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Licensing: Key Considerations In Obtaining And Negotiating A Trademark License

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The use of trademark licensing has become a widespread business strategy to increase sales and profitability and to build and extend the power of a brand. According to the industry publication License! Global's 2007 Industry Annual Report, the market for retail sales of licensed merchandise is an estimated $200 billion worldwide. With the increasing use of licensing as a means of growing their businesses, manufacturing business owners are increasingly facing decisions of whether to obtain a trademark license in order to create branded products. Critical to those decisions are the important legal issues and concerns governing the relationship between the owner of the trademark and other licensed material – the licensor – and the business owner obtaining the right to use the trademark – the licensee – that are set forth in the license agreement they negotiate. The licensor and licensee approach the license agreement from two different perspectives. On the one hand, the licensor seeks to leverage its brand and generate additional profit through royalties without being required to expand its own operations, while seeking to protect and retain strict control over its valuable

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intellectual property. On the other hand, the licensee seeks to gain the right to use the licensed material to enhance the marketability of its own products and to increase its own profit potential upon reasonable financial and other terms. This article will provide a basic overview of certain of the key issues a prospective licensee may face in negotiating a license agreement.[1]

Deciding To Take On A License

Assuming that it is the right decision for a business to operate as a licensee[2], the first threshold question faced is whether obtaining a license for the specific brand being considered is worthwhile, regardless of the financial and other terms that can be negotiated in the license agreement. There are a variety of questions that any potential licensee will want to answer for itself. What is the strength of the brand in the targeted product category and the marketplace generally? How does the brand fit into existing brands or product offerings? Is the brand associated with a sufficient reputation for style, function or quality? Is access available to the channels of distribution necessary to effectively sell the product? Is there a strong market for the product? Can it be sold through an existing sales force, or will it be necessary to develop the capability? Is there infrastructure and capacity to produce the product cheaply and efficiently while still maintaining adequate quality control? Will sufficient profit be achievable if favorable license terms are obtained, without there being an uncomfortable level of risk? What is the reputation of the licensor in the marketplace; would she be a difficult partner to work with? These are some of the questions that any licensee will want to answer before taking on a license.

Issues In Trademark Licensing Agreements

Economics and Royalty Rates

Not surprisingly, the core financial terms of the license are usually the most important for a licensee. Although the basic terms usually appear to be straightforward – e.g. the licensee is required to pay a percentage of sales as a royalty – there are many other factors that may affect the economics of the license. How are "sales" defined? Are trade discounts or product returns limited? Will the licensee be required to contribute to the licensor's advertising fund? Will the licensee be expected to incur other significant set-up or recurring costs?

When negotiating the applicable royalty rate, a licensee will want to use market intelligence to determine current rates for businesses selling similar products. Attention should also be paid to the costs of implementing and producing the product, the expected market penetration and sales volume opportunity and the likely sales price points for the products. In addition to the royalty rate, a licensor may

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demand a minimum guaranteed level of annual royalty regardless of actual sales activity. Besides its financial impact, the guarantee can have significant implications in the event the license is terminated as it may be used as a measure for liquidated damages by the licensor.

Term/Right of Renewal

Negotiating a proper license term can be critical to the success of the license. A licensee wants to have the use of the licensed material for a sufficient amount of time to develop and market the product, but also provide for a short enough term to limit its risk in the event the relationship is not successful or there is a significant change in market conditions. After a licensee makes a thorough assessment of its business plan for the license, the term needs to make economic sense. A licensee should negotiate a unilateral right of renewal so that, as long as the licensee has acted properly throughout the term of the license, it can continue the license without having to renegotiate its key terms. The right of renewal may be tied to meeting specific performance benchmarks, such as sales levels, or other conditions before a renewal option is available. The licensee will want to be sure that the conditions provide a realistic opportunity to renew the license.

Territory/Distribution Channels

Where a licensee will be permitted to produce, market and sell the licensed products is key to the viability of the license. The desired terms will depend on the specifics of the situation. In most cases, a licensee will want to obtain as broad a territorial license as possible so that it will have both the opportunity to sell the product throughout both domestic and international channels and the ability to control the geographic expansion of its business.

Similarly, a licensee will frequently want to obtain the right to sell to as broad a category of wholesale and retail outlets as possible. However, a licensor will likely want to retain strict control over the types of outlets where its licensed products can be sold in order to protect its brand and its licensing program. This is particularly the case for luxury and other higher-end goods. In the license agreement, it is essential to find the right balance between the licensee's desire to sell the licensed products as widely as possible, and the licensor's need to protect its brand without having to closely manage the licensee's sales efforts. Before entering into the agreement, a licensee will want to have a well thought out sales plan so that it can negotiate which areas and outlets are critical for the license to be a success, and which ones are desirable, but not necessary for its business.

Termination/Default

Entering into a license agreement requires a licensee to make a significant financial commitment, both directly to the licensor and indirectly though operation of the licensee's business. The most critical provisions in a license agreement are often those governing the rights of each party to terminate the license agreement and those detailing what the licensee can and cannot do upon termination or expiration of the agreement.

A license agreement typically contains a number of grounds for the licensor to terminate the agreement for cause. For example, if the licensee misuses the trademarks, fails to obtain a requisite approval, uses a manufacturer that has not been qualified by the licensor or sells outside of the permitted territory or distribution channel, and the licensee is unable to cure the default, the licensor may end the license. In such cases, a licensee often faces two problems: it may have to make a significant payment for its breach (e.g. the minimum royalties for the balance of the original license term), and it may have a significant amount of money tied up in inventory, work in process and other commitments without the ability to continue operating its business under the license. Negotiating which "major" defaults are appropriate for the significant financial consequences associated with a termination and which defaults are minor enough that it would be unfair to have such consequences can be a key battleground between the licensor and licensee in finalizing a license. As well, negotiating how "tight" the grounds for termination are and the specific effects of termination – typically the size of the liquidated damages and the amount of time that the licensee has to sell off its existing inventory – are important areas for a licensee.

Right of First Refusal

In taking on a new license and building the licensed product line under it, a licensee will be making a significant financial investment of time, money and resources. In order to protect that investment, a licensee should try to obtain a right to extend the term of an existing license (after any pre-negotiated option or renewal periods expire) or to take on a new license for an additional territory or for complementary brands or products. These types of provisions come in many varieties (e.g. right of first offer, right of first refusal, right of negotiation), but all seek to make sure that the licensee has the opportunity to protect the investment she has made in the licensor's brand.

Product Approval

A key aspect of the ongoing relationship between the licensor and licensee will be the development, approval and quality control processes for creating the licensed products. The license agreement will frequently set forth the specific requirements for a licensee to meet prior to bringing a product to market, including design process, requirements for qualifying manufacturing facilities, screening of pre-production samples and rights of inspection. The licensee will want to ensure that these requirements are achievable and, where possible, consistent with the licensee's existing operations.

Conclusion

The decision to enter into a license agreement presents many challenging and complex issues for any business. Although this article seeks to identify certain of the key issues a prospective licensee may encounter when entering into a license agreement, the specifics of each situation will ultimately dictate the areas of concern and opportunity. A prospective licensee's success in negotiating various provisions will depend upon many factors, including the relative bargaining power of each side. Qualified counsel familiar with the licensing process can be invaluable in helping a prospective licensee navigate the process. Although few agreements will have everything one desires, by understanding the issues and approaching the agreement with a sense of priorities, a prospective licensee can be successful in obtaining a license that can present a valuable business opportunity.

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[1] *Please note that this article is presented for informational purposes only, and is not intended to constitute legal, tax or accounting advice.*

[2] *The decision whether to become a trademark licensee is a complex one that is beyond the scope of this article, but includes considerations such as whether to develop one's own new brand, whether to purchase a brand, rather than license it, or whether to simply continue focusing on existing businesses.*