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A legal update from Dechert's Intellectual Property Transactions and Counseling Group

House of Lords Clarifies Compensation Rules for Commercial Agents

Background

For those brought up with common law contract rules, it used to be a "given" that if a contract was terminated properly in accordance with its terms, then no damages or compensation would be payable. While this has been eroded over the years, for social reasons, particularly in areas such as employment, it remains generally the case in the UK for most commercial contracts. A major exception to this is the position on termination or expiry of contracts with those acting as commercial agents for the sale of goods.

As Lord Justice Staughton once wryly put it, the European Commission appeared to believe that "commercial agents are a downtrodden race, and need and should be afforded protection against their principals". They therefore brought in a Directive (86/653/EEC) to coordinate the laws of the member states with regard to self employed commercial agents. This was brought into effect in the UK by the *Commercial Agents (Council Directive) Regulations 1993*.

While the Regulations set out a number of sensible rules on payment of commission, such as adequate notice, the provisions which have caused most difficulty to businesses—and, indeed the courts—in the 14 years since they were introduced are the provisions requiring that the agent be compensated on expiry or termination. Compensation of some sort will be payable in practically every case—even if the agent himself terminates because of old age or infirmity—unless the agent is in material breach which would justify immediate termination. The parties cannot derogate from this right in the contract. The issue over the years has been how the payment to the agent would be calculated.

The Directive actually provides for two alternative compensation regimes—an "indemnity" (based on the German position) or "compensation" (based on the French). Each is subject to different rules and Member States were supposed to choose one or the other. The UK, bizarrely, chose to adopt both with the choice left to the parties at the time of contract. If the parties do not expressly specify an "indemnity", however, the agent will receive "compensation".

Most practitioners acting for principals have traditionally advised their clients to opt for the *"indemnity"* regime as:

- this is only payable "if and to the extent" the agent has brought in new customers or substantially increased trade with existing customers and the principal will continue to derive substantial benefit from the trade and it is equitable in all the circumstances.
- it is also capped at the equivalent of one years average commission calculated over the five years prior to termination.

The "compensation" option, however, was believed—certainly by the representatives of the agent community, following the Scottish case of *King –v–Tunnock Ltd*—to be based on the French position where, "by judicial custom", the agent receives two years average commission.

However, on 4 July, the House of Lords dealt a final blow to the idea of calculating "compensation" automatically on the basis of two years commission.

The House of Lords Ruling

In the case of *Lonsdale –v– Howard and Hallam [2007] UKHL 32*, the Appellant, Mr Lonsdale, had been a commercial agent for the shoe manufacturers, Howard and Hallam. The business had been steadily declining and in 2003 Howard and Hallam gave Lonsdale six

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months notice to terminate his agency and subsequently ceased trading. Lonsdale claimed over £30,000 in compensation—a figure based on 2.5 years gross salary. At first instance, the judge awarded only £5000 and this was upheld by the Court of Appeal. Mr Lonsdale then appealed to the House of Lords.

His counsel argued that the courts in any Member State opting for the "Compensation" route would be bound to treat the French norm of twice gross commission as the norm and only vary this in cases where the principal could prove that the actual loss was less. If not, the purposes of the Directive would not be achieved.

In a short but very pithy judgement, Lord Hoffman pointed out that, while the Directive mandates the payment of compensation in some form, the ECJ had made it clear that the method of calculation is a matter for each Member State to chose and that the English courts were not bound by the French rules.

Going back to the text of the Directive, he pointed out that the aim of compensation was to recompense the agent for "the damage he suffers as a result of the termination of his relations with the principal". The value lay in the prospect of earning commission from the proper performance of the agency contract. While any valuation would assume, for the calculation, that the relationship was ongoing, he found that:

- it was for the *agent* to prove the value of the loss with proper valuation evidence rather than for the court to "pluck a figure out of the air from across the channel". The valuation should be to ascertain what a prospective purchaser would actually pay for the agent's business as a going concern
- valuation should be based on *net income, not gross* as this would be what mattered to a hypothetical purchaser
- Evidence should be adduced of the "going rate" for such businesses rather than a crude deemed multiple
- A decline in the business would affect the valuation
- Lack of a non-compete from the former agent would also depress the deemed valuation.

On the facts of the case, Lord Hoffman upheld the original award—remarking that the judge could not have been faulted had he simply dismissed the claim.

He also looked at what the position would have been on the "Indemnity" basis. As this was based on continuing value to the principal, in cases such as this, where the principal had ceased trading, no compensation would be payable.

Their Lordships felt there was no issue to refer to the European Court and leave to appeal was refused. It remains to be seen whether an attempt will be made to challenge this.

Conclusions

It is clear that agents will, from now on, have to do a great deal more to prove actual loss in order to get compensation and the days of the instant demand for two years gross commission are over. While the need for proper valuation evidence might seem onerous, an appreciation of the true basis for compensation will probably result in fewer marginal or undeserving cases reaching the courts.

That said, the valuation method will still be likely to result in an award based on some multiple of commission—albeit now net. It is likely that practitioners will still advise their clients to agree to the "indemnity" basis because of the greater certainty of the one year cap.

To avoid the risk of compensation entirely, however, it is still worth bearing in mind that:

- the Regulations only apply to *goods not services*;
- they only apply to true agency.

In the UK at least, there is still no compensation on expiry or proper termination of a distribution agreement. (Put simply, a distributor takes title to the goods and sells on their own account for their own profit—an agent sells goods owned by the principal for the principal's profit.)

If possible, therefore, despite the new ruling, a distribution deal is still generally preferable.

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