



## It's Just Not Fair: Unintended and Unforeseen Interpretations of License Agreement Language

By Debora R. Stewart, CPA/CFF and Judy A. Byrd, CPA/CFF

### About InvoTex Group

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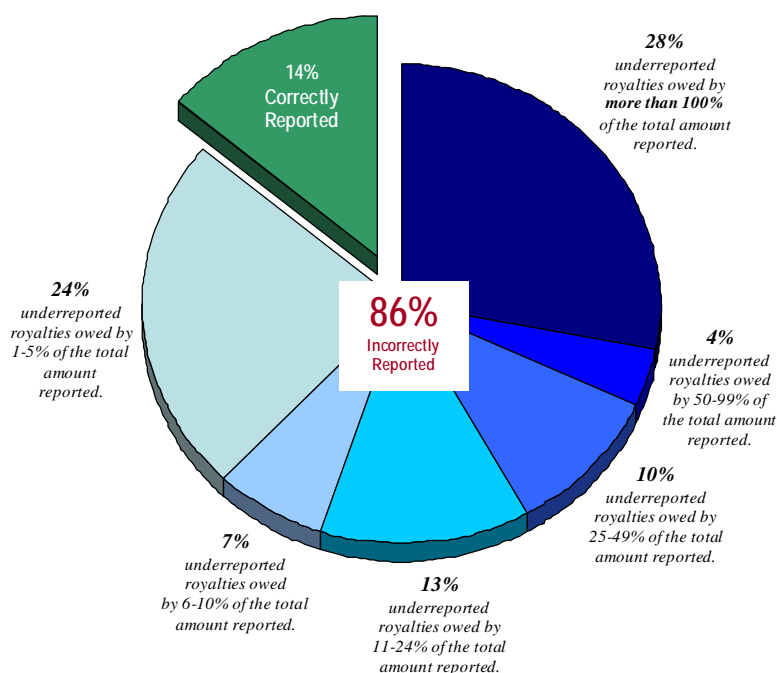
### About the Authors

**Debora R. Stewart, CPA/CFF**, is a Managing Director and co-founder of InvoTex Group's IP Management & Finance practice, which assists clients in managing their intellectual assets. With more than 20 years of financial and consulting experience working with corporations, universities and government entities and their counsel, Ms. Stewart provides strategic assistance and tactical expertise to help clients optimize the value of their IP, primarily in the areas of License Management and Royalty Compliance. She can be reached at 410.824.0141 or [dstewart@invoTex.com](mailto:dstewart@invoTex.com).

**Judy A. Byrd, CPA/CFF** is a Director with InvoTex Group's IP Management & Finance practice. With over 20 years of financial consulting and audit experience, Ms. Byrd joined InvoTex to perform royalty audits. In both public accounting and corporate settings, she has led financial statement and royalty audits and other assurance engagements in various industries. She can be reached at 410.824.0142 or [jbyrd@invoTex.com](mailto:jbyrd@invoTex.com).

Chart 1

**Underreported Royalties as a Percent of Reported Royalties**  
86% Underreported – 14% Reported Accurately



*Eighty-six percent of licensees misreport their royalties to their licensors. This means that in each case of misreporting, a licensor should be exclaiming, "It's just not fair!"*

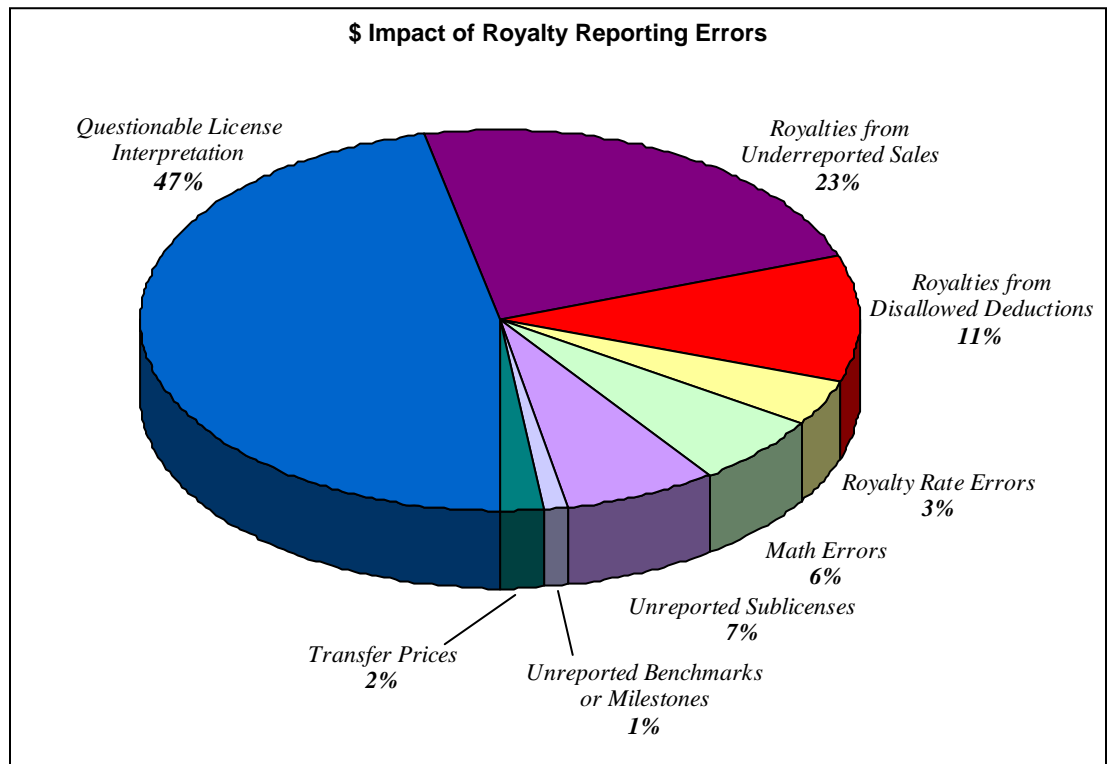
Your mother was right. At least about this statement: Life is not fair. There are vivid memories of friends who got away with copying each other's exam papers and all scoring *As* while others of us studied hard, worked alone and earned the best we could. There are other memories of the person who got a great job in a prestigious firm because their aunt was in the human resources department. And everyone's favorite: "You can not compare your salary or your raise with anyone else's, even if you've done an exemplary job and have been with the company longer." It's just not fair.

Remember another cliché: All's fair.... Your partnership with your licensee is a relationship. At one time you were in love. Now, you find that time has marched on, and ambiguities may have entered this once loving relationship. No, it is not all fair.

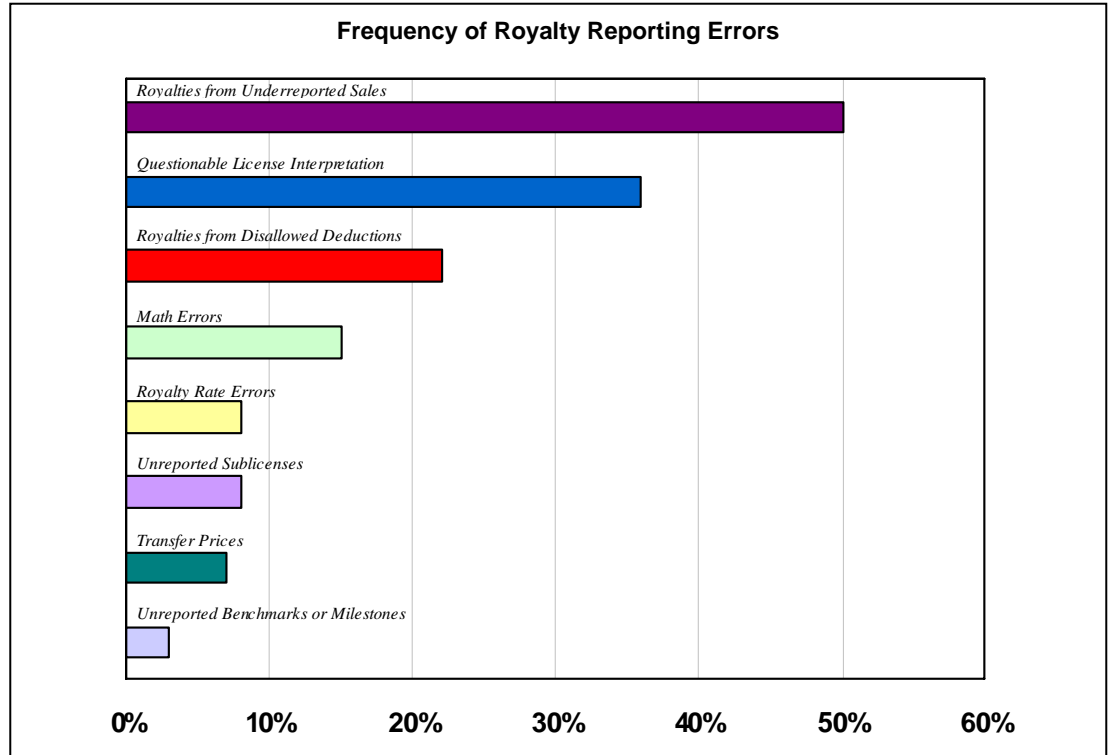
Our royalty audit practice puts us in a unique position to observe how all parties to a given license agreement position themselves, manage their businesses and interpret the written words that bind them. It is not a surprise that issues arise. As illustrated in **Chart 1**, our latest statistics show that in 86% of the licenses we audit, there are instances of misreporting. With regular frequency we see oversights when it comes to new products launched or when sales are made in new territories. In fact, as shown in **Chart 3**, this is

our most common finding. Underreported sales occur approximately 50% of the time. Other errors, such as math errors and royalty rate errors, occur simply because someone did not check their work. However, there are other categories of findings that are characterized another way: unexpected, unintended license interpretations and unforeseen business model changes. Sometimes such issues can be measured and quantified, and they show up in our License Interpretation category, as shown in **Chart 2**. Other times, as unfair as it seems, we are not privy to the documents that would allow quantification because, in accordance with the language of the license agreements, the licensor is just not due compensation for the manufacture, sale or use of the product or service.

**Chart 2**



**Chart 3**



This article focuses on some definitions, terms and conditions of license agreements that, when written, seemed to encompass what was fair, according to how you saw both the relationship and the businesses developing over time. You agreed to sign because you understood each other's goals and direction to reach those goals. Years later, you find out that your partner has changed focus, has a new direction or even has new management who interpret the relationship differently. It is difficult to foresee all the ways technology might be used or sold and also is difficult to envision how businesses and relationships might change over time. Sometimes your partner is moving ahead without you, denying that you had anything to do with the success they've enjoyed. Almost always though, our relationships change. It is not surprising that these changes, when taken into the construct of license agreements, can have severe monetary effects and leave the Licensor feeling as if it's just not fair.

### **Business Partners/Sublicenses**

There are a host of issues related to new relationships. For starters, you agreed to an open relationship, and you granted rights to sublicense. When the terms were drafted, everyone agreed that the sublicensee could make, use or sell licensed products and that the flow-through royalties would be 25% of the royalty payments the licensee received. Now you've learned that the licensee has such a relationship with another party who is selling the licensed technology in Europe. The licensee hasn't told you about it, but your license manager saw the press release. When you ask the licensee, you're told that this is not a sublicense but merely a distribution agreement and that the distributor is a third party. What your licensee isn't telling you is that they sell to this distributor for an agreed upon reduced price, a transfer price, and the licensee gets a payment of 3% of the distributor's sales. Instead, the licensee claims that this isn't a

sublicense because they don't have access to any of the licensed technology. Distributors, marketing partners and development partners are frequently masks for sublicenses, and a sublicense by another name may still be a sublicense. You may not be getting your fair share.

Perhaps the licensee did tell you about the sublicense and even provided a copy of the sublicense agreement with their latest royalty report. That sublicense agreement has all the terms and conditions consistent with their license agreement with you, the licensor. The licensee even paid 25% of the royalty they received! This is all going to plan, right? However, when you get around to reading the sublicense agreement, you notice that the royalty rate is much lower than expected. Why would that be? In lieu of a higher royalty, the licensee negotiated a rather large signing fee and really large milestone payments based on sales. Your license agreement didn't contemplate signing or milestone fees. As such, your royalty report didn't include that signing fee! Hey, that's not fair!

What if you were again told about that sublicense, and this time, instead of it being a distributor, the sublicensee was a no-name little development partner? Or, maybe the licensee, who never intends to develop a product, has a number of these sublicenses forming joint ventures for development. You receive copies of the sublicense agreements and you get a very reasonable royalty under those sublicense agreements. The sublicensees are diligently doing their research and development, and you are getting progress reports. All is well and continues to be well for many years. The sublicensed development partners are

making slow progress until all of a sudden there is a breakthrough. One development partner finally gets a blockbuster product ready for market, and the outlook is phenomenal. Sales are projected to skyrocket. This is great. Too bad the patent expires next year. You, the licensor, may never enjoy the flow-through royalties of this blockbuster product, as the license is about to terminate. How unfortunate. Then, to add insult to injury, the final audit of the agreement reveals that you did not get a piece of the development milestones the sublicensee paid for their license. Is this fair?

What might make this last scenario even more painful is if the licensee received some stock in this development partner under sublicense. Now that the blockbuster is in the mix, the no-name little development partner is being acquired by a large, wealthy, multinational, public company. The licensee is going to make a ton of money from their stock ownership in no-name after the acquisition closes, and you, the licensor, get nothing. Ouch!

Sometimes there might just be a cross-sublicense including the licensed technology. No money exchanges hands, so it is very difficult to track the value of the exchange and nearly impossible to report on a royalty report.

## **Service Revenue / Changes in Business Models**

Now we will move away from the sublicense issues and on to another but no less prevalent finding. What happens when the licensee, the company that promised they were interested in manufacturing and selling the licensed

product, changes direction? For a few years they worked under the manufacturing business model and although you, the licensor, were happy, the company was busy thinking of change. The licensee's new management team noticed that the market for the licensed product was good but there was also an unfilled need related to providing services using the licensed product. The company changed focus to service revenue, and they now employ just a few of their manufactured licensed products – there was no sale so there were no royalties paid on the products. The licensee did generate service revenue of 10 times what product sales revenue would have been. Does the licensee have to pay a royalty on the service revenue? No, not unless royalties on service revenue were included in the Net Sales definition. Many of us wish we had a crystal ball to let us know how our technology was going to be used so we could write that into the license. It is difficult to consider all scenarios and write in contingencies that will stand the test of the negotiation process and time. It's just not fair.

### **Non-specific Deduction Definitions**

Let's briefly discuss deductions. Gross to Net Sales deductions are common, and, sometimes, very little thought goes into them when drafting a license agreement. Usual and customary discounts, credits for returns and allowances, taxes and tariffs on sales and, sometimes, cost of transportation and insurance are allowed. Be careful to avoid vague language. If the license agreement doesn't specify "on the invoice" or "billed separately to the customer," sometimes licensees expand the definition to include cost of warehousing as transportation to the customer. Company fire insurance premiums

are apportioned and taken on the royalty reports, accrued prompt pay discounts are deducted on the royalty reports even though the customers who purchased the licensed products did not pay promptly. Also, for the record, stop negotiating that commissions to outside third parties are allowed deductions. These commissions are no different than allowing commissions to licensee's own company sales persons; it is a cost of sales. It is like allowing the licensee a deduction for their accounts receivable function costs – it is a cost of doing business, not a cost of the product.

### **Combination Products**

Similarly, be mindful when drafting sales price allocations. Many licenses allow for apportionment of the sales price of a licensed product if that licensed product is sold in combination with other products that may or may not be sold separately. Regularly, this apportionment is based on the sales price of the components sold separately. What if the components are not sold separately? Write that contingency in the agreement. Ideally it should be on the market value of the component pieces but at a minimum, negotiate that if this comes up, the parties will notify and commence further negotiations on the matter. In the absence of this, many licensees are taking it upon themselves to apportion the price based on some other methodology. 2009 was the year of apportionment. We have seen apportionment based on cost to manufacture, and apportioning based on transfer prices as a percentage of combined third party prices, among others. We have also seen licensees apportioning products that, in our opinion, should never have been apportioned because

the pieces cannot be sold separately; rather, they are a required compilation for the licensed technology.

To this last point, be aware that some of your licensees may be selling “knock down” units and not reporting them on the royalty reports. Knock down units are essentially the component pieces of a licensed product that are sold separately and assembled by the consumer. Sometimes only a very small portion of the true sales value, if anything at all, is reported on the royalty reports. This is common practice in some countries. Just be careful.

### **Marketing / Pricing Strategies by Licensee**

Bundling – giving away or selling at a drastic discount – licensed product when customers purchase another product is another way to have the royalty cut unexpectedly. Sometimes free goods may be anticipated, such as for charitable use and indigent patients, but other times this is just a marketing strategy for the licensee who just happens to reduce the royalty. If units aren’t reported, there may simply be a slight decline in the revenue stream.

Bundling can also be seen in another light, commonly referred to as disposables. Frequently, when the licensed product is an instrument, that instrument will require use of a disposable: the old razor, razor blade issue. The company entices you to buy a fancy razor for very little money because that razor requires the continued purchase of some very expensive razor blades. Sometimes the instrument or machinery is even given away so that the customer purchases the

disposable. With larger machinery, sometimes the money follows the insurance coverage. To entice customers to buy, very large instruments are priced low because they have not yet been approved for coverage by insurance. In such a case, insurance may have approved the disposable, so the company charges high prices for the disposable, which is not necessarily a licensed product. In this scenario, it may be possible to argue that it is the price of the combination that should be reported.

Speaking of machinery, don’t forget to consider the potential for leased equipment. If the royalties are based on Net Sales, and this potential exists, include lease and rental income in the definitions.

### **Expiration**

Finally, this article would not be complete without a discussion of the termination of a license agreement and what happens to ending inventory of the licensed product. For this discussion, assume that for the term of the agreement, there was very little disagreement over definitions or products, territories or deductions, and that the relationship was relatively fine. However, at termination, licensed product inventory stock was overflowing. Sales orders might have been held so that royalties did not have to be paid, or perhaps there is just inventory to sell. Try to negotiate royalties on manufactured but unsold licensed product at patent termination to avoid an uncomfortable situation, because it really feels unfair when the licensee says no. This is no way to end what might have been a very mutually enriching and positive relationship.

## **Our Suggestions**

Monitor the agreements that have been negotiated and continue to develop the relationships with your licensees. At least this will maximize the potential that is rightfully yours. Yes, you may realize that what you've negotiated or forgot to negotiate just isn't fair. Learn from these experiences, change the license template and try not to do that again.

Regardless, know that no matter how hard you try, it is impossible to envision every way in which the technology might be employed, how the products that embody the technology will be made, used or sold, and how your licensee's businesses will develop and change over time. This is what makes intellectual property and technology transfer so exciting and one of the reasons we love it so much. The possibilities are endless.

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