Distributorships and Agency Agreements in the United States - Fifteen Quick Tips.

A quick guide for foreign businesses interested in selling their products in the U.S. market.

By: Anne-Mette Elkjær Andersen, Holland & Knight LLP[1]

Introduction: Picking the Sales Right Model - Basic Differences:

When entering the U.S. market, it is important that a company picks a method that is best suited to its culture, its product, and the market it caters to. The most common entry points are to join with a U.S. party that will be a distributor, agent, employee, franchisee or a joint venture partner. Each method has different legal and business implications, although, in some scenarios, a particular business arrangement can be a hybrid, with elements of more than one type of structure.

This article will focus on distributorships and agencies. Franchises are heavily regulated in the U.S. by the Federal Trade Commission with onerous restrictions and disclosure requirements. There are serious implications for non-compliances, and therefore, a franchise arrangement is rarely a practical solution for a company just entering the U.S. market.

A distributorship is an arrangement where the products are sold by the manufacturer to the distributor who resells to retailers or end-users. The distributor makes a profit by selling the products at a premium.[2] The distributor is the sole (or one of few) purchaser(s), and the principal does not need to deal with or negotiate contracts with multiple buyers. Once the distribution agreement has been signed, sales can take place simply with purchase orders and acceptances. This arrangement is probably the simplest path to entering the U.S. market and the least burdensome method (in terms of administration costs) for the principal.

Agency agreements come in many forms, varying to what extent the agent can make binding sales for the principal and to what extent the agent merely promotes the sale while the principal makes the final decision (this latter situation is typical). The agent typically gets paid a commission calculated as a percentage of the price of the products sold. The principal and agent need to agree in advance if the agent is to be paid a commission in case the buyer fails to pay or only pays in part.

Agents and distributors are both independent parties and not employees. However, with respect to an agent, it is important to respect the independence of the agent, and avoid contractual provisions that could result in the agreement being treated by the courts (and other government authorities) as an employment agreement. These might include: provisions governing the

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[1] The author is partner in New York the law firm Holland & Knight LLP where she practices in the New York office. The author's practice primarily focuses on private equity, mergers & acquisitions and assisting foreign clients in setting up their U.S. operations, e.g. through distribution, agency, manufacturing, licensing, and joint venture agreements. Holland & Knight LLP is a full service commercial law firm with approximately 1,000 attorneys located throughout its 17 offices in the U.S. and its offices in China, Abu Dhabi, Mexico and Colombia. Anne-Mette Elkjær Andersen may be contacted at anne-mette.andersen@hklaw.com.

[2] Although fixed minimum sales prices are no longer illegal *per se* in the U.S., such terms and the enforcement of the same may be illegal under various circumstances, and it is generally recommended not to provide the distributor with anything more than "recommended" resale prices.

number of hours the agent should work or the specific location where the agent should work. Such a disguised employment relationship could have tax and labor law ramifications, with the company being responsible for withholding and other payroll taxes, workers compensation insurance coverage, overtime pay, and other compliance

Whether an agency or a distribution agreement is chosen, it is important to avoid the elements that could make it a franchise agreement. If (i) a party is granted the right to distribute products using the principal's trademark or logo, (ii) the principal has significant control of or provides significant assistance to the agent (e.g. approval of site, specification of opening hours, training programs, operations manuals, mandatory participation in promotional campaigns), and (iii) the principal charges the party a fee under the arrangement, whether disguised as a royalty, a training fee, or a service fee or stated to be a franchise fee, the arrangement will likely be deemed a franchise. The easiest way to avoid falling into the franchise trap is to simply not have the principal charge any fees.

1. Use of U.S. Subsidiary:

The foreign principal can enter directly into an agreement with the U.S. distributor or agent, but frequently a U.S. subsidiary is established to serve as the direct contract party. From a direct contract liability perspective, such an arrangement is advantageous because it can protect the foreign parent company and its assets (e.g. intellectual property rights) against contractual liability claims from the U.S. party. From a product liability perspective, however, the foreign parent company will not be shielded from liability if it has sold the products to the U.S. subsidiary. From a tax perspective the principal should seek tax advice as to whether a pass-through entity (typically a limited liability company) or a regular taxable corporate entity (typically a corporation) is the best choice for it in terms of tax rates, U.S. tax jurisdiction over the foreign entity, and U.S. and foreign transfer pricing issues.

If the U.S. subsidiary or the foreign parent company has U.S. offices and storage facilities, it will typically be required to register a branch office with the local corporate authorities in such states and pay franchise taxes in such states. Such requirements may, depending on the specific activities of the office and its employees, be kept to a minimum if all sales contracts and acceptances of purchase offers are signed in one location only.

2. Getting the right person:

When entering the U.S. market, it is important to pick the right partner to sell the product. Many ventures into the U.S. market have languished because the wrong partner was chosen. Is the right partner an individual person or an established company? If choosing an established company, consider if it would remain the right partner if ownership changes. If not, the contract should provide for a right to terminate in case of change of ownership. Whether an individual or a company is chosen, it is important to pick a party well-connected in the industry, with a proven track record in the field and in the geographic territory to be covered, backed up with examples and documentation outlining its prior successes. In some industries, breaking into certain markets can be very difficult without a very well-connected distributor or agent.

In some cases, a foreign entity might prefer to hire a local employee as a sales representative without any other allegiances and give him or her specific work instructions.[3] Hiring a U.S. person presents its own challenges for a foreign company. Although U.S. and foreign business cultures may be similar at a superficial level, differences exist and it can be difficult for a foreign company to assess if an American employee or agent's behavior in a particular context simply reflects a different culture or should be cause for alarm. Foreign companies often gravitate toward hiring or sending a person from their own country. Sending a trusted employee with whom the company shares a history and a language can provide great comfort, but presents its own set of challenges. These include: unfamiliarity with U.S. business culture, limited access to certain industry players or networking opportunities, and lack of sufficient language skills that can lead to misunderstandings. Proper training to avoid antagonizing employees and clients, and steer clear of harassment and discrimination claims is vital preparation. A question that most foreigners might view as innocent, such as asking a person with an Italian sounding last name if he watched the *Sopranos* or if his family are from Italy may have unintended repercussions. Moreover, English profanity and related idioms are not as acceptable in the business world as their use in popular movies and songs might have one believe. Preparing the employee's family for life in the U.S. may prevent early departures.

3. Using the Right Contract Format:

Standard distribution, and agency contracts are generally not available or used in the U.S. If you are presented with one, you can be quite sure that it has been prepared by an interest organization with only one party's welfare in mind or by the party itself. Contracts are negotiated individually. Nevertheless, U.S. distribution and agency agreement have developed distinctive features, and as a general matter it is better to start out with a U.S. draft than to try to adapt a European or other foreign model agreement into a U.S. agreement. Usually the most efficient method is to provide a U.S. attorney with the key terms agreed, and then have the attorney draft an agreement using a format the attorney is already familiar with.[4]

4. Exclusive - or Non-Exclusive Agency or Distributorship - Geographic and Other Restrictions - Competing Products:

An agent or distributor will often ask for exclusive distribution or agency rights in the U.S. or perhaps even North America. Consider if the agent or distributor has the staffing and office locations to satisfactorily serve customers in the entire region. If not, the agency or distributorship can be restricted to certain regions (e.g., particular states) or particular customer segments, (e.g., retail stores, or medical clinics and hospitals). The contract can also be made

[3] To avoid unpleasant surprises, it is generally recommended to have policies in place making it clear that any kind of nepotism (e.g. in hiring other employees, leasing offices, obtaining bookkeeping services, entering into other contracts) is against company rules and cause for termination.
[4] Be extremely careful in drafting your own agreement. Danish companies sometimes overestimate their English skills and contracts written in "Danglish" frequently end up in court. I have seen contracts provide for damages payable by the principal to be "maximized to" a certain amount, when in fact the intention was for the damages not be in excess of such amount. The use of "to" instead of "by" resulted in the exact opposite meaning, although use of the word "maximized" should have been avoided in the first place. The language also needs to be American English and not British English. Especially for electric products there are important differences. For instance a "flex" and "mains" in British English are called "electric cord" and "power supply" in American English, and in the U.S., the mains refer to water supply, not electricity supply.

non-exclusive, although even the presence of a non-exclusive distributor or agent in an area will make an appointment less attractive to future distributors or agents, and potentially raise issues about which agent has earned a commission. If the principal already has certain customers in the U.S., the principal may want the ability to continue to serve such customers without paying the agent commission. It is also important to clarify how internet sales to customers in the U.S. should be treated.

The contract should state explicitly if the distributor or agent is allowed to promote and sell competitive products. The contract should also specify restrictions, if any, on representing the competition after termination of the contract. The restrictions should be specific as to the customer segment, geographic restrictions, and duration, to the extent applicable.

When describing the territory as the "United States of America," it is best to specify whether it includes the District of Columbia (i.e., Washington D.C.) and the territories of the U.S.(e.g., Guam, American Samoa, the Northern Mariana Islands, the U.S. Virgin Islands and Puerto Rico). Puerto Rico makes it very difficult to terminate distributors, and often the territory will exclude those territories. When describing the territory as "North America,", note that this encompasses the U.S., Canada and Mexico.

5. Performance Targets:

It is generally useful to include performance targets for the agent/distributor in the agreement. Exclusivity terms and extensions in general can be conditioned upon the agent/distributor having met specific minimum sales within relevant periods of time. It provides the agent/distributor with an incentive to perform, and provides the principal with an exit, if the agent/distributor fails.

6. Reporting Obligations and Information about Customers:

The geographic distance and the time difference makes it difficult to monitor a distributor's or agent's performance, yet many manufacturers have learned the hard way that it is crucial for success to stay informed of the local day-to-day activities. Contracts should generally contain regular reporting requirements so the principal is reasonably up-to-date on the agent/distributor's performance, and planning can take place if the agent/distributor is underperforming. If possible, the principal should also try to negotiate with the distributor for reporting of and access to names and contact data for customers, so the principal or a new distributor can take over without loss of customers if the distributorship is terminated.

7. Product Liability:

Please be aware that while the principal and the distributor, between the two of them, may be able to negotiate for a different liability allocation, end-users of products (and other individuals who have suffered personal or property injury) have the ability to sue any link in the chain of sale, including parties who have arranged to bring the product into the U.S. market. Therefore U.S. plaintiffs can typically go after, among others, a foreign manufacturing company that has made and sold the product, any U.S. subsidiary used for resale, the distributor, and any retail seller. To be sure, the best way to protect against product liability is to have a quality product which does not contain unnecessary unsafe features. Other best practices include: having product liability insurance that covers the U.S. for both the parent company and any U.S.

subsidiary, and making sure appropriate product warnings are included and properly displayed on the product, packaging and user manual. Please note that the pictograms used in the EU cannot substitute proper U.S. warnings, and for products that have a serious potential to cause damage, it is highly recommended that U.S. attorneys with experience in preparing product warnings review the warnings.

8. Term and Termination - Generally:

As a general matter, the parties to an agency or distribution agreement have "freedom of contract" and may agree on the terms and conditions they wish, such as specific causes for termination, termination notices, and duration/expiration of time-limited contracts without renewal. The fact that the parties have had a very long contractual relationship is unlikely to affect an expressly agreed term and termination notice. Time-limited contracts are often preferred by principals, as they are less likely to be challenged as terminations in bad faith. However, certain legal principles provide special protection for certain parties to a contract.

Recoupment is a doctrine generally applied in the U.S. that operates to imply a minimum term, which is defined as the length of time in which the dealer can reasonably expect to recoup its initial investment in becoming a distributor (e.g. money spent on renting a store and training employees). The doctrine applies only where an agreement is terminable "at will", that is, without a specified notice or term agreed in advance. Recoupment has traditionally been confined to the recovery of preliminary expenses in setting up a distribution or franchise system. For a relationship that has lasted many years, such costs have typically been already absorbed.

For agents, the question of compensation in connection with a termination may also arise. It is preferable that the parties agree in advance whether the agent is to receive commission on sales to customers the agent has developed, even if such sales take place after the agency has ended. Typically (and contrary to the laws of the EU), the agent is not entitled to commission in the U.S. in such situations, but it is prudent to state so explicitly in the written agreement. It is also highly recommended to state expressly that commission payments made under the agreement constitute full consideration for the services and that no compensation for goodwill or other severance payment will be due in case of termination or non-renewal. Similar provisions may provide added protection of a principal in a distribution agreement.

9. Specialty Areas:

Car dealers and petroleum product dealers (e.g., gas stations) have special protection in relation to termination and other issues under both federal and state law. Similarly, many states provide protection of dealers of farm equipment, industrial equipment, vessels, and alcohol. Therefore, agreements in such specialty areas need to be carefully tailored to comply with the relevant state laws. In many cases, for example, such dealers cannot be terminated without cause, and certain repurchase obligations may apply.[5]

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[5] As an example of a lesser restriction, in Delaware, dealers of industrial equipment are entitled to a minimum termination notice of 6 months from the supplier, if (i) the dealer is required by the agreement to maintain minimum inventory of $25,000, (ii) does maintain a combined minimum inventory of equipment and parts of $50,000, and (iii) the dealer provides repair services for the equipment.

10. Inventory:

If a distributor is required to keep inventory, the agreement may specify the volume and possibly repurchase obligations of the principal. Depending on the type of goods (and to prevent deterioration of the products and customer claims), the agreement may also specify the storage conditions, such as temperature and humidity. If the distributor is also required to provide repair services, it is important to check in advance if this creates a protected dealership in the relevant state under the governing law, which might result in restrictions on the principal's right to terminate and certain obligations to repurchase inventory.[6] Please note that excessive requirements of maintenance of inventory might be viewed as a hidden franchise fee. If the principal agrees in the contract to repurchase inventory (e.g., if obsolete or in connection with a termination), it is important to have regular reporting requirements in place that enable the principal to assess and perhaps mitigate the potential financial risk of such a repurchase obligation.

11. Warranties and Representations:

In addition to any express product warranties provided by the seller, products sold in the U.S. are sold with implied warranties of "merchantability" and "fitness for particular purpose," unless they are expressly and validly excluded in the contract. The warranty of merchantability, under the Uniform Commercial Code, Section 2-314, is a warranty that the goods (1) will pass without objection in the trade under the contract description, (2) in the case of fungible goods, are of fair average quality within the description, (3) are fit for the ordinary purposes for which such goods are used, (4) run, within the variations permitted by the agreement, of even kind quality and quantity within each unit and among all units involved, (5) are adequately contained, packaged, and labeled as the agreement may require, and confirm to the promises or affirmations of fact made on the container or label, if any. The implied warranty of fitness for a particular purpose, is a warranty under the Uniform Commercial Code, Section 2-315, where "the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is …the goods shall be fit for such purpose." An exclusion of an implied warranty of merchantability must be conspicuous and mention "merchantability." An exclusion of an implied warranty of fitness for a particular purpose must be in writing and be conspicuous. It may state, for example, that "There are no warranties which extend beyond the description on the face hereof."

12. Indemnity:

Agency and distribution agreements usually contain mutual indemnity clauses requiring each party to indemnify the other for its breaches of the agreement and for damage claims arising out of the quality and use of products and use of trademarks. Often the parties agree to limit the indemnification to exclude consequential damages, and in some cases, the principal may successfully limit its liability for defect products to reimbursement, replacement or repair of the products. If such limitations are to apply as the exclusive remedies, they must be expressly be

[6] Please see footnote above.

stated to be so. They may be set aside under the Uniform Commercial Code Section 3-719 if they are unconscionable or cause the remedy to fail of its essential purpose.

13. Transfer of Title and Risk and Transportation and Insurance Obligations:

A distribution agreement should expressly state when transfer of title, risk and transportation and insurance obligations take place. Both Incoterms and the Uniform Commercial Code provide useful standard terms that can be elected -- in the case of Incoterms with the indication of the version (e.g. "2010."). These standard terms address only transfer of risk and transportation expenses and sometimes insurance expenses, but not transfer of title. The time of transfer of title should be expressly addressed in the agreement, typically as the time of receipt of payment, and retention of title should be expressly reserved. Note, however, that if the distributor is a merchant who deals in goods of that kind, which is usually the case, under Uniform Commercial Code Section 2-403, the distributor has power to transfer title to a buyer in the ordinary course of business.

14. Trademarks and Trade Secrets:

The agency or distribution agreement should specify to what extent the U.S. party is licensed and required to use the principal's trademark, and the distributor should be prohibited (unless otherwise agreed) from selling the principal's products under other trademarks or logos (e.g. their own brands) than those of the principal. The trademark(s) should be registered in the U.S. for trademark protection throughout the U.S., and the agreement should provide that use must be in accordance with the instructions of the principal. Having the agent or distributor expressly acknowledge the principal's ownership of the trademark is a useful measure in preventing subsequent attempts from the distributor/agent to make claims to such trademark.

The principal should also insist on a confidentiality clause (continuing past the duration of the contract) to protect trade secrets. Trade secrets may include information about the product itself (e.g., manufacturing process), but should also include sales and customer information.

15. Governing Law, Venue and Jurisdiction:

The contract should specify which law governs the contract and any disputes arising out of or in relation to the same. It should be noted that for contract purposes, there is no such thing as "U.S. law." The law of a particular state, such as New York, should be elected. Some are tempted to try to have foreign law they are familiar with be the governing law, but foreign law is rarely suited to the U.S. market, and particularly in relation to agents, EU law would confer rights on the agents in relation to termination notices and compensation for goodwill not usually granted to agents in the U.S. In a distribution agreement, the choice of law clause should also specifically address whether the parties want the United Nations Convention on Contracts for the International Sale of Goods to apply or the Uniform Commercial Code under the chosen law.[7]

[7] Some states and territories (e.g. Puerto Rico, California, and Washington) have a reputation of being more protective of agents and distributors (and in some cases employees) and for that reason are frequently avoided as the governing law, although the work location of the distributor or agent may also affect the applicability of the protective legislation.

Please note that a choice of governing law is not automatically an election of the courts of the same country. It is highly recommended that the law specify whether a dispute is to be resolved by arbitration or by the courts, and that the parties agree to an exclusive or semi-exclusive court jurisdiction or specific arbitration tribunal. Please consider that while a "home court advantage" is often preferred, there are frequently obstacles to obtaining a judgment in one country and enforcing it in another country. Therefore, agreeing to a U.S. court would often be advantageous to the foreign party. Arbitration awards, whether awarded in the U.S. or another contracting state (e.g., Denmark) are mutually enforceable under the New York Arbitration Convention.