Firing Your Customer – Facing The Challenges Of Changing Your Distribution Network

GERALD G. SALTARELLI
JASON S. DUBNER

Breaking up is hard to do, especially when the jilted party has been your customer for many years. As a reseller of your product, the soon-to-be fired distributor may have depended on you for its livelihood. Loss of your line may, in an extreme case, destroy the distributor's business, providing a powerful incentive to contest the termination.

The longer your relationship with a distributor, and the greater its dependence on you, the greater the risk that a court will find a way to protect the distributor in the event of termination. To minimize that risk, you should adopt and enforce a termination protocol. With outside counsel as the gatekeeper of that protocol, you can thoroughly weigh the risks of termination and take the appropriate steps to minimize those that are unavoidable.

• *Employ a termination checklist to which company personnel must respond*

The termination checklist ensures that key information is sought and obtained. For example, the checklist should require that sales personnel identify the reasons for termination, investigate and determine whether promises were made to the distributor that are inconsistent with termination, and identify complaints that could ripen into claims against the company.

The checklist should also require that company personnel forward to counsel the distributor's file and contract for review. Be sure the process encourages counsel to speak directly with the company's field representatives in order to develop the full story.

• *Review the contract and correspondence file.*

The written distribution agreement should set forth your right to terminate along with the required notice. If the contract is silent or ambiguous, termination will be more difficult, and the parties' course of dealing and performance should be considered to assess the company's right to terminate. Absent an agreement, most jurisdictions require reasonable notice of 60 or 90 days.

A successful protocol will force the company to comply with all of its contractual obligations on termination. For example, if an obligation to repurchase the distributor's inventory exists, counsel should remind company personnel to satisfy that requirement.

• *Determine whether any state franchise law applies*

State franchise statutes often require "good cause" for termination regardless of the parties' agreement. These broadly-worded statutes arguably cover a variety of distribution relationships. The termination protocol should identify whether a state franchise statute is likely to apply. Although this inquiry is fact intensive and a definitive answer is often impossible, the risk of a franchise statute's application can, at a minimum, be identified and evaluated.

If a state statute is likely to apply, the protocol should require an analysis of the statute's good cause requirements. Some statutes specify in detail what qualifies as "good cause." For example, your written contract may permit termination if the distributor materially changes its ownership structure. Some state statutes, however, supersede this contractual provision and mandate approval of ownership transfers.

State franchise statutes often require that you provide the "franchisee" with an opportunity to cure any defaults. When such a statute applies, counsel should orchestrate the termination scenario in order to afford the distributor the requisite opportunity to cure.

• *Determine the reasons for termination*

If you are fortunate, your agreement allows termination on written notice and without cause. If no state franchise statute applies, termination on notice – without a stated reason – is preferred. The company should provide the requisite termination notice and avoid debating the underlying reasons.

Sometimes, however, either the distribution agreement, or – as discussed above – a governing state statute, requires good cause. Good cause generally refers to the distributor's failure to substantially comply with the terms of the contract. Failing to meet agreed-upon sales quotas or targets can be good cause, but the company must have clearly articulated its expectations.

Good cause generally does not encompass the manufacturer's unilateral desire to change its method of distribution or its judgment that a different distributor will more effectively cover the territory. Some failing on the part of the distributor is necessary. Because good cause is so restrictive, every new distribution agreement should be drafted to allow the manufacturer to terminate for any reason or no reason at all.

If good cause is needed, the termination protocol should force the company to identify the cause and test its factual support. A bald conclusion that the distributor is not doing a good job will not suffice. Once cause is identified, the protocol should ensure that it is accurately reflected in subsequent communications with the distributor.

• *Consider the potential for common law claims*

The termination protocol should articulate whether the terminated distributor may assert common law claims, such as *promissory or equitable estoppel*. These claims could involve allegations that the manufacturer made oral or written promises that the distributor would not be terminated if, for example, it improved its performance or made certain investments in its business. Counsel should investigate the potential for such claims by speaking directly with company personnel responsible for the account.

Terminated distributors may also allege *tortious interference with contract or business expectancies*, claiming that the manufacturer's wrongful termination caused the distributor to lose existing or potential business. If the termination is not wrongful in the first instance, if proper notice is given, and if the manufacturer engaged in no extracontractual wrongful acts, a claim for tortious interference should not prevail.

• *Look at antitrust issues*

The termination protocol should also require counsel to consider potential antitrust challenges to your decision to terminate, or your policies towards distributors in general. Termination of a single distributor usually will not be deemed to adversely impact competition. If the termination is linked to a distributor's failure to adhere to suggested retail prices or was done in response to rival distributors' complaints that the distributor's prices are too low, a colorable antitrust claim could be asserted. Consequently, counsel should review the contract and course of dealing with the distributor to identify any areas of potential antitrust exposure.

• *Communicate how the terminated distributor should be treated during the "lame duck" period.*

You must treat your terminated distributor as a distributor in good standing until the actual date of termination. If you do not, the distributor will have a legitimate claim that it was not given the requisite advance notice. Counsel should evaluate whether the company can compete with the distributor once notice is given and whether a replacement distributor can be appointed during the notice period. If the distributor's territory is exclusive, whether by agreement or, possibly, by long standing practice, the company should not compete with the terminated distributor until the notice period has ended. Counsel should also warn company personnel not to solicit the distributor's employees or customers, or otherwise disparage or undermine the terminated distributor.

Breaking up with a long-time customer is more than an unfortunate occurrence, it is a high-stakes decision. Companies that impose sufficient discipline on the process, however, should reduce their legal exposure.

Gerald G. Saltarelli is a partner and Jason S. Dubner is an associate with Butler Rubin Saltarelli & Boyd, a Chicago litigation boutique. They regularly advise companies on distributor termination issues.