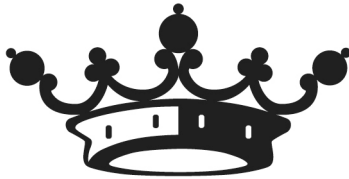


I N S I D E T H E M I N D S

Navigating Fashion Law

*Leading Lawyers on Exploring the Trends,
Cases, and Strategies of Fashion Law*



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The Opportunities of Fashion Law

Vicki Dallas

Partner and Chair, Apparel Industry Practice Group

Rutan & Tucker LLP



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Introduction

As a corporate partner in a regional law firm, I have had extensive experience working with start-ups and emerging growth companies in various industry sectors, taking them from their formation to their exit strategy, which is typically an acquisition, licensing transaction, or initial public offering.

I have always been interested in the fashion industry, having followed the local Southern California action sports and apparel companies for many years. In the last five years, I have noticed the uptick in M&A and IPO activity involving our local apparel and action sports companies. I also became aware of the local talent that was joining forces with veteran apparel entrepreneurs to start new brands.

What Fashion Law Encompasses

My skill set was ideal for a fashion law practice, a rapidly growing specialty that requires thorough knowledge of several different legal practice areas, such as, business and corporate law, financing, commercial sale transactions, licensing and distribution arrangements, intellectual property, including copyright and trademark law, and employment law.

Having worked with many technology companies, I was familiar with these practice areas, and I easily adapted to the fashion industry. Lawyers need to understand that the fashion law business is different in that there are ever-changing product cycles and trade arrangements, so adaptability to change and understanding an apparel company's basic business strategy is essential to being an effective legal advisor in this practice area.

In recent years, fashion law has become a quickly growing legal specialty. More and more fashion law courses and programs are springing up in American law schools and design schools. Fashion is now an international business. Small to mid-sized companies are being acquired by large international apparel and lifestyle companies, and private equity firms have also entered into the playing field, making this a dynamic and growing practice area.

The Trends of Fashion Law

Copyright infringement cases have been on the rise. In an effort to stem the tide, Congress is addressing the Innovative Design Protection and Piracy Prevention Act, a bill to amend the Copyright Act to add fashion designs as a protected type of design. To fit within the definition of fashion design and gain protection under the Act, the article of apparel must include original elements or the original arrangement or placement of original or non-original elements, resulting from the designer's own creative efforts, and must provide a unique and non-utilitarian variation over prior designs for similar types of articles. To receive protection under the Act, registration is not required. Instead, a design notice is utilized, and the protection under the Act extends for a period of three years from the date the design was first made public. This Act has generated much controversy, with proponents on both sides of the issue. How this issue will be resolved remains to be seen.

Fashion Law as a Distinct Practice Area

With the globalization of the fashion industry, fashion conglomerates are looking for new small to midsized brands with strong growth prospects. For example, the sports and lifestyle segments are huge and still growing, particularly internationally in emerging markets. These international conglomerates can pay higher premiums for newer brands, since they have the business structures in place to maximize profits by capitalizing on their international market knowledge, sourcing capabilities, and operational expertise in product development, distribution, and retailing. Although many of these companies have in-house counsel, the in-house legal departments generate sufficient legal work to justify employing outside lawyers and experts who are specialists in the fashion industry.

Licensing

Licensing has traditionally been an important way for a brand to increase profit and revenue streams by expanding into new product categories. This trend is continuing and expanding.

Strategic licensing enables a company to form an alliance with a third-party licensee with expertise in a particular brand category, thereby off-loading the manufacture and marketing costs of product categories that are not part of the company's core business. One facet of this is celebrities creating new brands and entering into licensing arrangements to promote their celebrity status.

The Lawyer's Role

For a lawyer involved in a licensing transaction, it is important to make sure that the arrangement makes sense to the client and that it will enhance and improve the client's brand. It is also important to understand and limit the time commitments that will be involved from a creative and management point of view for the client.

Performance metrics need to be incorporated into the agreement to ensure performance goals and objectives are met. Other key terms include which products and trademarks are covered, the royalty arrangements and design fees, whether the arrangement is exclusive or nonexclusive, the definition of the design and approval relationships relating to the products and product promotion, and the term and termination of the license agreement.

Working with Fashion Law Clients

Working with fashion clients presents challenges that are unique to the particular company. Much depends on the maturity and size of the company. I represent start-ups and early stage apparel companies as well as mature companies. Generally, the start-ups and early stage clients have unique issues and challenges.

Challenges of New Companies

One of the first challenges faced by young companies is finding the money to hire an attorney and other professionals. Although it sounds like a cliché, every small business needs to assemble a team that includes a lawyer, a banker, and an accountant. This is particularly true for an apparel company interested in developing a brand.

A more mature company typically has a management structure in place, with a general strategic plan for developing the business. This is usually not the case with start-ups and early stage companies. They typically have a designer, and perhaps a few other people who are multitasking in various positions.

Determining Objectives

At the first meeting with a new client, the lawyer must ascertain the long-term objectives of the client. For example, is the client interested in building the brand and operating it as a stand-alone business? Is the client interested in developing the brand and then licensing the brand? Is the client interested in going public? Is the client interested in selling the company after developing the brand? In each of these scenarios, there are certain critical issues that need to be addressed up front to avoid problems later.

Laying the Foundation

Larger companies need new brands to grow their businesses internationally. Rather than developing the new brands in-house, these companies are paying premiums for proven brands. If a small to midsized company is planning to capitalize on an acquisition down the road, it is important that the early formation steps are done properly to attract a suitor and to maximize value. There are several issues that need to be addressed at a fashion company's beginning; these issues must be structured properly as they may affect the feasibility and value of a future deal.

Agreements

First, founder's agreements and option grants need to be formalized so that the ownership of the company is clearly reflected in the corporate records.

Freelance Contracts

Employment and consulting relationships need to be carefully documented. Many small companies use freelance designers, which requires the use of carefully drafted work-for-hire contracts that specify that any IP created by the designer is the property of the company. These contracts are critical going into an acquisition setting, as the buyer will conduct substantial due

diligence to ensure that the company owns the rights that the buyer is purchasing in the deal.

Real Estate Issues

Real estate contracts and leases need to be properly drafted so that a company can grow or contract its real estate requirements as needed. In an acquisition setting, for example, a buyer may need to consolidate facilities, so it is important to understand the termination options in a lease. If a lease is favorable, it is important to negotiate and understand renewal options in the lease.

Import Considerations

If a company is involved in the importation of products or materials, there are a number of issues to be addressed, such as human rights compliance issues, monitoring import duties, inspection certificates, and letters of credit and bank guarantees.

Marketing, Licensing, and Sales

Marketing and advertising issues are also critical. If the company has been using photos of celebrities using or wearing their products, a buyer will want to be sure the company has the rights to exploit the celebrity's image on the website and in the marketing materials. Copyright permissions and releases need to be included in the company files.

If there are any licensing arrangements in place, the scope of the license, the royalty rates, and the termination provisions need to be addressed to determine the impact of the license on a future acquisition opportunity.

Sales arrangements, such as the use of distributors, sales representatives, dealers, consignment, and leased departments, need to be reviewed and the impact of those arrangements on a potential deal needs to be assessed.

Labor Concerns

Labor and employment issues, including antidiscrimination and sweatshop issues, need to be addressed on an ongoing basis. A purchaser of a

company will almost always require representations and warranties regarding labor and employment issues.

Making sure the company is ready for the intense due diligence process from the onset makes getting the deal done so much easier in the end.

Licensing and Compliance in Fashion Law

Licensing has become an important tool for a company to grow a brand. For example, licensing may facilitate the expansion of a brand's awareness by increasing market opportunities in new niches, opening up new distribution channels, creating new markets in new geographic areas, and extending core products into complementary products that might not otherwise be available to a company.

Before embarking on a licensing opportunity, a licensor should have a design philosophy and creative vision in place in order to keep the brand identity intact. A licensor may also need a compliance group in place to monitor production and marketing, as well as an accounting team to ensure that proper accounting for royalties is in place.

Selecting a Licensee

In selecting a licensee, it is important to determine if the licensee has the financial strength to perform its obligations under the license agreement and to ensure that no conflicting obligations exist to which that licensee is a party and that might interfere with the licensee performing its obligations under the license agreement. There are several key issues to address and alternatives to consider in a licensing agreement.

License Grant

Defining the products to be covered and the rights granted in the license agreement is the first step and it is a critical one. A licensor can control the scope of the license by carving out specific provisions. For example, exclusivity and territorial restrictions are key factors for consideration by the parties.

Specifying the trademarks that are the subject of the license also need to be set forth in writing. The broader the license grant, the higher the royalty rate. The ability to sublicense or assign the license is also a key factor, and in many cases will depend on whether the licensor intends to compete with its licensees.

If the licensor does not intend to compete, then permitting sublicensing or assignment may allow the licensor to increase its potential revenue stream by expanding its sales base through sublicensing or assignment. If authorized, the licensor should retain approval rights over the assignment or sublicensing parties, and they should be subject to any restrictions contained in the underlying license agreement.

Initial Payments, Royalty Rates, and Advertising and Promotion Minimums

Initial payments are generally nonrefundable license fees, used to compensate the licensor for the costs of investigating the licensee and covering documentation costs, and they may or may not be creditable to future royalties. The royalty fee is the main source of revenue for the licensor, and may be fixed, or varied based on a percentage of sales, or other factors.

Royalties are often structured with minimum payments to ensure that the licensor will have a reliable royalty stream. In negotiating the royalty rate, gross sales and net sales are generally favored by both licensors and licensees. From the licensor's point of view, gross sales and net sales are harder to manipulate, and from the licensee's point of view, the licensee can avoid disclosing profit information to the licensor.

Another method of calculating royalties is to use gross profit. This method subtracts from gross sales the cost of goods sold, which generally includes directly allocable expenses, such as manufacturing expenses, raw material costs, and direct labor costs. An advantage of this method for the licensor is that the licensor can take advantage of increasing profit margins. On the other hand, from the licensee's perspective, the licensee is forced to open up its books to the licensor, disclosing more financial information than the licensee may desire to disclose.

A third royalty option is to use a per unit royalty rate on product sold. This method does not require the licensee to disclose financial information. Like the sales method, this method does not take profitability into account, and therefore this method is useful if the licensee wants to limit disclosure of financial information.

The license agreement may contain advertising and promotion minimums, in addition to the initial payments and royalty payments. In all cases, the licensor needs to retain audit rights to verify the accuracy of the licensee's accounting for royalties and other financial obligations. The licensor will also need to retain rights to police the quality control of any licensed products to ensure brand integrity. The licensor may want to retain approvals over manufacturing quality, distribution channels, and advertising and promotion programs, and to incorporate a compliance program requiring samples, or rights to inspection.

Term and Renewal Options

The term of the license agreement needs to be set forth in the agreement, with clearly specified instructions on what occurs upon termination. Any proprietary materials belonging to the licensor should be returned immediately. As is the case in other agreements, the parties should be able to terminate the license agreement upon the occurrence of a material breach.

A licensee will generally want a longer term if a substantial start-up investment is involved. That must be balanced by the licensor with a minimum sales requirement to ensure that the licensee will be actively marketing the licensed products. The licensor will want to reserve the right to terminate the license if the licensee is not performing to the minimum performance thresholds.

Managing Fashion Law Complications

Designers are by nature creative people, and continually on the move. It is important to stay on top of them and to encourage them to identify the people and resources in their company who have the authority to assist you in tying up the loose ends. For example, making sure all the trademarks are

filed with correct descriptions and in the right classes can be challenging, as well as documenting a transaction or relationship that is in flux. If getting access to the designer or owner is problematic, it is critical to explain to your client why it is important to have access to the people you need so that you can do your job and be an effective attorney and advocate.

Conclusion: The Future of Fashion Law

There are always challenges in any economic environment. Despite these challenges, the Internet and other digital technologies have made the world a smaller place and have allowed the fashion and apparel industry to become a large and dynamic force in the global economy. The image of a celebrity in a beautiful gown at the Oscars or a famous actor wearing designer denim at a sporting event is immediately transmitted by digital technology and new trends can become instant mega hits in a fast fashion environment. This creates enormous opportunities for the fashion industry, and in turn for the legal professionals who support the industry.

Key Takeaways

- Because the fashion law business is different, with its ever-changing product cycles and trade arrangements, adaptability to change and understanding an apparel company's basic business strategy is essential to being an effective legal advisor.
- When forming an apparel company, formalizing founder's agreements, option grants, and freelance contracts are important, as well as addressing marketing, sales, and employment concerns.
- Licensing is an important way for a brand to increase profit and revenue streams by expanding into new product categories. Strategic licensing enables a company to form an alliance with a third-party licensee and allows it to offload the manufacture and marketing costs of product categories that are not part of its core business.
- In drawing up a licensing agreement, defining the products to be covered and the rights granted is the critical first step. A licensor can control the scope of the license by carving out specific provisions, such as exclusivity and territory.

- If a small to midsized company wants to capitalize on an acquisition in the future, it is important that the early formation steps are done properly to attract a buyer and to maximize value. Making sure the company is ready for the intense due diligence process from the onset makes getting the deal done easier in the end.

Related Resources

- The California Fashion Association (CFA) is a non-profit organization established to provide information for business expansion and growth to the apparel and textile industry of California.
- The Fashion Business Inc., a 501(c)(3) non-profit organization, provides the fashion industry with entrepreneurial development, resources and training, to support its growth and profitability. The Fashion Business Inc. (FBI) offers targeted business education, sourcing, networking opportunities, marketing and consulting services through its resource center and business partnerships.

Vicki Dallas is a partner in the law firm of Rutan & Tucker LLP, and is the chair of the firm's Apparel Practice Group. She has a JD and an LLM from the University of Florida College of Law. Ms. Dallas specializes in mergers and acquisitions, emerging growth company representation, corporate finance, venture capital, licensing, distribution, and marketing arrangements. She counsels fashion companies of all sizes in all aspects of their business law requirements, including structure and formation of business entities, capital raising and financing arrangements, mergers and acquisitions, strategic partnerships, joint ventures, and other growth and exit strategies.



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