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Legal Affairs

The Basics of Patent Licensing Explained

Avoid Misunderstanding by Making Sure Your Agreement Is Clear and Accurate

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So, you've got a patent but you don't have the resources to market the patented invention. Or you have the manufacturing and marketing infrastructure in place but you are looking for a novel new product to expand your product line. Maybe you're involved in a patent infringement dispute and are looking for a way to resolve it. A patent license may be the answer to your problems.

What is a patent license? Generally speaking, a license is a document or agreement giving permission to do something. However, a patent is only a right to exclude others from making, using, or selling your invention. A patent does not give its owner the affirmative right to make, use, or sell the patented invention. It is entirely possible to have a patent that cannot be used without infringing another person's patent. For example, a patent on a chair having four legs, a seating surface, and a back cannot be practiced without infringing an earlier patent on a four-legged stool.

Thus a patent license is not an affirmative right to exploit the patented invention, only an agreement by the licensor (the patent owner) that he will not enforce his right of exclusion against the licensee (the party wishing to utilize the patented invention).

The licensee must always be aware that there may be other patents that cover the product. The licensee should exercise caution, either in the form of clearance studies conducted prior to entering into the license agreement that seek to identify other patents that might form a barrier to exploiting the licensed technology, or in the form of warranties from the licensor that practicing the licensed technology will not infringe any third-party patents.

The goal of any license agreement is to obtain a clear, unambiguous document that accurately describes the transaction. There are three basic functions of a license agreement:

- defining each party's rights under the agreement;
- defining each party's obligations under the agreement; and
- defining each party's remedies if the obligations are breached.

Threshold Issues

In granting rights under the agreement, a threshold issue is whether the license should be exclusive or non-exclusive. From the licensee's perspective an exclusive license is usually more desirable, as it eliminates competition. On the other hand a licensor might tend to favor a non-exclusive license so as not to put all his eggs in a single basket.

Another threshold issue is "field of use," i.e., is the licensor granting the licensee the right to exploit the invention in any technological field or only in a limited field? In a license for a patent pertaining to a new type of engine, for example, the licensor might grant the licensee the right to exploit the licensed invention only on lawnmowers, keeping the right to himself to take advantage of the invention on cars, boats, motorcycles, etc.

Geographical territory might be another way to limit the scope of the grant, for example giving the licensee the right to exploit the licensed technology only in certain areas of the country. If there are going to be restrictions on the field of use or geographical territory, there must be express language in the license so providing, because such restrictions will not be inferred.

Royalties

Payment of royalties is usually the most important obligation of the licensee. The manner in which royalty payments are structured is limited only by the imagination of the parties. The license obligation might be a one-time paid-up license, a percentage of sales, a fixed amount on a periodic basis, milestone payments, a cross-license of the licensee's technology to the licensor, or a combination of one or more of these arrangements.

The licensor must avoid the situation where he has exclusively licensed the patent and the licensee is not marketing the invention and therefore not generating any royalties for the licensor. Conversely the licensee wants to avoid a situation where he is obligated to pay royalties but cannot sell enough of the licensed product to be profitable.

Another issue is deciding who has the duty of enforcing the licensed patents against infringing third parties. While an exclusive licensee can usually enforce a licensed patent against a third-party infringer, a non-exclusive licensee cannot and must rely on the licensor to police the market. But the licensor is not obligated to sue third-party infringers unless the license so provides.

An otherwise profitable license can quickly turn unprofitable for the licensor if he is required to enforce his patent against multiple third-party infringers. Conversely, a non-exclusive licensee obligated to pay royalties cannot compete in price against infringers and may have no recourse unless the licensor has agreed to police the market.

In the event of breach of the licensing agreement, what remedies are available? A requirement in the license agreement that any litigation be brought in the home venue of one of the parties can be a distinct disadvantage to the other party. Because contract laws vary from state to state, the choice of which state's law will govern the license may favor one party over the other.

The license agreement can provide for alternative dispute resolution, such as arbitration or mediation. A "liquidated damages" clause may be included to fix the amount of damages in the event of a breach.

There is no one-size-fits-all license agreement. More often than not, the negotiated license agreement will be biased in favor of one or the other of the parties. Whether the favored party is the licensor or the licensee will depend largely on the relative bargaining positions of the parties. A party with the better bargaining position should be careful not to abuse the position, however.

It may be possible for a potential licensor to use a superior bargaining position to negotiate an excessively high royalty rate, but he may soon find that the licensee cannot sell any licensed products at the price commanded by the high royalty rate, with the net effect that there are no sales (and therefore no royalties) at all.

Considerations

Parties should consider several subjects when entering into a license agreement:

- What is being licensed—patents, trademarks, copyrights, trade secrets, know-how
- Exclusivity, right to sublicense
- Duration of license
- Field of use
- Territorial limitations

- Consideration: upfront fee, running royalties, minimum payments
- For royalties based on sales, what kind of records is the licensee required to keep? What audit rights does the licensor have?
- How often must the licensee make reports to the licensor?
- Who owns improvements made by the licensee to the licensed product?
- Who will be in control, and who will bear the cost, of any pending patent applications?
- Which party has the obligation of bringing infringement actions against third parties?
- Under what conditions can the parties terminate the agreement?
- Requirements for the licensee to place patent marking on licensed product
- Indemnification
- “Most favored licensee” provision, in which the licensee gets the benefit of any more favorable terms negotiated by another licensee
- Warranties and representations
- Alternative dispute resolution: mediation, arbitration
- Are the terms of the license to be kept confidential?
- Which state’s law will govern disputes over the license?
- To whom should notices concerning the license be sent?
- Integration: are all previous oral and written agreements voided by execution of the license?
- Force Majeure: what happens in the event of breach of the license because of circumstances beyond the control of the parties, e.g., flood, war, etc.?

This list is by no means intended to be comprehensive but it should give an idea of the breadth of issues posed by a potential patent license.

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