exclusive from a legal

perspective because the licensor is free to grant additional licenses in other regions or markets. However, because patents are issued/granted by territory, in the case of a litigation brought by a licensee in a particular territory against an alleged infringer, the patent(s) being asserted may well be considered exclusively licensed if the licensee enjoys an exclusive license in that territory.

Field of Use

Non-exclusive licenses often limit the licensee's activities to a particular industry or product, or "field of use." For example, a license to technology that could be used in various industries may be limited to the medical device market, or the warehouse and distribution market. As with regional or market limitations, the parties may refer to such a license as exclusive, although it may be effectively non-exclusive. Field of use limitations may also arise in an exclusive license context when, for example, a patent's claims are also limited by their express terms to such particular field of use.

Retention of Rights

At times, a latent ambiguity in the grant clause may arise where the license identifies some licensed rights, but is silent as to others. For example, if the licensee receives a right to "sell" a patented article, does that impliedly include a right to make the articles? You can avoid this problem by including a "retention" provision, which states that any rights not expressly granted to the licensee are reserved for the licensor. A retention of rights provision may be helpful in establishing that a licensor intended the grant of rights to the licensee to be limited.

Future Rights/New Technologies

In license agreements of long duration, disputes may arise if grant provisions fail to address the effect of future new technologies. Issues relating to "new technologies" tend to arise often in copyright licenses, which usually have a longer duration than patent licenses. Copyright licensees, not patent licensees, more frequently attempt to distribute the licensed work in a form that did not exist at the time the license was consummated. For example, the right to use a musical composition for purposes of a "motion picture" may not provide the licensee with the right to distribute the production as a television program or DVD recording.

In the context of pharmaceutical licenses, either or both parties will frequently continue development to invent new formulations, such as time release and extended release formulations. Such developments may result in new patents extending the term of patent coverage under the license agreement. The intent of the parties to include or exclude such new developments should be clearly stated in the agreement to avoid future disputes.

Courts have adopted two approaches to determining whether a license grant provision allows the licensee to exploit the intellectual property in question through new channels made possible by technologies developed after the agreement was entered into. The first approach, most famously used by the Second Circuit in *Boosey & Hawkes Music Publishers, Ltd. v. Walt Disney Co.*, 145 F.3d 481, 485-88 (2d Cir. 1998), is that the range of uses covered by the license includes all those uses that reasonably fall within the medium described in the license. Under this approach, the licensor bears the burden of expressly excluding any medium or use that would otherwise fall within the description. The second approach is that the grant language should be read restrictively to only cover those uses or media that fall within the unambiguous core meaning of the terms used in the license. Between these two approaches, the trend of cases seems to be to apply the former.

As a result, the licensor should take particular care in describing the uses of licensed patents. If the licensor intends to restrict use of the licensed IP in new modes of exploitation that may be developed in the future, the grant clause must clearly preclude those new technologies.

Exclusive vs. Non-exclusive Patent Licenses

One critical term in any license agreement is the degree of exclusivity the licensee receives in the grant. Licenses may be structured to fall in a continuum between exclusive to non-exclusive. The extent to which the licensor

Patent Licenses: Key Provisions

retains the right to practice or control the associated IP, not the parties' characterization of the license, determines whether the license is exclusive or non-exclusive.

Obligations of Exclusive Licensee

An exclusive licensee has certain rights and obligations that generally do not apply to a non-exclusive licensee.

Best Efforts/Performance Obligations

In some cases an exclusive licensee may be obligated to use its "best efforts" – or some other performance standard, such as "reasonable efforts" – to implement or commercialize the licensed technology. The rationale behind this requirement is that the patent-holder wants to rely on the exclusive licensee to actually commercialize the invention.

In the absence of a provision expressly requiring a specified level of performance, a licensee generally is not under an implied obligation to use best or even reasonable efforts to implement a technology covered by a licensed patent. Courts uniformly refuse to recognize such an implied obligation in non-exclusive patent licenses. See, e.g., *Permanence Corp. v. Kennametal, Inc.*, 908 F.2d 98, 101 (6th Cir. 1990).

In exclusive licenses, on the other hand, courts may recognize an obligation to use best efforts to commercialize the licensed technology when the terms of the license would otherwise leave the licensor without the ability to protect the economic value of the license. Thus, if a licensor grants an exclusive license with no performance standard, in which the payments from licensee to licensor are based solely on a percentage of the licensee's sales (i.e., a running royalty, discussed below), and with no opportunity to terminate the license or grant additional licenses, a court may (in the absence of a contrary provision) interpret the contract to require the licensee to use reasonable efforts to commercialize the technology. Without such an implied obligation, the licensor would be at the financial mercy of the licensee, wholly dependent on the licensee's performance to realize any economic benefit from the license. However, courts generally do not find such an implied obligation where the license provides for minimum royalties, advance royalties, or the ability to terminate the license or grant additional licenses in the event the licensee does not meet performance criteria. See *Vacuum Concrete Corp. of America v. American Mach. & Foundry Co.*, 321 F. Supp. 771, 772-74 (S.D.N.Y. 1971).

Some license agreements contain provisions expressly directing the licensee's level of performance. For example, a license agreement relating to technology developed at a research university often will include benchmarks for product development and product launch. Those express provisions supersede any implied obligations of best or reasonable efforts. Frequently such benchmarks are embodied in milestones, resulting in either payments by the licensee, or the right to terminate by the licensor if such milestones are not reached by a certain time. In addition, a licensor can protect against the risk that a licensee will not aggressively exploit the licensed patents by including minimum periodic royalties in the license terms.

Right to Bring an Infringement Action

Another important right conferred on an exclusive licensee is the right to maintain an action for infringement of the licensed patents. As a licensee, your client might be keenly aware of infringement by competing companies, and have the financial incentive to commence an infringement suit.

Only a patent owner or an exclusive licensee has the required constitutional standing to bring an infringement suit; a non-exclusive licensee lacks standing. "If the party has not received an express or implied promise of exclusivity under the patent, i.e., the right to exclude others from making, using, or selling the patented invention," the party has only a "bare license" and a "bare license to sell an invention in a specified territory, even if it is the only license granted by the patentee, does not provide standing without the grant of a right to exclude others." *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1552-54 (Fed. Cir. 1995) (en banc). This is true even though other parties also may have rights to practice the patents in the same field. However, a license may still be considered an exclusive license even when restrictions have been placed on the licensee, or when the licensor has retained some rights. See, e.g., *Alfred E. Mann Found. for Scientific Research v. Cochlear Corp.*, 604 F.3d 1354, 1359-60 (Fed. Cir. 2010).

Patent Licenses: Key Provisions

"[R]ecent Federal Circuit decisions have moved away from a focus on the restrictions placed on a licensee in determining whether or not a licensee has an exclusive license and have held that restrictions on the licensee alone are not dispositive." *My First Shades v. Baby Blanket Suncare*, 914 F.Supp.2d 339, 348 (E.D.N.Y. 2012).

Courts have divided licensees into three categories for purposes of standing:

- Those who hold "all substantial rights" to the patent,
- Those who hold "exclusionary rights...but not all substantial rights to the patent," and
- Those who hold "less than all substantial rights to the patent and lack exclusionary rights."

Morrow v. Microsoft Corp., 499 F.3d 1332, 1339-41 (Fed. Cir. 2007); *NeuroGrafix v. United States*, 111 Fed. Cl. 501, 504 (2013).

An exclusive licensee who receives all substantial rights in the licensed patents has standing to bring an infringement action without joining the patent owner. The Patent Act states that a "patentee" has the right to initiate a "civil action for infringement of [its] patent." 35 U.S.C. § 281. The term "patentee" includes both the patent owner and an assignee of all substantial rights in the patent. If the patentee transfers all substantial rights under the patent pursuant to an exclusive license agreement, it has the practical effect of an assignment, and the licensee has standing to maintain an infringement action under 35 U.S.C. § 281. *Sicom Sys. Ltd. V. Agilent Techs., Inc.*, 427 F.3d 971, 976 (Fed. Cir. 2005). License agreements may also provide that the licensor and licensee both be joined in any litigation regarding the patents, or that the licensor only be joined when necessary to provide standing. Cost sharing between the licensor and licensee is a negotiable term, as is sharing the reward of successful litigations.

Patentees who hold exclusionary rights may have standing to bring an infringement suit even if they hold less than all substantial rights in the patent. These patentees typically must join the patent owner in order to maintain standing in the suit. Recently, the Federal Circuit has broadly interpreted "exclusive license," allowing licensees to maintain constitutional standing if in possession of an exclusionary right that another party cannot subsequently obtain. Thus, an exclusive licensee may have standing to sue some parties and not others, depending on the scope of its exclusive license, even if that licensee is not the only party with the ability to license the patent (e.g., if its license was granted subject to a preexisting nonexclusive license). However, "an exclusive licensee lacks standing to sue a party for infringement if that party holds a preexisting license under the patent to engage in the allegedly infringing activity. Similarly, an exclusive licensee lacks standing to sue a party who has the ability to obtain such a license from another party with the right to grant it." *WiAV Solutions LLC v. Motorola, Inc.*, 631 F.3d 1257, 1266-67 (Fed. Cir. 2010).

Finally, patentees without exclusionary rights who hold less than all substantial rights to the licensed patent do not have standing to bring an infringement suit. Once a licensor has effectively assigned its patent through a transfer of all substantial rights, that licensor may lose standing to bring an infringement suit in the future.

To determine whether an exclusive licensee has the status of an assignee for standing purposes, a court must assess whether the licensee retained any substantial rights in the licensed patents. Many rights are considered in this analysis, including approval rights over sublicenses, reversionary rights to the licensor upon termination of the license, and the ability of the licensor to control the activities of the licensee. The most significant consideration when determining whether a licensee has standing to sue on its own is the nature and scope of any right to sue retained by the licensor. *Alfred E. Mann Found. for Scientific Research v. Cochlear Corp.*, 605 F.3d 1354, 1361 (Fed. Cir. 2010). If the licensor retains enough substantial rights to the licensed patents, such as a right to practice the inventions, approval rights over sublicenses, or the right to grant additional licenses, then the licensee must join the patent owner as a party in any infringement action.

Obligations of Exclusive Licensor

The exclusive licensor has certain obligations to the licensee, including an implied promise not to grant future licenses of the subject intellectual property rights within the scope of the license to a third party. Indeed, where the licensor transfers *all substantial rights* in the licensed patents, so that the transaction is effectively an assignment,

Patent Licenses: Key Provisions

then the licensor lacks the ability to grant additional licenses for the same subject matter during the license term. If an exclusive licensor attempts to grant another license, it is ineffective, and the would-be licensee may not obtain rights as a bona fide purchaser. *Rhone Poulenc Agro, SA v. DeKalb Genetics Corp.*, 284 F.3d 1323, 1333-34 (Fed. Cir. 2002) (en banc).

Whether an exclusive licensor impliedly represents that no previous licenses of the same subject matter are outstanding is an open question. A licensee may protect itself against the risk of outstanding conflicting licenses by obtaining the licensor's representation that no such licenses exist. In addition, since a co-owner of a patent has the independent right to grant licenses without consulting co-owners, an exclusive licensor may impliedly represent that it has exclusive ownership in the licensed patents. Once again, a licensee concerned about controlling the risk of additional licensees obtaining rights to the licensed patents may negotiate a representation that the licensor is the sole owner of the licensed patents.

Generally, the exclusive licensor does not provide the licensee with any implied assurance that the patents subject to the license agreement are valid, or that they may be practiced without infringing another patent owned by a third party. See *Representations and Warranties in Patent Licenses*. Agreements often provide for mechanisms to govern the situation where the licensee requires a license to a third party's patent rights, such as lowering the royalty rate in a royalty stacking context, sharing the cost of acquiring the necessary rights, or even requiring the licensor to acquire the rights.

In most cases, unless the license agreement provides otherwise, an exclusive licensor does not retain the right to continue its use of the licensed IP. A licensee needs to assess whether the patentee's continued use of the licensed patents represents an unacceptable competitive threat to the licensee's implementation of the technology. A "patentee has no more right to practice his patent in a field of use where an exclusive license has been given, than does a stranger. Therefore, if the exclusive license has been violated by the patentee, the patentee may be sued for infringement." *Sanofi, S.A. v. Med-Tech Veterinarian Products, Inc.*, 565 F. Supp. 931, 937 (D.N.J. 1983)(citations omitted). Some licenses contain a "retained rights" provision which may allow the licensor to use the licensed subject matter for limited purposes, such as research or personal use. In the absence of a provision permitting some residual use, the licensor in an exclusive license retains no right to practice the patent.

Licensee Estoppel

Licensees are not automatically precluded from challenging the validity of patents. In *Lear, Inc. v. Adkins*, 395 U.S. 653, 670-71 (1969), the Supreme Court held that the then-prevailing rule that a licensee was estopped from challenging the validity of a licensed patent, known as "licensee estoppel," violated public policy.

However, a licensee's ability to challenge a patent under the *Lear* doctrine is not unlimited. A licensee cannot take advantage of a licensor by not paying royalties, then raising patent invalidity as a defense to a breach of contract claim. Thus, a licensee cannot invoke the *Lear* doctrine until it (1) ceases payment of royalties, and (2) provides notice to the licensor that the reason for ceasing payment of royalties is because it has deemed the licensed patent to be invalid. *Studiengesellschaft Kohle v. Shell Oil Co.*, 112 F.3d 1561, 1568 (Fed. Cir. 1997). As a result, if a licensee considering challenging the validity of a patent, it should do so promptly, and not hold itself out as a licensee with a right to exclude based on a patent that it considers invalid or unenforceable.

Rights Granted to a Patent Licensee

The Right to Make, Use, Sell, and Offer for Sale

The owner of a patent has the right to exclude others from making, using, offering for sale, selling, or importing into the U.S. the covered invention during the patent term. One important point of negotiation is whether the licensee will receive the right to practice all of these rights, or whether the license will be limited. For example, the patentee may grant the licensee the right to sell a product, but not the right to make articles covered by the licensed patent. In that event, the licensee would be required to obtain the articles from the patentee or some other authorized source. Since courts generally interpret a patent license agreement so that the licensor retains any rights not expressly

Patent Licenses: Key Provisions

granted, you should make sure that the rights granted to your licensee client are sufficient to permit the contemplated use of the patented inventions.

If the parties do not clearly identify the rights covered by a license or the right to make, use, sell, and/or offer for sale, a court may need to evaluate the parties' intent in structuring the license relationship. For example, where a licensor grants a licensee the right to use a patented process, a court may in some circumstances interpret the license to include a grant of the right to make a claimed apparatus necessary to practice the process.

"Have Made" Rights

In addition to obtaining the right to make an article covered by the licensed patent, a license may grant the right to arrange for the manufacture of a patented article by a third party, such as a contract fabricator. Although the parties also may accomplish this by including a limited right to sublicense, the license grant may include "have made" language, which authorizes the licensee to contract for the manufacture of the patented article from another source.

Even if the license does not include "have made" language, however, a court may find that the right is implied. The Federal Circuit has held that a non-exclusive licensee who obtained the rights to make, use, and sell a product, but not the right to grant sublicenses, inherently received the right to have the product made by a third party manufacturer, where the license agreement lacked a clear indication of intent to the contrary. *CoreBrace LLC v. Star Seismic LLC*, 566 F.3d 1069, 1072-73 (Fed. Cir. 2009). On other occasions, however, the Federal Circuit has found that the use of "have made" rights can constitute the creation of a sublicense. *Cyrrix Corp., v. Intel Corp.*, 77 F.3d 1381, 1387-88 (Fed. Cir. 1996). Furthermore, some courts have interpreted a license's silence with respect to a particular activity as an implied prohibition of that activity. *Cook Inc. v. Boston Scientific Corp.*, 208 F.Supp.2d 874, 879 (N.D. Ill. 2002). In light of these decisions, a licensee planning to use a third party fabricator should consider inserting "have made" language into the license granting clause, or including the right to sublicense fabricators. To foreclose the possibility of third party fabricators, a patentee/licensor must include language expressly prohibiting third party use.

Trade Secrets & Know How

Technology license agreements, including patent licenses, often include a grant of right to practice related technology protected by trade secret law. Frequently proprietary information concerning commercial-scale implementation of a patented technology is not disclosed in the patent specification, but is maintained as a trade secret or confidential know how. A key feature of a trade secret license is a comprehensive provision dealing with safeguarding the confidentiality of the trade secret, including prohibitions on reverse-engineering the licensed information or challenging the validity of trade secret status. If the IP rights subject to the license agreement are identified by subject matter, the description may include trade secrets and other proprietary know how in addition to patents and other IP assets. As discussed below regarding royalties, explicitly including trade secret and know how in the agreement confers another advantage should the parties agree: the ability to provide for royalties even after the patents have expired, albeit at a discounted rate.

Patent License Payment & Royalty Provisions

Most license agreements provide some form of monetary payment to the licensor as consideration for the license grant. In negotiating a payment or royalty provision, the parties will be guided by two basic considerations. First, the amount of the payment to be paid should be determined by the value of the IP subject to the license, or more particularly the value of the right to practice the subject IP granted in the license. Second, the structure of the payment provision allows the parties to allocate risk between the parties and, in some cases, to either encourage or deter the future behavior of the parties. There is an almost endless variety of structures available for IP license payment provisions.

The payment clause in a license agreement sets forth: (i) the amount to be paid, (ii) by whom, (iii) at what time, and (iv) by what mechanism. So long as they agree, parties are free to design a structure that best fits their business

and accounting practices, though a handful of payment styles are used most frequently. In negotiating payment structure, you should consider the potential advantages or disadvantages of each.

Lump Sum

In a lump sum provision, the licensee pays to the licensor a single, fixed amount as consideration for the license. The payment can either be a one-time payment or a series of defined payments over time. The defined payment, however, is the only revenue that the licensor receives for the duration of the license. The payment amount, timing of the payment, and payment mechanism should all be defined in the agreement.

The principal advantage of a lump sum license is that it is easy to administer. The licensee does not need to maintain detailed records of product sales, and does not need to prepare periodic royalty reports. The licensor is not required to audit the licensee's royalty payments. On the other hand, the lump sum structure poses potential risk to both the licensee and licensor. In order to determine the amount of the payment, the licensor and licensee must forecast the expected use of the licensed technology, and the likely profitability of products or services. If the parties' projections are inaccurate, the licensor bears the risk that it will not be able to recover for an increase in the licensee's sales that it would otherwise capture with a running royalty. Conversely, the licensee bears the risk of a drop in sales or exiting the business altogether.

Running Royalty

A running royalty provision is a common compensation structure for IP licenses. In a running royalty, the licensee pays a periodic amount based on its use of the licensed technology. Running royalties pose less risk to the licensor and licensee. One important advantage of the running royalty is that the amount paid for the right to practice the licensed patents is based on some defined volume of commercial activity, such as the sales of products embodying the licensed technology. A disadvantage is that a running royalty is more costly to administer than a lump sum payment. The royalty provision sets forth the royalty rate (the percentage applied to the sales), the royalty base (the sales that fall within the royalty structure), along with other particulars such as how often payments are to be made, the content of the sales reports from licensee to licensor, and whether and when an audit can be conducted.

A running royalty structure has pluses and minuses for those on either side of the negotiating table:

- 1 For the licensor, the running royalty has the advantage of being tied to the licensee's actual sales, allowing the licensor to capture unexpected increases in sales (though also putting it at risk for declines in sales).
- 2 For the licensee, payment is made over time and is in sync with its revenue stream from the licensed products. This wait may be less desirable for the licensor even though the licensor may ultimately receive more in fees than a strictly lump sum arrangement.
- 3 For both parties, a running royalty structure imposes administrative costs and increases the risk of litigation. The licensee must generate royalty reports and potentially open its doors to an audit of its records by the licensor. For the licensor, it must verify the accuracy of the licensee's royalty reports and conduct an audit where applicable. Since the cost of licensee audits are often borne by the licensor, additional costs may apply.

Royalty Rate

The royalty rate is the percentage applied to the royalty base to calculate the royalties due during a specified period. The royalty rate is negotiated, and is related to the value of the licensed property, the expected profitability of the licensee's use of the technology, and the performance risks borne by the parties. Royalty rates vary widely across industries and for different technologies.

One rule of thumb is that the royalty rate is based on the projected profitability of the licensee's use of the technology. Generally, the licensee should expect to pay as a royalty 25 to 33 percent of the expected increase in profitability (for instance, increased sales or decreased cost) resulting from the implementation of the licensed technology. Royalty rates also may be affected by industry custom and practice, as well as the licensee's need to acquire multiple technologies in order to produce a product. For example, royalty rates in the pharmaceutical

Patent Licenses: Key Provisions

industry are generally significantly lower. The terms of the license agreement also may affect the negotiated royalty rate. For example, a licensee should expect to pay a higher royalty rate for an exclusive license than a non-exclusive license.

The parties may negotiate for royalty rates that are variable over time, or for different levels of product revenue. For example, a license may call for a royalty rate that decreases as revenue increases, so that the highest levels of periodic revenue are applied to a lower royalty rate. From the licensor's viewpoint, declining variable royalty rates may encourage a licensee to implement the technology in the widest range of applications. On the other hand, the parties may agree to variable royalty rates that are lower at lower product sale volumes. Since the marginal cost of product production is greater at lower volumes, especially if the licensee is incurring research and development costs, a lower variable royalty rate may protect licensee profitability as a new product is launched. Additionally, in a pharmaceutical license, the risk of a generic product entry to market, which results in drastic reduction in profitability of the product, is commonly mitigated by lowering the royalty rate upon the first such entry, further reducing upon subsequent entries, or even abandoning royalties altogether upon generic entries.

Royalty Base

The royalty base is the volume of economic activity that is multiplied by the royalty rate to calculate the royalty payment due in a specific period. Many license agreements define a royalty-bearing sale as a sale of a defined product in a territory where a valid claim in an unexpired patent covers the product. Although parties usually focus on the royalty rate in license negotiations, the royalty bases may be nearly as important. The royalty base often is related to the role of the licensed technology in a complete product. For example, if the technology relates to an isolated component of a much larger product, such as a windshield wiper design for an automobile, then the royalty base may be the sales value of that component. On the other hand, if the technology is responsible for the consumer demand for the entire product, the royalty base could be the total revenue resulting from the product, or the "entire market value" of the product. The Federal Circuit has noted that in determining patent infringement damages based on a product made from many components, damages generally should be based on revenues for the "smallest salable patent-practicing unit." However, under the entire market value approach, "[i]f it can be shown that the patented feature drives the demand for an entire multi-component product, a patentee may be awarded damages as a percentage of revenues or profits attributable to the entire product." *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 67 (Fed. Cir. 2012).

Since the royalty rate and the royalty base both are negotiated terms, agreement on a more expansive definition of the royalty base frequently results in a lower agreed royalty rate. In addition, the parties should take into consideration whether any royalty base definition is convenient to administer.

Note that the royalty base is more likely to trigger subsequent disagreements than the royalty rate. When defining terms in the license agreement, you should include specific descriptions of the products that will generate royalties, and whether the base is determined using gross revenue or net revenues. In the case of net revenues, the parties may require substantial negotiation to agree to terms for what will and what will not be offset from gross revenues to be considered net revenues. For example, the parties may disagree about whether the base includes bundled products, optional or add-on components, parts, or services included in the product sale transaction.

Royalty Minimums

The licensor may be concerned that the licensee will enter into an exclusive license agreement, but not implement the licensed technology at all (a practice known as "shelving"), or not be able to develop a commercially successful product. In that case the licensor may advocate for royalty minimums in the license agreement. Royalty minimums require that the licensee pay a minimum amount of royalties to the licensor during a specified period, usually one year. Minimums are a way for a licensor to minimize the risk that the licensed technology will not be used in a way which generates an adequate running royalty. It also may act as an incentive for the licensee to develop a product using the technology, since it will be required to pay some royalties whether it uses the licensed technology or not. On the other hand, a royalty minimum places risk on the licensee, since it is required to pay some royalties even if the technology proves unsuccessful. This is especially true if the technology requires some further research and development efforts prior to implementation, or if the technology has not been proven to be commercially viable. In

Patent Licenses: Key Provisions

such situations, a licensee may wish to negotiate a royalty maximum, so that the absolute ceiling on a royalty payment may be fixed.

Royalty Reporting

In addition to terms defining the amount of royalties required for the right to practice the licensed patents, the license agreement also must define a reporting and payment mechanism. In most cases, the licensee submits periodic reports, either quarterly or annually, to the licensor. The reports identify the royalty base for the appropriate period, such as either a unit volume of royalty-bearing products or total net revenues for royalty-bearing product sales during the period. The reports also calculate the royalty due for the period, considering factors such as variable royalty rates and minimum royalties. In addition, the license must include details concerning royalty payments, including payment schedule, the currency to be used to make the payments, and any penalty for untimely payment.

Audit Rights

In most license agreements, the licensor will reserve the right to periodically audit the licensee's product sales and royalty reports to verify that the proper amount of royalties have been paid. Royalty audit terms commonly provide that the licensor may elect to audit royalty reports at most once per year, and to cover reported royalties for a reasonable period of time, usually two to three years. Provisions with longer audit periods often are unacceptable to licensees, because the cost of retaining records for longer periods of time is great and the accumulated liability for miscalculated royalties could be staggering. The audit usually is performed by a public accounting firm. Although the licensor generally pays the cost of an audit, the license may provide that the licensee is obligated to pay for the audit if it reveals a significant underpayment of royalties. Parties (particularly the licensee) should make efforts to structure an audit clause that is the least disruptive to their operations.

Royalty Term

A term may vary from a period of years to the life of the patent. However, licensors and licensees should take care not to agree to pay royalties on patents after they have expired. This has been held by the Supreme Court to constitute patent misuse. See *Brulotte v. Thys*, 379 U.S. 29, 32-33 (1964). Diminished royalties, however, may extend beyond the expiration of the patents if the license includes trade secret or other proprietary know how and explicitly provides a discount to the royalty rate following the expiration of the patents. See, e.g., *Kimble v. Marvel Enters.*, 727 F.3d 856, 863 (9th Cir. 2013).

"Most Favored Licensee" Terms

In non-exclusive licenses, the licensee may negotiate for a "most favored licensee" provision to protect against the risk that subsequent licensees could obtain rights to practice the licensed subject matter at a significantly lower cost. A most favored licensee provision usually requires the licensor to notify the licensee if it grants a subsequent license for the same technology. In addition, if the subsequent license contains specific terms more favorable than the terms of the earlier license, then the earlier licensee has the option to adopt those terms in its license.

The provision may be drafted a variety of ways, and the actual operation of the provision will depend on the interpretation of the exact language used. Some provisions focus on royalty rate, while others are based on the overall terms of the agreement. The provisions usually exclude license agreements resulting from settlement of infringement disputes, since an effective royalty rate in a settlement agreement is likely to be lower than in an arms-length negotiation not involving litigants. Parties negotiating a most favored licensee clause should also consider the antitrust implications, particularly where the parties are in the same field or have market power.

Licensees should be wary of these clauses because of the administrative burden and practical difficulty of monitoring the licensor's activities. Licensors may find that having such an obligation on the books may hinder the licensing program, making it difficult or economically unattractive to take on new licensees. The most fundamental issue with the most favored licensee clause is the question of whether subsequent terms are "better" than what was originally offered to the licensee. This may be difficult to measure in circumstances where the scope of the later

Patent Licenses: Key Provisions

license is different. Thus, while such a provision provides some comfort to the licensee, its inclusion increases the risk for both sides that the license ends up the subject of litigation. The practical value of a most favored licensee term may be to discourage the licensor from granting more favorable terms to other licensees.

Other Payment and Royalty Formats

In addition to running royalty and lump-sum royalty structures, the ability of parties to structure provisions defining monetary consideration is almost limitless. The following are examples of provisions that may be appropriate in some license agreements:

Hybrid royalties. Hybrid forms of royalty provisions are common, featuring a one-time, up-front payment followed by a periodic running royalty. The parties may adopt a hybrid royalty to reflect costs incurred by the licensor in developing the licensed technology.

Annual License Fee. This gives the licensee the option of renewing the license annually by paying a set license fee on the anniversary date of the license. If the licensee opts not to pay the fee, then the license terminates.

Milestone payments. The license agreement may provide that in addition to royalties, the licensee must pay a fixed sum on the occurrence of a specified event, such as the regulatory approval of a product embodying a licensed patent.

Conditional Reduction of Royalty Rate. The license agreement may provide that the royalty rate decreases upon the occurrence of certain conditions that makes the license less valuable to the licensee, such as the licensee's need to license other essential technology from another source (called a "royalty stacking" provision) or another competitor's entry into the market, particularly a generic entry in the pharmaceutical context.

Royalty Caps. The parties may agree that the licensee's obligation to pay royalties ends when a certain aggregate amount has been paid. This provision protects the licensee from unforeseeably high royalties.

Representations and Warranties in Patent Licenses

No matter the nature of the agreement, certain fundamental assumptions and expectations exist on both sides of the negotiating table, without which there would be no agreement. For example, in a license agreement, the licensee reasonably expects that the licensor owns the licensed assets—or at least has the right to grant the license—and the licensor rightfully assumes that the licensee is capable of entering into the agreement.

The representations and warranties section expressly states these assumptions and expectations, giving the parties additional security and putting each side at risk of a breach if they are not accurate. For this reason, a patent license agreement usually includes a number of representations and warranties by both the licensee and licensor. For example, in a license agreement, the licensee reasonably expects that the licensor owns the licensed assets—or at least has the right to grant the license—and the licensor rightfully assumes that the licensee is capable of entering into the agreement.

Capacity to Grant Rights

The most common representations and warranties focus on the capacity of the licensor to grant the license and confirm that the title of the licensed assets is clear. For example:

- LICENSOR warrants and represents that it has the right to grant rights, licenses, privileges, releases, non-assertions and immunities under or relating to the licensed assets.
- There are no liens, conveyances, mortgages, assignments, encumbrances, other licenses, or other agreements which would prevent or impair the full and complete exercise of the rights, licenses, privileges, releases, non-assertions and immunities granted by LICENSOR to LICENSEE, their respective successors and assigns, customers, both immediate and remote, and suppliers with respect to the Licensed Assets pursuant to the specific terms and conditions of this Agreement.

Patent Licenses: Key Provisions

Similarly, a licensor should look for a provision confirming that its licensee has the legal capacity to enter into the agreement:

- LICENSEE warrants and represents that it has the right to enter into this Agreement with LICENSOR on behalf of itself and its Subsidiaries.

Title and Validity

Unlike in an ordinary asset sale situation, a patentee may be unable to provide warranties of title and validity. Although patents issued by the USPTO enjoy a presumption of validity, a patent may be invalidated at any time during the term, as a result of court litigation or administrative reexamination proceedings. In addition, a putative inventor, not named as a co-inventor on the patent, may seek to establish co-ownership of the patent at any time by initiating an inventorship proceeding. As a result, the degree of uncertainty concerning the legal status of a patent is generally too great for a licensor to extend blanket warranties as to title and validity, and should be avoided when representing the licensor. As an alternative, the licensor may extend warranties based on facts known as of the date of the license. See *Prudential Insurance Co. of America v. Premit Group, Inc.*, 270 A.D.2d 115, 115-16 (1st Dept. 2000). For example, the licensor may offer a representation that, as of the date of the license agreement and after a reasonable inquiry, it is unaware of facts that would invalidate the licensed patent or result in a claim to ownership by a third party.

Miscellaneous Representations and Warranties

Absent a special relationship between the parties, there are fundamental conditions precedent to nearly any license of intellectual property that should always be included.

In an agreement that includes payment for past damages for infringement, the parties may also include a representation concerning the licensee's total sales to date:

- LICENSEE warrants and represents that as of the Effective Date of the Agreement, it has sold no more than 50,000 units of the Accused Product.

In addition to giving binding force to expectations and assumptions, representations and warranties can clarify what the agreement *does not* cover. Depending on whether your client is a licensor or licensee, these may be appealing or unfavorable. Examples include:

- No warranty that the licensed products do not infringe patents of third parties. This favors the licensor and the licensee may not be inclined to include this.
- No admission of infringement (by the licensee) or of validity (by the licensor).
- Disclaimer/acknowledgment that no implied licenses are extended to licensee.
- An acknowledgment as to any right that is specifically excluded.

Finally, representations and warranties can be used to address information imbalances between the parties. For example, where the licensor is unwilling to include a broad scope of licensed assets (perhaps out of obligations to other parties or for valuation reasons) and the licensee has lingering concerns about what other assets are under the control of the licensor, the licensee may want to consider a provision in which the licensor represents that it does not own or control any assets that it could assert against the licensee.

Patent License Provisions That Protect Against Risk and Govern Future Disputes

No Contest Clauses

"No contest" clauses, which prohibit a licensee from challenging the enforceability of a licensed patent, are invalid in situations where the prohibition does not protect a recognized interest of the licensor. In general, a provision in which the licensee is prohibited from challenging the validity or enforceability of a licensed patent will be

unenforceable. *Lear, Inc. v. Adkins*, 395 U.S. 653, 670-71 (1969). No contest clauses may be enforceable in licenses that are part of agreements settling litigation, however. The Second Circuit recently held in *Rates Tech., Inc. v. Speakeasy, Inc.*, 685 F.3d 163, 172 (2d Cir. 2012), that a no contest clause was invalid in a "pre-litigation" agreement settling a patent dispute, though other courts have held that no contest clauses may not be enforceable in an agreement to settle "ongoing litigation." See *Indus. Eng'g & Dev., Inc. v. Static Control Components, Inc.*, 45 F.Supp.3d 1311, 1318-19 (M.D. Fla. 2014). In view of these cases, many licensors now include contractual "penalties" for contesting the validity of patents. These may include, for example, clauses that require the licensee/challenger to pay its legal costs for defending against the challenge or clauses that escalate royalty payments in the event of an unsuccessful challenge.

Indemnification

If the licensee plans to use the technology covered by the license to produce or sell a product, both the licensee and licensor likely will seek indemnification for the resulting risk. Although indemnification may be implied in some cases, the parties to the agreement generally will negotiate an indemnification or hold harmless provision.

Infringement Risk

The licensee generally will seek indemnification for the risk that a third party may assert a claim for infringement of a patent, or other intellectual property right, based on the licensee's activities in practicing the inventions. For example, the licensee's product embodying the licensed technology may infringe a third party patent.

Product Liability Risk

The licensor generally will seek indemnification for the risk that a third party may assert a tort claim based on the licensor's product, such as a product liability or negligence claim, and name the licensee as a responsible party. This is especially true if the licensor is a larger, well-capitalized establishment, such as a major corporation or a university.

In most instances, a licensor is not liable for defects in a licensee's product simply because it makes available technology embodied in the article. However, if the licensor actively participates in the design or manufacture of the resulting product, liability under a product liability theory is possible. See *Firestone Steel Products Co. v. Barajas*, 927 S.W.2d 608, 614 (Tex. 1996) ("mere licensor" not liable, "some purposeful activity with respect to the design by the licensor" is also required). On the other hand, a licensor may be named as a co-defendant by a tort plaintiff, and an indemnification provision may obligate the licensee to provide a defense of product-related claims and pay any resulting judgment or settlement. In some cases, the licensor may require that the licensee provide third-party insurance to the licensor to protect against complete operations claims by adding the licensor as an insured under the licensee's commercial liability policies.

Cap on Damages

Since the liability for defending infringement claims made by third parties may be costly, a licensor generally seeks a cap on liability. One common cap is based on the amount of royalties that the licensee has paid during the term of the license.

Dispute Resolution

Since the success of many license agreements depends on the preservation of a cooperative relationship between the licensor and licensee, parties often will include dispute resolution mechanisms to potentially resolve controversies without the need for litigation. In patent licenses, however, the licensor must consider whether a mandatory arbitration provision will subject the licensed patents to binding determinations of validity or claims construction by an arbitrator, with only limited ability to appeal. See 35 U.S.C. § 294(a).

However, with the growing popularity of alternative dispute resolution ("ADR"), it is increasingly common for licenses to provide that disputes under the agreement are to be resolved by negotiation, mediation, binding or non-binding arbitration, or some combination of these techniques. The choice as to the dispute resolution technique is

Patent Licenses: Key Provisions

up to the parties. The use of these types of out-of-court dispute resolution techniques have grown in popularity due to several factors, including speed, confidentiality, and comparably lower costs to resolving disputes in litigation.

An ADR clause sets forth the specific procedure for which disputes are to be resolved and how. As to which disputes may be resolved, the parties may broadly agree that any dispute arising out of or relating to the agreement are subject to the ADR provision. Otherwise, the parties may agree that only a narrower set of disputes (e.g., whether some future product qualifies as a "Licensed Product") are subject to the provision.

As to how the dispute is to be resolved, the ADR clause may use a combination of techniques. For example, one party may first be required to give notice of the dispute. This may be followed initially by business negotiations between high-level executives, which, if unsuccessful, are then submitted to binding arbitration. Other choices include use of non-binding mediation or binding or non-binding arbitration.

In the event that binding arbitration is to be used, the arbitration clause should specify which commonly accepted arbitration rules and guidelines are to be used. Among the more popular arbitration bodies are the American Arbitration Association ("AAA"), JAMS, the International Court of Arbitration of the International Chamber of Commerce ("ICC"), and the International Institute for Conflict Prevention and Resolution ("CPR"). Different arbitration bodies use different bodies of rules and procedures. For example, though there are many commonalities, different arbitration bodies have different procedures for the number of arbitrators used and the arbitrator selection process.

Generally, the ADR clause also specifies the timing and place and entity that will resolve a dispute. For example, a clause that submits disputes to arbitration may specify that "within ninety days of notice, the dispute shall be finally resolved by a binding arbitration to be held in New York, New York, U.S.A.," according to the then existing rules of the American Arbitration Association. The provision may also specify the number of arbitrators, the specific rules, the language of the arbitration, as well as any variations the parties agree on concerning the rules. The parties may modify the procedures and rules on such issues as to the extent of discovery, whether the arbitrators must have a particular technical background and whether the prevailing party is entitled to recover costs and expenses. In addition, the clause should require a written opinion specifying the factual and legal basis of the decision so that the decision will have a final binding effect on the losing party.

Where a different form of ADR, such as non-binding mediation, is selected by the parties, it is likewise appropriate for the ADR clause to specify timing, location, and the various specifics of the mediation process.

Choice of Law & Venue

In order to provide some level of certainty for how future potential disputes will be handled, the parties often negotiate dispute-related procedures. A key part of the dispute resolution process is the substantive law that will apply when interpreting the agreement, the conduct of the parties, and coming to an ultimate resolution.

As such, a choice of law provision can be significant. Although many intellectual property issues are governed by federal law, issues of contract interpretation (and thus licenses) are resolved by looking to state law—even when those issues are raised in federal court. New York and California (among other states) have small but potentially significant differences with respect to contract interpretation, which could impact the outcome depending on in which state the parties bring the action. For example, different states have different rules as to when and whether it is appropriate to use extrinsic evidence in interpreting the contracting parties' intent.

The parties will each likely seek the application of state law that is familiar or potentially favorable to them. In many cases (such as where the parties are in the same state), this clause will be a confirmation of what the parties already expected. In other situations, such as when the contracting parties come from different states or even countries, the choice of law will be the subject of negotiation.

A choice of venue clause sets forth a particular venue for dispute resolution. Parties will typically look for what they perceive to be an advantageous forum such as a court in the city where their company is headquartered, or one where their counsel is located.

Patent Licenses: Key Provisions

A standard clause specifies that both parties agree to a particular forum to resolve any dispute, for example:

"Any dispute relating to this Agreement shall be resolved by a court in San Francisco County, California; the parties consent to the jurisdiction and exclusive venue of such courts for purpose of the resolution of any such dispute."

Parties who already have their preferred choice of law in place should consider the importance of also securing their preferred venue, and determine whether the preferred venue is a matter of personal preference and convenience or if it is crucial to protecting their interests.

Beyond courts, the parties are free to consider alternative forums for dispute resolution, such as mediation or arbitration.

Term & Termination of Patent Licenses

Term

The term provision of a license agreement specifies how long the agreement will be in effect. Often, the license is limited to a specific term of a number of years, particularly if the future value of the intellectual property or plans for future products is uncertain, as is often the case. In the patent license context, five or ten year term agreements are common industry practice, with ten years on the outside realm of the range. Alternatively, many patent licenses set the license term to endure until the expiration of the last of the licensed patents. In some cases, the term may extend beyond the expiration of the patents where royalties continue (at a reduced rate) for non-patent licensed intellectual property, such as know how.

The parties may choose to include a renewal clause, whereby the license automatically renews after the term expires, unless prior written notice is provided by the licensee. Such a clause can also be contingent on the licensee meeting certain royalty minimums. The downside of including an automatic renewal clause from the licensees' perspective is that the agreement must be monitored and requires that the licensee specifically act in order to discontinue the license. However, such clauses give the licensee an effective option to continue the agreement, which may be desirable depending upon the underlying business rationales.

Termination

Patent license agreements should include a termination provision that outlines the circumstances under which the agreement may be terminated. Commonly, termination provisions permit either party to terminate the agreement upon the uncured material breach of the other party (such as a licensee's failure to pay royalties under the agreement), and set forth procedures for providing notice of breach and an opportunity to cure. In addition to termination for a licensee's failure to pay under the agreement, other types of triggers that may be set for the right to terminate include: a failure to meet minimum sales requirements, insolvency or other financial problems of the licensee, changes in the business, such as a merger, asset sale or other attempt at assignment, as well as defensive termination.

If the license agreement terminates, the agreement must specify how the parties will unwind the license relationship, including the sale or disposal of unsold inventory, the return or destruction of proprietary materials relating to the license technology, and identification of any obligations continuing beyond the termination, such as confidentiality or noncompetition obligations.

The license agreement must make clear that the licensee's obligation to pay royalties only continues for the term of the licensed patents, since courts may interpret a license to require perpetual payments as patent misuse, unless the license agreement includes trade secrets or other know how, and provides for a reduction in royalty rates upon the expiration of the patents. See, e.g., *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257, 264-66 (1979); *Warner Lambert Pharm. Co. v. John J. Reynolds, Inc.*, 178 F. Supp. 655, 665-66 (S.D. N.Y. 1959), *aff'd* 280 F.2d 197 (2d Cir. 1960); *Kimble v. Marvel Enters.*, 727 F.3d 856, 861-864 (9th Cir. 2013).

Assignability of Patent Licenses

One important aspect of patent licensing is to plan for likely or potential future business transactions that could affect the rights. As patent licenses usually have terms on the long side (e.g., five years, ten years, or for the life of the patents), it is a good practice to include provisions in the agreement to deal with events under which the licensee may want to assign the patent rights. Such an assignment may take place as part of a sale of assets, the sale of a business operation, a merger or acquisition, or a bankruptcy reorganization.

As discussed below, the default rule is that a licensee may not transfer the license rights it receives without the express permission of the licensor. However, depending on the future transaction, obtaining such consent may be difficult. For this reason, many parties choose to include a provision that specifies when and under what circumstances and limitations, a licensee may assign its rights to a new entity.

Whether an assignment is permitted under the terms of the license agreement, or under applicable law, requires careful analysis of both the terms of the license and applicable federal and state law principles.

Assignment in Absence of Governing License Provision

If the patent license agreement does not contain a provision controlling the question of assignability, the issue is governed by common law principles. The default rule under federal law for non-exclusive patent licenses is that they are non-transferable without the permission of the licensor, because they are "personal rights." See, e.g., *Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 677 (9th Cir. 1996) ("Allowing free assignability [through state corporate merger statutes] would undermine the reward that encourages invention In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents"). This is an exception to the general rule that contracts are freely transferable.

The U.S. Court of Appeals for the Federal Circuit has indicated that the assignability of patent licenses, in the absence of a controlling provision in the license agreement, is determined by federal common law. *General Mills, Inc. v. Kraft Foods Global, Inc.*, 487 F.3d 1368, 1373 (Fed. Cir. 2007) (recognizing a need for a "uniform national rule" on assignability). In spite of this, the California Supreme Court has ruled that assignability, like other aspects of patent licenses, is governed by state contract law, and that federal cases discussing the issue are merely "persuasive." *Farmland Irrigation Co. v. Dopplmaier*, 48 Cal. 2d 208, 221 (Cal. 1957). If state contract law is to be applied, just like under federal law, the "personal" nature of the contract is taken into account; if assignment of the license would effectively deprive the other party of the benefit of their bargain, the contract is not assignable under the "personal service" exception.

Assignment by Licensee

In the absence of a provision governing assignability, most courts considering the issue have ruled that, absent specific provisions in the license agreement, patent licenses are not assignable by a licensee. The result often depends on whether the assignment involves an exclusive or non-exclusive licensee. Courts uniformly have held that non-exclusive patent licenses are non-assignable, citing a "long standing federal rule of law" that patent licenses are personal and not assignable. *Unarco Indus., Inc. v. Kelley Co.*, 465 F.2d 1303, 1306 (7th Cir. 1972). In addition, licenses characterized as "exclusive," but not amounting to a transfer of all substantial rights to the licensee, also have been held to be non-assignable. For example, in one recent case involving an "exclusive" license limited to a particular field, the court held that the rule against assignment applied to both exclusive and non-exclusive licenses. The court reasoned that, "[a]lthough, in granting an exclusive license, the licensor relinquishes the ability to provide additional licenses, nothing about that act implies or necessitates the licensor's forfeiture of the right to control which or how many entities practice the art at issue." *ProteoTech, Inc. v. Unicity Int'l, Inc.*, 542 F. Supp.2d 1216, 1219 (W.D. Wash. 2008). If, however, an exclusive license results in the transfer of all substantial rights in the patents to the licensee, the license is likely assignable, because the license is essentially an assignment of the patent to the licensee. See *Moraine Prods. v. ICI Am., Inc.*, 538 F.2d 134, 141 (7th Cir. 1976) ("Where the patentee or his assignee has granted an absolute exclusive license, the exclusive licensee usually has the authority to grant sublicenses.") Nonetheless, recent cases addressing the issue reach conflicting results, and the trend may be to consider even exclusive license agreements to be non-assignable in the absence of a provision

Patent Licenses: Key Provisions

permitting assignment. It is advisable to include specific provisions in the license agreement to govern assignability to best reflect the intent of the parties.

Assignment by Licensor

Although a patent license agreement is likely a personal service agreement from the viewpoint of the licensor (in part, because the patentee may want to select the entities authorized to practice its patented inventions), the license is likely not personal from the viewpoint of the licensee. The licensor's performance under the license might include receiving royalties, performing audits, and refraining from granting additional licenses, none of which are likely to be regarded as "personal." Thus, unless the licensor had personal obligations to the licensee under the agreement (e.g., collaborating in future technical developments), it would likely be able to assign its interest in the license to a third party. Again, it is advisable to include specific provisions in the license agreement to govern assignability to best reflect the intent of the parties.

Assignment of License in Corporate Transactions

Rights under a patent license may be an important corporate asset. Since many technology companies are candidates for eventual acquisition, the ability to transfer these license rights to an acquiring company may be essential. However, patent licenses are treated differently in corporate transactions than traditional assets, such as leases or commercial contracts. Whether a patent license agreement may be assigned as part of a corporate transaction depends on the form of the transaction and the applicable assignment provision in the license, if any. To avoid future disputes arising out of such transactions, parties to license agreements may negotiate assignment provisions as part of the license, such as expressly permitting assignment in conjunction with a sale of all or substantially all of the business.

Mergers

Most courts have held that mergers count as an "assignment." In general, under state corporate merger statutes, the effect of a merger is to automatically transfer all property by operation of law. See, e.g., ABA Model Business Corp. Act, 11.07(3)) ("All property owned by, and every contract right possessed by, each corporation, or other entity that merges into the survivor is *vested* in the survivor without reversion or impairment" (emphasis added)). The "vest" language of these statutes has been repeatedly construed as denoting an assignment or transfer. However, a minority position has held that if the merger results in a change in corporate form but not substance (e.g., the surviving entity has the same officers and directors, and same business as licensee), it does not count as an assignment, because the merged entity is merely a continuation of the original licensee. See, e.g., Synergy Methods, Inc. v. Kelly Energy Sys., 695 F. Supp. 1362, 1364-66 (D.R.I. 1988).

Although most forward (target/licensee merges into acquirer) and forward triangular (target/licensee merges into subsidiary of acquirer) mergers would result in an "assignment," reverse mergers (acquirer merges into target/licensee) are generally not considered an assignment absent special provision because the target company/licensee survives and there is just a change of ownership.

Change of Control

If the license includes a change-of-control provision, terminating the licensee's right if a transaction results in transfer of effective control, the provision is likely to preclude assignment by any form of transaction. In a leading case involving a forward merger, PPG Industries, Inc. v. Guardian Industries Corp., 597 F.2d 1090, 1096-97 (6th Cir. 1979), the court ruled the transfer of the licensee's rights in a patent license agreement was not permitted, based in part upon a change-of-control provision.

Asset Sale

If the licensee or licensor sells the patent license agreement as an asset as part of a sale transaction, the transfer will likely violate any anti-assignment provision in the license agreement, as well as the common law rule on non-assignability, at least for non-exclusive licenses.

Stock Sale

In a stock sale transaction, the ownership of the stock of the licensor or licensee is transferred to the purchaser, but the corporate form and assets remain undisturbed. As a result, a stock sale is not likely to violate a non-assignment provision in a license agreement, or the common law rule of non-assignability. In one case, for example, the court ruled that a non-exclusive patent license was not transferred through a sale of the licensee's stock, and therefore was not an assignment, noting that "[a]bsent compelling grounds for disregarding its corporate form, therefore, [licensee's] separate legal identity, and its ownership of the patent cross-licenses, survive without interruption notwithstanding repeated and even drastic changes in its ownership." *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 494 (1st Cir. 1997). In contrast, however, a stock sale may trigger a term in the license agreement that provides that the license terminates upon a change of control of the licensee's business.

Bankruptcy

The assignability of license agreements frequently arises in the liquidation or reorganization of a licensee in bankruptcy. For a more detailed discussion of the effect of bankruptcy on a licensing relationship, see *IP License Agreements: Change of Corporate Control and Bankruptcy Issues*.

License Terms Governing Assignment

As noted above, given the potential uncertainty on the assignability question, many licensee and licensors will opt to deal with the issue expressly in the license agreement. If the license agreement provides for assignability, the applicable state contract law governs that provision. *General Mills, Inc. v. Kraft Foods Global, Inc.*, 487 F.3d 1368, 1373 (Fed. Cir. 2007). Three common means by which an agreement may address assignability are described below.

First, the license agreement may define the parties in a way which contemplates at least a limited right of assignment. The definition of a party may refer to "successors and assigns," or may define the party as including affiliates, subsidiaries, or other related companies which might be future assignees.

Second, the agreement may expressly allow assignment, subject to restrictions. The assignment provision may take many forms, but issues to consider include:

- Should the prohibition of assignment apply to both licensor and licensee?
- Should assignment be allowed only with the advance written consent of the other party? This provision is likely to trigger negotiation in the event one party seeks to assign the license, which may be unsatisfactory to a party with a weak bargaining position.
- If consent is required should the license include the qualification that the necessary consent will not be withheld "unreasonably"?
- If the licensor mainly is concerned about technology falling into the hands of its competitors, should the assignment provision include a list of entities (such as competitors of the licensor) to whom assignment is prohibited?

Third, the license may provide for the effect of future corporate transformations. It is common to provide that a party may assign the license to a subsidiary, either wholly or majority-owned, established to exploit the licensed technology. In addition, the license may include a "change-of-control" provision, which calls for the termination of the licensee's rights in the event of a sale of shares, merger or acquisition. Such a provision also may create a right to assign a license where it might otherwise not exist. For example, where an exclusive license agreement provided that transfer was permitted in connection with the "sale of [a] substantial portion of [licensee's] assets," one court held that the license was assignable in a bankruptcy proceeding, even if exclusive patent licenses were not assignable as a matter of federal law. *Murray v. Franke-Misal Techs. Group, LLC (In re Supernatural Foods, LLC)*, 268 B.R. 759, 803-05 (Bankr. M.D. La. 2001).

Patent Licenses: Key Provisions

For a discussion on general contract clauses that are also regularly included in patent licenses, see IP License Agreements: General Contract Provisions.

Assistance provided by Christina Williams, Wiggin and Dana LLP

End of Document