

## How Much Effort is “Best Efforts”? A Marketing Analysis

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*It is not enough to do your best; you must know what to do, and then do your best.*

*- W. Edwards Deming*

### **Introduction**

In today’s competitive and unforgiving business environment, Dr. Deming’s words ring true as a reminder that only those companies who provide the most outstanding and focused service will enjoy ultimate success. But what happens when you know what to do, do your best, and it still isn’t enough? Regrettably, businesses who agree to use their “best efforts” in fulfilling contractual obligations are frequently faced with this bitter reality, and the consequences—legal, monetary, and otherwise—are often difficult to swallow.

Best efforts provisions are a common source of conflict among contractual parties. Although such clauses are intended to provide assurance that a party will invest time and resources in fulfilling its contractual duties, such provisions rarely provide details as to how this should be accomplished. In the event of a breakdown in the relationship between the parties to the agreement, this seemingly innocuous clause may result in lengthy litigation leaving a jury to sort out what constitutes “best efforts.”

Despite the veil of uncertainty surrounding best efforts clauses, they are a common occurrence in contractual agreements. Such clauses are an attractive feature because they offer blanket protection for the manufacturer or licensor and reduce the need for outlining specific obligations and procedures to be undertaken by the distributor or licensee. However, such “catch-all”

phraseology often blurs the lines of contract fulfillment and can put one of the two parties at a distinct disadvantage. In such situations it is often a question of the level and success of the marketing effort that will determine whether best efforts have been met.

#### **Where do “best efforts” clauses appear?**

Best efforts provisions are a common feature in contracts between businesses. They are most often found in agreements whereby one company enlists another to provide a service, usually related to the sale of a product. For example, manufacturers often employ best efforts clauses when hiring a distributor to sell their products. Similarly, companies that decide to license or franchise their product or brand will often require the licensee or franchisee to adhere to best efforts standards to ensure a profitable return. Best efforts provisions also regularly appear in leveraged buyout agreements in which one party agrees to use their best efforts to secure financing for the purchase. Thus, provisions establishing “efforts” standards have become a common component in many agreements.

#### **What does “best efforts” mean?**

One understanding among legal professionals is that best efforts implies a strict obligation requiring the licensee to fulfill its contractual duties by any means possible—even if this means driving itself into bankruptcy.<sup>1</sup> This assumption is problematic in that it creates an entirely subjective measure of performance. In the absence of clearly defined performance standards in the contract, such a system invariably tips the balance of power in favor of the licensor who is free to decide whether the licensee has fulfilled its contractual responsibilities. In this context, companies can attempt to hold their contractual partners to an extreme level of responsibility.

At the same time, licensors and manufacturers can also be put at a disadvantage by agreeing to a best efforts clause. By agreeing to a best efforts clause rather than setting clearly defined performance requirements, the licensor essentially gives its licensee free reign to determine when it has fulfilled the contract. Because best efforts clauses generally do not include performance standards, this can result in wide differences in opinion between licensors and licensees regarding fulfillment obligations. Thus a licensor might find that it cannot reason with a licensee regarding interpretation of best efforts without waging a legal battle.

#### **“Best efforts” and case law**

Rather than taking polarized position favoring either party, the courts have generally taken a milder stance on the definition of best efforts. In several notable cases,<sup>2</sup> U.S. courts have

determined that a business should not be forced to take excessive and self-destructive actions to fulfill a best efforts agreement.

For example, one court found that “best efforts is equal to a good faith effort to meet one’s obligations” and does not require efforts “out of all proportion to economic reality.”<sup>3</sup> Courts have held that best efforts provisions exist not to force businesses to exhaust every effort but rather to ensure that the obligated party will exert reasonable efforts under their particular circumstances. Consequently, some courts have upheld the opinion that best efforts provisions are fulfilled when a party exhibits reasonable or good faith efforts toward fulfilling their contractual obligations.

However, this is not always the case. Past interpretations of the definition of best efforts have resulted in courts ruling in favor of licensors and holding licensees to a high burden of performance in fulfilling best efforts clauses. This lack of a legal “gold standard” defining best efforts leaves many cases to the vagaries of local interpretation, a considerable liability to companies operating under best efforts agreements.

#### **“Best efforts” vs. “reasonable efforts”**

In light of these inconsistencies and in an attempt to balance the playing field between contractual parties, businesses involved in contract negotiations sometimes opt to discard best efforts terminology in favor of more forgiving language.

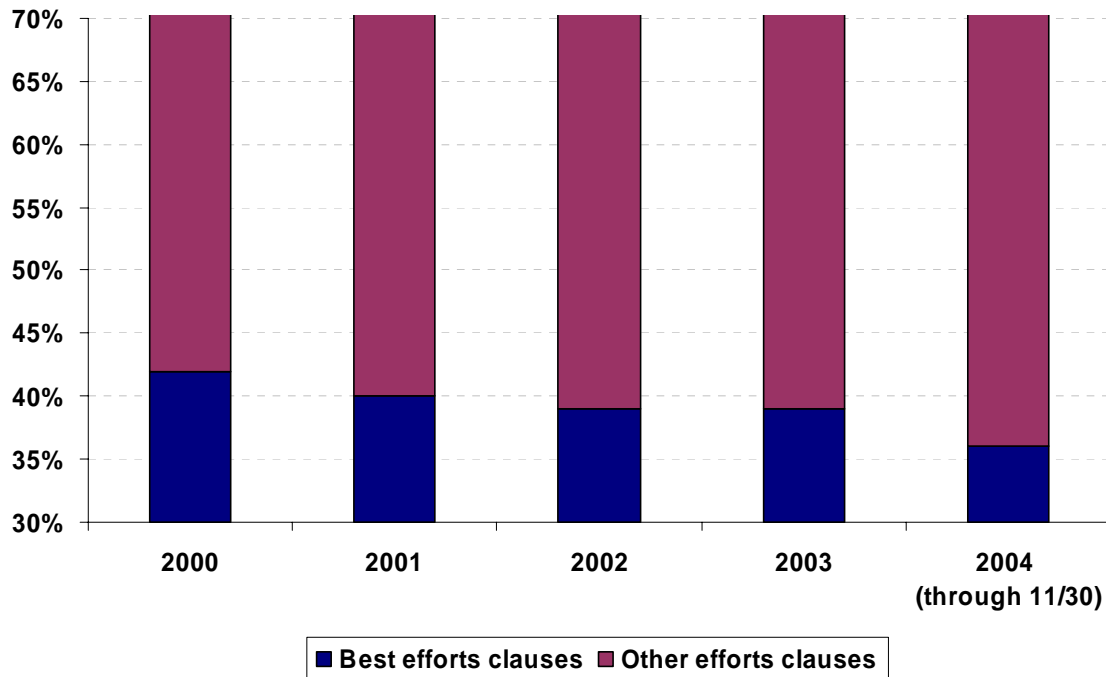
For example, a study of contracts filed with the SEC in January 2004 revealed that of all contracts containing an “efforts” clause, 627 contained the phrase “best efforts,” while 1,220 opted for more flexible terminology, including “reasonable best efforts,” “commercially reasonable efforts,” “good faith efforts,” “diligent efforts,” and others.<sup>4</sup> These results suggest that current drafting language might be moving away from the potentially strangling ties of best efforts provisions and toward more explicit options.

To further explore this idea, we replicated the methodology used in the aforementioned study and examined SEC filings from January 2000 through November 2004. Specifically, we examined all 10-K Exhibit 10 (“Material Contracts”) filings to determine how usage of the term “best efforts” and nine other efforts clauses<sup>5,6</sup> (e.g., “reasonable efforts”) in corporate contracts has changed from 2000 to the present. Figure 1 presents our results.

Our analysis revealed that use of the phrase “best efforts” decreased as a percentage of all efforts clauses from 2000 to 2004. Whereas “best efforts” was used in 42% of contracts containing an efforts clause in 2000, only 36% of contracts with an efforts clause contained this term by 2004.

Conversely, alternative efforts clauses gained popularity during this time period, rising from 58% of all contracts containing an efforts clause in 2000 to 64% in 2004. These results support the theory that companies are becoming wary of the inherent risks associated with using the term “best efforts” and are adopting more flexible language in drafting contracts.

Figure 1. Percent composition of “best efforts” vs. “other” efforts clauses, 2000-2004



The results of our analysis also support what is fast becoming a common belief in business and legal circles regarding best efforts: best efforts clauses may be more trouble than they are worth. For example, management professionals have advised against using best efforts clauses in contracts and proposals, as such provisions can create obligations that go “well beyond a firm’s normal duty to a client.”<sup>7</sup> Phrases such as “reasonable efforts” have been endorsed as potentially less problematic, as they theoretically allow all parties a greater level of clarity in determining when contractual obligations have been fulfilled.

In practice, however, it is unclear whether semantics plays a role in the actual determination of a party’s efforts. In fact, best efforts variants can be just as subjective as best efforts alone. The fact that lawyers and executives are increasingly using best efforts variants in drafting contracts suggests professionals recognize the potential problems that can arise by relying upon best efforts provisions. However, substituting additional subjective wording into contractual agreements does

little to quantify or clarify parties' obligations. Thus, this strategy ultimately offers little in the way of a solution.

Additionally there is a lack of evidence suggesting that courts have, for example, consistently treated "best efforts" and "reasonable best efforts" any differently. Pending a definitive precedent, it is likely that reasonable and best efforts clauses will continue to be interpreted differently by different courts.

How to prove "best efforts"

It remains to be seen whether courts will decide that "reasonable efforts" provisions impose less stringent requirements upon contractual parties than "best efforts" provisions. Thus, the challenge for attorneys continues to be providing convincing evidence that the client did or did not exert its best or reasonable efforts.

A company cannot extend itself beyond its available resources if it wishes to succeed. With this in mind, it is our opinion that a company involved in a best efforts agreement is obligated to develop a plan to effectively market a product or service within the limits of the resources that are available to it. The ultimate scope and success of such a marketing plan is inextricably linked to these resources and the extent to which the licensee and licensor control them. Consequently, any dispute that arises regarding fulfillment of best efforts can only be resolved by evaluating the marketing strategy, plan and activities of the licensor and licensee. Thus, at its core, best efforts is an issue often based in the principles of marketing, and is most fittingly argued as such.

#### **"Best efforts" in the marketing context**

The most effective and appropriate method of measuring best efforts is by examining a company's performance in view of established marketing principles. Most best efforts cases boil down to a fundamental disagreement over whether a licensee exhibited acceptable performance in its capacity as a revenue generator for the licensor. From this perspective, it is helpful to think of the licensee as a marketer of a product or service.

Marketing is the process of creating, promoting and delivering products and services of perceived value to consumers and businesses.<sup>8</sup> Marketing can serve a number of purposes, including:

- Increasing sales
- Increasing public awareness
- Building brand strength
- Building company profits
- Building customer relationships

- Satisfying consumer wants
- Growing market share

Additionally, marketing is the primary means by which businesses and consumers exchange information. As such, marketing is an indispensable facet of any successful organization.

As a marketer, there are many tools available to licensees that allow them to achieve the goals outlined above. Included in these tools are the four Ps of marketing: Product, Price, Place and Promotion. By adjusting the types of products and services they offer (product), the price at which those products and services are offered, channels of distribution (place), and the types of marketing communications (promotion, such as advertising, personal selling, events and public relations), the licensee, at times working with the licensor, can develop an optimal marketing strategy that will maximize value for the customer and profits and competitive advantage for itself and its contractual partner (see Figure 2).

Figure 2. *The Four Ps of Marketing*<sup>9</sup>



### Product

Perhaps the most essential component of any marketing campaign is the product that is being offered. On a fundamental level, if a product is perceived by the public to fulfill a want or a need, demand will develop for that product and the product will sell. Conversely, a product that does not fill a specific need will likely be doomed to failure. Thus, a large function of marketing is to develop a dynamic and desirable product line and frame these products in a way that makes them irresistible to the public.

The product being offered (and the markets in which it operates) often plays a pivotal role in a best efforts case. For example, if a licensor develops a superior product that fulfills an unbridled public need, but the licensee fails to develop an innovative marketing plan to sell the product, this might constitute a breach of best efforts on the part of the licensee.

On the other hand, a licensee that makes a valiant effort to move an unpopular product in a hostile market-place might still be said to have upheld a best efforts clause even if sales are well below the licensor's expectations. A marketing expert can provide detailed analysis of the markets and specific factors at play and arrive at a factually-grounded opinion regarding the scope and impact of the product offering in best efforts litigation.

### **Price**

Price can have a profound effect on the success of a product in the market-place. If a licensor does not grant its licensee enough flexibility to adjust prices to meet its customers' needs, the licensee will lose sales to other vendors providing more competitive pricing. All else equal, such low sales figures can hardly be blamed on the licensee's lack of best efforts in attempting to sell the product. Rather, this failure likely would be a direct result of the licensor's rigid pricing scheme.

However, if a licensee is granted pricing flexibility, it must utilize this asset to the best of its ability. If the licensee attempts to maintain a high profit margin by offering a higher price than competitors, the licensor might be able to claim breach of best efforts because the licensee did not utilize every reasonable tool at its disposal (e.g., price cuts) to attempt to sell the product.

### **Place**

Another important factor that influences the ultimate success of a marketing campaign is place, or the distribution channels that direct the flow of products to consumers and add value to the final product. These channels include the manufacturer (i.e., licensor), wholesalers, brokers, distributors, retailers and others. To ensure a product's success, these players must work together to make products available where and when consumers want them. In addition, participants in the distribution channel must engage in research about potential markets, maintain sufficient levels of inventory, arrange for the shipping of the product, and provide consumer credit and other services.

Successful orchestration and execution of these logistical services are essential to the overall success of a marketing campaign. Licensors and licensees must work together to identify the most

relevant markets for the product and determine which retailers will bring the product to the public. Failure on the part of the licensor or licensee to fully explore and exploit the appropriate distribution channels could constitute a breach of best efforts.

### **Promotion**

The final critical element of a successful marketing plan is promotion. Promotion, or marketing communications, refers to any action or program that stimulates consumer interest and purchases. Promotions can be designed to add psychological value to a product—for example, using advertising to foster a product image of dependability or quality. Promotions can also be used to add tangible value to a product, such as a price discount or a “buy-one-get-one-free” offer.

Promotions often serve the purpose of adding extra value to a product that a customer may already want or need. By adding this value, the marketer hopes to convince the consumer to discard any reservations and make the purchase.

Developing a dynamic and effective range of promotions can be critical to parties attempting to fulfill a best efforts obligation. For the licensee, making attractive sales incentives available to customers can be the deciding factor in building repeat customers and gaining new business.

Licensors (manufacturers), on the other hand, must make special incentives (wholesale discounts, etc.) available to licensees (distributors) to give licensees the flexibility to sell the product in different marketplaces.

Disputes over best efforts can often be linked to a party’s lack of commitment in developing attractive sales promotions, whether on the part of the licensor or licensee. Detailed marketing analysis can identify promotional weaknesses in a marketing campaign and opine on the effects that such weaknesses have on the success of the campaign.

### **The 4 Ps in action**

To develop a dynamic marketing strategy, a company must have the ability to adjust the 4 Ps to its advantage. If, for example, a licensee controls only place (i.e., distribution channels), while the licensor controls the product, price and promotion, it will be difficult or impossible for the licensee to achieve the same level of success as a comparable competitor with control of all 4 Ps. Nevertheless, this licensee could have exhibited its best efforts, and therefore fulfilled or exceeded its obligations, even though their sales would be low.

A more striking example involves pricing. Licensees are at a distinct disadvantage in terms of marketing flexibility if they are unable to adjust their pricing. Consider a best efforts agreement

between a manufacturer and its distributor. The manufacturer is able to control a wide variety of factors to control its costs, including R&D, procuring raw materials, manufacturing, advertising, product line, and others. The manufacturer has the ability to adjust any number of these factors to ensure that it generates a desirable profit margin.

The distributor, however, is at a gross disadvantage. Because the distributor must purchase inventory from the manufacturer, the distributor is then bound to resell the inventory to its customers at a price that is no less than the price the manufacturer charged (i.e., reselling margin). If the manufacturer's prices are above the market average, the distributor must either charge an above average price or adjust its prices to below its reselling margin and take a loss. Because taking a loss would be fatal in the long-run, the distributor is essentially forced into selling at an above-market price, an option that will severely restrict its ability to make sales.

A common yet often incorrect argument used by attorneys is that the licensee failed to sell enough product to constitute best efforts. This approach assumes that best efforts can be determined by examining sales or purchase data without considering any other factors. As we have seen, however, this is not the case. A multitude of factors can impact sales numbers, and some or many of these can be beyond the licensee's control.

A thorough evaluation of best efforts will extend far beyond total quantities purchased or sold and examine the actions and channels through which the licensee attempts to fulfill its obligation. For instance, it is possible that due to market conditions a company might sell little or no product despite executed a reasonable marketing strategy and plan. Such a company may have exhibited best efforts.

This scenario is quite common. In one recent Keegan & Company case,<sup>10</sup> our client, a distributor of medical supplies, was accused of failing to exhibit best efforts in distributing the manufacturer's goods based on the manufacturer's claim that the distributor's sales were unacceptably low. Upon conducting a marketing analysis, however, we found that the manufacturer severely restricted the distributor's marketing abilities by discontinuing funding earmarked for marketing activities and retaining tight control over the product line and product pricing without understanding the complexities of the local market. Based on this evidence, it was apparent that the distributor was performing to the very best of their abilities given their limited flexibility with many elements in the marketing mix. After a trial on the issue in which we presented our marketing analysis and findings, the jury ruled in favor of our client.

The lesson is that a best efforts case is not necessarily lost (or won) simply because the “numbers” are off. A marketing expert will be able to identify many additional factors that will have an impact on determining whether best efforts were indeed met.

### **Conclusions**

Best efforts clauses, no matter how potentially problematic, are a popular and prevalent option in contractual agreements. Despite the results of our analysis indicating that that the use of more definitive contract language (e.g., “reasonable efforts”) has been on the rise in recent years, best efforts disputes will likely be heard in our courts for years to come.

Until a clearer precedent is set, it is imperative that litigators employ a strategic approach to best efforts cases. If a company has acted in good faith and performed to the best of their ability under their particular circumstances, they have likely exhibited best efforts. Without a “gold standard” upon which to define best efforts, courts are forced to rely upon case-by-case circumstances to decide whether contractual obligations have been fulfilled. Often, cases can be made or broken based on a detailed analysis of the marketing techniques employed by the parties at hand.

At the core, best efforts disputes are essentially disputes over marketing efforts and the successes of such efforts. If all parties engage in an innovative and detailed marketing plan that skillfully employs the 4 Ps to its advantage, the chance of widespread product success increases significantly.

In such cases best efforts disputes rarely arise. It is when there is a critical breakdown in the marketing process—be it through inflexible pricing, targeting the wrong market, failing to devote enough resources to advertising, not developing a well-received set of promotions, or otherwise—that best efforts comes into question. As Dr. Deming so wisely pointed out, it is not enough to simply do your best—you must also know what to do if you are to be successful. This maxim is especially true in the field of marketing when operating under a best efforts obligation.

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<sup>1</sup> Kenneth A. Adams, *Understanding “Best Efforts” and its Variants*. The Practical Lawyer. 12-13 (August, 2004).

<sup>2</sup> See, for example, *Bloor vs. Falstaff Brewing Corp.*, 454 F. Supp. 258 (S.D.N.Y. 1978).

<sup>3</sup> *Macksey v. Egan*, 36 MA. App. Ct. 463, 633 N.E.2d 408 (1994).

<sup>4</sup> Kenneth A. Adams, *Understanding “Best Efforts” and its Variants*. The Practical Lawyer. 12 (August, 2004).

<sup>5</sup> We examined the same nine phrases examined in Adams’ study.

<sup>6</sup> Because we limited our search to the nine phrases included in Adams’ study, it is possible that we excluded a small percentage of contracts using alternative efforts language. However, we are confident that we captured all contracts containing the phrase “best efforts.” Therefore any omitted contracts would fall into the “other efforts clauses” category and would strengthen the observed result.

<sup>7</sup> See, for example, *Six Deadly Phrases to Avoid in Proposals*. Design Firm Management & Administration Report. November, 12 (2001).

<sup>8</sup> Philip J. Kotler, *Marketing Management*, 5 (11<sup>th</sup> ed., 2003).

<sup>9</sup> Warren J. Keegan, Sandra E. Moriarty, and Thomas R. Duncan, *Marketing*, 18 (2<sup>nd</sup> ed., 1995).

<sup>10</sup> *TACT Medical Instruments, Inc. v. Biomet Orthopedics, Inc.* 3:01CV895 (N.D.IN. 2004).