TO MARKET, TO MARKET: ALTERNATIVE METHODS OF DISTRIBUTION IN A WORLD OF E-COMMERCE

Prepared for the New York State Bar Association

Montreal Seasonal Meeting

October 25, 2018

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A manufacturer or other supplier seeking to distribute its goods or services internationally has an entire spectrum of distribution options available to it. These options carry varying costs and benefits, offer different advantages and disadvantages, and are regulated in different ways in different countries. Counsel advising a client on choosing among these options must understand the legal distinctions among the alternatives and the legal framework under which they will be regulated, both in the supplier's home country and in the nations in which it will distribute. E-commerce brings its own challenges, especially where e-commerce sales are made to customers in an area serviced by an otherwise exclusive distributor or agent.

Qualified local counsel in foreign jurisdictions thus is essential. Equally important, counsel must understand the client's business objectives and culture, so as to be able to select options that will best fulfill those objectives and are subject to restrictions that the client can adhere to, thereby minimizing the legal risks associated with meeting the business goals.

A. <u>Alternative methods of distribution --- Definitions</u>.

1. <u>Owned outlets</u>

Perhaps the simplest approach – but not necessarily the best – to distribution abroad is the do-it-yourself method. A domestic manufacturer can set up shop in another country in which it wishes to market, hire employees, and act as its own importer and distributor in that country, either directly or through a wholly-owned subsidiary. A supplier electing this option bears all the costs of distribution, from start-up capital and facilities to employee costs, administration and risks of non-collection from customers. It also subjects itself to full jurisdiction in the market country, may need to qualify to do business there and otherwise comply with national regulation of businesses, including restrictions that may apply to foreign-owned companies, will be subject to taxation on income and assets in the market country, and will have to comply with applicable employment laws, including, in some nations, onerous severance requirements in the event of termination. However, this approach does offer maximum control over distribution, as the supplier itself is in charge of its products and how

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they are marketed, presented and sold, at the cost, perhaps, depending on the employees hired, of reduced knowledge of local market conditions and sensitivity to local culture and customs.

2. Sales agents

Next on the spectrum of distribution options is the engagement of a local commercial agent. Such a sales agent does not take title to the goods; instead, it arranges sales on behalf of the supplier, which then makes the sales. Sales fulfillment, billing and collection, while the responsibility of the supplier, may also be delegated to the agent, which is also usually responsible for any product merchandising, and point of sale displays. Advertising and marketing in the market country could be assigned to either party, although typically the local knowledge of the agent makes it advantageous to give it charge of marketing, subject to the supplier's global branding. Local costs are borne by the agent, which is compensated by a sales commission on the sales it arranges (and typically on all sales in the agent's territory, even if arranged by the supplier). In many countries, the supplier will need to comply with the regulations imposed on those doing business there and pay income taxes, since the sales, while arranged by the agent, are legally made by the supplier, although delivery terms where title is transferred in the supplier's home jurisdiction may avoid that need in some countries. The need to comply with market nation employment laws may vary by country and may depend on whether the agent is an individual or a corporate entity with its own employees. Control over the sales and distribution of its products is nearly as great, for the agent will be bound by contract to follow its principal's directions.

3. Independent distributors

Independent distributors, which buy from the supplier and resell in the market country at a profit, can offer local knowledge and experience and substantially reduced costs for the supplier, particularly where an established distributor takes on the supplier's product line. Once the distributor takes title to the products, all sales and distribution costs in the local market are the distributor's, making this perhaps the least costly option from the supplier's perspective, although its reduced investment in the market country comes at the cost of giving up the distribution profit to the local distributor. The supplier generally will not be doing business in the market country, largely minimizing regulatory compliance costs and concerns over jurisdiction and taxation, although some countries do imposes taxes on payments to foreign suppliers for goods. Control over distribution is reduced, except to the extent the distributor can be bound by contract to follow the supplier's instructions as to sales methods, distribution targets, merchandising and presentation. Advertising and marketing responsibilities can be assigned to the distributor, subject to global branding concerns, or retained by the supplier.

4. E-Commerce Intermediaries

E-commerce intermediaries offer suppliers the e-commerce infrastructure to make online sales to customers directly without having to develop and invest in its own e-commerce platform. Suppliers who take advantage of this opportunity – often called third party operators, or 3POs – sell directly to the customer, but on the e-commerce intermediary's website. All online presentation, order processing and collection of payment are handled, for a fee, by the intermediary. Fulfillment – shipment and delivery to the customer – may be handled either by the intermediary or the 3PO. The arrangement is similar to a sales agency, in that the intermediary does not take tittle or make sales, and is compensated by a fee rather than by resale at a profit. How the supplier's goods are presented to the customer is a matter of agreement between the supplier and the intermediary.

5. E-Commerce Retailers

Similar in appearance to the customer, but different as a legal matter, are sales by e-commerce retailers. Here, the supplier simply sells the products to the e-commerce retailer, which resells at a profit. Again the supplier avoids incurring the e-commerce infrastructure costs, leaving those to the e-commerce retailer, which takes on the role of an independent distributor or dealer. Presentation to the customer will be controlled by the retailer, subject to any contractual or other agreements that may be negotiated.

6. Franchising

Franchising is a method of distribution that, as defined in most U.S. jurisdictions, amounts to the use of independent distributors who are licensed to use the supplier's trademarks, either in the business name itself or in the products sold, are required to follow a prescribed marketing plan or method of operation, and pay a franchise fee to the supplier.[1] Notably, in New York, however, a franchise is formed where a fee is paid and ***either*** a trademark is licensed ***or*** a marketing plan prescribed, thus subjecting most trademark licenses to franchise regulation.[2] In many U.S. jurisdictions, franchises are regulated in one or both of two methods. Many jurisdictions require disclosure documents in a prescribed format, akin to a securities prospectus, to be provided to the franchisee, who is treated as an investor in the business. [3] Some jurisdictions regulate the substance of the relationship between franchisor and franchisee in a variety of ways, most notably by restricting the right of the franchisor to terminate the relationship – or even not to renew it on expiration of a stated term – except for statutorily limited good cause, often requiring a specified period in which the franchisee may cure any asserted default in performance of the franchise agreement [4] Jurisdictions that regulate franchising often require franchisors to submit to jurisdiction and appoint an agent for service of process in the market nation or state.[5] The franchisor may also be subject to taxation on franchising income.

International regulation of franchising has grown swiftly in recent decades as well. Disclosure laws, relationship regulation, or both, now exist in Canada, Mexico and several Latin America countries, Europe, Asia and the South Pacific, and other regions.[6]

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[1] *See, e.g.,* Federal Trade Commission Franchise Rule, 16 C.F.R. §436.2(a); Calif. Corporations Code §§ 31005.

[2] N.Y. Gen. Bus. Law §§ 681(3). While the New York Department of Law will often grant exemptions for pure trademark licenses that do not carry other indicia of franchising, the need to seek such an exemption in circumstances that would go unregulated by franchise laws in most jurisdictions remains a trap for the unwary.

[3] *See, e.g.,* Federal Trade Commission Franchise Rule, 16 C.F.R. Part 436, *available at* http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf; N.Y. Gen. Bus. Law §§ 680 *et seq.*; Calif. Corporations Code §§ 31000 *et seq.*; Arthur Wishart Act (Franchise Disclosure), R.S.O., c. 3 (2000).

[4] *See, e.g.,* N.J. Rev. Stats. §§ 56:10-1 *et seq.*; Wis. Stats. §§ 135.01 *et seq.*

[5] *See, e.g.,* N.Y. Gen. Bus. Law §§ 686; Calif. Corporations Code §§ 31155; Arthur Wishart Act (Franchise Disclosure), R.S.O., c. 3 § 10 (2000).

6 As of April 2017, the following countries have disclosure laws: Belgium, Brazil, France, Spain, Sweden and Taiwan. The following countries have relationship laws: Angola, Belarus, Estonia, Kazakhstan, Kyrgyzstan, Lithuania, Russia and Ukraine. And the following countries have both: Albania, Argentina, Australia, Azerbaijan, China, Georgia, Indonesia, Italy, Japan, Latvia, Macau, Malaysia, Mexico, Moldova, Mongolia, Romania, South Africa, South Korea, Tunisia, Turkmenistan, Vietnam and the Canadian provinces of Alberta, Manitoba, New

As with independent distributors, control over the sale, distribution and presentation of products and services is by contract, with franchise agreements typically embodying detailed requirements – the prescribed marketing plan of the franchise definition – and often incorporating a operating manual that sets out in detail the required methods of operation imposed by the franchisor.

Costs are higher than for independent distributors, both because of the costs of regulatory compliance and administration to monitor franchisee compliance with the requirements of the franchisor's marketing methods. These costs can be offset by franchise fees, which may be in the form of upfront fees that provide the franchisor with capital, as well as ongoing royalties on sales, which amount to a sharing of the distribution profit earned by the franchisee.

7. Joint ventures

Not really a separate method of distribution, a joint venture can be established by a supplier with its distribution partner in the market country, whether the partner is an agent, distributor or franchisee, by having the local distribution entity owned in part by the supplier. Such equity can provide greater control through the ownership interest and board or management committee representation, although perhaps leading to jurisdictional and tax exposure. Foreign ownership may be restricted or regulated in some countries or industries.

8. Licensing manufacturing rights

Another option for manufacturer is simply to license a manufacturer in a target market country to use its intellectual property – whether patent, copyright, trademark or trade secrets – to make its products locally and sell them. While all the implications of licensing intellectual property are beyond the scope of this presentation, care must be taken by the licensor to maintain quality control over the finished product and the use of the intellectual property. Failure to do so can not only put the brand equity at risk, but also risk the loss of trademark protection. [7] Costs of licensing are relatively low, but for the costs of monitoring compliance with license terms, including quality control, and distribution profit is shared by means of royalty payments. Any national regulation of intellectual property licenses, including registration of the license in some nations, must be complied with, and there may be tax and jurisdictional implications in some countries. Of course, the scope of intellectual property protection in the market country must be considered, along with the risk of disclosure of trade secrets and know-how.

9. Private label

Finally, the distribution of products by private label methods amounts to a reverse licensing arrangement, where a distributor or retailer in the market country distributes the supplier's products under its own trademark. In essence, the supplier gives up its own brand name in exchange for the distribution muscle of its local partner, with the benefits of wider distribution and marketing inuring to the strength of the local partner's brand, with supplier reaping no enhanced brand value. Control over sales, distribution and presentation, as well as marketing and advertising, are in the hands of the local brand owner, resulting in negligible distribution costs to the supplier, virtually no control save

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Brunswick, Ontario and Prince Edward Island, Philip Zeidman, Presentation to ALI CLE Product Distribution and Marketing Course of Study, June 2015, updated April 2017.

[7] *See, e.g., Kentucky Fried Chicken v. Diversified Packaging,* 549 F.2d 368, 387, (5th Cir. 1977); *Sheila's Shine Products, Inc. v. Sheila Shine, Inc.*, 486 F.2d 114, 123-24 (5th Cir. 1973).

perhaps for sales and performance benchmarks in the contract, and benefits to the supplier are limited to its profits on sales of the product to the local brand owner.

B. Advantages and disadvantages of each method.

1. Costs and Control over Brand Image and Services

Each of the distribution methods discussed above carries with it varying costs and degrees of control over the brand image, distribution and sales methods used and presentation to the public, which have been discussed briefly above. In addition, the supplier can require distributors, agents, franchisees and licensees to provide certain services, such as product merchandising and point of sale display installation, warranty service, and the like, or may provide such services itself through owned outlets. In private label contexts, such services are generally in the discretion of the local brand owner.

Where sales are made via e-commerce intermediaries and retailers, the impact on pre-sale and post-sale services must be considered. E-commerce businesses often are far more limited in the services they provide. Educational efforts, offline marketing, warranty service and other responsibilities desired by the supplier or imposed by law (such as empty bottle and can redemption in jurisdictions with so-called "bottle laws") may need to be provided by the supplier or by bricks and mortar distributors and agents – who have little incentive to do so when they may not make the sale. Options, if the supplier does not wish or is not able to perform these tasks itself, include payment of invasion fees to the exclusive distributor or agent for its lost margin or commission on e-commerce sales (which requires reporting from the e-commerce intermediary or retailer as to sales in the distributor or agent's territory, or another method of allocation), contracting with third party service providers, or paying distributors or agents for fees for performing services that would otherwise be funded from distributor or agent profits. Each of these options may be regulated and taxed differently in different jurisdictions, and may have different liability and jurisdictional consequences.

2. Control over resale prices

In addition, suppliers often desire to maintain control over the resale prices of their products, whether out of a desire to maintain brand image, to provide resellers with profit margins that allow for the provision of brand-enhancing services, or, on the other side of the coin, to maintain the price competitiveness of the products and avoid profiteering by resellers. Such control over resale prices is regulated differently by the antitrust and competition laws of different jurisdictions. So long as the supplier itself is making the sale, as with owned outlets and, in most jurisdictions, through a sales agent, the pricing is unilateral and usually not problematic. But an agreement between independent entities in which the supplier regulates the resale prices of a distributor, franchisee or licensee, raises antitrust or competition law concerns.

In general, U.S. antitrust laws, in the absence of monopoly power, are concerned with concerted action, not unilateral conduct. Moreover, concerted action among competitors – "horizontal" conduct – is generally considered *per se* unlawful, meaning that economic or other justifications will not be heard. Until 2007, the same was true for vertical agreements – that is, agreements between buyer and seller – that set a minimum resale price for the affected product. The Supreme Court overturned that rule in the landmark decision, *Leegin Creative Leather Products, Inc.*

v. PSKS, Inc.[8] Now all vertical agreements, whether related to pricing or to non-price matters such as territorial restrictions, are judged under federal law by the "rule of reason," under which the court must determine whether the anticompetitive harm from the conduct is outweighed by potential competitive benefits.[9] The proof required of a plaintiff in a rule of reason case is generally much greater, as are the costs of litigation. And even under *Leegin*, there are several situations in which resale price maintenance could be found to be anticompetitive, such as where resale price maintenance is initiated by dealers rather than suppliers; where most suppliers in an industry use resale price maintenance; and where either the supplier or dealer involved has market power.

In addition, U.S. state antitrust laws do not always follow federal precedent. At least thirteen states "do not strictly adhere to federal precedent in developing and administering their own antitrust laws … [and] do not appear bound, or even likely, or follow *Leegin*'s interpretation of the Sherman Act as to [RPM]."[10] Moreover, eleven states possess antitrust statutes that explicitly bar RPM programs.[11] As a consequence, at least some state attorneys general are likely to continue to address RPM schemes under state law using the *per se* rule.[12] Businesses should be hesitant to adopt RPM programs in this environment, notwithstanding the widely held, but erroneous, belief that the Supreme Court made resale price-fixing lawful in *Leegin*. If an RPM program is to be implemented, counsel needs to review all the facts and determine whether any of the factors described by the

[8] 551 U.S. 877, 127 S.Ct. 2705 (2007). It is worth observing that the Supreme Court took pains to observe that there were circumstances in which resale price arrangements would be found to be anticompetitive and unlawful.

[9] *See generally Continental T.V. Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

[10] *Id.*

[11] *Id.* (citing Richard A. Duncan, Alison K. Guernsey, *Waiting for the Other Shoe to Drop: Will State Courts Follow 'Leegin'?*, FRANCHISE L.J. 173, 174 (Winter 2008), *available at* http://www2.mnbar.org/sections/antitrust/Duncan-Guernsey.pdf; Lindsay, *Resale Price Maintenance and the World After "Leegin,"* 22 ANTITRUST 32 (No. 1, Fall 2007) (ABA), *available at* http://www.dorsey.com/files/upload/antitrust_lindsay_fall07.pdf. Examples of state statutes prohibiting RPM include California (Cal. Bus. & Prof. Code § 16720(e)), Kansas (Kan. Stat. Ann. § 50-112), Maryland (Md Code Ann., Com. Law § 11-204(b)), and New York (N.Y. Gen Bus. Law § 369-a, rendering RPM agreements unenforceable).

[12] For example, in March 2008, the State of New York filed an antitrust complaint against Herman Miller, Inc. in connection with the company's resale price-fixing. "Although filed post-*Leegin*, in keeping with the New York Attorney General's *per se* stance, the complaint pled only *per se* violations of Section 1 of the Sherman Act and the New York, Illinois, and Michigan antitrust statutes." Herman Miller settled for $750,000 and agreed to a court order that prohibits it from agreeing on retail prices with its retailers, from passing on retail prices among its retailers, and from coercing its retailers to agree on a retail price. Additionally, Herman Miller must notify retailers of their right to set their own prices. *See State of New York, et al. v. Herman Miller, Inc.*, No. 08-CV-02977 (S.D.N.Y. March 21, 2008); *FTC Approves Resale Price Maintenance Agreements under Rule of Reason But State AGs Appear Undeterred*, Morgan Lewis antitrust lawflash (May 14, 2008); New York State Attorney General, Antitrust Bureau Feature release *available at* http://www.oag.state.ny.us/bureaus/antitrust/feature.html. A few years later, the Appellate Division, First Department, affirmed dismissal of a *per se* RPM claim brought by the Attorney General in *New York v.Tempur-Pedic International, Inc.*, 2012 NY Slip Op 3557 (1st Dept. May 8, 2012).NY Slip Op 3557 (1st Dept. May 8, 2012), but that case was brought only under New York General Business Law § 369-a, and not under New York's general antitrust law, the Donnelly Act, which the court did not consider. Moreover, the facts in *Tempur-Pedic* did not involve a true RPM agreement, but rather a unilaterally announced policy which resellers were free to reject at risk of no longer receiving *Tempur-Pedic* products, a practice long permitted under *United States v. Colgate & Co.*, 250 U.S. 300 (1919). Thus the more general question of whether New York law will treat RPM under the rule of reason or continue to apply the *per se* rule remains unresolved.

Supreme Court in *Leegin* are present, or if there are other indications that the proposed program will have anticompetitive effects rather than enhancing interbrand competition. In addition, a careful analysis of the applicable state laws in each state in which the firm does business needs to be made, to avoid state enforcement and private actions under the state antitrust laws.

And, of course, outside the U.S., resale price maintenance may still run afoul of the competition laws of other jurisdictions. In Europe, non-compliance with prohibitions on resale price maintenance can have daunting consequences. For example, Greek retail giant Carrefour Marinopoulos SA faced a €12.5 million (US$16.1 million) fine in an investigation by Greek antitrust authorities for imposing resale price restrictions among members of its franchise network in violation of European Union competition laws.[13]

3. Ability to end the relationship

As indicated above, some states restrict the ability of franchisors to end a franchise relationship without statutorily-defined good cause. The same is true for non-franchise relationships in certain industries in many U.S. jurisdictions, notably alcoholic beverages, automobiles dealerships, gas stations and, in the Midwest farm belt, farm equipment.[14] In other countries, restrictions on the termination of commercial agents, or mandatory compensation requirements, are not uncommon,[15] and in some cases termination of independent distributors may also be regulated.[16] The advice of local counsel is critical ***before*** a distribution relationship is entered into, so that an arrangement can be structured that offers the greatest ability to end an unsatisfactory relationship.

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[13] *See* "Carrefour Marinopoulos Fined €12.5M for Price-Setting", *available at* http://www.law360.com/web/articles/181155 (subscription required).

[14] *See, e.g.* 15 U.S.C. §§ 1221 et seq. (automobile dealers); 5 U.S.C. §§ 2801 *et seq*. (motor fuel); N.Y. Alc.Bev. Control Law § 55-c (beer); N.Y. Gen.Bus. Law §§ 195 *et seq.* (motor vehicles); N.Y. Gen.Bus. Law §§ 199-a *et seq.* (motor fuel); Kan.Stat.Ann. §§ 16-1201 *et seq.* (farm equipment).

[15] *See, e.g.,* EC Commercial Agents Directive (86/653/EEC) (implemented by national legislation, *e.g.*, "Gesetz zur Durchführung der EG-Direktiv zur Koordinierung des Rechts der Handelsvertreter" dated 23 October 1989 Germany; Commercial Agents Regulations 1993 (UK)).

[16] *See, e.g.*, Law on the Unilateral Termination of Exclusive Distribution Agreements of Indefinite Duration, Act of July 27, 1961 (Belgium).

APPENDIX OF KEY DISTRIBUTION CONTRACT TERMS

The distribution agreement is the critical document defining the rights and obligations of the parties in any distribution relationship, and thus must be drafted carefully, with a full understanding of the business relationship intended and each party's objectives. We can address here only a few of the key provisions.

1. Product definition

The contract should specify whether the distributor has the right to buy the supplier's entire line or only specified products. The supplier may be given the right to reduce the range of products sold to the distributor, under certain specified circumstances. It is important to consider how broadly or narrowly to define the products, as well as the extent to which product characteristics may be changed. For example, a product definition tied to a trademark may leave a distributor without a product if the trademark is changed or a separate one adopted for new products. It is also necessary to decide whether to give the distributor an option or right of first refusal with respect to any new products the supplier may introduce in the future, or to require the distributor to handle such products. In addition, it may be important to specify whether different products or product lines are part of a single distribution agreement or are separable. In one case in which different product lines were included in separate product addenda, they were held to constitute separate franchises, so that the termination of one product line violated a state franchise law. This might not have been the case had the various product lines been part of a single franchise, since a substantial portion of the franchise would have continued.[17]

2. Exclusivity

The distributor may be granted exclusive rights in the territory, or the supplier may sell to others.[18] The distributor may require the supplier to provide protection against "gray market" imports from other distributors outside the Territory.[19] Another option is to require distributors

[17] *General Motors Corp. v. Gallo GMC Truck Sales, Inc*., 711 F. Supp. 810 (D.N.J. 1989). *Contra Central GMC Inc. v. General Motors Corp.*, 946 F.2d 327 (4th Cir. 1991).

[18] A supplier's express reservation of rights to sell to others has been held to defeat Puerto Rico dealers' claims that the supplier's sales to others had impaired its existing relationship in violation Law 75, Puerto Rico's strict Dealers' Act. *Graphics Supply, Inc. v. Polychrome Corp.*, BUS. FRAN. GUIDE (CCH) ¶ 11,192 (1st Cir. 1997) (not for publication); *Vulcan Tools of Puerto Rico v. Makita USA, Inc.*, 23 F.2d 564 (1st Cir. 1994).

[19] Alternatively, for trademarked goods, importation of goods bearing the trademark, even if genuine, can be blocked through the U.S. Customs and Border Patrol Service, provided the non-U.S. manufacturer is not affiliated with the U.S. trademark owner, under § 526(a) of the Tariff Act, 19 U.S.C. § 1526, which prohibits the importation of a product manufactured abroad "that bears a trademark owned by a citizen of … the United States and … registered in the U.S. Patent and Trademark Office." In addition, where the parallel imported goods are materially different from the U.S. goods in quality, features, warranty or the like, it may be possible to take action on a theory of trademark infringement where customer confusion is likely to result. *See, e.g., Original Appalachian Artworks, Inc. v. Granada Electronics, Inc.*, 816 F.2d 68 (2d Cir. 1987); *Dial Corp. v. Manghnani Inv. Corp*., 659 F. Supp. 1230 (D.Conn. 1987).

selling outside their principal territory to pay a portion of their profits over to the distributor in whose territory the sale was made. The supplier may reserve the right to sell to certain types of customers (for example, national accounts, e-commerce retailers, governmental customers or military bases), or by certain methods, such as e-commerce or catalogue sales, directly. Some national retailers insist on purchasing directly from the manufacturer, so reserving the right to make such sales may be critical. In such situations, the distributor may receive compensation for those sales in the form of a per unit or percentage invasion fee. Thought must be given as to how such invasion fees will be determined, so that the distributor is fairly compensated for lost sales and incentivized to provide necessary or desirable services, but not overcompensated, for example, for resales made to customers outside the distributor's territory.

The supplier should consider its own long-term goals before granting an exclusive territory to a distributor, particularly in relation to the supplier's possible plans for direct marketing on the internet. One American Arbitration Association decision held that the establishment of a franchisee's exclusive territory precludes internet sales by the franchisor to customers located within the franchisee's territory.[20] (Another arbitration panel came to the opposite conclusion, finding H&R Block's internet offering of its tax preparation services did not unreasonably intrude on the franchisee's operations and so did not violate the exclusive territory provisions of the franchise agreement.)[21] Some state statutes for specific industries also preclude direct sales by suppliers on the internet, and the supplier should be aware of these state regulations when determining exclusive territories.[22]

3. Restrictions on Competition

If the supplier will be providing valuable competitive information to the distributor, including information regarding customers and their needs, a restriction on competition by the distributor with the supplier during and after the agreement may also be advisable, particularly if trade secrets are to be disclosed to the distributor. Otherwise, a knowledgeable distributor could do substantial damage by selling competing products to the supplier's customers. A review of local law is important here, as jurisdiction, differ widely in their treatment of such clauses, with some holding such restrictions to

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There is much less ability to restrict gray market importation under a copyright theory. The Supreme Court held just this year, in *Kirtsaeng v. John Wiley & Sons, Inc*., 133 S. Ct. 1351 (2013), that a copyright owner cannot exercise any control over a copyrighted work after its first sale, even if that first sale occurs abroad. Moreover, reliance on an insubstantial element of a product protected by copyright to attempt to block parallel imports may be held to be copyright misuse, which blocks enforcement of the copyright. *Costco Wholesale Corp. v. Omega S.A.*, 2011 U.S. Dist. LEXIS 155893 (E.D. Cal. 9 Nov. 2011).

[20] *Emporium Drug Mart., Inc. of Shreveport v. Drug Emporium, Inc*., AAA Case No. 71-114-00126-00(2000), *reported at* BUS. FRANCH. GUIDE (CCH) ¶ 11,966.

[21] *Matter of Arbitration between Franklin 1989 Revocable Family Trust and H&R Block, Inc.*, BUS. FRAN. GUIDE (CCH) ¶12,473 (December 31, 2002).

[22] *See, e.g.*, *Ford Motor Co. v. Texas Department of Transportation*, 106 F. Supp. 2d 905, 2000 U.S. Dist. LEXIS 11666 (2000) (W.D. Tex. 2000) (operation by Ford Motor Company of web site allowing prospective purchasers within the state of Texas to view previously owned vehicles and arrange for them to be viewed at a local dealer brought Ford within the statutory definition of a dealership, thereby violating the Texas law prohibiting a manufacturer from operating or controlling a dealership).

be entirely unenforceable.[23]

To be enforceable in the U.S., at least after the agreement ends, such clauses generally must be "ancillary" to the agreement and in furtherance of the agreement's lawful purposes.[24] Courts have applied a reasonableness standard in assessing whether a noncompete clause is enforceable, taking into consideration (i) the length of time,[25] geographic area, and activities restricted; (ii) the hardship to the distributor; and (iii) the public interest.[26]

In all cases, it is critical to define precisely the competition that is prohibited. Rather than simply referring to "competing products," it is important to define what is intended. To illustrate the potential spectrum, a distributor of craft beers might restricted from distributing other beverages, alcoholic beverages, beers, craft beers, craft beers from a specified country or region, or craft beers from a specified country or region in a specified style. Rather than allow a court to determine what "competing products" means along such a spectrum, it is best for the parties to define it themselves.

4. Indemnification and Insurance

A distributor typically will want protection against third party claims, in the form of an indemnification, insurance or both. Third party claims can include claims under a product warranty, product liability, and infringement of patents, trademarks or copyright, or claims by a prior distributor of interference. To the extent that the distributor also fabricates or assembles the product, incorporates it into another product or services it, the supplier may require the distributor to identify it for third party claims arising out of those activities.

In examining this issue it is necessary to consider the nature of the product and the use (industrial vs. consumer), as well as the service or assistance which is given to a customer by the manufacturer or distributor. The scope of indemnification should be spelled out, whether it covers all losses or only third party claims, as well as whether the indemnification includes attorneys' fees and either the right or the duty to assume the defense of any claims, and whether it includes only proven claims or all allegations of covered claims. If insurance will be required of either party, the amount should be specified and the other party should be named as an additional insured.

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[23] *See, e.g., Cottman Transmission Sys., Inc. v. Melody*, 851 F. Supp. 660 (E.D.Pa. 1994) (Calif. law); *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Cal. 1990).

[24] *See United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 282 (6th Cir. 1898), *modified and aff'd*, 175 U.S. 211 (1899) ("[N]o conventional restraint of trade can be enforced unless the covenant embodying it is merely ancillary to the main purpose of a lawful contract, and necessary to protect the covenantee in the enjoyment of the legitimate fruits of the contract, or to protect him from the dangers of an unjust use of those fruits by the other party").

[25] A case in New York held that a one year non-compete clause was unreasonable in duration as applied to an editor for a technology information publication, because of the speed at which the Internet industry moves. In that context, the court held, one year is "several generations, if not an eternity." *Earth Web, Inc. v. Schlack*, 71 F. Supp. 2d 299, 316 (S.D.N.Y. 1999).

[26] *See*, *e.g.*, *Interstate Automatic Transmission Co. v. W.H. McAlpine Co.*, 1981 WL 2193, 1982-1 TRADE CAS. (CCH) ¶ 64,538 (N.D. Ohio 1981); *see generally* RESTATEMENT OF CONTRACTS § 514 (1932). Post-term noncompete clauses have been upheld if they are short in duration and in a limited geographic area. *See*, *e.g.*, *Wilkinson v. Manpower, Inc.*, 531 F.2d 712 (5th Cir. 1976) (in a six-county area; for two years); *Meineke Discount Muffler Shops, Inc. v. Bleier*, Civ. Act. No. H-80-2495 (S.D. Tex. 1981) (25-mile radius of former shop; for one year); *Shakie's, Inc. v. White*, No. 77-106, slip op. (E.D. Mo. 1977) (within 30 miles of the franchised location; for one year); *Snelling & Snelling, Inc. v. Dupay Enters., Inc.*, 125 Ariz. 362, 609 P.2d 1063 (1980) (within 35 miles of franchised location; for three years).

5. Termination

The parties will generally wish to specify the basis on which the agreement may be terminated. Local laws may restrict these grounds.[27] Among the issues to be considered are the following:

a. *Without Cause*. May either party terminate without cause? If so, this should be explicitly stated.[28]

b. *Performance Standards*. The inclusion of mandatory performance standards appropriate to the product, industry and territory may be desirable. They can be stated in dollar or local currency terms, unit terms, as a percentage of average regional or national performance, in terms of market share, or on some other basis. Sales figures are generally better for the supplier and worse for the distributor than purchase requirements; the latter, if they force a dealer to buy more product than it can sell, might be deemed a franchise fee. Moreover, if achievement of standards results in automatic renewal, standards based on purchases rather than sales allows the dealer to obtain a renewal by buying into inventory without genuinely building a larger market for the product. If the intent is to allow the supplier to terminate or not renew if minimum standards are not met, this should be explicitly set forth. Distributors will wish to make clear that termination is the only remedy for failing to meet the standard and that there is no liability for damages as a result of any shortfall. Similarly, the supplier may wish to provide for a right to terminate if the parties cannot agree on new minimum standards for a renewal term, while distributors should resist such a provision.

Courts may examine the reasonableness of performance standards.[29] The supplier, in setting the standards, thus should be prepared to exercise the right to terminate consistently among those who do not meet the standard.[30] An alternative is to provide for the right to add additional distributors (*i.e.,* to terminate the distributor's exclusivity) if performance levels are not reached.[31]

c. *Other Breaches*. The parties should specify what breaches justify termination and when, if ever, the party in breach is to be afforded an opportunity to cure, and in what period. It may be prudent to stipulate that certain breaches are agreed to be noncurable.

d. *Changes in Ownership and Control*. The supplier may provide that a change in ownership, management, or control of the distributor justifies termination. Some conditions might be included. For example, termination might be permitted upon a transfer of some

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[27] *See*, *e.g.*, Cal. Bus. & Prof. Code § 20020 *et seq*.

[28] But see notes 4 and 5 above and accompanying text.

[29] *See*, *e.g.*, *R&R Assocs. of Connecticut, Inc. v. Deltona Corp.*, BUS. FRAN. GUIDE (CCH) ¶ 7526 (D. Conn. 1980); *see generally* E. Spalty and T. Dicus, *Risky Business: Franchise Terminations for Failure to Meet Performance Quotas*, FRANCH. L.J., Spring 1987, at 1.

[30] *See*, *e.g.*, *Marquis v. Chrysler Corp.*, 577 F.2d 624, 632-33 (9th Cir. 1978) (the selective enforcement of an unrealistic quota may violate the federal Automobile Dealer's Day in Court Act).

[31] This option may not be available in some industries in some states where the practice of "dualing" may be prohibited. *See, e.g.,* Ga. Regs. §560-2-5.02 (Alcohol Beverage Control regulations).

percentage of the ownership of one or the other party or upon the replacement of specified officers.

e. *Financial Problems*. The supplier may wish to terminate if the distributor is financially unstable. The triggering event can include liens (other than routine financing liens), insolvency, the inability to pay debts as they become due, or bankruptcy. Note that if the agreement has not been terminated before a bankruptcy filing, section 365 of the U.S. Bankruptcy Code will allow the distributor the option to reject the contract or to affirm it and so prevent termination unless independent grounds for termination exist apart from the bankruptcy.[32] This suggests providing for a right to terminate for insolvency prior to bankruptcy, although to terminate for insolvency, the supplier may be required to have had knowledge of the insolvency at the time of termination.[33]

Finally, the distributor may wish to be compensated upon termination for the value of its lost distribution rights. Suppliers will generally resist such compensation, although they should consider the benefit of an increased incentive for the distributor to invest in the brand if it knows it will be fairly compensated for the value of its distribution rights on termination, especially given that the incoming distributor should ordinarily be willing to pay fair value for the rights it is obtaining. The practice varies from industry to industry and from jurisdiction to jurisdiction. Beer distribution rights in the U.S. are regularly paid for on termination, and indeed such compensation is required by law in some states.[34] In contrast, such compensation is atypical for wine and spirits, a distinction perhaps lacking in any internal logic.

Assuming compensation is to be provided, the parties may wish to define the basis upon which it is determined. Fair market value, whether based on appraisal or economic analysis, or formulae based upon multiples of sales, gross profits, net profits or other factors, are all possibilities. If the distributor does not pay for the distribution rights initially, then compensation on termination might be based only on increases in value, sales or profits over the life of the distributorship.

[32] 11 U.S.C § 365. A termination notice given before the bankruptcy filing, but effective afterward, generally will be given effect, so long as only the passage of time is necessary for the termination to become effective, *i.e.,* there is no right to cure remaining after the time of filing. *See Atlantic Richfield Co. v. Herbert*, 806 F.2d 889 (9th Cir. 1986); *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1212-13 (7th Cir. 1984). *But cf. In re Krystal Cadillac Oldsmobile GMC Truck, Inc.*, 142 F. 3d 631, BUS. FRAN. GUIDE (CCH) ¶ 11,389 (3d Cir. 1998) (where termination was not effective until rejection of appeal by Pennsylvania Vehicle Board, and appeal was not rejected until after bankruptcy filing, franchise agreement was part of bankruptcy estate and subject to automatic stay).

[33] *See Bruno Wine & Spirits, Inc. v. Guimarra Vineyards*, 573 F. Supp. 337 (E.D.Wis. 1983) (applying Wisconsin Fair Dealership Law).

[34] *E.g.*, N.Y. Alc. Bev. Law §55-c; New Jersey Malt Alcoholic Beverage Practices Act, N.J.S.A §§33:1-93.13 *et. seq*.