Assessing Bargaining Strength

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How to assess important attributes of relative bargaining positions of parties in licensing negotiations

The essence of license negotiation, as in most forms of business negotiation, is the determination of relative bargaining positions (i.e. strengths and weaknesses) between licensee and licensor. Relative bargaining positions largely depend on the range of options, or alternatives, open to each party. This article highlights some of the important attributes associated with making bargaining strength assessments. This article also provides an illustration of how this knowledge can be used to narrow the range of possible royalty rate outcomes and therefore aid the negotiation process.

CONCEPTS

The topic of bargaining has, in recent years, received a good deal of attention among academic and applied business economists,[1] and among licensing professionals.[2] Applied business economists have used bargaining theory in various ways. For example, in the licensing of intangibles between a manufacturer in one country and a related distributor in another country, quantifying an arm's-length royalty rate is an important transfer price consideration for tax purposes. This is particularly true if one of the related entities is operating in the United States. The arm's-length standard dictates finding the range of royalty rate outcomes that could be reasonably expected as if the parties were not under common ownership.

The determination of the relevant "threat points" for the licensee and licensor is important in specifying an arm's length range in this scenario and other types of bargaining interactions. The process of identifying relevant "threat points" requires determining the highest net economic benefit that could be expected from the next best option available to the licensor and potential licensee. This involves determining for each party (a) what options are feasible, (b) what the expected level of net economic benefit would be with each option, focusing particularly on incremental revenue and costs, and (c) determining which option then provides the next best payoff putting aside the royalty negotiation under review.

Academic economists have expanded on the use of bargaining concepts in a variety of ways. For example, there have been papers examining how factors such as impatience, random risk of a negotiation "breakdown" and the availability (to each party) of various degrees of information about the other party's true bargaining strengths and weaknesses affect the outcome and efficiency of the bargaining process. These items help refine the basic usefulness of bargaining analysis which is illustrated in the following application.

BARGAINING: HYPOTHETICAL EXAMPLE
TRADE NAME EXAMPLE

LICENSOR	Option 1 Mfg. & Dist.	Option 2 License to sub.		Option 3 Purchase unbranded products from other mfg.
	(numbers are dollars per unit)			
Production costs	50	50		--
Incremental mark./distrib./admi8n.	15	0		--
Incremental Carrying cost of inventory	10	0		--
Royalty income	0	12	(a)	--
Sales price	100	70		--
Profit	**25**	**32**		
LICENSEE				
Sales	--	100		80
Cost of goods sold	--	70		60
Royalty expense		12	(a)	0
Operating (SGA) expense	–	15		15
Profit	**–**	**3**		**5**

(a) Assume as a starting point, for illustration purposes, an initial royalty of $12 per unit. Exhibit 2 depicts how the economic payoffs change when the royalty rates changes.

Exhibit 1

1. See, for example, an article by Michael Patton and Perry Quick ("Location Savings After Sundstrand v. Commissioner: Out of the Ballroom and into the Gameroom?," *Tax Management International Journal*, Vol. 20, No. 7).

2. For example, a recent article by Wes Anson ("Artful Negotiation of Licenses," *les Nouvelles*, December 1993) discusses the usefulness of the "BATNA" concept, or "The Best Alternative to a Negotiated Agreement," for each party to a licensing negotiation.

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BARGAINING RANGE

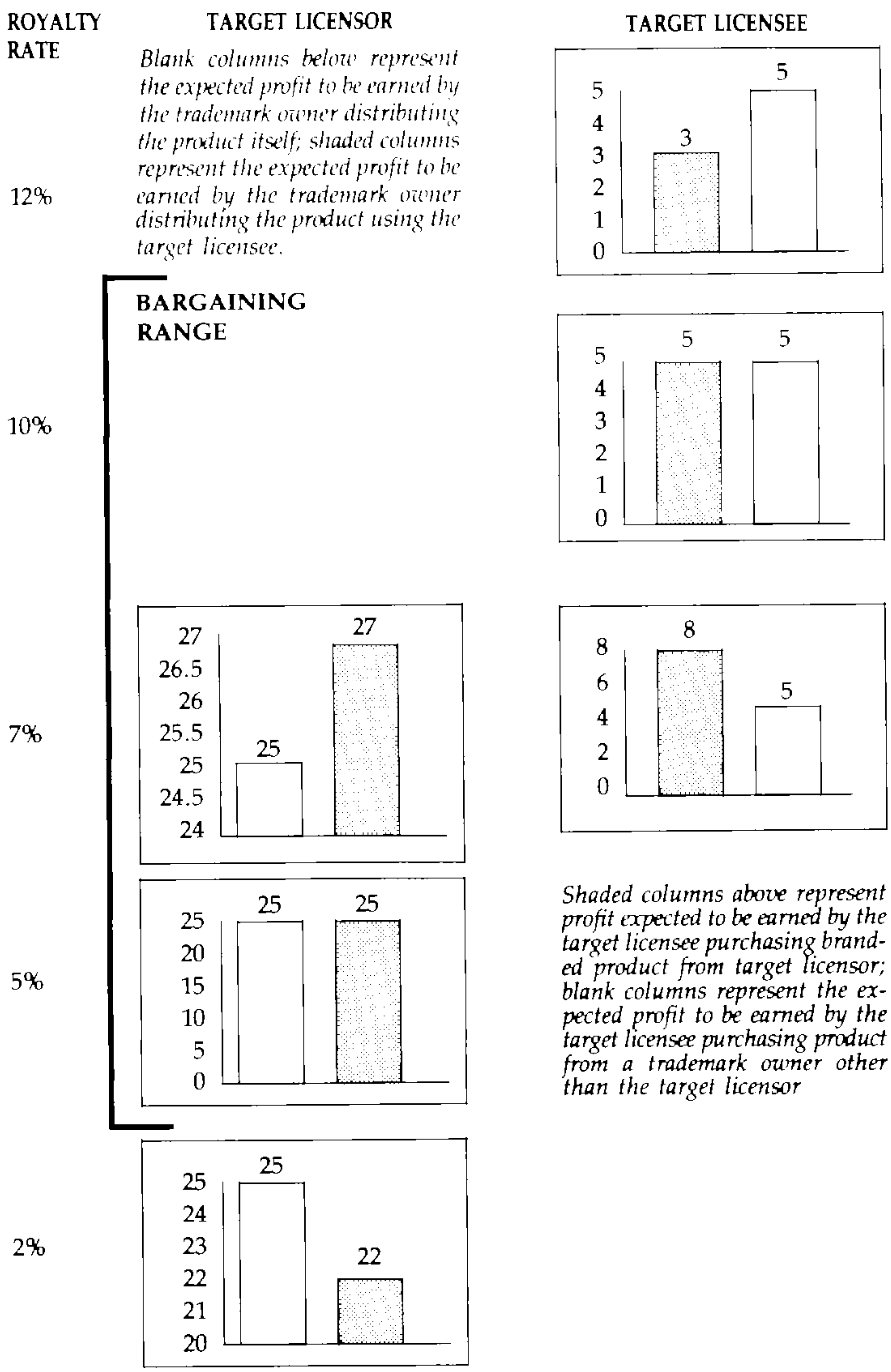

Exhibit 2

APPLICATIONS

Consider the following scenario. The owner, a U.S. corporation, of a fashion trademark wishes to expand its market into continental Europe. Assume its options are as follows:

Option 1

Manufacture product through the use of offshore contractors and use its U.S. marketing department to open accounts among selected European department store and retail outlets, thereby by passing the need for a foreign marketing/distribution subsidiary.

Option 2

Produce the product through the same offshore manufacturers but sell exclusively through an independent European wholesaler (referred to as the target licensee), whereby this entity would incur the direct marketing costs. In return for the use of the tradename, the wholesaler would then pay a royalty in addition to the purchase price for the purchase of the product.

The relative economic payoff to the licensor of these two alternatives is depicted in the top portion of Exhibit 1. Note that the options could be expanded to represent the payoffs available from using other distributors as well. To keep the application's simple, this scenario assumes that the option of the licensor undertaking the wholesale function itself provides the next most attractive payoff (i.e. "Option 1") should a licensing transaction with the target distributor not be consummated.

From the target distributor or licensee's perspective, assume the next best option available, should a licensing deal with the target licensor not be consummated, is to license a similar trademark from yet another branded manufacturer (i.e. "Option 3" is the next best alternative). The payoffs available to the target license for these two options are expressed in the bottom half of Exhibit 1.

With this information, the bargaining *range* is depicted in Exhibit 2. The payoffs (the shaded bars represent the expected payoffs from an agreement between the target licensor and target licensee) to both licensor and licensee are depicted, and rank ordered, for various royalty rate levels. Specifically, the lower end of the bargaining range is determined at the royalty rate whereby the economic payoff from (a) licensing to the target licensee versus (b) undertaking the wholesale function from the U.S., are equal. This is the licensor's threat point.

A lower royalty rate would mean a better payoff is available to the trademark owner by forgoing an arrangement with the target licensee. Similarly, the upper end of the range is determined when the alternative payoff to the licensee from distributing another brand equals the expected payoff from consummating the transaction with the target licensor. This is the target licensee's threat point. Hence, in this example, the bargaining range becomes 5-10% is derived (obviously if the relative expected payoffs were changed, the range could be smaller). Accordingly, this process generates narrower outcome boundaries for the negotiation process. The actual royalty rate negotiated should fall within this range.

EXTENSIONS

The assumptions of this illustration were simplified to facilitate the derivation of the bargaining range. In practice, other factors would likely be present. For example, there may be multiple alternatives available to each party that need to be identified, screened for business feasibility, estimates undertaken as to relative net economic benefits, and rankings made to determine the most attractive set of threat points. By way of example, typical feasibility constraints could include the following characteristics. Given the relatively closed nature of the Japanese economy, a U.S. manufacturer may not find it at all feasible to forego a Japanese presence and manage the distribution function itself.

Similarly, in certain consumer goods industries, the need for the manufacturer to have a European based distribution presence may be necessary (hence, eliminating the "do-it-yourself" alternative for the manufacturer) given the need to be "close to the market" in industries where demand changes are frequent. Evaluation of factors such as these are important in determining legitimate threat points.

SUMMARY

This article has sought to highlight the importance of knowing your, and your negotiation partner's relative bargaining power (and more specifically the relevant set of threat points) as a means of generating a more efficient negotiation process and appropriate range of royalty rates.