The Limited Monopoly™

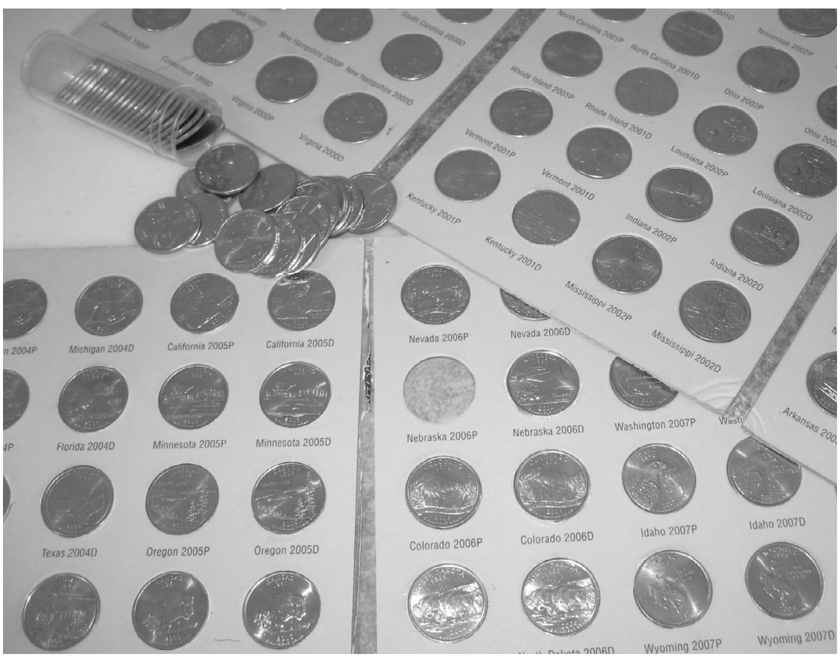
Patent License Agreement Audits - Ensuring the Reward for Innovation

by Robert Gunderman, PE and John Hammond, PE

Patent license agreements are vitally important to many companies. A patent royalty payment goes straight to the bottom line, unlike product sales where materials and overhead must be taken out first. So getting more money from your existing license agreements can have a significant impact on the bottom line. Most patent license agreements contain provisions for an audit, usually annually. But most licensors do not take advantage of an audit, and hence do not improve their bottom line in this area. Often a licensor doesn't want to upset the licensee by requesting an audit. If a reasonable amount of money comes in each month, there is complacency that everything appears right. Since there are no offsetting costs such as materials and labor, a licensor will often take a softer, less critical view of the royalty check and be grateful for whatever is reported and paid on. Experienced audit firms will tell you that license underreporting is commonplace. Many audit firms will even work on contingency or partial contingency, a strong indicator that it is likely there is money to be found and recovered in an audit.

"Insisting on an audit as your right under the license agreement is not only good business, but it could improve your bottom line."

Audit Provisions in License Agreements



A well written license agreement should contain a well written audit provision. While most standard license agreements contain a "boilerplate" audit provision, it is important to consider some of the "what ifs" when your attorney drafts the audit provision language. When defining audit rights, one should insist that the right to inspect and audit be clearly established, and that no restrictions be placed on the scope of the investigation. Site audits should also be specified in addition to desk audits. During a site audit, discussions with the licensee's management and staff often helps discover errors or deliberate concealments. In many license agreements, the licensor bears the cost of the audit unless underreporting beyond a certain threshold is discovered. For example, if the audit results indicate an underpayment greater than five percent for any six month period, the licensor pays for the audit. Also, underpayments are usually reimbursed with interest.

An audit provision should also clearly define reporting requirements, including the format of the report, information contained in the report, and frequency at which a report is sent to the licensor. The contents of a royalty report should be carefully defined based on the terms of the licensing transaction. Information that may be important in a royalty report includes units sold, units manufactured but not yet sold, sales revenue, royalty calculations, costs, returned units, promotional units, royalty payments made, minimum royalty payments made, and any currency exchanges used. A licensor should define what reporting requirements are important and ensure that they are included in the license agreement. Also, it is common to specify that accounting records be kept for several years (two or three years is common) to allow an auditor to apply underreporting findings retroactively.

Why Perform an Audit?

The simple answer is to get more money from your license agreement by receiving all royalty payments that you are entitled to. There are several other reasons to perform an audit that may be of value. A regular audit program ensures future compliance. A licensee will be more careful with reporting and payments if regular audits are being conducted. Also, if your company actively licenses technology as part of ongoing business operations, and regularly audits licensees, a new licensee is less likely to underreport if others have been routinely audited for compliance.

Another reason for performing an audit and documenting material non-compliance with a license agreement is that the licensor may wish to terminate or modify the terms of an existing license agreement. Well written license agreements often contain clauses that allow for termination or modification only when certain conditions are met, such as material non-compliance with the license agreement itself.

Planning for a Successful Audit

To conduct a successful audit, the licensor should work with the auditor up front to help identify the greatest areas of concern. Usually a licensor suspects that royalties paid, product sales and other facts reported by the licensee are not as they should be. Pointing out these concerns to the auditor helps to focus the investigation. Most auditors request electronic records before the start of an audit, and then conduct field work that includes interviews with the licensee's management and employees, requests for additional information, and related work performed at the licensee's facilities. The licensee should not know the reasons behind requests for information or questions, in order to not bias the investigation.

Common areas that yield payoffs in an audit include underreported sales, inconsistency between shipments and sales reports, improper cost allocations, transactions between related parties that unfairly underreport royalty numbers such as sales figures, variations between license agreement terms and royalty payment calculations, and slow payments of royalties outside the terms of the license agreement.

Common Errors of Underreporting

So is your licensee capable of making either innocent accounting errors or perhaps even misreporting royalties? With difficult economic times, licensees may not have the accounting personnel necessary to properly calculate and apply royalty payment calculations, or worse, the temptation to misreport may be higher in difficult economic conditions. Either way, good auditors are not bound to a spreadsheet checklist of things to look for, but rather, analyze the overall situation and apply good judgment in how they go about the audit for favorable results. A list of some common errors includes:

- Intentional under or misreporting
- Unintentional clerical errors due to human error
- Unintentional clerical errors due to improperly designed spreadsheets or computer programs
- Promotions, samples, damaged goods or refused sales are not accounted for even though the license agreement provides for payments
- Incorrect foreign exchange rates are applied
- Costs are incorrectly applied that lower royalty payments
- Limitations in the license agreement such as minimums or maximums are not applied
- Misinterpretations of what is covered under the license agreement, such as variations or improvements on the originally licensed products
- Misreporting sublicense revenue
- Bundling of royalty bearing products with non-royalty bearing products and treating the bundle as non-royalty bearing
- Transactions between related parties or relationships that cause underreporting of royalty payments
- Slow payments of royalties outside the terms of the license agreement
- Unreported or misreported transactions that occur at international locations
- Use of convenience ("back of the envelope") calculations by the licensee to simplify the accounting process that are not the same as the more complex license agreement royalty calculations
- Differences of opinion regarding interpretation of the terms of the license agreement, and the use of licensee favorable interpretations by the licensee in performing the royalty calculations.

This list is a sampling only, and there are many other errors as varied as the business relationships defined by license agreements themselves. Insisting on an audit as your right under the license agreement is not only good business, but it could improve your bottom line. Most companies that have developed a technology for license have done so at their own expense and risk. If it weren't for the licensor's investment and initiative to take a calculated risk and develop and patent a technology for license, the opportunity for the licensee to benefit would not exist. So it only makes sense to ensure that the licensor is getting everything from the license agreement that has been earned. The royalty itself is a financial reflection on the innovation, creativity and initiative that was taken to materialize the technology for license. It is only through investment in new technologies and the associated financial rewards that can be realized that the United States will continue to maintain its legacy of independent self-sufficiency.

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