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SEPTEMBER 2015 WWW.METROCORPCOUNSEL.COM

IN FOCUS: LICENSING

Forging Win-Win Royalty Deals

Clear terms, fair dealings are the path to success for licensors and licensees

By Lewis Stark / EisnerAmper LLP

Properly reporting and accounting for royalties can be challenging and complex for licensees. Ensuring that your licensees are operating as intended and paying you properly can be daunting for licensors. However, no matter how technical royalty and contractual obligations may be, there are a number of straightforward actions that both licensors and licensees should consider and take to better understand their contractual obligations. Doing so will place licensees in a better position to adhere to the terms of licensee agreements and will enable licensors to protect their rights and properties proactively.

For licensors: Know as much as you can about your licensees. By undertaking some reasonable due diligence, licensors can learn how the licensee operates. It is important to ensure that the licensee's business and accounting systems and controls are structured in a way that enables them to adhere to the financial provisions of your license.

Knowing how the licensee conducts and accounts for their business will allow you to draft a license agreement with well-defined and clearly stated financial provisions that are tailored to your licensee's business environment. This will enhance your licensee's ability to comply with such provisions resulting in more accurate royalty accountings. Countless times I have heard licensees comment that the contractual sales, discounting and reporting requirements are not in sync with their business model. Thus they try to apply their model into the contractual reporting requirements, which can result in royalty disputes that can become costly.

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For licensees: Enter into agreements that make sense financially. There's real risk in assuming you can change or circumvent the contractual terms after the game has started. Similarly, have a thorough understanding of the financial provisions and be sure your understanding is in sync with licensor. Being on the same page helps avoid incurring unexpected royalty costs.

We have been involved in situations where the licensee reported royalties based on their business model and not the agreement, resulting in large royalty underpayments. Their argument that the agreement did not consider the characteristics of their business did not resolve the dispute and proved costly.

Licensors should be proactive in protecting their properties. The key: "Trust but Verify." Monitor your licensee and your licensed products in the marketplace. Is your licensee having financial problems, do they have a lot of turnover, are they growing rapidly or were they just acquired? If so, there is a greater chance that royalties are not being reported properly. Compare your licensee's royalty accountings to product approval files to identify both unreported products and sales of unapproved products; identify where your products are being sold at retail; and monitor the Internet. This intelligence can be used to determine if problems exist. Know the limitations of your contractual audit provision so you don't lose the right to audit older statements. Exercise your rights in a non-punitive manner by managing expectations. Royalty auditing is commonplace, so don't be afraid to audit your licensee. The marketplace knows when licensors are passive and may take advantage. We have seen 10 percent to 20 percent increases in royalty revenue for established licensors after commencing a royalty compliance program.

> ***For licensors the key is: "Trust but verify."***

Licensees should build a reputation for rendering accurate and transparent royalty statements. Take advantage of the tools at your disposal. Explore the functionality of various brand licensing software packages. Implement a package that fits your model and/or the reporting requirements of your largest licensors. This will enhance your ability to monitor minimum guarantees, deadlines and milestones and to report accurately. Additionally, licensing software creates an archive of accounting records to support your royalty accountings that are subject to audit, which can extend over many years. Being known as a licensee with accurate and transparent royalty statements is a competitive advantage.

For both licensors and licensees: Document all revisions to the agreement in writing even for temporary or immaterial issues. License agreements are often amended verbally, which can result in problems down the road, especially when personnel changes. It is commonplace to find that small requests are not documented when the use of a simple confirming email could suffice. Consider documenting all changes to your license agreements either formally or informally.

We had a situation where a licensee purportedly received a verbal waiver to discount a product beyond contractual limitations and to sell the product outside of the licensed channels. Because the licensee could not document the waiver and the license had subsequently been acquired by another entity, the licensee ended up having to pay additional royalties for the excessive discounts.

The bottom line for both licensors and licensees: Create systems, processes and procedures to enable you to understand, adhere to and monitor your license obligations. Clear and unambiguous licenses, coupled with honest, straightforward dealings, go a long way toward mitigating costly problems and ruined relationships down the road. If both parties under a license agreement are successful, everyone wins!