IP bits

June 2013

Getting a royalty, not on sales of your own product, but someone else's

It doesn't quite sound right, does it ? How can a licensor get a royalty, not on sales of the licensor's own product, but someone else's product ?

Most patent license agreements provide for an infringement based royalty. That is, a royalty is only payable upon the sale of a product that but for the license would infringe the licensor's patent.

But that is not the only way to structure license payments.

One basis of a royalty is that a licensor should be remunerated by the licensee, for the licensee's use of the licensor's IP, by reference to the licensee's quantity of use of the licensor's IP. That quantity of use is measured by the number of products that the licensee sells (the quantity of use approach).

An alternative basis of a royalty is that a licensor should be remunerated by receiving a fair proportion of the income that the licensee receives, which would not have been received but for the license (the proportion of licensee's profit approach).

For some licenses, the only way to fairly remunerate a licensor, on either basis, is for the licensor to receive royalties based on, not sales of the licensor's own product, but someone else's product.

Some examples of some recent transactions will illustrate.

License of software – royalty on the sale of Ipads

A company developed a unique software application that served the needs of a specialist industry sector, and which was designed to run on an Ipad. A license to commercialise the unique software application was negotiated with the leading seller of products for that industry.

The sale of Ipads was not part of the licensee's usual business. It had never sold Ipads before.

The licensee was effectively a licensed reseller of the software application. A royalty was negotiated, being a percentage of the end user license fee that was paid by the consumer, based on the usual invoice price model.

But we felt that that did not fairly compensate the licensor for all the financial benefits that the licensee was expected to receive, which would not have been received but for the license.

Some end users would purchase a license of the software, and install it on an Ipad they already owned, or which they might choose to buy from another vendor. But some end users would, as well as purchasing a license of the software, also purchase an Ipad from the licensee.

The licensee would therefore make a sale of the Ipad, and receive a financial benefit from that sale. That being a "bonus" financial benefit, it did not seem inappropriate for the licensor to share in that "bonus".

An additional royalty was negotiated, based on 35% of the difference between the retail sale price of Ipads sold, and the wholesale price for which they were purchased.

The rationale of this royalty was that the licensee should receive 30% of the profit for the licensee's work and overheads relating to the ordering, storage, insurance, and administration etc of Ipads and the remaining 70% profit, the "bonus" should be shared in equal proportions between the licensor and licensee.

OPTEON

helps you ***optimise your IP***

Philip Mendes
Principal
Adj Professor, QUT, Brisbane, Australia

Mobile: + 61 414 615 345
Email: philip@opteon.com.au
www.opteon.com.au

IP bits

June 2013

Getting a royalty, not on sales of your own product, but someone else's

In this way, the licensor of software received a royalty based on sales of someone else's product – Apple's Ipad.

This example illustrates the proportion of licensee's profit approach to a licensor's remuneration. The licensee realised profit on two ways:

1. the sale of end user licenses (and a royalty was paid based on the invoice price of the end user license)
2. the sale of Ipads (and a royalty was paid based on the gross profit on the sale of each Ipad).

License of chemical catalyst reagent – royalty on off-patent product

The licensor's technology was a catalyst that made a manufacturing process more efficient. It was calculated that the efficiencies produced resulted in a lowering of production costs by 15%.

The product made in that manufacturing process had been protected by a patent, but the patent had expired 10 years earlier.

The market for this catalyst product was small. Only a handful of producers, throughout the world, could be identified. Manufacturing and selling the catalyst to be bought by this handful of buyers was not economical.

The commercialisation pathway that was more appealing was to license the catalyst technology to each user. Each user would make its own catalyst, to the extent of its own requirements.

How was the licensor to be properly compensated ? There were not to be any sales of catalyst products. But there were to be sales of the off-patent product. A royalty was negotiated based on the invoice price of the sales of the off-patent product.

This reflected both:

1. the quantity of use approach (the licensor's remuneration was to be based on the licensee's quantity of use of the licensor's IP, as measured by the number of off-patent products sold that had been manufactured with the assistance of the catalyst), and
2. the proportion of licensee's profit approach (the licensor's remuneration was to be based on the additional profits that the licensee would make selling the off-patent product, given the lower costs of production that it experienced as a result of the use of the catalyst).

Conclusion

Sometimes there will be challenges in formulating a royalty structure for a license.

Not all IP that is licensed lends itself to attract a royalty based on the invoice price of a product (such as in the catalyst example).

And some IP when licensed will result in side benefits to a licensee which it is not inequitable for a licensor to receive a proportion of (such as in the royalty on Ipads example).

In each case, when considering how to structure the financial terms of a license, the question to consider is how it is best, on that occasion, to capture a fair remuneration to the licensor.

Most of the time, the answer will be a royalty based on the sale of products that infringe the licensor's IP. But sometimes, there may be a need to be more inventive in arriving at the best answer.