

ASC 606: Classifying Settlement Proceeds and IP Licenses

Litigation and Dispute Resolution





In the second part of this two-part series on the ASC 606, Litigation Columnist Noah Webster delves into the considerations for recognizing revenue from settlement contracts, the two distinctions of IP licenses, and more. Read the first article of the series here.

Classification of settlement proceeds

KPMG believes that the considerations described in a 2007 US Securities and Exchange Commission (SEC) speech generally remain applicable under ASC 606 principles. In that speech, the SEC discussed identifying the distinct elements of a settlement (e.g., promise to drop the lawsuit, covenant not to sue, and patent license) and allocating a transaction price to each. This is the process required by ASC 606. To illustrate how it works, KPMG provides the following example of applicable considerations for a patent infringement settlement contract:

> *"First, the settlement of a patent infringement should be distinguished from a settlement of past due license fees. If an entity is in the business of licensing intellectual property (e.g., licensing software) and is required to pursue legal action to enforce its licensing rights, whether from an existing customer (e.g., to collect unpaid license fees) or from an entity that is not party to an existing contract (e.g., an unrelated entity that has obtained unauthorized use of the entity's IP), the settlement amount should be allocated between 'past due license fees' (which would be recognized as revenue in accordance with Topic 606) and any settlement gain. Generally, this would be based on the stand-alone selling price of the license with amounts in excess of the stand-alone selling price of the license being characterized as a settlement gain."*

The example highlights how a specific obligation in a settlement contract can be recognized as revenue under ASC 606; specifically, a license provided as part of the licensor's ongoing business activities. But proceeds associated with a settlement gain will not be recognized as revenue.

IP Licenses

ASC 606 distinguishes between two types of IP licenses: Functional IP and Symbolic IP.

ASC 606 describes a Functional IP license as "a license to intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired) [that] does not include supporting or maintaining that intellectual property during the license period." Functional IP is recognized at the time control is transferred. An example in the guidance illustrates how a patent may be considered Functional IP: the "patented drug formula is functional intellectual property (that is, it has significant standalone functionality in the form of its ability to treat a disease or condition)" and "there is no expectation that the entity will undertake activities to change the functionality of the drug formula during the license period." Microsoft apparently believes it licenses Functional IP by disclosing how it recognizes revenue up front for its patent licensing revenue.

Symbolic IP provides the customer access to IP during a license period, which is recognized over the course of the license period. ASC 606 describes a Symbolic IP license as "intellectual property that does not have significant standalone functionality [and] includes supporting or maintaining that intellectual property during the license period." Symbolic IP includes "brands, team or trade names, logos, and franchise rights."

Furthermore, these additional considerations of ASC606 may apply to a license settlement agreement:

- **Royalties exception.** As an exception to the above IP license principles, consideration for a

license of IP based on sales- or usage-based royalties are recognized when “the later of the following events occurs: (a) the subsequent sales or usage occurs; (b) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).” This perhaps is why Microsoft emphasized how the patent license revenue it now recognizes upfront relates to *non-volume* licenses.

- **Minimum payment.** Where a customer is obligated to pay a set guaranteed amount for a Functional IP license having a royalty, it is a fixed minimum payment that can be recognized at the point in time when the customer obtains control of the Functional IP license.
- **Perpetual license.** For a perpetual license to symbolic IP, the licensee recognizes the revenue over the economic life of the IP, which needs to be estimated.
- **Sale.** A sale of IP is not a license under ASC 606, so the general revenue recognition model applies.
- **Not distinct.** Where a good or service is not distinct from a license, the obligation combines and the general revenue recognition model applies (not one of the Functional or Symbolic license principles). This may occur when a computer is sold to an end user along with software licenses.
- **Attributes.** Contractual provisions that define the attributes of a license are not additional obligations. That is, a single license with a limited, defined scope of time, use, or geography constitutes one obligation in most cases. Along these lines, ASC 606 further explains: “[g]uarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use do not affect whether a license provides a right to access the entity’s intellectual property or a right to use the entity’s intellectual property. Similarly, a promise to defend a patent right is not a promised good or service because it provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.”

Other considerations

The accounting of settlement proceeds depends on the facts and circumstances. ASC 606 guidance has additional considerations for settlement contracts that are applicable in different circumstances; for example, contingencies, non-cash exchanges, and options. In negotiating a settlement contract, you can look to ASC 606 for guidance on how any revenue will be recognized.

References

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Noah Webster is chief legal & compliance officer for Everbridge, a global software company that empowers enterprises and government organizations to anticipate, mitigate, respond to, and recover stronger from critical events. In today’s unpredictable world, resilient organizations minimize impact to people and operations, absorb stress, and return to productivity faster when deploying critical event management (CEM) technology. Everbridge digitizes organizational resilience by combining intelligent automation with the industry’s most comprehensive risk data to Keep People Safe and Organizations Running.