ESTABLISHING AND CONTROLING INTELLECTUAL PROPERTY ROYALTIES

By
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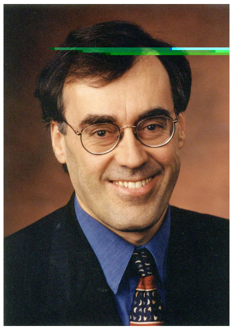

Mr. ROBERT BROUILLETTE[1] is a lawyer, a civil engineer and a Canadian and U.S. patent and trade-mark agent. He obtained his education in engineering at the University of Sherbrooke and his education in law at the University of Laval. He became a member of the Order of Engineers in 1972, member of the Quebec Bar in 1977, trademark agent in 1978 and patent agent in 1980.

Mr. Brouillette began his professional career with Ogilvy Renault in 1977. He founded Brouillette Charpentier Fortin (now BCF) in 1992. Mr. Brouillette recently founded Brouillette & Partners a Law/Patent and Trade-mark firm focussing on Entrepreneurs and Innovators. A majority of his clients are entrepreneurs and a great number of them operate technological enterprises. He has become a leading Canadian expert in the field of direct sales. He is recognized by The Best Lawyers in Canada as an expert in Information Technology Law and by Lexpert in Intellectual Property Law.

Mr. Brouillette is a former president of the executive of the national division of Intellectual Property Law of the Canadian Bar Association. He is a member of different associations operating in the field of intellectual property including the Intellectual Property Institute of Canada, the Licensing Executive Society, the American Intellectual Property Law Association, International Trademark Association and la Fédération de l'Informatique du Québec. He was a member of the board of directors of Hydro-Quebec between 1998 and 2001 and of Hydro Quebec Capitech and Hydro-Quebec Industech between 2001 and 2007. He is currently a member of the board or advisory committee of Simsmart Technologies Inc., Iweb Group Inc., Mondias Investments Inc., Leddartech Inc. and other technological enterprises. He has also acted as an angel investor in a number of start-ups.

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While in private practice, she pursued her Masters of Law (LL.M.) degree at Université de Montréal, which she completed in February 2000. The subject matter of her thesis relates to internet domain names and trade-marks in an international context (“Domain names in the realm of Trademark Law”).

Ms. Vermette is licensed to practice law in the Province of Quebec, Canada and is a registered Canadian trade-mark agent. She practices in Montreal in the field of intellectual property and commercial transactional law representing a diverse clientèle ranging from multinational pharmaceutical companies to small start-up enterprises. She has published articles and has made numerous presentations on intellectual property issues related to the Internet.

Ms. Vermette is a member of the Federation of Defense and Corporate Counsel ("FDCC") and of the International Trademark Association ("INTA"). She is also Chair of the Intellectual Property Law Committee of the Tort Trial & Insurance Practice Section of the American Bar Association (“ABA”) for bar years 2006-2007 and 2007-2008. Ms. Vermette was elected to public office for a 4 year term as a municipal councillor for the municipality of Wentworth-Nord in the province of Quebec.

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Introduction

First and foremost, there exists no universally recognized method to determine what a royalty should be. Each legal jurisdiction has its preferred method(s), and tax considerations, however with the globalization of markets, multi jurisdictional business relationships, and the liquid-like flow of technology, it is difficult to assert one jurisdiction's preferred method(s) over another. In this article, we will briefly examine several factors that influence the determination of royalties.

This article does not however purport to be a detailed treatise on the subject of royalties, but rather an overview or "check list" of things to consider when negotiating royalties in relation to intellectual property rights[3].

Royalties are generally determined according to the "Law of Offer and Demand" In the case of royalty determination, the two main components of this Law are "anticipated profitability" and the parties' respective "negotiation power". A party's negotiation power can be evaluated by establishing whether there are any viable alternatives to the intellectual property sought, and if so, at what cost?

What is targeted?

In securing or granting rights to a technology, it is of utmost importance to understand the nature of the rights sought after. In most cases, both the licensee and the owner have a vested interest in protecting the technology and/or brand that will be shared by the licence.

Therefore, one of the first questions one must ask is whether or not this technology is protectable by Patent or otherwise. If so, the parties' must choose between the disclosure of the "invention" by filing a patent application in exchange for a 20 year monopoly (from the date of filing), or protecting it by leaving it within the realm of "know-how" or "industrial secret" thereby avoiding revealing its inner workings.

Once this determination has been made, the next question should be at what stage of development is the technology and whether there exist any prototypes? This will usually indicate what research and development investments will be required and by whom, thereby helping to clarify the risk sharing factor.

If the technology is patentable, and the owner has already proceeded to file a patent application, it is important to determine at what stage the application is (i.e. whether the patent has been issued, or is still pending). Again, this will help to determine the risk sharing factor and whether or not the licensee will be "expected" to participate in the patent process, and in what capacity.

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3 For a more detailed review of valuation methods, we invite you to consult an article regarding the acceptable methodologies for valuation of intellectual property assets and recent issues affecting the valuation of intellectual property assets for tax purposes: STEPHENS, John "Intellectual Property Valuation for Tax Purposes", California Society Certified Public Accountants, Los Angeles, CA, August 14, 2007.

Although in the case of a technology license, the main focus of protection is usually patent protection, there exist other targets or intellectual property such as (1) the related trade-marks attached to the existing or potential goodwill; (2) copyright attached to any works created in relation to the technology (i.e. software, manuals, etc.) and (3) possible industrial designs that may flow from the technology.

Once the nature of the rights identified, one must determine the legal relationship between the parties. To this end, there are several categories of legal arrangements or contracts that can help manage the relationship.

Types of Contracts

The most common types of arrangements generating royalties are: licence agreements; franchise agreements; research & development agreements; joint-venture, strategic alliance or collaboration agreements, "acquisitions", and training agreements.

"Value" of the Intellectual Property

After the legal frame work has been determined, the next step is to value the intellectual property. Sadly, there exists no "perfect" evaluation method: it is often a form of "futurology" combining elements of development costs, discounted cash-flow and earn-outs requiring the assistance of experts in the field such as specialized accountants or actuaries.

Other Financial considerations

In addition to the valuation of the intellectual property, one must take into account other financial considerations when establishing how to pay the royalties. Will it be in the form of a single fixed amount? Will there be a licence fee with scheduled payments or based on attaining certain milestones in the research and development? Alternately, will there be a "per unit" or "per use" fee? How will the parties manage, both strategically and financially, lawsuits relating to the intellectual property?

Other Contractual Factors

In contemplating the contractual arrangement between the parties, one must take into account several considerations. Among such considerations is the possibility of cross licensing and cross collateralization, with the ensuing cross default clauses and penalties. Another consideration is whether the license is exclusive or not. Normally, exclusive licenses fetch higher royalties since they limit the owner's revenue capacity by putting all of his proverbial eggs into one basket. Additionally, we verify whether there will be an exchange of wares and/or services that may ease the licensee's cash flow situation. Finally, one must also consider disbursement reimbursement in relation to securing and maintaining protection, technical support/marketing/development and/or litigation.

Determining a Royalty

A royalty is a form of profit sharing resulting from the use of the licensed intellectual property. The ideal situation would see the licensee share the actual profits earned. This is however unrealistic since the owner has no control over the licensee's operations, real losses are always possible, accounting rules allow a certain "flexibility" in calculating profits and there is always the possibility of un-booked sales or inflated expenses. There is however a solution to the problem. One can estimate the "probable gross profitability". The parties can then share the "probable gross profitability" according to what seems reasonable (20% to 33% of the profitability to the owner, the remainder to the licensee). The royalty is then calculated based on an amount equivalent to the "net sales". For example, in the case of **software** sold with an 80% gross profit margin: a reasonable royalty would be between **16%** (20% of 80%) and **26%** (33% of 80%) of the net sales. Another example, in the case of **produce** sold with a 10% gross profit margin: a reasonable royalty would be between **2%** (20% of 10%) and **3.3%** (33% of 10%) of the net sales. For the purposes of this exercise, the definition of "net sales" is an amount invoiced to a "client" (an arms length third party) for all "products" and/or "services" and accessories thereto. Factored into the net sales are price exclusions such as returns, credits for defective products not returned, shipping and handling, sales taxes and customs charges, promotion/marketing allowances, discounts, commissions, bad debt, royalties, and other fees and credits.

Controls

Negotiators will often build several types of controls into the contractual arrangement between the owner and the licensee in order to protect the owner's interests and counter balance his lack of control over the licensee's operations. These controls can take the form of minimum royalty payments, minimum sales, minimum promotional expenses, sales reports, and audits.

Tax Reserves

Last but not least, careful consideration must be paid to the whole tax question, especially when dealing with cross jurisdictional agreements. Normally, the tax burden rests with the licensee. It is always wise for the licensee to take reserves on the payment of income taxes since, in Canada, for example, it is the licensee who is liable for the payment of income taxes to *Revenue Canada* and *Revenu Québec* (a 2nd time!) if a foreign owner does not pay its Canadian income taxes. Furthermore, the Canadian tax system works on an income percentage basis and the tax rate varies according to established tax brackets. It is always advisable to have tax advisors review any tax clauses included in the contractual arrangement.

Albeit not a detailed article, we hope that these pointers will be useful to you in preparing the groundwork to negotiate royalties relating to intellectual property rights.