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TEN KEY CONSIDERATIONS FOR SUPPLIERS WHEN TERMINATING A DISTRIBUTORSHIP AGREEMENT

It is always a difficult decision to terminate a distribution relationship, especially if it was a long-standing and previously profitable relationship. A manufacturer/supplier must be strategic when terminating a distributor to ensure compliance with the distributorship agreement, as well as applicable statutes and common law that may govern the relationship. Beyond contractual and legal implications, a supplier must also consider more practical business-related issues, including servicing customers in the terminated territory, notice to other distributors in the network, and external communications with the terminated distributor and customers.

To assist suppliers contemplating this crucial decision to terminate a distributorship relationship, the following are issues that a supplier should consider:

1. Is the decision to terminate the relationship within the terms of the written distributorship agreement?

A careful review of a distributorship agreement should be first and foremost to ensure that the reasons for termination are permitted under the terms of the agreement. For example, does the agreement provide that sales goals must be met, or that a distributor must comply with certain reporting requirements or payment terms with the supplier? To the extent a supplier can pinpoint the terms of the agreement that have not been fulfilled by the distributor, the less likely a supplier will be challenged for its decision to terminate and/or the better the defenses for a supplier, if challenged.

2. Is there a statute requiring "good cause" as a basis for termination?

State statutes often provide greater protections for the distributor when termination is threatened by a supplier. Specific statutes governing distributorship relations for farm implements, motor vehicles, or intoxicating liquors often exist under state law that require "good cause" before an

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agreement can be terminated, but only after notice and an opportunity to cure period is provided. *See, e.g.*, R.S.Mo., §§407.840 and 407.842 (good cause is required under Missouri law with 90-days' notice before termination, cancellation, or non-renewal pursuant to Missouri's Farm Implement Dealership statute). Good cause is frequently defined statutorily as a bankruptcy action filed by the distributor, complete withdrawal from the market by the supplier, moral turpitude by the distributor or, sometimes, the simple failure to abide by the terms of the agreement under some state statutes. Federal law may also provide additional protections for a distributor/dealer depending on the industry and characteristics of the relationship. *See, e.g.,* 15 U.S.C. § 2801 (Petroleum Marketing Practices Act); 15 U.S.C. § 1221 (Automobile Dealers' Day in Court Act).

3. Is the basis for the decision to terminate supported by objective and quantifiable data?

If the basis for a supplier's decision to terminate is based on a written term in the agreement and/or "good cause" pursuant to a statute, then it is imperative to possess objective criteria and quantifiable data to support the decision. For example, if a distributor has not met its objective sales requirements, or it has failed to pay invoices within the agreed-upon timeframes, these reasons should be supported by documentation. If termination is based on poor performance such as customer complaints, the supplier should have written documentation of the complaints and all previous admonishments sent to the distributor. If documentation exists, ensure that the documentation is correct, authentic and preserved. It is a good idea to make sure that all knowledgeable supplier representatives who regularly interact with the dealer agree that the documentation is accurate, and they agree that the basis for termination is correct and supportable. Documentation is critical in the event that a terminated dealer pursues litigation to show that the termination was unauthorized or unlawful and, undoubtedly those critical supplier representatives will be deposed in litigation.

4. Have other distributors in the network performed in a similar manner as the terminated distributor?

Reasons for termination should be consistently applied within a distribution network. If another distributor has acted or performed in a similar manner as a distributor receiving notice of termination, but that distributor was not terminated for the same or similar conduct, this fact will likely be revealed during discovery if litigation is pursued. Inconsistent reasons for termination are a terminated distributor's best friend, and the supplier's worst nightmare, especially in front of a jury. If a particular reason is proffered for termination, but the "real reason" is exposed in discovery, defending a supplier's decision can be extraordinarily difficult. If the reason for termination is based on particular conduct or non-performance, that conduct or non-performance

should not be tolerated within the distribution system by other dealers or distributors. A supplier's consistency provides credibility.

5. Once termination is decided, notice of termination must comply with the distributorship agreement and applicable statutes.

Providing notice of termination within a distributorship relationship must often comply with a particular time period, and many state statutes will also require an opportunity to cure period. Notice requirements typically provide the terminated distributor with sufficient time to get its business affairs in order, provide notice to customers, sell existing inventory purchased from the supplier, and, perhaps, allow for time to find alternative suppliers. If an opportunity to cure period is required, and the dealer cures the alleged default within the requisite time frame, the clock re-sets and new notices of termination are likely required if the offending conduct occurs again. *See, e.g.,* R.S.Mo., §407.842 (60-days' to cure and, if default is cured, notice of default is void). A supplier must ensure that those notice requirements comply with any written agreement, as well as applicable statutes or case law interpreting those statutes.

Careful legal analysis may be required to ensure that a distributorship relationship, as opposed to a franchise relationship, exists to avoid liability for non-compliance with franchise statutes. A franchise relationship exists if a trade name or trademark is licensed by the supplier/franchisor, an oral or written agreement for a definite or indefinite period exists, and a "community of interest" in the marketing of goods or services also exists. *See, e.g., Missouri Beverage Co., Inc. v. Shelton Bros., Inc.*, 796 F.Supp. 2d 988, 995 (W.D. Mo. 2011), *aff'd* 669 F.3d 873 (8th Cir. 2012).

Determining if a "community of interest" exists is not always easily discernible. A community of interest is often expressed by courts as a substantial investment that is specific to the franchise business and/or investments that are required by the parties' agreement or the nature of the parties' business. *Cooper Distr. Co., Inc. v. Amana Refrigeration, Inc.*, 63 F.3d 262 (3rd Cir. 1995); *Frieburg Farm Equipment, Inc. v. Van Dale, Inc*., 978 F.2d 395, 399 (7th Cir. 1992). But a community of interest has also been defined more generally as a franchisor benefitting from a franchisee's marketing, or the franchisee benefitting from the franchisor's marketing, of the product or service. *See, C&J Delivery, Inc. v. Emery Air Freight Corp.*, 647 F.Supp. 867, 872 (E.D. Mo. 1986).

If a distributorship exists without any definite duration, sometimes referred to as an "at-will distribution agreement," the recoupment doctrine may apply. *Newco Atlas, Inc. v. Park Range Constr., Inc.*, 272 S.W.3d 886 (Mo. App. W.D. 2008). The recoupment doctrine imputes duration of time to a terminable at-will dealership equal to the length of time that is reasonably necessary for a dealer to recoup its investment in the business. *See id.*; *Ernst v. Ford Motor Co.,*

813 S.W.2d 910, 918 (Mo. App. W.D. 1991).

6. What potential claims may exist for the terminated distributor?

A prudent chess player thinks two steps ahead of the current move. Similarly, prudent suppliers must consider the potential of a lawsuit filed by a terminated distributor. A supplier should always consider what potential causes of action exist in litigation for the terminated distributor. Depending on the jurisdiction, terminated distributors may have claims under state law, including the breach of the implied covenant of good faith and fair dealing, which is implied in all contracts in many states, including Missouri. A terminated dealer may also have a claim for tortious interference with contract and/or tortious interference with a future business expectancy if a new distributor is appointed and allowed to sell during the notice of termination period and before the termination actually occurs. A terminated distributor may argue that "good cause" did not exist, if required by law, or that insufficient time was provided under a statute or a common law doctrine like the recoupment doctrine.

Or a terminated distributor may argue that the relationship was a disguised franchise relationship, requiring a franchisor's disclosures under the Federal Trade Commission regulations and some state registration laws. If a franchise relationship exists in Missouri, state statute requires that ninety days' notice must be provided to a franchisee in the event an agreement is terminated. *See* R.S.Mo., §§407.400 and 407.405. Failure to disclose or provide the requisite notice of termination under franchise laws could provide additional legal protections preventing quick termination, including the possibility of rescission and/or pursuit of fraud claims.

7. How will a supplier handle post-termination issues?

Once notice of termination is provided to a distributor, a supplier must analyze thorny post-termination business issues. For example, does a distributor possess trademarks of the supplier? If so, how will the distributor's use of the supplier's trademarks cease in an orderly fashion? If trade secrets were provided to the distributor, how will those trade secrets be returned in an orderly and verifiable fashion?

With respect to the distributor's inventory supplied by the supplier, will the distributor be permitted to continue selling the product in its inventory after termination? Is the supplier required to repurchase that inventory, and at what cost? Many of those issues are governed by dealer statutes under state law.

Will a new distributor be appointed to replace the terminated distributor within the same geographic area? If so, when will the new distributor begin selling to customers in that area? Can the newly appointed distributor compete with the terminated distributor during the notice of termination period? Will the newly appointed distributor attempt to hire the terminated distributor's

employees or salespersons? If so, is there potential liability for the supplier? These business issues can unexpectedly raise legal problems with dire consequences.

8. Plan for post-termination discussions.

Once notice of termination is provided to the distributor, the decision to terminate will inevitably be learned by customers, as well as other distributors within the network. Intra-company discussions should occur before any public communications are distributed to ensure that all personnel with supplier are aware of the termination. All communications should be factually accurate and not defamatory with respect to the terminated distributor. Any written communications, not protected by a legal privilege, should be considered discoverable in litigation.

Terminated distributors often seek clarification for their termination. However, any communications from the terminated distributor to a supplier's personnel should be handled by particular person or department at the supplier to ensure a consistent response is conveyed to the terminated distributor, and that the response is consistent with the notice of termination to the terminated distributor.

9. Plan for litigation.

A supplier who has terminated a distributor should expect the possibility of litigation, especially if the relationship is long-standing, the distributor had substantial investment in the relationship, and the distributor's overall on-going business could be jeopardized without the distributor relationship.

A terminated distributor will often seek injunctive relief from a court to preserve the status quo and prevent termination. *See, e.g., Heck Implement, Inc. v. Deere & Co*., 926 F.Supp. 138 (W.D. Mo. 1996). To prevent or minimize the risk of such relief, a supplier should consider all potential defenses to injunctive relief when preparing the notice of termination. Defenses to injunctive relief include the availability of liquidated damages in a contract, that monetary damages are available as an adequate remedy, and/or that the distributor is not entitled to equitable relief because of past misconduct or "unclean hands."

Suppliers should know that courts loath monitoring on-going business relationships, which is typically required during the time when injunctive relief is entered until a decision on the merits can be finalized. Disputes during that time frame often occur, such as whether the supplier is shipping product to the dealer on a timely basis, whether payment or shipping terms were altered, or if the terminated distributor is soliciting customers to purchase a new supplier's product while slandering the old supplier.

10. Consult with legal counsel before terminating a distributor.

Legal counsel should always be consulted before terminating a distributor. A legal eye is necessary to ensure that a proper basis exists for termination, proper notice requirements are provided, and that any defenses or claims for the terminated party are analyzed, including franchise protections, common law protections such as the recoupment doctrine, or whether "good cause" exists for termination, if it is required.

Armstrong Teasdale LLP's attorneys practicing in the Franchise, Distribution and Antitrust Group work with manufacturers and suppliers guiding suppliers through the decision to terminate an underperforming or noncompliant distributor. Our attorneys have defended and resolved distributorship terminations in state and federal courts, private arbitrations, and through skilled settlement negotiations with distributors and their counsel.