

Managing a Global Licensing Program

Strong contract terms, detailed definitions, and efficient reporting and communications are key.

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Licensing programs that extend across international territories are a fact of life today. In fact, 38% of retail sales of licensed products worldwide occur outside the U.S. and Canada, according to *The Licensing Letter*, and some U.S.-based licensors count close to 60% of their business outside their home territory. Many licensors in other territories also look outside their domestic markets for significant sales revenue.

Implementing a global licensing program can bring significant challenges, some of which are beyond your control. For example, you can't expect to comprehend every language, familiarize yourself with every local custom, work 24/7 across every time zone, or control the exchange rate. You can't expect every licensee to read your contracts or comply with them fully. And no, you can't make the world stop spinning all by yourself.

However, you can help smooth some of the bumps in the road by building consistency inside your organization, ensuring licensees are all on the same page, strengthening your compliance practices, and tightening up your business processes with a little effort in the right areas. You will not only improve quality and product delivery times, but also mine more revenue and gain peace of mind.

Some of the key issues we will review in this article include:

- How to refine contract terms, including *net sales*, for maximum clarity.
- How to outline audit rights clearly and completely.
- How to carefully define the grant of rights, including authorized products, geography and distribution, in detail.
- How to set up an efficient automated system to simplify royalty reporting.

Defining Net Sales

Defining net sales can be one of the most contentious issues in the contract negotiation. Typically, net sales are defined as actual invoiced billings (sales quantity times selling price) for articles sold, less allowable deductions. Deductions can include product returns (actual returns or allowances for returns) and discounts.

There are various types of discounts, depending on the customary and trade practices in each country. For example, in Taiwan and China, discounts for listing fees (e.g., rent or commissions paid to supermarkets and hypermarkets for placement) are common and have become a customary discount practice. Some typical scenarios globally involve volume discounts given by a retailer based on the quantity of products purchased, discounts taken by a retailer for advertising expense incurred, markdown discounts taken on

sale items, defective-goods discounts for products that cannot be sold, early payment discounts, and new-store discounts for products sold by the retailer in just-opened outlets.

Some discounts are tied to identifiable, specific products that can be verified in a vendor agreement and traced to a particular licensor. These deductions from net sales are reflected on the invoice and usually are allowed. Off-invoice discounts, on the other hand, are given to a customer for its overall business and are difficult to trace back to a single licensor. Most licensors do not allow them. A third option is a flat discount percentage, which can be given as an allowance in lieu of actual returns.

It is important to strongly word the definition of net sales in the contract to eliminate confusion later. Many contracts contain weak definitions of net sales, such as "net sales shall mean gross invoiced price billed to customers less customary and trade discounts" but no definition is provided of what customary and trade discounts are or "net sales shall mean gross invoiced price billed to customers less actual discounts not to exceed 5%" but what are actual discounts?

Refine the definition so there is no confusion:

Net sales shall mean gross invoiced price billed to customers less "allowable deductions."

Allowable deductions shall mean:

- 1. Volume discounts and other discounts from invoice price (or post-invoice credits) imposed in regular course of business by Licensee's customers, so long as Licensee can document such discounts and credits to Licensor's satisfaction.*
- 2. The following discounts are not allowable, whether granted on invoice or as post-invoice credits. Early payment discounts, advertising allowances, markdown allowances, etc.*

Unauthorized Uses

Licensors also must include precise language in the contract to define unauthorized uses of the intellectual property and of the licensed products. These can include selling counterfeit or unapproved products, selling in distribution channels or territories that are not included in the agreement, selling product after the contract ends and the three- to six-month sell-off period is over, and sublicensing or subcontracting without licensor approval.

The definition of unauthorized uses included in the contract should be as specific as possible. Many are vague, such as:

License granted under this Agreement extends only to the Distribution Channels in the Territory. The Licensor specifically reserves the right to manufacture, distribute and sell Licensed Product

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outside the Territory or inside the Territory other than through the Distribution Channels.

This general definition only mentions distribution channels and territory by name. A more refined and better definition would be:

Licensee shall not use the Intellectual Property in any way other than as authorized in this Agreement. Unlicensed uses include, but are not limited to, unauthorized product, unauthorized distribution channel sales, unauthorized territory sales, sales after authorized sell-off. Licensee agrees that any unlicensed distribution or sale of Articles or items bearing Intellectual Property shall constitute trademark or copyright infringement, or both.

This reworded clause not only contains as many specific unauthorized uses as possible, but also notes that unauthorized uses are not limited to these examples.

In addition to defining unauthorized uses in as much detail as possible, licensors should retain the right to assess damages when unauthorized uses occur. Such uses can harm the value of the licensor's intellectual property, reputation and brand image, and cause it to lose royalty and guarantee income that it is entitled to. Unauthorized uses also harm the authorized licensees, since they may lose sales due to competitive disadvantages.

Many contracts do not specifically mention damages aside from a general termination clause, such as "Licensor has the right to terminate the License Agreement if the Licensee breaches any provision relating to the unauthorized assertions of rights."

But damages should be outlined in the contract, and they can take many forms. Some licensors opt to charge net revenues (gross margin) for each unauthorized product sold, in which case a clause would be included in the contract that looks something like this:

Licensee agrees that it is extremely difficult to fix actual damages which may proximately arise from such unauthorized use. Licensee agrees that the net revenues (that is, gross revenues less only the cost of manufacture and distribution of such products) from any such unauthorized use of the Intellectual Property without written authorization from Licensor shall be immediately payable to Licensor as damages.

Other licensors assess a penalty of double or triple the royalties due on each unauthorized product.

Audit Provisions

Another key contract provision when it comes to setting up international licensing contracts is the audit clause, which includes the right for a licensor to audit its licensees' books and the requirement for licensees to retain records. It also outlines which party covers the cost of the audit.

The requirement for licensees to maintain complete and accurate records of all transactions relating to the agreement seems straightforward, but a number of issues come up. Licensees and licensors may disagree on what

"records" consist of, with licensees citing confidentiality as a reason for not granting licensors full access to sales and production records. Licensors should expect full visibility of all licensees' records, not just those related specifically to their own activity. This will give them a reasonable comfort level that everything has been reported.

Licensors also need access to any of the licensee's affiliates or sublicensees that are involved in the licensing agreement. Licensors should not only demand approval of all such companies, but also ensure that they have access to all of their records during an audit.

Another provision of the audit clause relates to the reimbursement of audit costs. Licensors typically demand that licensees pay audit costs if they underreport net sales or royalties by a certain percentage. They also need to consider what term will trigger the reimbursement: the audit period, a set timeframe such as a quarter, or the term of the contract?

It is important to define whether the audit threshold is triggered by discrepancies in net sales or by discrepancies in royalties. Say a licensee correctly reports net sales of \$500,000 in a quarter, but calculates \$50,000 in royalties using a 10% rate, rather than the 12% stated in the contract. If the contract's audit clause states, "Audit Costs are due if Net Sales are underreported by 5% in any quarter," there would be no audit cost reimbursement because net sales were correctly reported. If the contract says "Audit Costs are due if Royalties are underreported by 5% in any quarter," the audit threshold would be triggered, because royalties were underreported by \$10,000, or 20%.

Reality Check

Mistakes are part of the process of setting up and implementing a licensing program, especially one with a global scope. It may take time for licensors and licensees to gain an understanding of each others' businesses. To manage the process, keep these tips in mind:

- Be proactive in defining terms and expectations.
- Clearly define terms and reporting requirements to alleviate differences in interpretation.
- Maximize communication so the right hand knows what the left is doing.
- Keep audit periods short to catch discrepancies early.
- Remember, it's not personal.

Content Sharing

Up to now, we've been talking about the need to manage expectations by creating the strongest possible contract terms. But there are other factors that are key to a successful global licensing program, and they kick in once the contract is signed and the day-to-day licensing relationship begins.

One issue is the sharing of content, from style guides to samples to artwork. The easier the mechanism is for sharing content, the faster and more efficient the product development

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and approval process will be. In addition, automating the process will ensure that all products developed meet contractual requirements. This is something that may not happen without an online system, since the personnel involved in product development are not involved in contract negotiations and often have not read the contract.

One of our clients has thousands of pre-approved images online that it shares with authorized licensees. Its online image database serves as an online style guide that helps licensees adhere to the licensor's rules for using its brands and artwork. Now the licensor is able to give authorized licensees around the world 24/7 access to images, guidelines, and suggestions for product development, as well as allow licensees to post images for approvals whenever they want to, with quick response times. The licensor also can limit access for new parties who are interested in the property, but not yet authorized licensees.

Royalty Reporting

Developing a standardized reporting template for all licensees—one that is easy for them to fill out properly—gives you, as the licensor, all the information you need when you need it. It allows you to spot errors in royalty rates, distribution or territory violations, unauthorized or unapproved products, and other discrepancies early, when they are easy to rectify.

Rather than waiting for an audit to kick in two to four years down the road, you will be proactively addressing issues

in real time. You will also reduce costs by keeping the process simple and lowering staffing requirements. You will increase revenues by catching late or unpaid royalties as soon as contractual deadlines occur and receiving a heads-up about contracts that are about to expire, so they can be renewed or terminated in a timely manner.

Some of the discrepancies that will be detected right away include late-payment interest, deduction issues, incorrect guarantee offsets, disallowed royalty-free sales, and unauthorized uses including unapproved products or territorial or distribution gaffes.

Automated royalty reporting does not only reduce costs and increase revenues. It also allows management to make better business decisions and to communicate those decisions to all licensees involved in the program. You can spot trends, both positive and negative, highlight areas for growth, and detect important developments that might have gone unnoticed without automation. It is simple, for example, to monitor sales by geographic region down to the zip code level, or by licensee, category, SKU, or particular IPs such as individual characters or images.

Thinking about your contract terms and licensing processes up front will enhance communications, alleviate challenges, and increase financial benefits, particularly if your licensing program is global in scope. Once systems are in place, you can expect more from your licensees and have better controls in place to ensure that your licensees, as well as your internal staff, can help you achieve your goals.

About the Authors:

- **Serj Dhami** has 19 years of professional experience, including 10 years specifically focused on the licensing industry. He was formerly a Director at PwC's Intellectual Property Rights Management consulting practice and prior to that was the Head of Disney Consumer Products European Licensing Compliance Division. In 2008, Serj founded Insight Licensing Services, Inc. At Insight Licensing, Serj advises clients on licensing best practices, contract compliance, effective royalty audit programs, and revenue maximization. He consults with companies in the Entertainment and Media, Consumer Products and Publishing sectors.
- **Neena M. Gordon**, President, N Gordon Company Inc., is a seasoned royalty compliance professional with over 15 years of experience. Prior to the founding of N Gordon Company Inc., she served as Vice President, Royalty Compliance at Equity Management Inc., one of the country's largest corporate trademark licensing agents. While there, Neena developed and managed the audit programs for over 20 major licensors, including General Motors, DrPepper/7Up, Kawasaki and Whirlpool/Maytag. During her career Neena has conducted well over 100 royalty compliance examinations across a wide variety of industries. Neena also specializes in the development and implementation of royalty compliance and tracking systems.
- **Marty Malysz**, President, Dependable Solutions, Inc., has worked in royalties, licensing and creative software solutions for 22 years, including in the music industry, with record companies, music publishers, and music libraries, and now in the consumer product industry with licensors, agents, and licensees. Marty currently manages a team of 15 employees in offices in Belgrade, New York, Dallas, and Los Angeles, and many consultants around the world. DSI supplies royalty, licensing, and creative solutions to 30 companies including Harley-Davidson, Elvis Presley Enterprises, Gmodelo, US Olympics, Li & Fung, Creative Artists Agency, and Performance Brands. Marty is a new LIMA board member and has served on the LIMA west coast committee for three years.