

Defining “Best Efforts” In Licensing: An Alternative Solution

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Every year of delay means a year’s loss at the end, which is the best part of the patent, if it should turn out to be successful, and cuts off the greatest harvests, if there be a future harvest at all.

—Judge Learned Hand

1. Introduction

Many studies have examined the possible reasons for two or more parties having strengths in disparate but complementary disciplines to come together to form a ‘cooperative exchange relationships’¹ or ‘open-ended sharing relationships.’² These studies have concluded that a reasonable hypothesis would be the desire of one party to garner the specialized skills of the other to derive increased return which he would not otherwise have achieved. Licensing is perhaps one of the most prevalent cooperative mechanisms practiced in the market place. Licensing involves a product belonging to a person or a corporation being produced, marketed, or maintained by another person or corporation. Although this coming together of different entities in cooperative ventures is undertaken to increase both the chances of success and the expected joint return, there always exist incentives for these entities to direct efforts to maximize their individual returns while undermining the joint returns. Since, both parties are aware that unless suitable harnessing and incentive³ mechanisms are in place, the other party would rather seek maximization of the individual return rather than the maximization of the joint return, they enter into a contract, such as a licensing contract, hoping to modulate the behavior of each party.

Under a contract, the participating entities vow to bring their unique expertise to the venture. This postulates that each participant is aware of his role and the role of other participants, and that the responsi-

bility of each party to the venture becomes common knowledge.⁴ Hence, it is rather ironic that despite the parties coming together willingly to pool their unique skills, the contract should identify the components of performance or non-performance or sub-optimal performance, and the concomitant remedies for the resultant loss if such behavior cannot be enforced. Herein lies a major issue. In a relational contract, identification of these components of performance and their treatment both by specifying standards and by stipulating remedies is by no means an easy task. This is due to the inherent ‘unpredictable’ nature of these components and the complicated inter-relationships among the components of relational contracts.⁵ Thus, we have the situation wherein the parties know, more or less, in advance the desired result and also probably possess the capability to achieve it but yet are handicapped in not being able to stipulate the actual steps to be taken by each to collectively achieve it. This is essentially because of the complexities, uncertainties and dynamics associated with most of the jobs;⁶ which in fact not only makes the identification and spelling out of the components of performance in a relational contract setting extremely difficult and cost intensive but also makes it dangerous to do so due to the high possibility of omission of some particulars. Yet, the parties’ desire to provide against the possibility of one of the entities working in a manner detrimental to the group’s interest compels them to incorporate, in the underlying contract, some controlling mechanism that can be used as a catch-all for any type of

1. Charles J. Goetz and Robert E. Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089, 1090 (1981).

2. Mark P. Gergen, Use of Open Terms in Contract, 92 Col. L. Rev. 997 (1992).

3. Harnessing will force an entity to avoid or indulge in an activity while incentives will entice the entity to avoid or indulge in that activity in order to achieve some stated goal.

4. The phrase ‘common knowledge’ has a special meaning in economics. Suppose that A and B are the two parties to the contract. Existence of common knowledge implies that A knows about B’s role and B knows about A’s role, A also knows that B knows A’s role while B also knows that A knows B’s role, etc.

5. We suggest that relational contracts are ‘unpredictable’ and not as ‘contingent’ in the classical sense because the possible alternatives are non-quantifiable, not in the sense that they are always numerous but in the sense that it may not be possible to identify them with certainty. See Goetz & Scott, supra note 1, at 1091.

6. Goetz and Scott explain this for a job as simple as the lawn care. Goetz & Scott, supra note 1, at 1092.

non-performance. One such controlling mechanism is the ‘best efforts’ clause that is typically found in many licensing contracts.

It is interesting to note that this best efforts clause is deliberately left as ambiguous as possible, perhaps to avoid any detailed explanation of efforts. Specifically, whenever there is under-par performance of a joint venture, this ambiguity of the best efforts clause has been used by the licensor as a versatile catch-all clause to question the efforts expended by the licensee⁷ and by the licensee as an escape route to shirk away from all responsibility in expending some efforts expected of her.⁸ Hence, because of its potential use or misuse, this ambiguity creates a lack of trust between the parties. The mistrust manifests itself in making the licensor apprehend that instead of ensuring the execution of various efforts at appropriate points of time, the vagueness of the best efforts clause may serve as an excuse for the licensee for not keeping up her end of the bargain. Similarly, the licensee may fear that instead of tempering the licensor’s expectations, the vagueness may encourage him to make unrealistic assumptions about the licensee’s efforts.

Hence, it is no wonder that the best efforts clause has been the subject of study by experts both as an inherent part of ‘relational contracts’ and in its independent status as an ‘open term,’ commonly employed in contracts.⁹ Since the relational contracts fall into a class of their own but possess some elements of contingent contracts, it defies definition in the strict legal sense.¹⁰ The state of existing literature on the subject of best efforts postulates that courts should ‘look to the likely intent of the parties or the goal the parties might reasonably be deemed to have sought’ and that the ‘optimal output definition of best efforts is the single most

plausible interpretation of the underlying economic motivations involved.’¹¹ Specifically, Goetz and Scott recommend that courts should adopt the joint profit maximization as the performance standard for evaluating best efforts litigation, in the absence of contrary agreement.¹² In order to achieve this goal what the licensing contracts typically do is to adopt the two pronged strategy of ‘reward and punish.’ Contracts provide suitable rewards or incentives to encourage the licensee to put in whatever efforts are required of her to achieve a stated goal and simultaneously stipulate the punishment that would be visited upon if the goal is not achieved.

In *Monumental Insurance*¹³ the plaintiff was asked to put in its best efforts so as to generate a minimum of certain number of additional members to an organization, failing which the plaintiff would be deprived of its commission. It is generally acknowledged that the adoption of best efforts clause with suitable incentive and bonding arrangements to regulate conduct is the optimal solution.¹⁴ A list of bonding arrangements including capital contributions, covenants not to compete, self-imposed ethical standards for agents, unilateral termination authorizations, performance bonds and liquidated damages provisions is suggested by Goetz & Scott.¹⁵

Defining one’s responsibility in terms of the maximum joint return is definitely objective and less ambiguous, but is beset with a lot of problems. From a pragmatic point of view, it is almost impossible to state what the maximum joint return should be, essentially because of the same reasons that plague the accurate definition of best efforts clause, namely, uncertainties and complexities. Even if one were to

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7. *Martin v. Monumental Life Ins. Co.*, 240 F.3d 223 (3rd Cir. 2001)

8. *In Re Cambridge Bio-tech Corp.*, 186 F.3d 1356, 51 U.S.P.Q.2d 1129 (Fed. Cir. 1999)

9. We are taking into consideration two papers that are a decade apart, but both of which underscore the fact that maximization of the parties’ joint return is the avowed objective. Charles J. Goetz and Robert E. Scott, *Principles of Relational Contracts*, 67 *Virginia Law Review* 1089 (1981) and Mark P. Gergen, *The Use of Open Terms in Contract*, 92 *Columbia Law Review* 997 (1992).

10. Goetz & Scott, *supra* note 1, at 1111—Notwithstanding the frequency with which such terms are observed empirically, the precise legal meaning to be attached to a best efforts requirement is not clear, either from a consideration of the case law or from theoretical discussions in standard legal scholarship.

11. Goetz & Scott, *supra* note 1, 1117.

12. This recommendation of Goetz & Scott is defended by Gergen, *supra* note 2, at 998, 1000.

13. See *Martin v. Monumental Life Ins. Co.*, 240 F.3d 223 (3rd Cir. 2001).

14. Goetz & Scott, *supra* note 1, at 1093.

15. Goetz & Scott, *supra* note 1, at 1131.

build an elaborate theoretical model to identify that critical value of the maximum joint return, the model will employ numerous parameters whose values are hard to obtain for a given situation.¹⁶ Further, markets are very dynamic and so a goal specified at one point of time look way off the mark as the venture proceeds to a different stage or period.¹⁷ This is especially true with new products. Noting that market dynamics imply outcome uncertainties, since the basic premise in not attempting to define the performance (i.e. efforts) parameters is the complexities and uncertainties involved, it is not clear whether by merely stating outcome the licensee would be able to fashion her actions to achieve it. There is another important problem with this approach. By looking only at the finishing line and not the hurdles presented along the race track, this approach forgoes the golden opportunity for any corrective action that could be taken. Not providing opportunities for such corrective action results in loss of economic efficiency, however skillful and experienced the licensee is. This is explained in detail later in this paper.

Thus, we are in a dilemma—on the one hand, while it is always advisable and less problematic (i.e. from a legal point of view) to specify the efforts to be undertaken, the complexities and uncertainties surrounding such specification makes the detailed spelling out of the best efforts very difficult, if not impossible. On the other hand, simply anchoring the definition of best efforts in terms of one final goal to be achieved, while appearing to be free of complications and more pragmatic, is impractical, misleading and likely to result in loss of efficiency in the economy. We propose an alternate method in this paper which incorporates the advantages of both the approaches—the efforts approach and the goals approach.

The paper is organized as follows. In Section 2, we look at how the best efforts clause has come to be widely used in the contracts. In Section 3, we show at what stage of their decision making process do courts face the problem in interpreting the obligations of the best efforts clause, and explain in detail the three factors that cause this difficulty. Here, we also show why the method proposed by Geoff and Scott cannot fully solve the problem. In Section 4, we present our proposed recommendation and show how this solves the problem. Finally, in Section 5 we conclude the paper with our remarks on directions on future research.

2. Best Efforts Clause: Evolution and Adoption

In this section we show how the best efforts clause has come to be used widely by contracting parties

in different types of agreements including licensing agreements. We will first trace the evolution of the concept of ‘best efforts.’ We then list out a sample of cases where the best efforts clause has been explicitly used. We also consider the cases where there is no explicit ‘best efforts’ obligation imposed in the contract but where the parties exhorted the court to find an implied best efforts obligation; some succeeded while others did not.

2.1 Evolution of the concept of ‘best efforts’

The basic premise of the law relating to contracts is *pacta sunt servanda*¹⁸ and the general policy is to uphold consensual transactions deferring to the wisdom of the contracting parties in arranging their mutual duties and obligations. The main purpose of contract law is the realization of reasonable expectations induced by promises.¹⁹ With contracts becoming a necessary adjunct of commercial market place, litigation involving such contracts also proliferated. Courts of law called upon to interpret contractual clauses encountered situations where the mere upholding of contracts in order to accommodate parties’ reasonable expectations or encouraging commerce would lead to wholly inequitable and unconscionable results. Therefore, over the years, a set of principles based on equity, that addressed these situations, have come to be established in Common Law and one such equitable doctrine that was devised by the courts is the ‘best efforts’ obligation.²⁰ The ‘best efforts’ clause came to be adopted in situations where parties sought to avoid obligations under contracts by labeling them ‘illusory.’²¹

In the context of Requirements and Output contracts, where parties agreed to exclusive dealing relationships, courts invoked the ‘best efforts’ doctrine. The adoption of this doctrine to construe the obligations of the promisor and promisee enabled

16. More detailed arguments are provided in Appendix 1.

17. For example, a prominent competitor may change his positioning strategies for which a reactive strategy would take a long time. In this case, expecting the same outcome may be fallible.

18. The maxim means that ‘agreements are to be observed.’

19. Arthur Linton Corbin, *Corbin on Contracts* § 1.

20. Good faith and fair dealing, best efforts, reasonable notice, unilateral mistake, mutual mistake, frustration and impracticability, fraud, misrepresentation, duress, undue influence, lack of capacity to contract are some of the few.

21. An illusory contract is one where one party has the right to terminate the contract at will and without notice to the other contracting party. Traditional contract law mandated that there be mutuality of obligation. The lack of mutuality vitiated the contract and although the transaction might have the makings of a contract, it was not really a contract but only an illusory contract.

the courts to make meaningful transactions out of seemingly unenforceable contracts. Interpretation of Requirements and Outputs contracts based on the best efforts principle came into the mainstream of contract theory and has been included in the Uniform Commercial Code. The Uniform Commercial Code stipulates that ‘a lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale.’²²

Lady Duff-Gordon²³ was a famous fashion designer whose endorsements of fabric and clothes meant commercial success to milliners. She granted an exclusive license to Wood to permit others in the clothing and fabric industry to place her name on their products signifying her endorsement. In return, Wood was obligated to pay Lady Duff-Gordon a percentage of the profits earned from those endorsements. Without reference to Wood and in breach of the exclusive license, Lady Duff-Gordon began licensing to others the right to permit similar endorsements. She did not pay Wood any portion of the profits that she derived through her other ventures. In response to Wood’s legal action, Lady Duff-Gordon alleged unenforceability of contract on the then valid ground of lack of mutuality of obligation. The contract did not specify that Wood had a duty to exploit the license. The court found an implicit obligation holding that a “promise may be lacking, and yet the whole writing may be ‘instinct with an obligation’ improperly expressed.”

Duff-Gordon was decided in 1917 and it involved a licensing transaction and the ‘best efforts’ principle had been invoked to satisfy the mutuality of obligations requirement for validity of contracts. Despite this, it is not very clear why licensing agreements drafted in the subsequent years did not uniformly impose a ‘best efforts’ obligation on licensees in the post Duff-Gordon era. We have many cases of contemporaneous contracts, some containing ‘best efforts’ obligation explicitly and others not containing it. We will now see some of them.

2.2 ‘Best efforts’ obligation in contracts

In the steelmaking industry, The Babcock & Wilcox Company agreed to “use its best efforts to exploit and license a continuous casting process covered by

the patent rights of the parties.”²⁴ Bolt Associates, inventor of a pneumatic acoustical repeater (used in marine seismic exploration), in a 1963 exclusive license agreement with Western Geophysical Company of America, imposed an obligation to “use its best efforts to promote worldwide licensing and use of the licensed apparatus” and founded its claim for termination of the exclusive license on breach of this obligation.²⁵ In the alcoholic beverage industry, a 1972 agreement for purchase of ‘brewing labels, trademarks, accounts receivables, distribution systems and other property’ by Falstaff Brewing Corporation from Ballantine & Sons obligated the purchaser to “use its best efforts to promote and maintain a high volume of sales” of the Ballantine brands.²⁶ In the motion picture industry, Arnold, owner of two motion pictures required Favorite Films Corp. the exclusive licensee to “use its best efforts diligently and in good faith to exploit the said photoplays and to obtain as wide a distribution thereof and as many exhibitions and bookings thereof as possible.”²⁷

In the publishing industry, Don Pendleton, an author, entered into an agreement in 1976 with Pinnacle Books, a publisher of mass-market and trade paperback books, that stipulated he would not offer rights in a series of books to be authored by him “to any other publisher until, after extending their best efforts, Pinnacle and Pendleton, were unable to agree on the terms of a new contract.”²⁸ In another case involving an agreement between a publisher and author, the publisher made an undertaking to use its best efforts in the promotion of the books.²⁹ The exclusive distributorship agreement in 1977 between manufacturer Polyglycoat Corporation and C.P.C. Distributors imposed a best efforts obligation on the distributor.³⁰ Even in the non-exclusive but authorized distributorship agreement between A.B.

22. U.C.C. § 2-306(2) (1992).

23. Wood v. Lady Duff-Gordon, 222 N.Y. 88 (1917).

24. Williams v. The Babcock and Wilcox Co., 262 F.2d 253, 255 (3rd Cir. 1959).

25. Western Geophysical Co. v. Bolt Associates, Inc., 173 USPQ 284 (D. Conn 1972) aff’d 584 F.2d 1164 (2nd Cir. 1978).

26. Bloor v. Falstaff Brewing Corporation, 454 F. Supp 258, 260 (S.D.N.Y. 1978) aff’d 601 F. 2d 609 (2nd Cir. 1979).

27. Arnold Productions, Inc., v. Favorite Films Corp. 176 F. Supp. 862, 863 (S.D.N.Y. 1959) aff’d 298 F.2d 540 (2nd Cir. 1962).

28. Pinnacle Books, Inc. v. Harlequin Enterprises Limited, 519 F. Supp. 118, 120 (S.D.N.Y. 1981).

29. Van Valkenburgh Nooger & Neville, Inc., v. Hayden Publishing Co., 330 N.Y.S.2d 329, 30 N.Y.2d 43 (1972).

30. Polyglycoat Corporation v. C.P.C. Distributors, Inc. 534 F. Supp 200 (S.D.N.Y. 1982).

Chance Company and Fasteel there was a best efforts clause.³¹ A 1989 cross-licensing agreement between Pasteur Sanofi Diagnostics and Cambridge Biotech Corporation stipulated a best efforts obligation on Pasteur to reclaim exclusive sublicense granted by it to another company.³² An employment agreement required the employee to “devote his full time and best efforts towards furthering the interest of Employer.”³³ An insurance company included the best efforts obligation in its contract with its underwriter.³⁴ An exclusive license to Walt Disney to market and promote Marsupilami, a cartoon character, contained a best efforts clause.³⁵

There have been numerous cases where the contracts in question did not contain a best efforts obligation. A 1964 contract between the owner of an automobile anti-skid braking device and manufacturer provided that the manufacturer “in its absolute discretion shall determine the method of manufacturing, exploiting and marketing the product.”³⁶ The court concluded that “clearly implied in the contract is the intention of that Singer would use its best efforts to perfect and market the product.”³⁷ Singer was required to “incur direct and indirect costs of at least \$100,000 for marketing, promoting and advertising the device during every calendar year after January 1, 1966, but was silent about his obligations prior to that period. The court construed the contract to impose an obligation on the manufacturer ‘to use its best efforts to manufacture and market the product.’ Permanence Corp., granted an exclusive license, subject to a pre-existing nonexclusive license, to patents relating to a process for forming an alloy to Kennametal.³⁸ The licensor was paid an up-front fee and an advance on royalties by the licensee. The licensor sued alleging breach of the implied obligation to use best efforts. The courts refused to read best efforts obligation in the contract. Similarly, Emerson Radio granted to

Orion a three-year exclusive license to utilize and exploit the Emerson trademark in the manufacture, sale, marketing and distribution of video and television products to Wal-mart in exchange for a minimum royalty payment.³⁹ Emerson sued when Wal-mart sales of its goods markedly declined during the license period. The appeals court refused to read any implied obligation to make reasonable efforts to exploit the license because the minimum royalty provision in the agreement protected the licensor against the risk that the licensee would not exploit the trademark.

The snapshot of the decisions listed above shows that the use of the best efforts clause is not limited to licensing contracts, but is incorporated in employment contracts, underwriting contracts, distributorship contracts, and even marketing agreements. It only goes to emphasize the fact that its use in a wide variety of contracts underscores the need to crystallize the meaning of the term and try to make its interpretation more predictable. When we set out to consider the cases where best efforts obligation was sought to be fastened on the defaulting party, we find cases where the underlying contract contained the best efforts clause and those that did not. Even among the former category of cases, there are cases where the actions of the obligor warranted a finding of satisfactory performance and others where the actions amounted to a breach of the obligation. In the latter category of cases, there are cases where the courts refused to find an implied best efforts obligation and those where such an obligation was implied in law and the actions of the obligor were evaluated against that standard.

3. Best Efforts Obligation: Analysis by Courts

Having shown that the best efforts clause is widely adopted in contracts, we now analyze how the courts have interpreted the ‘best efforts’ clause in different situations and the parameters that they have considered to evaluate performance that satisfies or falls short of that standard. The principles of Common Law dictate that courts should strive to achieve uniformity when possible and so there should be a common thread among all these decisions. The identification of this common thread should help us to predict how the existence or otherwise of specific clauses in a licensing agreement or specific fact in

31. *Ruiz v. A.B. Chance Co.*, 234 F.3d 654, 57 U.S.P.Q.2D (Fed. Cir. 2000).

32. *In Re Cambridge Bio-tech Corp.*, 186 F.3d 1356, 51 U.S.P.Q.2d 1129 (Fed. Cir. 1999).

33. *EEOC v. R.J. Gallagher Co.*, 181 F.3d 645 (5th Cir. 1999).

34. *Martin v. Monumental Life Ins. Co.*, 240 F.3d 223 (3rd Cir. 2001).

35. *Marsu v. The Walt Disney Co.*, 185 F.3d 932 (9th Cir. 1999).

36. *Perma Research & Development Co. v. Singer Company*, 308 F. Supp. 743, 747 (S.D.N.Y. 1970).

37. *Perma Research & Development Co., v. Singer Co.*, 402 F. Supp. 881, 896 (S.D.N.Y. 1975).

38. *Permanence Corp. v. Kennametal, Inc.*, 908 F. 2d 98 (6th Cir. 1990).

39. *Emerson Radio Corp. v. Orion Sales, Inc.*, 253 F. 3d 159 (3rd Cir. 2001).

the underlying transaction would lead courts of law to decide cases.

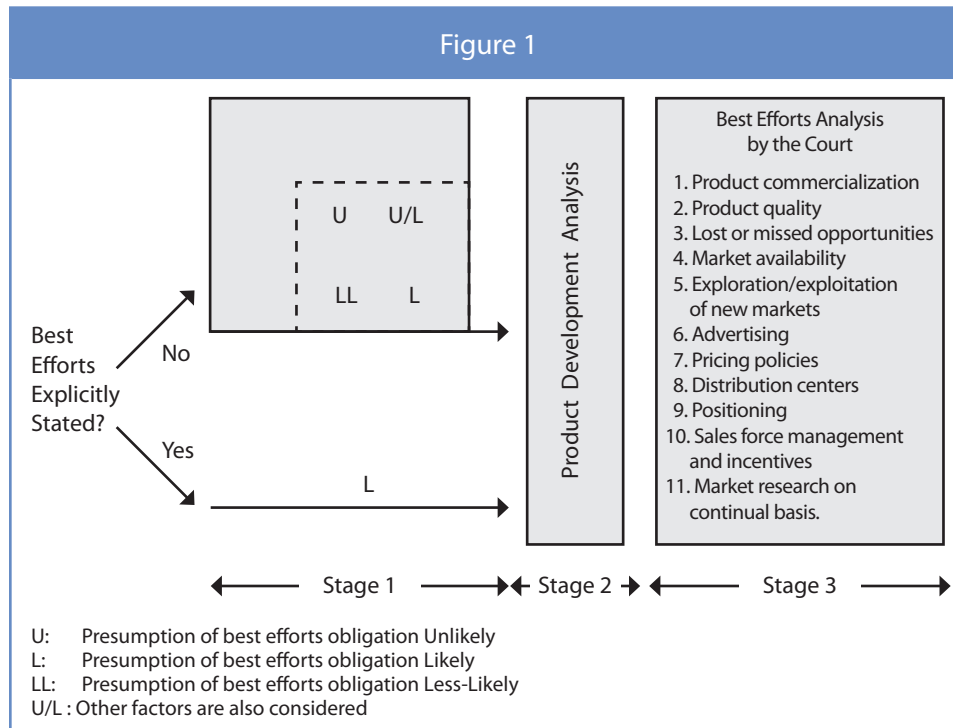
3.1 Three-stage decision making process by courts

In litigation involving aborted or mired licensing ventures, courts of law called upon to decide the thorny issue of “discharge of best efforts obligation” are seen to undertake a three-stage decision making process. In Figure 1, we provide the three stages.

licensing situation coupled with no advance royalty payment by the licensee to the licensor seem to be a classic case where best efforts obligation is likely to be implied by the courts. A non-exclusive licensee who has made an advance royalty payment and an exclusive licensee who has made advance royalty payment⁴¹ seem to be the less likely candidates for imposition of implied best efforts obligation. If the

case involves an exclusive licensee who has obtained the license after making an advance royalty payment, though is seemingly less likely to be fastened with an implied best efforts obligation, courts examine additional factors. At the end of the Stage 1 inquiry courts conclude whether the licensee is obligated to put in best efforts or not.

Stage 2 is a product centric inquiry. After deciding whether there is a subsisting best efforts obligation the courts take up for consideration the



Stage 1 involves the examination of the recitals in the underlying license agreement to decide the question whether a best efforts obligation is contractually mandated or should be implied in law. Even in cases where the best efforts obligation is explicitly stipulated, instead of embarking on the quantum and quality of efforts expended by the licensee, the courts inquire to find out whether the facts warrant evaluation of licensee’s performance against the exacting best efforts standard.⁴⁰ When the license agreement does not specify an express best efforts obligation but the licensor exhorts the court to imply a best efforts obligation and impose the standard on the licensee, the court evaluates the claim. The two major factors that are considered are the type of license (exclusive or non-exclusive) and advance royalty (payment or non-payment). An exclusive

stage of development that the product has reached. This analysis is required to enable the court to decide whether the licensee was required to expend full-blown marketing efforts to commercialize the product. The inquiry is to find out if the licensed product had achieved commercial feasibility at the time of license or whether it was just a prototype. In licenses involving products that have not reached either technical perfection or commercial feasibility, factors such as collaboration by the licensee with the licensor to fine tune the product, research and development efforts, and attempts to devise solutions to solve problems hampering the product development are all considered. At the end of Stage 2 the

40. *Western Geophysical Co. v. Bolt Associates, Inc.*, 173 USPQ 284 (D. Conn 1972) aff’d 584 F.2d 1164 (2nd Cir. 1978).

41. In reality, given the mechanics of a licensing situation, although it is highly unlikely for a licensee to make an advance royalty payment in return for a non-exclusive license, it is possible. We believe that these situations are likely when licensor grants non-exclusive licenses to multiple licensees for different geographical areas and the product has a proven track record.

courts conclude whether the product was worthy of market introduction and whether the licensee should have put in marketing efforts to commercialize the product.

Stage 3 analyzes the actions of the licensee in marketing the product. Here the stress is more on the efforts put in by the licensee, the results that have been produced and the reasonable expectations of the licensor. The different factors that have been considered by various courts include—efforts towards product commercialization, maintaining or improving product quality, lost or missed opportunities, market availability, exploration of new markets, advertising, pricing policies, distribution, positioning, sales force management and market research. This is the final stage of the inquiry which decides the culpability or otherwise of the licensee.

Thus, in Stage 1 of the decision making process, the focus is on the terms and conditions in the contract, and in Stage 2 the focus is on the technical matters of the product per se, and in Stage 3 the focus is on the marketing aspects of the product commercialization. An analysis of the decisions of the courts reveals that they have very clear road signs for deciding issues relating to Stage 1 and 2. However, when it comes to Stage 3, it appears that they are beset with difficulties. Let us now discuss why.

In Stage 1, the questions before the court are capable of easy verification and resolution. In Stage 2, there are mainly three reasons why the decision making is rather straight-forward. First, the factors involved are such that there is absolute correlation between the technical efforts put in by the licensee (and the licensor) and the effect of those efforts. This absolute correlation makes it easy for a court to map the efforts on to the results and isolate those efforts that were necessary but not forthcoming from the licensee. Secondly, the licensee, either individually or in active collaboration with the licensor, expends efforts directly on the product and the results also manifest on the product itself, which result is easy to verify. Thirdly, there are only two entities involved in the process and their efforts are directed towards either the product itself or the surrounding technology on which the product or its feature is based. The effectiveness or otherwise of each effort is also easily reviewable and the licensor or the licensee who receives the feedback from such reviews is in a position to effectively communicate with the other. On matters relating to the licensed product, invariably, both the licensor and licensee are operating in an area of individual competence and

so the scope for miscommunication and suspicion is highly reduced.⁴²

Unlike Stages 1 and 2, the Stage 3 factors are made complicated by the nature of the environment in which they operate. Here, the licensee's efforts are expended not directly on the product but on the targeted market, and hence the effect of these measures does not materialize on the product but is reflected in the speed with which the market adopts the product and/or in the size of the market which the product penetrates or captures. Thus, a third entity, i.e. the market, is the focus of these efforts. By nature, market is for a large part, characterized by many uncertainties and influenced by many factors some of which are actually licensee's marketing efforts while others happen from outside the realm of the licensee's and licensor's control.⁴³ Hence, there is naturally a lack of perfect correlation (i.e. causation) between what one might observe as the licensee's marketing efforts and what he might see as outcomes in the marketplace. There is another issue pertaining to Stage 3 that has largely been overlooked in the previous research. It is the possibility that the product under focus might per se be an unsuccessful product in the market, not due to the lack of best efforts one puts in, the product failing to capture a significant market share.⁴⁴ We call this the P-factor. The complex interaction between factors, uncertainty and the P-Factor make it difficult to claim that a certain outcome in a market place is due to the licensee's efforts or the lack of it. Since this is the main focus on our research, we will see this (i.e. the marketing issues) in detail in the next section.

3.2 Marketing issues (pertaining to Stage 3)

As mentioned earlier, marketing process of the product is the focal point of Stage 3 inquiry by the courts undertaking the best efforts obligation analysis. A marketing process is, put simply, making the target customer buy the product. This needs various

42. This assertion is made because in the case of an under developed or not fully developed product licensing, the licensor will be particular that he licenses the product to such licensees who are capable of understanding the problems or deficiencies of the product and who have the capability to address such issues in addition to having the competence to successfully market the product.

43. More of this is explained shortly in next section.

44. There are scores of marketing cases that have recorded the failure histories of many products that failed despite the fact that the marketing research had predicted success and the company had put in its best marketing efforts.

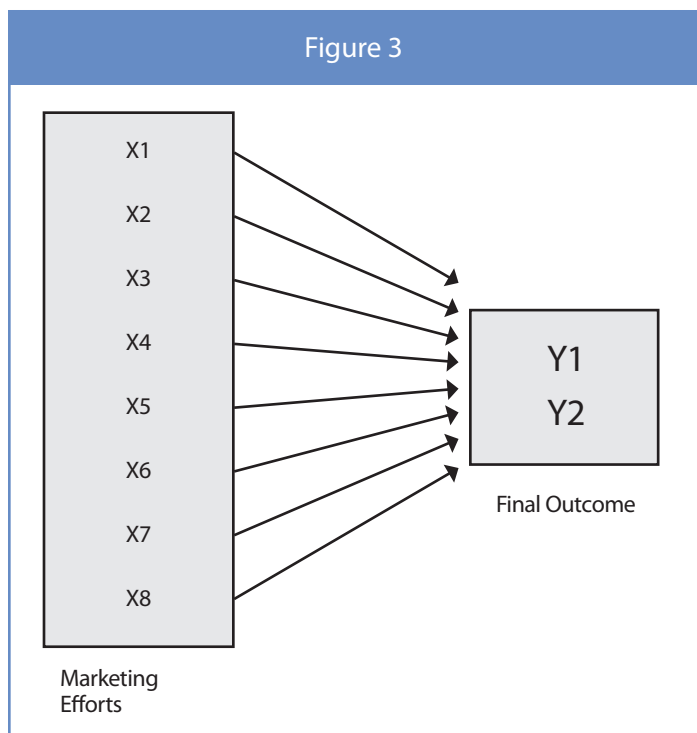
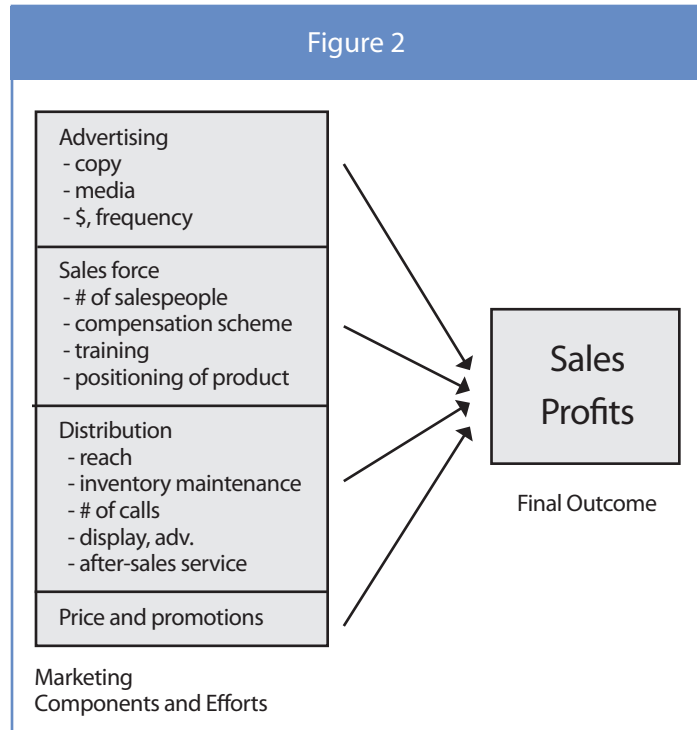
kinds of marketing efforts. All the marketing efforts we normally witness in a market can be classified under one or more of the four components that the marketers typically make use of to influence the purchase decision of the consumer. These components are advertising, sales force management, distribution and price.⁴⁵ The advertising component includes those efforts that seek to create awareness in a consumer about the product and inform her about the product's usefulness (ex: media advertising or direct advertising through salespersons calls), the sales force management component includes those efforts that go to convince her on the product's usefulness⁴⁶ and helps her choose the product type that is appropriate to her needs, the distribution component includes those efforts that make the product available at a convenient place, time and in proper form for her to purchase, and the price component include those efforts that seek to ensure that she gets the value worthy of the money that she is about to part with to acquire the product.⁴⁷ Stated in simple terms, advertising can be equated to awareness, sales-force to convincing, distribution to availability, and price to value.

A more detailed picture of what efforts constitute these four components is given in Figure 2. For example, advertising consists of marketing efforts that generate a good copy of the message to be told to the consumer, efforts that select a good media to reach that consumer and efforts that ensure sufficient frequency of delivery of the advertisement to repeatedly reach that consumer. We have provided in Figure 2 some of the key efforts that constitute each of the four components.

All these efforts will affect the purchasing decision of each individual consumer and thus the overall sales from the market and thereby the eventual profits to the venture. In Figure 3, which is the same as Figure 2,

we have used X1, X2, etc. to represent the various marketing components and efforts, and used Y1 and Y2 to represent the outcome. Thus, X's affect Y's.

Complexities and Marketing Models: Marketing scholars have been successful in not only identifying



45. There may be more components but for demonstration purposes we focus here on four main factors.

46. For matured product categories such as grocery goods, the use of sales force is not necessary.

47. Detailed explanations are provided in Appendix 2.

“Best Efforts” In Licensing

these efforts (i.e. X's) but also in finding out to what degree each of these X's affects the sales (individually and in combination with others) and how to model those impacts.⁴⁸ For example, by using choice models such as Logit⁴⁹ and analyzing the yogurt purchase data⁵⁰ over a span of 3 to 4 years, researchers are able to get good estimates of how in-store display, advertising, price, etc. affect a consumer's purchasing behavior. These models can be found in some of the academic marketing journals, or obtained from market research companies or consultants or marketing professors in various schools.

However, as feared by Geotz and Scott, the efforts do interact with each other in influencing the final purchasing decision. For example, a higher advertising expenditure spent on convincing the customer may enable a company to charge a higher price. Or, a faster delivery may enable the company charge a higher price. However, these interactions or complexities can also be captured using such models. So, with respect to any product, it is possible to develop a good model that captures in a simple but robust mathematical set of equations the rationale behind the underlying purchasing process and determine how X's affect Y's. To use such a model for prediction (ex: what would happen to Y if we increase X1 by 10 percent) and control purposes (ex: how X's are to be manipulated to achieve a certain Y) we need to evaluate the parameters of the model. This can be

done statistically by estimating these models using previous data or through experiments or through a combination of both. The point we make here is that there is an objective way of tying the key marketing components to the key outcomes.

Thus, given a set of marketing efforts, it is possible to use a well-proven model and predict objectively what outcome (i.e. sales) is very likely to result from that set of efforts. Although there will be a margin of error, both the licensor and the licensee can be expected to agree on a specific “efforts \neq outcome” relationship model (i.e. $X \neq Y$) and thus on the outcome suggested by the model, perhaps with some degree of reservation.⁵¹

Uncertainties: However convincing a model is, both to the licensor and the licensee, the outcome such as sales depends not only on what the company does but also on what the competitor does, what happens to the whole industry and what happens to the economy as such. We cannot control those factors but can modulate our behavior to minimize their effect on the outcome since they do affect the outcomes. See Figure 4. They are denoted by U1, U2 and U3.

If the company could predict them, say by analyzing prior competitive behavior or by analyzing the economic conditions in detail, we can include them in the marketing model and still predict or control the outcome by manipulating X's.⁵² In reality it is

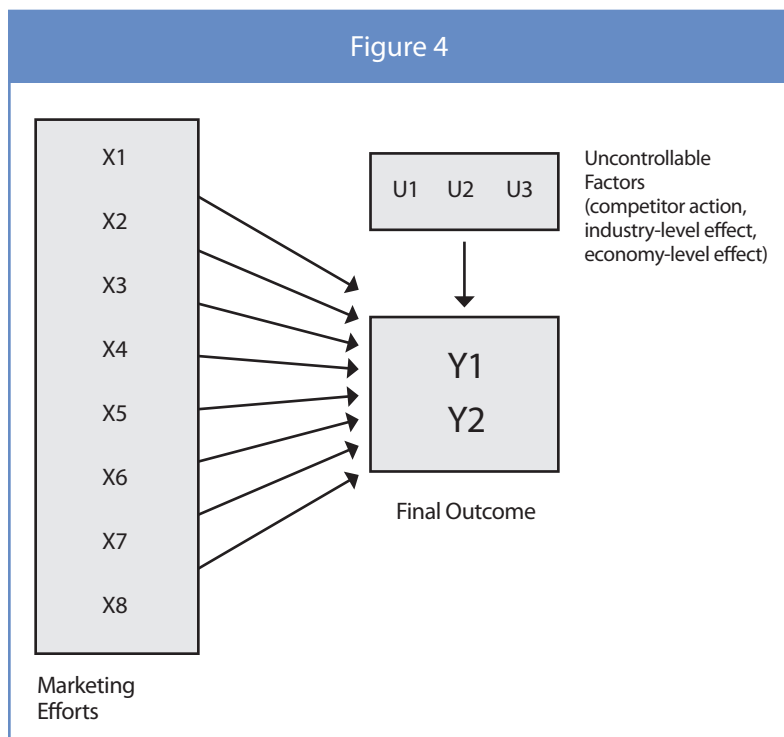
48. An example of a simple model is $Y1 = b0 + b1 X$, where X is the effort and Y is the outcome, and b0 and b1 are called parameters of the model. Knowing b0 and b1, we can get Y for a given X.

49. If X represents the row vector of efforts and B the corresponding column vector of coefficients, then the Logit model says that market share of a product in a given week is $\frac{\exp(XB)}{1 + \exp(XB)}$. Although the model looks simple, it is a very powerful model. McFadden, a statistics professor at UCLA, showed the rationale behind the Logit model and he was awarded Nobel Prize for economics in 1998 for this derivation and other contributions.

50. Data collected through scanning machines in the retail stores and from certain panel members can be readily bought from companies such as AC Nielsen and IRI.

51. Note that although no model is 100% accurate, as long as the proposed model is plausible, accounts for the key marketing factors, is able to predict with reasonable accuracy and is acceptable to both the parties, both the parties would be better off if they use the model and specify the expected or ideal outcome in the contract, instead of the efforts.

Figure 4



difficult to predict them. So, companies wait out and react to these uncertainties as they unfold. How timely and in what manner the company reacts to such uncertainties depends directly on the experience of the company in the industry. This is because not every uncertainty can be treated in the same manner. For example, if the competitor decides to permanently cut the price in order to arrest the growth of the focal product, the reaction—whether to follow the competitor or stay put or do something else—cannot be taken instantaneously. The implications of each possible reaction have to be studied in detail and this implies understanding of the competitor’s motives, cost structure, etc. To take another example, if the competitor suddenly changes its copy ad, it would mean that he is changing the manner his product is being perceived in the market place. This will have serious and long term implications for the focal product. Reactions to such long-term strategic moves have to be another long term strategic action and this will take a lot of patience and a careful study. Similarly, reactions to economic or industry-wide downturn cannot be carried out overnight but have to be done carefully after due deliberation. Because of the availability of so many alternatives and because of the need to understand so many factors and the need to make many judicious assumptions in each situation, how to react to those uncertainties as they unfold cannot be put in writing right in the beginning. The licensor has to rely on the experience, gut feel, diagnostic and analytical abilities of the licensee. He cannot avoid asking her in simple terms to put in her best efforts. What best efforts these would be are licensee’s

decision but these best efforts will be in terms of, again, the same X’s since these are the only variables that the licensee has in order to control the outcome. See Figure 5.

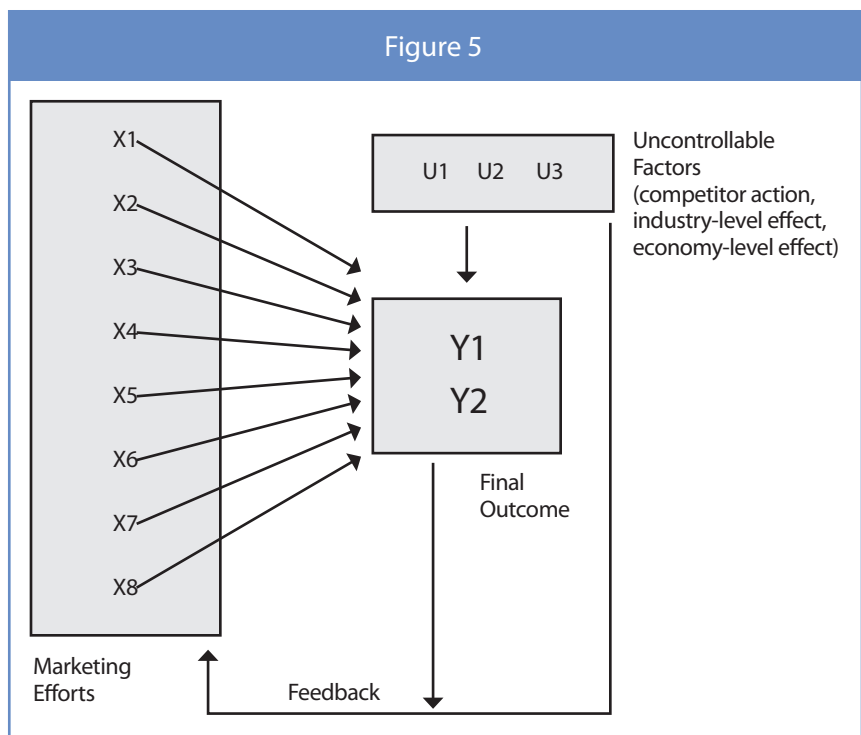
P-factor: The third issue that has largely been ignored in the licensing area has to do with the probability of product failure in a given marketplace. In such a case, no matter what efforts one puts in, the product will fail in the marketplace. One may be able to ‘test market’ or do a lab-experiment to find out if the product would get accepted in the market⁵³ or the licensee, with her wealth of experience, would be able to tell whether the focal product would succeed or not, but in spite of all these, new products may simply fail to get into the good books of the customer.⁵⁴ In the case of established products, their quality may deteriorate over time due to poor management or change in management, or the management may fail to see the market dynamics, thus letting the products become obsolete, etc. It is suffice to say that there is always a high probability that the product per se could fail in the marketplace in spite of a good dose of marketing efforts to back it up (X’s) or without the intervention of uncertain (U’s) negative forces. We call this inherent poor nature of the product the P-factor. Obviously, the licensee cannot be blamed in such situations.

Thus, we have three seemingly uncompromising

52. Sometimes, companies guess not one set of values for those U’s but three or four sets and chart out different scenarios and take action accordingly.

53. Test market is very expensive and will slow down the marketing of the product. Lab experiment has to be done very carefully in order to closely simulate the actual market situation in the lab and hence needs help from market research companies or consultants.

54. Refer to the two key reasons discussed in the Introduction section for a high failure rate of new products.



results. First, with respect to complexities (among components of marketing), we said that it is possible to develop a framework that links the different efforts associated with the marketing components and their interactions to the outcomes and shows how one can use the efforts to achieve certain outcome. From this angle, it is better to specify in the licensing contract the desired final outcome and leave out the efforts clause altogether. Second, with regard to uncertainties (such as competitor behavior, economy and industry condition), we argued that it is not possible to put in writing the ways to handle them. From this angle, it is better to simply ask the licensee to put in her best efforts to overcome or accommodate the uncertainties as they unfold. Third, with respect to P-factor, we claimed that there are product related factors that could lead to product failure in the marketplace but for which the licensee cannot be held accountable. The main point to note is that the final outcome of the interaction of these three factors is just one, and we cannot, for the most part, disentangle these three causes without doubts and concerns.⁵⁵ Hence, it is almost impossible to use the Geoff and Scott’s recommendation to craft a licensing contract.

We introduce a new type of outcome, what we call as intermediate outcome, hitherto unexplored in the licensing arena, that we show solves this problem.

4. Intermediate Outcomes: An Alternate Solution

We have previously noted that the outcome is affected by the complexities (of marketing components), uncertainties and P-factor and that the licensee can use the marketing efforts alone to control that outcome. The complexities, as we noted earlier, are amenable to solution through specific models. Although the licensee, to some extent, could be able to accommodate the uncertainties by adjusting

55. The inseparability of the three causes (efforts, uncertainty and the P-Factor) will be a bigger trouble if the product concerned is new to the market. A new product, that is not proven yet, is obviously difficult to defend by the licensor. Even if the consumers like the product, there is another issue here: consumer’s uncertainty on when to adopt. Many new products do not take off immediately, rather follow a slow diffusion pattern wherein sales grow gradually initially and then rapidly before tapering off. Understanding the diffusion process and how price, advertising and distribution affect that process is not a straight forward job. Hence, it is more difficult to untangle the three causes (exerted efforts, uncertainties and P-factor) from the series of outcomes. More details on this can be seen in the paper by Krishnan and Santhanam.

his marketing efforts, but with respect to P-factor, he is helpless. When one can model the causal link between X’s (exerted efforts) and Y (the outcome), there is a set of intermediate outcomes that takes place between the two. These outcomes however are not readily observable in the marketplace and are usually silent. For example, advertising copy’s⁵⁶ main goal is to create a perception in the consumer’s mind on why she should consider purchasing this product. This is called positioning. This positioning, if carried out to the exact precision as dictated by the design of the product, will result in desired sales if every other piece of the puzzle (i.e. distribution, sales force management and pricing) is in place. Thus advertising copy is the exerted effort, X, and the eventual sales is the outcome, Y, which we are usually worried about. However, in between the two we have something called positioning. We call this intermediate outcome, denoted by Z. In essence what we have is $X \rightarrow Z \rightarrow Y$.

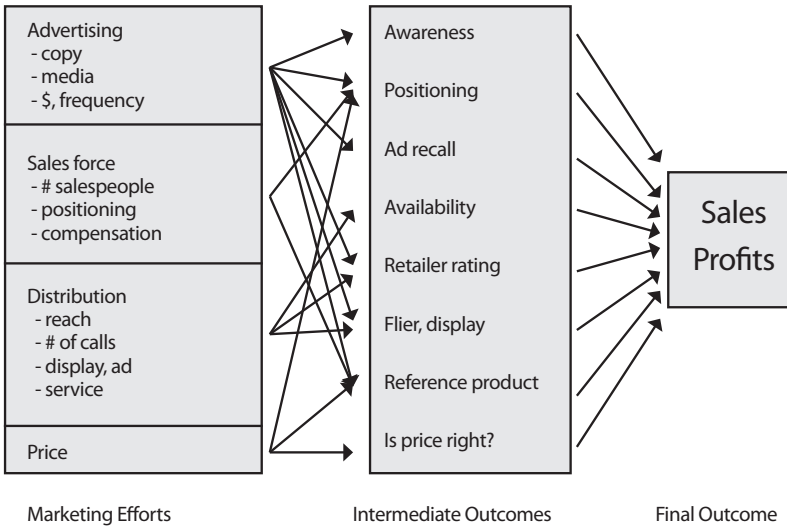
Given this process sequence, instead of looking at the sales (Y) alone, we suggest that we should mainly check whether the desired positioning (Z) has in fact been created by the ad copy (X). This can be done by developing what is called a perceptual map which tells us how the consumer actually perceives the focal product with respect to the other products that she regards as more or less equal in the basic utilities they provide. But a main problem with this perceptual map outcome is that it is not easily obtainable, while the final outcomes such as sales are. To get a perceptual map from a potential customer we need to prepare a questionnaire, ask the consumer to respond to those questions, do some statistical analysis on the responses and use statistical software to get that map. It is doable albeit through some involved process. Similarly, the impact of repeated advertising (X) can be tested using an intermediate outcome called ‘ad recall’ (Z), which basically finds out from the consumers how rapidly they are able to recall seeing the ad for this product. Again, this is doable but needs some involved consumer research. In Figure 6 we have given a set of intermediate outcomes that can be measured by doing consumer research.

4.1 Need for intermediate outcomes

We will see how measuring Z is useful in delineating the impact of U’s from that of X’s, and in

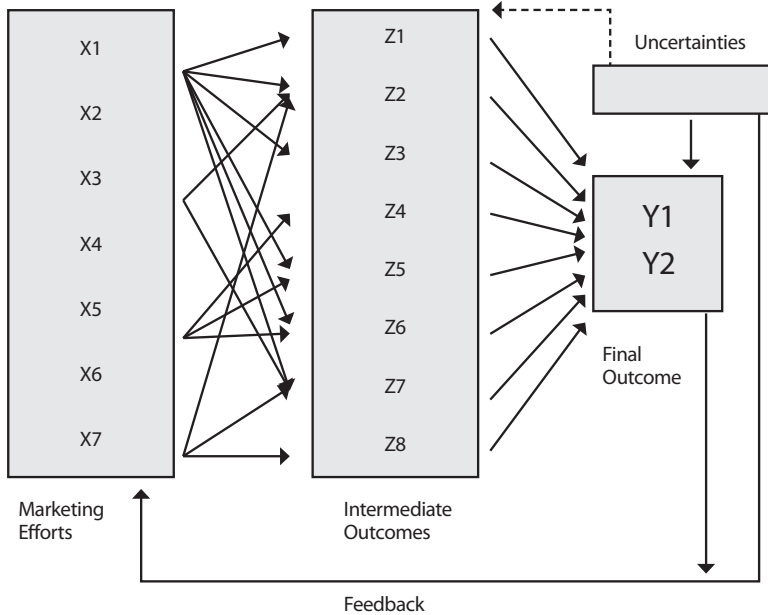
56. Advertising copy refers to the content of the advertising. While exposure to an advertising message creates awareness in a potential customer’s mind, how that message portrays the product’s unique value and utility to the customer is the purpose of the advertising content, i.e. copy.

Figure 6



Z's due to X's and that due to U's can be disentangled using some simple but clever modifications in the consumer research process. For example, certain things such as distribution reach (i.e. to what extent a product is available within consumer reach), which can be measured rather easily, will be only a function of the corresponding X's and not due to any U (unless the U comes in the form of a distributor or retailer refusing to carry the product). As another example, let us consider the perceptual map discussed earlier. By designing carefully the questionnaire, it is possible to find out whether the current position of the focal product is a result of X's or U's. So, it is possible to remove the effects due to U's and objectively find out the impact of X's on Z's. Hence, if the contract specifies that the licensee should achieve certain level of Z's (intermediate outcomes), there would be no qualms as such. And, interestingly enough, it is possible to measure this intermediate outcome as applicable to the corresponding X (or X's) alone.

Figure 7



Intermediate Outcome (Z) and the P-Factor: Now let us see how Z helps us delineate the impact of the P-Factor from that of the X's. This is very critical because this helps us decide whether the blame for failure goes to the licensor (i.e. the P-Factor) or to the licensee's efforts (X).

Let us consider again ad copy. As mentioned earlier, the ad copy is supposed to create in consumers

minds a perception about the product regarding how it differs from the other products in the market place, what it could do for the consumer if she uses it, what the unique utility it provides, etc.

Case 1: Suppose that the expected positioning (Z) was not achieved after the ad copy was watched by the potential customer. Either the ad copy (X) was bad but the product was good in the attribute

delineating the impact of the P-Factor from that of the X's.

Intermediate outcome (Z) and Uncertainties (U): Note that from Figure 7 it can be seen that the intermediate outcomes are also affected by the U's (uncertainties). See Figure 7.

But the good thing here is that sometimes this impact is minimal; even if it is there, the impact on

ers minds a perception about the product regarding how it differs from the other products in the market place, what it could do for the consumer if she uses it, what the unique utility it provides, etc.

it tries to position on, or the ad copy was good but the product was bad (P-Factor), or both are bad. By directly surveying the customers through a questionnaire, the real culprit can be found out: ad copy (X), the product (P-factor) or both. For example, consider a new car in the market that the licensor and licensee want to be perceived as more rugged than others in the market. The licensee puts out an ad accordingly. However, when a perceptual map was drawn from a sample of customers, say that it revealed a poor positioning, i.e. the consumers who rated all the cars didn't rate the new car better than other cars in any dimension.⁵⁷ Now, we can go back to those consumers and explain to them in person what the new car designers wanted to portray with respect to ruggedness. Then if we carry out the positioning exercise again, and if now consumers show up a totally different perceptual map, it can be concluded that ad copy (X) was poor; otherwise, if a more or less similar perceptual map turns up, we can blame the product, i.e. the P-factor.

Case 2: Suppose that the initial perceptual map reveals that the expected positioning (Z) has been in fact achieved after the ad copy was watched by the potential customer. So, clearly X (ad copy) has led to Z (positioning) and hence the licensee can be said to have done her job. Similarly, suppose that we checked other Z's and all turned out to be good. But still, sales outcome (Y) may not happen. This is because although the consumers believe in what the ad copy says but do not like the product or its newly touted attribute.⁵⁸ Thus in this case, it is clear that the P-factor has affected only the final outcome (Y) and not the intermediate outcome (Z). Given that the product is rightly advertised but is unfortunately not liked by the consumers, measuring the Z (i.e. positioning) alone will help us identify the real problem. On the other hand, if we go by the final outcome Y (i.e. sales number) alone we will be unnecessarily blaming the X (ad copy).

To cite a real life example, the marketing savvy company Coca Cola introduced a new cola product, called New Coke, in 1985 to fight Pepsi. The com-

pany carried out very extensive market research for a long time, and then unleashed an unprecedented marketing campaign during the launch. In spite of the very positive market research results and excellent marketing efforts and the market power of the Coca Cola, the product failed miserably in the market. Basically the (X's) were good but the product was not liked by customers (P-factor).⁵⁹ Suppose that, in a hypothetical scenario, Coca Cola had licensed out the marketing part alone to another company. Suppose that the licensee used the same efforts (in all details) that Coca Cola used in the real case. Suppose further that the product failed here also as in the real case. Who would be to blame? The blame might have gone, at least partly, on the licensee. But, if they followed our suggestion and measured some of the critical intermediate outcomes (Z's), the licensee would be then able to show that the Z's had been achieved by the X's expended and thus would have been able to rightly point to the P-factor.

Thus we showed that using the intermediate outcome as the check point, we can diagnose the 'unadulterated' impact of the licensee's marketing efforts without having to bother about the contamination from uncertainties and the P-factor. This is the main virtue of the intermediate outcome. Having explained the advantages of focusing on the intermediate outcomes, we are now in a position to formally state our recommendation for defining the best efforts clause.

4.2 Recommendation: Intermediate Outcomes and the Best Efforts Clause

We recommend the following for a licensing contract that seeks to avoid the ambiguity in the best efforts clause: A license agreement should specify:

- 1) the desired outcome, in terms of Y^* (which is a specific value we choose for Y outcome),⁶⁰

59. Such failures are not rare. One may wonder why the customers told in the market research surveys that they liked the product but later rejected it. A simple answer is: it is their prerogative. A more serious answer is that there are differences in how consumers behave in a survey or an experiment and how they behave in a real market situation. This is one of many things that marketers have to live with.

60. One may wonder why specify a guideline on Y at all. The reason is as follows. Suppose we pick a sample size of 100 consumers to measure a particular Z, say, ad recall. We would be interested in two measurements: how many in the sample size are able to recall seeing the ad, and how quickly and vividly a consumer can recall the ad. The latter tells about the attractiveness of the ad as such. The former, on the other hand, tells us about the size of the target market reached by the ad, which is important from the volume of sales (i.e. Y^*) point of view. This is the need for the guideline Y^* .

57. Perceptual map has a great quality as a tool because this captures how consumers view different brands in a market without being told how to make those comparisons.

58. Consider the product coffee-flavored yogurt. If we test in the market how this product is perceived, invariably everyone will agree that the new product does have the coffee flavor. If we further ask how many like that taste of coffee in yogurt, only a few might say yes. Thus believing what a product offers may not translate to liking it. Note that sometimes even if they say they like it when asked, they may not buy it in a real market condition.

2) the intermediate results, in terms of a corresponding specific set of Z*⁶¹; and

3) that if the specified Z's* are not reached, licensor will evaluate what the root cause is and see whether the licensee can be directed or motivated (through some incentives) to improve here efforts or terminate the contract (if X's are the cause), or pull out the product (if the product is found to be poor, i.e. the P-factor), or ask the licensee to justify if she had put in her best efforts to handle the uncertainties properly (if U's are the cause).

Said differently, what we suggest is that a broad outline of the key responsibilities be specified in the contract. This will help the parties to define their expectations, identify the major key responsibilities, act as sufficient notice to the contracting parties as these outcomes unfold in the due course of time, and thus narrow down the scope of inquiry to be mounted by courts in the event of litigation. Moreover, by affording the parties an opportunity to re-align their efforts and goals with other entities to achieve greater optimization, this will lead to more transparency and efficiency in the performance of contracts, which in turn will enable market forces to play out at appropriate points of time leading to an efficient market system and economy overall. The usefulness of the timely corrective action is explained in Appendix 3 (parts 1 and 2) in detail, where we show how specifying in terms of final outcome is inferior to specifying in terms of intermediate outcomes.⁶¹

4.2.1 An example

An example is in order here to explain how the proposed method based on intermediate outcomes (Z) can be implemented in a contract. We also show through this example how our proposed method is different from what was suggested by Goetz and Scott that was based on the final outcome (Y).

We will consider a product that failed in the marketplace apparently due to a lack of good marketing efforts.⁶² The company concerned here is Rohm & Haas, a big chemical company based in Philadelphia. Rohm & Haas—call it RH—has a variety of products in its portfolio. One of its product portfolios consists

of biocides that are meant for the lubricants used in big machineries found in huge companies such as GM, GE and Caterpillar. In the 1980s, RH developed a product called Kathon 80MWX, which is another biocide, but meant typically for the lubricants used in small machineries that are found in small machine shops. Thus the target market for the new biocide is not those big manufacturers RH is accustomed to, but small machine shops that usually operate with a few machineries. These machine shops are spread throughout the country and not concentrated in any one place and this presented a big challenge to RH. Not realizing the need for a strong and entirely different marketing strategy to back the new biocide product, RH apparently tried to market it on its own, but the product failed to garner enough sales to justify the investment. Eventually the product was pulled off the market although it was a good product for the target customer.

Let us now go back in time to the 1980s when RH developed the product. Let us assume that RH decides to license the marketing of Kathon 80MWX to another company, called LEE, a fictitious company. Thus we have: RH as licensor, LEE as licensee and Kathon 80MWX as the product.

For this product, marketing is obviously very critical because its target customer is completely unaware of, unappreciative of and short of resources to learn about the usefulness of the product. Further, as mentioned earlier, the customers are spread throughout the country making it difficult to easily access them.

Terms to be specified in the contract: First, an expected level of mutually agreeable output has to be specified. However, it should be a rough guideline only, as mentioned earlier. The current sales of equivalent products can be used as the starting point. With respect to new products, it should be realized that it takes time to penetrate the market, and hence the expected output should be specified on a periodical basis. Call this Y*. It will be better if this Y* is dynamically updated. For now, let us assume that these Y*s are specified in advance.

Next, we need to list the key intermediate outcomes, i.e. Z's in the contract. Here we describe some of them for demonstration purposes.

1. Awareness level: This measures the extent of awareness generated by the advertising (media advertising and banner in tool shops) in the market place. This can be evaluated by asking a sample of customers whether they could recall seeing the ad and remember what the product is about, whether

61. This change will certainly affect the compensation structure because of the reduced ambiguity and uncertainty. The authors are working on a mathematical model and hope to publish it in a sequel to this paper.

62. Quoted with permission from HBR. Note that we use the case solely for demonstrating our proposed method and not to comment on the case or the company's decision.

the ad they recalled enticed them to look for the product, etc.

2. Positioning: This measures the amount of information customers have about the product, what they think about the main use-feature of the product, and how they think about the product with respect to other competing products in the marketplace. This is a more involved market research exercise but, as said before, is doable within a short time. Since the machine tool retail shops act as an important spokesperson for this product, a sample of tool shops also need to be surveyed, apart from surveying the customers, to evaluate what they think about the product.

3. Reach: This measures the extent of the product availability to an interested customer in terms of whether he can get it at his nearby tool shop without encountering any stock-out situations or other problems. This can be measured among a sample of customers asking them direct questions on availability, or asking a sample of the tool shops whether they have the information about the product, whether they are able to get adequate product supply and required credit terms etc., how long it takes to replenish the stock, how much shelf space they have allotted for the product, whether they get information of where to stock the product in the store, how to contact the company if they or some customer have any questions, etc.

4. Price: Surveys can be done among the interested customers to find out whether the price they face is too high, average or too low, whether the price correctly conveys the true value of the product's unique attributes compared to the competing products, etc.

5. Promotions: Since promotions are mainly meant to induce trial purchase by the customers, this can be directly measured from a sample of customers walking into a sample of tool shops. Since the retail tool shops need also to be induced, they have to be asked whether enough incentive is there for them to push the product, whether they can bundle the product with other products, etc.

6. Sales and service support: A sample of the machine tool shops can be surveyed to find out if the sales persons from LEE were knowledgeable enough to clear any apprehensions about the product use and were ready to help them. A sample of consumers also can be surveyed to get these pieces of information.

Thus, it is possible to list out all the important Z's and specify what values they would take if the

marketing efforts are carried out properly. Call these specific values Z^* . In other words, it is possible to relate which X's lead to which Z^* s. Note that, as with Y^* , the Z^* too should be specified on a periodical basis and dynamically updated as the product gains ground. It is important to realize that RH and LEE should jointly decide on the Z^* s. They should also draft a rough framework that details how these Z^* s that LEE is interested in, are related to the Y^* that RH is eventually interested in. Although such details will be beneficial to both, they might be better off asking some marketing expert to verify the same.

Actual scenario

Suppose that the product is introduced in the market by LEE. Let us say the sales of the product were not up to the expected level, i.e. the sales were well below the specified Y^* . This would have occurred either because one or more of the following. (a) LEE did not put in best efforts, (b) some uncertain event happened in the market place and LEE did not put in her best efforts to tackle the impact of that event and (c) the product was not favored by the customers, i.e. the P-factor.

Analysis of whether LEE had put in her best efforts

Our objective is to isolate and investigate if LEE put in her best efforts. To do that, let us first focus exclusively on the efforts she had put in. Take the ad copy and the sales person effectiveness because these two determine the key ingredient in the marketing of any product, namely, positioning. Without a proper positioning, a product is most likely to fail. To check whether the ad copy and sales force used by LEE to project the main and unique product attributes were correctly done or not, we need to obtain the perceptual map (as explained earlier) by surveying a sample of consumers. This is a critical Z to evaluate and check. If it is revealed that the unique attributes were not perceived by the target customers as dictated by the product design, then we can immediately blame the licensee for the lack of proper efforts (i.e. in creating the ad copy or in choosing the right medium to communicate it or in training its sales force). Thus, poor sales (Y) can be traced to the ad copy and the sales force (X's). However, if the perceptual map reveals that the Z (i.e. positioning achieved) is in line with what the product is about, then we should turn our attention to other Z's such as distribution reach, value as perceived by the consumers, etc. The objective of this exercise is to systematically check every Z mentioned in the contract and diagnose if the problem of low sales

could be attributed to one or more the Z's, and if so, quickly trace back to the corresponding Xs. If, however, after proper diagnosis all the important Z's turn out to be within an acceptable range of their corresponding specified values (i.e. Z*s), we should turn our attention to the next item, the uncertainty.

For demonstration purposes we will focus one particular type of uncertainty. Noting that the small machine shops are the customers for the focal product, suppose that the machine shops are finding it difficult to in turn sell their output to one of their customers downstream due to slump in that industry. This will result in the small machine shops cutting down their purchases upstream, which will hamper the sales growth of Kathon 80MWX in spite of LEE's efforts. However it will not be obvious if LEE had executed her job or not, because in either case the outcome is the same. To check this, we can pick some of the Z's mentioned in the contract and measure them. We can also check if LEE took extra efforts (i.e. the best efforts) to tackle the impact of that uncertain event. For example, we can survey the machine tool shops and customers to see if any special incentives were offered to the tool shops and to the consumers. Once we get the Z's, we need to compare the measured Z's against their specified values adjusted for the uncertain event. If on comparison we find that the measured values are within an acceptable range, then we can conclude that LEE did use her experience and put in her efforts to tackle the uncertainty of the industry-wide slump.

If the observed Z's indicate that LEE had put in her best efforts and the efforts to tackle the impact of the uncertain event, one could conclude that the lower sales was purely due to the uncontrollable nature of the uncertain event. Suppose if no uncertain event occurred, and if still the observed Z's closely match the specified Z*s, then one can conclude that the product itself is not liked by the consumers in spite of LEE's best efforts. This is the P-factor.

4.2.2 Costs considerations of our proposed method

Having explained the new method, let us now look into the cost aspect. Evaluating Z's, the intermediate outcomes, definitely involves cost. These costs are typically market research costs. Fortunately, there are many market research companies who have expertise and experience in measuring these intermediate outcomes. So, these Z's can either be evaluated by the licensee or outsourced to third parties should the licensor want an unbiased evaluation. Because these measurements are pretty much routinely done by market research companies, costs are easy to evalu-

ate once the Z's are defined. As mentioned earlier, what Z's are to be chosen depends on the type of product-market we are dealing with. The costs of evaluating Z's have to be considered as a part of the licensing costs, i.e. costs to both the licensor and the licensee, since it helps both to achieve their final objective, the success of the licensing venture.

However it should be borne in mind that these costs help avoid many other hidden costs such as cost of litigation, costs of late action (note that by evaluating Z's periodically things can be set right as and when they go wrong), and costs to the economy since the proposed method brings in efficiency and timely corrective action which prevents wastage of precious economic resources, ensures that licensors of worthy products do not suffer for want of licensee expertise and finally protect diligent licensees from being dragged to court for failure of poor products. In Appendix 3 (Parts 1 and 2) we have a given how using Z's in place of Y's make the system more effective. Thus, the proposed method provides both the parties and the economy a cost effective way of solving the long standing ambiguity issue of the best efforts clause.

5. Conclusion

In this paper we focused on the ambiguity issue associated with the oft used best efforts clause in licensing contracts, especially those that involve licensing of the marketing of a product. The best efforts clause in a contract is at best ambiguous because it does not specify any particular set of actions needed of a licensee (such as how much \$ to be spent on advertising by the licensee) nor does it specify any expected outcome of the licensee's actions (such as how much \$ sales should result from licensee's efforts). The ambiguity of the best efforts clause owes its existence to the inability of both the licensor and the licensee to chart out all the details necessary to handle the complexities and uncertainties associated with carrying out a responsibility. Because of this ambiguity, whenever there is under-par performance of a joint venture, the best efforts clause has been “used” by the licensor as a versatile catch-all clause to question the efforts expended by the licensee and by the licensee as an escape route to shirk away from all responsibility in expending some effort expected of her. Hence, because of its potential use or misuse, this ambiguity creates a fertile breeding ground for misunderstanding and mistrust between the parties, leading to expensive and time consuming law suits when the joint venture runs into problems.

A currently existing solution to avoid the best ef-

forts clause is the stipulation of an objective output figure, which if not attained by the licensee would land the licensee in court automatically. Although, specifying a final output figure in place of the best efforts clause is clearly objective and less problematic, arriving at such a final output figure is not feasible or practical in many real world situations and is likely to be misleading as well, just as the best efforts clause it is trying to replace. Perhaps for these reasons, it has not found any wide acceptance.

In this paper we have suggested a different kind of output, which if specified in the contract would perform better than specifying the best efforts clause or a final output figure. We suggest an outcome that occurs before the final outcome. We call this intermediate outcome. Actually, there is not just one but a set of intermediate outcomes that need to be specified. These outcomes occur in the marketplace much before the final outcome takes place. For example, instead of specifying that a licensee should use the best efforts in putting up advertising or should achieve a specific sales figure, one intermediate outcome to specify would be the amount of awareness that the licensee should create in marketplace for the product under question. A main advantage of keeping track of these intermediate outcomes is that they, unlike the final outcome, directly result from the efforts of the licensee. Hence, the truthfulness of licensee's efforts can be immediately brought to light. Because of this transparency, both the licensor and the licensee can have more trust and cooperation between them, which in turn will make the venture more successful. Further, because these intermediate outcomes are measured periodically, corrective actions can be taken in a timely manner leading to more efficiency to not only the venture but to the usage of the precious economic resources as well. A minor issue one may face with specifying these intermediate outcomes in the contracts is that these outcomes are not readily observable in a market place. However, they can be measured periodically and unambiguously through various consumer research tools that are available readily in the marketplace.

One interesting research question at this juncture is “where do we go from here?” One could look into the implementation problems that may arise with respect to adopting our suggested method. These issues could, however, very well be industry specific. One could also explore what type of time line we could specify with respect to these intermediate outcomes. For example, when you introduce a new product, the awareness level in the market place is likely to increase for certain duration of time and

then stabilize at certain equilibrium level. We could try to specify the dynamic path of the intermediate outcome, which specification will be much more realistic than specifying the final equilibrium level. In fact, this dynamic nature will be a rather common characteristic with almost all the intermediate outcomes when we deal with a new product. In other words, with respect to new products, licensing contracts need to go beyond specifying a static set of measures to specifying a dynamic set of measures. This will be another area for future research.

If the licensor and the licensee accept to base their contract on a set of intermediate outcomes, they may have to redesign their royalty and other compensation terms because now the uncertainty is reduced compared to the situation where only the best effort clause used to be the sole factor. We arrive at a mathematical structure for such a compensation scheme in our next paper.

Appendix 1

Specifying the final outcome, Y^* ?

Goetz and Scott's economic model implies that if one knows the distributor's marginal cost and the manufacturer's marginal cost then it is possible to get a optimal final outcome, Y^* . But as many accounting professionals would attest, the currently followed accounting systems and rules do not permit the evaluation of the marginal cost. This is especially true if the company is involved with several products, which is normally the case with any distributor. The inability to evaluate the Y^* would naturally result in differing opinions between the licensor and the licensee and this will result in delay in the execution of the contract.

Secondly, a lowering cost of distribution does not necessarily mean higher sales because lower cost does not lead to a lower price automatically. In fact, from a marketing strategic point of view, optimal price has to be determined actually by the consumer's appreciation of the utility of the product and the associated distribution efforts, and this usually does not have anything to do with the cost of providing that utility or efforts. For example, the great discount chain Wal-Mart does not determine the price of its product based on the cost, but it employs such an intelligent distribution network that the cost of distribution is contained within the price it has decided to charge.

Thirdly, even though the company licenses its distribution to another, it would still have to carry on with its promotion and other activities in order to effectively compete in the marketplace. Hence,

the final outcome is a result of both the licensee's distribution efforts and the licensors' pull efforts. In such a situation, it is obviously impossible to get a true Y^* . If the product is such that its sales are driven mainly by distributor's efforts, then it becomes very important that a proper Y^* is accurately evaluated since so much is now riding on the various assumptions of the model one uses to evaluate that Y^* .

This discussion tells us that it is difficult to obtain a specific Y^* . But it is always possible to focus on the key marketing factors and come up with a Y^* that could act as a guideline instead of a finishing line.

Appendix 2

Key Marketing Components

Here our objective is to explain the four marketing components and show how they produce the intermediate outcomes.

Advertising: Marketers do advertising with three objectives in mind. Consumers are made aware of the existence of the product. This is called 'awareness creation'. Secondly, they are made to understand the purpose of the product for the consumer. It will inform what unique usefulness or utility she would derive from using that product. This is called 'positioning'. Thirdly, repeat advertising keeps reminding consumers about the product and what it does so that the consumer does not forget considering it. This will ensure that the consumer would be able to recall quickly having seen the ad for the product. This is called 'ad recall'. Thus advertising does three things: awareness creation, positioning, and ad recall.

These can be achieved through media advertising or print, or through sending brochures, or through Internet, etc. What mode(s) one chooses depends on the product and the intended consumer, but the objective is more or less the same.

Sales force management: In many B-2-B markets, companies employ salespeople who go and meet in person the intended customers (professionals such as doctors and lawyers, customer firms, potential consumers for electronic goods) and convince them of the usefulness of the product and guide them to choose the type of product that suits that particular customer the best.

Distribution: After getting convinced about the product, the consumer would like to buy it. But she would choose her own place, time, etc. to make the purchase. For a typical product, when, where, in what form and how many units she wants to buy, consume and seek help differs widely from

where, when and how the manufacturer makes the product.⁶³ Also, while she looks for how the product fits in with her other products (i.e. economies of scope) so as to get more utility in her life or for the company she works for, the manufacturer typically focuses on one product to achieve economies of scale and thereby reduce the cost of manufacturing. The main job of the manufacturer is to close this multi-dimensional channel gap between himself and the consumer. In other words, it has to ensure that the consumer gets the product at a convenient place and time, in the form required by her and along with other products she is purchasing.

To fill this channel gap, the manufacturer has to depend on other economic entities such as wholesaler, retailer, distributor, financier, etc. Since the manufacturer does not own them, he has to entice them to carry his product. Of all the channel members, retailers hold the greatest sway on consumer's product purchasing process because of their physical proximity to consumers.⁶⁴ Retailers employ many tools to further influence the purchasing process. They put up displays, put ad in the fliers, employ salespeople and train them well to help the consumers make the "right" choice, offer after-sales-service help and free technical services over phone, easy return policies, quick warranty procedures, etc. Retailers also take up some of the job of the advertising discussed earlier.

Pricing: Although advertising and distribution play a major role in informing the consumer, convincing her, making the product available to her where, when, in what form she wants it, etc., the price she is going to pay to acquire the product play perhaps a much bigger role in many product categories. So she would be extra careful in judging whether the price is right. One way she does this is by comparing the price with the prices of other products that provide more or less the same basic utilities. That benchmark price is called reference price. How she compares the additional utility the focal product provides with respect to the benchmark product

63. For example, various cars are manufactured by GM in Detroit. However, a consumer in El Paso, TX, would like to buy a maroon colored Chevy pick-up, on a Sunday morning, from a dealer within 50 miles radius, preferably with some financing made available to him, and would like to choose a dealer much closer for services, etc. How exactly GM can meet this person's requirements (of what, where, when, etc.), is a big challenge.

64. This is true even after Internet purchasing has taken off. The 'click' has not put up any challenges so far to the 'brick'.

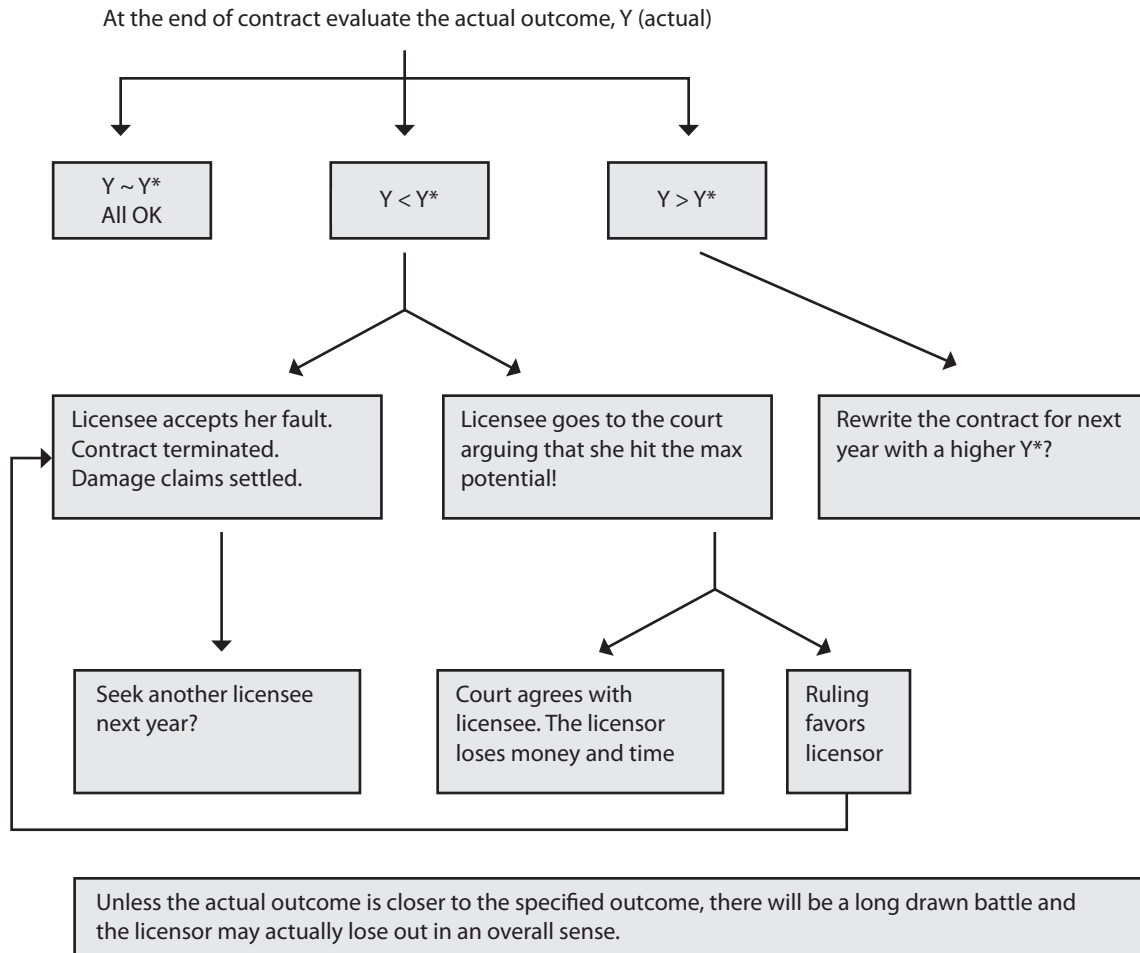
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can be influenced by the advertising claims, and thus to some extent clearing the doubt whether price is right is under the company’s control. Another approach is to use a technique called conjoint

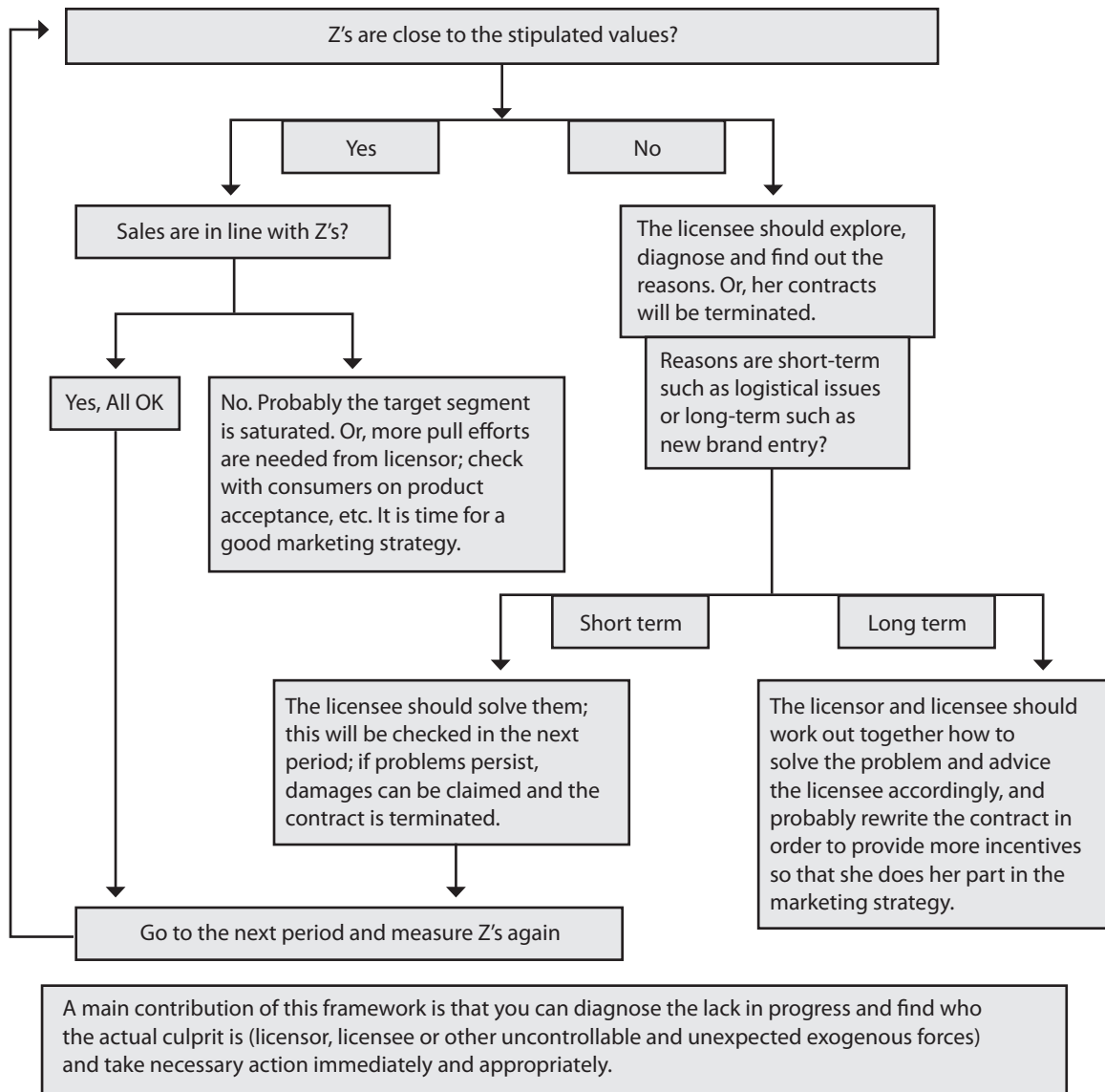
analysis which measures how far a consumer is ready to make a trade-off between the increased utility the product provides and the price she is ready to pay to get that additional utility.

Appendix 3 (Part 1): Modus Operandi With Final Outcome Specification

Things get discovered too late?



Appendix 3 (Part 2): Modus Operandi With Intermediate Outcome Specification (Z's Are Measured Periodically)



It is easier to specify the intermediate outcomes that depend solely on the efforts of the distributor. See the Appendix 4 table for a simple demonstration of this.

Note that it is also easy to arrive at a reasonable Z^* . For example, consider the 2nd row in the Appendix 4 table. This measures the extent of the product reach in the retail outlets in the targeted zones. Suppose that the vertically integrated company currently has a reach of 40 to 50 percent. If it seeks a distributor it is quite easy to measure how much reach the dis-

tributor could achieve given her current performance in other related products. Say that it is achieving 70 to 80 percent reach. Then the Z^* can be specified to be 75 percent. It is also possible to measure the Z achieved at periodic intervals. For example, by doing a telephonic survey one can measure the reach achieved by the distributor every month or every two months, etc. Similar surveys can be done with the end user and other Z 's can be measured. These then are to be compared with the stipulated Z 's in every period.

Appendix 4: X → Z: An Example With Distribution

	Distributor's efforts (X's)	Corresponding Intermediate Outcome that could be checked and verified (Z)
1	Good planning and maintenance of inventory; Appropriate shipments and scheduling.	Products of different forms and sizes are available in the right retail outlet at the right time in right amount. No out-of-stock situation; Retailers have enough of the stock in hand.
2	Good demand forecasting and ability to get quick feedback from the salespeople and various retail outlets; Good logistics abilities.	Products are available in as many retail outlets as possible throughout the targeted geographic regions and segments.
3	Good rapport and connectedness with the shippers and other logistics people.	Unexpected surge in demand during weekends or for parties is met easily.
4	Promotions to retailers.	Proper placing of the product in appropriate shelves and sizable slots.
5	Good rapport with retailers; Proper instructions and arrangements on product returns and other warranty steps .	Customer satisfaction on after-sales service and on retailers' help (ex: in providing information on the product, discounts, etc.).