

Case Study: Reading Instructor Software Technology

Introduction

The Company:

Educo (fictional name) creates and provides tools, systems and services to help educators teach smarter, such as technology designed to improve classroom assessments and data-based instructional decisions and technology that analyzes student data and provides tailored curriculum (based on individual learning needs). Educo's tools, systems and services are currently used by more than 200,000 educators and three million students.

The Technology:

The Reading Instructor software technology adapts automated speech recognition to analyze oral reading. The Reading Instructor technology responds with spoken and graphical assistance modeled in part after expert reading teachers. Research and experimental use of the Reading Instructor technology in elementary school classrooms produced dramatic gains in reading comprehension.

History:

The Reading Instructor software technology was developed in 1997. A US patent issued for the technology in 1999. The technology was marketed widely for many years and disseminated through research–use licenses to other educational researchers and, in some cases, end users.

The technology was originally licensed exclusively to an education company in 2005. The terms of that original license included reimbursement to the university for all prior patent expenses, a royalty of 2.5% of net sales, annual minimum payments increasing over the term of the license from \$25,000 to \$100,000, and an up-front fee paid to the university in stock of the education company (the education company was a private company and, therefore, its stock was not tradable).

Unfortunately, no sales of products or services based on the technology were ever generated by the education company, and the original license was terminated in 2007. Shortly after the license was terminated, Educo, a company with which the inventor of the technology was familiar and interested in working, approached the university about the possibility of obtaining an exclusive license to the technology.

The Market:

The educational software market is notoriously difficult. Although it is a \$2B market overall, sales are tied to education budgets, which are usually tight and heavily scrutinized at the school and/or district level. The distribution channel is dominated by large textbook publishing companies, who tend to view software as an add-on or supplement to a textbook. In addition, sales cycles through traditional channels (K-12 schools) are 9 – 12 months due to budgeting cycles. There is also competition from open source software providers.

You are negotiating the license with Educo on behalf of the university.

Questions: How do you value this deal? How do you the structure of the deal in terms of upfront payments, minimum payments, and royalties? What is your starting proposal to Educo? What is the minimum amount you would be willing to accept?

Questions 2: Milestones and Consideration

In any exclusive license, the university requires minimum performance requirements to be specified in the license. Failure to meet these minimum performance requirements is grounds for termination of the license and/or the license's exclusivity by the university.

The following minimum performance requirements were proposed by the university to Educo for the technology:

4.1. Licensee shall use its best efforts to effect introduction of Licensed Technology into the commercial market as soon as possible; thereafter, until the expiration of this Agreement, Licensee shall keep Licensed Technology reasonably available to the public.

4.2. Licensee shall achieve the following milestones:

1) Submission of a product development plan for the Licensed Technology solely acceptable to Carnegie Mellon within four (4) months of the Effective Date.

2) Introduction of a commercial product based upon the Licensed Technology within twenty-four (24) months of the Effective Date.

The following consideration for the license was proposed by the university:

5.1. Royalties payable by Licensee to Carnegie Mellon shall be two percent (2%) of Net Sales. Royalties payable to Carnegie Mellon for the term of this Agreement shall be paid by Licensee to Carnegie Mellon, as set forth in this Section 5, for each Fiscal Quarter within sixty (60) days after the end of such Fiscal Quarter, until this Agreement expires or is terminated in accordance with the terms of this Agreement. If this Agreement terminates before the end of a Fiscal Quarter, the payment for the terminal fractional portion of a Fiscal Quarter shall be made within ninety (90) days after the date of termination of this Agreement. All Royalties hereunder shall be paid in U.S. Dollars and shall be made by wire transfer to Carnegie Mellon's account No. _____, Carnegie Mellon Ref. _____, at Mellon Bank's Pittsburgh office, or by Licensee's check sent in accordance with _____.

5.2. Licensee shall pay Carnegie Mellon a non-refundable up-front royalty of Fifteen Thousand U.S. Dollars (\$15,000 U.S.) due and payable thirty (30) days after the Effective Date. This up-front royalty will not be credited against any other amounts due under this Agreement.

5.3. Licensee shall pay Carnegie Mellon a non-refundable, minimum royalty of Thirty Thousand U.S. Dollars (\$30,000 U.S.) ("**Annual Minimum Royalty**"), payable on <date> of each Year. The Annual Minimum Royalty shall be credited against the Royalties payable in a Year. Annual Minimum Royalty payments are to be adjusted by the cumulative percentage change in the CPI-W Consumer Price Index between December

_____ and the December preceding the date on which the payment in question is payable.

Educo's counter proposal to the university for the minimum performance requirements was as follows:

4.1. Licensee shall use its commercially reasonable efforts to effect introduction of Licensed Technology into the commercial market as soon as possible; thereafter, until the expiration or termination of this Agreement, Licensee shall keep Licensed Technology reasonably available to the public.

4.2. Licensee shall achieve the following milestones:

1) Submission of a product development plan for the Licensed Technology acceptable to Carnegie Mellon within four (4) months of the Effective Date, where acceptance shall not be unreasonably withheld and given within the date of submission of such plan.

2) Introduction of a commercial product based upon the Licensed Technology within twenty-four (24) months of the date specified in the product development plan.

Educo's counter proposal to the university for the consideration was as follows:

Educo did not propose any changes to Sections 5.1 or 5.2. For Section 5.3, Educo proposed:

5.3. Licensee shall pay Carnegie Mellon a non-refundable, minimum royalty of Thirty Thousand U.S. Dollars (\$30,000 U.S.) ("**Annual Minimum Royalty**"). Quarterly payments described in Section 5.1 will be credited toward the Annual Minimum Royalty. Any additional payment required to meet the Annual Minimum Royalty shall be payable within 90 days of the end of the Annual period. During the product development period set forth in Section 4.2(1) and (2), the Annual Minimum Royalty will be waived until the end of the year following its commercial launch. Annual Minimum Royalty payments are to be adjusted by the cumulative percentage change in the CPI-W Consumer Price Index between December _____ and the December preceding the date on which the payment in question is payable.

Questions: Would you accept Educo's counter proposals? Why or why not? What would be your next proposal to Educo?

Section 2.1 of the university's standard license provides the basic license grant to the licensee. Section 2.4 of the university's standard license provides that the university retains the right to continue to use the licensed technology for research, educational and administrative purposes.

The university's standard language for Sections 2.1 and 2.4 is:

2.1. Carnegie Mellon hereby grants to Licensee, and Licensee hereby accepts, an [exclusive or non-exclusive], [world-wide or Territory] right to use the Licensed Technology to make, have made, use, [copy], and otherwise Dispose of Licensed Products [and to create Derivatives for the Field of Use].

2.4. Carnegie Mellon shall have the right to use the Licensed Technology and, free of charge, any product or process developed by Licensee [and/or any sublicensee] which contains or is based on any of the Licensed Technology [and/or Derivatives], for Carnegie Mellon research, educational, academic, and/or administrative purposes.

The university had granted in the past, and wished to continue to grant in the future, research-use licenses for the technology to other universities and, in some cases, end users. Based on this, the university's initial proposal to Educo was as follows:

2.1. Carnegie Mellon hereby grants to Licensee, and Licensee hereby accepts, an exclusive, world-wide right to use the Licensed Technology to make, have made, use, and otherwise Dispose of Licensed Products and to create Derivatives for the Field of Use, subject to Section 2.4.

2.4. Carnegie Mellon shall have the right to use and modify, free of charge, any product or process, developed by Licensee or any sublicensee which contains or is based on any of Licensed Technology and/or Derivatives, solely for Carnegie Mellon's own research, educational, academic, or administrative purposes, including the right to sublicense the Licensed Technology and any Derivatives to third parties (and to permit such third parties to further sublicense) to the extent reasonably necessary for the research purposes of Carnegie Mellon provided that the right to sublicense Derivatives to third parties does not apply in the event that Licensee determines in good faith that such sublicense could materially interfere or conflict with Licensee's efforts to sell Licensed Products. Carnegie Mellon shall disclose to Licensee all proposed sublicenses of Derivatives.

Educo made no modifications to Section 2.1, however, they proposed the following modifications of Section 2.4:

2.4. Carnegie Mellon shall have the right to use and modify, free of charge, any product or process, developed by Licensee or any sublicensee which contains or is based on any of Licensed Technology and/or Derivatives, solely for Carnegie Mellon's own research purposes. *[Educo's comment: We only want them to have for research reasons; they may have our competitors on their boards]* Carnegie Mellon also shall have the right to sublicense the Licensed Technology to third parties (without the right to further sublicense) to the extent reasonably necessary for the research purposes of Carnegie Mellon, provided that the right to sublicense Licensed Technology to third parties does not apply to purported sublicenses to direct competitors, efforts to commercialize, and in the event that Licensee determines in good faith that such sublicense could materially interfere or conflict with Licensee's efforts to sell Licensed Products. Carnegie Mellon shall disclose to Licensee all proposed sublicenses of Licensed Technology.

Questions: How would you respond to Educo's suggested changes? Would you accept them or not? What are the issues for the university? What are the issues for Educo? What are the potential effects on the inventor's current or anticipated future research efforts? What would be your counter-proposal?

The university does not typically offer or provide in its licenses rights to improvements beyond what could be filed as a divisional, continuation or continuation-in-part to a licensed patent. However, the university allows licensees to establish proprietary rights in Derivatives made by them.

Educo was offered the university's standard license grant and Derivatives language as follows:

2.1. Carnegie Mellon hereby grants to Licensee, and Licensee hereby accepts, an exclusive, world-wide right to use the Licensed Technology to make, have made, use, and otherwise Dispose of Licensed Products and to create Derivatives for the Field of Use, subject to Section 2.4.

2.2. Licensee shall be entitled to establish all proprietary rights for itself in the intellectual property represented by Derivatives, whether in the nature of trade secrets, copyrights, patents or other rights, provided that Licensee shall promptly notify Carnegie Mellon of Licensee-originated bug fixes to the Licensed Technology, which shall be part of the Licensed Technology and owned by Carnegie Mellon. Any copyright registration by Licensee for Derivatives shall give full attribution to Carnegie Mellon's Copyrights. Carnegie Mellon shall have the right to use and modify Derivatives for research, educational, academic, or administrative purposes.

Educo's comments to the university's offer were as follows:

2.1. Carnegie Mellon hereby grants to Licensee, and Licensee hereby accepts, an exclusive, world-wide right to use the Licensed Technology to make, have made, use, and otherwise Dispose of Licensed Products and to create Derivatives for the Field of Use, subject to Section 2.4. *[SHOULD INCLUDE CMU'S IMPROVEMENTS]*

2.2. Licensee shall be entitled to establish all proprietary rights for itself in the intellectual property represented by Derivatives, whether in the nature of trade secrets, copyrights, patents or other rights. Licensee shall promptly notify Carnegie Mellon of Licensee-originated bug fixes to the Licensed Technology, which shall be part of the Licensed Technology and owned by Carnegie Mellon.

Questions: What are the issues in granting rights to future improvements? Is it appropriate in this instance? How broad or narrow a right would you accept? Are derivatives and improvements the same thing? Would you accept Educo's modifications (i.e., deletion of the last two sentences) to Section 2.2? Why or why not?

Typically, the term of the university's licenses is 20 years or the last to expire patent, whichever is later. However, this can vary, and certainly with software licenses it can be much shorter (especially if there is no patent). In addition, the university does not typically grant a termination right to the licensee.

Educo was offered the following language for Term and Termination:

The term of this Agreement shall conclude at the end of twenty (20) years from the Effective Date, or on the expiration date of the last-to-expire Patent, whichever comes later, unless otherwise terminated pursuant to another provision of this Agreement. The term of this Agreement shall be automatically extended for an additional period of ten (10) years unless terminated earlier.

Licensee may terminate this Agreement no less than two (2) years after the Effective Date upon not less than thirty (30) days prior written notice to Carnegie Mellon, and upon payment of (i) all amounts due to Carnegie Mellon through the effective date of termination, including reimbursement of patent expenses, and (ii) a termination fee of Thirty Thousand U.S. Dollars (\$30,000 U.S.).

Educo's comments to the university's offer were as follows:

The term of this Agreement shall conclude at the end of twenty (20) years from the Effective Date, or on the expiration date of the last-to-expire Patent, whichever comes later, unless otherwise terminated pursuant to another provision of this Agreement. The term of this Agreement shall be automatically extended for an additional period of ten (10) years unless terminated earlier. *[TERM IS LONGER THAN PATENT –DISCUSS]*

Licensee may terminate this Agreement no less than one (1) years after the Effective Date upon not less than thirty (30) days prior written notice to Carnegie Mellon, and upon payment of (i) all amounts due to Carnegie Mellon through the effective date of termination, including reimbursement of patent expenses and (ii) for terminations prior to the ____-year anniversary of this Agreement a termination fee of Fifteen Thousand U.S. Dollars (\$15,000 U.S.).

Questions: Why would the university request a term longer than the patent? What is a logical rationale for this request? Would you accept Educo's revised proposal to the termination section? What is your counter proposal?

Questions 6: Warranties

The university does not make any warranties for the licensed technology, and requires the licensee to indemnify the university for various matters relating to the technology.

Educo was offered the university's standard language as follows:

12. NO WARRANTY; LIMITATION AS TO TYPES OF DAMAGES

ANY AND ALL INFORMATION, MATERIALS, SERVICES, INTELLECTUAL PROPERTY AND OTHER PROPERTY AND RIGHTS GRANTED AND/OR PROVIDED BY CARNEGIE MELLON PURSUANT TO THIS AGREEMENT, INCLUDING THE LICENSED TECHNOLOGY ARE GRANTED AND/OR PROVIDED ON AN "AS IS" BASIS. CARNEGIE MELLON MAKES NO WARRANTIES OF ANY KIND, EITHER EXPRESS OR IMPLIED, AS TO ANY MATTER, AND ALL SUCH WARRANTIES, INCLUDING WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, ARE EXPRESSLY DISCLAIMED. WITHOUT LIMITING THE GENERALITY OF THE FOREGOING, CARNEGIE MELLON DOES NOT MAKE ANY WARRANTY OF ANY KIND RELATING TO EXCLUSIVITY, INFORMATIONAL CONTENT, ERROR-FREE OPERATION, RESULTS TO BE OBTAINED FROM USE, FREEDOM FROM PATENT, TRADEMARK AND COPYRIGHT INFRINGEMENT AND/OR FREEDOM FROM THEFT OF TRADE SECRETS. LICENSEE IS PROHIBITED FROM MAKING ANY EXPRESS OR IMPLIED WARRANTY TO ANY THIRD PARTY ON BEHALF OF CARNEGIE MELLON RELATING TO ANY MATTER, INCLUDING THE APPLICATION OF OR THE RESULTS TO BE OBTAINED FROM THE INFORMATION, MATERIALS, SERVICES, INTELLECTUAL PROPERTY OR OTHER PROPERTY OR RIGHTS, INCLUDING THE LICENSED TECHNOLOGY GRANTED AND/OR PROVIDED BY CARNEGIE MELLON PURSUANT TO THIS AGREEMENT.

CARNEGIE MELLON SHALL BE LIABLE TO LICENSEE OR ANY THIRD PARTY FOR ANY REASON WHATSOEVER ARISING OUT OF OR RELATING TO THIS AGREEMENT (INCLUDING ANY BREACH OF THIS AGREEMENT) FOR LOSS OF PROFITS OR FOR INCIDENTAL, INDIRECT, SPECIAL OR CONSEQUENTIAL DAMAGES, EVEN IF CARNEGIE MELLON HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR HAS OR GAINS KNOWLEDGE OF THE EXISTENCE OF SUCH DAMAGES.

Educo proposed the following modifications:

12. NO WARRANTY; LIMITATION AS TO TYPES OF DAMAGES

ANY AND ALL INFORMATION, MATERIALS, SERVICES, INTELLECTUAL PROPERTY AND OTHER PROPERTY AND RIGHTS GRANTED AND/OR PROVIDED BY EITHER PARTY PURSUANT TO THIS AGREEMENT, INCLUDING THE LICENSED TECHNOLOGY ARE GRANTED AND/OR PROVIDED ON AN "AS IS" BASIS. NEITHER MAKES ANY WARRANTIES

OF ANY KIND, EITHER EXPRESS OR IMPLIED, AS TO ANY MATTER, AND ALL SUCH WARRANTIES, INCLUDING WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, ARE EXPRESSLY DISCLAIMED. WITHOUT LIMITING THE GENERALITY OF THE FOREGOING, NEITHER PARTY MAKES ANY WARRANTY OF ANY KIND RELATING TO INFORMATIONAL CONTENT, ERROR-FREE OPERATION, RESULTS TO BE OBTAINED FROM USE, *[Educo comment: Will need basic representations as to ownership, non-infringement and exclusivity]*. EACH PARTY IS PROHIBITED FROM MAKING ANY EXPRESS OR IMPLIED WARRANTY TO ANY THIRD PARTY ON BEHALF OF THE OTHER PARTY RELATING TO ANY MATTER, INCLUDING THE APPLICATION OF OR THE RESULTS TO BE OBTAINED FROM THE INFORMATION, MATERIALS, SERVICES, INTELLECTUAL PROPERTY OR OTHER PROPERTY OR RIGHTS, INCLUDING THE LICENSED TECHNOLOGY GRANTED AND/OR PROVIDED BY SUCH OTHER PARTY PURSUANT TO THIS AGREEMENT.

EXCEPT IN THE CASE OF A BREACH BY LICENSEE OF ANY OF ITS OBLIGATIONS UNDER SECTIONS 2 OR 14, OR IN THE CASE OF LICENSEE'S OBLIGATION TO INDEMNIFY UNDER SECTION 15 OR TO PAY INTEREST PURSUANT TO SECTION 5, NEITHER PARTY SHALL BE LIABLE TO THE OTHER PARTY OR ANY THIRD PARTY FOR ANY REASON WHATSOEVER ARISING OUT OF OR RELATING TO THIS AGREEMENT (INCLUDING ANY BREACH OF THIS AGREEMENT) FOR LOSS OF PROFITS OR FOR INCIDENTAL, INDIRECT, SPECIAL OR CONSEQUENTIAL DAMAGES, EVEN IF SUCH PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR HAS OR GAINS KNOWLEDGE OF THE EXISTENCE OF SUCH DAMAGES.

Questions: Is it reasonable for the university to accept Educo's modifications? Why or why not? What is the potential effect on the university if it does so? Should the university make any representations (as suggested by Educo's comment)? What representations can and cannot be made?