IP bits

September 2015

Who Should Make the Opening Offer in a License Negotiation?

Scenario

We are negotiating the financial terms of a license. It may be the royalty rate, or the upfront amount, or milestone payments, or a combination of these.

Who should make the opening offer? Should it be the licensor, or the licensee? Or, should it be us, or the other party?

Best Practice

Most people respond by preferring the other party to make the first opening offer in a negotiation of financial terms. But in fact best practice is that we should make the first opening offer – whether we are the licensor or the licensee.

This is because the first offer has an anchoring effect upon the negotiation. Whichever party makes the first opening offer, by doing so, will set an anchoring point, and set the negotiation range of the financial negotiation that follows.

It is not unlike the price of a car being painted on a car windscreen by the car salesyard. The price painted on the windscreen is the first opening offer, and it achieves that anchoring effect, which dictates the price range negotiation that follows.

Making the first anchoring offer also has a calibration effect. A licensee may have expected to pay a royalty of 4% to 6%. But when a licensor makes a first anchoring offer of say 9%, the licensee may have to recalibrate its expectations, and consider having to pay a royalty rate of at least 6% (its maximum), or an even higher royalty rate. The licensor has by its opening anchoring first offer achieved a tilt in its favour in the negotiation that follows.

The same is true in reverse. A licensor may have expected a royalty rate of 10% to 12%. But a licensee that makes a first anchoring offer of 5% forces a licensor to have to recalibrate its expectations, and consider having to accept a royalty rate of less than 10%. This time, the licensee has by its opening anchoring first offer achieved a tilt in its favour.

These examples demonstrate that the anchoring effect can be achieved by the licensor or by the licensee, whichever of them makes the first opening offer.

As a general rule, this tilting of the negotiation in favour of the party that makes the first opening anchoring offer results in the party that made the first offer getting a "larger slice of the pie" in the negotiation.

Highest (or lowest) credible offer

But this does not mean that the party making the opening offer can make a ludicrous offer.

If the anchoring effect is to be achieved, and if the recalibration effect is to be achieved, the first opening offer must be a credible one. If the other party asks for justification for the amount offered, the party making the opening offer must be able to provide a commercially acceptable response.

If a commercially acceptable response cannot be given, the first opening offer will not have the anchoring and recalibration effect that was intended.

Instead, the first opening offer will be dismissed, and the party that made it will now have to deal with a negative perception of its credibility, and not just in relation to the failed impact of the first offer, but indeed in relation to the whole negotiation.

To achieve the anchoring and recalibration effect described, and to avoid any adverse impact on one's credibility, the first opening offer must be credible.

For a licensor this means making the highest first offer that it can commercially justify, confident that its credibility will be preserved because it has its justification prepared.

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For a licensee this means making the lowest first offer that it can commercially justify, again confident that its credibility will be preserved because it has its justification prepared.

What if the other party makes the first offer?

If the other party makes the first offer, does that mean that we have lost the opportunity to make the anchoring first offer that we had intended?

Not necessarily. Best practice is not to respond to the first offer, not to seek justification for it, and not to discuss it to any extent, but instead to make a counter offer, and to do so immediately. The counter offer made would be the opening offer that had been intended.

By making the counter offer immediately, and not engaging in any discussion of the first offer, the intention is to have the counter offer achieve the anchoring effect and recalibration effect that was sought.

First exception – when the other party does not know the value

As with all general rules, there are exceptions.

The first exception is when one party perceives that the other party does not know the value of what is being negotiated. By allowing the other party to make the first offer, it is hoped that the other party will over-value and offer too much.

Market places where haggling is the norm illustrate this exception. Often, sellers will invite the customer to make the first offer, knowing that the customer is unlikely to know the real value of the item, and is likely to make an over-valued first offer. The negotiation proceeds from that over-valued first offer. The seller, by inviting the buyer to make the first offer, and the result being an over-valued first offer, has tilted the outcome of the negotiation in the seller's favour. But if the buyer had made an under-valued first offer, the seller would immediately dismiss it and make a countering anchoring first offer, seeking to recalibrate the buyer's expectations.

In any marketplace where prices and not displayed and haggling is the norm, these strategies will often be employed by sellers.

Second exception – a licensor perceived to have a weak bargaining position

The second exception is the strategy very often used by pharmaceutical companies and other multinational companies.

When there is a perception that the licensor has a weak bargaining position, they may invite the licensor to make the first offer, in anticipation that the licensor will under-value its IP.

This may occur when the licensor:

1. seeks to license out at an early stage in the development of the technology, or
2. is a university or research organisation, and is assessed by a licensee to have limited other options, or even no other options, or
3. has been searching for a long time for a licensee, and is perceived to be anxious not to lose the present opportunity it has.

The licensor will be perceived to be likely to not want to ask for too much, in case doing so makes the potential licensee uninterested. A licensor might, at such an early stage, respond by stating a royalty, or a royalty range, which is at the low end of the commercial spectrum for the technology concerned. The licensee of course will respond by replying that the licensor's expectation is too high (whatever the licensor stated), and the negotiation proceeds from the under-valued point offered by the licensor. The licensee has in this way titled the outcome of the negotiation in its favour.

This strategy, and how to deal with it, was described in an earlier edition of *IP Bits*, which can be read here.

Conclusion

Negotiation is often thought of as involving little more than "turning up and saying what you want". But of course, there is a science to negotiation, and there are strategies to employ, as well as to watch out for.