

OUTSIDE PERSPECTIVES

The Changing Face Of Distribution: Obstacles And Opportunities

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Changes in distribution have touched virtually every industry over the last decade. Competition, computerization and shipping efficiencies, as well as the internet, all conspire to increase customer expectations for more efficient, seamless delivery of products and services. These forces are causing manufacturers to reexamine and change downstream distribution regularly.

In the face of this wave of change, corporate counsel is often in the uncomfortable position of having to explain the legal and related practical obstacles. Absent an express contractual right, and often despite it, meaningful change in distribution is fraught with potential for ill-will, objections and litigation. Done properly, however, change can be relatively painless, and even present opportunities to strengthen distribution relationships and improve product delivery.

Legal Obstacles

The terms of a parties' written distribution contract still govern in most industries in a majority of states. Of course, this is of little comfort to a manufacturer who

lacks a written contract with downstream distributors, only to discover at the most inopportune time that (1) the lack of a writing does not preclude, and more often than not creates, a contract "implied at law" and (2) its downstream distributor remembers different conversations or interprets the same conversation differently. The legal analysis is further complicated in most states by an implied covenant of good faith and fair dealing running with the distributor agreement, and the equitable doctrines of promissory estoppel, recoupment, unjust enrichment and fraud.

If this were not enough, a patchwork of ever-changing state statutes preempt distribution contracts depending on the type of distributor (e.g., general dealer, franchisee or sales representative) or the industry involved (e.g., motor vehicles, farm and industrial equipment), imposing requirements of advance notice, opportunity to cure and/or good cause before substantial changes can be implemented.

Practical Obstacles

Of course, a manufacturer's ability to implement change is often dictated more by market power than legal rights. If distributors are standing in line for the right to sell a manufacturer's prod-

uct, the imposition of new distribution terms may be relatively easy to accomplish. If, however, distributors have other suitors or control access to customers, a manufacturer will likely be unable to impose meaningful change.

Where to Step Softly

There is no hard and fast rule as to which changes will cause resistance or legal exposure, or at least the assertion of exposure by creative distributor counsel. Experience teaches, however, that a number of changes are likely to give rise to such assertions.

Distribution channels

It is a virtual certainty that a manufacturer's change to a channel(s) of distribution will give rise to legal claims. This is particularly true where the restructuring appears at least facially to enhance the manufacturer's ability to market product to the detriment of its downstream distributors, as in the case of a manufacturer taking on some or all of the responsibilities of its distributors directly.

Territorial restrictions

Another area fraught with peril for a manufacturer is a decision, however justified, to restructure or restrict the sales territory assigned

DISTRIBUTION & FRANCHISE LAW

its distributors. Such action often leads to statutory and common law claims by disgruntled distributors. Even where the manufacturer is only restructuring its downstream distributors in response to insufficient market penetration, a number of courts have been willing to entertain challenges.

Performance goals

While the establishment of sales goals or quotas have also given rise to statutory and common law challenges, manufacturers have been successful generally where the goals were uniformly established and implemented in response to reasonable concerns about a lack of market penetration.

Product mix

Also, manufacturers have been successful in defending against modifications in product availability, especially if the existing contract reserves the manufacturer's right to modify product offerings, the product is discontinued or the product is new.

How to Step Softly

Numerous steps can be taken to insure orderly implementation and reduce legal exposure. First, input and commitment must occur at all levels of the company. If there is insufficient commitment or appreciation for the legal risks on the part of top management, proposed changes will likely fail as distributor resistance builds. Downstream input and buy-in internally is also crucial, particularly from those in

product sales and delivery likely charged with implementing –therefore in the best position to undermine –change. At the same time, discussions should be limited to those who can be trusted to keep the information confidential. Loose lips sink change, as well as ships.

Second, meaningful feedback from select downstream distributors is crucial. If a distributor council exists, then it typically is comprised of the most important and influential distributors. Input from these identifiable opinion leaders within the distributor network can head off misunderstandings and unnecessary disputes. However, the manufacturer should go to distributors with a concrete, well-reasoned proposal. “Brainstorming” change with distributors is a recipe for disaster.

Third, an effective roll out will often determine how change is received. Present straightforward business justifications for change at the time of roll out. Carefully choose and prepare individuals who will present and answer questions about the program. Without unfairly burying changes, make them look and feel as much like the old as possible. Distributors are likely to view any proposed change as an invitation to negotiate. Be prepared to discuss issues, adopt appropriate modifications and assess the risks of proceeding to litigation with individual distributors. Finally, a manufacturer should consider offering distributors “give backs” as inducements, such as new product lines, buying

back inventory or indemnification from product liability or patent infringement.

Opportunity Knocking

With advance legal analysis and planning, the orderly implementation of change can actually have an upside. Often in the course of articulating the need for specific changes, a manufacturer will identify more uniform, cost-effective methods of dealing with its distribution network. The manufacturer may also find that its most troublesome dealers face increased pressure to comply with changes. If not, the orderly and non-discriminatory implementation of change to a distribution network may well provide stronger grounds to sanction or even terminate non-performers. Indeed, reasonable, essential and non-discriminatory changes are most likely to pass legal muster.

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