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COMMERCIAL LAW

THE DISTRIBUTION CONTRACT: TERRITORIAL EXCLUSIVITY AND PRODUCT GOODWILL

Whenever a manufacturer finally completes the creation of the product it intends to offer, work has only begun! The marketing of the products offered remains the fundamental step of any business plan.

A manufacturer may take into its own hands the commercialization of its product. However, this causes the manufacturer to allocate a large quantity of resources and time to this operation. Furthermore, when the opportunity to enter new foreign markets arises, the manufacturer itself does not always possess the necessary experience and contacts. Hence, it will often be advantageous for the manufacturer to secure the assistance of a business partner whose expertise and distribution network will allow efficient marketing for the product.

In such a case, the contract with its distributor is an essential component of the manufacturer' commercial success. When it is equitable and carefully developed, the contractual relationship between these two partners will not only allow efficient and mutually profitable rapports between them, but will also augment proportionately the value of both businesses involved.

As part of the negotiation of a distribution agreement, two important aspects must be taken into account: territorial exclusivity and ownership of product goodwill.

1. The Distribution Contract and Territorial Exclusivity;

Whenever a manufacturer relies on a middleman such as a distributor in order to commercialize its product, the parties must consider the pertinence and necessity of granting exclusivity.

A) The Territorial Exclusivity Clause

An exclusivity clause presupposes the delimitation of a territory and of a period for which exclusivity is granted. Otherwise, the clause would be devoid of sense (unless the parties' intent had been to grant world-wide exclusivity – a rather unordinary occurrence); if no definite term is provided, the contract will be deemed to be indeterminate in term (i.e. terminable simply upon notice given).

The manufacturer takes a risk whenever it grants to another person the exclusive rights to market his product on a given territory and for a given time. Indeed, its business then becomes dependent upon the distributor in regard to the product's success (i.e. sales volume). Furthermore, even if the distributor's performances are not satisfactory, the manufacturer could not, as a rule, take away the other contracting party's exclusive rights.

When a product has yet to become known on the market, the distributor must invest an important amount of time and financial resources to develop the product's reputation and market positioning. Thus, exclusive rights are a major motivator for a distributor who must market a product that he does not own and that has little notoriety yet. Indeed, every product requires some time between its introduction to the market and commercial success. The commercialization efforts accomplished before a product becomes profitable constitute a major investment. In consequence, a distributor who invests his resources in such an endeavor wishes to insure he will share its future

benefits. Without the guaranty of exclusive rights over a given territory, the risks related to a product's marketing might become too important for a distributor to invest himself in that undertaking.

When a manufacturer considers granting exclusive rights over an area, he must know that many different contractual tools are at his disposal in order to establish a fair and mutually profitable relationship with his distributor. During the drafting of such contracts, two important aspects must be assessed: the territory's performance and the exceptions to the exclusive rights.

B) Performance

In a distribution contract, performance must be deemed the consideration in exchange of which exclusive rights are granted. In practice, this means that the distributor shall only retain exclusive rights over the granted territory as long as he continues to meet or exceed the performance objectives set out in the contract. The parties should accordingly negotiate reasonable objectives. When the objectives are not met (presuming there is no fault on the manufacturer's part), the contract could provide the following mechanisms:

1. The possibility of reducing the territory exclusively granted; or
2. The possibility of withdrawing the exclusive rights before the end of the contract, while maintaining the rights to distribution (which would become non-exclusive); or
3. The possibility of canceling the contract before its term, with or without paying an indemnity to the distributor for the loss of goodwill.

C) Exceptions to Exclusivity

It is possible for the two parties to provide for certain specific circumstances in which the exclusivity granted to the distributor would not apply. During the negotiation of the distribution contract, the parties must be able to identify the problematic situations that could arise. For example, a manufacturer and a distributor should consider the following situations:

The possibility that a client would operate its business within multiple different territories but centralize his purchasing within a single region (which could be within the exclusive territory or not);
Internet sales, which by definition ignore territorial concerns;
The possibility that a client would prefer to deal directly with the manufacturer with no intermediary;

In such cases, as well as in any analogous situation, potentially conflicting occurrences must be addressed prior to the conclusion of the exclusive contract. In order to avoid future discord, the parties must define from the outset of their relationship whether these problematic situations shall constitute contractual exceptions to the exclusive rights to be granted.

2. Product Goodwill

At the outcome of a distribution contract, the goodwill acquired by a product can have a large value. Indeed, a distributor that invests time and financial resources into the development, reputation, and marketing of a new product usually finds that his efforts are rewarded by increased goodwill toward the product, and thus increased sales turnover for the distributor. However, who shall benefit from the product's goodwill when the distribution contract will end?

The default answer: the goodwill reverts to the product's manufacturer. Indeed, goodwill is usually attached to the product rather than to the distributor (except in cases where the product's trademark belongs to the distributor, or when goodwill is not dissociable from the distributor). Hence, the results of the distributor's abundant efforts can escape him when the distribution contract is terminated or is cancelled.

In order to protect the distributor from the eventual loss of goodwill, the distribution contract can provide for payment of a compensating indemnity at the end of the contract. However, manufacturers are not always satisfied with such a solution, and consequently are not generally well disposed toward the insertion of such a clause in the distribution contract.

Nonetheless, if both parties consent to an indemnity clause, their negotiation should consider the following variables for the determination of the indemnity's value:

1. The duration of the distribution contract;
2. The notoriety of the product at the beginning of the distribution contract;
3. The publicity and marketing costs that shall be supported by the distributor;
4. The publicity and marketing costs that shall be assumed by the manufacturer;
5. The increased in goodwill that shall be accrued by the product;

The length of distribution contract could be a determining factor in the manufacturer's decision to grant or not to grant an indemnity to the distributor at the end of the contract. It could indeed be very onerous for the manufacturer if he were to pay multiple successive indemnities because he was forced to change distributors many times over a short period. Furthermore, if the distributor were only to market the product for a short time, the value of the increase in goodwill would be proportionately reduced.

The distributor should also consider the following elements:

1. Is he granted exclusivity over a definite territory by his contract with the manufacturer, And:
2. Does his contract with the manufacturer have a definite or indefinite duration?

When the contract does not stipulate a definite time-length, the manufacturer can terminate the contract at any time, simply by giving notice thereof to the distributor, and thus removing the distributor's right to distribute the product. Consequently, the previous two criteria must be duly considered before the distributor starts investing his efforts and energies in the marketing of a new product or trademark that does not belong to him.

In any case, it is always preferable for the distributor to consider these various issues before accepting to contribute his time, efforts, and money in marketing costs so as to bring notoriety to a product or trademark unknown to the public. Before committing himself and investing his resources in this manner, may be well served by consulting his legal advisor.

Conclusion

The distribution contract must be fair to both parties so that they may profit mutually. In practical (non-legal) terms, the distribution contract presupposes a partnership. The negotiations must be approached from this angle. Furthermore, before entering a binding agreement, it is equally important to consider the fundamental elements and aspects of the distribution contract:

1. The ownership, between the manufacturer and the distributor, of the product's trade-mark;
2. The notoriety of the product, or whether the product is unknown in the market;
3. The territorial exclusivity (or not), as well as the length of its term;
4. Who shall invest in publicity and advertisement;
5. Performance clauses guarantying the distributor's territorial exclusivity;
6. The pertinence of an indemnity in favor of the distributor at the term of the contract, so as to compensate the work invested.

The distributor-manufacturer relationship shall only be solid and profitable if the parties take care to duly consider these fundamental elements. Normally a long-term relationship, the interests of both parties must be protected if the relationship is to become both enduring and gainful. More than any other contract, equity must be the foundation of a distribution agreement.

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