Review recovers millions in royalties for life sciences company

Overview
Our client is a multibillion dollar life sciences company that has developed and patented technologies for several self-testing conditions, such as strep throat, premature labor and mononucleosis.

Background
Our client's business strategy includes licensing out certain patents, where a third party manufactures and sells commercial products incorporating the technology. In return, our client receives significant royalties from those product sales. The company maintains several lucrative license agreements, and as part of its compliance program, they audit their licensees to determine if the royalties paid are accurate.

Based on reported sales, the licensor felt the sales and related royalties for three separate products were not being reported in accordance with the agreements. In addition, the company frequently conducts royalty audits as a good business practice, and wanted more transparency and consistency from its licensees.

Project
The company chose McGladrey to conduct several royalty audits, based on the team’s experience and success in recovering underreported royalties. With respect to the licensees in question, the client provided an audit notice to each company indicating that McGladrey was retained to conduct the reviews. The McGladrey team then performed fieldwork at each of the licensee’s locations to determine whether the sales and applicable royalties reported were accurate.

In each instance, McGladrey discovered underreported royalties; however, there were several different reasons for these inaccuracies. In one instance, the licensee took deductions for cash discounts when the agreement did not allow for them. Therefore, royalties were understated by the cash discounts. In other cases, the McGladrey team uncovered situations where sales within certain countries were omitted from the royalty report. Additionally, entire product lines were found to be missing from the royalty reports.

With one specific licensee, McGladrey found a significant issue in how they defined sales subject to royalties. The agreement dictated that sales subject to royalty were the Gross Final Sales (GFS); however, this term was not defined in the contract, and GFS is not a recognized term within GAAP methodology.

The licensee embedded several costs, netting them against the gross invoiced cost, in the sales amount used as the basis for calculating royalty payments due. Based on McGladrey’s experience conducting these reviews, it established GFS as a sale based on the amount invoiced and the date the invoice was created.

McGladrey’s review of that licensee determined that the underpayment to our client amounted to approximately $3.5 million in royalties. McGladrey was subsequently informed that a settlement was reached with this licensee in an amount in excess of 50 percent of the determined royalty underpayment. Due to the ambiguity of the GFS wording, neither the client nor the licensee wanted to expend the time or the dollars to litigate the matter, as both parties felt this was an equitable compromise.
Outcomes

In the analysis of the separate licensees, McGladrey identified underpayment of royalties totaling nearly $4.5 million. The team’s findings included omitted products, unallowable discounts and deductions and unreported sales in patent-covered countries. In addition to the underreported royalties, the underpayments were subject to late payment interest and penalties, and processes were put in place for future compliance.

The benefits to our client included:

- Discovery of significant underpayment of royalties from three licensees, with some products not reported and other royalty-bearing products that were reported irregularly
- Royalty recoveries exceeding $2.5 million, in addition to late payment penalties and interest
- Greater transparency into licensee practices and processes to induce future compliance