ROOT CAUSE ANALYSIS & CORRECTIVE ACTIONS

Stop Unauthorized Sales At The Source, Reduce Enforcement 'Whack-A-Mole', And Realize A Cleaner, Healthier Online Marketplace

VORYS eCONTROL

Overview: Brand Harms Caused By Uncontrolled Online Marketplaces

Commerce has been irrevocably transformed in the age of online marketplaces, driven in large part by the rise and dominance of Amazon.com. These 3P sellers are often fueled through product diversion – i.e., the siphoning of product from authorized channels of distribution for resale in an unauthorized manner. While product diversion has certainly existed for as long as modern retail itself, it has surged in its frequency and capacity for disruption with the explosive growth of online marketplaces. Indeed, there are now countless workshops, conferences, seminars, online videos and other avenues purporting to educate would-be 3P sellers on how to profitably obtain products and resell them online.

When brands are susceptible to diversion and confronted with numerous unauthorized 3P marketplace sellers, multiple harms occur. For example, brands with a first-party ("1P") Amazon relationship may experience major erosion of brand value, margin chargebacks, CraPed products, and reduced profitability as a result of the massive intrabrand competition caused by unauthorized 3P sellers. Brands employing their own 3P strategy – either through their own storefront or through an exclusive 3P seller – see their sales eroded by these unauthorized sellers along with harmful freeriding on marketing funds, search investment and the like. Making matters worse, the poor quality products sold by unauthorized 3P sellers result in a poor consumer experience, negative product reviews, and cause even further reputational and economic damage to the brand.

All the while, the brand's longtime brick-and-mortar retailers are harmed when consumers decide not to buy products in their stores after seeing bad online reviews. Additional harms result as a consequence of the "showrooming" phenomenon, when consumers use stores to inspect and gather information about products only to purchase them online from unauthorized sellers. These unauthorized sellers have made no investment in the brand and offer products at prices below which invested retailers can meaningfully compete. Tellingly, eBay knows this dynamic all too well, having run a promotional video highlighting it.[1] In response,

1 https://www.ispot.tv/ad/os0w/ebay-when-youre-over-overpaying

brick-and-mortar retailers are increasingly incorporating price-match policies and chargebacks into their dealings with brands and may even reduce shelf space or refuse to carry brands that lack sufficient control over online sales.

Brands must take control to succeed; unfortunately, there is a great deal of confusion over how best to do so.

Fragmented Approaches Like MAP Policies, Monitoring Software, Scary Letters And Marketplace Takedown Requests Often Result In "Whack-a-Mole" Because They Do Not Address The Root Cause.

In what is becoming a familiar refrain across virtually all B2B and B2C verticals, achieving better control over online sales is now imperative for success. It is common for brands attempting to achieve control over online sales to first attempt various half-measures that quickly prove incapable of solving the problem. For example, many brands turn to MAP policies and price monitoring software – only to quickly realize that anonymous unauthorized sellers, and Amazon, do not adhere to MAP. Those brands are now faced with the difficult decision of whether to terminate a longstanding good customer that drops its advertised prices to compete against unauthorized marketplace resellers.

Other brands work with certain technology vendors that tout their ability to send unauthorized sellers automated "scary" letters through marketplace platforms or other vehicles in order to reduce their numbers. Such tactics invariably come up short. Without the appropriate legal foundation, "scary" letters asserting that a seller is "unauthorized" are ineffective against seasoned resellers who are conditioned to ignore them and continue unabated. Frequently, these types of vendors tout the number of sellers they have "removed", but do not account for new sellers flooding into the platform or the fact that many of the sellers removed were never those driving commercial disruption in the first place – *i.e.*, large resellers capturing meaningful sales volumes.

Yet others work initially with vendors who claim to be able to remove unauthorized sellers through vague Amazon or other marketplace enforcement "tricks". Often, these "tricks" involve some form of outreach to unauthorized sellers demanding that

THE ONLINE MARKETPLACE EXPLOSION HAS BROUGHT WITH IT SWARMS OF ANONYMOUS THIRD-PARTY ("3P") MARKETPLACE SELLERS WHO ARE NEITHER LOYAL NOR ACCOUNTABLE TO THE BRANDS THEY PURPORT TO REPRESENT.

the seller make contact and disclose product source information. When no response comes, the vendor makes a brand registry or other complaint stating that the seller's products are counterfeit, which results in the platform removing the listing. Multiple sellers have sued vendors and brands engaged in these tactics, claiming that their products were never counterfeit and that the vendor and/or the brand unlawfully interfered with their business.

Finally, other brands may turn to their usual law firms and spend significant resources to send formal cease and desist letters that are commonly ignored. Or they spend large amounts of money to sue an individual reseller. These are akin to an expensive drop in the ocean that never comes close to solving the problem. Brands that have leveraged one or more of these fragmented approaches become frustrated upon realizing they have signed up for a never-ending game of whack-a-mole and lose hope.

The takeaway is this: brands will never obtain marketplace sales control through fragmented approaches. Rather, brands must implement a comprehensive eControl program. That is, an integrated business, legal and technology system that provides brands with optimized distribution practices, control over online sales, protection of brand equity, and the ability to enhance sales and margin growth in the age of eCommerce. The remainder of this paper will focus on one of the critical components of an effective eControl program – root cause diagnostics and corrective business actions.

The Critical Role Of Root Cause Diagnostics In Achieving Online Sales Control – Where Is It All Coming From?

Pursuing unauthorized sellers through legal enforcement is a critical part of any eControl program, particularly during the initial cleanup phase. Indeed, no matter how tightly a brand attempts to control its distribution, leaks will occur and unauthorized products will appear online. Thus, companies need the necessary legal foundation to support enforcement, and the ability to execute the appropriate legal enforcement program. At the same time, however, companies must take steps to prevent a never-ending game of "whack-a-mole" against unauthorized sellers to most effectively protect brand equity, eliminate channel conflict and realize optimized distribution. If not, companies are likely to face a constant stream of unauthorized sellers, eventually exhausting their budgets and stamina without ever reaching their commercial goals.

In Vorys eControl's experience, the companies that reach their online sales control goals not only establish the necessary legal foundation for enforcement, they concurrently diagnose the true root cause of their unauthorized sales and then take appropriate corrective actions to prevent the problem from continually reoccurring.

This process usually begins with uncovering the identities of unauthorized online sellers and working towards identifying their product sources. Vorys eControl leverages open source intelligence, advanced cyber investigation techniques, access to enhanced informational databases and, ultimately, the legal subpoena power to uncover the true identities of those persons and businesses engaged in the unauthorized sale of your company's products. Once those identities are obtained, our root cause diagnostics team performs a comprehensive analysis of the identified sellers, including with respect to their firmographic profile, and their sales and financial activities.

Once unauthorized sellers are identified and the analysis above is completed, the next step is to gather and review your brand's customer lists, purchasing and other transactional information, product order volumes, invoices, bills of lading and other information that may be relevant for your brand's particular product type and go-to-market strategy. Once this information is appropriately triaged, analytics routines are applied leveraging proprietary data sources, data gathered from marketplace intelligence efforts and other tactics to ascertain patterns, such as their societal, familial and business connections to authorized sales channels, and hone in on diversion sources within your authorized channels.

After identifying the sources of unauthorized sales in your channels, our root cause diagnostic team works with brands to further assess the root cause of diversion in your authorized channels. For example, the true cause may be a promotion the brand is running on its own D2C website, which leads to bulk buying and resale on marketplace channels. It may be that distributors are leveraging volume discounts to supply diverters. In other instances, channel promotions, rebates or other trade management practices may be fueling the unwanted activity. Other examples include exploitation of differentiated international pricing corridors and liquidation practices, among others. To truly achieve online sales control and the commercial benefits that flow from it, these root causes must be uncovered and appropriately addressed through corrective action.

IT IS COMMON FOR BRANDS ATTEMPTING TO ACHIEVE CONTROL OVER ONLINE SALES TO FIRST ATTEMPT VARIOUS HALF-MEASURES THAT QUICKLY PROVE INCAPABLE OF SOLVING THE PROBLEM.

Corrective Action – What Can Be Done To Stop Diversion Sources?

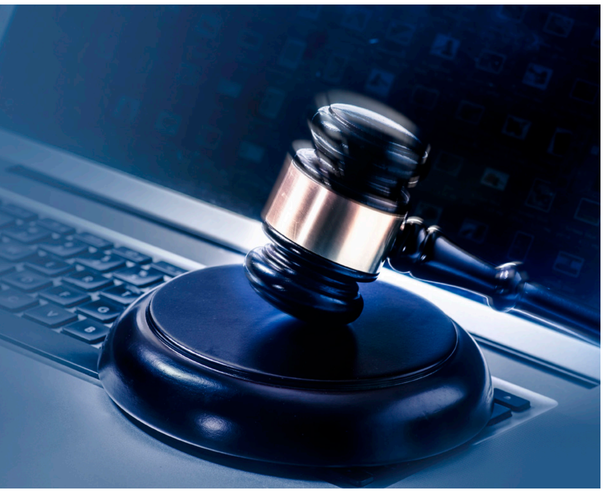
Once the sources and root causes of diversion are identified, companies must next decide the best strategy for stopping them. For those companies whose diversion problems can be tied back to authorized customers, and who wish to maintain the business relationship, the best first step is to engage the customer directly to explain that it is clear that they are a source of diversion; that the long-term health of both the brand and the customer depend on stopping harmful diversion; and that the customer's authorized status is in jeopardy if it does not cease sales to diverters. Many customers will come into line when approached in this manner. Indeed, some may not even know that they are fueling diversion.

If, on the other hand, it appears that the customer will not comply or the company wishes to terminate its business relationship, the customer's authorized status can be revoked and, assuming there are no contractual or other legal limitations on terminating the relationship, the company can cut off the customer. This approach has been very effective for many companies in stopping diversion and has allowed them to focus even more time, attention and resources on those channel customers truly committed to the brand's success.

For some companies, however, their root cause diagnostic effort will reveal that a particular business practice is creating the economic environment for profitable diversion and unauthorized online selling. In these instances, companies must weigh the economic and relational impacts of changing a particular practice against the countervailing benefits that could be achieved if the practice at issue – as well as the resulting diversion and brand harm – was amended or stopped altogether. Some companies may decide that for a multitude of reasons it is not possible to change a particular business practice on the front end, and these companies accept that continuous marketplace enforcement will be a core component of their eControl program indefinitely. Others, however, are eager to begin evolving their business practices so that they are best positioned to minimize diversion and resulting marketplace disruption going forward. The following are common business practices that fuel diversion and where corrective action – if possible – can be most impactful in terms of mitigating the opportunity and profitability of diversion practices and allowing the brand to achieve control:

- **Outdated Channel Strategy.** Many brands still sell to and through as many sales channels as possible without putting any expectations or limitations on their resellers. Brands must evolve to ensure that their channel strategy is consistent with the market dynamics at play today. This involves having a defined go-to-market strategy that has been clearly communicated to channel customers. Customers must be informed regarding how and where products may be sold in an authorized manner, and the brand must be prepared to discipline customers that do not adhere to its channel directives. Gone are the days of sales teams being able to look the other way when selling to certain distributors they know will be offloading product quantities to diversion outlets, as these diverted products will quickly find their way to online marketplaces and wreak commercial havoc for the brand. Some key aspects of channel strategy that may warrant corrective action in the online marketplace age include:
  - Online Marketplaces (i.e., Amazon): Brands must give considerable thought as to how they will engage with online marketplaces. They must have an online marketplace strategy that is precisely defined, that squarely aligns with the brand's overall business strategy, and that is aggressively enforced. Brands that do not are likely to face a chaotic reseller environment with multiple unknown 3P sellers, poor consumer experience and products in the channel, harmful intrabrand competition, and an overall disincentive for customers across the channel map to invest in the brand. This will result in sub-optimized sales growth, brand erosion, and destructive channel conflict.
  - Authorized Sellers in Remaining Channels: Brands must also have a strategy for defining and managing their authorized sellers in other channels and ensuring that their authorized sellers understand this strategy. Authorized sellers – including distributors and independent retailers – are a frequent cause of product diversion, as they are a common source of sales to unauthorized sellers. Brands should strengthen their policies that clearly define how, where and to whom authorized sellers may sell. Brands should communicate their policies and expectations to their authorized sellers, explaining the problems caused by product diversion and the importance of preventing it. Brands should also assist their authorized resellers with best practices for detecting and stopping product diversion. In our experience, most downstream

GONE ARE THE DAYS OF SALES TEAMS BEING ABLE TO LOOK THE OTHER WAY WHEN SELLING TO CERTAIN DISTRIBUTORS THEY KNOW WILL BE OFFLOADING PRODUCT QUANTITIES TO DIVERSION OUTLETS, AS THESE DIVERTED PRODUCTS WILL QUICKLY FIND THEIR WAY TO ONLINE MARKETPLACES AND WREAK COMMERCIAL HAVOC FOR THE BRAND.



customers take such policies or contracts seriously. Brands often experience significant improvements just by implementing appropriate policies and contracts with their customers prior to any legal enforcement.

- Monitoring and Business Enforcement: Although many authorized sellers will comply with the brand's policies, some may not. To effectively deal with recalcitrant authorized sellers, brands should continuously monitor their channels to identify likely sources of diversion (see *root cause* diagnostics above) and take appropriate action against violators. These actions can range from limiting product supply, reducing or eliminating trade allowances or terminating the relationship altogether.

- **Outdated Pricing and Promotional Practices.** The various ways that brands manage and incentivize their customers can also promote diversion and harm brand equity in today's market. Brands should look critically at each of the components below, individually and collectively, to determine whether what was once standard operating procedure may now be doing more harm than good. Before adjusting pricing and promotions, you should seek legal counsel to ensure compliance with applicable laws and regulations. Some common traditional pricing and promotional practices that can cause a great deal of harm today include:
  - Pricing Differentials: Pricing differentials between markets or channels can facilitate product diversion as products intended for one market or channel are diverted into another. Indeed, many brands – whether they know it or not – are underwriting the business of many resellers, causing themselves significant harm. This issue is often pronounced in the context of international sales, where brands may sell products in some countries at lower prices only to find those products resold by unauthorized sellers on Amazon or other marketplaces. Brands should carefully scrutinize for both legal and diversion risk those markets or channels where such differentials may exist and determine if alternative structures can be implemented.
  - Excessive Retail Margins: Brands should pay their authorized sellers fairly for the work they do, but must be careful to avoid overpaying. When retail margins are too high, especially when the brand lacks sufficient control over its other channels, unauthorized sellers are often able to acquire product and resell

it on marketplaces. Because these sellers make no investment whatsoever in the brand, they are content to trade at margins far below those at which invested channel partners are able to compete. Brands can mitigate these issues by adjusting channel pricing, trade spend and/or incentive stacks; lowering MSRP or MAP; or in some instances even implementing maximum resale prices, particularly on aging products.

- Volume Discounts and Incentives: Brands frequently overcompensate distributors relative to their cost to serve through volume-based discount structures. Additionally, brands often provide growth rebate programs that provide payments based on achievement of revenue targets, which further enrich wholesale margins. Such incentives, independently and collectively, incentivize distributors to purchase at levels beyond that which natural demand supports. This overstock becomes the primary source of diversion for many brands. Given their better initial margin levels, distributors can "dump" inventory and still make an attractive return. These practices are especially difficult to detect with larger distributors where incremental purchase increases escape scrutiny in the context of traditionally large ordering patterns. Worse yet, distributors are increasingly establishing their own retail storefronts on Amazon and other marketplaces, which given their margin structure, can foster huge disruption for the brand. In addition to scrutinizing these programs carefully, brands can use them as "carrots or sticks", depending on the brand's strength, contingent on the receipt of verified distributor sell-through data. This data also helps to aid diversion diagnostics work described above.
- Promotions: Promotions are also a frequent cause of product diversion, especially when unlimited quantities and/or compounded couponing are at play. The ability to "game" promotions should be carefully scrutinized as promotions are being designed. Brands should also ensure they have good perspective on promotions that are currently being run by other areas of their business or within the channel itself to ensure they aren't inadvertently providing additional economic incentives that aren't necessary to drive demand. Additionally, brands should carefully structure and tailor their promotional programs to the target audience. For example, they should ensure that two-tier channel promotions are carefully directed toward

ONCE THE SOURCES AND ROOT CAUSES OF DIVERSION ARE IDENTIFIED, COMPANIES MUST NEXT DECIDE THE BEST STRATEGY FOR STOPPING THEM.

the appropriate retail or dealer sales channel and that guardrails are in place for subsequent resale on marketplaces. Further, to mitigate these issues, brands should (i) ensure that consumer promotions have quantity purchase limits; (ii) have a deliberate strategy regarding compounded couponing; and (iii) only pay sales channels for the promotion based on proof of sale.

- Liquidation: Liquidation is also a frequent source of product diversion. Before the rise of eCommerce and online marketplaces, liquidated inventory was typically sold in special liquidation stores or clearance sections, where consumers would know that they were purchasing "as-is" liquidated product. Today, however, liquidated product is often resold on Amazon under the same ASIN as the brand's new products, and consumers often have no way of knowing whether they are buying liquidated inventory. It is important today that brands maintain close oversight of liquidation outlets and consider the possibility of working through one or a very small number of trusted liquidation partners. Brands should also consider implementing return or destroy-in-field protocols for liquidation inventory.

- **Supply Chain Practices and Oversight.** Unauthorized sellers are frequently able to obtain products through supply chain opportunities. Common supply chain issues that fuel diversion include:
  - International re-routing: Brands often sell products to distributors for resale abroad. These products are often sold at lower prices than U.S. products in alignment with the economic dynamics of the intended foreign market. Such pricing differentials can present an alternative arbitrage opportunity, with such products never leaving port – or even traveling around the world and back – and ending up on Amazon. Brands should carefully evaluate and monitor their international distributors to ensure that products are being sold where intended. If this is not possible, brands can look into regional or national product segmentation or variation strategies so that it is clear that the products at issue were manufactured for foreign markets, or look into means of enforcement through customs. Additionally, making incentives contingent on export confirmation and/or sell through reporting can be a useful tactic to mitigate harmful behavior.

– Theft: Unauthorized sellers can also obtain products through simple theft, sometimes with the cooperation of a brand's own employees. Brands should regularly audit their supply chains to ensure that any anomalies are not a result of a theft ring – whether internal or within a channel customer's operations.

- **Internal Misalignment.** Many online sales control issues can be traced back to a lack of internal alignment. For example, the brand's sales team may be selling to known diverters at the same time that its eCommerce team is attempting to enforce against unauthorized sellers. Indeed, cooperative sales teams are a key factor for success here. Problems quickly ensue when unauthorized sellers easily obtain products because sales teams are content to sell to anyone in an effort to more expediently retire their quotas. Brands should thoughtfully consider whether their current sales incentives are a catalyst for diversion. If so, some potential corrective options to consider include:

  – Basing sales incentives on sales to authorized channels only

  – Penalizing sales teams if products are later resold in unauthorized channels

  – Rewarding sales teams for complying with do-not-sell lists

  – Requiring sales teams to identify suspicious transactions for higher-level review

  – Hiring an empowered leader familiar with diversion issues to develop and manage governance guidelines and processes regarding sales team pricing, promotions and incentive authority and activities

  – Training sales teams on the problems of product diversion

  – Basing incentives for both eCommerce and traditional sales teams in part on the health of the Amazon channel

FOR SOME COMPANIES, HOWEVER, THEIR ROOT CAUSE DIAGNOSTIC EFFORT WILL REVEAL THAT A PARTICULAR BUSINESS PRACTICE IS CREATING THE ECONOMIC ENVIRONMENT FOR PROFITABLE DIVERSION AND UNAUTHORIZED ONLINE SELLING.

In addition to sales teams, customer service and marketing teams should implement protocols designed to educate customers about both the harms caused by unauthorized sales and also the benefits of purchasing from authorized sellers, including superior quality controls and product benefits that only accompany products purchased from authorized sellers (i.e., warranties or satisfaction guarantees). Order processing and finance teams should also implement procedures governing new account vetting and ensure existing customer order deviations are flagged for further review prior to processing. Finally, C-suite buy-in for anti-diversion and broader eControl efforts will exponentially increase odds of success and should be obtained at the outset of efforts relating to asserting greater control over online sales.

- **Lack of Diversion Impact Knowledge.** A brand's efforts to assert greater sales control and stop diversion are more likely to succeed if internal champions are able to measure key metrics and tie their efforts to overall business success. While some of the harms caused by unauthorized sellers are multi-faceted, interdependent, and in some cases difficult to precisely collectively quantify (such as broad-based brand erosion and product quality issues), there are quantifiable metrics that should be tracked. These metrics may include the percentage of sales revenue captured by authorized and unauthorized sellers on marketplaces. While some may argue that the brand has captured unauthorized seller revenues at some initial point through its authorized channels, it often comes at a lower margin and great cost to the brand as a result of its cascading impacts. Working to increase the percentage of marketplace revenue captured by authorized sellers will pay material dividends for the brand. Additionally, understanding trends around overall MAP or MSRP compliance as well as price erosion trends across key SKUs will be informative, as will: buy box share, margin chargebacks from retailers, suppressed listings, and overall sales volumes. By agreeing upfront on meaningful metrics to track and measure, internal champions can evaluate and report on the effectiveness of their programs, making any necessary adjustments along the way to increase program effectiveness.

Vorys eControl's Root Cause Diagnostics And Corrective Action Team

WORKING WITH BRANDS TO SOLVE THEIR CHANNEL AND BUSINESS MANAGEMENT CHALLENGES AND POSITION THEM FOR SUCCESS THROUGH CONTROL IN TODAY'S MARKET.

Vorys eControl's mission is to provide multidisciplinary, end-to-end control solutions for brands seeking to maximize revenues and profits in the age of eCommerce. In furtherance of this mission, Vorys eControl has formed a thought-leading Root Cause Diagnostic and Corrective Action Team to help our clients identify and stop product diversion sources, as well as to counsel on the implementation of appropriate corrective actions to mitigate product diversion and resulting commercial disruption. This team is led by Denise Zmuda, a veteran practitioner, who prior to joining Vorys eControl led channel strategy for a multi-billion dollar international technology company. Denise is supported by teams of investigators and data analysts, all of whom have one goal – to find your company's sources of diversion and unauthorized sales and help you to stop them. Based on our experience in working with hundreds of companies across numerous product verticals, we are deeply familiar with how companies in nearly all B2C and B2B sectors go to market, as well as the likely sources of diversion in their distribution channels. With the addition of the Root Cause Diagnostics and Corrective Action Team, Vorys eControl is able to provide a truly 360-degree approach to controlling online sales leveraging legal foundation, enforcement, root cause diagnostics and corrective action, and other tactics. Our Root Cause Diagnostic and Corrective Action Team stands ready to work with your internal personnel to help uncover your diversion sources and determine ways to help stop them as part of your comprehensive eControl program.

If you would like further information on how our Root Cause Diagnostic and Corrective Action Team can help your company, please contact us at 513.723.4076.

TO LEARN MORE, VISIT VORYSECONTROL.COM OR CONTACT US AT 513.723.4076.

About the Authors

Denise Zmuda

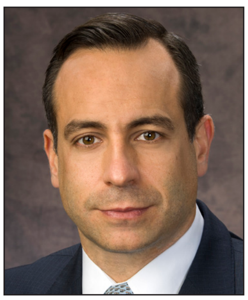
513.723.4824
dezmuda@vorys.com

Denise is a strategy and client success expert on the Vorys eControl team who specializes in developing a wide range of channel management strategies, for which she has more than 20 years of experience in the U.S. and around the globe. In her role with Vorys eControl, Denise assists clients in a variety of critical areas, including quantifying the financial impact of uncontrolled online sales, counseling on the enhancement of channel management efforts, and helping organizations to evolve their distribution and related strategies. Denise is not licensed to practice law in any state and does not provide legal services.

Whitney Gibson

513.723.4823
wcgibson@vorys.com

Whitney is partner and chair of the nationally recognized Vorys eControl group. He and the firm's team have developed cutting-edge, yet cost-effective, solutions to help brands control their sales in the digital age. Whitney has developed custom programs for companies confronting unauthorized sales, grey market sales, counterfeit sales, channel conflict and other online sales issues. The team combines legal, technological and investigative tools and services.



Daren Garcia

513.723.4076
dsgarcia@vorys.com

Daren is a partner in the Vorys Cincinnati office and dedicates his practice to the development and implementation, both domestically and internationally, of strategies and enforcement systems designed to protect brand value in the digital world. Daren has counseled hundreds of brands and manufacturers confronting unauthorized sellers, channel conflict and other online sales challenges. Daren also regularly leads litigation matters against grey market sellers disrupting brand value for Vorys' clients.


VORYS eCONTROL