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DISTRIBUTION AGREEMENTS: MARKET EXPANSION THROUGH AN INTERNATIONAL DISTRIBUTOR: BOON OR BUST FOR SOFTWARE COMPANIES

A software company is created. A small group of employees develops a marketable software package over an extended period of time. Once finely tuned, the software package is demonstrated to potential clients and showcased at trade shows. Interest is garnered, but the relatively small sales force of the company is unable to adequately promote the product. How can the software company overcome this problem?

Many end up seeking assistance from a national or international distributor in the belief that the distributor will provide a much greater marketplace for the product at an acceptable cost to the software firm. In many instances, such may be the case. However, in countless other cases, the sales of a good product have languished for lack of appropriate preparation and sound contractual practices. Selection, rights and compensation are three essential items to be considered when an expanded distribution network is the route taken.

SELECTION CRITERIA

For many, the selection of a distributor represents a major business decision which requires background information on the potential candidates, knowledge of the marketplace and global vision.

The financial health of a distributor should quickly be assessed. Credit bureaus are an excellent source of information. If further information is required, the Department of External Affairs may provide an evaluation of the creditworthiness, reputation and integrity of the selected candidates. The use of the company's own contacts (i.e. business, professional and personal) may also reveal information on the potential partner.

Summary

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Information obtained directly from the distributor should include the demonstration of past successes in marketing products, the composition of its salesforce and the curriculum vitae of its members, together with an outline of any training offered to the salespeople that would be pertinent to the marketing of the product.

Will the distributor offer a national or international network? Does the distributor operate independently or with subdistributors? Where the distributor is to operate in conjunction with subdistributors, the same rigour should apply to the subdistributors' background research.

Product marketing on an accelerated growth scale is one reason why a company would consider a distributor. Therefore, it behooves the company to find out if the distributor markets any competitive products in order to avoid any conflict of interest. Commissions and discount levels associated with the sale of other products by the distributor's salesforce are business practices that should also be scrutinized. Such practices may reduce the attraction of selling one product as opposed to another that may be more profitable or sell faster.

NATURE OF THE RIGHTS TO BE GRANTED

Once the distributor has been selected, the question is whether or not it will be given exclusive rights. If non-exclusive rights are granted, the distributor may not consider it to be worthwhile to market the product alongside several others without any territorial protection.

Alternatively, the right could be exclusive within a province, a country, a continent or on a worldwide basis. To avoid loss of control of its market, the software company may grant conditional exclusivity based on the fulfillment of minimum requirements. These include: the achievement of sales

objectives, training of the salesforce, participation in trade shows where the product will be promoted, and the allocation of funds to promotional campaigns. Default on the part of the distributor to reach these milestones would provide an off ramp to the company and an opportunity to reassess its relationship with the distributor. Periodic reports to be submitted by the distributor, coupled with the company's right of audit, are additional elements to be inserted in any contract with the distributor.

There are situations in which end users may want to deal directly with the company holding title to the software. Contractual provisions could establish, from the outset, the rules that would govern exceptions to the exclusive rights of the distributor.

If the distributor uses subdistributors, the contract between those parties should reiterate the terms and conditions of the distributor agreement with the software company, and the latter should be informed of the use of such subdistributors.

In the event that the software needs to be translated into a different language or adapted to local legislation or otherwise changed, the contract should stipulate that these modifications made by the distributor shall become and remain the property of the software company and that a right to use and to market the modifications shall be provided to the distributor.

To protect the intellectual property rights relating to the software, a license agreement should always be executed by the end user.

CONSIDERATION

In consideration of the rights granted to the distributor, how should the software company be compensated? There are different ways of establishing the payment terms.

When the software company necessitates a cash injection and the distributor is anxious to market a “hot” product, the receipt of non-refundable payments by the software company upon the execution of the agreement, and ongoing royalty payments by the distributor thereafter, may satisfy both parties. An alternative is to make an advance payment on royalties, procuring instant cash to the software company upon execution of the agreement. This incites the distributor to sell a corresponding amount of software products to recuperate its initial investment.

In the context of exclusivity and minimum requirements, as previously discussed, the distributor that has not achieved its objectives at the end of the applicable period could still retain exclusive rights to market by paying the difference between achieved and targeted levels.

How will the above-mentioned royalties be established? They may represent a percentage of the value of the product. They may also be a reflection of the set price at which the software company licensed the software product to the distributor. The latter, then, is free to add on to the sublicensing price an acceptable profit margin. The concept of “net sublicensing price” is also frequently used for this purpose. In such instance the distributor is required to pay the software company a predetermined percentage of the “net sublicensing price” of all products. The “net sublicensing price” is commonly defined as the total gross sublicensing price on all invoices of products sublicensed to end users by the distributor, less any applicable taxes, trade, cash or quantity discounts and any credit for returns.

If the product is to be distributed on international markets, it is recommended that payments be made in U.S. currency.

CONCLUSION

The software company should retain adequate flexibility to ensure the appropriate marketing of its product. In today’s business environment, windows of opportunity are quickly opened and shut. A software company selects a distributor to maximize its growth potential, not to put its product on a shelf and lose out on what might have been!

Daniel Paul

In order to obtain more information in this respect, please communicate with Daniel Paul, at our Montréal office, at (514) 877-2909.

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