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Calculation of damages due to distributors because of an insufficient period of notice and for goodwill

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I. Introduction

In the Belgian legal system the damages due to a distributor following termination of a contract will depend on whether the contract is governed by the law of 27 July 1961.

The law of 1961 is only applicable if certain conditions are met: it regulates,

* the unilateral termination
* of an exclusive distribution agreement
* whose territory partly or entirely covers Belgium
* and lasts for an indefinite time period.

Therefore, legal requirements for termination will vary according to whether the agreement covers an indefinite or a fixed time period. Parties are obviously free to agree on a contract for a fixed or indefinite period of time.

With respect to an exclusive distribution contract that lasts for an indefinite period of time, the law provides significant protection for the distributor.

However, the law also provides specific provisions regarding contracts that last for a fixed period of time.

We will thus deal:

* first (rapidly) with the termination of agreements covering a fixed period of time
* second with the termination of agreements covering an indefinite period of time

Whenever the distribution agreement at issue does not fall within the categories ruled by the law of 1961, the general rules of the Belgian Civil Code will apply.

Therefore either party may terminate the agreement by sending notice to the other party or by seeking a judicial resolution of the agreement in court according to article 1184 of the Civil Code in the case of breach of contract.

II. Regarding fixed period agreements

In general, if the agreement is terminated as originally planned at the end of the term, the parties cannot make a claim.

The parties are free to stipulate what will happen in the event of a termination of the relationship before the end of the term. The terms of the contract can provide for an indemnity to the party who is not responsible for the unexpected termination, or they can provide for an enforced execution of the agreement until

the final date, but Belgian case law most emphatically does not admit claims for the enforced execution of the contract.

Therefore, the distributor can only claim the contractually agreed indemnity or damages resulting from the premature termination of the agreement.

However, the law of 27 July 1961 contains two provisions concerning contracts that cover a fixed time period.

Indeed, according to article 3bis of the Belgian law, a distribution contract for a fixed duration must be terminated with notice given by registered mail, at least three months and at the most six months before the end of the term. Therefore, even if the parties have contractually decided what will happen in the event of a termination, they cannot depart from this provision.

By disrespecting the period of notice provided by the law, the parties are considered to have tacitly renewed the agreement, either for an indefinite duration or for the duration provided in a possible clause of renewal. If there is no specific renewal clause in the contract, the renewed agreement shall be considered to be for an indefinite period of time.

Furthermore, according to the same article 3bis of the law, a distribution agreement for a fixed period is considered to cover an indefinite period as soon as it is renewed for the third time between the same parties, whether the clauses of the agreement have been modified or not or whether the distributorship has been tacitly renewed as a result of a clause in the agreement.

III. Regarding agreements covering an indefinite period of time

Nevertheless, a distribution agreement usually covers an indefinite period of time, which means that the parties may not know when the contract will come to an end at the time of conclusion. In such a situation, the specific provisions of the Belgian law of 1961 regarding termination will be applicable.

According to article 2 of the 1961 Law, an exclusive distribution agreement for an indefinite time period and regulated by this Law cannot be terminated by either party, except with a reasonable period of notice or a fair indemnity to be agreed upon between the parties, unless for a serious breach of duty.

Two situations are therefore to be considered: termination for serious breach and all other cases of termination.

III.1. Termination for serious breach of contract: no indemnity in lieu of notice and no goodwill indemnity unless the termination for serious breach is unlawful.

When a party legitimately terminates a contract for serious breach, no indemnity is due to the other party.

The law does not provide a definition of “serious breach” but it is commonly defined as a breach which makes any further collaboration immediately and totally impossible, even during a very short term of notice. The parties may stipulate in their contract the instances that will be considered a serious breach.

Examples of frequently used clauses:

- the distributor’s obligations to sell a certain quantity of the supplier’s products or
- to achieve a certain annual turnover

Without such a clause, it is up to the court to determine whether the alleged breach by the distributor or the supplier is serious or not.

The following circumstances have, for example, been considered as serious breaches according to Belgian courts:

* Unilateral modification of his territory by the supplier;
* Breach of the exclusivity granted;
* Frequent failure to meet regular payment deadlines despite promises to do so;
* Sales by the distributor of competitive products despite an exclusive purchasing clause;

The party who has alleged a serious breach must **immediately desist** from any further collaboration. However, according to the courts, there can be a period of time between the notice of termination and the moment the contract totally ends in practice to allow the parties to become organized in order to avoid the disadvantages of a sudden termination. (*Example: Court of Appeal of Ghent, 12th April 2000: the Court considered that a period of 6 weeks between the notice of termination and the actual end of the contractual relationship was not incompatible with the notion of serious breach*).

If a party terminates the contract assuming that there is a serious breach and it becomes clear thereafter that earlier termination was not justified (because the breach did not exist or was not serious enough), the agreement will end in any case and damages, as well as compensation for unjustified early termination, are due.

In fact, when a judge does not determine the existence of a serious breach, it means that the terminating party was not entitled to terminate the contract immediately and should have given a **reasonable period of notice** or a **fair indemnity** as provided by article 2 of the law.

We will now deal with the situation of termination where a reasonable period of notice or a fair indemnity is normally due, in particular for the calculation of damages due because of the lack of a sufficient notice period.

III.2. No serious breach

When no serious breach is invoked, the party who wishes to terminate the agreement has the choice to either give reasonable notice or to pay an indemnity in lieu of notice.

The damages for the lack of a sufficient period of notice normally correspond to the loss of profit during such a period.

However, the question as to how to calculate such a loss of profit remains. Should it be based on the gross or net profit and how should the determination be made?

I will examine this crucial issue with reference to case law in Belgium.

III.2.1. Choice between a reasonable period of notice or an indemnity in lieu of notice

Regarding the possibility of choosing between the period of notice and the indemnity, the Court of Cassation (4th December 2003) decided that *"the obligation to pay an indemnity replaces a contractual obligation to respect a reasonable period of notice whenever that is not respected"*.
According to this case law, it is the terminating party's duty to give a reasonable notice period. However, according to doctrine and to the text of article 2 of the law of 1961, the terminating party can choose to compensate with a fair indemnity, without granting a notice period.

Therefore, if no notice period has been granted or if it is considered to be insufficient, the courts shall decide the amount of the indemnity in equity.

On the other hand, whenever the terminating party chooses to offer an indemnity to the other party in lieu of the notice period and the parties cannot agree on the amount of this indemnity, the courts shall also decide the matter in equity.

III.2.2. A reasonable period of notice

* What is a reasonable period of notice?

The definition of a *"reasonable notice period"*, according to doctrine and case law should take into account the interests of both the distributor and the supplier.

According to the Court of Cassation (10th February 2005) *"the aim of the legislator is to provide the distributor with a period which is necessary for reorienting his activities, in order that the distributor is not ruined because of the termination of the distribution agreement"*.

It should enable the distributor to obtain a net income equivalent to the income lost. Thus, the period of notice granted was deemed insufficient when a distributor had to fire several employees and had lost a considerable part of his

turnover (Court of Appeal of Liège, 9th November 2006 - confirmed by Court of Cassation, 20th June 2008).

* **How long is a reasonable period of notice?**

Since a minimum notice period is not required by Belgian law, a reasonable notice period shall be agreed upon by the parties at the moment the notice is sent.

If the parties cannot agree upon the notice period, the courts will settle the matter equitably, taking the interests of both parties and the particular circumstances into consideration.
In practice, in order to set the real term of the notice period, the courts are guided by commercial customary practices and by valuable classic criteria, such as the,

* duration of the agreement;
* extent of the territory and the number of clients and other advantages linked to the agreement;
* percentage of the distribution activities within the global activity of the distributor;
* development of turnover during the agreement;
* reputation and specificity of the supplier's products and the possibility of selling similar products or replacing the distributorship;
* complexity of the organization and the obligations assumed by the distributor in order to perform the contract;
* investments.

Case-law confirms that it is necessary to take into account the classical criteria and, in addition, *"all criteria useful for settling the notice period necessary for total or partial reconversion of a distributor's activity need to be considered"*. (Court of Appeal of Brussels, 21st March 2003)
Therefore, it is important to determine the percentage of the distribution activities in question within the global activity of the distributor; indeed, if the distributor has already developed other side activities beyond the distribution activity in question, it would be easier to carry out a reconversion of the activity.

In practice, case-law shows that the notice period granted by the courts can vary enormously, depending on the particular circumstances.

In fact, decisions on this issue range between 3 and 42 months.

According to the recent interpretation of a *"reasonable notice period"* settled by the Court of Cassation (10th February 2005), the term of such a period would probably be shortened; indeed, a reasonable period notice is not the period which is necessary to enable the distributor to find an equivalent distribution agreement, but rather the period necessary to obtain a net income equivalent to the income lost. Moreover, the judge has discretionary power to decide whether or not a fact known at the moment of the decision but subsequent to the termination can be taken into account for the equitable evaluation of the period of notice, even if the

parties have reached an agreement on a notice period at the time of the termination (Cass. 14 January 2010, C.08.0082.N, unpublished).

III.2.3. Assessment of the indemnity in lieu of notice

The indemnity in lieu of notice is meant to compensate the loss of profit due to the lack of a reasonable period of notice and especially the profits that the distributor could have made during the period of notice, had he been given one. Therefore, the loss of profit should be calculated in order to give the distributor what he would have obtained as a result of the period of notice.

The indemnity can be calculated in two ways which would typically lead to the same result:

* on the basis of the “semi-net profit” which is the sum of the net profit and the irreducible overheads related to the execution of the distribution agreement;

* on the basis of “semi-gross profit” which is the gross profit margin reduced by the reducible overheads directly related to the distribution agreement.

The calculation of the indemnity normally takes into account the average profit (net or gross as explained above) made by the distributor during the last 2 or 3 years of the distribution agreement. This average would be multiplied by the months of the notice period which was due and was not respected and determined through the above-mentioned criteria.

Some courts consider it easier to take the gross profit as the starting point because it is directly linked to the sales made within the framework of the distribution contract. In fact, the gross profit margin is the difference between the turnover generated by the distribution agreement concession and the sales made by the supplier to the distributor. Therefore, the gross profit margin can be controlled by the supplier who is aware of what he has sold to the distributor.

However, most court decisions apply the first method and are based on net profit. For this purpose: the net profit includes the operational profit before taxation.
The "irreducible overheads" contain the costs which remain due regardless of the continuation of the distribution, while "reducible overheads" means the costs which can be linked directly to the products connected to the distribution agreement and which disappear when the products are no longer sold.

We can find several examples of "irreducible overheads" in case law:

- rent,
- property tax,
- accountant’s fees, lawyer’s fees,
- fixed contributions and subscriptions,
- minor equipment,
- legal publication costs,
- maintenance costs for IT systems, the building, … (Bruxelles, 6 mai 2004, *R.D.C.*, 2005, p. 72),

- to a certain extent, the remuneration of employees. The Court of Appeal of Liège decided that remuneration of the work of the employees dedicated to the distribution agreement at issue is necessarily irreducible to the extent that this remuneration is not reduced because of the termination of the distribution agreement.
- regarding remuneration of the managers and the executives: Belgian case law is not unanimous. Several decisions have considered that only the part of the remuneration which exceeds the typical remuneration of an employee holding a similar position is a part of the net profit. As a matter of fact, only this part of the remuneration is to be considered as a distributed profit. However, it could be quite difficult for the judge to determine the typical remuneration.

Costs that are considered as reducible overheads are all the costs related to the sales e.g.:

- transport costs,
- preparation,
- import,
- commissions,
- advertising costs,

In case of a loss-making activity, some courts have considered that no indemnity could be claimed. Similarly some authors (Willemart) considered that the distributor is not entitled to claim an indemnity in lieu of notice if he does not suffer any harm i.e. in case of a high loss-making activity or when there have been serious losses in the last years of the activity. However, according to the method of calculation based on the net profit, the irreducible overheads should be compensated. What matters is that the irreducible overheads that keep on running must be covered. Indeed, one must assume that, at a certain level, the irreducible overheads do not decrease while the sales decline.

Moreover, according to some authors, if the loss is temporary, due to e.g. economic fluctuations, the possible profitability of the activity during the period of notice that ought to be granted should also be taken into account.

When calculating the profit related to the distribution contract, the annual accounts of the distributor are often referred to. The percentage of the distribution activities in question within the global activity of the distributor may then be taken into account when calculating the percentage of profit generated by the distribution contract at issue within the global profit of the distributor. The same percentage should be applied when calculating the overheads.
Regarding the period to be taken into account for the assessment of the indemnity in lieu of notice, most of the courts (Court of Cassation, 25th March 1976, Court of Appeal of Brussels, 21st March 2003, Court of Cassation, 4th December 2003) refer to the period of activity preceding the termination of the agreement only (2 or 3 years usually). In practice, courts try to refer to the period that best represents how the contract has been executed between the parties.

However, according to a more recent interpretation by the Court of Cassation, the judge may consider all the facts that he is aware of at the time of making his decision. This means that the courts, in making their decision, may be guided by

the particular circumstances following the termination of the agreement including the period of notice (provided that termination has not affected the distributor's activity). Therefore, the results that the distributor has obtained during the period in which the termination of the agreement was carried out can be taken into consideration.

Nevertheless, Belgian doctrine indicates that this new interpretation by the courts does not offer sufficient legal certainty. Therefore, the majority of Belgian literature uses evaluation *in abstracto* as a general rule i.e. only the period of activity preceding the termination of the agreement, and the evaluation *in concreto* as an exception, i.e. the period also following the termination of the agreement.

However, equity and the real facts have always guided the judge in each case. It must be pointed out that the courts often require an assessment of the indemnity by an expert.

III.2.4. Supplementary indemnity (goodwill - investments - redundancies)

According to article 3 of the law of 1961 in case of termination of a distribution contract governed by the law of 1961, the distributor and only the distributor has the right to a so-called "supplementary indemnity" when:

* the agreement is terminated by the supplier for reasons other than for serious breach, or
* when the distributor terminates the agreement because of a serious breach by the supplier.

The right to a supplementary indemnity is completely separate from the indemnity in lieu of notice. Indeed these two indemnities have a different aim: the indemnity in lieu of notice aims to compensate the reasonable notice period which has not been awarded, while the supplementary indemnity is meant to compensate all other financial consequences of the agreement's termination. In addition these indemnities are reciprocally autonomous which means that one indemnity is not conditioned by the other.

The additional indemnity may be due for the following three items:

(i) ***any substantial increase of the clientele which has been introduced by the distributor and which remains attached to the supplier after termination of the contract (goodwill indemnity in the stricter meaning);***

The distributor must prove that his work has created the alleged substantial increase of clientele and that this clientele will continue to purchase the products from the supplier. Normally this increase should be calculated using a comparison between the clientele at the beginning of the distribution agreement and the clientele at the end of the agreement but the judge can assess, simply according to the circumstances of the case, that there has been an increase.

However it is not always easy to determine the size of the clientele at the beginning of the distribution activity, especially when the agreement has lasted for a long time. Normally in this last case the court presumes that there was an increase. The conclusion is the same in the case where the distributor was the first distributor of the product in this territory.

(ii) ***all expenses incurred by the distributor in furtherance of the distributorship which will benefit the supplier after the termination of the contract.***

For example, advertising costs might be compensated if the effect of the advertising can still benefit the supplier e.g. when the advertising has been carried out shortly before termination. Costs incurred for after-sales services are also considered to continue to benefit the supplier after the termination of the contract. Indeed, such services can help maintain the reputation of the supplier's products. Therefore, the distributor is entitled to request their compensation.

(iii) ***the amounts to be paid by the distributor to the employees he or she is obliged to dismiss as a result of termination of the distributorship.***

The amount to which the distributor may be entitled is limited. As a matter of fact, the part of the employee's notice period which falls within the notice period that has been granted by the supplier to the distributor may not be compensated. Only the part exceeding this period of notice given by the supplier with respect to the distribution agreement may entitle the distributor to compensation.

The amount of the indemnity is to be calculated on the basis of all the relevant circumstances. In this respect, the courts have a very large power of appreciation as the law does not provide for any mode of calculation of the indemnity.

Case-law shows that no real methodology is followed. Moreover, since there are factual circumstances to be taken into consideration, the outcome of the decisions by the courts is really difficult to foresee and it cannot be held that a particular amount will be generally recognized by the court.

The indemnities awarded vary from 6 months of net profit to 2 years of gross profit. The gross profit is commonly taken by the courts as the basis of the evaluation of the goodwill indemnity. Indeed, the courts consider that the clientele must be valued according to its capacity to produce profit. Other decisions calculate the amount as a percentage of the turnover.

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