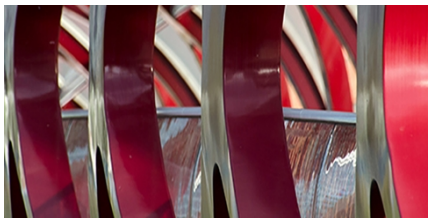
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News & Types: Client Advisories

California Refuses to Recognize the Theory of Constructive Termination

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Practices: Commercial, Competition & Trade

Manufacturers often use exclusivity clauses in distribution agreements which allow them to sell products to designated distributors for resale within a specific territory. Sometimes, exclusivity clauses can be negated if an end dealer or distributor does not meet sales targets or key performance indicators. The clause itself might also include a provision that allows for the manufacturer to "invade" a distributor's authorized territory regardless of performance—a harsh penalty, which might lead a distributor to argue the agreement is therefore "constructively terminated." The recent decision of *Carolina Beverage Corporation et al. v. Fiji Water Company LLC* (2024) 102 Cal.App.5th 977, was one such case, and led to a significant ruling in a California appellate court's refusal to recognize this theory.

In 2009, Fiji Water entered into a qualified exclusive agreement with distributor Carolina Beverage Corporation for a five-year term. The exclusivity agreement was subject to, in relevant part, the following terms:

1. Fiji could invade Carolina's territory by selling directly to retailers so long as: (a) Fiji first discussed and negotiated sales terms with Carolina; and (b) if the parties were unable to agree on a sales term, Fiji could only invade by paying Carolina an "invasion fee" of $1 per case sold.
2. The exclusivity agreement could be terminated in one of four ways: (a) by both parties immediately, provided 30-days' notice is given; (b) by Fiji immediately without penalty for any 1 of 8 enumerated reasons (usually insolvency); (c) by Fiji any time and for any reason upon 30 days' notice, so long as Fiji paid a "termination payment" of $5 per case sold by Carolina in the previous year; and (d) by Carolina for any reason, provided 180-days' notice is given.

However, by November 2018, Fiji had invaded roughly 85% of Carolina's distribution territory, which caused Carolina to declare Fiji in breach and to demand, among other requests, a termination payment of approximately $1.9 million based on a theory that the contract was "constructively terminated." Instead, Fiji paid an invasion fee of around $55,000, denied terminating the agreement, and informed Carolina it would not renew the exclusivity agreement after January 2019. Despite these actions, Carolina continued performing under the agreement.

In September 2019, Carolina sued Fiji for breach of contract under a theory of constructive termination and won at trial, after a jury returned a verdict in favor of Carolina recognizing constructive termination where a party engages in conduct that "substantially interferes with the other party's ability to obtain the benefits of the contract, and the relationship between the parties ends." Fiji appealed, and the appellate court reversed. The appellate court held that Fiji had never actually terminated the agreement within 30 days that would require it to

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pay the $5 per case “termination payment,” and nor was constructive termination a valid theory. The court indicated that the law does not recognize this theory outside of employer-employee and lease agreement—scenarios where there is almost always an economically weaker party that requires additional protection. By contrast, Fiji and Carolina were sophisticated parties that had clear provisions set forth for termination and they had the ability to include additional methods that would have further protected Carolina.

This case is important as manufacturers and suppliers enter into new agreements with distributors. Though exclusivity provisions must always be detailed, manufacturers must be even more vigilant now to ensure termination provisions are carefully drafted.

If you have any questions about this case or how this decision applies to your business, please contact your Masuda Funai relationship attorney or any member of Masuda Funai’s Commercial, Competition and Trade practice group.

Masuda Funai is a full-service law firm with offices in Chicago, Detroit, Los Angeles, and Schaumburg.

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