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News & Types: Commercial, Competition & Trade Update

"Exclusive" is a Dangerous Word to Use in Agreement

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Many sales and distribution agreements purport to grant "exclusive" rights to a distributor or sales representative. A recent 7th Circuit Court of Appeals decision shows how elusive and ambiguous the use of this word can be. (*TMG Kreations, LLC, et al, v. Peter Seltzer; Flat Be Co. Ltd.*, 7th Circuit Court of Appeals, Nos. 13-3535, 13-3730, November 13, 2014)

The case was described by Judge Posner as a "complex commercial case." It certainly had an interesting cast of characters. On one side was Peter Seltzer and a company partially owned by him called Kashwere USAJPN LLC ("USAJPN") and a company allied with, but not owned by, him called Flat Be. Flat Be was owned by a Japanese man named Hiroshi Miyakawa. Judge Posner refers to the parties on this side as "Seltzer." On the other side are two affiliated companies which Judge Posner refers to collectively as "TMG."

In 1999, Peter Seltzer registered the word "Kashwere" as a trademark for soft goods to be manufactured out of cotton using a production process that originated in the 18th century. This manufacturing method produces yarn or fabric called "chenille." It is notable for its fuzzy surface.

Being in some financial difficulty, Seltzer sold his company's assets to another company called TMG, formed by two of Seltzer's company's principal officers. The transaction included the following terms:

- TMG granted Seltzer an exclusive license to sell chenille products under the "Kashwere" name in Japan, but only through Flat Be, which Seltzer had made Kashwere's exclusive distributor in Japan.
- Seltzer entered into a "non-compete" agreement with TMG that prohibited him from encouraging existing customers to reduce its purchases of chenille from TMG and from disparaging TMG or its principals.

But Seltzer, according to TMG, did not comply with his agreement. He created USAJPN and transferred to it his exclusive license from TMG. But USAJPN appeared to be dormant, with no assets, employees, office or revenue. Miyakawa, the owner of Flat Be, had a 10% interest in USAJPN. But Flat Be paid royalties to Seltzer, not to USAJPN. In addition, Flat Be registered trademarks for Kashwere in Japan. But only TMG was authorized to register the Kashwere trademark in Japan, not Flat Be. In Judge Posner's view, the effect was that Seltzer transferred his license to Flat Be without TMG's consent, a violation of his agreement with TMG.

On top of this, Flat Be created a line of non-chenille fabrics under the name Kashwere Re without obtaining TMG's consent or even notifying TMG. All of these acts represented "multiple violations" by Seltzer of the license granted to him by TMG. Concluded Judge Posner, "The evidence of these license violations was strong . . ."

TMG had another set of claims against Seltzer under the "non-compete" agreement. TMG alleged, based on evidence that Judge Posner called "compelling", that Seltzer tried to damage TMG's business. Examples include an e-mail Seltzer sent to the person who was to become TMG's liaison with Asian manufacturers that accused TMG of engaging in illegal activities, selling inferior products and lying. Seltzer sent another e-mail to the liaison in which he falsely claimed that he was seeking an injunction against TMG to prevent the Asian manufacturers from being paid for the chenille product they were manufacturing for TMG.

TMG had still another claim against Seltzer which, while confusing, goes to the meaning of "exclusive." USAJPN and Flat Be charged TMG and fourteen distributors with infringing Seltzer's exclusive rights to the Japanese market by reselling in Japan Kashwere products they bought from TMG. The opinion, rather confusingly, describes USAJPN and Flat Be's claim as without merit but not frivolous. The claim resulted in a settlement with the fourteen distributors, which did not involve TMG. The distributors agreed to stop buying Kashwere products from TMG. TMG's claim against Seltzer was based on the loss of these distributors, which "required TMG to reconstitute its chain of distribution, something difficult to do because any new distributors would have to worry about being sued by Seltzer, like the old ones, especially if they resold Kashwere products in Japan. . . ."

Seltzer, in turn, made a mirror image claim against TMG, alleging that TMG knew its distributors were reselling in Japan, knew that the Kashwere products sold by these distributors was inferior, and assisted these distributors by providing them with "hang tags" in Japanese to the Kashwere products they were selling in Japan.

Faced with these claims, the lower, district court dismissed the entire litigation. But the 7th Circuit, in Judge Posner's opinion, reinstated TMG's claims, but affirmed the dismissal of Seltzer's claims.

In dismissing Seltzer's claims, Judge Posner then described the key issue as to whether Seltzer's license required TMG to prevent resale by other distributors of Kashwere products in Japan. This goes to the meaning of "exclusive." When a supplier grants a distributor "exclusive" rights to sell does it mean a) the supplier will only give these exclusive rights to this distributor, b) the supplier will prevent anyone else from selling the products in competition with the distributor, c) the supplier will not make direct sales of the products, or d) some variation of these terms?

In the TMG case, was TMG required to prevent resale in Japan by other distributors when TMG gave exclusive rights to Seltzer? According to Judge Posner, the answer is no. This was a separate provision that Seltzer could have, but did not, negotiate. Judge Posner's conclusion was supported by a provision in the contract that prohibited TMG from making direct sales in Japan, suggesting that TMG had no obligation to prevent indirect sales by its distributors.

So what does an "exclusive" distributor get? Judge Posner analyzed previous cases that dealt with this question. He found a "paucity" of cases and no consensus. For example,

- Pepsi granted a Peruvian bottler exclusive rights in certain areas of Peru. This did not obligate Pepsi to prevent bottlers in other areas of Peru from selling in areas in Peru covered by the exclusive bottler.

- In another Pepsi case, there was evidence that Pepsi promised bottlers that it would protect their territories from encroachment by other Pepsi bottlers. So the court concluded Pepsi had such an obligation, but did not discuss whether Pepsi would have such an obligation in the absence of evidence that Pepsi had agreed to prevent encroachment.
- Another 1956 case from New York federal court held that, under Illinois law, a manufacturer is liable for violating an exclusive sales agency agreement where the manufacturer made direct sales into a distributor's exclusive territory. Even when the manufacturer did not sell directly, the manufacturer could be held liable if it knew that the product sold to a third party was intended to be resold in the exclusive territory.
- But another federal court, also applying Illinois law, came to an opposite conclusion. ". . . in Illinois the intention of the parties to a contract is determined by the language of the contract itself, and the courts may not construe into a writing provisions that are not there. What is more, contracts which restrict the free and unlimited exchange of services or commodities are strictly construed, and the restrictions will be extended no further than the language of the contract absolutely requires." So a supplier was not obligated to prevent resale into an exclusive territory it had granted to a distributor.

Judge Posner also cited the difficulty of requiring a supplier to police all its other distributors, in the absence of an agreement to do so.

So a party either granting an "exclusive" right or accepting an "exclusive" right should evaluate carefully what exclusivity actually means. Does the grantor of the exclusive right have an obligation to protect the distributor from competition or is the only obligation not to appoint another distributor in the exclusive territory? Can the grantor sell directly into the exclusive territory? From Judge Posner's opinion and the cases he cites, most courts would not require the grantor to police all its distributors to prevent sales in the territory. So those receiving an "exclusive" right to sell and distribute have the burden of negotiating those protections in the contract.

In any event, parties to an agreement will no doubt have different assumptions and perspectives on the meaning of "exclusive." So, at a minimum, the court's opinion should encourage parties to negotiate these points up front, rather than allow them to create misunderstandings and disputes later.