# The Limited Monopoly®

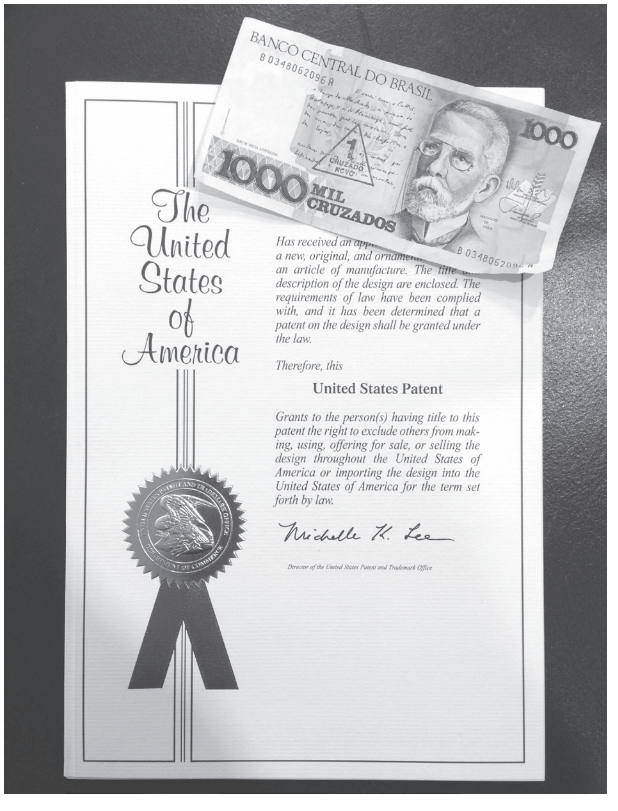
## *The Licensing and Royalty Route - One Option for Patent Monetization*

*by John Hammond, PE and Robert Gunderman, PE*

### The Concept…

The concept of a "royalty" as an economic construction has a long history. Not surprisingly, the concept relates to the use of the word to describe ancestry – "royal lineage" – and likely dates back at least several centuries, when most of the world was ruled by kings. The Merriam-Webster Dictionary lists one historical definition of the word as "a right or perquisite of a sovereign (as a percentage paid to the crown of gold or silver taken from mines)."[1] A broad definition more aligned with contemporary economics is a payment made by one party in exchange for the right to use an asset owned by another party.

Of course, there are a variety of assets for which licenses to use may be granted by their owners, including oil, gas, and mineral rights, franchise rights, and intellectual property rights. The latter category is also very broad, and includes art, music, literature, brands, and inventions. The rights to these intellectual property assets may be protected by copyrights, trademarks, and patents, and in some instances, combinations of them.




### …As Applied to Patents

Inventions are of course protected by patents. A patent is a property right – the right to exclude others from making, using, selling, or importing a covered product, or practicing a covered method in the jurisdiction (i.e. country) of issuance. A party that violates this right by performing one or more of these actions infringes the patent. Under such circumstances in the United States, the relevant statute[2] states, "A patentee shall have remedy by civil action for infringement of his patent."[3] Accordingly, the patent owner may sue the infringing party in federal court for patent infringement. If the lawsuit is successful, the "remedy" may include an order by the court for the infringing party to cease the infringing actions, and to pay monetary damages to the patent owner.

It follows that when the patent owner grants a "patent license," the patent owner grants the right to practice the patented invention, and in effect permits the party to infringe the patent, in exchange for payment of a royalty. (The royalty payment is typically monetary, but may include other considerations, including a "cross-licensing" agreement.)

It is common for patent owners and patent licensees to enter into a licensing agreement that sets forth the royalty payments and other licensing terms, before the licensee proceeds to make, use, and/or sell the patented invention. While this path is usually the most amicable arrangement, and may seem like the least stressful one to the patent owner, it is not the only path to monetization, and it also may not be the most financially rewarding one. When a party clearly infringes a strong patent that is likely to survive a validity challenge, the patent owner has considerable leverage. The infringing party has invested in the resources to make and market the claimed invention, and is at risk of the court ordering its production to be shut down, and to pay monetary damages to the patent owner.

***"By a "patent license," the patent owner grants the right to practice the patented invention, and in effect permits the party to infringe the patent, in exchange for payment of a royalty."***

Under these circumstances, the likely best course of action for the infringing party is to engage in a settlement, in which the patent owner withdraws the suit in exchange for a royalty payment (and possibly other considerations). The royalty payment may include a lump sum, as well as periodic payments for the ongoing licensing of the patent. Given the leverage that the patent owner has, the financial terms will likely be considerably more adverse to the infringing party than they would have been, had the infringing party made the effort to approach the owner upfront before proceeding to invest money and resources in the infringing actions.

Unfortunately, even by parties of good will, such diligence is not always possible. In the U.S., some patent applications are not published, and are made public record only when they issue as patents. Moreover, even when patent applications are published, there is considerable uncertainty as to whether they will issue as patents, and if so, what the scope of the claims will be. Therefore, this is simply "a risk of doing business." Best practices to minimize this risk are to use a patent alert service[4], and to know how to track the prosecution progress of a potentially blocking patent application in the USPTO via Public PAIR[5,6].

### The Art of the License

There are many terms to be negotiated when entering into a patent licensing and royalty agreement. Some of the key considerations in negotiating any agreement are the following:

• Exclusive or non-exclusive: Will you pursue licensing by only one party, or across several parties that may be in competition with each other? If you grant an exclusive license, you will likely demand a higher royalty payment, and or/more money up front, and have stringent performance standards. Since you are "tying up" your patent(s) with only one party, the latter criteria are critical. You need to be able to terminate the agreement if your exclusive licensee does not perform.

• Performance standards: These are the minimum performance standards that the licensee must meet in order to maintain the license. Key terms are a minimum amount of sales (and hence a minimum periodic royalty payment), timeliness of payments, and the ability of the patent owner to terminate the agreement if the standards are not met.

• Licensing by market sector/application: Your patented technology may be applicable across a range of market sectors that are not in competition with each other. Thus you may have the opportunity to grant exclusive licenses to a single party within each market sector.

• Licensing by geographical location: You may have the opportunity to grant separate licenses to parties in different geographic locations, particularly if you have obtained patents in multiple countries or regions.

• Royalty rates: Obviously one of the most critical considerations, royalty rates vary considerably across product and industrial sectors, based on many criteria. An important factor to consider is what exactly is being offered as part of the deal. Is it simply a patent for license? Or is the patent owner also offering to bundle other "technology transfer" content that adds value – detailed know-how, consulting support, or even a business case for commercializing the patented technology? In addition to a possible upfront payment upon execution of a licensing agreement, royalties are typically paid as a percentage of gross sales of a patented product. There are several common financial approaches in determining a possible royalty rate: Cost, Comparable Market, and Income methods. How royalty rates may be determined (or proposed in negotiations) using these methods is a subject for an entire column itself. Median royalty rates across a range of industrial sectors mostly range in the 4-6% range, although median internet and software technology royalty rates are around 11%. But the spread is huge – from a few tenths of a percent minimum to as high as 70%. Indeed, this is why due diligence by a patent owner is critical, even before contacting a prospective licensee – you must have some idea what a typical royalty rate is for a patent in your sector. (Independent inventors are often the most disappointed in this regard. Their expectations and reality often differ by an order of magnitude.)

• Licensee audits: The maxim, "Trust, but verify"[7] applies well to your licensing agreement. You will want provisions to be able to audit your licensees if you suspect that they are not being truthful in their reporting of sales of the products covered by the license agreement.[8]

• Enforcement responsibilities: For exclusive licenses, it may be possible to have the licensee carry some or all of the burden of enforcing the patent against infringers. In other cases, the licensee will demand terms for the patent owner to strongly assert the patent against any infringers. (If infringement is occurring, a licensee would reasonably ask, "Why am I paying a licensing royalty, while Bokshed Inc. is getting away with infringement scot free?"[9])

## Finding prospects

Identifying a prospective licensee, engaging with the prospect, and successfully executing a licensing agreement is a daunting task. For some patented products, such as certain consumer products, the prospective companies may be obvious. For other products and technologies, a substantial research effort will be required. Conventional internet searching, as well as a search of issued patents and published applications may provide some good leads. Again, using a patent alert service can deliver timely information on new prospect opportunities as they arise. Once an attractive prospect is identified, then sales skills are needed. You must identify the right people at the company to contact – the decision makers who could make a deal with you. You must also analyze their business, and identify the reasons why licensing your patent can help them make money.

## Closing the deal

Most importantly, you will need to track down the contact information of the decision makers at the company, contact them directly, and engage with them. Despite this being the age of tweets, texts, and e-mails, nothing is more effective than a face-to face meeting and conversation.

There are many "patent brokering" businesses that will take on these tasks, under various fee arrangements. Some require an upfront fixed fee, and a percentage of the ongoing licensing royalties, while others will take a case entirely on contingency. In many instances, it will depend upon the patent being offered for licensing. No doubt the competence and success rate of patent brokers varies widely. In a sense, if you decide to go the patent broker route, you will have substituted the need to do due diligence on a prospective licensee with the need to do due diligence on the patent broker. Regardless of which path you choose, along the way you should seek the advice of a qualified attorney[10] with expertise and experience in patent licensing agreements.

Once you have successfully closed a deal, and have a licensing agreement in place, you are still not home free. You have to collect your royalties. Compared to all of the problems solved to reach this point, this falls into the "nice problem to have" category. Don't hesitate to use your audit provisions if you must in order to solve it.

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1. **http://www.merriam-webster.com/dictionary/royalty**
2. 35 U.S.C. § 271.
3. See also additional infringement-related statutes, 35 U.S.C. §§ 281-289.
4. See ***The Limited Monopoly®***, April 2016.
5. See ***The Limited Monopoly®***, May 2006.
6. See also ***The Limited Monopoly®***, June 2010.
7. See **https://en.wikipedia.org/wiki/Trust,_but_verify** for the origin of this maxim.
8. See ***The Limited Monopoly®***, May 2011.
9. ***http://blog.oxforddictionaries.com/2015/04/scot-free-origin/***
10. Readers may contact either of the authors if a referral to a qualified attorney is needed.

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