

# Technology Transfer Tactics™



The monthly advisor on best practices in technology transfer

## Require detailed royalty reports, audit power in sublicensing deals

Validating an accurate flow of revenue from sublicensees back to the original licensor is one of the thorniest issues of sublicensing, sources tell *Technology Transfer Tactics*. Increasingly, TTOs are placing language in licensing contracts that permits or even obligates them to audit not only direct licensees, but sublicensees as well.

And with good reason. A 2007 report by Invotex Group, an accounting and IP management firm based in Baltimore, indicated that, in 2006, 80% of all licenses had underreported royalties, and 40% underreported their royalties in excess of 25%. Unreported sublicenses accounted for 17% of the total unreported royalty dollars uncovered by Invotex's audits. In fact, errors in sublicenses occur often enough "that I investigate sublicenses in every audit," says **Debra R. Stewart**, PCA, the company's manager director.

One of the biggest issues with sublicenses is that licensors "generally are kept in the dark," Stewart adds. To protect themselves, licensors should include language in their original licensing agreements requiring the licensee to provide them with copies of sublicense agreements as well as copies of royalty reports. Agreements should also give licensors the authority to audit each sublicensee's records, she says.

"Auditing a company that receives a sublicensee royalty statement is useless," Stewart says. "You would know whether you're getting your piece of what the licensee received, but you don't know if that piece is accurate. Licensors should require royalty reports from sublicensees to have at least the same detail that they require from the original licensee."

Based on her auditing experience, Stewart also advocates the use of pass-through royalty rates from sublicensees, enabling the original licensor to receive the same percentage of proceeds as the direct licensee, and she advises licensors to make licensing language clear on this point. In addition, Stewart cautions against allowing licensees to grant any kind of discount to sublicensees. "These don't make economic sense," she says.

But a greater concern is that licensors pay too little attention to the definition of sublicensees in their original

licensing agreements. Especially in pharmaceuticals, many licensors enter into what they call distributor licenses, marketing agreements, and other types of third-party arrangements, Stewart explains. In her view, these are essentially sublicenses, yet the third parties often pay the original licensor only a fraction of the royalty that would be owed under a sublicensing agreement.

"The definition of sublicensee -- or any partner involved with the technology -- needs to be broader to capture all of the economic benefit the technology generates," she emphasizes.

As part of their standard business practices, well-managed tech transfer programs should regularly audit every licensee and sublicensee, typically on a three-year schedule, she advises.

"When people know you're watching, they take a little more care in preparing their royalty reports," Stewart says. "That being said, you can have an audit program but still look for red flags, such as errors on royalty reports." Sometimes, even publicly reported information on the industry or a sublicensee will provide a licensor with sales or profit figures on a licensed technology.

"It sounds too easy, but many times I conduct an audit and see from public statements that a licensee is misreporting its royalty rates," Stewart says.

Audits cost money, but over time an audit program recoups more dollars than it costs, according to Stewart. Audits that detect underreported royalties at least pay for themselves and sometimes recover millions of dollars.

In general, licensees and sublicensees are not purposely stealing from licensors, Stewart emphasizes. Instead, audits typically uncover mistakes due to underreported sales, disallowed deductions, unreported sublicenses, differences in license interpretation, unreported benchmarks, transfer prices -- even simple math errors.

"The world is pretty busy," she says. "Reporting royalties is one minor part of a company's business, and often it's an afterthought."

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