



Sublicensing Income: The Words Still Really Matter

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Introduction

- The Importance Of Sublicense Income
- The Purpose Of Sublicense Income
- The Incentive Problem
- Key Issues

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The Importance Of Sublicense Income

- Universities Receive Substantial Revenue Under License Agreements
 - AUTM 2016 survey reported total license income for U.S. academic and nonprofit institutions was close to \$3 billion.
 - But, the share of licenses generating more than \$1 million remains less than 1 percent, and that share has been decreasing.
 - Sublicense income can be significant with a blockbuster.

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The Importance Of Sublicense Income

- **Particularly In The Bio-Tech Space, Many University Licenses Are With Small Companies.**
 - AUTM 2016 survey reported that small and startup companies were 70% of executed licenses.
 - Such licenses often have modest upfront fees and royalties.
 - Sublicensing income can be basis to share in success if development of invention reaches that stage.
 - Equity can be another alternative to share in upside success.

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The Importance Of Sublicense Income

- **Consideration To The Sublicensor Can Take Many Forms.**
 - Upfront Fees, Milestones, Cost Reimbursement, Royalties On Sales, Profit Sharing, Investment, Equity.
- **Amount Of Consideration Received By Sublicensor Can Be Far In Excess Of What Owed To University.**
 - Upfront payment can be over \$100 million.
 - Royalties on sales can be many multiples greater than royalty in the original license.
 - Overall compensation might be greater than 10 times that due to the University under provisions other than sublicensing income.

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The Purpose Of Sublicense Income

- Allows universities to share in the value that their inventions create.
- Enables universities to look to small companies to license technology, not just large companies.
- Having a broader range of companies to sublicense to maximizes the probability technology will be developed, provide public benefit, and generate revenue for university.

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The Purpose Of Sublicense Income

- **What is a Sublicense:**
 - Sometimes not defined.
 - If not defined, will original licensee claim compensation it receives is for something other than sublicense?
 - If defined, what is the significance of the differences in language?

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Sublicense Income Sharing

- A very difficult issue
 - Need to anticipate an event that won't happen until well into the future
 - Negotiators won't know:
 - The value of the technology at the time of the sublicense
 - How much the licensee will have invested in developing the technology by the time of the sublicense
 - The bargaining strengths of the licensee and sublicensee
 - What the financial structure of the sublicense will be.
- University's main objective will be to ensure that the licensee can't structure the sublicense to minimize what it pays the university.



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What is a Sublicense

- First step is to clearly define the rights granted:
 - Sublicense should be defined as "**any right**" granted to third parties under the license grant, and capture all types of agreements including options, bundled IP rights, profit-sharing agreements etc.
- Questions for TLO to ask:
 - Is the licensee intending to "flip" the license?
 - Will sublicensing be the sole method of revenue generation?
 - Will the licensee be bundling University IP and it's own IP in agreements with third parties?
 - E.g. Licensee licenses it's proprietary platform, plus options university product-related IP



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Solution

- University gets a piece of every payment that the licensee gets from the sublicensee:
 - “You will pay me every which way there is”
 - Louis P. Berneman*
- Exclusions for items for which there is a deliverable, and are documented in itemized accounts:
 - Patent expense reimbursement
 - Research support payments
 - Purchases of equity

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Solution

- Three models:
 1. Pass Through
 - University gets same running royalty on sublicensee's sales, as if the licensee sold the product; plus
 - A set percentage of every payment received other than running royalties (sometimes termed “non-royalty income”)
 2. Allocation
 - University gets a set % of every payment the licensee gets from the sublicensee
 - Including running royalties
 3. Tiered Allocation
 - University gets a lower % of payments received from sublicensee, before commercialization
 - University gets a higher % of running royalties after commercialization
 - Tiers may be based on timing of sub-licensing (flipping) post-license execution (e.g. year 1-25%, Year 2-20%, year 3-15%)¹²



A Standard Sublicense Income Definition (Pass Through)

- “Sublicense Income” means payments or other value that Company receives from a Sublicensee in consideration of a Sublicense granted by Company, including without limitation, license fees, equity, milestone payments, license maintenance fees, payments for distribution rights, and the fair-market value of any non-cash consideration, but excluding the following payments:
 - (a) payments made in consideration for the issuance of equity or debt securities of Company at fair market value,
 - (b) payments specifically committed to and incurred in the research and development of Licensed Products, including patent-related costs and expenses, and
 - (c) running royalties.

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The Incentive Problem

- Because sublicense income provision shifts value to university from original licensee, licensee will have incentive to try and avoid sublicense income provision.
- Some licensees will treat sublicense income like a tax and try to avoid paying it.
- Licensee may try to treat payments received as falling outside definition of sublicense income.

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The Incentive Problem

- Licensees have an incentive to avoid paying
 - The Incentive To Say Deal Not A Sublicense.
 - The Incentive To Say Payments Not Related To Sublicense But Some Other Deal Between Original Licensee And Sublicensee.
 - The Incentive To Say Payments Not Within Definition Of Sublicense Income.
 - The Incentive To Minimize Percentage.

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Key Issues

- Issue 1: Is There A Sublicense?
- Issue 2: Are Payments Related To Sublicense?
- Issue 3: Are Payments Within Definition Of Sublicense Income?
- Issue 4: Minimizing Percentage
- Issue 5: Importance Of Information

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Issue 1: Is There A Sublicense?

- What About Mergers And Other Equity Deals?
- Should Those Deals Be Captured By Sublicense Provision?
- Should All Value Obtained By Subsequent Deal Be Subject To Some Percentage Going To University?

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Issue 1: Is There A Sublicense?

- What If Licensee Says Deal Is Not A Sublicense?
- Does Purpose Of The Deal Matter? Yes.
 - A de facto sublicense may result when a transfer of rights occurs through the legal effect of a particular agreement, regardless of the parties' label. *E.g., Cook Inc. v. Boston Scientific Corp.*, 333 F.3d 737, 743 (7th Cir. 2003).
 - Transfer of the right to control a joint research program is evidence supporting a transfer of rights by sublicense or assignment. See *Biosynexus, Inc. v. Glaxo Grp. Ltd.*, 11 Misc. 3d 1062(A), at *5-6 (N.Y. Sup. Ct. 2006).

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Issue 1: Is There A Sublicense?

- The Importance Of The Language Of The License Agreement.
- Judges And Juries Will Seek Neutral Way To Resolve Issue So Words Matter.

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Issue 1: Is There A Sublicense?

- Hypothetical: What if you had a licensee that entered multiple agreements with a sublicensee?
 - Agreement 1: Called a sublicense. Payment of \$10 to licensee.
 - Agreement 2: Services to develop the technology licensed via the Sublicense. Payment of \$10 million.
 - Agreement 3: Rental of facility in which to develop the technology. Payment of \$100 million.
- Is Agreement 2 a Sublicense? Agreement 3?

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Issue 2: Are Payments Related To Sublicense?

- Many Times “A Collaboration” Between The Small Biotech Company And Big Pharma Have Multiple Aspects.
- To Avoid Paying Sublicense Income, Original Licensee May Claim Payments Due To Some Aspect Of “A Collaboration” Other Than Sublicense.

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Issue 2: Are Payments Related To Sublicense?

- Hypothetical: What Happens If Sublicense Not A Defined Term?
 - What will the licensee say it means?
 - What will the university say it means?

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Issue 2: Are Payments Related to a Sublicense?

- What's the difference?
 - “Sublicense means any transaction in which the Licensee grants a third party a license to make, have made, use, sell, offer for sale or import any Licensed Products . . .”
 - Sublicense defined “to be portion of transaction that grants to a third party a license to make . . .”

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Issue 2: Are Payments Related to a Sublicense?

- *City of Hope v. Juno Therapeutics, Inc., Case No. 2:17-cv-06201 (C.D. Cal. 2017)*
 - Sublicense Revenue means “all consideration received by Licensee in return for the grant of rights to manufacture, use, offer for sell, or sell a Licensed Product other than [exceptions for running royalties, reimbursements, etc.]” (Rate was 15%.)
 - Licensee entered into a Master Research and Collaboration Agreement with Sublicensee, which included other technology. Licensee asserted that City of Hope’s contribution was 9.4% of the option fee only. No payment for other parts of the deal or Share Purchase Agreement.
 - Is City of Hope entitled to 15%? Is City of Hope entitled to a portion of the rest of the deal?

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- Are Payments Within Definition Of Sublicense Income?
 - Many Times Definition Includes Broad Definition With Exception.
 - Sometimes Defined To Only Include Certain Payment Types And Then No Exclusions (“Sublicense Income is limited to upfront payments and milestones.”)
- What Incentives Does This Language Create?

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- Example Broad Definition of Sublicense Income:
“Sublicense Income means all remuneration received by Licensee under or on account of any sublicense.”
- UC Regents Licensing Guidelines provide, “The University should receive a fair share of all consideration, including royalty and non-royalty income, received by licensee from the sublicensee.”

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- Key Issue Is What Exclusions Cover.
 - Common Payments Excluded Are “royalties on sales” and “reimbursement for research costs.”
 - Should Royalties Be Excluded? What Is A Royalty On Sales?

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- *Medivation, Inc. v. The Regents of the University of California (Medivation I)*
 - Definition in contract: “**Sublicensing Income**’ means income received by Licensee under or on account of Sublicenses. Sublicensing Income includes income received including but not limited to license issues fees, milestone payments, and the like but specifically excludes royalties on the sale or distribution of Licensed products or the practice of Licensed Methods.”

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Language

- The language at issue:
 - Sublicensing Income includes income received including but not limited to license issue fees, **milestone payments, and the like** but specifically **excludes royalties on the sale** or distribution of Licensed Products or the practice of Licensed Methods.....

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- *Medivation 1: Are Sales Milestones within definition of Sublicensing Income?*
 - “(1) it is commonly understood in the industry that milestone payments connote “event-driven or success payments, which are distinct from royalty payments”; (2) it is also commonly understood that milestone payments include payments “made upon the occurrence of both regulatory milestones and sales milestones”; and (3) the parties understood that these terms had these commonly understood meanings when they negotiated the ELA.” *California Court of Appeal*

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- “At all relevant times,” the court found, Medivation and The Regents understood that the term “royalties” was used in the ELA to mean “monetary payments based on a percentage applied to each individual sale.” They also understood that the ELA imposed separate obligations on Medivation to pay The Regents 4 percent of earned royalties and an additional 10 percent of sublicensing income, and that these two types of payments represented separate streams of income owed to The Regents.”
-- *California Court of Appeal*

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Language

- Suggested Improvements:
 - Sublicensing Income includes income received including but not limited to license issue fees, **milestone payments, including, but not limited to, payments conditional on the achievement of patent, pre-clinical, clinical, regulatory, sales or any other milestone** but specifically excludes royalties on the sale or distribution of Licensed Products or the practice of Licensed Methods.....

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- *Medivation 2*: Are Profit Sharing Payments within definition of Sublicensing Income?
 - Court said that the definition of Sublicensing Income was ambiguous. The question of whether a “royalty on the sale” included or excluded profit sharing was to go to a jury to decide what the drafters meant. Matter settled after jury selection.

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Issue 3: Are Payments Within Definition Of Sublicense Income?

- How does a jury decide such an issue?
 - The evidence would have been presented to show what the parties intended at the time of contracting: (a) what are the words used in the contract? (b) what did they say to each other about profit-sharing, royalties? (c) how did the parties treat the money? (d) what is the industry standard, as presented by experts, on the meaning of royalties, royalties on the sale, profit-sharing, and sublicensing income?
 - **Fairness**

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Language

- Suggested improvements:
 - Sublicensing Income includes income received including but not limited to license issue fees, milestone payments, and the like, including, but not limited to, payments conditional on the achievement of patent, pre-clinical, clinical, regulatory, sales or any other milestone but **specifically excludes running royalty payments on the sale or distribution of Licensed Products or the practice of Licensed Methods, irrespective of whether based on sales revenues, unit sales or some measure of profits.....**

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Language

- Other potential problem areas:
 - Research support
 - What if payments not based on time and expenses, but only paid on achievement of technical milestones
 - Shouldn't get sucked into milestone payments
 - Potential language:
 - ...excluding payments received for research carried out by licensee at request of sublicensee, whether made to reimburse scientific effort on an FTE plus expenses basis, or on achievement of scientific milestones

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Issue 4: Minimizing Percentage

- Some agreements have multiple tiers:
 - Percentage of sublicensing percentage goes down as original licensee moves compound towards approval. For example, percentage goes down if first person tested in phase 3 clinical trial.
 - Agreement might also set up classes of sublicense income with varying percentages.

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Issue 4: Minimizing Percentage

- Does the university have information to determine if the condition for lower percentage is met?
- Is the condition action by licensee and therefore subject to manipulation or by action of third party such as FDA?
 - What if licensee tests one or some small number of people at time deal closes?

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Issue 5: Importance Of Information

- Often universities receive limited information.
- Can receive redacted copies of sublicense.
- Incomplete reports or the failure to report.

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Issue 5: Importance Of Information

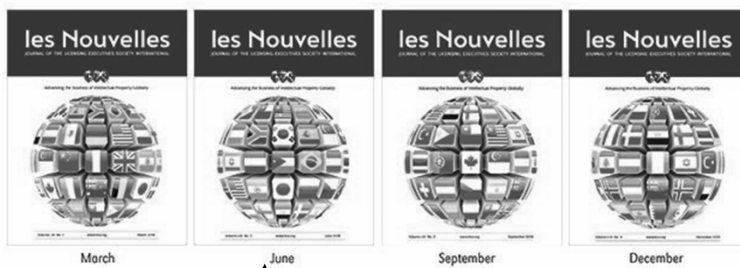
- Language specifying access to unredacted copies of sublicense.
- Language stating consequence of failure to provide information.
- Audit rights.

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Additional Information

Read the Featured Article of the Month ►



“Defining Sublicense Income to Avoid Problems Down the Road”, Ashley J. Stevens, *Journal of the Licensing Executives Society International (les Nouvelles)*, LIII, 1-10, March 2018

