Drafting License Agreements:
Key Considerations for the Licensee

Drafting a proper licensing agreement is indispensable before striking the actual deal to keep both the parties, a licensee and licensor, on the safe side. The exercise entails intricate legal application.

Edmund J. Ferdinand, III

The current economic crisis has reached all corners of the globe, and the licensing industry has certainly felt the sting of the down economy. The level of deal activity is down and deals that are being made are often subject to increasingly strict terms from wary licensors and licensees. As a result, now more than ever particular attention must be given to business and legal terms while negotiating and drafting license agreements. This column will highlight some of the most important license agreement terms from the perspective of licensee-manufacturers.

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GRANT CLAUSE

As with any license agreement, the grant clause is of particular importance to the licensee. A licensee will look to obtain the broadest possible exclusive rights - whether the exclusivity relates to all product categories, distribution channels and territories, or something less than that. Clearly, a broad grant of exclusive rights will serve to protect the licensee from competition from the licensor or other third-party licensees for the same products in the same territories. The grant of an exclusive license affords the licensee two additional benefits. It gives the licensee standing to sue a third party for trademark infringement without joining the trademark owner. In addition, the licensee may record an exclusive license with the U.S. Patent and Trademark Office and other trademark offices throughout the world, thereby giving notice to the public of the existence of the license.

BEST EFFORTS CLAUSE

An obligation for a licensee to use its "best efforts" to perform an act under the agreement (e.g., market, distribute and sell licensed products) is a recipe for disaster because the licensee's performance is always subject to scrutiny by the licensor. This type of language unfortunately often leads to litigation because the standard of what constitutes "best efforts" is a subjective one. If the licensor requires some affirmative obligation in the agreement, there are two important considerations. First, licensees should seek to soften the standard from "best efforts" to a lesser standard such as "commercially reasonable" or "reasonable business judgment." Second, licensees should seek to limit the scope of their obligation. A broad clause that requires an obligation to "market, advertise, promote and sell the licensed products in all territories throughout the term" is dangerous because it is an affirmative obligation to promote and sell all products, even ones that may prove to be unpopular or underperforming, during the term. Instead, licensees should look to soften the language to a standard such as "making product available" during the term, thereby insuring that it will have enough products on hand to meet demand.

Definition of Net Sales: The parties are typically most concerned with the material financial terms, including the royalty rate and any advances or guaranteed minimum royalty payments by the licensee. To be sure, these are all important considerations. But equally important to the licensee is the definition of "Net Sales" under the agreement. This is a critical definition because payment to the licensor is derived by multiplying the royalty rate (e.g. 8per cent) by the Net Sales figure. The licensee must ensure that it is permitted to deduct from gross sales the following categories: shipping charges; freight; taxes; credit for returns and for discounts and allowances. Licensors will typically seek to cap the total amount of deductions from Net Sales to a figure of no more than 10per cent or as high as 20per cent. This will be a point of negotiation.

Approvals: There is often tension between the licensor, who typically maintains final approval on all creative and product quality issues, and the licensee, who is often faced with tight production deadlines. One way to simplify the process is for the licensee to require that failure by the licensor to respond to requests for approval within a set time (e.g. 5 or 10 business days) shall be deemed approval.

IP Protection: Most licensees will require the licensor to own valid trademark registrations covering the licensed territories in any merchandising agreement. The licensee should obligate the licensor to protect the licensed marks by maintaining trademark registrations for the marks in connection with the licensed products at licensor's cost. Licensees should also resist any requirement that they bear the cost of enforcement of the licensed trademarks.

Edmund J. Ferdinand, III,
Partner with Grimes & Battersby, LLP, a leading U.S. law firm specializing in the law of intellectual property and licensing

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TERMINATION

This is perhaps the most important (and often overlooked) consideration for licensees. Licensees need the ability to terminate a license in the event the products are not successful. Otherwise, licensees can be stuck with marketing and sales obligations for an unpopular product for a period of years, with devastating consequences for the licensee's business. For this reason, ideally licensees will secure the right to terminate the license for any reason on written notice.

Post Termination Sell-Off Rights: In anticipation of the licensee being in possession of inventory following the expiration or termination of the agreement, the licensee should build in a right to sell any inventory on-hand for a set period of time. Six months typically represents the industry standard.

The provisions discussed above are only a small fraction of the terms to be considered in any licensing negotiation. In future columns we hope to continue this discussion and introduce other important considerations to both licensors and licensees. ©BL