# Avoiding the Top 10 Mistakes with Distributor Agreements

Many factors go into the creation of a great distributor agreement. Mistakes in a distributor agreement are almost invisible during the courtship between a distributor and a manufacturer. Unfortunately, those same mistakes grow into glaring errors at the end of a distribution partnership. In order to avoid problems at the time of termination, the creator of a distributor agreement must ensure that unsound clauses are not inserted and that particular phrases are not omitted. Here is a checklist of ten common mistakes to avoid when drafting your next distributor agreement.

## 1. Too Much Too Fast

Every new partnership between a distributor and a manufacturer is born in a period of bright optimism. Like marriage, there is a limit on the number of partnerships in which a supplier or distributor may engage. By aligning with a new distributor, a supplier is prohibited from singing an alternative distributor. By aligning with a new supplier, a distributor is prevented from immediately signing an additional supplier. When aligning with a new distributor, it is important to assign a territory that is not too large initially. If a distributor is proven in only small territory, it is not prudent to assign a large territory and hope for the best. A better policy would be to open a new distributor relationship in that distributor's proven territory and expand the territory gradually, after results in the smaller territory suggest that an expanded geography is judicious.

## 2. Termination for Cause Only

Most distributor agreements involving seasoned distributors and manufacturers allow for termination for cause and termination for convenience, (or no cause at all). Less experienced partners sometimes attempt to allow for termination for a limited set of specific causes. Termination for cause is sometimes straightforward and without controversy, as when one partner declares bankruptcy. However, partners sometimes disagree over the presence of cause. Partners often disagree over responsibility for cause. The best distributor agreements allow for termination for cause and for termination for convenience. When an agreement allows termination for convenience, a partner wishing to disengage from the agreement serves *Notice of Termination* to the other partner with 30 days notice. When the convenience clause is invoked, cause and responsibility for cause need not be argued. More important, the distributor agreement does not end in a legal skirmish. Without a legal confrontation, the distributor and manufacturer are able to focus on their respective customers and businesses without consuming management time, corporate focus and financial resources on attorneys, courts and arbitration.

**3. Annual Termination and Semiautomatic Renewal**

Parties that are inexperienced with distributor agreements sometimes attempt to minimize the opportunity for termination. Calling for annual termination and semiautomatic renewal is a routine procedure among experienced players. In theses cases, there is a provision in the agreement calling for termination of the agreement at the end of the first full calendar year after the agreement is placed in effect, and each year thereafter. Terms and conditions allow either party to submit a *Notice of Intention to Not Renew* 30 days prior to the end of the calendar year.

When annual termination and semiautomatic renewal is written into the agreement, both parties have the opportunity to exit the agreement, without proving cause, once per year. The partnership is held together, using this methodology, by performance and not with a collection of words in the agreement. Experienced partners always prefer to have performance as the binding force in the partnership.

**4. Exclusive or Nonexclusive**

Distributor franchises may be either exclusive, where there will be no other distributor franchised in the territory; or nonexclusive, where the new distributor might be one of several distributors franchised in the territory. Distributors sometimes make an appeal for an exclusive territory, arguing that without an exclusive territory, the distributor has no incentive to allocate adequate resources toward development of sales for the manufacturer. Once a supplier agrees to an exclusive territory, it forfeits the opportunity, for a period, to franchise an additional distributor. Assignment of an exclusive distributor in a territory represents an unnecessary leap of faith on the part of the supplier. One alternative to assigning an exclusive territory is to draft the distribution agreement in such a way that the distributor is nonexclusive, but to franchise only one distributor. A verbal understanding would suggest that if a supplier's objectives were met, no additional distributor would be added to the nonexclusive territory. Such an arrangement provides encouragement for the distributor to perform without restricting options of the manufacturer.

**5. Frequency of Price Changes**

Distributors sometimes believe that they would have a competitive advantage if their manufacturers are restricted to adjusting prices only once per year. This may serve the distributor well, but at the expense of the supplier. An arbitrary advantage of one party over the other party does not bode well for the partnership. During periods of inflation or other rising costs, the manufacturer must have the opportunity to pass along increases in cost. The marketplace disallows aggressive price increases. Allowing a manufacturer to increase prices upon 30-day notice eliminates one opportunity for conflict and reinforces the principle of fairness in the partnership.

**6. Termination by Only One Party – Not Both**

Distributor agreements that allow for termination by only one partner are biased. Experience suggests that such lopsided agreements more frequently end in a legal dispute. By allowing both parties to terminate the agreement, some legal disputes can be avoided. The best distributor agreements allow either party to terminate the agreement.

**7. Frequency of Amendments**

Relationships between manufacturers and distributors are organic. They are born. They develop. They grow. They mature. They decay. Ultimately, they expire. External factors periodically apply pressure to the distributor and manufacturer. Those pressures sometimes call for a change in the distributor agreement. If the agreement allows changes to be made throughout the year, there is little problem. However, if the agreement allows for changes only once per year, one or both partners must survive undue pressure until the agreement can accommodate such an annual change. The best distributor agreements allow changes to be made throughout the year.

**8. What Happens after Termination?**

The distributor agreement must spell out responsibilities of both parties during and after the life of the agreement. All distributors and manufacturers understand that responsibilities of the parties must be defined during the period that the agreement is operational. However, fewer truly understand that responsibilities must be spelled out for the period after termination. Distributors and manufacturers must be specific about which products may be returned for credit and the timetable for such returns. A reliable distribution agreement must clearly state the responsibilities and obligations of both parties during the life of the agreement, upon notice of termination, and after the agreement is terminated officially.

 

**9. Comparison with Proven Industry Agreements**

Most mistakes written into distribution agreements are made by parties lacking experience with creation and negotiation of those agreements. Most large companies with years of experience with agreements rarely write mistakes into those agreements. Many mistakes are the result of one partner attempting to gain advantage over the other partner by inserting a bias into the agreement favoring the party with greater experience.

How does an inexperienced party to distribution agreements level the playing field during negotiation? There are several methods: First, solicit a model agreement from your industry's distributor association. Many distribution associations provide a model agreement free or at modest cost to their membership, (National Electronic Distributors Association, Material Handling Equipment Distributors Association, etc.). The model is a good baseline from which to compare the agreement that you are being asked to sign.

Second, use your network of friends in the industry. Although it is unlikely that your direct competitor would lend a copy of its distributor agreement, friends at indirect competitors might have no fear of sharing an agreement that has proven over time to be problem free.

Third, if you are attempting to sign a distributor agreement in a foreign land, use the foreign network. American Chambers of Commerce can be found in most countries around the world, (American Chamber of Commerce in Hong Kong, American Chamber of Commerce in The Netherlands, American Chamber of Commerce in Egypt, etc.). If your foreign subsidiary does not yet have a connection with the local chamber of commerce, initiate one immediately. The cost of membership in these organizations is miniscule and the benefits extend far beyond learning how to negotiate a balanced distribution agreement.

Fourth, ask the distributor or supplier with which you are negotiating an agreement for a blind copy of two or three agreements that are currently in effect. You need not know the name of the parties in the agreement; you are just looking to establish a feel for what is considered normal.

**10. Leaving the Negotiation Process Strictly to Attorneys**

Problems with distribution agreements are quite often discovered after the agreements are negotiated and signed, even when the agreements were reviewed by corporate counsel or outside attorneys. How does this happen? Too often, attorneys eliminate onerous clauses, but are simply not aware of industry norms. They lack an understanding of the problems with agreements that arise most frequently. It is a good practice to have the agreement reviewed by both a legal professional and an industry professional. If your company lacks an industry professional experienced with distributor agreements, such assistance should be sought. Having a legal professional review a distributor agreement is necessary, but never sufficient, for the creation of a great distributor agreement.

## Conclusion

Distribution agreements are an integral tool in the construction of a relationship between a distributor and a supplier. A well-written agreement can assist in developing that relationship. The agreement cannot extend the life of a relationship once the relationship expires. A poorly written agreement often leads to a legal quarrel that in turn consumes management time, financial resources and the involvement of attorneys, courts and arbitration. A well-written agreement can eliminate expenditure of resources on these unproductive activities and encourage the distributor and manufacturer to go about their respective businesses upon expiration of the relationship.

Mr. Glen Balzer has over thirty years of semiconductor industry experience as a sales, marketing and product marketing executive with major semiconductor manufacturers. His experience includes the development of world wide OEM sales and distribution channels and customer service organizations. Mr. Balzer holds a Bachelor of Science degree in Electronic Engineering and a Master in Business Administration, giving him a unique combination of technical and business skills.