

## ROYALTIES: ARE YOU GETTING YOUR FAIR SHARE?

by **Joshua Kaufman**

According to one recent survey 88% of all royalties

are underpaid, which is a really staggering statistic. According to the study conducted by InvoTex Group, there are a wide variety of reasons for



*Joshua Kaufman.*

underpayment. The largest single reason for underpayment was erroneous contract interpretation. In second place was disallowed deductions being taken from the royalties. Third runner-up was unreported sales. Rounding out the other reasons were royalty rate errors, math errors, unreported sublicenses, unreported benchmarks and milestones and transfer prices.

The next question which the survey tackled was the size of the underreporting. InvoTex found that 27% of the underreporting resulted in a discrepancy of only 1% to 5% of the total amount reported. One might take comfort in the fact that the underreporting was a small percentage of the royalties. However, when we look at the second-largest segment, they found that 25%

owed more than 100% of the total amount reported!

Next was 12% of underreporting in the range of 11% to 24%, and 10% underreported in the range of 6% to 10%. Then 9% incorrectly reported 25% to 49% of the totals, and 5% improperly reported 50% to 99% of the total amounts. This study shows a very significant and substantial underreporting, not only in overall percentages (88%) but in the size of the under reporting.

**Are you getting your fair share of your royalties? 88% of licensors are not. Efforts will indeed yield meaningful and measurable results for your investment of time and money.**

A full 30% underreported from 50% to over 100% of the amounts owed.

### **Erroneous Contract Interpretation**

The single largest factor for underreporting, according to the study, was based on questionable license interpretations. Almost half of the licensors misinterpreted what the contract provided

for as the basis of royalty payments. Certainly, there were those who try to underpay their royalties and attempt to find shelter, or a defensible position in contract misinterpretation. Others who misinterpret the contract could have easily done so without any malice or intention which results in underpaying their obligation.

The problem of contract interpretation, when it comes to royalties, can be based on several factors. For example, licensors have a system in place by which they calculate their royalty

payments, which are one-size-fits-all formulas. Or, that the person in charge of royalty payments has a certain pre-conceived understanding of how to calculate royalties, has not read the contract and instituted a policy based on their (mis)understanding. Also, contracts might have changed and the accounting department was not notified of any changes.

The other principal reason for contract misinterpreta-

tion is poor draftsmanship. The contract is not clear as to what revenues are included, what deductions are permissible, or when a sale occurs. The definitions are usually buried somewhere under the definition of "Net Sales." Most licensing contracts begin with the concept of gross revenues and then provide for certain deductions and contingencies, then come up with a "Net Sales" number off of which the royalties are keyed.

Almost all licensing agreements state that royalties are based on "goods sold." It sounds simple enough, but when are goods actually "sold" and the royalty obligation is incurred? There are generally two trigger points for when goods are sold for the purposes of owing a royalty; either when the goods are shipped or when the funds are received.

If royalties are due upon receipt of funds and the licensee gives terms of 30, 60, or 90 days the sale does not technically occur until payment is received, which would be 30, 60, or 90 days after the customer receives the goods. This is a significantly different timeframe than from when the goods were invoiced or shipped. What if the customer never

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pays? No royalty may be due even though the licensed goods are in the market place. Under a sale defined as goods shipped it does not really matter if the licensee ever gets paid or when the licensor is due their royalty based on the shipment of the goods.

This important difference as to when or if royalties are due all depends on one or two words buried in the definition of Net Sales. There is no right or wrong definition. Valid arguments can be made on both sides as to which definition should apply. It is a matter of negotiations. But, if the definition is not thought through and discussed, then when it comes time to pay the royalties, there very well may be a serious dispute and an under payment of royalties finding in an audit.

Another area of misunderstanding can be when the licensed goods are not sold as a standalone product and there may or may not be any allocation of the sales price upon which the royalties are based. Let us say if an artwork (print) is licensed but is shipped without a frame, is the royalty paid on the sales price of the finished goods which includes the frame, or is the value of the print separated out from the value of the overall products sold and

the royalty is paid on only the value of the print?

## How Are Discrepancies Discovered?

In certain instances an alert licensee might notice problems when they review the royalty report which accompanies the royalty payments. However, since the royalty report is generated by the licensee it is unlikely that the report is going to be drafted in such a manner as to highlight or red flag problem areas. Which raises the issue of what is covered in a

**A comprehensive royalty report is invaluable. What is to be included in the report needs to be in the contract or, if the standard license royalty report is used, it should be reviewed ahead of time and incorporated by reference to the agreement.**

royalty report. This is another area which is often ignored by the parties when negotiating a contract. Most licensing agreements simply state that a royalty report will accompany the payments. A comprehensive royalty report is invaluable. What is to be included in the report needs to be in the contract or, if the licensee's standard license royalty report will be used, it should be reviewed ahead of time and incorporated by refer-

ence as an exhibit to the agreement in reality. Licensees that have a standard format are going to be very hesitant to provide a customized royalty report for only one of their licenses.

## How Does a Licensor Ensure They Get What Is Due to Them?

Almost every licensing agreement has a provision for an audit which provides for reasonable notice and that the auditor is provided access to the licensee's

cess to knowledgeable employees who can answer questions, and also to copying facilities. Additionally, the auditor should be allowed to follow-up when necessary. The licensee should be provided with an opportunity to respond where they think the auditor might have made mistakes, or be able to provide subsequent documentation to back up certain deductions which might not have been readily available or understood by the auditor.

The audit is generally paid for by the licensor unless a discrepancy to their detriment is found, then the burden of payment shifts to the licensee. Contracts range from any discrepancy at all will trigger the switch in obligation, to as high as a 10% deviation needs to be identified prior to the onus being shifted to the licensee. Generally the number is somewhere between five and 7 1/2%.

books and records as they apply to the licensor. Having a properly well thought out, well drafted audit clause can avoid a myriad of problems. Audit clauses should provide the nature of the notice to be provided, and what kind of information the licensee should provide the auditor before the on-site inspection. It should provide that the auditor is given access to the materials that they need, are provided with workspace, as well as ac-

Many licensors hesitate to undertake an audit, even if they think they are not being under-paid because they do not want to alienate their customers. However, most licensees have been in the business long enough, have been audited many times, and understand that it is not any kind of personal attack or a questioning of their veracity, it is a normal business occurrence.

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If you are a licensee or licensor and want to avoid being in the 88%, the key is to raise issues during the contract negotiations, draft a contract with proper language, and monitor activities to be sure that the contract is being adhered to. Then, from time to time, make sure everybody is on mark to conduct an audit.

The ways to interpret contracts, disallowed deductions being taken, and underreported sales can go on and on. The key is to understand

where these differences might arise and to discuss them up front and include the various contingencies in any


these matters and incorporating them into the contract up-front is a classic example of penny wise pound foolish.

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agreements. In the short term, it will make for a longer, more cumbersome and potentially more complex agreement, but at the back-end there will be fewer problems, issues, and disputes. Not properly going through

*Joshua J. Kaufman, Esq., is a partner in the law firm of Venable, LLP, and chair of their Copyright & Licensing Group. He is one of the country's foremost attorneys in art, copyright, and licensing law. Mr. Kaufman*


*has a wealth of experience in all forms of licensing including software, trademarks, copyright, sports, art, and personalities. He has negotiated hundreds of licenses involving most of the major licensing entities (representing licensee, licensors, and agents). He has published more than 200 articles and regularly lectures on various topics in the field, is an adjunct law professor at American University Law School, and is counsel to the Art Copyright Coalition. To reach Mr. Kaufman, e-mail him at: [jjkaufman@venable.com](mailto:jjkaufman@venable.com) or call him at (202) 344-8538.*




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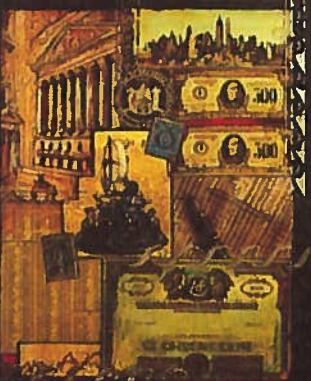
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