



Trademark Licensing

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Quality Control: Controlling the Risks of Licensing

Trademark licensing always poses risks—the worst being the injuries that a licensee can inflict on the brand equity (and bottom-line) of a licensor through negligence in manufacturing or marketing its licensed products. As the owners of more big brands develop licensing programs (and for a number of reasons more big brands than ever are either licensing or trying to figure out how), avoiding those risks will become as important as structuring the best possible deal terms for royalties and guarantees.

Quality control limits the biggest risks posed by licensing, and no area of licensing is now receiving more attention. This column discusses the ways that licensors and their agents are working to avoid the risks of product liability—the injury that can hit a licensed brand closest to home—before entering into a license agreement.

A Little History

Not long ago, many brand-owners got into licensing for opportunistic reasons, with a focus on the revenue they could generate by sharing their trademarks with third-party licensees.

For a number of reasons, this opportunistic model of licensing has faded away. One reason is that licensing has become increasingly important to the brands themselves, and has become, like advertising or direct marketing, an integral part of brand management.

When licensing was viewed as a world unto itself (little more than a way to pick up some extra dollars on the side), it got little attention.

As brand managers and others have learned what licensing can do to affect the long-term value of their brands, so has their understanding that anything with the potential for great good also has the potential for great harm.

Due Diligence

Quality control begins for licensors and their agents long before they are negotiating a contract with a licensee. Licensors must conduct a full quality assessment on potential categories for licensing as well as potential licensees. Licensors need to develop quality standards for any product that they are prepared to license. In sensitive areas (product categories that present special issues of functionality or safety) they need to gather quality information from potential licensees, information regarding error and recall rates, warranty rates, rework-redo policies, recall policies, provisions for lot inspections, all the things that can provide a sense of comfort that the licensee has a record of high-quality work and procedures in place to keep it up.

Licensors should also do reference checking on quality-related issues with other licensors and retailers who have worked with their prospective licensees. Is the licensee good at producing consistent, high-quality products? How well does it handle returns and complaints? How diligently does it comply with the licensor's exercise of its approval rights in the product-development process?

If the products are likely to be manufactured overseas the licensor should perform some due diligence on a licensee's qualifications and strength in this area. How does the licensee qualify its products with its vendors? How do they

conduct inspections in foreign production facilities?

Contractual Quality-Related Provisions

The simplest way to avoid a risk is to get another party to assume it, and almost all license agreements impose minimum insurance requirements on licensees and require the licensee to indemnify the licensor for any obligations the licensor might incur in connection with the licensed product. Because indemnification provisions are only as valuable as the licensee assets underlying them, insurance provisions are getting increasing attention. Those insurance requirements have been rising. Many large trademark licensors now require \$5 to \$10 million of insurance, especially for products that could pose harm to consumers.

Other contractual provisions that address quality are clauses that specify the licensor's right to inspect manufacturing facilities; requirements that the licensee enter into approved agreements with any sub-contractors (who are also subject to the licensor's quality controls); and specific provisions that address consumer complaints and product recalls.

Termination provisions are often overlooked as an alternate way to address (and enforce) quality control issues. A typical license agreement grants the licensor the right to terminate the contract immediately in the case of certain events; in the case of other breaches, the licensee usually has the right to correct its mistakes within 30 days. When the licensed products pose genuine quality risks, the agreement includes the violation of its relevant quality provisions as grounds for immediate termination of the license. In such cases the licensee must understand that its mistakes (and the harm they inflict on the brand) cannot be cured.

In the end, even careful due diligence and thorough contractual protections cannot reimburse

