

Licensing considerations in an Asian marketplace

By Michael Quackenbush, C.P.A.



Michael Quackenbush, CPA

Partner, Royalty Compliance
mquackenbush@millerkaplan.com
p. 415/956-3600
f. 415/402-5600

Given the growth in international licensing opportunities with Asian based companies in recent years there are important matters for consideration prior to, during and after a Licensor enters into a licensing arrangement with an Asian based company. For purposes of this article, we will focus on four Asian countries, Japan, South Korea, Taiwan and China.

1. Understanding the Licensee and its country

A. "My competitor signed so did I"

Small to medium size companies in Asian countries are frequently unable to read and understand a complex licensing agreement drafted by a sophisticated US based attorney. It is not uncommon, where the Licensor issues one standard license agreement (e.g, the Licensor is a patent pool), to find companies in these countries simply signing a license agreement, without any review, because their local competitor signed the agreement. Larger, multinational companies have typically retained English speaking attorneys and staff who can understand the terms of the license agreement. Licensors should be mindful that Licensees in foreign countries may have the engineering departments to manufacture a technology based product but do not have the legal or finance departments to understand and implement a complex license agreement.

B. Language

Given the understanding of a potential licensee's English reading capabilities, consideration should be given to having a license agreement in several different languages. A multi-lingual license agreement will allow a Licensee to understand its terms in order to avoid a dispute or misunderstanding during the license agreement.

C. China-Special considerations

In China "auditing" of the Licensee's books and records subsequent to the execution of the license agreement is not viewed by Chinese companies as intending to be a thorough process. Chinese companies, typically in the manufacturing cities of Dongguan, Shenzhen and Guangzhou (capital city of Guangdong province), believe that providing excel spreadsheets and not books of original entry should be satisfactory in support of their royalty reporting. These regions are prime sourcing locations for the



fake goods that are produced in the world today. It is estimated that upwards of 20% of the consumer goods in the Guangdong province are fake. In addition, it is possible to purchase fake People's Republic of China ("PRC") tax receipts on the streets in these cities. These receipts can be used to show taxes paid to the government, which in fact were never paid.

The creative license some companies in this province take in using a Licensor's intellectual property is also extended to the way they keep their books and records. It is no secret and even commonplace that Chinese companies in this province can maintain several sets of financial records. One set of financial records is maintained for PRC government tax reporting purposes, another set for their external auditors, and one for their own internal records.

Given these issues, specific consideration should be given to terminology in a license agreement to provide for a certain level of records to be made available during the audit. Some examples may include bank account statements, original entry books, and sequential numbered purchase and sales orders. All of the records should be original records, not copies. The license agreement may need to also specify approved manufacturing and Original Equipment Manufacturer ("OEM") sources. The approved OEM's should also be determined to be not related to the Licensee. Chinese companies have been known to use separate friends and family companies to transact business. Failure to meet the records or manufacturing requirements should have meaningful consequences. Higher minimum guarantee payments may also be useful to offset the creative accounting Chinese companies tend to use in royalty reporting.

In addition, the wiring of money from a China based licensee to a US based Licensor can be a challenging process given China's currency controls. Currently, there are restrictions on the wiring of money unless certain qualifications have been met. A thorough discussion should be conducted with a prospective China based Licensee as to how they will be paying their royalty payments prior to licensing.

2. The License Agreement

Prior to entering into a license agreement with an Asian based company, the following is a brief list of some terms and conditions to consider:

A. Letter of credit

Providing for a letter of credit ("LC") to be established by the Licensee with a local US Bank can provide a guarantee of royalty payment. The LC should be clearly stated in order to allow the Licensor to easily

draw on the LC. Should the Licensee have insufficient US based assets, the LC will allow the Licensor to draw on it should the Licensee fail to make a required payment under the license agreement.

B. Clearly definable terms

Obviously, there are numerous terms and conditions contained in a license agreement. However in order to ensure that the Licensee understands the basis for the royalty payment, the exact calculation of the royalty payment should be defined in the agreement. Examples of the calculation may also be useful in order for the Licensee to agree to the calculation methodology. It is not uncommon when dealing with Licensees and people from Asia to receive a "Yes" answer when asked if they understand terminology in an agreement. However, the "Yes" answer does not always mean that they will follow the terms or actually do understand the terms.

C. Currency of choice

Typically license agreements will provide for payments via wire transfer of US dollars to satisfy royalty obligations. Since many licensees will transact business in their local currency the agreement should specify how the local currency licensed product sales transactions will be converted to US dollars. The currency conversion should also be verifiable to a published source in order to prevent the Licensee from manipulating the foreign currency conversion in their favor.

D. Royalty based on units or sales

Depending upon the product being licensed, a royalty per unit or percentage of sales or some combination should be considered. The use of a per unit measurement is more readily definable and accountable. However, it does not allow for additional royalties should the price or value of the licensed product increase during the license agreement. A percentage of sales basis allows for additional royalties should the product increase in price or value and allows for the Licensor to share in that growth or popularity of the licensed product. However, the accounting surrounding the calculation of net sales can be manipulated by the Licensee and if left unchecked can lead to a significant underpayment of royalties.

E. Cash vs. Accrual basis

When using a net sales basis for royalty reporting the Licensor should consider defining whether the Licensee should report using the cash basis or accrual basis. Using the accrual basis would allow the Licensee

to possibly deduct allowance for bad debts. However, the Licensee would need to include sales which are unpaid even though licensed product may have already been shipped. Under a cash basis typically all sales whether paid or unpaid by the customer are subject to royalty. Under either method, the agreement should define what is included and excluded from the royalty calculation.

F. Reduction of royalty rates for good behavior

Another consideration for a license agreement would be to reduce the royalty rate, on a prospective basis, if the Licensee pays on time and has an “audit” performed on its company’s books without significant findings. The license agreement would need to specify what significant is with respect to the findings. Having an incentive for proper reporting can sometimes be stronger than having a punishment for failure to properly report.

3. Meetings, education and due diligence before licensing

In many agreements appropriate due diligence does not take place prior to a license agreement being signed. There are meetings that take place to discuss products and markets and terms of the deal, however, little attention seems to be paid to the Licensee’s internal reporting policies, procedures and capabilities considering the terms of the license agreement. We have seen a number of agreements and Licensees that were unable to accumulate the information required by a license agreement. Performing due diligence with respect to the Licensee’s financial reporting systems and overall financial health may prevent signing a Licensee who does not have the capability to report or pay its financial obligations under the terms of a license agreement. Once it is determined that a Licensee can properly report and has the ability to meet its financial obligations under an agreement, it may be worthwhile to have the Licensor’s Independent Accountant meet face to face with the Licensee in order to educate the Licensee on the specifics required in the royalty report and other items required under the license agreement.

4. After licensing

A. Royalty reporting

It is of utmost importance to obtain as much information as possible from a Licensee in order to determine that the Licensee has met their reporting obligations under a license agreement. In developing royalty reporting forms, careful consideration

should be given to the terms of the license and the calculation of the royalty owed. By properly designing the royalty report it is possible to determine reporting inconsistencies which can signal the need for additional review of the Licensee’s reporting.

B. Port Import Export Reporting Service (“PIERS”) reports
PIERS can be helpful to Licensors whose licensed products are being shipped through ports in the US, Asia and elsewhere. PIERS can provide a movement of goods reports from one port to another. These reports can be helpful in determining an estimate of the number of licensed products shipped by Licensees.

C. Withholding tax considerations

Depending upon the Licensee’s country and the type of licensed product, governmental taxes may apply on the royalty being paid from an Asian based Licensee to a US based Licensor. China and South Korea generally require withholding tax to be leveled by a Licensee whereas Japan does not. Taiwan does require withholding. However, it is possible to apply for waiver of the tax via filing of a waiver request with one or more of Taiwan’s territorial tax administrations. The US has double tax agreements in force with certain countries and these should be researched where applicable.

Also, should foreign taxes be withheld, the corporate Licensor may be able to claim the foreign tax credit on their US income tax return. However, the license agreement has to address this issue since the Licensor may be restricted, due to losses, in immediately benefitting from this tax credit.

D. Publicly available information

The Taiwan Securities and Exchange Commission maintains a very open source of financial information concerning Taiwanese companies who are public or considering going public. This information is publicly available and has in depth information on ownership structure, management, and a vast array of financial reports. Financial information is also available on other Asian stock exchanges but typically with less detail and only pertaining to public companies.

E. “Auditing”

Having the ability to review the Licensee’s books and records is always an excellent approach to determining the accuracy of the royalty reports submitted by a Licensee. As stated previously, companies in China, as well as South Korea, may not have a thorough

understanding of the detailed nature of an “audit” in the terms of a license agreement. Communicating expectations concerning the Licensee’s cooperation with the “audit” may prevent a common tactic by companies in Asia; stalling and delaying the completion of the “audit”.

One important point to make here is that license agreements typically refer to “auditing” a Licensee’s books and records. However, the independent accountant or CPA firm does not audit the Licensees books, rather they perform an agreed-upon procedures attest engagement or a consulting engagement for the Licensor.

F. US Customs

US Customs can also be an excellent source for assistance in policing licensed products coming from Asia into or through the United States. Customs maintains offices in most major domestic ports including Anchorage, which is a frequent refueling spot for air freight bound for the US and Latin America.

