The Secret Decoder Ring: 5 Things Smart IP Licensors Look for in **Licensing Contracts**

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Introduction

A desirable piece of intellectual property (IP) is powerful. To manage that level of power, it is essential that the licensor hire a professional attorney who specializes in IP and individual copyrights. There is a deep case history of precedent, and a qualified attorney will understand the restrictions that need to be put in place, and the terms included to ensure the licensor profits fairly from the licensee.

The structuring of a licensing contract is critical; when written correctly and well executed, life is good for both parties in the agreement. On the flip side, poorly written contracts can result in costly disputes. Time and money can be wasted resolving them. The harmonious business relationship between licensor and licensee is sometimes irreconcilably damaged. Equally disconcerting, industry reputations on both sides can be tarnished indefinitely.

Every year, more than $270 billion in global revenue stems from licensing contracts. However, there are still licensing contract disputes filed in court every year, indicating that contracts are still being executed without legal clarity. The additional opportunities identified for profit are vague, if covered at all. Many of these errors are preventable. Licensors should never have to experience financial or creative suffering due to poorly written and executed contracts.

One can liken demystifying the licensing contract to having the “secret decoder ring.” This eBook is designed to teach licensors about some licensing contract business elements that — if missing — can compromise an IP. The goal of this eBook is to arm new licensors with the ability to recognize an incomplete contract, and teach them about which elements should be included.

A Pocket History: How We Got Here

Disney was the first clear example of brand licensing. In the 1930s and '40s, they leveraged the popularity of their beloved, squeaky voiced rodent IP Mickey Mouse into consumer products they didn't manufacture. This set the stage. Since then, several brands followed, fully deserving hall-of-fame-level recognition for their legendary licensing guile. In the 1980s, Harley-Davidson® transitioned from a motorcycle manufacturer into a manufacturer that was also a lifestyle brand. In 1985, the former "Charlie's Angels" actress Jaclyn Smith pioneered the concept of the celebrity-branded fashion line. Mary-Kate and Ashley Olsen applied Smith's concept to their own "Tween Girl" fashion empire in 2001. The Olsen twins made history as the first celebrity-branded fashion line to break the $1 billion barrier, setting a new bar in licensing success for any who follow them.

Arguably one of the most surprising-yet-legendary brand extension exploiters was Finnish company Rovio and their IP Angry Birds®. Their seemingly simplistic Angry Birds mobile game launched in 2012, cascading into a flurry of licensing opportunities — Angry Birds-themed soda, a mashup game with Star Wars®, soft goods, and by 2019, their second Angry Birds movie.

When a new product creator pitches a retailer for shelf space in big box stores, retailers typically require the creator to have at least two follow-up products beyond the introductory piece. The potential for brand extensions (retailer translation: the promise of future sales) is often the hook that closes the deal. Another example is the book publishing industry. Fiction books with a built-in trilogy or series potential are often a literary agent's dream sales situation. Brad Meltzer, cited in The Hollywood Reporter's "25 Most Powerful Authors" list, is a strong example. Meltzer's recently launched "Ordinary People Change the World" kids' book series is extending into plush toys and a PBS animated series.

The Dark Side of Licensing: Violation Frustrations

The digital age has ushered in an unprecedented level of content dissemination and exposure through that ubiquitous “share button” on most websites, encouraging social sharing and virality. Licensors and licensees alike find themselves at the intersection of law and technology.

Some dangerous assumptions have been made about “fair use” protections by content creators acting as licensees, but without the legal contracts to support their usage. For example, in February 2007, parent Stephanie Lenz posted a YouTube video of her baby dancing to the Prince song, “Let’s Go Crazy.” The music played for 20 seconds of the 29-second video. By June of 2007, Universal Music sent YouTube a notice demanding they take down Lenz’s video, citing that Lenz had violated copyright. In September, Prince declared his intention to “reclaim his art” in released statements, and in October 2007, Universal announced that Prince and Universal were removing all online user-generated content involving Prince, “as a matter of principle.”

In July 2007, Lenz sued Universal for misrepresentation under the Digital Millennium Copyright Act (DMCA), seeking confirmation that her Prince song usage wasn’t infringement. The district court didn’t satisfy either party. Lenz appealed the takedown decision to the 9th U.S. Circuit Court of Appeals, who also pushed back against Universal, stating that copyright holders could not demand videos be taken down without first identifying if the “Fair Use Act” applied in the situation.

Lenz ultimately appealed to the U.S. Supreme Court, who in 2017 declined to grant a writ of certiorari in this case, meaning that at least four judges determined that the circumstances described in the petition were not sufficient enough to warrant a Supreme Court review.

Licensors often prevail in court, but the damage done to their brand via viral internet sharing can be devastating and cannot be undone. To date, the “Dancing Baby Video” stills resides on YouTube. The two parties settled their dispute in June 2018.

Some content creators would argue the value derived from the added exposure and web traffic justifies their unlicensed usage. And some licensors, like photographer Gage Skidmore, intentionally upload and share photos to Flickr with a creative commons license. For example, Skidmore's professional-quality 2012 presidential election photos were shared out with his prominent photo credits, and were linked back to his web properties more than one million times.

The Suzanne Vega hit, "Tom's Diner" is another legendary breach of a copyright license. Vega released her song a cappella in 1987 on A&M records, but two British record producers known as "DNA" remixed her song with an R&B beat. The duo started selling it at their local record store without rights or permission. A&M nearly pursued legal action, but at the 11th hour, Vega asked to hear the DNA version first. Luckily for DNA, she loved it. Vega convinced A&M to pay DNA a flat fee and then redistribute it. The remixed version peaked at No. 5 on the Billboard Hot 100, but this is the unicorn of happy endings to a copyright violation.

In 2013, Idaho photographer Kai Eiselein found himself in a high-profile licensor rights dispute situation when Buzzfeed copied his photo from his Flickr account for a montage they created. By the time he sent them the takedown notice, the "share button" propagated the image on 23 additional sites. Eiselein told online news site Arstechnica, "I'm not against sharing, when it's done properly. The infringement problem comes into play when big players like Buzzfeed bulldoze their way through the web with no regard for others' IP rights in search of content to drive traffic to their site and ultimately, cash into their coffers." In the end, Eiselein lost his lawsuit, but it made many content creators think twice about their unabashed fair rights usage presumptions. Copyright infringement incites unwanted, unnecessary lawsuits.

In seeking licensor profitability, the Gage Skidmore playbook is *not* on trend. Only a small percentage find success with that revenue model, and as the advertising algorithms change to the content creator's disadvantage on blogs and YouTube, that revenue will continue to shrink. Rather, a business model where licensees pay for the contractual usage of a licensor's IP is optimal. However, the contract must be written to ensure the brand remains relevant, evergreen, and profit-driven.

Before putting ink to contract, it is wise to review the contract and compare it against the following five contract details as applicable; their inclusion is considered a best practice in successful contracts.

1. Specific Rights

Grant the rights in a way to garner the best brand image, exposure, and revenue.

Specific Retailers

There's a reason Rolls Royce products are never seen in the T.J. Maxx clearance bin, but their branded t-shirts are sold on luxury goods designer Giorgio Armani's website. The cachet of the Rolls Royce brand will never align with the deflated stature of discount retailers. They have carefully cultivated the exclusivity cachet into their brand and established strict rights controls.

Specific Regions

Licensors should isolate their products based on the local culture and environment. For example, a licensor would never sell immodest clothing or inappropriate secular pop culture content in countries with strict religious beliefs, nor would they sell snow shoes in Hawaii. Licensors must honor the local culture, while also sheltering the brand.

Targeted Combinations

Successfully aligned licensed rights that are consistent with the brand will help preserve its equity and extend its lifespan. For example, an infant-based brand would never include weaponry. The selection of product combinations for a brand extension is also important. The combinations granted need to remain true to the brand. There are no Starbucks-branded television sets or interior design fabrics. Instead, they'll license their IP for more organically-fitting brand extensions, like exclusive music CDs, coffee cups, coffee makers, and other kitchen or coffee-based accessories.

2. Guarantees and Royalty Rates

These rules are in place to drive the licensee's marketing plan and generate more revenue for all the parties involved.

Higher Guarantees for Licensor Rights Exploitation

When a licensor has several brands, but one is particularly in high demand, they should only license it to the licensee willing to take on a couple of less-popular brands as a quid pro quo for the rights to the "hot item." The in-demand brand can then command a higher guarantee, because it incentivizes the licensee to sell more.

Lower Royalty Rates for Certain Rights Encourage Increased Sales

For example, if a licensee sells t-shirts to a high-end retailer like Nordstrom, the licensor would reward the licensee with a lower royalty rate than if they sold product to a mid-tier store like JC Penney. The licensee is not necessarily restricted to specific retailers, but they are incentivized to sell to higher-end retailers to pay a lower royalty. Licensors can encourage this higher exposure by category, region, product line, or channel.

Escalated or De-Escalated Royalty Rates

Licensees with multiple granted rights can be incentivized to focus more heavily on one or more areas. Using Territory of Sale as an example: a licensor might initially establish the same royalty rate for sales in Region A and Region B. But once the licensee sells beyond a pre-determined amount in Region A, they have to pay a higher royalty, whereas they will continue paying the same royalty for Region B. This incentivizes the licensee to lower the cost of sale by selling more in Region B.

3. Performance-Based Renewal Provisions

This is another way to incentivize sales. If the licensee doesn't hit a minimum of net sales, for example, the license will not be renewed once the contract is over. Additionally, licensors should add compliance elements that affect the right to renew. These would typically include requirements like commanding the licensee to spend a certain amount on targeted advertising, strict adherence to submission of annual insurance certificates, and timely reporting and payment toward the licensed IP. If these demands are not met, the license would not be renewed.

4. Clear Definition of Net Sales Values

This accounting method must be made clear in writing (and it's astounding how many contracts are obtuse when it comes to this) as to what can or cannot be deducted from the gross to determine the calculable net. When an audit occurs, the licensor is entitled to proof of truth. If the auditor doesn't have a clear net sales value definition, then it's possible the licensor will be cheated out of earnings.

Customary Trade Discounts

Licensors must clearly outline whether customary trade discounts (such as volume discounts or cash payment discounts) qualify for this license.

Merchandise Returns Reporting

Licensors also need the contract to clarify how merchandise returns are reported. For example, licensors can dictate the terms that they will only allow the licensee a total of 10 percent in merchandise returns. Whether these are reported as separate/negative sales or as a deduction against gross sales, is often not clearly defined. In absence of clarity for reporting, the licensee will simply subtract 10 percent without a defined burden of proof. If no audit ever occurs, the licensor could end up being shorted. Implementing a discrete mechanism for reporting returns can help prevent this.

Optional Discount Approaches

There are many schools of thought on how to approach net sales values. Some licensors will not allow discounting of products, but will allow a certain percentage reserve to set aside (so that if the licensee does get returns, the reserve can be applied to cover the royalty on those returns instead of reporting negative sales). Some licensors will limit which SKUs the licensee can discount, or set a discount threshold by specific product. Ultimately, if licensors don't want to see their brand equity diminished by being heavily discounted at the retail level, they might prohibit discounts altogether.

5. Discrete Conditions for the Sell-Off Term

Let's say the licensor is a major comic book publisher, and one of their licensing partners is licensed to manufacture and sell prints of the licensor's superheroes. The licensee might have a three-year licensing agreement, but at the end of the three years, that business partner may still have art prints sitting in their warehouse. Now what? Ideally, the licensor's contract would include these caveats:

Sell-Off Period

The contract should introduce a sell-off period, and most contracts do. This is usually 90 to 180 days after the contract expires. The contract would need to clearly state the length of time allowed to sell excess inventory.

Specific Pricing Requirements for Sales in the Sell-Off Period

There are many consumers out there who will commit to buying a product, but only once it's heavily discounted. If licensors don't want to see their carefully cultivated brand's image eroded by bargain-basement pricing, they can mandate that their licensee cannot reduce the price by more than 25 percent. This indirectly signals a message to the consumers, through the licensee, that they can never purchase this licensor's product for more than a 25 percent discount.

Additional Inventory Post Sell-Off Period

Again, it is confounding how many contracts do not clearly state what happens to the remaining merchandise after the sell-off period. Technically, the ownership remains with the licensor. The licensee has two options at this point: (1) Return all product to the brand owner or (2) Abide by the "Affidavit of Destruction" clause in the contract. This means the licensee must destroy leftover product and send a legal affidavit proving they destroyed it, so if they're audited in the future, the auditor doesn't find it sitting on a warehouse shelf.

Conclusion

In short, “Licensing success occurs where preparation and opportunity meet.” The likelihood is high for a copyright license infringement lawsuit when a licensing contract has ill-defined legalese, or the contract is written so that terms remain open to misinterpretation. Even when following industry best practices and the advice of a well-informed copyright and licensing attorney, IP licensors will still benefit from scrutinizing these five key elements against their contract. These are the areas where misinterpretation or unclear definitions are most likely to trigger disputes and damage business relationships.

First, the licensee should be mandated to abide by the IP’s specified usage rights. This prevents any reputational damage to the licensor’s IP and brand. Second, the contract should specify the financial guarantees and royalty rates, one area most ripe for disputes, so there is no room for misunderstanding of the terms. Third, to incentivize the licensee to achieve sales goals at a higher level, the contract must mandate a performance-based review before renewing the license. Fourth, in another section of the contract that can be easily misinterpreted — often to the disadvantage of the licensor — terms must be clearly defined for what both sides agree will constitute the net sales values. Fifth, when the license expires, the protective contract safeguards the licensor by outlining specific terms for the licensee to either sell off, destroy, or return any remaining products (that is, if the IP is a physical product). This is another area of a licensing contract that can be murky, often to the financial disadvantage of the licensor.

Licensors must exhaustively identify and remove every possibility of risk to secure their IPs. Unlike Universal Music, most licensors will not have the funding, fortitude, nor bandwidth to fight copyright or licensing violations all of the way up to the Supreme Court.

1. Specific Rights
2. Guarantees and Royalty Rates
3. Performance-Based Renewal Provisions
4. Clear Definition of Net Sales Values
5. Discrete Conditions for the Sell-Off Term

How Vistex Can Help

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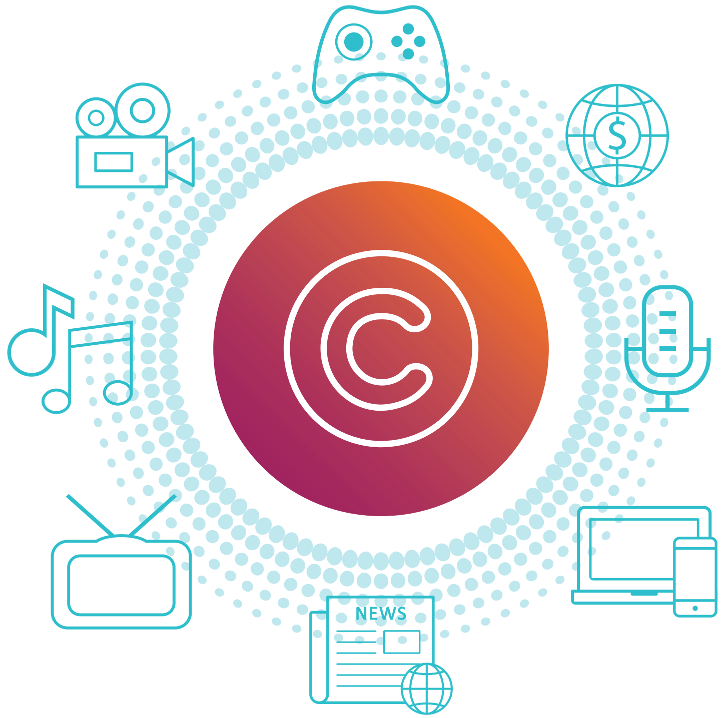

About the Author

Jon Robinson is a Senior Product Manager for Licensing at Vistex. Jon brings more than 30 years of experience designing and developing software applications for leading corporate, entertainment, retail, and government organizations. The last 25 of those years have been solely focused on financial and royalty-based applications for the merchandise licensing industry. Jon has designed, developed, managed, and implemented Vistex's industry-leading software for more than 100 licensing companies, several of which are on the Fortune 500 list. He is a licensing subject matter expert, a respected best-practices consultant and technician, and a highly-regarded advisor to clients and staff.

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