

ROYALTY RATES

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KEY POINTS

- ◆ Factors that influence the setting of royalty rates
- ◆ Royalty rates in uncontrolled and controlled transactions
- ◆ Factors to look for in finding and adjusting comparables
- ◆ Royalty rates and the centralised management of intellectual property
- ◆ The need for independent advice

ESTABLISHMENT AND FUNCTION OF ROYALTY RATES (I)

- ◆ Intellectual property normally generates future economic benefits when combined with other business assets
- ◆ A royalty rate is established by isolating the required rate of return directly attributable to the IP component of the business
- ◆ The royalty, or rate of return is agreed after considering the risks each party must bear

ESTABLISHMENT AND FUNCTION OF ROYALTY RATES (II)

- ◆ The party bearing the higher risk should receive the higher rate of return
- ◆ The more risk eliminated, the more value created
- ◆ The higher the margin, the higher the royalty

FACTORS THAT INFLUENCE THE SETTING OF ROYALTY RATES (I)

- ◆ The industry
- ◆ The nature of the intellectual property
- ◆ The rights in the property
- ◆ The level of incremental profits or cost savings through the use of the IPR
- ◆ The strength of protection
- ◆ Exclusivity
- ◆ Competition

FACTORS THAT INFLUENCE THE SETTING OF ROYALTY RATES (II)

- ◆ Barriers to entry
- ◆ Investment requirements
- ◆ Ability to sub license
- ◆ Risk of technological obsolescence
- ◆ Government regulations
- ◆ Compulsory licenses
- ◆ Counterfeiting
- ◆ Prevailing economic conditions

ROYALTY PAYMENT STRUCTURES

- ◆ Flat percentage of X for the term of the agreement
- ◆ Descending percentage of X when certain targets are achieved
- ◆ Ascending percentage of X when certain targets are achieved
- ◆ One time flat fee
- ◆ Flat fee plus X percentage
- ◆ No direct payment (royalty free) usually in exchange for credibility, public service or some other non-monetary payment

FIVE PER CENT OF WHAT?

- ◆ Wholesale price
- ◆ Gross sales
- ◆ Gross turnover
- ◆ Net sales
- ◆ Hectolitres

SOME DEFINITIONS

- ◆ **Gross sales invoices** less Sales Tax or VAT, logistical discounts, invoice/retroactive rebates, cash discounts
- ◆ **Net invoice price.** The actual invoiced price of product less transport, freight and VAT

WHERE DO YOU FIND THEM?

There is very little published data on the makeup of deals. Companies rightly feel that this competitive edge information must be kept firmly in house

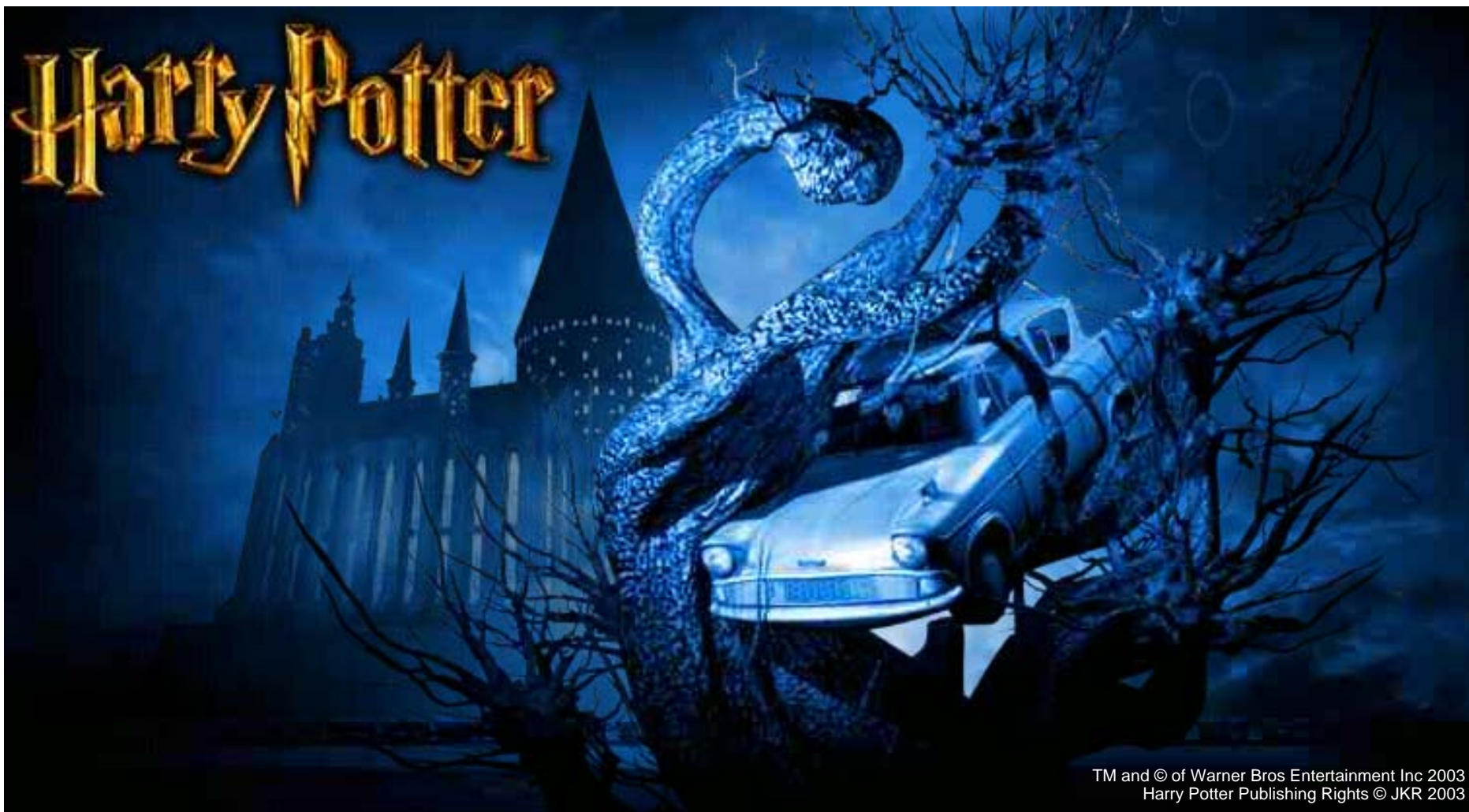
- ◆ Personal experience
- ◆ Organisations that sell information from their data bases
- ◆ In house data that either everyone has forgotten or no-one thought of
- ◆ Mergers and acquisitions
- ◆ Litigation
- ◆ You can always ask

ROYALTY RATES IN UNCONTROLLED TRANSACTIONS

- ◆ Royalty payments are normally expressed in a manner that provides a fair rate of return on the investment made by the owner of the IP being transferred
- ◆ In an uncontrolled transaction the royalty rates are negotiated between unrelated parties
- ◆ Each party is attempting to maximise the respective benefits
- ◆ Royalty rates are often the most flexible part of the deal because they are being taken from a revenue stream

PRICE ELASTICITY

- ◆ A 2% higher price on a commodity is usually sufficient to put the product out of 99% of the sales category and virtually shut it out of the market in which it competes
- ◆ This applies to paper products, plastic resins, metals, fruit and vegetables, bread and milk



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SPLIT ROYALTIES

- ◆ In 1992, 1 million Americans voted to decide which image of Elvis would be used on the stamp to be released in 1993
- ◆ The royalties were 15% of the wholesale price
- ◆ EPE received 60%, the USPS 40%





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EXAMPLES OF ROYALTY RATES

- ◆ Yoghurts UK 2% - 3% of wholesale price
- ◆ Biscuits UK 4% - 5% of wholesale price
- ◆ Chocolate UK 5% of wholesale price
- ◆ Designer perfume 6% - 15%
- ◆ Harry Potter 10% - 15%
- ◆ Toys 5% - 15%
- ◆ Homewares 1% - 7%
- ◆ Car accessories 3% - 8%
- ◆ Michael Jordan 17%

ROYALTY RATES IN CONTROLLED TRANSACTIONS (I)

- ◆ Section 1.482-2 (d) Income Tax Regs (IRS) provides a framework for determining an arm's length consideration for the transfer, sale, assignment or loan of intangible property or an interest therein between related entities

ROYALTY RATES IN CONTROLLED TRANSACTIONS (II)

- ◆ Arm's length consideration is specifically defined as “the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances”

ROYALTY RATES IN CONTROLLED TRANSACTIONS (III)

- ◆ Section 1.482 - 2(d) (2) (ii) The best evidence of such arm's length consideration is the amount actually paid by unrelated parties for the same or similar intangible property under the same or similar circumstances

ROYALTY RATES IN CONTROLLED TRANSACTIONS (IV)

- ◆ In the absence of sufficiently similar transactions involving an unrelated party, Section 1.482-2 (d) (2) (iii) lists several factors as relevant in determining the amount of an arm's length consideration

ROYALTY RATES IN CONTROLLED TRANSACTIONS (V)

- ◆ Standard of comparability 1.482-1(d)(2) An uncontrolled transaction need not be *identical* to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result

If the royalty is seen merely as a means of moving profits between companies and not justified by the commercial circumstances the deductibility could be challenged

FACTORS TO LOOK FOR IN FINDING AND ADJUSTING COMPARABLES

- ◆ The prevailing rates in the same industry or for similar property
- ◆ The terms of the transfer (the License Agreement)
- ◆ The uniqueness of the property and the period it is likely to remain unique
- ◆ The degree and duration of protection afforded to the property under the laws of the relevant country
- ◆ Capital investment and start up costs
- ◆ Availability of substitutes
- ◆ Prospective profits to be made and costs to be saved

CENTRALISED IP MANAGEMENT

- ◆ Many future dramas can be avoided or managed more effectively if the Intellectual Property portfolio is managed centrally
- ◆ Tax disputes are costly, time consuming and stressful. CIPM makes it much easier to deal with investigations
- ◆ CIPM reinforces the concept that the company's IP is a shared resource
- ◆ CIPM ensures that the IP is managed for the whole group and not just one part of it which may have a narrow or particular focus

THE NEED FOR INDEPENDENT ADVICE

- ◆ Royalty rate due diligence should not be carried out by the auditors or lawyers of the owner of the intellectual property that has been licensed
- ◆ Companies that license IP to subsidiaries must carry out regular independent audits
- ◆ Following any M&A or other transaction the newly acquired IP should be swiftly subjected to an independent study



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