

**SCCE Higher Education Conference**

**Assessing Compliance in Technology Transfer Programs:  
Royalty Underreporting and Faculty Non-Disclosure**

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**Presentation Goals**

- Outline two important compliance issues in technology transfer programs:
  - underreporting of earned royalty by licensees of university intellectual property and
  - non-disclosure of inventions to university
- Identify strategies for addressing non-compliance through monitoring and auditing efforts
- Discuss cost/benefit ratio of potential monitoring/auditing activities

## Underreporting of Earned Royalty by Licensees

### Key Points to take away about Royalty Audits

- Not all licensees underreport royalties
- However, enough do that action on your part is required
- Royalty audits help because they:
  - Provide essential intelligence about licensee
  - Do not end relationships
  - Require experience and specialized skills
  - Generate additional royalty income

### Frequently asked questions

- What is a royalty audit?
- Why should I care about royalty audits?
- Who should do the audit for my institution?
- How should audit candidates be selected?
- How much will it cost and how long will it take?
- What is the licensor's role in the audit process?
- How are issues identified typically resolved?
- What are the primary reasons for underpayment?

### What is a royalty audit?

Addresses two key questions:

- Has the licensee accounted for all Licensed Product sold?
- Have they done so in a manner consistent with the License Agreement?
- *Thus, the issues are contractual, not GAAP*

Consists of:

- Prep work: gather info & define terms, schedule, confidentiality
- Fieldwork on site: interviews and extensive analytical procedures
- Reporting findings and laying groundwork for successful negotiation
- *Balance multiple channels of communication for success and cost mgmt*

### Why audit?

- To Maintain an Aligned IP Strategy
  - Correct past errors and avoid future ones (generating cash)
  - Ensure compliance with contract payment terms
  - Fulfill fiduciary responsibilities
  - Emphasize the value licensor placed on IP
  - Peace of mind

### Who should conduct the licensing investigation?

- Some licensors want to use their own internal audit staff...
- however, license agreements often require independence, and...
- licensee may object on grounds of confidentiality.
  
- Using 3<sup>rd</sup> party investigator with nondisclosure agreement generally addresses confidentiality issue
- Investigator should have experience in adversarial environments

## How should audit candidates be selected?

Key idea: selection of candidates is only as good as ability to assess risk

- Most university licensors want income to exceed costs
- However, underreporting by definition means lower income
- What does inventor say?
- Research usually identifies good audit candidates

Develop some tools for assessing licensee compliance...

## How can Universities assess licensee compliance?

We suggest three approaches:

- 1) Scoring Chart or Red Flag Checklist (do this for all licensees)
- 2) Follow-up research (or all licensees)
- 3) Approach some licensees directly

The design and implementation of fully-developed Licensing Compliance Systems is beyond the scope of this discussion, however, we have assisted many clients to develop such capabilities. In addition, we offer a half-day training course to assist licensing officers to better assess licensee compliance and the likelihood of royalty underreporting.

**Approach #1: Red Flag Checklist (do for all licensees)**

<u>Red Flag to check for</u>	<u>Points</u>
1. Licensor's gut instinct & inventor feedback regarding underpayment	3
2. Royalty reporting is inconsistent or lacks detail	3
3. Complex royalty based on COGS, profit or other allocation formula	3
4. Royalties are declining sequentially from last quarter or last year	3
5. Invention is part of an assembly or is described by licensee as an option	2
6. Licensee pays minimum year after year, but no earned royalty	2
7. Overseas affiliates/manufacturing, and/or sublicensees	2
8. Licensee uses invention in multiple applications	2
9. Licensee is under regulatory scrutiny for financial matters	1
10. Licensee was recently acquired; turnover in CFO/Controller role(s)	1
11. Licensee has mentioned "design around" in connection with licensed rights	1
12. Patent is near expiration and licensee has never been audited	1

If you can check-off any two 3-point items, or where the total of checked off red flags is at least 10 points, a royalty audit may be warranted.

**Approach #2: Research and analysis (do for all licensees)**

Key resources:

- Royalty reports
  - Sequential analysis of licensee's own results
  - Compare against competitors, industry averages, or other non-exclusive licensees, if any.
- Licensee: Press releases, website review
- Public companies: analyst reports, market research, Factiva, etc.
- Private companies: Hoovers and other specialized services
- Markets / technologies: analyst reports, trade associations, etc.

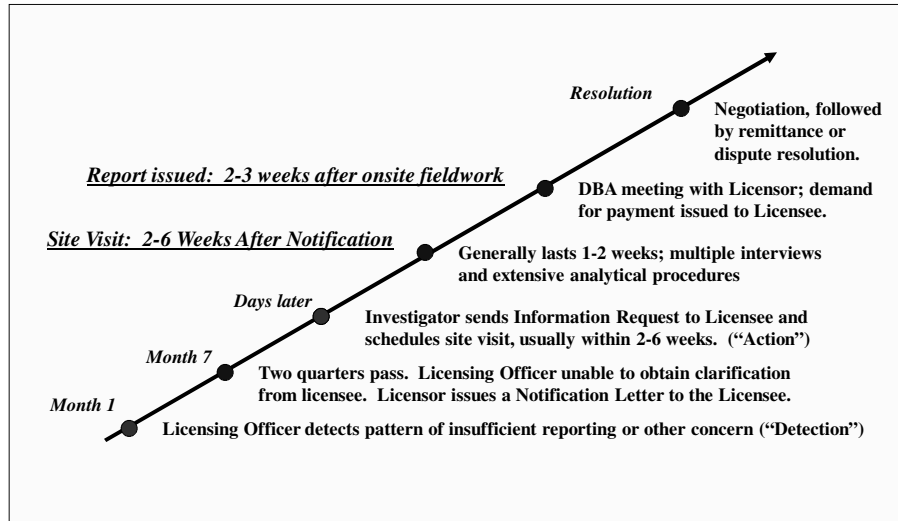
### Approach #3: The direct approach (some or all licensees)

- Ask questions and demand responses
  - Questionnaire with follow up phone interview
  - Questionnaire can be for one, some, or all licensees
  - May commit licensee to positions that benefit you later
  - May cause licensee to undertake “self-audit” (useful, but not a complete answer)
  - Can incorporate hypotheticals: what royalty would result if conditions A, B, and C are true?

### Case study

- Licensee is publicly traded maker of medical devices
  - Licensee claimed licensed product is an “optional” component
  - 6 Red Flags from Checklist
  - Website describes licensed product as “integrated” part of entire system
  - SEC filings disclosed product sales as distinguished from service and warranty revenues
  - “Backing out” revenues on royalty report permitted accurate approximation of unreported revenue and thus, unpaid royalties
    - ***Audit showed no systems sold without the allegedly “optional” feature; in fact, the feature drove the sales of the system***
    - ***Royalty shortfall quadrupled in 4 quarters after problem identified***
- Lessons:
- Licensee may try “same thing a different way,” in this case, to redefine base.
  - Act quickly to reduce size of the problem

### Timeline of “typical” licensing investigation



### Role of the licensing office in the royalty audit process

- Organize key information for us: agreements, amendments, key correspondence, royalty reports, etc.
- Get inventor involved if there are questions about definition of licensed products
- Audit notification letter from licensing office to licensee
- Confidentiality issues: licensee usually wants us to enter NDA -- this is not usually a problem provided we can fully disclose our findings to you
- After the audit, follow up promptly with the licensee to resolve underpayments and other issues

## Resolution

- Often involves credible threat of termination or adversarial proceeding
- Understand alternatives available to them and to you
- Impact on relationship going forward
- Lengthy delays hurt your negotiating position

## Frequent reasons for underpayment of royalties

- Underpayment on licensee's own sales: key issues are definition of Licensed Product, the number of units sold, the sales price, and deductions taken
  - Units
    - Newly developed products not treated as royalty bearing
    - Royalty calculated on only part of a composition
    - Licensed product defined as an "option" of larger apparatus
    - "Allocation" of value between licensor's IP and licensee's "contribution"
    - Territories where product made or sold are not patent protected
  - Pricing
    - Proxy price established for royalty accounting
    - Royalty based on sell-in price to Affiliate
  - Deductions
    - Impact of Sarbanes-Oxley: external accountants requiring larger reserves
    - Order of deductions or offsets can impact calculation
- Sublicenses and sublicensing income
  - Agreements not reported or characterized as other types of agreements
  - Multiple elements of agreement cloud value of IP transferred
  - This is a large and growing problem

Summary Point: Be Proactive About Both of These Activities

- Assessing Compliance
  - Requires diligence and time
  - Increasing # tools available
  - “Red Flag Checklist” or High Level Review can help to rank challenging licensees
  - Early problem recognition increases cash collection and reduces long-term expense
- Royalty Audits
  - Not all licensees bad actors
  - Provide essential intelligence
  - Don’t end relationships
  - Require experience and skill
  - Produce positive results

Knowing is Better

## University of California FY09-10 Royalty Audit Program

- Engaged Daniel Burns & Associates to develop monitoring questionnaire and conduct royalty audits
  - Questionnaire sent to 500 active licenses; included technology from all 10 UC campuses
  - 10 royalty audits conducted in FY09-10

## University of California FY09-10 Royalty Audit Program

- Questionnaires:
  - Questionnaire sent to 500 active licenses;  
included technology from all 10 UC campuses
    - Approach (central with decentralized review)
    - Response rate (43%)
    - Recovery (\$55,000)

## University of California FY09-10 Royalty Audit Program

- Royalty Audits:
  - 6/10 royalty audits concluded (FY09-10, to date)
    - Includes 5 campuses
    - Recovery identified = ~ \$1,230,000 (from 3/6 audits)
    - X# of audits funded by licensee = 3 audits, ~ \$79,000
      - Audits ranged from 14K – 32K per audit, depending on complexity
  - FY10-11 program
    - 4-5 royalty audits
    - Development of post-licensing monitoring tool

## Failure to Disclose/Assign IP

### Failure to Disclose/Assign IP: Issues

- Compliance with University policy
  - Policy statement:
    - “I acknowledge my obligation to assign inventions and patents that I conceive or develop while employed by University or during the course of my utilization of any University research facilities or any connection with my use of gift, grant, or contract research funds received through the University.”
    - Duty to assign those inventions to University that are within scope of work
- Compliance with Bayh-Dole
  - Duty of University to report inventions funded with federal \$\$ to the funding agency
  - Duty of University NOT to assign away rights in federally funded inventions, and to actively promote and commercialize them
  - Duty of University to provide federal sponsor of invention with free license to use invention
- Stewardship of public assets

## Failure to Disclose/Assign IP: Pilot Approach

- Used systemwide approach (10 campuses)
- Conducted data merge
  - USPTO data (833K data lines; CY08 published patent applications)
  - UC payroll data of researchers (35K data lines; FY08 & 09 data)
    - Matched first, last names and city of residence
- Informed Leadership (PCC, systemwide VCR, TTO Director calls)
- Requested follow-up from Technology Transfer Offices

## Failure to Disclose/Assign IP: Follow-Up

- Requested follow-up from each campus Technology Transfer Office:
  - Is individual listed a current UC employee (follow-up with HR)
  - If so, is identified IP *currently* assigned to UC (used CY08 USPTO data)
  - If not, *should* identified IP be assigned to UC (follow-up with inventor; possible follow-up with consulting company and/or dept. chair)

## Failure to Disclose/Assign IP: Challenges

- Limitations of data
  - CY08 USPTO data; city of residence issues; exact name matches only; published patent apps only
- Lack of resources in Technology Transfer Offices for follow-up
- Technology Transfer Offices do not want to appear like ‘cops’ to their inventors with whom they have built important relationships

## Failure to Disclose/Assign IP: Addressing the Challenges

- Limitations of data
  - Remind stakeholders of pilot project status; collect metrics re ‘utility’ of data from TTOs and evaluate at end of project; report back to stakeholders; USPTO may soon have better data available; work with systemwide payroll/IT resources to get better data
- Lack of resources in Technology Transfer Offices for follow-up
  - Remind TTOs of importance of monitoring (i.e., Grassley inquiries)
- Technology Transfer Offices do not want to appear like ‘cops’ to their inventors with whom they have built important relationships
  - TTOs may want to use ‘Compliance Office’ as bad guy to distance themselves
  - Cite success stories to inventors (i.e., ability to identify when an inventor is making \$\$ from an invention that properly belongs to the University—appeal to sense of fairness)

## Summary: IP Monitoring/Auditing General Strategies

- Royalty Monitoring Strategies
  - Questionnaire to licensee about royalty calculations
  - Proactive discussions with licensee prior to first Sale
  - Audit of books and records
- IP Assignment Monitoring Strategies
  - Data query between USPTO data and internal sources
  - Discussions with HR & inventor
  - Discussions with consulting companies
  - Litigation

## Summary: Cost/Benefit of Royalty Auditing/Monitoring

- Costs
  - Could impact relationship with licensee
  - Could result in license termination
  - Auditing costs \$\$, and recovery is not guaranteed
  - Could discover overpayment by licensee
- Benefits
  - Could improve communication with licensee re royalty calculations/expectations & clarity re terms of license agreement
  - Could recover underpayment
  - Could result in renegotiation of license agreement to improve clarity

## Summary: Cost/Benefit of IP Assignment Monitoring

- Costs
  - Data only as good as sources and systems
  - Labor intensive (data queries & follow-up)
  - Push back from Technology Transfer Offices
  - Litigation expensive
- Benefits
  - Practice of good stewardship of public assets
  - Promotes effective IP compliance program

## Questions?

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