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The Distribution Agreement in Mexico

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I. INTRODUCTION

THE distribution agreement is one of the most common and important legal instruments in the field of foreign investment. In such agreement, a distributor agrees to commercialize a supplier's products in a determined territory and under certain terms. Unlike some legal systems, Mexican law does not regulate distribution agreements and thus its parties are able to negotiate its clauses freely. During the negotiation, small Mexican distributors, particularly at the beginning of the commercial relationship, usually are either not aware of the importance of these issues or do not have enough leverage to negotiate protective clauses such as indemnity, termination, or exclusivity. In many instances, Mexican distributors do not want to appear too demanding because of the risk of having the potential supplier choose another distributor.

In practice, this lack of proper protection may result in a case where a Mexican distributor opens up the Mexican market to a foreign supplier to

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find that, after years of hard work, it is being left out without just cause or compensation. Some countries like Puerto Rico and El Salvador have opted to regulate distribution agreements, defining and specifying obligations and rights for both the supplier and distributor, and establishing strong penalties and indemnities for issues such as the early termination of the agreement.

In 2002, attempting to create a more balanced agreement, the International Chamber of Commerce (ICC) published a Model Form for International Sole Distributorship, clarifying the rights and obligations for both the distributor and supplier.[1] Although it has no formal enforceability, such contract has become an important instrument within international commercial practice because of the influence of the ICC. The ICC model contract was based on the customs and rules of international commerce and was drafted without any governmental intervention. This model contract will be addressed throughout this article.

This article evaluates the importance of a distribution agreement as a foreign investment instrument in Mexico and the problems caused by its lack of protection, especially for small to medium size distributors. Problems related to distribution agreements such as short duration, unwillingness to renew, and early termination by the supplier, without cause, will be addressed. In particular, this article will analyze different compensation schemes, triggered by the early termination of the agreement. Finally, a policy reform proposal will be put forward, which will provide for the regulation of such agreement in Mexico.

II. ROLE IN COMMERCE

The importance of the distribution agreement is related to its economic efficiency. On the one hand, it allows a supplier to mass-produce at wholesale prices, without worrying about retail distribution or consumer-level sale liabilities. On the other hand, it allows a distributor to concentrate its efforts solely on the retail distribution or sale of a product, not worrying about complex issues such as product development and manufacturing. In such relationship, the distributor often operates within a market and territory it already knows and with a product already accepted by the public. In other words, each party concentrates on what it does best.

The supplier usually looks for the simple and affordable distribution of its products, seeking to reduce its efforts and expenses as much as possible. Distributors, on the other hand, generally have a privileged position in terms of marketing and points of sale. In this sense, the distributor becomes the "extended arm of the supplier."[2]

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1. INT'L CHAMBER OF COMMERCE [ICC], MODEL FORM OF INTERNATIONAL SOLE DISTRIBUTORSHIP CONTRACTS, (2002). [hereinafter MODEL FORM].
2. José Luis Iglesias Prada, *Notas para el Estudio del Contrato de Concesión Mercantil*, in ESTUDIOS DE DERECHO MERCANTIL EN HOMENAJE A RODRIGO URÍA, 254 (1978).

A good potential supplier has accumulated experience in product development as well as adequate elements for manufacturing, such as the right technology and personnel. In most cases, the distributor lacks all of the above, but is located within a market that is attractive for the supplier. This means that the distributor knows its potential clients, and their necessities. In fact, one of the most sought-after elements in a distributor is proximity to the ultimate consumer. Conversely, the distributor often looks for a product that has proven successful in the past and which is manufactured by an experienced supplier.

In general, the distribution agreement is a very efficient instrument that captures an essential economic necessity, and is therefore commonly used. According to the ICC, the distribution agreement is the most used instrument in the field of international trade and commerce[3]. Yet, surprisingly, the distribution agreement tends not to be regulated. The ICC confirms this notion: "like commercial agency agreements, distributorship agreements suffer from the absence of a set of uniform rules governing the rights of the parts."[4]

III. ORIGIN

Contrary to other commercial agreements that date back to the Middle Ages, the distribution agreement is a product of the industrial revolution.[5] Mass production, which experienced a tremendous boom during that period, was a force that pushed towards creation of this legal instrument. Although it is unclear exactly when it was born, some of the first accounts of the distribution agreement refer to the beer distribution industry in early nineteenth century Germany.[6] Later on, at the end of that century, distribution agreements were commonly held with the specific objective of regulating the import and export of certain products.[7] During the 1920s, such agreements became more frequent within the U.S. automobile industry.[8] During the second half of the twentieth century, as international companies such as Pepsi and Coca-Cola started to consolidate, the distribution agreement became an essential legal instrument used by businesspersons in different countries.

Usually unregulated, the distribution agreement has developed within the realm of the *Lex Mercatoria*, or usual commercial practices. Its lack of regulation in Mexico causes various legal and commercial problems, which will be addressed in the next section.

3. ICC, THE ICC MODEL DISTRIBUTORSHIP CONTRACT: SOLE IMPORTER-DISTRIBUTOR (2004), *available at http://www.iccwbo.org/policy/law/id274/index.html*
4. *Id.*
5. Iglesias, *supra* note 5, at 253.
6. *Id.*
7. *Id.*
8. 2 EDUARDO CHULIÁ VICÉNT & TERESA BELTRÁN ALANDETE, ASPECTOS JURÍDICOS DE LOS CONTRATOS ATÍPICOS 333 (vol. 2 1995).

IV. PROBLEMS CAUSED BY LACK OF REGULATION

The lack of regulation of the distribution agreement in Mexico causes uncertainty between parties to the agreement, especially when their relationship takes a wrong turn. Sparse legislation has only been supplemented by secondary regulation, applicable only to some of the effects of the distribution agreement, such as antitrust issues, but not to the agreement itself. The above situation is not very different in other countries. Although there are exceptions, most countries do not specifically regulate distribution agreements.

This lack of regulation gives latitude to foreign suppliers to impose all kinds of burdensome clauses on small and mid-size distributors, who are compelled to accept such clauses because of the risk of having the supplier terminate or not renew the agreement. Examples of the type of conditions that the supplier commonly imposes on the distributor include the supplier's ability to: (i) unilaterally terminate the agreement without just cause or compensation for the distributor, who is sometimes left with dead inventory and uncollectable accounts receivable, (ii) unilaterally modify important clauses such as exclusivity or the applicable distribution territory, (iii) get away with the non-compliance of important obligation under the agreement without a penalty or contractual remedy, and (iv) specify a very short agreement duration, which does not guaranty that the distributor will recover its investment. These kinds of clauses emphasize the need to level the playing field between the parties of the agreement.

Unlike the distribution agreement, the franchise agreement is regulated by Mexican law, protecting the franchisee against early termination by the franchisor. The regulation establishes that any party that unilaterally terminates the agreement without cause shall pay damages to the other party.[9] This article contends that the distribution agreement should be regulated in a similar manner.

V. ESSENTIAL CLAUSES

Some of the fundamental clauses in the distribution agreement are exclusivity, duration, termination, and compensation.

A. Exclusivity

Exclusivity is not a formal or necessary element of the distribution agreement; it must be agreed upon by the parties. Such clause is very important, especially for the distributor. Without exclusivity, the distributor's position in the market is uncertain. In its model contract, the ICC suggests granting exclusivity in favor of the distributor in a determined geographic territory;[10] the reasoning behind this is that if the distributor is dedicating time and resources to the distribution, it should get some security in exchange. Ideally, if the supplier breaches this clause, the dis-

9. Ley de la Propiedad Industrial, art. 142 BIS 3 (Mexico).
10. Model Form, *supra* note 4, at cl. 1.1.

tributor should have the right to ask for damages or terminate the agreement. Having such territorial exclusivity prevents distributors from entering into price wars with other distributors of the same supplier that could bring about a "race to the bottom" effect.

Exclusivity can also be granted in favor the supplier; in such case, a distributor would be forced only to commercialize products of a certain supplier. Some distribution agreements prohibit the distributor buying products from any other supplier, whether it is a competitor or not. The ICC suggests in its model contract that the distributor should be allowed to sell a second supplier's products, provided they are not in competition with the first supplier's products.[11]

B. Duration

Duration is a crucial clause for the distributor because most distribution operations are based on medium or long-term business objectives. Yet, suppliers frequently force distributors to enter into one-year contracts, thus keeping an "easy way out" from the relationship.

Usually, the distributor invests a considerable amount of money to build or set up proper facilities, train personnel, and carry out marketing campaigns. Yet, such agreements often only have a very short duration; thus, unless the agreement is renewed at the end of the year, the distributor has a hard time recovering its investment. Thus the renewal is often left to the discretion of the supplier.

This situation can be observed within the Mexican automobile industry. International automobile manufacturers usually sell their cars through independent distributors, commonly referred as dealerships. Therefore dealerships are forced to make significant long-term investments such as building appropriate facilities, buying enough inventory and spare-parts, hiring and training permanent personnel, et cetera. Despite these investments, such distribution agreements usually specify a duration of one year.

As previously discussed, suppliers sometimes push for a short duration of the agreement in order to have absolute discretion as to its renewal. Yet, the informal understanding between the parties often is to hold an open-ended relationship, which may be renewed except when there has been a significant breach by the distributor. This obviously creates a very inconvenient situation for the distributor, who risks serious losses if the supplier does not grant renewal, including leftover inventory, uncollectable accounts receivable, property rental payments, and labor indemnities. Also, one-year agreements usually prevent distributors from obtaining favorable financing and loans, as credit institutions often demand longer distributorship agreements.

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11. *Id.* at cl. 4.2.

C. Termination

Termination is commonly perceived as the most important clause in distribution agreements. Here, the ICC suggests that the parties should hold a meeting three months before the completion of the term to discuss the possibility of renewal. Early termination, on the other hand, occurs when one of the parties terminates the agreement prior to the end of the specified term and may be with or without cause. The ICC suggests that only where one party substantially breaches the agreement should, the other party have the right to terminate the agreement with prior notification,[12] in other words, to terminate with cause.

The ICC defines substantial breach as: "[a]ny failure by a party to carry out all or part of its obligations under the contract resulting in such detriment to the other party as to substantially deprive such other party of what it is entitled to expect under the contract."[13] Thus, the ICC model contract attempts to limit the parties' right to terminate only to those cases in which there is a breach of an essential obligation. But, in commercial practice, suppliers usually have the right to terminate because of non-substantial breaches, such as when the distributor does not meet the minimum inventory numbers, makes late payments to the supplier, does not respect resale terms, does not perform the marketing efforts demanded by the supplier, or hires sub-distributors without the supplier's authorization. According to the ICC's breach definition, all of the above would not be considered material breaches that would allow the early termination of the agreement.

A more serious problem arises when the supplier unilaterally terminates the agreement without any reasonable justification. Here, distribution agreements with Mexican automobile dealerships are illustrative. These agreements usually establish that any of the parties may terminate in advance by means of written notification, even if the distributor complies with all its obligations. Although this clause could be perceived as being beneficial to both parties, it is usually more adverse for the distributor because of its invested capital. In addition, the same agreements often establish that the early termination or cancellation of the agreement, does not grant distributors the right to demand damages or the return of investment. Thus, in addition to the risk of being left with dead inventory and uncollectible accounts, the distributor commonly waives the right to demand any further compensation. Furthermore, after an early termination, the distributor runs the risk of having the supplier take over the distributor's market and clients, without any compensation.

VI. COMPENSATION

A very important provision, and something that the supplier rarely grants, is compensation because of the early termination of the agree-

12. MODEL FORM, *supra* note 4, at cl. 20.1.
13. *Id.* at cl. 20.2.

ment. Such compensation may be established in the agreement or mandated by law. Some countries offer protection to the distributor in this respect, providing relief for a distributor when a foreign supplier terminates early the agreement.

Goodwill indemnity attempts to compensate the distributor for the value created by the distributor in regard to the supplier's products, and its impact in future sales. Goodwill indemnity may be defined as the "the benefit and advantage of the good name, reputation, and connection of a business. . . the attractive force which brings in customers. It is the one thing which distinguishes an old-establishment business from a new business at its first start."[14] Because it takes into account the value added by the distributor as well as expected earnings, goodwill indemnity can be a more equitable method to calculate an early termination indemnity. Different jurisdictions set different methods to calculate this compensation.[15] Some of these compensation schemes will be analyzed below.

A. Mexico

As previously stated, Mexican law does not regulate distribution agreements, much less grant any compensation for its early termination. The only protection for the distributor is found in article 2104 of the Federal Civil Code,[16] which prescribes that any party that breaches a contractual obligation is responsible for damages caused to the other party; but, if a distribution agreement expressly permits its early termination, then the above legal provision would not grant any relief.

B. Latin America

Latin American countries have created strong protectionist laws in favor of the distributor, establishing severe penalties against suppliers in case of early termination without cause. Some of these countries are Puerto Rico, El Salvador, Colombia, the Dominican Republic, and Costa Rica. The Puerto Rican Law of Distributorship Contracts of 1964 establishes perhaps the strongest penalties for noncompliance by the supplier.[17] In case of early termination without cause or a denied renewal by the supplier, such law compensates the distributor for its start-up costs, inventory value, and capital gain of the business. Overall, such indemnity may amount to the last five years of the distributor's profits.[18]

El Salvador's Commercial Code prescribes a three-month written prior notice obligation for any party that justifiably desires to terminate the

14. Yoav Salomón, *Termination of Distributorship and Agency Agreements and Cost of Termination*, *in* INTERNATIONAL DISTRIBUTION LAW 19 (Cristof Siefarth & Dennis Campbell eds., 2001).
15. *See* EXHIBIT 2 for detailed compensation schemes in different countries
16. Codigo Civil Federal [C.C.F.] [Federal Civil Code], Art. 2104, 2005 (Mex).
17. Jorge R. Gonzalez, *Distribution Relationships in the Latin American Context* in INTERNATIONAL DISTRIBUTION LAW 31 (Cristof Siefarth & Dennis Campbell eds., 2001).
18. P.R. LAWS ANN. tit. 10 § 278b (2008).

distribution agreement, allowing the distributor the necessary time to collect all pending commissions and accounts receivable. In case of termination without cause, the distributor has the right to recover the expenses incurred in the distribution such as machinery or personal property, as well as the value of the present inventory plus an indemnity of up to three years of the distributor's profits.[19] El Salvador's goes even further, establishing as a penalty for supplier's noncompliance an import ban on its products.[20]

C. United States

In terms of the supplier's domination, the situation in the United States is not very different. In regard to this point, Stephen Story, American legal author writes:

> Increasingly, distribution agreements [in the United States] also contain express provisions designed to give manufacturers the upper hand in distributorship termination disputes. These provisions, which are generally enforced, include mandatory arbitration provisions, choice of law provisions (stipulating that the law of the supplier's home state applies) and choice of forum provisions (mandating that any litigation be brought exclusively in the supplier's local courts).[21]

Yet, some U.S. regulation offers protection to distributors. Such regulation may be found in:

- state commerce laws;
- industry-specific federal and state laws;
- anti-trust laws;
- Uniform Commercial Code

In fact, various legal authors agree that: "If one looks at the percentages, the overall Latin American picture [in regard to the protection of distributors] is not too different from the picture in the United States."[22]

At the federal level, there are industry-specific laws that offer protection to the distributor, such as the Petroleum Marketing Practices Act[23] and the Automobile Dealers' Day in Court Act.[24] Both laws establish specific standards in the relationship between the parties, preventing any party to terminate early without a cause.

At the state level, there is a wide variety of industry-specific legislation in favor of the distributor.[25] In fact, at least nineteen states, including the District of Columbia, Illinois, Virginia, and the Virgin Islands, have legis-

19. Commercial Code no. 671, art. 397 (El Sal.).
20. Commercial Code no. 671, art. 99-B (El Sal.).
21. Stephen E. Story, *Distributor Terminations,* Va. Law. Magazine 31 (2000), *available at* http://www.vsb.org/docs/valawyermagazine/oct00story.pdf.
22. *Id.* at 35.
23. Petroleum Marketing Practices Act, 15 U.S.C. § 2801 et. seq. (2008).
24. Automobile Dealer Franchise Act, 15 U.S.C. § 1221 et. seq. (2008).
25. Exhibit 1 displays a summary of the regulation status of the distribution agreement in different countries.

lation that limits the supplier's ability to terminate early or to deny the renewal of the agreement.[26]

Furthermore, antitrust regulation bans unilateral termination when the objective is ultimately to drive competitors out of the market. Also, U.S. courts have constantly ruled against suppliers for early termination, calling for the payment of damages in favor of distributors. In some noted cases, the courts have ordered the parties to continue their relationship until the distributor recovers its initial investment.[27]

D. International Chamber of Commerce

The ICC suggests in its model contract, to include different compensation schemes for early termination without cause. One of those schemes suggests that, where a party does not justify an early termination, the other party will be entitled to damages equal to the average profits of the sale of the products for the period the contract would have lasted in the case of normal termination. In addition, the ICC suggests that the damaged party may be entitled to goodwill indemnity, which consists of:

> 50% . . . of the annual gross profit made with customers introduced by the Distributor or with customers with whom the Distributor has significantly increased the volume of business, to be calculated on the average of the preceding five years (or, if the contract has lasted less than five years on the average of such duration).[28]

The ICC suggests that the above compensation should be granted "in lieu of any goodwill indemnity or equivalent compensation the Distributor may be entitled to by virtue of rules of law applicable to the present contract ("Statutory Indemnity") and will consequently replace such Statutory Indemnity (if any)."[29] Here, a foreign supplier may prefer establishing a specific compensation formula in the agreement, rather than being subject to a particular country's legal compensation scheme, which could bring much uncertainty.

VII. CONCLUSION

Mexican distributors are often placed in vulnerable positions in distribution agreements; this is primarily due to the lack of regulation that allows the foreign supplier to keep an uncommitted relationship with its Mexican counterpart. As discussed, several countries have opted to regulate (some excessively) distribution agreements in an effort to balance the relationship between the parties.

In a law and economics perspective, perhaps the following question should be asked: if distribution agreements are so unfavorable, why do Mexican distributors enter into them in the first place? The answer prob-

26. Gonzalez, *supra* note 23, at 32.
27. Story, *supra* note 25, at 38.
28. Model Form, *supra* note 4, at annex XI.
29. *Id.* at cl. 21.2.

ably is that such agreements are not so unfavorable as to make distributors not enter into them. In fact, even with a vulnerable position in the market, distributors could still run very profitable businesses.

Still, if distributors felt they had more of a locked-in agreement, they would probably invest more in the distribution, which would eventually also benefit the supplier; this would bring about more economic social welfare in the long term. Now, it is clear that very few suppliers would agree with this analysis; in other words, it would be rare if a supplier would voluntarily grant more rights to distributors, without receiving anything in return. An apparent and plausible alternative would be to enact a policy, providing for a more balanced distribution agreement.

Some critics may argue that such a policy could hinder economic transactions and ultimately deter foreign investment Mexico. There are some arguments that can be made against this notion. First, as was previously discussed, the franchise agreement has been regulated by Mexican Law since 2005, imposing damages against the franchisor for early termination - yet the franchise sector remains one of the fastest-growing foreign investment areas in Mexico. Of course, one could argue that the franchise sector is not growing at the same rate that it would if such agreement were not regulated. Still, the franchise sector does not appear to be slowing down. Similarly, distribution sectors in countries like Puerto Rico do not appear to be negatively affected after the enactment regulation of the distribution agreements.

In terms of policy reform, the conditions set forth by the ICC seem to be appropriate:

- six month written prior notice obligation for any party that desires to terminate the distribution agreement;
- in the case of early termination without cause, the other party shall be entitled to damages equal to the average profits of the sale of the products for the period the contract would have lasted in the case of normal termination;
- the damaged party may be entitled to goodwill indemnity, based on the annual gross profit made with customers introduced by the distributor or with customers with whom the distributor has significantly increased the volume of business; and
- penalties may be to the benefit of either party.

Another, more subtle, option would be to adopt a policy that establishes good faith as precondition for distribution contracts. In any case, the key is to find the right balance between the parties' freedom to contract and more equitable distribution agreements.

Exhibit 1

Country	Specific Regulation?	Applicable Law
Mexico	No	Rules that apply to atypical, mercantile contracts.
European Union	No	Two regulations regarding exclusivity and antitrust, derived from the application of article 85(3) of the Rome Treaty.
France	No	Rules that apply to mercantile contracts.
Spain	No	Rules that apply to mercantile contracts.
Italy	No	Rules that apply to mercantile contracts.
Germany	No	Rules that apply to mercantile contracts.
United States	No	State commercial law; federal and state industry-specific legislation; antitrust law, Uniform Commercial Code
Belgium	Yes	Belgian Law of July 27, 1961.
Puerto Rico	Yes	Distribution Agreements Act of 1964.
El Salvador	Yes	Art. 392 to 399 of Commerce Code.
Costa Rica	Yes	Ley de Protección al Representante de Casas Extranjeras [Law for Protection of the Representative and Distributor of Foreign Suppliers], no. 6209 (1978) (as reformed by no. 6333) (Costa Rica).
Colombia	No	Rules that apply to mercantile contracts of the Commerce Code of Colombia (Decree 410 of 1971)
Dominican Republic	Yes	Ley Sobre Protección a los Agentes Importadores de Mercaderias y Productos [Law Regarding the Protection of Market and Product Import Agents], no. 173 (1973)

Exhibit 2

Country	**Fault**	**Compensation to Distributor**
Mexico	Breach of contractual obligations	Responsible party is subject to payment of damages
Puerto Rico	Early termination without a cause or Unwillingness to renew agreement	Start-up costs value of inventory expected profits from distribution up to 5 years of past distributor's and continue agreement until conflict is resolved
El Salvador	Termination with cause but without a 3-month prior notice termination without a cause	Distribution expenses value of inventory up to 3 years of past profits possible import ban against the products of a foreign supplier, if it fails to comply with the above conditions
Colombia	If parties did not specify duration of agreement and/or compensation, and the supplier incurs in early termination without cause	The law prescribes a compensation calculated in the following manner: amount equivalent to 1/12 of the average of the profits received in the last three years for every year of duration of the agreement, or the average of all profits received, if the agreement lasted for less than three years plus, in the case of early termination without cause, the supplier shall pay the distributor an amount, established by experts, as a compensation for the distributor's efforts to credit the brand, line or products or services The experts shall take into account the duration, importance and volume of the business value that the distributor created during the agreement
Dominican Republic	in case of early termination without cause	5 years of gross income of the distributor expected earnings possible import ban against the products of a foreign supplier, if it fails to comply with the above conditions
Costa Rica	Early termination without a cause; or Unwillingness to renew agreement	4 months of gross income for each year or faction of a year of the agreement's duration possible import ban against the products of a foreign supplier, if it fails to comply with the above conditions
ICC	Early termination without cause	50 % of the annual gross profit made with customers introduced by the Distributor or with customers with whom the Distributor has significantly increased the volume of business, to be calculated on the average of the preceding five years (or, if the contract has lasted less than five years on the average of such duration)

Comments and Casenotes