Things to consider when formulating a royalty rate

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At some stage during the negotiation of any agreement in which one party licenses the use of intellectual property to another, the parties will need to negotiate and agree on a suitable royalty rate. So how should prospective licensors and licensees deal with this issue?

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There is no shortcut to undertaking a detailed analysis of the transaction and intellectual property involved. Using an average industry royalty rate should only be used as a guide and care should be taken, as royalty rates differ from transaction to transaction.

During the detailed analysis of the transaction and the intellectual property involved, a number of factors should be taken into account, as they can influence the royalty rate applicable to your transaction. These factors include:

- **Importance.** Does the licensed intellectual property constitute a technological breakthrough or is it merely an ancillary product or minor improvement?

- **Competitive advantage.** What is the competitive advantage of the licensed intellectual property, including the scope and remaining life of any patents relating thereto?

- **The market.** What is the market size and what are the dynamics, growth rates and extent of competition?

- **Market exploitation.** What are the barriers to entering the market and what degree of work and expenses will be required to take the licensed product or technology to market?

- **Product complexity.** What is the degree of complexity in the sale of licensed product and what is the extent of customisation required in customer-specific applications?

- **Stage of development.** Can the licensed product be used immediately, or will it require substantial R&D or regulatory approval to be commercialised?

- **Risk.** How certain is it that the licensed product as a solution will work as expected? This inquiry would involve an assessment of potential product liability issues.

- **Profit margins.** The economic status of the relevant market is important. What profit margins are expected?

- **Cashflow model.** Understanding the cash flow model of the licensee and any sub-licensee is essential.

- **IP protection.** The stage (provisional, granted, PCT with national phase patents or trade marks) and extent of registered intellectual protection must be considered. What is the scope of the patent/trade mark protection and how many countries are covered by patent/trade mark protection? What is the ability of the licensor to maintain and defend the patent/trade mark portfolio?

- **Local restrictions.** From a South African perspective, the provisions of the Exchange Control Regulations and the approval of the payment of royalties by a South African licensee to a non-South Africa licensor should be considered. Further, should the Licensor be a publicly funded entity, then the provisions of the Intellectual Property Rights from Publicly Financed Research and Development Act, 2008 (Act 51 of 2008) must be carefully considered.

- **Payment currency.** In cross-border license agreements, factors such as royalty withholding taxes as well as the payment of royalties in a currency other than the licensor's home currency must be considered. While it may be possible to hedge exchange risk over a relatively short period, this may not be possible over entire term of the license agreement.

Whether you are the licensor or the licensee, there are certain characteristics of the licensor that normally have a bearing on royalty rates and these inter alia include:

- **Resources of the licensor.** The financial and organisation size of the licensor. Are the knowledge and technical abilities of the licensor limited to a few individuals? Can the licensor support the licensed product, both financially and through ongoing technological improvements or enforce and maintain of its patent/trade mark rights?

- **Strategic plans.** What are the licensor's plans and strategies for the commercialisation of the licensed product?
- **Support.** What is the extent of the support offered by the licensor, both in terms of technical product advice?

An application of the above principles should provide you with an objective assessment of the value received by the licensee from the licensor when negotiating the royalty rate for your transaction. Such royalty rate should be fair for both parties. Where the factors driving the royalty rate are complex and numerous, multiple rates or tiered royalty structures should be considered.

ABOUT THE AUTHOR

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