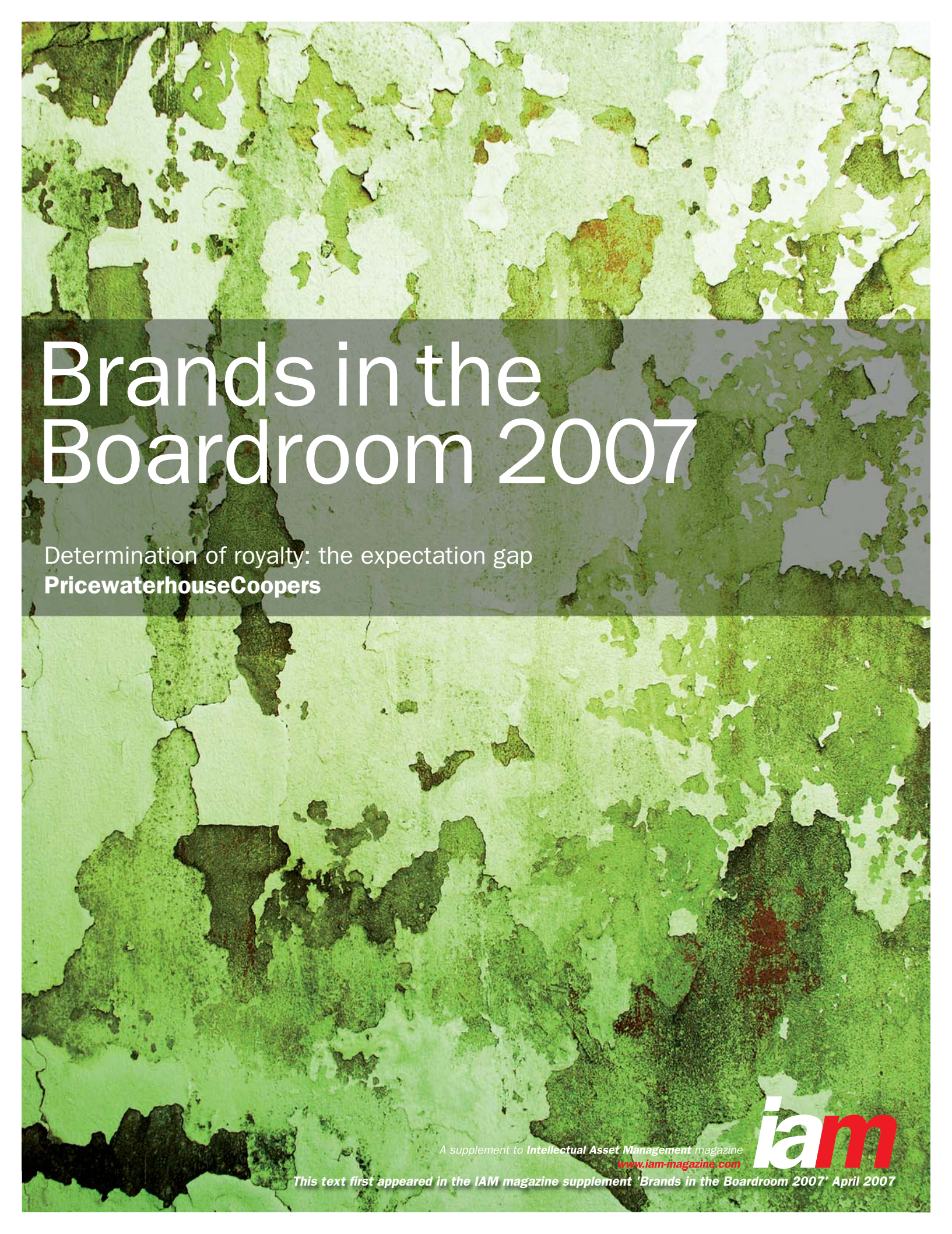




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PricewaterhouseCoopers

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Determination of royalty: the expectation gap

By **Mark Walters** and **Michael J Yachnik**,
PricewaterhouseCoopers, New York

As companies within the apparel, high-tech, infocomm, consumer products, pharmaceuticals, entertainment and media, and various other industries seek new revenue streams, licensing is becoming a significant component of their strategy. From entering new markets – both domestic and international – to creating brand extensions, licensing can be an effective growth strategy.

The objective of licensing is to generate royalty income, but also to increase brand awareness and support your core products. With these strategic needs come many decisions along the way – from the tactical questions, such as: “Which product(s) do I even license?” to the trailing questions, including: “What is the right royalty rate for my products/technologies?” Whichever decisions your organisation chooses to make, one thing is for certain – if you do decide to license your products/technologies, you must be entirely certain you are structuring your agreements as clearly and definitively as possible in order to achieve the maximum return while protecting the value of your intellectual property.

Generally speaking, once a licensor and licensee agree to do business with one another, there are two areas of focus in the agreement:

- The qualitative terms of the agreement – such as design approval and quality control.
- The quantitative terms – specifically, the determination of the royalty base and the royalty rate itself.

While there tends to be an extensive amount of time spent on both sides of the table ironing out the details behind the terms and royalty rate, one would think

both parties come away with a firm understanding of the agreement’s structure. In many cases this conclusion could not be further from the truth.

Given that the intention of both parties is to form a business relationship that is mutually beneficial, the terms of the agreement must be clearly defined so that each party understands its responsibilities and the financial impact of the relationship. The result, far too often, is that each party interprets key sections of the agreement differently and, usually, in a manner that is financially detrimental to the other party. While these interpretations, or misinterpretations, are not reached consciously, they can lead to very uncomfortable discussions down the road. This article will further examine some of the reasons why this happens.

The process

One of the main reasons for the gap in understanding between the two parties is the lack of involvement by all relevant parties during the structuring and ultimate execution of the agreement. Quite often the process starts and ends with a business unit leader and a representative from the legal department as the only two parties within an organisation involved in the structuring of a licence agreement. While the business unit leader may be most intimate with the company’s strategy as it relates to some of the leading questions or decisions mentioned above, he/she may not have the required background to address the entire structure of the agreement fully.

Generally speaking, it should be up to the business unit leader to frame the strategy within the organisation and be firmly engaged in negotiations with the licensee. However, there are clearly components of an agreement, unless he/she has the required background, for which additional members of an organisation

should be called upon to analyse the agreement.

One of the individuals who should certainly be included (in addition to legal) is someone who has an accounting background. Far too often terms are included within an agreement that would require (a) an accountant to interpret or (b) further expansion and definition of a term, and it is an accountant who is best qualified to develop this understanding. The significance of having an accountant examine the agreement is especially important when defining the royalty calculation model or the net sales definition which is a common component in many of the industries mentioned above.

As it is typically individuals within the company's accounting/finance department who are either calculating the royalties based on the definitions of the royalty base (the licensee) or receiving the royalties and examining the statements which support such agreements (the licensor), they are the ones best suited to address requirements such as required back-up related to the royalties. Far too often royalty payments and the related statements are not adequately reviewed merely because the licensee is not required to provide the level of detail within the statements.

The terms

In addition to the prospects of the process having fundamental weaknesses, in many cases the agreement verbiage also has fundamental weaknesses. What may appear upon the face of it to be a simple agreement with a simple structure could contain all sorts of hidden traps in the form of ambiguities.

In recognition of the reference above to include a qualified accountant, an example of an ambiguity which may be caught is something as simple as the word "allowances" as an accepted deduction within a net sales definition. For example, while "allowances" to an individual in the apparel industry may mean strictly "markdown allowance", to an individual within a licensee's financial organisation "allowances" may mean markdown, bad-debt, discounts and/or any miscellaneous adjustment. The result of this difference in interpretation can mean hundreds, if not thousands, of dollars in the bottom-line royalty calculation.

Also important when discussing terms is the need to consider fully the effects of one party not being in compliance with certain

terms. Again, to use an example within the apparel industry, many agreements provide the licensee with the ability to sell a particular product in multiple channels; ie, wholesale and discounted or closeout sales. While the agreement may define a limit as "not to exceed" a certain amount of sales being sold at "discounted" pricing, in many cases the licensor will not expand to define the financial repercussions should a licensee exceed the limit. Depending upon the exact terms of the agreement, generally it is understood that a licensee would be in breach of the agreement should it exceed the maximum "discounted" sales allowed; however, a licensor should also consider expanding the clause to include a component which would define a "true-up" of those sales in the event a licensee does exceed the maximums allowed and the licensor chooses not to terminate the agreement (should the agreement allow for termination). An example may include a true-up for sales, for royalty purposes, which would involve having the licensee value the sales at full wholesale list price. This would then further clarify the issue of a licensee exceeding the discounted sales.

From a non-financial sense, particularly with regard to an organisation operating in a manufacturing environment, licensors should also consider the significance of not clearly defining within their agreements the requirement on a licensee to obtain and maintain in its files the contractor's written agreement to abide by the contract conditions, including, but not limited to, adherence to child labour laws, all applicable international, national, state, provincial, local and other laws, rules, and regulations, including applicable environmental laws. This issue can most directly be related to brand erosion. Should the contractor not abide by the conditions listed above, the negative effects on the brand are almost immeasurable.

Conclusion

As agreements tend to be in an ever-changing state, many of the issues outlined above can be easily addressed in a contract template which would be the starting point for an organisation's contracts. As your business model grows and evolves, so should your contracts in order to fit the needs of your current business environment. These key considerations may help to place your organisation in as favourable a position as possible with relation to your contractual agreements.



PricewaterhouseCoopers

300 Madison Avenue,
New York, NY 10017, USA
Tel: +1 646 471 3038
Fax: +1 813 329 2688

www.pwc.com

Mark Walters

Director
mark.c.walters@us.pwc.com

Mark Walters is a director in the dispute analysis and investigation practice of PricewaterhouseCoopers, and serves as the regional leader for the licensing management service within the New York metro region. Mark primarily consults with companies regarding intellectual property, specifically related to licensing management programmes and contract compliance-related issues.

Mark joined PwC five years ago. Prior to joining PwC, having spent 10 years with a global provider of disbursement-related consulting services, where he served as VP of operations for the eastern region. Mark has over 15 years of professional experience, including 11 years primarily focused on development of contract compliance programmes.



PricewaterhouseCoopers

300 Madison Avenue,
New York, NY 10017, USA
Tel: +1 646 471 8314
Fax: +1 813 329 5486

Michael J Yachnik

Partner
michael.j.yachnik@us.pwc.com

Michael J Yachnik is a partner in the Advisory Services practice of PricewaterhouseCoopers LLP in New York. He has over 17 years of diversified financial, economic and accounting experience working with corporate management and outside counsel.

Mr Yachnik's experience includes a variety of intellectual property consulting, with a focus on licensing management, compliance and valuation-related issues. He is currently leading ongoing licensing compliance projects for large global corporations involving several foreign licensees. He has served clients in a variety of industries, including insurance, not-for-profit, healthcare, pharmaceuticals, telecommunications, retail, apparel, textiles, hospitality, manufacturing, computer hardware and software, and real estate. He has instructed at training courses on a variety of valuation and accounting concepts, approaches and techniques.

Mr Yachnik received his BSA degree in accountancy from Villanova University and his MBA degree in economics and finance from New York University.

PricewaterhouseCoopers

300 Madison Avenue,
New York, NY 10017, USA

Tel: +1 646 471 4000

Fax: +1 813-286-6000

Web: www.pwc.com