



Contracts Report

A Handbook for a Successful
Distributor-Manufacturer Relationship

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Foreword

This report was initially published in 2005. It was based on theories of "principle-based negotiation" developed as a part of the Harvard Negotiation Project and well explained in the best-selling books *Getting to Yes: Negotiating Agreement Without Giving In* (Roger Fisher and William Ury, 1981), *Getting Together: Building Relationships As We Negotiate* (Roger Fisher and Scott Brown, 1988), and *Getting Past No: Negotiating with Difficult People* (William Ury, 1991).

The goals of this style of negotiation are to reach agreement without jeopardizing business relations, to develop long-lasting relationships, and to focus on interests and not on positions. As reflected in the subtitle "Handbook for a Successful Distributor-Manufacturer Relationship," these themes are continued in this update. The authors have retained the original structure of the 2005 handbook, which organized the discussion of an equipment manufacturer/dealer agreement into three broad areas: formation of the relationship, maintenance of the relationship, and termination of the relationship. The authors have added a fourth chapter to provide discussion of four areas of law which, in some cases, may supersede the concepts discussed in the first three chapters. These additional topics of discussion are dealer protection laws which are in place in almost every state, franchise law, antitrust law, and general contract law principles of good faith and fair dealing.

AED offers this handbook solely to inform and educate its members. The reader should not consider the guidance offered here as a substitute for the advice of a qualified legal professional. The nuances of state contract law, its constant revision by legislators and reinterpretation by courts, and the complications imposed by state dealer protection and franchise laws, all make the advice of counsel a critical element of negotiating the dealer-manufacturer relationship. Readers looking for further general information about state laws affecting dealer-manufacturer contracts are directed to AED's *State Equipment Distributors Law Book* (10th Ed., 2015).

Introduction

The dealer-manufacturer relationship works best when it is mutually profitable and both parties are treated fairly. The fundamental purpose of this handbook is to provide a simple guide to help manufacturers and dealers negotiate distribution contracts which balance the needs and interests of both parties. A well-written and fair contract provides a foundation for a solid dealer-manufacturer relationship. The terms of the contract will determine how the parties interact and how problems that arise during the business relationship will be resolved. The contract also generally governs what happens when the relationship ends. It is, therefore, important that both parties understand the purpose of the various clauses in the contract and the rights and obligations those clauses create. To prevent problems during and after the business relationship, the parties must carefully consider the fairness of specific language in a contract before the contract is signed.

This handbook was developed at the request of Associated Equipment Distributors (AED), which perceives a need for guidance about legal issues surrounding equipment distribution contracts. It is intended to provide general information about the purpose and effect of some of the most common and important clauses unique to equipment distribution agreements. It also addresses clauses that are often at the center of dealer-manufacturer disputes and provides alternative ways to formulate those clauses to prevent future disputes.

Although contract negotiations can create an adversarial atmosphere, both parties to a distribution contract must remember that the purpose of the negotiations is to lay the groundwork for a long and mutually profitable relationship. Contract negotiations, therefore, should not be approached as battles or contests, but as opportunities to plan for a fruitful partnership. This book is intended to facilitate that relationship.

We recognize there may be many solutions to the same problem. In the equipment industry, one size rarely fits all. We have resisted the temptation to include "model" contract provisions and have instead chosen to identify the major issues to consider when negotiating the various provisions of a dealer contract. However, as readers shall see, we have not shied away from providing our perspective about a fair way to handle a specific problem.

We have organized the contents to reflect the stages of the dealer-manufacturer relationship. Chapter 1 examines the clauses that control the formation of the distribution arrangement. Chapter 2 addresses the provisions that control the day-to-day interaction between dealers and manufacturers. Chapter 3 deals with the contract clauses implicated when a distribution arrangement is terminated, whether on mutually agreeable terms or as the result of a dispute. Chapter 4 briefly discusses and summarizes the dealership protection and franchise laws which have been enacted in virtually every state in the nation, as well as the impact of antitrust law and the common law principle of good faith and fair dealing in the context of equipment dealer agreements. These laws may, depending on circumstances and the state in which a

manufacturer an express right to modify the territory, the contract may be deemed to have been orally modified (to allow unilateral territory modifications) if the distributor acquiesces to an expansion or reduction of its territory in the course of the parties' relationship over the years.

Distributors and manufacturers should be aware that vertical restraints can raise antitrust issues. While vertical restraints that fix minimum resale prices are strictly scrutinized, courts will generally find non-price vertical restraints to be permissible if the restraint benefits competition (e.g., encouraging strong competition between brands). At a minimum, clauses should provide exceptions for the sale of used equipment acquired from customers in trade-in deals. These antitrust concepts are discussed further in Chapter 4.

2. Manufacturer Direct Sales and National Accounts

A manufacturer may wish to preserve the right to make direct sales to customers in the dealer's exclusive territory. The manufacturer may also seek to retain authority to enter into direct contracts with national or major accounts whose operations span numerous dealer territories, such as local, state and federal governments. These arrangements can benefit both the manufacturer and the dealer if the contract is designed to treat the dealer fairly in such situations.

A direct sales clause allows the manufacturer to sell directly to the end users of its products in the dealer's territory, thus superseding exclusive territory provisions in the contract. While it may be impractical to demand the manufacturer relinquish all rights to sell directly, a dealership should carefully consider such clauses and make certain these sales do not interfere unreasonably with the dealer's business.

The contract should specify under what circumstances direct sales are permissible. This can be accomplished by identifying and limiting those types of end users to whom the manufacturer can sell, e.g. governmental entities, educational institutions, purchasers for export, etc. The dealer should also make certain the contract prevents the manufacturer from selling to parties identified on customer or potential customer lists provided by the dealer to the manufacturer as part of the contract negotiation.

The dealer might also seek a provision that requires the manufacturer to provide the dealer with the option of making the sale. When the manufacturer wishes to make a direct sale, it would be required to offer the sale to the dealer. Under such a provision, for its role in obtaining and identifying the client, the manufacturer could impose an additional fee. In such cases, the manufacturer may believe that to obtain the party's business it must have uniform terms that apply to the party in all of the manufacturer's dealer territories. As a result, the manufacturer often retains control over the formation of national account agreements. This means price, delivery, warranty, and service requirements are made outside the requirements of the dealer-manufacturer contract. A dealer may conclude that because a certain national account generates smaller profits it does not justify the dealer's participation. In such a case,

Contract tips – Territory:

- The nature and scope of the "territory" of the proposed equipment distribution agreement is an essential economic term which should be negotiated well before the parties exchange a first draft of a dealership agreement. The scope of the territory, and whether it is exclusive, non-exclusive, or semi-exclusive, must be reasonable given the market opportunities available to the proposed dealer. Proposed dealers, before beginning negotiations as to the "territory" with the manufacturer, should create a well-resourced market plan which will identify the economic opportunity, proposed customer base, product competitors, and opportunities and barriers for entry of the product into the proposed territory. Avoid territories based on arbitrary, non-market-based definitions.
- Distribution contracts frequently limit dealer sales areas and impose other restrictions on distributors that can operate in the interests of both parties. Such restrictions are generally permissible under antitrust laws provided the restrictions do not unreasonably limit competition.
- A distributor should be wary of giving the manufacturer a unilateral right to redraw the distributor's exclusive territory. Changes to territories should be based on the mutual agreement of the parties or the occurrence of a specific and easily identifiable objective event, such as a decrease in market share.
- If the sales area is non-exclusive, dealers should steer clear of contract clauses that impose penalties for sales outside the dealer's territory. If the sales area is exclusive, penalty provisions can benefit both parties.
- Both parties should consider including language defining how territorial restrictions would affect internet equipment sales.
- Penalties, which will be characterized as higher fees or commissions to the manufacturer, should be reasonable and there should be some consideration of a sharing of fees with distributors in other territories in the event of internet sales.
- Direct sales and national account clauses can benefit both parties, provided the dealer has the option, but is not required, to sell to customers within its exclusive territory with whom the manufacturer enters into separate agreements.

Chapter 2: Maintaining the dealer-manufacturer relationship

A. Minimum Inventory and Delivery Rights

A central component of an equipment distribution agreement is the obligation of the dealer to stock the manufacturer's products and the right of the dealer to order and take delivery of those products. The success of the dealer-manufacturer relationship depends on the ability of the parties to balance these obligations and rights in a manner that allows the dealer's business to thrive.

1. Minimum Inventory

A manufacturer has an interest in making certain the dealer purchases as much inventory as is commercially reasonable. A dealer has an interest in maintaining an inventory sufficient to serve its customers without unnecessarily tying up resources and capital. These seemingly divergent interests often manifest themselves in the contract terms that impose minimum inventory requirements.

In general, a dealer is best protected from unnecessary inventory purchases when the contract is silent as to the dealer's responsibility. Thus, a contract that does not specify the amount or type of inventory the dealer must carry may be ideal. Given the reality that a manufacturer may seek certain assurances that the dealer will maintain an inventory sufficient to properly serve its territory, a dealer may be required to accept some contractual minimum. How that requirement is described will help the dealer and manufacturer better maintain positive relations.

Some contract clauses state broadly that a dealer must maintain the minimum inventory necessary to service the equipment the dealer sells and services. This simple statement, however, can have unforeseen consequences for a dealer. A dealer may believe this requirement means it must stock the parts most commonly used in the repair of equipment in its service department. A manufacturer, however, may take the position that this language requires the dealer to stock the complete line of parts for all products sold and serviced in the dealer's territory. The gulf between the two perspectives is vast and could undermine the dealer-manufacturer relationship.

It may be preferable in these circumstances to draft precise contract language that identifies what parts and equipment the dealer must maintain in inventory and what parts and equipment the dealer can order from the manufacturer as needed. This can be accomplished by linking inventory requirements to historic sales figures. Doing so will allow the dealer's inventory to be dynamic and responsive to market needs, while at the same time ensuring the dealership has sufficient inventory to serve its territory's needs.

8. Post-Contract Warranty Service

Even after a contractual relationship between a dealer and a manufacturer ends, the dealer's obligations to customers who purchased the manufacturer's products may continue. Many warranty statements require a dealership to repair the manufacturer's product if a defect develops during the warranty period. Consequently, the dealership must make certain the contract provides for continued warranty support from the manufacturer for the length of any warranty under which the dealer may be held liable.

A contract can protect the dealership in this situation in two ways. The dealer could seek a provision that continues the manufacturer's obligations under the warranty provision of the contract after the contract's termination. With this provision, the dealer can continue to provide warranty support for its customers and the manufacturer will continue to reimburse the dealer for the costs it incurs in the manner defined in the contract. This allows the dealer to maintain the good will of customers who return expecting warranty service and support from the dealership.

A second approach would require the manufacturer to assume responsibility and liability for all warranty claims occurring after termination of the distribution contract. This approach may be less desirable for the dealership, which may have to act as a mediator between the manufacturer and the purchaser. It may also require the distributor to send the customer to a competitor to obtain service the dealer would otherwise be able to provide. Regardless of which option the dealer chooses, a well-drafted contract should contemplate and provide for this eventuality.

Contract tips – Warranties:

- Equipment distribution contracts should clearly describe the manufacturer's reimbursement policy for warranty labor and parts.
- Dealers should be wary of contract provisions that reference external documents, such as warranty policy guidelines, that the manufacturer may change unilaterally.
- A fair approach is to key warranty reimbursement to the dealer's normal labor rates for non-warranty service. Contract warranty provisions should also provide reimbursement for related costs, such as travel and diagnostic time.
- State equipment dealer protection statutes may impose specific warranty reimbursement requirements on manufacturers.
- Dealers should consider asking for special warranties for equipment kept in the dealer's rental fleet.

F. Selling the Dealership

Some manufacturers may seek to include in the agreement limitations on a dealer's ability to sell the dealership during the term of the contract. In negotiating distribution agreements, dealers must make certain that restrictions on the sales of a dealership are reasonable and do not reduce the value of the business or prevent transfer to a successive generation in the case of a family-owned company.

Some contracts prohibit the sale of a dealership. In these contracts, a dealer's sale of or attempt to sell its business results in breach or termination of the contract. Given that the distribution agreement may represent a significant inducement to potential buyers and that many family-owned dealerships are intended to transfer ownership to the younger generation in the course of maintaining the business, this frustrates a dealer's ability to reap all the benefits of ownership.

In addition, if a contract treats the sale of the dealership as a breach rather than a termination (see Chapter 3 for more on termination), the dealer could face a lawsuit for breach of contract if it opts to sell its business while the contract remains in effect.

Other contracts, while allowing the dealer's sale of the business, make the sale contingent on the manufacturer's approval. This approval is provided at the sole discretion of the manufacturer. While this type of contract is more flexible than an absolute ban on sale of the dealership, the manufacturer retains too much power and discretion to decide the dealer's fate. Although contract principles require that the manufacturer exercise such discretion in "good faith," the dealer may desire to have more certainty regarding its ability to sell its business.

A more reasonable way to address the sale of a dealership is to allow the manufacturer to provide input into the process. This can be accomplished by allowing the manufacturer to review a potential buyer's finances, business plan, or other data the manufacturer would normally examine before entering into a contract with a dealership. The contract might also require a less stringent set of conditions or a more cursory review if the buyer is simply a second generation assuming control of the business.

Then, the manufacturer could decide to approve or reject the sale of the dealership, provided approval is not unreasonably withheld. If the manufacturer disapproves of the sale, the dealer would have the option to sell with the understanding that the dealer-manufacturer agreement would terminate as a result.

This would provide the manufacturer the comfort of only having to do business with parties that met its criteria, while allowing the dealer the flexibility and advantage of selling the business with a valid dealer-manufacturer agreement in place.

Chapter 3: Ending the dealer-manufacturer relationship

A. Termination for Cause or Convenience

Dealer-manufacturer relationships are rarely permanent. Eventually, through changed circumstances and the evolving needs of the distributor and manufacturer, one or both parties may no longer benefit from the continuation of the relationship. Drafting a contract that deals with this reality will make the termination of the distribution contract less contentious and help avoid costly litigation.

As discussed briefly in Chapter 1, some equipment distribution contracts limit the parties' rights to terminate as a result of specified events or occurrences. This is known as termination "for cause." Other contracts allow for termination at the option of either of the parties for any or no reason, referred to as termination "for non-cause" or "for convenience." Both types of contract have advantages and disadvantages. It is important a dealer understand these options before entering into an agreement.

Termination for convenience allows a party to end the relationship by providing notice, often as little as 30 days, to the other party of its intention to withdraw from the contract. The benefit of this arrangement is that it allows the parties flexibility. This arrangement is best suited to a contract that has no defined termination date.

When a party invokes termination for convenience, there is no dispute over cause and responsibility. This allows the parties to avoid costly and time-consuming litigation. A dealer should make certain a "for convenience" clause provides equal rights to the manufacturer and dealer with regard to their rights to terminate for convenience. Otherwise the dealership may find itself bound to an agreement the manufacturer can exit at will.

In addition, to minimize the disruption an unexpected termination can cause, the dealer should consider demanding at least a 90-day notice requirement.

In a "for cause" contract, the parties can only disengage from the contract if a particular event occurs. In this type of contract, once the event occurs, the party can exit the contract, in some cases, without notice. Often a "for cause" clause accompanies a "for convenience" clause to allow a party to disengage from the contract immediately, if necessary.

"For cause" clauses often specify the filing of bankruptcy, relocation of the dealership without the manufacturer's consent, a felony conviction, or a breach of certain provisions of the contract as cause for termination. Again, the dealer must make certain the rights to terminate are equitably allocated between the dealer and the manufacturer to ensure balance and fairness.

Appendix I: Equipment Distribution Contract Checklist

The following checklist identifies contract terms that are unique to the equipment industry and commonly found in distribution contracts, as well as terms generally found in commercial agreements in the United States.

- Identification of the document as an agreement to create a distributor-manufacturer relationship.
- Identification of parties.
- Statement that the agreement does not create an agency-principal or employer-employee relationship.
- Assignment of the distributor's exclusive territory. (See Chapter 1, page 5)
- Description of how the parties will deal with extra-territorial sales, national accounts and manufacturer direct sales, and internet sales. (See Chapter 1, page 5)
- Statement granting distributor the right to use manufacturer trademark. (See Chapter 1, page 13)
- Description of support manufacturer will provide for marketing activities. (See Chapter 1, page 15)
- Statement of ownership of customer lists. (See Chapter 1, page 16)
- Description of distributor's minimum inventory obligations. (See Chapter 2, page 18)
- Statement of manufacturer's obligations for timely delivery of equipment and assumption of liability for condition of equipment upon delivery to distributor. (See Chapter 2, page 19)
- Statement of length of notice manufacturer will provide for price increases. (See Chapter 2, page 20)
- Statement of warranty policies, including description of reimbursement warranty parts and labor costs, special warranty provisions for rental equipment, continuation of warranty obligations upon termination of distribution agreement, and dealer authority to extend and expand warranty at dealer's cost. (See Chapter 2, page 21)
- Statement of manufacturer's obligation to reimburse distributor for costs associated with recalls. (See Chapter 2, page 25)