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THE NEGOTIATION OF ROYALTIES AND OTHER SOURCES OF INCOME FROM LICENSING

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I. INTRODUCTION

Technology transfer agreements involving long-term relationships should be creative in both organization and structure. In fact, long-term profitability is often achieved by subtle and indirect forms of consideration. Accordingly, skilled practitioners of licensing should not be slaves to a "plain vanilla" approach. Rather, by combining resources from several aspects of various intra- party business dealings, practitioners can frequently generate greater income for both parties to a negotiation.

Without the prospect of substantial benefits, there is no point in making a deal. Thus, when valuing a prospective transfer of technology, one should first quantify the total possible profit. This valuation should include the effect of combining the rights and resources which each party is expected to contribute. Only after making this determination may parties logically negotiate their portion of the profit. If the preliminary apportionment is realistic and equitable, the parties may achieve the ultimate goal of licensing professionals: the "win-win" relationship.

The above approach may seem strange to newcomers to the licensing field who are only familiar with licenses based on royalty rates, which are often a simple percentage of the licensee's net sales of the licensed product. Indeed, the thought of basing a license upon a profitability analysis is distasteful to many in the licensing field. But royalty rates are merely expressions, or mechanical forms of calculation, employed by parties when making decisions or assumptions based upon profitability. Thus, many people make decisions based on profitability without even realizing it.

Parties to potential licensing transactions should remember that a technology transfer may have broad, corporate implications. Transactions *2 susceptible to these implications may include: licensing in technology to complement existing core technologies; licensing out technology to a larger company to fund further research; or, for a small proprietor, generating capital funds for growth by selling a minority equity interest to the licensee. Later, the licensee might also consider acquiring the proprietor.

License creations are often important transactions in their own right. However, they may also be integrated into multi-faceted arrangements to meet both the short and long-term objectives of the parties. Furthermore, licenses are not the only way to realize returns on investments made during discovery, creation, and development of the subject technology; many alternatives exist. This article exposes and discusses many profit-generating alternative methods for achieving a mutually-satisfactory bottom line.

II. PARAMETERS OF OPPORTUNITIES

There are several questions which help quantify the profit potential of a specific license. Some of these questions include the following:

A. Size of Relevant Market

Is this item widely utilized by the general public, or is it a relatively specialized item that is important to only a narrow sector of the population, or to only a limited geographical region? Additionally, does the deal have wider implications for the proprietor or the licensee?

B. Dynamism of Market

Is this a rapidly expanding sector of the economy that is expected to continue growing? Is this optimism a reaction to the novelty of the technology involved in this particular transaction, which may be supported by a patent or trade secret protection or both? Is the relevant market stagnant or declining? Indicators of market stagnation are excess production capacity, too many competitors, changes in consumer tastes, and general technological obsolescence.

*3 C. Special Characteristics of Technology Intended to be Licensed

Is the technology a unique breakthrough which is creating a new market? Is a "pioneer" patent involved? Has a validity search of the patent(s) been conducted by competent persons? Is the subject invention an improvement that is easily discernible over other, widely-known products or processes? Alternatively, is it an evolutionary refinement of something relatively standard? Is it a key component of a larger system? Can it stimulate additional sales of ancillary products or services?

D. Quality of Contribution by the Proprietor

Does the proprietor enjoy a well-recognized reputation as an innovator and a continuing source of useful ideas and improvements? Is the proprietor known to vigorously defend

its rights against infringers? Is there goodwill attached to being associated with this company, person, or group?

E. Expected Asset Contributions From the Technology Recipient

Is the recipient financially powerful and an efficient manufacturer, or does it possess an effective marketing organization, or both? If properly motivated, is it likely to maximize the potential of the relevant technology? Does the recipient require, ancillary to the patent, know-how from the proprietor, or does it already possess such knowledge?

F. General State of the Economy

Does the economy show signs of expansion, recession, or recovery? Are there economic indicators, existing or proposed laws, or tax incentives which could affect the licensing parties' contemplated business?

These criteria, interpreted individually and in combination, should help parties assess the financial outlook of a given license. These tools may generate a forecast that will help proprietors and licensees avoid disappointing relationships.

*4 III. CONCEPT OF INHERENT VALUE

When attempting to license an invention, a proprietor will sometimes justify a high royalty rate by noting that it has expended enormous time, effort, and money to create and develop the subject technology. To counter this argument, astute licensees should characterize those expenditures as the proprietor's "sunk-costs." As such, they are irrelevant to the licensee, who is only interested in the technology's future profitability.

Fortunately for the licensor, there is a way to trump this "sunk-costs" theory. Consider, for example, a pharmaceutical company which, with very little out-of-pocket expense, discovers a new application or use for an existing drug. Assume further, that the licensor has existing, fully-depreciated production facilities to satisfy the large and urgent need for this new use. In such a case, the proprietor might alternatively choose to exploit the opportunity directly. This extra option provides the proprietor with enough leverage to demand a high royalty rate; thus, the proprietor can afford not to make a deal.

The element of risk is also important in determining which party should realize the lion's share of the return from a licensing relationship. The licensor typically bears the principal risk, since that party usually makes the initial investment required to introduce the subject technology. When the subject of the license is a process, however, licensees may have to make investments as well. Often, their existing production facilities must be reorganized, and sometimes, completely new facilities are needed in order to exploit the license. In situations where no such licensee capital outlays are needed, a high royalty

rate would be justified. A high rate will serve to compensate the proprietor for the risks associated with its initial investment.

IV. RELATIVE CONTRIBUTIONS OF PARTIES

After reaching a consensus about the overall profit potential, the parties should establish a profit-sharing ratio. This apportionment of future profit rarely occurs on a conscious level, but it is nevertheless important.

It is here that the so-called "25 percent rule" can be put to useful effect. The rule compares the licensee's expected pre-tax profitability rate from the combined resources of the parties to the expected profitability of a similarly- situated, model license. It cannot be overemphasized that this technique merely provides a starting point from which the parties can often gain a better perspective on their relative contributions. *5 Although helpful, the "25 percent rule" is not universally applicable. If it were, there would be no point in applying it in the first place. [n.1]

Apparently, the "25 percent rule" was utilized by practitioners even prior to 1971. The late Worth Wade, citing Albert S. Davis, Jr., [n.2] listed three basic patent licensing considerations: "(1) scope of patents, (2) validity of the patents, and (3) profitability of the patents' use. If the patents protect the licensee from competition and appear to be valid, the royalty should represent about 25% of the anticipated profit for the use of the patents." [n.3]

Accordingly, if the existing factors correspond closely to the model, the parties should seriously consider adopting a 25 percent to 75 percent profit split between the licensor and licensee. But where the circumstances differ from those in the ideal model, the ratio should be adjusted accordingly. The author's recent experience demonstrates that the ratio can successfully be adjusted to reflect pertinent factors, like varying levels of party participation.

The author suggests basing calculation upon pre-tax profitability because pre-tax profitability is one of two figures (the other being "net invoice value" or "net invoiced sales," [n.4] the most common basis for the calculation of royalty payments) which are least subject to differing interpretations by accountants. When developing a strategy that will work in a variety of settings, this type of consistency is important. [n.5]

*6 Licensors with a relatively strong arsenal of assets should begin licensing negotiations by requesting a 25 percent royalty rate. With this as a starting point, the involved parties may adjust that rate to account for mitigating circumstances.

Elements that increase the strength of a prospective licensor's assets include the following:

(1) the existence of relevant, assumable, and enforceable patents;

(2) the existence of trade secrets and know-how that are related to the subject technology;

(3) the existence of ancillary trade secrets and know-how, including marketing insights and contacts;

(4) one or more established product trademarks, house marks, or logos that could promptly contribute goodwill and credibility to the licensee;

(5) software programs, advertising support and other expressions of creative work, whether or not protected by copyright;

(6) an active, well-financed and historically-productive R&D facility that could reinforce the licensed technology on a regular basis;

(7) a pattern of successful licenses between the licensor and similar or current licensees;

(8) a reputation for diligence in pursuing infringers of its rights; and

(9) a reputation for protecting its licensees from independent actions initiated by third parties.

Licensee risk assumption is probably the most contested factor in the entire profit-apportionment equation. Prospective licensees who assume unusual risks should expect to adjust their portion of the profit up from the standard 75 percent. For instance, licensees may need to make substantial investments in new plants and staffing. They may also face *7 serious competition in the relevant market. From the licensee's perspective, other risk-related factors exist and may include:

(1) the possession of a pre-existing manufacturing plant and the capacity to produce the licensed product or process;

(2) the possession of a skilled marketing force that can effectively reach the licensed technology's intended market; and

(3) the availability of critical raw materials, local government approvals, or financial grants that can have an impact on both short and long-term success.

To the extent that the licensee and licensor have overlapping resources, the licensor's leverage is reduced. However, the contemplated technology transfer may enable the licensee to make better use of under-employed resources. When this is the case, the licensee's overall risk is reduced, and the licensor's leverage is increased.

The 25 percent rule is not actually a rule, in the formal sense. It is merely a rough guideline that should be refined to fit a given situation. While licensing professionals sometimes follow other royalty setting approaches, careful presentation of licensing terms based on the 25 percent rule is usually well-received. Because it was originally conceived in the real world, this rule has a ring of common sense and is becoming widely accepted.

In a recent negotiation, the parties reached a consensus on several projections: the costs of production, including raw materials to the licensee; the selling prices obtainable; the levels of sales; and the expected market share. This data, along with predicted inflation rates and expected market demand, made it possible for the potential licensor to construct a ten year spreadsheet.

During the following negotiating session, the potential licensee offered to pay a 5 percent royalty rate on the mutually agreed royalty base. The licensor then presented its spreadsheet. The spreadsheet illustrated that the licensee could expect a weighted pre-tax profitability of more than 40 percent over the next ten years. Based on the value of the intellectual property offered, the proprietor requested a minimum of 25 percent of this revenue, which was actually a 12 percent royalty rate. The spreadsheet's numbers were indisputable and the 12 percent royalty was adopted. Additionally, since the "bottom line" achieved in the negotiation was supported by credible figures, the contracting parties' boards of directors accepted it as well.

*8 V. SETTING RATES

Quite often, parties will agree that the division of profits will be manifested in practice as a percentage royalty of the licensor's net invoiced sales. This mechanism is frequently chosen for two basic reasons:

(1) licensees operating at "arm's length" with their licensors often prefer to release raw sales figures over actual profit margins; and

(2) this approach compensates for inflation.

Although commonly used, a "percentage of sales" approach actually disfavors licensees. This is because it regularly generates royalties to the licensor, regardless of the actual future profit performance of the licensee. Consider the following situation:

(1) suppose, at the outset, a licensee is able to sell the licensed products at $100 and has total material labor and overhead costs of $70. This yields a pre-tax net profit of $30. Accepting the 25 percent rule, the licensor is entitled to 25 percent of the pre-tax net profit. Therefore, the parties should agree to a 7.5% royalty rate, because: 25% of pre-tax profit = (.25 x (100-70)) = 7.5%; and

(2) if conditions change, and costs increase from $70 to $94, without a corresponding increase in licensee prices above $100, the pre-tax net profit would be only $6. If the parties previously agreed to a royalty of 7.5% of the licensee's net invoiced sales, the licensor would be entitled to the same royalty rate, but the licensee would actually be incurring a loss. (100-94 = 6% pre-tax net profit; a 7.5% royalty would mean a 1.5% loss to the licensee).

This "heads I win, tails you lose" aspect of royalty calculations based on a percentage of sales can provide licensees with an argument to fix the royalty rate lower than the 25 percent guideline. An increased likelihood of substantial market fluctuations may also aid the licensee in arguing for a lower rate when applying the 25 percent rule.

*9 VI. ROYALTIES AS A PARTICIPATION IN SUCCESS

Licensors who have confidence in the future performance of their licensees may maintain a high royalty rate by offering to share in the fortunes of the licensee, good or

bad. This approach is often useful in licenses for processes designed to improve efficiency or lower costs. For example, a confident licensor might set royalties at 25 percent of the savings the licensee realizes from the improved process. The danger here is that the licensor must forgo royalties if the licensed technology fails to achieve its predictions.

Indeed, by assuming this added element of risk, the licensor might even attempt to negotiate a bonus for exceptional performance attributable to the licensed process. This bonus is a logical request, because even marginal increases in efficiency often produce increases in profit.

When the above "cost savings" approach is used, the parties must agree upon exactly how the "cost savings" will be calculated. This type of planning reduces the likelihood of disputes related to royalty amounts later on, and therefore, helps maintain long-term business relationships.

Even where product licensing is concerned, licensors sometimes offer to share the licensee's risk by accepting royalties calculated as a given percentage of profit. If royalties are based upon an objectively-determined profit calculation formula that allows for verification, this method is an effective way to license products.

VII. OTHER FORMS AND APPROACHES TO LICENSING REMUNERATION

Although running royalties account for most of the remuneration received by licensors, additional approaches exist. These include the following:

A. Lump-Sum Payments

A would-be licensor (now called the proprietor) can simply sell its technology for a so-called "lump-sum payment." This approach is useful for technology that licensors no longer need. It is often used when a given technology falls outside the proprietor's business or when, as is common after a policy shift, the proprietor abandons activities relating to the subject technology. Care should be exercised before choosing this method because it may elicit capital gains tax treatment if the technology's cost basis can be established.

*10 After quantifying the payment, the proprietor's minimum acceptable amount should, at least, account for the disposal costs and any risk arising from the purchaser's possession of the technology. The proprietor may also justify a higher selling price by pointing out the benefits the sale will bring to the purchaser.

The upper boundary of lump-sum payments is the purchaser's cost to duplicate or "invent around" the technology. If the technology is patented, the remaining patent life should be considered. Similarly, a body of know-how or trade secrets can also be

transferred, with the cost and time needed for duplication accounting for its purchase price.

The same 25 percent rule which is useful in setting periodic royalties may also be used to set lump-sum payment prices. To apply the rule to lump-sum payments requires the following steps:

(1) perform a 25 percent rule analysis and arrive at a royalty rate;

(2) project the economic life of the technology in question;

(3) project a royalty base for the technology, taking into account the significance of such technology to the product, process, or service being transferred; and

(4) multiply the rate by the base and perform a discounted cash flow analysis on the product of such multiplication, using the interest rate for borrowing available to the technology purchaser.

Of course the sum reached by the foregoing method is subject to final adjustments. Often these adjustments reflect the parties' need to complete the transfer.

B. Periodic Lump-Sum Payments

Sometimes it is onerous for parties to calculate royalties on the use of a particular invention because it is a component of a complicated piece of equipment or system. In these cases, an annual lump sum may be a more practical approach.

For instance, suppose an auto manufacturer licenses technology that improves its current technology. Assume further that the invention is incorporated into each of the millions of vehicles produced by such licensee each year. If an annual lump sum of $1 million were fixed as a *11 "paid-up royalty" for that year, it would represent a very narrow slice of the profit generated by the total sales of the vehicles concerned. Nevertheless, the actual payment may well be reasonable to the parties concerned. Because the auto market's and the licensee's gigantic proportions are not attributable to the licensor or its invention, a more "normal," heavily discounted royalty rate is appropriate.

An alternate approach involves charging a fixed royalty per item sold or used by a licensee. This method is favored because it affords easy royalty calculation. Whatever method is used, it is advisable to key the lump-sum royalty to a recognized economic indicator. This link will facilitate later increases in the payments, consistent with inflation or other economic events.

C. Initial Payments

The availability of initial payments is very important in the negotiation of licenses. It is also important during the calculation of the parties' relative profit entitlement. Initial payments are popular because they provide front-end cash to a licensor, which can immediately be applied to recover the costs associated with developing the licensed

technology. Additionally, because the costs must be recouped before a licensee can begin to realize profit, these payments are strong evidence of licensee commitment. The licensee's maximum payment should correspond to the reasonable amount of working capital earmarked by the licensee for the license.

D. Prepaid Royalties

Sometimes a licensor is financially weaker than the licensee, but is required to further develop the licensed technology. The licensee may provide these needed funds. The amount paid in excess of the reasonable initial payment can sometimes be applied against future running royalties, depending on how they are calculated.

In a current negotiation, this device is being cleverly employed by a start-up licensor who has patented a significant invention, for which there are several powerful licensees. The licensor requires significant working capital to grow its business and to further develop its technology. However, the entrepreneurs who founded the business do not currently wish to dilute their equity holdings by bringing in equity funding. So each licensee is required to pay, in lieu of an initial fee, a pre-paid royalty of $250,000 in U.S. currency. This sum is then recovered by the licensee at the rate of one-half of the running royalties as they accrue.

*12 In other words, if a licensee sells $5,000,000 of the licensed products at a 10% royalty rate, then $500,000 in royalties would accrue. The licensee would pay $250,000 in running royalties to the licensor and would credit the remaining $250,000 to the prepaid royalty previously advanced to the licensor. This device provides the licensor with funding, while helping the licensor maintain its ownership position.

E. Minimum Royalties

Minimum royalties are another device which can ensure commitment and adequate licensee performance. The word "adequate" is used advisedly because the level set is usually less than excellent performance. Instead, it reflects results which are at the low end of the licensor's acceptable range. It has been said that "minimum royalties are the handmaiden of exclusive licenses." This is because the minimum amounts must be paid in order to assure the continued exclusivity of the licensees.

Minimum royalties can also be employed when non-exclusive licenses are involved. They can improve a licensor's cash flow, especially in times of high interest rates, by requiring each licensee to pay the greater of the minimum or the accrued royalties at the end of each calendar quarter, with the possibility of a final adjustment at the end of each reporting year. Minimum royalties may also be used to eliminate licensees who cannot perform adequately by providing a mechanism to "weed out" the unsuccessful licensees.

The licensor has three recourses to enforce the minimum royalty, which vary in severity. In ascending order of impact, they are as follows:

(1) if the activity level of a licensee is insufficient to generate enough accrued royalties to exceed the minimum level, a licensee may merely pay the difference;

(2) on the same facts, even if a licensee pays cash to cover its shortfall, a licensor has the discretionary right to reduce the rights of the licensee (e.g., by retracting exclusivity, by reducing the scope of the products licensed, or by narrowing the territory covered by the license); and

(3) on the same facts, a licensor has the discretionary right to cancel a license.

The agreement may provide that remedies (2) or (3) would only be available to a licensor if a licensee had failed to accrue sufficient royalties *13 to meet or exceed the minimum level in more than a set number of years or consecutive reporting periods.

Minimum royalty levels usually increase from zero, during the initial year of a license, up to a maximum level during later years. For instance, a license which starts on February 1, 1995, might provide the following royalty payments:

Until 12/31/95	10,000 U.S. Dollars
From 1/1/96 to 12/31/96	25,000
From 1/1/97 to 12/31/97	50,000
From 1/1/98 to 12/31/98	75,000
Every calendar year thereafter	100,000

In some instances, parties can also provide that minimum royalty requirements will decrease over time to reflect the maturity of the licensed technology. Providing for inflation by tying minimum royalty figures to some recognized index (e.g., the Producer's Price Index of the U.S. Department of Labor) is a useful device that is frequently employed.

F. Sale of Key Ingredients, Components, or Special Items by Licensor to Licensee

A licensee may purchase a key component from a licensor at a price sufficient to eliminate the licensor's need to exact royalties in any form. Provided the purchased item is truly proprietary to the licensor, these arrangements need not run afoul of tying prohibitions under the antitrust laws.

Frequently, it is cheaper for a licensee to purchase certain components from a licensor who is prepared to make the components and can take advantage of long production runs.

By exploiting their production ability, some licensors may offer a price and royalty combination that makes the subject technology cheaper than if the licensee produced it. Licensors who do this can sell the component at a price that includes incremental profit; they can also charge running royalties.

Sales also occur when licensed products are available in a range of sizes or models, with some being much more in demand in a licensee's territory than others. In these cases, it may be more economical for a licensee to purchase the less popular sizes or models from a licensor. Royalty payments may or may not attach to resales by the licensee of those items, depending on the circumstances, including the relative bargaining strengths of the parties.

*14 G. Barter and Payments in Kind

Barter and payments in kind are common when licensing to third world countries and to the People's Republic of China because these countries have insufficient hard currency available to fund their licensing interests. A barter system frequently utilizes specialized intermediaries who arrange the trade of goods offered as payment by the licensees.

Alternatively, licensees may offer to sell goods made under the license back to the licensor, at attractive prices. This system works when the licensor makes a resale profit that is sufficient to compensate the licensor for granting the license. However, arrangements of this sort are not frequently of interest to licensors because there are often ample supplies of the subject goods available.

H. Receipt of Equity

Skeptics of the licensing process claim that these transactions educate future competitors. To reduce this risk, licensors should require interested potential licensees to form a new corporate entity for the purpose of executing the substance of a proposed license. As total or partial consideration for a license grant, the licensor should receive a mutually agreed percentage of the voting stock of the new corporate licensee, usually with the right to veto decisions that are considered important to the continued viability of the venture.

There are many possible variations on this theme, including provisions for royalty payments to the licensor or potential dividends from the licensor's holdings in the licensee corporation. Also, the licensor might sell or increase its holdings, in accordance with some express formula.

I. Sublicensing

By granting licensees the right to appoint one or more sublicensee, a proprietor can increase its earning potential. To do so, the licensor should require that sublicensors remit a pre-agreed percentage of the income from sublicensees, e.g., from 5 to 95 percent, depending upon the role of the licensee. Another approach is to require the licensee to remit to the licensor the same sum per licensed product that the licensee pays on its direct sales, with the understanding that the sublicensees will pay a somewhat higher royalty; the difference being retained by the principal licensee.

*15 VIII. SUPPLEMENTAL FORMS OF REMUNERATION TO LICENSORS

By performing special, additional services for its licensees, technology proprietors can often increase the profitability of licenses. Proprietors often provide consulting or trouble-shooting services. Profits from these services can come from annual retainers or per diem charges. To encourage licensees to utilize these licensor-operated services, a certain (usually modest) amount of the service may be offered free of charge, with fees only attaching to the excess.

Licensors can also increase their profitability by retaining marketing rights to products produced by licensees outside the licensed territory. This clearing house function can enable licensors to earn commissions on sales from a licensee, who is a very efficient producer, to other licensees, who may be less efficient or not manufacturing a full line. Moreover, such an arrangement may allow a licensor to better protect and serve its home market. For example, if the licensor has a highly proficient Japanese licensee, the licensor may be able to make some high quality and cost-effective purchases from its Japanese licensee, while also protecting its home market from competition by the same Japanese licensee.

IX. FAIRNESS DOCTRINE

One overall consideration applicable to licensors' management of licensees is the "fairness doctrine." Its basic concept is that although an unaffiliated licensee is an independent party, a licensee is somehow part of the licensor's family. There exists an underlying, and often unspoken, critical bond between a licensor and a licensee; they are collaborating on a business venture in which, in effect, they are sharing profits.

The sharing may be spelled out in black and white terms, e.g., five percent of net sales. Yet, in key ways, a licensing agreement is more involved for both sides than is a straight arm's length sale. First, the relationship is long term. Second, it usually involves an exchange of know-how, personnel, and management techniques; it is not merely a sale of goods. If one side is too demanding, the other may simply find the venture unprofitable and either abrogate the agreement or treat it in such a haphazard manner that both sides lose potential profits.

Perhaps more of the responsibility for maintaining a fair relationship rests with the licensor than with the licensee, if only because the licensor has more to give. Ultimately, both must share in making the relationship work. However, if the licensor demands too much, the deal will not be mutually profitable and will fail. By comparison, it is less *16 likely that a licensee who is realizing an unforeseen windfall will voluntarily offer a corresponding increase in its royalty rates. Such an initiative would not be counterproductive, however, because it could inspire the licensor to be more active in supplying improvements and other services back to the licensee.

X. STANDARD INDUSTRY LICENSING RATES

Negotiators or so-called "licensing experts" often suggest that standard, industry-specific royalty rates exist and that it is very difficult to depart from them. Indeed, there have been efforts to publish standard rates as guidelines to practitioners. However, since the author feels that royalties are essentially an expression of underlying contemplated profitability, he disapproves of royalty rate standardization.

For example, third-party licenses are rare in the agricultural chemical industry. Instead, they are kept within the immediate corporate "family," and are usually handled by close affiliates. Only less important technology is licensed. Therefore, if negotiated royalties were to be tabulated and averaged in the agricultural chemical business, the results would be unrealistically low.

It is believed that the same considerations hold true for many other industries, particularly those in which multi-national companies are active. If industry trends indicate low royalties, they could merely be a reflection of the general level of profitability in that industry. To limit innovation in that industry to an artificially low royalty standard would be inappropriate. The licensing process should not be subject to the pressures of Gresham's law. [n.6]

XI. CONCLUSION

The various approaches and examples described in this article are intended to be illustrative, not exhaustive. Any informed description of ways to obtain income from licensing must highlight the scope for creativity provided by the technology transfer process. This is perhaps the touchstone of the art of licensing. Moreover, such a description requires discipline and an appreciation of a methodology intended to *17 locate solutions that will motivate both parties to work diligently toward mutually-profitable goals.

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[n.1]. The author first discussed the "25 percent rule" in print in 1971 in Goldscheider & Marshall, The Art of Licensing from the Consultant's Point of View, 6 LES NOUVELLES 4 (1971), reprinted in FINNEGAN & GOLDSCHEIDER, THE LAW AND BUSINESS OF LICENSING 645 (1980). This concept arose from a world-wide series of successful licenses. Beginning in 1959, the author negotiated a series of licenses that were based upon a 20 percent pre-tax profit and a 5 percent royalty on net sales (i.e., a 25 percent of total profit). This rate satisfied both licensees and licensors. While the rule has been refined, it is now widely employed by licensing executives and has been mentioned frequently in licensing literature.

[n.2]. The late "Sam" Davis, formerly General Counsel of Research Corporation, is a fondly remembered and highly regarded American pioneer in the licensing profession.

[n.3]. WORTH WADE, HOW TO PROFIT FROM LICENSING 1 (1969).

[n.4]. This is usually specifically defined in the agreement as gross sales less cost of freight, insurance, returns and allowances, and sales or use taxes, but not income taxes.

[n.5]. In some situations, it may be preferable to refine pre-tax profitability to the concept of Income Before Income and Taxes (IBIT), or Earning Before Income and Taxes (EBIT), where the former is sometimes referred to by accountants. This refinement can remove anomalies in the earnings of particular companies that are carrying a heavy debt burden from some past, unrelated, transactions. A company's projected operating profits from the specific licensing transaction might be equal to those of another potential or actual licensee that is debt free, but the requirement to make interest payments on such debts could distort this reality by a lower corporate profitability rate.

[n.6]. "Gresham's law" is an economic principle observed by Thomas Gresham, an English financier and economist in the 1570s. The economic observation is that "bad money [over-valued] drives out good." By analogy, a "bad" royalty standard drives out innovation in industry. See 5 THE NEW ENCYCLOPAEDIA BRITANNICA 391 (15th ed. 1993).