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Foreign Distributor Protection Laws: A Veritable Minefield For U.S. Suppliers

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As our global economy expands, U.S. manufacturers and suppliers are increasingly seeking out opportunities to sell their products in new foreign markets. To gain entry to these markets, they often rely on local, well-established distributors to market and sell their products. As the local competitive environment can sometimes require consummating a relationship with a distributor rather quickly, U.S. sales and marketing officials may expect their company's counsel to accommodate this urgency by expeditiously helping them get a distribution agreement in place with the local distributor. The temptation, therefore, may be great for counsel to rely heavily on the "standard" distribution agreement which the company has successfully used for its U.S. business operations. As explained below, this kind of legal approach to doing business overseas can potentially result in business disruption, unfamiliar legal proceedings in foreign courts based on unfamiliar and xenophobic distributor protection laws, and the requirement to pay substantial damages and penalties to the local distributor when the relationship turns sour or in other circumstances.

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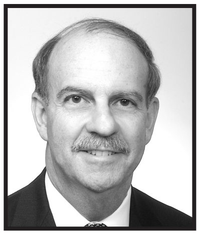

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Besides appreciating and understanding these and other substantial risks, U.S. companies also need to take the appropriate steps to minimize or eliminate the risks. Of course, in business, especially when doing business overseas in unfamiliar markets and with unfamiliar partners, there may be inherent payment and other business risks which need to be examined before entering into the relationship. Similarly, a company needs to examine, both at the outset and periodically throughout the relationship, the legal risks which are relevant to structuring an agreement with the distributor, during performance of the distribution contract and, if it becomes necessary, in terminating the relationship prior to its scheduled expiration or simply in not renewing the contract when the term ends.

Throughout this process it is essential that the supplier understand the potential impact of the laws of the distributor's country on the intent of the parties as set out in their contract. This survey highlights examples of the different approaches that selected U.S. export markets take in regulating contracts between U.S. and other foreign suppliers and local distributors, specifically with regard to issues surrounding the termination of such contracts. The differences from country to country can be significant, and at times startling and chilling. This fact alone underscores the critical importance of not only understanding and appreciating what the local laws are, but also, with help from experienced U.S. and local counsel, seeking to tailor each agreement to provide the supplier with maximum protection and flexibility in its distribution operations in each relevant country.

Basis For Termination

One very important area where differences between countries' laws governing distribution contracts are evident is in the restrictions, both substantive and procedural, placed on the manner in which a contract may be terminated in advance of the expiration of its stated term. For example, Costa Rican law identifies specific lists of actions by both the supplier and the distributor that will be considered "just cause" for either party to terminate the agreement. Brazil's law is similar. In countries like these, it is important for a supplier to consult with local law when drafting the termination provision in its contract to ensure that the identified conditions under which it would like the freedom to terminate are not inconsistent with the law in the distributor's country. In contrast, Korean law identifies a breach of contract by the distributor, but not any specific acts, as cause for termination while also permitting parties to agree to allow the supplier to terminate the agreement without cause.

Similarly, close attention must be paid to procedural requirements. For example, under Belgian law, for distributorship arrangements of indefinite duration, "reasonable" notice must be provided by a supplier prior to termination. Belgian courts have interpreted this to mean anywhere between three months and three years, depending on the specific facts. In contrast, Korean law requires two months notice for indefinite term contracts. Belgian law does not require any notice under certain defined circumstances (such as failure to meet minimum sales quotas) when parties agree to permit termination without notice. Where a contract has a definite term, Belgian law

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requires a supplier to still provide notice of its intention to terminate; otherwise, the parties can be deemed to have renewed their contract. Needless to say, such a renewal may have damaging business and legal implications for a supplier.

Duration Of Distributorship Contracts

Local laws also can impact the term of a distributorship agreement. Under French law, a distributorship contract that grants both territorial exclusivity and an exclusive purchasing obligation must be limited to a specified duration. However, the law also provides that the term of the agreement must not be more than 10 years, and French courts have applied this law to reduce the validity of longer-duration exclusivity clauses to 10 years.

Even if the contract identifies a specified term, under some countries' "evergreen" provisions, renewal of such a contract can cause it to be viewed as a contract of indefinite duration. For example, with respect to an exclusive distributorship agreement that specifies a term and is subject to renewal, Malaysian law provides that if the parties continue to deal with each other and fail to give notice to the contrary, their relationship can be implied to be one of indefinite duration.

Penalties For Improper Termination

In many countries, where the supplier terminates a distributorship contract in a manner inconsistent with contract terms and/or local law, the law provides for damages, in many cases in the form of lost profits to the distributor deemed to be caused by the termination. The extent of such compensation available as damages varies widely among these countries. For example, under Belgian law, where a contract of indefinite duration is terminated without sufficient notice, the non-terminating party can seek profits as well as a broad range of other costs and compensation, including for overhead during the period notice of termination should have been provided and for goodwill generated by the distributor in developing the local market for the product. At times, there is even recovery of severance pay for the distributor's employees who lost their jobs because of the termination.

On the other hand, Mexican law does not provide specific indemnification rights for termination, even if the termination is not based on just cause. In Brazil, while the law governing agency contracts includes extensive provisions on indemnification in the event of termination, the law that governs distributorship contracts limits indemnification either to the degree agreed upon by the parties or to damages actually incurred. In Denmark, absent specific language in the agreement, courts generally will compensate a distributor upon termination only in the rare circumstances in which the facts demonstrate that the distributor's close relationship with the supplier makes its role more closely resemble that of an agent.

Effect Of General Laws' Application To Distributorship Contracts

Consideration of distributorship contract issues, including as to termination, can be more complicated in certain countries which do not have laws that specifically address the rights and obligations of local distributors and their foreign suppliers. For example, while elements of German laws governing standard contract terms and agency relationships can apply to distributorship contracts, the lack of dedicated law on these types of contracts places a greater burden on parties in their contracts to detail their rights and obligations.

Effect Of A Free Trade Agreement: The Example Of The Dominican Republic

The law that applies to most contracts for the distribution of foreign goods in the Dominican Republic ("DR") is known as a "public order" law, one whose provisions supersede those agreed to in contracts between private parties. This law is unusually protective of local distributors. However, in January 2007, the DR implemented a requirement of the Dominican Republic-Central America-United States Free Trade Agreement (DR-CAFTA) and amended that law. As a result, the DR's restrictive law will not apply to a distributorship agreement involving a supplier of goods or services from the United States, unless the contract explicitly provides for its application. Thus, in most instances, it appears that the intent of the parties expressed in their contract will prevail over contrary provisions in the law. This requirement of the DR-CAFTA specifically addressed the DR's law, and only as applied to contracts with U.S. companies; the other DR-CAFTA partner countries are not affected.

Tailoring An Agreement To Recognize Local Laws

As this brief sampling of foreign laws demonstrates, a U.S. supplier seeking to enter into distribution relationships in various foreign markets is on an extremely perilous course if it relies on its "U.S. standard" or other template distribution contract for these markets. Consideration of local laws, and how those laws are applied by the local courts, is paramount. Furthermore, even where parties may specify in their distribution contract that New York or other U.S. law applies, a foreign court may refuse to apply that law and instead apply local law.

Notwithstanding the above, besides being familiar with local laws and their potential impact on the relationship, there are some general guidelines concerning termination that a U.S. supplier may consider in entering into a contract with a foreign distributor. One is that the contract identify in detail the actions or inactions by the distributor that constitute cause for termination. More specific terms may help protect the supplier when the distributor contests the termination, even though the weight that reviewing courts may give to parties' adherence to contractual terms can vary by country. Suppliers should also establish a reasonable and quantifiable method of tracking the various aspects of their distributors' performance throughout the contractual relationship.

Determining supplier-favorable provisions in other areas, such as the contract's term and renewal provisions, are more heavily dependent on the particularities of local laws.

As reflected in this overview, suppliers and their in-house attorneys can benefit greatly if they are aware of the relevant laws of the potential distributor's country. Knowledge of local laws, and tailoring a particular distribution contract to best take those laws into account, with the help of knowledgeable U.S. and local counsel, can help a supplier build a positive and productive relationship with a local distributor. Of equal importance, this knowledge can also provide flexibility and protection if the relationship sours and the distributor needs to be replaced, or if a supplier decides to instead focus on other markets, and termination becomes necessary.

Serious consideration also should be given, where appropriate, to including in the distribution contract an agreement to arbitrate disputes, including as to termination, before an international arbitration tribunal as this may preclude or minimize the impact of local laws on the outcome of the dispute. However, it is noteworthy that some local courts may find this kind of agreement to be unenforceable as essentially against that country's "public policy."