

Best Practices: Events and Learning from AME and its Partners

Breaking Up Is Hard to Do — But Not Impossible

Well-planned distribution agreements can save your sanity when supplier-distributor relationships go south.

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Elizabeth Taylor and Richard Burton. Ted Turner and Jane Fonda. Tom Cruise and Katie Holmes.

These famous celebrity divorces involved legal battles over money, jewelry and property, but that is nothing compared to a thorny dispute with a distributor that delays a \$5 million shipment of coaxial cables to Europe.

Ending a business relationship causes almost as much heartache and stress as real-life romantic blunders. However, by tucking a handful of key contract requirements into a distribution agreement at the outset, a supplier can save itself major strife later if the relationship turns sour.

The more specific, the better. If a supplier and distributor are clear about their expectations, it is much easier to terminate the agreement when one party falls short or when it is simply more profitable to end the relationship and pursue another partner.

Listed below are the top considerations that suppliers should include in any distribution agreement with a downstream intermediary. Building a proper agreement is an innovative process that lays the foundation for a better business relationship. It also empowers suppliers to cut ties with underperforming partners and strategically grow their businesses.

Overview

A distribution agreement is an agreement between a supplier or manufacturer and its distributors or dealers that helps define the parties' respective rights and obligations and reduces risk of the unknown for both sides. The failure to forge a written agreement can lead to disastrous consequences — usually to the detriment of the supplier. Vague contracts — or the total lack of contracts — breed disagreements, which can result in costly litigation.

The Product

It is important to clearly define which products are included in the agreement. For example, if the agreement only contemplates one line of products, be sure to explicitly state that.

As new products are developed and introduced to the market, it is essential for a supplier to create and maintain various channels of distribution to remain competitive in today's global marketplace. But when a new product arrives in the market using a new distribution network, it is not unusual for an existing distributor to raise objections. Therefore, it is essential that the distribution agreement squarely addresses which products are included. Additionally, the distribution agreement spells out whether, or to what extent, new products are covered.

In the same vein, a supplier occasionally discontinues the manufacture and/or distribution of obsolete or underperforming products, and sometimes even entire product lines. This may create tension for a small percentage of distributors whose customers still rely on these products. To avoid a potential dispute, ensure the agreement addresses the possibility of discontinuance. And be sure to state that the supplier has the discretion to halt the manufacture and/or distribution of the products contained in the agreement.

Territory

While often referred to as the grant of a territory, a territory need not be solely

geographic in scope. For example, a territory can be defined based upon a product line, a line of business, a type of customer (e.g. government, consumer or business) or some combination of the foregoing.

A widely used provision for the granting of territory in distribution agreements does not actually limit the area where a distributor may sell. Instead, the provision states that the distributor's performance will be measured by sales in a specific region. In this way, if a distributor focuses its efforts on selling the supplier's products in a region outside of that designated performance area, the supplier can retain the power to terminate the agreement for deficient performance as defined by the agreement.

When properly drafted, this provision does not obligate the supplier to referee competition between intra-brand distributors. However, it may discourage a distributor from spending its resources to push the supplier's product to market.

For example, a distributor needs to spend significant time and financial resources introducing a new product to potential customers. So it lays the groundwork and expends considerable resources to sell the product — all while operating within its performance-measured territory. Then, an intra-brand extraterritorial distributor shows up and offers the product at a lower price. The bottom line: Distributors will no longer make the necessary investment if an intra-brand distributor can show up at the 11th hour and take advantage of the agreement's lack of express limitations in the granting of territory.

Exclusive Dealing

To ensure a distributor's alliance, a supplier may want to include contractual language that prohibits a distributor from carrying products that compete with those manufactured or sold by the supplier. Various legal issues arise when using this type of exclusive dealing clause, including antitrust laws, state relationship laws and enforceability issues. Some of these legal issues preclude exclusive dealings clauses altogether.

However, if these legal obstacles seem insurmountable, a supplier may prefer to use other drafting tools that can achieve a similar result. For example, including a provision that sets up incentives and sanctions for a distributor's specified activities is a great way to achieve a heightened level of exclusivity without the legal problems associated with an exclusive dealings clause.

Performance Obligations

A supplier's success largely depends on how well a distributor can locate customers and sell the product within the assigned territory. Therefore, it is vital that the agreement set performance standards to which the distributor will be measured. If the performance objectives are not stated in the agreement, then they will be construed by a court as being reasonable goals. Unfortunately, a court's determination of reasonable may not be what the supplier intended. Accordingly, it is advisable for a supplier to state its performance objectives in detail in the agreement.

Similarly, a contract should contain a failure to perform provision that empowers a supplier to terminate the agreement if the distributor does not perform to the standards of the supplier. To provide maximum flexibility to the supplier, the supplier should include qualifying language that allows it to modify the standards if needed. An example would include the setting of an annual quota that the distributor must achieve.

In the agreement's termination section, the supplier should note that failure to attain the requisite performance levels is good cause for termination. However, instead of merely terminating the agreement upon the failure to perform, a supplier may wish to include a time period for which the underperforming distributor is allowed to cure its deficiency. Be mindful of state laws that protect distributors in these agreements. (See Table 1 below for a breakdown of three states and their laws protecting distributors. However, each state varies.)




 <h2 style="text-align: center;">Wisconsin</h2>	 <h2 style="text-align: center;">Maryland</h2>	 <h2 style="text-align: center;">Delaware</h2>
<ul style="list-style-type: none"> • No grantor may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. • A supplier must give distributor at least 90 days' written notice. The distributor has 60 days to cure the deficiency. • "Good cause" is defined by the code as: (a) Failure by a dealer to comply substantially with essential and reasonable requirements imposed upon the dealer by the grantor, or sought to be imposed by the grantor, which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement; or (b) Bad faith by the dealer in carrying out the terms of the dealership. 	<ul style="list-style-type: none"> • Suppliers must give 60 days' notice before terminating or failing to renew the agreement. • The distributor has the opportunity to cure any asserted deficiency. • Deficiency is defined as the failure of a distributor to comply substantially with the fair, reasonable, and material requirements imposed or sought to be imposed on the distributor by the grantor. 	<ul style="list-style-type: none"> • Cannot "unjustly" terminate a franchise. "Unjustly" is defined as "without good cause or in bad faith." • Statute does not define "good cause." • Suppliers must give 90 days' notice before terminating or failing to renew the agreement.
<div style="background-color: #4b4b4b; color: white; padding: 10px; border-radius: 5px;"> <h2 style="margin: 0;">State Statutes Protecting Distributors</h2> </div>		

Table 1. Examples of state statutes that protect distributors.

Distributor Obligations

Other possible obligations for the distributor could include the following:

- Carry a minimum amount of inventory to avoid inventory shortages.
- Advertise and promote the sale of the product to the best of its ability.
- Pursue regular contact with present and potential retailers of the product.
- Train salespersons in the product.
- Maintain adequate salespersons, sales and warehouse facilities.
- Don't engage in any unfair practices or make any false or misleading statements or representations about the product.

Terms of Sale

When suppliers and distributors sit down to hash out an agreement, they draft the document in the context of present market conditions. Still in the future, a supplier may want to change the terms of sale without having to amend the

agreement. That type of change is possible if the agreement allows for flexibility. To achieve this flexibility, ideally the supplier will attach its detailed terms and conditions of sale as an exhibit to the agreement, and retain the right to modify the exhibit from time to time at its discretion.

To avoid confusion as to whose terms and conditions control the relationship (known in the legal field as the battle of the forms), the distribution agreement should also state that no other terms or conditions exchanged by the parties to the agreement will govern any transactions between the supplier and the distributor.

The Duration of the Agreement

Often called the term of the agreement, this provision provides a clear beginning and ending point to the business relationship. Without a set duration, a distributor may claim that the agreement is perpetual and only subject to termination for a failure to comply with the terms of the agreement, often called a for cause termination.

Termination

In the past, distribution agreements allowed suppliers to terminate the relationship without cause and with relatively short notice to the distributor. However, many states now protect distributors from termination without cause. In addition to the generally applicable protections for distributors, some states have enacted industry-specific statutes, including some affecting products such as motor vehicles, liquor/beer/wine, farm and industrial equipment, and gasoline, motor oil and petroleum. See the sidebar for a few of these state specific rules.

Dispute Resolution

Even with the most well-crafted distribution agreement, parties face the possibility of ending up in court. To prepare for that possibility, it is advisable for the supplier to include a forum selection clause. With this clause, the supplier has

the power to select the court forum and be better able to litigate in the event a dispute arises.

Conclusion

By setting clear expectations at the beginning of the supplier-distributorship relationship, companies can be better prepared and prevent later problems and disagreements. Even in Hollywood, it can't be denied that a solid foundation builds a better future.

Robert Kamensky gratefully acknowledges the assistance of Joshua Bergmann of Thompson Coburn LLP. The author can be contacted via email at rkamensky@thompsoncoburn.com. Disclaimer: This article is intended for information only and should not be considered legal advice.

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