

To: Dr. Jeanette Ball, Superintendent
Judson Independent School District

Rene Paschall, Board President
Board of Trustees of the Judson Independent School District

From: Winifred H. Dominguez, Attorney
Walsh Gallegos Treviño Russo & Kyle, P.C.

Re: Licensing Agreement Royalties and Board Questions

Date: October 3, 2019

During our recent conversation we discussed questions that had recently come up with regard to trademark licensing and the related royalties. You asked that I address the following:

- (1) review of your current License Agreement and advise the Board on any changes necessary to provide audit rights to the District on its collection of royalties for use of its trademark logos;
- (2) whether the District's requested royalty rate of 20% is within the range of the standard rates charged by others in the area; and
- (3) explain how royalty amounts are figured.

In order to answer your questions, I first reviewed your current Licensing Agreement (prepared several years ago by our firm). The Licensing Agreement provides for a percentage royalty to be charged to the license holder based on its net sales of merchandise bearing the licensed Judson logo. The "net sales" (net of taxes) was defined to include all sales to any source including "downstream" sales by distributors who purchase the products from the License holder and sell to ultimate retailers, as well as the sales by those retailers.

Since the current Licensing Agreement was drafted (a number of years ago) it was determined that this structure we were recommending for capturing revenue was broader than the industry standard definition of net sales. Under the current structure, the entity holding the license would pay a specified percentage of its sales on sales of the distributor to the stores it distributes to and the sales of those stores to the ultimate consumer. The more standard practice in the industry, for a number of reasons including the difficulty in tracking these downstream sales, is for the royalty to only be charged on first-tier of sales. Thus, if a local license holder sells directly to WalMart then the royalty would be charged based on his or her sales of merchandise to WalMart, but not sales by WalMart to the ultimate consumer. Similarly, if the license holder sells products with JISD's logo on them to a distributor who later distributes to WalMart and other retailers, a royalty will be owed based on the license holder's sales to that distributor but not the distributor's sales. This makes sense, since the distributor will likely have a larger order and will ultimately pass through the cost of his license to the entities distributing the products, effectively charging all or part of the license cost to them. As I recall, we made a change to at least one of JISD's contracts in the first year to reflect this, but we did not make the change unless it was requested by the licensee.

JISD's Licensing Agreement that was forwarded to me for review reflected this older "net sales" definition calling for the royalty percentage to be based on all downstream sales. This has been edited to reflect the more standard measure; which frankly, should be far easier for all parties to audit and will reflect what has, in all probability been followed by the parties, regardless of how the contract was written.

Industry Standards for Royalties on Athletic Wear and Branded Merchandize

Research regarding the standard royalty percentages revealed that the 20% royalty requested by JISD in its recent renewals is likely well above the industry average for use of high school logos on athletic wear and merchandize – even high schools and Districts like Judson, who have very successful football programs. While I found no industry information specifically addressing high school logo royalties, there was a great deal of information about college trademark royalties and those charged by pro-teams. Generally speaking, royalties for these teams range from 8% to 10%, with royalties above 10% being reserved for use of specific play-off logos or Super Bowl logos which are generally licensed in the 18% to 20% range. This led me to conclude that the 10% royalty being charged by the District prior to the increase, was probably closer to the industry standards expected by licensees. This may be why the District received some pushback when it increased the royalty to 20%. Returning the royalty back to the 10% level or even increasing it incrementally to 12% might be a more acceptable to the licensees.

Auditing Options

Your current Licensing Agreement does not include a specific provision allowing the District to audit the books and records of the Licensee to verify the sales on which the royalty percentage is based. I have a vague recollection of discussing this and deciding that the cost would probably outweigh any recovery, but I am not sure exactly why it was not included. I have added the following audit provision to the revised Licensing Agreement:

Books, Records and Audit Rights. The Licensee shall keep full and accurate books, source documents, records and accounts sufficient to substantiate all Net Sales, and the Judson shall have the right, through its representatives, and at all reasonable times upon no less than ten (10) business days' written notice to Licensee, to inspect and audit all such books and records as may be necessary to verify the reported Net Sales. All such books and records shall be made available to the Judson, upon the Judson's reasonable. For the purpose of verifying the Net Sales hereunder, or any other reasonable business purpose, the Judson reserves the right to audit the Licensee's books and records of receipts and charges at any time during the term of this Agreement, and any extensions thereof. If, as a result of such audit, it is established that the Licensee has understated its Net Sales by three percent (3%) or more of the amount reported to the Judson during the previous annual report period under this Agreement, all reasonable expenses of said audit shall be borne by the Licensee, and any additional Percentage Payments determined to be rightly due and owing by any audit, shall immediately be paid by the Licensee to the Judson, with interest thereon at a rate of ten percent (10%) per annum, from the original date the Percentage Payments became due.

Please feel free to contact me for additional information or with questions if you have them, regarding the information above.