Financial Considerations in International Intellectual Property Licensing Transactions

Emile Loza, Kimberly S. Chotkowski, Scott J. Stevens, & Gregory J. Urbanchuk*

I. Introduction

Tax consequences, payment, currency, and other financial challenges are important issues to consider when structuring international licensing agreements. Many intellectual property and other transactional attorneys, however, do not have sufficient understanding of these issues or give them appropriate consideration. This article aims to identify these issues and to suggest best practices or approaches by which to address these issues and to improve the

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collection of payments under international licensing agreements. By becoming more knowledgeable about the financial issues involved in international intellectual property licensing transactions, attorneys can add demonstrable value to their services to clients and correspondingly improve client satisfaction, retention, and referrals.

To provide the appropriate context for this article, discussions of licensing agreements typically take on a licensor or a licensee perspective or, as to financial aspects, a payor or a payee perspective, respectively. This article primarily adopts the perspective of U.S. licensors, although its discussions are relevant to licensors domiciled elsewhere. In addition, this article focuses specifically on transactions between U.S. licensors and foreign licensees. The discussion and suggestions in this article apply across the spectrum of intellectual property rights without an intentional focus on any particular species of right, except in the last section, which deals with the important topic of the compulsory licensing of foreign patent rights.

First, this article posits the view that there are three stages of an international intellectual property licensing transactional relationship. Focusing on the negotiations stage, this article provides an economic model of the financial considerations that affect the parties' respective positions as to royalty pricing. In particular, the model addresses the factors that licensors should consider with respect to international royalty pricing.

Second, this article discusses contract drafting strategies and certain tactical drafting mechanisms that practitioners should seriously consider. Effectively harnessed through the contract language, these strategies and mechanisms work to accomplish a number of key financial objectives, including the minimization of exchange rate risk to the licensors; the creation of sustained incentives for timely and accurate royalty payment and reporting by foreign licensees; and a licensor's improved ability to force compliance.

Third, this article turns to issues of international law and concomitant control exerted over intellectual property licensing agreements under foreign domestic law regarding taxation of, and more specifically the funds withheld from, royalty payments for payment in foreign jurisdictions. As to taxation in the licensor's jurisdiction, the characterization of payments in intellectual property licensing agreements affects the treatment of such payments and revenue recognition in financial reports to company executives, securities authorities, and shareholders. For this reason, this article discusses drafting devices that may provide licensors with financial options not previously contemplated, honoring the principle

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1. This article excludes discussions of transactions involving foreign licensors and U.S. licensees.
that the legal strategy reflected in international licensing agreements should aim to appropriately support the licensor client's business and financial strategies.

Fourth, this article discusses another critical aspect of the interface between international and foreign domestic law with respect to international licensing transactions and how that intersection of laws can impact clients' financial expectations and risks as to these transactions. Specifically, this article addresses how, under the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), governments of foreign countries as member states in the World Trade Organization (WTO) may compel holders of patents issued in those foreign countries to license those patents and may dictate the terms of those compulsory and even privately executed licensing agreements, including the terms regarding royalty rates.

II. The Economics of and Risk Factors in International Licensing

Every licensing relationship has three important stages to specifically address and consider so as to ensure proper payment performance by the licensee: the beginning, the middle, and the never-ending. The first stage is a period of relationship-building. This stage of the deal may be the most difficult because it requires the ability to convince the potential licensee that it needs to pay for the benefit of using the patented technology for product development or distribution or for resolving an intellectual property infringement issue. The second stage of the relationship corresponds to the drafting of the license agreement. The relationship enters its third stage upon the execution of the agreement. Ideally, this stage aims to maintain the relationship, a vital part of ensuring payment and other performance by the licensee.

When entering into the first stage of an international licensing relationship, the licensing professional must consider each party's relative situation so as to build the relationship for the purpose of proceeding in the negotiations. Understanding each party's strengths and weaknesses is paramount to estimating the extent of any offers, irrespective of whether by the licensor or the licensee, and the likelihood of an agreement. Rather than occurring in a binary environment, negotiations tend to occur within a range of outcomes. The economic value of the intellectual property rights in question and the parties' respective estimates of that value determine this negotiating range.

From a financial perspective, an intellectual property right may provide future economic benefits to its holder. Quantification of the future economic benefits, sometimes called economic rent, of a particular intellectual property right occurs by reference to the expected revenues generated by or the cost savings attributed to the licensed technology less any costs associated with obtaining and performing under the licensing agreement.

A licensing agreement provides the opportunity for a licensor to transfer the economic benefits associated with a particular intellectual property right, or a collection thereof, to

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the licensee in return for compensation (i.e., royalties). The licensee may enter into the license agreement because the technology encompassed within the intellectual property right provides a technical advantage leading to increased profits, competitive advantages, or additional cost savings. The licensor may enter into the license agreement so as to introduce its technology into new geographic regions and markets. Neither party, however, is likely to enter into a licensing agreement that is not mutually beneficial. Accordingly, the licensee’s ceiling and the licensor’s floor set the upper and lower limits, respectively, for the negotiating range in any given negotiation.

The ceiling of the range is represented by the maximum amount of royalties that a licensee is willing to pay for use of the technology encompassed by the intellectual property right(s) in question. The floor is represented by the minimum royalties that a licensor will accept for the use of its technology by that particular licensee within the specified geographic market or for the specified application. The floor for the negotiating range in an international licensing transaction is determined by the sum of the present value of the licensor’s:

1. cost of transferring the technology to the licensee, including, for example, engineering, legal, accounting, and other costs; and
2. foregone profits (i.e., opportunity costs, arising from the licensee’s use of the technology).

The ceiling for the negotiating range is quantified by reference to the lower of the present value of the licensee’s:

5. See id.
Table 1.
Risk Factors Affecting the Economics of International Licensing Transactions.

<table>
<thead>
<tr>
<th>Risk Factor</th>
<th>Description</th>
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<tbody>
<tr>
<td>Suboptimal Choice Risk</td>
<td>The opportunity cost of making the wrong choice (e.g., the benefit forgone in choosing a licensing versus a direct investment strategy or patent infringement litigation, the benefit forgone in choosing one licensee versus another licensee).</td>
</tr>
<tr>
<td>Opportunism Risk</td>
<td>The risk that the licensee will misappropriate and internalize the technology.</td>
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<tr>
<td>Quality Risk</td>
<td>The risk that the licensee will not produce or utilize the technology in a manner consistent with the licensor's standards.</td>
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<tr>
<td>Production Risk</td>
<td>The risk that the licensee will not meet capacity requirements, will not do so in a timely manner, or will overproduce.</td>
</tr>
<tr>
<td>Payment Risk</td>
<td>The risk that the licensee will fail to make payments, is late with payments, or underreports sales.</td>
</tr>
<tr>
<td>Contract Enforcement Risk</td>
<td>The risk of being unable to enforce the contract with the licensee, including, for example, the ability or inability to obtain effective enforcement in foreign and potentially hostile jurisdictions, or the ability to collect abroad on a judgment entered by a domestic court.</td>
</tr>
<tr>
<td>Marketing Control Risk</td>
<td>The risk associated with losing control of the licensee's marketing of the licensed product or technology in question, e.g., the product may be under-marketed or positioned in a manner inconsistent with the licensor's objectives.</td>
</tr>
</tbody>
</table>

1. incremental profits or cost savings associated with the use or sale of the technology;
2. cost associated with obtaining similar technology (i.e., a non-infringing substitute, from another source);
3. cost of designing around the technology; or
4. cost of obtaining the technology through infringement.

As adapted from an article in *Sloan Management Review* and modified for this discussion, Illustration 1 summarizes the economic factors to be considered by the parties in determining the negotiating range in a licensing transaction. 6

In international licensing transactions, certain risks may affect the economic factors that, in turn, may impact the negotiating range for these transactions. Increased risks in international licensing transactions operate to push the licensor's floor bar upward, thereby narrowing the negotiating range. Table 1 identifies and describes some of these risks. 7

Often times, licensors negotiate and execute international licensing agreements without understanding their transfer costs or the risk factors that may increase those costs. A full

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6. See id.
appreciation of these costs and risks includes a clear view as to the complexity of the financial aspects of their licensing agreements with licensees based in other countries.

The following sections of this article aim to provide this clear view and to provide useful and practical solutions with which licensing attorneys may reduce the risks and costs to their licensor clients and improve their clients' satisfaction with their international licensing deals.

III. Ensuring Royalty Payments From Foreign Licensees

Once the negotiations have reached the point at which the parties begin to document the agreement, the parties have already discussed, agreed, hashed, and rehashed the significant terms of the deal, and the first stage of the licensing relationship (i.e., the negotiation stage, draws to a close). Now begins the second stage of the licensing relationship and the daunting task of reflecting the terms of the deal precisely and accurately on paper. The resultant document will chronicle the work for years to come, for the unknown reader to peruse, and to guide the courts to interpret the agreement in a light most favorable for the legal practitioner's client. Consider, that licensing agreements may last for long terms. For example, licensing agreements involving newly issued patents may run for the twenty-year life spans of those patents. If the contract is well- and comprehensively-crafted in the second stage, then the third stage of the relationship (i.e., the implementation stage) functions well, and the possibilities for a successful relationship grow.

As the contract drafting stage draws to conclusion, licensors often gloss over provisions for payments for their foreign licensees. Licensing professionals and attorneys experience growing relief and elation that the deal is nearing actual execution, sometimes after many stressful and exciting months or even years of negotiations. Careful and methodical thoughts of how to ensure payment under the agreement are often lost in the drive to just get the deal done!

Unfortunately, that euphoric period lasts only until a payment or royalty report runs past due. Often only then do licensors learn whether the enforcement and dispute resolution provisions in their licensing contracts are sufficiently well-written to permit them to collect the owed royalties and royalty reports. That collection effort, however, may take more than a year to accomplish and may even be foreclosed if the licensee enters bankruptcy or receivership. It is not a pretty picture.

What can licensing attorneys do to help their clients avoid the cost and frustration of a licensee's non-payment of royalties or, better yet, to provide significant incentives for the licensee's full compliance with the agreed terms? This section of the article contemplates several successful tools that will help to ensure that foreign licensees make the agreed royalty payments timely and accurately.

A. A Note about the Importance of Qualified Counsel

To maximize their opportunities to build value in their intellectual property portfolios and to engage in successful international licensing transactions, licensors must recognize their need to engage legal counsel and tax and accounting professionals having special knowledge and expertise, including local counsel familiar with the intellectual property and other laws in the subject country; counsel with international law experience; and specialists in issues of foreign and international taxation. This article offers practical solutions to many
financial challenges in international intellectual property transactions, and these solutions will be most effective when licensors appropriately employ these important contributors to their success.

B. CULTURE AND AN ON-THE-GROUND PRESENCE

Business relationships having the intent to establish a license agreement involving foreign entities face additional challenges when compared with those involving domestic partners. Often, pervasive language, cultural, and economic differences, and standards of business practice in the foreign domain affect the negotiation and enforcement of the agreement. Failure to comprehend these differences and practices can be detrimental to the negotiation and to the ultimate goal of receiving payment under the agreement.

Today's business practitioners and lawyers must understand and anticipate these differences and practices to be successful in the negotiation and administration of foreign agreements. If this knowledge is not readily attainable by the business or legal practitioner, a foreign representative or national may provide the missing link. This individual preferably should have an imbedded relationship with other business people in the foreign country and thus experience regarding culture, language, business, and financial practices in that country. Wisely choosing an on-the-ground representative in the licensee's home country can impact the ability to effectively and efficiently execute and enforce license agreements.

Once the contract term has begun, this representative is best utilized when fully integrated in the licensing relationship. Any move, business or otherwise, embarked upon in that country should be made only after the representative has been informed. Otherwise, the representative's authority could be undermined and wrong messages signaled to future licensees. This in-country person is the first line of defense when payment is not received and may be the sole reason why payment is indeed remitted. A well-established relationship may mean many years of successful license negotiations and, more importantly, payment and other performance under those license agreements.

C. DRAFTING CLARITY AND THE RISKS OF AMBIGUITY

During the term of the agreement, the people who negotiated the agreement and drafted the contract will have moved on to different roles and perhaps different companies and, in any case, will no longer be available to enforce the agreement for the client. Should a merger or acquisition be later contemplated, the agreement will be valued as an asset of the company and eventually enforced by a new regime. It is, therefore, a requirement to ensure future legal interpretation of this unambiguous agreement and align that interpretation with the actual intent of the parties at the conclusion of the negotiations. At no place is this accord between the parties' intent and the contract language more critical than in the payment terms, which will do much to ensure that royalty payments owed by foreign licensees are paid timely and consistently.

Clarity of agreement is a recurring theme for the licensing attorney. Indeed, one of the most important contracting features to ensure timely and accurate royalty payment performance is clarity—the ability to align the express terms of the agreement to reflect the negotiated deal. This is a simple, obvious statement of every practitioner's drafting goal, which, if realized, would eliminate the possibility of needing a court to interpret the terms of an agreement.
Actual practice reveals, however, that achieving clarity is often neither simple nor obvious. A failure to define terms and utilize such terms consistently throughout licensing agreements and internal inconsistencies in those agreements are surprisingly common drafting errors, even among parties otherwise sophisticated in intellectual property-based transactions. Although some ambiguity may prove helpful to clients, such as in most-favored licensee provisions, the better practice for ensuring the prompt and accurate payment of royalties is to avoid the assumption that ambiguity in the agreement will be resolved in the client's favor.

To reduce this risk, the drafting attorney should avoid complicated phrases when simpler ones will suffice. Simpler drafting minimizes the risks of language and cultural barriers, as discussed above. The drafting attorney, therefore, should take special care to avoid difficult and complex language to explain the terms, especially the payment terms. This is not a suggestion to compromise on the ultimate goal of best protecting the client's interest, but rather a statement that simpler contracting language can achieve this goal. Consider that, in most instances, after the contract is signed and the celebration of the deal is over, the business person assigned to administer the contract may lack the ability or desire to traverse the legalese to determine when and how payment performance is required. In addition, complex language may be subject to interpretation and potentially the wrong—not the client's—interpretation.

The all-out war between Texas Instruments (TI) and Hyundai Electronics Industries, Co. Ltd. (Hyundai) over a licensing agreement provides a sharp illustration of the value of this recommendation to seek clarity and simplicity in documenting the terms of these transactions. In that litigation war, the parties made the circuit of the world's courts, each seeking affirmation of its respective interpretation of the licensing agreement.9

One battlefield included the United States District Court for the Eastern District of Texas where, at summary judgment, the court was called upon to interpret what it held to be the unambiguous TI-Hyundai contract, one which the parties predictably argued unambiguously supported their respective contentions.9 At issue was whether the license granted by TI to Hyundai had terminated by virtue of Hyundai's sales having reached a sales cap.10 The court pointed out the agreement's unnecessary complexity that contributed to the dispute, stating that "[t]he parties reach this [sales cap] amount by taking 'an amount equal to the product of one and one[-]tenths (1.1) multiplied by three billion five hundred forty one million United States dollars (U.S.$3,541,000,000.00).' This Court can discern no reason why the parties didn't just say '$3,895,100,000.00.'"11 Defined terms referenced in the highly complex agreement between TI and Hyundai also played a key part of the dispute, and again the court pondered the rationality of the parties' use of such tortuous language when simplicity and its concomitant clarity would have minimized the potential for what turned out to be a significant dispute between them. In the end, the court rejected Hyundai's convoluted interpretations of those terms because, if adopted, the contract would devolve into a "legal nightmare."12 The lesson from Texas Instruments v. Hyundai is this: do not use twenty-four words when one will suffice.

9. See id. at 669-92.
10. See id. at 671.
11. Id. at 664 n.7 (internal citations omitted).
12. Id. at 677-82.
D. Maintained Leverage as a Means to Ensuring Payment

With clarity and simplicity of drafting overarching all other suggestions that follow, there are additional methods of ensuring payment from foreign licensees. One such method is to ensure that the licensor client retains something that the licensee wants. As one experienced commentator observed about business relationships with Chinese licensees, "'[i]t's all about leverage.'"13

In one example, the license agreement may call for the licensor to provide the licensee with a so-called black box Product X. In its deliberations of whether to license, the company may prefer to reverse engineer Product X and may consider the cost of infringement or misappropriation, as depicted in Illustration 1, along with a calculation of licensor's realistic chance of prevailing on infringement or misappropriation claims arising from that reverse engineering, as a lower cost alternative to licensing. If Product X cannot be practicably reverse-engineered, however, and if Product X is integral to the licensee's business, then the black box nature of Product X allows the licensor to retain the necessary leverage in the relationship, and the licensee has an ongoing incentive to pay the royalties imposed by the licensing agreement. The licensing agreement can build in additional leverage for the licensor by including terms prohibiting reverse engineering or attempts toward that end and by exposing the licensee to both breach of contract and infringement actions if it engages in such prohibited conduct.

Hybrid agreements provide an excellent vehicle for retaining leverage in the licensing relationship because they include an element of technology transfer, joint development, or some other desirable consideration to the foreign licensee. This leverage retained by the licensor in the hybrid agreement may produce a higher rate of successful payment performance than that of an agreement based solely upon the licensing of intellectual property rights or products based upon those rights.

Consider a scenario in which the licensor engineers and licenses a product that requires ongoing maintenance from the licensor. By hybridizing a licensing agreement to encompass the licensor's maintenance services, the licensee is more likely to pay the ongoing royalties, particularly if the licensor does not equip the licensee with the means to maintain the product without the licensor's involvement.

Licensing professionals and attorneys can be highly creative in negotiating hybrid agreements so as to maintain leverage in the hands of the licensor. Freedom of contract is the watchword, and parties are free to creatively negotiate and draft such hybrid contracts. That freedom to contract is not without limits, however, and the licensing attorney must give appropriate consideration to compulsory licensing regimes in the licensee's home country, as discussed below, and to limitations imposed under patent, competition, securities, and international law.14 For example, the United States Supreme Court has spoken to limits of antitrust law against abuses of the patent monopoly power, stating that

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[a] patent empowers the owner to exact royalties as high as he can negotiate with the leverage of that monopoly. But to use that leverage to project those royalty payments beyond the life of the patent is analogous to an effort to enlarge the monopoly of the patent by [tying] the sale or use of the patented article to the purchase or use of unpatented ones.15

Thus, irrespective of the negotiated terms, royalties cannot continue beyond the life of the subject patent, and a licensee may challenge the patent’s validity as a means of avoiding its royalty obligations.16

E. General Payment Terms

The best way to ensure payment under international licensing agreements, and to virtually eliminate the licensor’s risk of non-payment, is to obtain that payment up front for the entire term of the agreement, rather than to receive it in periodic installments.17 The natural tendency of the licensee may be to pay periodically and, here, special intelligence about the licensee plays an important role in guiding the licensor’s decision in this regard. Examination of a series of the licensee’s financial reports is warranted, particularly an examination of its balance sheets as to its cash and other current assets and its legal reserves, the money on hand to cover potential litigation, is warranted. Downward trends in current assets or profit margins, the bottoming out of legal reserves, or significant loans owed to related companies should raise red flags to suggest that a licensor’s best interests are served by demanding payment up-front or by the licensee’s placement of the funds in an interest-bearing escrow account for payment out to the licensor over time and in accordance with the escrow agreement.

Proper drafting of international licensing agreements can help licensors eliminate or minimize their exchange rate risk. For example, exchange rate risk arises for a U.S. licensor when it agrees to accept royalty payments in Indian rupees. If the value of the rupee falls, then the real value of the royalty decreases and, under this example, this risk of this lost value rests entirely upon the licensor. The licensing agreement best protects the licensor client against exchange rate risk associated with payment in foreign currency when the agreement requires that payment be made in U.S. dollars. Foreign exchange laws and the impact of currency value fluctuations on the licensing relationship, however, likely will require some moderation in this best-for-the-licensor approach.

Ideally, the royalties paid by a licensee will be available immediately upon payment to a U.S. licensor. Funds availability rules that are in place at the licensor’s banking institution, however, may delay that availability, particularly when the payment instrument is drawn upon an overseas financial institution. For this reason, electronic, or wire, transmittals are the most expeditious way to receive these funds. To allow the licensor to track and verify the fact and timeliness of payment, the licensing agreement should impose upon the licensee the obligation to forward to the licensor a copy of the wire transmittal advice upon payment.

17. Note that by accepting up-front royalty payments, the licensor may reduce its payment risk, but may experience new problems related to its correspondingly increased quality and marketing control risks. See Illustration 1 accompanying Root & Contractor, supra note 4.

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In addition, the transmittal advice provides additional financial account information, as compared to a check or other hardcopy payment instrument, and this information can be useful, for example, in seeking asset freezes if the licensor needs to seek injunctive relief against the licensee in the future, such as might arise if the licensee transfers licensed products to a market or third party excluded under the licensing agreement.

F. Creative Discounting as a Means of Ensuring Payment and Best Efforts to Exploit

Another method for better ensuring royalty payment is to draft contract provisions that create incentives for that payment. These incentives may be positive, negative, or both. The typical and natural preference may be to provide positive incentives for licensees to pay the agreed fees. The value of the threat provided by negative incentives should not be discounted, however, as these types of incentives may become the stronger methods to ensure payment.

Licensor discounts provide a particularly interesting and effective positive incentive for the licensee's initial or periodic payments. For example, a licensor may structure a discount for prepayment of the licensee's royalties otherwise due over the three-year term of the agreement. The discount could be based upon a calculation of the net present value of the three-year royalty stream, that is, the time value of money. A licensor may also wish to offer a fixed discount for the prepayment of royalties. For example, for a given number of units of licensed products expected to be sold during a given period, or X, such a licensor discount may offer the licensee the opportunity to make a fixed prepayment, or Y, that is some percentage less than 100 percent of the royalty rate multiplied by X. The royalties are then recognized against the discounted prepayment for the sale of up to that X number of units. With royalty prepayments, licensees initially have a higher outlay of cash. Their ultimate royalty payments under the agreement are reduced, however, based upon the value of the total discounts, for example, ranging from 15 to 35 percent. Because the payment is made to the licensor upfront, the licensor is guaranteed money. Note, however, that depending upon the basis of accounting it has adopted, the licensor may need to properly recognize the revenue based upon an accounting of actual qualifying unit sales.

Note that with a discount offered for upfront unit-based royalties, the licensee may need to make additional royalty payments beyond Y if the licensee accrues more unit sales than X over the period. Optionally, the license agreement may provide for an adjustment to X for prepayments for future periods based upon the licensee's actual prior sales. In such instances, the licensor ordinarily should demand that a minimum X be met to qualify the licensee for participation in the prepayment discounting scheme. By providing prepayment as an ongoing option for all future payments, the effective reduced royalty rate provides

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18. The net present value calculation incorporates an assumption as to the annual rate of inflation over the term. If inflation grows at greater than that assumed annual rate, the licensor may effectively undervalue the three-year royalty stream. Various inflationary indicators are generally available, however. With careful selection of an inflationary indicator that relates to the industry or geography encompassed by the licensing agreement and examination of the trends in that indicator, the licensor should be able to minimize its undervaluation risk when offering a time-value-of-money discount, while simultaneously eliminating the risk of non-performance or incomplete performance by the licensee over the term of the agreement.
incentives to the licensee and its management and financial teams while also providing to the licensor the valuable benefits of front-end cash to enhance the licensor's business and of reducing the cost of enforcing payment terms under the licensing agreement. The pre-payment evidences the licensor's commitment to the relationship, while the ongoing royalty obligation creates a risk and reward relationship for both the licensor and the licensee.19

The licensor may wish to impose a substantial minimum or advance royalty payment requirement upon the licensee in lieu of obtaining the licensee's express agreement to use best efforts to maximize sales, and therefore royalties back to the licensor, under the license agreement. In this case, courts have held that the licensor has protected itself against the possibility that the licensee will do nothing. Rather than leaving the licensor at the mercy of the licensee, the demand for a substantial minimum or advance royalty payment creates an incentive for the licensee to exploit the licensed technology or intellectual property.20 Where a duty to exploit exists in the licensing agreement, an upfront payment may also operate to minimize the licensor's risk that the licensee will not fulfill that duty.21

G. Payment Reporting Requirement

If the licensor has a preferred form of payment reporting and accounting, the licensing attorney should incorporate into the agreement an exhibit showing an example of the payment report and setting forth a detailed explanation of how the payment due is to be calculated. The licensor may choose to engage in this practice, even in licensing relationships with relatively simple reporting structures, because it will serve to establish and align the parties' understanding of the contract through a written record. This record not only ensures that the parties will have distinct knowledge about their agreement as to payment reporting and calculation, but also it ensures that a judge or arbitration panel can easily decipher these contract terms, should the need arise. For example, the drafting attorney may wish to provide a spreadsheet in hard copy and perhaps even in electronic copy form in the payment reporting and calculation exhibit to the licensing agreement to set forth the necessary details. The object of this drafting exercise is to make the payment process exceedingly clear to and easy to execute for the licensee. The clearer and easier it is for the licensee to make the payment, the more likely the licensee will make the payment timely and accurately.

H. Escrow Accounts as Payment Incentive and Tool to Reduce Licensor's Risk

Third-party escrow accounts, and the underlying escrow agreements, also provide another positive incentive for licensees to pay royalties owed under a license agreement. The incentive is that the licensee's money earns value in the form of interest or other agreed

20. See HML Corp. v. General Foods Corp., 365 F.2d 77, 80-81 (3d Cir. 1966) (holding seller not at buyer's mercy when contract provided substantial advance payment of $250,000, thereby negating duty implied under equitable consideration to use best efforts); Vacuum Concrete Corp. of Am. v. Am. Mach. & Foundry Co., 321 F. Supp. 771, 773-74 (S.D.N.Y. 1971) (contract's requirement for minimum royalty of $25,000 per year for first two years assured plaintiff of amount equal to 10% royalties on sales of at least $250,000/year).
21. See Permanence Corp. v. Kennametal, Inc., 908 F.2d 98, 102 (6th Cir. 1990) (plaintiff received substantial total advance payment of $250,000 for its right to the exclusive license and, unlike licensor, in most cases where duty to exploit has been implied, did not depend on its consideration solely on defendant's sale of products developed under the patents).
investment growth while assuring the licensor that money has been specifically tagged for payment under the agreement and that the money is in the hands of an objective third party with an escrow agreement in hand to release the money to the licensor upon triggers set forth in that agreement.

One potentially negative aspect to such an escrow arrangement is that the licensor may gain more value for the arrangement than does the licensee. For parity of value to exist, the economic conditions must be that the investment return on the escrow-deposited funds is greater than the return the licensee could gain by investing those funds in the growth of its company. If the licensing agreement settles an infringement claim threatened or brought by the licensor, the value to the licensee of the avoidance of legal risk, and potential damage awards or exclusion orders, coupled with the value of the return on its escrowed funds, however, may more than suffice to resolve any parity concerns.

I. Risk of Loss of Positive Payment Incentives as a Means of Ensuring Payment

It is a well-established principle that the best negotiators will tie a string to every concession given to the other party to the negotiation. Licensing contracts can engender this principle as a means to ensure timely and accurate payment. Following this principle, the licensing attorney may wish to draft into the licensing contract provisions that tie a string to the prepayment or other discount concession, thereby creating a disincentive for a licensee's non-payment or significant under-payment. Such strings might include provisions to back out and eliminate previously granted positive payment incentives with that elimination triggered by a licensee's failure to timely pay or by a licensor's discovery through an audit, for example, as discussed below, that the licensee has underpaid its unit-based royalties by a given percentage. Previously granted discount amounts then become immediately due and payable to the licensor. Such reversionary provisions can provide a strong tool to effect payment.

The imposition of late fees and collection fees, including reasonable attorneys' fees to effect that collection, can also provide a useful disincentive for non-payment and late payment. For example, the licensing attorney may draft a provision reading, "Any payment not made on or before the dates for payment set forth herein shall be deemed late and shall be subject to interest accrual at the rate of X% per month calculated from the original payment due date."22 In using such a provision, the attorney must exercise care to ensure that such imposition of the specified interest rate does not exceed those permitted by usury laws of the governing jurisdiction. Another important drafting requirement is to clearly state how late fees are accrued when the payment due continues to be unpaid for successive periods.

J. Audits as Best Practice for Ensuring Accurate Payment

The inclusion and regular exercise of an audit provision under the licensing agreement is another licensing technique that ensures accurate royalty payments.23 Many licensors

23. For example, an appropriate audit provision may read:
Licensee shall and shall cause its Affiliates to keep books and records adequate to accurately determine the payments due under this Agreement. The books and records must be retained for at least five (5)
include audit provisions in licensing agreements as mere afterthoughts, never expecting to exercise these provisions and never understanding how useful these provisions can be in ensuring payment or how, effectively-written, such provisions can be powerful tools when a payment falls past due. Although many licensors only undertake audits upon the licensee's failure to pay, the best practice is to establish a yearly right to audit in the agreement and to randomly exercise that right. This practice tends to keep the parties honest and may often uncover underreporting by the licensee, entitling the licensor to audit costs, late fees, and the unpaid royalties. In addition, the conducting of audits as a regular business practice between the parties allows the relationship to be maintained in a more positive light as compared with audit rights only exercised in a more punitive context where circumstances may illustrate a lack of trust between the parties. That said, the licensing attorney should draft into the agreement punitive measures triggered upon an underreporting by the licensee, such as provisions for the removal or a prepayment option, as discussed above, or for the imposition of a penalty, the amount of which corresponds to the degree of underpayment.  

K. PRODUCT LIENS AS MEANS OF GUARANTEEING PAYMENT OR ENABLING COLLECTION

The idea behind product lien clauses is to provide a basis for collection when the agreement is breached. Product liens act as a powerful deterrent against non-payment of royalties. Under such provisions, the licensee understands that its failure to pay a royalty will result in the execution of a lien against its property, a remedy that most licensees seek to avoid at all costs. In agreements with foreign licensees, the licensor must take care to ensure that foreign laws provide for such a remedy and that such liens are enforceable.

L. PROMISSORY NOTES AS MEANS OF ENABLING COLLECTION, BUT WITH JURISDICTIONAL CAVEATS

The incorporation of promissory notes into licensing agreements can enable the effective enforcement of payment provisions by providing a basis for collection from the licensee in any subsequent collection actions. Generally, jurisdiction to enforce a debt may be established by a promissory note, and the proper jurisdiction for the enforcement of such a note is the situs of the loan.

years after the delivery of the royalty report to which they relate. Licensor shall have the right, once per calendar year, to have an independent certified public accountant, who shall enter into an appropriate nondisclosure agreement with Licensee, inspect all relevant books and records of Licensee and its Affiliates on seven (7) business days prior notice and during regular business hours to verify the reports and payments required to be made hereunder. Licensee shall impose similar obligations on its sublicensees for the benefit of itself and of Licensor. The auditor shall disclose no more information than is reasonably necessary to determine the royalties owed hereunder. Should an underpayment in excess of five percent (5%) be discovered, Licensee shall pay the cost of the audit. In such event, Licensee shall promptly pay any underpayment, together with interest at the compounded annual rate of ten percent (10%). All information obtained through such audit shall be held in confidence by Licensor except as necessary to enforce this agreement.

24. See Batterson & Grimes, supra note 20, § 2.05.
The best and easiest way to ensure that collection claims fall within the licensor’s preferred jurisdiction is to specify in the loan agreement the location of the loan’s situs. U.S. courts are split as to the proper jurisdiction for a promissory note that is silent as to the loan’s situs. Some courts have held that the default situs of a promissory note can be the jurisdiction in which the note is held.26 Other courts have held that jurisdiction can be more varied. Putting comity aside, the United States Court of Appeals for the Fifth Circuit appeared to rationalize its decision against a foreign situs for debt, stating that

[the] power to collect a debt is for the benefit of the creditor, not the debtor; the fact that a debt can be enforced by the creditor in one forum should not be the basis of depriving him of his ability to enforce the debt in a different forum. Otherwise, the sword of the creditor would become a shield for the debtor . . . . [W]e do not believe that debts owed by foreign banks to American nationals are always sitused [sic] in the foreign country . . . .27

Although jurisdiction over a promissory note may be established by holding the note in the jurisdiction of choice, the most effective way to establish such jurisdiction is to, first, negotiate the terms of the promissory note so that the note specifies the jurisdiction of choice; and, second, ensure the note is held in that jurisdiction.

M. LETTERS OF CREDIT AS MEANS OF ENABLING COLLECTION

The issuance of a letter of credit may be extremely valuable to perfecting the licensor’s interest in royalty payments due and to establishing personal jurisdiction over the licensee for any future collection action. Generally, when a letter of credit is used as collateral, the Uniform Commercial Code (UCC) permits enforcement in the issuer’s jurisdiction, which is defined as “the jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer.”28

U.S. federal courts have been virtually unanimous, however, in holding that a bank issuing a commercial letter of credit at the request of its customer and payable at the bank’s offices does not, without more, subject itself to personal jurisdiction in a distant forum, such as the jurisdiction in which the beneficiary of the letter of credit resides.29 Thus, the issuer of the letter of credit likely will determine the jurisdiction under which the debt is to be enforced. The licensor, however, has some flexibility to negotiate with its bank so as to

specify the jurisdiction of the letter of credit and, therefore, maintain control over the question of where the licensee's debt will be enforced.

There are many creative ways to inject positive and negative incentives into an agreement to ensure royalty payments are in fact made from foreign licenses; however, the best course of action is to ensure you have an excellent dispute resolution clause drafted by competent lawyers with international experience and jurisdiction to bring a future action.

IV. Royalty Taxation and Other Tax Liability and Financial Reporting Issues in International Licensing Agreements

When drafting international intellectual property transactional documents, licensing attorneys and professionals often fail to consider financial aspects of the deal beyond royalty rate and basis and, in a transaction settling infringement claims, past damages. When it comes time to implement the deal or to encompass the deal in annual and other financial reports, this lack of consideration and planning can become painfully evident and may result in unanticipated and unpleasant consequences for the client and, correspondingly, the attorney.

A. Tax Treaties and Foreign Tax Regulations and Their Impact Upon Licensing Revenues

When drafting international licensing agreements, attorneys may view tax questions as a Pandora's Box better left unopened and the transactional documents remain silent as to these questions. At best, the contracts may deal with tax matters in cursory fashion, stating, for example, "All taxes imposed due to the performance of the parties under this Agreement shall be paid by the party required to do so by the applicable law." This language leaves the door open to conflicts with governing law provisions elsewhere in the agreement, difficulties in determining and agreeing as to what constitutes the applicable law, and other unpleasant surprises for the client. Too often, little to no tax planning goes into these international agreements.

When licensing revenues are to be transferred to a foreign licensor, the local taxing authorities in the country in which the licensee is based may require that certain of those revenues be retained in that country and not be transmitted to the licensor. These retained funds are to pay income tax in that foreign jurisdiction, that is, a tax imposed upon the licensor for generating revenue by conducting business in that country. Often times, this scheme for withholding funds for the purposes of tax payment abroad seems completely unanticipated in licensing contracts. Imagine the nasty surprise and the serious explanations that ensue when revenues of several million dollars are expected and those revenues arrive with a significant chunk taken out of them as withheld taxes.

Predictability is essential to clients' finances. The predictability principle applies with particular impact with respect to planning by companies where licensing revenues constitute an important, if not the most important, part of their revenue picture.30

30. As an example of how meaningful intellectual property licensing revenues have become, International Business Machines Corporation's (IBM) licensing program adds value of from $1.2 to $1.8 billion to the company. See, e.g., Tomas Kellner, Silicon Strip Search, 175(6) FORBES 68 (Mar. 28, 2005), available at 2005 WLNR 4093739; IBM, About IBM, http://www.ibm.com/ibm/us/ (last visited Feb. 3, 2006); but see Lenovo
The better practice is to undertake the following three steps prior to or during negotia-
tions: (1) identify the jurisdiction in which the licensee is headquartered; (2) determine in
advance and agree as to the applicable tax law;\textsuperscript{11} and (3) work with the client's business
professionals to manage internal expectations. It is important that the clients' view of the
prospective licensing deal, including their \textit{pro forma} financial projections, encompass an
understanding that, absent other tax treatment mechanisms or strategies, a percentage of
the anticipated licensing revenues will likely never reach the company coffers, but will
instead remain in the hands of the taxing authority abroad.

The Republics of Korea and China provide, from a United States licensor’s perspective,
two examples of how tax treaties and foreign tax regulations may affect licensing royalty
revenues.

1. \textit{International Law Governing Royalty Tax Regulation by the Republic of Korea}

The United States and the Republic of Korea (South Korea) have executed a bilateral
treaty, the United States-Republic of Korea Income Tax Convention (Tax Treaty) that gov-
erns the taxation of, among other transactions between companies based in the United
States and South Korea, royalty payments made under intellectual property licensing agree-
ments.\textsuperscript{12} As defined and subject to certain triggers in that treaty, royalty payments are subject
to withholding at varying percentages.\textsuperscript{13} Generally, where a resident of South Korea or the
United States, (i.e., one of the two contracting states) derives royalties from sources within
the other contracting state, then the maximum tax burden that the other contracting state
may impose is 15 percent of the gross royalties.\textsuperscript{14}

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\textsuperscript{11} See Gary M. Hoffman, Address at ABA, 20th
Annual Intellectual Property Conference (Crystal City, Virginia): Maximizing the Return on Intellectual Prop-
erty Assets (Apr. 16, 2005) (on file with author). There, TI made money because its
$100 million loss from
operations was offset by a $500 million gain from its intellectual property licensing division, the only profitable
business unit reported for the entire company for that period. See \textit{id}.

31. In addition to important hardcopy resources, such as \textit{Treaties in Force} and \textit{International Legal
Materials}, a number of excellent resources for international legal materials exist online. \textit{See generally}, e.g., \textit{The
www.asil.org/resource/pil l.htm (last visited Feb. 3, 2006) (providing brief overviews and hyperlinks regarding
private international law). The ABA's International Law Section also provides excellent resources by virtue of
its fifty-some committees and numerous publications. \textit{See generally} American Bar Association, Section of In-

irs-utl/koreatwweb.pdf} (last visited Feb. 13, 2006); \textit{see also generally} Republic of Korea, National Tax Service,
\textit{http://www.nta.go.kr/eng/default.html (last visited Feb. 3, 2006) (providing information about Korea's tax trea-
ties); \textit{PriceWrighthouseCoopers}, \textit{Doing Business and Investing—Global Intelligence from \textit{PriceWright-
houseCoopers}—Korea 429-36 (2002). Note that, in the twenty-plus years since the Tax Treaty entered into
force, no courts appear to have opined on its operation or interpretation.

33. \textit{See Tax Treaty, supra note 30, at art. 14(4) (defining royalties); \textit{id} at art. 6(3) (setting forth circumstances
that trigger the treatment of royalties as sources of income under the treaty). A smaller 10\% tax cap applies to certain royalties based upon rights to literary,
dramatic, musical, or artistic works. \textit{See id} at art. 14(2).
Exemptions may apply, however, when the licensor is a resident of one contracting state, but has a permanent establishment in the other and when the right or property from which the royalties arise is effectively connected with that permanent establishment. In that case, the royalties fall within the Tax Treaty's business profits treatment provisions. Like other industrial or commercial profits of a permanent establishment, the basis for taxing royalties may be reduced by the expenses reasonably connected with those intellectual property-derived profits. The Tax Treaty contains other relevant provisions regarding, for example, mechanisms to avoid double taxation and the treatment of royalties paid to related entities.

a. Proof of Tax Payment in Korea

Proof of payment of taxes withheld from royalty payments is in the form of a Certificate for Non-resident's Tax Payment, which South Korea's National Tax Service makes available online. The certificate should be completed and filed by the licensee with the tax authorities, who acknowledge the payment with signatures and stamps or chops. Licensing attorneys should incorporate in the international licensing agreement terms creating an obligation on the part of the South Korean licensee to timely provide the licensor with a copy of the filed certificate that the licensee warrants or certifies as being complete and correct.

When handled appropriately, the licensee is to withhold the applicable percentage of those royalties from the royalty payments due and the royalties net of this percentage are to be transferred to the licensor. The licensee is then to submit the withheld amount, together with a tax certificate, to the South Korean tax authorities. This payment should be timely made by the licensee on behalf of the licensor to the South Korean tax authorities, and the U.S. licensor should monitor that performance by demanding proof of payment to those authorities.

b. Provisions for Timely Performance or by Dates Certain—An Example from South Korea

Here, an aside is appropriate to discuss the relative benefits of date certain versus timely performance provisions, although the discussion is broader in applicability than to only the tax certificate aspect of international licensing agreements.

The obligation of the licensee's provision of the tax certificate by a date certain, as compared to a term calling for timely provision, is preferable from the licensor's perspective because it allows the licensor to monitor performance closely and to establish a culture of compliance, and therefore excellent performance, within the relationship.

With date certain provisions as to tax certificates and other obligations owed to it, the licensor can build a precise record of compliance or non-compliance by the licensee. The

35. Id. at art. 14(3). The determination of a connection between the property or right producing the royalties and the permanent establishment is factor-driven under article 8(6)(b) of the Tax Treaty.

[T]he factors taken into account shall include whether the rights or property are used in or held for use in carrying on industrial or commercial activities through such permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income from such property or rights. Id. at art. 8(6)(b).

36. See id. at art. 14(3); see id. at art. 8 (dealing with business profits).

37. See id. at art. 8(3).

licensor maintains its negotiating power throughout the licensing relationship, in part, on the strength of this record. Under- or non-compliance by the licensee may trigger late fee obligations, withdrawal of territorial exclusivity or other desirable benefits, or termination of the licensing agreement. Any or all of these triggers may be tactically or strategically important to the licensor, particularly when the industry in which the parties operate is highly competitive, replete with strategic alliances, or fluid with trends of consolidation, for example.

That said, considerations of the licensee’s operational practicalities and of relationship-building between the parties may call for extending the less definitive timely provision term. Licensing partners often appreciate an accommodation of its operational constraints and procedures, and reasonableness of both sides does much to create and foster a positive working relationship under the licensing agreement.

If the licensor is to agree to performance under a timeliness standard rather than a date certain standard, however, the licensor owes itself and its shareholders a duty to set expectations of performance under that timeliness standard and to utilize its own or external intelligence services to monitor conditions influencing the licensee.

An example from the high technology sector demonstrates this point. After implementing a new program of careful monitoring and insistence upon complete and timely compliance, a U.S. licensor rehabilitated a South Korean licensee that had, for an extended period, failed to pay royalties due and to provide royalty reports. Even after payments and royalty reports had been received by the licensor in clockwork fashion, the licensee failed to deliver the tax certificates to demonstrate that the percentage of the royalties due that it had withheld under the governing Tax Treaty from the funds transferred to the licensor had, in fact, been paid over to the South Korean tax authorities.

This failure created anxiety for the licensor because of the risk of liability to the South Korean government, a liability that, if enforced and penalized, could have impacted its operations in South Korea and its intellectual property licensing efforts. The risk to the licensor was truly appreciated where ongoing intelligence-gathering about the licensee had shown that its reporting to the South Korean securities authorities had become spotty and, indeed, flatly false, and that its financial picture was deteriorating. The intelligence uncovered what was viewed as a subterranean plot by the licensee under which it was funnelling monies into another closely-allied entity to grow a new distribution network and new product brand in another geographic market, one in which the new brand was brought into direct competition with the licensee’s brand. All of this intelligence data justifiably heightened the licensor’s anxiety about the failure of the licensee to show that the withheld monies had been paid over to the South Korean tax authorities. The licensor then extracted promises from the licensee as to dates for delivery of the tax certificates bearing the appropriate receipt acknowledgements of the authorities and, through meticulous enforcement, persistent demands, and other pressures exerted by the licensor, the licensee finally delivered the filed tax certificates to the licensor. The importance of having accomplished that compliance was especially relieving to the licensor when, a few months later, the licensee obtained bankruptcy protection.

c. Compliance Monitoring of South Korean Licensees

Returning to compliance monitoring and the certificate of tax payment and as a starting matter, the compliance examination may require the licensor to translate the tax certificate from the Korean language and to perform currency conversions to express the amounts
paid in U.S. dollars. The licensor then should examine the contents of the certificate to ensure its compliance with the terms of the licensing agreement, specifically, as to the date and amount of payment noted on that certificate. The date of payment on the certificate should be matched with the date of royalty payment on the wire transmittal advice or other documentation of that payment. Any discrepancies should be immediately raised by the licensor and brought to rights.

Beyond these evaluations for compliance with the contract terms existing between the parties, the licensor should confirm that the appropriate, and not excessive, taxes are being withheld from the royalty payments.

2. Domestic Law Governing Royalty Taxation by the Republic of China

In contrast to South Korea, the United States and the Republic of China, or Taiwan, have not executed a bilateral tax treaty addressing the subject of royalties. Therefore, and putting aside the issue of whether governing law provisions in licensing agreements are enforceable, domestic Taiwanese law governs the taxation of intellectual property licensing royalties. Helpfully, the Taiwanese authorities publish much of this domestic law as searchable online and in English. As in the case of interpreting and applying the bilateral tax treaty between the United States and South Korea, the licensor should also seek appropriate professional advice as to the interpretation and application of Taiwanese law.

When royalty payments are to be made by a Taiwanese licensee to the foreign licensor, the licensee should file a Republic of China Withholding and Non-withholding Tax Statement. The statement sets forth the required payor, payee, and payment particulars, including the total amount paid and the period for which the royalties are being paid. In addition, the licensee must report the withholding rate applied, net tax withheld, and the correspondingly net payment wired or otherwise transmitted to the foreign licensor. The tax statement filed with the Taiwanese authorities will report the currency figures in New Taiwan dollars, and the licensor will need to perform the necessary currency conversions to read the statement against the terms of the licensing contract.

Bear in mind that, just as there are differing strategies to comply with U.S. federal tax law, Taiwanese licensees may have different approaches under the tax laws of the Republic of China. For instance, one licensee may file the above-reference statement and withhold 20 percent from the royalty payment. Under an alternate approach, a licensee may, instead of withholding tax, apply for an income tax refund for royalties paid to a foreign licensee.

under article 4.21 of the Income Tax Act of the Republic of China.\textsuperscript{43} In the tax refund application example, the foreign licensor will need to appoint the licensee as its representative for matters related to pursuing that application with the Taiwanese authorities. This appointment, however, should be drafted so as to be fully revocable upon the licensor’s sole discretion.

B. Allocation of Tax Risk in International Licensing Agreements

The Korean and Taiwanese examples above demonstrate the tax liability and withholding issues that may impact U.S. licensors. When licensing agreements encompass multiple jurisdictions or even the entire globe, licensors could face a jungle of intertwining bilateral and multilateral treaties and foreign laws that impact the taxation of their royalty revenues. Governing law provisions may help reduce the tax liability questions to a manageable several, but parties likely will not be able to opt out of the application of tax treaties as easily as they can do, for example, in transactions involving the international sale of goods.\textsuperscript{44} In any case, the licensor’s counsel should incorporate into the licensing agreement a clear expression of each party’s sole responsibility for their respective compliance with all applicable laws, including their respective domestic tax laws. In addition, the licensee should indemnify the licensor for any foreign tax liability arising from the licensee’s failure to report royalty payments made to the licensure and to pay to the relevant tax authorities any withholdings made from those payments.

C. Financial Reporting Considerations in Drafting International Licensing Agreements

As to the recognition of royalty revenues on the licensor’s financial reports under the applicable accounting standards, alternate drafting strategies may help the licensor treat these revenues in ways more favorable to those reports. A discussion of the governing legal, accounting, and ethic standards falls outside the scope of this article. For the present purposes, it is sufficient to note that if a licensor client wishes to recognize, under an accrual accounting basis, more revenues upfront rather than parsed out over the multiple-year term of the licensing agreement, contract drafting strategies can support those objectives. For example, the drafting attorney may structure payments under an international licensing agreement as a payment for past damages or payment as consideration for the licensor’s covenant not to sue for patent infringement for past conduct still within the relevant statute of limitations, rather than as royalties accruing over the term of the agreement. In that instance, the licensor may be able to receive those payments upfront and to immediately recognize these as revenue.

In another note, accounting standards and various laws govern the value assigned by a company to intellectual property, including intellectual property licensing agreements, as an intangible asset list on the company’s balance sheets. Ideally, drafting counsel should


\textsuperscript{44} United Nations Convention on Contracts for the International Sale of Goods (1980), art. 6, 52 Fed. Reg. 6262, 6264-6280 (Mar. 2, 1987) ("The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.").
consult with the licensor's financial and accounting professionals to determine whether varying drafting approaches provide adequate support to the application of those intellectual property valuation methods.

V. The Financial Impacts of Foreign Licensing Laws and Regulations upon Licensing Agreements

In the preceding sections, this article discussed ways in which licensing attorneys can protect the rights and investment returns of their licensor clients with respect to payment performance, collection, and taxation issues regarding foreign licensees. In this section, the article turns to licensing as it relates to foreign patents owned by companies or individuals based in the United States or elsewhere. Here, foreign governments play a significant role in whether a licensing agreement will be compelled and the extent to which the license terms will be mandated by those governments. Such foreign government control of international licensing transactions may significantly impact the licensor's financial position and the attainability of the benefits it expected from those transactions.

A. Transactions Involving Foreign Patent Rights—A TRIPS for the Unwary

Companies typically seek foreign patent rights in countries where products covered by a patent are manufactured, sold, or imported; the production of counterfeit goods is rampant; or manufacturing costs are comparatively lower. Some primary reasons for obtaining patents in those countries include to: (1) stop infringement at the source of manufacturing before any products leave the country; (2) provide a protected market for the importation of goods; and (3) license local companies to manufacture products for domestic sales within that country.

Patent holders desiring to exploit their foreign patent rights commonly enter into license agreements with companies located in the issuing countries. In the case of developing countries, it was historically often necessary to obtain approval from the foreign government before any license agreement could enter into force.

The WTO's establishment in 1994, along with the implementation of its accompanying trade agreements, including the TRIPS Agreement, largely obviated the need for official government approval of licensing agreements. The TRIPS Agreement, however, allows WTO member countries to implement restrictions governing the terms and conditions of licensing agreements under the auspices of protecting competition and thereby to exert some level of control of licensing terms and conditions. Ostensibly, the purpose of these restrictions is to ensure that domestic licensees are not subject to overly onerous license restrictions or unreasonable royalty fees or rates due to their relatively weaker bargaining power compared to licensees in more developed countries, such as the United States.

B. Foreign Government Control of Licensing Agreements

Two measures used by many countries to maintain control over licensing transactions are through the issuance of compulsory licenses, and the preemption and revision of agreed

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45. See WTO Agreement, supra note 3; TRIPS Agreement, supra note 2.
46. See TRIPS Agreement, supra note 2, § 8, art. 40, ¶ 2.
licensing terms subsequent to licensee-initiated allegations of the unfairness of those terms. These measures are often used in combination. The U.S. government does not currently employ either of these measures, although it has compelled the granting of licenses in the recent past, and an amendment to the Federal Food, Drug, and Cosmetic Act recently has been introduced to provide for such compulsory licensing of patented inventions related to health care emergencies.

A party who owns pending patent applications or issued patents or who anticipates acquiring similar rights in any foreign country must be fully cognizant of the financial risks inherent in that country's intellectual property laws. For example, a company may acquire foreign patents for the tactical purpose of using those exclusive rights to prevent the manufacture of products in the country of issue and thus to control distribution. Those circumstances may subject the foreign patents to a licensing agreement compelled by the issuing government, irrespective of whether the patent holder desires such a license, or to licensing terms imposed by the issuing government that are less favorable than those offered or desired by the patent holder. Similarly, a licensor for foreign patents may find part or all of its negotiated licensing agreement declared invalid because the agreement creates an adverse effect on competition in the country in which the patents were issued.

Importantly, practitioners must understand the restrictions that may apply to licensing agreements in a given country so as to avoid compromising the value of any patents owned in that country. Most, if not all, countries' patent laws include compulsory license limitation language and require reasonable or fair compensation to a patent owner, although the reasonableness or fairness of such compensation as seen by a U.S. licensor of foreign patent rights abroad is subject to question.

C. COMPULSORY LICENSES

The purpose of a compulsory licensing requirement is to prevent a patent owner from using a patent or patents to prevent certain products, or particular technologies, from entering into or being used in that country.

1. Working Requirement under Compulsory Licensing Regimes

Compulsory license legislation often relies on a working requirement in the subject country's patent laws. Working is generally defined as the commercial use of the invention covered by a patent. Typical compulsory license legislation requires that the patent owner work the patented invention in the subject country within a certain number of years of the

47. Responding to the anthrax bioterror attacks that followed in the wake of the events of September 11, 2001, the U.S. government compelled the licensing of the pharmaceutical Cipro, the best known treatment for that deadly infectious disease. See Joseph E Stiglitz, Set Ideas Free for Development, Bus. Day, Aug. 15, 2005 (South African publication of Financial Times Ltd.).


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The degree of use required to satisfy the working requirement also varies between countries. South Korea, for example, requires exploitation of the invention of a patent on a considerable commercial scale within three years following the patent grant or within four years following the application filing date.53

2. Compulsory License Grants by Foreign Governments

Regardless of the time period or degree of patent exploitation, if a patented invention does not meet the working requirement, a third party may request that a compulsory license be granted. An agency or government entity then evaluates evidence from both the applicant and the patent owner to determine the grant of a compulsory license. The evidence necessary to obtain a compulsory license again varies between countries.54 There exists, however, a consistent requirement for the evidence to show that: (1) a need exists for the patented invention in the country and (2) the potential licensee has failed to obtain a license on reasonable terms after a reasonable effort to do so.55

Upon the granting of a compulsory license by the foreign government, the new licensee and the patent owner have a period of time in which to conclude a mutually acceptable licensing agreement. If the parties fail to accomplish such an agreement within the given time, then the license granting agency will determine the governing terms and conditions.56 A failure to agree may place the patent owner in the undesirable position of finding itself obligated to terms and conditions that it otherwise would have rejected. Although compulsory license legislation usually grants only what the licensee needs to practice the pat-

51. France requires the invention to be worked within three years from the grant date or four years from the application filing date. See French Patent Act of Jan. 2, 1968, art. 32 (as amended by Law of Nov. 26, 1990), in 2D JOHN P. SINNOTT, ET AL., WORLD PATENT LAW AND PRACTICE—PATENT STATUTES, REGULATIONS AND TREATIES 123 (2005).

52. See, e.g., the Great Britain Patents Act of 1977, ch. 37 § 48(1), in 2D SINNOTT, supra note 49, at 250-51 (allowing for compulsory licenses at any time after three years from grant date if patent is not being worked); see also Spain, Patent Law of Mar. 20, 1986, pt. 9, ch. 1, art. 83, in 2H SINNOTT, supra note 49, at 115 (trans. Sres. Elzaburu) (requiring working patent within four years of filing date or within three years of date of publication of notice of allowance).

53. See Republic of Korea Patent Act of 1961, ch. V, art. 107, § 1(ii) (as amended by Act No. 6768 (Dec. 11, 2002)), in 2F SINNOTT, supra note 49, at 51-52 (trans., S.Y. Cha Patent Office) (enabling adjudication by Commissioner of Korean Intellectual Property Office for nonexclusive license, in part, "where the patented invention has not continuously been worked commercially or industrially in the Republic of Korea on a substantial scale during a period of three years or more without justification . . . [.]"); see also 4 DAVID M. EPSTEIN, ECKSTROM'S LICENSING IN FOREIGN AND DOMESTIC OPERATIONS § 32:20 (Thomson West 2005 ed.).

54. For example, Great Britain requires proof that demand is not being met on reasonable terms or that demand is only being met by substantial importation. See Great Britain Patents Act of 1977, pt. I, ch. 37 § 48(3)(a)-(e) (complete listing of various factors), in 2D SINNOTT, supra note 49, at 250-52.

55. See, e.g., Australia Patents Act 1990, Act No. 83 of 1990, ch. 12, § 133(3A) (as amended), in 2B SINNOTT, supra note 49, at 347 ("Before making the order, the court must be satisfied that the applicant has tried for a reasonable period, but without success, to obtain from the patentee in respect of the patented invention an authorisation to work the invention on reasonable terms and conditions.")

ented invention,\textsuperscript{57} and awards the patent owner a reasonable royalty in exchange,\textsuperscript{58} the risk may exist that domestic companies and industries will be favored over foreign patentees.

What constitutes a reasonable royalty may vary between countries and may turn upon the nature and presentation of evidence. A party that is familiar with compulsory license proceedings in their own country logically will have an advantage over a foreign patent owner and will negotiate from a position of strength with the knowledge of what terms likely will result if the parties do not reach a negotiated agreement.

For example, a Canadian licensee may gain the grant of a compulsory license from its government if the licensee, or indeed any person engaged in any industry in Canada, is unfairly prejudiced by the use conditions attached to a patent by a patentee.\textsuperscript{59}

The subject technology or the degree of public interest related to the patented subject matter also affects the degree of control exerted by a country's government over the license agreement terms.\textsuperscript{60} Depending upon its degree of economic and social development, a country's government will scrutinize inventions related to human rights or health, such as pharmaceutical, medical device, and food product inventions, to a greater degree than inventions related to less critical technologies.\textsuperscript{61} For example, the Philippines,\textsuperscript{62} France,\textsuperscript{63} India,\textsuperscript{64} and Japan\textsuperscript{65} have justified the grant of compulsory licenses for patents related to food, medicine, or medical devices. In addition, the tremendous influence exerted by African nations, India, and Brazil over licensing AIDS-related pharmaceuticals and its resultant impact upon TRIPS through the Doha Declaration provides a striking example of this point.\textsuperscript{66}

\textsuperscript{57} See id. at art. 53 (authorizing Patent Office to grant compulsory license for earlier of later invention when necessary to exploit invention).
\textsuperscript{58} See id. at art. 52 (requiring grantee of compulsory license to pay reasonable exploitation fee to patentee).
\textsuperscript{59} See 3 Epstein, supra note 51, at § 25:47.
3. Compulsory Licensing Provisions from Selected Foreign Patent Laws

a. Argentina

A compulsory license can be requested if a patent has not been worked in Argentina by the later of three years from the patent grant or four years from the application filing date.\(^{67}\) The potential licensee must show that an attempt to obtain a license on reasonable terms has been unsuccessful, despite at least 150 days of effort.\(^{68}\)

b. Mexico

The applicant for a compulsory license must have the technical and economic capacity to efficiently work the patented invention.\(^{69}\) Before the first compulsory license for a patent is granted, the patentee will be given one year to begin working the patented invention. The Ministry of Industry and Commerce will determine the terms and conditions of the license, including the amount of remuneration due to the patentee.\(^{70}\)

c. Republic of Korea

A compulsory license may be granted if a patent has not been exploited on considerable commercial scale within the later of three years from the patent grant or four years from the application date.\(^{71}\)

d. Philippines

A compulsory license may be granted as early as two years following the patent grant if a patented invention relates to food, medicine, public health, or safety; or if the patent has not been worked commercially.\(^{72}\)

e. Singapore

Here, the government may grant compulsory licenses if the price of the patented invention in that country is unreasonably high, or if the patentee refuses to grant a license on reasonable terms and the market in Singapore is inadequately supplied.\(^{73}\)

f. Spain

Spanish patent law reads, in relevant part:

The grant of a compulsory license under a certain patent shall proceed when, the patent not being subject to the offer of licenses of right, any of the following suppositions occurs:

(a) Lack of or insufficient working of the patented invention[...]


\(^{68}\) See id. § 42.


\(^{70}\) See id. § 72.

\(^{71}\) See 4 EPSTEIN, supra note 51, § 33:18.

\(^{72}\) See citations accompanying supra note 51.

D. Domestic Regulation of License Agreement Terms

As stated above, governments may exert control over licensing transactions on the grounds that the provisions of the license agreements are unfair. Many countries set up regulatory schemes specifying unacceptable license terms and conditions. Unacceptable terms may include, for example, geographic allocation of markets;\textsuperscript{75} requirements for purchase of raw materials or parts;\textsuperscript{76} or unreasonably high royalty rates.\textsuperscript{77} Under such regulatory schemes, a licensee may object to attempts to enforce an agreement containing such provisions, and that enforcement will be disallowed, despite the licensee's prior acceptance and execution of the subject agreement.\textsuperscript{78}

Most, if not all, countries' patent laws include compulsory license limitation language and require reasonable or fair compensation to a patent owner. Anecdotal evidence, however, suggests that royalty rates, as well as other terms and conditions, favor a domestic party over the foreign party. This seems to be true particularly in underdeveloped or rapidly developing countries where local businesses and industries may greatly benefit from such favorable treatment. The risk here is that the licensor will be forced to accept less value for its licensed intellectual property than is appropriate. The imposition of this undervaluation by foreign governments and such disparity of treatment may indeed run afoul of the WTO's regime to prevent discriminatory treatment.\textsuperscript{79}

VI. Conclusion

Intellectual property licensors and their attorneys should be aware of the financial aspects of international licensing transactions, including taxation, payment performance, compulsory licensing, and currency risks. This article has addressed many of these financial issues with practical solutions and insight. Going forward, intellectual property and other transactional attorneys should be better informed as to these issues and thus better equipped to add important value to their services to clients.


\textsuperscript{75} \textit{See} 3 Epstein, \textit{supra} note 51, § 26:51.


\textsuperscript{79} \textit{Accord, e.g., Appellate Body Report, United States–Tax Treatment for “Foreign Sales Corporations,” §§ 177(d), 178, 180, WT/DS108/AB/R (Feb. 24, 2000); see generally Michael Daly, The WTO and Direct Taxation, Discussion Paper No. 9 (June 2005), available at http://www.wto.org/english/res_e/booksp_e/discussion_papers9_e.pdf.}