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THE MECHANICS OF MINIMUM GUA-RANTEES PART I - NEGOTIATION AND CONTRACT

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SUMMARY

The minimum guarantee is the most frequent deal breaker in brand licensing negotiations. While the licensee tries to minimize risk and future financial obligations, the licensor's intention is to secure as much of his (unsecure) future revenues from the deal as possible.

The following paper discusses the perspectives of both sides and proposes a number of tools how to deal with the different positions during negotiations.

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THE NATURE OF MINIMA

Unlike hit and done agreements with a fixed price, license agreements are by nature commercial lease contracts where the intensity of the use of the leased good (the brand) is uncertain at the time of the contract signature. The licensor does not know in advance the revenue he can expect from the license agreement, nor does the licensee know its future obligations he accepts when signing the contract. All depends finally on the licensed turnover which is usually an important issue in the form of “expected turnover” during contract negotiations. In this context, the licensee presents his “business case” including a projection of future revenues. The key question for both parties is: What will the future “actual turnover” be compared to the expected or estimated turnover at the time of negotiations.

It is common practice that a specific part of the expected turnover is defined as **guaranteed** or **minimum** turnover which is the basis for minimum royalty payments. The objective of the licensor is to secure or even collateralize as much future income as possible by minimum provisions in the agreement. The licensee however tries to minimize his future commitments in the form of minimum royalties, advances or penalties. From his perspective, such provisions are the most serious deal breakers. It is therefore vital to consider negotiation power and to develop win-win-situations for both sides.

Minimum guarantees are on one side very important to fix the long-term commitment of the licensee. In a way, guarantees are the price for exclusivity. On the other side however, minimum guarantees constitute a financial risk for the licensee, as he can not be certain whether he will achieve the sales levels required to cover the guarantee. Generally speaking, the minimum guarantee is the most frequent **deal breaker**. Therefore, in some cases it may help to "soften“ the minimum guarantee clauses by reducing uncertainty. There are a number of different approaches how to make future royalty payments more certain.

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In practice there are two different types of minima with different consequences. One is the **guaranteed minimum** which the licensee has to pay regardless of the licensed sales. The other is the **termination minimum** which has no financial consequences but allows the licensor to terminate the agreement in the event the licensee's sales do not reach that level. Both minima can be equal or differ. The following reflections concentrate on the guaranteed minimum.

THE TWO OPPOSITE POSITIONS

From empirical research we know that in an average situation of two experienced parties negotiating at eye level the royalties actually paid will be on average between 2 and 2,25 times the minimum guarantee that was originally fixed in the contract. This means that on average licensees deal well with the situation of negotiating minimum guarantees in a contract over a longer term.

The negotiation process usually begins with a submission of the turnover expected by the licensee. Minimum turnover and guaranteed royalties are later derived as a percentage of the expected turnover. This can vary significantly; in 50% of the cases the minimum is at 50% of expected, in 35% it is above 50% and in 15% it is below. On average, minimum is 55%-60% of expected.

Minimum in % of Expected Royalties	No. of Cases
< 50%	~ 15%
50%	~ 50%
> 50%	~ 35%

Source: EPM/TLL, Best Practices in Trademark Licensing

There are two different **negotiation** approaches to arrive at the guaranteed minimum:

- maximize the expected turnover and then accept a lower percentage as guarantee, or
- downsize the expected turnover to a level where the licensee feels safe and guarantees it at nearly 100%.

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Both approaches lead to similar results.

LICENSOR	LICENSEE
The Royalty Rate Optimizer	**The Cautious / Anxious**
The Guarantee Optimizer	**The Confident / Optimistic**

When it comes to numbers and money in a brand licensing negotiation, we distinguish four different types of negotiators.

On the licensor side, the **royalty rate optimizer** focuses on a high percentage royalty rate in the negotiation, while the **guarantee optimizer** cares much more about the total amount of money he can safely expect from the agreement (the minimum guarantee).

The **cautious/anxious** licensee type is risk-averse and fears commitments; he is not concerned about the percentage royalty rate (which is in his view just a matter of product calculation), but he fears the minimum commitments. On the other side, the **confident/optimistic** has no problems to commit to an ambitious sales plan including minimum guarantees. In turn, he tends to challenge on the percentage royalty rate, arguing that most of the expected success will be his own—and not the brand's—merit.

In principle, any constellation of different types can lead to a signed agreement. Negotiating with a party on the same level is generally speaking easier but often involves only one major issue (i.e. royalty rate or guarantee). Parties on different levels usually have more issues to solve, but at the same time have a larger tool box to apply.

TOOLS FOR NEGOTIATION

A number of different tools can be applied during negotiations, and a number of tactical issues need to be solved. The opening move (or the first bid) is always very important. There is no general rule which side should open the negotiation process. The opening party takes a cer-

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tain risk of under– or overpricing. On the other hand, a serious opening sets a certain corridor within which the final results will most likely be. Therefore, the opening party has a first mover advantage.

Below we discuss several **negotiation tools** for the minimum guarantee issue from the perspective of a licensor (they can be applied similarly from the perspective of a licensee with reversed signs). If the minimum guarantee offered by the licensee is too low and the licensor wants to increase it, he can do the following:

- Reduce territories or product areas which the licensee claimed for her business plan and minimum guarantee proposal.
- Require separate minima for each major territory.
- Detach the sales level required for a renewal option from minimum guarantees and increase renewal sales.
- Increase minimum figures, and in return allow for yearly minima to be credited against the total minimum over the contract term.
- Increase, and in exchange grant a one-time termination right (i.e. after year 2).
- Fix minimum guarantee only for contract years 1 and 2; after that, define a flexible minimum that is closer to the last actual (i.e. 90% of last actual)

This list is not exhaustive, the toolbox is indeed very large. As a general rule, it is important that both parties "give and take“, in other words don‘t stick to their maximum positions.

THE FLEXIBILISATION CLAUSE

If nothing helps, the **flexibilisation** of the minimum clause can make the breakthrough. Such flexible clauses could read:

- To be fixed at September 30th for the following calendar year upon

mutual agreement; minimum royalty for year t+1 shall be no less than (i.e.) 80% and no more than (i.e.) 120% of the actual royalty of year t; minimum royalty for year t+1 shall be no less than (i.e.) 80% of the actual royalty of year t-1.

Specifically interesting is the last sentence which limits the **downside risk** on consecutive years for the licensor.

The disadvantage of such clauses is that the total guarantee is not quantified which makes reporting, accounting and damage calculation more difficult or even impossible. But on the other side, there is also an upside potential of such flexible clauses: the actual minimum can be significantly higher than what the licensee would have allowed at the time of signing the contract. The advantages of both principles can be combined in a “the greater of …” clause, i.e.:

- Minimum year t+1 shall be the greater of royalties paid in year t ± x% or xxx.xxx € (amount fixed in the contract).

THE SECURITIZATION OF MINIMUM PAYMENTS

Another important issue for the licensor is how to secure future minimum payments, or in other words how to make future contractual commitments as safe as possible. A number of tools are available:

One is to fix the minimum over the whole **lifetime** of the contract instead of yearly or quarterly minima. This makes the collection of minimum royalties easier in case of an early termination of the agreement.

Another is to tie a contract **renewal** option to the (higher) expected turnover figures (instead of the minimum figures). This is a good resilience test for the wholeheartedness of the expected turnover.

Further, the licensor can secure payments by requiring a **letter of credit** from the bank of the licensee. Such letter of credit can be re-

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volving , covering the minimum payment of the next year or the next quarter. In exceptional cases, it can be a letter of credit to cover the minimum of the whole lifetime of the contract.

Many licensors have faced the situation that a licensee asks for early termination of the agreement, hoping to “save” some of the remaining minimum payments. To prevent this case, some licensors use a **penalty clause** saying that in the case of an early termination or a breach of contract the licensee has to pay the amount of the minimum royalty owed for the remainder of the contract term, plus additional damage claims.

Another instrument to make minimum payments more secure is the get them paid in advance through **advance payments**. In some regions it is usual to command an advance payment at the date of signing the agreement where the advance payment makes up for 25%-50% of the first year’s minimum. Such “entry payment” is to show the seriousness of the licensee.

Advance payments can also be used over the whole lifetime of the contract., i.e. in the form that each yearly or quarterly minimum payment is due in advance, at the beginning and not after the period.

While such advances certainly help the licensor to collect royalties early, they do not help the licensee. The appropriate timing of payments for the use of a brand is a key question. Firstly, the date of payment is much more important for the licensee who bears the total cash flow of the project (investment, working capital and expenses). The licensor himself has no cash issue at all. And secondly, the benefit of the leased good (brand) occurs only when the licensee realizes turnover in the marketplace. The logical timing for payments would be exactly that date. Insisting on advance payments can therefore grow into another deal breaker.

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A different instrument is a **lost upfront payment**. Such a payment is made only once with the signing of the contract and is not credited against future minimum royalties. It is the “purchase price” for the goodwill of the business. Such upfront payments are applicable 1) if the license is already established in the market, and/or 2) if the brand is really a top brand.

THE GROWTH OF THE MINIMUM OVER TIME

All exclusive and serious brand licenses include a **stipulation** concerning minimum or guaranteed sales and royalty payments over the term of the agreement. Fixing a guarantee for the next year is not too difficult. Fixing a guarantee for a term of five or ten years is however quite delicate for both sides and can break the deal.

The updating of the yearly guarantee into the future can be based on either the numbers in a dedicated **business plan** year by year, or—if a dedicated sales forecast beyond year 2 or 3 is too difficult—on general **rules of thumb**. Following the latter approach, the updating of the guarantee in year t+1 is based on the guarantee of year t as fixed in the contract, plus something on top of that depending on a defined growth scheme. As a result, the minimum guarantee is contractually fixed over the whole contract term. Here are some examples:

- Minimum of prior year, increased by constant percentage
- Minimum of prior year, increased by constant money amount
- Minimum of prior year, increased by growth of total factory sales of products in territory, as published by independent trade association or official government statistics.

This principle increases the uncertainty and risk the longer the lifetime of the contract.

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Another principle would be to break-up the increasing uncertainty, and to tie the minimum guarantee of year t+1 to the royalty actually paid in year t. This principle ensures that the minimum in each contract year will be "relatively“ close to actual sales levels, and therefore less risky. Such minimum guarantee clauses are often used for the second term of the contract:

- Royalties paid in prior year, increased by constant percentage
- Royalties paid in prior year, increased by constant money amount
- Royalties paid in prior year, increased by growth of total factory sales of products in territory, as published by independent trade association or official government statistics.

If nothing helps to find agreement on the minimum guarantee, one can still go back to the other basic economic terms including the royalty rate itself, the basis on which the royalty rate is applied, and the term of the agreement. A high minimum guarantee may lead on to concessions of the prevailing party with respect to the royalty rate or other.

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