Disintermediation

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1. Introduction

It is commonplace for a business to go through a cycle of start up, growth, maturity and sometimes, stagnation or worse. In the past as part of this cycle the business could be expected to use and then seek to discard intermediaries. This process of discarding can be called "disintermediation" in that commercial intermediaries are eliminated from supply chains. The process occurs when suppliers and customers cut out the middleman and deal directly with one another.

The process of disintermediation has important consequences. For example, in Japan, wholesalers account for approximately four million jobs. In certain parts of the European food industry there are eight or more layers of distribution between manufacturer (farmer) and end user (consumer). Such layers of distribution have served as a spur to many manufacturers to find ways of using disintermediation. Companies are increasingly establishing business-to-business portals, which make intermediaries redundant, except where advice and additional support are needed.

This booklet is an introduction to the legal issues of disintermediation arising from the growth of ecommerce.

2. Distribution and agency agreements

The most common types of middlemen known to the commercial world are agents and distributors.

Sales channels involving agents and distributors were originally put in place to help manufacturers deal with the needs of customers. But now in the rush by suppliers to sell directly to customers (whether on a B2B or B2C basis), agents and distributors are worrying that there will be no longer be a role for them. Indeed it is the case that some suppliers have looked at dismantling existing distribution and sales channels.

For many years traditional distribution and agency agreements pre-supposed that the agent or distributor would have exclusivity. This could be territorial or in respect of a specific group of customers or a product range. Granting exclusivity provided the agent or distributor with confidence to make the necessary money, management and time investment. However, websites offer the possibility of cutting across exclusivity.

2.1. The role of agent and distributor

The agent is instrumental in the conclusion of the contract between his principal and the customer. This is either because he introduces the two parties to each

other, or because he actually negotiates and concludes the contract between them, acting by virtue of the powers delegated to him to bind the principal. However, the agent has no liabilities under this contract. Nor is he a party to it.

It is for these reasons that it is usual for the agent to be remunerated for his services by means of a commission payment (normally a percentage of the net amount payable to the principal).

A distributor, unlike an agent, purchases products from the supplier for his own account, takes title to the products purchased and then resells them to customers in his territory. As a result there is no contractual relationship between the supplier and the distributor's customer. Instead there will be two contracts – one between the supplier and distributor, the other between distributor and customer. In view of this relationship the distributor will be remunerated from the difference between the price at which he sells and the price at which he buys.

By reference to the price for which he buys, the distributor's margin in percentage terms is likely to be higher than that of the commission payable to an agent. This reflects the greater risk assumed by the distributor.

2.2. The terms of the agreement

Although the principles upon which an agent and a distributor will do business are well understood, it is the case that the relationship which each has with his principal and supplier respectively can be adjusted by the terms of the agency or distributorship contract.

In the case of both agent and distributor it is usual for the relevant agreement to impose obligations on the performance of their duties. This might be expressed as:

During the continuance of this Agreement the Agent shall serve the Principal as agent on the terms of this Agreement with all due and proper diligence, observe all instructions given by the Principal, act in the Principal's interest and use its best endeavours to increase the sale of the Products in the Territory and to improve the goodwill of the Principal in the Territory.

A corresponding provision in a distributorship agreement might read:

The Distributor shall during the period of this Agreement diligently and faithfully serve the Principal as its distributor in the Territory and shall use its best endeavours to improve the goodwill of the Principal in the Territory and to further increase the sale of the Products in the Territory.

Invariably agency and distributorship agreements are drafted in order to protect the territory of the other agents or distributors with whom the principal or supplier has entered into such agreements. As a result there can be expected to be a provision that:

The Agent shall not without the prior consent of the Principal market or promote the Products outside the Territory during the continuance of this Agreement.

In respect of distributorship agreements a corresponding clause might be:

During the period of this Agreement the Distributor shall:

- refer to the Supplier all enquiries it receives for the Products for sale outside of the Territory; and

- not sell outside or market, export or assist in or be a party to the export of the products from the Territory unless the prior written consent of the Principal has been obtained.

The purpose of including an obligation on the distributor, for example, not to sell outside the territory is clear. Such a clause is usually supported by a corresponding obligation on the supplier to exercise his rights under other distributorship agreements to prevent third parties exporting into the distributor's territory and so breaching the exclusivity provision.

3. The use of websites by agents and distributors

With the growth of ecommerce, agents and distributors are considering using websites in order to fulfil their obligations, especially in the light of their duty to use best endeavours to increase sales. However, most of the agency and distributorship agreements currently in force make no reference to websites. The question therefore needs to be asked whether it is open to agents and distributors to use websites for the purpose of fulfilling their contractual obligations. Or will such websites result in an infringement of the rights retained by the principal or be in a breach of the exclusivity given by a supplier to other distributors?

To establish this, the terms of the agency or distributorship agreement must be analysed. The starting point in construing a contract is that words are to be given their ordinary and natural meaning. However, this rule is liable to be departed from where that meaning would involve an absurdity or would create some inconsistency for the rest of the document. It may also not be applied where, if the words were construed in their ordinary sense, they would lead to a very unreasonable result or impose upon the contractor a responsibility that it cannot reasonably be supposed he meant to assume.

Furthermore it is the case that commercial agreements must be construed in a business fashion. In turn it is necessary to give to the words a meaning that would make good commercial sense. However, it is accepted that in commercial agreements the words used may have acquired a special meaning that may be a different meaning from their natural one.

Every contract is to be construed with reference to its objects and the whole of its terms. Accordingly the whole context must be considered in endeavouring to establish the intention of the parties. On the other hand, where, even by the use of general words, the intention of the parties is clearly and unequivocally expressed, the court is bound by it.

Where different clauses are inconsistent, attention must be given to that clause which is calculated to carry into effect the real intention of the parties as determined from the agreement as a whole. Correspondingly the other, inconsistent, clause must be rejected. For this purpose a clause will only be inconsistent if it contradicts another clause or is in conflict with it so that effect will not be given to both clauses.

It is also necessary to consider the rules of construction which apply in respect of implied terms. A court will be prepared to imply a term if there arises from the language of the contract itself, and the circumstances under which it is entered into, an inference that the parties must have intended the stipulation in question. An implication of this nature may be made in the following situations:

- where it is necessary to give business efficacy to the contract; or

- where the term implied represents the obvious, but unexpressed, intention of the parties.

The terms of the sample clauses above are clear to the extent that a website established by an agent or distributor would result in a breach of contract. But this might not be the situation if:

- the obligation to increase sales of the product was not qualified by a reference to the agent's or distributor's territory; and

- there was no prohibition on marketing outside the territory.

What is clear is that care is needed in the drafting of these clauses.

3.1. The position in France

In 1999 there were two cases in France concerning the ability of a retailer and agent respectively to use the Internet in order to promote the products that they were trying to sell.

In the first case, SA Pierre Faber Derma Cosmetics v Alain Berkeley a retailer who had entered into three selective cosmetics distribution agreements set up a website to market the cosmetics. The retailer was sued by the distributor on the ground that the use of the Internet as a distribution medium constituted passing off. The court noted that the use of the Internet as a marketing medium was not expressly mentioned in the distribution agreement entered into by the parties. The court found that the lack of a clause was to be construed as an implied authorisation to the retailer to electronically market the products provided that as a result he was trying to increase the volume of sales.

This case was followed by Société Norwich Union France SA v Jean-Francois Peytureau. In this case Norwich Union sued one of its agents for having created on his own initiative a website under the domain name norwich-union-france.com. Through this website Norwich Union insurance contracts were available for sale.

The agent argued that he had notified Norwich Union of the existence of his site and had made changes to the site as requested by Norwich Union. These changes had included making it clear that it was not an official Norwich Union site as well as modifying his email address from norwich-union-france@ to Peytureau@. On this basis the agent claimed that an agreement had been reached with Norwich Union allowing him to use his website.

The Court rejected the argument that an agreement had been reached. On the other hand the Court noted that the use of a website was not expressly mentioned in the agency agreement. Furthermore it was clear from the home page of the website that it was not an official Norwich Union site. On this basis the court found that the agent was not liable for passing off.

It would appear from these two decisions that failure to mention the Internet as a distribution medium in a distributorship or agency agreement will be deemed to be an implied authorisation to a retailer or agent to create a website and start electronic marketing.

Alternatively it is uncertain whether the same decisions would have been arrived at had the first case been concerned with an exclusive distributorship agreement as opposed to a selective distribution agreement or in the second case had the insurance agent been appointed on an exclusive basis. This is because “offers” (or, in English law terms, invitations to treat) could not be

limited to particular territories without self-denial by the retailer or agent as the case may be. In respect of agency and distributorship agreements this would have to be on the basis that the distributor or agent expressly refuses to take account of orders issued in departments or countries not within the scope of the distribution or agency agreement.

4. The effect of the supplier's website

Granting an agent or distributor exclusivity restricts what the principal or supplier can do. As such it may be that there is included in the agency agreement a provision that:

The Principal shall not submit offers or quotations nor enter into any negotiations nor effect sales or disposals to any person in the Territory without the Agent's prior consent and shall refer all such offers, quotations or tenders to the Agent.

The corresponding obligation on the supplier in a distributorship agreement is not so different in that:

The Supplier shall during the continuance of this Agreement refer all enquiries received by it for sale of the Products in the Territory to the Distributor.

Again it is a question of how the particular provision is drafted in order to determine whether there is an express prohibition on the principal or supplier from creating its own website for the online sale of goods. Alternatively, can the provision be interpreted more narrowly so that the principal or supplier can have a website which is a showcase but not for any other reason?

In respect of distributorship agreements another approach might be where the supplier effectively "sells" the goods on its website and then refers the prospective customer to the exclusive brick-and-mortar dealer in the town where the customer lives to complete the transaction. This is already commonplace for car manufacturers.

Where there is no express provision, it is a question of determining to what extent such a restriction can be implied.

5. Active and passive selling

It is important to be clear as to what is meant by active and passive selling.

So far as distributorship agreements are concerned, a few months ago the European Commission defined "active" sales to mean:

- actively approaching individual customers inside another distributor's exclusive territory or exclusive customer group by, for instance, direct mail or visits; or

- actively approaching a specific customer group or customers in a specific territory allocated exclusively to another distributor through advertisements in media or other promotions specifically targeted at that customer group or targeted at customers in that territory; or

- establishing a warehouse or distribution outlet in another distributor's exclusive territory.

In contrast "passive" sales mean:

responding to unsolicited requests from individual customers including delivery of goods to such customers. General advertising or promotion in media or on the Internet that reaches customers in other distributors' exclusive territories or customer groups but which is a reasonable way to reach customers outside those territories or customer groups, for instance, to reach customers in non-exclusive territories or in the distributor's own territory, are passive sales.

For distributorship agreements, the distinction is important in respect of the use of websites by distributors as well as for competition law. Depending on the language of the contractual provisions, active selling might result in a breach of the agreement. Alternatively "passive" selling is not regarded by the European Commission as amounting to a breach of a distributorship agreement.

The use of a website by a principal to actively sell (or obtain orders) from a specific territory or group of customers might also breach the right of exclusivity granted to the agent.

For those agents who are commercial agents under the Commercial Agents (Council Directive) Regulations 1993 (as amended) the distinction has an added importance. The Regulations set out the entitlement of an agent to commission on transactions concluded during the agency contract -

where the transaction is concluded with a third party whom he has previously acquired as a customer for transactions of the same kind.

In other words, passive sales. Accordingly where the first order of a customer is obtained by an agent but subsequent orders are made online via the principal's website, the agent will be entitled to commission on such orders.

The Regulations also provide for the entitlement of an agent to commission on transactions concluded during the agency contract where the agent has -

an exclusive right to a specific geographical area or to a specific group of customers and where the transaction has been entered into with a customer belonging to that area or group.

Accordingly if an agent has an exclusive right to particular customers or territory, he is entitled to commission on all sales made to such customers or to customers in the territory even if such sales are made online through the principal's website.

6. Competition law aspects

Article 81(1) of the EC Treaty outlaws agreements between undertakings, decisions by associations of undertakings or concerted practices which:

- may affect trade between Member States; and
- which have as their object or effect the prevention, restriction or distortion of competition within the common market.

The EC Treaty specifies particular types of agreements which are caught by the prohibition in Article 81(1):

- agreements which directly or indirectly fix purchase or selling prices or any other trading conditions;
- agreements which limit or control production, markets, technical development, or investment;
- agreements under which the parties share markets or sources of supply;
- agreements which apply dissimilar conditions to equivalent transactions with other trading parties, so placing them at a competitive disadvantage;
- agreements which make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

For more than 30 years the European Commission has considered how various categories of vertical agreements should be treated for the purposes of Article

81. For this purpose a vertical agreement is an agreement entered into between two or more undertakings each operating, for the purposes of the agreement, at a different level of the production or distribution chain. Accordingly agency and distributorship agreements are vertical agreements.

A new Commission Regulation exempting various categories of vertical agreements from Article 81(1) was published in 1999. As a result of this Regulation, Article 81(1) does not apply to vertical agreements which relate to the conditions under which the parties may purchase, sell or resell certain goods or services to the extent that such conditions constitute restrictions on competition falling within the scope of Article 81(1).

However, the Regulation provides a list of hardcore restrictions, which lead to the exclusion of the whole agreement from the scope of application of the exemption. For example, there is no exemption from Article 81(1) for vertical agreements which directly or indirectly, in isolation or in combination with other factors under the control of the parties, have the object of restricting resales in as far as these restrictions relate to the territory into which or the customers to whom the buyer may sell the contract goods or services.

This hardcore restriction relates to market petitioning by territory or by customer. This may be the result of direct obligations, such as the obligation not to sell to certain customers or to customers in certain territories or the obligation to refer orders from these customers to other distributors. It may also result from indirect measures aimed at inducing the distributor not to sell to such customers, such as:

- refusal or reduction of bonuses or discounts;
- refusal to supply;
- reduction of supplied volumes or limitation of supplied volumes to the demand within the allocated territory or customer group;
- threat of contract termination; or
- profit pass-over obligations.

It may further result from the supplier not providing a Community-wide guarantee service, whereby all distributors are obliged to provide the guarantee service and are reimbursed for the service by the supplier, even in relation to products sold by other distributors into their territory.

These practices are even more likely to be viewed as a restriction of the buyer's sales when used in conjunction with the implementation by the supplier of a monitoring system aimed at verifying the effective destination of supplied goods. For example, the use of differentiated labels or serial numbers.

Exceptions to the hardcore restriction

A prohibition is not classified as a hardcore restriction if:

- the prohibition is imposed on all resellers to sell to certain end users and there is an objective justification related to the product. For example, a general ban on selling dangerous substances to certain customers for reasons of safety or health. However, it also implies that the supplier himself cannot sell to these customers;

- the prohibition is imposed on all resellers to sell to certain end users and the obligations on the reseller relate to the display of the supplier's brand name; or, most importantly,

- the restriction is on active sales into the exclusive territory or to an exclusive customer group reserved by the supplier or allocated by the supplier to another buyer, where such a restriction does not limit sales by the customers of the buyer.

The last exception allows the supplier to restrict active sales by its direct buyers to a territory or customer group which has been allocated exclusively to another buyer or which the supplier has reserved to itself. For this purpose a territory or customer group is exclusively allocated when the supplier agrees to sell its product only to one distributor for distribution in a particular territory or to a particular customer group and the exclusive distributor is protected against active selling into its territory or to its customer group by the supplier and all other buyers of the supplier inside the Community. The supplier is allowed to combine an allocation of an exclusive territory and an exclusive customer group by, for instance, appointing an exclusive distributor for a particular customer group in a certain territory.

6.1. The view of the European Commission

It is the view of the European Commission that this protection of exclusively allocated territories or customer groups must, however, permit passive sales to such territories or customer groups. For this purpose "active" and "passive" sales are defined as above.

With reference to this the European Commission takes the view that every distributor must be free to use the Internet to advertise or to sell products. A

restriction on the use of the Internet by distributors can only be compatible with the Regulation to the extent that promotion on the Internet or sales over the Internet would lead to active selling into other distributors' exclusive territories or customer groups. On this basis a contractual prohibition on the distributor from using a website for passive selling would take the distributorship agreement outside the safe harbour of the new Regulation.

Generally the European Commission does not consider the use of the Internet to be a form of active sales into such territories or customer groups. This is because, in the Commission's words, "it is a reasonable way to reach every customer". The fact that it may have effects outside a distributor's own territory or customer group results from the technology and, in particular, the easy access that it provides.

So far as the Commission is concerned if a customer visits the website of a distributor and contacts the distributor and if such contact leads to a sale, including delivery, then that is passive selling.

The Commission has also stated that the language used on the website or in the communication plays normally no role in that respect. Insofar as a website is not specifically targeted at reaching customers primarily inside the territory or a customer group exclusively allocated to another distributor, the website is not considered a form of active selling.

In contrast the website will be treated as specifically targeted at reaching customers primarily inside the territory or customer group where, for example, it uses banners or links in pages of providers specifically available to those exclusively allocated customers. In addition unsolicited emails sent to individual customers or specific customer groups are considered as active selling by the Commission.

It is the Commission's view that the supplier may require quality standards for the use of the website to resell its goods, just as the supplier may require quality standards for a shop or for advertising and promotion in general. The latter may be relevant in particular for selective distribution.

It is also the Commission's view that an outright ban on Internet selling is only possible if there is an objective justification.

6.2. Horizontal Agreements

Many of the above issues are concerned with vertical agreements. But what cannot be ignored is the likelihood of disintermediation resulting from the growth of B2B online trading exchanges.

In Spring 2000 thirteen leading airlines launched Aeroxchange. The object of Aeroxchange is to lower procurement costs. But this is likely to be achieved only by excluding suppliers' agents and distributors from the supply chain. This is entirely satisfactory for the purchaser. It will, however, cause a problem for a principal if under its existing agency agreement it is obliged to pay commission to an agent who has an exclusive right to particular customers or territory.

The European Commission is looking critically at such horizontal agreements. However, in Summer 2000 MyAircraft.com – a joint venture for the sale of aircraft spare parts and engines set up by Honeywell International, United Technologies and iz Technologies – was approved by the European Commission.

7. Fox Williams

Fox Williams is a firm of solicitors practising in the City of London dealing with all aspects of e-commerce law, commercial litigation, commercial property law, corporate law and employment and partnership law. We are dedicated to providing clients with the highest quality of legal service.

Please contact any of the partners if you would like to know more about any of the matters mentioned in this guide or simply to discuss our particular approach to your legal needs.

Our expertise is at your disposal.

The law in this booklet is stated as at 31 August 2000.