INTERNATIONAL SUPPLY AND DISTRIBUTION ARRANGEMENTS:

CURRENT TRENDS & ISSUES

By David B. Eberhardt and John E. McCann, Jr.

In today's global economy, and with the advent of purchasing via the Internet, the world is indeed shrinking. With the click of a mouse, any business, anywhere, can suddenly be an international distributor of goods. If you are buying or selling goods across international boundaries, there are certain trends and issues that impact the drafting or negotiation of an agreement for the supply or distribution of goods. This article highlights a few of those trends and issues.

Financing and Credit Issues

These difficult political and economic times have resulted in a dichotomy – in order to accelerate or protect cash flow, the parties to supply and distribution agreements have become both more creative and more conservative in financing their transactions.

Some creative financing witnessed recently is best described as "reverse factoring with a twist." With traditional factoring, a supplier typically sells all its accounts receivable to a third party, usually a bank or finance company (for purposes of this article, the "bank"), for cash at a discount to face value instead of holding the receivables and waiting to be paid within terms. With traditional reverse factoring, rather than merely selling receivables, the supplier, its bank and a high-credit, quality purchaser are all involved in the arrangement, through which, upon the issuance of purchase orders from the purchaser, the supplier sells its invoices to quality purchasers to the bank. The purchaser of the goods shipped by the supplier then pays the bank directly, after receipt of the goods, within its contract terms (*i.e.*, net 60 days). The advantage to the supplier is increased cash flow and no credit risk with respect to the purchaser; the entire credit risk is borne by the bank.

The "twist" recently introduced in some arrangements reduces the bank's risk and provides it with security in the goods to be sold; this scenario involves not only the sale of invoices, but also the transfer of title to the bank. Goods are shipped directly to the purchaser, the purchaser pays the bank within terms, and title transfers from the bank to the purchaser upon payment. The bank never takes physical possession of the goods, of course, but retains title until paid – thus giving the bank more security than in a traditional reverse factoring arrangement.

As mentioned above, traditional reverse factoring only works with credit-worthy purchasers, but this reverse factoring with a "twist" can reduce the bank's risk. The buyer must be aware of the situation in order to negotiate manufacturers' indemnities and warranties directly from the supplier, notwithstanding that title to the goods at issue has transferred to the bank.

A more conservative and traditional approach to financing and credit issues in supply and distribution agreements is a return to requirements for credit enhancement in the transaction in the form of a trade letter of credit.

In the early 2000s, trade letters of credit lost favor in the market to trade credit insurance. Trade credit insurance is a type of property and casualty insurance used as a trade credit tool, most often used for insuring foreign accounts receivable. In the late 2000s, because of the global economic crisis, many businesses found that their insurers withdrew or cancelled their trade credit insurance, fearing large losses if they continued to insure the accounts receivables from faltering businesses. This trend has lead to a return to the traditional trade letter of credit.

To use a trade letter of credit in a supply or distribution arrangement, suppliers require buyers to put in place an irrevocable letter of credit, against which the supplier can draw for payment when goods are shipped, upon the presentation of the appropriate documents as agreed upon with the issuing bank. In an international arrangement, it is not unusual for the purchaser's letter of credit to be issued by a foreign bank. To provide greater comfort, a supplier may ask to have the letter of credit confirmed by a U.S. bank. Once so confirmed, the U.S. bank must pay the supplier even if the foreign bank defaults. Depending on a supplier's appetite for risk, the extra fees required for such a confirmation may provide greater comfort.

Dispute Resolution, Choice of Law & Enforcement

What happens if, even after all due attention to the law and financing, there is a dispute over payments or other terms of the agreement? With international transactions, it can be difficult to obtain jurisdiction in the U.S. over a foreign party and even more difficult to enforce an award in a foreign jurisdiction if one is obtained in the U.S. To avoid these kinds of difficulties, it is important to plan in advance.

Supply or distribution agreements negotiated with a foreign party should contain a choice of law provision and a selection of venue for the resolution of disputes. In the U.S. supplier's perfect world, the law governing the contract would be the laws of an appropriate state in the U.S., and the venue would be exclusive to the state or federal courts located in that state. Many foreign purchasers or distributors will not agree to those terms however, and a compromise is necessary.

Arbitration can be an appealing compromise. The advantages to arbitration include (i) the ability to choose an arbitrator with specific substantive knowledge, (ii) reducing the "home court" advantage a party might have if a matter is litigated in its own jurisdiction, (iii) adding certainty to the choice of law, procedure, language, and location of the proceedings, and (iv) the ease of enforceability compared to court judgments.

When drafting an arbitration clause for an international supply and distribution agreement, choosing an established, sophisticated foreign tribunal is likely the best way to proceed, as its procedures are known, its fees are established, and a database of sophisticated arbitrators should be available. The Court of Arbitration of the International Chamber of Commerce is probably the best known, but there are other well-established tribunals that are also commonly used, such as the London Court of International Arbitration and the Hong Kong International Arbitration Centre.

In international arbitration, the choice of law is generally agreed upon by the parties in the underlying contract. In an international supply or distribution agreement, if U.S. law will not be agreed upon by the foreign party, a "neutral" selection should be agreed upon by the parties. An appropriate "neutral" law will vary by transaction depending upon the parties. For example, U.S. and China based parties may agree on Hong Kong law, while U.S. and Eastern European parties may agree on German law. If choice of law is not agreed upon, the arbitrator may choose. In addition to a neutral choice of law, the parties should agree on a neutral location for arbitrating. For example, contracts between U.S. parties and parties located in the Far East are frequently arbitrated in Hong Kong or Singapore, and contracts between U.S. parties and European parties are frequently arbitrated in London or Paris.

Arbitral awards are generally easier than court judgments to enforce in foreign jurisdictions. The enforcement of such awards is generally provided for through the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention"), the international treaty in which signatory countries agree to recognize foreign arbitral awards as binding and to enforce such awards through the local court systems, while multilateral treaties for the enforcement of court judgments are practically non-existent. There are approximately 142 signatories to the New York Convention (approximately 50 U.N. Member States and Taiwan have not yet adopted the New York Convention), so the enforcement of an arbitral award should be achievable in almost any country in which international commercial transactions occur today.

Antitrust and Fair Trade Laws

Regardless of the choice of law chosen for purposes of interpreting and enforcing a supply or distribution agreement, one must ensure that the agreement complies with the antitrust and fair competition laws of all countries that may exercise jurisdiction over the arrangement. In addition to the complex body of federal and state antitrust laws in the United States, at least 35 foreign countries (including, *inter alia*, Canada and the European Union) now have some form of antitrust or fair competition laws that may apply to all or certain aspects of a supply or distribution agreement.

Determining what nations' antitrust laws apply to a particular agreement is often a difficult legal question that can raise complex issues of conflicts of law and international comity. An international supply or distribution agreement may be subject to the antitrust laws of several different nations, and one should ensure that the provisions comply with the antitrust laws of all potentially applicable jurisdictions. In so doing, one should recognize that what may be permissible or viewed with less scrutiny under United States antitrust law may be treated differently under the antitrust laws of other countries whose commerce may be affected by the arrangement.

To illustrate this point, we turn to two antitrust issues that commonly arise in the context of international supply and distribution agreements: (1) resale price maintenance; and (2) exclusive dealing arrangements.

Resale Price Maintenance – An antitrust issue that commonly arises in the context of supply and distribution agreements is resale price maintenance ("RPM") – *i.e.,* "agreements between participants at different levels of the market structure that establish the resale price of products or services." JONATHON M. JACABSEN, ANTITRUST LAW DEVELOPMENTS (SIXTH) 131 (2007). RPM typically takes two forms: (1) "maximum" RPM, which sets a price ceiling that precludes a reseller from selling above a certain price; and (2) "minimum" RPM, which sets a price floor that precludes a reseller from selling below a certain price. WILLIAM C. HOLMES, ANTITRUST LAW HANDBOOK 2009-2010 EDITION § 2.12, at 218.

Under United States federal antitrust law, a manufacturer or supplier unilaterally can "suggest" the price at which a retailer should resell its products (as a "Manufacturer's Suggested Retail Price"), *United States v. Colgate & Co.,* 250 U.S. 300 (1919), but cannot agree upon that price without inviting some level of antitrust scrutiny. For many years, any form of RPM (whether "maximum" or "minimum") was treated as *per se* unlawful under Section 1 of the Sherman Act (15 U.S.C. § 1). In 1997, the United States Supreme Court lifted the *per se* prohibition against "maximum" RPM holding that, in some circumstances, such restraints could be found to be competitively justified and, therefore, lawful under the more lenient "rule of reason" standard. *State Oil v. Khan,* 522 U.S. 3, 22 (1997). More recently, in 2007, the United States Supreme Court's landmark decision in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007), lifted the *per se* prohibition against minimum RPM allowing such restraints also to be scrutinized under the more lenient "rule of reason" standard. *Id.* at 2720.

Even within the United States, *Leegin* has been controversial. Leading the charge against *Leegin,* the Maryland General Assembly recently amended its state antitrust statute to reinstate for purposes of Maryland law the *per se* rule of illegality for minimum RPM. MD. CODE ANN., COM'L LAW § 11-204(a)(1). At the federal level, there are ongoing efforts to legislatively overturn *Leegin* through bills that, as of the date of this article, are currently pending before both the United States Senate and the United States House of Representatives. *See* S. 148, 111th Cong. (2009-2010); H.R. 3190, 111th Cong. (2009-2010).

Given the recent revisions to the Maryland Antitrust Act and the considerable uncertainty surrounding the future of *Leegin* at the federal level, a Maryland company should be especially careful to ensure that nothing in its supply and distribution agreements or arrangement runs afoul of either the Maryland state or federal law regarding minimum RPM – even when those arrangements relate only to domestic commerce. When those arrangements reach beyond our shores to affect foreign commerce, careful consideration also should be given to the treatment of RPM under the antitrust laws of any other potentially applicable jurisdictions.

As in the United States, RPM is an evolving antitrust issue internationally. For example, in March 2009 the Canadian government enacted certain amendments to its Competition Act (Competition Act, R.S.C.. 1985, c. C-34 (as amended) (hereafter referred to as the "Canadian Act")) that removed criminal sanctions for minimum RPM and established a purely civil standard for evaluating such restraints. That new civil standard requires a showing of an "adverse effect on competition" that is analogous in many, but not all, respects to the "rule of reason" standard adopted by the United States Supreme Court in *Leegin.* Canadian Act at § 76(1)(b).

Similarly, RPM is also an evolving subject under the antitrust laws of the European Commission (the "Commission"). The Commission has traditionally viewed minimum RPM as a form of prohibited vertical price fixing governed by Article 81(1) (now Article 101(1)) of the EC Treaty. European Commission Guidelines on Vertical Restraints, OJ C-291/1 (October 13, 2000) ("Old EC Guidelines") ¶ 47. Although not technically *per se* unlawful under Article 101(1) of the EC Treaty, defending RPM as an exempted pro-competitive arrangement under Article 101(3) of the EC Treaty was so difficult that it was generally presumed to be unlawful in most circumstances. *See* EC Guidelines, ¶ 112. More recently, effective June 1, 2010, the Commission adopted a new set of Guidelines on Vertical Restraints, SEC (2010) 411 ("New EC Guidelines") including those relating to RPM. *See* New EC Guidelines, § 2.10, ¶¶ 223 -229. The New EC Guidelines now explicitly state that minimum RPM falls within Article 101(1) and "gives rise to the presumption that the agreement is unlikely to fulfill the conditions of Article 101(3), for which reason the block exemption does not apply." *Id.,* ¶ 223.

Given the rapidly changing landscape of RPM law both in the United States and abroad, careful consideration should be given to these issues in any form of international supply and distribution arrangement.

Exclusive Dealing Arrangements: Another antitrust issue commonly confronted by suppliers and distributors arises in the context of exclusive dealing arrangements. Exclusive dealing typically occurs when: (1) a manufacturer agrees to sell all or a substantial portion of its products to one distributor for resale in a particular territory or market (an "exclusive distribution agreement"); or (2) a manufacturer agrees to purchase all or a substantial portion of its requirements

from a particular supplier (an "exclusive supply agreement"). HERBERT HOVENKAMP, ANTITRUST LAW § 1800(a) [hereinafter HOVENKAMP].

Under United States antitrust law, exclusive dealing arrangements are governed by Section 1 of the Sherman Act, and in the context of goods or other physical commodities by Section 3 of the Clayton Act (15 U.S.C.§ 14). Exclusive dealing arrangements are not *per se* unlawful, but rather are subject to the more lenient "rule of reason" standard. HOVENKAMP, at § 1820(a); *see also Jefferson Parish Hisp. Dist. No 2 v. Hyde*, 466 U.S. 2, 45 (1984). Under that standard, federal courts will balance the potential anticompetitive effects of the exclusivity restraint against its pro-competitive justifications and efficiencies based a number of market factors. Such factors typically include: (1) percentage of market foreclosed by the arrangement; (2) barriers to entry; (3) term of the agreement; (4) ability of the parties to terminate the agreement; (5) the nature of the purchaser (whether an end-user or reseller); (6) actual anticompetitive impact; (7) existence of alternative distribution channels; and (8) pro-competitive business justifications. HOVENKAMP, at § 1821(d).

The antitrust laws of other countries also regulate exclusive dealing arrangements. The Commission, for example, analyzes exclusive supply and distribution agreements based on many of the same factors as those embraced by the "rule of reason" under United States law. *See* New EC Guidelines § 2.2, ¶¶ 151-167 (guidelines for exclusive distribution agreements); § 2.6, ¶¶ 192-202 (guidelines for exclusive supply agreements). Exclusive dealing is similarly regulated under the Canadian Act. Under section 77 of the Canadian Act, the Canadian Commissioner of Competition or a private party (with leave of the Canadian Competition Tribunal) may make an application to the Canadian Competition Tribunal where exclusive dealing has been engaged in by a major supplier of a product. In order to bring a successful application of exclusive dealing, the Canadian Commissioner of Competition must prove: (a) the existence of a "practice" of exclusive dealing; (b) the practice is engaged in by a major supplier of a product in a market; (c) the practice is likely to impede entry or expansion of a firm or product into a market or have other exclusionary effects; and (d) as a result, competition is, or is likely to be, lessened substantially. Canadian Act, at § 77. *See also* Competitor Collaboration Guidelines, *available at* http://competitionbureau.gc.ca/eic/site/cb-bc.ncf/eng/03177.html.

Notwithstanding the general similarity in the approaches taken in the United States, Canada and Europe with respect to exclusive dealing arrangements, there are differences as well. Again, careful analysis of the law of each potentially applicable jurisdiction should be undertaken before entering into such agreements.

Conclusion

With ever-increasing frequency, "local" suppliers and distributors engage in international commerce. As such suppliers and distributors take advantage of the world market that is easily accessible today, careful planning and forethought, and an awareness of the potential legal issues that might arise, are critical to the drafting and negotiation of their supply and distribution contracts.

Disclaimer

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