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Is this license comparable?
– The issue of related transactions

White Paper

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Intangible assets account for major parts of the value of businesses. Valuation methods for intangible assets often use the relief from royalty method whereby the value of the subject intangible asset is established based on the value of comparable assets observed in the marketplace. Basis of the royalty relief method is to identify royalty rates that were paid for similar assets in comparable transactions. These are known as “guideline licensing transactions” in financial and accounting valuations, and as “CUT” or “comparable uncontrolled transactions” in tax valuations and transfer pricing.

Establishing comparability

All intangible assets are unique by nature and by definition. Therefore, a major challenge of the market approach is for the appraiser to identify transactions that are sufficiently comparable. Comparability involves three different areas:

1. First and foremost, comparability involves the characteristics of the asset in question, as well as the market (sector) and the business model under which the asset is used. For example, the appraiser must establish that the royalty rate for trademark used by a sports retailer is sufficiently comparable to one use by an operator of supermarkets, or that the royalty rate for a trademark used by brick and mortar retailer is sufficiently comparable to one used by an e-commerce retailer.
2. Second, comparability requires that the terms of the transactions to be compared are sufficiently similar. This involves aspects like duration, exclusivity, territory, date, pricing structure (i.e. the structure between upfront payments or minimum guarantees with running royalties in license agreements), profitability and other.
3. And finally, comparability involves the business relation between the parties to a comparable transaction. The market approach requires that the parties to a transaction must be unrelated and act independently, or to the arm’s length principle. While this principle reads fairly common sense, it is much more complex in reality. Almost all transactions for non-commodities are based on existing business relations between the parties, on limited choice, and/or on limited freedom to act.

In practice, it is often difficult to find transactions between independent parties that are similar enough to a subject valuation case such that no differences have a material effect on price. Comparable data will rarely be perfect. It is a matter of professional judgment to decide whether or not the available comparable transactions are sufficiently reliable. Often, direct comparability is difficult to establish with intangible asset transactions. Regulations and textbooks then suggest to make appropriate adjustments to the CUT royalty rates to make them more similar to the subject IP.

This paper will cover the third aspect of comparability – existing relations between buyers and sellers, or licensors and licensees, their potential impact on comparability and royalty rates, and their frequency of occurrence.

Related parties

Under the market approach, the price for an asset is agreed between two unrelated parties dealing at arm’s length. This is generally defined as a price that an independent buyer would pay an independent seller for a similar (comparable) item under similar (comparable) terms and conditions, where neither is under any compulsion to act. This price is then considered a good proxy of the market price not only for this particular, but also for similar assets. The two most import terms of this definition are: **independence**, and **non-compulsion**.

In the past, a lot of attention has been paid to the issue of independence between the parties. A related (dependent) party is an entity or a person which has control or significant influence over the other party, or is a member of the key management personnel. The presumption is that the price in a transaction between related or dependent parties is influenced by their relatedness, and thus not same as a market price. Accordingly, license transactions between related (controlled) parties should not be treated as comparable (or otherwise be adjusted).

Typically, a license agreement states the identity and address of both parties, but rarely if and how the parties are related or not. Therefore, the relatedness between the parties is often not evident from the agreement itself. Historically, license agreement database vendors made no distinction of their agreements into “related” and “unrelated”. Meanwhile, they attempted to re-qualify their datasets and added a field or search filter for “related party agreement”. Between 10% and 20% of all license agreements in the public domain have since been qualified as “related party agreement”. This is certainly an important improvement, even if not all related party agreements have yet been identified and effectively re-qualified. For the valuation community, the issue of erroneously using related party agreements as guideline transactions seems to be solved.

Related transactions

Another, much different and often overlooked issue is if the comparable transaction itself is independent from other transactions between the parties. The market approach requires “non-compulsion”. Under no compulsion to act means in other words that both parties have other options and neither party is being forced into entering this transaction. Both parties are assumed to have the ability to walk away from the transaction if they are unable to reach agreement on the price and other terms

Ideally, comparable uncontrolled transactions (CUTs) are stand-alone transactions. Sadly, this is rarely the case for license transactions. There is reason to believe that a large majority of license transactions (in the public domain) is more or less linked to other transactions. Two important groups are to be differentiated.

1. **Renewals**. Many license agreements – in particular for trademarks – are renewals, extensions, amendments or restatements of previous agreements. Both parties would lose existing business if they went away from the renewal. Often, the situation for a renewal or restatement is much different than when the license was first concluded. In order to understand the terms of the CUT agreement, it is essential to know the terms of the preceding agreement, and the circumstances that led to their current revision. In particular, the appraiser needs to understand if the parties signed the CUT agreement under no compulsion. Therefore, he needs to analyze how the terms changed from the preceding to the renewed agreement, the circumstances of the renewal, the risk for both parties to not renew the agreement, and if and how the terms of the CUT agreement were impacted.

   Moreover, the CUT license agreement often has a subsequent renewal or amendment. A renewal or amendment eventually means that the terms of the current agreement were not balanced enough to keep the agreement going for a longer term. In such case, the appraiser must analyze how and why the terms of the subsequent agreement changed, for how long the initial agreement was in place, and which of the two (differing) contract terms and royalty rates are closer to market reality.

2. **Overriding or associated agreements**. Often, license agreements are drafted as separate, stand-alone agreements but are in fact part of a more complex set of adjunct agreements. For their different terms, jurisdictions, legal bases and parties to the agreement, there is often no choice than to split a complex transaction into several separate agreements one of which is a license agreement. The price negotiated for the grant of the licensed asset is then part of another, often more important or overriding transaction, and not fully independent from the prices for its other, contractually separated elements. The existence of such associated agreements and **collateral transactions** may have dominated or influenced the terms of the CUT license agreement. Therefore, a license agreement embedded in a complex set of other agreements can hardly be considered “independent” or “non-compulsory”.

   Typically, if license agreements do not come stand-alone, they involve one or several of the following:

(1) **Asset deals**. Eventually, license agreements facilitate the acquisition of the assets of a business, i.e. when a part of a branded business is divested to a new owner and the ownership in the trade name shall remain with the seller. The acquirer will purchase the business assets, and "lease" the use of the trade name under a license agreement. Usually, the license agreement will be ancillary and minor in relation to the asset transaction.

(2) **Share deals or joint venture deals**. Sometimes, license agreements follow the transfer of ownership interests between the parties below the level of controlling ownership (which would necessarily be qualified a related party agreement). I.e., licensor acquires an ownership interest in licensee, or vice versa, and both parties agree upon a closer collaboration including a license agreement. Or, one party of a 50/50 joint venture contributes trademark rights through a license agreement. Reversely, the sale of shares in a commonly owned entity with a license from the selling party often involves a license agreement between now unrelated parties. It is evident that the terms of such license agreements are influenced by the circumstances of the underlying share transaction and the future role of the parties in the venture.

(3) **Service and collaboration agreements**. Often, the collaboration between two parties goes far beyond granting some rights to use intangible assets. In conjunction with use rights, partners often collaborate through distribution agreements, development or design agreements, marketing agreements, supply and sourcing agreements, maintenance and updating agreements, and other support agreements. If so, the analyst needs to understand the importance, value and direction of such agreements, and their potential influence on the terms of the license agreement. I.e., if a supply agreement is involved in the collaboration whereby licensee sources products or raw materials from licensor, most of the total deal value and profit will come from this supply deal and likely override the license agreement.

(4) **Dispute settlements**. Sometimes, license agreements arise out of a dispute on intellectual property rights whereby an infringer or potential infringer cures his wrongdoing by accepting and securing a license, instead of compensating for damages and ceasing to use the IP. In this situation, the licensee's freedom of choice is limited, and the terms of the license agreement are not fully arm's length. Sometimes they may even include some sort of punitive elements.

Sadly, related transactions are rarely mentioned in the licensing agreement itself, let alone in the agreement summary provided by the license agreement database vendor. To find out, the appraiser has no choice but to go back to the original financial reporting at around the date when the license agreement was filed, and trace all information and hints on any related or collateral transactions. There are reasonable grounds to suspect that such circumstances occur frequently with (supposed) CUT license agreements, and that their impact on the license terms and royalty rates is serious.

The nine CUT agreements used in Amazon vs IRS

To illustrate this, we will have a closer look at the license agreements used as (supposed) CUT transactions in a recent landmark dispute: the case of Amazon Amazon.com Inc. vs. Commissioner of Internal Revenue[1] . The subject matter of the dispute was the transfer of some intangible assets from Amazon US to a subsidiary in Europe back in 2005, and their taxable value. Its most important part was the value of the transferred trademarks. IRS had calculated their value at $ 3.125 million, eventually the highest litigated trademark value ever. Amazon in turn offered a value between $ 252 and $ 312 million. The case has been unfolded in documents released by the court, and by a journalist network called DocumentCloud[2].

[1] Amazon.com Inc & Subsidiaries v. Commissioner of Internal Revenue, US Tax Court, Docket No. 31197-12

[2] https://www.documentcloud.org

The case was negotiated on the premise of the CUT (comparable uncontrolled transactions) method. It can be assumed that the experts of the parties used their best efforts to identify and establish robust CUT license agreements. To do this, Amazon's expert searched two commercial databases[3], and introduced seven license agreements as comparables. Expert for IRS searched one database[4] and introduced four license agreements. Of these agreements, two overlapped, making up for a total of nine different agreements. For each of these nine agreements, we researched from publicly available sources[5] the circumstances of their conclusion, their history and aftermath, and any associated, preceding of subsequent agreements between the parties. Particular emphasis was placed on whether there was no compulsion to act, and whether the license agreement was concluded independently from other agreements, transactions or business relations.

1. Merchandising Corp. of America and Sports Archives, Inc. (1991)

This CUT agreement involves a merchandising license agreement between licensor Merchandising Corporation of America (MCA) and licensee Sports Archives, Inc. (SAI), governing the use of the Fields of Dream trademark. The agreement was signed in 1991.

The Field of Dreams trademark is owned by Universal City Studios (UCS), the company who turned and published the Field of Dreams fantasy-drama sports movie in 1989. Licensor MCA is a subsidiary of UCS in charge of licensing UCS' properties and copyrights. The licensee SAI (which changed its name to Dreams, Inc. in 1992), operates as a franchisor and operator of retail stores under the "Field of Dreams" banner which sell sports-related merchandise and celebrity-oriented merchandise, sports collectibles, memorabilia, trading cards and related merchandise and products.

The parties entered into a trademark license agreement in 1991 (the 1991 TLA). This license agreement covers the use of the Field of Dreams trademark for a chain of sports memorabilia stores, both owned and franchised. SAI pays a running royalty of 1% on gross sales, plus a fixed fee on the opening of each new store, to MCA. SAI in turn charged a franchise fee of 6% plus an advertising contribution fee of 3% to its franchisees. By 1995, there were 19 franchised FoD stores, with revenues of approx. $10 million. By 2004, there were 18 franchised and 13 SAI owned stores, with systemwide revenues of $34 million. As of today, there are no more than four Field of Dreams stores left.

In this case, licensee is unrelated to and independent from licensor. There were no collateral transactions with this license transaction, and no other business relations between the parties.[6] The 1991 TLA was introduced as CUT agreement at a 1% royalty rate by Amazon. The much higher margin in sports memorabilia retailing compared to Amazon's business was not considered with this royalty rate.

2. The Sports Authority, Inc. and Mega Sports Co. Ltd. (2004)

This CUT agreement involves a license agreement between licensor The Sports Authority, Inc. (TSA) and licensee Mega Sports Co. Ltd. (MSC), governing the use of the Sports Authority trademark and related technology in Japan. The agreement was signed in 1991.

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3 ktMine and Royalty Source
4 ktMine
5 SEC filings, press releases
6 The question remains why this transaction was considered comparable to the Amazon business and trademark. Sports memorabilia stores have little in common with the retail business of Amazon. Margins, range size, stock velocity, and other parameters are much different. Field of Dreams was a franchise license. Further, the agreement was concluded in 1991, years before the subject case effectively happened in 2005.

TSA, the licensor, operates sports stores in the United States under "The Sports Authority" trademark. In order to expand into the Japanese market, TSA entered into a joint venture agreement in 1995 with JUSCO Co., Ltd. (Japan United Stores Companies), a Japanese operator of general merchandise stores (hypermarkets). At this date, Jusco owned 9.6% of the shares of TSA. Under the JV agreement, TSA and Jusco formed Mega Sports Co. Ltd. (MSC) to operate sports stores under "The Sports Authority" banner in Japan. TSA owned 51% of the JV, Jusco 49%. The JV agreement involved various service agreements between TSA and MSC, and Jusco and MSC, and a trademark and technology license agreement between TSA and MSC.

In 1999, TSA reduced its share in the JV. Jusco acquired 32% of the shares from TSA for $1.1 million, a low price obviously. By then, MSC operated 13 stores with revenues of $85 million. Seemingly, TSA had problems to establish its business model in Japan, in particular the size of its stores, and decided to give up its leadership in favor of Jusco which increased its shareholding to a majority shareholding of 81%. In connection with the share deal and restructuring in 1999, TSA and MSC entered into an amended and restated license agreement for the long-term use of the trademark and some technology (the 1999 TLA). The royalty rate under the 1999 agreement was 1.0% on gross sales for 1999, 1.1% for 2000, and 1.2% for all years thereafter. The terms of the previous 1995 TLA are not known.

It is evident that this license agreement was influenced by various "collateral transactions". First is licensee's holding of 9.6% of the shares in licensor which in itself is not high enough to argue for a transaction between related parties. But it certainly helped to keep the royalty rate lower than it would have been between fully unrelated parties.

Second is the share deal in 1999. The 1999 TLA (with increasing royalty rates from 1.0% to 1.2%) was signed as an ancillary agreement to a restructuring of the joint venture whereby licensor reduced its shares from 51% to 8.4%. The shares were divested at a very low valuation ($3.3 million EV for revenues of $85 million in 1998). It must be assumed that later royalties compensated for the low cash price of the shares. In all likelihood these royalty rates were higher than what licensee would have accepted in an independent transaction.

In 2002, TSA exercised a repurchase option and increased its shareholding in licensee MSC back to 19.9%, at the same low price per share as it had received in 1999. By then, the cheap share deal of 1999 was (partly) reversed.

In 2004, TSA and MSC signed a first amendment to the 1999 license agreement (the 2004 TLA). The royalty rate for stand-alone stores was now reduced to 1.1% for 2004, 1.0% for 2005, 0.9% for 2006. 0.8% from 2007 to 2014, and 0.5% from 2015 onwards. Further, the parties agreed on a royalty rate of 0.5% on sales from "TSA departments" operated within Jusco stores.

By 2004, TSA stores in Japan had increased to 39, and licensed revenues had increased under Jusco's leadership to $325 million in 2003. This number would further increase to 74 stores in 2006. Having such growth plans at around 2003/2004, Jusco negotiated in the 2004 TLA a reduction of the long-term royalty rate from 1.2% to 0.5%, and a reduced rate of 0.5% for "TSA departments" operated within Jusco stores. Obviously, Jusco was not willing to support the high growth of the licensed business under the same high royalty rate to TSA. The royalty rate Jusco was willing to accept now was 0.5%, with a transitional period of 10 years to achieve this lower rate, and starting immediately for non-free-standing stores.

Overall, the most independent royalty rate from these various agreements is the 0.5% rate which involved no share or other transactions or compensation for a cheap share transaction. Eventually, the 0.5% may be adjusted (downwards) for the technology components included in it (store layout, range, inventory, software, brands and suppliers, etc.), and upwards for the effect of the shareholding of Jusco in licensor. In any case, the impacts from collateral transactions affected the terms and the comparability of this license agreement.

The 2004 TLA was introduced as a CUT agreement at a 0.85% royalty rate by Amazon (the mean rate between 1.2% and 0.5%), and 1.2% by IRS (the maximum rate). The most likely rate licensee would have accepted in the case under no compulsion would have been 0.5%.

3. Rampage Clothing Company and Charlotte Russe, Inc. (2001)

This CUT agreement involves a trademark license agreement between licensor Rampage Clothing Company (RCC) and licensee Charlotte Russe, Inc. (CRI), governing the use of Rampage trademark. The agreement was signed in 2001.

RCC as licensor and CRI as licensee were fully independent and unrelated businesses. However, the license agreement was part of an overriding asset transaction.

RCC was a business engaged in young women's and children's clothing based in Southern California. In addition to a wholesale fashion business which supplied to multibrand retail stores, RCC had also established an own retail business (Rampage Retailing Inc.) operating 50 stores under the Rampage, Judy's and Friends names nationwide. Total revenues of RCC were in the area of $200 million, of which $50 million from the retail business. In 1997, RCC and RRI filed for Chapter 11 protection.

CRI was a vertical supplier of fashionable, value-priced apparel for young women in Southern California, Arizona and Nevada who sold fashion products under its own brand names in its own retail stores. Still in 1997, CRI acquired the assets of 16 Rampage retail stores from bankruptcy proceedings for approximately $9 million. Together with these assets, CRI secured a trademark license to use the Rampage name as store banner on these (and future) stores (the 1997 TLA). The license did not include the rights to use the Rampage brand on fashion products. Instead, CRI sold its own "Heart Moon Stars" branded products in the acquired Rampage stores, while licensor RCC continued to sell Rampage branded fashion products to other independent retailers.

The trademark license was granted to CRI at a royalty rate of 1% for years one through four, 1.5% for years five through eight, 1.25% for years nine through twelve, and 1.0% from year 13 onwards.

In 2001, the parties entered into an amended license agreement (the 2001 TLA, the CUT agreement). By then, the number of Rampage stores had increased to 34. By 2005, the number of Rampage stores would increase further to 66. The 2001 TLA considered further growth and stipulated reduced royalty rates of 1.0% for total revenues from $0 to $150 million, 0.75% from $150 million to $250 million, and 0.5% for total revenues over $250 million. Revenues under the 2001 TLA were $69 million in 2001 and $93 million in 2002. The effective royalty rate paid was 1.0% in 2001 (instead of 1.5% as originally fixed in the previous 1997 agreement), and in the years thereafter.

Under normal circumstances, CRI would have acquired the store assets together with the trademark from bankruptcy proceedings, instead of licensing it. However, RCC survived chapter 11 protection with its wholesale fashion business and continued to use the Rampage brand on their own products. The coexistence of Rampage as a fashion brand, and Rampage retail stores not selling Rampage fashion collections, was certainly an aspect which reduced the attractiveness of the business. The 2001 TLA was effectively terminated in 2005.

Certainly, the transaction of the store assets influenced the trademark license agreement, but it is hard to say in which direction. Typically, an acquirer would try to reduce risk by paying less in cash, and more in future success or revenue-based payments. Thus, CRI eventually accepted a higher royalty rate for a lower cash price of the assets. On the other hand, the administrator likely tried to get a maximum of cash payments. In any case, the cash price paid for the store assets was higher than the cumulative royalties paid during 10 years; therefore, the TLA was rather an ancillary agreement to the transaction of the store assets. The royalty rate was certainly influenced by the terms of the asset deal.

The 2001 TLA was introduced as CUT agreement at a 0.75% royalty rate by Amazon. It is hard to say what the royalty rate would have been in this case but for the compulsion. In any case, a fashion retail business is more distinctive and has a higher margin – and supports a higher royalty rate – than the Amazon business.

4. F.A.O. Schwarz Family Foundation and The Right Start, Inc. (2002)

This CUT agreement involves a trademark license agreement between licensor F.A.O. Schwarz Family Foundation (FAOS) and licensee The Right Start, Inc. (TRSI), governing the use of the F.A.O. Schwarz trademark. The agreement was signed in 2002.

FAOS as licensor and TRSI as licensee were fully independent and unrelated businesses. However, the license agreement was part of an overriding asset transaction.

F.A.O. Schwarz is a traditional, high-end toy store in the US, founded in 1862 in Baltimore and named after its founder Frederick August Otto Schwarz. The Schwarz family sold their last shares in the business in 1963, but kept the naming rights through the Schwarz family foundation. Since, the business went through a series of different owners and operators, all under licensing arrangements.

In 2002, TRSI – a children's retailer - acquired from Netherlands based Royal Vendex KBB the assets of 23 the 41 FAO Schwarz toy stores including catalog and internet operations, and including the flagship store on 5th Avenue, for $35.5 million, with revenues of approximately $125 million[7]. Before, Royal Vendex KBB had operated the FAO Schwarz business since 1990 under a trademark license from FAO Schwarz (the terms of which are unknown). The transaction with TRSI was a non-cash deal, with Royal Vendex becoming an 18% shareholder of TRSI. Through this transaction, the parties hoped to create substantial synergies between the loss-making FAO Schwarz stores and the US based retail business of TRSI. Around the date of the asset transaction and license agreement, the business was making heavy losses. One year after the transaction, the number of FAO Schwarz stores had decreased to only 15.

In connection with the asset transaction in 2002, TRSI entered into a trademark license agreement with FAOS governing the use of the FAO Schwarz trademark on retail stores, and on toy products (the 2002 TLA). It was an "amended and restated" agreement. This trademark license was granted to TRSI at 0.25% on the first $50 million of revenues, and 0.375% on revenues in excess of $50 million. In addition, the TLA stipulated a royalty rate of 0.25% for the use of the FAO name in the corporate name of licensee during the first weeks of the agreement, and a flat $25,000 per annum thereafter. TRSI changed its name to FAO Inc. after the transaction. It had total revenues of $535 million. The flat royalty for the corporate name license then translates into an effective 0.005% rate on revenues.

The annualized royalties represented a much smaller amount than the value of the acquired tangible assets, and the trademark license agreement must be considered an ancillary agreement to a complex asset and share deal which certainly influenced the royalty rate. It is however unclear in which direction. Royal Vendex was interested on one side to safeguard parts of the value of the business and its book assets (23 of 41 stores), which made them dependent on getting the trademark license renewed. On the other side, Royal Vendex and TRSI certainly argued for a low royalty rate based on the weak profitability of the licensed business and the long-lasting commercial inactivity of the FAO Schwarz family foundation as owner of the trademark and brand. The resulting royalty rate was rather low. Worth to note that the business continued to decline, and that licensee TRSI filed for Chapter 11 protection shortly after the transaction, in

[7] A business in distress, obviously.

2003. All but two FAO Schwarz stores were closed, and the license with TRSI was terminated.

The 2002 TLA was introduced as CUT agreement at a 0.4375% royalty rate by Amazon; it is not comprehensive how the expert for Amazon concluded on this rate from the terms provided in the agreement. The effective rate at initial revenues of $125 million was however 0.325% for the FAO Schwarz retail banner plus 0.005% for the FAO corporate name (the latter of which is not applicable to the Amazon case). Both parties acted under significant compulsion. Vendex tried to safeguard their tangible assets of an existing business. FAO Schwarz tried to safeguard a maximum of revenues from the existing stores, as opposed to granting the license to a new licensee which would have started from zero.

5. Kmart Corp. and Kmart Australia Limited (1994)
6. Kmart Corp. and Kmart New Zealand Limited (1994)

These CUT agreements involve two trademark license agreements between licensor Kmart Corp. (KMC) and licensees Kmart Australia Limited (KMA), and Kmart New Zealand Limited (KMNZ), governing the use of the Kmart trademark. Both agreements were signed in 1994.

These two cases involve a complex series of transactions. The parties were somehow related, and the license agreement was part of a set of overriding transactions including various share deals.

Kmart is an important operator of general merchandise stores (supermarkets, hypermarkets) in the US. In the 60s, Kmart established a JV in Australia with Australian retail firm Cole Myers, to operate Kmart Stores in Australia. Kmart held 51% of the shares of Kmart Australia Ltd., Cole Myers 49%. In 1978, Kmart's 51% shareholding in KMA was switched into a 21.5% shareholding in Cole Myers, whereby Cole Myers gained full control over KMA. This restructuring involved a first trademark license agreement to secure the rights for KMA to use the Kmart trademark on their stores (the 1978 TLA) as an ancillary agreement to the share swap.

In 1988, Cole Myers expanded Kmart into New Zealand. For that reason, a trademark license for the New Zealand territory was concluded between KMC and Kmart New Zealand Limited (KMNZ) (the 1988 TLA).

In 1994, in an attempt to streamline its portfolio and to divest some non-core businesses, Kmart sold all of their shares in Cole Myers to Cole Myers. This buyout required new, extended trademark license agreements between the two parties (the 1994 TLAs) to cater for the full independence of Cole Myers and KMA/KMZ from licensor KMC.

The 1994 TLA for Australia fixed a royalty rate of 0.188% on KMA's revenues up to a maximum annual amount (cap) of AU$ 5 million. In 1993, Kmart Australia operated 147 Kmart stores and paid US$ 3 million of license fees, the cap was not (yet) reached. By 2004, Kmart Australia had 168 stores and revenues of AU$ 3.5 billion; at that time, the effective royalty rate was approximately 0.14%, thus the cap was exceeded.

The 1994 TLA for New Zealand fixed a royalty rate of 0.125% on KMNZ's revenues up to a maximum annual amount (cap) of NZ$ 1 million. By 2004, Kmart New Zealand had 12 stores and revenues of AU$ 293 million; at that time, the effective royalty rate was approximately 0.09%, thus the cap was exceeded.

Kmart's likely interest in the 1994 restructuring was to raise a maximum amount of cash; in compensation, they would accept a low amount of future royalty payments from the 1994 TLA. With hindsight, it is likely that the royalty was capped in 1994 for the then existing business, and that any additional revenues above the cap were royalty free, resulting in even lower effective royalty rates. Moreover, both 1994 agreements secured the license rights for a very long period (25+5+5 years). Both agreements are still in place today.

The royalty rates in 1994 were influenced by two elements: the value of the shares sold by KMC, and the royalty rates fixed in the previous agreements 1978/1988. Insofar, the 1994 license agreements were ancillary agreements to some collateral and preceding agreements. Interestingly, the New Zealand TLA (the 1988 TLA) was concluded independently and undisturbed from any share deal. The fact that the 1994 New Zealand agreement was concluded at a lower (and not at the same) rate than the 1994 Australia agreement indicates that the 1994 agreements were not materially different from the preceding 1978/1988 agreements (except the duration and the cap). Overall, the 1988 New Zealand agreement at a 0.12% royalty rate was the most undisturbed of all license agreements.

The 1994 TLAs for Australia and New Zealand were introduced by Amazon as CUT agreements at royalty rates of 0.188% and 0.125% respectively. Through the maximum royalty amounts (caps) in these agreements, the effective royalty rates in 2004 were 0.14% and 0.09%. It is likely that the royalty rates would have been higher but for the 1994 share deal.

7. Snap! LLC and ValueVision International, Inc. (1999)

This CUT agreement involves a trademark license agreement between licensor Snap! LLC (Snap) and licensee ValueVision International Inc. (VVII), governing the use of the Snap.com and SnapTV.com trademarks. The agreement was signed in 1999.

The Snap transaction involves a complex affiliation structure, including a share deal of licensor in licensee, a warrant agreement, a marketing and distribution agreement, a promotion agreement, and a shareholder agreement which altogether overrode the trademark license agreement.

Snap.com was an Internet portal service for consumers owned by NBC in 1997. Snap.com offered efficient, high-quality Internet search results, comprehensive directory listings, proprietary Resource Centers and content from hundreds of leading Web publishers. VVII was a leading 24-hour per day television home shopping business, whose primary offering were high-margin jewelry items.

In 1999, NBC intended to converge internet content services, e-commerce services and cable television. Among other initiatives, NBC entered into a strategic alliance with VVII to strengthen its TV shopping capabilities. In March 1999, NBC acquired 19.9% of the shares in VVII. In July, NBC increased its shareholding in VVII to 39.9%. The transaction valued VVII at $200 million, for revenues of $200 million, negative operating income and cash-flows, and an equity value of $108 million. For NBC, the acquisition was very strategic. Together with the investment and shareholder agreements, NBC also got an exclusive (commissionable) right to negotiate on behalf of VVII for the distribution of its television home shopping service and the increase of its subscriber base. Four years later, VVII's revenues had almost tripled under NBC's leadership (the exclusive distribution agreement). In September 1999, NBC (through Snap) and VVII entered into a trademark license agreement (the 1999 TLA) whereby VVII would rebrand its television home shopping service using the SnapTV trademark and operate an e-commerce website at www.snaptv.com. For the use of the SnapTV trademark, VVII accepted to pay a royalty rate of 2.0% on revenues. By then, VVII had annual revenues of $222 million.

In June 2000, NBC announced a strategy to integrate all of its consumer properties under the single NBCi.com brand name, effectively abandoning the Snap name. As a result, in June 2000, the 1999 TLA between Snap and VVII was effectively terminated, and NBC and VVII entered into a new license agreement covering the ShopNBC tradename in November 2000.

Looking at the transactions around the 1999 TLA, it is rather unusual that VVII submitted – without need - the entirety of their existing revenues under a royalty-bearing license agreement at a 2% rate. This would have been something different for a new add-on business, but it was VVII's existing business. Even if licensor had 39.9% of VVII's shares and could exert some pressure on VVII to do so, there are only two plausible reasons for VVII to accept such a deal. Either, the price for the shares and the benefits of the other agreements were so attractive that VVII in return accepted the royalty as future compensation. Or NBC/Snap committed to substantial future business and revenue growth which VVII would not have achieved on a stand-alone basis. In any case, the royalty rate was certainly higher than it would have been without the collateral transactions. Thus, it was not an agreement between independent parties. Moreover, the agreement effectively survived not much longer than one year.

The 1999 TLA was introduced by IRS as CUT agreement at a royalty rate of 2.0%. Likely, the royalty rate in this case would have been lower but for the collateral agreements and close collaboration between the parties.

8. MacMark Corporation and Equilink Licensing Corporation (2000)

This CUT agreement involves a trademark license agreement between licensor MacMArk Corporation (MMC) and licensee Equilink Licensing Corporation (ELC), governing the use of the MacGregor trademark. The agreement was signed in 2000.

This transaction involves a series of preceding transactions and a settlement agreement between the – otherwise unrelated - parties. Interestingly, the license is not between MMC and ELC as stated in the ktMine database. The licensee is Sport Supply Group Inc. (SSG), and the licensor is Equilink (ELC).

MacMark Corporation owns and licenses the MacGregor trademarks for sports equipment, apparel and footwear. MacGregor was one of the first US manufacturers of baseballs and baseball gloves, and later added team uniforms, caps and other equipment to its range. By 1989, MacGregor filed for Chapter 11. The remains of MacGregor were sold in parts to different investors in 1991. MacMark acquired major parts of the MacGregor trademark rights. MacMark Corp. is 50% owned by Riddell Sports Inc. (a supplier of football gear), and 50% by Hutch Sports Inc. (a supplier of licensed teamsport apparel). Equilink (ELC) is a subsidiary of Riddell Sports Inc. in charge of sub-licensing the MacGregor trademarks.

SSG (previously named Blumenfeld Sports Net Co. or BSN in short) is a direct mail marketer of sports related equipment and leisure products to the institutional market in the US (schools, colleges, universities, government agencies, military facilities, athletic clubs, athletic teams). In 1992, MacMark had granted a perpetual, fully paid up (!) license (the 1992 TLA) to SSG/BSN to use the MacGregor trademark on various ball sport equipment for distribution channels other than store-based retail (i.e. team sport supply), subject to annual minimum turnover. Later, disputes arose between MMC/ELC and SSG concerning breach of the 1992 TLA and termination by MMC. In 2000, the parties resolved this dispute in a settlement agreement, which involved the conclusion of a new trademark license agreement (the 2000 TLA) with a limited term and royalty payments based on annual revenues.

Royalties to be paid under the 2000 TLA were a flat annual minimum of $100.000 for revenues of up to $17 million, 2% on all revenues above $17 million, and 1% on certain closeout sales above $22 million. Financial statements suggest that SSG paid the annual minimum royalties in 2001, but provide no details as to licensed revenues.

By the late 90s, SSG “had converted a substantial portion of its products to the MacGregor brand”; the eventual termination of the disputed 1992 TLA would have had a material adverse effect on the Company's results of operations and its financial position. Therefore, SSG had a vital interest to keep the license with MacMark alive, and to accept royalty obligations and other terms which it would not have accepted without the litigation. Eventually, the settlement included a punitive element on top of a fair market term. On the other side, the effective royalty rate under the flat royalty was eventually as low as 0,59% at annual revenues of $17 million. It is likely that effective revenues were approximately (or even exactly) at that level when the agreement was signed, and that any revenues above this amount had to be paid at the higher rate of 2%. In 2000, SSG had total revenues of $113 million under 28 different tradenames (including MacGregor).

The 2000 TLA was introduced by IRS as CUT agreement at a royalty rate of 2.0%. It is likely that the 2% royalty rate (for additional sales) was influenced by the litigation settlement. The effective rate in this case was much lower.

9. Tandy Corp. and InterTan Australia Ltd. (1999)

This license transaction involves a complex relation and previous transactions between the parties. The licensee was a former international distribution division of licensor.

Licensor Tandy Corporation (TC) was a manufacturer of personal computers until the early 90s under the Tandy brand. Moreover, TC operated the RadioShack retail stores for consumer electronics in the US and Canada, and Tandy stores outside the US, i.e. in UK and Australia. InterTan Inc. is the former retail business of Tandy Corp. outside the US which was spun-off to the Tandy shareholders in 1986 in the form of a tax-free dividend of one share of InterTan common stock for each 10 shares of Tandy stock owned. Through the spin-off, InterTan became a fully independent company. However, InterTan remained under strong influence of Tandy through various collaboration agreements. Tandy even fended off later takeover attempts aimed at InterTan, saying that if InterTan is controlled by another party it would exercise its rights to terminate these collaboration agreements.

After the spinoff, Tandy remained InterTan's principal supplier, the licensor of the Company's principal trade names, and a secured creditor. In 1986, Tandy and InterTan entered into a merchandising agreement whereby a Tandy subsidiary was the exclusive exporter of products to InterTan. Given the different local market requirements, InterTan sourced an increasing share of its inventory from other suppliers. By 1995, InterTan sourced only 30% of its inventory through TC; former synergies and economies of scale between the two firms went lost. To cater for the new situation, Tandy and InterTan entered into a new merchandising agreement and into some license agreements to use various trade names owned by Tandy (the 1999 TLA). Among other, these license agreements permitted InterTAN Australia Ltd. (ITAL) to use the "Tandy Electronics" trade name in Australia and New Zealand. Thereby, the royalty fee for the trade name was a function of the share of ITAL's inventory sourced through TC, where the trademark royalty decreases with an increasing share of inventory sourced from TC. By 1986, ITAL had operated 350 stores in Australia and generated revenues of US$ 60 million under the Tandy Electronics name which increased to US$105 million by 1999. By 1999, ITAL did not reach full-cost profitability.

Royalties to be paid under the 1999 TLA were 1% for all products not sourced through TC, and between 1% and 0.35% for products sourced through TC depending on their share in total sourcing. In 1999, InterTan paid 1% on products sourced from TC. In addition to the royalty, there was a sourcing commission on inventory sourced through TC.

The 1996 TLA was a predecessor agreement to the 1999 TLA; it had a royalty rate of 0.25% for 1996, 0.5% for 1997, 0.75% for 1998, and 1% beginning in 1999. The 1999 TLA was terminated in 2001, and InterTAN sold its Australian business to Dick Smith/Woolworths, with 330 stores and revenues of US$ 120 million, at a purchase price of US$ 47 million, indicating low margins and weak profitability. Information available related to this divestiture suggests that Dick Smith/Woolworth acquired the business from InterTan together with the full ownership in the Australian trademark rights from TC. Thus, the 1999 TLA survived for only 2 years and found no successor agreement.

ITAL was not independent when it signed this license agreement. InterTAN and its subsidiary ITAL had no choice but to accept any royalty rate demanded by TC. Further, the total revenues of TC from the business relation with ITAL consisted of royalties and sourcing commissions (and embedded economies of scale); both elements were interdependent, with a maximum of 1.0%. In any case, the 1999 agreement with a 1% royalty rated survived only two years, and only six years after a trademark royalty of initially 0.25% was fixed in 1996. This short survival indicates that this deal was not financially attractive to InterTan/ITAL.

The 1999 TLA was introduced as CUT agreement by IRS at a royalty rate of 1.0%, and later adopted by Amazon at the same rate. It is likely that licensee did not act free of compulsion when he accepted this royalty rate. Licensor imposed this (higher) royalty rate to compensate for the decreasing sourcing of licensee through licensor's channels, and the decreasing economies of scale.

Recap of related transactions

The nine agreements discussed above have been introduced as CUT agreements in Amazon vs IRS. From this sample, the issue of related transactions and overriding business relations is evident. Only one agreement is a pure play, stand-alone license transaction free of collateral transactions which fully meets the comparability criterion of independence and non-compulsion under the CUT method. Eight of nine CUT agreements however involve several collateral transactions and fail to meet the stand-alone criterion. Preceding trademark license agreements were the most frequent collateral transactions, followed by share deals, service agreements, asset deals and dispute settlements. Interestingly, no collateral transaction was a standalone collateral; typically, they occur as combinations of several collaterals. On average, there were more than three collateral transactions per CUT license agreement (!). As has been shown above, the likely impact of the collateral transactions on each license agreement was substantial and - in all likelihood – had a material effect on the license terms and royalty rates of the license agreements considered as CUTs.

#	Licensor	Licensee	preceding TLA	asset deal	share deal/ JV	service agreement	dispute settlement
1	Merchandising Corp. of America	Sports Archives	-	-	-	-	-
2	The Sports Authority	Mega Sports	X	-	X	X	-
3	Rampage	Charlotte Russe	X	X	-	-	-
4	FAO Schwarz	The Right Start	X	X	-	-	-
5	Kmart	Kmart Australia	X	-	X	X	-
6	Kmart	Kmart New Zealand	X	-	X	X	-
7	Snap	Valuevision	-	-	X	X	-
8	MacMark/Equilink	Sport Supply Group	X	-	-	-	X
9	Tandy	InterTan Australia	X	-	X	X	-
Σ			**7**	**2**	**5**	**5**	**1**

Handling of the deficiencies in Amazon vs IRS

All but one CUT agreements showed interferences from associated transactions. In such cases, textbooks and course materials suggest to make adjustments to "normalize" CUT royalty arrangements to make them more comparable to the subject transaction, or to the arm's length and fair market premise of value. [8] These normalization

[8] *Robert Reilly and Robert Schweihs*, The Handbook of Business Valuation and Intellectual Property Analysis, McGraw-Hill 2004; *Robert Reilly*, The Relief from Royalty Method of Intellectual Property Valuation, *Willamette Insights Autumn 2008*; *Robert Reilly*, Analyzing Intellectual Property Royalty Rate Data, *Presentation to the AICPA Fair Value Conference in Las Vegas on Nov 12, 2013*; *Business Valuation Update*, Three-Step Analysis to Manage the 'Noise' in IP Royalty Rate Data, Vol. 20, No.5, May 2014; *John Elmore*, The Valuation of Trademark-Related Intangible Property, *Willamette Insights Winter 2015*; *Robert Reilly and Robert Schweihs*, Guide to Intangible Asset Valuation, Wiley 2016; *Robert Reilly*, Intellectual Property Valuation – Application of the Relief from Royalty Method, *Presentation to the ASA Advanced Business Valuation Conference in Houston on Oct 7, 2017*.

adjustments typically reduce the “noise” in what appears to be a wide range of aberrational and unrelated royalty rate data. Any adjustment requires thorough consideration of all relevant circumstances of a CUT transaction which goes far beyond the reading of the full-text license agreement. Adjustments will be made on a qualitative and quantitative basis, based on a profound understanding of all relevant circumstances. Textbooks also suggest to eliminate from consideration those anomalous observations that cannot be normalized or adjusted.

In a landmark case like Amazon vs IRS, one would expect the parties to pay utmost attention to considering all circumstances and facts to make the CUT agreements as comparable as ever possible. Surprisingly, this did not happen.

- According to the records, neither expert eliminated CUT agreements for associated transactions from his initial selection prior to introducing them as CUT agreements.
- Neither expert made any qualitative or quantitative adjustment to the CUT agreements he had selected and introduced.
- Neither expert challenged the CUT agreements introduced by the other party for associated transactions – with one exception. Expert for Amazon challenged the MacMark/Equilink agreement – among some other aspects – for being the outcome of a litigation settlement.
- And finally, the court did not challenge the experts for using CUT agreements with considerable noise.

Five agreements were (rightly) challenged and rejected - but for very different reasons (i.e. financial problems and declining brand, low price image and positioning, different business sector, short survival of the agreement, different rights granted, litigation settlement), and the court accepted all of the challenges and rejected these five agreements.

In Amazon vs IRS, the issue of associated transaction interfering with the CUT agreements presented was obvious, but the parties did not really pay attention to it. Under usual standards of comparability, it would have been easy to get all the nine CUT agreements rejected.

Conclusions

1/
Eight out of nine CUT trademark license agreements used in the Amazon vs IRS tax dispute showed significant noise from associated transactions. This does not seem to be an accidental finding. From wider research of nearly 300 trademark license agreements in the public domain there is reason to believe that that approximately 75% of such agreements carry similar noise from associated transactions.

2/
Associated transactions can have substantial impact on the terms of a so-called CUT license agreement. The – assumed – market price stated in a CUT agreement may turn out to be an artificial, tactical, tax-induced or earnout-related price. Applying such royalty rates in valuation without due reflection and appropriate adjustment will result in impaired values – either over- or understated.

3/
Although postulated in textbooks and course materials, the impact of associated transactions is not appropriately considered by appraisers when using CUT license agreements. There is reason to believe that such noise is not considered at all. There can be two reasons for that: either appraisers are not aware of this problem, or they simply hope that all noise disappears in a statistical average.

4/
Not considering the influence of associated transactions in CUT agreements can be a risky approach for appraisers in litigation. It is reported that CUT license agreements are frequently rejected for non-comparability. However, searching and documenting associated transactions can be long, time-consuming and costly.

5/

License agreement data vendors carry low-quality CUT agreements in their databases. They are invited to classify and qualify their data for associated transactions, similar to what they have done with the related parties issue.

6/
Appraisers are invited to use more than one – if not all – sources of comparable data. The annual subscription model offered by most of the data vendors however inhibits users to search (and pay) elsewhere, outside the one subscription one typically pays for

7/
If – for the numerous interferences - robust comparable data is so difficult to obtain for the royalty relief approach, complementary valuation methods need to become more popular (i.e. profit split, asset value / enterprise value, MEEM).