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**M&A DISTRIBUTION ISSUES**

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## M&A DISTRIBUTION ISSUES

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### I. *COMMON M&A DISTRIBUTION SCENARIOS*

In the world of mergers and acquisitions, one of the most overworked—or misunderstood—words is “*synergy*.” Synergy is an acquirer’s capacity to use its significant strengths to improve the performance of an acquired company or take one of the acquired company’s strengths to counter a weakness of its own.

Frequently, a distribution system can be a significant source of synergy. Synergy is taking a company that sells \$50 million of its products a year in the United States, putting it through the acquirer’s distribution system, and selling \$100 million a year worldwide.

Far too often, the M&A implications of distribution are assigned a low priority or not fully understood. Acquisitions that appear promising from a number of viewpoints can subsequently fail or require major surgery if distribution issues are neglected in the preacquisition evaluation process.

The M&A landscape is cluttered with legal issues attendant to both supplier level and distributor level transactions. For example:

#### **A. Supplier Level Transactions**

Scenario 1: A merger between two suppliers leaves the successor with excess distribution capacity. Successor supplier terminates “overlapping” and “inefficient” distributors.

Scenario 2: One franchisor acquires another and, pursuant to the terms of the merger, the acquired chain and all of its franchisees must adopt the trade name of the acquiring franchisor. As a result, the franchisees of the acquired chain find themselves with a new name operating across the street from franchisees who have had the same name for years. Both the established and the new franchisees are unhappy.

Scenario 3: An established software company (“Company”) is considering the acquisition of a new software company (“Newco”). Two aspects of the acquisition analysis have focused upon whether or not the Company (1) must offer Newco products to its existing dealers, and (2) has the flexibility to terminate Newco dealers and establish new distribution channels to handle Newco products.

Scenario 4: In an effort to fend off a hostile takeover, the parent of a fast food franchisor announces an LBO of the parent and the spin-off of the franchisor. Shareholders of the parent will receive a sizable cash dividend, but franchisees fear the newly emancipated franchisor will be so burdened with debt that product

development, advertising, promotion and chain expansion will be precluded or greatly reduced for the foreseeable future.

## **B. Distributor Level Transactions**

Scenario 5: Supplier's agreement with distributor prohibits distributor from handling "competitive products." Distributor announces the acquisition of XYZ, whose products compete with supplier's products. Supplier sues to enjoin distributor's acquisition of XYZ.

Scenario 6: One of an east coast-based supplier's most successful distributors informs the supplier that it is selling its voting stock to the supplier's west coast-based competitor. At first shocked, the supplier recovers and terminates the distributor.

Scenario 7: A successful distributor sells his business to buyer. Supplier refuses to continue the relationship, and buyer—not the former distributor—threatens suit.

Scenario 8: Supplier's policies prohibit dealer transfers to multidealer owners. Supplier terminates a dealer who sells its dealership to a "mega-dealer."

## **II. SUPPLIER LEVEL DISTRIBUTION ISSUES**

### **A. Duty to Inform Distribution System of Sale**

The securities and franchise registration laws may require disclosure of the transaction at some point, although when that point arrives depends on the specifics of the transaction.

Separate from any statutory obligation, does the supplier have a duty to inform its distribution system of an impending sale?

Suppliers historically have not had a duty to disclose their business plans to members of their distribution system. A change in the supplier's corporate ownership is simply one of the risks assumed by the distribution system.<sup>2</sup>

A recent line of commentary suggests that, while franchisors historically were not under a duty to disclose sale or purchase activity, contemporary caselaw developments have partially eroded this historical assumption and a conservative approach to disclosure must be considered. In other words, a planned merger or acquisition among franchisors must either be fully disclosed to prospective franchisees or, in order to avoid potential liability, franchisors should suspend new franchise activity and remain silent.<sup>3</sup> This line of reasoning interprets recent caselaw upholding franchisee causes of action for fraud and misrepresentation against a franchisor for failure to disclose, and extends the court's reasoning by applying statutory concepts of disclosure upon material change to common law duties of disclosure.<sup>4</sup>

As an extension of this reasoning, when a proposed merger or acquisition will require existing franchisees to execute a materially different franchise agreement, the rules governing disclosure to prospective franchisees apply. When a planned merger or acquisition reaches a level of materiality to

trigger the duty to disclose is unclear, but certainly the execution of any writing memorializing an agreement is the latest possible disclosure date.<sup>5</sup>

### **B. Transferability of Supplier's Distribution Relationships**

Nearly every merger and acquisition transaction contemplates the assignment of one party's distribution arrangements to the merging or acquiring entity. While most distribution agreements provide for assignment by distributors under certain circumstances, they are frequently silent with respect to the supplier's ability to do so.<sup>6</sup>

How a particular transaction will impact the target's distribution relationships is a function of many factors, including the transaction's form. If the transaction involves the purchase of the target's assets by the acquirer, it is more likely to be considered as an assignment of the target's distribution rights. On the other hand, if the target's stock is purchased by the acquirer, the effect on the target's distribution rights is less likely to be characterized as an assignment.

Obviously, the precise language of the distribution agreement dealing with transferability is critical to the result. Is the agreement "non-assignable" or "non-transferable?" Are transfers occurring by "operation of law" or "by merger" addressed? Does the agreement speak to "changes in control?" The form of transaction, itself, may trigger one or another of these provisions.<sup>7</sup>

However, state franchise law may apply and work a different result where the assignment results in a substantial price increase to the franchisee<sup>8</sup>, or when the assignee is unable to perform the franchisor's obligations.<sup>9</sup>

### **C. Channel Conflicts**

The supplier's merger with or acquisition of a competitor may cause conflicts between the competitors' distribution networks, including changes in the channels used to distribute the products, or outright conversion of the acquired distribution system to another brand.

Successors who wish to implement changes involving significant capital expenditures by franchisees may have to do so "reasonably" and in a manner consistent with the reasonable expectations of the parties or they may violate the implied covenant of good faith and fair dealing.<sup>10</sup>

In other instances, the successor's ability to impose a significant change may depend on the language of the underlying distribution agreement. If, for example, the underlying agreement reserves to the supplier the right to distribute the product by any other means, the successor has the ability to distribute products by any other method, including other distribution channels, even though reseller sales are adversely affected.<sup>11</sup>

#### **D. Rebranding**

Issues relating to a company's ability to require distributors or franchisees to convert to the new owner's brand are closely related to the specific language in the controlling agreements.

There has been little caselaw or commentary on the right of a newly acquiring company to force an existing distributor or franchisee to rebrand its products or otherwise make material capital expenditures to fall in line with the new company's business plans.<sup>12</sup> However, the sparse caselaw that does address the issue suggests that even in the absence of express language prohibiting such behavior, a franchisor must act reasonably in its demands on franchisees.<sup>13</sup>

#### **E. Postacquisition Territorial Conflicts**

Territorial conflicts often arise when competing distribution systems are acquired. Not surprisingly, the key to operating two previously separate distribution systems with territorial overlaps is the applicable underlying contract language.<sup>14</sup> However, one thing is clear – courts will tend not to expand the express terms of an agreement by employing “gap-filler” provisions that would invoke an implied covenant of good faith and fair dealing.<sup>15</sup>

In a related issue, in some instances the underlying contract calls for territorial exclusivity on the part of one franchisee or another. When territorial exclusivity issues arise, as in the case of mergers or acquisitions involving mature franchises, special conflicts arise. The franchisor may resolve these issues prior to merger or acquisition by offering economic inducements in exchange for a waiver.<sup>16</sup> Such inducements might include a right of first refusal to establish new units in the proposed market or in a new market, or offer supplemental advertising programs to the franchisee.<sup>17</sup>

#### **F. Postacquisition Distributor Consolidation**

A common by-product of M&A transactions is distribution “consolidation.” For a variety of reasons, the buyer may decide to replace one distributor with another. The legal status of these terminations will depend upon a number of factors, including the provisions of any applicable contracts, the existence of applicable state statutes as well as the post-transaction structure of the consolidating market.

On occasion, the cut-off distributor may be able to challenge the merger giving rise to his subsequent termination. Section 7 of the Clayton Act prohibits any merger, stock or asset acquisition in which the effect of the transaction “may be” to “substantially lessen competition” or “tend to create a monopoly.”<sup>18</sup> Any person injured by a Section 7 violation may sue for treble damages or obtain injunctive relief, including divestiture.<sup>19</sup> This is exactly what the cut-off distributor did in Lucas Automotive Engineering v. Bridgestone/Firestone, Inc.<sup>20</sup>

The Lucas case involved “vintage tires,” tires which are manufactured for use on antique, vintage and collector cars vintage tires differ from modern tires; vintage tires are generally bias ply tires, whereas modern tires are radial construction. Vintage tires are distributed through specialty tire channels of distribution. The market for original equipment vintage tires for American cars consists of only four brands: Firestone, B.F. Goodrich, U.S. Royal and Goodyear.

In our global economy, we should not be surprised to learn that Firestone vintage tires were manufactured by Firestone’s New Zealand subsidiary, that the business was underperforming, and that Firestone decided to relocate the business to the U.S., where production would continue under the auspices of an exclusive third-party licensee. Firestone asked its two vintage tire distributors, Lucas and Coker Tire, to submit bids. Coker was selected when Lucas resisted the bidding process.

After the Firestone line was transferred to Coker, Coker controlled 90 percent of the original equipment vintage tire market. Lucas, which had previously been an active participant in the vintage tire market, was now reduced to an indirect purchaser from Coker.

Lucas brought suit. The complaint alleged that Coker and Firestone conspired to monopolize the worldwide market for the marketing and sale of vintage tires in violation of Section 2 of the Sherman Act. The complaint also alleged a substantial lessening of competition in the marketing and sale of vintage tires in violation of Section 7 of the Clayton Act. Lucas sought monetary damages pursuant to Section 4 of the Clayton Act and divestiture pursuant to Section 16 of the Clayton Act. The district court deflated Lucas’ case by granting summary judgment in favor of the defense.

On appeal, a divided Ninth Circuit reinflated Lucas’ divestiture claim. According to the court, Lucas had standing to seek divestiture as a customer in a market now controlled by a monopolist. On the other hand, the court unanimously rejected the terminated distributor’s assertion of standing to seek damages under Section 4 as both a distributor and customer.

### **G. Exclusive Dealing Clause as an Anti-Merger Vehicle**

Exclusive dealing occurs when a supplier restricts its distributor from handling products which compete with the supplier’s. What happens when the distributor acquires a competing supplier? Consider Ocean Spray Cranberries Inc. v. PepsiCo Inc.<sup>21</sup>

Ocean Spray sought to throw a major wrench into PepsiCo Inc.’s proposed \$3.3 billion acquisition of Seagram Co.’s Tropicana juice business by asking that the court immediately stop Pepsi/Tropicana from selling or distributing any single-serving drinks that would compete with Ocean Spray. Ocean Spray maintained that the acquisition of Tropicana violated a three-year distribution agreement Pepsi made with Ocean Spray in March, 1998, in which Pepsi agreed not to sell single-serving drinks that would compete with Ocean Spray products. According to the lawsuit, the contract with Pepsi states that Pepsi agreed not to “sell

or distribute ... directly or indirectly any noncarbonated juice that imitates, competes with or may be confused” with Ocean Spray.

Analysts were initially skeptical that Ocean Spray could sink the proposed acquisition or block Pepsi from selling the single-serving drinks, which don’t need to be refrigerated. The analysts were proven right; Pepsi’s acquisition of Tropicana was completed on August 25. Ocean Spray’s initial application for a preliminary injunction was denied due to lack of irreparable injury to Ocean Spray, in part because Pepsi’s company-owned bottlers continued to faithfully distribute and market Ocean Spray products and would not handle competing Tropicana products during the remainder of the 1998 agreement. The action of the district court was upheld on appeal.<sup>22</sup>

### **III. *DISTRIBUTOR LEVEL DISTRIBUTION ISSUES***

#### **A. Background**

A distributor purchasing a distribution business wants to ensure that the supplier consents to the sale. Suppliers often have two prime transfer-related concerns. First, is transfer necessary to maintain an adequate sales effort in the distributor’s area? Second, if the answer is “yes,” a distribution relationship should be transferred only to capable and energetic owners who will be in a position to make the expenditures of time, money and effort necessary to satisfy all of the supplier’s requirements.

#### **B. Supplier’s Consent**

##### **1. Common Law**

Suppliers have a legitimate interest in the proposed transfer of distribution relationships, including the maintenance of the conditions present when the distribution arrangement was first established. Restrictions may be imposed on the financial strength and business experience of the proposed transferee, the execution of the supplier’s current agreement, execution of a release from the transferor, etc. Disapproval for legitimate and reasonable business reasons will generally be upheld.<sup>23</sup>

##### **2. Franchise Registration/Relationship Statutes**

The transaction may trigger disclosure consequences, and may actually be prohibited by a registration statute prior to registration. Most state registration statutes, however, will exclude the transfer of a franchise for the franchisee’s own account where the franchisor is not involved in the transaction. Many statutes specify that the mere exercise of approval or disapproval of the proposed transfer is not sufficient “involvement” to deny the exclusion.

Relationship statutes, such as the Arkansas Franchise Practices Act, require that the transferring franchisee and the franchisor each take certain procedural steps in order for the transfer to be valid. For example, the Arkansas statute states:

“It shall be a violation of this act for any franchisee to transfer, assign or sell a franchise or interest therein to another person unless the franchisee shall first notify the franchisor of such intention by written notice, setting forth in the notice of intent, the prospective transferee’s name, address, statement of financial qualification and business experience during the previous five years. The franchisor shall within sixty days after receipt of such notice, either approve in writing to the franchisee such sale to the proposed transferee or by written notice advise the franchisee of the unacceptability of the proposed transferee, setting forth a material reason related to the character, financial ability or business experience of the proposed transferee. If the franchisor does not reply within the specified sixty days, his approval is deemed granted. No such transfer, assignment or sale hereunder shall be valid unless the transferee agrees in writing to comply with all the requirements of the franchise then in effect.”<sup>24</sup>

State statutes impose further limitations on a franchisor’s right to restrict franchise transfers. For example, in addition to the procedural requirements quoted from the Arkansas statute, Nebraska<sup>25</sup> and New Jersey<sup>26</sup> also require notice from the franchisee and response from the franchisor.

Some state laws provide that the supplier may not unreasonably refuse to allow the distributor to assign the distributorship. Hawaii prohibits franchisor’s disapproval in the absence of “good cause,” which is defined to include:

1. The failure of a proposed transferee to meet any of the franchisor’s or subfranchisor’s reasonable qualifications or standards then in effect for a franchisor or subfranchisor;
2. The fact that the proposed transferee or an affiliated person of the proposed transferee is a competitor of the franchisor or subfranchisor;
3. The inability or unwillingness of the proposed transferee to agree in writing to comply with and be bound by all lawful obligations proposed by the franchise, including without limitation all instruction and training obligations, and to sign the current form of franchise agreement used by the franchisor or subfranchisor; and
4. The failure of the franchisee or proposed transferee to pay any sums owing to the franchisor or to cure any default in the franchise agreement or other agreements with the franchisor existing at the time of the proposed transfer.<sup>27</sup>

Many states restrict the franchisor’s ability to refuse to consent to a transfer upon the death of the franchisee or, in some instances, the transfer of stock.

### **3. Other State Laws**

A variety of special industry specific state laws impose restrictions on a manufacturer's ability to reject a proposed transfer or oppose changes in a dealer's capital structure necessary for public ownership.

#### **a. Beer distributorships .**

In Guinness Import Co. v. Mark VII Distributors, Inc.,<sup>28</sup> the Eighth Circuit held that Guinness did not violate the Minnesota Beer Brewers Act when its parent purchased a Jamaican brewer and substituted the Guinness distribution network to handle the Jamaican brands in Minnesota.

#### **b. Motor vehicle dealerships .**

Can an auto manufacturer impose a limitation on the number of *its* franchises an individual/corporate entity can acquire? Mega-dealers and holding companies assert that their common ownership of multiple same-brand franchises is no threat to competition and may even increase competition because of efficiencies realized in the administration of the franchises and their enhanced ability to secure cost efficient flooring or peripheral products. Many manufacturers view holding companies or large publicly owned conglomerates owning several of its franchises as a threat to their long-term ability to maintain a rational distribution system and participation and support for their coordinated marketing programs.

Dealer networks have been developed on the premise that each dealership's location and facility size are determined by the volume of business that can be expected to be available to it based on the popularity of the brand of vehicles in the marketplace, the location of intrabrand competitors, and the distance that consumers in a particular marketing area can be expected to travel to buy a vehicle and have it serviced. It is in the interest of manufacturers to make certain that all their dealers have the opportunity to operate profitably, so that they can make the necessary investments in personnel and facilities to satisfy consumers, and to promote the dealership and the brand. Auto manufacturers also fear that high concentration of dealer ownership in one entity will leave them vulnerable in the markets in which the owner operates should the owner fail.

### **4. Contract Provisions**

In most cases, the distribution agreement will set forth those terms and conditions under which the supplier will permit the relationship to be transferred. Common conditions which must be satisfied include:

- (a) The financial strength of the proposed transferee must be adequate.
- (b) The business acumen and business experience of the transferee must indicate a probability of success.
- (c) The transferee must execute the then-current agreement.
- (d) The transferor must execute a release.
- (e) The transferee must agree to completion of training.

- (f) The ethical and moral character of the proposed transferee must be acceptable to the supplier.

#### **IV. DRAFTING CONSIDERATIONS**

##### **A. Background**

Carefully considered contractual provisions in both distribution and acquisition agreements can eliminate many problems. If any doubt exists about the power of a well-chosen word or phrase, compare two relatively contemporaneous, but opposite, results involving the separate subsidiaries of the same parent company – Pillsbury.

In Rosenberg v. The Pillsbury Company,<sup>29</sup> Haagen-Dazs' franchise agreement specifically reserved to it the right to "distribute products identified by the Haagen-Dazs trademark throughout not only Haagen-Dazs Shoppes but through any other distribution method which may from time to time be established." As a result of this language – drafted by one group of lawyers within the Pillsbury corporate family – the court determined that Pillsbury and its Haagen-Dazs subsidiary did not breach a contractual duty of good faith to the owner of a Boston Haagen-Dazs franchisee by distributing prepackaged pints of ice cream to supermarkets and convenience stores.

Scheck v. Burger King Corp.,<sup>30</sup> is where the court denied Burger King's motion for a summary judgment, leaving open for determination the issue of whether or not Burger King violated the implied covenant of good faith and fair dealing by converting a Howard Johnson restaurant to a Burger King restaurant within two miles of the franchisee's unit. The agreement at issue in Scheck granted the franchisee a license to operate a Burger King restaurant at a specific location only, and neither granted the franchisee an exclusive territory, nor reserved the rights to Burger King to place additional restaurants near the site granted franchisee. The court reasoned that since Burger King did not explicitly reserve the right to place restaurants in close proximity to the franchisee, the franchisee was entitled to "expect that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract." The court noted, however, that had the franchise agreement explicitly stated that the franchisor maintained the unlimited right to establish additional franchise restaurants at any location, the court's analysis and conclusion would have been different. You will not be surprised to learn that the Burger King franchisee agreement was drafted by a different group of lawyers within the Pillsbury family.

##### **B. Distribution Agreement—Selected Provisions**

Distribution agreements involve a higher likelihood of disputes than other contracts for a number of reasons. First, unlike discrete sales, the distributor agreement governs a relationship that may last several years. Over time, the business environment, as well as the parties interests and fortunes, may dramatically change. Second, unlike contracts that are closely managed by senior executives and their lawyers,

distribution relationships are often established and administered by personnel of the manufacturer and distributor who are unassisted by legal counsel and who have varying experience levels. Third, because a distribution arrangement can represent a predominant portion of the business of at least one of the parties, actions taken with respect to the contract may have an enormous impact on that company's viability, making virtually any dispute a serious subject for litigation. Because of these reasons, the drafter of a distribution agreement should be sensitive to a number of key concerns.

### **1. Product Definition**

Not only does a distribution agreement appoint the distributor - it should also designate the products which are subject to the appointment. Often, the products which are subject to the appointment are set forth on an attached schedule which may simply describe them as "food products" or "machinery." Can a simplistic product description impact the ability of the supplier to utilize alternative distribution channels post – M&A transaction? Yes. The product description can have a profound effect when additional distribution channels are added to the mix.

The best way of avoiding controversy over the products which can be sold into a new distribution channel is to list each product by "name, rank and serial number" so that there is no lack of knowledge over which products the supplier may or may not assign to a new distribution channel. If a supplier wishes to preserve future management's ability to react to potential opportunities, the more detailed the product definition, the less future questions may arise. Similarly, the greater the detail in the definition, the better the distributor can evaluate which new products might not be available to it.

### **2. Provisions Recognizing the Supplier's Ability to Acquire Additional Product Lines and Distribution Systems**

It is difficult to name a business today that is not interested in offering new products under the appropriate circumstances. And the source of these new products is just as likely to come from the acquisition of another company's product line as through internal development. However, no matter how wonderful the new product opportunity, it will be meaningless if distribution efforts fail to make the product available to likely purchasers.

While the obligation of a distributor to sell new products is a key consideration in any distribution arrangement, it may be of even greater concern when those new products arrive not from the R&D efforts of the trusted supplier, but from the supplier's purchase of an additional product line without the existing distribution channel. Hoping to translate an anticipated distribution synergy to the "bottom line," the supplier desires to rely upon its existing distribution base to bring the new product to purchasers.

However, not all new product opportunities are greeted by distributors with open arms. Handling a new product may mean additional investment in an increased employee complement, training, product

handling and storage costs. The distributor may conclude that business is "just fine, thank-you" without the added investment or effort needed to handle the new product.

As a result, the supplier will want an agreement that obligates its distribution network to handle new products. One way of doing so is to include, in the agreement's product definition, "such products as the Supplier may from time-to-time add to Exhibit A hereto." In addition, the provisions of the agreement dealing with the right of the parties to amend the agreement, should specifically reference that with respect to the addition of products to Exhibit A by the supplier, the agreement's amendment procedures do not apply.

In every situation where a supplier gains a new product line via an acquisition, a corresponding supplier is losing an existing product line via a divestiture. Again, the supplier's flexibility to make such a divestiture is dependent upon a distribution agreement that vests the supplier with sole discretion to stop making or selling any covered product. For example, a potential buyer may conclude that the servicing of the product is not up to the level of the competition and post-acquisition distribution changes must be part of any turnaround strategy.

While a major product restructuring may leave the distributor with obsolete inventory, the flexibility to drop a product offering can be an important component of the marketability of the supplier's business. Without the ability to consider product distribution on a clean slate, potential purchasers may lack serious interest in acquiring all or portions of the supplier's business.

### **3. Termination of the Distribution Agreement in the Event of a Sale of a Business or Product Line**

While it may be argued that an agreement's provision granting the supplier the ability to withdraw a product from coverage offers adequate protection in the event of a sale or divestiture, the ultimate comfort is a provision which explicitly references such situations and provides the right to terminate the distribution relationship in its entirety.

The natural inclination of the business personnel for both the manufacturer and the distributor is to provide for an evergreen duration (i.e., the agreement will continue until such time as it is no longer automatically renewed.) However, the ability to terminate the relationship in its entirety is often important because typical sales agreements include a non-competition clause, precluding the seller from conducting operations in the type of business being divested for a number of years. If the seller's ability to exit a distribution arrangement is contractually restricted, it may be difficult to pledge non-competition. At best, the result may be a reduction in the purchase price realized; at worst the purchaser may not be interested in the deal.

Consideration should be given to reserving the right to terminate immediately (or on very short notice) if either party takes steps that are fundamentally inconsistent with the purpose of the relationship such as, for example, if the distributor is acquired by a competitor in whole or in part.

#### **4. Exclusive or Nonexclusive**

Often a distribution arrangement may impose obligations on the distributor from handling products which are competitive to those of the supplier. The object of such provisions is that the supplier is best able to compete with its competitors if it has the full attention or "share of mind" of its distribution channel, thereby linking their efforts in triumphing over the competition.

As the product portfolio of the supplier is restructured through acquisition or divestiture, there may be a similar impact on the product portfolio of the distributor who must live with an exclusivity obligation. In such situations, the distributor may deserve an adequate amount of time to transition to exclusivity where the products necessitating the change were not part of the supplier's portfolio at the beginning of the relationship.

#### **5. Territory**

Once provisions regarding the obligations of the parties to the suppliers' products have been spelled out, it is equally important to consider how an M&A transaction might impact the area in which the products can be sold.

Sometimes distribution arrangements are established on an "open basis," meaning that the distributor is free to resell the supplier's products anywhere. In other situations a more limited or "closed" area of distributor operations is specified. In virtually all situations it is important to spell out in detail what the rights of the parties are and consider how alternative distribution systems might impact the parties rights. For example, if the distributor may engage only in sales in the Northeast Corridor, the contract should say so as well as reserve to the supplier the right to sell in all other geographic areas. Unless the territorial grant is carefully considered, the parties' later options may be restricted. And as with product definition, the restrictive effect may not surface until relationship changes are introduced through the purchase or sale of a product line.

#### **6. Channel of Trade**

When a product line is purchased, channel conflicts may be introduced. Will the potential buyer be able to continue to utilize its existing distributor network as it had in the past? The supplier's ability to utilize alternative distribution channels may depend upon whether the underlying agreements permit such "encroachment" or restrict it. For example, retail ice cream store franchisees may complain about losing sales when the new corporate owner decides to begin selling ice cream directly to supermarkets. Or, a buyer may desire to start up a centralized mail-order or web based sales program after the original owner granted distributors the exclusive rights to sell to consumers in certain defined geographical territories.

The ability to make changes following an M&A transaction may affect the desirability of the transaction, and hence the value of the supplier's business. The ability of the new owner to do so will depend upon how artfully the arrangement previously entered into between the seller and its resellers dealt with reserving rights to alternative distribution methods.

## **7. Trademark Rights**

Similar encroachment issues are inherent in the provisions of the agreement which describe the rights of the purchaser (and likely franchisee) to use the supplier's mark during the course of the agreement. These rights are also frequently defined in terms of geographic or channel restrictions.

## **8. Assignment**

From the standpoint of the supplier who may someday become the M&A seller and wish to transfer its distribution relationships to a buyer, it is important to have the ability to do so without the burden of obtaining consents from the distribution community. Of course, it is simply more efficient to be able to move forward without the necessity of investing in the time necessary to prod slow (at best) or reluctant (at worst) distributors into providing necessary consents.

From a negotiating standpoint, the seller is going to want to avoid conveying to its distribution community the notion, whether true or not, that consent is a *sine qua non* to the deal. Most distributors with that kind of leverage simply cannot resist the temptation to extract a little bonus for bestowing their blessing on the transaction.

## **C. Acquisition Agreement—Key Provisions**

### **1. Form of Transaction**

From the buyer's standpoint, if seller's distribution contracts are not assignable without the consent of the other contracting party, the buyer's inability to obtain the consent may result in depriving the buyer of a valuable contract right. This problem may be addressed to a certain extent by structuring the transaction as a statutory merger, or a sale or exchange of stock, but a restructuring may not always avoid the Assignability issue. Third-party contracts, for example, may require the consent of the third party if there is a change in control of the seller, including changes resulting from a sale of stock, or a reorganization.

### **2. Seller's Residual Liability**

If the third party to the contract with the seller consents to the assignment, the buyer will inherit all rights and obligations under that contract, although the seller will still be secondarily liable in the event of the buyer's non-performance. This may pose a significant dilemma for the seller if there is some concern over the buyer's ability to fulfill outstanding obligations under contracts assumed by the buyer.

In a sale-of-assets transaction, the selling corporation may subsequently liquidate and distribute the sale proceeds to its shareholders; such a course of action would leave the third party little practical recourse against the seller. The third party, therefore, may be unwilling to consent to the assignment of the contract unless it can be convinced of the buyer's creditworthiness and ability to perform. In some cases, the third party may require additional guarantees and other collateral to secure the buyer's obligations under such contract, including guarantees or other accommodations from the seller or its affiliates.

### **3. Buyer's Residual Liability**

In the context of a sale of assets, successors generally have no liability for obligations of the transferor.<sup>31</sup>

The assets being purchased should be described, and the liabilities to be assumed by the buyer should be clearly specified.<sup>32</sup>

### **4. Third-Party Interests**

Does the purchaser have a breach of contract claim against the seller's supplier who refuses to consent to the sale? Purchaser's claim may be dependent upon whether or not purchaser is deemed to be a third party beneficiary to the distribution agreement. Because the purchaser is not a party to the distribution agreement, it does not have standing to assert a breach of contract claim unless it is a third party beneficiary. If the agreement has been drafted to expressly disclaim third party beneficiary claims, purchaser will lack standing to assert a breach of contract claim based upon the distribution agreement.<sup>33</sup>

Does the purchaser have a tortious interference with contractual relations claim? Does it make any difference if the distribution agreement authorizes the supplier to arbitrarily withhold its consent to assignment? Apparently not, at least in California. The key is whether or not supplier's refusal to consent "was justified," i.e., was it fair and reasonable under the circumstances?<sup>34</sup>

### **5. Indemnification From Claims Made by Seller's Former Distribution Partners**

The buyer runs the risk that claims will arise against the business from members of the seller's distribution network. The buyer will often require that the seller agree to indemnify and defend the buyer against all loss, liability, cost and expense related to such claims. At first glance this provision seems simple, but it is often difficult to negotiate. Sellers readily understand that they should protect the buyer against their failure to eliminate obvious liabilities arising prior to the closing date. However, some sellers become anxious about indemnification of liabilities not identified until after closing. On balance it is good to get the issue of possible claims by seller's distributors, dealers, etc. "out in the open" at an early juncture.

### **6. Cooperation in Defending Post-Acquisition Claims**

Unfortunately, the buyer may be faced with claims from the seller's distribution community that raise issues for which the buyer has little personal knowledge or has inherited little in the way of records. This is often the case when distributors claim that they were "granted" certain distribution rights for which there are no written agreements. As a result, it is important to obtain some form of commitment from the seller to cooperate in the defense of any future distribution-related claims, even as to those for which the seller may not have a contractual obligation to indemnify the buyer.

**7. Walk-Away Rights in the Event of Significant Litigation**

Even in the best of worlds, there may be a time when the parties, while desirous of going forward with the acquisition, may fear that there is a lawsuit waiting in the bushes. If the lawsuit were to materialize, either party might wish the opportunity to reconsider whether to continue their new arrangement or to “just forget about it” and not spend the time and resources necessary to fight the lawsuit. Often a provision can be included in the agreement which gives either party an option for a limited amount of time to terminate in the event that certain specified acts occur. This right of termination is in addition to any other right of termination that would otherwise be included in a standard agreement.

**8. Competing Brands**

If the seller’s distribution agreements do not allow the seller to operate a competing brand or concept, the buyer may choose to create a new corporate entity to acquire the seller’s business, thereby avoiding operating a contractually prohibited concept.

**ENDNOTES**

<sup>1</sup> Mr. Wegener, a partner at Fredrikson & Byron, P.A., practices in the areas of antitrust and trade regulation counseling and litigation, with a special emphasis on product marketing, distribution, pricing, acquisitions and joint ventures, advertising and sales promotion, licensing, trade secret, intellectual property and related transactional issues.

Mr. Wegener received both his Bachelor of Arts and Juris Doctor degree from the University of Nebraska, where he served as Managing Editor of the *Nebraska Law Review*. Before returning to private practice in 1989, he served as Division Counsel to the United States Food Group of The Pillsbury Company and Assistant to the General Counsel for Antitrust and Trade Regulation.

Mr. Wegener is a member of the Advisory Board for the Bureau of National Affairs *Antitrust and Trade Regulation Report* [BNA ATRR], the world's leading weekly antitrust and trade regulation publication, and *The Antitrust Counselor*, a key monthly publication for those who advise clients in these important areas. He also is a member of the Minnesota, Nebraska, New York and American Bar Associations. He is a frequent speaker and writer on government regulation of the marketplace, the business and litigation aspects of distribution and marketing practices and strategies to avoid criminal and civil antitrust liability, both in the United States and abroad. Based on a survey of practicing attorneys, Mr. Wegener is listed by the prestigious American Research Corporation as a "Leading Attorney" in antitrust and trade regulation law.

<sup>2</sup> Sanders v. Robertson American Corporation, 698 S.W.2d 480 (Tx. Ct. App. 1985) (supplier sold its business and distributor claimed that supplier's failure to inform distributor of the impending sale created losses for the distributor which should have been considered in determining an amount owed on account; plaintiff failed to establish any duty of the supplier to inform its distributors of the sale).

<sup>3</sup> David J. Kaufmann, Franchise-Related Mergers and Acquisitions, 823 PLI/Comm 555, PLI Order No. A0-0086, New York City, June 11-12, 2001.

<sup>4</sup> Id. See also David J. Kaufmann, Duty to Disclose Purchase or Sale Activity, 18 FALL - Franchise L. J. 39, 40 (1998).

<sup>5</sup> Id. See also David J. Kaufmann, Duty to Disclose Purchase or Sale Activity, 18 FALL - Franchise L. J. 39, 40 (1998).

<sup>6</sup> Baxter Healthcare Corp. v. O.R. Concepts, Inc., CCH Bus. Fran. Guide ¶ 10,684 (D. Ill. 1995) (medical products manufacturer did not breach the anti-assignment clause of its contract with a distributor by selling most of its stock to a competitor of the distributor, since the sale of stock did not constitute an assignment under the contract; nowhere in the contract was there an express provision prohibiting the manufacturer from selling shares of its stock. If the parties had intended for the sale of stock to constitute an assignment, they could have done so).

<sup>7</sup> Verson Corp. v. Verson Int'l Group PLC, 899 F. Supp. 358, 363 (N.D. Ill. 1995) (right to "subdistribute" may not be the same as right to assign the contract).

<sup>8</sup> Bames v. Gulf Oil Corp. et al., CCH Bus. Fran. Guide ¶ 8616, at 16,528 (4th Cir. 1986) (gasoline franchisor's assignment of a franchise agreement to another gasoline distributor allegedly resulted in an increase in gasoline costs to the franchisees; held, that assignment may constitute a termination of the underlying franchise agreement giving rise to a cause of action against the franchisor if the franchisee could prove that the

assignment resulted in a substantial price increase and would constitute constructive termination under applicable franchise law).

<sup>9</sup> Marc's Big Boy Corp. v. Marriott Corp., Bus. Fran. Guide (CCH) ¶ 9100 (E.D. Wis. 1988); Pecan Shoppe of Georgetown, Inc. v. Stuckey's, Inc., C.A. No. C85-3710A (N.D. Ga. 1987), aff'd, No. 87-8446 (11th Cir. 1988) (if assignee is incapable of performing obligations of franchisor, franchisee's consent will be required).

<sup>10</sup> Burger King v. Austin, 805 F. Supp. 1007 (S.D. Fla. 1992).

<sup>11</sup> Carlock v. Pillsbury, 719 F. Supp. 791 (D. Minn. 1989).

<sup>12</sup> See e.g., Mary M. Bonacorsi, Who Wins, Who Loses, 18 FALL Franchise L.J. 39, 45 (1998).

<sup>13</sup> Burger King v. Austin, 805 F. Supp. 1007 (S.D. Fla. 1992); Dayan v. McDonalds Corp., 466 N.E.2d 958 (Ill. App. 1984).

<sup>14</sup> Clark v. America's Favorite Chicken Company, 110 F.3d 295 (5th Cir. 1997) (post-merger challenge by former competing franchisees which had previously enjoyed exclusive territorial rights failed because franchise agreement allowed franchisor to operate a competing system, under a different trademark, in franchisees' territories); Lee v. Flintkote Co., 593 F.2d 1275 (D.C. Cir. 1979) (franchisees who enjoyed contractual protection against the establishment of another "licensed location" within a 2-mile radius lost suit against distributor selling to other retailers because franchisees were not granted "exclusive" selling rights in any territory).

<sup>15</sup> Mary M. Bonacorsi, Who Wins, Who Loses, 18 FALL Franchise L.J. 39, 45 (1998).

<sup>16</sup> David J. Kaufmann, Network Expansion/Dual Distribution/Encroachment, 823 PLI/Comm 503, PLI Order No. A0-0086, June 11-12, 2001.

<sup>17</sup> Id.

<sup>18</sup> 15 U.S.C. § 18.

<sup>19</sup> 15 U.S.C. §§ 15, 26.

<sup>20</sup> 74 BNA ATRR 362 (9th Cir. 1998).

<sup>21</sup> No. 98-CV-11676 NG (D. Mass., filed Aug. 10, 1998).

<sup>22</sup> Ocean Spray Cranberries, Inc. v. Pepsico, Inc., No. 98-1948 (1st Cir., Nov. 12, 1998).

<sup>23</sup> See Call Ford, Inc. v. Ford Motor Co., 48 F.3d 201 (6th Cir. 1995) (upholding Ford's refusal to approve transfer because too much profit was being paid); Kestenbaum v. Falstaff Brewing Corp., 575 F.2d 574 (5th Cir. 1978) cert. denied, 440 U.S. 909 (1979) (franchisor justified in withholding consent on the grounds of the company's dissatisfaction with the terms of the proposed purchase; the purchase price was, in the franchisor's judgment, one that would jeopardize the financial stability of the business). See also Hamro v. Shell Oil Co., 674 F.2d 784 (9th Cir. 1982) (business qualifications); Carozza v. Webber Chevrolet Co., 1978-1 Trade Cas. (CCH) ¶ 61,982 (D.R.I. 1978) (criminal record); Hawkins v. Holiday Inns, Inc., 634 F.2d 342 (6th Cir. 1980), cert. denied, 451 U.S. 987 (1981) (unacceptable business activities); Sally Beauty Co., Inc. v. Nexus Products Co., Inc., 801 F.2d 1001 (7th Cir. 1986); Berliner Foods Corp. v. Pillsbury Co., 633 F. Supp. 557 (D. Md. 1986) (sale to supplier's competitor).

- <sup>24</sup> CCH Bus. Fran. Guide, ¶ 4040.06.
- <sup>25</sup> Requires sixty (60) days advance written notice by a franchisee to the franchisor of an intent to transfer, assign or sell a franchise, or an interest in a franchise, together with the prospective transferee's name, address, statement of financial qualifications and business experience during the past five years. If the franchisor does not respond, in writing, within the sixty (60) day period either approving the franchise or setting forth the unacceptability of the proposed transferee and the material reasons for the disapproval relating to the character, financial ability or business experience of the proposed transferee. The proposed transferee must agree, in writing, to comply with all of the requirements of the franchise then in effect. *Revised Statutes of Nebraska §87-405.*
- <sup>26</sup> Same as Nebraska. *New Jersey Revised Statutes §56:10-6.*
- <sup>27</sup> CCH Bus. Fran. Guide, ¶ 4110.01.
- <sup>28</sup> 75 BNA ATRR 223 (8th Cir. 1998).
- <sup>29</sup> 718 F. Supp. 1146 (S.D.N.Y. 1989).
- <sup>30</sup> 798 F. Supp. 684 (S.D. Fla. 1992).
- <sup>31</sup> See Teeters & Associates, Inc. v. Eastman Kodak Co., 836 P.2d 1034 (Ariz. App. 1992); Hartford Accident & Indemnity Co., Inc. v. Canron, Inc., 43 N.Y.2d 823, 373 N.E.2d 364, 402 N.Y.S.2d 565 (1977).
- <sup>32</sup> See Schwartz v. Pillsbury, 969 F.2d 840 (9th Cir. 1992) (successor owner in an asset, not stock, deal did not expressly or impliedly assume liability for previous owner's actions since the acquisition agreement expressly limited successor's obligations to certain assets listed).
- <sup>33</sup> See McKinney v. Anheuser-Bush, Inc., No. 90-16263 (9th Cir. 1991) (not for publication).
- <sup>34</sup> Sade Shoe Company v. Oschin and Snyder, 162 Cal. App. 3d 1174, 1179-80 (1984) (the fact that the supplier may have had a contractual right to refuse assignment does not necessarily defeat purchaser's claim; the question "is whether the actor's conduct was fair and reasonable under the circumstances, which is a question for determination by the trier of fact.").