
Protecting the Value of License Agreements in Uncertain Times: The Role of Royalty Audits

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Contact Daniel Burns at 415-738-6022 or at db@danielburnsassociates.com. The concepts addressed herein are for discussion purposes only and are not intended to be all-inclusive on the topic of licensing investigations. No part of this article should be construed to constitute legal or accounting advice.

In recent years, the curtain has been lifted on all manner of incompetence, indifference, and outright malfeasance in connection with matters financial, exposing a rogues' gallery of companies including Enron, WorldCom, Bear Stearns, and Lehman Brothers, as well as individuals such as Bernard Madoff, Allen Stanford, and others who appear to have believed they were entitled to do whatever they pleased with the assets entrusted to them. Though these seemingly disparate market participants plied their trades in different corners of the financial bazaar, there are important lessons to be drawn from their activities. For purposes here, none is more important than understanding that regulatory agencies and investors both failed in their responsibility to conduct due diligence and ongoing monitoring that might have limited the carnage left in their wake.

These financial tragedies and the current weakness in the economy should resonate with intellectual property (IP) owners that have licensed their IP in return for royalties. License agreements provide a framework for the IP owner's compensation,

but the determination of royalties is made by the licensee, usually with very little transparency that permits the licensor to understand the underlying assumptions made by the licensee—which often have a powerful impact on royalty payments. However, in most license agreements, the licensor is afforded the protection of an audit remedy. This author puts the question to licensors: Does it make sense for you to rely exclusively on the licensee's self-reporting? I submit that both intuition and experience argue strongly that it does not, and that, to protect the value of your license agreements, you should think of yourself as a "regulator" with the right to employ an objective third-party CPA to investigate, in a non-adversarial manner, the accuracy and completeness of your licensee's royalty reporting.

The primary goal of this article is to assist licensors and their legal counsel in understanding the risks and benefits of royalty auditing and the factors that contribute to conducting such procedures successfully. It is not the goal to describe the actual procedures conducted in the course of a royalty audit. After defining the term royalty audit and identifying the reasons licensors have them done, the discussion shows that there is a structural bias in the licensing process that tends over time to result in royalty underreporting. The article identifies the primary types of royalty underreporting I have encountered as well as other benefits to licensors of actively monitoring and auditing their license agreements. After addressing the most common objections licensors have to royalty auditing, I describe various approaches used to select licensees for audit and discuss the contributions of licensing professionals and legal counsel at different stages in the royalty audit process, including post-audit resolution. Finally, guidance on actions licensors can take to limit the risk of royalty underreporting, including suggestions for license agreement terms as well as the characteristics of successful licensing compliance programs is provided.

Definition of Royalty Audit

A “royalty audit” is defined as a procedure performed by an objective third party, usually a CPA, to determine the accuracy and completeness of royalty reports submitted by a licensee to a licensor. The notion of completeness is particularly important because it focuses on the existence of conditions not reported to the licensor that should have been reported. Royalty audits almost always are conducted in the context of a potential dispute, which has implications for the manner in which the royalty auditor maintains his or her work papers. Royalty audits are different from financial statement audits, in which a CPA renders an opinion as to whether his client’s financial statements are fairly stated. In fact, many CPAs use terms such as “royalty examination” or “licensing investigation” to describe a royalty audit. However, because so many non-accountants employ the term royalty audit to describe services encompassing the examination of a licensee’s royalty reporting, it has been adopted in this article.

Reasons for Performing Royalty Audits

Licensors conduct royalty audits to assess licensees’ compliance with the terms of license agreements. This includes the manner in which licensees interpret potentially opaque terms in license agreements, as often is the situation when the licensed property is early-stage technology and the ability to manufacture and commercialize products embodying the licensed property were significant risks when the agreement was executed. This is of the highest importance, because aggressive interpretation of nebulous terms has caused some of the largest royalty underpayments.

Although it cannot be stated that all, or even most licensees underreport, my experience has been that most royalty audits result in recoveries of underpaid royalties, with recoveries in the millions of dollars being distressingly common. Over time, I believe a systematic program of periodic royalty audits is likely to produce recoveries of ten dollars for every dollar of cost. In many cases, licensors also are able to recover audit costs and interest on underpayments.

In addition, licensors should expect the quality and timeliness of royalty reporting to improve once licensees learn that the licensor has implemented an ongoing royalty audit program. Finally, lessons learned from royalty auditing tend to be incorporated

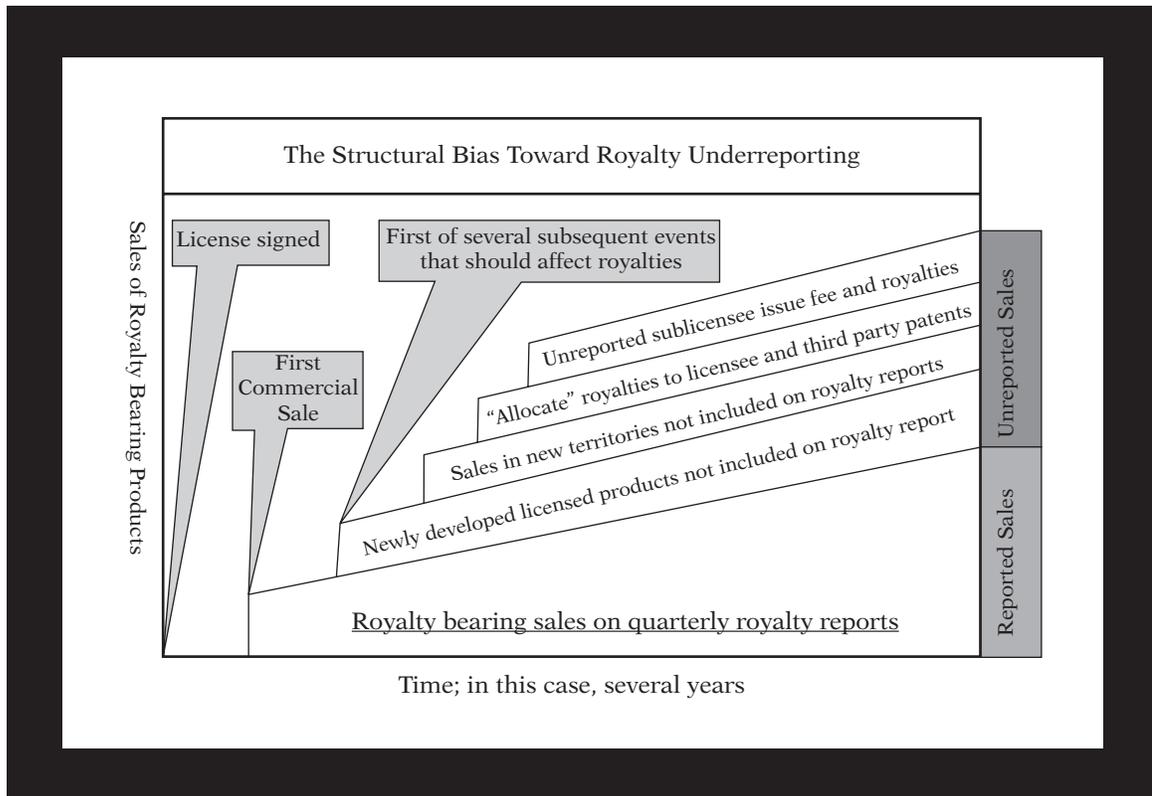
into the provisions of renegotiated license agreements with existing licensees, as well as new agreements with other parties.

Structural Bias in Licensing Toward Underreporting

Having performed a very substantial number of royalty audits, I have analyzed how circumstances tend to play out over time after two parties enter a license agreement. In most royalty audits, there are multiple forms of underpayment. It is usually the case that the conditions giving rise to underpayment arose after the first commercial sale of those products for which the licensee was paying royalties. In other words, the propensity for sales of licensed products to “fall through the cracks” increases over time. This structural bias does not imply dishonesty on the part of the licensee, though the licensor cannot ignore that possibility. Rather, at the risk of stating an obvious point, a contract is an imperfect tool to use to model for an uncertain future in which the licensee may derive a financial benefit from its own lack of rigor in striving to capture all royalty bearing transactions that occurred during a period. Exhibit 1 illustrates how events occurring after the agreement was executed are likely to result in greater proliferation of use of the licensed property while simultaneously requiring the continued attention of the licensee to ensure all royalties and other income due to the licensor are accounted for.

In Exhibit 1, the licensee paid royalties over time on a given set of products but failed to pay royalties on additional licensed products the licensee developed or on the sale of licensed products in new territories. An underpayment occurred when the licensee took a license from a third party and, without the benefit of a stacking provision, reduced its royalty burden under the license agreement to account for the fact that patents from multiple parties covered the licensed products. Finally, the licensee granted a sublicense and failed to pay the licensor its share of a license fee or earned royalties. So, over time, a number of events occurred involving the licensee’s proliferation of the licensed property within product lines, business units, and territories in which it operated. In addition, the licensee entered into sublicense and license agreements involving the licensed property or the licensed products. Together, these events resulted in a substantial amount of underreported sales. The point in this illustration is simply that it takes a very committed licensee to identify these events and to ensure that the licensor receives just compensation. Most licensees

Exhibit 1



are not this committed. That is why licensors need to monitor licensees and conduct royalty audits on a systematic basis.

Licensor Objections to Royalty Auditing Are Often Misplaced

Licensors generally object to doing royalty audits on two grounds: (1) they are expensive and (2) they will harm relationships with licensees. These are substantive concerns, but we believe they are exaggerated. The cost to perform a royalty audit must be balanced against the considerable benefits. Over time the benefits of royalty auditing more than pay for itself. When underpayments are sufficiently large, the licensee may bear the cost of the audit. In any case, most companies have been on the same accounting system for at least three to five years, the usual look-back period for a royalty audit. Five or ten years ago this was not generally the case, requiring royalty auditors to deal with records from at least two different accounting systems, where the ability to run customizable reports, or to use licensee data

in electronic form was not what it is today. Although it is impossible to speak for all royalty auditors, these efficiencies should reduce significantly the number of hours required to complete a royalty audit in 2009 as compared with several years ago.

A licensor should consider asking the royalty audit firm for a not-to-exceed fee quotation: an opportunity to review the license, relevant amendments, and royalty reports, supplemented by their own research, should be adequate to give experienced royalty auditors the necessary comfort to make such a commitment. Some licensors want royalty audits to be done on a contingency basis. However, the licensor would do well to consider beforehand the potential impact to the royalty auditor's credibility as an expert witness in the event the licensor and licensee enter into litigation.

Licensees do not, as a general rule, react negatively to notification of a royalty audit. They understand they have a contractual requirement to make relevant books and records available to the licensee's representative. They also understand that the recent accounting and financial scandals have heightened licensors' awareness of their own role in safeguarding their assets and ensuring transparency

concerning their value and performance. This is as true for IP and license agreements as it is for any other asset, and licensees understand this is part of a licensor's best practices. Nevertheless, licensors can "soften the blow" by notifying all of their licensees that the licensor is implementing an ongoing royalty audit program. Indeed, our clients often elect to use this opportunity to request that licensees complete a brief questionnaire relating to the manner in which licensees determine royalties payable, suggesting that the licensees' replies will be one factor taken into consideration in ranking royalty audit candidates. The questionnaire should strike a balance between seeking information that is useful and being so burdensome that the licensee decides they are better off ignoring it. Often, these questionnaires induce licensees to conduct limited "self-audits" that produce additional royalty payments. Still, licensors should be cautious regarding such self-audits. Although they may disclose certain errors obvious to the licensee, they do not typically inspire re-examination of the contract interpretation issues that often are at the source of very large underpayments.

Primary Reasons for Royalty Underpayment

Most audit post-mortems reveal that, in dollar terms, most royalty underpayments relate to aggressive interpretation of license terms by the licensee. This may mean, for example, that products that should have been treated as royalty bearing were excluded from the royalty calculation, or that the licensee treated only part of the sale as being royalty bearing, or the licensee adjusted its royalty liability downward to reflect the fact that its own patents were practiced in the products at issue. These types of underpayments are highly correlated with limited royalty report disclosures regarding the number of units sold and the prices at which the sales occurred.

Other common types of royalty underpayments include: (1) failure to capture all royalty bearing sales as the licensee achieves greater proliferation of products embodying the licensed property, (2) unreported sublicensing income, (3) unreported benchmark or milestone payments, (4) transfer pricing and/or exchange rate discrepancies, (5) inappropriate deductions from royalty bearing revenue, and (6) other miscellaneous errors. All of this is well and good in terms of explaining the results of royalty audits and the reasons for underpayments. However,

of greater relevance to licensors is to know before the fact which licensees are attractive candidates for an audit.

Selecting Licensees to Audit

Licensors either employ a systematic approach to royalty auditing or they do not. Those licensors that have a systematic approach typically audit their larger licensees on a periodic basis, usually every few years. For the remainder of their licensees, the licensor should plan to audit enough licensees each year to provide a level of coverage over a multi-year period that they believe will be sufficient to: (1) communicate to their actual and prospective licensees their seriousness in monitoring licensee compliance, and (2) provide adequate empirical data to allow the licensor to evaluate the effectiveness of its compliance activities and adjust them accordingly.

Whether licensors have a systematic approach to royalty auditing or simply audit licensees on a case-specific basis, the decision to audit is usually predicated on the existence of enough warning signs or red flags that a tipping point is reached at which the risks of auditing are outweighed by the risks of not auditing a licensee. How can a licensor be confident that it has sufficient data to determine the existence of these warning signs? At what point should the licensor conclude that the tipping point has been reached and that the most reasonable course of action is to initiate a royalty audit?

In reviewing the results of royalty audits over the years, I have observed that certain red flags appear regularly, often regardless of the context (industry or business model) in which the royalty audit occurs. In most cases, the red flags could have been identified by the licensor *prior to* the royalty audit. From this, our firm has developed a "scoring chart" to assist licensors in ranking potential royalty audit candidates by the degree of risk for material levels of underpayment. In the scoring chart (*see* Exhibit 2), each of 12 factors is assigned a point value of one to three points. Some of the factors contain two separate but similar elements; if both are present, count the associated points twice. Four of the factors have a weighting of three points, four are worth two points, and the remaining four are each worth a single point. Of course, these point values are not ironclad. Depending on the circumstances, some factors may deserve a greater or lesser weight. In general, however, the presence of three separate three-point factors, or a total of at least 12 points for all red flags that are checked off, indicates the licensee is a strong candidate for a royalty audit.

Exhibit 2: “Scoring Chart” for Selecting Royalty Audit Candidates

Factor	Description	Points	Yes / No
1	Licensor’s gut instinct and research indicates a problem may exist, or there is a “whistleblower” such as a current or former employee of the licensee	3	?
2	Royalty reporting is late or incomplete; royalties are declining sequentially or there are inconsistencies with the licensee’s financial disclosures, industry trends, or the reporting of other licensees for the same property	3	?
3	There are sublicenses for which you have not been provided copies of the sublicense agreement(s)	3	?
4	The invention is one part of an assembly containing multiple components and the licensor cannot clearly determine the royalty base used by the licensee; or, the royalty calculation based on cost of goods, profit, or some other allocation formula	3	?
5	The licensee manufactures licensed products overseas or sells them overseas through distributors or affiliates	2	?
6	The licensee is under scrutiny from regulatory bodies such as the SEC or FTC	2	?
7	There has been turnover in key roles such as CFO, Controller, or General Counsel, or it has been announced that the licensee will be acquired by a third party	2	?
8	The licensee is in a distressed financial condition, or is seeking to renegotiate the license; or, the licensee has stated that it has a “design around” the licensed patent	2	?
9	There is poor communication between the licensee’s accounting, legal, and product development functions	1	?
10	The licensee uses the invention in multiple product lines or processes	1	?
11	The licensee pays the minimum royalty year after year but does not pay an earned royalty	1	?
12	More than five years have passed since the licensee was last audited	1	?
		Total	Audit if 12 or more

Let’s consider some of the factors individually. Factor 4, where the product in which the licensed patent is embodied is a complex article of manufacture with multiple components, can be especially important when early-stage technology was licensed and the licensee performed significant work bringing the product to market. In such cases, licensees may feel

empowered to make unilateral decisions about the royalty base or other elements of the royalty calculation (*i.e.*, excluding components of the entire product from royalty bearing revenue, or to assign a lower, proxy price to the components treated as royalty bearing). I have heard many explanations for such unilateral adjustments, yet the licensee’s logic was

never so inescapable that it was shared with the licensor, and in every case the effect of the change reduced royalties dramatically.

In one of the many examples of this theme, a licensee assigned a value to certain components of a multi-part device. Those royalty-bearing parts were not sold separately, and, in any case, the price the licensee assigned was clearly low by comparison with the contribution of the components as drivers of customer demand. The licensor's argument that the royalty should not have been calculated on anything other than the price for the entire system eventually prevailed and the licensor demanded significantly greater transparency in subsequent royalty reporting.

Some factors are less obvious because they are not observable from the license agreement, royalty reports, licensee financial statements, or press releases. Factor 3 involves the existence of sublicenses for which the licensor has not received a copy of the sublicense agreement. In recent years, several of our royalty audits identified large sublicensing-related underpayments to licensees. In each case, the licensor was not provided a copy of the sublicense agreement. In two cases, the arrangements were called something other than a sublicense (*e.g.*, a "Teaming Agreement") and the licensee never disclosed it had received substantial upfront payments it was obligated to share. In another case, the sublicense grant was one of multiple assets exchanged in the deal and a lump sum payment was made to the licensee with no allocation of the payment by asset class. As a result of the royalty audit, the licensor and licensee were able to negotiate a share of the lump sum payment from the sublicensee to the licensee that was to be paid to the licensor.

Factor 7 (turnover in key licensee personnel, or acquisition of the licensee) is another red flag that deserves greater attention than it typically receives. When those individuals who negotiated the license for the licensee leave their positions, their replacements are likely to review contracts and license agreements, if only to understand them. In many cases, they have a different interpretation than their predecessor. The reader perhaps may share my dismay that I have never found a situation in which the new reading of the agreement resulted in a greater amount of royalties being paid. When you become aware that one of the original negotiators has left, it is always a thoughtful gesture to call his or her replacement to introduce yourself. At that time, ask the new person to confirm the propriety of their predecessor's approach to calculating royalties, and then summarize your conversation in an email or letter.

Regarding acquisition of a licensee, the other element of factor 7, the acquirer may welcome the royalty

audit because they may be able to take an adjustment to the purchase price paid to the seller-licensee for any underpayments as well as interest, audit costs, and the present value of higher future royalties.

Licensor's Role Before, During, and After the Royalty Audit

As part of ongoing due diligence regarding its licensees, the licensor's staff should analyze royalty reports sequentially to track sales and the part numbers of licensed products. In addition, the licensor should review relevant Web sites, press releases, and regulatory filings—these often are valuable stores of information. More licensors are doing this, but only a few have internalized these and similar activities as part of best practices. It is essential to do.

Royalty reporting problems often stem from a lack of communication between the licensor and the licensee. Mistrust tends to build, and basic questions—How do you define a licensed product in coming up with the royalty?—often go unasked. One of the single most effective things you can do to limit the risk of underpayment is contact each licensee to review their royalty calculation methodology soon after they first report a commercial sale. If the licensee is local, pay a visit and have them walk you through their calculation, together with supporting documents. Afterward, document your understanding in a letter.

Once the decision is taken to conduct a royalty audit, the royalty auditor will request data to prepare a preliminary information request to provide to the licensee. At a minimum, the royalty auditor will need the license agreement, relevant amendments, sublicenses, royalty reports, and possibly other information, as well as access to certain licensor personnel. By this time, the licensor and royalty auditor should have a shared understanding regarding written communications during the engagement, as well as the royalty auditor's document retention policies.

The licensor should notify the licensee by email or letter of the decision to undertake a royalty audit and that the audit commences on that date. Sometimes, licensees will pay back royalties before the royalty auditor conducts a site visit. The licensee usually expects these underpayments will not be used in determining whether or not the licensee will bear the costs of the audit. I disagree with this view and believe those payments should be added to any additional underpayments found by the royalty auditor in determining if any threshold level specified in the license agreement regarding audit costs has been exceeded.

The licensor should expect the licensee to require the royalty auditor to enter a confidential disclosure agreement (CDA). The CDA should permit the royalty auditor to discuss all findings with the licensor, and to consult with the licensor and its agents on matters regarding the licensee's use of the licensed property.

During the royalty audit, the licensor or its outside counsel should be available to consult with the auditor (in a manner consistent with any CDA) on technical matters and to review the auditor's preliminary findings before the auditor shares them with the licensee in a site visit exit meeting.

After the royalty audit, the licensor should act quickly to press its claims. You will need to identify the right licensee contact, and direct an effective collection letter to that individual. The senior licensing person or the senior business development person for the business unit is a good place to start. This individual usually will be highly motivated to avoid a notice of termination from the licensor. Determine whether the licensee has substantive reasons to dispute the findings of the royalty audit. Conduct the follow-ups quickly—often, licensors wait too long after detecting a problem to initiate the audit—by making the same mistake after the royalty audit is complete, the licensor allows the problem to grow. Delays in achieving resolution also may impact both parties' negotiating strategies, especially when the licensee has a credible good faith argument for the underpayment. If the licensor delays, the licensee may read that as a sign that resolution is not a high priority or that the licensor lacks conviction in its claims.

Remember, the licensee's goal will be to settle the matter for pennies on the dollar. Expect the licensee to seek to negotiate away a portion of the amount owed, interest on late payments, and responsibility for the audit fee. Also expect a request that back-royalties be paid over time as opposed to all at once. Acting quickly after the audit will limit the size of the problem from growing and impress upon the licensee their need to take the matter seriously. Establish firm deadlines for payment and other actions necessary to resolve issues identified in the royalty audit, specifying consequences if the deadlines pass unmet.

License Agreement Language Can Reduce Risk of Underpayment

A well-crafted license agreement is central to the licensor's efforts to ensure the measure of royalties

received meets expectations. Too often, licensors seem unwilling to press during license negotiations for the kinds of protections they later wish they had. Although it is not always possible to secure all of these protections, it is recommended that the royalty- and audit-related provisions of license agreements achieve as many of the following goals as possible:

- Accounting terms used in the license agreement should be recognized terms of art.
- Royalties expressed as a percentage of gross sales, net sales, or as an amount per unit are much easier to verify than royalties expressed as a measure of profit.
- Sales to Affiliates should be valued at the sell-through price to end user.
- If a tiered royalty structure is used, be clear whether thresholds are cumulative or reset periodically.
- Allowable deductions from gross or net sales should be defined clearly.
- Right to meet or confer with licensee after first commercial sales to gain an understanding as to their definition of the licensed product(s) and royalty calculation methodology.
- Right to audit, at least annually.
- Right to select royalty auditor.
- Books and records should be retained for at least five years, and the auditor should have access to key licensee personnel and to be able to copy relevant licensee records as part of the royalty audit.
- Avoid provisions that state that the royalty audit may not extend beyond a specified prior reporting period.
- The books and records provision should be broader than simply "royalty-related documents" and should include marketing and technical documents, records necessary to reconcile sales of licensed products up to the income statement level, and production and inventory records adequate to perform an inventory rollforward analysis.
- State that any CDA in connection with a royalty audit will permit the auditor to meet with relevant licensee personnel, retain copies of documents, consult with licensor personnel on technical matters, and convey all findings to the licensor.
- The licensee should be responsible for the costs of the royalty audit in the event of discrepancies of 5 percent or more in any period covered by the audit.
- Audit rights should extend at least one year beyond termination.

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- Late payments should bear interest of at least one percent per month compounded monthly.
 - Consider including additional monetary penalties, such as a percent of the amount underpaid, or a figure that compensates the licensor for its administrative time associated with the royalty audit.
 - Include a “*MedImmune* provision” to state the effect on royalty rate (or on the agreement itself) if the licensee brings an action for declaratory judgment of invalidity.
 - Consider using examples to illustrate how the parties intend for the royalty calculation to be performed, especially in connection with issues related to royalty stacking, combination products, or defining the correct royalty base to use when products contain multiple components or are sold in conjunction with other products.
 - Sublicensees need to be pre-approved by the licensor and the licensor should receive the same audit protections as between licensor and licensee.
 - Be as broad as possible in covering the types of sublicensing income to which the licensor is entitled to participate (include a “for the sake of argument” statement for clarification purposes, if necessary).
 - The licensee must provide copies of all sublicense agreements and royalty reports, and either the licensee or the licensor should have the right to initiate a royalty audit of the sublicense (or third-party manufacturers).
 - The licensee should be required to inform the licensor when it has received a buy-out offer or when there is turnover among senior licensing or financial personnel.
 - Licensees should use your royalty reporting format, a sample of which should be included as an exhibit to the license. (Feel free to contact this author for a template that may be customized to suit your specific needs.)

In conclusion, it is not possible to know the propensity of a licensee to underreport. However, experience shows that, for those licensees for whom numerous red flags are present, the risk of substantial royalty underreporting is high. These risks are likely to be exacerbated during periods of significant economic stress. I believe these risks are most effectively managed in the context of a systematic licensing compliance program that includes periodic royalty audits.

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