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ENTERTAINMENT
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Royalty Misreporting: Magnitude and Meaning

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Are you reaping the full benefits of your license agreements? Does this concept concern you? It probably should. Enormous resources are expended in drafting and negotiating license agreements, not to mention the time, effort, and money spent generating or acquiring the intellectual property (IP). Some people may be altruistic, only interested in promoting society's common good. But others, primarily investors and trustees, are interested in recouping their investments through royalty payments to the organization. Because of these forces, management is tasked with the responsibility of ensuring that assets are protected and used to their fullest earning potential.

Problems arise when no one takes responsibility for protecting assets. We read about it in the papers and hear about it in the news. Cash is embezzled. Fraud is perpetrated. Machinery and other consumables "walk" out the door. These asset misappropriations are quite clear to everyone. What may not be so clear are inattention to efficiencies, time value of money, and operating below full potential. IP is often victim to this category of inattention. It is overlooked because by its nature it is intangible. Sometimes it is not income generating, or is it? Perhaps no one is monitoring the assets.

For whatever reason, in today's business environment, management is in the spotlight. They are being asked to design and implement systems

and procedures to protect and maximize their organization's assets, both tangible and intangible. They are being asked to profess in writing that their financial statements are their responsibility and that the statements are fairly stated.

Up until now, many have overlooked intellectual property revenues as incidental and immaterial to their organization. They might be wrong. If you are a licensor in a royalty-bearing license agreement, chances are high that you are not receiving full compensation from your licensee. Since we began aggregating data from our royalty audits, we have found that approximately 80 percent of licensees both underreport and underpay royalties to their licensors, frequently in staggering amounts. Frequently, the licensor has missed critical warning signs that should have alerted them to the potential for misreporting. Exhibit 1 illustrates the magnitude of this underreporting epidemic.

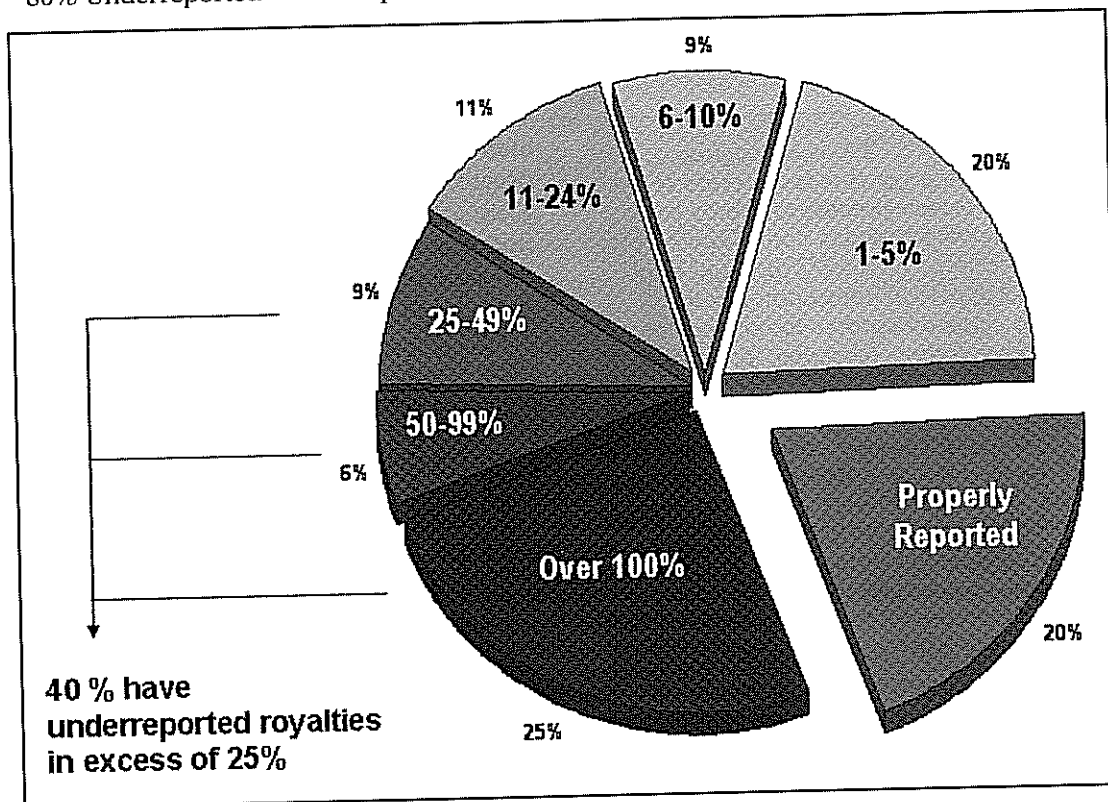
Why versus How

It is important to explore the reasons why underreporting happens. The answers are predictable but noteworthy. The cynics of the group will tell you that people are dishonest and will try to push the envelope on minimizing their payments. Yes, willful misreporting happens, but, in our experience, it only happens in a minority of the cases. Typically, we find misreporting happens because of inattention, oversight, or a disconnect between those who negotiated and wrote the license agreement and those who are put in a position to interpret it, or, worse yet, those who have never seen the agreement but are asked to report under its terms.

Rather than focusing on the "why," we think it is more important to understand "how" the misreporting happens. Understanding how errors occur and being able to spot the indications early can mean the difference between a healthy licensor-licensee business relationship and an adversarial or awkward one. The goal of the first is to initiate regular communication that produces mutual satisfaction with benefits rightfully enjoyed by both parties, the way it was negotiated. The other is silent and allows

Exhibit 1: Historical Statistics for Underreported Royalties as a Percent of Reported Royalties

80% Underreported – 20% Reported Accurately



Source: Invotex Group royalty compliance audit results.

a build-up of resentment for money and time wasted and distrust for current and potentially future collaborations. Which would you choose? Despite the clarity of this question, we find that many licensors want what they perceive as the best of both worlds. They try to promote a feeling of trust with silence, fearing that any question asked is perceived by the licensee as an accusation of deceit. Are you offended when the clerk behind the counter scrutinizes your \$20 bill for counterfeiting indications? Don't you verify that your credit card statement includes only items that you charged before you pay it? These actions are good, fiscally responsible actions, and verifying royalty reports is no different.

To understand misreporting, first we need to examine where the misreporting occurs. Exhibit 2 is a representation of the royalty audits Invotex performed during 2006 and shows where we found variances between what was originally reported and our examination results. Exhibit 3 depicts the frequency at which each of these common errors occurred. It is

important to note that reporting errors are not mutually exclusive. In fact, in most instances where one type of error was found, we also found at least one other type of reporting error.

The remainder of this article discusses the findings in Exhibit 2, how the error occurred, actions to limit future misreporting, and red flags that can alert a licensor to the likelihood of misreporting.

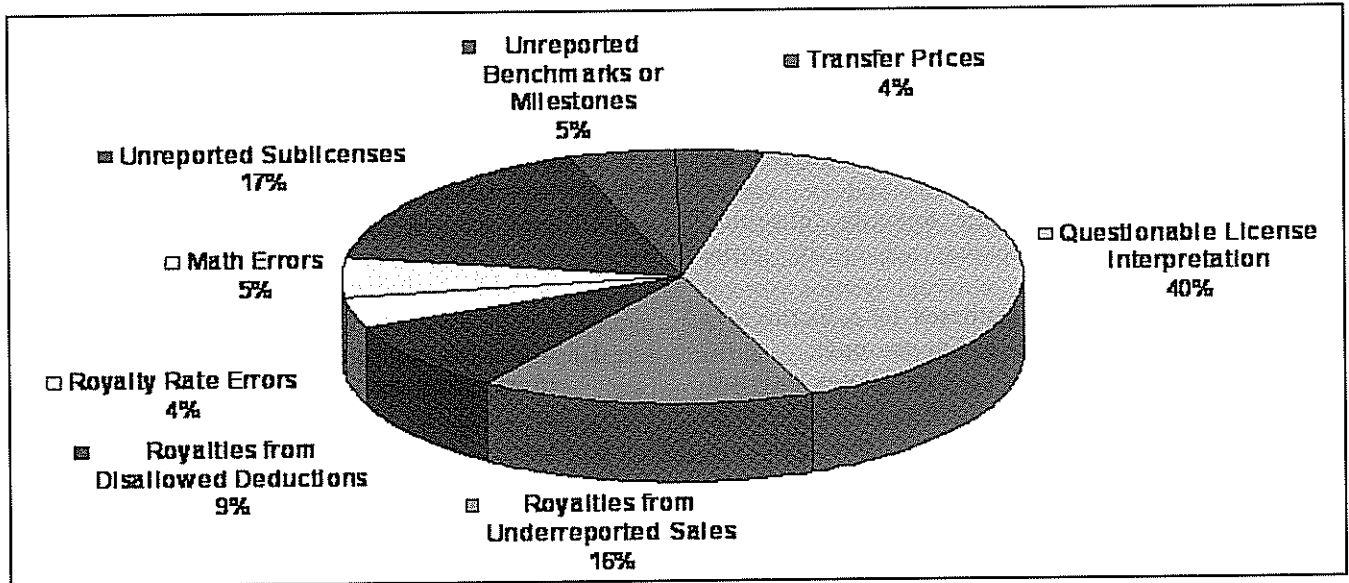
Math Errors: 5 Percent Error Rate

The fact of the matter is that although we use computers for calculations and try our best to be accurate, we are human. At one time or another, each of us makes mistakes. Can any of you identify with any of the following scenarios?

- You created a simple spreadsheet that adds a column of hundreds of numbers. Unfortunately

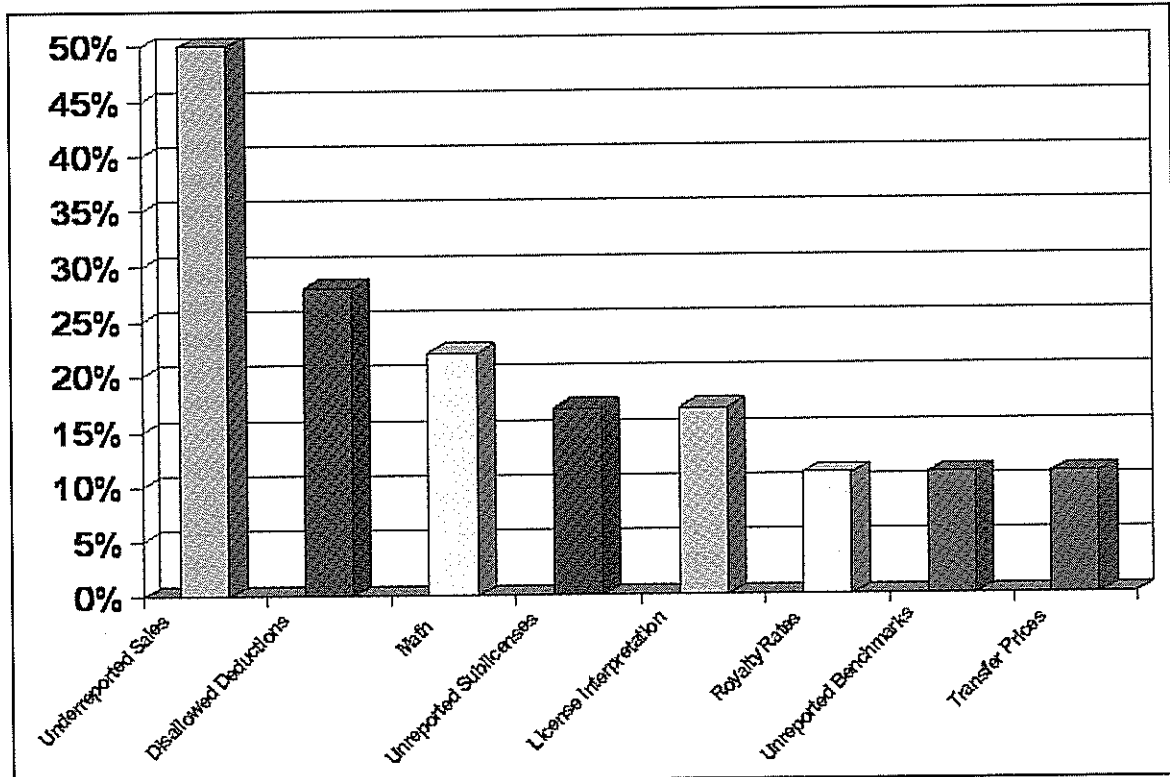
Exhibit 2: 2006 Finding by Error Type

Based upon Total Unreported Royalty \$ Uncovered



Source: Invotex Group royalty compliance audit results.

Exhibit 3: Frequency of Common Underreporting Errors



Source: Invotex Group royalty compliance audit results.

you have forgotten an item and you need to add a row, which you do above the total. However, when you add the row, you forget to change the formula that calculates the total so that it includes the new row. This is bad enough, but then, next month you use this same spreadsheet and import amounts for a rolling total. The problem compounds.

- You meant to multiply cell C24 by D27 but pointed to cell D28 instead.
- You forgot to make your formula “absolute” before copying and pasting across the entire spreadsheet.
- You forgot to use parentheses in a formula to change how Excel reads it. For example:
 - a. $5+2*3=11$, because Excel calculates multiplication before addition. The formula multiplies 2 by 3 and then adds 5 to the result.
 - b. $(5+2)*3=21$. If you use parentheses to change the syntax, Excel adds 5 and 2 together and then multiplies the result by 3 to produce 21.

Do these errors sound silly? Well, these are precisely the errors that comprise the 5 percent in Exhibit 2. The licensors receiving the reports were so excited by the royalty revenue amounts on checks they were receiving that they did not notice that the numbers just didn't make sense. Not one of the reports was math checked.

The lesson: Plug in the 10-key and make sure the arithmetic works. Better yet, ask for electronic copies of the spreadsheets so that you can easily examine the formulas and method behind the spreadsheets. An added benefit of electronic reports is that you can combine and compare them for trends, consistency, and, potentially, internal forecasting and budgeting.

Royalty Rate Errors: 4 Percent Error Rate

Misapplied royalty rates accounted for 4 percent of the dollar value of our findings. A large number of products with a correspondingly large number of royalty rates were the primary cause of this problem. Unless the reporting systems are fully automated and have been accurately programmed to apply the proper rates to the products, errors happen. Such errors are the hardest to find because you must be diligent with the review process. Depending on the volume, nickel and dime variances can add up to big money.

To complicate matters, some agreements are written to include complex calculations of the rate based on an index, such as the consumer price index. It sounds simple and reasonable to adjust the royalty rate by the cost of inflation, right? Well, unless the agreement specifies, your licensee might be deciding between the following:

- Traditional Consumer Price Index for All Urban Consumers (CPI-U)
- The newer Chained Consumer Price Index for All Urban Consumers (C-CPI-U)
- CPI-W, which is based on the expenditures of households, included in the CPI-U definition that also meet two requirements:
 1. More than one-half of the household's income must come from clerical or wage occupations and
 2. One of the household's earners must have been employed for at least 37 weeks during the previous 12 months.

Each month, consumer price indexes are published along with short-term percent changes, the latest 12-month change and, at the national item and group level, unadjusted and (when appropriate) seasonally adjusted percent changes (and seasonal factors), together with annualized rates of change.

Is the selection of this rate something you want to leave to chance?

The lesson: Try to simplify the application of royalty rates in the license agreement. If a large number of products exists or is expected, group them and apply the rates by type or price range, rather than by individual product. If volumes are a concern to the licensee, use tiers and apply graduated rates. Whatever method is used, the license agreement should contain clear and precise language. It should provide detail on how the calculations are to be performed and include a sample calculation as an example. If some published index or other rate is to be used in the calculations, specify who publishes the rate and precisely which rate is to be used and include a copy of the last published index to be assured all are considering the same piece of data.

If you have an existing agreement that contains unclear language, clarifying the correct method to calculate royalties could take some time and effort. After you understand how the rates are being applied, thoroughly discuss the matter internally (to decide what your legal and political positions are) and then with your licensee to get a common understanding going forward. Then, consider amending the agreement.

Transfer Prices: 4 Percent Error Rate

Transfer price is the price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company to calculate each division's profit and loss separately. Sometimes organizations charge transfer prices to partners under a marketing and distribution agreement, providing a price break in exchange for other financial returns, including royalties.

In contrast, arms length pricing or third party pricing is the price at which two unrelated and non-desperate parties would agree to a transaction. Prices are higher in third party pricing, and, typically, these are the prices contemplated in license agreements when net sales is used as the royalty base.

Even if the license language specifies third party pricing, which we recommend, sometimes the licensee only has access to the sales generated at their level or entity and cannot access the sales dollars generated from the sale to the ultimate consumer.

How do you spot this type of error? Oftentimes, an on-site audit is the only means of reviewing the licensee's internal financial documents to discover such a problem. Most likely, your licensee will not provide you the same access to this confidential information. You should, however, be aware of the market price of the licensed products and perform analytics and trend comparisons on the royalty reports to ensure that the numbers make sense.

The lesson: This type of error is not easy to identify. Even in trend analyses, changes in volumes and pricing as well as multiple country sales can muddy the data. Do your best and verify with an Internet price or catalog price. Watch publicly reported information such as annual reports and press releases for sales alliances that relate to your licensed product(s). Lastly, of course, try to be specific in wording the license agreement, particularly in the definition of the royalty base if it is related to sales.

Unreported Benchmarks and Milestones: 5 Percent Error Rate

Not surprisingly, we find that university and governmental clients are the hardest hit by this reporting deficiency, due to the development state of the technology licensed. Because benchmarks and milestones generally must be tracked outside of the general ledger accounting for sales, licensees must have additional systems and checks in place to ensure

that these license requirements are fulfilled. Persons compiling the reports must have access to the license agreement and be mindful to consider if and when these payments need to be made. Frequently, benchmarks and milestones get lost in the shuffle.

These types of payments may be based on research and development, product trials or sales volumes, and geographies. This information can be ascertained from press releases, annual reports, and other promotional material. Ensure the royalty report and payments correlate with public information.

Additional complications arise when benchmark and milestone payments based on your licensee's sub-license activity are due. The sub-licensee payments are collected by the licensee then recorded in their other income categories but frequently forgotten by the time the royalty reports are due to the licensor. This situation is what gave rise to most of the errors in our 2006 audits: Either the licensor did not have a copy of the sub-license agreement and was not aware of the milestones or the licensor had read about the payments in a press release or other company information and neglected to inquire about the flow-through payment back to them.

The lesson: It takes time to investigate properly and effort to follow up. Alternatively, as the licensor, you should request a regular status report on the progress toward the various milestones. Let the licensee know that you are mindful of the requirement and are monitoring the activity. Milestones can be significant, and considering the time value of money and the opportunity costs, the losses can be dramatic.

In addition, it is helpful to word the license agreement such that the licensee is required to supply the licensor with copies of any sublicense or other type of agreements contracted concerning the subject licensed technology.

Unreported Sales: 16 Percent Error Rate

Unreported sales are the expected finding in our reports. Our 2006 results show that approximately 16 percent of the underreported royalty dollar amount was from this type of misreporting. Exhibit 3 confirms this expectation; 50 percent of the licenses we examined last year contained this type of error. In a couple of the audits, the licensee was reporting the completely wrong product—one that did not include the licensed technology. However, in a majority of the cases, the licensee did not report a second generation or legacy product. In certain instances, the persons preparing the royalty reports

simply did not consider that a new product had been launched. They used a standard form with a static set of licensed products, filled in the sales amounts, let the computer do the arithmetic, and sent the report along with a check. There was no mechanism for considering new products that should have been added to the form.

We are accountants, not scientists. However, we do our best by looking at documentation supporting the products. We examine bills of material, product specification worksheets and similar documents and ask questions until we are satisfied that we understand the proper classifications as to whether it is royalty bearing or not. We look to product numbering and naming conventions to identify products we should consider unreported. We read product descriptions and industry/consumer reports.

Very frequently we rely on our client's knowledge. Typically, the inventors are aware of the players in the industry and monitor what is happening with their offspring. When they are willing to speak with us, we have found their input invaluable in pointing us to direct findings. Their hunches are frequently on point. We recommend that you use them too.

The lesson: Know your licensee's products and monitor what is happening in their research and development efforts. Examine publicly reported information and compare it to what is on the royalty reports. Look to industry trends and see if your licensee is tracking with them. Use your internal resources for tips and, of course, communicate with your licensee.

Disallowed Deductions: 9 Percent Error Rate

Here is where you find people cheating on their taxes. Deductions from gross sales are very frequently spelled out in the definitions of "Net Sales" because this is most often the royalty base. If the royalty reports are detailed, you can spot the suspicious deduction immediately. If not, you might need to ask for it.

Our biggest findings were from vague license definitions, such as "handling." A handful of licensees we audited stretched this term to include administrative corporate expenses such as accounts receivable management, storage facility rent and customer service. Some licensees try to push back on these findings but mostly they hang their head, "busted."

The lesson: Ask the licensee to provide details of the gross to net sales deductions to ensure they compare to the allowable expenses in the license agreement. Beware of deductions that are the name of a service

provider; frequently their contracts include more than simply freight. Finally, many times the amounts we see as deductions are estimates or accruals; if the license agreement states that only amounts paid may be deducted, these may be disallowed.

Unreported Sublicenses: 17 Percent Error Rate

If your license agreement grants rights to sublicense, please include language giving you rights to copies of the agreements as well as copies of the resulting royalty reports and access to audit the sublicensee's supporting books and records. Licensees usually place scope limitations on auditors when the license is silent to these matters. We can be persuasive and we can sometimes obtain redacted copies but then our position becomes somewhat more contentious.

Here again, the lesson is to be aware of the industry, your licensee and their publicly reported statements. We research Securities and Exchange Commission filings, annual reports, press releases, and news stories, but our hottest tips come from inventors. As with unreported sales, inventors, faculty, and others who have a financial or other stake in the amount of royalties collected have their finger on the pulse.

At times, the sublicense is not reported because the entity exists in a geographic area not covered by the patent rights. However, depending on how the license is written and from where the sales are generated, arguments can be made that include the sales in the royalty base. You will not know unless you can get the agreements and be able to ask the right questions.

Questionable License Interpretation: 40 Percent Error Rate

Ah, our favorite category. As you can see from Exhibit 2, 40 percent of the errors we found in 2006 are due to a variance between the way we interpret the license agreement, the way the licensor interprets it and the way the licensee interprets it. Many times, neither the licensor staff nor the licensee staff are the ones who initially negotiated and drafted the agreement, so unless the language is crystal clear, who really knows the intent or the spirit of the agreement? We all do our best and play our role.

Findings in this category run the gamut. The only way we discover these errors is by gaining a thorough knowledge of the accounting and reporting systems relative to royalty reporting and asking many

questions. Some clients are surprised at the amount of time we spend performing investigative interviews during our site visit. We talk with anyone we can access in the accounting, royalty reporting, technical, marketing, and business development areas. We tour facilities when appropriate. We show a true interest in the process in a professional, non-threatening manner. We are fortunate in that our objective is not to prove who is right and who is wrong; rather, our objective is to gather information. It takes a special person with an inquisitive mind, who will ask questions, without annoying or becoming too invasive, until the subject matter is understood, to perform these types of audits. Not everyone can do a thorough job.

The lesson: Know who you are hiring, their experience, methods, and philosophy when engaging a firm to perform your royalty audits. Your goal is to get what is rightfully yours, no more and no less. Be sure that the firm that you hire will represent you well and respect the relationship between you and your licensee. Royalty audits are not financial statement audits. Of course you want to verify that support exists for the amounts reported, but you also want to ensure that who you hire will find that which has not been fully reported in a thorough and professional manner.

Red Flags

One of the easiest ways to overcome misreporting is to recognize the signs and prevent its occurrence before it becomes a problem. As we've discussed, most misreporting occurs because of inattention, oversight, or a disconnect between those who negotiated and wrote the license agreement and those who are put in a position to interpret it. To follow are examples of key warning signs of which licensors should be aware.

Licenses govern which products may be sold and where they may be sold, so you should take note if a licensee has launched new products or if the licensee has started selling your product(s) in new territories. Even the opening of a new manufacturing facility should send up a red flag to the licensor. Such changes in marketing and sales practices warrant an investigation and explanation to ensure that the licensee is still within the scope of the license agreement. Further, if the licensee's sales of licensed product(s) are not tracking with the industry, you should be concerned.

In addition to marketing practices, you should also monitor major changes that could impact the licensee, such as changes in ownership. Has the licensee been acquired or has it merged with another company? In either situation, the licensor and licensee may need to revisit the license agreement to ensure that the

licensee remains in compliance. Also, when companies combine, sometimes the licensed products lose importance to the main product line of the new company and gets lost in the shuffle. The key is to maintain the licensee relationship, ask questions about the merging company's product line to see if sales of the licensed product(s) will change. Further, you need to know if there will be any changes to the royalty reporting department and the current royalty report preparer, or if the new company will consolidate the reporting.

Some warning signs are not easy or may take longer to identify. These signs comprise internal changes at the licensee that may compromise the accuracy of royalty reporting. If the licensee has changed its accounting system, the method of calculating and paying royalties may have also changed. If the licensee changes its information systems, new programming furthers the opportunity for errors and omissions. When licensees make such changes, the availability of relevant information may increase or it may decrease; key reports may be discontinued or modified and rendered useless for royalty reporting. Another warning sign is the report itself. You should take note if the royalty report format or, more importantly, the level of detail on the report has changed. It is important to understand why the report has changed. Was someone rethinking what should be presented on the report? Or, has someone automated the report? Either way, you should question the licensee about the change. Further, an occasionally late report may not be cause for alarm. However, if royalty reports are late consistently and if the lag time between reports has been increasing, you should make a phone call. Late reports may indicate internal problems in producing the report or it may indicate something more serious, including an indication that the licensee is experiencing financial difficulty. In short, it is important to know what is happening, maintain regular communication with the licensee and do trend analyses to spot sudden changes in reporting.

Finally, as we've described, simple human error accounts for a significant number of royalty reporting errors. First and foremost, license negotiation and royalty report preparation are generally done by different people. Proper training for those who prepare the report is critical to accurate reporting. Further, ongoing training is important, particularly if the person preparing the royalty report has changed. Still, regardless of the level of training, if royalty report preparation or computer programming is done by humans, you should audit the reports occasionally to assure compliance.

Licensors need to be vigilant and have regular, ongoing communication with their licensees. This is particularly important if warning signs that may impact royalty reporting and payments appear. Again, some signs are harder to discern than others. However, a regular program of auditing may help identify and reduce the number of royalty reporting errors.

Conclusion

Your intellectual property is valuable, probably more valuable than you realize. Make sure that systems are in place for inventorying, monitoring, and

performing desk audits for your licenses. Perform or hire someone to perform regularly scheduled royalty audits.

As we have discussed, it takes a lot of time, effort, and experience to properly investigate license agreements, the subject companies, and their business activities. Not every organization has these resources. Not all organizations need or want in-house expertise in this area. At the same time, there is always someone, usually either investors, directors or board of trustees, who expect and demand that the organizations be run well; their money and reputations are at stake. Make sure your entity has the proper controls in place to withstand the scrutiny.