

Royalty terms in licences

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Evaluation of intellectual property (IP) is an essential component of any technology transfer process. Financial negotiations for IP licensing require in-depth knowledge of royalties and licence fees. Current practices with regard to licensing include different types of royalty terms and methods depending on the nature of licensing involved. This article provides an assessment of different royalty rate and payment methods commonly used in IP licensing.



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Introduction

All too often, the focus of financial negotiations in an intellectual property (IP) license is on the percentage royalty rate - whether 3 or 5 or 10 per cent, or something else.

But there is much more to the financial terms of an IP licence. Royalty terms, in fact, are tools that can be used imaginatively and flexibly. They can be used to effectively reduce the amount of royalties that a licensee might pay, while leaving a royalty rate unchanged. They can also be used to increase the royalties payable, again leaving a royalty rate unchanged. Royalty terms can also be used as effective performance obligations upon a licensee.

The purpose of this article is to identify and assess some of the ways in which royalty rates can be used as tools, imaginatively and flexibly, to maximize a licensor's or a licensee's position.

It explores 14 different types of royalty terms that might make their way into a licence of intellectual property. No licence would contain all of them. In fact, no licence would ever have

more than just a minority of the royalty terms described.

A licence can as well contain other types of financial terms, where the remuneration to a licensor may be in addition to royalties, or, instead of royalties, be lumpsum licence fees, milestone payments, annual licence maintenance payments, or other types of payments.

The selection of the royalty terms and other financial terms to be sought in a licence will depend upon such matters as:

- The type of technology to be licensed;
- The benchmarks in the industry in which the technology will be exploited;
- The position of the licensor (whether it is risk averse, whether it has a strong or weak bargaining position, etc.);
- The position of the licensee, (similarly, whether it is risk averse, has a strong or weak bargaining position, etc.);
- The identity of a licensee, (whether it is a multinational company or otherwise);
- Whether the licence is worldwide or other than worldwide; and

- What country the licensee is located in.

This list is by no means exhaustive.

In relation to each licence, an assessment of these matters, and any others that may be relevant, will be required to determine the appropriateness or otherwise of some of the royalty terms referred to below.

Royalty on sales by a licensee

This is the most commonly encountered type of royalty term. In this royalty term a licensee agrees to pay to a licensor a royalty on the revenue that the licensee receives from the sale of products that are sold.

A royalty-based licence is a quantity-of-use licence. That is, the greater the number of sales of a product, the greater the use being made of the intellectual property that is licensed, and correspondingly the greater the remuneration, in the form of a royalty, paid by the licensee to the licensor. This is different from a licence that is granted for a single-once-only lumpsum licence fee payment, which is not a quantity-of-use licence.

A royalty upon sales is typically expressed as a percentage of the sale price of products that are sold by the licensee. For example, if expressed as a royalty of 5 per cent on the sales price, then the royalty payable on a sales price of \$ 100 would be \$ 5.

Usually, the royalty rate is assessed on the "arm's length" invoice price of a product, and often after deductions from that invoice price are taken into account, such as taxes, products returned, rebates, discounts, and the like.

Royalty on sub-licence income received by a licensee

What may be a more important royalty term for a licensor, however, is not a royalty upon the sales of a product, but instead, a royalty upon sub-licence income that is received by a licensee.

A licence may be granted for example to a licensee that has the capability to exploit in one geographical area, but the licence may be a worldwide licence. In such a licence there will be reliance upon sub-licensing for the exploitation of the IP in territories

where the licensee itself has no marketing capability. In this type of licence, the licensee will receive royalties pursuant to that sub-licence, from that sub-licensee.

Those royalties paid by that sub-licensee to the licensee is sub-licensee income, which itself is subject to a royalty being payable to the licensor.

The question now becomes what might that royalty rate be? If the royalty on product sales is 5 per cent, should the royalty on sub-licence income also be 5 per cent?

Some licenses operate in that way. But let's consider the appropriateness of that. If:

- The royalty that the licensor receives is 5 per cent of the licensee's sub-licence income;
- A product is sold for \$ 100;
- The sub-licensee pays to the licensee a royalty of 5 per cent, or \$ 5;
- The licensee in turn pays a royalty of 5 per cent to the licensor; and
- The amount of the royalty payable would be 5 per cent of \$5, which is \$ 0.25.

The result is that the licensor receives, in this example, a royalty of \$ 5 where the sale is made by the licensee, but only \$ 0.25 when the same product is sold for the same price by a sub-licensee.

A fairer royalty rate for this type of royalty is 50 per cent, or some other such similarly high amount.

This reflects that a licensor and a licensee are equally contributing to the sub-licensing opportunity: the licensor contributes by granting a licence with a territorial application that is greater than the licensee's capability to service, and the licensee is contributing by accessing its networks and affiliates, or if it has none, creating them, to facilitate the sub-licence, and in turn, access to a market unavailable to the licensor.

This often being regarded an equal contribution, a royalty rate of 50 per cent would not be unusual, although, in some industries, the benchmark might be a lower rate of 30 per cent, or 25 per cent, or some other industry-benchmarked amount.

Often, by the time a licensee grants a sub-licence, the licensor and the licensee have made improvements or otherwise added value to the technology,

and a higher royalty may be obtained upon sales than the royalty that the licensee pays.

For example, while the licensee may pay a royalty of 5 per cent to the licensor, the licensee may succeed in obtaining from the sub-licensee a royalty rate of say 8 per cent.

That 8 per cent rate is then subject to the 50 per cent royalty rate on sub-licence income payable by the licensee to the licensor, with the licensor accordingly obtaining 4 per cent.

Royalty on last sub-licence's sale

Instead of a licensee paying a 50 per cent royalty (or some other similarly high rate) on sub-licence income, an alternative royalty structure is for the licensee to pay to the licensor the agreed royalty rate, for all sales of all products, whether those sales are made by the licensee, a sub-licensee, a sub-sub-licensee, or any other licensee further down the licensing chain.

This royalty structure might, in fact, result in a greater quantity of royalty payments to a licensor, than a royalty on sub-licence income. This is because the licensor is always assured the same royalty, say, of 5 per cent on all sales, by all sub-licensees, however down the licence chain they may be. The licensor does not become subject to a reduced royalty, as might operate where royalties are upon sub-licence income; as, for example, where a 50 per cent royalty on sub-licence income effectively reduces a 5 per cent royalty to a 2.5 per cent royalty. A licensor may therefore prefer this royalty structure, in lieu of the royalty on sub-licence income structure.

But there are a number of factors to be assessed in selecting this structure.

- There is no direct contractual relationship between the licensor and all the sub-licensees who make the bulk of sales. The absence of a direct contractual relationship means that all these sub-licensees have no reporting obligations to the licensor, and the licensor has no right to audit the records of sub-licensees.
- There may also be so many of them, potentially, that it would be administratively burdensome to even try to regulate the reporting obligations of

all the sub-licensees, and next to impossible to efficiently audit the records of all of them. Reliance at the end of the day would therefore have to be placed on the reporting by each sub-licensee, up the licence chain, to the licensee, and ultimately to the licensor. Reliance would also have to be placed upon the integrity of each link in the sub-licence chain.

- A greater risk, however, is that this structure of royalties will result in less royalty payments to the licensor where the licence is granted at an early stage of the development of the technology. For example, suppose that a licence is granted at an early stage for 2 per cent. Suppose also that the licensee and licensor both make improvements, so that, with the increased value of the technology, the royalty to a sub-licensee becomes as much as 7 per cent. In this example, if the licensor were to receive a royalty of 50 per cent on sub-licence income received by the licensee, the licensor's effective royalty rate would be 3.5 per cent. But, if the licensor were to receive 2 per cent on all sales by the last sub-licensee, then the licensor would continue to receive 2 per cent, which is substantially less than that 3.5 per cent. This is an example of an occasion where a royalty upon the last sub-licensee's sale would not operate to maximise the licensor's financial returns.

In each case, whether it is in a licensor's interests to agree to a royalty structure based on the last sub-licensee's sale, or to agree to a royalty on a licensee's sub-licence income, will depend on factors such as reporting, audit, and the stage of development of the IP at the time that the licence is granted.

Royalty on sales by affiliates

In a licence to a multinational licensee, it is not unusual for the royalty to be based on the sale made by the affiliate company of the licensee that sells a product on the first occasion to a non-affiliate, "arm's length" purchaser.

This is a royalty structure not unlike the sale by the last sub-licensee, except that these licences are custom-

arily expressed to be granted to the multinational licensee and all its affiliates, which is defined by reference to the control over the affiliate company.

Similar issues considered above impact upon the selection of this model, like reporting, audit, and the stage of development of the IP at the time that the licence is granted. It also gives rise to additional issues, such as the meaning of an affiliate, and the prospect that companies may drift into and out of the scope of the definition of an affiliate, and thus drift in and out of being licensed, without a licensor necessarily being aware of this.

Nevertheless, multinational companies are unlikely to accept a royalty structure based on sub-licence income. That is because affiliates do not customarily pay royalties internally, within the affiliate group, because this is regarded as inefficient.

This is an occasion, therefore, where the use of the royalty upon last licensee's (or affiliate's) sale is the only practical model that works, for this type of licensee.

Royalty on sales where a patent claim is granted

Sometimes a licensee is only prepared to pay a royalty in relation to products that are captured by a claim in a granted patent, and are otherwise unwilling to pay royalties. The result is that a royalty is paid in relation to sales where a patent is granted, but no royalty is paid in relation to sales made in countries where no patent has been granted, since in such a country, anyone can make and sell that product, there being no patent granted in that country.

This may sound quite equitable: why would a licensee want to pay a royalty on the sales of a product that does not infringe a granted patent?

There are a number of ways that this type of royalty structure may be implemented.

A licence may provide that a royalty is payable on products sold, which, but for the grant of the licence, would infringe a valid patent claim, which in turn is defined to mean a claim made in a granted patent. Or a licence may provide that royalties are payable for the

royalty term, and proceeds to define the royalty term as commencing when a patent is granted, and for the duration of the granted patent.

The first issue is assessing the appropriateness of this. There may be a commercial basis for a licensee to pay a royalty on all worldwide sales, even where those sales are made in countries where no patent has been granted. This is explored later in this article.

The second issue is the risks to a licensor where royalty obligations are structured in this way. Products may be sold while a patent is in an application stage. The pre-grant application stage may last for years, and, for the whole of that time, if structured in this way, a licensor will receive no royalties, while the licensee is making use of the IP.

There may also be opposition proceedings, which too can last many years, and again, for all of that time, the licensor is receiving no royalty, while the licensee is making use of the IP.

Both licensor's and licensee's positions are understandable.

A licensor is not receiving royalties for what may be a substantial period of time, and is understandably not prepared to be without royalties for that time.

A licensee however will not want to pay royalties should a patent claim fail, which would result in there being no royalty obligation at all, and then will not want to have to deal with the potential difficulty of obtaining a refund of paid royalties from a licensor, if a patent claim should fail.

However, the most likely scenario is that a patent will be granted without opposition proceedings, and so the licensor is being denied the benefit of royalties that should properly be payable. Further, there being a published patent application, infringers are on notice of their infringement, and indeed a licensee can recover damages for infringements right back to the time of the patent's publication. In all these circumstances, it may be inequitable for a licensor, during this period, not to be receiving royalties, when the licensee is receiving economic benefits from the grant of the licence.

A structure that accommodates the positions of both a licensor and a licensee needs to be negotiated. One example may be as follows:

- Some part of the agreed royalty being paid during the patent application period, which would not be refundable, acknowledging that the licensee is receiving economic benefits from the licence, even during the application phase; and
- The balance of the agreed royalty being paid into a trust account, being paid to the licensor upon the patent being granted with the relevant claim included, or refunded to the licensee upon the patent being granted with the relevant claim omitted.

Royalty on sales where no patent is granted

A licensee's position, as described above, may be that the licensee is unwilling to pay a royalty in relation to sales of a product in countries where there is no granted patent.

On the face of it, this does not appear unfair. In fact, the opposite appears so: that a licensor should expect a royalty on the sales of a product in countries where no patent has been granted.

A licensee's justification for its position may be that competitors may enter the market in countries where there is no granted patent, and compete with the licensee in those countries, yet have no royalty obligations. In such a case, the licensee, if it had royalty obligations in those countries where there is no granted patent, cannot compete as effectively, having royalty obligations while the competitor has none.

Here, however, there is a presumption that competitors may enter the market in countries where there are no granted patents and compete with the licensee. But this presumption may not necessarily be a valid one. For example, seeking patents for a pharmaceutical product in about 25 countries will secure those countries that represent approximately 95 per cent of the world market for pharmaceutical products.

Having such a small remaining market, there are cost inefficiencies that a competitor would face that effectively operate as a barrier to the entry of competitors into the marketplace in those countries where the decision was taken not to seek a patent. The practical result is therefore that patents granted in those

25 or so countries effectively secures to the licensee 100 per cent of the world market for pharmaceutical products.

In other industries, a different number of countries and a different combination of countries may lead to a similar market dominance that effectively precludes competitors. In this situation, a licensor's technology, and the opportunity that it provides, being patented in the required number of countries, enables a licensee to dominate the marketplace in even those countries where no patent has been granted.

That being the case, there is no reason why a licensor should not receive the full royalty on sales made in countries where there is no patent protection.

Sometimes there may be a real risk that a competitor may enter the market in countries where there are no granted patents. Where that is so, a licence might provide that, if a competitor does enter the market in a country where there is no patent, and obtains a market share of greater than X per cent, then royalties are reduced by some agreed percentage. They might even go further and state that, where the competitor's market share exceeds Y per cent, only then would royalties in that country without patent protection be suspended.

Royalty splitting

Royalty splitting occurs when a royalty is split into components that are referable to different parts of the IP being licensed.

For example, a royalty rate may be agreed at 5 per cent. However, it may be agreed that it would be expressed:

- As a royalty of 3 per cent on the sales of products in relation to that part of the IP that is granted patents; and
- As a separate royalty of 2 per cent on the sales of products in relation to that part of the IP that is other than granted patents, such as trade secrets, know-how, technical knowledge which complements the claims in the granted patents, and without which either products cannot be manufactured, or cannot be manufactured as efficiently.

There are at least three reasons for seeking a royalty structure that splits royalties into these separate components in this way:

- By this mechanism, a licensor may obtain royalties in relation to sales made in countries where no patents have been granted (see the discussion above);
- In some countries, if a patent should be revoked, that is grounds for the termination of the licence, yet, both the licensor and the licensee would prefer to keep the licence on foot, in relation to the use of knowhow, for a lesser royalty, until that knowhow enters the public domain; and
- Where a licensor's knowhow continues to be used after the expiration of a patent, the licensor may seek a royalty to be paid on that use of its know-how, even after the patent has expired (subject to the operation of European competition laws which may place limitations upon this in the European Union).

Royalty-stacking

Royalty-stacking occurs when a number of separate royalty obligations, in relation to the same product, but pursuant to separate licenses to separate licensors, are stacked or layered, each upon the other.

A product may rely upon a number of separate technologies to be combined, each being critical to the product, and without which there would not be a product for sale. For example, in a pharmaceutical product, a compound may be licensed in from Licensor A, and a delivery system for the compound may be licensed in from Licensor B. Both licenses are required to enable the product to be produced and sold.

The benchmark royalty rate for the compound from Licensor A may be 5 per cent. The benchmark royalty rate for the delivery system may be 3 per cent.

However, the economics of the product is such that a combined royalty of 7 per cent being attracted upon that product is the maximum rate that can be paid, with any greater royalty rate putting at risk the economic viability of exploiting the product at all.

It would not be in the interests of either Licensor A, or Licensor B, or the licensee, to abandon the exploitation of the product altogether. It is preferable for all of them to reduce their expectations, and in that way, have a product that can still be exploited.

At the time of the negotiation of a licence with Licensor A, a negotiation has not yet occurred with Licensor B. The licensee will wish to ensure therefore that the royalty structure in the licence with Licensor A will accommodate the outcome of negotiations with Licensor B. This is where a royalty-stacking structure will be used. The licensee will wish to stack, or layer the royalty to Licensor A and the royalty to Licensor B, so that the aggregate does not exceed the maximum royalty that can be economically borne.

However, the licensor will wish to ensure that it receives the maximum royalty, for example, if it turns out that a licence from Licensor B should prove to be unnecessary, or should prove to be obtainable on more favorable terms than are anticipated at the time of the negotiation between Licensor A and the licensee.

The operation of a royalty-stacking model is such that: the benchmark royalty rate is agreed, unaffected by any later licence that may need to be negotiated with Licensor B (in this example, 5 per cent), subject to a provision that that royalty rate may be reduced by a proportion of the royalty rate that is later negotiated with licensor B (in this example 3 per cent).

The result of royalty-stacking in this way is that the licensor may commence with a royalty rate of 5 per cent; and the licensor may later be automatically reduced to a lower rate. It is not uncommon in this royalty structure, for the amount of the reduction to be something less than the full rate to Licensor B. It may, for example, be a reduction of only one half of the rate to be paid to Licensor B.

In that case, the licensor may commence with a royalty rate of 5 per cent and later be automatically reduced to a royalty rate of 5 per cent less half of 3 per cent, (i.e 1.5 per cent), effectively 3.5 per cent.

Sometimes, a royalty-stacking mechanism will refer to a minimum roy-

alty rate, so that, despite all royalty-stacking calculations, particularly where there may be more than one other parcel of IP to be licensed in, there would always be a minimum rate.

Royalty reduction

Similar to a royalty-stacking structure is one that reduces the royalty rate by the royalty that has to be paid to license in another IP, to have freedom to operate.

A product derived from the licensor's patent may infringe another person's patent. Both patents may co-exist, protecting different parts of a product. A licensee of one patent, in exploiting that patent, will infringe the second patent, and will therefore not have freedom to operate, being exposed to the risk of infringement proceedings.

A licensee that anticipates such a freedom-to-operate obstacle to the exploitation of a licensor's patent may seek to have a model incorporated in the licence that operates in much the same way as a royalty-stacking model.

Reach-through royalties

Reach-through royalties are royalties that are paid, not on the sales of products that are derived from a licensor's intellectual property, but instead on products that are enabled or produced with the licensor's IP. The critical aspect of reach-through royalties is that a royalty is paid in relation to the sale of a product that is unrelated to the IP that is licensed.

A few examples include:

- A research tool, such as a transgenic mouse, may validate a drug target, and result in the development of a drug for that validated target;
- A new catalyst may result in the production of industrial chemicals more efficiently, and therefore at a significantly reduced cost; or
- A computer programme is written with unique innovative algorithms that diagnose a specific medical condition from an analysis of biological fluid placed upon a reagent, the reagent being a consumable item.

In the first example, the research tool transgenic mouse is protected by a patent, say Patent 1. But Patent 1 is un-

related to the drug that is ultimately exploited, which is derived from Patent 2. Nevertheless, the research tool has played a critical role in the validation of that drug. It is not unusual for the price for access to Patent 1, that patented research tool, to be negotiated by reference to what it enables, which, in this example, is the exploitation of a new drug, derived from Patent 2. The result is that a royalty for the use of Patent 1 is negotiated by reference to the products derived from Patent 2, in this way "reaching through" to Patent 2.

But this need not necessarily be confined to an exploited product that is protected by a patent. In the second example, suppose that the industrial chemicals were the subjects of patents that have long since expired. Nevertheless, the new catalyst is protected by a patent, and it enables the cost of producing a litre of the chemical to be reduced from \$ 100 to \$ 80, resulting in a cost saving of \$ 20. A litre of that chemical is sold, say, at \$ 150. The profit margin used to be (150-100) \$ 50. With the use of the new catalyst, it is now (150-80) \$ 70, resulting in the profit margin increasing by almost 50 per cent, even with the cost of the product remaining unchanged. Here, therefore, a royalty would be sought for the use of the catalyst, on the sale price of the industrial chemical, even though the patent on the industrial chemical had long expired, again, "reaching through" to an unrelated product.

In the third example, the business model adopted by the licensee is to license in the computer programme, and make it freely available to pathology laboratories, who buy the consumable items, namely the reagents, from the licensee. The licensee's business model is therefore to earn profits, not from licensing the computer programme, but instead from selling the reagents. Nevertheless, the technology that is the platform for this commercialization, remains the computer programme. In this example therefore, a royalty for the licence of the computer programme to the licensee may be a percentage of the sales price of the reagents sold by the licensee to the pathology laboratory. In this way, the royalty for the use of the computer programme is "reaching through"

to the unrelated product, which in this example is the reagent.

What all these three examples have in common, however, is that a quantity of use remuneration is sought by the licensor for the quantity of use of the licensor's technology.

Whether it is a transgenic mouse, a catalyst, or a computer programme, in each case, the quantity of use is quantified by the sale of an unrelated product, and it is a royalty upon the sales of the unrelated product "reaching through" that is sought, to achieve a remuneration based upon the quantity of use made of the licensor's technology.

Royalty suspension

Sometimes, a licence may make provision for the suspension of royalty obligations where proceedings are commenced for the revocation of a patent. The justification here is that if it turns out that a patent is revoked, then there should not have been any royalty payments to the licensor.

Anticipating that revocation proceedings may be successful, a licensee may wish to have the payment of royalties suspended, pending the outcome of the revocation proceedings. If it should turn out that the revocation proceedings are successful, then the royalty payments that were suspended are never paid. If it should turn out that the revocation proceedings are unsuccessful, then the royalty payments that were suspended are promptly paid.

Ramped-up royalties

Ramped-up royalties are royalties that increase progressively. This may occur, for example, where:

- A licensor defers a proper royalty rate in the early commercialization phase when commercialization costs are high; but when economies of scale are achieved, and production costs reduced, thus increasing the licensee's profit margin, the royalty rate ramps up, with the increased profit margin being shared by the licensee with its licensor;
- Commercialization milestones or marketing milestones are achieved; with the achievement of the mile-

stones demonstrating commercial success of the IP and triggering a higher rate of reward to the licensor. Usually, ramped-up royalties would be linked to sales revenue increases, or to some other milestones.

For example, a licence might provide that, until sales revenues reach \$ 10 million, the royalty rate will be 5 per cent, once they reach \$ 100 million, the royalty rate increases to 6 per cent, and once they exceed \$ 200 million, the royalty rate increases to 7 per cent. This would usually be expressed by reference to cumulative aggregate sales.

Royalties on damages

Damages recovered by a licensee in infringement proceedings are compensation for the licensee's lost profits arising from the infringement. A licensor has also lost profits as a result of the infringement, and customarily, the damages recovered by a licensee, after taking into account the cost of the proceedings, are shared between a licensor and a licensee. The question becomes, in what manner should they be shared?

Sometimes, the same royalty that applies in relation to sales, such as 5 per cent, is agreed to be the proportion of damages payable to the licensor. But is that the correct percentage?

Suppose the cost of producing a product is \$ 60; the profit margin is \$ 40; the sale price of the product is therefore \$ 100; and the royalty rate is 5 per cent.

As damages are compensation for actual loss, a licensee's damages will not be \$100. That is not what the licensee has actually lost. The licensee has actually lost \$ 40, and that will be the extent of the damages recovered. The licensor's actual loss is 5 per cent of \$ 100, namely \$ 5. If the licensor receives only 5 per cent of \$ 40, that would be merely \$ 2.

The royalty on damages should therefore be expressed as the amount that would have been received by the licensor on the sales by reference to which the licensee's damages have been assessed (\$ 100), instead of the actual damages which the licensee has received (\$ 40).

Minimum annual royalties

A minimum annual royalty is a performance obligation. It is a royalty provi-

sion intended to provide incentive to a licensee to achieve minimum sales, and to penalize a licensee that fails to do so, without the penalty extending as far as the termination of the licence.

It is customary for a licence to have performance obligations of some type, requiring the licensee to perform the obligation to exploit, so as to maximize the financial returns back to a licensor.

There are two types of performance obligations:

- Commercialization milestones, which are pre-market-entry milestones that a licensee has to achieve along the pathway to market; and
- Minimum sales, requiring a licensee to sell products to some minimum extent.

A breach of either type of performance obligation in a licence can lead to the termination of the licence, with the licensor then able to license another licensee, which is able to meet the performance obligations.

Examples of performance obligations that are pre-market-entry milestones that a licensee has to achieve along the pathway to market include:

- Completing research and development;
- Producing a prototype;
- Construction of a pilot plant;
- Construction of a production plant;
- Conducting trials for any required regulatory approval;
- Obtaining such a regulatory approval; and
- Granting a sub-licence to a sub-licencee for a territory that the licensee is unable to service.

The types of milestones that are appropriate will depend upon such factors as the technology that is licensed; the industry concerned into which the technology is licensed; and the type of licence; but this is by no means an exhaustive list.

Customarily, if milestones such as these are not achieved, and continue not to be achieved despite any mechanisms for the extension of the dates by which they have to be achieved, the licence is terminated.

Examples of performance obligations that are minimum sales requirements are:

- Selling a minimum of X units of products in North America during the first year after the licensing;
- Selling a minimum of Y units of products in Europe during the first year after the licensing;
- Selling a minimum of Z units of products in Asia and the Pacific during the first year after the licensing;
- Selling a minimum of 2xX units of products in North America during the second year after the licensing;
- Selling a minimum of 2xY units of products in Europe during the second year after the licensing; and
- Selling a minimum of 2xZ units of products in Asia and the Pacific during the second year after the licensing.

Customarily, if these minimum sales are not achieved, exclusivity in a territory might be lost, or the licence might be terminated.

A licensor is motivated to have performance obligations of both types in licences, to ensure that commercialization does in fact happen, and that

there is a maximum financial return back to the licensor.

But not surprisingly, licensees resist performance obligations of both types. Whether performance obligations can be secured on any particular occasion will depend upon such matters as the benchmarks in the industry in which the IP will be commercialized, and the relative bargaining strengths and weaknesses of the parties negotiating.

Where performance obligations of these types cannot be secured effectively, a licensee's position is that it wishes to retain the licence, even if it does not commercialize, or should decide not to commercialize. A licensee may, for example, wish to do so merely to secure the IP and make it inaccessible to a competitor.

Looked at in this light, a minimum annual royalty is an annual fee, or annual price, that the licensee pays, to continue to be licensed, without termination being invoked, regardless of the amount of royalties that are paid, or even if no royalties are actually paid.

Actual royalties would customarily be credited against the minimum annual payment, so that it is the greater of royalties, or the minimum annual payment, that is to be paid each year.

Conclusion

Fourteen types of royalty terms have been described in this article, but no single licence would make provision for all of them.

While a non-exclusive licence might lend itself to a standard form, that is not the case with an exclusive licence. Each exclusive licence represents an individual, customized transaction, which is responsive to the needs of the particular parties, and the needs of the specific technology that is being licensed.

In such a customized licence, some of the types of royalty structures described might be appropriate to consider, having regard to the specific needs of the transaction, and the specific needs of the parties' relationship, that the licence is intended to serve. □

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