IP bits

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Negotiating *the right* royalty rate

Every license negotiator's worst nightmare #1 – seeking too little

There is nothing worse in a license negotiation but for your first royalty offer to be accepted.

If you are a licensor and the licensee accepts your first royalty offer, without any negotiation, your first offer was too low – the licensee would have paid more. You have missed out on receiving the higher royalty that the licensee was prepared to pay.

If you are a licensee and the licensor accepts your first royalty offer, without any negotiation, your first offer was too high – the licensor would have accepted less. You are paying more for the licensed technology than you should have.

Every license negotiator's worst nightmare #2 – seeking too much

Surely seeking too much in a negotiation of royalty rates is not a nightmare – you can always negotiate from your opening position. But it can turn into a nightmare if you lose the deal as a result of seeking too much.

A licensor that seeks too much is one that offers a commercially unreasonably high royalty rate. A licensee can draw a number of inferences from that, including that proceeding to negotiate the licensor's unrealistic high opening position may be too difficult, too time consuming, and too expensive. A licensor that starts too high might therefore deter the licensee, and put the whole deal at risk.

The same is the case when a licensee offers too little. Similar inferences may be drawn by the licensor, including that proceeding to negotiate the licensee's unrealistic low opening position will be too difficult, too time consuming, and too expensive. A licensee that starts too low might therefore similarly put the whole deal at risk.

Not just royalty rates – up fronts and milestone payments as well

Nightmares #1 and #2 are not confined to royalty rates. They might also concern the amount of an upfront payment, the amounts of milestone payments, and other payments.

Ways that *do not* lead to the right answer #1

Sometimes a license negotiator's approach to negotiating the financial terms of a license is to seek more than what is offered. There are two things wrong with that approach.

The first is that even after you believe that you have extracted as much as you can, you may still have not reached the market rate, and worse, you do not know that that is the case. When this happens, if you are a licensor, you have settled for too little. And if you are a licensee you have committed to pay too much.

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The second is that this approach requires the other party to make the first offer. If you wait too long for the other party to make a first offer, it may well infer that you do not know the market value of the technology. With that inference comes the further inference that you may be likely to settle on a package of terms well below the market rate. There is a negotiation best practice rule that whoever makes the first offer in a negotiation has the advantage (see the September 2015 edition of *IP Bits* Who should make the First Offer in a License Negotiation). The approach of waiting for the other party to make the first offer of a royalty rate so that more can be sought entails negotiating contrary to negotiation best practice.

Ways that *do not* lead to the right answer #2

Sometimes a license negotiator's approach is to seek the standard 5% royalty.

Statistically 5% is a very common royalty rate. But that does not make it *the right* royalty rate. 5% might be OK. But if the market value of the licensed technology is 10%, you will have worst nightmare #1. And if the market value of the technology is only 1%, you might have worst nightmare #2.

Ways that *do not* lead to the right answer #3

Sometimes a license negotiator's approach is to consult statistical tables of royalty rates in different industries for guidance.

There are five things wrong with that approach.

The first is that the table may give a single average rate for a particular industry. The trouble with that is that this gives no comparability guidance when your own technology is very advanced, and therefore of greater value, or when your own technology is at a more infant stage of development, when is obviously will be of lesser value. Nightmares #1 and #2 will be on the horizon.

The second is that the table might give a range, such as 4%-8%. You might infer that 8% is appropriate for a mature technology, and 4% is appropriate for a technology in a more infant state of development, and then judge where in that range you might lie. The trouble with that is that 4% might have been the royalty rate in a license for a very mature technology, where the royalty rate was negotiated at a modest level because that specific license agreement provided for a generous upfront payment and generous milestone payments.

The third is that statistical tables do not always give the full story. A statistical table of royalty rates will give no indication of other valuable payments under the license such as upfront payments and milestone payments.

The fourth is that these tables may, and often do, present statistically unreliable information. If the sample size for a range of 4% to 8% was only two licenses, and you would not necessarily know if that was the case, nothing at all can be reliably inferred.

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What is the "right" royalty rate?

The "right" royalty rate under a license is the market royalty rate applicable for the technology that is licensed. So also, the "right" "package" of financial terms including royalties, upfront payments, and milestone payments, is a package of terms that accords with the market.

How do you know what that is?

How do you know what the market value of a house is? You look at other comparable houses, inspect them to compare the extent of comparability, and compare the market price for which they were sold. The more points of similarity the greater the price comparability.

The market royalty rate (and other financial terms) is assessed in the same way. You need to find comparable technologies that have been licensed, and find the financial terms of those licenses. The greater the similarity between your technology and the ones you find, the more you may be persuaded that the royalty rate (and the package of all the financial terms) in the compared licenses, represent the value of your own technology.

This is called undertaking a benchmarking or comparables analysis, a skill that every licensing professional needs to have. There are tools, methodologies, and best practice to find the data and comparable licenses to undertake this analysis.

For some license transactions, a discounted cash flow analysis might additionally be done to help formulate the market royalty rate and other financial terms.

There are also some methodologies which should never be used to formulate a market royalty rate. And then there are some which are useful sometimes, but not always, and a licensing professional needs to know when these can be used, and when they should not be used.

It is beyond the scope of an issue of IP Bits to deal with all of these topics. It takes two days to cover it all, and this is what our next workshop is about - Setting Royalty Rates and Other Financial Terms.