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Trust But Verify

Law360, New York (May 26, 2011) -- A recent opinion of the U.S. Court of Appeals for the Seventh Circuit underscored the danger to trademark owners of not exercising quality control over its licensees: the trademark goes abandoned and the owner loses its rights. And "exercise" is the key word. It is not enough to trust the licensee but do nothing. And it may not be enough just to insert a boilerplate quality control provision into the license agreement.

Even a powerful brand worth millions of dollars can suffer the fate of being declared invalid for abandonment if the owner fails to exercise sufficiently the duty of quality control. Careful definition and exercise of quality control rights is required.

Background

In *Eva's Bridal Salon Ltd. v. Halanick Enterprises Inc.*, No. 10-2863 (7th Cir. May 10, 2011), the owner of the mark "Eva's Bridal" licensed the use of the mark to relatives, who then sold their bridal shop to their relatives, the defendants. The license provided for a fixed yearly royalty, but "did not require [the licensee] to operate the ... store in any particular way and did not give the licensor any power of supervision over how the business was conducted." Nor did the licensor ever try to control any aspect of how the licensee operated the store or used the mark.

After the licensee stopped paying the yearly royalty, the licensor sued for trademark infringement. The district court held that the licensor abandoned the mark by engaging in "naked licensing" — that is, licensing the trademark without exercising reasonable control over the nature and quality of the goods.

The Seventh Circuit

"Consistent and predictable" quality, not simply high quality.

On appeal, the plaintiff/licensor argued that they "never doubted the high standards of [the defendants], so they had no reason to superintend any aspects of defendants' business." The plaintiffs also noted that the defendants' shop sold dresses from the exact same designers since it opened, and that is all customers care about.

Judge Easterbrook, writing for the panel, was unpersuaded. He rejected the argument that "licensors may relinquish all control of licensees that operate 'high quality' businesses." He emphasized that the quality control the law requires does not mean "high quality" but "consistent and predictable quality": "The trademark's function is to tell shoppers what to expect — and whom to blame if a given outlet falls short." With his familiar flair, Judge Easterbrook noted that "'Kentucky Fried Chicken' is a valid mark, though neither that chain nor any other fast-food franchise receives a star in the Guide Michelin."

The Seventh Circuit held that the licensor fell far short of the required standard "because

plaintiffs did not retain any control —not via the license agreement, not via course of performance.” As a consequence, the plaintiff was held to have abandoned its rights in the EVA’S BRIDAL mark, and the ex-licensee was allowed to continue to use it without payment.

The Lesson

Quality control is crucial; write it into the license, then exercise it.

The Seventh Circuit’s holding emphasizes the importance of two steps that are easy in theory, but one of which frequently is ignored in practice. First, include quality control provisions in trademark licenses. As a general rule, a trademark license should contain the following provisions concerning quality control:

- Recite the licensor’s reputation for consistent quality under the licensed mark and consumers’ reliance on it, or, alternatively, define an industry standard.
- Provide that the licensee will adhere to the licensor’s standards for format and usage of the mark and type and quality of the products or services, and that the licensor may dictate changes to those standards at its discretion.
- Provide that, both at the outset of the license and periodically, the licensee must submit samples for approval of advertising, promotional material, packaging and labeling.
- Provide that the licensee must submit samples for approval at the outset of the license, before selling any new or changed product, and at periodic intervals.
- Provide that the licensee cannot begin advertising and selling before the licensor gives written approval of the initial samples.
- Provide for periodic inspections of the licensee’s premises.
- Provide that the license may be revoked for failure to adhere to the licensor’s standards for mark usage and quality of the goods or services.

Second, the trademark owner must actually and periodically exercise its powers to control the format and usage of the licensed mark and require the licensee to perform fully its obligations for maintaining the trademark owner’s standard of quality as to the goods or services. If the licensee fails, over a significant period of time, to perform fully its obligations to maintain the trademark owner’s standards over the goods or services, the trademark owner should take appropriate action, including, if necessary, revoking the license.

Trademarks are symbols to the consumer of predictable and consistent quality. To maintain trademark validity and commercial strength, the trademark owner must actively ensure that the quality of the goods and services sold under a licensed trademark actually remain true to the vision of the owner and the expectations of the consumer.

For significant failures to perform this essential duty, the courts will likely impose the death penalty: holding the trademark invalid based on abandonment. In a suit between the trademark licensor and licensee, such a ruling will permit the licensee to continue to use the name or symbol that had been a trademark without payment of royalty to the licensor. More important, it will render the former owner powerless to stop others from adopting and using the mark.

In short, it’s good to trust your licensee. But it’s better — and necessary — to verify.

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