Tricks of the trade

Licensing deals are made, not born. And that means those looking to commercialise their intellectual property in this way need to have a strategic approach to the negotiation process

By **Joff Wild**

Licensing is not just about finding a partner with whom to share intellectual property. Before anything can actually happen there is the small matter of negotiating an acceptable deal to consider. During negotiations, there are a number of obstacles in the way of getting an agreement: compatability, valuation, royalties being just three of them. It all means that successful negotiation is an art.

And when it comes to negotiation artists, there are probably few in the world that have more experience than Chris Haase of BTG, Don Merino of Intellectual Ventures, Brian Oliver of CRA International, all three of whom are based in the US, and Nigel Poole, of CSIRO in Australia. They came together in April 2005 to discuss a few of the tricks of the negotiator's trade and to look at some of the issues they face when looking to conclude licensing deals.

Joff Wild: *When beginning a licensing negotiation, what do you see as the key components in ensuring that it ends successfully for both sides?*

Chris Haase: *Ultimately, the success of a licensing negotiation is influenced by the real needs of the parties involved, and not simply the economic needs. One of the most important things to accomplish at the outset, therefore, is to identify the real needs and issues of the other party, and to use this to prepare a thorough negotiation plan. This will describe the background of the stakeholders, their current situation and needs, predict future needs, identify common ground, and anticipate the positions and counters of the involved parties. Rarely is the outcome of a licensing deal driven exclusively by the science or the economic interests. Successful outcomes are built on a foundation of understanding, trust and communication between the licensor and licensee of an asset.*

Nigel Poole: *CSIRO is a publicly funded research organisation based in Australia, conducting research across a wide range of disciplines. We are an originator of intellectual property and therefore are normally licensing out technology. For us, therefore, the usual parameters of preparation, preparation, preparation apply to the commencement of a licensing discussion.*

This includes a full understanding of our – normally originator side – position, including the possible preparation of a full IP due diligence that covers competitive assessment and an understanding of potential encumbrances of our IP position, understanding of costs/investment undertaken to get to the decision to license, a business case for the adoption or further development of the technology and, as far as possible, understanding of the potential licensee's position.

Areas for investigation for a potential licensee include precedent licensing activity, understanding of decision process, implementation path for the technology, total business case for licensee and licensor, and possible methodologies for value splitting and sharing.

Brian Oliver: *From a licensor's perspective, having a strategic licensing plan will increase the likelihood of success for both parties. Components of this plan should include: a valuation analysis, which can be used to set the licensor's expectations, identify appropriate*

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deal structures and create internal and external term sheets; an analysis of potential licensees, which will allow the licensor to identify and select the most attractive and compatible licensees from both a quantitative and qualitative perspective; and an opportunity memorandum that can be used to communicate, in a non-confidential manner, the licensing opportunity to potential licensees.

All of this up front planning and analysis will enable the licensor to anticipate and answer the initial questions that would be asked by the potential licensees and to provide the potential licensees with useful information so that they can evaluate the opportunity in a very efficient manner. We have used this approach on behalf of many clients and we always receive positive feedback from potential licensees.

Don Merino: *Empowerment is also a critical factor. Both teams should have a clear understanding of their individual authority to negotiate scope, price and contractual terms. It is also important that both sides have reasonable expectations about the overall scope of the deal, the price and the length of time required to make a typical deal happen.*

JW: *Who should be involved in the negotiation process and what decision-making authority should they have?*

DM: *Ideally, the negotiating team should include a business person, a lawyer and a technologist. It might be that all three areas of expertise can be found in one person; but in order for the deal to flow smoothly, all three components are necessary. If the executive sponsor is not directly involved in the negotiation process, the ultimate decision maker should provide a clear envelope to the team regarding acceptable parameters for price and terms. Contract negotiation most often involves trade-offs – one party trading a less important aspect of the deal in order to gain a more important aspect in another area.*

CH: *Like preparing a gourmet meal, assembling the people ingredients for a deal team is not just about employing good ingredients – it is also about assembling the right ingredients appropriate for the situation. This is an art that only experience can perfect.*

An empowered negotiation team should possess the diversity of skills, background and personalities required to navigate successfully through the relationship dynamics, economic issues and deal mechanics in a transaction. With a clear remit to negotiate from management, at least three to four people should be involved, depending on the needs or complexities to be overcome. An ideal team should include the lead negotiator, listener/recorder and an attorney. In some instances, additional technical or financial expertise can be represented. However, without exception, one person must assume the role as lead negotiator.

BO: *Personnel will vary depending on the organisation and the size and scope of the transaction. But, as Chris implies, one thing that should be the same across all transactions is that each side needs a deal champion, and that person should be responsible for all external communications with the counterparty. Multiple communication channels can lead to significant problems during negotiations. One person needs to be the lead negotiator.*

NP: *From my perspective, there are many answers possible here. Normally CSIRO uses what you might recognise as the zipper model of engagement with potential licensees – we try to match the seniority and capability of people on either side and only bring in legal or more senior people as required. Of course, what we are trying to do is to get to the decision maker to understand their parameters, needs, constraints and hopefully turn them into a champion and owner for the transaction – but you have to go through a few steps to get there.*

Quite often we go backwards to go forwards in the negotiation – we go from a technology or problem-based discussion to business development or commercial people facing off, then back into a more detailed technology due diligence process, then, assuming the promise is proved up by that process, forward into a final commercial negotiation.

Being a government-owned and funded organisation means that the transaction itself will require sign-off at several layers and may become subject to external scrutiny or review. Being upfront and transparent about the level and extent of that process is the only way to manage expectations.

JW: *How important is the way in which the parties to a negotiation get on? How do you establish trust?*

NP: *We often forget that a technology licensing transaction is nearly always a buyer-seller negotiation, and that many of the resulting behaviours are not about licensing – they just reflect long-established business protocols. Good and bad manners, coyness, scepticism,* overselling, uncertainty, defensiveness, delays, reluctance and hope are often present, and might all be experienced in the first meeting!

One of the best ways to establish trust is by doing things together. It cannot be demanded or expected. Meeting at each others' offices is a very basic way to get moving, then if it is a larger or more complex negotiation, at a third-party site, such as a hotel or airport lounge, to keep momentum. The legal adviser's office – we normally leave that option to last!

CH: Because all negotiations involve information exchange, risk and perceptions, trust is the most important ingredient in any negotiation. Establishing trust requires four principal ingredients: the reputation that precedes one entering into a negotiation; mutual respect on individual, cultural and organisational levels; the credibility of the negotiator; and operating with ethical business practices.

It is important to make a distinction between negotiation formalism and true negotiation experience. While the former may be sometimes improvised, the latter cannot be replicated without real-world experience. An experienced negotiator is able to handle all matters of a deal – people, terms, personalities and even surprises – and has a deep insight into how an innovation or patent will impact a business.

DM: I am with Nigel here – in my experience, parties who do not actually want to meet face to face will have a harder time reaching a successful conclusion to a deal. When both parties spend time communicating clear expectations and goals, the deal advances more smoothly and the discussion points are resolved more effectively. Both sides need to deal with each other honestly in order to build mutual trust. Successfully resolving differences during the negotiation process depends upon a willingness to work together. The value of a mutual cooperative attitude should not be underestimated.

JW: Obviously valuation of the assets to be licensed is a crucial part of the process – what particular problems are there in valuing IP for licensing?

BO: Often the most crucial valuation issue in licensing negotiations is the perception, pricing and, ultimately, sharing of risk. For example, if a licensor needs or wants the licence payment to be a one-time, lump-sum payment – in other words, they need or want the licensee to assume 100% of the risk of the opportunity – but the licensee believes the opportunity has greater risk than the licensor, it is unlikely the parties will agree on the value or price of the deal. Therefore, both the licensor and licensee have to work to develop a deal structure where risk is shared and properly valued.

DM: If it is know-how/tech transfer, it is a make versus buy decision. If it is a patent assertion situation, then the valuation discussion always considers the merits of a particular case. There are five key questions to consider: is the IP being used? Is the IP valid? What is a reasonable royalty rate for using the IP? What risk is involved? Which products do the claims read on? Determining whether a patent is used and valid is of critical importance.

CH: Valuing IP assets for licensing is dependent on many things, including timing, strength of patent claims, market dynamics and other risks that underlie the opportunity. One of the greatest difficulties in valuing IP assets is that no two assets are ever identical so that true apples-to-apples comparisons are not possible. Herein lies the paradox of IP valuation: the uniqueness that drives value of an IP asset makes it necessarily distinct and separate from other IP assets in a similar class. Were apples-to-apples comparisons possible, patent valuation would be precise and, frankly, a commodity across all industries. As we all know, this is far from the case!

The challenge in IP valuation is to describe accurately the differences between apples and oranges as precisely as possible. Accurately describing differences and uncertainties between IP assets has an impact on revenue forecasts and cost projections which, in turn, affect how risks are assumed and brokered among the parties in a deal.

NP: The emerging profession of IP valuation is following a development path trodden by corporate financiers, property valuers, leasers, infrastructure investors and brand managers over the past 30 years.

Sharpe's Capital Asset Pricing Model, the various enhancements from option pricing theory, and more detailed understanding of net present value and IRR concepts set the theoretical underpinnings. In practice, the emergence of specialist IP advisory firms with deeper competency was the first step; we are now seeing schools containing different valuation methodologies and preferences and the emergence of draft accounting standards – finally valuation of IP will become a mainstream accounting/valuation issue. Right now in Australia we have not yet seen IP

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Brian Oliver
Brian Oliver is a Chicago-based vice president of CRA International and has specialised in IP valuation and transactions for the past 13 years. His consulting experience includes the development of IP licensing plans and technology commercialisation strategies, IP-based due diligence and competitive intelligence, and IP valuations in the context of licensing, mergers and acquisitions, and financial reporting. He has provided expert testimony in the United States Federal Court and Bankruptcy Court, and in arbitration proceedings regarding accounting, financial and economic issues. He serves on the Board of Trustees of the Licensing Executives Society (USA and Canada) and is a frequent lecturer on the subject of IP valuation and licensing. He earned an MBA from the Kellogg School of Management, Northwestern University, and is a graduate of Indiana University.

become an asset class in its own right – but the emergence of securitisers and secondary market funds for IP streams means that it is only a matter of time.

The particular problems we face are those of all valuers – and that is uncertainty about the future. As an originator, we fear not licensing something at all (it must be worthless) with an offset fear – we license it too cheaply and therefore do not capture benefit for Australia. We work hard on finding the best partner to deal with our first fear, and we might plant small, out of the money, upside clauses to deal with the uncertainty of the second.

***JW:** Who do you think should be doing the valuation and how should it be approached?*

***NP:** We will always try to get the transaction promoters to prepare their own business case (by this I mean internally in CSIRO and by the potential licensee), which will underpin and justify a negotiating position and lay out deal parameters. If we go outside for advice then there are a number of risks. The first is the consequences – one or other of the parties will get a result they do not like! The second is the cost and time delay of introducing a third party, and what it does to reduce trust.*

The value of a third party is their objectivity, their rigour and their focus. A quick first cut valuation can be completed in a week and you can obviously spend a lot more time, money and effort than that.

***DM:** The entire team is involved from each side of the deal. For know-how, the technologist determines how good the IP is based on how the IP will be used and how long it would take to recreate in-house; the lawyer determines whether the terms are too onerous; and the business person understands the trade-off in market timing and the ability to make it (build, design or develop it) internally. For patent cases the technologist provides information about how the IP is being used; the lawyer determines whether the IP is valid; and the business person brings forward reasonable royalty rates and risk components.*

***CH:** A valuation exercise must never be conducted solely by a specialist or in a vacuum. Generally, the greater the depth and breadth of skills that are brought to the table by deal team members involved with a valuation, the greater the ability to pressure-test the valuation assumptions. This, of course, has implications on the optimum number of individuals who should be involved with the valuation exercise. Speaking personally, based on years of commercial experience and exposure to multiple patent situations, BTG has honed its commercial edge and begins a valuation with identifying the key uncertainties and model assumptions that are driven by the market – not the corporate – needs.*

***BO:** As discussed earlier, I think the licensor should do a valuation of the technology or licensing opportunity as part of its strategic planning which is even before contacting licensees. This will help set expectations, identify appropriate deal structures and allow for the assessment of pre-emptive bids that may be received when initially contacting licensees. The licensee will, obviously, perform its own analysis at a certain point of the deal or due diligence process, and the licensor should work hard to communicate information that is important to the key assumptions that will need to be made in the valuation.*

***JW:** How flexible should the two sides be in order to get convergence between their respective valuations?*

***DM:** Very flexible. In many deals, there are a number of non-financial elements that can be traded back and forth. Although price is certainly important, price alone is not always the primary consideration when negotiating successful deals. Each team member should look for reasonable opportunities to say yes, eliminating non-critical differences in order to define and resolve more important topics.*

***CH:** After watching and participating in many negotiations over the years, one of the most common mistakes made among licensing negotiators is the assumption that any two issues or aspects of a licensing deal are independent. Every aspect of a negotiation is dependent – some more strongly so – on other aspects of the deal. Scope, improvements, control, timing, liability insurance, representation and warranties, indemnification and so on; all have follow-on effects in a licensing relationship. By understanding how all aspects of a licensing negotiation are interdependent, parties can manage the ebb and flow of terms in a way that focuses on the long-term objective.*

***BO:** There comes a point in negotiations where I think it makes sense for the two sides to share valuation models and analyses. However, this has to be done in a* quid pro quo *manner – it has to be a mutual exchange of valuation analyses between the parties. This will lead to* *the identification of key assumptions for which the parties have divergent views. This often assists in deal structuring. For example, one party may be estimating the risk associated with going from a prototype to full-scale production as being higher than the other side believes. This could be in the form of a higher discount rate or a lower probability of success, which could easily be identified in the financial model. Therefore, the two parties may agree to create a deal structure that includes a milestone payment if that risk is eliminated instead of trying to place a value on that risk today.*

NP: *Comments about flexibility always sound like compromise to me. There is often going to be widely varying positions at the start – the important thing is to listen to the respective views and justification. The question is, how can you take the positions that appear adversarial and turn them into alignment of interest? For example, how can you turn a share of revenue into share of profit and share of upside via capital growth or equity milestones? Or, alternatively, turn a request for assignment of IP into licence with assignment occurring on payment at milestone event or up round financing? The role of the licensor is not to get the best deal upfront – it is to maximise overall return. Too tough a deal can lead to marketplace failure – then there are no royalties at all.*

JW: *Royalties will always be an issue – how do you make sure that the royalty rate you are asking for or paying is a realistic one?*

CH: *You cannot ensure that a royalty rate is correct based on industry norms for the sole reason that each licensing situation is unique. Royalties can be influenced by a host of factors including product longevity, sales volumes, geography, cost, shelf-life, competitive landscape and so on, all of which are situation-specific. Consequently, it is nearly impossible to rationalise a royalty by relying exclusively on industry standards. Our definition of a standard royalty rate is what the open market bears among a willing licensor and willing licensee.*

NP: *I agree. Royalties are jumping all over the place – what is the industry royalty for the application of complex software and modelling for the minerals or chemical industry – is it the IT industry rates or the chemical industry rates that are more relevant? While we recognise that relevant precedent transactions are instructive, it is the value that should or could be created by the technology and how that value should be split between originator and implementer of the technology that is more relevant.*

DM: *This is all true. However, it makes sense to use industry standards as a starting point. Even more important, though, is the concept of make versus buy, especially with regard to tech-transfer negotiations. Royalties for assertion-based licensing are often focused upon litigation-related risk.*

BO: *There are many approaches to royalty rate determination. Comparable agreements are often considered. The challenge with using or relying upon comparable agreements is that, as Chris and Nigel say, each transaction is unique, and every term and condition of every agreement serves to shift risk and reward between the various parties. For example, one comparable agreement may have a 5% royalty rate, but if there were significant upfront payments, milestone payments, minimum royalties, maximum royalties, or other considerations that are not included in your own contemplated deal structure, the 5% royalty rate may not be that instructive. In addition to comparable agreements, one also needs to consider profit-based approaches such as excess earnings analysis, profit apportionment and others.*

JW: *What kind of factor will affect the type of royalty fee being negotiated? If you are being asked for an exclusive licence, what do you want in return? Alternatively, if all that is being offered is a non-exclusive licence, how will that affect your approach?*

DM: *Exclusivity will obviously result in higher royalty rates than a non-exclusive licence. Trading upfront dollars for royalty dollars allows the licensee/licensor to share the risk as well as the reward.*

CH: *The basis of this question assumes no interdependence of factors surrounding a licensing fee. While exclusivity always comes with a price and non-exclusivity introduces competitive dynamics and issues involving improvements, two parties will ultimately have to live with the terms that are agreed upon.*

JW: *Will the way in which you approach an assertion licensing negotiation be very different to the way in which you approach a negotiation based around technology transfer?*

DM: *Yes, absolutely. The approach to tech transfer licensing is based upon a cost-saving*

Don Merino

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Prior to joining Intellectual Ventures, Don spent four years at Intel Corporation where he was Director, Strategic Business Development. In this position, he was responsible for managing the Intel licensing programme. He was also the Director of Licensing for General Instrument, one of the founding members of MPEG-LA. Prior to General Instrument, Don was VP of Operations for Engineering Information, an internet start-up that was sold to Elsevier Science.

Don Merino received his BS from the US Naval Academy in 1984 and his MEME and PhD from Stevens Institute of Technology. He is a US Navy veteran and served on the USS New Jersey, USS Arkansas and NAVSPECWARGRU 1. For his service, he was awarded both the Navy Achievement and Navy Commendation Medals.

perspective, whereas assertion-based licensing is really an approach that is dealing with risk. In effect, a situation is created where there is a significant consequence for not licensing.

CH: *Obviously, parties in an assertion negotiation can begin in a win-lose/adversarial relationship, as compared to a win-win/collaborative relationship in a technology-transfer licensing negotiation. In this way, while a technology licence focuses on enabling sales or cost reduction in a product's design or production, an assertion licence focuses on what property is owned by whom and where a product intersects with this property. In addition, technology transfer licensing negotiations can be heavily influenced by access to wetware or know-how of an inventive team to ensure a smooth transition of the technology to product. In contrast, assertion licensing is largely influenced by the quality of patent claim construction, demonstrating the relevance of the claim coverage to a product and scope of infringement. As our experience has demonstrated multiple times in the past, when an assertion negotiation is managed well by those with a long-term view to the licensing business, it often gives rise to future ongoing relationships and deal flow opportunities among the parties.*

NP: *It should not affect the preparation – but psychologically it does. With an assertion, the feeling that permission should have been previously sought and gained inevitably leads to a change in mindset towards the discussion and negotiation.*

To assert is a decision taken only after significant discussion and internal debate, and it is a decision that is taken very seriously. The global IP system is predicated on conferring a right through invention, and an ability to defend one's IP through assertion or enforcement.

JW: *Does the type of intellectual property right involved have a major bearing on the way in which deals are negotiated?*

NP: *Of course. Not only do different classes of IP give rise to different legal rights, but also they give licensees different levels of competitive advantage in the market. Copyright or registered design will confer a very different set of advantages than a suite of patents in a crowded marketplace with the existence of patent pools.*

CH: *Well before an IP deal is negotiated, even before a thorough valuation is conducted, a review of the IP is made in the context of the holder's core business. The type of intellectual property rights captured by the holder is very much the product of the R&D, business, academic and economic climate from which it originated. After all, the time, energy and effort required to obtain broad intellectual property protection in a market requires understanding of a firm's patent needs, its business strategy and how the firm captures value from the protected technology in the marketplace.*

JW: *If you are involved in a licensing negotiation that fails, have you failed?*

BO: *Not at all. Licensing is a very risky business and it should be expected that not every negotiation will lead to an agreement. In fact, some of the best licensing decisions are those made not to do a deal. Since our firm is frequently involved in high-stakes IP litigation matters, we have seen first-hand the aftermath of deals which the parties involved probably wish had never happened. From a licensee's perspective, we do find it is often useful, however, to do a post-mortem analysis on a deal if it was lost to a competitor. This can help you understand issues that you may have missed in your analysis or understand how your competitors assessed and priced a transaction so that you can possibly be more prepared for the next transaction opportunity.*

CH: *Failure of a licensing negotiation may not be a complete failure but rather a visible indication that two parties lacked sufficient incentive to get a deal done. While superficial negotiators view a failed negotiation as an inability to move the other party from an intransient position, a skilled negotiator will ask in what way does the other party view reality so different to me that it cannot trade concessions? Should sufficient incentives be present to get a deal closed, interested parties will always find a way to work together and compromise.*

DM: *It is like playing baseball. If we could all bat .400, we would be in the Hall of Fame. Which is another way of saying that it is important to walk away from deals if the terms are not right for you and your organisation.*

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