Taking the "Exclusive" Out of Exclusive Distribution Agreements

on 07.01.2009 | Posted in Client Updates and Alerts

Every day, manufacturers and distributors enter into exclusive distribution relationships with a marked sense of optimism. The manufacturer hopes this arrangement will provide incentives to distributors to vigorously promote their products. The distributor gets to “own” a territory, free from competition. However, these agreements do not always achieve the desired benefits. Because the pitfalls can be significant, manufacturers need to take care before signing exclusive distribution agreements.

The Basics
Through an exclusive distribution agreement, a manufacturer appoints a preferred distributor to have the sole rights to sell its products in a defined territory. The manufacturer looks for the increased product demand created by a motivated, aggressive seller of its products.

With exclusivity, distributors are free from potential price and other competition from other sales forces in “their” territory.

The Agreement
A thorough and well-drafted agreement requires input from both manufacturers and legal professionals. This interaction is critical in creating an agreement that avoids uncertainty later, reflects the intent of the manufacturer and addresses the potential pitfalls in the relationship. Through this interaction, six considerations should be central to crafting a successful distributor agreement:

1. Exclusivity – Is it necessary? If yes, does it mean that manufacturer is prohibited from engaging other distributors, from itself selling directly in the exclusive territory, or both? How does the agreement treat sales to a customer in one territory resulting in a drop shipment to the customer’s branch office in another’s exclusive area? Should certain of the manufacturer’s existing accounts be excluded? A mutual exclusivity should also be considered. In most cases, a manufacturer will not want the distributor selling competitive products but it may not have the market strength to force that concession. It is very important that manufacturers consult an attorney regarding the antitrust and non-competition rules of the relevant jurisdiction(s).

2. Conditions for maintaining exclusivity – Generally, the grant of exclusive rights in a territory will impose on the distributor the legal obligation to make a good faith effort to sell the product. The potential for conflicting expectations under this uncertain standard is obvious. Further, if the distributor has paid the manufacturer a fee or incurred high upfront costs for the exclusive rights, the manufacturer may not be allowed to quickly terminate the relationship for poor performance. In order to provide some certainty, a distributor is usually required to purchase product minimums as scheduled for designated periods for the term of the agreement. It is preferable for manufacturers to have the discretion to either terminate the entire agreement or the exclusivity in an event of non-compliance with these minimum obligations.
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3. Duties of the distributor – Manufacturers need to be deliberate in their selection of distributor and require a representation of the distributor that it has the ability to distribute and sell in the territory. The manufacturer should see and approve a marketing plan prepared by distributor.

4. New products – It is important to distinguish between a new product and an updated product. Updated products usually remain subject to the exclusivity provisions. A new product does not need to be offered to distributor on an exclusive basis, but often times is. Manufacturers should be clear about their intended treatment of new vs. updated products.

5. Terms – If a distributor has a limited historical performance, the manufacturer needs to agree on a shorter term as an initial trial period. Of course, a distributor will demand a longer term if its start-up costs or required minimums are high.

6. Post termination obligations – As with all distribution agreements, the manufacturer must include clear procedures for such issues as return of product, timetable for returns and the obligation to honor continued sales. Since an exclusive seller is being terminated, it will take a period of time before a new distributor can be identified in the market. Don’t allow the exiting seller to complicate the process.

Whether the relationship is exclusive or not, manufacturers need to be proactive and ensure that their distribution agreements are thorough: specifically addressing their expectations and anticipating what may go wrong. Manufacturers should not lock themselves into form distribution agreements, which most likely contain provisions that either do not apply to the specific relationship or, worse, contradict the intent of the parties, increasing the chance of costly litigation.

Success without Exclusivity

A successful manufacturer-distributor relationship is certainly possible without exclusivity. Manufacturers can limit exposure to antitrust violations by proposing non-exclusive agreements to distributors; imposing duties and providing incentives through other means, such as assigning areas of primary responsibility (“APR”) and implementing drop shipments and profit pass-over arrangements.

- An APR provision requires a distributor to use its “best” efforts to sell a manufacturer’s product in a geographic area, but does not limit the distributor from selling outside of the APR.
- A manufacturer can use drop shipments to encourage a distributor to focus on the APR by assuming the shipment costs to customers within that APR.
- Pass-over clauses encourage distributors to focus on their APRs by requiring a distributor that sells a product in another distributor’s APR to provide a portion of the sales price to the other distributor.

Further Pitfalls

The last thing a manufacturer wants to happen is find itself in a dispute with a distributor and realize that one of the following provisions is in its own distribution agreement:

- The absence of specific performance targets, causing the manufacturer to remain in a relationship with an underperforming distributor;
- Termination for cause only, making it difficult for parties to exit the relationship without a legal dispute;
- Lack of terms outlining the obligations of the parties upon termination of the relationship.
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- Unintended retail price maintenance that can cause antitrust concerns.

In the end, whether the relationship with a distributor is exclusive or not, a careful selection of distributor and a detailed agreement specific to the contemplated relationship can save manufacturers time and money by allowing the maintenance of a strong distribution system and avoiding unnecessary disputes and litigation.