

Allegations of royalty underpayments in two new litigations are just the tip of the iceberg

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Two recent US lawsuits raise allegations that companies which agreed to patent licences have failed to pay all the royalties due to the IP holder. The complaints are in line with data in a recent report showing just 13% of licensees correctly report their royalties.

One example: A dispute over alleged royalty underpayments bubbled up last month in the US oil and gas industry. Patent owner and licensor ReedHycalog UK and its owners Grand Prideco Inc and National Oilwell Varco alleged in litigation, among other things, that ReedHycalog launched a royalty audit of Smith International Inc, a Schlumberger subsidiary, for licensed downhole tools sold from 2016 to September 2019. The licensor claims its licensee failed to cooperate by not producing revenue records. Instead, Smith claims it terminated its ReedHycalog licence in 2011 (which is disputed) and all parties are embroiled in an arbitration over the disputed royalty underpayment .

Another royalty dispute is ongoing between Genentech Inc and Biogen AM Inc, as IAM reported yesterday. Rights holder Genentech alleged that its licensee, Biogen, made a final royalty payment in 2019's first quarter for products sold through the final quarter of 2018 – which coincided with the expiration of Genentech's patents (they cover fundamental steps for producing therapeutic antibodies). In the lawsuit, Genentech alleges that while the patents were still active, Biogen manufactured and stocked up on several quarters' worth of product. The licensor argues its licensee must pay royalties on the pre-manufactured ingredients even if Biogen sold the drugs in 2019 and beyond.

Data in a report compiled by Invotex, which specialises in royalty audits and licensing compliance, shows the problem of royalty underpayments is common – with only 13% of licensees correctly reporting royalties. For 25 years it has reported royalty audit data and its latest edition finds that 87% of licensees underpay royalties.

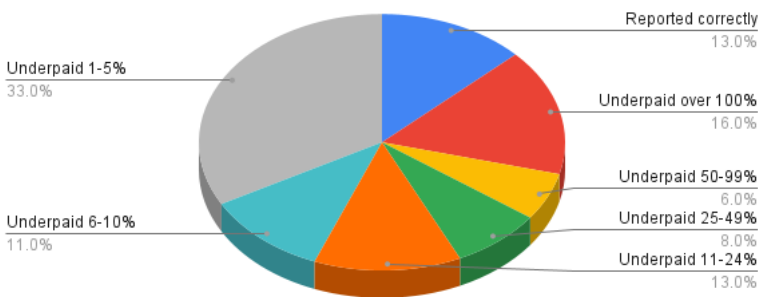
“Generally, it is across all sectors because most of the reason for the misreporting is human nature: people make mistakes; people misinterpret things. That goes across all areas of technology,” notes Invotex managing director Deborah Stewart. “In general, there is not one bad industry and one good industry.”

She states that patent pools typically have robust audit programmes, but within industry they are hit or miss – and the size of a company has no bearing on whether it routinely audits licensees. Even some public companies totally based on patent licensing have never done audits, she says.

Invotex statistics from 1997 to 2022 revealed that 16% of licensees underpay royalties by over 100% -- which is a larger group than the 13% who correctly report their royalties.

Underpaid royalties, 1997-2022

Source: InvoTex



Graphic: IAM

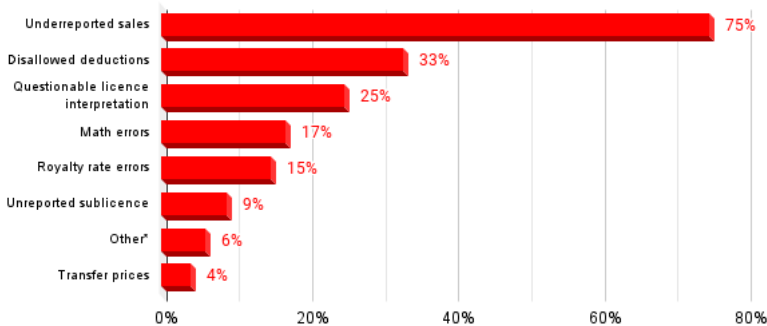
The level of underpayment has shifted over time. For example, when InvoTex issued a similar report in 2010, it found that 28% of licensees had underreported royalties by more than 100%, but today this group has decreased to 16%. What remains the same between the 2010 and 2023 editions of InvoTex’s report: underpayments of just 1-5% were the most common. In 2010, 24% of licensees underpaid by 1-5%, and in 2023 that group had grown to 33%, according to InvoTex.

Reasons for underpayment

InvoTex’s study also delved into the most frequent reasons that licensees underpay royalties. Most commonly they have underreported sales or claimed unallowable deductions. But other underpayments stem from a licensee making a mathematical error or interpreting a licence incorrectly.

Reasons for underpayment of royalties, 1997-2022

Source: InvoTex



*Unreported benchmarks, milestones, or missed minimum

Graphic: IAM

According to the report, licensing businesses ought to view compliance “as an effective tool to open lines of communication and assure that all parties are on the same page”. Often, the people who track, calculate and pay royalties have not read the licence, it notes. InvoTex recommends sending a “licensee welcome package” that provides:

- a copy of the agreement;
- a contact at the licensor who can answer questions;
- an Excel royalty report template;
- payment instructions;
- interest calculation for late payments; and
- a letter about compliance practices including routine royalty audits.

InvoTex also advises licensors to reach out to licensees on an annual basis to reiterate that they conduct royalty audits routinely. It's good practice to request licensees to perform a self-audit annually, and to disclose changes in licensed products, sales channels, geographies, and more, the company says. Someone should be responsible for reviewing royalty reports and payments to check for errors and to compare royalty reports quarter-by-quarter for inconsistencies.

The report states: "You may be pleasantly surprised to receive a check from a licensee for a spontaneous correction of a royalty underpayment as a result of this annual inquiry."

Stewart says she feels that more licensors are beginning to embrace the practice. While in the past licensing businesses were afraid their partner-licensees might take offence, today they feel better about conducting audits as a good business practice. The poor economic conditions we are facing now may accelerate the trend. Stewart comments: "I do see a lot more people auditing, trying to recoup as much money as possible."

But the cost of a compliance programme can be a barrier to some licensors because it can take multiple years to see results. Audit programmes might look unappealing if a company solely sees it as an expense line in the budget – without offsetting the cost by the revenue that eventually comes in.

"If you look at the big picture, it is a good deal, but people aren't often motivated by the big picture," she mentions. "I will clearly say a programme over time will make you money."

Documents

[InvoTex Royalty Audit Article 2023](#)



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