Key advisory issues

Don’t get your wires crossed: common pitfalls in licence agreements

As more companies introduce inspection programmes and thus need to perform royalty investigations of their licensees, misreported royalties continue to be found on a regular basis. The reasons for these misreported royalties are numerous and fall into four broad categories:

• wilful under-reporting (luckily, this is still rare);
• clerical errors (eg, arithmetical errors on manual royalty returns, use of spreadsheets with inaccurate formulae and transposition errors);
• system failures (eg, the failure to identify and capture sales of all royalty-bearing products); and
• contract interpretation (ie, licensees adopting a different interpretation of the agreement to that intended).

Misreporting due to clerical errors or system failure is usually uncontested and can be resolved quickly, with the licensee making a payment within a few weeks of the inspection. This, together with the licensee’s commitment to resolving any system weaknesses, will generally leave the business relationship with the licensor intact. In contrast, differences of contract interpretation can take months to resolve and may tie up considerable management resources. They are more likely to damage the relationship and contribute to a climate of distrust, ultimately leading to litigation in some cases.

This chapter, which is based on many years of royalty inspections, highlights some of the areas where ambiguous contract wording or the adoption of a ‘one size fits all’ approach has led to disputes over royalties, sometimes many years after the agreements have been signed and often involving large sums of money. It is important for the licensor to understand a licensee’s business and distribution channels at the outset, and to revisit the agreement regularly as the business and the use of the licensed intellectual property develop.

Getting the rate right

Where a licensee produces a variety of products and the licensed intellectual property contributes a greater proportion of value to some products than others, the parties may apply differential royalty rates so that the royalties properly reflect the value contributed. A variety of mechanisms are used in licence agreements to achieve this, including:

• the segmentation of products into defined groups with different royalty rates for each; and
• sliding scales of royalty rates based on the selling price of the finished products, often with floor and ceiling rates.

Where sliding scales of royalty rates are agreed based on the selling price of the licensed product, in some cases licensees have taken a unilateral decision to move from a royalty on the finished product to applying a rate to a transfer price that is assigned to the particular component containing the licensed intellectual property, leading to a significant reduction in royalties.

By way of example, take the following, rather simplistic, sliding scale:

<table>
<thead>
<tr>
<th>Net selling price</th>
<th>Royalty rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10</td>
<td>6 per cent</td>
</tr>
<tr>
<td>$10.01 to $20</td>
<td>5 per cent</td>
</tr>
<tr>
<td>$20.01 to $30</td>
<td>4 per cent</td>
</tr>
<tr>
<td>$30.01 to $40</td>
<td>3 per cent</td>
</tr>
<tr>
<td>More than $40</td>
<td>2.5 per cent</td>
</tr>
</tbody>
</table>

If a newly developed finished product sells for $100, a scale royalty rate of 2.5 per cent applies and the royalties would be $2.50 a unit. If the licensed intellectual property is contained within just one component of that product with a transfer price of, for example, $15, a licensee may seek to adopt a rate of 5 per cent from the table above and...
the royalties will be just $0.60 a unit (5 per cent of $15).

Such clauses need to be drafted carefully and reviewed regularly as the licensee’s business develops and new products are introduced. This will avoid a situation where a licensee takes advantage of a loose or outdated definition to adopt lower royalty rates for new product categories.

Selling price
Problems frequently arise where licensed products are sold to sister companies or other related parties, either for distribution into their local market or for incorporation into other products. Most licence agreements include clauses to deal with this – for example: “Net sales’ shall mean the regular selling price… in a bona fide arm’s-length transaction.”

In a recent example in the consumer electronics industry where royalties were based on a percentage of net sales, a licensee was using overseas subsidiaries to distribute products in each of the major territories. The selling price that it was using for the royalty base was the price charged to the overseas subsidiary rather than the ultimate customer.

In this case, the subsidiary did not make a profit on the resale of the products but raised the selling price to cover its own costs. The licensee argued that as its own distributors did not make a profit and it would use the services of external distributors if this function were not performed in-house, the lower selling price to the subsidiary, rather than the ultimate customer, should be adopted as the royalty base. The licensor argued that the price should be that charged by the distributor to the ultimate third party as that distributor was in the licensee group and its sales were the point at which the goods left the group. The licence agreements did not specifically address this channel to market and the parties eventually negotiated a compromise settlement.

Problems can also arise where licensees simply do not have a benchmark arm’s-length price as all production may be sold to related parties (which are not party to the licence agreement) and incorporated into other products. A number of alternative approaches have been adopted by licensees where agreements are either silent or ambiguous in this area, for example:

- simply using the internal transfer price as the assumed net selling price;
- using cost plus a standard margin; or
- taking the third-party price of the closest available product.

Each of these approaches can result in significantly understated net sales and the parties should agree on an acceptable formula early in the life of the contract to avoid misunderstandings later on.

Allowable cost
The deductions allowed in calculating net sales to which the royalty rate is then applied constitute a common source of disagreement between licensee and licensor. Therefore, the definition of ‘net sales’ should be made as unambiguous as possible.

Take, for example, the following wording: “Net sales shall mean the gross invoice price after deducting any credits, normal discounts and freight charges.” In a recent royalty investigation, this wording led to two significant areas of disagreement:

- What is a normal discount? The licensee regarded prompt settlement discounts as normal, but the licensor argued that when it signed the agreement it did not wish to subsidise the licensee’s attempts to improve its working capital by allowing discounts for prompt payments as a deduction.
- What were the freight charges? The licensee did not invoice freight charges to its customers but developed a complex and highly subjective formula for allocating its total freight costs to the licensed products.

The following alternative clause might have avoided this misunderstanding: “Freight and insurance charges may be deducted provided that they are itemised on the invoices. No deduction shall be allowed for uncollectible accounts or prompt settlement discounts.”

Credit for returns
Another area prone to misinterpretation is allowances for returned products. Take, for example, the following clause: “For each licensed product sold or distributed by the licensee, a royalty will be payable.”

This clause is silent on the treatment of returned products and a strict interpretation would be that no credit is allowable as the royalty is payable upon shipment. Many licensors simply assume that credit can be taken for a returned product, particularly if that product is repackaged and sold again, generating a second royalty. However, licensees may have sound commercial reasons for not allowing the deduction of returns (eg, to control the amount of products entering the market) and may seek to recover these royalties. Again, the key is to have clarity in the terms – for example: ‘Net sales’ shall mean the gross invoice price less any credits for returns of licensed products.”
Penalties and interest

Most agreements will include clauses to encourage accurate royalty reporting, including interest on overdue amounts and the payment of audit fees if royalties are found to be underpaid, usually by over 5 per cent. The following is a common clause: “The audit will be at the licensor’s expense unless it reveals an underpayment of royalties of 5 per cent or more, in which case the licensee shall reimburse the licensor for the cost of such audit.”

This may seem a straightforward clause, but consider the following scenario, which is not uncommon.

Upon notification of an audit, a licensee performs its own review of historic royalties and finds an underpayment resulting from clerical or system errors. The licensee admits to this underpayment when the audit team arrives on site to carry out its work. The review itself identifies further underpayments which are less that 5 per cent but, added to this voluntary disclosure, which breach the 5 per cent rule. Should the full inspection cost be borne by the licensee? Are the royalties identified in-house revealed by the audit as they came to light following the notification? Would the licensee have carried out its own review but for the notification? These are all valid questions.

Licensor should consider making the definition of an ‘underpayment’ identified by an audit clear in the agreement. For example, any underpayments identified, either by the licensee or the auditor, between notification and closure of the audit could count towards the 5 per cent threshold.

Conclusion

This chapter has highlighted five areas where royalty clauses in licence agreements can be misinterpreted and may lead to friction between the parties. These can be avoided at the drafting stage if the licensor spends time understanding the licensee’s business, its supply chain and distribution channels. The ‘one size fits all’ approach is not always appropriate. But that is not the end of the story – the parties should not just leave the agreement to gather dust, but should carry out regular reviews to ensure that it still meets the parties’ needs as new products are developed and new channels to the market open up. It is important to identify any ambiguous or outdated clauses early on before the parties become entrenched and large amounts of back royalties are at stake.

It is not just the licensor that benefits from unambiguous agreements that are regularly reviewed as the licensee’s business develops. A clear understanding on both sides of the operation of the royalty clauses avoids later misunderstandings that can tie up management time, prove a nasty financial surprise and lead to acrimony.

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