Preventing problems with international distributors

Trade

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A U.S. company entering the international market will frequently link up with an independent distributor with a strong presence in the target country or market. The traditional distributor buys the company's products at a discount and then resells the products for its own account at a profit.

Such a distributor is readily distinguishable from an independent sales representative which solicits orders for the company's products and is paid a percentage commission by the company on the net value of the customer order. Unlike a representative, the distributor typically invests in local market advertising, adapts the products for local needs, stocks product and spare parts inventory, and handles both pre-sale and post-sale product service and support to customers in the territory. A distributor relationship permits the U.S. company to avoid the costs and tax liabilities of establishing its own operation or "permanent presence" in the territory and the credit risks posed by sales to foreign customers. But the company also faces an important disadvantage — it has minimal control over the conduct of the independent distributor's business.

Like a marriage, the relationship between the company and its international distributor evolves over time and sometimes reaches an impasse. Consider two common scenarios: 1) the U.S. company successfully penetrates the market with the assistance of its distributor and wishes to take greater control of its destiny by establishing a wholly owned distribution entity, or 2) the international distributor has failed to perform and the company now wishes to terminate the relationship or appoint additional distributors.

After several rounds of voluminous and increasingly threatening faxes, the company consults counsel to interpret its agreement with the distributor and evaluate options and termination risks. A few of the key areas which would be closely scrutinized include:

Scope of appointment

Has the distributor been appointed on an exclusive basis? If so, the company probably does not have the option to retain the distributor and appoint additional distributors in the territory. Has the company reserved the right to make sales directly to customers in the territory? A non-exclusive appointment and direct sales reservation provide the company with optimal flexibility. Of course, such provisions may not be palatable to a distributor with a strong negotiating position.

If the distributor is being called upon to make a substantial investment in the marketing and sale of the company's product, an exclusive appointment may be viewed by the distributor as an essential tool to amortize its initial investment in the relationship.

Term and duration

Does the agreement have a fixed term of duration which ends automatically on a specified date? Does the agreement automatically renew if not terminated during a certain period of time?

If the agreement has expired and not automatically renewed, the company may be able to discontinue the distributor relationship on the less-adversarial basis of nonrenewal. Does the agreement have a "termination at will" provision which permits the company to terminate for any reason, with or without cause, upon notice to the distributor? Even if included in the agreement, such provisions may be unenforceable in particular countries. Expert counsel will be aware of those countries whose laws may override the terms of the distributor agreement and prescribe any termination or failure to renew the agreement without "just cause." If the company unilaterally severs a distributor relationship without adequate cause in these jurisdictions, it risks extensive damages and the assessment of "good will" indemnities.

The distributor's obligations

In reviewing the agreement, counsel will also focus on whether the operative obligations and responsibilities of the distributor are spelled out in detail. For example, if the distributor is being taken to task by the company for failure to employ competent and trained personnel or to maintain certain inventory stocks, are these performance requirements included in the agreement?

If the distributor has failed after notice to meet one or more defined performance criteria, the company will probably have a strong basis to terminate the agreement. In particular, every international distributor agreement should contain a provision requiring the distributor to sell a specified quarterly or annual minimum quantity (by units or dollar value) of the company's products. Failure to meet agreed minimum quantities is almost always held to be adequate cause for termination in any international jurisdiction.

Post-termination obligations

A businesslike termination of a distributor agreement is inevitably accompanied by negotiation of a windup arrangement. At the outset, a termination should be planned and implemented by the company with a close eye on the distributor's trade account.

It is a fact of life that a distributor on the receiving end of a termination notice frequently responds by withholding any further payments. The company's position in this process will also be enhanced if the agreement has defined the responsibilities of the parties in the post-termination period. For example, does the agreement cover the disposition of company products which may be held in the distributor's inventory?

The company retains significant leverage if it has reserved the option to repurchase any new and unused products in the inventory at distributor's original net purchase price. In particular, the company may want to exercise such an option if a successor distributor has an urgent need for the inventory. Repurchase of the inventory also reduces the risk that the pricing and quality image of the company's products may be undercut by "distress sale" activities of the terminated distributor. How does the agreement treat distributor quotations which may be outstanding on the date of termination? This is an important consideration, inasmuch as the company's failure to honor such quotations may force the distributor into contractual breach with its customers. These are only a few examples of post-termination issues which might be addressed in a windup arrangement.

A well-drafted international distributor agreement provides a blueprint for both the conduct of a business relationship and its termination.

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