Strategic Licensing Considerations

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Strategic licensing by companies to expand their brands into new product categories is a growing trend. Additionally, celebrities are now, more than ever, creating their own brands and entering into licensing arrangements to promote their celebrity status.

Strategic licensing arrangements enable a licensor to forge alliances with licensees who have expertise and presence in a particular brand category, thereby leveraging the licensee's existing relationships. For example, licensing enables a licensor to off-load the manufacture and marketing costs of product categories that are not part of a licensor's core business, open up new distribution channels, create new markets in new geographic areas, and extend core products into complementary products that might not otherwise be available.

From the View Point of the Licensor

Brand Identity

First and foremost, a licensor must evaluate whether a strategic licensing arrangement will enhance and improve the licensor's brand. A licensor should have a design philosophy and creative vision in place in order to keep the brand identity intact. It is also important to understand and limit the time commitments that will be involved from a creative and management point of view for the licensor. Performance metrics should be addressed and incorporated into the agreement to ensure performance goals are met by the licensee.

The licensor also needs to evaluate whether the licensee has the financial strength to perform its obligations to promote the identity of the brand in a manner that will satisfy the objectives of the licensor. Other key issues to address include: which products and trademarks are covered, the royalty arrangements and design fees, whether the arrangement is exclusive or nonexclusive, the definition of the design and approval relationships relating to the products and product promotions, and the term and termination of the license agreement. The licensor will also need to retain rights to police the quality control of any licensed products to ensure brand integrity. Other licensor considerations include retaining approvals over manufacturing, distribution channels, and advertising and promotion programs.

License Grant

The initial step is to define the products and trademarks to be covered and the rights to be granted in the license agreement. A licensor can control the scope of the license by including and excluding certain products and trademarks, incorporating exclusivity and territorial restrictions, and limiting assignment and sublicensing arrangements.

Royalties and Other Payments

Most licensing arrangements include initial up-front payments that are generally nonrefundable license fees, used to compensate the licensor for the costs of investigating the licensee and covering documentation costs, and which may or may not be creditable to future royalties. The main source of revenue for the licensor is a royalty fee, and this fee may be fixed or varied based on a percentage of sales or other factors. Royalties are typically structured with minimum payments to ensure that the licensor will have a reliable royalty stream.

Royalties based on gross sales or net sales are generally favored by both licensors and licensees. From the licensor's point of view, gross sales and net sales are harder to manipulate (in contrast to royalties based on net profits which may be manipulated by the licensee often leading to litigation), and from the licensee's point of view, the licensee can avoid disclosing profit information to the licensor. Another method of calculating royalties is to use gross profit, whereby the cost of goods sold is subtracted from gross sales, which generally includes directly allocable expenses, such as manufacturing expenses, raw material costs, and direct labor costs. An advantage of this method for the licensor is that the licensor can take advantage of increasing profit margins. Another royalty option is to use a flat per unit royalty on products sold.

The license agreement may also contain advertising and promotion payment minimums. In all cases, the licensor will need to retain audit rights to verify the accuracy of the licensee's accounting for royalties and other financial obligations.

Term and Termination

The duration of the license, any renewal provisions, and the termination provisions need to be clearly set forth in the license agreement. A licensee will generally want a longer term if a substantial start-up investment is involved. This is often balanced by the licensor with a minimum sales requirement to ensure that the licensee will be actively marketing the licensed products.

Clearly defined termination provisions need to be included. As is the case in other agreements, the parties should be able to terminate the license agreement upon the occurrence of a material breach. The termination provisions should instruct the parties on what occurs upon termination, and should address the return of all proprietary materials to the licensor. The licensor will want to reserve the right to terminate the license if the licensee is not performing to the minimum performance thresholds.

Key Takeaways

Strategic licensing is an important way for an owner of a brand to increase profit and diversify revenue streams. A licensor can exploit its brand presence by expanding into new product categories, gaining access to new technology, resources, markets and geographic areas. A well thought out written license agreement, which aligns the business interests of the licensor and licensee, is a key tool in implementing a successful strategic licensing plan.

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