Key Financial Building Blocks Of Licensing Agreements To Maximize Revenue And Protect Intellectual Properties

By Lewis Stark

In the retail marketplace, the cachet of licensed brand merchandise has consistently buoyed consumer sales. In fact, a survey by the International Licensing Industry Merchandisers' Association (LIMA) showed that global sales of licensed goods rose 4.4 percent from 2015 to 2016, significantly higher than the 2.9 percent growth rate for overall global retail sales.[1]

However, a more pertinent issue to brand owners and licensors is royalty revenue, which showed a year-over-year increase of just 1.3 percent. In its survey, LIMA noted that actual year-over-over royalty rates declined slightly (from 8.5 to 8.2 percent),[2] largely because the continued growth of online shopping among consumers is forcing retailers to be more aggressive about preserving gross margins. More specifically, it is wise to understand that when royalty revenue rises at a time when average royalty rates are falling, that trend almost always indicates strong demand for licensed brand merchandise.

Given the reality that margin pressure on retailers will not ease anytime soon, it's important for both brand licensors and licensees to have greater clarity on the financial—not just legal—provisions of their agreements. Why? Consider the following:

For licensors, a well-designed financial agreement provides strong incentives for the licensee to fully exploit the branded properties, while setting specific terms by which the licensor will receive royalties or profits. This includes clearly defined financial provisions and the removal of ambiguous language from a licensing agreement, which will increase royalty revenue and prevent unnecessary disputes down the road. Well-designed agreements also help enable the licensor to recapture certain rights or terminate the agreement if a licensee misses sales or other targets for the rights granted, while protecting the value and integrity of the licensor's trademarks, brands and characters. In addition, a solid agreement will include financial provisions that maximize royalty revenue while preventing, limiting or penalizing certain activities that can damage those valuable assets.

1) *LIMA Annual Global Licensing Industry Survey 2017 Report*, International Licensing Industry Merchandisers' Association.

2) Ibid.

For licensees, the key advantage of a well-crafted financial agreement is to ensure the licensing partnership is profitable and free of surprises, largely via defined incentives to maximize sales within industry standards, which also provide flexibility to handle marketplace shifts. That said, some licensees make the mistake of entering into partnership agreements simply to gain access to a "hot property," without carefully considering how well that property fits with their marketing model and whether it will be profitable. If financial underperformance and/or onerous terms pressure the licensee into breaching the financial provisions to make the agreement "work," that significantly raises reputational risk if discovered in an audit—or if the breach becomes public and ends up in litigation.

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License agreements contain material financial provisions often written by people who are unfamiliar with accounting and finance. We often see references to improper accounting and auditing standards such as Generally Accepted Accounting Provisions (GAAP) or Generally Accepted Auditing Standards (GAAS), which sound good, but also include unintended accounting and audit treatments that are frequently contradictory to other financial provisions within an agreement. When such standards are incorrectly referenced, defined or applied, it can result in ambiguities that may circumvent limitations on deductions, which can enable licensees to underpay royalties. In this article, we'll discuss some of the problems we see in the financial and audit provisions of licensing agreements, along with suggestions to improve such language.

Key Starting Point: Defining Gross Sales

In many licensing agreements, the focal point is net sales, since that is generally the basis on which royalties are calculated. However, licensors who do not insist on a carefully-considered definition of gross sales are literally leaving money on the table. That's because a licensor wants as little space as possible between the net and gross sale amounts, with maximum exclusions or limitations for allowances, credits or discounts that can reduce net sales.

In poorly structured agreements, we often find no clean definition for gross sales. Frequently, there is a vague starting point that often begins, "Net sales is sales less…," which allows the licensee to interpret what is—and what isn't—expressly communicated. But defining gross sales is not as simple as it sounds, depending on the licensor's goals and contractual limitations on deductions.

A common error in many licensing agreements is to define gross sales simply as the "invoice selling price." That definition leaves plenty of loopholes for the licensee, such as the ability to subtract disallowed discounts and allowances from the invoice selling price, leading to a lower gross and net sales figure. If a license agreement limits the type or amount of discounts and allowances, the licensee can circumvent these limitations by building disallowed deductions into the invoiced price. For that reason, it's wise to ensure that the gross sales definition is linked to "list price" or another measure hard to manipulate, such as the highest actual sales price. Alternatively, you can define gross sales as the invoiced price before any deductions, which is better than just "invoiced price." However, this approach is still nebulous and subject to interpretation.

Other issues that should be addressed in the definition of gross sales (if applicable) include:

Retail sales. If the licensee is able to sell licensed products at retail within their own stores or online, this capability should be addressed in the gross sales definition. To maximize royalty revenue, gross sales should be defined as either the retail list price or the actual selling price to end-user consumers. Because allowances are not usually associated with retail sales and discounts are usually minimal, actual selling prices can be a proper definition for gross sales at retail. Alternatively, wholesale list, top wholesale pricing or average wholesale pricing can be used to define gross sales at retail. The key is to disallow intercompany transfer pricing as the basis for gross sales, especially when a licensee has a retail division.

Direct-to-retail licenses. Gross sales in a direct-to-retail license can vary widely. Royalties can be based on the cost to manufacture, or on a cost of goods linked to actual retail selling prices. If based on manufacturing or purchase costs, the agreement must clearly spell out cost components to be included and excluded. If royalties are based on retail sales, the agreement must clearly define if the basis is actual sales pricing or retail list pricing.

Sub-licensing. Under certain circumstances, it can make sense for a licensor to grant a "sub-license." In this scenario, revenue received by the licensee from the sublicensee should be addressed separately from revenue the licensee receives from selling the merchandise themselves. Sublicensing royalties received by the licensee should not be considered gross receipts from sales. Instead, royalties would be payable based on the sublicensee's sales and not the licensee's royalty receipts from such sales. Alternatively, sublicensing gross receipts (royalties received from sublicensees) can be split with the licensor at a rate much higher than the royalty rate, commonly 50 percent. If a license grants sublicensing rights, make sure those rights separately address sublicensee receipts in the financial provisions. Otherwise, the licensor will receive a royalty based on the regular rate applied to the amount of royalties received from the sublicensee.

Non-monetary transactions. In many cases, licensees can seek to lower the net sales amount by not recognizing the value of certain non-monetary transactions, such as bartering, intercompany sales, sales to affiliate entities or by improperly valuing such activity. To address these issues, make sure the license agreement clearly defines how such activity should be accounted for and valued. For instance, intercompany transfers should not be recognized for royalty purposes, since royalties should be based on sales of the entity that received the transfer (which may be at retail pricing). Barter transactions should be based on list prices, highest sale prices or average pricing.

Once a gross sales definition is clearly established, it should be used as the benchmark from which to cap allowances, discounts and returns (either by fixed amount or by percentage) that are deductible for royalty calculation purposes. Do not cap discounts and allowances as a percentage of net sales, as this results in a circular calculation.

Finally, it's crucial to specify in any licensing agreement that gross sales are to be recognized on an accrual basis (at the time the product is shipped, the invoice is rendered or when payment is received, whichever is first). This avoids the problems of basing gross sales on cash receipts, which potentially could include noncontractual deductions such as bad debts or delayed recognition of sales, which can result in delayed royalty payments.

Deductions. Reducing gross sales for deductions is commonplace, as many retailers require discounts and allowances from suppliers. However, for royalty calculation purposes, make sure to include only those deductions that are measurable, pertain to the sales of licensed products and support the licensee's ability to sell those products in the retail environment. For example, markdown allowances and price protections enhance sales and should be deductible by the licensee (up to a limit). On the other hand, cash discount and freight allowance deductions solely benefit the licensee and thus should not be considered part of the royalty calculation. Licensees should not be allowed to deduct any of their selling, shipping, warehousing, general or administrative costs, since royalty deductions should only pertain to certain amounts "given back" to customers. Unlike the recognition of sales, deductions should be recognized on a cash basis when amounts are actually credited to the customer. In order to protect the integrity of licensed brands, overall deductions should be capped at a percentage of gross sales. Such caps normally range between five and 15 percent.

Four Critical Financial Provisions for Any Licensing Agreement

Minimum guarantee clause. For licensors, a major goal in any agreement is to ensure that one or more licensees are selling desired quantities of the product. By inserting a minimum sales (or performance) guarantee clause, licensors can lock in a baseline level of royalty revenue they can expect over the duration of the agreement. This, in turn, provides incentive to the licensees to sell product to cover costs specified in the minimum guarantee. If the licensee does not meet the defined minimums, the clause should allow the licensor to "claw back" certain contractual rights or to terminate the agreement ahead of schedule.

As a structuring tool, all periodic payments for a minimum guarantee should fall on the same due date as regular royalty payments, and the agreement should specify that the licensee is responsible for paying the greater of either the cumulative royalty or the cumulative minimum guarantee on each of those dates. If the cumulative payment for royalties exceeds the guaranteed minimum amount due, then the minimum guarantee payment does not need to be made. Licensors may create different minimum guarantees for different product lines, properties, geographies or other variables. In that scenario, however, licensors must closely monitor scheduled minimum payments and royalties reflected under those variables, ensuring that a licensee does not "cross-collateralize" royalty income from one to make up for shortfalls in another. If shortfalls occur, the unrecovered amounts of the minimum guarantees should not be carried forward to a new season, year or agreement term.

Royalty escalations and *de-escalations*. In a trademark/brand license, royalty rate escalations or de-escalations are typically tied to designated sales milestones. While such milestones can be based on currency or units, the use of currency will ease the calculation and minimize the potential for manipulation.

That said, if units are selected as a milestone, note that a licensee can apply the highest royalty rate to the lowest priced product and vice versa to improperly reduce its royalty obligations. To prevent this from happening, licensors should include language in the agreement that addresses how escalations or de-escalations should be calculated in the accounting periods in which the milestones were achieved. Consider the following points:

- When unit sales exceed one or more defined escalation thresholds, all dollar sales within the quarterly or semiannual accounting period should be allocated to each royalty rate tranche. This should be done based on the proportional volume of unit sales in the same accounting period that are below and above each escalation threshold, or
- When unit sales exceed each escalation threshold, all dollar sales after that date (or invoice) should be applied to the higher or lower rate.

The agreement should also specify how deductions are to be applied to each royalty rate tranche (such as on a first-sale or a last-sale basis). In this case, each deduction should be matched to a related sale and applied at the same royalty rate as that sale. Each deduction should be proportionally allocated to each royalty rate tranche, based on the amount of dollar sales allocated to each royalty rate tranche from inception.

Interest penalties. A strong licensing agreement should contain specific provisions that cover any interest payments due to the licensor, such as penalties for delinquent royalty payments, self-reported adjustments or audit settlements. This language protects the financial interests of the licensor while also providing incentives for licensees to make timely, correct royalty payments. The simplest way to establish an interest rate is to add a premium onto the prime rate and calculate penalty payments using compound interest.

Other monetary penalties. In any licensing relationship, licensees can engage in activities detrimental to the licensor. This might include selling unapproved or unlicensed products, selling licensed products to unapproved customers, outside of contractual sales channels or outside of approved sales territories, or using sublicensees without explicit approval within the licensing agreement. To help dissuade this type of activity, licensors should insert specific monetary penalties into their agreements. These penalties should have teeth, such as multiple increases of the standard royalty rate during the period in which a licensee was in breach, or a steep (50 to 100 percent) penalty on all profits related to sales in violation of the agreement. Contractual language surrounding penalties should be carefully crafted to avoid granting the right to conduct prohibited activity at the higher "penalty rate," typically by emphasizing that such activity constitutes a breach of the license agreement.

Make Sure to Include a Robust Royalty Audit Provision

During his presidency, Ronald Reagan coined the now-famous phrase, "Trust, but verify" when it came to the negotiation of international agreements. While the relationship between licensors and licensees is not on that scale, the concept of verification and recourse remains sound.

In our experience, an audit clause is either missing from a license agreement or neglected during negotiations, resulting in a weak and ineffective provision. Why does this happen? Frequently, it's because a licensor places too much faith in a good relationship with one (or more) licensees, they don't believe they have the negotiating power to add or negotiate a robust royalty audit clause, or they spend too much time focused on negotiating other provisions in a licensing agreement. However, the absence of a robust audit provision can be an expensive mistake, because licensors will have no real means to determine if royalties are being paid according to the terms of the agreement and limited recourse to recover underpayments. In addition, the lack of an audit provision may actually encourage some less-than-ethical licensees to underperform financially and to exploit properties inappropriately, since there are no "teeth" in the agreement.

For these reasons, any solid licensing agreement requires a robust, thoughtfully considered royalty audit provision, which includes a broad range of licensor rights and a narrow scope regarding audit limitations. Key elements every licensor should consider as standard language for an audit provision include:

Audit period. Consider at least a three-year window from the end of the term of the agreement in which an audit can be invoked, and as long as five years from the date that each statement was rendered.

Location of records. Consider requiring the licensee to maintain all relevant books and records at their principal business location for at least two years after an audit, in the event follow-up litigation takes place.

Required documentation. The royalty audit provision should specifically identify any and all documentation the licensee must make available in the event of an audit. This may include performance records on the specific licensing agreement, complete records about the licensee's business and information on the company as a whole (which may include disclosure of other licensor relationships and activity).

Accounting definitions. Do not use the term Generally Accepted Auditing Standards to describe the standards on which the royalty audit must be conducted. This term has legal meaning and is associated with audits of financial statements, which would only allow the auditor to express an opinion on whether the amounts presented on the royalty statements are reasonably accurate. Insert language in any audit provision that specifically states that the auditor may choose accounting standards and procedures that are most relevant to the work required.

Employee access. A strong audit provision must include a clause that allows "reasonable access" during an audit to key employees who had management oversight of the agreement's terms and conditions.

Expense reimbursement. Royalty audits cost money. Licensors should ensure they include a clause with a low threshold that allows them to recoup audit fees and expenses. For example, a reasonable bar for reimbursement is if an audit discovers a royalty underpayment discrepancy of five percent or more for any given accounting period.

Defense on limitations. An audit clause should ensure there are no restrictions on the licensor's choice of an audit firm or the fee structure for such services. This arrangement allows the licensor to also use internal audit resources if they desire or to select a qualified outside accounting/CPA firm on an hourly, flat or contingent fee basis. In addition, a licensor must exclude all limitations on the time frame in which it can either file a complaint or pursue legal recourse for any breach of contract discovered in an audit.

Clearly, it is in the best interests of both licensors and licensees to have a well-defined agreement in which specific rights, responsibilities, performance obligations and avenues of recourse are in place to protect their respective financial interests. Licensors want to maximize royalty revenue while ensuring their properties are protected, and licensees want to ensure they have the ability to make a profit under the terms of the agreement. By taking the aforementioned points into account, each party can take concrete steps toward reaching those goals. ■