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CAFTA And The Liberalization Of Dealer Protection Regimes

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With the passage by the U.S. Congress of a Free Trade Agreement between the U.S., five Central American countries and the Dominican Republic (referred to as CAFTA) and the "rolling" implementation of the agreement in the signatory countries, many U.S. companies may ask transactional lawyers to provide some guidance on how U.S. companies can use the agreement to their advantage. One way in which U.S. companies can benefit greatly from the CAFTA agreement is to know the recent changes that have been made to what are known as "dealer protection" regimes in the CAFTA countries.

Historically, many countries in Central and South America have provided protection to dealers, distributors and sales representatives, all basically defined to be local residents who buy or sell a foreign supplier's product. These protections were usually granted by statute and, in many cases, could not be waived by contract. Many of these dealer protection regimes were originally conceived as a way to regulate the local labor market and to provide protections to workers who were not otherwise beneficiaries of union membership. Termination was often allowed only for "just cause" and terminations without cause were subject to draconian indemnification provisions. Indemnity formulas were provided primarily as a disincentive for suppliers to terminate the relationship and were meant to be extremely onerous for the supplier. Limiting indemnity amounts was factually difficult for the supplier, usually relying upon information (such as local accounting information) that was more likely to be in the control of the distributor than of the supplier. Learning these lessons by trial and error has often proved a costly experience for U.S. companies.

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During the CAFTA negotiations, U.S. negotiators, having consulted extensively with the U.S. business community prior to and during the negotiations, were aware of these concerns and made the "updating" of these regimes part of their negotiating strategy. The goal was to move the dealer protection regimes in all of these countries towards a more modern, contract-based system, much like the U.S. system where the general principles of local contract law govern the relationship between distributor and supplier. While the ideal was a completely contract-based model, the result was imperfect and likely was the result of other trade-offs being made. In the end, the country-specific results implemented under CAFTA contain variations but the overall effect is first, to improve the freedom of the parties to set terms under contract and, second, to provide more realistic means of settling disputes.

In order to illustrate how the CAFTA may benefit U.S. suppliers, the following is a brief description of the results of the CAFTA implementation in this area and some suggestions for how U.S. companies may utilize the agreement's provisions.

El Salvador

On March 1, 2006 CAFTA entered into force between El Salvador and the U.S. El Salvador was required to amend the application of its Commerce Code for distribution contracts executed between U.S. suppliers and entities in El Salvador after that date. The CAFTA commitments made by El Salvador allow the parties to elect *not* to apply Articles 392 through 399-A of the Commerce Code. As with most dealer protection regimes, these Articles provided strong statutory protection to distributors. Pre-CAFTA, the Articles were mandatory and any contract clause contradicting or modifying their provisions would be deemed null and void. Under CAFTA, El Salvador will now allow contracting parties the alternative of choosing either not to apply the Articles or to modify their application to the contract.

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For example, under a CAFTA distribution agreement in El Salvador, the parties can contractually establish any procedures and/or fora for dispute resolution. Further, if a specific provision on indemnification (including a provision for no indemnification) is included in the contract, then the statutory article setting forth specific indemnification rights for the distributor will not apply. Any rights of exclusivity can only be granted expressly, as set forth in the contract, and will not be implied. Thus, with careful attention to drafting, U.S. suppliers can craft distribution contracts which are substantially more favorable to the supplier than would have been possible under the existing distribution agreement regime in El Salvador.

Honduras

On April 1, 2006, CAFTA entered into force between Honduras and the U.S. Pursuant to CAFTA, Honduras was required to implement significant changes to its Commerce Code for contracts between CAFTA entities which were executed after that date. Under the amendments introduced by a March 26, 2006 law known as "Decree No. 16," for covered contracts, Honduras may no longer require that a representative, agent or distributor be a national of Honduras or an enterprise controlled by Honduran nationals. Further, Honduras may no longer regulate the type of relationship chosen. With respect to distributor relationships, exclusive rights to distribute products must be explicitly provided for by contract and may not be implied by the relationship. The right to indemnification must be provided in the contract and, if the amount or form of an indemnification payment is not explicitly provided for by the parties, general principles of contract law will apply in determining the form and amount of any such payment. Finally, any indemnification based on an argument that the termination of a contract was without "just cause" will be subject to resolution based upon the general principles of contract law. Therefore, the amendments introduced by Decree No. 16 provide significant protections for U.S. suppliers which were completely unavailable under the old legal regime and which are unavailable to suppliers from non-CAFTA countries.

Guatemala

On July 1, 2006 CAFTA entered into force between Guatemala and the U.S. Pursuant to the Agreement, Guatemala was required to amend the application of its Commerce Code for distribution contracts executed between U.S. suppliers and entities in Guatemala after that date.

For contracts subject to the new laws, the laws state that, for contracts where the parties do not expressly address the issue of settlement of disputes, there is now a "rebuttable presumption" that the parties intended to settle any disputes through binding arbitration. Similarly, if the amount or form of any indemnification payment is not established in the contract, then the parties may agree to arbitration to establish the amount of the payment although calculation of the payment by the arbitrator will still be based on the factors enumerated by statute. While not required by CAFTA, as a direct result of the implementation of the agreement, agents and distributors are now required to register before the Mercantile Registry of Guatemala. The practical effect of this requirement is that the Mercantile Registry will now have a record, going forward, of the agents and distributors operating in Guatemala for U.S. suppliers. Currently, there is no penalty assessed for failure to register but the Government is considering whether fines should be assessed and such a regulatory change may be made by executive action without a need for further legislation. As a practical matter, failure to appear on the Mercantile Registry might be used against a party who later claimed that a distribution relationship existed.

Nicaragua

In 1997, Nicaragua's former legal regime regarding dealer protection was repealed, so parties are now allowed to freely negotiate and determine the terms and conditions of their relationship. The amendment grandfathered existing relationships and provided that all contracts, past and future, were subject to local law and resolution solely in the courts of Nicaragua. Given the 1997 revisions to the legal regime governing this sector, no additional commitments were required of Nicaragua in the CAFTA, which entered into force between Nicaragua and the U.S. on April 1, 2006.

Costa Rica

Costa Rica is the only signatory to the CAFTA which has not yet ratified the agreement through its internal domestic process. Once the Government of Costa Rica completes this process, implementing legislation will have to be prepared. Such legislation will include revisions to its dealer protection laws consistent with CAFTA. The agreement will then have to be scheduled for an "entry into force" date in both countries. Due to political constraints and election cycles in both countries, it is unlikely that any new laws governing dealer protection will be in effect before 2007.

Dominican Republic

At present, the Dominican Republic has ratified CAFTA but is still trying to complete drafting of implementing legislation in three areas, one of which is dealership provisions. The revised legislation will then have to be adopted internally. The two governments will then have to agree to an "entry into force" date for the agreement. Given this process, it is likely that the implementation will be no earlier than late 2006 or early 2007. Under CAFTA, for contracts which post-date the implementation date, the general norm applied will be one of "freedom of contract," in which the statutes of the old legal regime will no longer apply and the general principles of the Civil Code will be applicable. Under the new provisions, no further registrations by distributors with the Banco Central will be required. Further, if a contract has no termination date, the law will allow such a contract to be terminated by any party by giving six months advance termination notice (this notice provision can of course be explicitly shortened in the contract). Contracting parties will be allowed to expressly state the grounds for termination of the contract and those bases for termination will be honored. Indemnification provisions, as negotiated in a contract, will be honored and, in cases where the contract is silent regarding indemnification, any damages award will be based on actual economic damages. There is also an endorsement of the commercial preference for binding arbitration as a remedy.

Advice To Clients

As discussed above, the process of implementation of CAFTA is well under way. Clients who have existing relationships in any CAFTA country should be encouraged to review those relationships and think strategically about how to terminate those relationships or re-negotiate their terms. It should be noted that contracts which pre-date the implementation dates discussed above may be "grandfathered" under the old rules so care must be taken to examine the specific history of each relationship. New entrants to the market in this region should be counseled to carefully construct Distribution Agreements which take the newly-enacted laws into consideration. Local counsel should be consulted in connection with all of these assessments as the negotiated results were not uniform and variations to the general norm of freedom of contract are still present in a number of CAFTA countries. A client willing to engage in these steps should find that the U.S. negotiators' efforts to modernize the region's antiquated dealer protection laws can have a practical effect on the bottom line.