

# Designing And Implementing An Effective License Compliance Program

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It is inherently obvious to all readers of *les Nouvelles* that intangible assets and intellectual property have become increasingly important to companies in recent years. These intangible assets take on many forms, including patents, trademarks, trade secrets, and license agreements. What may not be so obvious is that most companies do not regularly make it a business practice or priority to maximize the economic impact that these assets can and should generate to their firm. This means that many companies, large and small, in industries such as hi-tech, software, biotechnology, pharmaceutical, and branding, consistently leave money on the table.

The purpose of this article is to address the specific area of maximizing the economic impact from one type of intangible assets—a portfolio of license agreements. By designing and implementing an effective license enforcement program, companies can ensure that they are maximizing licensing revenue. While this may sound obvious, such systematic and successful programs are surprisingly few in the real world. There are many possible reasons to explain this void. However, there are many more reasons why such a program should be a top priority for upper management.

In recent years, companies have begun seeking out consulting firms to help develop effective license enforcement programs. Such “Licensing Management and Revenue Recovery” programs can easily pay for themselves over time and are becoming more common. When considering the establishment of such a program, companies should be focused on addressing the following areas:

- Establishing a world-class program utilizing best practices to address company specific needs efficiently and effectively. This means getting management commitment and buy in from the top down, and requires certain dedicated resources to ensure success;

- Developing a systematic enforcement program, designed to protect the company’s intellectual property and licensing rights, which sends a clear message to the market that such a program has become a normal part of doing business. At the same time, the program must be carefully designed to be sensitive to ongoing strategic business relationships and channel partners;

- Creating a program that includes a quantifiable measurement of success, both in the establishment of short-term and long-term goals. The program should be cost effective, that is, it should be revenue/expense neutral. In many examples I have seen, such a program becomes a profit center in and of itself. There will inevitably be certain one time up front costs, that will not necessarily generate immediate tangible results, but will definitely benefit the long-term success of the project.

## Life Prior to Implementation of a License Enforcement Program

Prior to the establishment of a systematic enforcement program, most companies approach this issue in a very ad hoc or exception basis. There is generally no strategic thought process, no regular on-going plan, and no owner of such a program within the company. Most of the actions simply tend to be reactions. These reactions are generally a result of rumor, speculation, or incomplete facts, and are not applied consis-

tently across all licensees, regions, or channels.

Based on our experience, a typical situation that we would find at a subject licensor would include one or more of the following factors:

- a. Lack of existing internal controls, policies and processes in place to address even the highest risk areas of potential revenue leakage (ie. controls designed to identify licensees that have not reported as contractually required);

- b. No enterprise-wide information system or management report designed to capture and analyze the relevant and critical license agreement data and reporting data in a single electronic tool;

- c. All royalty reporting from licensees is done on a self-reporting/ honor system, and licensor has no visibility into the basis or support for such reporting. No royalty examinations are being performed, even though certain licensees clearly do not appear to be reporting accurately.

- d. There are usually no processes in place to analyze reporting variances from historical or anticipated royalties. Thus, there is no quantifiable methodology in place to measure risk on a licensee by licensee basis;

- e. There are no processes in place to stratify royalty payments by customer, by geographic region or by type of license;

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f. There are no historical standard license agreements in place, meaning that key terms and conditions likely vary dramatically, even with the same customer, generally resulting from a company making numerous acquisitions and acquiring intellectual property rights in so doing;

g. There is not centralized control over licensing, or a designated owner of licensing issues. This means that physical license agreements are not centralized in any one location, and multiple agreements likely exist with certain customers (to the ultimate surprise of the licensor);

h. Lastly, the process of conducting royalty examinations is rarely done, and if so only initiated due to known intentional under-reporting or as leverage for future license agreement negotiations.

### **Development of a Successful License Enforcement Program**

A well-designed enforcement program includes various processes and internal controls, monitoring, and enforcement activities. However, the first and most critical key to success is to get management commitment and “buy in” from the top of the organization. It is imperative that the company’s Chief Executive Officer, Chief Financial Officer, V.P. of Sales and General Counsel are solidly supportive of such a program. Day to day responsibilities are generally delegated to a middle manager, and without the support of these key people, the program will not be successful. If there is internal turmoil among top management, again, the program will not be successful. With buy in, there is a unified strategy and consistent message from management, both to internal staff and external customers. Thus, it is absolutely essential that everyone on the management team be on the same page with regard to design and implementation methodologies.

The next priority in developing a program is to get your arms around the existing licensee situations and the key data within each of the license agreements. The development and implementation of an electronic data base tool is important to future success. These processes would

include the identification, capture, and analysis of all the relevant data within the various license agreements. This allows the company to manage the program with real-time information and knowledge. Such relevant data would include items such as the relevant royalty rate, the basis of the calculation, technology or products covered, territories, termination date, “owner” of the royalty reporting, auditing rights, etc. Such a tool does not necessarily have to be cumbersome, complex or expensive. However, it does have to be easy to use, interface with existing systems, and be cost effective.

Once you have your arms around the facts, you can start developing internal processes and controls over any possible revenue leakage. Maximizing all legitimate revenue from licensees requires a high degree of focus, attention by management, and internal processes that address the major risk areas. These processes and controls should allow for both qualitative and quantitative analysis to detect potential abusers of license reporting requirements.

For example, a process should be established to ensure that all licensees who should be reporting royalties are in fact reporting and doing so on a timely basis. If licensees are not reporting timely, there should be a process in place to automatically and immediately contact that customer and inquire as to the status of the report. Another example is the ability to compare the royalty reports to historical reporting or anticipated reporting for trends, possible errors, etc. This will allow for targeted enforcement activity against licensees who do not take their reporting responsibility seriously. These analytical tools should be a routine practice and done on a regular, recurring basis. The more automated this process can become, the more efficient and effective it will be. These processes are sometimes called “desk audits”, and can identify many issues (i.e. under-reported royalties) without much cost or effort. This is an often overlooked, but an easy first step towards a successful compliance program.

Systematic and regular enforcement activities are another important component of a successful program. This means questioning royalty reports that do not make sense, and the implementation of royalty examinations at licensee sites to review books and records. Our experience is that a vast majority of royalty examinations result in the identification of under-reported royalties, thus generating some level of incremental revenue. Frequently, the licensee will find under-reporting when they are preparing for a royalty exam, and report them to the licensor before the exam actually begins.

Most license agreements contain a fee clause that mandates that the licensee cover the costs of the examination if a certain percentage of under-reporting is identified. These “5%” clauses provide motivation for the licensee to report accurately, because if they do not, they must cover the cost of the examination. Often, the examination identifies specific reporting issues (e.g., internal control breakdowns) that, once addressed by the licensee, will enhance future reporting. Target licensees should be selected for examination based on two methodologies—specific companies where facts exist that might support possible under-reporting and a random selection of at least some of the highest paying licensees.

In addition to the immediate economic benefits, there are also substantial intangible benefits to performing regular royalty examinations. Experience shows that channel partners communicate with one another, and the grapevine provides an opportunity for these partners to know which companies do and do not police their licensing rights. By implementing such a program, an organization will create a reputation for taking their agreements seriously, and the channel is likely to respond with more accurate and timely reporting of royalties. Sometimes, even the written announcement of a formal enforcement policy to the channel results in immediate upward adjustments to previously filed royalty reports.

## The Settlement Process

The settlement processes used to negotiate any identified findings from royalty examinations is an often overlooked and poorly handled area. A company should develop a systematic process for the immediate follow up and settlement of findings, such that any negotiations with licensees are not allowed to drag on for extended periods of time. The timing of any action is critical, for the more time that goes by without a specific demand, the more likely that the company will not get the economic settlement that it desires. Late fees or interest can be used as leverage to expedite the settlement process. Settlement discussions may involve General Counsel, V.P. Sales and the CFO, or may be handled by only one person. Also, settlement discussions often result in the opportunity to renegotiate the license agreement and resolve any problems with the agreement language.

Typically, findings fall into two types—hard and soft. Hard findings are those items where there is very little dispute and are fact based (i.e. under-paid royalties due to an error in the calculation). Soft findings are those items where some grey area exists (ie. contract interpretation). Both hard and soft findings must be considered, as well as other ramifications, before agreeing to a negotiated settlement. The following types of questions should be discussed internally before reaching a negotiated settlement: a) how comfortable are we that the amount of the under-reporting is all-inclusive? b) are we potentially leaving money on the table? c) would the licensee allow us to perform additional procedures in order to quantify the settlement amount? d) does this set a precedent with this customer or others in the future? e) has the licensee fixed the underlying reporting problems and

will we face a similar situation in the near future? f) is this customer in financial danger and is some cash now better than no cash later?

## Other Items to Consider

The concept that the program needs to be cost efficient (i.e., a profit center, or self funding at a minimum) is a very important one. Regardless of how the identified and collected incremental royalties are internally allocated within an organization, the program should be able to demonstrate that it is at least revenue/cost neutral. Certainly, it would be better if the program were actually a profit center, but in no event should it be a major drain on corporate resources or create large incremental expenditures. Licensors often use a strategy of selecting two or three large customers suspected for under-reporting to generate immediate, tangible results. The findings and settlements from these examinations are then used to fund the early one-time expenses.

The use of best practices, including the drafting of certain language in future license agreements is also very important. Some best practices that should be considered might include:

- Every effort should be made to convert all license agreements into a single standard format, such that managing the license review process becomes much simpler.
- A right to “audit” clause should be included in every contract.
- A letter of program introduction should be sent, so that when licensees are selected they are aware of the program and do not feel singled out.
- Default penalties or late payment penalties for under-reported royalties should always be in the contract.
- Contract language should include a clause in the agreements

with regard to the royalty examination fees. If the examination were to identify an under-reporting of 5% (can also be a specific dollar amount) or more for any single period, the fees to perform this work would revert to the licensee.

- Royalty examinations should be performed in all territories, on a regular and systematic basis.

Finally, companies should not be afraid of implementing such a program due to fear of alienating customers or business partners. Often times, the sales and marketing staff will object to a royalty examination for this very reason. However, by not performing this work, you send the message that you are not serious about enforcing your intellectual property rights. After all, the audit clause was originally negotiated into the license agreement so that it could be utilized as necessary. Royalty examinations neither have to be adversarial or burdensome if planned and carried out correctly. Such examinations should simply be performed to identify the facts and determine if all the relevant terms and conditions of the license agreement are being adhered to properly.

## In Conclusion

There is definitely an incongruity between revenues generated from licensing intellectual property and the level of resources companies expend to enforce these agreements. Compliance by licensees is often just taken for granted. This is a mistake. Licensees know which licensors enforce their agreements, and royalty reporting is impacted by this knowledge. If companies derive revenues from licensing, a compliance program should be part of their on-going business practices. In our current economic times, why would a company not employ a program designed to identify incremental revenue for very little cost?