

**FINANCIAL TERMS FOR
INFORMATION TECHNOLOGY
TRANSACTIONS**

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1. **INTRODUCTION**

Almost without exception, the parties to a technology transaction arrive at the negotiating table with the same primary goals in mind: namely, to make as much money as possible (whether through direct payments to the transferor by the transferee, or through the exploitation of the technology by the transferee) while at the same time taking on the fewest risks. It is this balancing act, or in some cases, tug of war, between risk and reward that characterizes nearly all decisions made during negotiations. In this sense, one might argue that all terms and conditions of a technology agreement are “financial” terms. In other words, issues such as warranty provisions or indemnities should not be viewed in isolation from decisions regarding price and timing of payment.

Having said that, it is beyond the scope of this paper to review each element of a technology transaction and its affect on price and the mitigation of risk. Instead, this paper focuses on a narrower set of issues; those that are more traditionally thought of as financial terms. However, in discussing topics such as royalty rates, settlement of payment and security of payment, the same elements of risk and reward remain in the foreground.

In addition, you will note that this paper is not overly legalistic. No case law and very few statutes are cited. That is not to suggest that case law and legislation are not important to the discussion of financial terms in a technology transaction. However, it is the author’s experience that most disputes arising from the financial terms of a technology transaction could have been avoided through better drafting rather than through a better understanding of the law. As a result, the goal of this paper is to provide an overview of some of the most common, and some not so common, drafting and business issues that should be considered when negotiating the financial terms and conditions of a technology transaction.

Finally, while lawyers play an important role in the construction of a technology transaction, they are only a part of a larger team. Other individuals such as business development mangers, IT specialists, accountants, and tax specialists all have a crucial

role to play in the planning of a technology transaction. Failure to seek the input of all relevant individuals is done so at the peril of your client.

2. **TECHNOLOGY/INTELLECTUAL PROPERTY TRANSFERS**

2.1 **Remuneration**

Fixing a price for the transfer or licensing of technology or intellectual property rights involves not only a determination of the value of the technology or intellectual property right being transferred, but also a consideration of the immediate and future needs of the parties and a balancing of the risks inherent in setting a price based primarily on future expectations. For this reason, setting a price is not only a matter of selecting a dollar amount, but also of establishing how payments will be calculated and made.

Not surprisingly, the parties to a technology/IP agreement will typically bring opposing interests to the table. The transferor will usually have invested a considerable amount of time and money in the development or conception of the technology/IP and will wish to see a return on its investment as soon as possible. In addition, where the remuneration payable to the transferor is dependant on the performance of the transferee, the transferor will wish to structure the payment obligations such that the transferee is motivated to perform. Conversely, the transferee may have limited financial resources with which to pay the transferor and will wish to use proceeds derived from the exploitation of the technology/IP to fund its payment obligations. Concerns regarding paying too much, or too little, relative to the benefit received by the transferee will also be present for both parties.

In attempting to strike a balance between their interests, the negotiations between the parties will typically revolve around the basis on which payments are to be calculated and the timing of such payments.

2.2 **Fixed Sum Payments**

The simplest payment option in a technology/IP transfer is the payment of a fixed sum. With a fixed sum payment, the amount to be paid is typically determined by the time the

agreement is executed and, therefore, the parties to the agreement are not burdened with administrative matters such as record keeping, royalty calculation and reporting, and the auditing of records.

Examples of situations where a fixed sum may be appropriate include transactions where the technology/IP transferred is to be used in a variety of products or processes or is to be included as a component in a much larger combination of other components. In such situations, it may be impractical or impossible to assign an appropriate value to each use of the technology/IP and/or to track each instance where the technology/IP has been used. A fixed sum price may also be desired by a party who wishes to keep its sales and other information confidential. As a result of the difficulties in tracking the use of the technology/IP, or the desire for confidentiality, the parties may be willing to trade off the risk of miscalculating the benefit derived from the use of the technology/IP in exchange for the certainty of using a fixed sum model.

Where a fixed payment has been agreed upon, the timing and frequency of payment must also be determined. The transferor will typically seek a one-time payment to be made no later than the delivery of the technology to the transferee. The transferee, however, may not have the financial resources to pay the entire amount at such time. In addition, transferee may wish to hold back a portion of the amount payable until all or certain of the transferor's obligations have been met. As a compromise, the payment of the fixed sum can be structured such that it is spread out over a series of payment dates or "milestones" (see Section 4.9 for further discussion).

2.3 Variable Consideration

Unlike fixed sum payment models, the aggregate consideration payable under a variable consideration model is not predetermined.¹ Instead, amounts payable (often referred to as royalties) are based on a formula agreed upon by the parties. The use of a variable consideration model necessitates the creation of a process to deal with the calculation and reporting of amounts owed. It also gives rise to the need for a process for verifying the accuracy of the calculation of royalties. In establishing the variable consideration to be

used, the parties must select the base on which the royalties will be calculated and the rate of such royalty.

(a) Selection of Royalty Base

When establishing a variable consideration model, the parties must select the base upon which royalties will be calculated. While the base used is limited only by the imagination of the parties, the parties should choose a base that has some relation to the benefit derived by the transferee. Some of the most commonly used royalty bases include the following:

(i) Units

Often referred to as a “per unit” royalty, the payment of a flat sum per unit of a particular product or good allows for a relatively easy calculation of amounts owed by the transferee. Despite its relatively simple structure, however, per unit royalty models can give rise to disputes among the parties if not properly constructed.

By way of example, consider the following royalty provision taken from a licensing arrangement whereby the licensor grants the licensee permission to incorporate licensor’s software application into the licensee’s larger software product, called “SuperCode”:

Sample Clause 1:²

In consideration of the licence granted herein, Licensee shall pay Licensor a royalty of \$1.00 per copy of Licensee’s “SuperCode” software product sold or otherwise disposed of by Licensee.

Now consider the following:

¹ Subject to any minimum royalties or payment caps, as discussed below

² The sample clauses used in this paper are provided for illustrative purposes only.

- A. Licensee has decided not to include Licensor's software in its "SuperCode" product. Does it owe Licensor any royalties?
- B. As is not unusual in the industry, Licensee has produced a 30-day trial version of its "SuperCode" software (which includes Licensor's software) and distributed no charge copies of the trial version at trade shows, in industry publications and over the Internet. Does Licensee owe Licensor royalties for its distribution of copies of the trial versions of its "SuperCode" software?
- C. Though originally designed as a client side software product, "SuperCode" has been re-engineered such that a single copy can be installed on a server and accessed by multiple client computers.

In the circumstances described in paragraphs A and B above, Licensee may be surprised to find that it owes royalties to Licensor. In the circumstances described in paragraph C, Licensor may find that the royalties it receives are less than it had expected.

The above example illustrates the importance of precisely defining the base upon which royalties will be calculated. In doing so, the parties must try to anticipate all possible circumstances that could give rise to unexpected results. An example of a royalty provision which anticipates the above referenced circumstances is as follows:

Sample Clause 2:

1.1 In consideration of the licence granted herein, Licensee shall pay Licensor a royalty of \$1.00 per copy of Software Product sold or otherwise disposed of by Licensee. Notwithstanding the foregoing, Licensee shall not be

obligated to pay Licensor royalties for copies of Software Product that are distributed by Licensee to end users at no charge and that are designed to automatically become disabled within thirty (30) days following installation by the user. In the event that Licensee distributes a version of the Software Product that may be installed on a single computer (a "Server"), but also accessed and used by users of other computers connected to the Server (a "Networked Version"), the royalty payable for each copy of a Networked Version of the Software Product sold or otherwise disposed of by Licensee shall be \$20.00 per copy.

1.2 For the purpose of Section 1.2, "Software Product" means any version of Licensee's software development kit, currently marketed under the trade-mark "SuperCode", which is bundled with, includes or otherwise incorporates Licensor's "BugFix" software application.

Pursuant to the preceding sample clause, the Licensee shall not be obligated to pay royalties on copies of its software product that do not include the Licensor's software, or for trial versions of 30 days in duration or less. On the other hand, the Licensor will receive a larger royalty payment for networked versions of the Licensee's software.

(ii) Sales

Another commonly used base upon which to calculate royalties is sales by the transferee. Those who favour this form of royalty argue that such a formula most closely represents the value of the technology or intellectually property transferred. In other words, if the parties can agree that the transferred technology represents 10% of the value of the end product incorporating such technology, then the transferor should get 10% of the revenue derived from the sale of such end product. While such an argument is compelling, as with the per unit royalty described above, the parties may not end up with what they thought they

were bargaining for if they fail to properly define what is meant by “sales”.

Sample Clause 1:

In consideration of the licence granted herein, Licensee shall pay Licensor a royalty equal to ten (10%) percent of net sales of the Software Product.

It is surprising to see how often the term “net sales”, “net selling price” or something similar are used in technology agreements without being defined. While certain industries might have a common understanding as to what these terms mean, they have no fixed definition. As a result, to avoid a misunderstanding, it is important for the parties to include a definition for “net sales”. In crafting such a definition, the parties should consider whether net sales will include any of the following: (i) revenue from related services such as installation, training or support; (ii) deductions for returns, rebates, shipping, or sales commissions; or (iii) damages awarded to, or settlement payments received by, Licensee as a result of the infringement of Licensee’s intellectual property rights in the licensed product. In addition, will net sales be based on amounts invoiced or on amounts received?

Sample Clause 2:

1.1 In consideration of the licence granted herein, Licensee shall pay Licensor a royalty equal to ten (10%) percent of Net Sales of the Software Product.

1.2 For the purpose of Section 1.1, “Net Sales” means (i) all amounts invoiced by Licensee in connection with the distribution of the Software Product; (ii) maintenance fees and other revenues invoiced by Licensee in connection with providing maintenance, training or support services related to the Software Product; and (iii) damages, interest thereon, and similar monetary amounts (other than the awards of attorney’s fees) paid by third parties to Licensee in connection with

infringement of intellectual property rights associated with the Software Product.

In the case of paragraphs (i) and (ii) Net Sales shall not include sales taxes, duties or shipping charges separately listed on invoices.

In addition to defining “net sales”, the transferor will want to ensure that the sale referred to in the defined term is one that occurs between the transferee and an arm’s length party. If such is not the case, an unscrupulous transferee may attempt to evade paying royalties by selling the royalty-bearing product to a related party at lower than market prices. The related party can then sell the product at a higher price and on a royalty-free basis. Where royalty evasion is a concern to the transferor, a provision such as the following may be considered:

Sample Clause 3:

In the event that Licensee sells, licences or otherwise disposes of copies of the Software Product to a Person who Controls, or is Controlled by, Licensee, the royalties to be paid in respect of such copies of Software Product will be calculated based upon the Net Sales derived by such Person from the disposition of such copies of Software Product, and not upon the Net Sales of Licensee for such copies of Software Product.

While the above sample clause addresses situations where the initial recipient subsequently distributes the royalty-bearing product, the license may also be concerned with the situation where the recipient acquires the royalty-bearing product for its own use at prices lower than would typically be charged in an arm’s length transaction.

Sample Clause 4:

In any transaction between the Licensee and any Person who Controls, or is Controlled by, Licensee, or any Person which is otherwise associated with or acting in concert with Licensee, or

in any non-arm's length transaction, Net Sales will be the greater of:

- (i) the actual amount invoiced in such transaction; or**
- (ii) the amount that would have been invoiced in a similar transaction at arm's length.**

Finally where significant concerns regarding non-arm's length transactions exist, one should consider whether the use of a fixed sum royalty would be preferable.

While the transferor might reasonably expect that the transferee will want to maximize its proceeds received from the disposition of the royalty-bearing product, there may be circumstances where the transferee will decide to dispose of the royalty-bearing products for little or no consideration. For example, the transferor may decide to give away copies of the royalty-bearing product for free as a promotional item or to generate sales for a related product. While the transferee may reap a reward from such giveaways, unless contemplated in the parties' agreement, the transferor will not share in such benefit.

Measures to protect the transferor might include a minimum fixed sum royalty for copies of the royalty-bearing product disposed of by the transferee or a minimum aggregate royalties payable over a defined period of time.

Sample Clause 5:

In consideration of the licence granted herein, Licensee shall pay Licensor a royalty equal to ten (10%) percent of Net Sales of the Software Product; provided that, if for any royalty period, royalties payable by Licensor are less than the product of the number of copies of Software Product sold or otherwise disposed of by Licensor and \$1.00 (the product of such calculation hereinafter referred to as the "Minimum Royalty"), the royalties payable for such royalty period shall be the Minimum Royalty.

(iii) Profits

One might argue that the profits derived by the Licensee from the sale of the licensed product are an even more accurate measure of the benefit derived by the Licensee from the transfer of technology or intellectual property rights. Using profit as a base for calculating royalties, however, is a difficult task involving complex calculations and requiring a very detailed and well-defined method of calculation. For this reason, profit is not often used as a base for royalty calculation.

(iv) Raw Materials Consumed

When the subject matter of a technology transfer is a process by which other goods are produced, a measure that is sometimes used to calculate royalties is the amount of raw materials consumed (on a cost or volume basis) when utilizing such process. If using such a formula, however, one should consider the potential for price fluctuations in the cost of such raw materials.

(v) Reach-through Royalties

Sometimes the transferred technology is not used in the end product but instead is used in the development of the end product. For example, in health care industry, specialized tools are used in the research and development of pharmaceutical products. In such cases, the provider of the research tool may take the position that the price of the end product is the truest indication of the value of the tool. As a result, royalties payable for the use of the tool will be based on the revenue received from the sale of products derived from or developed through the use of the research tool. This method of royalty calculation has the benefit for the transferee by

delaying its payment obligation until the end product is successfully commercialized.

(b) Royalty Rate

(i) Decreasing/Increasing Royalty Rate

The examples of fixed sum and variable royalties referred to above contemplate a steady royalty rate throughout the term of the agreement. It is not unusual, however, for parties to agree to a royalty rate that decreases or increases over time or as sales increase.

A decreasing royalty rate is often used in recognition of the fact that there is a point at which royalties paid by the transferee represent a reasonable return to the transferor, after which any royalties paid are pure profit. Increasing royalty rates are often used where the transferee must use a greater portion of its capital on costs related to entering into a new market. After such costs have stabilized, a higher royalty rate can be borne by the transferee.

(ii) Minimum Royalty

Minimum royalties are commonly used in order to provide the transferor with a guaranteed return from the transaction. When including a minimum royalty, the parties should consider whether the minimum royalty is to be paid up-front and credited against royalties accrued, or whether it is to be used as a measuring stick for royalties earned over a specified period of time.

An example of the former is as follows:

Sample Clause:

Upon the Effective Date and, during the term of this Agreement, on each anniversary of the Effective Date, Licensee shall pay Licensor as non-refundable minimum royalties, the amount of \$100,000 (the "Minimum Royalty"). The Minimum Royalty shall be credited against royalties payable pursuant to Section • for sales made in the year to which the Minimum Royalty relates.

Where Minimum Royalties are not paid up-front, but used as a standard against which royalties paid and accrued are measured, the repercussions of failure to meet such standard must also be considered. For example, if the royalties earned in the applicable time period are less than the minimum royalties, can the transferor terminate the agreement? Short of terminating the agreement, can the transferor terminate certain rights of the transferee, such as rights of exclusivity? Can the transferee pay the difference between the minimum royalties and royalties paid in order to avoid such actions?

(iii) Ceiling on Royalty Payments

Just as the transferor will want a guaranteed minimum return from the technology transaction, the transferee may wish to protect itself from excessive payment to the transferor. While used less often than minimum royalties, a maximum royalty is sometimes used where the parties agree that royalty payments beyond a certain value would be excessive given the limited contribution of the transferor.

(iv) Lump Sum Payment for Paid-up Licence

While the parties may agree to employ a variable royalty rate, for reasons similar to those cited in paragraph (iii) above, a transferee may wish to have the option to pay a fixed fee at any time during

the term of the agreement in order to turn the variable royalty into a fully paid-up licence.

(v) Lower Royalty on Lump-Sum Payment

A variation of the lump sum for a paid-up licence model described in paragraph (iv), is a reduction in the royalty rate in exchange for a lump sum payment. In this model, the transferor does not forgo all proceeds from future sales by the transferee, but receives a portion of such proceeds earlier than would otherwise occur in exchange for a smaller royalty rate.

(vi) Ceiling if Lump Sum Payment Made

Yet another variation of a lump sum payment in exchange for a change in the payment model is the incorporation of a ceiling on aggregate royalty payments upon the payment of a lump sum payment. The ceiling may apply to aggregate payments over the life of the contract or only to royalties payable during a defined period of time (e.g. annual).

2.4 Royalties for Combination Products

(a) Formula

If the technology transfer agreement permits the combination of royalty-bearing products with non-royalty bearing products, the agreement should provide a formula for calculating the fees payable.

Sample Clause:

If any of the Licensed Materials are marketed and distributed by Licensee incorporated into or bundled with another software or hardware product (“Bundled Product”), the Net Sales in respect of the Licensed Materials shall be that proportion of the net sales in respect of the incorporated or bundled product that the fair market value of the Licensed Materials portion of the product is to the fair market value of the whole product. Licensee and

Licensor shall jointly determine the Net Sales in respect of any Licensed Materials incorporated into or bundled as part of a Bundled Product.

(b) Floor Rate

If the royalty-bearing product constitutes one of many components in a product, the calculation required by the formula illustrated in paragraph (a) above might prove to be too complicated or result in a smaller payment to the licensor than anticipated. In such situations, the use of a fixed sum payment for combined products or the inclusion of a floor rate should be considered.

2.5 Pricing of Different Components

Technology transfers often involve more than one intellectual property right (e.g. patent and trade secrets). In such cases, it may be appropriate to designate separate consideration for each right. Alternatively, a reduction in the price can be specified if a specific intellectual property right is found to be invalid or ineffective. The parties should also consider the effect of antitrust and competition laws in the applicable jurisdiction(s) on a requirement to continue to pay royalties in the event that the subject intellectual property right is invalid or ineffective.

2.6 Other Forms of Consideration

While the majority of technology transfers are made in consideration of the payment of money, there are occasions where other forms of consideration are used.

(a) Equity

While the end of the stock market boom has made equity a less used form of consideration, there remain occasions where the transferor will be willing to accept shares or other securities of the transferee as full or partial satisfaction of the transfer price. Where securities are used as consideration, great care must be used to ensure that the transaction is executed in compliance with all applicable securities laws.

(b) Appointments

Where the transferor is an individual, money may not be the prime motivation for transferring his or her rights to a piece of technology or a specific intellectual property right. Instead, an appointment to the transferee's technical advisory board or a similar position may be of greater value to the transferee.

(c) First Rights to Exploit

Where the transferee is expected to produce something that is derived from the transferred technology, the transferor may be willing to transfer the technology in exchange for the first right of refusal to exploit the derivative work in a particular market or geographical location.

(d) Pooling

It is common for companies in particular sectors of the technology industry to create standards setting organizations ("SSO") for the purpose of establishing technical standards to which manufacturers can design and build their products. In consideration of being granted membership in the SSO, many SSOs require each member to grant the other members, or in some cases, any person who wishes to implement the standard, a licence to use any patent owned by a member which is necessary to utilizing the standard. Other forms of patent pools are also established by patent holders who which to aggregate their respective patents into a group of patents that is made available for licensing to others. The members of such pool typically agree to split the proceeds received from such licensing.

(e) Cross-Licence

A cross-licence involves two or more holders of intellectual property rights (usually patent holders) who grant the other party (or parties) a licence to utilize its intellectual property rights. In such situations, a cross-

licence might be in addition to, or lieu of any cash payments or other forms of consideration.

(f) Ownership Rights

Where a technology transaction contemplates the conception or development of new inventions or works, the designation of ownership rights to such inventions and works can be used as consideration for the provision of services or materials by one or more parties to the transaction. Often parties will decide that ownership of new inventions and works conceived of or developed with the input of both parties will be jointly owned. Unfortunately, joint ownership gives rise to complicated issues regarding the prosecution, maintenance and enforcement of such jointly owned rights, especially where more than one jurisdiction is involved. If such issues are not carefully considered and properly address in the technology transaction documents, the parties may find that their ownership rights are of less value than anticipated.

(g) Settlement of Litigation

Litigation involving technology and/or intellectual property rights is often settled with one party agreeing to drop its claims against the other in exchange for being granted a licence to exploit certain of the other party's intellectual property rights. Such a settlement often results in a cross-licence of intellectual property rights (see paragraph (e)) above.

2.7 Circumstances Affecting Price/Payment Obligation

(a) Price Escalation/Decrease

In cases of technology transactions that will be in effect over a long period of time, the parties may wish to protect themselves from changes in economic conditions that would radically affect the profitability calculations that were used to establish the initial royalty rates or other

fees. There are a number of methods which the parties can utilize in order to address this issue, including the following:

- (i) Changes to Price List. Where the technology transaction contemplates the ongoing purchase of units or copies of the suppliers products, the parties will often agree that the price payable by the purchaser will be tied to the supplier's standard price list (often with some percentage of discount). Where the supplier wishes to change its price list, the agreement will typically provide that the supplier must give the purchaser advance notice of such changes and that such changes will not come into effective for a prescribed period of time. In some cases, the supplier will be restricted in the number of times it can raise prices during a defined period of time. The supplier may also be prohibited from raising prices by more than a specified percentage. This procedure allows the supplier to change its prices to reflect changing economic conditions, but also gives the supplier a reasonable period of time in which adjust to such price changes (e.g. change the prices of its products or find an alternate source of supply).

If the change is a decrease in price, the agreement will sometimes allow for a credit to the purchaser equal to the difference between the new price and the price at which the purchaser acquired the affected products during a defined time period.

- (ii) Formula. Another method for adjusting prices is the use of a formula. In some cases the formula will consist of a non-variable equation (e.g. 2% increase in prices per year), while in others, the formula will be tied to an external variable, such as the rate of inflation as determined by an identified independent body.
- (iii) Negotiation. Where the parties cannot agree upon a mechanism or procedure for the increase or reduction of prices, they still may

wish to acknowledge their concern with future changes in economic conditions in their written agreement. While such a provision typically amounts to no more than an “agreement to agree”, it may at least impose on the parties a duty to negotiate in good faith.

Sample Clause:

In the event that economic or political conditions outside the control of the parties change sufficiently so as to affect the continued applicability of the assumptions used in negotiating the royalty rates set out herein, the parties agree to negotiate in good faith a higher or lower rate, as the case may be, [but in no case higher than • percent or lower than • percent. The parties agree that the assumptions made in negotiating the royalty rates herein include the following: •, • and •.]

(b) Volume Discount

When items are purchased in large quantities, it is often the case that the supplier will offer its purchasers discounts based upon the volume of product purchased. Such discounts need not only apply to the purchase of physical product, but can also be applied in other circumstances such as the volume of units produced by a licensor using licensed technology.

Volume discounts can be structured such that they apply only to those number of items which exceed the specified threshold, or to apply to all items purchased once the threshold is exceeded.

Sample Clause 1:

In consideration of the licence granted herein, Licensee shall pay Licensor the following royalties:

- (i) **for the first 10,000 copies of Licensed Product - \$5.00 per copy;**
- (ii) **for copies 10,001 to 25,000 of the License Product - \$3.00 per copy; and**
- (iii) **for copies 25,001 and greater - \$1.00 per copy.**

Sample Clause 2:

In consideration of the licence granted herein, Licensee shall pay Licensor the following royalty:

- (i) **if 10,000 copies or less of the Licensed Product are sold by Licensee in a calendar year, the royalty for Licensed Products sold in such year shall be \$5.00 per copy; and**
 - (ii) **if Licensee sells more than 10,000 copies of the Licensed Product per year for three (3) consecutive calendar years, the royalty for such calendar years shall be \$3.00 per copy, and Licensee shall receive a credit for the difference between any amounts paid to Licensor on account of royalties in any such years and amounts payable under this paragraph; such credit to be applied against royalties owing under this Agreement in future calendar years.**
- (c) “Most Favoured Nation” Pricing

Regardless of how favourable a deal the purchaser thinks it may have secured from the supplier, a purchaser will often seek assurances that the supplier will not offer a better price to any of its other customers regarding the purchase of similar goods or services.

Sample Clause 1:

If the Licensor grants to any third party a non-exclusive license to the Licensed Patent, it will so notify the Licensee, and if the terms contained in the license agreement with the third party are more favourable than the terms contained herein, the Licensee shall be entitled to the benefit of the more favourable terms.

The above sample clause is representative of “Most Favoured Nation” or “Most Favoured Customer” provisions found in many technology agreements. While its brevity may be attractive to the parties, there are a number of issues that the clause does not deal with. First, do the words “more favourable terms” apply to all terms contained in the agreement or is it restricted only to pricing? For example, if the third party has obtained a more favourable indemnity from the licensor, should the licensee receive

that benefit? What if the third party is required to pay a higher price in order to receive the benefit of such indemnity? What if the subsequent licence provides for the payment of a lump-sum rather than a royalty rate? What if the lower royalty rate is in recognition of other consideration received by the licensor, such as the grant-back of a licence to improvements made by the licensee? As the foregoing questions illustrate, most favoured customer provisions give rise to many difficult issues. While the following sample clause provides an illustration of how some of these issues might be dealt with, such a provision must be carefully tailored to the circumstances surrounding the specific transaction under consideration.

Sample Clause 2:

If the Licensor grants to any third party, other than a company in which Licensor holds securities which account for at least 10% of the votes which may be cast at a general meeting of shareholders of such company, a non-exclusive licence to the Licensed Patent to manufacture, have manufactured or sell any of the Licensed Products, or products substantially similar to the Licensed Products, Licensor will advise Licensee in writing (“Licensee Notice”) of any material terms or conditions of such licence agreement that are substantially different from the terms and conditions contained herein, whereupon, Licensee can determine whether those terms and conditions are more favourable than the terms and conditions granted herein. If Licensee determines that the terms and conditions of the subsequent third party licence are more favourable to the third party than the terms and conditions of this Agreement are to the Licensee, Licensee may elect to have this Agreement amended to substitute the terms and conditions of the more favourable licence for the terms and conditions of this Agreement, as of the date when the more favourable third party licence became effective. In making such election, Licensee agrees to accept and be bound by any terms or conditions for the benefit of Licensor that are contained in the third party licence and that are more favourable to the Licensor than the terms and conditions of this Agreement.

In the event a subsequent third party licence provides only for the payment of a lump-sum and does not include a royalty rate, the Licensee shall have the option of paying the difference between such lump-sum and royalties already paid by Licensee to Licensor.

Licensee agrees that in determining whether the royalty rate charged to a third party in relation to the Licensed Patent is more favourable, Licensor can assign a reasonable value to licence rights or other consideration it has or will receive in return for the grant of the licence to the Licensed Patent.

The foregoing shall only be effective if, within • days of receipt of the Licensee Notice, Licensee delivers to Licensor its written election to accept the more favourable terms and conditions, and also accept the terms and conditions of the third party license that are more favourable to Licensor and which the Licensee is capable of accepting. Licensee will forfeit its rights hereunder if it fails to make such a timely election.

The foregoing shall not apply to licences granted in the settlement of disputes between the Licensor and a third party for past infringement relating to the Licensed Patent; provided that this Section • will apply to any licence granted with respect to future use of the Licensed Patent.

(d) Competitive Pricing

While most favoured customer provisions typically provide for a comparison of terms and conditions offered by a supplier to each of its customers, a purchaser may also wish to receive assurances that the prices it pays are competitive with those available from other suppliers of similar goods and services.

Sample Clause:

(i) Following the first anniversary date of this Agreement, Customer shall be entitled to request the appointment of a neutral third party (the “Adjudicator”) for the purpose of assessing the competitiveness of the rate charged by Supplier to Customer. If the parties cannot agree on the appointment of the Adjudicator within • days of Customer’s request for appointment, the Adjudicator will be selected in accordance with the dispute resolution procedures set out in Section •.

(ii) In conducting its assessment, the Adjudicator will benchmark Supplier’s rate against the rates offered by third parties for comparable service offerings in [insert geographical location]. The parties agree that, without limiting the scope of the Adjudicator’s assessment, the rates offered by the companies identified in Schedule

●, as amended from time to time by the parties, should be considered by the Adjudicator's in making its assessment. In addition, the Adjudicator will be instructed to solicit submissions from each the Supplier and Customer.

(iii) If the Adjudicator finds that on average the rates of such third parties for substantially the same or similar services (the "Average Rate") is more than 25% lower than the rate charged by Supplier hereunder, then the actual rate payable by Customer will decrease by one-half the difference between the then current Supplier rate and the Average Rate (provided that the adjusted Supplier rate shall continue to be subject to the price escalation provisions set out in the Fee Schedule). By way of example, if the then current Supplier rate were \$100.00, and the Average Rate was found to be \$70.00, then the new rate would be \$85.00 ($\$100 - 70 = \30 ; $\$30 \times 0.5 = \15.00 , which is split 50-50, with \$15.00 of the savings passed on to Customer).

(iv) The Adjudicator will be instructed to deliver only the results of its assessment to the parties and not to share with the parties any confidential information obtained during the course of its investigations.

(v) The costs and expenses of the Adjudicator will be borne by the Customer; provided, however, that if the Adjudicator's findings result in an adjustment of the Supplier's rates, the costs and expenses of the Adjudicator shall be borne by the Supplier.

(vi) Once an Adjudicator has been appointed, the Customer shall not be entitled to request a subsequent appointment for at least twenty-four (24) months from the date of the last appointment.

(e) Expiry or Invalidity of IPR

As discussed in Section 2.5 of this paper, the parties should consider whether the transfer price should be affected by the expiry or invalidity of the intellectual property rights that are subject to the technology transfer.

(f) Royalty Stacking

Many technology products require the use of dozens, if not hundreds, of patented inventions. As a result, a manufacturer may find itself having to negotiate multiple licence agreements with third party patent holders. If one were to add up the royalties payable for each of the licensed patents,

one might easily find that the manufacturer's profit margin has been eroded by all of the royalty obligations it has incurred. For this reason, it is customary for licensees to request "royalty stacking" provisions which give the licensee some relieve from the burden of having to pay for multiple licensed patents.

Sample Clause:

If, following the effective date of this Agreement, Licensee is required to obtain a royalty-bearing licence under intellectual property rights owned by a third party in order to make, use, sell, offer for sale or import Licensed Products in the Territory, Licensee may deduct from royalties owed to Licensor hereunder relating to such Licensed Products, [thirty-five percent (35%)] of royalties actually paid by Licensee to such third party; provided that, in no event shall the royalties payable by Licensee hereunder relating to Licensed Products be less than [seventy percent (70%)] of the royalties due pursuant to Section •. Notwithstanding the foregoing, no credit will be extended to Licensee for any lump sum licence fees, milestone payments, minimum royalty payments in excess of accrued royalties, amounts paid for past infringement of third party intellectual property rights, or amounts paid for any rights not necessary to permit Licensee to make, use, sell, offer for sale or import Licensed Products in the Territory, as permitted hereunder.

(g) Third Party Infringement

Sometimes a company that has obtained the right to use the technology or intellectual property rights of another will discover that such technology or rights are being infringed upon by a third party. If such infringement is being conducted for the purpose of selling goods or services that are competitive to the goods and services of the licensed user, the licensed user will want assurances that the infringing behaviour will not be ignored. Unfortunately, unless expressly stipulated in the parties licence agreement, the licensor has no obligation to protect its licensees from the infringing actions of third parties.

Sample Clause:

In the event that Licensee gives Licensor written notice that it is of the opinion that a third party is producing or selling Licensed Products without a valid licence under Licensed Patents (and therefore is infringing such Licensed Patents), and if:

(a) Licensor has not already served such third party with a statement of claim (or taken similar legal action) regarding such alleged infringement;

(b) Licensee requests in such written notice that Licensor initiate legal action against such third party regarding such alleged infringement;

(c) Licensee supplies Licensor with an opinion of its legal counsel that such third party is infringing a Licensed Patent;

(d) Licensor fails to bring suit against such third party or obtain the discontinuance of such infringement within • (•) days after receive of Licensee's written request; and

(e) sales of such infringing products is of such a quantity that, if licensed on the same terms and conditions as set out herein, royalties of at least \$• would have been payable by such third party in the year immediately preceding the date of receipt of Licensee's written request, or could reasonably be expected to be payable, in the year immediately following the date of receipt of Licensee's written request;

then, Licensee will be relieved of the payment of royalties that would otherwise accrue as to the Licensed Patents allegedly being infringed from the time conditions (a) through (e) are all satisfied until the day that Licensor brings suit against such third party or obtains discontinuance of such infringement.

3. SERVICES

In addition to the transfer or licensing of technology and intellectual property, technology transactions often involve the provision of services from one party to another. While many of the financial terms used in conjunction with the transfer of technology and intellectual property are also applicable to the payment of services, the provision of services carries with it some unique circumstances for consideration.

(a) Types of Services

There is no exhaustive list of the types of services that can be included as part of a technology transaction. Some of the most common services include consulting, training, installation, technical support, maintenance, back-up/disaster recovery, and the outsourcing business processes.

(b) Time and Materials

The simplest payment model for the provision of services is a time and materials fee structure. Under this model the service provider charges an hourly or per diem rate to its customers. As discussed in Section 4.2 of this paper, detailed reporting and auditing provisions should be included in the agreement so that the amounts invoiced to the customer can be verified.

(c) Other Fee Bases

(i) Performance Standards

The inclusion of performance standards in service agreements is a popular method used to establish the compensation to be paid to a service provider. Generally speaking, if the services provided by the service provider meet the prescribed service levels, the service provider will be paid the negotiated base rate. If the service provider's performance falls short or exceeds the service levels, the agreement will typically provide that the service provider be penalized in some fashion or receive a bonus, as the case may be. The standards of service, or "service levels", against which the service provider's performance is measured, must be tailored to the circumstances of the particular services under consideration. As an illustration of the complexity involved in establishing service levels, in some service agreements, such as those relating to outsourcing transactions, the schedules dealing with service levels are larger than the rest of the agreement.

Popular standards used to measure performance in outsourcing agreements include system availability, server response time and support response time. By way of example, a company that decides to outsource certain services to an independent service provider will want assurances that the services will always be available to its personnel and/or customers. Conversely, the service provider will want to ensure that brief interruptions in service for reasons such as regularly scheduled maintenance are permitted. As a result of their negotiations, the service provider and its customer might agree on a clause such as the following:

Sample Clause:

The Service Provider agrees to provide no less than ninety-nine (99%) percent Service Availability. For the purpose of this Agreement, the term "Service Availability" means the percentage obtained by dividing (i) the total time during the applicable time period that the Services are available to the Customer and its clients, by (ii) the total time during the same time period that the Services are scheduled to be available to the Customer and its clients.

In the example above, failure to provide the agreed upon Service Availability may result in certain penalties, as discuss further in paragraph (e) below.

In establishing performance standards, it is often difficult for parties, before the service provider has begun to provide services, to know what is a reasonable standard of performance. For example, in the case of company that decides to outsource certain of its business processes, the equipment, software, personnel and economies of scale used by the company when performing such processes internally may be significantly different that those used by the service provider. As a result, the parties should consider including a mechanism by which performance standards may be adjusted following the initial transition period.

(ii) Benefit Participation

Rather than measuring the service providers performance against specific technical standards, some service arrangements provide that all or a portion of the service provider's compensation will consist of a share of the benefit derived by the customer from the service providers services. For example, if the outsourcing of services results in \$X annual savings to the customer, the service provider will be entitled to a share of such savings. One of the drawbacks to using such a model is that measuring savings can be a difficult exercise.

(d) Pass-through Expenses

In providing services, a service provider will often have to make certain expenditures such as the purchase of hardware and software, as well as travel and lodging for its personnel. If the responsibility for such expenses is not expressly addressed in the services agreement, the inference will be that the cost of such items is included in the service fees and shall be borne by the service provider.

If the intent is for certain expenses to be paid for by the customer, the parties should consider the following: (i) should such expenses be specifically identified in the agreement; (ii) are such expenditures subject to the prior (written) approval of the customer; (iii) should there be caps on expenses incurred on behalf of the customer; (iv) is the service provider obligated to use reasonable efforts to minimize costs incurred; (v) must the service provider deliver evidence of the costs claimed; (vi) is the service provider entitled to a mark-up on the costs to account for its efforts in procuring the items purchased?

(e) Price Adjustments

(i) Price Rebates/Credits

As referenced above, when a service provider falls short of the standards for performance set out in the services agreement, it is typical that the fees payable to the service provider be adjusted to reflect such non-conformity. Not only does this compensate the customer for the deficiency in services, it also provides the service provider with incentive to perform to the agreed upon standard.

In outsourcing transactions, the adjustment of prices is typically achieved by providing discounts or rebates for the fees payable during the period in which the services were deficient. Alternatively, the customer may be provided with credits that may be applied against fees payable for future services.

The service provider, however, may wish to have the opportunity to recoup any penalties assessed against it. For example, if the service provider fails to meet a performance standard in one time period but exceeds the standard in another, the service provider might argue that it should be able to use its exceptional performance to offset past or future deficiencies. How far back or forward such a setoff can be applied will be a matter for negotiation between the parties.

Another added complexity is the fact that many service agreements consist of more than one performance standard. In addition, where multiple performance standards exist, they may not all be of equal value to the customer. In such cases, the parties will often agree to a weighting of performance standards such that a deficiency in a standard that is deemed to be of high importance will result in a higher rebate/credit. Similarly, exceeding a performance standard

that is deemed to be of low importance will typically not be sufficient to fully earn back rebates/credits resulting from deficiencies in the performance of more important standards.

(ii) Bonuses

As discussed in paragraph (i) above, a service agreement might provide that the service provider is entitled to earn back rebates/credits that have been awarded to the customer as a result of the deficient provision of services. Similarly, the service provider might insist that recognition for exceptional service not be limited to an earn back situation. In other words, the service provider might insist upon receiving a bonus payment for exceeding the agreed upon service standards.

(iii) Improved Technology Performance

As we are well aware, technology is ever evolving. Generally speaking, the cost of providing a specific level of technical performance is reduced over time as superior technology, with higher performance capabilities, is developed. As a result, the performance levels and fees negotiated in year one of a services agreement may no longer be appropriate in year three. Therefore, the parties should consider including in their agreement a method by which prices can be adjusted to reflect the lower cost to the service provider for providing its services.

4. SETTLEMENT OF PAYMENT

4.1 Reporting

(a) General

Where royalties are payable pursuant to a technology transfer agreement, the transferor will typically require that the transferee provide the

transferor with a report which documents the calculation of royalty payments.

(b) Frequency

While reports are typically delivered together with royalty payments, reports may be required more, or less, frequently.

(c) Content of Royalty Reports

The content of the report will depend upon the formula used to calculate royalties, and need not be restricted only to the calculation of royalties. Reports often include other information requested by the transferor such as details on the competitive landscape in the transferee's market, transferee's marketing plans and sales forecasts.

Sample Clause:

Each royalty payment made by Distributor pursuant to Section • shall be accompanied by a written report, in a form acceptable to Supplier, stating the description, number of copies, and aggregate Net Sales for Software Product sold or otherwise disposed of by Distributor during the preceding calendar quarter.

(d) Post-termination or Expiration Reporting

In addition to the requirement to provide regular reports during the term of the agreement, consideration should also be given to the delivery of a final report following the termination or expiry of the agreement between the parties.

Sample Clause:

Within • days of the expiration or termination of this Agreement, Distributor shall deliver to Supplier a written report stating the description, number of copies, and aggregate Net Sales for Software Product sold or otherwise disposed of by Distributor that have not been previously reported to Supplier.

4.2 Maintenance and Inspection of Records

(a) Right to Inspect

While the royalty reports delivered to the transferor will provide the transferor with a means to verify the accuracy of the payments made to it, there may be occasion where the accuracy of the reports themselves may be in doubt. Rather than simply taking the word of the transferee, the transferor will typically require that it be given the right to inspect the relevant books and records of the transferee. While the right to inspect is often limited to an inspection of the transferred financial records, consideration should be given to whether other records or information should also be available for inspection.

(i) Financial Records

As referred to above, the right to inspect typically includes the right to inspect the other party's relevant financial records.

(ii) Production Records

Where the calculation of royalty payments are based on factors not typically found in the transferee's financial records, the right to inspect the transferee's production records might be appropriate. The right to inspect production records is also useful as a means of verifying the accuracy of the information contained in the transferee's financial records.

(iii) Inventory on Hand

Where royalties are based on number of units manufactured by or for the transferee, a right to inspect the transferee's and/or its manufacturer's warehouses to count inventory on hand might be appropriate.

(iv) Quality Control and Secrecy Measures

While inspection rights are usually considered in the context of verifying payment obligations, the right to inspect a party's manufacturing or other facilities is also useful for the purpose of verifying such party's compliance with obligations regarding quality control and the protection of confidential information.

(v) Right to Audit Other Persons

Often overlooked in technology agreements is the ability to inspect the records or facilities of persons or entities that are not a party to the agreement. By way of example, if a licensee is permitted to sublicense the licences granted to it under the technology agreement, the licensor will have no means by which to verify the accuracy of the reporting by such sublicensee. One means to address this situation is by requiring the licensee to include a right for the benefit of the licensor to inspect the records or facilities of the sub-licensee. Many licensees, however, will resist any direct interference in its relationship with its sublicensees. As a compromise, the licensor might instead require that all sublicense agreements between the licensee and its sublicensees include a right for the benefit of the licensee to have an independent third party inspect the records and/or facilities of the sublicensee. The agreement between the licensor and licensee can then include a right for the benefit of the licensor to compel the licensee to exercise its inspection rights upon the request of the licensor and to share with the licensor the results of any such inspection.

(vi) Frequency of Inspection

The party who is subject to audit by the other party will want to limit the number of audits that might be performed by the auditing

party. The auditing party will want to reserve for itself the right to audit the other party at any time it thinks that there is an inaccuracy in the audited party's reporting. As a means of compromise, most auditing parties will agree to limit their audit rights to a specific number of times per year, with the proviso that if material discrepancies in the audited party's reporting are found during any inspection, more frequent inspections will be permitted.

In addition to the frequency of inspections, the audited party will typically want there to be some limitations placed on the manner in which inspections are conducted. For example, an audited party will typically require that it receive reasonable advance notice prior to any inspection, that any inspection be conducted during normal business hours and be conducted in a manner that is not unreasonably disruptive of the audited party's operations. Similarly, the auditing party will want to require the reasonable cooperation of the audited party, including making relevant individuals available for questioning during the inspection and providing the auditing party with work space and any reasonably requested telecommunications equipment.

(vii) Cost

Inspections of records and facilities can involve considerable time and expense. As a result, it is important that the technology agreement stipulate who is responsible for such expenses. Typically, inspections are conducted at the cost of the auditing party, unless a material discrepancy (usually defined as a discrepancy beyond a defined monetary threshold) is discovered as a result of the inspection.

(b) Inspection by Transferor

Where sufficient internal resources are available, the transferor may prefer to have any inspections conducted by its personnel. In addition to potential cost savings, the transferor's personnel are often best positioned to know what to look for and what is of most importance to the transferor.

(c) Inspection by Independent Auditor

The audited party will often be reluctant to have its books and facilities inspected by the other contracting party. This is especially the case where the parties, while business partners for the purpose of the contract in question, are in competition with one another in other areas of their businesses. In such cases, the audited party will usually insist that an independent third party conduct inspections.

One party's view of "independent", however, may not be the same as the other's. While an auditor who is not the accountant or auditor of either of the parties might be considered to be independent, what if that auditor is the auditor of the main competitor of the audited party? In order to avoid a future conflict regarding auditors, the parties should consider agreeing in advance as to the identity of one or more auditors who may be engaged to perform the inspection. If inspection rights involve more than the inspection of financial records, more than one auditor or inspector might have to be selected.

(d) Time Limitation

The right to inspect should survive the expiration or termination of the agreement and should continue for a defined period of time following the fulfillment of all royalty payments and reporting obligations have been fulfilled. Consideration of statutory limitation periods should also be given in determining the duration of inspection rights.

(e) Confidential Information

If the agreement does not already deal with the subject of confidential information, the inspection provision should clearly state that the books and records, and any other information, reviewed by the auditor, including the results of the audit, shall be considered confidential information and be protected from disclosure to any other third party. When the auditor is an independent third party, consideration should be given to requiring such third party to execute a non-disclosure agreement with the audited party.

Sample Clause:

Supplier shall have the right no more often than once per twelve (12) month period, upon no less than ten (10) days advance written notice, to appoint an independent accountant who is reasonably acceptable to the Distributor, to examine Distributor's books and records, during normal business hours, in order to verify Distributor's compliance with the terms of this Agreement. In reporting its findings of any such audit to the Supplier, the accountant will limit its report to its final conclusions as to the accuracy of payments and reports made by Distributor hereunder; provided that if it is unable to verify the accuracy of such payments and reports it may indicate the reasons for which it is unable to verify the payment and/or report. All information contained in the accountant's report shall be deemed Confidential Information and be subject to the provisions contained in Section •. If requested by Distributor, the accountant shall be required to execute a non-disclosure agreement with the Distributor that contains commercially reasonable terms and conditions regarding the protection of the confidential information of Distributor. Any such audit shall be at the expense of Supplier unless the audit reveals an underpayment of greater than five percent (5%) from the amount of any royalty calculation contained in any report delivered by Distributor, in which case the full cost of the audit, [but in no event more than \$•] shall be at the expense of the Distributor. In the case of an underpayment by Distributor, Distributor shall forthwith pay to Supplier the difference between such underpayment and the amount that should have been paid, together with any interest on such amounts. In the event that the audit reveals an overpayment by Distributor, Distributor shall be entitled to credit such amount against future royalties owing to Supplier hereunder.

4.3 Duty to Maintain Records

The right to inspect the books and records of another party will be of little value if the audited party has not maintained such books and records in an appropriate manner. As a result, the agreement should clearly set out the obligation to maintain records.

Sample Clause:

Licensee will maintain, in accordance with generally accepted accounting principles, complete and accurate books and records in respect of its marketing and distribution of the Software and the fees and other amounts received there from. At a minimum, such books and records shall contain all data reasonably required for the full computation and verification of the royalties to be paid and the information to be furnished in the reports provided for in Section •. Such books and records must be retained by Licensee for no less than • (•) years following the royalty payment period to which they relate. For the purpose of this Section •, “generally accepted accounting principles” means the generally accepted accounting principles from time to time approved by the Canadian Institute of Chartered Accountants, or any successor entity thereto, applicable as at the date on which such principles are to be applied or on which any calculation or determination is required to be made in accordance with generally accepted accounting principles.

4.4 Withholding of Taxes

The tax legislation in many jurisdictions requires the domestic transferee of technology to withhold a proportion of the payments to be made to a foreign transferor. In some cases, these tax withholding requirements have been reduced, or eliminated, by tax treaties between the applicable two countries. Where such tax withholding obligations remain, the withholding rates often vary for different forms of property. As a result, if the consideration payable for different forms of property being transferred (e.g. copyright vs. trade-marks) is not listed separately, the transferee may be required to withhold at the highest rate for the entire amount payable. As the foregoing illustrates, not being aware of the international tax consequences of a technology transaction can give rise to unwelcome surprises to the parties.

Assuming that the parties are aware of their tax withholding obligations, they must also consider how to deal with such obligations. In some cases, the parties require that the transferee withhold such amounts and provide evidence of such withholding so that the transferor can claim a tax credit under its own domestic tax laws. While this may be a reasonable approach in some situations, it will not always have the desired result. For example, if the transferor does not have taxable income in its resident jurisdiction (as is often the case for early-stage technology companies), the available tax credit is of little value.

Another approach that is sometimes adopted, is to require that the transferee gross up the amounts payable to the transferor so that the net amount received by the transferor equals the amount originally agreed upon. Obviously this approach will not be welcomed by the transferee as it will result in the increase of its payment obligations and amounts to a shifting of the transferor's tax burden to the transferee. In addition, as there will still be an amount withheld for taxes, the transferor may still be entitled to receive a tax credit in its domestic jurisdiction. Such "double dipping" may be mitigated by requiring the transferor to apply for any available tax credits and to remit the benefit of any such amounts to the transferee.

Sample Clause 1:

In the event any payments required to be made by Distributor under this Agreement are subject to applicable withholding tax that Distributor is required to deduct from such payments, Distributor shall promptly deliver to Supplier receipts issued by the appropriate government authorities for all such taxes withheld or paid by Distributor and Distributor shall fully and promptly cooperate with Supplier to provide such information and records as Supplier may require in connection with any application by Supplier to obtain available tax credits.

Sample Clause 2:

In the event any payments required to be made by Distributor under this Agreement are subject to applicable withholding tax that Distributor is required to deduct from such payments, the amounts payable to Supplier hereunder shall be increased such that the net amount paid to Supplier, after deduction of the tax withheld, shall be equal to the original gross amount owing to the Supplier hereunder. Supplier shall use commercially reasonable efforts to obtain all available tax credits respecting amounts withheld hereunder and, if received, will pay to Distributor an amount equal to the benefit of such tax credits. Distributor shall fully and promptly cooperate with Supplier to provide such information and records as Supplier may require in connection with any application by Supplier to obtain available tax credits.

4.5 Sales Tax/GST

The responsibility for the payment of sales tax and GST should be expressly stated in the agreement. In addition, the agreement should state whether such taxes are included in the price or are in addition to the prices listed in the agreement.³

³ GST is deemed to be included in the price unless expressly stated otherwise.

Sample Clause:

All fees payable hereunder are exclusive of all taxes, duties, levies and similar charges (“Taxes”) of any kind levied, assessed or imposed by any government authority. Licensee shall be liable for and shall pay, either to the Licensor, or directly to the appropriate government authority, as required, all Taxes properly payable in connection with this Agreement, including, but not limited to sales tax and GST, but excluding any income tax payable by Licensor as result of the transactions contemplated hereunder.

4.6 Designation of Currency

In international transactions, it is important to designate the currency in which payments are to be made. Where the exchange of currency is required, a method for determining the appropriate exchange rate should also be included.

4.7 Currency Controls

In the case of international transactions, consideration must also be given to restrictions on the export and conversion of currency. Some countries restrict the exit of both foreign and local currencies from their countries. In other cases, agreements must be approved by the local government agency or central bank before payments can be made in a foreign currency. As a result, it is important to be aware of any restrictions on currency exchange and export and to construct a method of dealing with such restrictions.

By way of example, if a country does not permit the exchange of local currency into a foreign currency, but does permit the export of local currency, consideration should be given to whether such local currency can be exchanged in the free market once it has been exported. If domestic approvals are required in order to exchange and/or export foreign currency, obtaining such approvals should be made a condition precedent to the domestic party’s ability to exercise any of the rights granted to it in the agreement.

Added to the difficulty presented by the restrictions imposed by currency controls is the fact that such controls are often volatile and can change without warning. As a result, it is wise to have a third party guarantee the obligations of the party whose payment obligations may be affected by such controls (e.g. a U.S. or Canadian bases subsidiary or related party).

Sample Clause:

If the laws of any country or territory are changes so that the transmission of any royalties payable by the Licensee hereunder in the lawful currency of Canada is prevented by embargo, currency regulations or otherwise, the Licensor may terminate the rights and licences granted to Licensee herein with respect to such country or territory by giving Licensee • days written notice.

4.8 Payment(a) Timing and Place of Payment

The payment provisions should clearly state when payments are due and where payment is to be made.

(b) Invoicing

Where the payment provisions require the delivery of an invoice, the form and content of such invoice should be expressly stated. In particular, the agreement should stipulate that each invoice clearly describe the goods or services to which the invoice relates, the quantity and price of such goods or services, and also include separate line items for other amounts being invoiced such as taxes, shipping costs and other pass-through expenses.

(c) Method of Payment

The payment provisions should state the method(s) of payment that are acceptable to the payee (e.g. certified cheque, bank draft or wire transfer).

(d) Interest

The agreement should expressly state what, if any interest, is payable on overdue payments and how such interest is to be calculated.

(e) Effect of Failure to Pay

In addition to imposing interest on overdue payments, the parties should consider what other effect, if any, the failure to pay will have. Some of

the common effects of failure to pay include: (i) acceleration of payment obligations; (ii) loss of certain rights, such as exclusivity; and (iii) the right of the non-defaulting party to terminate the agreement.⁴

4.9 Payment Milestones

In order to manage the risks involved in a technology transaction, it is common to structure the payment obligations so that they are spread out over a series of “milestones”. Milestones are typically defined by the passage of time or the occurrence of specific events. Examples of milestones include: (i) the completion of a phase of development; (ii) the delivery or shipment of a product; (iii) the acceptance by the recipient of the delivered technology; (iv) the successful installation of the technology; (v) the first commercial use of the technology; and (vi) the expiry of the warranty period.

When designing milestones it is important that the parties achieve a reasonable balance between the cash flow needs of the party who is obligated to perform under the agreement and the payer’s desire to mitigate the risk of the payee’s failure to perform. In addition, milestones should be defined as objectively as possible so as to reduce the risk of a dispute over whether the milestone has been achieved.

5. SECURITY OF PAYMENT

Often overlooked in technology transactions is the securing of payment obligations. Depending on the type of transaction, some of the methods to secure payment that might be considered include the following:

5.1 Letters of Credit

A letter of credit is an instrument issued by a bank pursuant to which it obligates itself to make a defined payment to a party upon the presentment of certain documentation. For example, a letter of credit may stipulate that the bank will accept drafts by a supplier up to an aggregate amount on the condition that such drafts are accompanied by a document

⁴ With respect to item (i) and (iii), note the limitations on acceleration of payment and termination imposed by s.65.1 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c-B-3, as amended.

executed by the supplier, stating that the amount of such draft constitutes the amount by which the distributor is in arrears in payments owed to the supplier.

5.2 Performance Bond

A performance bond is a bond issued by an insurance company to guarantee satisfactory performance of a project by a contractor. In the event of the failure to perform by the contractor, the beneficiary of the performance bond can enforce the bond in accordance with its terms and conditions.

5.3 Third Party Guarantees

In addition to banks and insurance companies, other third parties may be considered as sources of guarantees for the performance of contractual obligations. For example, in a licensing transaction, the parent company of the licensee may be required to guarantee the performance of the licensee's payment obligations, including the payment of any damages or indemnification payments. Of course, the value of any such guarantee is only as good as the guarantor's ability to satisfy such guarantee. As a result, consideration should be given to obtaining further security for the guarantor's guarantee.

5.4 Payments in Advance

Perhaps the best form of security is to obtain some, or all, of the other party's payment obligation in advance. The quantity of such pre-payment will be a matter of negotiation as any pre-payment will have an impact on the payee's cash flow.

Sample Clause:

Beginning with the second calendar quarter following the commencement of this Agreement, and for each calendar thereafter, Licensee will, together with the royalty report delivered pursuant to Section ●, remit to Licensor as partial payment of royalties (the "Partial Payment") payable for the then current calendar quarter, an amount equal to seventy-five (75%) of the royalties payable for the previous calendar quarter. The Partial Payment shall be credited against royalties owing for the current calendar quarter. If the fees payable by Licensee for a particular calendar quarter are less than the applicable Partial Payment, the difference shall be credited against the royalties payable for the next calendar quarter.

5.5 Joint and Several Liability

The beneficiary of contractual obligations may wish to make two or more parties jointly and severally liable for any losses incurred by the beneficiary as a result of a default by the obligated party.

Sample Clause:

Licensor, together with its shareholders, X Co. and Y Co., shall be jointly and severally liable to Licensee for any loss or damages suffered by Licensee as a result of any breach of warranty, misrepresentation, or breach of covenant by Licensor contained herein.

If a person who is not otherwise a party to the agreement is to be made jointly and several liable, it is important that such person be made a signatory to the agreement. The parties that share joint and several liability may wish to limit the extent of their liability by imposing a cap on liability and/or provide that they may seek contribution from the party with they share liability.

5.6 Security Over Assets

Whether an obligation is that of the principal contracting party, or a third party who has agreed to support such obligation, the beneficiary of such obligations has little protection if the obligated party (or parties) do not have the financial wherewithal to make good on their commitments. Therefore, it is important to not only seek the commitment of a third party, but to ensure that such commitments are properly secured.

Security over personal property or real estate are effective means by which to secure financial obligations. When granting or taking a security interest in property, care should be taken to ensure that the security granted takes priority over the interests of other secured parties.

6. CONCLUSION

As the discussion above illustrates, drafting financial terms for a technology transaction involves more than simply inputting the price and payment schedule provided by the client. Financial terms must be structured such that the bargain reached by the parties

(i.e. the balance between risk and reward) is maintained throughout the term of the agreement. In doing so, the drafter must anticipate changing circumstances such as errors in the parties' original assumptions, or the failure of a party to fulfill its obligations, and provide a means by which the pricing and payment terms can be adjusted to preserve the original risk and reward balance. In many transactions this involves careful consideration of complex issues and almost a clairvoyant's vision of the future. A lawyer who can navigate his or her client through the potential pitfalls and minefields will have proved himself or herself to be an invaluable member of the transaction team.