2. DISTRIBUTION

2.1 Definition

A distributor buys goods from a supplier or manufacturer and resells them to his customers. In contrast to the agency model, there is no contract of sale between the supplier and the customer – this relationship exists between the distributor and the customer. A distributor does not usually receive commission from his supplier. Instead, he takes his remuneration from the margin he adds to the resale price of the goods.

The supplier has less control over the distributor’s activities in the distributorship model compared with the agency model, but he benefits in being able to pass on some of the risk of the sale of the goods to the distributor which under an agency model rests with the supplier.

2.2 Basic Aspects of Distributorship Agreements under UK Law and Court Practice

2.2.1 Formalities

Distributorship agreements are not subject to any formality required by law. There are no formal registration requirements and distributorship arrangements can exist even where there is no written evidence of the arrangement. Nevertheless, it is sensible for the protection of both the supplier and distributor to enter into a comprehensive written distributorship agreement.

There is no legislation in the United Kingdom specifically directed at distributorship arrangements. Where a distributorship arrangement exists, limited rights and obligations are implied by common law and general principles of contract and competition law will be relevant.

2.2.2 Exclusivity

Distributors are usually afforded either exclusive, non-exclusive or sole rights in their defined territory. In general terms, exclusive rights prevent the supplier from actively seeking sales and appointing other agents or distributors in the distributor’s territory; non-exclusive rights allow the supplier to appoint other distributors and to actively seek sales in the territory; whilst sole rights allow the principal to sell into the territory but not appoint other distributors.

The words ‘exclusive’ and ‘sole’ have no statutory definition in the UK and the rights being conferred by these terms are often the subject of misunderstanding between suppliers and distributors. For these reasons it is highly recommended that the distributorship contract sets out in detail the extent of any exclusivity conferred on the distributor, rather than relying on the words ‘exclusive’ or ‘sole’.

When drawing up exclusivity provisions in UK distributorship agreements you must ensure that UK competition rules are not breached.
Following the enactment of the Competition Act 1998 (the ‘Competition Act’), UK competition law on distribution now closely mirrors EU law so the principles which apply are almost identical. The EU regulations, guidelines and case law are therefore as relevant as those emanating from the UK.

Section 2 of the Competition Act (known as the ‘Chapter I Prohibition’) corresponds to Article 101(1) TFEU and prohibits agreements and concerted practices which appreciably restrict or distort competition and appreciably affect trade within the UK or part of the UK.

The European Vertical Restraints Block Exemption Regulation 330/2010 (the ‘Block Exemption’), which applies in the UK by way of parallel exemption under section 10 of the Competition Act, exempts ‘agreements . . . between two or more undertakings each of which operates . . . at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services (‘vertical agreements’)’ (Article 2).

The Block Exemption provides a ‘safe harbour’ for vertical agreements from the Chapter I Prohibition and Article 101 TFEU provided that:

– the parties do not have a market share for the goods or services in question exceeding 30%; and
– the vertical agreement does not contain any ‘hardcore restrictions’.

(This Exemption expires on 31 May 2022 and will, presumably, be replaced by a new Regulation.) As well as the Vertical Agreements Guidelines, the ‘OFT has issued Guidelines on Market Definition and Assessment of Market Power, which closely follow EU principles, and which should be considered when calculating market share.

Calculation of market share pre-supposes defining the relevant market on which that share is held. This comprises the product and geographic market. The product market comprises those goods or services which are ‘reasonably substitutable’ with the goods or services being sold. Substitutability is viewed firstly from the point of view of the consumer, in the light of the nature, characteristics and intended use of the good or service. Substitutability should also be viewed from the supply side to ascertain whether potentially competing suppliers could enter the market at reasonably short notice if the supplier were to increase prices above competitive levels.

The geographic market will be the area in which the agreement produces its effects and will exclude those areas where the goods or services in question are not sold or sold only in limited quantities.

As a rule of thumb, for the purposes of defining the relevant market, the OFT, Competition Commission and UK National Courts will ask whether the hypothetical monopoly supplier of the good or service in question could profitably make a small but significant increase in prices – say 5% to 10% above competitive levels – over a period of one year (known as the ‘SSNIP’ test). If it could not, due to the volume of purchases being switched to substitute goods or services, or due to competitors entering the market at short notice, the definition should be broadened until a definition is reached whereby such an increase would not be profitable.

The following exclusivity and non-compete restrictions are often found in distributorship agreements and need to be assessed in light of the Chapter I Prohibition, Article 101 TFEU and the Block Exemption.
EXCLUSIVE DISTRIBUTOR: ONLY ONE DISTRIBUTOR PER TERRITORY

Here, the supplier agrees that it will appoint only the distributor in the distributor’s territory. This may be a national territory, or a region within a national territory. An exclusive distributor can be protected against active sales into his territory by distributors in other territories, but a non-exclusive distributor cannot. This is discussed further in the next paragraph.

BAN ON SALES OUTSIDE THE TERRITORY

It is permissible for a supplier to prohibit a distributor from actively selling into territories which are exclusively allocated to other distributors or reserved to the supplier.

Under no circumstances, however, may a distributor be prohibited from making passive, that is, unsolicited sales to customers outside his territory. Such a restriction constitutes a ‘hardcore restriction’ under the Block Exemption, is void and exposes the supplier – and potentially the distributor – to fines of up to 10% of their UK (or worldwide in the case of an EU as opposed to UK infringement) turnover for the preceding financial year. Injured parties, whether third parties or other parties to the agreement, may also sue for damages in respect of loss they have suffered. It will equally be a hardcore restriction for the supplier to prohibit the distributor from selling to customers whom it suspects may sell outside the territory, or to require the buyer to contractually restrict his customers from making such exports.

It should be emphasized that where other territories are not exclusively allocated to other distributors or reserved to the supplier, no restriction on exports, whether active or passive, can be imposed on a distributor in relation to those territories.

With regard to sales via the Internet, a distributor cannot be prohibited from having a web site from which the supplier’s goods or services may be purchased, even if purchasers are from other Member States. Such sales will be deemed passive sales. However, if a distributor sends targeted emails to potential customers outside the territory, or creates a web site with a country specific URL, for example ending in.es for Spain, that will be deemed active selling and may be prohibited by the supplier.

CUSTOMER RESTRICTIONS

The general rule is that a distributor cannot be restricted as to the customers to whom he may sell. There are exceptions to this general rule, in particular a supplier may reserve named customers or categories of customers to himself – for example, a pharmaceutical producer may reserve hospitals to itself, leaving the distributor to sell to pharmacies.

BAN ON EXPORTS OUTSIDE THE EU

This will be acceptable unless there is a realistic prospect that the goods will be re-imported into the EU. A cumulation of profit margins, transport costs and customs duties often rule out this possibility, but it may happen if a product is sold in one or more Member States at a much higher price than it is sold to a non-EU distributor.
**NON-COMPETE OBLIGATIONS**

Non-compete obligations consist of exclusive purchase obligations, thereby preventing or limiting the distributor from dealing in competing goods.

It is generally permissible for a supplier to require a distributor to purchase all or the majority of its requirements for a particular good or service from him. The Block Exemption automatically exempts an obligation on the distributor to buy 80% or more of its requirements exclusively from the supplier, provided the obligation is in force for no longer than five years.

Similarly, the Block Exemption allows the supplier to restrict the distributor from dealing in competing goods, provided the restriction is in force for no longer than five years.

In relation to all non-compete obligations the obligation must not be in force for longer than five years. Both parties must expressly – not tacitly – agree any extension of this period. If the parties have more than a 30% share of the market for the sale, or purchase, of the goods in question, a non-compete obligation of any duration will have to be exempted individually by reference to the criteria set out in section 9(1) of the Competition Act, which correspond to Article 101(3) TFEU. Individual exemption is no longer a matter requiring notification to the OFT or European Commission, it rather being a matter for self-assessment by the supplier and distributor by direct reference to the exemption criteria.

Unlike territorial restrictions on passive sales and minimum resale prices (discussed at below section 2.2.5), non-compete obligations in excess of five years are not a ‘hardcore restriction’ under the Block Exemption. This means that whilst the offending clause itself is void, it will be severed from the rest of the agreement, which may continue to benefit from the application of the Block Exemption. In the case of hardcore restrictions, not only is the hardcore restriction void, but the rest of the agreement is brought outside the Block Exemption as a result so that key obligations which are normally exempted by the Block Exemption are likely to be void.

**EXCLUSIVE SUPPLY**

Here the distributor is given exclusivity over the whole of the EU. Such agreements are automatically exempted by the Block Exemption provided that the market share of the parties do not exceed 30%. The rules applicable are otherwise the same as for other distribution agreements.

**SELECTIVE DISTRIBUTION**

While not an exclusivity obligation as such, selective distribution is a form of limited distribution whereby the supplier restricts the distribution of its goods or services to those distributors who satisfy criteria laid down by the supplier to become authorized distributors.

Such systems require distributors to agree not to sell the supplier’s goods to unauthorized distributors. This enables the supplier to retain control over the manner in which his goods are distributed.

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*The four cumulative criteria provides that the agreement must improve production or distribution, consumers must get a fair share of the benefits, restrictions must be indispensable and competition must not be eliminated in a substantial part of the market.*
goods are marketed. Selective distribution systems are particularly suitable where: the nature of the goods require an enhanced level of service or advice at the point of sale to the customer; the supplier or manufacturer is required to provide after-sales support, most commonly, high-tech goods; or the goods are luxury, branded goods (such as certain cosmetics) where image is integral to the retail outlet.

Selective distribution systems raise different issues from other distributorship arrangements. For example, criteria for qualification as a distributor must be objective, non-discriminatory and uniformly applied. ‘Quantitative’ criteria which limit the number of authorized distributors, such as limits on how many distributors per territory are permitted or minimum turnover requirements will be a matter for assessment as to whether distributors are unduly foreclosed from access to the distribution network. A selective distributor may not be subject to exclusivity obligations such as the obligation to purchase only from the supplier – he must also be free to purchase from other authorized distributors. Equally, the distributor may not be prohibited from selling (actively or passively) outside his territory provided that he is selling to authorized distributors or end users.

Franchising agreements, whereby the franchisor appoints the franchisee to sell its goods or provide services under a certain retailing formula, are subject to rules that are similar to the selective distribution rules.

ABUSE OF A DOMINANT POSITION

In addition to the Chapter I Prohibition, Article 101 TFEU and the Block Exemption, section 18 of the Competition Act (known as the ‘Chapter II Prohibition’), which broadly corresponds to Article 102 TFEU, prohibits abuse of a dominant position by an undertaking occupying a dominant position in the UK (or part of the UK) or a substantial part of the EU. ‘Dominance’ denotes a position of economic strength such that the dominant company is able to act independently of competitors, customers and ultimately consumers. On a practical level, a market share of at least 40% will generally be required for dominance to be established, but this may be higher or lower depending on a variety of other factors, including the number and relative size of competitors and technological lead over competitors.

By definition, this means that most, if not all, dominant companies will fall outside the ‘safe harbour’ afforded by the Block Exemption. It will also be more difficult for dominant companies to prove that exclusivity or non-compete restrictions are compatible with the UK and/or EU competition rules. For example, a dominant supplier who imposes a five-year ‘non-compete’ obligation on his distributor may find that the obligation is void due to the possibility of foreclosure of competing suppliers from selling to the distributor.

2.2.3 Territory

The scope of territory in which a distributor may distribute goods or provide services is entirely a matter for negotiation between the supplier and his distributor. It is important to define what constitutes the distributor’s territory in the distributorship agreement, since this determines where the distributor is permitted to exercise his rights in respect of the distributorship. Mistakes are often made through use of geographic titles that are
misunderstood by suppliers and distributors – for example the UK includes Northern Ireland whereas Great Britain does not – and therefore it is best to list each country covered by the distributorship agreement to avoid any confusion.

2.2.4 Other Main Obligations of Supplier

Common law and legislation impose a number of general obligations on manufacturers and suppliers:

– the Sale of Goods Act 1979 implies certain terms into the sale of goods by the supplier to the distributor, including terms relating to title to, and the price, delivery and quality of, the goods;
– the Consumer Protection Act 1987 and the General Product Safety Regulations 2005 place obligations and liabilities on manufacturers and suppliers of goods sold in the United Kingdom;
– the common law tort of negligence creates civil liability where the manufacturer or supplier is in breach of his duty of care and this results in reasonably foreseeable loss; and
– product specific regulations impose obligations and liabilities on manufacturers and suppliers of specific types of goods, such as food and medicines.

The express provisions of the distributorship contract can vary some, but not all, of these implied obligations and terms.

It is usual for a distributor to include additional contractual obligations on his supplier in the distributorship contract. Examples of additional obligations include: maintaining adequate product liability insurance; supplying spare parts at the distributor’s request; and repairing or replacing defective goods.

Distributors resell supplier goods to their own customers and it is they, rather than their suppliers, who are primarily liable to their customers for the goods sold. A distributor should seek protection from his supplier for some of this liability under the distributorship contract.

2.2.5 Other Main Obligations of Distributor

Common law and legislation impose few general obligations on distributors in their arrangements with suppliers, but suppliers usually look to include a number of contractual obligations on his distributor under the distributorship contract, including: submitting written reports showing the details of sales, stocks and outstanding orders; keeping accurate sales and customer records; ensuring the goods conform with applicable legislation and regulation in the sales territory; and promoting and advertising the goods.

Suppliers often place obligations and restrictions on distributors, in addition to exclusivity obligations, non-compete restrictions and post-termination non-compete obligations,\(^5\) that may be subject to competition legislation and restraint of trade common law principles.

\(^5\)Exclusivity obligations, non-compete restrictions and post-termination non-compete obligations are discussed elsewhere in this chapter.
By far the most serious of these is the fixing by the supplier of the price (usually the minimum price) at which the distributor must sell the goods. This is a ‘hardcore restriction’ and will invariably attract fines, as well as being void and opening up the possibility of damages actions by injured parties. It is permissible, however, for a supplier to recommend resale prices provided this does not amount to indirect fixing of minimum prices, for example by means of incentives or other pressure to adhere to the recommendations. It is also generally permissible for a supplier to impose maximum resale prices.

2.2.6 Duration

It is advisable for the distributorship agreement to provide expressly for its duration and to set out the circumstances in which the agreement can be brought to an end.

Under common law an agency contract can either be for an indefinite period, for a fixed-term or terminable on the giving of reasonable notice by either side.

2.2.7 Compensation upon Termination

Under UK law, a distributor is not entitled to compensation on termination simply because of the fact that he is a distributor. As with any contract, damages may be payable for breach of contract on a wrongful termination, but this is not specific to distributorship arrangements.

2.2.8 Non-competition after Termination

Under UK and EU competition law it is not generally permissible to impose a post-termination non-compete restriction on a distributor. The very limited exception to this is where the restriction relates only to competing goods or services, is limited to the premises from which the distributor has operated during the contract period, is indispensable to protect know-how transferred by the supplier to the distributor and is limited in duration to one year after termination of the agreement (Article 5(2) Block Exemption).

In all cases it is, however, possible for a supplier to impose restrictions which are unlimited in time on the disclosure of know-how that has not entered the public domain.