

ONLINE EXCLUSIVE:

Well-planned Distribution Agreements Can Save Your Sanity When Supplier-Distributor Relationships Go South

By Robert Kamensky, JD, Partner, Thompson Coburn LLP

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. But by tucking a handful of key contract requirements into a distribution agreement at the start, 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 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



Robert Kamensky, JD, offers simple guidelines to help manufacturers navigate distribution agreements.

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 a contract — 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 a challenge. Therefore, it is essential that the distribution agreement squarely address which products are included, including whether and to what extent "new products" are intended to be 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. But 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 eleventh 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. It is therefore 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. But 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. However, be mindful of any state laws that protect distributors in these agreements. (See the attached table for a breakdown of three states and their laws protecting distributors. However, each state varies.)

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.

Conclusion

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

To read more on distribution agreements including terms of sale, duration of the agreement, termination and dispute resolution, pick up the fall issue of *Target* magazine.

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.