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CORPORATE POLICIES ON INTERNATIONAL LICENSING ✓

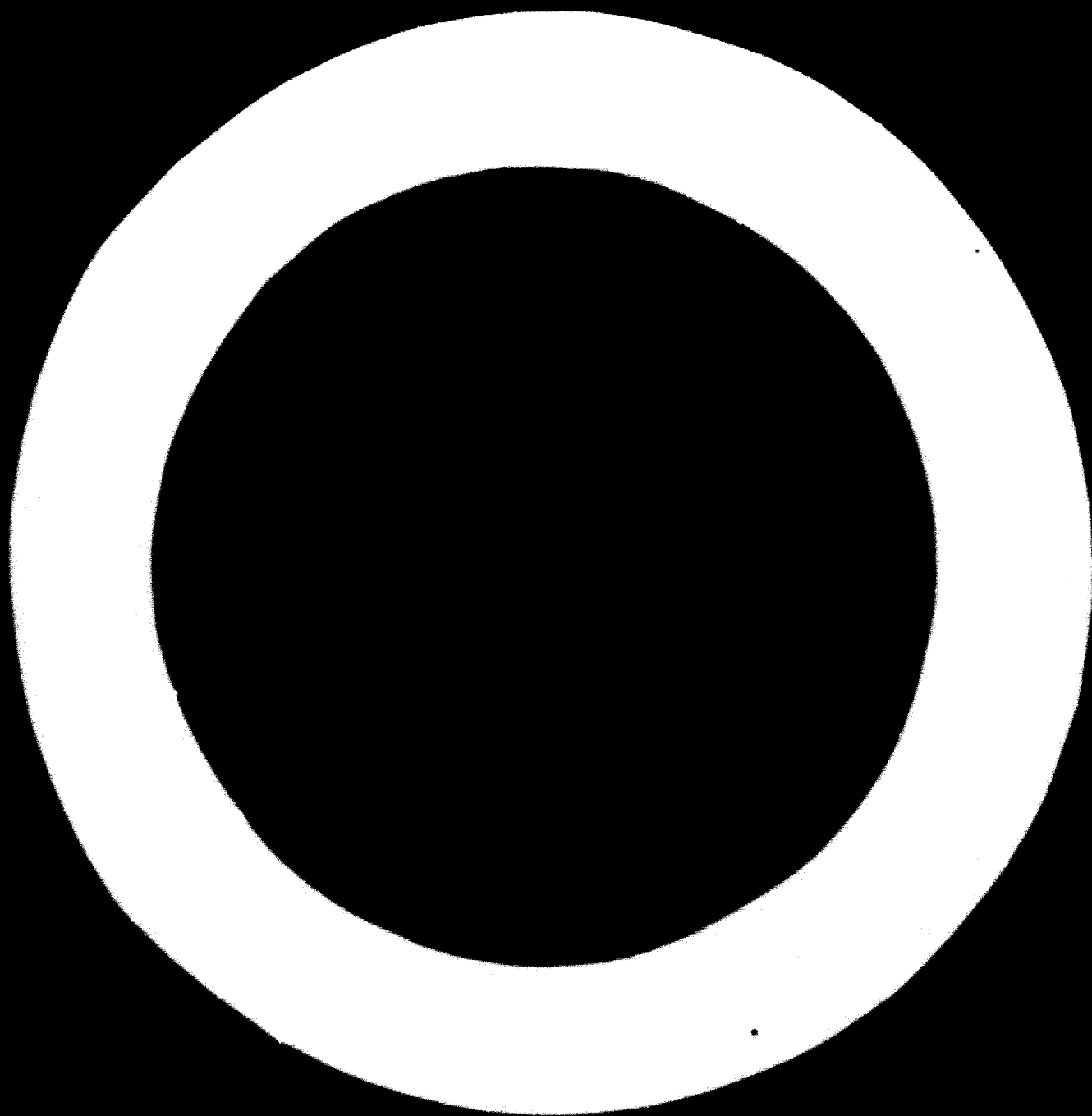
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The Principles of Industrial Licensing to the Developing Countries

This paper has as its object an outline of the basic principles likely to be involved when a company in, presumably, an industrially advanced country is in a position to licence to a developing country, and of the considerations which influence the policy of licensor companies in such circumstances. Controversies can arise, as is well recognised. To resolve them the basic principles need to be understood by those concerned on both sides.

This paper does not deal with controversy, but with the constructive criteria which need to be analysed in each instance. It has been observed that everything in the present paper is obvious after it has been expressed, but that until it has been expressed it is not always appreciated in the developing countries. The two most important principles which have to be understood are first that a licensor company can only embark on a licensing contract if it is an acceptable commercial proposition to the licensor, and second that economic realities are common to the licensor and licensee alike. A licence needs to be paid for, and it is to be regarded as a raw material analogous to any other element required to carry out the licenced process, involving a cost which is part of the manufacturing cost. This in the final analysis has nothing to do with the commercial success or failure ultimately achieved by the licensee, whether in a developing country or anywhere else. If, from the point of view of the licensee, a licence will not stand up to this economic evaluation then the project is questionable from the very beginning.

The present paper is by way of being a check list of the issues which need to be faced by both the licensor and licensee, and which must inevitably determine the policy.

It is a truism these days that any company developing a new process or product must give consideration to the possibility of licensing it to others. The conclusion in some instances may certainly be that it is better for the company to keep the development to itself, but to an increasing degree in industry the possibility of licensing is assuming importance. There are of course two primary reasons; the first is that the cost of research and development is becoming so high that it is often difficult for a company to recover these expenses from its own operations alone, and the second that few companies can cover the markets in all countries. This second reason makes international licensing more significant than licensing inside the same country, and so the developing countries must be of interest to any potential licensor.

When it comes to licensing in the developing countries, moreover, further considerations apply. The wish of the leading industrial countries to assist the advance of the developing countries is a very real one, and industrial corporations are run and staffed by people having the same wish to encourage the developing countries as anyone else.

Nevertheless, while a Government can decide as an act of policy to give assistance to a developing country, an industrial company of sheer necessity has to look upon a licensing proposition as a

commercial venture. An industrial company has obligations to its shareholders. This consideration applies to all licensing operations, and special considerations apply when licensing to the less developed countries for reasons which will appear. A realistic approach in a commercial sense is moreover in the interest of the licensee as well as the licensor, for when the plant is ultimately erected the licensee will encounter the same economic climate as the licensor.

To define the problem more specifically, it is useful to be explicit about what type of licensing is in mind in this connection. The simplest form of licensing, which is associated with the existence of patents, is when a company makes a development of its own and then finds this falls within the patent rights of another company. In such an event, which is very common in the more industrialised countries, the first company needs a patent licence from the second. Such licences are paper documents giving freedom to the first company to proceed; they involve no transfer of technology, plant design or knowhow. This is not the kind of licence needed by the developing countries, which require this very technology, plant design and knowhow in order to proceed. * Another kind of licence is the franchise type of licence where permission is given to operate say under an established trade mark of another company for commercial

* For reference on the subject see Guidelines for the Acquisition of Foreign Technology in Developing Countries with special reference to Technology Licensing Agreements - UNIDO PUBLICATION.

reasons. This also is not a usual consideration in the developing countries. This paper is concerned with the type of licence which enables the establishment in the developing country of a new industry or production which it does not have, and which it needs the technical knowledge and assistance of the licensor to establish.

In such a circumstance, when licensing a developing country, substantial obligations are placed on the licensor, who assumes an obligation in seeing to the successful establishment of manufacture in a country which itself does not in general make a technical contribution. Not only does the technical contribution come wholly from the licensor, but in addition he will have much more experience of the kind required to estimate if the operation is likely to be an economic success in a given set of conditions. Such considerations as the following come immediately into question:

- (a) Does the licensor have a fully worked out operation?
It is useless to think of licensing an experimental idea, or an incompleated proven process, if the licensee is not likely to have the technical capability of reaching a final project or the resources to make this effort. This consideration has led to many companies adopting the policy, even when licensing in the most sophisticated countries, of not being prepared to licence before the process in question is fully established and in commercial operation.
- (b) Is the market in the licensee's country large enough to make the project economic? This is a very important factor which is at the root of any licensing operation in a small country. In some industries, in the petro-chemical industry for instance, an economic project

may only be possible with a very large plant and hence a very large capital investment. The cost of some processes is a function of the size of the plant, the cost increasing greatly as the size of the plant is reduced; if the market in or open to the country in question is not sufficient to absorb the production of a plant of the minimum size needed for economic production then prima facie a licensing operation would be a misjudgement on the part both of the licensor and licensee.

- (c) If there is a possibility of an economic plant, will this be of the same size as the licensor has himself erected and for which there will be a precise plant design and existent drawings, or is a special design necessary for a smaller plant? This would involve further expense in itself, which again might make the exercise less economic.
- (d) Is the scale of production in the licensee country likely to be sufficient to bring a fair return to the licensor which would justify in a realistic way the effort needed to provide plant design and ensure that the final result is successful?

This last factor is an important one that any licensing company has to face in licensing to a developing, and perhaps small, country. The burden placed on a company licensing a process and undertaking to see that it is successfully installed is often under appreciated; it is likely to mean committing staff and effort badly needed by the company for its own operations, and to involve the expense of sending staff abroad perhaps for prolonged periods. Obviously the return must cover this cost, but it is sometimes overlooked that if the

return is marginal or even conjectural it is often difficult for a company to justify effort which can be more usefully employed elsewhere.

These are the kinds of consideration on which the licensing policy of any company must be based. They apply whenever licensing is in mind, be it in the same country, or abroad in an industrially developed country, or in a developing country. The issues become more significant in the latter, for it is there that the burdens on all parties can be greatest.

The Contribution of the Licensor

As a general rule, when a potential licensee wants a licence from another party, he knows what level of production he has in mind and can negotiate the licence on this basis. The assessment requires an estimate of the cost of production and a market evaluation giving the likely sales and price. This basic analysis on the local ground by the potential licensee is just as relevant in a developing country as in any other, but in a developing country the skills necessary may not be so readily available as in a country already heavily industrialised. It is just the same an analysis which must be made. The potential licensor will be willing to give what assistance he can. Also it is conventional practice that a company having a process to licence will make available information on the capital cost of a plant of a given capacity and the quantities of raw materials, labour, power and such like required, thereby enabling an assessment of the economic possibilities of a project.

It nevertheless has to be recognised that a licensor-outside the country may not be well equipped to judge the economic potentiality inside the country of the licensee, and there is a very real obligation on the licensee to make and take responsibility for the basic decisions.

If following the economic evaluation a licence is decided upon, the licensor can agree to undertake some or all of the following, which are dealt with subsequently:

- (a) The first requirement is clearly a plant design and an operating manual;
- (b) The licensor can undertake to erect the plant or supervise its erection;
- (c) The licensor can undertake to start up the plant and to train the operators and managerial staff.

Dealing with these individually:

The Plant Design

The licensor can be expected to provide drawings of the plant and specifications for its components, instructions for its operation, and specifications for the raw materials required. In theory this should be sufficient to erect the plant and operate it, though a good deal of assistance will certainly be required from the licensor.

The problem then is to erect the plant.

Erection of the Plant

There are in principle three approaches to this; the plant can be erected by the licensee, by the licensor, or by an outside contractor. In the case of a developing country it is quite common that the licensee is not in a position to undertake erection of the plant, so that it usually becomes the task of the licensor (probably with the assistance of local personnel) or of an outside contractor.

Which formula is adopted is a matter for analysis and negotiation. It is not uncommon for the licensor to send one or two engineers to the site and for them to hire local help. However, at the present time it is very common for outside firms to contract to erect the plant, and in some instances companies licensing the same process in different areas will place a single contractor in a position to erect all of the plants; such a contractor will then gain experience in the plant, and in addition the features of it, probably highly confidential, are thereby kept in restricted circles. Of course a licensee is required to keep confidential the technical information with which he is supplied, and a reliance on the confidentiality of licensed technology is an essential part of licensing procedure.

Start-up of the Plant

When the plant is erected, and the raw materials available, it is normal for the licensor to supervise its initial operation. This will involve the training of operatives (a need as important in the developed countries as in the developing), and the local management

will need instruction in the technical complexities, safety and so on. This can if required be extended to accountancy procedures or any other of the management functions.

When the plant is properly operating (and every plant has its start-up problems) it is handed over to the licensee.

A licence agreement needs to specify precisely the duties of the licensor in the above respects. A factor of importance here is the provision of the items of equipment in the plant; the licensor or the contractor can for instance act as purchasing agent for items purchased from outside. It is all a matter for negotiation. Also in some instances if the plant includes especially critical items of equipment it is not uncommon for these special items to be manufactured and supplied by the licensor under an ordinary purchasing contract.

The Terms of the Licence

The cost of the licence will of course depend on the commercial value of the licensed process, but a normal procedure is to provide for an initial down-payment and a running royalty for an agreed period of years.

The initial down-payment for the plant design and technology will cover the cost of preparing and transmitting the information, and provides an initial justification for the supply of what is invariably highly confidential knowhow and for the effort needed from the licensor in conveying to the licensee a full understanding of this knowhow. If the licensor himself contracts to erect the

plant the cost of supplying the knowhow and the cost of erecting the plant would probably be treated together in the negotiations preceding the deal.

When, then, the plant is in operation, the licensor can expect a continuing royalty based on the production in the plant or on the sales of the product. This royalty can be a percentage of the selling price, or a fixed sum for each kilogram of product or for each article produced. There are arguments for and against each of these formulae; a fixed royalty has the advantage of certainty, but selling prices can go up or down, and a fixed royalty which is reasonable at a preconceived selling price can prove unsatisfactory either to the licensee or licensor if the selling price is found to be different from that supposed before the plant is erected. A percentage royalty will to this extent cater for changes in the selling price. If (as is commonly the case when basic products are in question) the licensee is himself to use the product and not sell it then the formula adopted needs to be adjusted to the circumstances; here the royalty can be fixed, or perhaps based on an assessed selling price - which can be the market price or the selling price when the licensee sells to others, if he does.

Equity Participation

A most important circumstance arises when the licensor, instead of receiving a payment for the licence in the above manner, acquires an equity interest in the licensee's operations. In such a case the licensor will receive an agreed proportion of the equity in return

for the provision of the process, and will then obtain his return from the dividend corresponding to this equity share. Sometimes the licensor will also make a contribution of capital, with a corresponding effect on the proportion of the equity.

This is a matter which can raise issues beyond the economic ones. A licensor may not wish to become involved in this way in investment in another country, and some countries might look with doubt upon the prospect. In a similar way, one advantage to the licensee of the licensor having an equity interest is that the licensor identifies himself more with the commercial success of the licensed plant, yet this in itself may involve the licensor needing to become involved in management in a manner which may not be appropriate to the circumstances. It is however an undeniable fact that among most industrialised countries investment from abroad, and the application of management skills from abroad, have been highly beneficial to the receiving countries. It has been a two-way operation between industrialized countries.

This whole matter is too complex, and so dependent on outside considerations which differ in different countries, to be susceptible to general analysis. In the end the same basic principle really applies, that a licence needs to be paid for, and a royalty charge and an equity share are simply alternative methods of payment which need to be compared on their merits.

Continuing Information

In principle, the essence of a licence is that the licensor supplies plant design and knowhow, and when the plant is erected and in operation the licensor has fulfilled his contractual obligations. It is, however, a common feature of licensing to provide for the licensor to continue to supply information on improvements to the plant for a period of so many years, and perhaps for the period of the royalty payments. In this event of course provision must also be made for payment for this information.

In some instances this may be partly or fully paid for by the supply by the licensee of his own improvements to the plant. A cross-licensing arrangement of this kind may however involve the licensee himself carrying out research work to obtain such improvements, and any developing country investing in a new process must clearly decide what its policy is to be in this respect. There have moreover been instances over recent years, where a company has licensed numerous licensees, for the licensor to create a "licensing pool" to which the licensor and any of the licensees who elect to participate contribute their experience and research results for the benefit of all parties in the pool. It is not uncommon to institute yearly meetings of the licensor and the participating licensees for the discussion of this common knowledge. This, however, is a system which is probably only applicable where there are sufficient separate licensees to make the idea of a pool a realistic one.

Third Party Rights

It will be appreciated that when erecting any plant in any country, the possibility that licenses may be needed under patents held by third parties may arise. This is a factor which needs to be considered in deciding upon a project and in estimating the likely financial returns from the project. The situation seems no different in a developing country from that in any other, except that as a generality it is probably true to say that in most developing countries fewer patents exist than in the highly industrialised countries.

Arbitration and Governing Law

In any licence agreement there are two formal matters which need to be given consideration, though fortunately they seldom prove to be other than academic in practice. These are:

- (i) What is to be done if there is subsequent disagreement between the parties, and
- (ii) Under the law of which country is the agreement to be interpreted.

It is always hoped that any agreement will provide for all contingencies, and this should be the objective, but human frailty does not permit perfection. Of course if there is disagreement on the interpretation of an agreement, or if circumstances arise which are not provided for on which the parties cannot reach agreement, the Courts are always available to decide. However, legal procedures in the Courts are complicated and expensive, and few people wish to

be involved in them unnecessarily. It is therefore common for provisions to be included in the agreement that in the event of a disagreement which cannot be resolved the matter will be taken to arbitration before an appointed arbitrator or perhaps a group of three appointed arbitrators.

Any arbitrator acceptable to both parties can be appointed. In some countries it is common to specify that the arbitrator will be one chosen by some person of note who can be identified in the agreement, such as the President for the time being of some leading professional organisation in the law. Another formula is that each party should choose an arbitrator, and the two arbitrators so appointed should agree a third arbitrator to establish a panel of three. In Europe at any rate one formula is to adopt the arbitration procedure of the International Chamber of Commerce of Paris, in which case the International Chamber recommends a clause in the agreement reading as follows:

"All disputes arising in connection with the present contract shall be finally settled under the Rules of Conciliation and Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the Rules."

A pamphlet setting out these Rules can be obtained from the International Chamber of Commerce in Paris (38, Cours Albert ler, Paris VIII).

As regards the country whose law is to prevail, it is not uncommon for the licensor to want the law of his own country to apply, and for the licensee to take a similar view. Ultimately agreement one way or the other has to be made. It must be very rare for the law involved to make much difference to the interpretation of the agreement, though in some developing countries the Courts have been so seldom called upon to rule on licensing agreements that it may be more satisfactory for a country to be specified where the law is more defined.

It is true that there are occasions when disagreement between licensor and licensee is serious enough for a reference to the Courts, or to arbitration if there is provision for such, to become inevitable. They are few. Most problems in licensing agreements become resolved by discussion between the parties, when the generally accepted principles of licensing will be found to be adequate to meet most circumstances.

APPENDIX

It must be recognized that any company wishing to benefit from the potential of the market in a foreign country, be it a developing or already heavily industrialized one, has two basic possibilities apart from licensing. These are by export from the home country or by manufacturing itself in the foreign country. As regards exporting, this is always possible to a degree. Moreover a market can be developed by exporting, perhaps developed to the point where local manufacture is economically justifiable. This is for that matter a very valuable preliminary to a licensing programme. But it is probably true to say that ultimately for most types of product the full potentiality of a market can seldom if ever be achieved by exporting into that market from abroad. There are no doubt exceptions, but it can be seen that once an adequate market exists in a country local manufacture by somebody (either of the product in question or of another which in effect replaces it) is sure to result. Moreover exports must take their place in a competitive environment, whereas local manufacture is at an advantage in this respect, to say nothing of the possible impact of duties, import licenses and currency restrictions. The automobile industry is an instance; the cars in a developing country may all be imported, but the imports would not be from one manufacturer alone. A locally manufactured car might on the contrary be the prevailing one used.

The value of exports is recognized by every manufacturing country, and its immense importance is not to be depreciated. The point at issue is that for a given company local manufacture in a

country will invariably find a larger market than an export into that country. Of course it is certainly possible that the export might be more profitable than a larger local manufacture would be (whether this is under license or by the originating company itself); this is one of the balances the company needs to consider in settling its policy, and brings in factors such as cost of production vis-à-vis size of plant which are beyond the confines of this paper.

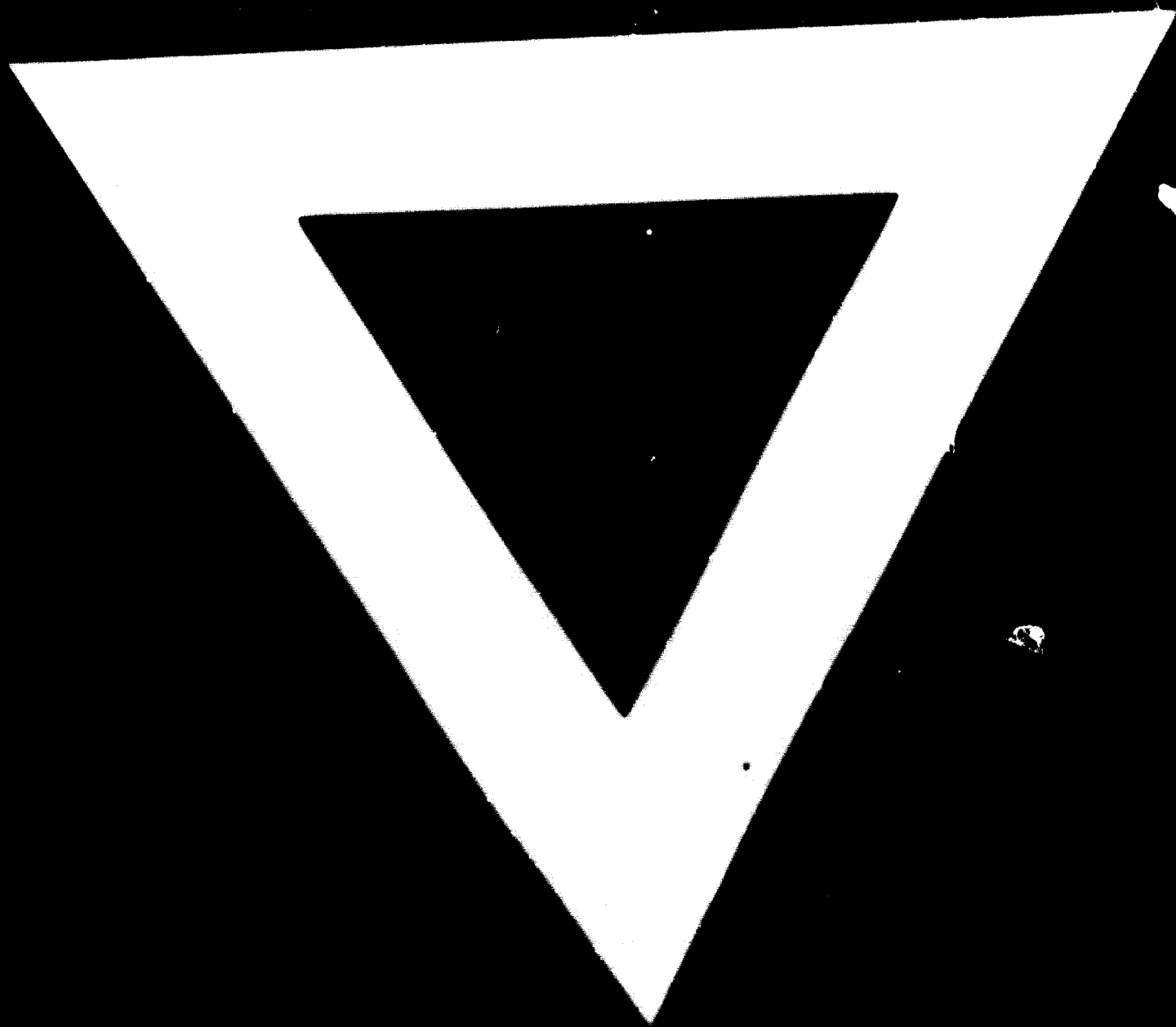
The second possibility a company has is to establish manufacture itself in the foreign country, and this raises complex issues indeed. In a sense this is the reciprocal of licensing, especially in a developing country whose basic objective may be to see that local manufacture is brought into being in one way or another. This can equally be achieved by licensing or by local manufacture by the company concerned. In the case of licensing, the return to the licensing company is a royalty payment of some kind and the profits (or losses) remain with the developing country, as do the management and control. In the case of local manufacture by the company, the developing country gains by the introduction of that measure of industrialization, but the profits (or again the losses) are left with the company, and so in principle are likely to be the management and control. Both result in a new industrial project in the country concerned.

It is probably in this area of management and control that difficulties can most easily arise. Any developing country needs to develop, and wishes to manage and control. Indeed there are countries where foreign control of a local manufacture is not legally permissible.

It is a commonplace that in some countries a majority interest in a local company cannot be held outside the country, or even if this is not so that a 100% foreign ownership is impossible. Indeed, some companies manufacturing abroad might themselves wish to have part of the interest held within the foreign country, in order to benefit from the contribution which could be forthcoming.

It is said elsewhere in this paper that a company licensing in a developing country might receive part of the equity of the local licensed company as the royalty payment. It is an interesting reflection that if the company decided instead to embark on manufacture in the country itself, and part of the equity came to be held within the developing country, either by the course of law or by chosen policy, a remarkably similar situation might ensue. One can see in fact that identical situations could result from these two apparently diametrically opposite approaches. The distinction perhaps usually lies in this factor of management and control, whether explicit or implicit, and this again is beyond the confines of this paper. It would need a separate study of its own, which would bring in Governmental attitudes and political factors as well as technical and economic ones.





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