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Challenges in Distribution: Terminating Dealers and Distributors

Do you have dealers or distributors who are underperforming or who are not complying with your distributor agreement? Do you wish to change distribution for other reasons? If you do, and if you are considering terminating a dealer or distributor, this article will be of interest to you.

The Legal and Business Risks of Termination

Terminating any relationship often gives rise to risks and costs. When terminating a dealer or distributor, the risks and costs can be significant. Among other things:

- The dealer or distributor might claim that you improperly terminated the arrangement and sue forcing you to devote considerable time and resources to defending a lawsuit. Your litigation costs could be substantial.
- If the dealer or distributor succeeds on a claim of improper termination, the court may impose an injunction that precludes you from terminating and requires you to carry on in business together or order you to pay damages for losses incurred as a result of the improper termination.
- The dispute may have a negative impact on your position in the marketplace and on your relationships with other dealers.

An informed and well-considered termination process will reduce the risks and potential costs of termination. This bulletin is intended to assist you in doing so.

Managing the Risks: Pre-Termination Dealer Management

Making an informed termination decision, and being able to defend that decision if challenged by a dealer or distributor, requires the supplier to do its homework long before any termination decision is made. Most challenges to termination decisions are based on how the supplier has dealt with the dealer ***well before*** the termination notice is sent. Your objective for every dealer should be to have a record documenting the history of the relationship (and, in particular, any poor performance issues or related concerns) so that your termination decision (and the reasons supporting it) does not come as any real surprise to the dealer.

There are a few "Golden Rules" for communicating with dealers during the course of the relationship. Some of these "Golden Rules" are as follows:

Keep Records

- Maintain a complete written record of your communications with dealers on any matter of significance – and in particular, matters regarding substandard performance or other related issues. Make routine use of confirming letters and file notes.
- Maintain one centrally located dealer file for every dealer with all key documentation and communications. This file should contain all communications between all of your personnel and the respective dealer.

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Document Agreements

- Document any agreements with the dealer in writing and ensure that none of your representatives say anything to the dealer that conflicts with the terms of your dealer agreement. Whenever possible, use dealer agreements.

Act Reasonably

- Always ensure that your communications to the dealer are reasonable. Do not use an insulting or high-handed tone. Imagine that every communication you send will one day be read by a judge or published on the front page of a newspaper, and choose your language and tone accordingly.
- Termination should almost never come as a surprise to a dealer, and the reasons for termination should be foreshadowed in your communications with the dealer well in advance of termination.

Follow up

- Write to the dealer often to follow-up on performance issues. Once a performance issue with a particular dealer has been identified and discussed with the dealer, follow-up regularly to ensure that the dealer rectifies the issue.

Respond to Dealer Requests

- If a dealer requests a meeting to discuss an issue, promptly communicate to meet with the dealer to discuss its concerns and to arrange a meeting, if appropriate. Confirm your discussion in writing. Never leave a letter or request from the dealer unanswered.

While following these practical guidelines cannot insulate you from potential litigation, they will assist you in defending wrongful termination or other claims.

Managing the Risks: Termination Rights

Manufacturers and suppliers often believe that their termination rights are completely defined by the express terms of their written (or oral) dealer agreement. This belief is ***incorrect***. This mistaken belief can also lead to costly errors when terminating dealers.

The rights and responsibilities of a supplier and its distributors are only ***partially*** dealt with by the terms of the dealer agreement. The relationship is also governed by external forces, which include the common law (precedent cases decided by judges), industry mediation or arbitration agreements, and in certain circumstances, legislation and regulations made by the federal and provincial governments. These external forces can sometimes render specific termination rights unenforceable – in other words, they can "trump" the specific and express termination provisions contained in a written dealer agreement. You must accordingly be sensitive to the legal framework surrounding termination of dealers generally, not just the specific language of your dealer agreement.

For example, the law in Ontario requires a manufacturer or supplier to act in "good faith" when exercising some discretionary power under a contract (such as the power to terminate or not renew a dealer or distributor). "Good faith" is an imprecise concept but, generally speaking, it means to make your decision honestly, fairly and by observing reasonable commercial standards. A supplier may be found to have acted in "bad faith" where it, without reasonable justification, substantially nullifies the benefits contracted for by the dealer, contrary to the original expectations of the parties. You must act in "good faith", both when making the decision to terminate and in handling the termination generally.

What constitutes "good faith" will depend upon the facts of each particular case. The following guidelines, however, are generally applicable:

- Generally speaking, the longer the relationship between the manufacturer and the dealer or distributor, and the more money a dealer has invested in the business, the higher the standard of "good faith" required. The courts expect manufacturers to act reasonably to all distributors, but a higher standard will be used where the relationship has been a long one or where the dealer has invested large amounts.
- Before issuing a notice of termination or non-renewal, advise the distributor orally of your intended actions and explain why. To the extent possible, you should invite the distributor to address your concerns and provide it with an opportunity to do so. Wherever your dealer agreement requires a period of notice to be given to the dealer, give the longest notice possible in the circumstances.
- Ensure that you apply the dealer or distributorship agreement to dealers and distributors consistently. When terminating for a particular reason, ensure that other dealers with similar defects in performance have been or are being treated in a similar fashion.
- You should consider whether there are any special or unusual facts that may make it unfair to terminate or to insist on strict compliance with the dealer agreement.
- You should consider whether the dealer's performance or default was in any way caused or contributed to by your own actions or inaction.
- Do not discuss the possible termination of one dealer with other dealers or potential new dealers. The dealer being terminated should be the first to know of its pending or possible termination.

Managing the Risks: Should You Terminate?

When deciding whether you should terminate any particular dealer or distributor, consider applying the following four-step analysis:

- Review the facts and the dealer file to identify all possible reasons for termination and collateral issues, such as amounts owing by the dealer and its relationships with customers, and the implications for other agreements you may have with the dealer and the potential for cross default;
- Review the dealer or distributorship agreement (whether oral or written) to identify potentially applicable termination provisions;
- Perform a cost-benefit analysis of termination and consider whether there are viable alternatives to termination, and whether there are ways to mitigate the impact of termination, for example, by repurchasing inventory; and
- Consider the potential for the dealer to challenge the termination decision, whether in Court, to the Competition Tribunal, or otherwise.

The termination decision is driven largely by the language of the dealer agreement and the specific facts in each case, and for this reason, we recommend a disciplined process using a Dealer Termination Diagnostic as the platform for this analysis.

Is your Dealer or Distributor Agreement in Writing?

Most dealer or distributorship agreements that are in writing contain express termination provisions. You may be entitled to terminate a dealer:

- for cause based on specified default provisions;

- without cause on some specified period of notice; or
- by notifying the dealer that you do not intend to renew the agreement when it expires.

This analysis of whether termination is advisable, and by what means it can and should be effected, is critical.

What if your Dealer Agreement is not in Writing?

If the parties operate under an oral arrangement, or have a written contract that does not provide for termination on notice or for cause, generally the common law requires a manufacturer or supplier to provide its dealers or distributors with "reasonable notice" of termination. The amount of "reasonable notice" required in any given case depends on a range of factors, including the length of the relationship between the parties, the percentage of the dealer's total income represented by the supplier and the extent of the dealer's investment, particularly if it is made at the request of the manufacturer or supplier.

The objective in determining "reasonable notice" is to give the dealer or distributor a reasonable amount of time to obtain an alternate supply of goods or otherwise rearrange its affairs to adapt to the loss of the supplier. The amount of notice typically awarded by the courts is between one and twelve months or more in the case of relationships of long duration.

The Final Analysis: To Terminate or Not to Terminate, That is the Question

Once you have considered the above, one of four courses of action will likely become apparent:

Work on the Relationship

- You do not really need to terminate the dealer. Where the dealer is actually doing a fairly decent job and is not hurting you, you are probably better not to terminate and instead work on ways of improving the relationship.

Develop your Case

- You would like to terminate the dealer as soon as possible, but the potential litigation risks militate against immediate termination. The dealer may be troublesome and may be in breach of the dealer agreement, but the potential for the dealer successfully litigating the termination is too high to warrant the risk and cost. If so, it is likely better to wait and build a better record against the distributor before terminating.

Do Not Renew

- Depending on the wording of your dealer agreement, you may conclude that you do not have sufficient cause to warrant an immediate termination based on some breach of the distributorship agreement but you do have a rational and defensible basis to bring the relationship to an end to by issuing a non-renewal notice.

Terminate

- You have sufficient grounds to warrant a termination and the risks are manageable.

Conclusion

Making the decision to terminate a dealer or distributor requires careful thought and a consideration of many factors, not all of which are covered here. The process is dynamic and begins long before the reason for termination becomes apparent. Ideally, you will have an adequate written record with your dealer or distributor that fairly and reasonably captures defaults or non performance and key issues in the relationship. The notice of termination or non-renewal itself should only be issued after you are satisfied that it meets your business needs and is within an acceptable risk/consequence outcome.

Legal counsel plays an integral role in effectively managing the termination process. Early involvement in the planning process so that the array of arguable reasons for termination can be examined and a course of action can be planned to minimize the likelihood of litigation risk is encouraged.

The foregoing is a summary of some general issues that confront manufacturers and suppliers when ending a relationship with a dealer or distributor. Obtaining legal advice before making any specific termination decision is recommended.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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