Brand monetisation – trust, but verify

To maximise brand monetisation, parties entering into a formal licensing agreement must do so in good faith and with a transparent and open approach. To avoid any future pitfalls, the expectations of both parties must be aligned

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The monetisation of a brand is challenging in a variety of ways. One common challenge is that for the purposes of scale, leverage or speed, brand owners must partner with third parties in order to maximise brand value. Third parties can be used for regional or global manufacturing, distribution, retail or a combination of all three. Brand owners (licensors) will often enter into a formal licensing agreement with third parties (licensees). Both parties usually view this relationship as a partnership or strategic alliance. However, due to many potential issues, it is important that both parties have a transparent and open relationship. In order to protect the brand and maximise value, the parties need to have a mind set of "trust, but verify". Yes, the well-known Ronald Reagan line applies even in brand situations!

The formal licence agreement executed by the parties is the foundation for such a strategic partnership. A licensor grants use of its intellectual property – or brand – in return for, among other potential benefits, a stream of royalty payments. The two parties enter into an agreement in good faith, with the intention of allowing both parties to benefit mutually from brand monetisation. However, while the best of intentions stand behind the partnership in its initial stage, all too often these partnerships run afoul.

This article addresses some of the issues which may negatively affect the partnership and considers what companies can do to overcome these hurdles. Experience indicates that one of the most important things is that licensors and licensees should work hard not to put themselves in a difficult position from the outset. The underlying licence agreement should be a major focus of the parties, with the definitions and reporting requirements being given far more attention than they typically receive. Generally, both parties are naïve about this and do not anticipate some of the future issues that may arise if these areas are not thoroughly understood and documented.

Licence agreements and reporting – getting it right first time

When involved in discussions between a licensor and licensee regarding issues related to differing expectations or opinions, these issues tend to revolve around perceived non-compliance by one of the parties as it relates to the agreement. Such non-compliance issues can take various forms:

- Perceived misreporting of net sales (and thus royalties, as most brands' royalty payments are based on net sales).
- Sales outside an approved territory.
- Sales to unapproved customers.
- Sales by the licensee of non-licensed products.

Many of these issues can be addressed through a variety of solutions, including:

- The use of clearer definitions within the agreement.
- Better reporting on behalf of the licensee.
- More transparency in reporting and operating within the two organisations.

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Getting the agreement clauses to align with the parties’ expectations and understandings is possibly the most important part of a successful long-term relationship. This is much harder than it sounds, and will require multiple stakeholders on both sides to work diligently in order to achieve a well-crafted licence agreement. Many companies rely solely on lawyers for this exercise and the responsible operational teams must be very active in order to achieve a mutually beneficial agreement. The lawyers are important, but if future problems are to be avoided, those responsible for execution must be involved before the agreement is finalised.

Examples of agreement pitfalls

Far too often, the expectations of both parties are not aligned with regard to certain aspects of the agreement (eg, when net sales is the metric that a licensee must report and on which royalties are paid). This tends to be due to a lack of clarity within the definition of “net sales” in the agreement, as well as a lack of an exhibit within the agreement which lays out the net sales transactions. A simple example of a lack of clarity aligned with the definition may be as follows:

“Net Sales is the Gross Sale of the Licensed Product less the following:
a) Returns
b) Allowances
c) Trade discounts.
No other deductions are allowed.”

In this case the term “allowances” may be assumed by a licensor (eg, in the luxury goods industry) to mean a markdown allowance that the licensee provides to a retailer. A licensee, on the other hand, may assume that “allowances” include markdown allowances, freight allowances and bad debt allowances. Thus, the opportunity exists for wide-ranging differences of opinion or understanding as to the amounts of net sales which are to be reported. Since this issue is directly aligned with an economic component of the agreement, the sensitivity of the parties tends to be heightened.

An additional pitfall may be a clearly defined term on which the parties disagree when it comes to the impact of not following such a term. For example, if there is a cap aligned with certain types of sale (eg, off-price or deeply discounted sales), the cap may be a certain percentage of the licensee’s overall gross sales. If the licensee makes an abundance of off-price sales and exceeds the cap amount, the licensee may be deemed to have been non-compliant. Yet what are the ramifications? Does the licensee have to pay a royalty on the gross basis of those sales which exceed the cap? The lack of an established basis by which the parties are to be held accountable should they exceed caps, for instance, is another pitfall.

In addition, far too frequently, licence agreements do not include exhibits that are in alignment with core components of required reporting. A core component of any licensing agreement is the structure under which a licensee is to report royalties — again, typically net sales-based. By utilising an exhibit and laying out each line item which feeds into net sales, the future required reporting on those net sales can be made clearer. Again, the challenge starts with clearly defining “net sales”.

Reporting requirements

Numerous aspects of reporting within an agreement can lead to mismanaged expectations:

- The level of required reporting by the licensee to result in transparent information.

- Adherence by the licensee to such reporting.
- Ownership and action within the licensor's organisation to review such reporting.

Transparent information

This issue is a fundamental first step in the process of reporting and sets the tone for any future steps related to reporting. A poorly written agreement does not require the licensee to provide detailed backup reporting in supporting calculations such as net sales. All too often, agreements require a licensee to report "total gross sales less total deductions". This does not allow the licensor to determine, in any manner, the basis on which the licensee is calculating its royalties. Under this approach, among other issues, a licensor cannot determine:

- Which products are being sold.
- What types of deduction are being taken.
- To whom the products are being sold.
- Into which territories the products are being sold.

Requirements should be established within the agreement, dictating that the licensee report:

- All sales at a detailed style or stock-keeping unit (SKU) level.
- All deductions at a style or SKU level.

Included in this data should be critical fields, such as customer names (to confirm that the customers are approved customers) and product shipping location (to confirm the territory of sale).

In addition, and related to the level of reporting, a licensor should not lose sight of its "right to audit" clause and the level of reporting required in this clause. For instance, the licensor should be careful not to limit an audit to a review of the calculation of royalties, as this would limit an analysis of a potentially unapproved customer, as well as a confirmation of items such as image or advertising funds/placements. The clause should also allow for access to inventory information in addition to sales, as this will allow for independent confirmations of units sold.

Adherence to reporting

After setting the levels of reporting required of the licensee, the next step in the process is to ensure that the licensee is generating and sending such reports. While most agreements require a more detailed level than that which is highlighted above, this issue often revolves around the licensee delivering reporting at the required levels. It is easy to lose sight of the required reporting and numerous licensors are content with a quarterly royalty payment, accompanied by a statement which lists one line of gross sales and one line of deductions, giving a net sales number.

In many cases the majority of a licensor's efforts relate to the processes of negotiating the agreement, meeting periodically to understand the next season of styles and receiving and reviewing upcoming forecasting. Totally lacking is the analysis of the prior period's transactions. This leaves a hole in the process that could otherwise allow the two parties, early on in



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the partnership, to reach a better understanding of issues such as differing opinions or understandings related to key terms. A detailed, proactive approach to reviewing net sales transactions after the first quarter of reporting under an agreement could eliminate future issues. Licensors should focus on the first monthly or quarterly reporting from the licensee and address issues on a real-time basis. Too often, licensors wait until years into the agreement and raise issues that are not timely and cannot be addressed or resolved.

Closing

The examples provided above are just that — examples. The possible issues that may arise between two parties are impossible to quantify or entirely anticipate. Both parties generally want to do the right thing and will both benefit by maximising the value of the brand. By working together, this is achievable, and providing the necessary level of transparency builds a strong foundation moving forward. Conversely, if the parties are not aligned and there is no established level of transparency, there is potential for diminution of brand value.

It is in the interests of both licensors and licensees to get it right from the beginning. If the parties can establish an effective agreement and develop a trust-based relationship, the value of any brand can be enhanced. This effort takes time and energy, but is well worth it in the long term. To trust but verify is one way for licensors to ensure more easily and transparently that the value of their brand is truly being maximised. ***iam***

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