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PREPARATION OF LICENCE AGREEMENTS AND NEGOTIATING STRATEGY ✓

by

K.D.N. Singh \*

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\* UNIDO Consultant and UNIDO Project Manager,  
Capital-Goods Development Programme, Mexico.

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## PREPARATION OF LICENCE AGREEMENTS AND NEGOTIATING STRATEGY

The preparation of licence agreements and the related negotiating strategy need essentially to be reviewed in the context of (a) the extent and nature of foreign ownership and the consequent corporate structure, (b) evaluation and selection of appropriate technology and technology-supplier, (c) definition of nature of technology and technological services supplied by the licensor/foreign partner and (d) the detailed terms and conditions of the licence agreement. As is obvious, the negotiating strategy related to these aspects would inevitably depend on the relative bargaining strength of the domestic partner/licensee.

### A. Equity Participation

It is initially necessary to determine the needs for and extent of foreign equity participation. Licensees in developing countries are often prone to accept foreign equity participation as generally being desirable. This may well be so where highly sophisticated techniques are involved, where a great deal of "hand-holding" and support on the part of the foreign licensor may be necessary over a period of time or where a particular technology is not available except to an affiliate company. In cases where techniques can be easily absorbed and where the domestic market has a high and rapid growth potential, foreign equity participation should be avoided or kept to a minimum. However, it is precisely in such cases, particularly when the foreign party cannot otherwise enter a domestic market, that technology suppliers would be interested in part-ownership and there has to be a trade-off between technology and know-how on the one hand and entry into protected or insulated markets on the other. In most other cases, particularly where market prospects are uncertain, a foreign manufacturer would be more inclined to a licence arrangement without equity participation. In recent years, high labour costs have forced many foreign manufacturers to seek production outlets in developing countries. In the latter case, however, foreign majority ownership is usually sought and has to be considered at the policy level by governments of the countries considered in relation to the export benefits that may accrue. At the enterprise level the licensee must carefully assess the full implications of

foreign equity participation in terms of overall resource availability, the nature of technology and the absorption capacity of the domestic enterprise, the size and growth potential of the domestic market and the relative cost-benefit ratio of such participation over a period of time. The association of a foreign partner may have certain short-term advantages in terms of domestic resource mobilisation and product sales and even as a status symbol but may be disadvantageous in the long run through dividend outflows over an indefinite period. Even greater care is necessary in cases where the foreign partner buys into an existing enterprise as this affords an incremental advantage in respect of the existing markets and profitability of the domestic enterprise. While, in many developing countries, the state plays a significant role in the determination of foreign investment inflows, the recipient enterprise needs also to make a judicious appraisal in this regard. Related to the question is that of capitalisation of know-how costs. By and large, such capitalisation is not in the interest of licensees. Even where technology costs are high and constitute a heavy burden, on licensee enterprises, specially in new production units, the balance of advantage lies in charging such costs to the cost of manufacture rather than to permit such costs to be converted into equity, constituting a burden on the dividends of the enterprise in perpetuity. The fact that much of the know-how may be in the form of intangible items is an added reason for non-capitalisation. Even where capitalisation becomes inevitable because of the oligopolistic situation of the technology supplier, such capitalisation should be kept to a minimum and should not exceed a small percentage of the total equity capital involved. Thus, between the extremes of a foreign-owned subsidiary and a licence agreement without capital participation, a number of intermediate positions may emerge, involving foreign capital participation to varying extents from 20% to 40%. This joint-venture approach is proving an increasingly popular corporate tool in many developing countries.

The availability or otherwise of alternative technology, together with the knowledge of such alternatives is an important aspect of the negotiating strategy. Where alternative production techniques are available and known, a prospective licensee can satisfactorily evaluate

the cost and value of such alternatives. Where the technological oligopoly is sharper, or where knowledge of alternatives is not adequately available, the licensee is in a much weaker position. This situation applies equally whether the licence arrangement involves foreign equity participation or not.

#### B. Selection of Technology and Licensor

The selection of appropriate technology and the most suitable licensor is perhaps the most significant element of the pre-negotiation strategy. Where choice of alternatives is restricted because of local factor-endowments or the nature of the process or technique, the licensee should seek to ensure that the technology is obtained on at least similar terms as it has been made available to other licensees. Where there is a choice of alternatives and this is the normal pattern in most manufacturing sectors, the technology selected should be the one most appropriate to the factor situations in a particular country. In the selection of the licensor, it needs to be ensured that the foreign party is both equipped and willing to provide the necessary know-how and technological support that may be essential for the licensee enterprise. Technological services in particular present considerable problems to a number of licensors and technical manpower availability for ensuring adequate training of the licensee in plant operations and management, for example, may be severely limited. Such aspects need to be carefully assessed, both by the prospective licensee and licensor, in the context of each licence arrangement.

#### C. Licensee Draft

Once the licensee has selected a potential licensor or partner from the viewpoint of technological suitability, the licence negotiations would commence. As a matter of strategy, licensees should themselves be armed with a draft licence agreement which could constitute the initial basis for negotiations. This enables the licensee to define (a) the general policy provisions which may be prescribed by the respective government and (b) the specific terms and conditions considered appropriate by the licensee enterprise. Since a number of

multi-national companies start licence negotiations with their own standard contract forms, it is useful to have one's own draft also available so that the scope of difference in the two approaches may be more clearly delineated.

#### D. Definition of Technology

From the licensee's viewpoint, it is necessary that the licence agreement should initially define (i) the products to be covered and (ii) the production processes involved, including specific reference of production capacities where this may be relevant and defining specifically the production documentation such as manuals, blueprints, manufacturing drawings and all other production data that may be necessary in a particular context. For example, the present unit of measurement for engineering products may be different in the case of a particular licensor and may require modification to suit the licensee's production programme. Drawings of certain parts and components, which may be bought-out by the licensor in his country, may require to be manufactured by the licensee in a developing country as such parts may not otherwise be available within the country. Or, the licensee may be required to use some locally-manufactured materials or components which may necessitate some modification in the manufacturing processes for a particular product. All such technological aspects need to be catered for and need to be incorporated in the licence agreement in order to avoid subsequent misunderstandings and disputes. Similarly, technological services need to be specifically defined, so that the scope of technical assistance is adequately understood by both parties from the start. Such technological assistance can well include a number of services which a licensor would not normally be expected to provide to a licensee from a developed nation but which would be essential for a licensee in a developing economy and could cover detailed plant engineering, selection of equipment, testing of local materials, assistance in start-up and initial operations and, above all, a comprehensive training programme, including training in the licensor's plant and in the licensee enterprise. In certain cases, licensors seek to impose certain technical services at high cost as part of the technology package and this needs to be guarded against.



In other cases, licensors cannot perform such services directly and have to obtain those from other sources and it needs to be ensured that no unearned cost element is included on this account.

#### E. Training

From the licensee's angle, provision for adequate training of domestic personnel is a very significant aspect. A provision is usually provided for visits of a specified number of licensee's personnel to the licensor's plant for short, defined periods. The licensee needs to be sure that the number of such personnel and the time-periods specified are really adequate for technological absorption of the processes and techniques involved. An important element, particularly in contracts relating to machinery and engineering-goods production related to training in designs. This is often resisted by licensors who tend to consider design training as outside the scope of licensing for manufacture. This may, however, in the long run prove to be of crucial importance to the licensee for future adaptations and its usefulness or necessity; particularly the manufacturing context needs to be carefully assessed.

#### F. Technology Payments

Once the nature of technology and technological assistance has been defined, the remuneration for technology is among the most important elements to be negotiated. Where a licence agreement is accompanied by capital participation, the extent of such participation should be related to the overall payment for technology. Foreign investors argue that the two issues of returns on investment and payments for technology and know-how should be viewed independantly. While this argument may have theoretical validity, it is necessary to evaluate the overall benefits and returns accruing to a licensor who is also an equity shareholder. While no hard and fast rule can be laid down, technology payments should be low and correspondingly with the extent of accompanying foreign investment. Thus, in the case of a wholly-owned foreign subsidiary, there is little or no justification

for any payment for technology. Correspondingly, remuneration for know-how could be higher for a licence agreement with no equity participation than say, 40% licensor shareholding.

Technology payments normally tend to take the form of (i) a fixed lump-sum fee (ii) a running royalty ranging from 1% to 5% and sometimes even higher and (iii) a combination of a lumpsum fee and a running royalty for a period of time. The payment for specific technical services should be considered separately for each item of such services. Where this is aggregated by the licensor as part of the overall technology package, it should be disaggregated by the licensee and considered independantly. Lumpsum payments are usually made in cases where the know-how can be fully and completely transferred in the first instance. This usually related to relatively simple manufacturing techniques or drawings and should be negotiated by a licensee where no continuing support or assistance of the licensor is required. The more common form of payment is that of a percentage royalty, usually related to sales, though sometimes to production. In such cases, it is necessary that the landed value of imported intermediate products and components is deducted from the sales figure for royalty computation so that only the value-added is taken into account. Sometimes, royalty is sought to be calculated on production, in which case also only the value-added should be assessed for royalty. Two alternative approaches can also be considered, viz. (i) linking royalty with unit production costs and (ii) calculating royalty as a percentage of profits. The former is difficult to determine except in series production items and even in such cases this method presents considerable practical difficulty in determination and computation. The latter would not normally be acceptable to licensors but is worth consideration in cases where management responsibilities are also entrusted to the licensor for a period of time. Whatever method of assessing royalty is negotiated, it is important for the licensee to assess the payments involved against projected production and sales in arriving at the percentage rate. A rate of 4 - 5% may prove reasonable where related to tailor-made items of high unit sales but may prove unduly high for items produced in large series or for process industries. Over the last decade, a fairly defined pattern is gradually emerging in respect

of licence royalties paid in different production sectors and prospective licensees are in a better position to compare payments made by other licensees for the same or similar know-how. While such information was a closely guarded secret formerly, information in this regard is now often available. The fact that, in many countries, licence agreements require approval of a governmental agency also ensures that arbitrary high royalty rates would not be accepted in many countries, particularly where similar technology has been acquired in the past. In some countries, a ceiling limit is prescribed for royalty payments. For example, in Mexico, there is a ceiling of 3% of net sales. While such a ceiling may be somewhat arbitrary, it does undoubtedly serve to ensure that the licensee is not forced to agree to an unduly high percentage. A highly undesirable provision sought to be imposed by licensors in certain cases is that of minimum royalty. This can prove a very heavy burden for licensees and may well result in the effective royalty becoming 10% or over, depending on the extent to which actual sales fall short of projected sales income.

In a number of licence agreements, technology payments are a combination of lump-sum fee and a royalty percentage. The former is often treated either as a disclosure payment or payment for basic documentation while the royalty is linked with production know-how. Where there is a royalty ceiling or where the duration of the agreement is for a short period ( up to 3 years or so), the lump sum fee insisted on by licensors tends to be correspondingly higher and has to be specifically guarded against. Ultimately, in determining the technology payment, the overall figure has to be considered. It is not practicable to formulate any uniform principles as to the size of the lumpsum fee or the rate of royalty (except that such rate should not exceed 5% but in very exceptional circumstances) as this has to be negotiated on a case to case basis but what is essential is that the licensee should be fully aware of the implications and impact of such payments on the production structure of his enterprise and should also be aware, to the extent possible, of royalty payments in the same sector and for similar know-how asked for by alternative licensors and paid by other licensees either in the same country or in other countries. It is only when the licensee is armed with such information and knowledge that he can best

ensure that the licence payment is, by and large, in accordance with the market value for a particular technology or know-how.

#### G. Duration of Agreements

Closely linked with the technology payment is the question of duration of agreements. It is to the advantage of the licensor to extend such a period as long as possible ranging over 10 to 15 years and even longer in some cases as royalty income accrues to an increased extent with greater production and sales by the licensee while the technological support effort is less and less. On the part of the licensee, the period should be as short as possible, consistent with the licensee's capacity to fully absorb the know-how involved within such period. The question of technological absorption is, however, very important and may take several years, depending on the nature of the technology and the specific efforts and capacity of the licensee enterprise for such absorption. Two other general principles should also be considered in this context. Firstly, where the technology is fast-changing in a particular sector such as pharmaceuticals or electronics and where the licence agreement adequately provides for full access to all innovations and improvements effected by the licensor, it may be of advantage to the licensee to have a somewhat longer duration. Secondly, it is important that the life of the patents involved in any licence agreement are adequately taken into account in defining the duration of a licence agreement. A licensee may find himself in serious difficulty if, after negotiating a 5-year licence agreement, he finds that the life of a critical patent covered by the technology is for a period of 10 years. While it may not be necessary to have the technology agreement for the full life of a critical patent, it is important that the arrangements in this regard are sorted out at the time of the initial agreement itself. It may be possible at such time, to negotiate a 3% royalty for the duration of the principal technology agreement of, say, 5 years and a 2% or lower rate for the remaining life of any patents that may relate to the technology in question. Again, in respect of duration of agreements, no uniform pattern can be prescribed but, in general, it is accepted that where royalty payment is involved, the period of agreement would range from 5 to 10 years. In India, a 5-year

limit is generally imposed by the government while in certain Latin American countries the maximum period permissible is 10 years. Whatever the period negotiated, however, it is important that technological absorption is as full and complete as possible within such period.

#### H. Access to Improvements

The question of access to innovations and improvements during the life of the licence agreement is an important aspect and needs to be specifically provided for in the contract. It would also be desirable to have a clear understanding between the two parties as to what would constitute such improvements. In general, any innovations or improvements which are introduced in the plant of the licensor should be available to a licensee during the period of agreement. Where it is not agreed to in respect of a technological "break-through", it may be necessary to renew the contract for some time. In general, however, renewals of licence agreements should only relate to new products and completely new processes or techniques which would not fall in the category of improvements.

#### I. Warranty

As mentioned earlier, the licence agreement should define the nature of the technology. This could be extended in the form of a warranty as to the results of its use. A technology should, for example, be capable of achieving a specified level of production in a process industry or a defined level of manufacturing integration in the licensee's plant over a period of time for the engineering-goods. In any event, the contract should provide that the technology supplied is full and complete for the purposes defined in the preamble to the agreement. Licensors can argue, with a degree of justification, that the technology supplied cannot be more complete or better than that used in their own plant and that licensee enterprises should consequently take the same risks that the licensor takes in using particular processes and techniques. Whatever the form negotiated in a particular licence agreement, it must provide for transfer of full

and complete technological know-how to the extent of such know-how used in the licensor's plant.

### J. Territorial Sales Rights

A major difficulty in licence negotiations relates to the exclusivity or other-wise and to the territorial restrictions in sales imposed by licensors. A technology licence should normally be exclusive for a country and it is of course to the advantage of the licensee if it is made exclusive for a region. At least for a particular country, this clause does not present too much difficulty. It is in respect of territorial restrictions in sales that negotiations tend to be difficult. Licensors, are, for the most part, multi-national companies operating in a number of countries and often in countries such as the UK or Japan, exporting a substantial percentage of the production from the licensor plant. Even where non-exclusive territorial rights are incorporated, the licensee enterprise may, and often does, prove a serious competitor over a period of time. From the licensee's viewpoint, the imposition of restrictions on exports is a grave disadvantage. From a national viewpoint also, territorial sales restrictions constitute a grave handicap in licence agreements. In many developing countries, regulatory measures ensure that unreasonable territorial restrictions would not be permitted to be incorporated. A reasonable approach in this regard is to provide for non-exclusive sales rights in all countries, except where the licensor is legally precluded because of exclusive manufacturing rights given to other licensees. In respect of areas where the licensor may have given exclusive sales and distribution rights, the matter needs to be negotiated so that the licensee can also use such distributors and is not excluded from these markets. There is general recognition of the unfair nature of territorial restriction clauses and it should be possible, by and large, to arrive at a suitable arrangement in most cases.

#### K. Tie-in-Provisions

The question of tie-in clauses relating to supply of intermediate products and components exclusively from the licensor has been the focus of considerable critical attention and the question of 'transfer pricing' has figured prominently in recent licensing literature. It is obvious that tie-in clauses are not desirable and constitute a serious disadvantage to the licensee in terms of component costs. The fact remains, however, that in practical terms, a licensee usually does look upon the licensor for supply of intermediates and components. What has to be ensured is that the pricing of such components and intermediate products is not unreasonably high. This is where there is considerable practical difficulty. It is possible and desirable to avoid any restrictive tie-in clauses in the licence agreement and, in fact, this would not be permitted in many developing countries, but the intermediates and components have to be obtained and the licensee does tend to rely on the licensor in this regard. The first need is to ensure that domestic manufacture is undertaken to the maximum extent as may be economically and commercially justified. This would reduce the magnitude of the problem and would avoid a common tendency on the part of licensors, especially in the engineering-goods sector to phase integration over as long a period as possible. Even where maximum integration is programmed the problem of pricing still remains and negotiations could centre around certain aspects. (i) In respect of intermediate products and components bought-out by licensors, the cost to the licensee should be the same as the cost to the licensor plus any handling or other charges that may be involved. This sub-clause is generally acceptable. (ii) Where components are manufactured by the licensor, the cost of such components should legitimately be the cost at which the components are priced in the next stage of production in the licensor's plant plus any handling and other costs that may be involved. This is, however, very difficult to incorporate in any agreement as the licensor would not accept such a provision. In some licensors' plants, there may not even be such stage-by-stage costing. In any event, licensors would not normally be willing to open factory accounts to licensees. The solution in terms of the contract provisions can perhaps be that (a) the licensee shall be free to obtain

such items from any source, and that if the licensor supplies such products and components, he shall (b) supply such items at internationally competitive prices and (c) he shall accord most favoured licensee treatment to the licensee from a developing country.

#### L. Patents

In a number of technology agreements not involving composite technology and services, it is right to use the patent that is, in fact, being obtained through the licence. The first need is to define the various patents that may be involved in any process know-how and stipulate that the licensee obtains user rights over all such patents. It is also necessary for the licensee to be fully aware of the life of the patent in each context. It is through patents, in a number of instances, that licensors hold the real bargaining strength and it would be rare to find the system of patents proving to be of advantage to developing nations in any instance. However, as long as the patent system exists in its present form in most developing countries, licensees must ensure that the patent provisions are carefully determined. As pointed out earlier, where the life of the patent extends beyond the duration of the agreement, the arrangements for continued use of the patents after the agreement expires should be made at the initial stage. The licence agreement should also provide that, if any patent is applied for or registered by the licensor in respect of the technology licensed, the licensee would be kept informed and would acquire user rights for the period of agreement. It is also necessary to stipulate that, in the event of any alleged or actual infringement of third party patents by use of a particular technology licensed, both the licensor and licensee would deal with such a situation jointly.

#### M. Public Domain

An important clause often included by licensors is that the technology licensed would not be utilized by the licensee after the period of agreement. Where such technology is covered by a patent or patents, the situation has to be taken care of by the licensee. Where it relates to unpatented know-how, this would normally be considered as knowledge



in the 'public domain' in the USA and the licensor would find considerable difficulty in enforcing such a clause legally. Know-how once imparted cannot really be withdrawn except that its use can be restricted when it is covered by a patent. Such a clause should be resisted by licensees and should also be reviewed by regulating authorities.

#### O. Trademarks

Trademark rights constitute the right to use a particular brand name. This is often viewed with great importance by licensees in developing countries, partly because certain names have a strong consumer preference and partly because without the use of a foreign brand name, initial sales are more difficult. It is important that licensees should, over a period of time, develop their own brand names as otherwise they would always be subject to royalty payments for the usage of a foreign name. This is applicable both to consumer products and to producer goods. For the period of agreement, however, the foreign brand name should be used preferably in conjunction with a local name, as that after the agreement terminates, the local name alone can continue to be utilized.

#### P. Arbitration and Governing Law

In providing for arbitration, it is necessary to provide that such arbitration takes place in the country of the licensee and that it is by a group of 3 persons, two of whom would be appointed by the respective parties and the third person agreed upon. Where the place of arbitration is outside the country, the licensee is placed at a great disadvantage and has to incur considerable costs. In any event, the country of the licensor should not normally be accepted. As for governing law, many developing countries have already prescribed that such law would be that of the country in question. This is very legitimate and needs to be insisted upon.

### 2. Other Clauses

A number of other clauses relating to aspects such as (i) assignability, (ii) confidentiality, (iii) sub-licensing, (iv) language, (v) currency of payment, (vi) inspection and reporting, (vii) force majeure and the like, do not normally present too much difficulty in the course of negotiations and can generally be satisfactorily resolved.

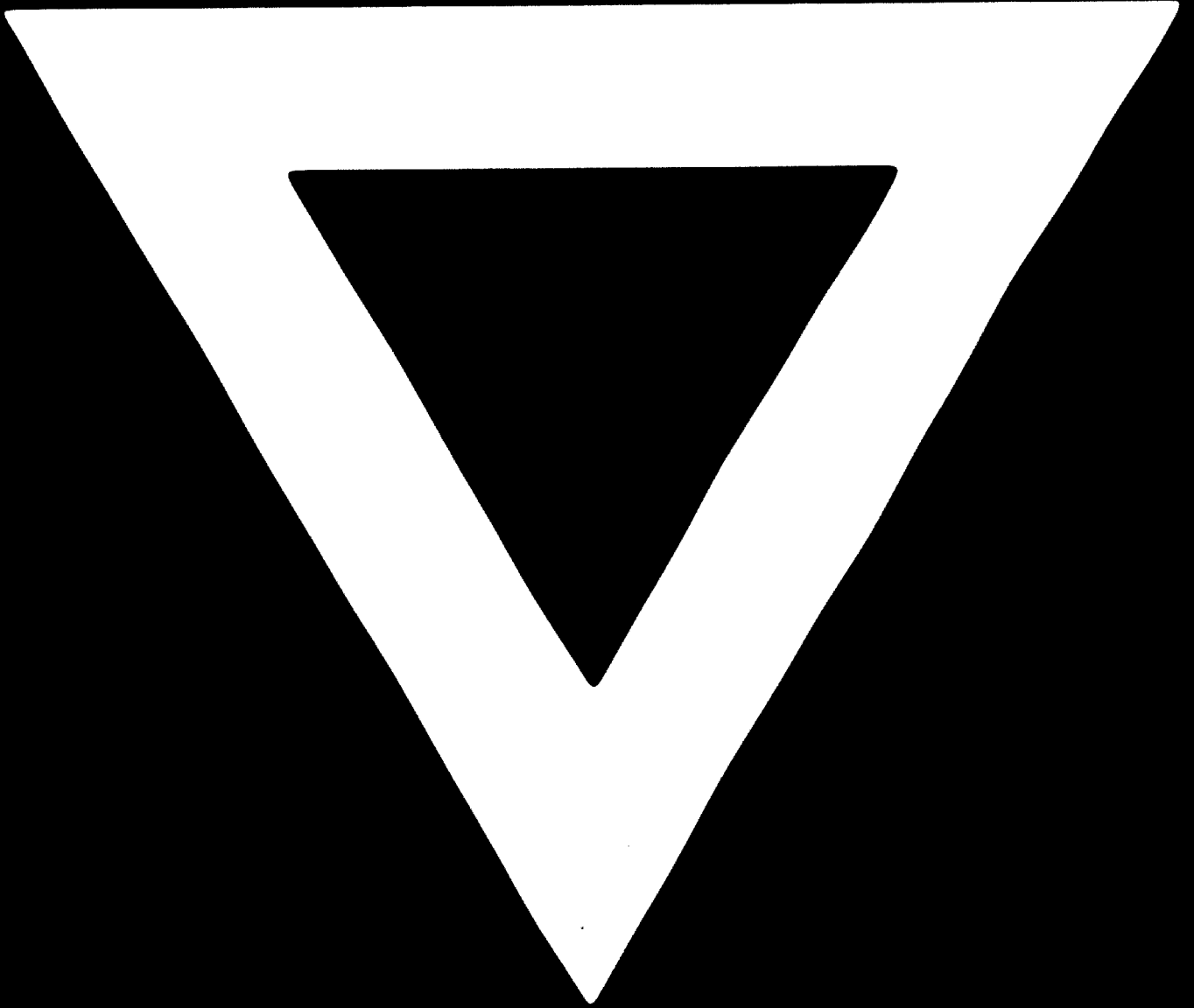
From the above brief resumé, it will be seen that the preparation of a licence agreement and the related negotiating strategy is a fairly complex issue and requires considerable knowledge on the part of the licensee as to the intricacies of the licensing mechanism. The licensor, in most cases, is much more experienced in the field of licensing and most multi-national companies have a separate section dealing with this subject. In developing countries, such a function is partially sought to be discharged through the regulatory institutions set up in a number of countries. Such institutions have necessarily to view the licensing function from a national viewpoint and there may be aspects where the approach of the licensee and that of the regulatory institution may be in conflict. This may be so on a number of matters such as (a) the need for importing technology for a particular product, which may be a non-priority or luxury item or in which adequate technological development may have taken place within the country, (b) cost of a particular technology, (c) phasing of local integration, (d) duration of agreement and the like. An overall national view has to be taken on many of these matters and these may not coincide with the approach of a licensee enterprise.

### 3. Enterprise to Enterprise Transactions

It is finally necessary, however, to stress that a technology licence is essentially an enterprise-to-enterprise transaction. In the weaker situation in <sup>which</sup> licensees from developing countries find themselves, there is undoubted need for a national regulatory organisation which can ensure that such licensees are not placed in an unduly disadvantageous position. The role of such a regulatory agency must, however, be a careful balance between overall national

interests and the freedom of enterprises to acquire technology from different international sources. Such harmonious balance is often difficult to achieve as it necessitates the avoidance of undue interference on the part of the regulatory body. Such an agency cannot substitute the licensee in the licence negotiations. It can and should provide general guidelines and prescribe the rules of the game! Thereafter, prospective licensee enterprises must be left free to select the technology and the licensor and to negotiate the terms and conditions of the licence within the framework prescribed. In the ultimate analysis, technology is acquired by and transmitted to an enterprise and the enterprise must be left unfettered as far as possible. Technology licensing, where successful, has been so because of the goodwill that develops between the licensor and the recipient enterprise and such goodwill can only grow and develop if licensee enterprises have the necessary initiative, capacity and authority to proceed with negotiations and licensing within a broad policy framework that may be prescribed by the government concerned.





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