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Kenneth H. Slade
Morgan, Lewis & Bockius

Anne E. Stone
Morgan, Lewis & Bockius

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Survey of Distribution and Sales Methods Commonly Used to Enter the United States Market

Kenneth H. Slade and Anne E. Stone*

INTRODUCTION

A foreign company desiring to enter the United States market to distribute and sell its goods and services is faced with a choice among several different methods for introducing those goods and services. Very often, the foreign company chooses a method because it has previously used that method in other countries or in its own home market. To the eventual regret of many of those foreign companies, that initial choice may not be the right one. The U.S. market frequently differs substantially from the markets in which the foreign company has had prior experiences. Moreover, certain initial choices may actually preclude the foreign company from correcting its mistake and switching to a different distribution or selling method better suited to the company and its products or services.

This article will describe several of the more common distribution and selling methods used by foreign companies entering the U.S. market: (1) direct sales by foreign company; (2) direct sales by subsidiary; (3) sales representatives; (4) distributors; (5) franchises; (6) manufacturing and distribution licenses; (7) joint ventures, and

* Mr. Slade and Ms. Stone are based in the Los Angeles office of Morgan, Lewis & Bockius, but spend a significant amount of time working in Japan. The authors would like to thank Elmer J. Stone of the Tokyo office of Morgan, Lewis & Bockius, for proposing the topic of this article, and also extend thanks to John I. Forry and Michael J.A. Karlin of the Los Angeles office of Morgan, Lewis & Bockius for their editorial suggestions.

(8) sales of technology, trademark or expertise.[1] The relative advantages and disadvantages (both legal and economic) of each method will be discussed, with the aim of helping foreign companies make a better informed choice in selecting their U.S. distribution and selling methods. The article also will discuss what steps can be taken when a foreign company decides that it must switch to another method.

Specifically, this article will begin with the most direct method—*i.e.*, direct sales by the foreign company into the U.S. market—and conclude with the most indirect method—*i.e.*, selling the foreign company's technology/trademarks/expertise and thereby empowering someone else to sell its products and services in the United States.

We will not attempt to discuss the advantages and disadvantages of each of these methods from a tax perspective. Each foreign company should consult with its U.S. and home country tax advisors before embarking on any of these methods.

1. Direct Sales by Foreign Company

The foreign company can attempt to sell its products and services in the United States, just as it might sell those products and services in its home country. Direct sales in the United States may be very attractive financially. The profits from direct sales are not shared with any middlemen. Because foreign companies know their own products and services better than anyone else, they often conclude that they are the ones best situated to herald the virtues of those products and services.

On the other hand, there are many business disadvantages of direct sales in the United States. The foreign company may have little knowledge of the U.S. market. It may not understand how to reach U.S. purchasers, or appreciate how U.S. purchasers may choose between its products or services and those of its competitors. Furthermore, U.S. purchasers may be reluctant to deal with a foreign company unless the foreign company has committed significant re-

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1. For further discussion of each of those methods, *see infra* notes 2-3 and accompanying text (direct sales by a foreign company itself); *infra* notes 4-7 and accompanying text (direct sales by a U.S. subsidiary of the foreign company); *infra* notes 8-10 and accompanying text (sales representatives); *infra* notes 11-12 and accompanying text (distributors); *infra* notes 13-28 and accompanying text (franchises); *infra* notes 29-32 and accompanying text (manufacturing and distribution licenses); *infra* note 33 and accompanying text (joint ventures); and *infra* note 34 and accompanying text (technology, trademark, and expertise sales).

sources to establishing an after-sales service capability in the United States.

There are two principal legal disadvantages which arise from operating directly in the United States. These relate to (a) U.S. courts possibly having jurisdiction over the foreign company if it is named as a defendant in a U.S. lawsuit; and (b) the inability to limit the foreign company's exposure in a lawsuit to liabilities arising from its U.S. activities.

As the number of the foreign company's *direct* U.S. activities increase, its exposure to the personal jurisdiction of U.S. courts also increases. If a U.S. court has personal jurisdiction over a foreign company, (i) that company must defend litigation brought against it in the United States; (ii) all of that company's U.S. assets will be available to satisfy a judgment rendered by the U.S. court; and (iii) any U.S. judgment against that company may be wholly or partly enforceable in foreign countries, without the case having to be retried on its merits in those other countries.

U.S. courts recognize two types of personal jurisdiction. First, if the foreign company's contacts with the United States are limited, U.S. courts may have "limited" personal jurisdiction. Under "limited" personal jurisdiction, the foreign company is only subject to jurisdiction for causes of action related to its U.S. activities. For example, if the foreign company enters into a contract in California, a California court would have jurisdiction for causes of action stemming from the contract.

Second, if the foreign company's activities in the United States are "substantial" or "continuous and systematic," U.S. courts may have "general" personal jurisdiction. Under "general" personal jurisdiction, the foreign company is subject to the jurisdiction of a U.S. court for any cause of action, provided that the U.S. court is entitled to exercise jurisdiction over the subject matter of the cause of action. The U.S. court will have jurisdiction even if the cause of action is unrelated to the activities of the foreign company in the United States.

In evaluating whether a foreign company's activities in the United States are "substantial" or "continuous and systematic," a court will look to various factors, which include the following:

(i) Does the foreign company have an office, agents, property or employees in the United States?;

(ii) Does the foreign company advertise or otherwise solicit business in the United States?;

(iii) Has the foreign company established distribution facilities in the United States?;

(iv) Does the foreign company have a significant volume of business in the United States?;

(v) Has the foreign company registered to do business in the United States?;

(vi) Does the foreign company maintain a bank account in the United States?; and

(vii) What are the duration and continuity of the foreign company's activities in the United States?

No one factor is critical. However, as the presence of any of these factors increases, the probability that a U.S. court will exercise general personal jurisdiction over a foreign company also increases.[2]

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2. The U.S. Supreme Court case which forms the basis for the limited/general jurisdiction distinction is Perkins v. Benguet Consol. Mining Co., 342 U.S. 437 (1952), *reh'g denied*, 343 U.S. 917 (1952). In *Perkins*, the Benguet Consolidated Mining Company S.A., a Philippine corporation ("Benguet"), carried on a limited part of its general business in Ohio. When Benguet's Philippine mining operations were halted by World War II, its president returned to Ohio and maintained an office from which he carried on both personal and Benguet business, maintained bank accounts for Benguet, and supervised the rehabilitation of properties of Benguet. A Benguet shareholder sued Benguet in Ohio for damages because of Benguet's alleged failure to issue certain certificates of stock to her. The claim did not relate to Benguet's activities in Ohio.

The issue decided in *Perkins* was whether, as a matter of due process, the activities of Benguet in Ohio were continuous and systematic enough to permit Ohio to exercise general jurisdiction. The Court concluded that such contacts were continuous and systematic and, therefore, that it would not violate due process for Ohio to take general personal jurisdiction over Benguet.

In contrast to *Perkins*, in Helicopteros Nacionales de Colombia, S.A. v. Hall, 466 U.S. 408 (1984), the United States Supreme Court determined that the contacts of Helicopteros Nacionales de Colombia, S.A., a Colombian corporation ("Helicol"), in Texas were not continuous and systematic enough to support the exercise of general jurisdiction by the federal district court in Texas. In 1974, a representative of Helicol had flown to the United States to negotiate with representatives of a U.S. company to provide helicopter services for Williams-Sedco-Horn (WSH), one of Helicol's customers in Peru. The final contract for such services was signed in Peru. Helicol had purchased 80% of its fleet of helicopters from Bell Helicopter Company in Fort Worth, Texas and had sent its pilots and maintenance people to Fort Worth, Texas for training. Subsequently, in 1976, a Helicol helicopter crashed in Peru. Four U.S. employees of WSH were killed. Their survivors instituted wrongful death actions against Helicol in Texas. The causes of action were unrelated to Helicol's contacts with Texas.

The U.S. Supreme Court held that Helicol's contacts with Texas did not rise to the level of the continuous and systematic general business contacts that Benguet, the Phillipine corporation, had in *Perkins*. Therefore, the Court concluded that an exercise of general jurisdiction based on intermittant contacts would fail to satisfy the requirements of due process.

Similarly, in Asahi Metal Indus. Co., Ltd. v. Superior Court, 480 U.S. 102, 111-13 (1987), four U.S. Supreme Court justices concluded that a Japanese company could not be subjected to the jurisdiction of a California court merely because it was aware that some of its component products sold to a Taiwan company were to be incorporated by that Taiwan company into end products sold in California. Even with such an awareness, the Japanese company had not been shown to have purposefully availed itself of the California market. These four justices concluded that exercising general jurisdiction over the Japanese company would have violated the requirements of due process. *Id.* at 112-13.

As indicated above, all of a foreign company's U.S. assets are available to satisfy a judgment rendered by a U.S. court. In addition, any U.S. judgment against a foreign company may be wholly or partly enforceable in foreign countries, without the case having to be retried in those other countries.[3]

A direct sales strategy does not preclude a foreign company from switching strategies as its products and services become well-known in the U.S. market. Direct sales do not involve any contractual relationships with distributors or other agents that might later restrain a foreign company from selling in the United States by another, completely different method.

2. *Direct Sales by Controlled Subsidiary*

To reduce the jurisdictional and liability concerns described above, a foreign company can form a U.S. subsidiary corporation, wholly-owned by the foreign company, and then have that subsidiary sell the foreign company's products and services in the United States. Of course, in lieu of forming a new U.S. corporation, the foreign company can acquire an existing U.S. corporation to serve this same function. Such an acquisition poses numerous other legal issues that are best left to other articles which specifically address merger and acquisition strategies in the United States. However, by selling through a U.S. subsidiary, either by incorporating a new U.S. corporation or by acquiring an existing U.S. corporation, the foreign corporation can enjoy all of the advantages of direct sales, and may avoid the legal disadvantages described above.

Rather than risk subjecting the foreign company to the general personal jurisdiction of U.S. courts, foreign companies often transfer all of their U.S. operations to their U.S. subsidiaries, thereby subjecting their subsidiaries alone to general personal jurisdiction. Ownership of a U.S. subsidiary will not, for that reason alone, subject the foreign company to U.S. jurisdiction.[4] After a transfer of oper-

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3. There is no international convention on the enforcement of judicial awards. U.S. DEP'T OF STATE, TREATIES IN FORCE (1989). In contrast, there is a multilateral international convention on the enforcement of U.S. arbitral awards in foreign countries. *See* Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, *acceeded to with reservations* by the United States, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38. The enforceability of a U.S. judgment in a foreign country will most likely depend on whether the principals of comity under the laws of that foreign country permit the courts of that foreign country to recognize judgments of courts of the United States and other countries.

4. Bulova Watch Co., Inc. v. K. Hattori & Co., Ltd., 508 F. Supp. 1322, 1334 (E.D.N.Y. 1981).

ations to a U.S. subsidiary, the foreign company would be subject to U.S. jurisdiction only in those matters where it has direct U.S. contacts or with respect to those products which it has knowingly introduced into the U.S. stream of commerce.[5]

Similarly, a foreign company can reduce the risk of exposing its world-wide assets to U.S. judgments by operating through a U.S. subsidiary company. Generally, creditors in the United States cannot "pierce the corporate veil," meaning that they cannot sue the foreign company for the debts of its subsidiary operating company, even though it is the foreign company's wholly-owned subsidiary. If the U.S. subsidiary's corporate veil is pierced, the foreign company will be held directly liable for the obligations of that subsidiary company, as if that subsidiary did not exist.

In order to assure that the corporate veil will not be pierced, the subsidiary's issued shares must be fully paid and the subsidiary's capital must appear to be adequate for its projected activities when those activities begin. In addition, the foreign company must respect the subsidiary's separate corporate existence. The subsidiary must be managed in accordance with the management structure prevailing under the law of the subsidiary's place of incorporation. As the sole shareholder, the foreign company should not directly participate in the subsidiary's management decisions. Instead of direct participation, it can still control the subsidiary by appointing and removing the subsidiary's directors, by lending employees to the subsidiary for specified periods and, if appropriate, by providing in the subsidiary's articles of incorporation that key decisions require shareholder approval.[6]

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5. The "stream of commerce" theory supports the exercise of personal jurisdiction by a U.S. court over a foreign manufacturer when the manufacturer merely foresees or is aware that its products will make their way into the United States while still in the stream of commerce. *Asahi*, 480 U.S. at 109-10. The United States Supreme Court may be cutting back on jurisdiction based on this "stream of commerce" reasoning. In *Asahi*, four justices rejected the "stream of commerce" theory of general personal jurisdiction with respect to a defendant who was merely aware (or for whom it was merely foreseeable) that its products would enter a particular state while in that stream of commerce. *Id.* at 112-13.

6. Generally, the parent-subsidiary relationship is not enough by itself to subject a foreign corporation to jurisdiction in the United States. In certain cases, jurisdiction has not been exercised even where there is a parent wholly-owned subsidiary relationship. *See, e.g.*, Saraceno v. S.C. Johnson & Son, Inc., 83 F.R.D. 65 (S.D.N.Y. 1979); Delagi v. Volkswagenwerk AG of Wolfsburg, 29 N.Y.2d 426, 278 N.E.2d 895, 328 N.Y.S.2d 653 (1972). For a case where additional connections beyond stock ownership supported the exercise of jurisdiction, *see Bulova*, 508 F. Supp. at 1322. Whether or not a U.S. court would pierce the corporate veil and impose unlimited liability on a parent company for activities of its U.S. subsidiary is a separate issue. Generally, the shareholders of U.S. corporations are not responsible for the debts or other liabilities incurred by those corporations beyond the value of their equity contributions to those corporations.

As a practical matter, until the foreign company's U.S. subsidiary has been in business in the United States for a substantial period of time, the foreign company may be required to guaranty performance of the subsidiary's obligations under bank loans and under certain major contracts. However, the use of a separate subsidiary will still provide protection to the foreign company against other creditors and claimants who are not in a position to insist on guaranties.[7]

As was the case when the foreign company made direct sales itself, a direct sales strategy through a U.S. subsidiary does not preclude the foreign company from switching strategies as its products and services become known in the U.S. marketplace. This strategy of selling through a U.S. subsidiary is implemented through agreements between the foreign company and its U.S. subsidiary. Assuming that the U.S. subsidiary is wholly-owned by the foreign company and thus has no minority shareholders, and also assuming that the U.S. subsidiary's creditors have been paid, there is no one to object if the foreign company suddenly decides to cancel all agreements with its U.S. subsidiary, and then redirect its sales efforts through some other mechanism.

3. *Sales Representatives*

A foreign company can make sales of its products to customers in the United States without having any of its people (either its own employees or the employees of its U.S. subsidiary) physically present in the United States. The foreign company can empower entities or individuals in the United States, acting as its sales representatives or manufacturer's representatives, to solicit orders for its products and services. Those orders are then sent to the foreign company's home office, for acceptance or rejection. If accepted, the foreign company pays the sales representative a percentage commission based on the value of the sale.

Solicited orders will be accepted by the foreign company outside the United States. In this way, the foreign company will minimize

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7. As noted above, this article is not discussing the tax implications of various strategies. An exception will be made here, however, in order to refer in passing to transfer pricing problems. If a foreign company chooses to market through a U.S. subsidiary, it must set prices for goods which it sells to that subsidiary. Those prices might be challenged by U.S. tax authorities if they are seen as part of an effort to artificially reduce the taxable income of the subsidiary in the United States. For example, Japanese automobile manufacturers have, in recent years, agreed to millions of dollars in retroactive tax assessments as a result of their overpricing (in the eyes of U.S. tax authorities) of automobiles sold to their U.S. subsidiaries.

its contacts with the United States and minimize the risk that it will be considered to be doing business in the United States.

Reliance on sales representatives is a very low-cost method of entering the U.S. market. The foreign company only pays its sales representatives when they make sales for the foreign company. In fact, the foreign company usually does not pay its commissions until the proceeds from those sales have been received by the foreign company. A well-drafted sales representative agreement will excuse the foreign company from paying any commissions on sales which are not paid for by their purchasers.

Sales representative agreements are regulated by statute in 23 of the 50 states of the United States.[8] Those statutes are easy to comply with. They require that certain contractual terms be included in sales representative agreements. Most of those terms are included anyway, as a matter of course.[9]

The chief disadvantage of relying on sales representatives is that such independent entities and individuals may not be genuinely interested in developing a market for the foreign company's products. Sales representatives typically handle many products at one time, and may even handle competing products. They will concentrate on selling those products which "sell themselves." New products and services which are unknown require the expenditure of time and effort by

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8. The following statutes are intended to regulate various types of sales and manufacturer's representative agreements: ALA. CODE §§ 8-24-1 to -5 (Supp. 1988); 1989 Ark. Acts 464 (effective July 3, 1989); CAL. LAB. CODE §§ 2751-2752 (West 1971); FLA. STAT. § 686.201 (1987); GA. CODE ANN. §§ 10-1-700 to -702 (Supp. 1988); 1985 Ill. Laws, Public Act 84-627; IND. CODE §§ 24-4-7-1 to -6 (Supp. 1986); IOWA CODE § 91A:1-12 (Supp. 1989); KAN. STAT. ANN. §§ 44-341 to -347 (Supp. 1988); KY. REV. STAT. ANN. §§ 371.370-.385 (Michie/Bobbs-Merrill Supp. 1988); 1988 La. Acts 774; 1988 Md. Laws, S. Bill No. 716; MASS. GEN. LAWS ANN. ch. 104, §§ 7-9 (West Supp. 1989); MINN. STAT. § 181.145 (1988); MISS. CODE ANN. §§ 75-87-1 to -7 (Supp. 1988); N.H. Laws, ch. 244, § 339-E:1; N.Y. LAB. LAW § 191-a to -c (Consol. 1983); OHIO REV. CODE ANN. § 1335.11 (Anderson Supp. 1988); 1989 Okla. Sess. Laws, House Bill No. 1103, § 2, pt. 3; 1988 Pa. Laws 184; S.C. CODE ANN. §§ 39-65-10 to -80 (Law. Co-op. Supp. 1988); TENN. CODE ANN. § 47-50-114 (Supp. 1988); TEX. BUS. & COM. CODE ANN. §§ 35.81-86 (Vernon 1968).

9. Agreements covered by sales representative statutes must comply with three basic requirements. Each of the statutes identified in note 8, *supra*, requires that: (i) the agreement must be in writing and must specify the method by which commissions will be computed and paid; (ii) the sales representative must receive a copy of the agreement; and (iii) the manufacturer (here, the foreign company) must pay all commissions due within a specified period of time after the agreement is terminated. That specified period varies from three days in Minnesota to 45 days in Maryland. In addition, Alabama and Tennessee require that the manufacturer receive a receipt for the signed agreement. ALA. CODE §§ 8-24-1 to -5 (Supp. 1988); TENN. CODE ANN. § 47-50-114 (Supp. 1988). Finally, in Pennsylvania, the agreement must set forth the period within which the sales representative must perform, how job-incurred expenses will be reimbursed, and to which geographical territory or specific accounts the sales representative will be assigned. 1988 Pa. Laws 184.

the sales representative before he can earn commissions. The sales representative may determine that the effort is not worthwhile, particularly if he expects that the foreign company will eventually terminate its sales representatives and rely on some other selling strategy. This clash between the foreign company's need for start-up promotion and the sales representative's insecurity over his continuing role often renders the sales representative arrangement merely a temporary strategy.

Where a sales representative has a written agreement with a foreign company, it is left to the sales representative and the foreign company to determine how easily the foreign company will be able to switch to other sales strategies. If the sales representative can be easily terminated, he may be reluctant to spend the time and effort that usually is needed to introduce a product in the U.S. market. On the other hand, if the sales representative is given the exclusive right to solicit orders for the foreign company for some specified period of time, that sales representative may lack any incentive to concentrate on the foreign company's product or service and to spend less effort on other products. Between these two extremes, the foreign company and the sales representative can devise a whole series of solutions that address the competing goals of providing security for the sales representative and creating incentives for the sales representative to develop sales.

Where a sales representative has no written agreement with a foreign company, switching sales strategies is often difficult.[10] Faced with termination, the sales representative may allege that he was promised the right to sell the products on commission for some period of time or, perhaps, for an indefinite period of time. In fact, very often the sales representative believes that such promises were made, or else he never would have devoted his efforts to promoting the products or services. The foreign company and the sales representative may then become involved in costly and lengthy litigation over the exact nature of their arrangement. In these situations, foreign companies often face making the unpleasant choice between either losing in court and then settling with the sales representative for some monetary amount, or else entering into a written arrangement with the sales representative which is disadvantageous to the foreign company.

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10. As explained in note 8, *supra*, those 23 states which have enacted statutes regulating sales representative agreements require that such agreements be in writing.

The preferable approach is to enter into a well-drafted written agreement which serves as the cornerstone of a foreign company's relationship with its sales representatives. That agreement should spell out the precise nature of the relationship, and the circumstances under which the foreign company can end the relationship. Although a written agreement is not necessary in many countries, one should be obtained when establishing a sales or manufacturer's representative in the United States.

4. Distributors

A foreign company may want to go one step further. Instead of empowering an individual to act as its sales representative or its manufacturer's representative, the foreign company might sell its products to that individual with the understanding that the individual will resell those products in a designated area. Under that strategy, the foreign company does not receive orders from end-users. The individual purchases products from the foreign company with the expectation that he will resell those products to end-users. This individual is called a distributor. The foreign company does not pay a commission or other compensation to the distributor. In fact, it normally makes a profit when it sells its products to the distributor.

Essentially, there are two types of distributors. "Non-exclusive distributors" are granted the right to resell the foreign company's products, but are given no protection against the foreign company establishing other distributors in competition with it. Such distributors also are not protected against the foreign company continuing to make sales itself (either directly, through a subsidiary or through commissioned sales by sales or manufacturer's representatives). In contrast, "exclusive" distributors are given their very own territory, group of customers, or type of application of the technology in question. The foreign company assures its exclusive distributor that neither other distributors nor the foreign company itself will compete for sales in that territory, to those customers, or for that application of technology.

A foreign company's decision whether to establish a nonexclusive or an exclusive distributor will depend on the foreign company's conception of what is required to interest a potential distributor in selling its products. Generally, the more difficult it is to sell the foreign company's products to end-users, the more likely it is that the foreign company will give a prospective distributor some type of exclusive rights.

Between the extremes of grants of totally exclusive and totally nonexclusive distribution rights, there are many hybrid arrangements which the parties might agree upon. A nonexclusive distributor might be granted the exclusive right to sell to certain identified accounts. An exclusive distributor might lose his exclusive rights and become a nonexclusive distributor if he fails to meet certain sales targets. A foreign company might appoint a distributor in a territory and promise that it will not appoint other distributors in that territory, but reserve the right to make sales itself in that territory (either directly, through a subsidiary and/or through commissioned sales agents). The number of variations between the two extremes of total exclusivity and total nonexclusivity are almost endless.

For a foreign company, the primary advantage in appointing a distributor is that the foreign company's selling activities are simplified. Instead of selling to many customers, the foreign company sells to a few distributors. Collections should become less of a problem, as few distributors will want to risk the wrath of their supplier by paying late. Furthermore, distributors often will buy products in order to maintain a local inventory. Therefore, their purchases should occur earlier (at least theoretically) than purchases by end-users. Earlier purchases should mean shorter inventorying periods for finished products, smaller inventories for the supplier and, presumably, easier financing arrangements for the foreign company. Sometimes distributors can even be persuaded to provide local repair and installation services, thus reducing the foreign company's costs still further.

An individual also gains an advantage if he can purchase and resell products as a distributor, rather than soliciting orders as a sales or manufacturer's representative. Commissions on sales are normally only a modest percentage of the end-user's purchase price. In contrast, the mark-up between the distributor's purchase price and the end-user's purchase price is usually much greater than those percentage commissions. Furthermore, the distributor can control his own destiny to a large extent because he sets his own resale prices.[11] If products are moving quickly, he can increase prices and earn a

11. Under United States antitrust law, resale price maintenance schemes are illegal. While a manufacturer can recommend a resale price, it cannot enter into an agreement with its distributors that any particular price will be charged. This principle was first established in 1911 in Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), and has been recently reaffirmed by the United States Supreme Court in Business Elec. Corp. v. Sharp Elec. Corp., 485 U.S. 717 (1988).

greater profit per unit. If the distributor can convince the foreign company to wait some specified period of time after delivery of products before expecting payment, the distributor may be able to sell his stock and collect his sales receipts before paying for that stock. Of course, the distributor also risks being left with an inventory of unsalable products.

This advantage for the distributor might be a disadvantage, or at least a lost opportunity, for the foreign company. As the foreign company no longer sells directly to the end-user, it loses control over the price of its product. Furthermore, it loses the opportunity to develop a relationship with the end-user. The foreign company becomes dependent on its distributors to make sales. By losing contact with the customers and the market, it may be harder for the foreign company to respond to local trends in the market. For example, the resale prices charged to end-users may be increasing dramatically relative to the distributors' purchase prices from the foreign company. Unless the foreign company requires its distributors to report their resale prices, the foreign company may not realize that it could charge its distributors more for products. The foreign company also may be unaware that its distributors are ruining its reputation, either by selling products for improper applications or by failing to support those products after sale.

As was the case with a sales or manufacturer's representative, where a distributor has a written agreement with a foreign company, the terms of that agreement will determine how easily the foreign company will be able to switch to other sales strategies. Once again, there is a tradeoff for the foreign company. If the distributor can be terminated easily, he will be reluctant to spend the time and effort that is usually necessary to develop a market for the foreign company's products in the United States.

Where there is no written agreement between the distributor and the foreign company, switching strategies will be more difficult. Faced with termination, the distributor might allege that he was promised the right to resell products bought from the foreign company in a particular area, for a particular period of time, or perhaps for an indefinite period of time. The foreign company may have a hard time disproving those allegations before a U.S. jury.

As noted above, the preferable approach is to have a well-drafted written agreement with each distributor. That agreement should spell out the precise nature of the relationship between the distributor and the foreign company, and the circumstances under which the foreign

company can end that relationship. Although a written agreement is not necessary in many countries, as a practical matter, one should be obtained when establishing a distributor in the United States.[12]

5. Franchises

In most distribution arrangements, a foreign company will permit its distributors to use the foreign company's trademarks, trade names, service marks and other commercial symbols. If the foreign company also provides substantial assistance in marketing the products or services identified by such commercial symbols, that distributor is likely to be considered a franchise under various United States federal and state laws and regulations.

The popularity of franchising as a marketing technique in the United States is easy to understand. For the foreign company, selling its goods or services through independently owned and financed outlets which pay royalties based on their use of the foreign company's commercial symbol is a relatively inexpensive way for the foreign company to expand rapidly into numerous, and often noncontiguous, geographic areas within the United States. For the franchisee, the prospect of "running" his own business while at the same time benefitting from: (i) the expertise, credibility and purchasing muscle of a larger company; (ii) a significant amount of advertising; and (iii) identification with other quality-controlled retail outlets selling under the same trademark, can be very attractive.

In reaction to both public interest in investing in franchises and some highly publicized but isolated fraudulent franchising schemes, the United States Federal Trade Commission and many states have enacted or promulgated so-called "franchise" and "business opportunity" laws and regulations. Given the numerous varieties of franchise operations, those statutes and regulations are understandably broad in scope, particularly in their definition of "franchise" and "business opportunity." Those two terms have been so broadly interpreted as to apply to distribution arrangements covering sales at wholesale. Similarly, what at first glance might appear to the parties concerned to be a straight-forward distribution agreement can subsequently be deemed a "franchise" or "business opportunity" under some of those statutes and regulations.

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12. To the extent that a distributorship relationship is covered by one of the franchise statutes discussed above in Section 5 of the text of this article, that statute will limit the ability of the foreign company to terminate certain distributors.

It is often difficult, however, to determine when the relationship between a foreign company and its distributor qualifies that distributor as a franchisee. Unfortunately, many foreign companies realize they are franchising only when it is too late. By not having registered and otherwise complied with various state regulatory requirements, those foreign companies inadvertently have subjected themselves to possible civil penalties and, perhaps more importantly, given their distributors an excuse to void their contracts any time they want in the future and sue for damages. Therefore, it is essential to understand when a distribution agreement may be deemed to cross over and become a franchise agreement.

State governments have enacted franchise legislation with two primary goals in mind: (1) through the disclosure of information by the franchisor (*i.e.*, foreign company), to provide each prospective franchisee (*i.e.*, distributor) with as much relevant information as possible prior to making its initial investment in the franchise (*i.e.*, the distributorship); and (2) by controlling termination of the franchise after such an investment has been made, to insure that the franchisee is not deprived of a fair opportunity to recoup his investment. As many states have addressed these goals in separate statutes, this article will discuss franchise disclosure and franchise termination statutes separately.

Franchise disclosure statutes have been enacted in fifteen states. Eleven of those states rely on what can be termed the majority definition. Those eleven states are California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, Virginia and Wisconsin.[13] Under the majority definition, a franchise is defined as an agreement by which (a) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system *prescribed in substantial part* by a franchisor; (b) the operation of the franchisee's business pursuant to such plan or system is *substantially associated* with the franchisor's commercial symbol; and (c) the franchisee is required to pay a *franchise fee.* To constitute a franchise, an agree-

13. CAL. CORP. CODE §§ 31000-31516 (West 1971); 1973 ILL. ANN STAT. ch. 121, para. 1761-44 (Smith-Hurd 1988); IND. CODE § 2-2.5-1 to -.51 (1986); MD. ANN. CODE, art. 56, §§ 345-365D (1988); MICH. COMP. LAWS §§ 445.1501 to -.45 (1968 & Supp. 1988); N.Y. GEN. BUS. LAW §§ 680-695 (Consol. 1983); N.D. CENT. CODE §§ 51-19-01 to -17 (1989); OR. REV. STAT. §§ 650.005-.085 (1983); R.I. GEN. LAWS §§ 19-28-1 to -15 (1986); VA. CODE §§ 13.1-557 to -574 (Supp. 1984); WIS. STAT. §§ 553.01 to -.78 (1957).

ment must usually, but not always, meet each of those three criteria.[14]

As for the first criteria, state agencies will consider whether the distributor is required: (i) to purchase its goods from designated sources; (ii) to follow operating plans, standard procedures or training manuals; (iii) to sell only certain products; or (iv) to sell to only certain purchasers. They also will consider whether the distributor might be terminated at any time, and whether the foreign company actually assists the distributor in training, obtaining locations or marketing products.

For a state to conclude that a distribution agreement establishes a "prescribed marketing plan," the distributor need not be contractually required to follow a set of marketing standards. Many states consider whether the distributor has received a marketing plan prescribed *by implication*. For example, California and Rhode Island consider the making available to a distributor of any marketing suggestions as the prescribing of a marketing plan.[15] Illinois, in the very wording of its statute, declares a distribution agreement to be a franchise if a marketing plan is prescribed *or suggested*. In regulations interpreting its statute, Illinois proclaims that marketing suggestions may constitute such a prescribed or suggested plan even when those suggestions or the agreement between the parties include declarations which grant the distributor complete freedom to ignore those suggestions.[16] The California franchise agency has interpreted the California statute to reach the same result.[17] In short, in some states, most notably California and Illinois, the first criterion—the presence of a prescribed marketing plan — can be met whenever a distribution agreement involves communications between the parties

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14. Virginia does not require the payment of a franchise fee. VA. CODE § 13.5-559(b) (Supp. 1984). Oregon's subparagraph (c) requires the giving of "valuable consideration for the right to transact business" pursuant to the plan. OR. REV. STAT. § 3650.005(4)(c) (1983). The New York statute would apply so long as an agreement satisfied either subparagraphs (a) and (c), or subparagraphs (b) and (c). N.Y. GEN. BUS. LAW § 681 3(a)-(c) (Consol. 1983).

15. CAL. DEP'T OF CORPS., RELEASE NO. 3-F (REVISED), GUIDELINES FOR DETERMINING WHETHER AN AGREEMENT CONSTITUTES A "FRANCHISE" 3 (Feb. 21, 1974) [hereinafter CALIFORNIA FRANCHISE GUIDELINES]. The California franchise agency has declared that: "If the franchisor in his advertising to prospective franchisees claims to have available a successful marketing plan, the element of a marketing plan presumably will be present." *Id.*

16. Illinois General Rules and Regulations under the Franchise Disclosure Act, tit. 14, subtit. A, ch. II, § 200.102(c) [hereinafter Illinois General Rules].

17. CALIFORNIA FRANCHISE GUIDELINES, *supra* note 15, at 5. In California, contractual provisions that the retailer-distributor is to be considered as an independent contractor or that the foreign company is not concerned with the means employed by the retailer-distributor to make sales, do not preclude the California franchise agency from concluding that the retailer-distributor's business is in fact operated pursuant to a prescribed marketing plan.

concerning suggested marketing practices, or even the availability of such suggestions, should the distributor request them.

The second criterion of the majority definition is that the operation of the distributorship be substantially associated with the foreign company's trademark or other commercial symbol. Illinois considers that criterion to be met whenever a licensee is permitted or required to identify his business primarily with that trademark or commercial symbol, or if the distributor otherwise uses that trademark or commercial symbol in a manner likely to convey to the public the idea that he is selling products or services on behalf of the foreign company. In other words, this criterion is always met in Illinois.[18] The second criteria is applied almost as broadly in Maryland, Wisconsin, Rhode Island and California.[19]

The third criterion is that the distributor be required to pay the foreign company a franchise fee. Distribution agreements will usually satisfy this third criterion. The foreign company will require its distributor to pay for products which the distributor purchases from the foreign company and then resells to end-users. The distributor's payment will be deemed a franchise fee, unless the foreign company can prove that such a payment represents the bona fide wholesale price of the products, and includes no premium above that bona fide wholesale price for the "right" to engage in the business of selling the foreign company's products. It is difficult for any seller to satisfy that burden of proof. That burden will be especially difficult for a foreign company introducing a new product or service into the U.S. market. It will be very difficult to prove that a price for a product is the bona fide wholesale price for that product when that product has not previously been sold in the United States.[20]

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18. Illinois General Rules, *supra* note 16, at § 200.103. To avoid classification as a franchisor, Illinois imposes an affirmative duty on foreign companies and other manufacturers to make sure that their trademarks and commercial symbols are *not* being used by their retailers-distributors. *Id.* The regulation states that: "Mere absence in the franchise agreement of permission to use the franchisor's name or mark will not alone negate 'substantial association.' A contractual prohibition on use of the franchisor's name or mark must be policed and enforced to insure that the name or mark is not being substantially used without the franchisor's knowledge." *Id.*

19. Md. Regs. § 02.02.10.01(D)(1) (State Law Dep't, Div. of Securities) (June 1986); WIS. ADMIN. CODE § 31.01(7)(a) (Securities Comm'n) (Dec. 1989). Where the trademark is communicated to the customers of the foreign company, California considers whether the appearance of "unified operation" of the foreign company's retailer-distributors is established. Subparagraph (b) is satisfied in California if the retailer-distributor is granted the right to use the foreign company's trademark, even if the retailer-distributor is not obligated to display the trademark. CALIFORNIA FRANCHISE GUIDELINES, *supra* note 15, at 7.

20. CALIFORNIA FRANCHISE GUIDELINES, *supra* note 15, at 7. The California franchise

In sum, any distribution agreement that involves the potential disclosure of marketing suggestions by the foreign company to his distributor can easily be deemed a franchise under many of these eleven statutes.

Four states, Hawaii, Minnesota, South Dakota and Washington, follow a minority definition.[21] The essential difference between the majority and minority definitions is that, instead of requiring the providing of a prescribed marketing plan, the minority definition requires a "community interest in the marketing of goods or services" between the foreign company and the distributor.

In practice, Washington and Minnesota have defined the phrase "community interest" to mean a continuing financial interest of the foreign company in the operation of the distributorship.[22] Such a continuing interest will almost invariably be present between parties to a distribution agreement throughout the term of the agreement.[23]

To complicate matters further, on top of these fifteen franchise disclosure statutes, seventeen states have enacted franchise termination statutes.[24] Those statutes set forth the conditions upon which

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agency has declared that: "While a truly optional payment is not a franchise fee, a payment by a franchisee, though nominally optional, may in reality be a required one, if the article for which payment is made is essential . . . for the successful operation of the business." *Id.* at 11. If a foreign company requires a retailer-distributor to purchase any amounts of inventory, that company would probably be precluded, at least in California, from arguing that such purchases are at a bona fide wholesale price, and that such purchases therefore do not constitute the payment of a franchise fee.

California and North Dakota further limit the bona fide wholesale price exclusion. There must be no obligation to purchase quantities in excess of those which a reasonable businessperson would purchase as a starting or on-going inventory. Illinois' statute requires that there be an established market in that state for the goods that are purchased. Michigan's expired regulations also imposed a requirement that there be an established in-state market. Along similar lines, to determine whether a wholesale price is bona fide, the California franchise agency looks for an "open and public market in which sales of the goods are effected to consumers of the goods." *Id.* at 9.

21. HAW. REV. STAT. §§ 482E-2 to -12 (Supp. 1982); MINN. STATS. §§ 80C.01-.22 (1986); S.D. CODIFIED LAWS § 37-5A-1 to -87 (Supp. 1984); WASH. REV. CODE ANN. § 19.100.010(4) (1989).

22. In an unreported interpretative opinion, the Washington Department of Licensing explained that: "The community interest is evidenced by the interdependence between the company and its distributors. The failure of either means the failure of the other." (copy on file at the offices of the authors).

23. *But see* Moore v. Tandy Corp., 131 F. Supp. 1037, 1048-50 (W.D. Wis. 1986), holding that under the Wisconsin franchise termination law, refundability of the dealer's security deposit meant the dealer's investment did not create a "community of interest" between the dealer and the manufacturer, despite the existence of an incentive compensation arrangement. *Id.*

24. ARK. STAT. ANN. § 42-72-204 (1987); CAL. BUS. & PROF. CODE §§ 20000-20043 (West 1987); CONN. GEN. STAT. § 42-133e (1986); DEL. CODE ANN. tit. 6, § 2551-2556 (1980); HAW. REV. STAT. § 482E-6 (Supp. 1982); ILL. ANN. STAT. ch. 121 1/2, para. 1719 (Smith-Hurd 1960

and the methods by which a foreign company, if it is deemed a franchisor, can terminate its distributors. Generally speaking, those statutes require foreign companies to give distributors minimum cure periods to remedy any breaches or violations of their distribution agreements. Such statutes also set out parameters for a court to determine whether a termination is for good cause.

To the extent that termination provisions in distribution agreements are inconsistent with statutory cure periods and parameters, the statutes will control. Distributors cannot in their distribution agreements waive statutory protections to which they are entitled.[25]

Not surprisingly, many franchise termination statutes rely on the majority and minority definitions discussed above. The franchise termination statutes in California, Illinois, Indiana, Michigan and Virginia have adopted the majority definition. Connecticut's franchise termination statute relies on that majority definition, in a modified form. The franchise termination statutes in Hawaii, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, Washington and Wisconsin rely on the minority definition discussed above.

This is an extremely complicated area of law, in large part due to the number of states which have passed these types of statutes and the enormous variations in the ways such statutes have been interpreted.

In addition to the rules noted above, many states have passed business opportunity laws which also can apply to distribution agreements. Business opportunity laws are effective in California, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia and Washington.[26] In some, but not all of

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& Supp. 1989); IND. CODE ANN. §§ 2-2.7-1 to -7 (West 1989); MICH. COMP. LAWS ANN. § 445.1527 (West 1967 & Supp. 1989); MINN. STATS. § 80C.14 (1984); MISS. CODE ANN. §§ 75-24-51 to -61 (1972 & Supp. 1984); MO. REV. STAT. §§ 407.400 to .410, 407.420 (1978); NEB. REV. STAT. §§ 87-401 to -410 (1943); N.J. REV. STAT. §§ 56:10-1 to -12 (1937); S.D. CODIFIED LAWS § 37-5A-51 (Supp. 1984); VA. CODE ANN. § 13.1-564 (1950 & Supp. 1984); WASH. REV. CODE ANN. §§ 19.100.180, 19.100.190 (1983); WISC. STAT. §§ 135.01-07 (1981-82).

25. For example, California's franchise disclosure law states that: "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." CAL. CORP. CODE § 31512 (West 1977). Similar provisions are found in many other franchise statutes.

26. For those statutes, *see* CAL. CIV. CODE §§ 1812.200-.220 (West 1985 & Supp. 1990); CONN. GEN. STAT. §§ 36-503 to -521 (1987 & Supp. 1989); FLA. STAT. ANN. §§ 559.80-.815 (West 1988); GA. CODE §§ 10-1-410 to -416 (Harrison 1988); IND. CODE ANN. §§ 24-5-8-1 to -21 (1987); IOWA CODE ANN. §§ 523B.1-.11 (West 1988); KY. REV. STAT. ANN. §§ 367.801-

those states, a foreign company can avoid those business opportunity statutes by registering its trademark with the United States Patent and Trademark Office.

In addition, the U.S. Federal Trade Commission's franchise rule combines the definitions used in state franchise and business opportunity statutes.[27] Many of the individual U.S. states have their own versions of the U.S. Federal Trade Commission Act. Those statutes also may apply to distribution agreements.

The franchise statutes mentioned above are usually statutes of general applicability, applying to distribution relationships in all industries. In addition, some states have enacted "special industry" franchise laws, which apply only to distribution relationships in the specific industries identified by such laws.[28]

With such broad statutory definitions, with state agencies adopting such expansive interpretations of those definitions, and with so many overlapping laws and regulations, franchise, business opportunity and related laws and regulations often can affect the proposal, negotiation and execution of distribution agreements. Before entering into any distribution agreement, a foreign company should be advised by its U.S. attorney whether the proposed agreement would be covered by any of those statutes or regulations.

A foreign company must determine whether it is covered by such statutes and regulations before it begins discussing distribution arrangements with prospective distributors. For example, if its distribution agreement is a franchise, the foreign company may be required to register with a state agency prior to offering that agreement to a prospective distributor. Once registered, the foreign company can discuss the agreement with prospective distributors only after giving

.819, 367.990 (Baldwin 1989); LA. REV. STAT. ANN. §§ 51-1821 to -1824 (West 1987); ME. REV. STAT. ANN. tit. 32, §§ 4691-4700-B (1988); MD. CODE ANN. §§ 401-415 (1988); MICH. COMP. LAWS §§ 445.902-.903b (West 1967 & Supp. 1988); MINN. STAT. ANN. §§ 80C.01-80C.22 (West 1986); NEB. REV. STAT. § 59-1718 (1988); N.H. REV. STAT. ANN. §§ 358-E:1 to E:6 (1984); N.C. GEN. STAT. §§ 66-94 to -100 (1985); OHIO REV. CODE ANN. §§ 1334.01-.99 (Anderson 1979 & Supp. 1989); 1985 Okla. Sess. Laws 1289; S.C. CODE ANN. §§ 39-57-10 to -80 (Law. Co-Op. 1985); S. D. CODIFIED LAWS ANN. §§ 37-5A-1 to -87 (1984); TEX. REV. CIV. STAT. ANN. arts. 59-16.01-.15 (Vernon 1987); UTAH CODE ANN. §§ 13-15-1 to -7 (1986); VA. CODE §§ 59.1-262 to -269 (1987); WASH. REV. CODE ANN. §§ 19.110.010-.930 (1989).

27. 16 C.F.R. § 436.2(a) (1989).

28. Such special industry statutes and regulations include disclosure requirements for dealers of gasoline (adopted in 11 states); motor vehicles (adopted in two states); and hardware (adopted in Minnesota only); termination restrictions protecting dealers of motor vehicles (adopted in 49 states, excluding Alaska); gasoline (adopted in 36 states); farm equipment (adopted in 37 states); and liquor, beer, and wine (adopted in 31 states). *See* 1 Bus. Franchise Guide (CCH) ¶ 2001 (Mar. 1990).

each prospective distributor a detailed prospectus, called a Uniform Franchise Offering Circular, which has been reviewed in advance by the relevant state agency.

Even after providing the required prospectus, foreign companies which are deemed to be franchisors may have continuing and substantial reporting requirements to state agencies. Any changes in their distribution agreements offered in that state must be registered as an amendment to the prospectus before they can be offered to new distributors.

A foreign company can switch from the other strategies discussed above, albeit with varying levels of difficulty. Where no contracts with third parties are involved, switching is not a problem. Where there is an agreement with a third party, or at least the potential of a third party asserting the existence of an oral agreement, switching becomes difficult.

Once franchising is involved, switching becomes even more difficult. In order to switch, the foreign company must address concerns beyond the terms of its agreement or alleged agreement with its distributor. In addition, the foreign company must worry that the distributor also will be able to rely on statutory provisions to prevent his termination. For this reason, foreign companies should be particularly cautious when establishing distributors, so as to insure that they are not inadvertently creating franchisees. If those distributors in fact are franchisees, the foreign company may be locking itself into its marketing strategy indefinitely.

6. *Manufacturing and Distribution Licenses*

Licensing is the granting of permission by the foreign company to a U.S. party to undertake certain endeavors which the foreign company otherwise would have been able to legally prevent the U.S. party from undertaking. For example, the foreign company may have patented an invention in the United States. A U.S. party cannot manufacture that invention itself without infringing on the foreign company's patent. However, if the foreign company licenses the U.S. party to manufacture that invention, the U.S. party may do so, subject to the terms and conditions of its license agreement with the foreign company. In essence, a license agreement is a promise by the foreign company that it will not sue the U.S. licensee for infringing on its rights, so long as the U.S. licensee adheres to the conditions set out in that license agreement.

There are four basic types of intellectual property rights which can be licensed.

The first type is patent rights. A patent is a legal monopoly which entitles the patent owner to bar everyone else from manufacturing or selling his invention in the country which granted his patent. When a foreign company licenses its U.S. patent, the foreign company is promising not to sue its licensee for manufacturing or selling the patented invention in the United States.[29]

The second type is trademarks, trade names, services marks and other commercial symbols which, for the sake of convenience, we will refer to as trademarks. Like a patent, a trademark entitles its registered owner to bar others from using that trademark to identify certain goods or services in the country in which the trademark is registered. Likewise, when a foreign company licenses its U.S.-registered trademark, it is promising not to sue its licensee for using its trademark in the United States.

The third type is information which is proprietary to a particular individual or business. This type of information is commonly referred to as trade secrets. Trade secrets are valuable to that individual or business precisely because they are secret and confidential. When a foreign company licenses its trade secrets, the foreign company is revealing its trade secrets to its licensee, for the licensee's use subject to specified terms and conditions.

The fourth type is copyrights. A copyright gives its owner the exclusive right to reproduce, distribute, prepare derivative works from, and in some cases, perform and display various "works of authorship." That phrase includes communications in many different forms—books, magazines, newspapers, music, motion pictures, television shows, lectures, art, ballets, dances, maps, photographs, sound recordings, scientific drawings, and even computer software.

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29. A patent is a legal monopoly which is granted by a national government and is valid only within that nation's territory for a limited period of time. If a foreign inventor obtains a patent in his home country and wishes to enjoy similar exclusionary rights in the United States, a separate patent must be obtained under U.S. law. When a patent is issued in a foreign country, that patent is typically published in some official journal. That publication of the invention may prevent the invention from being patented in the United States. Under U.S. law, no United States patent can be granted if a patent issues in another country before the U.S. application is filed, unless either the Paris Convention (1883), 25 Stat. 1372, T.S. No. 37, *as revised* at Stockholm (1967), 2 U.S.T. 1583, T.I.A.S. No. 6923, or the Patent Cooperation Treaty (1978), 28 U.S.T. 7645, T.I.A.S. No. 8733, *codified at* 35 U.S.C.A. §§ 351-371 (West Supp. 1989), provides otherwise.

A copyright license granted by a foreign company[30] permits the licensee to reproduce, distribute, prepare derivative works, perform or display the copyrighted work.[31]

The foreign company which owns a patent, trademark, trade secret or copyright could sell those rights to a party seeking to use them. However, for the foreign company, licensing may be a more flexible way to profit from its intellectual property rights than an outright sale to the user. Licensors often grant permission for limited periods of time, with respect to limited geographic areas, or with respect to some, but not all, of the potential applications of their patent, trademark, trade secret or copyright. A licensor may license two or more individuals to use those rights at the same time. For instance, a fashion designer may license two different parties to use his name on their respective blue jeans. Such time, geographic, functional and other restrictions are quite common in licensing agreements, but virtually impossible in sales agreements.

From the perspective of the party wishing to acquire such rights, licensing also offers flexibility. A party might require rights only with respect to certain geographic areas or for certain functions, rather than the whole bundle of rights. Also, if the party acquires rights, generally it will have the responsibility of defending against legal actions brought by third parties disputing ownership of such rights. A licensee often can shift administrative and legal costs and legal responsibilities to its licensor. A purchaser rarely has such leverage and, even if it did, it is risky to expect a seller to pay such costs and discharge such responsibilities after it has received its sales price for the rights transferred.

A license is a private contractual arrangement by an owner of an intellectual property right which gives another party permission to

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30. Effective March 1, 1989, the United States joined the Berne Convention for the Protection of Literary and Artistic Works. After that date, works created in foreign Berne Convention member nations are exempt from registration requirements under U.S. copyright laws. However, United States law still encourages foreign companies to register copyrightable works with the U.S. Copyright Office. If such rights are registered, the copyright plaintiff is eligible to recover statutory damages for infringements of its registered works. In contrast, actual damages in a copyright case are often difficult to prove.

31. It is important to realize, however, that a copyright protects the "work of authorship," but not the underlying idea. Someone may copyright an article on how to bake the best cheesecake in the world. That baker can prevent someone from republishing the article but, unlike a patent, cannot prevent that person from following the recipe and baking the cheesecake himself.

Congress enacted a statute in 1984 which provides a type of copyright protection for mask work rights written on semiconductor chips. For the purposes of this discussion, this article shall group those rights together with copyrights.

use that right. Licenses almost always are committed to writing, as most owners want to limit that permission geographically, functionally and perhaps in other ways. Switching from a license arrangement to another marketing strategy thus becomes a question of terminating the written license agreement. As long as the foreign company has anticipated this possibility and retained adequate termination rights, switching should be fairly easy.[32]

7. Joint Ventures

Another alternative is joint venturing. A joint venture is an enterprise created by two or more parties for some specific purpose. For example, that purpose could be the manufacture and distribution of a product in the United States.

Joint ventures usually take a legal form, such as a partnership or a corporation, in which each participant holds an equity interest. At least one party typically contributes a patent, trademark, trade secret or copyright. The other party or parties contribute their expertise, their personnel, their facilities or, most commonly, their capital.

In this sense, a joint venture is also a license. The licenses discussed in the preceding section are contracts between the foreign company and a U.S. party. In contrast, joint ventures involve licenses granted to entities which are owned by both the foreign company and the U.S. party.

Joint ventures involve a sharing of both the profits and risks of a licensing relationship. When a foreign company enters into a license agreement, its profits are dictated by the terms and conditions of its license agreement. When royalties are involved, its profits are a function of the future performance of its U.S. licensee. The foreign company's risk is that it will not earn as much under its license agreement as it could have earned if it had used those rights itself, or licensed those rights to another party.

Under a joint venture agreement, the foreign company is exposed to the same upside and downside, that is—profits and risks, as are its joint venture partners. If the joint venture is more successful than anticipated, the foreign company may receive greater compensation

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32. As discussed above with respect to distributors, switching becomes more difficult if a licensing arrangement is deemed to be a franchise and if the licensee-franchisee is thus protected under various franchise disclosure and termination laws. For a detailed discussion of this problem, *see* Slade, *Applicability of Franchise and Business Opportunity Laws to Distribution and Licensing Agreements*, 15 AM. INTELL. PROP. L. A. Q.J. 1 (1987).

then if it had licensed its rights for a fixed amount or for a percentage of sales. On the other hand, if the joint venture is a failure, the foreign company may receive nothing—not even minimum amounts which it would have received under a license agreement. In fact, if the joint venture is operated in the form of a general partnership, the foreign company might very well suffer financial losses, from which it would have been shielded if it had licensed its rights.[33]

From the prospective user's perspective, joint venturing may allow him to spread out his risks. It may also ensure that the foreign company takes an active role in the development and exploitation of its rights. This can be important with respect to patents not yet reduced to practice, to trademarks with which the foreign company is personally identified, to trade secrets which must be adapted for new applications and to copyrights for theatrical works to be performed or for books to be adapted for movies.

As noted above, most joint ventures are based on licenses, which in turn are private contractual arrangements by which permission is given to use specified intellectual property rights. As with the licenses discussed in the preceding section, abandoning a joint venture is essentially a question of terminating the written license agreement.

In fact, it may be easier for a foreign company to extricate itself from a joint venture than from a license. In joint ventures, the foreign company has rights under both the license agreement to the joint venture and the joint venture agreement itself. Very often, by exercising its rights under that joint venture agreement, the foreign company can create a situation where the other participants in the joint venture must concede that the joint venture is no longer feasible. In addition, on its own, the foreign company has whatever termination rights it reserved for itself under the license agreement by which it granted rights to the joint venture.

It is for this reason that many foreign companies prefer joint ventures to simple license agreements. When licensing, the foreign company must rely on the terms of the license agreement to protect itself. However, when creating a joint venture and then licensing

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33. For example, a patent owner which licenses its patent to a third party and which plays no role in the use or practice of that patent is probably shielded from product liability claims arising from products produced pursuant to that patent. Ownership of a U.S. patent, by itself, does not expose the owner to product liability claims arising from products or equipment produced pursuant to any licenses which that owner grants with respect to its patent.

rights to it, the foreign company is protected by the terms of both the license agreement and the joint venture agreement.

8. Sale of Technology/Trademark/Expertise

This last strategy is perhaps the easiest to describe. The foreign company essentially surrenders any hope of entering the U.S. market itself, or with others. Instead, for some specified amount, it sells, transfers or otherwise assigns its proprietary rights and whatever is unique about its products or services to a third party, which then treats the U.S. market as its own. The foreign company collects that compensation, and watches to see what, if anything, happens.

The advantage to this strategy is that, if those rights stand on their own without much assistance from the foreign company, the foreign company may be able to raise more cash for its non-U.S. operations by selling those U.S. rights than if it spent years on its own to develop the product for the U.S. market.[34]

There are a number of significant disadvantages in selling U.S. rights under this strategy. It is very difficult for a foreign company to value its rights before making such a sale. If the product has never been in the U.S. market, the risks of introducing it are great. The compensation for those rights will be discounted significantly.

Further, the foreign company may have little if any continuing relationship with the U.S. owner of those rights. Improvements developed in the United States may not be passed back to the foreign company. Conversely, the U.S. party's failure to keep the product up to date may give the product a reputation of being obsolete, and might even affect the foreign company's ability to sell new, updated

34. Under U.S. law until October 1988, executory contracts which were not completely performed (including most license agreements) could have been repudiated by a debtor (trustee) after filing for bankruptcy when one of the parties to such a contract became involved in bankruptcy proceedings. *See* Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985). To protect themselves, some licensees insisted on purchasing technology. Unlike a license, purchase agreements were completely-performed contracts and were not subject to repudiation under these circumstances.

In October 1988, the Intellectual Property Bankruptcy Protection Act, 102 Stat. 2538-40, amending 11 U.S.C. §§ 101-1330, amended U.S. bankruptcy law and permitted patent, trade secret and copyright licensees to choose between (i) suing for damages after such a repudiation; or (ii) using certain of their licensed rights even after such a repudiation. The rights which such licensees can now elect to retain include the right to use or duplicate the technology specified in their license agreements and the right to the physical embodiment of the technology to the extent set forth in their license agreements. Any licensee which elects to continue to use those rights must still pay all amounts due under its license agreement, even though it no longer can force the licensor to perform other provisions of their license agreement. The October 1988 statute does not apply to trademark licenses.

versions outside the United States. Without keeping an eye on the owner of the U.S. rights, the foreign company may someday be surprised to find that U.S. owner is exporting products and competing with the foreign company outside the United States.

Of the eight strategies discussed in this article, the sale, assignment or transfer of rights is the most difficult strategy to abandon. It is irreversible, short of a repurchase by the foreign company. This strategy must therefore be considered extremely carefully before it is followed. It is, after all, a result rather than a strategy. It is not a way to try to enter the U.S. market; it is a surrender of the U.S. market in return for some specified compensation.

Conclusion

This article has reviewed eight strategies commonly pursued by foreign companies attempting to introduce their products and services into the U.S. market. Those strategies include direct sales by the foreign company itself, sales by or with the help of intermediaries (controlled subsidiaries, sales representatives and distributors), sales by entities over which the foreign company has varying amounts of control (franchises, licenses and joint ventures) and the outright sale of the essence of the products or services themselves. Each strategy discussed offers its own advantages and its own disadvantages. Some of these strategies can be easily and quickly abandoned in favor of alternative strategies. Others are quite difficult to abandon, as discussed above.

Which strategy a foreign company should follow will depend on that company's history and current goals, the nature of its products and services, the perceived potential of those goods and services in the U.S. market, the level of interest expressed by U.S. parties in participating in such marketing efforts and the tax implications (not discussed here) of each strategy on that company. A foreign company must consider its choices very carefully, lest it embark on a strategy which will not achieve its goals and which will be difficult, if not impossible, to revise.