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Use these strategies to contain patent prosecution costs

There is no inexpensive way to go about prosecuting a patent, but at the same time, TTOs spend tens of thousands of dollars every year on late fees and other expenses they might have avoided with a better game plan on the front end of the process. That's the word from several tech transfer officials, whose organizations have developed a collection of strategies to keep their patent prosecution costs from spiraling out of control.

When it comes to the ratio of patent costs to number of applications filed, **David Allen**, PhD, associate VP for technology transfer at the University of Colorado system, says his TTO is one of the top performers, according to data compiled by AUTM. He cites two key reasons: "One is that we mostly use

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Revamped inventions policy adds incentives, removes disincentives for researchers

The University of Toronto's (UT) TTO has revamped its inventions policy in hopes of jump-starting its tech transfer activities. The strategy involves dramatically increasing financial rewards for researchers and removing disincentives to using the TTO as a commercialization partner.

The policy changes were combined with an institutional shift that brought the TTO in-house and removed the requirement that it completely fund its own activities. The goal is to enable tech transfer staff to take on more invention files, as well as encourage more inventors to bring them to the Innovations Group, as the TTO is known within UT.

"It's early days yet, but we seem to be getting assignments to the university [from researchers] who might previously have retained ownership," says Innovations Group executive director

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Guest Commentary

Tips for when and how to conduct an effective royalty audit

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Royalty auditing is an important topic for all licensors, helping keep everyone honest during the term of a license agreement.

To be sure, not all licensees underreport royalties, but if you've spent any time looking over royalty reports, you know how impenetrable they can be. Here are a few common examples where clarity is often lacking:

• you may not be able to tell whether new products practicing the patent are captured in the royalty calculation;

• it may be unclear whether sales through the licensee's overseas subsidiaries are captured at the transfer price or end user price;

• you may be unable to decipher that the licensee changed its royalty calculation to pay royalties on only a single component of a larger apparatus.

In short, enough licensees do underreport, often innocently, that royalty auditing must form part of a your TTO's comprehensive IP strategy. In our experience, most audits result in recoveries well in excess of audit costs and produce higher royalties going forward. Underpayments in the millions of dollars are distressingly common.

Use scoring chart to ID red flags

We have observed in audit post-mortems that certain red flags appear regularly regardless of the industry or licensed technology. From this, we developed a "scoring chart" to help rank potential audit candidates. Each of its twelve factors is assigned a value of one to three points: the presence of three separate three-point factors, or a total of at least twelve points across all of the factors, indicates the licensee merits closer scrutiny.

Red flags (12 factors):

1. Licensor's gut instinct and research indicates a problem may exist; inventor strongly believes there is underreporting; there is a whistleblower (3 points)

2. Royalty reporting is late/incomplete; inconsistent with financial disclosures or industry trends or reporting of other licensees the for same property (3)

3. Royalties are declining sequentially without clear reason; large, unexplained deductions are taken against royalties or royalty-bearing sales (3)

4. Complex royalty calculation based on cost of goods, profit or other allocation formula; or the invention is one part of an assembly containing multiple components (3)

5. Overseas distributors/affiliates/manufacturing; there are sublicensees for whom you have not been provided agreements and royalty reports (2)

6. 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, General Counsel or IP Counsel; it has been announced the licensee will be acquired (2)

8. Licensee has sought renegotiation of royalty terms or has stated it has a "design around" (2)

9. Licensee pays minimum royalty year after year, but no earned royalty (1)

10. There is poor communication between licensee's accounting, legal and product development functions; management information systems are weak (1)

11. Licensee uses invention in multiple product lines or processes (1)

12. Patent is near expiration and licensee has never been audited (1)

Weight adjustments may be necessary

Depending on the circumstances, some factors may deserve greater or lesser weight. Factor 4, for example, can be highly important, especially where early-stage technology was licensed and the licensee performed significant work bringing products to market. In those cases, licensees may feel empowered to make unilateral decisions about the appropriate royalty base or other elements of the royalty calculation. We have heard many explanations for these unilateral adjustments, yet the logic was never so inescapable that it was shared with the licensor, and in every case the effect of the change reduced royalties. In one of many examples of this theme, a licensee determined the royalty on the "value" of patented components of a device that included other components. The royalty-bearing parts were not sold sepa-

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rately and the licensee applied a price that was artificially low for purposes of calculating the royalty. The licensor's argument that the royalty should not have been calculated on anything other than the system price eventually prevailed, but the underpayment went on for three years before the audit.

Some of the factors are less obvious. For example, factor #5 relates to sublicensing. In the past two years, five of our audits found large sublicensing-related underpayments. 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., "Teaming Agreement") and the licensee never disclosed it had received substantial up-front 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. The licensee ultimately backed away from its position that no proceeds were due to the licensor.

Factor #7 is another less obvious source of potential underpayment. New legal or financial personnel in the licensee organization often review existing agreements as a good place to squeeze down costs (think royalties) based on their interpretations of those agreements. That's why it's important for TTOs to monitor turnover in key roles. You may wish to proactively introduce yourself and ask the new person to confirm the propriety of their predecessor's approach to calculating royalties. Regarding acquisitions of a licensee, the other element of factor 7, the acquirer may welcome the audit since 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.

Be a proactive communicator

TTO staff should analyze royalty reports sequentially to track sales and part numbers. In addition, review relevant websites, press releases, and regulatory filings -- these are often valuable stores of information. More TTOs are doing this, but only a few of our clients have internalized this as part of best practices. It is essential to do so.

Most problems with royalty reporting stem from lack of adequate communication. Mistrust tends to build, and basic questions ("How do you define a licensed product in coming up with the royalty?") often are not asked. 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 a recent quarter using their accounting records. Afterward, document your understanding in a letter.

For TTOs with many licensees, we often structure questionnaires covering, among other things, royalty payment practices. Questionnaires can be used to raise licensee awareness of the potential for an audit ("licensee responses will be one factor we consider in our selection of audit candidates") and often result in additional payments as licensees conduct limited self-audits. Be careful, though, since self-audits tend to reveal mechanical calculation errors or omitted product codes, but generally do not encompass interpretive issues such as the definition of licensed products.

Audit do's and don't's

In terms of the audit itself and reacting to the results, here are some important issues to address:

- Where underpayments appear to pre-date the beginning of the period being audited, licensees often argue that the audit period should not be extended to an earlier date -- but don't let them off the hook easily. The "shall maintain books and records for X years" provision of a license is not intended to frustrate your attempt to recover underpayments that may pre-date the audit period. If the licensee wanted that protection, it should have secured language specifying that "in no case shall the audit extend more than X years from the last date of the most recently submitted royalty report."
- Regarding fees, seek auditors that charge for their services on an hourly basis, and ask the auditor to provide a "not-to-exceed" quote in their proposal. Contingent-fee arrangements may undermine the auditor's credibility with the licensee or in the context of a legal proceeding.
- After the audit, follow up quickly to resolve underpayments and any other problems uncovered. Too often, TTOs wait too long to audit after detecting a problem and do not follow up determinedly enough to achieve resolution. The size of the problem is usually growing each quarter, making resolution even more difficult. Delays impact both parties' negotiating strategies, especially

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ticated targets, China is still struggling to understand the basic tenets of intellectual property as a key corporate asset. "There are huge problems in China with export controls, and particularly software work can go out the back door. They have some very new IP statutes. You name it, from top to bottom, it's fraught with problems," West warns.

His company, TPG, has focused much of its effort on German companies that want to enter the $80 billion U.S. medical device market. A medical device powerhouse long known for cutting-edge technology, Germany is home to more than 1,000 companies making anything from surgical equipment to prostheses.

Ready to pitch your technology

After the market research is done, you've targeted prospect companies and individuals, and you've even identified a local attorney or consultant to help out, be careful about how you approach people from different cultures, Borman stresses.

"You don't have to be an international diplomat, but you have to be pretty savvy and sensitive," he says. "There are always [cultural differences] and laws that you have to be aware of."

For example, there are basic differences between U.S. and European marketing styles. "U.S. companies' marketing tends to focus on the benefits," West says. "American style is more in your face. Like car commercials telling you it's not just a 300 horsepower engine, but driving it will make you grin from ear to ear when you hit the pedal. Europeans tend to market their products by focusing on the features; it's more subtle."

He has also noted a distinct difference in negotiating styles in cross-border deals. "Americans are willing to start the negotiations farther apart and then come to a consensus," West says. "Europeans start negotiations with the two parties closer together."

de Wit says to beware of treating Europe as one homogenous region. "The speed of doing business is different too," he adds. "In Spain, Italy or Portugal, the issues of culture become much more different from America than in the U.K., Holland or Germany. You might find that you must be much more patient than when you do deals in the U.S."

[Editor's note: Encouraging International Technology Transfer, published by Geneva, Switzerland-based International Centre for Trade and Sustainable Development, can be downloaded at http://www.iprsonline.org/unctadictsd/docs/CS_Maskus.pdf.]

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where the licensee has a credible good faith argument for the underpayment. Expect licensees 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 can reduce their ability to soften the blow and can bring more total dollars into the TTO.

Contracting tips

Well-crafted license agreements that limit the potential for underpayments and secure effective audit rights are crucial to ensuring your office gets all the royalty revenue it deserves. Key contractual items in this regard include:

- make sure accounting terms in the license agreement are recognized terms of art;
- a royalty expressed as percent of net sales is best (do not use "net sales in accordance with GAAP"), and avoid royalties based on any measure of profit;
- carefully define allowable deductions from net sales;
- seek a five-year books and records retention period and a provision for the licensee to pay the audit fee in the event of a 5% or greater underpayment in any period audited;
- your audit rights should extend at least one year beyond termination;
- require the licensee to provide all sublicense agreements and royalty reports, and either the licensee or the licensor should have right to audit the sublicensee.

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