Royalties Don't Need To Be Lost

BY JOE ZIER*

Are you collecting all royalties due you? Intellectual property in high-tech society creates opportunities for fraud, deceit

Your company invests substantial time and capital in developing trademarks, patents and other forms of intellectual property. If applied knowledge creates value (and cash) for your firm, are you collecting all the royalties you are entitled to?

One effect of the ongoing shift from an industrial to a service economy is the explosion of intellectual property and the rapid integration of high-tech products into combined packages. As the frontiers of different technologies meet the arts, business and science, royalty and franchise agreements are being formed with growing frequency. Unfortunately, most businesses, and especially young, growing businesses, are not equipped to monitor royalties. These creative and dynamic companies, while resource strained, are at risk and suffer high exposure to insufficient royalties remittances.

About 400 years ago, Sir Edmund Coke noted, "Fraud and deceit abound these days more than in former times." Only the means and the property have changed — not the motives. In the past, stolen property consisted of items that could be seen and touched, and most victims knew when they had been robbed. Today, the property at risk may be ideas and concepts. Former CitiCorp chairman Walter Wriston noted that international customs continue searching for physical goods of value, while ignoring something like a floppy disk carrying data worth much more. It is clear that a differing concept of valuable property has been created in the last 20 years.

A recent KPMG fraud survey indicated that fraud and deceit are still with us. The survey of 2,000 senior executives in large corporations around the U.S. revealed:

- 76% of executive consider fraud a major problem today.
- 52% think fraud incidents will increase.
- 77% suffered some sort of fraud in the last 12 months.

The respondents pointed to two primary causes:

- 98% indicate economic pressure as the main motive.
- 58% cite a weakening of societal values and a decrease in the ethical and moral fabric of society.

Young companies, especially undisciplined, cutting-edge companies are under intense pressure to generate cash. Money saved by avoiding royalty payments can fall right to the bottom line and, more importantly, into that ravenous cash account. One can easily understand a desire to defer or not make royalty payments to maintain a higher cash flow. On the other hand, companies receiving royalties may not have the resources to monitor and ensure that they are getting all their earned royalty and franchise payments. In general, most businesses are not well-equipped to process and evaluate royalty and franchise payments.

Are You Being Cheated?

In today's business environment, knowledge and know-how are the key to a firm's competitive advantage. A simple understanding of what should be included in royalty and franchise agreements can allow you to significantly enhance the probability of getting what you deserve.

Royalty and franchise agreements arrange for payment to an inventor or proprietor for the right to use their invention or service. Royalty and franchise payments are generally defined by some form of legal agreement. The accord may be based on a friendly, mutually beneficial relationship where there is an understanding to share or develop a product. Conversely, it may have been borne of a settlement between the parties, where one agreed to pay a "reasonable royalty" to resolve a dispute. Weak provisions to assess any loss of royalty due to competitive issues often result in an ongoing adversarial environment.

Royalties are often payable on:

- Patents or copyrights.
- Franchise payments.
- Propriety information.
- Trade secrets.

Royalty and franchise agreements generally include a provision for reporting by the licensee to the licensor on sales of units and the royalty due. However, that reporting is often limited to the number of units sold and the total sales in dollars. This minimal information leaves ample opportunities for some form of under-reporting, whether intentional or not. Given this minimal reporting, what can you do when there is a suspicion of under reporting?

A Simple Example

Your licensee has reported sales dollars and units sold to your organization. Your standard review includes dividing those sales by the reported units sold, producing an average price per unit. But this average price appears substantially higher than your understanding of the market price. As a result, you now have a specific concern that

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there is under or incorrect reporting in either units or pricing. In addition, your royalty agreement has the typical weakness of failing to provide for adequate documentation to determine the discrepancy.

The identified error could be due to an innocent mistake, negligence, or intentional misrepresentation. Innocent mistake and negligence can be easily resolved. Intentional misrepresentation is often driven by the payor's aversion to parting with its precious cash for what it perceives to be a money-for-nothing situation. Fraud, which requires intent, is more than a mistake or bad bookkeeping. Most individuals committing fraud attempt to cover their tracks. Numbers may be misreported in order to foil simple arithmetic tests such as the one above, and to maintain the expected result.

Once a discrepancy is uncovered, the licensor may have to re-evaluate the relationship of trust between the two parties. Can an ongoing relationship be maintained if fraud appears to have occurred, or is it premature to decide without a full-scale audit of the sales? If an audit takes place, then what is the nature of the inquiry? If the examination does result in a finding of significant under-reporting, then is the license holder prepared to move toward discussions with respect to recovery and to possible litigation? This requires an investment of money as well as time, with uncertain results, possibly months or years away.

Are All Audits Conceived Equally?

Traditional audit procedures are simply not designed to detect fraud. There are several reasons why traditional procedures may not be effective. First, information provided to the auditor may be incomplete. This is because the fraud audit will most likely be conducted in an adversarial environment, giving rise to a number of problems with respect to the disclosure of competitive information between the parties.

Second, traditional procedures assume a certain level of trust and are more likely to be misled by false documentation and misrepresentation. There may be elements of collusion between members of the licensee and licensor's organizations. If an element of collusion or fraud exists, then it is reasonable to assume there will be cover-up along with it. It is likely that a fraud will attempt to hide the deception. The cover up may require a collateral act, such as forgery or the creation of false documentation, and can go as far as destruction or alteration of existing and secondary records to support false documentation claim.

Third, the traditional audit is unprepared to address the issue of diversion. Diversion, difficult to detect or to prove, could be accomplished by simply setting up secondary companies to move product and/or profits outside the normal reporting entity.

Our experience leads us to advocate that a different approach be taken. This alternate approach to examining royalty reporting requires a knowledge of not only the techniques for under reporting royalties, but it also requires the ability to recognize some form of cover-up when it appears. A healthier dose of reasonable skepticism is called for in most cases. After all, isn't this why you conducted the royalty audit in the first place?

A Flu Shot for the Royalty Line?

It's important that a company entering into a royalty or franchise agreement evaluate the compliance issues. Specific items that should be addressed include: enhancing the incentive to report accurately, allowing access to source documentation, frequency of reporting, and making provision for a royalty compliance audit. Good agreements prevent mistakes and discourage abuse by clearly stating the expectations of the parties and defining a course of action in disputes. Remember, the nature and extent of the reporting should be evaluated at the time the agreement is made to provide the licensor with more information than merely units and gross revenue.

Questions You Should Ask

What procedures are currently in place to detect potential fraudulent activity?

What criteria is currently being used to detect whether a royalty compliance audit is necessary?

How well do you know your licensee? What is the current relationship between the parties?

Is the royalty agreement structured to handle disputes?

Reverse the roles: If you were the licensee and did not want to pay royalties, what would you do to circumvent the process?

What incentives or disincentives are in place to motivate the licensee to report correctly?

Is the licensor motivated by limited resources or some other form of financial need to underreport the royalties?

It can be valuable to model an organization's exposure based on its past experiences so that deviations can be detected and resolved. Further, it may be possible to look at historical noncompliance and project it as part of your risk model. While the initial hurdle of developing a model seems difficult, it can be implemented with reasonable effort. It will save you time and effort in the long run.

There are a number of solutions a licensor may elect to use:

Out-source the royalty process so that full collections happen transparently to the company. This frees the company's talent from worrying about collection issues. Outsourcing is a common practice in licensing.

Structure your agreements to improve the information flow between the parties.

Use more skepticism in existing compliance audits. (And don't feel bad about it.)

The number and dollar value of royalty agreements continues to grow. The continued merging of technology with art, business and science will only accelerate the pace. Unfortunately, our survey indicates that traditional ethical and moral standards appear to be decreasing while the need for trust is even greater. For companies or individuals who depend on royalties, a critical evaluation of the royalty payment process can be very rewarding. Finally, every business must take risks; reduce your exposure by taking calculated risks. Don't take risks merely by being rash!