

ALTERNATIVE COMPENSATION SYSTEMS FOR THE ADVERTISING INDUSTRY

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COMMISSION

It is important to understand that what we call commission today would be viewed as a kick back scheme in most businesses. Think about it: the supplier increases its bills to include an amount to compensate the purchaser's agent who selected the supplier. How did we get to this and why would we continue?

The sales commission of fifteen percent (15%) of the total raised in selling the media space was an obvious way to compensate the media sales force. Like any other salesman, the sales agent would get a higher commission for selling the product at a higher price. There was a congruence of interest on the part of the sales agent and the media to get the highest price possible. In order to sell advertisers on the idea to purchase media, it became necessary to explain to them how the media could best be exploited. This resulted in the development of advertising. When the advertisers then wanted to place the advertising in other media, the sales agent for the original media who had created the advertising objected. He wanted additional compensation. The advertiser said, get the other media to pay you. He needed to obtain permission to represent competitive media. The media agreed. Thus, the media sales agent became an advertising agency, and an agent for the advertiser. As agent for the advertiser, however, the ad agency was now working for the advertiser. He now was judged by negotiating discounts off the rate card. This of course put the agency in a conflict of interest, since the "Commission" would be less if the price paid for the media was less. Who says a servant cannot serve two masters?

An agreement, which preceded the enactment of the antitrust law, was entered into by the advertising agencies and the newspapers. The newspapers agreed that they would charge advertisers full rate card (including a 15% commission), and they would continue to give the advertising agencies invoices reflecting the total charge including the 15% commission but expect payment only of the net amount less the fifteen percent (15%) commission. In this way the advertising agencies could continue to represent to the advertiser that hiring an agency didn't cost anything and the agencies would continue to receive 15% off the gross media cost (an effective 17.65% of the actual amount paid to the media). This way the media cost the advertiser the same amount with or without an ad agency, and so it seemed that advertisers need not pay the agency anything for the services they provide. (This same concept continues today in the minds of many advertisers.) In exchange for this commitment on the part of the media, the agencies

agreed that they would be solely liable for payment in full to the media, regardless of whether the advertiser paid the advertising agency. Thus was born another novel business concept: the agent for a disclosed principal who agreed to be liable for the principal's obligation. In this way advertising agencies created the distinct possibility of having liability far in excess of their actual size as a business: a recipe for bankruptcy.

The Federal Trade Commission busted the agreement in 1956. Slowly but surely, the media were forced to permit advertisers purchase media directly at the net charge (rate card less 15%). Once advertisers were able to obtain the media at the same cost as the agency, it was no longer possible to argue that the advertising agency services were free. After a while, clients would hear from media buying services that media planning and purchasing could be purchased for far less than 15%. The client came under the misapprehension that they were being overcharged by agencies that were seeking fifteen percent (15%) of media costs as compensation. The fact that it was called Commission on Media falsely implied that this was the cost related to media purchasing, resulting in clients incorrectly assuming that they were being ripped off by paying more than the cost of media buying. Thus the so called "Commission" engendered mistrust and misunderstanding damaging the relationship between advertising agencies and advertisers.

Why Clients Like Commissions

The principal advantage for the client in basing compensation on commission is the fact that when the client cuts the budget it cuts the agency's compensation as well. Thus as clients strive to meet their P&L goals to receive their own bonuses and cut the overall the ad budget they get the benefit of also cutting the compensation paid to the agency. (The agency, of course, has not only done all the work creating the advertising but has done the media planning and buying, and it now has the extra work of canceling the media: more work for less money.)

The second thing clients like about commissions is its virtual invisibility. Clients will indicate that by burying the agency's compensation in the expenditure for media they avoid any questions by their internal auditing, bookkeeping and financial people regarding the amounts paid to the agency. While they will argue that this is to the agency's advantage: "if my people knew what we were paying you they would try to cut your compensation"—it may well be that the agency's efforts would be given greater respect and attention if they were not mistakenly assumed to be paid for by the media.

The third reason for favoring commission basis for compensation is the inability to value what the agency does and therefore what appropriate compensation might be. Determining an appropriate fee requires an analysis that a commission (or sliding scale commission) might obviate. Some clients feel that by simply negotiating the commission rate down from fifteen percent (15%) they have done their job and need not understand what the agency is actually doing for the money it is being paid.

Why Agencies Cling to Commission

The principal reason that agencies favor media commission is the hope that the client won't notice that with increasing media expenditures the agency is making a great deal more money without necessarily doing a great deal more work. Since there is not necessarily any direct relationship between the amount the client spends on media and the amount of work the agency must do, the agency hopes to achieve a substantial return on a more successful campaign. The agency may also find the Client's second rationale to be helpful. It may be that if the financial people at the client fully understood the total compensation achieved by the agency they would be quicker to cut the agency's compensation. And, of course, agencies do not know what they should be charging. Commission is a substitute for a rational determination of appropriate compensation for the services of the agency. Many agencies have no idea about profitability on a client-by-client basis and otherwise do not have a handle on what it costs to service the client.

Commission Gone Awry

Where an agency accepts a pure commission compensation, it is at total risk if the client for any reason decides not to advertise. The destruction of a manufacturing facility, a government recall of the product, terrific success selling the product, termination of the product line or simply a brand manager trying to achieve his own bonus goals may result in a severe curtailment of media spending. When this happens, the agency had all of the costs of a full staff on the account and none of the income. In one case, the agency had done all the work to create the campaign and had purchased the media, when the client decided not to advertise. The agency was contractually obligated to cancel all the media and otherwise provide services for 90 days. Its only compensation was the production commission. The agency went bankrupt.

Consider also the speculative creative issue. An agency that declined to do spec creative entered into contract for compensation based only on commission. The agency presented three campaigns over six months which were all rejected. The client then terminated the contract. It never spent any money on advertising. The agency had done three speculative creative campaigns for only production commission. It never received the anticipated compensation to cover the cost of servicing the client.

Another favorite is where the agency has never explained its compensation to a new client, and merely relied on media and production commission being the standard in the industry. Along comes a media buying service who tells the client that it is willing to charge only 5% media commission as the cost of buying media, leaving the client with the impression that production commissions cover all of the other services of the agency. The client pulls back the media buying and refuses to pay the agency anything more than the production commissions already billed and paid.

COST RECOVERY

Commission should never be an excuse for failing to assess profitability on a client by client basis. It is a simple enough matter for an agency to determine what resources it is putting against a particular client and what it is being paid. The resources are fundamentally a function of the talent dedicated to the client's business plus the overhead associated with those people. Agencies should be able to calculate either on an hourly basis (where time sheets are kept) or as a fraction of each individual's total time dedicated to a particular client. This will give the total salaries (including bonuses) devoted to the client. Add to the total salary cost the payroll related costs (a percentage calculated by the accountant) to determine the direct labor cost. Then add an overhead charge (as a percentage of the direct labor of cost). These costs constitute the break even point for the agency.

Staff Cost
Salary/Bonus (% of time)* + Payroll Related % (25%) + Overhead % (100%) = Cost

*E.g.: \$125,000 /yr. salary
 + 25,000 annual bonus
 150,000 "salary" (total compensation)
 will spend 2/3 of her time on the client = \$100,000 "salary" cost

Obviously, the total income received by the agency in connection with a particular client in excess of the total cost of servicing the client is the profit or the return on the investment which should be available to the shareholders or principals of the agency. An intelligent assessment of what resources the agency will have to be put against the client's needs will determine what the break even point is in taking on that client. A reasonable return on investment should be included to come up with the minimum compensation the agency must obtain.

		25%		100%		20%
Salary	+	Payroll	+	Overhead	+	Profit
1x		1.25x		2.5x		3x

Thus 3 times total staff salaries should be an acceptable minimum fee (provide a 20% margin).

FEES

Minimum Fee

When the agency succeeds in solving the client's problem with a minimum of effort (and a maximum of brilliance) there will be lower cost of people to produce the same result. If the agency can re-allocate its staff time, it will realize a greater profit. Truly great advertising will permit the client to reduce its media expenditures. A fixed fee compensation system precludes the client coming back and seeking a diminution in the agency's compensation because there was less staff or less man hours applied than originally anticipated. On the other hand, where the client is increasing media expenditure because the advertising is mediocre and only greater media weight will manage to produce the sales necessary for the client, the agency is rewarded for its poor performance. In this way a commission based compensation system rewards mediocrity (if not incompetence) and is subject to criticism as being an exceedingly imprecise tool.

An agency should calculate the breakeven point in terms of income from the client as a starting point. If advertising spending is certain, a commission may yield a greater income than a fee. A fee must be sought, however, where commissions will not be sufficient. An agency that simply assumes that commission is the proper compensation without considering the deliverables that will be required or the staffing needs necessary, may find that although it is obtaining the so called full fifteen percent (15%) commission its total income in connection with the client is less than its direct cost and proper allocation of overhead resulting in a loss on the client. Come the end of the year agency principals may find that they are only able to pay themselves less than they could earn working elsewhere, because there is no profit—there is actually a loss.

In all likelihood the client that significantly increases its media expenditure or shifts from print to broadcast or otherwise increases the profitability of a commission account, will in due time move to a sliding scale or move off of commission completely depriving the agency of the long anticipated windfall that was supposed to make up for all the losses that the agency suffered waiting for the day the client would become profitable. In short, commission may have its advantages but only where the agency has fully analyzed the income necessary to make a reasonable profit on the client and monitors its income or obtains a minimum fee to protect against client cutbacks in media spending or commission rate.

Any agency must continually monitor its profitability on a client-by-client basis. Knowing the total revenue to the agency on an ongoing basis and adjusting staffing and costs to that revenue is essential to the survival of the agency. If that level of staffing is inadequate then additional compensation has to be obtained through billing the client for special services and additional services the client wishes to obtain or moving to a fee or increasing the percentage of the so-called commission. Obviously, it does not matter how the dollars are obtained, whether it is through fee, commission, production commission or charges for special services. What is essential is that the agency know what it is costing the agency to provide the services required by the Client and that the agency ensure that it receives sufficient revenue to cover those costs and a reasonable rate of return on investment.

A minimum fee (it can be applied against commissions earned) protects the agency from catastrophic loss. The client expects certain levels of staffing, and the agency necessarily assigns staff to the client's account. Whatever may happen to media spending there should be a minimum fee for service. The fee can be established as a matter of simple negotiation (based on the agency's projection of its cost recovery and its desire to win the account) or it can be based on hours. Hourly fees can be based on standard rates dictated by the marketplace (permitting the agency to retain any additional profit attributable to its productivity and efficiencies and lower overhead) or hourly rates can be based on the agencies' actual cost recovery calculation plus a profit margin dictated by the client (giving the client the benefit of the agencies' productivity and lower overhead). Increasingly, consultants for clients demand that the agency reveal its most proprietary information to insure that the client can dictate the allowable profit for the agency.

A fixed fee permits the agency to benefit from solving the client's marketing problem quickly and effectively. A single winning campaign with "legs" will be rewarded by fees that are not consumed by staff and overhead costs. On the other hand, failure will be costly. Having to produce six or eight campaigns before selling one or having to replace a failure in short order may cause the agency to incur huge staff (and freelance) costs and the overhead costs that go with them. The account may well turn out to be unprofitable if the agency staffing against the deliverables turns out to be underestimated.

Hourly Fees

Hourly fees should be established based on the market. With hourly charges the client pays more to see more. The client's costs are open ended. It may have to settle for a campaign sooner rather than continue to invest in an unhappy choice or fire the agency and go to its second choice in the last review. The more confident the agency, the more likely it is to want a fixed fee, but a difficult client may still insist on seeing ten campaigns before accepting the first one that the agency recommended. Thus, hourly fees serve to protect the agency against underestimating the staff costs necessary to accomplish the client's goals (or to satisfy the client's whims).

INCENTIVE COMPENSATION

The agency relationship is most akin to an employment relationship. The client hires based on resumé and recommendation hoping for a fit and great work. As it would incentivize any other management of an important aspect of its business, it should consider offering bonus compensation to its advertising agency. Bonus compensation can be based on anything. Some examples include: (1) hitting targets set each year by the client and agency, (2) client achieving the goals set each year for the client's marketing managers, (3) an agency "report card" by the client evaluating the agency's performance or (4) any qualitative or quantitative testing of the advertising or the client's success. Some examples of contract provisions to include in contracts between agency and client may be helpful:

Bonus based upon yearly goals

The following is a provision which provides that the agency shall be entitled to a bonus if an agreed upon yearly goal is achieved. This provision (as well as many of the others set forth below) can be altered to base incentive compensation on any kind of performance, such as revenues, profits, sales, direct response rate, increased brand awareness, or cost savings (for example, buying the same level of media for less money).

Prior to the beginning of each contract year, Agency and Client shall agree upon a "Goal" for such year in writing. If such Goal is achieved during such year, Client shall pay to Agency, within thirty days after the end of such year, a bonus in an amount equal to 10% of the total minimum monthly fees payable hereunder during such year.

Bonus based upon yearly goals, with give-back

The following is a provision which provides that the agency shall be entitled to a bonus if an agreed upon yearly goal is achieved, but that the agency shall also be required to return a portion of its fee if the goal is not achieved. This provision could also be changed so that, for example, the give-back is a credit that is only applied against the next year's fees.

Prior to the beginning of each contract year, Agency and Client shall agree upon a "Goal" for such year in writing. If such Goal is achieved during such year, Client shall pay to Agency, within thirty days after the end of such year, a bonus in an amount equal to 15% of the total minimum monthly fees payable hereunder during such year. If such Goal is not achieved during such year, provided that Client has no outstanding indebtedness to Agency, Agency shall refund to Client, within thirty days after the end of such year, an amount equal to 5% of the total minimum monthly fees paid during such year.

Bonus based upon set sales goals

The following is a provision which provides that the agency shall be entitled to receive a bonus if a sales goal set in the contract is achieved.

If in any contract year, Client sells more than 500,000 [units] (excluding returns), Agency shall receive a bonus for such year in an amount equal to \$1 for each [unit] sold in excess of that amount. (For example, if Client sells 600,000 [units] in any contract year, then Agency shall be entitled to a bonus of \$100,000 for that year.) Any bonuses payable hereunder shall be paid to Agency by Client within thirty days after the end of the applicable year.

Bonus based upon client's own internal yearly goals

The following is a provision which provides that the agency shall be entitled to a bonus if the client meets its own internally set yearly goals.

For each contract year: (a) if Client's Sales (as defined below) for such year equal or exceed its Sales Goal (as defined below) for such year, but are less than 10% greater than such Sales Goal, Client shall pay to Agency a bonus in an amount equal to 5% of the total minimum monthly fees payable hereunder during such year; or (b) if Client's Sales for such year are at least 10% greater than its Sales Goal for such year, Client shall pay to Agency a bonus in an amount equal to 10% of the total minimum monthly fees payable hereunder during such year. Any bonuses payable hereunder shall be paid to Agency by Client within thirty days after the end of the applicable year. For the purposes of this paragraph, "Sales" and "Sales Goal" shall be defined as such terms are defined for Client's executive bonus program.

Optional bonus

The following are sample provisions which provide the client with a formal opportunity, but not the obligation, to pay the agency a bonus. Obviously, it is best to have an incentive compensation provision that requires payment if certain objective criteria are met; however, these provisions may be used when the client is not willing to commit to paying incentive compensation.

Within thirty days after the end of each contract year, Client agrees to provide Agency with a written evaluation of Agency's performance for such year and to pay Agency a bonus, in an amount that Client shall determine, based on such evaluation, within thirty days after the end of such year.

Within thirty days after the end of each contract year, Client agrees to provide Agency with a written rating of Agency's performance for such year (and a written explanation of such rating), on a scale of one to three (with one being the lowest), based on the following criteria: agency/client working relationship, quality of agency's work, and agency's attention to costs. If Agency receives a rating of "one" for such year, Agency shall not be entitled to a bonus for such year. If Agency receives a rating of "two" for such year, Agency shall be entitled to a bonus in an amount equal to 5% of the total minimum monthly fees payable hereunder during such year. If Agency receives a rating of "three" for such year, Agency shall be entitled to a bonus in an amount equal to 10% of the total minimum monthly fees payable hereunder during such year. Any bonuses payable hereunder shall be paid to Agency by Client within thirty days after the end of the applicable year.

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These provisions are, of course, only samples, and will need to be adjusted to fit into a particular contract. Please note that some of the sample provisions define the specifics of the incentive compensation plan, while others leave the specifics to be agreed upon by the parties.

(All of them can be revised to include, or not include, the specifics.) It will generally be advantageous for the parties to agree upon the specifics in the contract in order to eliminate the risk that the specific terms of the plan will not be agreed upon. Changes to the plan for subsequent years can always be added as a short amendment to the contract.

These provisions can be combined to create incentive compensation provisions that depend on multiple factors (e.g., a bonus based on sales and profits or a bonus based on quantitative and qualitative factors). These provisions can also be revised so that the bonus is paid in something other than money (e.g., the client's products or stock in the client). In addition, incentive compensation provisions can also be created that are tied to the agency's production or media spending (e.g., receiving a bonus, or a higher commission rate, if the agency's media spending exceeds a certain level).

Finally, when adapting these provisions for a particular contract, other issues relating to incentive compensation will need to be addressed in the contract as well, such as termination of the contract prior to the end of a year, notification of when goals are met or not met, audit rights, and other issues related to the particular incentive compensation structure that you choose.

STOCK

It seems that every startup — read “.com” — wants to pay its agency (and its lawyer) in stock options rather than cash. This is not as easy as it seems. First the valuation of the company for purposes of calculating the value of the options you receive may vary wildly. They should be based on the valuation recently or concurrently negotiated by the venture capitalists funding the venture. You are now an investor, not merely an employee—at least with respect to your basic fee, as opposed to bonus or incentive compensation.

Second, but equally important, you must review with your tax advisors the treatment of any options. You may receive income for tax purposes without the cash to pay the tax on that income. Your normal tax planning may center around compensation to principals, wiping out any profit at the corporate level, and now you have income that cannot be disbursed. You may therefore need to be able to distribute any options to the shareholders or principals of your agency. Finally, of course, too many high risk stock plays may leave you cash poor and—if none of these companies' clients make it to IPO plus the lockup period—just plain poor.