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Patent and Technology Licensing

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BIOGRAPHICAL INFORMATION

Joseph Yang is a partner at PatentEsque Law Group, LLP, and was VP & General Counsel of Cryptography Research, Inc. until its acquisition by Rambus, Inc.

Joe specializes in structuring and negotiating IP-centric deals (patent & technology transactions, JVs, and IP aspects of M&A), and in using patents as strategic business assets. He has been lead counsel on hundreds of deals involving billions of dollars in value in the computer, electronics, semiconductor, entertainment, consumer goods, healthcare, energy & manufacturing industries. Joe has also been an expert witness, arbitrator, overseen complex patent litigation, developed & licensed worldwide corporate patent portfolios.

Joe is a recognized authority on IP law. He is profiled in Marquis "Who's Who in American Law" and "Who's Who in America," and has been named one of the "World's Leading IP Strategists" by Intellectual Asset Management magazine. Joe co-chairs the "Advanced Licensing," "Understanding the IP License," and "Advanced Patent Licensing" and courses at PLI. He has written for journals & books, and been cited by courts & treatises, on patent and licensing law. Joe is co-teaching the "Patent and Technology Licensing" course at Stanford Law School, and has previously co-taught the "Patent Law and Policy" course at U.C. Berkeley School of Law.

Before PatentEsque Law Group, Joe co-founded and later led the IP Strategy & Transactions practice in the Palo Alto office of Skadden, Arps. Before becoming an attorney, Joe was a research engineer in the aerospace and energy industries. He holds a J.D. from Stanford and a Ph.D. (in engineering) from the California Institute of Technology, where he has served on the boards of the Alumni Association, and the Caltech Associates.

The licensing of patents, either per se or as part of a broader technology licensing deal, often reveals a gap between commercial law practice and patent law practice. The corporate attorneys responsible for the company's commercial licensing activities may not have the specialized knowledge of patent law to deal with the unique issues that arise in that area. Conversely, the patent attorney managing the patent portfolio may lack sufficient familiarity with transactional practice to draft a commercial license.

This paper will attempt to bridge that gap, by exploring some common issues that arise in patent and technology licensing deals:

I. Joint Ownership

II. Technology vs. Intellectual Property

III. A Promise to Grant is Not a Grant

IV. Different Types of IP Grants

V. Enforcement Rights vs. Grant Type

VI. Change of Control

VII. Reps, Warranties & Indemnification

VIII. Unintended Grants & Consequences

IX. Royalty Provisions

X. Negotiations

I. JOINT OWNERSHIP

The most common form of IP allocation in collaborative transactions is some form of joint ownership. This is because joint ownership is *perceived* to be a "fair" solution for situations involving multiple contributors. Unfortunately, many business people (and even experienced counsel) lack an in-depth understanding of what joint ownership really means yet are accepting of it because "it's always been done that way." In practice, joint ownership is fraught with pitfalls for the unwary. Contrary to common perception, it is often unfair and, even worse, is usually unworkable.

A. Jointly Owned U.S. Patent

For example, consider a U.S. patent. The default rule is that each joint owner can exploit the patent without permission of the other joint owners. 35 USC 262. Further, the exploiting joint owner has no duty

to share royalties with any other joint owner. Conversely, to enforce the patent, all the joint owners must normally join the suit.[2]

What happens when one joint owner wants to license a third party? A savvy third party will play the joint owners off against each other, to get the sweetest deal. Conversely, if one joint owner wants to sue (rather than license), any other joint owner can cut off the suit by granting a license or by refusing to join. Either way, the result is often a "race to the bottom" scenario that minimizes, rather than maximizes, the value of the jointly owned patent. It is no wonder that courts have characterized patent joint owners as being "at the mercy of each other."[3]

B. Jointly Owned U.S. Patent and U.S. Copyright

The situation becomes even more complicated if multiple IP types are involved, each with differing default rules.

For example, contrary to the U.S. patent rule, in the case of a jointly owned U.S. copyright, each joint owner can exploit without the permission of, but has a duty of accounting to, the other joint owners. See, e.g., *Richmond v. Weiner*, 353 F.2d 41, 46 (9th Cir. 1965), *cert. denied*, 384 U.S. 928, *pet'n. reh'g. denied*, 384 U.S. 994 (1966); and *Shapiro, Bernstein & Co.*, 221 F.2d 569, 571 (2nd Cir.), *mod'd. on rehearing*, 223 F.2d 252 (2nd Cir. 1955).

What happens when software covered by both patent and copyright is licensed by a joint owner? How can the joint owners determine which fraction of the software is exempt from royalty-sharing under U.S. patent law, and which is subject to royalty-sharing under U.S. copyright law? After all, the commercial product (the software) itself is indivisible.

C. Jointly Owned Foreign IP Assets

The situation is even more complicated when the same IP asset is protected in multiple jurisdictions, because different countries have different default laws, regarding joint ownership, of the same type of IP asset.

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2. In a recent controversial case (*Utah*, infra), the Federal Circuit may have created an exception to this rule. But the answer is far from clear, and other Federal Circuit cases (including subsequent to *Utah*) continue to follow the traditional rule requiring joinder under all circumstances.
3. See, e.g., *Willingham v. Loughton*, 555 F.2d 1340, 1344 (6th Cir. 1977).

By way of example, Table 1 illustrates the rights to exploit patents and copyrights in the United Kingdom[4] and Japan[5,6] compared to the United States.

As the table shows, the joint owners' rights in foreign IP assets may be the same as, somewhat different than, or entirely different than their rights in the U.S. IP assets. So, joint owners will be faced with the prospect of operating under a patchwork of default rules, covering the same basic IP asset (and the same commercial product covered by those IP assets) in many different countries.

An even more insidious problem occurs when parties from different countries attempt to negotiate a JV agreement involving joint ownership without specifying in detail what they really mean. Each party, operating from its own perspective, is likely to have a different view of joint ownership than the other. For example, in the case of copyrights, an American will interpret joint ownership as giving the joint owners complete freedom of operation, whereas an Englishman will interpret joint ownership as giving the joint owners no freedom of operation. One may even wonder whether the agreement is even valid, if there was no meeting of the minds on this issue when it was negotiated.

	Patent		Copyright	
	Right to Exploit for Self (e.g., use in own business)	Right to Exploit for Third Parties (e.g., grant licenses)	Right to Exploit for Self (e.g., use in own business)	Right to Exploit for Third Parties (e.g., grant licenses)
United Kingdom	Do not need permission of other joint owners [LIKE U.S.]	Need permission of other joint owners [UNLIKE U.S.]	Need permission of other joint owners [UNLIKE U.S.]	Need permission of other joint owners [UNLIKE U.S.]
Japan	Do not need permission	Need permission of other	Need permission of other joint	Need permission of other joint owners, but they

4. Information courtesy of U.K. attorney Alastair Breward, Esq., of Taylor Wessing.
5. Copyright information courtesy of Japanese attorney Yoshikazu Tani, Esq., of Tani and Abe.
6. Patent information from Kenichi Nakano, "Patent Rights of Co-Owners in Japan," *Les Nouvelles* (Journal of the Licensing Executives Society), March, 2000, pp. 48-53.

	of other joint owners [LIKE U.S.]	joint owners [UNLIKE U.S.]	owners, but they cannot unreasonably withhold permission [INTERMEDIATE BETWEEN U.S. and U.K.]	cannot unreasonably withhold permission [INTERMEDIATE BETWEEN U.S. and U.K.]
United States	Do not need permission of other joint owners	Do not need permission of other joint owners	Do not need permission of other joint owners	Do not need permission of other joint owners

Table 1 – Comparison of Right to Exploit Jointly Owned IP in U.S., U.K. and Japan

Also, parties in different countries – looking at joint ownership through the prism of their individual national laws – may have entirely different expectations of what it means to be a joint owner. So, for a product that is intended to be sold worldwide, the parties' legal rights and obligations with respect to exploitation and enforcement of the underlying IP may vary from country to country.

D. Contractual Provisions

Sometimes, the parties are aware of these difficulties, and draft their JV[7] agreement to include contractual provisions setting forth their rights and obligations regarding exploitation, and enforcement, of the jointly owned IP.

However, it is questionable whether these agreements are enforceable against third parties. For example, suppose the agreement prohibits selling products to a third party, yet one of the joint owners does so in violation of the covenant. The third party may be protected as a bona fide purchaser for value.

7. Here, "JV" is used in a general sense to refer to any relationship where two or more parties collaborate to develop IP that pertains, in some way, to their respective business. The relationship may be purely contractual (sometimes referred to as a strategic alliance), the parties may be members in a formal joint venture company (typically a LLC), or there may be some combination of the foregoing.

Even worse, in some cases, these agreements may not even be enforceable against the parties themselves. For example, if the JV agreement allocates newly developed IP as either solely v. jointly owned, but a patent filing commingles claims that should be solely owned with other claims that should be jointly owned, then the entire patent will be jointly owned. *Lucent v. Gateway*, 543 F.3d 710 (Fed. Cir. 2008)

E. Alternatives to Joint Ownership

In light of the foregoing, where possible, it is advisable to refrain from creating joint ownership in the first instance. Instead, one should consider allocating the IP rights to one of the participants (in a contractual joint venture) or to the joint venture itself (in an entity based joint venture). The IP owner can then grant specific field of use licenses to the participants to meet their individual needs. For a detailed discussion of IP allocation alternatives, see Joseph Yang, "What Corporate Counsel Should Know About IP Planning for Technology-Driven Alliances," *The Practical Lawyer*, February & April, 2005.

II. TECHNOLOGY vs. INTELLECTUAL PROPERTY

Business people, and even lawyers, frequently believe that "technology" is interchangeable with "intellectual property." Thus, one often sees contractual definitions such as:

> "Inventions" means all computer code, inventions, processes, patents and copyrights."

The foregoing fails to recognize that technology is a <u>thing</u>, while IP is a <u>legal right</u>. Failure to make a distinction between the two leads to ambiguity in the meaning of the contractual provisions. For example, the licensor may only have intended to grant the right to use the grantor's software inventions. However, by granting rights under a definition of "Inventions" that also includes patents, the license includes anything covered by the patent, even software that did not come from the licensor itself. Conversely, a warranty that "The use of the Invention does not infringe another party's intellectual property right" is equivalent to saying that owning a patent guarantees the right to practice the invention covered by the patent. This is obviously false.

Rather than using a single definition that includes both "technology" and "IP," a skilled attorney will separate the two. "Technology" should refer only to tangible and intangible things, for example, processes, techniques,

know-how, algorithms, software, content, data, databases, protocols, manufacturing processes, business or legal plans, etc. "IP" should refer only to legal rights, such as patents, copyrights, trade secrets & trademarks; and registrations of, applications to apply for & priority rights based on, the foregoing.

Having cleanly separated "technology" from "IP," one can then make a precise and unambiguous grant. In general, the grants will be of three types: (1) a pure technology grant; (2) a pure IP grant; or (3) a composite grant.

A. Pure Technology Grant

A pure technology grant is appropriate for a finished product, or other situations involving pure technology transfer. For example: "I license you to operate my car." The scope of this license is limited to the particular technology described in the grant. It carries an implied license, under all IP owned or licensable by the licensor, to utilize such technology.

B. Pure IP Grant

At the other extreme, a pure IP grant is appropriate when there is no tech transfer. For example, the license might be in settlement of patent litigation where the licensee's (use of its) own technology infringes the licensor's patents. A pure IP grant might be of the form: "I license you to make and sell products and processes covered by U.S. patent no x,xxx,xxx)."

C. Composite Technology and IP Grant

For all other kinds of licenses, one should be very specific, and address the following 8 factors in the license grant: (1) transferability (i.e., whether the license is personal or transferable[8]); (2) exclusivity (i.e., whether the grant is exclusive or nonexclusive); (3) the relevant IP type (i.e., patent, trade secret, copyright or trademark); (4) the corresponding grant verbs[9] (e.g., for patents: the right to make, use, sell,

8. Case law shows that, absent a provision to the contrary, IP licenses are by default (i.e., if silent as to transferability) personal to the licensee.
9. It is important to use the proper grant verbs for the particular IP asset type, to avoid ambiguities during interpretation. For example, what does it mean to grant the right to "create derivative works" under a patent? Should that be interpreted as a combined patent and copyright license? If so, under what copyrights? And what acts are

offer for sale, and/or import) (e.g., for copyrights: the right to reproduce, distribute, perform, display, and/or create derivative works); (5) the technology; (6) the licensed field; (7) the territory; and (8) the term of the license (which may or may not be the same as that of the license agreement itself). For example, a certain patent license for the automobile industry might read: "I grant you a personal nonexclusive license under U.S. patent 7,654,321 to make and use widgets in the automobile industry in the U.S. until 12/31/15."

By clearly distinguishing IP from technology, and crafting precise license grants, one can eliminate much of the differences in interpretation that lead to disputes and litigation.

III. A PROMISE TO GRANT IS NOT A GRANT

A. Mere Promissory Language

Another common mistake is use of mere promissory language, rather than an actual grant. This most commonly arises in development agreements where some future-arising (i.e., not yet developed) IP asset is to be assigned[10] to one of the parties. Typical examples of such language include: "I will assign"; "You shall own"; or "I agree to assign."

All of these are ineffective to transfer title in the purportedly assigned asset. Rather, the language merely expresses a promise that the grantor will (at some future time) convey title to the grantee. See, e.g., *IPVenture v. Prostar*, 503 F.3d 1324 (Fed. Cir. 2007) (employee assignment agreement did not contain an effective assignment), and *Stanford v. Roche*, 583 F.3d 832 (Fed. Cir. 2009). If the asset is a patent, since under 35 USC 261 the transfer will have to be in writing, another separate grant will be required.

B. Bona Fide Purchasers for Value

Even worse, the promise can be rendered impossible to fulfill if the grantor makes an intervening conveyance to a third party after making the promise but before effecting the conveyance. This is the

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authorized under the patent? Or should it be interpreted as a pure copyright license, with no patent license component? Or as a pure patent license under the most closely corresponding patent verbs (if one can even agree what those should be)?

10. The problem is not restricted to assignments, but also applies to license grants as well.

so-called *bona fide purchaser for value* problem. See, e.g., *Film Tec*, 939 F.2d 1568 (Fed. Cir. 1991).

C. "I hereby assign …"

The proper way to make such a conveyance is to use a present assignment of future rights. For example: "I hereby assign to you all patents that may be developed in the course of the collaboration." Under *FilmTec*, this type of grant conveys *equitable title* at the time of grant (even as to a not-yet existing patent), and the equitable title automatically converts to *legal title* when the patent (or patent application) comes into existence.

IV. DIFFERENT IP GRANT TYPES

Another common mistake is attempting to make a particular form of grant, coupled with restrictions that are legally incompatible with that form of grant.

A. Labels are Not Determinative

In general, courts are not bound by the parties' characterization of the form of a grant. Rather, they will examine the characteristics of the grant to determine what was actually intended. Thus, labels are not determinative, and the courts will correct inappropriate usage by attempting to divine the intent of the parties. What results often favors one party at the expense of the other – and in that respect will be contrary to what at least one of the parties intended!

B. IP Grant Types

In general, there are four types of IP grants: (a) an assignment (e.g., conveyance of ownership); (b) an exclusive license; (c) a nonexclusive license; and (d) a covenant not to sue. Each of these grant types is characterized (indeed, defined) by a certain set of attributes. These will be explained below, using patent law precedent as an example.

1. Assignment

An assignment is a conveyance of ownership (i.e., a transfer of title), which could include: (i) the entire right title and interest; or (ii) an undivided interest in the foregoing. The former creates a succession of ownership. The latter creates joint ownership. See, e.g.,

Rite-Hite, 56 F.3d 1538 (Fed. Cir. 1995) and *Waterman*, 138 U.S. 252 (1890).

The assignee, as an owner of the patent, has the right to sue others for infringement of the patent, and/or to license others to practice the patent.

Significantly, one cannot assign a patent on a claim-by-claim basis, or by field of use. See, e.g., *Pope*, 144 U.S. 248 (1892), *Intl. Gamco,* 504 F.3d 1273 (Fed. Cir. 2007), and *Lucent v. Gateway*, supra. Thus, assignment of a patent must be of an *undivided interest*.

An assignment can be effected: (1) formally, by a transfer of title (e.g., a bill of sale); or (2) informally, if the court finds that there has been a transfer of "all substantial rights" in the patent.

Thus, for example, the courts have reinterpreted grants that were nominally exclusive licenses to be *de facto* assignments – to the benefit of the grantee, and to the detriment of the grantor. See, e.g., *Vaupel*, 944 F.2d 870 (Fed. Cir. 1991).

Conversely, the courts have also reinterpreted grants that were nominally assignments to be *de facto* exclusive licenses – to the benefit of the grantor, and to the detriment of the grantee. See, e.g., *Abbott*, 47 F.3d 1128 (Fed. Cir. 1995).

Factors courts consider in determining whether a nominal exclusive license is really a de facto assignment include: (a) the nature and scope of the grantor's v. grantee's right to sue (which is often the most important factor); (b) the grantee's right to sublicense; (c) reversion of rights to the grantor upon breach; (d) the grantor's right to a portion of litigation recoveries by the grantee; (e) the duration of the grant; (f) the grantor's ability to supervise/control the grantee's activities; and (g) limitations on the grantee's ability to further assign its rights. See *Mann v. Cochlear* (Fed. Cir. 2010).

2. Exclusive License

An exclusive license is a lesser form of grant than assignment. By "exclusive," the courts mean that the grantor has expressly or impliedly promised that others shall be excluded from exploitation within the exclusive area. See, e.g., *Rite-Hite*, 56 F.3d 1538 (Fed. Cir. 1995) and *Waterman*, 138 U.S. 252 (1890).

As a corollary, the exclusive licensee must have the right to prevent others from making/using/selling in the exclusive field. See, e.g., *Ortho*, 52 F.3d 1026 (Fed. Cir. 1995). Thus, a true exclusive licensee necessarily has standing to sue infringers in the exclusive field – whether or not the agreement so states. *Ortho*, supra.

The exclusivity is usually not unrestricted for then the purported exclusive license might actually be in the nature of a transfer of all substantial rights (i.e., an assignment). Rather, the exclusivity if expressed in geographic, temporal, and/or field of use terms. See, e.g., *Amgen*, 808 F.Supp. 894 (D. Mass. 1992).

3. Nonexclusive License

The next smaller form of grant is a <u>nonexclusive license</u>. A nonexclusive license embodies the notion of freedom to operate (as opposed to freedom to exclude). It is basically a promise that the patentee – as well as the patentee's successors in interest – will not sue the nonexclusive licensee under the patent. Thus, a nonexclusive license is an *encumbrance* on the patent, and binds future assignees of the patent as well.

4. Covenant Not to Sue

The smallest form of grant is a <u>covenant not to sue</u>. Like the nonexclusive license, it represents a promise that the patentee will not sue the grantee. However, the promise does not run with the patent, so that future assignees are not so bound. Covenants not to sue are frequently used by patentees who wish to preserve their right to sell their patents free of encumbrances.

V. ENFORCEMENT RIGHTS vs. GRANT TYPE

Another common mistake is attempting to grant enforcement rights that are inconsistent with the grant type. Many otherwise knowledgeable counsel believe that one can first specify the type of grant, and then separately specify the enforcement rights (i.e., degree of standing to sue) of grantee. This is incorrect. Enforcement rights are not independent of the grant type. Rather, the degree of one's standing to sue necessarily follows the grant type one has received. This will be explained below, using patent law precedent.

A. Patentees and Assignees

In general, the patentee and its successors in title (i.e., assignees) have the right to sue. See, e.g., 35 USC 281 and 35 USC 100(d).

An infringement suit is a legal remedy, thus, the plaintiff must hold legal title at time of suit. See, e.g., *Arachnid*, 939 F.2d 1574 (Fed. Cir. 1991). Accordingly, an assignee of a patent cannot sue for past damages (i.e. prior to the date of assignment) unless the assignor also expressly conveys that right. *Minco*, 95 F.3d 1109 (Fed. Cir. 1996). A *nunc pro tunc* ("now for then") agreement made post-suit, but purportedly effective pre-suit, is ineffective. *GAIA*, 93 F.3d 774 (Fed. Cir. 1996); *Abraxis Bioscience v. Navinta*, 625 F.3d 1359 (Fed. Cir. 2010).

B. Exclusive Licensees

Exclusive licensees also have the right to sue, but only in connection with the patent owner. See, e.g., *Ortho*, 52 F.3d 1026 (Fed. Cir. 1995). More specifically, the exclusive licensee must file suit in the patentee's name, and therefore must join the patentee in any litigation. See, e.g., *Ortho*, supra, and *Arachnid*, 939 F.2d 1574 (Fed. Cir. 1991).

However, as discussed in Section IV above, one cannot deprive a (true) exclusive licensee of standing to sue. Any attempt to do so is likely to result in either: (a) the nominal exclusive license being construed as a nonexclusive license (in order to preserve the no-right-to-sue clause); or (b) a right to sue being imputed (in order to preserve the status as an exclusive license).

C. Nonexclusive Licensees

In contrast, a nonexclusive licensee has no (and cannot be given any) standing to sue.

D. Practice Tips

Thus, as a practice, tip, watch for inconsistent enforcement clauses, such as: (i) retaining control (by the assignor); (ii) inhibiting control (by the assignee or exclusive licensee); or (iii) improperly granting control (to a nonexclusive license). In each case, the courts will reinterpret grant type and/or enforcement right to be consistent with each other.

E. Joinder

A related issue is that of joinder. As noted above, joinder is normally required of all parties having standing to sue, such as owners and exclusive licensees. The reason is twofold: (a) to protect an absent party, who has an interest in the patent, from being impacted by an adverse

decision (e.g., a successful invalidity counterclaim) in a litigation in which the absent party did not participate; and (b) to prevent the defendant from suffering a later suit, on the same patent, by the absent party.

Thus, it is advisable for owners and exclusive licensees to obtain covenants of joinder from the each other. In practice, one sometimes finds that large companies often prefer to be involuntarily joined, particularly where there is a benefit to being able to portray the company as non-litigious. That does not necessarily mean that the large company is unwilling to sue, only that it wants to maintain a public perception of having been dragged into the litigation against its will – via the exercise of involuntary joinder.

However, one should be aware that the rules for involuntary joinder may vary from jurisdiction to jurisdiction. The classic (and seminal) court case (*Independent Wireless,* 269 U.S. 459 (1926)) permits joinder whether or not the party is subject to service of process. The modern rule of civil procedure (Rule 19) states that a party may be involuntarily joined when subject to service of process. It is not surprising that district court interpretations are mixed.

The foregoing states the general principles regarding joinder. As with any rule, there can be exceptions. Until 2013, the only known exception involved a unique fact pattern where the patentee and the exclusive licensee were under common control. Specifically, in *Dainippon v. CFMT*, 142 F.3d 1266, 1269 (Fed. Cir. 1998), the (original) patetee formed a patent holding company as a wholly owned subsidiary, and assigned patents to it. The holding company (which became the patentee) then exclusively licensed the patents back to the parent (which became the exclusive licensee). During litigation (e.g., a DJ defense) by the exclusive licensee (i.e., parent), the patentee (i.e., holding company) was found to be not indispensable, and not necessary be joined, since it was wholly controlled by, and thus its interests were fully represented by, the litigating parent.

But in 2013, another case took the limited *Dainippon* exception into a much broader fact pattern, with significant implications for licensing. In *Utah v. Max-Planck* (Fed. Cir. Aug. 9, 2013), a case which goes against the weight of authority and muddies the water, the majority held that patent joint owners should be joined if feasible, but they are not necessarily indispensible under Rule 19. In *Utah*, the majority held that there is no patent-specific exception to Rule 19's general requirement to conduct an indispensability analysis, and that the missing joint owner's interest was adequately represented because: (a) the other owners

were participating in the litigation; (b) those joint owners were represented by joint counsel; and (c) the missing joint owner contractually ceded control of the litigation to one of the participating joint owners. It is difficult to see how a first joint owner ceding control to a second joint owner shows that the first joint owner's interests are adequately represented. Indeed, many observers would say that the first joint owner's interests were not represented at all, but simply waived. And even if the missing joint owner had been willing to entrust control of enforcement to another joint owner, that does not necessarily imply a willingness to cede the defense of counterclaims of invalidity (which was one of the classic reasons for joining joint owners).

One implication of *Utah* is that parties to an agreement will need to draft more carefully (and in more detail) to effectuate the desired outcome regarding joinder, while at the same time increasing the likelihood that their contract will be second guessed by a court during litigation. Indeed, the *Utah* dissent argued that the majority decision was wrongly decided, not only legally, but also factually, because (according to the dissent) the missing joint owner's ceding of control was conditional, not absolute.

It remains to be seen whether *Utah* is good law. The critical question is whether (as many observers had believed), because of the special nature of patents, there is effectively a *per se* rule that joint owners (and patentees and exclusive licensees) are indispensable, or conversely, whether indispensability should be evaluated on a case-by-case basis.

The answer is far from clear. Indeed, a recent Federal Circuit case, post-*Utah* takes the traditional view that joint owners are all indispensable.[11] In *STC.UNM v. Intel* (Fed. Cir. Jun. 6, 2014), the majority opinion held that the default rule is that a joint owner has the absolute right to refuse to join a litigation of the jointly owned patent. Therefore, unless the joint owner has waived that right, it cannot be joined (even involuntarily under Rule 19) and the suit cannot proceed. That is, a joint owner's right to refuse to join – being a substantive right under patent law – trumps involuntary joinder under Rule 19, which is merely procedural.

Although *STC.UNM* reiterates the traditional view regarding joinder of joint owners, the opinion also created a potential controversy (or valuable clarification, depending on one's perspective) regarding joinder in exclusive license cases. In dicta, the majority opinion noted that

11. The majority opinion in *STC.UNM* did not use the term "indispensable" but it was clearly implied.

in those cases, the patent owner-licensor stands in a position of trust to the exclusive licensee, and therefore cannot refuse to be joined in a suit by the exclusive licensee.

VI. CHANGE OF CONTROL

Another common mistake is failure to adequately plan for change of control, particularly of the licensee.

This issue most often comes up in the context of mergers and acquisitions. For example, if a licensee believes it may one day be acquired, it may wish for its inbound IP licenses to pass to the acquiror. Conversely, the licensor may wish for those licenses to be extinguished.

In many areas of the law (other than IP), common law favors the free alienability of assets. Thus, many forms of (non-IP) inbound agreements are expressly transferable to an acquiror unless there is an express prohibition to the contrary. This general principle finds an exception in the case of IP.

The federal courts have consistently held that inbound licenses to federal IP rights (e.g., patents or copyrights) are, by default (i.e., when silent as to transferability), non-transferable by the licensee.[12] This, of course, would be the same outcome as if the agreement contained an express anti-transfer[13] provision.

It is important to recognize that some types of M&A transaction structures effect a transfer, while others do not.

A. Deal Structures Effecting a Transfer

More specifically, the following transaction types – in which the original licensee no longer holds the contract after the transaction – do constitute a transfer: (a) a forward merger (i.e., target disappears into the acquiror, which survives the merger); (b) a forward triangular

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12. A possible exception: A California appellate court has held that, under California law, an inbound patent license is, by default, transferable by the licensee. *SuperBrace v. Tidwell*, 2004 WL 2668306 (Cal. App.4th, Nov. 23, 2004). The author believes that this is an aberration, and that most courts will follow the overwhelming line of cases to the contrary (holding that inbound licenses are nontransferable).
13. Frequently loosely expressed as an "anti-assignment" provision. Such common usage is, technically speaking, incorrect. As a matter of proper legal terminology, one assigns one's rights, and/or delegates one's obligations. A complete assignment of all rights, and delegation of all obligations, is more properly called a transfer of the agreement.

merger[14] (i.e., target disappears into the acquiror's subsidiary, which survives the merger); and (c) an asset sale.

B. Deal Structures Not Effecting a Transfer

Conversely, the following transaction types – in which the original licensee still holds the contract after the transaction – do not constitute a transfer: (a) stock sale (i.e., where the target simply gets new owners); or (b) a reverse triangular merger[15] (i.e., acquiror's subsidiary disappears into the target, which survives the merger but in the process becomes a wholly owned subsidiary of the acquiror).

Thus, from the licensee's perspective, a license agreement that contains an express anti-transfer provision (or is silent as to transferability) can be continued for the benefit of the acquiror, by structuring the transaction as a stock sale, or as a reverse triangular merger.[16] Indeed, a majority technology transactions, involving licenses that cannot be freely transferred, are structured in this manner to avoid triggering the anti-transfer clauses.

C. Broad "Deemed Transfer" Provisions

Conversely, from the licensor's perspective, in order to prevent the license agreement from continuing for the benefit of the acquiror, the usual form of anti-transfer language should be expanded to encompass the stock sale and reverse triangular merger exceptions: *"This Agreement may not be transferred (and no rights hereunder may be assigned, and no obligations hereunder may be delegated) without the express written consent of the licensor, and any such attempted assignment, delegation or transfer shall be void. For the purposes of this provision, any form of change of control of the licensee shall be deemed an impermissible transfer, whether or not such change of control would otherwise be deemed a transfer under applicable law*."

14. Also known as a forward subsidiary merger.
15. Also known as a reverse subsidiary merger.
16. *MesoScale v. Roche* (Del. Ch. Feb. 22, 2013) (RTM does not trigger anti-"assignment" clause; follow-on to the court's 2011 decision in the same case denying MTD to study if RTM was assignment by operation of law). For completeness, the author notes one possible exception in California (believed to be an aberration). In *SQL Solutions v. Oracle*, 1991 WL 626458 (N.D. Cal. 1991) (unreported case), the court held that a reverse triangular merger triggered an anti-transfer clause, where the transaction resulted in the transfer of a copyright (or patent) license from the licensor to a competitor of the licensor. To the author's knowledge, no other court has ever followed this case (but it also has not been overruled).

The last sentence ("*For the purposes of this provision ...*") is what prevents the use of reverse triangular mergers or stock sales from escaping the anti-transfer clause. One might ask why this matters, since either way (transfer or not), the transferring party would still hold the agreement. The idea is to make violation of the clause a breach of the agreement, giving the non-transferring party the ability to terminate for breach.

The last part of the first sentence ("... *shall be void*") is necessary in those jurisdictions following *Rest. 2d Contracts, 322(2)(b)*, which provides that a violation of an anti-assignment provision gives rise to damages for breach, but that the assignment is not effective.

D. Bankruptcy Concerns

A related issue arises in the context of bankruptcy. May agreements include a provision that the rights granted will automatically terminate (or that the licensor has the right to terminate) upon bankruptcy of the licensee. This so-called *ipso facto* clause is, in fact, unenforceable.

1. General Principles

The ability to terminate the license is vested not in the licensor, but in the bankruptcy trustee,[17] who has the broad power to *reject* or *assume* any executory contract. See, e.g., 11 USC 363(1), 365(e)(1), 365(f)(1), 365(f)(3) & 541(c)(1)(B). Most IP licenses are executory by virtue of continuing obligations on both sides (e.g., the licensee's obligation to make reports, the licensor's obligation not to sue the licensee, etc.). See, e.g., *Lubrizol*, 756 F.2d 1043 (4th Cir. 1985); cert. denied, 475 U.S. 1057 (1986).

A rejection of the license abandons it (usually against the wish of the licensee, when the licensor is bankrupt), so that the trustee may increase the value of the underlying IP asset (by disencumbering it) prior to sale.

An assumption of the license effectively keeps it alive (usually against the wish of the licensor, when the licensee is bankrupt), so that it may remain for the benefit of the licensee, or be sold by the trustee to a third party to generate revenue to pay creditors.

The trustee's broad power of rejection or assumption is a starting point for the analysis of bankruptcy issues. However, the analysis must also take into account exceptions protecting both the licensor and the licensee.

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17. Or the debtor-in-possession in a reorganization.

2. *Exception Protecting the Licensor*

Under the exception protecting the licensor (e.g., when the licensee is bankrupt), the trustee may not assume and then assign the agreement when non-bankruptcy law excuses accepting performance from an entity other than the original licensee. 11 USC 365(c). As mentioned in Section II above, absent a provision permitting free transferability by the licensee, federal IP licenses are personal to the licensee, so that the licensor need not accept performance from other than original licensee. Thus, such a license cannot be assumed and assigned by the trustee.

3. *Exception Protecting the Licensee*

Under an exception protecting the licensee (e.g., when the licensor is bankrupt), the licensee may overcome that trustee's rejection of the license by invoking the protection of 11 USC 365(n). In that case, after the trustee rejects the license, the licensee has a choice of either: (1) treating the license as terminated and seeking a remedy for breach; or (2) electing to retain its IP license. If the licensee elects to retain, it must continue to pay royalties to the licensor.

VII. REPRESENTATIONS, WARRANTIES & INDEMNIFICATION

Representations, warranties and indemnification provisions serve as a risk allocation mechanism. For example, the licensor might be liable if the use of its technology infringes a third party's intellectual property rights.

A. Patents vs. Non-Patent Infringement

The licensor should, whenever possible, distinguish between guarantees with respect to patents versus other types of IP rights (such as copyrights and trade secrets).

In the case of copyrights and trade secrets, independent development is a complete defense to infringement or misappropriation. That is, one is guaranteed the right to use one's own work, provided that it was developed without access to others' works.

In contrast, patent infringement is a strict liability doctrine, i.e., one can infringe patents one does not even know about (and therefore had no access to), even if the infringing work was completely independently developed.

Furthermore, it is impossible to do an exhaustive patent search to identify the areas of risk, because pending patent applications are

secret for the first 18 months after they are filed. Even if this were not the case, an exhaustive patent search is also impractical, because many products are covered by so many patents (e.g., a personal computer would, absent a license, probably infringe tens of thousands of patents).

For these reasons, licensors should resist giving guarantees against patent infringement wherever possible.[18]

B. Limiting the Scope of the Guarantee

If a patent guarantee must be given, the licensor should negotiate for a guarantee that includes a closed universe of patents, rather than one that grows over time. For example, the licensor could limit the guarantee "as of the effective date,"[19] or to patents within the licensor's knowledge.[20]

The licensor can also negotiate for provisions permitting the licensor to ameliorate the infringement, for example, by: (a) replacing the infringing technology with a noninfringing substitute; (b) modifying the infringing technology to be noninfringing; (c) obtaining a license; and/or (d) if the foregoing are impracticable, refunding a pro rata portion of the license fees and terminating the license.

The licensor can further reduce its risk by disclaiming any liability to the extent resulting from: (i) use of the licensed technology outside the scope of the license; (ii) modification of the technology by the licensee; (iii) combination of the technology with subject matter not provided by the licensor; (iv) use of the technology with subject matter not approved by licensor; or (v) use of other then the latest version of the technology available from the licensor.

Finally, the licensor can negotiate for a cap on liability, either in absolute terms, or as a multiple of revenues.

All of the foregoing will serve to limit the licensor's liability generally, whether as to patent or non-patent infringement.

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18. Sometimes this guarantee is cast in terms of "sufficiency": The licensor guarantees that it has sufficient IP rights to allow the use of the licensed technology. This is nothing more than a noninfringement guarantee in disguise.
19. Conversely, the licensee will want to negotiate for a guarantee that the use of the licensor's technology "does not and will not" infringe any past, present or future patents.
20. Excluding patents where the knowledge is received from the licensee (e.g., by forwarding third party threat letters).

VIII. UNINTENDED GRANTS OR CONSEQUENCES

A recurring theme of this paper is precision in defining the scope of the licensor's grants to the licensee. Sloppy drafting is probably the most common cause of unintended grants.

Another cause is failing to understand the various legal doctrines under which rights may be imputed by the courts. The most well known is the implied license, and most agreements now include a boilerplate disclaimer of implied licenses. However, that may not be enough. Still other legal doctrines that arise independently of contract law.

A. Equitable and Legal Estoppel

For example, recall the classic doctrine of <u>equitable estoppel</u>, which entails misleading conduct by the plaintiff, <u>reliance</u> by the defendant, and material prejudice to the defendant. See, e.g., *Aukerman*, 960 F.2d 1020 (Fed. Cir. 1992) (en banc). The equitable estoppel doctrine has been used to prevent a patent licensor from enforcing their rights in areas that were not expressly licensed to the licensee. The estoppel can happen in a very short time. *Aspex v. Clariti*, 605 F.3d 1305 (Fed. Cir. 2010) (aggressive notice letters followed by 3-year silence).

A related doctrine which is much less well known, but which can pose risks in the patent licensing area, is known as <u>legal estoppel</u>. Here, the licensor grants a license (e.g., under a first issued patent), and later attempts to interfere with the licensee's enjoyment of that license (e.g., by asserting an later issued but related patent). See, e.g., *Spindelfabrik*, 829 F.2d 1075 (Fed. Cir. 1987), *Transcore v. Electr. Trans. Cons.*, 563 F.3d 1271 (Fed. Cir. 2009).

In *Transcore*, the court found estoppel notwithstanding a short form disclaimer of all rights not expressly granted. In many license agreements, a typical short form disclaimer might read something like this: "*No rights may arise by implication, other than those expressly granted herein.*" In light of *Transcore*, it may be advisable (at least for the licensor) to beef up the disclaimer should more completely state: "*No rights may arise by implication <u>or estoppel</u>, other than those expressly granted herein*." Even so, there is guarantee that this will be enough to keep the courts from finding equitable rights, given how aggressively the courts have been doing so in recent years.

B. In Recent Years, Courts Have Repeatedly Found New Rights for Licensees Beyond Those Expressly Granted

Some examples are as follows:

1. Continuation Patents

In one case, the Federal Circuit held that continuation patents are both subject to legal estoppel, and also impliedly licensed, when the parent patent is licensed, absent a clear mutual intent to the contrary. *General Protecht v. Leviton*, ___ F.3d ___ (Fed. Cir. 2011).

2. Reissue Patents

In another case, "Licensed Patents" were defined as all patents which licensor owns, controls or has right to license on the effective date, or during the term, of the license agreement. After the agreement expired, the patentee was granted reissue patents on some of the Licensed Patents. These were obviously not included in the grant (since the failed the capture period criteria), yet the Federal Circuit found they "should be treated" as such because of the parties' "intent." Significantly, the necessary intent was inferred from nothing more than existence of the U.S. patent reissue statute. *Intel v. Negotiated Data Solutions*, 703 F.3d 1360 (Fed. Cir. 2012)

3. Have Made Rights

In another surprising case, the Federal Circuit has held that granting the right to make, use and sell inherently includes a "have made" right, even where there was a broad (but non-specific) contractual disclaimer of all rights not expressly granted, absent evidence of (apparently, specific) contractual intent to negate the have made right. *Corebrace v. Star Seismic*, 566 F.3d 1069 (Fed. Cir. 2009).

4. Wiping Out "No Challenge" Provisions After M&A

In another surprising case, a defendant in a patent litigation obtained a license to the patent pursuant to a settlement agreement. As part of the settlement, the licensee agreed not to challenge the validity of the patent. Consistent with common licensing practice, the agreement permitted transfer of the license to an acquiror of the licensee, as long as the acquiror generally agreed to accept all of the

obligations of the licensee. The Federal Circuit held that the no-challenge covenant did not apply to the part of the acquiror's business not arising from the acquired original licensee. This, of course, effectively wiped out the covenant by holding it inapplicable to the new parent. *Epistar v. ITC and Philips Lumileds*, 566 F.3d 1321 (Fed. Cir. 2009).

5. Grants to Unintended Subsidiaries

In another (and somewhat unusual) license agreement, the term "Subsidiary" was defined as including any entity that the licensee "now or hereafter" controlled. The agreement had a fixed expiration date, but its patent licenses survived for the life of the patent. In that case, the Federal Circuit held that subsidiaries of the licensee, acquired after the expiration date, were also licensed. *Imation v. Philips*, 586 F.3d 980 (Fed. Cir. 2009).

6. A Possible Exception to the Trend

As the foregoing shows, the recent trend at the courts is clearly anti-patentee (or pro-licensee). However, there is one recent exception.

In the *Endo v. Actavis* (Fed. Cir. 2014), the patentee asserted its later (non-continuation) patents against a licensee of the patentee's original patents. The license agreement contained a short form disclaimer. This time, the Federal Circuit held: "*You get what you bargain for. And we will not use the implied license doctrine to insert ourselves into that bargain and rewrite the contact.*"

This case certainly bucks the recent trend. Is the momentum slowing? Time will tell.

C. Patent Exhaustion

In 2008, the Supreme Court issued a major decision on patent exhaustion, *LG Electronics v. Quanta*, 553 U.S. 617 (2008). Under *Quanta*, an authorized sale of a product made under patent license[21] exhausts the patent rights against downstream users of that product. In addition, *Quanta* held that exhaustion applies to both device and method claims.

21. An unrestricted covenant not to sue also exhausts a patent. *Transcore v. Electronic Transaction Consultants*, 563 F.3d 1271 (Fed. Cir. 2009).

Quanta also raised the controversial issue of whether exhaustion via an authorized sale under patent A also exhausts patent B owned by the same entity. In general, according to *Quanta*, the answer is no. However, *Quanta* also created an exception: If a product made/sold under license to patent A also "substantially embodies" patent B, then patent B can be exhausted as well. The opinion went on to suggest that a product might "substantially embody" a patent if the product practices "essential features" of a claim.

The exhaustion doctrine prevents the patentee from exercising patent rights against downstream users of an affected product. However, *Quanta* left open the possibility that the patentee could negotiate for contractual remedies (presumably with the patent licensee) against such downstream use. In particular, the *Quanta* court went out of its way to state that it expressed "no opinion" on whether such contractual remedies might be available in spite of patent exhaustion.

In an interesting post-*Quanta* case, the patentee argued that a licensee's failure to pay royalties made the licensee's sales unauthorized, particularly where the license grant was "subject to the terms and conditions" of the contract, and another provision deemed to be unlicensed those products for which royalties were not paid. The Federal Circuit held that the sale was authorized at the time it was made, and that the licensee's failure to pay royalties did not retroactively convert the authorized sale into an unauthorized one. *Tessera v. ITC*, ___ F.3d ___ (Fed. Cir. 2011).

On the other hand, see *Jacobsen v. Katzer*, 535 F.3d 1373 (Fed. Cir. 2008), where an open source copyright license was granted *provided that* the licensee's compliance with its terms and conditions (attribution, etc.). The licensee failed to meet the conditions, and the Federal Circuit upheld the licensor's right to sue for copyright infringement, holding that the licensee's breach of the terms and conditions led to being unlicensed, thus making the infringement suit possible.

It will be interesting to see how (if ever) the Federal Circuit distinguishes or reconciles the two cases. For example, one might distinguish *Jacobsen's* contingent grant qualifier ("provided that") from *Tessera's* (merely "subject to"). Or, one might characterize *Jacobsen* as a case where the license was never in effect, as opposed to *Tessera*, where the license grant was in effect (at least prior to non-payment of royalties). One interesting question (apparently not before the *Tessera* Federal Circuit panel) is whether the court would have found the license to be terminated (or terminable) upon failure to pay royalties, thereby at least precluding future sales.

In 2013, the Federal Circuit issued a pair of decisions holding that a patentee's sale of a machine substantially embodying the patentee's method claim exhausts the patentee's rights against unauthorized sales of (unpatented) copycat consumables used in the machine/method. *Keurig v. Sturm*, ___ F.3d ___ (Fed. Cir. 2013) and *Lifescan v. Shasta*, ___ F.3d ___ (Fed. Cir. 2013)

One interesting comment in *Keurig* characterized and distinguished *Quanta* as applicable to exhaustion by sales of unpatented components – a different scenario than in *Keurig*.

Another interesting comment from *Keurig* is that patent exhaustion applies to patents in their entirety, not on a claim-by-claim basis.

Keurig (and *Lifescan*, infra) both noted that a conditional sale restricting the brewer purchaser's use might have avoided exhaustion.

Otherwise, *Lifescan* held that if one item in a patented combination is unpatented and the inventive concept resides in a second item, then selling the second item exhausts a patent on the combination. More specifically, *Lifescan* elaborated on the test for "substantial embodiment" that is at the heart of the exhaustion inquiry: a sold product substantially embodies the patent if additional steps needed to complete the invention are non-inventive. In *Lifescan*, the patent claimed a method for improved glucose testing using a meter comparing blood measurements taken using over two sensors on a disposable test strip, and indicating an error if the difference between the measurements exceeded a threshold. The patentee had sought, but failed to obtain, claims on the strips due to prior art. In addition, the patentee had emphasized inventiveness of the meter in the specification and prosecution history. Therefore, even though the claimed method pertained to both the meter, and the use of strips in the meter, the strips were non-inventive, the meter substantially embodied the claim, and the sale of the meter exhausted the claim. (Conversely, the court also noted that "if a patent had actually issued on the strips, the patentability of the strips could be relevant to exhaustion.")

One surprising fact in *Lifescan* was that the patentee had been giving away its meters given away for free (or below cost). According to the Federal Circuit, even the free meters resulted in exhaustion, because there was an "authorized and unconditional transfer of title."

In fact, the meters came with a label notice specifying that they could only be used with Lifesscan strips, but the court found this to be insufficient – the label notice was not enough to make the sale conditional. To avoid exhaustion, there should have been an "express contractual undertaking." Citing *Jazz*, 264 F.3d 1094 (Fed. Cir. 2001).

The fact that gifts (without monetary consideration) may cause exhaustion may be disturbing to those who recall that exhaustion is the patent law counterpart of the copyright "first sale doctrine" because a gift is not a sale.

Adding to the confusion, the Federal Circuit then stated that "[t]o be sure, the amount of compensation received by the patentee may in some instances be relevant to … whether a … transaction is … an unconditional transfer or sale as opposed to a conditional sale or license," i.e., implying that conditional sales or <u>licenses</u> would not exhaust. Citing *Princo*, 616 F.3d 1318, 1328 (Fed. Cir. 2010) (en banc). However, the court also noted that a patentee's "<u>transfer of the right to use the machines</u> would have 'exhausted his rights as to those machines' " Citing *Univis*, 316 U.S. 241, 250 (1942). But isn't a transfer of the right to use the essence of a license?

As an aside, the court noted that "[t]he parties have not argued, and therefore <u>we do not decide</u>, whether there would be any impact on exhaustion principles if a strip were 'especially made or especially adapted for use in an infringement of such patent, and not a staple article or commodity of commerce suitable for substantial 'noninfringing use' within the meaning of 35 USC 271(c)."

It remains to be seen (in a future case) how the Federal Circuit comes out on exhaustion if the patentee is able to successfully argue contributory infringement. Which will take precedence? Will judge-made law (exhaustion) trump the patent statute (contributory infringement), or vice versa?

Finally, the Federal Circuit has also recently held that a "conditional sale" can be implemented by post-sale restrictions on the rights granted to the licensee. *Lexmark v. Impression Prods.*, ___ F.3d ___ (2016) (en banc), although the Supreme Court has granted *certiorari* to review that case.

As always, many interesting questions remain open (and indeed have been newly introduced) by each new exhaustion case!

D. Laches

Laches is another equitable doctrine that can prevent a patentee from enforcing its patent. Laches involves two elements: (1) that the patentee delays filing suit for an <u>unreasonable and inexcusable length of time</u> after it knew (or should have known) of its claim against the infringer; and (2) that the delay prejudices the infringer. With respect to the second factor, a delay of more than six (6) years is presumed to

be prejudicial, shifting the burden to the patentee to show either that the delay was reasonable, or there was no prejudice. Prejudice can be based on either evidentiary or economic factors. Evidentiary prejudice is shown by loss of records, evidence, etc. that prevents a party from proving another defense separate from laches. Economic prejudice requires at least some increased expenditures in reliance on the delay. Capital investment is not required, but owing damages for a longer period because of the delay does not qualify as economic prejudice. *Hearing Components v. Shure*, 600 F.3d 1357 (Fed. Cir. 2010)

E. Subsidiary Rights and Responsibilities

Unintended grants or consequences can also arise in the context of provisions pertaining to subsidiaries.

Specifically, in a (not particularly surprising) case, the Federal Circuit held that, absent a piercing of the corporate veil, a parent company is not liable for the acts of its subsidiary. Accordingly, where a license entered into with the parent also licenses the subsidiary, the parent is not liable if the subsidiary breaches. *Dow Jones v. Ablaise*, 606 F.3d 1338 (Fed. Cir. 2010).

This case illustrates why savvy licensors should include a "boilerplate" provision expressly requiring a parent to be responsible for breach by its subsidiaries.

F. Grants Limited to Existing Subject Matter Only

In some cases, defined terms used in the license grant (such as "Affiliates" or "Licensed Patents") have the potential to change over time. The question is, should those changes be accommodated in the agreement?

In one case, the New York Court of Appeals found that, under NY law, the term "Affiliates" was limited to only those in existence as of the effective date, absent an intent to bind future affiliates. *Ellington v. EMI Music* (N.Y. 2015)

Similarly, where the licensed patents were defined as those which the licensor "owns or controls," the Federal Circuit held that, under NY law, the use of the present tense (in the foregoing) limited the licensed patents to those in existence as of the effective date. *Wi-LAN v. Ericsson* (Fed. Cir. 2014)

In each case, the limitation of the licensed entities and/or subject matter to those in existence as of the effective date may not have been what (at least one) of the parties intended.

G. Sublicensing

Unintended grants can also arise (or intended rights can be inadvertently lost) from sloppy sublicensing provisions.

For example, a sublicense automatically terminates upon expiration of the underlying license, unless stated otherwise. In many cases, a license runs for a term of years, then either expires or is terminated because the licensee has moved onto an alternative solution.

If the licensee was not the ultimate user of the technology (e.g., the licensor's technology was incorporated into the licensee's software and deployed to end users), the end user base may need to continue to use the existing software long after the license has phased out the software. In that case, it is critical for the licensee to negotiate for survival of the existing end user sublicenses.

The licensor may or may not wish to permit such survival of sublicenses. For example, the licensor might wish to cut off the licensee's end users after the licensor-licensee relationship has ended. Conversely, the licensor might be willing to permit continued use, as long as any continuing revenue stream (e.g., annual royalties and/or maintenance fees), flows through to the licensor. Or, the licensor may want to be able to force the end users to upgrade to a new software version directly from the licensor. Thus, the licensor may wish to consider some or all of the following provisions: (a) requiring the licensee to notify the licensor of the name and address of each sublicensee; (b) requiring the licensee to recall and destroy all sublicensed technology post-term; (c) requiring that outstanding sublicenses to be automatically transferred to the licensor post-term; or (d) requiring the licensee to pass through to the licensor all post-term revenue.

IX. ROYALTY PROVISIONS

One of the most common mistakes is failure of the licensor to understand the licensee's revenue and reporting models, and their potential impact on the licensor.

A. Revenue Issues

For example, suppose that a license provides for a licensee to pay 10% of its gross revenues to the licensor. Suppose further that – unknown to the licensor – the licensee does not have any direct sales to end users, that all such sales occur through distributors or sublicensees, and the licensee's own revenue stream is 20% of the end user fees collected by

the distributor or the sublicensee. In that case, the licensee's revenue is only 0.1 x 0.2 or 0.02 = 2% of the end user fees, rather than the 20% the licensor was expecting. To avoid this problem, in the case of sales via distributors or via sublicensors, the licensor may wish to use a fixed per-unit royalty (e.g., $5 per unit) rather than a percentage of revenue. Or, the licensor could use a % of revenue, coupled with a floor of X$ per unit.

From the licensee's perspective, especially where the licensor is a competitor, the licensee may not want to open its books to the licensor. Thus, instead of royalties based on "net" quantities (i.e., those incorporating deductions or various kinds), the licensee may wish to negotiate a royalty based on "gross" quantities, such as end user sales price (which is often published or otherwise non-confidential).

Many times, a licensee will offer promotions, in which the product subject to the royalty is distributed together with another product not subject to the royalty. These are known as convoyed, bundled, or package sales. Since the licensee generally has freedom to set its prices, it can manipulate the royalty stream back to the licensor by underpricing the licensed product and overpricing the unlicensed product. Absent a mechanism to properly account for the value of the licensed product, the licensor may receive too little royalty in such cases. The licensor may, therefore, wish to include a provision for: (a) royalties as a percentage of the total price; (b) a pro rata allocation based on the respective list prices of the licensed and unlicensed technology when sold separately; or (c) a fixed per-unit royalty (e.g., $5 per unit) for the licensed technology.

Similar under-pricing problems also arise in the case of: (a) non-sale transfers of goods (e.g., payment in kind); (b) so-called "freebies" or "loss leaders"; or (c) related company sales.

B. Accounting and Reporting Issues

In addition to understanding the licensee's revenue model, it is also important to <u>understand royalty structure & royalty base issues, as well the licensee's accounting and reporting capabilities and structure</u>.

1. Royalty Structures

In transactions involving both patent and non-patent rights, the courts are wary of attempts (or perceived attempts) to leverage patents beyond their lifetime, even though other non-patent rights may still be in effect. Thus, the Supreme Court in *Brulotte v. Thys* (U.S. 1964)

articulated a rule requiring a step down in royalty rates in hybrid (patent + non-patent) license agreements after patent expiration, else the agreement could be unenforceable on the grounds of patent misuse.

The exact boundaries of *Brulotte* remain uncertain. At one extreme, the majority of product licenses simply throw in all relevant IP rights (patent or otherwise), and collect the same ongoing royalty for so long as the licensee is using the product. Yet these licenses are rarely challenged even though they would seem to violate the *Brulotte* rule.

But as patents become a primary or strong component of the transaction, the *Brulotte* risk can increase significantly. A recent case, *Kimble v. Marvel* (9th Cir. Jul. 16, 2013) (petition for cert filed Dec. 13, 2013), is illustrative.

In the *Kimble* case, an individual inventor (Kimble) invented a toy, and pitched it to a toy company (Marvel). The result was an (alleged) verbal contract to compensate the Kimble inventor if the toy was manufactured. Instead, Marvel brought out a similar toy, and Kimble sued for breach of contract and patent infringement. At the trial court, Kimble was awarded a 3.5% ongoing royalty (but apparently no up-front award) on past/present/future sales for the contract claim. This was unrelated to the patent, as the court ruled against Kimble on the patent claim. The parties cross-appealed, and eventually the parties settled via what they characterized as a "patent purchase agreement."

That agreement had a patent "purchase price" structured as an up-front payment of $516K, plus an ongoing royalty 3% of past/present/future product sales, whether patented or not. There was no mention of a license, or of non-patent rights. In effect, the parties converted what had been a non-patent trial court judgment into a patent-centric deal.

However, the overall economics were very similar. Either way, the toy company got the right to manufacture and sell the toy, for an ongoing royalty. In addition, in the settlement agreement, the toy company also got ownership of the inventor's patent. From an economic perspective, a small portion of the trial court royalty (0.5% of the 3.5%) was converted into an up-front fee ($516K), and title to the patent changed hands.

Later, when the agreement was challenged, the (appellate) court held that the lack of a step down royalty after the patents expired constituted misuse *per se*.

Some commentators argue that the *Kimble* was wrongly decided because it was a patent sale, not a license. I.e., how could the deal include a patent license from the inventor when the inventor sold the patent to the toy company? Instead, those commentators interpret *Kimble* as a patent sale for $516K and a non-patent license for 3%. Other commentators view *Kimble* as having been correctly decided, and representative of a bright line rule against hybrid royalties without post-expiration step downs.

Kimble is a controversial and confusing case, but even so, two lessons are clear: (1) the doctrine of patent misuse remains alive and well; (2) the existence (or appearance) of patent leveraging can trigger *Brulotte*; and (3) sloppy contract drafting is the licensor's own peril.

2. Royalty Base

An important practical consideration is specifying which products are included in the royalty base. The (seemingly) most straightforward approach is to define "Licensed Products" as those covered by the "Licensed Patents" and to require the reporting of all Licensed Products. As long as the licensee can determine where and when a product is covered by a patent, this approach is fine.

However, this is often not possible (and where it possible, it is often impractical). In many modern product environments, production and distribution may be global, multi-national, and subject to change over time. For example, components for a product might be sourced from America and Latin America, the product might be manufactured, assembled or undergo final assembly manufactured in Asia, and the product might be distributed in America, Asia and Europe. Further, the licensor might have patents in only some of the relevant countries, and even corresponding patents are likely to vary in scope from country to country due to differences in national laws, patent office practices, and/or patent prosecution counsel styles. The result is that a product might not be infringing when/where it is manufactured, yet become infringing upon distribution or upon downstream use. In such case, it can be a logistical nightmare for the licensee to track whether a product was or was not covered by a patent over its geographical and temporal lifecycle, and to calculate royalties accordingly.

Instead, as a matter of accounting/economic convenience, many license agreements use an "Accounting Product" definition (e.g., for royalty payment purposes) that is different than the "Licensed Product"

definition. In a common approach, the Accounting Product is any product manufactured (or sold) by or for the licensee of a specified type (e.g., a product type that would be covered by the a Licensed Patent in at least one country in the world at some point in time), without regard to where/when the product was actually make/sold/used. This gives the parties an unambiguous and easily implemented way of tracking what products to include in the royalty base.

Conversely, since such an Accounting Product definition is likely to sweep in more products than Licensed Products (i.e., those actually covered by a Licensed Patent at any given time), it is understood that the royalty rate should be decreased somewhat from what it would have been if counting only Licensed Products.

In at least one case, it was (apparently) not clear from the evidence that such an arrangement was for the economic convenience of the parties, and the licensee later argued that it would have been patent misuse to require the licensee to pay on non-covered products, and thus, in order to be valid, the patent license should be construed to require payment only on covered products. See *Powertech v. Tessera* (Fed. Cir. Sept 30, 2011). To avoid this pitfall, the savvy licensor should clearly document the parties' understanding that such an arrangement was constructed as a matter of economic convenience to the licensee – as opposed to an attempt by the licensor to collect royalties on non-covered products.

3. Recordkeeping

Many license agreements include a provision to the effect that: "The licensee will keep complete and accurate records necessary to demonstrate compliance with the royalty provisions of this Agreement." The problem is that this type of "bare bones" provision doesn't provide any guidance as to what kinds of records are actually required. Later, when there is a dispute, if sufficient records haven't been kept, it's too late – they cannot be re-created after the fact.

Instead, it is preferable to specify exactly what records the licensee must keep. For example, the licensee might be required to track and periodically report the number of units: (a) manufactured; (b) sold; (c) returned; (d) given away as samples; and (e) transferred on an intracompany basis. This is useful because it deters cheating: the licensee can easily check that: (i) the number of units in (a) equals the sum of (b) through (e); and (ii) the number of units in (b) through (e) is not a disproportionate share of the total production.

4. Termination

Another common provision permits termination for material breach, including non-payment or underpayment. The problem is, what degree of non-/underpayment is material? Does a 5% underpayment count the same as a 50% underpayment? What about full payments that are chronically late, and require constant follow up? Years of on-time payments, followed by a one-time failure?

It is better to include a clear provision that permits a reasonable (but limited) number of accounting violations before the licensee is penalized, together with unambiguous criteria for measuring the violation, and triggering the penalty. For example, a "Material Underpayment" could be defined as any underpayment of more than 10% of the amount actually due, and the licensor might have the right to terminate upon the occurrence of M Material Underpayments in an N-year period.

C. Interest Provisions

As a final comment on royalty provisions, one should not forget that many payment disputes are not resolved until years later, especially if the resolution is through litigation. One should not forget the power of compound interest. It is not uncommon for agreements to include interest on late payments at rates up to 1.5% per month. At that rate, in 4 years, the total amount due is double the initial under-/non-payment. In 8 years, the amount is quadrupled.

X. NEGOTIATIONS

A. Commercial + IP Counsel

All of the foregoing shows that drafting a patent license is an interdisciplinary exercise. Mistakes can be made on the commercial side, on the IP law side, or both.

In many organizations, the negotiation is handled by one counsel (either commercial or IP), with the agreement being "run by" the other counsel at some point after negotiations[22] and prior to signing. At this stage, serious mistakes may be effectively irreversible. The secondary

22. Or after substantial negotiations have already occurred.

counsel is effectively placed in the impossible situation of agreeing to a suboptimal solution, or being viewed as a "deal killer." To avoid this all too common occurrence, both counsel should be involved, not serially, but simultaneously, starting from the term sheet stage and continuing throughout negotiation. Even better, one should take care to select a single counsel with deep experience in both commercial and IP law.

B. Term Sheet vs. Drafting

It is also important to negotiate all the major issues at the term sheet stage, where the full range of variables is in play, and they can be traded off against one another. For example, one should not set the price during the term sheet stage, while deferring representations and warranties to the drafting stage. Representations and warranties are nothing more than a risk allocation mechanism. If the licensor is making enough money, it may be willing to take more risk and vice-versa. Thus, one cannot logically separate price from reps and warranties. More generally, a skilled negotiator will realize that everything is a function of everything else. By addressing issues collectively at the term sheet stage, one will generally achieve a better result, as well as save legal fees in the process.

C. Jurisdiction Specific Issues

Finally, it is important to remember that licensing outcomes can be jurisdiction dependent. This is obviously true when comparing U.S. versus foreign laws, but it is also equally true within the U.S. As just one example, consider California law, which has produced such anomalies as: (1) covenants not to compete being presumptively invalid, absent a sale of the business (Business and Professions Code 16600); (2) the *SQL Solutions* holding that certain reverse triangular mergers trigger an anti-transfer clause; and (3) the *SuperBrace* holding that patent licenses are, by default, transferable by the licensee. The first example is good law, although contrary to the rule in most jurisdictions. The second is probably bad law, as shown by the absence of any following decision in almost 20 years. The third should also turn out to be bad law – because it runs completely contrary to the weight of authority – but only time will tell.

CONCLUSION

Patent and technology licensing is a challenging and exciting area, with many business opportunities and some pitfalls for the unwary. I hope this paper has been useful to you, and encourage you to send me your thoughts and feedback at joe@patentesque.com.

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