Brand Licensing Strategies to Maintain Value and Goodwill

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Introduction

Laws in the United States limit and, practically speaking, prohibit brand owners from fixing prices or taking other anti-competitive steps that would ordinarily help them to maintain brand value and goodwill, not to mention increase revenue. This article addresses practical licensing and distribution strategies that transactional parties can use, under U.S. law, to maintain brand value and goodwill without crossing the line into illegal price fixing or unfair competition.

Generally, a brand licensor cannot simply dictate resale prices. But it can take other steps to maintain brand value and reduce the likelihood that a licensee will engage levels of discounting that will harm the brand.

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Resale price has long been a touchy subject when it comes to license agreements. A well-crafted license agreement affords a licensor control over many aspects of a licensee's manufacturing, marketing and sales of licensed products, but license agreements are typically silent about resale prices (or, if they say anything, they may say simply that the licensee is free to set the resale prices).

The problem is this—deep discounting can hurt the licensor's brand. When a licensed product shows up online with conflicting Suggested Retail Prices (SRP), or is heavily discounted, consumers associate the behavior with the brand itself. To rub salt into that wound, since royalty is often tied to "net sales," discounts that exceed what the parties initially contemplated deprive the licensor of the financial return it anticipated when entering into the license.[1]

Under federal law, for many years vertical price restraints were a *per se* violation of Section 1 of the Sherman Antitrust Act (a "vertical" restraint refers to a restraint between parties that have a "vertical" relationship in the supply or distribution chain, like sellers and buyers).[2] That changed in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*,[3] where the Supreme Court ruled that vertical price restraints are legal if the restraints satisfied the "rule of reason." Notwithstanding *Leegin*, in states such as California and New York vertical price restraints may still be considered *per se* illegal.[4] A brand licensor has a vertical relationship with its licensee, and as such, restraints on the licensee's ability to set its own resale prices for licensed goods are likely to lead to liability for the licensor in California and New York.

Therefore, it is customary—and advisable—to expressly state that the licensee is free to determine the prices at which it resells licensed products.

Nonetheless, even though a brand licensor cannot dictate the resale price for licensed products, there are strategies available to the brand licensor to protect itself. These strategies include: (1) imposing reasonable controls over inventory levels of licensed products; (2) employing a royalty structure that reduces incentives to discount and also ensures that the brand licensor gets the benefit of the bargain; (3) restricting distribution to selected and approved distribution channels; and (4) requiring an established SRP and that it be communicated to consumers.

Strategy 1: Include Restrictions on Inventory Levels

Manage Forecasts and Inventory

One common reason a licensee may opt to sell licensed products at low prices or to unauthorized resellers or customers is that the licensee has too much inventory. The licensee needs to pay the factory for the goods, and it needs to turn its inventory into cash to do so. If the licensee finds itself with a relatively large amount of inventory, it may have an incentive to try to move it more quickly by discounting or selling through unauthorized channels.

To mitigate against this incentive, brand licensors can employ a set of clauses to require that a licensee provide advance forecasting information to the brand licensor and also provide visibility to the licensee's inventory levels to ensure that such inventory levels are indeed consistent with the forecasts.

Here is a sample forecast provision:

> Within thirty (30) days of the date hereof, Licensee shall provide to Licensor a twelve (12) month rolling forecast of sales of Licensed Products by [month/quarter] (the "Rolling Forecast"). Licensee shall provide an updated Rolling Forecast by the fifth (5th) day of each calendar [month/quarter].

Here is a sample inventory provision:

> Licensee shall provide Licensor with a [monthly/quarterly] stock report of Licensed Products in Licensee's inventory (the "Monthly Stock Report"). The Monthly Stock Report must reflect actual inventory levels on the first (1st) day of each calendar [month/quarter] and be provided to Licensor by the fifth (5th) day of each calendar [month/quarter]. Licensee shall cease production of new units of Licensed Products if and when the inventory of Licensed Products exceeds the anticipated sales of Licensed Products for the next three (3) months as reflected in the Rolling Forecast.[5]

Even with proper inventory management, the licensee may still have some inventory of licensed product left at the end of the term. It is important for brand owners to have the option to take control of this inventory. Brand licensors should include a "sell-off" or "wind-down" provision that gives a brand licensor the option, but not the obligation, to purchase the inventory at prices which are predetermined in the license agreement. Here are two sample terms that can be used together or separately:

> Licensee shall not manufacture Licensed Products during the last six (6) months of any Term that is not being renewed in excess of the amount Licensee reasonably anticipates will be sold prior to the expiration of the applicable Term based on the Rolling Forecast.
>
> Within five (5) business days after expiration or termination, Licensee shall provide to Licensor a list of all inventory of Licensed Products, together with the landed cost and standard wholesale price for such inventory. Licensor shall have the right, but not the obligation, to purchase any or all of such inventory at the lower of Licensee's landed cost or ____ percent (__%) off of the standard wholesale price of the inventory. Licensor shall provide Licensee with written notice of Licensor's election to purchase any such Licensed Products within five (5) business days after receipt of the list of inventory. If Licensor fails to provide Licensee with such notice within such five (5) business day period, Licensee may sell any or all Licensed Products to any Authorized Customer for a period of three (3) months. All sales of Licensed Products to any Authorized Customer during such three (3) month period shall be Royalty-bearing and subject to the terms of this Agreement.

These provisions should effectively allow the brand licensor to control the inventory from its old licensee and maintain brand value for its new licensee in the marketplace.

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Strategy 2: Ensure That the Brand Licensor Actually Receives Its Anticipated Financial and Goodwill Benefits

Use a Minimum Guaranteed Royalty Structure That Only Counts Authorized, Goodwill Enhancing Sales

Minimum guaranteed royalties are common in brand license agreements. Often, licensors reserve the right to terminate a license agreement for failure of the licensee to achieve the minimum guaranteed royalty amount (and the license agreement may also provide that the licensee is financially liable for the shortfall).

Accordingly, in order to achieve the minimum guaranteed royalty level, the licensee will feel pressure to generate sufficient sales volume. Pertaining to the issue of pricing and distribution, licensors need to be aware that the minimum guaranteed royalty can itself become an incentive for licensees to engage in expanded, unauthorized distribution and excessive discounting.

To combat the risks of expanded, unauthorized distribution, the license agreement should expressly provide that sales in violation of the agreement shall still be royalty-bearing, but shall not count toward the minimum guaranteed royalty. As such, a licensee's sales to unauthorized customers will not help it make progress toward jumping the minimum guaranteed royalty hurdle.

Here is a sample clause:

> Licensee shall not offset against any Minimum Guaranteed Royalty any Royalties accruing on sales of Licensed Products to customers other than Authorized Customers or any Royalties accruing on sales of Licensed Products which are otherwise in violation of the terms of this Agreement. Sales of Licensed Products in violation of this Agreement shall be Royalty-bearing, and Licensor's acceptance of Royalties on such sales shall not be deemed to be a waiver of any right or remedy of Licensor hereunder relating to such unauthorized sales.

Use a Minimum Guaranteed Royalty Structure That Only Credits a Specified Amount of Deeply Discounted Sales

To combat the risk of excessive discounting, brand licensors should consider requiring that the minimum guaranteed royalty be primarily comprised of healthy sales which are goodwill enhancing for the licensed brand. This can be achieved by excluding unhealthy, overly discounted sales from counting toward the minimum guaranteed royalty if those sales exceed a certain threshold. Here is a sample clause:

> Licensee shall not engage in excessive discounting as a means to meet the Minimum Guaranteed Royalty requirement. "Deeply Discounted Net Sales" means Net Sales of licensed product where the discounts and allowances equal or exceed thirty percent (30%) or more off of the [standard wholesale price]. "Deeply Discounted MGR Cap" shall mean twenty (20%) of the Minimum Guaranteed Royalty. Royalties shall accrue on all Deeply Discounted Net Sales, although Royalties on Deeply Discounted Net Sales shall not count toward the Minimum Guaranteed Royalty requirement for any Contract Year after such Royalties on Deeply Discounted Net Sales reach the Deeply Discounted MGR Cap.

Limit the Amount of Discounts That Count When Calculating Royalties

In royalty structures that are based off a percentage of net sales, the brand licensor is actually subsidizing the licensee's discounts. One simple strategy to counteract this is to limit the amount of discounts that are allowed for the purposes of calculating royalties. Essentially, the licensee may discount further beyond the cap, but deeper discounting will not come at the licensor's expense.

Here is a sample clause:

> For the purposes of calculating the Royalty only, the total of all discounts or allowances of any kind which can be deducted from gross sales of Licensed Products shall be capped at ____% of the total gross sales. All sales of Licensed Products with discounts or allowances that exceed such cap shall be treated for Royalty purposes as sales made at the [standard wholesale price] of such Licensed Products prior to any discounts or allowances.[6]

One issue to be cognizant of is that excluding certain deeply discounted sales from the minimum guaranteed royalty and also using a discount cap can create a tight vice around the licensee. The discount cap effectively escalates the royalty for the deeply discounted sale, and then that royalty might still excluded from the minimum guaranteed royalty requirement. This increases the chance that there will be a shortfall. In light of this, brand licensors should expect pushback, and ultimately may have to settle for one method, but not both.[7]

Fixed Dollar-Per-Unit Versus Percentage Royalties; Royalty Increases

Another strategy to offset the economic and goodwill damage of deep discounting is to employ a royalty structure that increases as a percentage of sales when the discount level is increased.

This can be accomplished by using a fixed dollar-per-unit royalty instead of a percentage based royalty. If a brand licensor has a good understanding of the marketplace for licensed products, it may be worth eschewing the more common percentage of gross/net sales based approach in favor of a fixed dollar-per-unit approach. As the licensed product's selling price goes down, the fixed dollar-per-unit royalty represents a greater percentage of the selling price.[8]

The key, as with all of these strategies, is that the licensee can sell at whatever prices it chooses. But the licensor is no longer subsidizing the discount, and the licensor is hopefully incentivizing the licensee to sell at prices that will enhance goodwill and brand value.

Strategy 3: Include Terms Restricting Distribution to Specified Channels

Discount Resellers

Just about every license agreement has a definition of a geographic territory. But within that territory, there are various relevant markets and different channels by which one can access those markets. Brands may limit distribution of their own products to certain markets and specific channels within those markets which the brand believes are complimentary to its brand image. For example, a luxury fashion brand may opt to sell directly to upscale retailers like Barney's, but may choose not to sell directly to Walmart. And, barring unusual situations such as dominant market power, that same brand may elect not to sell directly to a competitor of Barney's, such as Bergdorf Goodman.

In structuring a license agreement where the licensee distributes products to resellers (as opposed to selling directly to consumers), a brand licensor should take care to define "Authorized Customers" to whom the licensee may distribute licensed products as those customers that the brand itself would chose to associate itself with. A restriction on "Authorized Customers" should be reasonable.[9] Therefore, the brand licensor should not merely state that any "Authorized Customer" needs to be approved by the licensor. Rather, the agreement should list the "Authorized Customers" on a schedule, and ideally include language setting forth criteria for approval of any new "Authorized Customers."

Here is a sample of such language:

> The "Authorized Customers" as of the date hereof are those customers listed in Exhibit __. Exhibit __ may be updated with additional Authorized Customers upon Licensor's reasonable approval. For the avoidance of doubt, it shall be reasonable for Licensor to withhold its consent if it believes the proposed customer does not deal primarily in products similar in quality and prestige to products bearing the Licensed Trademark(s) or whose quality of operations, including without limitation, delivery of retail services and presentation of products are not consistent with the quality and prestige of products bearing the Licensed Trademark(s).

In structuring a license agreement where the licensee sells direct to consumers, then the license agreement should expressly state that sales are limited to end using customers.

The brand licensor should also include language that prohibits the licensee from distributing products to customers that the licensee knows or reasonably should know would redistribute the licensed products to anyone other than the intended end-users:

> Licensee agrees that it will not sell or distribute Licensed Products to any entity that has in the past or that Licensee knows will, or has any reason to believe intends to, resell or redistribute Licensed Products to unauthorized customers.

Coupled with an audit provision that allows the brand licensor to review sales and shipping information, this clause prevents the licensee from making an end run around the Authorized Customer restriction.

These clauses cannot completely prevent licensed products from ending up at retailers other than those identified as "Authorized Customers." Pursuant to the first sale doctrine, if a bona fide purchaser (either from the licensee or the licensee's customers) purchases the product without having agreed to this restriction, such purchaser generally will be able to resell the licensed product where it wishes.[10] But, presumably the licensor and its authorized customer will have received the benefit of their deal, provided the licensee's authorized customer sold licensed products in accordance with the license agreement. If not, the brand licensor's remedy could be against the licensee for potentially violating the "Authorized Customer" definition or for failing to require or enforce the "Authorized Customers" clauses.[11]

As a final note on the topic of "Authorized Customers," in an effort to maintain brand value even after the licensed products are outdated or no longer in-season, some brand licensors include a provision that permits sales of discontinued or prior generation licensed products, seconds or irregulars to specified customers other than authorized customers outside of the territory of the license agreement. Another option to consider is permitting the donation of such licensed products to a mutually agreeable charitable organization. These alternate means for regulating the distribution of branded products that are arguably no longer valuable to the brand helps maintain the brand value for current and new products.

e-Commerce

It may not be realistic for a brand to prevent internet sales altogether. Even luxury retailers have their own e-commerce sites. That being said, a brand licensor should strongly consider requiring the licensee to limit the licensee's customers' sales to websites which are in fact owned or controlled by the customer (or, if the licensee is selling direct-to-consumer, then limiting sales to licensee's own website, the URL of which should be specified in the agreement itself).

The license agreement (in situations where the licensee is selling to authorized retailer customers) would state:

> Licensee shall require each Authorized Customer to enter into an agreement with Licensee providing that such Authorized Customer shall only advertise and/or sell Licensed Products on the website(s) that are owned or controlled by the Authorized Customer. Such agreement shall provide that Licensor is a third party beneficiary of this provision.

The same caveat noted above with respect to bona fide purchasers, which generally allows such purchasers to resell in any manner they want, applies in this context as well. If an online reseller is a bona fide purchaser of the licensed products, the brand licensor might not be able to prevent the resale of licensed products on that reseller's website, although the brand licensor should have remedies for breach and/or damages against the licensee.

Strategy 4: Require a Suggested Retail Price (SRP), and Require It to Be Printed and/or Published

Even though a brand licensor cannot set the ultimate resale price for the licensed products in the market, a brand licensor can insist that there exist a suggested retail price (SRP) for the licensed products. The brand licensor has an interest in ensuring price integrity, and inconsistent SRPs for the same licensed product erode consumer confidence and dilute brand value and goodwill.[12]

Here is a sample clause:

> To avoid the publication of inconsistent SRPs for the Licensed Product(s), which has a detrimental effect on the perceived quality of Licensor's brand and undermines consumer confidence in the integrity of the pricing for all products bearing the Licensed Trademark(s), Licensee shall ensure that the correct SRP for a particular Licensed Product is displayed on the package, unless prohibited by applicable law. Licensee shall also ensure that its Authorized Customers display the correct SRP for a particular Licensed Product on the package, unless prohibited by applicable law. To the extent Licensee and/or its Authorized Customers desire to include a sales price in print or in online offers or advertisements, such parties are entitled to determine the sales price in their sole discretion; provided however, that such advertisements shall also include a reference to the correct SRP as well.

By requiring the publication of the SRP, the consumers become informed that even if the current licensed products are being sold at a lower price, the products are usually sold at higher prices. This should effectively maintain brand value for future sales of similar/newer licensed products at higher prices, although brand licensors should always be aware that if such discounting becomes commonplace consumers may come to expect the discounting to continue later in the life cycle of the newer branded products.

Other Options

If the strategies discussed above do not do enough to satisfy a brand licensor's concerns about potential damage to goodwill, the brand licensor may be forced to evaluate different deal structures to the extent it still wants to do a deal.

Use of Sub-Brands

One such structure would be to create a sub-brand to be used in connection with the license. Sub-brands provide a layer of differentiation from the primary brand, and while still affiliated with the primary brand, discounted sales of products under the sub-brand through discounted channels should not necessarily detract from the primary brand's value or goodwill. The brand licensor could still consider the terms described in this article above, although arguably the risks to the primary brand from unauthorized distribution or deep discounts would be mitigated by use of the sub-brand.

Direct-to-Retail Business Models

Some brand licensors are cutting out the middleman between themselves and retailers through a "direct to retail" licensing model. In this scenario, the brand licensor grants the retailer a direct license to manufacture and sell the licensed product in that retailer's own stores and (in some cases) on that retailer's own website. The retailer still has the right to set the consumer resale price. But, instead of relying on an "Authorized Customer" definition, the brand licensor is directly selecting the retail seller(s) of the licensed product. Generally, this model results in far less unauthorized distribution. Where the licensed product is specifically designed for the retailer's stores only, or the packaging for the licensed product is specific to the retailer's stores, it will be obvious that the retailer or its supplier breached the agreement if that same product appears in different channels or stores.

Distributor Business Models

When having more control over price is essential to a brand owner, the brand owner may want to consider other business models altogether. For example, a brand owner could take on the cost and risk of developing, manufacturing and inventorying the product, and then find third party distributors (instead of licensees) to resell the product. As such, the brand could establish a "Minimum Advertised Price" and/or "Minimum Resale Price" policy.[13] Under these policies, the brand owner pre-announces that it may choose to discontinue supply of products if the reseller advertises or sells below the minimum price. Even in California and New York, these policies are legal to the extent they are truly unilateral, although brands should consult with antitrust counsel in connection with the establishment and continued compliance of such unilateral policy. Brands should also carefully consider the advantages and disadvantages of such policies.

Conclusion

Even though brand licensors cannot dictate or control resale prices for their licensed products *per se*, they should understand that a licensee's decision to price a licensed product at a certain price is influenced by many factors and incentives. The strategies discussed in this article are designed to properly align the incentives of both brand owner and its licensee. This alignment allows brand licensors to deploy the afore-described strategies to ensure protection for the brand's value and goodwill. And the maintenance of such brand value and goodwill will likely serve both parties interests in a successful business venture.

Endnotes

1. Depending on the circumstances, a licensee may be wholesaling to retailers or selling direct to consumers. In the wholesale scenario, if royalties are based on the "net sales" to these wholesalers, and these sales are discounted, then the base upon which the royalty is calculated is diminished. In the direct-to-consumer scenario, if royalties are based on "net sales" to consumers, again discounts cut into the base upon which royalties are calculated, and deep discounting directly to consumers can hurt brand value.
2. *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).
3. 551 U.S. 877 (2007).
4. *See Alan Darush MD APC v. Revision LP*, No. CV 12-10296 GAF AGRX, 2013 WL 1749539, at *6 (C.D. Cal. Apr. 10, 2013) (noting that "[u]nder current California Supreme Court precedent, vertical price restraints are per se unlawful under the Cartwright Act. There is no indication that precedent is changing") (internal citation omitted); Attorney General Eric T. Schneiderman, *Antitrust Enforcement*, http://www.ag.ny.gov/antitrust/antitrust-enforcement ("Resale price maintenance violates New York law.").
5. The number of months of supply of licensed products permitted to be held could be greater or lesser than three (3) months depending on the lead time for manufacturing.
6. To the extent a licensee will be introducing new models of the licensed product during the term, the licensee may want to see the discount cap raised for older models when new models are introduced. Generally, from the brand licensor's perspective, this may be agreeable as the brand licensor also has an incentive to make sure inventory of older models do not build up.
7. There are creative solutions to this problem, but such solutions are outside the scope of this overview.
8. Take this example:

	Target Sales Price of $100	Actual Sales Price of $50 After Discounting
Royalty Payable, where Royalty Equals 10% of Net Sales	$10	$5
Royalty as a Percent of Sales Price	10%	10%
Royalty Payable, where Royalty Equals $10 Per Unit	$10	$10
Royalty as a Percent of Sales Price	10%	**20%**

There are other ways to accomplish similar results with a percentage-based royalty that increases as the discount is increased.

9. An "Authorized Customer" provision would generally (but not necessarily always) be construed as a non-price vertical restriction which is subject to the rule of reason. *See O.S.C. Corp. v. Apple Computer, Inc.*, 601 F. Supp. 1274 (C.D. Cal. 1985) (holding that a prohibition against mail-order sales of products by authorized dealers was lawful under the rule of reason).
10. *See, e.g., Sebastian Int'l, Inc. v. Longs Drug Stores Corp.*, 53 F.3d 1073, 1074 (9th Cir. 1995) (noting the "basic limitation on the right of a trademark owner under the Lanham Act to control the distribution of its own products" and that "courts have consistently held that, with certain well-defined exceptions, the right of a producer to control distribution of its trademarked product does not extend beyond the first sale of the product").
11. Internet marketplaces themselves will often refuse to take down listings unless the article is counterfeit or the seller is making use of the brand licensor's trademarks or copyrighted materials beyond what would be considered "fair use" to describe the goods being offered for sale.
12. SRPs should not be used in a deceptive manner to suggest that the selling price represents a large discount. *See* Guides Against Deceptive Advertising, 16 CFR Part 233.
13. These policies are almost universally unilateral despite *Leegin* due to state law concerns. *See* footnote 4, above. A deeper discussion of these policies is outside the scope of this article.

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The authors thank Zach Eyster, an associate at Kilpatrick Townsend & Stockton, LLP, for his assistance in preparing this article.