Financial Elements of IP Contracts: Drafting, Monitoring & Compliance Audits

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Speaker Introduction - Sidney Blum, CPA, CFE, FACFEI, CPEA, CrFA, DAFBA, RI

• The preeminent royalty auditor, having represented leading licensors in a vast number of industries such as high technology, biotechnology, media & entertainment, toys, pharma, apparel, software, digital distribution, team sports, consumer products, medical devices, oil & gas, and aerospace.
• Wrote the royalty audit methodology for two of the Big 4 Accounting firms
• Over $8 billion of royalties audited for hundreds of audits.
• Royalty audit experience in dozens of countries.
• Published author and frequent guest speaker
• Expert witness testimony on more than 30 occasions.
• Financial Elements of Contracts: Drafting, Monitoring and Audits [Oxford University Press]
Reviews

"Blum unites his accounting expertise with a clear understanding of contract law to expose deficiencies in common practices that will cause many readers to rethink their audit and reporting procedures and provisions. This is a valuable resource for intellectual property owners and their advisors who want to ensure they get what they bargain for out of their contracts."

-- Kevin D. DeBre [Intellectual Property and Technology Transactions Practice Group Chair, Stubbs Alderton & Markiles, LLP]

"A great peek inside the mind of one of the country's leading strategic auditors. Must-reading for anyone drafting or laboring under a self-reporting contract."

-- Doug Lichtman [Professor of Law, UCLA]

"Mr. Blum's treatise is the product of 25 years of front-line experience auditing royalty and other contracts for the biggest industry players. He has provided a valuable service to attorneys and accounting professionals by sharing some of his knowledge and insights with the rest of us. Cover your bases. Learn from the expert. Read this book."

-- Pierce O'Donnell [O'Donnell & Associates, PC]

"Financial Elements of Contracts delivers a thought-provoking, habit-challenging compendium of do's and don'ts for lawyers and business people alike. No matter where you sit on the chessboard of contracts, Sidney Blum's forceful text provides a critical rethinking of contract drafting and enforcement that will change the way you play the game."

-- Lindsay Conner, Partner [Manatt Phelps & Phillips LLP]

"Blum's background as an accountant in Los Angeles—as well as his prior experience with a big accounting firm, a motion picture studio, and an oil company—amply qualifies him to offer his insights to lawyers engaged in drafting, performance, and litigation of licensing agreements. This book is helpful for lawyers involved in drafting licensing agreements, monitoring the performance of agreements, or contemplating litigation when performance proves to be less than satisfactory."

-- Paul D. Supnik [Los Angeles Lawyer]
Setting the Stage: Licensee Compliance

Licensees Underreport Royalties

• 99%+ of licensees underreport royalties

• 90% of licensees underreport more than 10% - depending on industry
  - Trademark (more than 20% underreporting)
  - Pharmaceuticals (more than 5% underreporting)
  - Software (more than 10% underreporting)

• 90%+ hit cost recovery provision

PLUS, IN ADDITION TO UNDERREPORTING ROYALTIES:

• 80%+ of licensees have non-monetary contract violations
Common Causes for Under Reporting

The two most basic reasons for under reporting are:

1. Poorly drafted contract wording that is vague and not specific to the industry and operations of the licensee.

1. Intentional underreporting through either:
   a. Reading the agreement only to licensee’s benefit
   b. Greed

• Fraud (aka: aggressive interpretation of the contract)
• Definition of “net sales”
• Definition of royalty bearing products or usages
• Not accounting for all uses or disposals of IP
• Clerical errors
• Foreign exchange conversion rates
• Omission of products
• Omission of territories
• Related party sales or transfers
• Misinterpretation of the agreement
• Controls not in place to ensure accuracy of the data, especially in the case where foreign entities or subs are involved
Common Findings (cont.)

- Wrong royalty rates
- Inflating deductible expenses
- Selling products outside of agreement term
- Bundling of products and sales price allocations
- Sub-licensing
- Under expenditure of marketing commitments
- Missing records
- Not maintaining adequate insurance
- Sublicensing
- Deducting 3rd party distributor expenses from sales
- Not capturing VAT refunds
- Deducing intercompany shipping expenses

Common Findings (cont.)

- Deductions of fees as taxes
- Excess returns
- Unapproved discounts
- Spreading of early payment cash discounts
- Deductions of unapproved expenses such as marketing, commissions, intercompany transportation, R&D
- Gross sales exclude sales and barter transactions
- Missing inventory
- Bundling product an inappropriately allocating revenues between products
  - Is it to be allocated based on price or relevance of IP to overall bundled sale and is allocation even allowed?
- Creation and selling of competing IP
End Result.....

There are many, many, many ways that licensees underreport royalties. It is not as simple as what is “net sales.”

The hard part about understanding causes for underreporting is identifying what is not mentioned in the contract as opposed to what is in the contract.

Protecting yourself for the unknown activities of the licensee is key to writing financial terms that are specific to define items, like net sales, but broad enough to make certain that all IP usage is royalty bearing, regardless if sold.

Why Licensees Violate Contracts and Underreport Royalties
Why Licensees Underreport Royalties

- Financial terms are not properly/adequately defined.
  - Gross to licensor is not the same as gross to licensee.
  - Not covered by accounting standards.
  - Use of “reasonable” and “customary” = dispute.
  - Vague and ambiguous financial terms and conditions.

- Inadequate instructions on
  - record retention
  - royalty calculation method
  - Need to have a sample royalty statement in the agreement and make certain the licensee understands how it is to be completed
  - Sample royalty statements needs to be customized for different international territories
  - qualifying deductions
  - other disposals
  - penalties/remediation for each potential contract violation
Why Licensees Underreport Royalties

- Lack of penalties
  - Interest
  - Cost recovery
  - Remediation

- Low risk of underreporting being identified
  - Royalty statements provide inadequate information
  - Inadequate monitoring program
  - Lack of enforcement
Basic Financial Terms and Conditions That Should Be in Each License Agreement, but Are Commonly Missed or Poorly Written

When Writing the Contract...

When writing the contract, lawyers tend to not properly address financial considerations.

• Rule #1: What can go wrong will go wrong
• Rule #2: Licensees always interpret financial terms to their benefit. Inadequate definitions cost licensors millions of dollars.
• Rule #3: Think remediation and not termination for ALL potential contract violations, not just royalty underpayment.
Contracts and Controls

- A well-constructed contract will contain enforceable clauses
- The licensor should make clear at the outset that the audit clause is in the contract and will be used as part of normal business practice
- Partners’ feelings of mistrust can be eased by explaining that enforcement will not be selective, and will be applied to all self-reporting partners
- Systematic enforcement of an audit clause serves as a foundation for a solid self-reporting relationship

When Writing the Contract...

- Questions to consider when creating the contract:
  - Are the information flows sufficient to enable the contract to be properly managed?
  - Are financial terms defined so they can’t be misinterpreted?
  - Are the reporting obligations realistic?
  - What control tools should be written into the contract that will help secure compliance?
  - Are these controls adequately set out in the contract?
  - Does the licensee understand the controls?
  - Are there monetary penalties for all non-compliance? (such as, not spending advertising dollars, selling out of territory, selling of unauthorized branded product, missing inventory, missing records).
Top Financial Mistakes in IP Agreements

- Defining gross sales as the “invoice price.”
- Not identifying royalties due on all units sold/disposed.
- Not limiting deductions to a percentage of gross sales.
- Not defining deductions.
- Not having monetary penalties instead of termination.
- Not listing records to be retained for an audit and rights under the audit.
- Not including interest on late payments and other monetary violations (i.e., not spending marketing commitments).
- Not including an audit cost recovery provision.
- Not providing a sample royalty audit statement with all the information the licensor will need to monitor the licensee.

Common Bad Financial Language

- Royalties are based on “invoice price.”
  - Why this is bad:
  - Does not account for discounts taken prior to invoice price.
  - Does not account for distributions off invoice (i.e., free product, contract, missing inventory)
  - Solution: royalties based on pre-submitted price list on all goods sold or otherwise disposed with specific discount limitations such as 5% off of list (don’t use “reasonable” or “customary”)
Need to Identify That a Royalty is Due on All Disposals of Licensed Products.

- Don't just base royalty on units “sold” or “money collect.”
- Sold should include all units disposed including those unaccounted for.
- Consider stating, at a minimum, a royalty is due based on the average selling price for missing units or otherwise disposed

Monetary Penalties Instead of Termination

- Advertising commitments
  - Weak: “Licensee shall spend 3% of revenues on advertising.”
  - Strong: “Licensee shall spend 3% of annual gross sales on TV or print media advertising and unspent funds shall be remitted by January 30th of the following year to the licensor”
- Territory
  - Weak: “Licensed territory is the USA.”
  - Strong: “Licensed territory is the USA. Gross sales of product outside the territory shall be paid to licensor”
- Missing records
  - Weak: “Licensee shall maintain records”
  - Strong: “Royalty auditor shall calculate findings based on missing records and those calculations are final.”
Deductions Must Be Specifically Defined

- Deductions to be limited to specific discounts and not customary trade discounts
- Deductions are from properly defined gross sales to reach net sales where gross sales is DEFINED. (ie., List price times units sold).
- Consider listing only deductions that are allowed: ie., Trade quantity discounts, price protection, rebates not to exceed 10%, sales taxes, value added taxes, and other taxes.
- The following are not allowable deductions: all other discounts and allowances including, but not limited to, cash discounts granted as terms of payment; early payment discounts; allowances or discounts relating to advertising (unless unilaterally imposed); mark down allowances; new store allowances; defective goods allowances or allowances taken by customers in lieu of returning goods; costs incurred in manufacturing, importing, selling or advertising licensed products; freight costs incorporated in the sale price; and unpaid accounts unless otherwise expressly agreed to and permitted by licensor...”

Other Areas Often Overlooked

- Gross Sales = price on the invoice
- What happens to revenues from out of territory sales or sales of unauthorized product?
- Value added taxes and government rebates
- Unspent marketing funds goes to licensor
- Provisions to stop flooding the market with goods
- Provisions for second hand product
- Minimum guarantees
- Missing inventory = sold inventory at highest price
- Inventory roll forwards must be maintained
Example NDA Language

- The auditor may consult with the Licensor and any of its employees or third party counsel on questions as they relate to the licensed technology. The auditor may not disclose financial or proprietary information except as required by the agreement, or it already exists in the public domain. No other NDA will be required to conduct an audit of the royalty payments.

Audit Paragraph

- Right to audit, at least annually
- If findings exceed cost recovery/pull through provision, then right to audit goes to quarterly for at least one year
- Right to interview all key personnel as determined appropriate by the auditor
- Right to visit third party manufacturers and sub-licensees
- Books and records maintained at least 3 (5) years from the date each royalty statement is submitted to the licensee (or after contract termination)
- Notification to the licensor in advance of system conversions affecting the financial records related to royalty reporting
- Sub-licensees need to be pre-approved by licensor and have same contractual protection to licensor as licensee
- Need to cooperate including providing special reports as requested by the auditor.
Late or Underpaid Royalties

• Should bear interest such as 1.5% compounded monthly. [don’t base it on a bank or other rate]
• If any underpayment are the lesser of 5% or $10,000 for any royalty reporting period included in the examination, the licensee bears the cost of the audit.
• Penalty provisions for underreporting (i.e., 30% of underreported amount).
• Audit cost recovery should also be achieved for other contract violations such as:
  - Selling out of territory
  - Failure to required maintain records
  - Failure to spend minimum advertising commitments
  - Failure to use proper copyright notifications.

Audit Paragraph (cont.)

• Right to inspect books and records, to include, but not be limited to:
  - Invoice registers and original invoices
  - Sales analysis reports
  - Accounting general ledgers
  - Sub-License and Distributor agreements
  - Price lists, catalogs and marketing materials
  - Audited financial statements and/or income tax returns
  - Sales tax returns
  - Inventory records
  - Purchase records
  - Shipping documents
  - Know how documents
  - Other documents deemed necessary by the auditor.
• Include a penalty provision if these documents are not available
  - Penalty equal to 100% of royalties reported in the period where adequate records were not available and / or right to terminate with explicit termination damages.
Audit Costs Should Include:

- The costs of the 3rd party auditors including fees and out of pocket expenditures
- The costs of any internal licensor personnel used at fieldwork
- $25,000 for the licensors administrative costs related to the audit


- Some example wording for cost recovery and penalty provisions for discussion with your counsel...
  
  Prompt adjustment shall be made to compensate for any errors or omissions disclosed by such audit. Any such audit shall be paid for by LICENSOR unless material discrepancies are disclosed. “Material” shall mean the lesser of Ten Thousand Dollars (US$10,000.00) or five percent (5%) of the amount that was reported in any given quarterly reporting period or in aggregate for the period under audit. If material discrepancies are disclosed, COMPANY agrees to pay LICENSOR for the costs associated with the audit. If audit is conducted on a contingency basis, the cost of the audit shall be calculated as the public accounting firm’s 100% chargeable rates plus any other charges from the firm such as administrative charges. Further, COMPANY shall pay LICENSOR an additional royalty of twenty-five (25%) of the applicable royalty on for each sale dollar COMPANY failed to report and shall pay interest on the underreported principal at the greater of 18% or the Prime Rate plus 5% as listed in the Wall Street Journal as of the date such underpayment is discovered to the date the claim is settled. Interest is to be compounded monthly. If, at any time, LICENSOR becomes aware of any distribution of Product in violation of this Agreement or if COMPANY cannot properly account for any units of Product acquired by COMPANY, then without limiting LICENSOR’S remedies, COMPANY shall pay LICENSOR the highest royalty applicable to such product and LICENSOR may charge COMPANY for each such unit of Product, an additional royalty equal to 30% of the highest royalty for the Product plus interest.

* - Consider adding cost recovery for other violations, such as: Not spending at least 80% of advertising commitment, unlicensed sales over $10,000, failure to use trademark, etc...
Include an Audit Cost Recovery Provision

- Cost recovery should be based on:
  - For underpayment of royalties in excess of 5% or $25,000 in any one royalty reporting period.
  - For any contract violation that could result in termination of the agreement.
  - For failure to meet financial commitments of $25,000 or more in any period (i.e., not making advertising or insurance spends).
  - Cost recovery shall include auditor costs, legal costs and licensor administration of $25,000.

About Royalty Audits
Monitoring Program

- In-house.
- Field inspections (aka: royalty audit). Inspection of a licensee's records to assess compliance with terms and conditions of the agreement.

Goals of the Royalty Audit

- Find money
- Trademark protection
- Assessment of licensee’s use of IP
- Assess overall contract compliance
- Increased knowledge and information flow
- Check for unethical behavior
- Identify weaknesses in licensee agreements for future contract drafting
- Obtain information prior to anticipated litigation
Need to Understand Statement to Use “Independent” Auditor

- Do you mean Independent under American Institute of Certified Public Accountant standards? If yes, state it in the license agreement.

- Do you mean independent in that auditor is not an employee of the licensor? If yes, then don’t use the word independent, and instead say royalty audit to be conducted by a CPA firm.

- Audit findings and right to audit can be lost if the audit requires independence and the auditor is not independent under AICPA standards. Very few royalty auditors are trained to perform independent royalty audits; perhaps 10 in the USA, but your auditor might not tell you of this issue if independence is required.

When to Conduct a Royalty Audit

Does it make economic and business sense?
Types of Royalty Audits

When to audit?

• Basic rule
  - Minimum 10% underreporting (brand / trademarks / software)
  - Minimum 5% underreporting (regulated industries – medical)
  - Audit cost @ $25,000 (range is $10K to $100K)
  - When royalties from one licensee are greater than $250,00

• Proactive: every one to two years
  - Records “disappear” if more than two years old, even if right to audit is longer

• Reactive: when red flags indicate violations
  - At this point, recoveries are often greatly reduced

• Prior to litigation
• Prior to execution of a new agreement
• Prior to expiration of audit rights
When to audit? Before or After a new Contract? – an ongoing controversy

- Leading Practice: Auditing before allows adjustments in the new contract
- Detractors are concerned it will affect negotiations

When to audit? Before New Agreement

- Licensee’s generally need IP
- Licensees are used to it
- Good business practice/governance
- If they are against the audit, what are they hiding?
- Make certain your auditors know how to conduct a nonthreatening audit
Questions to Ask Your Client

• Does monitoring effort exceed execution effort?
• Lower royalty audit costs or higher litigation costs?
• Is your intellectual property important to you?
• Do you want to increase your royalty income by 10% or more?
• Why do you think your licensees are honest when all others misreport?

Licensor’s Role During a Royalty Audit
Stages for Counsel in a Royalty Audit

1. Contract with auditor
2. Notification letter to licensee
3. Background information & instructions to auditor
4. OK report and communicate results to licensee & internally
5. Findings negotiations or termination and/or litigation
6. Gain approval for royalty audits
7. Determine extent of royalty audit program
8. Collect data to understand the license agreement(s) and revenues
9. Constant communications with audit team related to contract interpretation

What to give the auditor prior to the start of the audit:

- Agreement, amendments, side agreements, letters of intent
- Interviews with key licensor personnel such as relationship manager
- Royalty statements
- Licensee contact information
- Licensee notification letter
- Special requests
- Trademark usage notification requirements
- Approved schematics
- Quantity of licensed subcomponents delivered to the licensee
You’ve Got the Audit Report, Now What Do You Do?

Collecting overdue royalty payments

Collecting Royalty Payments (cont.)

• Establish the reason(s) for non-payment
  - Misinterpretation of the license
  - Inadvertently missing payment
**Green Hasson Janks**

**Collecting Royalty Payments**

- Send a demand letter
- Know your action plan prior to starting the audit!
- Establish firm deadlines for actions
- Detail consequences of missed deadlines
  - The loss of future licensing privileges
  - Referral to legal counsel
  - Incurs additional penalties and interest
  - Reporting to major credit bureaus

**Collecting Royalty Payments (cont.)**

- Settle any problems or disputes that are preventing payment
- Follow-up frequently with licensee until all overdue payments are resolved
  - Frequently would be at least once per month – more often if negotiations are at a critical phase
  - Consider compromise solutions

[SOPHISTICATED LICENSEES PURPOSELY UNDERREPORT AND SETTLE FOR PENNIES ON THE DOLLAR AND ALMOST NEVER PAY AUDIT COSTS AND INTEREST. IT IS PART OF A LICENSEE’S BUSINESS PLAN. THE LICENSOR MUST BE WILLING TO NEGOTIATE FOR WHAT THEY DESERVE. YOU SHOULD KNOW THE LICENSOR’S PLANNED RESPONSE BEFORE THE AUDIT STARTS]
Collecting overdue royalty payments

Selecting the Royalty Auditor?

No more than you should select the best brain surgeon in the world to operate on your heart, you shouldn’t ask the best financial statement auditor to perform a royalty audit.

- Financial statement audits are audits to determine compliance with Generally Accepted Accounting Principals.
- Royalty statement audits are audits to determine compliance with License Agreements.

License Agreements do not comply with GAAP. That is why License Agreements need to be so well written. GAAP deals with materiality while License Agreements don’t.
Experience, Experience, Experience

There is no certification requirement to be a royalty auditor, so buyer beware!

Ask to see sample reports.
Inquire about clients and number of royalty audits performed.
Inquire if they make findings for everything and see what sticks or just those items that are solid.
Interview them to see if they understand the industry and if they know what to audit for on items not in the contract (i.e., inventory).
Determine fee structure (avoid fixed fee). Consider hourly and/or contingency.

Independent Auditor Required

Read the right to audit provision and determine if an independent auditor is required.

If yes, make certain your auditor is qualified and has performed at least a dozen independent royalty audits under American Institute of Certified Public Accountant attestation standards.

I recommend that your royalty auditor has conducted at least 30 royalty audits. I spend a lot of time cleaning up mistakes of non-royalty auditors. Using someone who is inexperienced can lead to broken relationships between licensors and licensees plus you never know what they missed. So, they might report findings of $100K, but left $5 million on the table.
Question and Answer