

Maximizing royalty revenue:

Current trends in royalty contract reviews

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Licensing and intellectual property agreements are often complex, and in many cases, royalties are underreported or not reported at all. Whether through misinterpretation of agreement language, calculation errors or intentional understatement of royalties due, a licensee royalty audit and investigation program is essential to ensure that licensors are receiving the proper royalty amounts, as dictated by their license agreements.

The following topics illustrate current royalty audit and investigation trends, including: best practices for license agreement language, licensee monitoring and internal operations and common or unique reasons for understated royalty payments.

Underreported royalties—Sales in non-patent countries

It is important for licensors to have an understanding of what countries the patents of their technologies are filed in. Patent filings for licensed technologies allow the technology to be made, have made, used or sold in the country where filed. The grant provision, which is included in every license agreement, allows a licensee to make, have made, use or sell products in the countries where the patent has been filed, without patent infringement and potential litigation by the licensor.

In numerous instances, we have seen the licensee incorrectly apply the make, made, used or sold provision. As an example, a patent may be filed in the United States, but not in Mexico. If the product is manufactured by the licensee in the United States, and either sold directly to customers in Mexico, or shipped to the company's warehouse or distributor in Mexico and subsequently sold, the licensee should be reporting the sales to, or in, Mexico in their royalty calculation.

Using the same scenario, if the product was manufactured in Mexico, a non-patent country, and sold to a customer in the United States, a patent-covered country, these sales should also be included in the licensee's royalty calculation, as the product was sold in a patent-covered country. We find that licensees do not consistently report all sales and related royalties in these examples.

Underreported royalties—Patent or license agreement expiration

During performance of our royalty audits and investigations, we have discovered numerous instances where the termination clause, for either the license agreement or patent expiration date, is not applied correctly by

the licensee. In those instances, the licensee has failed a portion of their royalty payment obligations under the license agreement. More specifically, unless the agreement explicitly states otherwise, the grant clause—“to make, have made, used or sold”—allows the licensor to receive royalties on the subsequent sales of the licensed product’s ending inventory manufactured prior to the expiration date, regardless of when sold.

We consistently find instances where the licensee believes that the royalty obligation under the license agreement is terminated, simply because the agreement or patent has expired. In these instances, we obtain the licensed product’s ending inventory quantities and determine the subsequent sales. We then apply the appropriate royalty rates and late payment interest (if applicable) to quantify the total underreported sales and related royalties.

For future license agreements, we recommend that the following language be incorporated: “for purposes of clarity, at the expiration of this agreement, the licensee, its affiliates and/or sub-licensees, will provide to the licensor, an inventory listing of all licensed products on hand that were manufactured prior to the expiration date, and certified and signed by an officer of the licensee. The licensee, its affiliates and/or sub-licensees, will be responsible for paying royalties on sales of such products in accordance with Article XX of the agreement.”

Alternatively, consider the following language: “upon expiration of this agreement, an inventory of all licensed products on hand shall be provided, the quantities of which will be valued at the average selling price per unit for the month prior to termination, and the applicable royalty will be paid to the licensor within 60 days of the expiration date.”

Deductions—Estimated versus actual amounts

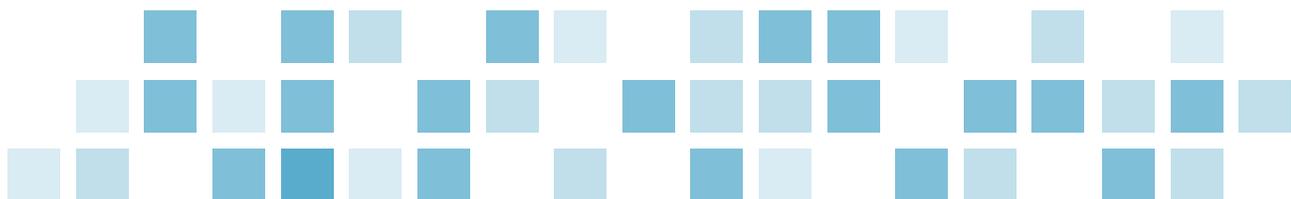
Most license agreements require the licensee to pay running royalties based on the net sales of licensed products for each royalty reporting period. Examples of typical deductions from gross sales to arrive at net sales subject to royalty include: cash discounts, sales taxes, chargebacks, rebates and returns. In many cases, if not stipulated in the license agreement, licensees estimate the amounts for these deduction categories, which are recorded as accruals on a monthly or quarterly basis for financial accounting and royalty reporting purposes.

As these are estimates, the licensee should reconcile the accrual amounts to the actual deductions throughout the year. Failure to true-up estimated deductions to the actual amounts on a periodic basis can lead to incorrect deductions taken, and large, unexpected fluctuations in deductions taken on the year-end royalty reports, when the licensee may adjust the estimates to the actual deductions.

Accordingly, it is important to understand from licensees whether reported deductions are actual amounts or estimates. If estimates are used, you should require the licensee to periodically true-up the estimated deductions to actual amounts. One method of achieving this is by incorporating appropriate language in the license agreement.

Unallowable deductions—Distributor activities

In recent royalty investigations, we have seen situations where the licensee has distributor agreements related to the sales of products incorporating the licensed technologies. For license agreements we have inspected, certain distributor fees were allowable deductions, as they related to the sales volumes (rebates) of licensed products. In several of our investigations, we have found distributors deducting, as rebates, expenses that constitute marketing and promotional activities.



Examples of this include the cost of advertising boards and the cost to obtain clinical data. We have seen distributors provide these services either as part of the distributor agreement or through a separate service agreement. These activities constitute marketing and promotional expenses, and are not allowable deductions under the definition of net sales in the license agreements. Thus, the licensee inappropriately deducted these activities as rebates in their royalty calculation.

When the distributor incurs this type of marketing and promotional expense, and receives an identifiable benefit for payment of consideration, the identified benefit is sufficiently separable from the customer's purchase of the distributor's products. The licensee must reasonably estimate the fair value of the benefit identified under the preceding condition. If these conditions exist, the payment for the service should be treated as an expense, and not a cost of sales (rebate) or allowable deduction.

If your royalties are not meeting your expectations, or you have reason to believe they are underreported, a royalty audit and investigation may determine the funds you are entitled to. In most cases, a review uncovers understated royalty payments through incorrect processes or activities, and encourages compliance moving forward.

The financial risk associated in performing the audit and investigation is often mitigated, as the additional royalties disclosed far exceed the cost of the investigation more often than not. Additionally, most agreements contain a clause dictating that the licensee is to pay the costs for the audit and investigation, if royalties are underreported by a stated percentage.

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