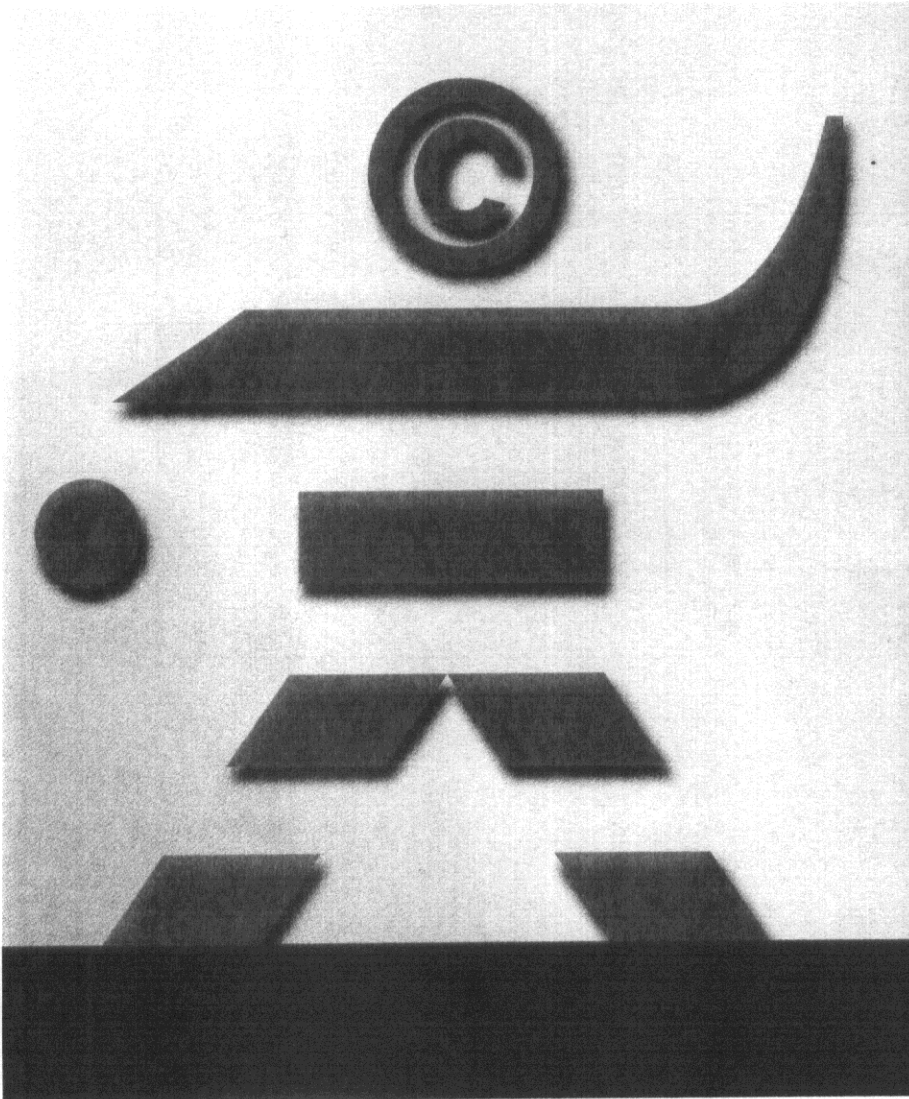


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TRADEMARK LICENSE NEGOTIATIONS FULL OF PITFALLS

By Oliver Herzfeld and Richard R. Bergovoy

A **TRADEMARK LICENSE** can be an important tool for a trademark owner, enabling it to derive rewards by granting a third party the right to use the mark pursuant to an agreement. Licensors may benefit from increased revenues in the form of advances, minimum guarantees and running royalty payments—without increasing capital

expenditures or ongoing expenses. They may benefit from promotion of their trademark through the licensee's advertising, marketing and sale of the licensed products bearing the trademark. And they may benefit from extension of the brand's reach and enhanced protection of the trademark in the licensed categories.

Licensees in turn may benefit from the trademark's selling power to build competitive advantage, increase sales, enter new channels of distribution, reach new consumer and retailer benchmarks, and to stave off competition.

A trademark license is not only a legal document, but a way of doing business. With that in mind, this article is a review of the key legal provisions and business considerations of a trademark license.

THE LICENSE GRANT

The license grant is the heart of a trademark license agreement since it defines the answers to the following three questions:

- Which trademarks are being licensed and what specific rights relating to such marks are being conveyed?

- What is the licensee permitted to do with such rights, and what is it prohibited from doing? What types of products is the licensee permitted to manufacture and sell, in which territories and in which channels of distribution?
- Is the grant exclusive or non-exclusive?

“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 of the licensed goods. Common distribution channels include mass, mid-tier, department stores, specialty stores, Internet, and catalogues.

The basic conflict in negotiating the channels provision is between the licensor’s desire to have the newest,

They include conversion of the entire license grant from exclusive to non-exclusive, “clawing-back” certain products or categories from the exclusive license grant to non-exclusive status, or total exclusion from the license grant. “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 license grants, a third alternative is the so-called “non-exclusive exclusive” license 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 license 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-

THE LICENSOR WANTS THE NEWEST, BEST QUALITY GOODS FOR SALE IN THE MOST PRESTIGIOUS CHANNELS. THE LICENSEE WANTS TO MAXIMIZE PROFITS BY SELLING AS MANY GOODS IN AS MANY CHANNELS AS POSSIBLE.

best quality goods for sale in the most prestigious channels and the licensee’s desire to maximize profits by selling as many goods in as many channels as possible. This conflict often comes into 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).

EXCLUSIVITY AND DEFEASANCE

One of the most important issues in crafting a license grant is whether and to what extent the licensee will have exclusive rights. Non-exclusive license grants, which do not restrict the licensor’s ability to grant licenses for like products to other parties, are the norm in trademark and brand licensing. Exclusive licenses grant exclusive rights to produce and sell certain products in certain territories and markets during the term of the license. Exclusive licenses may be exclusive against the whole world, including the licensor, or they may exempt the licensor, either explicitly or implicitly.

If a licensor agrees to an exclusive grant, it will usually make the exclusivity subject to defeasance (modification of exclusivity), in whole or in part, triggered by various performance shortfalls by the licensee. Example are failure to meet minimum net sales requirements, product roll-out deadlines, or minimum distribution requirements.

If triggered, defeasance may take a variety of forms.

exclusive grant, since there is some measure of protection against competition.

Another variation 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 licensor upon such grant provides the licensee with certain royalty relief or other predefined remedies.

The term of a license agreement is its duration. The length of the initial term, and the licensee’s ease or difficulty in obtaining a renewal term, is driven by business considerations. The licensor generally wants a short term with no automatic renewal, so it can easily replace an underperforming licensee or obtain better financial terms by engaging a new licensee or 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 license 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 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 AGREEMENTS MOTIVATE THE PARTIES

Royalties are the currency of trademark licenses. The most

common basis for calculating royalties on goods licenses is a percentage of net wholesale sales, defined as gross sales minus certain agreed deductions (e.g., 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 nets sales provision include.

- Which deductions are permitted from gross sales in calculating net sales and any limits to them. Most licensors permit deductions for taxes and returns, and many permit deductions for customary discounts granted by licensees to retail stores. Many other deductions are possible. Most of them are 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;
- 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, or based on sales by the licensee, regardless of no-pays. Receipts generally favor the licensee, while sales generally favor the licensor.
- The treatment of “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 license agreements, FOB is used more broadly to refer to any situation in which a retailer or other buyer takes delivery at the licensee’s location (e.g., 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, removing freight and related costs from the net sales price, results in lower royalties to the licensor, compared to a non-FOB sale of the same goods. Licensors frequently make up the difference by negotiating an FOB surcharge of 25 percent to 60 percent to recapture the lost revenue.

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. Advance payments are simply minimum guarantees that are paid at the inception of a license 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.

Trademarks 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 trademarks. A trademark licensor that does not monitor and control the quality of its licensee’s products is deemed to have granted a so-called “naked license” that may result in an abandonment and complete loss of the licensor’s trademark rights.

To avoid such an unpleasant outcome, every trademark license agreement must include quality control provisions that apply to the licensed products, as well as all 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.

It is important to properly negotiate trademark license agreements since there is always a lot at stake. For the licensee, the key risks are financial loss (i.e., 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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