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Trade mark licensing made easy

Carefully crafted trade mark licences can enrich both licensors and licensees by increasing sales revenues, expanding product lines and boosting brand awareness. The key to success is understanding what each side wants from the deal, say **Oliver Herzfeld** and **Richard Bergovoy** in the first of a two-part article

A trade mark licence can be an important tool for a trade mark owner, enabling it to derive significant rewards from granting a third party the right to use the mark under a licence agreement. In particular, licensors may benefit from increased revenues in the form of advances, minimum guarantees and running royalty payments, without increasing capital expenditures or ongoing expenses; promotion of their trade mark through the licensee's advertising, marketing and sale of the licensed products bearing the trade mark; and extension of the reach of the brand and enhanced protection of the trade mark in the licensed categories.

Similarly, licensees may benefit from the trade mark's selling power to build competitive advantage and bring new excitement to product lines; increase sales; enter new channels of distribution; reach new consumer and retailer benchmarks; and stave off competition.

Thus, a trade mark licence is a hybrid creature: it is not only a legal document, but also a way of doing business. With that in mind, this article reviews and summarizes both the key legal provisions and the key business considerations of a trade mark licence, since the successful negotiation and performance of a licence require an understanding of both aspects. A second article covering some additional provisions will appear in a future issue.

The licence grant

The licence grant is the heart of a trade mark licence agreement since it defines the answers to the following three key questions:

1) Which trade marks are being licensed and what specific rights are being conveyed?
2) What is the licensee permitted to do with such rights? What is the licensee prohibited from doing with such rights? In particular, what types of products is the licensee permitted to manufacture and sell, in which territories and in which channels of distribution?
3) Is the grant exclusive or non-exclusive?

A trade mark owner may also license copyrights (for logos and other brand-related original content) and rights of publicity (for celebrity licences).

AT-A-GLANCE

Licensors should include a reservation of rights provision that clearly states all rights not explicitly granted to the licensee in the agreement are reserved to and retained by the licensor.

Territories and distribution channels

"Territory" means the geographic area in which the licensee is permitted to sell the licensed goods. It is usually defined on a country-by-country basis.

Distribution channels are the permissible categories of buyers from the licensee and/or resellers to the public of the licensed goods. Common distribution channels include mass, mid-tier department stores, specialty stores, the internet, and catalogues.

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The basic conflict in negotiating the channels provision is between the licensor's desire to have only the newest, best quality goods for sale in the most prestigious channels (so as to enhance its brand image) versus the licensee's desire to maximize profits by selling as many goods in as many channels as possible, at whatever price the market will bear.

This conflict often comes into sharp focus in defining the licensee's ability to sell to discount channels without case-by-case permission from the licensor, especially for seconds (goods with minor but merchantable defects), closeouts (out of season, unsold inventory), and sell-offs (unsold inventory at the expiration of the agreement).

The sell-off scenario will be examined in greater depth in Part 2 of this article.

In negotiating distribution channel provisions, licensors usually want limited, well-defined channels and no right to sell seconds, closeouts, or sell-offs to discount channels without case-by-case approval. Licensees generally want to sell through all possible channels and want the right to sell seconds, closeouts, or sell-offs to discount channels without prior approval from the licensor.

Exclusivity

One of the most important issues in crafting a licence grant is whether and to what extent the licensee will have exclusive rights. Non-exclusive licences do not restrict the licensor's ability to grant licences for like products to other parties.

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A sample non-exclusive exclusive provision

Licensor hereby grants to Licensee a non-exclusive licence to use the Property in the Licensed Territory solely upon or in connection with the sale of Licensed Articles through any of the Authorized Distribution Channels and pursuant to the terms and conditions of this Agreement, *provided* that Licensor shall not allow any third party to source for sale any of the Licensed Articles through any of the Authorized Distribution Channels in the Licensed Territory, as long as Licensee performs its obligations in accordance with the terms and conditions of this Agreement, as determined by Licensor in its sole and exclusive discretion.

They are the norm in trade mark and brand licensing. Exclusive licences, as the name implies, grant exclusive rights to produce and sell certain products in certain territories and markets during the term of the licence. Exclusive licences may be exclusive against the whole world, including the licensor, or they may exempt the licensor, either explicitly or implicitly.

On the (less frequent) occasion that a licensor agrees to an exclusive grant, it will usually make the exclusivity subject to defeasance, in whole or in part, triggered by various performance shortfalls by the licensee, such as failure to meet minimum net sales requirements, product roll-out deadlines, or minimum distribution requirements.

If triggered, defeasance may take a variety of forms including the conversion of the entire licence grant from exclusive to non-exclusive; or the clawing-back of certain products or categories from the exclusive licence grant, to either non-exclusive status, or total exclusion from the licence grant. In particular, a claw-back is a common remedy for the licensee's failure to meet minimum net sales requirements.

In addition to the traditional exclusive and non-exclusive licence grants, a third alternative is the so-called "non-exclusive exclusive" licence grant. Such a provision begins with traditional non-exclusive language, but also promises not to grant to third parties the right to sell like products if the licensee complies with all the terms and conditions of the licence agreement.

Usually, compliance is judged in the licensor's sole discretion, which benefits the licensor since there is no need to prove licensee default. Licensees prefer a non-exclusive exclusive grant to a standard non-exclusive grant, since there is some measure of protection against competition.

Licensors should note that by not using the magic word "exclusive" in a licence grant, there is less likelihood under US law that a bankrupt licensee may assign the licence agreement without the licensor's consent.

Another variation on the theme includes a non-exclusive provision where it is not a breach if the licensor grants a third party the right to sell like products, but upon any such grant to a third party, the licensor agrees to provide the licensee with certain royalty relief or other pre-defined remedies.

AT-A-GLANCE

For licensees: Argue first for a pure exclusive licence grant, if not, then argue the reverse order of preference as the licensor (below). If forced to accept a standard non-exclusive licence grant, then resist or seek reduced minimum royalty guarantees, or seek extra territories or extra product categories to compensate for income insecurity.

For licensors: Argue first for a non-exclusive licence grant. If not, then a non-exclusive exclusive licence grant. If not, then an exclusive licence grant, subject to defeasance for licensee performance or compliance failures, as judged by the licensor in its discretion.

The licence term

The length of the initial term, and the licensee's ease or difficulty in obtaining a renewal term, is largely driven by business considerations. The licensor generally wants a short term with no automatic renewal, so that it can easily replace an underperforming licensee, or obtain better financial terms by engaging a new licensee or by manufacturing the goods itself. The licensee generally wants a longer term with an automatic renewal with few or no pre-conditions, in order to amortize its development costs, and guarantee a longer return on its investment.

The licence agreement may specify that the term may be renewed only at the consent of both parties, or it may include an automatic renewal provision. Automatic renewal provisions are frequently conditioned upon one of the following: the mutual agreement of both parties, the exercise of an option to renew by the licensee (sometimes subject to the licensor's consent not to be unreasonably withheld), or the licensee's achievement of certain sales or other objectives.

Royalty calculations

Royalties are the currency of trade mark licences. By far the most common basis for calculating royalties on goods licences is on a percentage of net wholesale sales, defined as gross sales minus certain agreed deductions (such as taxes and returns). The net sales figure is then multiplied by the royalty rate to yield the amount of royalties owing to the licensor.

Common points of contention in negotiating the net sales provision include:

1) Which deductions are permitted from gross sales in calculating net sales and any limits thereto. Most licensors permit deductions for taxes and returns, and many also permit deductions for customary discounts granted by licensees to retail stores. Many other deductions are possible, most of them based on out-of-pocket costs of the licensee, such as advertising, promotional allowances, year-end rebates to retailers, and commissions. Increasing the deductions that are permitted will decrease the base figure for royalty calculations, and ultimately reduce the amount of royalties to be paid by the licensee;
2) Whether the net sales figure (or other chosen stream of income) will be based on actual receipts by the licensee, exclusive of third party purchasers that fail to pay for whatever reason (no-pays), or based on sales by the licensee, regardless of no-pays. Receipts generally favor the licensee, while sales generally favor the licensor; and
3) The treatment of so-called free on board (FOB) sales. FOB in its strict sense is a legal term that specifies that the buyer of goods in international commerce will take legal title to, and arrange and pay for shipment of, the purchased goods from the point when they pass the ship's rail in the seller's home port. However, in licence agreements, FOB is used more broadly to refer to any situation in which a retailer or other buyer takes delivery

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Alternative royalty calculations

Flat fees per unit: Retailers that source/sell licensed products themselves instead of purchasing them from licensees sometimes negotiate a flat fee per unit, or royalties based on landed cost rather than price.

Also, interactive game manufacturers, multimedia developers and other licensees that license a number of different marks within one product may negotiate a flat fee per unit to simplify accounting.

Retail price: Book publishers, retailers, mail-order catalogues and e-commerce vendors that manufacture and sell licensed products themselves frequently negotiate royalties that are based on the retail price of those products.

Licensee revenues/profits: Mobile phone content and game vendors typically receive from the carriers a percentage of the download price multiplied by the number of downloads, and pay licensors a percentage of such revenues.

at the licensee's location (such as the licensee's factory loading dock) and ships the licensed products at the buyer's own expense, essentially removing freight, insurance, Customs, and related shipping expenses from the licensee's net sales price. Of course, this results in lower royalties to the licensor, compared to a non-FOB sale of the same goods. The following example illustrates this point:

Hypothetical sales comparison

Regular (non-FOB) sale:
Licensee's selling price per unit = $35.00
Royalty (at 10%) =$3.50

FOB sale:
Licensee's selling price per unit = $26.00
Royalty (at 10%) = $2.60

Net difference to the licensor:
Regular royalty per unit (at 10%) = $3.50
FOB royalty per unit (at 10%) = $2.60
Difference = $0.90
Difference as a percentage = 26%

Licensors frequently make up the difference by negotiating an FOB surcharge of 25% to 60% to recapture the lost revenue.

AT-A-GLANCE

For licensees: In a net sales-based licence, licensees will argue to deduct all of their costs of doing business (see above), as well as their bad debts, on the basis that it is unfair to pay royalties on money that they never realize.

For licensors: In a net sales-based licence, licensors will normally allow full deductions for taxes and returns. If they allow other deductions, they will normally seek to bound them by an upper limit. For example, licensors frequently limit all other deductions in the aggregate to a maximum of five or ten percent of annual gross sales. Such a limit reduces the licensor's exposure to the risk of large (and often difficult to verify) deductions from net sales that create unexpectedly large reductions in royalties.

Minimum guaranteed royalties

Minimum guaranteed royalties represent a contractual commitment by the licensee to pay the licensor a certain minimum amount of royalties regardless of the actual amount of sales of licensed products, if any. Advance payments are simply minimum guarantees that are paid at the inception of a licence agreement. Minimum guarantees are normally negotiated based on a percentage of expected earned royalties. They are intended to motivate the licensee to diligently promote the development and sale of licensed products in the marketplace, and reduce the licensor's risk by guaranteeing it a minimum rate of return on its asset.

Licensors also want to prohibit the licensee from utilizing excess running royalty payments above the minimum guarantee in one contract period as a credit to reduce a payment obligation in another period. This is sometimes referred to as a prohibition against cross-collateralization of royalties by period. Such a prohibition is intended to motivate the licensee to diligently promote the development and sale of licensed products in every contract period. It also helps maximize the amount of royalties the licensee must pay the licensor. Here is an example of how a prohibition against cross-collateralization of royalties by period can substantially increase the royalties that are payable to the licensor:

Cross-collateralization by period

	Contract year 2007	Contract year 2008
Running royalties	$40,000	$60,000
Minimum guarantee	$50,000	$50,000
Total if cross-collateralization is permitted	$50,000	$50,000 (after $10,000 credit from 2007)
Total if cross-collateralization is not permitted	$50,000	$60,000

AT-A-GLANCE

For licensees: To minimize over-all payments to licensors, endeavor to explicitly reserve the right to freely cross-collateralize royalty payments across time periods, as well as any other basis.

For licensors: In addition to prohibiting cross-collateralization of royalties by period, endeavor to set forth separate minimum guarantees by trade mark, product, territory, and/or channel of distribution, and prohibit the cross-collateralization of royalties on such basis too.

Approvals and quality control

Trade marks operate as designators of source that give consumers the ability to predict the quality of the products they purchase. Without consistency in quality, consumers would tend to be misled, not aided, by reliance on trade marks. A trade mark licensor that does not monitor and control the quality of its licensees' products is deemed to have granted a so-called naked license that may result in an abandonment and complete loss of the licensor's trade mark rights. In *Barcamerica International USA Trust v Tyfield Importers Inc*, 289 F3d 589 (9th Cir 2002), the US Ninth Circuit Court of Appeals said:

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Understanding what the other side wants

Provision	Licensors want:	Licensees want:
Territories and distribution channels	■ Include language that prohibits the licensee from selling licensed goods to any party it has reason to know will resell them in any country outside the licensed territory.	■ If the territory includes any EU member country, make sure the licence agreement includes language clearly stating that the licensee is permitted to fill unsolicited orders from EU member countries outside of the territory, as required by EU law.
Exclusivity	■ Exclusivity does not apply to licensor	■ Exclusivity does apply to licensor
	■ Exclusivity subject to defeasance, based on licensor's sole discretion	■ Exclusivity not subject to defeasance, except by termination of entire licence agreement. Alternatively, if exclusivity is subject to defeasance, it is based only on fair, reasonable and objective criteria
Term	■ Short initial terms with no automatic renewals or, alternatively, automatic renewals conditioned on the licensee achieving challenging financial or performance objectives	■ Long initial terms with automatic renewals at the licensee's discretion
Royalties	■ Minimal deductions that are easy to calculate and verify (such as returns and taxes)	■ Maximum deductions (such as discounts, rebates, promotional allowances, advertising), so that the royalty payments are based on actual net amounts realized by the licensee
	■ Royalty rate increased to compensate for lower-priced FOB sales, so that the sale of the same number of licensed products on an FOB basis yields roughly the same royalty payments	■ No royalty rate increase to compensate for FOB sales
	■ Royalties calculated on sales	■ Royalties calculated on collections
Minimum guaranteed royalties	■ Fully-earned upon the commencement of the licence agreement term, and immediately due and payable upon any termination thereof	■ Not fully-earned at commencement of the licence agreement term, and not payable at all or only a *pro rata* portion due and payable upon limited types of termination for material breach by licensee
	■ Front-loaded with a large advance payment and/or high initial payments by the licensee	■ Back-loaded with a low or no advance payment and low initial payments by the licensee
	■ Paid on a frequent payment period basis (such as monthly or quarterly)	■ Paid on a less frequent payment period basis (such as semi-annually or annually)
Approval and quality control	■ Review and veto rights of all licensed products on a sole discretion standard	■ Review and veto right of licensed products only on an objective, non-discretionary standard
	■ Review and veto rights of all packaging, advertising, and other uses of the trade mark, on a sole discretion standard	■ Review and veto right of packaging, advertising, and other uses of the trade mark, only on an objective, non-discretionary standard
	■ Long approval review periods (such as 30 days), with failure of the licensor to respond deemed a disapproval	■ Short approval review periods (e.g., 5 days), with failure of the licensor to respond deemed an approval, or contractually requiring the licensor to respond to a follow-up inquiry by the licensee
	■ Licensed products must exactly conform to submitted samples	■ Licensed products need not exactly conform to submitted samples, with non-material variances explicitly permitted
	■ Reservation of the right to withdraw a previous grant of approval in extraordinary circumstances (such as in the event of safety problems with licensed products, or perhaps because the licensor's marketing strategy has changed)	■ No licensor ability to withdraw a prior approval
	■ Right to inspect factories for (i) product quality control, (ii) worker health/safety and (iii) other corporate social responsibility issues, extending to manufacturers, subcontractors and sub-licensees, on short notice and without limitations on the number of inspections	■ Right to inspect factories limited to (i) product quality control and (ii) worker health/safety issues, only on long notice, during normal business hours, and with limitations on the number of inspections
	■ No right of the licensee to sell seconds (such as products with minor but merchantable defects), except with the licensor's prior approval as to both product and channel(s) of distribution	■ Right of licensee to sell seconds, either without the licensor's prior approval, or with pre-approval as to channel(s) of distributions

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> [U]ncontrolled or 'naked' licensing may result in the trademark ceasing to function as a symbol of quality and controlled source... Consequently, where the licensor fails to exercise adequate quality control over the licensee, a court may find that the trade mark owner has abandoned the trademark, in which case the owner would be estopped from asserting rights to the trade mark.

To avoid such an unpleasant outcome, every trade mark licence agreement must include quality control provisions that apply both to the licensed products, as well as all related packaging, advertising and marketing materials. Further, the approval provision should provide workable mechanisms by which the licensor can monitor the licensee's compliance.

Whereas licensors will seek to ensure that there is a sufficient level of quality control to prevent a finding of abandonment, and reserve the right to exercise actual control either directly or through a third party agent, licensees will seek to negotiate an efficient and streamlined approval process that minimizes any interference with their business.

AT-A-GLANCE

A licensor's reliance on a licensee to control the quality of the licensee's own products may be legally sufficient where:

1. The licensor has knowledge of the previous quality of the licensee's products;
2. The licensee is contractually obligated to maintain such quality; and
3. The licensor has an adequate basis for reliance on the licensee.

Negotiation is key

It is important to negotiate trade mark licence agreements properly since there is always a lot at stake. For the licensee, the key risks are financial loss (that is, minimum guaranteed royalties, investments in product development, and costs associated with the liquidation of inventory), and a loss of reputation with retailers. For the licensor, the key risk is the health and well-being of the brand itself.

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In the second part of the article we will explore some additional licence agreement provisions such as warranties, assignment/subcontracting, audit rights, ownership and protection of intellectual property, termination conditions, and post-termination rights.

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