

# Licensing Intellectual Property

## Chapter 1:

### Rembrandts in the Attic: Understanding Intellectual Property Licensing

#### 1.0 Introduction:

5 In a span of two hundred years, the human race has entered the information age from the industrial age. Today, the majority of a company's assets may be in the form of intangibles. Approximately half the market capitalization of the Fortune 500 companies now is on account of the intangibles that they own. The globalization of business, accelerated product life-cycles, advances in technology are helping create an environment where the  
10 intellectual property component is expanding rapidly and must be strategically managed<sup>1</sup>.

Managing intellectual assets (IA) till the very recent past meant defensive protection of a company's intangible assets designed to guarantee rights over the company's intellectual property (IP), to ascertain that there was no dilution of such IP rights and usually to stop others from infringing the IP. Very often IP created by companies was not commercialized or  
15 if done, it was at a very small scale. Even the companies that were very innovative looked at IP merely as a means to protect their technology. The philosophy that these IA could be licensed to earn substantial revenue was absent. Xerox, Bell-AT &T were invention generating powerhouses but they did not make a killing out of licensing IP. Quite literally their IP assets were the 'Rembrandts in the office attics'.

20 But the world has changed rapidly. Today to be competitive, companies must extract maximum value for their stakeholders from every available asset/ revenue generating opportunity. This includes creating value from their IP portfolio as well. Today in most big companies (in developed nations) IP portfolio management is strategically linked with the overall business strategy. As we shall see, IP drives revenue against measurable business and  
25 financial goals. Fixed assets can be duplicated but "for a given firm, the combination of tangibles with its own unique, knowledge based assets will be the key differentiator<sup>2</sup>.

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<sup>1</sup> "Strategic management of intellectual property", KPMG's Intellectual Property Portfolio Services, page 2.

<sup>2</sup> Bob Gruetzmacher, Licensing Business Director, Du Pont.

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Corporates look at their IP development and IP personnel as a profit centre than as a cost centre<sup>3</sup>.

### 1.2 Understanding Licensing and the terminology

5 **Intellectual assets (property)** are those intangible assets that can be specified, protected and traded. They are the creations of human mind. Some illustrative examples are patents, know-how, brands, trademarks & content.

10 **Licensing** is “A permission to engage in a specified activity.” It simply means granting to another person specified rights related to a property without transferring ownership in the underlying property. A licensing agreement is essentially a contract. A license differs from a sale in that ownership of the property is not transferred, and the licensor retains ownership rights to the property (e.g. Right to mortgage).

15 In simple terms, Licensing IP can be understood by looking at it as hire for rent transaction. The underlying asset is the IP. The royalty received is the rent for such use. There is no transfer in property in that asset, but the hirer (licensor) has the right to continue using the asset till the time he pays the rent (royalty).

20 **Royalty** is the rent received by the owner (Licensor) of the asset from the tenant (licensee) in return for granting the right to exploit (license) a particular right attached to a property.

25 **Non-exclusive License** is a license wherein the rights granted to the licensee may also be granted to others. Egs. Commercially available software is “licensed non-exclusively” to the end-user, since there are numerous other licensees for that product.

**Exclusive License** is a license wherein the licensee is the only entity that is granted the licensed rights. No other entity has any access to those rights.

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<sup>3</sup> Theo Grigoriou, President, Allied Signal Technologies, Inc.

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**Joint Development License** is a scenario wherein one company enters into a joint development agreement with another in order to collaborate in development of a product calling for the special resources of each company. Both companies will need to use some of the technology of the other in the course of such development. A joint development license permits such limited use of each company's technology. When development of the new product is completed, the joint development license will grant each party whatever rights may be required to market the product.

**Cross License** agreement is essentially when two licenses combined into one agreement, and is used when each party to the agreement wants to obtain certain rights to the other party's property. The consideration for each entity is the right given by the other entity (usually) without any actual asset transfer.

**Conditional License** is a license where contracting parties agree that if one party fails to do something, a license will be created in favour of the other party granting it certain rights permitting it to do specified acts to protect its interests<sup>4</sup>.

**Option based license** gives the buyer a future right to use the technology at a later date, if he so desires on the payment of payments. It gives him the security to use the technology if it is accepted at some point in future without the burden of paying huge license fees up-front. (Like the Stock market "call option"). **Reach-through licensing** is licensing of IP with royalties based on percentage of sales, where the licensed IP is not incorporated in the end product. This scheme creates a license the value of which can be measured, and thus simplifies the problem of valuing basic IP per se.

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### 1.2 Licensing Revenues

Now that we have understood the main terms in the licensing arena, let us take a look the phenomenal revenues that IP pro-active companies have garnered by following a diligent IP licensing programme.

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1. IBM collects upwards of US\$1 billion annually from royalty payments<sup>5</sup>.
2. Texas Instruments collected upwards of US\$2.5 billion during 1994-99 from royalty payments<sup>6</sup>. It generated more than 20% of its revenues from royalties<sup>7</sup> in 2000.
3. Pfizer paid US\$ 225 million, including an upfront payment of US\$ 85 million to Searle in 1998 for “celecoxib” (anti-arthritis)<sup>8</sup>.
4. Synaptic Pharmaceutical Corporation has received US\$ 2 million from Glaxo as payments for a non-exclusive licensing agreement<sup>9</sup>.
5. Johnson & Johnson’s in-licensed products accounted for 54% of its pharmaceutical revenues in 1997<sup>10</sup>.
6. In 1998, the top 10 US pharmaceutical companies derived 32% of their revenue from products licensed from other companies<sup>11</sup>.
7. Philips & Sony have collected more than US\$ 2 billion in royalty revenues relating to licensing of CD related patents<sup>12</sup>.
8. Lucas film’s one deal with toymaker Hasbro for Star Wars toys has resulted in revenues in excess of US\$ 500 million<sup>13</sup>.
9. Rambus, a company making memory chip interfaces for Intel expanded its revenues from US\$ 40 million to US\$ 2 billion (1998) within a period of 2 years due to a unique licensing<sup>14</sup>.

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<sup>4</sup> Stuart Meyer, “Exploiting Intellectual Property Assets through licensing: Strategic considerations” by in ‘Practising Law Institute’; February – March, 1997 pg. 34-36.

<sup>5</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 30.

<sup>6</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 31.

<sup>7</sup> Fortune, October 16, 2000.

<sup>8</sup> “A license to cure”; The McKinsey Quarterly, 2000 no. 1, page 80.

<sup>9</sup> PR Newswire, “Synaptic pharmaceutical reports second quarter and six monthly results”; August 10, 1998.

<sup>10</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 31.

<sup>11</sup> “A license to cure”; The McKinsey Quarterly, 2000 no. 1, page 81.

<sup>12</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 33.

<sup>13</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 34.

<sup>14</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 35.

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10. IP alliances helped Amgen increase its revenues from US\$44 million in 1987 to US\$ 1 billion plus in 1992; a rate of 90% a year<sup>15</sup>.
11. 14 of the 55 drugs in US markets having annual turnover upwards of US\$ 500 million are licensed from external sources<sup>16</sup>.
- 5 12. Martha Stewart Living Omnimedia earned \$7.8 million from merchandising in Q1 of 2001.
13. Licensing revenues at Marvel for Q1 (2001) more than doubled from the year-earlier quarter to \$5.4 million partly due to licensing of “Spiderman”.
- 10 14. The Hebrew University in Israel earned US\$ 1.5 million in royalties from licensing the image, papers etc of Albert Einstein in 2001 alone. Einstein had bequeathed his image, papers and IPR to the University before his death in 1955.

Indian companies too, are not totally unaware about IP asset management and monetization. For e.g.

- 15 i) Ranbaxy received an up-front payment of US\$ 6.3 million and further payments totaling up to US\$ 42 million from Schwarz Pharma for giving it the right to develop market and distribute Ranbaxy’s prostrate drug<sup>17</sup>.
- 20 ii) Ranbaxy Laboratories received US\$ 10 million from licensing Bayer AG its new formulation of “Ciprofloxacin—OD”. Another US\$ 50 million may come as milestone payments. In addition Bayer will also pay a royalty of up to 10% of sales depending upon other factors<sup>18</sup>.
- 25 iii) Dr. Reddy’s Laboratories has received US\$ 6.25 million in 3 installments from licensing a compound (DRF 4158) to Novo Nordisk in August 1998 and can get another eight more milestone payments<sup>19</sup>. It has received a total<sup>20</sup> of approx. US \$ 8 million as a result of its licensing initiative (DRF 2725, DRF 4158, DRF 2593).

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<sup>15</sup> Alberto Torres, “Unlocking the value of intellectual assets”; The McKinsey Quarterly, 1999 number 4 at page 36.

<sup>16</sup> “A license to cure”; The McKinsey Quarterly, 2000 no. 1, page 81

<sup>17</sup> Times Of India dated June 28<sup>th</sup>, 2002.

<sup>18</sup> The Economic Times dated September 9, 1999.

<sup>19</sup> The Indian Express dated February 11, 1999.

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## 1.3 Reasons to give IP license (seller's reasons)

A licensor has multiple motives to license out his IP. The prime motive being royalty earnings. These royalties represent a stable source of income. Royalties will not be discussed here as the figures above give sufficient “financial reason” to license IP. The remaining motives are essentially grouped below in a series of sub-headings.

### 1) Strategic positioning & Revenue Generation:

A company that cannot maximize the value of its core technology should go in for licensing it to all possible market players. These deals help accelerate its time to enter the market (market acceptability) for its technology when time is of essence and optimizes value and return on such IP. In addition, the license usually produces an immediate cash flow advantage to the IP owner in the form of lump sum and/or royalty payments.

It can also be the source for a cross license and thus the foundation of making the technology the de-facto standard of the standard. Moreover technology licensing can also be the currency for a technology exchange transaction.

Philips and Sony jointly licensed their CD, laser technology portfolio to all players at reasonable prices at an early stage. This prevented competitors from trying to developing alternative technologies, and also the acceptability of the CD was faster and more universal. (Refer no.7 above)

### 2) Lateral Revenue:

If a company has an IP that it cannot use in its main business, it may license the asset to others and earn lateral revenue that it would not have earned in absence of such a deal. It opens the doors for new revenue generation opportunities. This additional revenue stream is not to be regarded as “windfall” but rather as an active business opportunity. Such redeployment also reduces the maintenance cost involved in the core IP asset. Moreover lateral licensing does not hurt the company as it does not compete with the company's core business line.

Lucas film's income goes beyond earnings from films. It earns billions from licensing its assets to apparels, books, co-marketing deals. A company may earn more from such lateral

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<sup>20</sup> “Dr. Reddy's Lab in a free fall” <<http://www.capitalmarket.com>> (Monday, July 22, 2002).

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revenue streams than from the main asset (e.g. “The Lion King” licenses earned larger profits than the film.

### 3) Increased Organisational Efficiency:

For small companies, licensing is often a necessity. Licensing adds resources of the licensee to the licensor. Aligning with major players has benefits such as increased market capitalization, increased organizational capacity of the smaller IP development company. Such a move will strengthen its organizational strategic position by helping market creation, market expansion of its technology. Licensing helps broaden geographical markets as a licensor can now address markets that it otherwise could not hope to serve.

For e.g. Within five years of its alignment with Kirin Brewery for licensing Epogen, Amgen’s revenues crossed US\$ 1 billion in 1992 from US\$ 44 million in 1987.

### 4) Product Risk Reduction:

Many IP development companies do not have all the resources to fully develop/commercialize their IP assets. Or they may not have they corporate set up to bring the product in all they markets that they might want to. Also they might want to reduce their risk exposure in new business areas and so might get into a joint development license. Such companies opt in for licensing to overcome these hurdles. Licensing can broaden product markets. For e.g. independent content makers license their IP to firms that produce master video-tapes and manufacture as well as distribute the cassettes/ V.C.D.s etc.

Licensing helps in risk reduction as the necessity to develop physical assets from scratch and the associated risks diminish. Also licensing results in a faster and (possibly) stable source of revenue and reduced competition.

### 5) Reduced Litigation Risk & Market Control:

A license may be given to potential competitors so that they may not challenge the validity of such IP or involve the IP in time and cost consuming litigation. For e.g. in Patent license, the license can eliminate the expenditures associated with a patent infringement lawsuit, the risk that the claims will be construed not to encompass the accused device, and an even greater risk of losing the patent altogether if it is found to be invalid or unenforceable.

Generally a technology that is licensed to a competitor has reduced risk of litigation from that competitor. It can also be ensured that the competitor undertakes not to challenge the validity

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of the IP as well as work for maintaining the validity of the IP by means of suitable covenants in the license agreement.

Licensing may also allow a firm some degree of control over its own innovations and therefore over the direction of the industry as a whole. For e.g. Had Microsoft not allowed MS-DOS to be licensed, IBM would have probably developed an OS of its own which might have been different from MS-DOS and the result today would have been different. An IP holder can also control to a certain extent by using “natural” control or through contractual limitations.

### **6) Increasing Market Penetration through Product Bundling:**

Some products sell more when are incorporated in, sold for use with, or marketed with others. For e.g. software OS for computers are best supplied bundled when the hardware is first bundled, rather than as optional “add-ons”. (Refer MS-DOS case). This bundling creates synergy at two levels. For e.g. when Microsoft granted IBM a license to use MS-DOS, at the first level, IBM’s choice made sure that Microsoft’s product was furnished with every IBM PC, thereby multiplying Microsoft’s product market.

The second level involved independent, third-party software developers. They wrote software for use with MS-DOS as the IBM PC market was too small to ignore. This created a cycle where more software for MS-DOS was being written and this in turn was creating more customer base for MS-DOS. This created a new consumer, one who was “locked” with MS-DOS. They had to buy later systems that were IBM-- MS-DOS compatible (and in later years only MS-DOS compatible)! Or face the prospect of shifting to a new system and incur costs again.

### **7) Technology Barter:**

A licensee often has valuable IP of his own that the Licensor might benefit from. In such situations a technology barter agreement may result where the parties get access to each others technology. There can be “joint-development” or a “grant-back” (wherein improvements are licensed back to the original licensor). Cross-licensing can create a synergy as joint R & D project or even joint venture!

### **8) Enhancing Reputation and Goodwill:**



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A license increases “brand” availability. For e.g. a person may not be able to own “Harley-Davidson” bike for a variety of reasons. But he can always use a pair or (IP licensed) Harley sun-glasses. Such license spread the word for the original product and IP. Another e.g. is of AT&T which gained a lot of goodwill among computer specialists by licensing its proprietary UNIX OS to a number of computer makers for use with PCs.

### 1.4 Reasons to take a license (buyer’s reasons)

There are equally compelling reasons for the licensee to enter into a licensing arrangement.

#### 1) Access to technology:

This is the most basic reason for the buyer to enter into a licensing agreement. (Refer 5 & 6 above). Licensees have a variety of reasons for wanting the technology. Some want to fill gaps in their own research and development programs with an immediately available solution. Others are simply in the business of marketing licensed technology (refer 5,6 above). Also it must be borne in perspective that a license gives access to the IP which otherwise would not only have taken years of research but also huge monetary resources on part of the licensee to accomplish.

#### 2) To avoid litigation risk<sup>21</sup>:

A possible infringer of IP may go in for a license rather than face the threat of litigation. Good sense may prevail between both the potential licensor and the potential licensee faced with that situation to recognize the ramifications of not entering into a license agreement, which usually will be litigation. By taking the license, he can eliminate the downside risks of patent litigation and defer the final decision to challenge, and the challenge itself, indefinitely. The insurance in the form of the license may be advantageous to the accused infringer even when the decision to litigate has already been made.

The elimination of downside risk may even make litigation an obvious choice if the probability of prevailing and the potential savings as a result of successful litigation are both high when compared with the costs of litigation. On the other hand, the licensee should keep in mind that the license may eliminate his incentive to litigate and may make him subservient to the licensor in the field of the license.

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<sup>21</sup> Eckstrom’s Licensing in Foreign and Domestic Operations; Chapter 6.08.

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Digital Equipment and Intel's lawsuit ended in a settlement in which Intel and DEC entered in a 10 year cross-license agreement and Intel purchased semi-conductor operations<sup>22</sup>.

### 3) Leveraging complementary assets:

It is a fact that many large organizations are more adept at marketing, distributing a product i.e. commercializing rather than creating a new product. It makes business sense for such huge marketing giants to leverage their existing distribution chains and earn increased profits, increase turnover (and pay royalties) than putting a huge budget for in-house research on all possible products. In the Amgen – Kirin case, both the partners had complementary capabilities. Amgen secured Kirin's commitment to Epogen in return for the license. Kirin lacked the IP. Amgen lacked the manufacturing or distributing capabilities & rapidly developed its distribution network on the back of this alliance.

### 4) Enhancing product lines:

Taking the above logic further, it is more prudent for corporations to allocate their research budget on core products and in-license remaining products. This not only enhances the number of products that they offer but also increases their grip in their core product areas. For e.g. Schwarz Pharma took a license from Ranbaxy to try lifting its bottom-lines as its revenues were sagging.

### 5) Competitive Hedging:

A company may also license or acquire competitive technology that threatens its core business, because by doing so it gains an option to use it if the technology takes off. It gives the benefit of guaranteed future usage without paying huge licensing fees. A company may also take an option because it feels that the risk-adjusted cost of doing so, is less than that of developing the alternatives in house<sup>23</sup>.

## 1.5 Disadvantages of licensing<sup>24</sup>:

Whatever its advantages, licensing cannot compare with complete vertical integration. It has its fair share of disadvantage as well.

### 1) Loss of Control, Over-Exploitation & Customers and New Product Leads:

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<sup>22</sup> Jan M. Conlin & Ronald Schutz; "The Patent Files", 'Chief Executive', No. 135, June, 1988, P. 44.

<sup>23</sup> "A license to cure"; The McKinsey Quarterly, 2000 no. 1, page 81

<sup>24</sup> "Licensing of Intellectual property" by Jay Dratler, Chapter 1.04

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The primary disadvantage of granting licenses is loss of control over further exploitation of one's intellectual property. The quality of the final product incorporating the IP cannot be ensured normally (though contractual covenants may be good help). For e.g. by granting a marketing and distribution license, the licensor surrenders control over advertising, promotion, channels of distribution, and the licensee's pricing policies.

There is also the risk of licensee not fully commercializing the IP which would mean lower royalties and smaller market share for the IP. When a firm delegates part of its operations or research and development or product improvements to others, through licensing, it may lose contact with its ultimate customers, the "end users," and thereby lose its best source of competitive ideas as well its technological "edge."

### **2) Loss of Incentive for Expansion and Vertical Integration:**

By delegating approaches to new geographic or product markets to others, a firm reduces its own incentive and ability to compete in those markets. Over time, it may lose (or fail to generate) the capability of addressing those markets itself. A licensor may even lose valuable personnel or resources to its licensees. Licensing also may reduce a licensor's incentive to achieve full vertical integration.

If a firm delegates a significant fraction of operations to others through licensing, it may ultimately lose the incentive or ability to perform those operations itself. For example, if a firm delegates production through licensing, it may fail to attract technical and managerial personnel with interests and expertise in manufacturing, or it may lose the ones it has. Even if it performs some manufacturing, delegation of a significant fraction of production may dry up the stream of ideas that flows from actual trial-and-error experience.

### **3) Loss of New Business Opportunities:**

In exploiting its intellectual property, or in cooperating with others in related fields, a firm may discover opportunities for expansion of its business, improvement of its products or services, or both. The same opportunities, however, may not appear to a firm that is not actively present in the marketplace, or that has delegated important business operations to others.

Thus granting licenses may reduce the number of new business opportunities that come to the attention of the licensor. There is another school of thought. It tries to take the loss of revenue

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which would have otherwise accrued to the IP owner had he directly sold the asset. This is in essence, trying to calculate the “opportunity cost”. Note that there is a substantial loss of revenue on account of lucrative after sales service / upgrade contracts as well.

### **4) Dependence on Others for Revenue:**

- 5 If the license delegates responsibility for an entire business operation, the dependence on the licensee may be complete; the licensee's failure to manufacture, for example, may kill a product and deprive the licensor of any revenue. This dependence may be less significant if the license is non-exclusive. If the license is exclusive, however, the dependence is more acute.
- 10 In the Rambus memory case, Rambus became too dependent on Intel as its technology platform. After turn of events, the Company faced a heat because it started demanding higher royalties.

### **5) Risk of Piracy:**

- 15 One of the primary risks of licensing is the danger that licensed intellectual property will be used or disclosed without authorization. Unauthorized use may constitute willful "piracy," or it may be inadvertent. The delegation of business operations through licensing increases the risks of piracy by reducing the licensor's control over both the manner in which intellectual property is exploited and the precautions used to prevent unauthorized use and disclosure; as well increasing the possibility of trade secret misappropriation or exposure. There is a also a
- 20 latent threat that the Licensee may design around the IP and introduce competing products. (refer the recent AMUL trade mark issue.)

### **7) Loss of Public Recognition:**

- 25 Unless a licensor receives advertising credit for its contribution to a licensee's products or services, its contribution may be hidden. Then the benefits of public recognition, enhanced reputation, and goodwill flowing from the intellectual property may accrue to the licensee, rather than the licensor. Indeed, some licensees may use economic leverage to insist upon the right to take credit in the marketplace for intellectual property developed by their licensors.

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### 1.6 Alternatives to Licensing<sup>25</sup>:

International Licensing has its unique share of problems (most of them are disadvantages listed above and a few unique ones such as regulatory review as per foreign law!) For certain products, there may be several alternatives to the licensing of intellectual property when the legal and political environment in the foreign country makes licensing too risky. The alternatives can be discussed as follows:

**Direct foreign investment** allows maximum control over the enterprise by the IP Licensor. By investing in a wholly owned and controlled subsidiary located in the foreign country, the Licensor retains complete control of its intellectual property and is in a position to protect proprietary information. Investing in this way also bypasses import restrictions, takes advantage of cheap labor and skills, takes advantage of raw materials, and creates new markets. Many countries restrict this kind of investment especially in vital industries like transportation and telecommunications.

**Selling a turn-key package** means selling the entire technology package without breaking it up. The Licensor provides machinery, buildings, management expertise, and production plans. There is a risk of reverse engineering of coveted technology. This form of enterprise will probably work best with out-of-date first and second generation technology.

A **joint venture** is usually a long-term relationship involving the pooling of assets, joint management, profit and risk sharing, joint marketing, joint servicing, and joint production. A joint venture pools capital and corporate cultures so the partners must be fairly comfortable with each other. The players are limited so that the risk of theft of the intellectual property is minimized.

When the foreign entity simply purchases equipment, buyers make initial capital investments and then pay for the maintenance and upgrade of the purchased technology. Purchases occur continuously. The Licensor must do the work of **selling its equipment on its own** and must find a way to distribute its product. Although it may make the equipment in its own country or another country, there is still a risk that reverse engineering will occur.

Finally, the Licensor can **buy into an existing foreign corporation** thus acquiring instant market share, access to productions facilities, and a ready made distribution network. The

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<sup>25</sup> Nicolas S. Gikkas, *“International Licensing of Intellectual Property: The Promise and the Peril”*, 1

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Licensor takes the highest capital risk in this form of investment precisely because so much control is exercised by the foreign corporation. Unlike a joint venture, the Licensor is more like an investor that is betting that the company will perform well.

### 5 **1.7 Moving on....**

In this chapter we saw the basic concepts of licensing. Like all business initiatives, licensing too has its advantages, disadvantages and alternatives. The revenue generated by the companies (mentioned) does create a strong case for a Company to seriously consider IP licensing as a revenue generation avenue. The next chapter shall look at the legal and  
10 contractual aspects of a licensing agreement.

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