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Termination Compensation to Distributors under German Law

Business entities selling merchandise in Germany through local distributors, are often confused as to the statutory compensation payable to such distributors upon termination of the distribution agreement. The confusion is mostly due to the difficulty of statutory interpretation, and also the general fact that the common law legal systems define the various types of distributors less precisely than do the civil law counterparts. This makes it hard to assess what type of distributor is entitled to compensation upon termination.

Throughout this paper the following definitions will apply:

1. *Commercial Agent* (Handelsvertreter) is an independent contractor whose duty it is, on a continuing basis, either to solicit business on behalf of his principal or to transact business in his principals name.¹

(a) *Broker—Agent* (Vermittlungsvertreter) is a commercial agent who solicits business on behalf of his principal on a continuing basis.

(b) *Consignee—Agent* (Abschlussvertreter) is a commercial agent who transacts business in his principal's name and for his principal's account on a continuing basis.

2. *Independent Merchant* (Eigenhändler) is a person who buys and sells in his own name and for his own account.

3. *Commission Merchant* (Kommissionär) is a factor who buys and sells in his own name but for the account of his principal²

4. *Broker* (Handelsmakler) is a person who solicits business for his principal on an ad hoc basis.³

5. *Distributor* is broadly defined to be a generic term encompassing

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¹Section 84 Commercial Code (HG B). ²Section 383 HGB.

³Section 93 HGB.

commercial agent, independent merchant, commission merchant and broker.

6. *Indemnity* (Ausgleich) is the statutory compensation to which certain distributors are entitled upon termination of the distribution agreement.

I. Indemnity Payable to Commercial Agent

Pursuant to the theory that the activity of the commercial agent will continue to benefit the principal after the distribution agreement has come to an end, the principal is obligated to pay the commercial agent an indemnity for such future benefits. The law assumes that customers acquired for the principal by the commercial agent, will in many cases continue their business dealings with the principal even after employment of the commercial agent has been terminated.

The relevant portion of Section 89b HGB reads as follows:

I. After the contractual relationship has come to an end, the commercial agent may demand appropriate indemnification from the principal, if and insofar as

1. the principal derives substantial benefits after the termination of the contractual relationship, from the business connections with new customers which the commercial agent has acquired.

2. due to the termination of the contractual relationship, the commercial agent loses claims for commissions which he would have received upon continuation of the same from business transactions, either already concluded or to be concluded in the future, with those customers which he acquired. and

3. after considering all the circumstances, the payment of an indemnity would conform to the principles of fairness.

If the commercial agent has substantially increased the business connection with one customer, so that this is economically comparable to the acquisition of a new customer, such will be considered tantamount to the acquisition of a new customer.

II. The maximum amount of the indemnity shall be the average annual commission or other annual compensation over the past five years of the commercial agent's activity; if the contractual relationship has a shorter term, the average during the term of his activity shall control.

III. This claim does not arise if the commercial agent has terminated the contractual relationship without having been given cause therefor by the behavior of the principal. The same applies if the principal has canceled the contractual relationship, and there was an important reason for such cancellation due to the culpability of the commercial agent.

IV. This claim cannot be precluded in advance. It must be asserted within three months after the end of the contractual relationship.

A. *Required Elements*

The prerequisites for the commercial agent's claim for indemnification are the following:

I. END OF CONTRACT

The contract between the commercial agent and the principal must have come to an end. It is fundamentally insignificant how the termination came about. Typical situations are termination by the principal, expiration of a fixed term, and the occurrence of a condition precedent to termination. Situations such as the death, incapacity, or bankruptcy of the commercial agent also fulfill this requirement in most cases. The principal's reduction of the agent's territory or products, as well as other changes in the distribution agreement, can pose borderline problems⁴

The commercial agent, however, is not entitled to indemnification if he himself terminates the agreement without cause. The same applies if the principal terminates the agreement for important reasons such as the default or culpability of the commercial agent.

2. BENEFIT TO PRINCIPAL

A further requirement is that the principal must have substantial benefits after termination, from the new customers which the commercial agent acquired for the principal during the term of the agreement.

New customers are those with whom the principal did not have prior business relationships. The statute provides that if the commercial agent has so expanded the business with existing customers, and this expansion is economically comparable to the acquisition of new customers, the requirement that new customers be acquired will have been met. This is referred to as the intensification of business with respect to existing customers. A new customer can also be one who at one time had business dealings with the principal, and since then has been reacquired by the commercial agent.⁵

The principal must derive substantial benefits from the newly acquired customers after the termination of the distribution agreement. Such benefits include continued business dealings with such customers which have a substantial and favorable impact on the principal's earnings. If, for example, the principal goes out of business or if the new customers follow the commercial agent to a competitor, there is no benefit to the principal and therefore no indemnification.⁶

3. DETRIMENT TO COMMERCIAL AGENT

The statute not only requires that the principal have benefits, but con⁴For an extensive discussion see W. Küstner. *Der Ausgleichsanspruch des Handelsvertreters*, 65 et seq. (3rd ed. 1971).

⁵Baumbach-Duden. *Handeisgesetzbuch*, 300 (19th ed., 1971).

⁶*Id.* at 301.

versely the commercial agent must suffer certain disadvantages as a result of the termination. Due to termination, the commercial agent with respect to new customers, must forego commissions which he would have otherwise received, as a result of concluded business transactions, or as a result of probable future transactions.

The law contemplates that the commercial agent may have brought certain business transactions between a customer and principal to a conclusion, but due to provisions in the distribution agreement, the commercial agent receives no commission after termination. The statute regards such a situation to be a detriment to the commercial agent sufficient to fulfill this requirement for indemnification.

With respect to the loss of future commissions, the law views as a detriment those commissions which the commercial agent would have received, as a result of subsequent business transactions between the principal and the new customers, had the agreement not been terminated. Business transactions between the principal and the customer which are not related or due to the promotional activities of the commercial agent, are not considered for the purpose of determining detriment to the commercial agent.

4. FAIRNESS

After the commercial agent has proved benefit to the principal and detriment to himself, the law obliges him to show that the payment of an indemnity would be fair. The question whether the fairness requirement has been met, must obviously be determined on a case by case basis. The fairness requirement not only determines whether an indemnity should be paid to the commercial agent, but it also plays an important role in measuring the amount of such indemnity.

Generally those circumstances which are unrelated to the contractual relationship between principal and commercial agent are not to be considered when determining fairness. As a rule, the economic and social positions of the parties, as well as the personal relationship between the parties are irrelevant. Similarly, the age, state of health, and earning power of the commercial agent are not relevant except in extreme cases.⁸

How should the duration of the distribution agreement be viewed in terms of fairness? There are two schools of thought with respect to this question. One school takes the position that a long-term commercial agent should be viewed more favorably under the fairness concept, since presum-

ably the commissions did not fully compensate him for his lengthy service. The other school maintains that a distribution agreement of short duration should not be to the disadvantage of the commercial agent in terms of fairness, since the short-term distributor will in all likelihood not have had sufficient time to enjoy the fruits of his labor.⁹ Even though there are no definite rules on this point, the Federal Supreme Court stated on November 19, 1970, that in terms of fairness the commercial agent who acted in that capacity for many years until retirement age should be treated more favorably than a short-term distributor.¹⁰

Other factors which are taken into consideration are the circumstances surrounding the termination, the principal's contribution toward the agent's retirement benefits, liquidated damages, the general success or failure of the agent's activities, and the like.¹¹

B. *Amount of Indemnity*

The amount of the indemnity must be appropriate and reasonable. The amount of the principal's benefit or the amount of the commercial agent's detriment, whichever is less, will control. As mentioned above, this calculation is to be influenced by the fairness and equity of the surrounding, relevant circumstances. As a rule the commercial agent's operating costs will only be taken into account if they are unusually high. The fact that the commercial agent did not achieve a new profit will not necessarily preclude indemnification.¹²

The maximum indemnity payable is the average yearly commission received by the commercial agent over the past five years. If the term of the distribution agreement is less than five years, the average yearly commission of such shorter period will be used as the maximum. The gross commission (before deduction of expenses) is used to determine the maximum figure.

Needless to say the calculation for determining the amount of the indemnity is extremely complex. Projections must be made to determine the benefit to the principal and the detriment to the commercial agent, with respect to future business transactions between the principal and the new customers. Theoretically this figure could approach infinity unless one assumes that these customers will gradually drift away without the continuing efforts of the commercial agent.

⁹Baumbach-Duden at 303.

¹⁰Küstner at 203.

¹¹Baumbach-Duden at 303.
¹²Ibid at 303—304.

Consequently, the benefit/detriment for the first year after termination is calculated, and this figure is then diminished over subsequent years by a certain percentage reflecting estimated customer attrition. Thus the total benefit/detriment is calculated. Thereafter this number is either increased or decreased pursuant to the principles of fairness, and only after this has been accomplished will the maximum indemnity payable be considered.

Due to this extreme complexity, the temptation exists first to compute the maximum indemnity payable and thereafter to reduce that number, if necessary, by the concepts of fairness. This method is considered improper for it scarcely takes into consideration the benefit/detriment calculation, and the courts have so held.³

C. Preclusion and Assertion of Claim

Prior to termination the commercial agent, even on an entirely voluntary basis, may not waive this claim for indemnification, whether this waiver be supported by consideration or not. Any advance agreement restricting the agent's claim is void. Once the agreement has been terminated, the commercial agent may settle the claim in any manner he chooses. Consequently a waiver after termination will be effective. ~4

The claim must be asserted no later than three months after termination. It may, however, be brought prior to termination. The claim may be asserted orally or in writing, for there are no form requirements with respect thereto.⁵

7. CHOICE OF LAW

If a non-German principal enters into an agreement with a German commercial agent, the parties may stipulate that the agreement be governed by the law of the principal's domicile. This entire question would then be resolved pursuant to the laws of that other jurisdiction, and if those laws do not grant an indemnity, the German courts would deny the commercial agent's claim. It follows, therefore, that in such a case the parties may resolve the matter of indemnification in whatever manner they wish.⁶

II. Indemnity Payable to Independent Merchants

Section 89b HGB refers only to commercial agents. Ever since the enactment of this statute the question has therefore been posed, whether it could be made to apply by analogy to independent merchants.

³Küstner at 275.

⁴Baumbach-Duden at 304—305.

⁵*id.* at 305.

⁶KUstner at 53 *et seq.*

It has been held by the Federal Supreme Court that Section 89b HGB may apply by analogy to independent merchants, if the relationship to the principal is such that the independent merchant has become integrated into the distribution organization of the principal.⁷ The independent merchant must distribute the principal's products on a continuing basis pursuant to some kind of distribution agreement. It is not sufficient if the merchant occasionally acts as a wholesaler or retailer with respect to the principal's products. No clear and definite guidelines have been established, but the courts speak of three requirements which should be met before granting an indemnity to an independent merchant:⁸

1. The relationship between independent merchant and principal should be similar to the typical relationship between commercial agent and principal. In particular the agreement should provide the independent merchant with an exclusive sales territory and bind him to obligations which the ordinary independent merchant does not perform, such as providing extensive information with respect to sales and customers, promising not to compete with the principal, selling at prices determined by the principal, etc. In essence, the courts are saying that one cannot evade Section 89b HG B by merely changing the distributor's classification from commercial agent to independent merchant.

2. Just as with the commercial agent, the principal must, at the end of the distribution agreement, have the benefit of the new customers. Since the commercial agent acts on behalf of the principal, and is obligated to further the interests of the principal, the new customers can be said to be customers of the principal and not of the agent. This, however, is not the case with the independent merchant. He acts in his own name and for his own account. and therefore the customers he acquires can be said to be his own.

In order for the independent merchant to be sufficiently similar to the commercial agent, the merchant's customers must somehow become the principal's customers at the end of the agreement. Therefore the courts look to an agreement between principal and merchant, obligating the merchant to relinquish customers to the principal upon termination. It is assumed that by relinquishing his customers to the principal, the independent merchant has suffered a detriment, and the principal has received a benefit for which an indemnity is payable.

However, a mere contractual provision obligating the independent merchant to relinquish his customers upon termination is not sufficient. An indemnity is only allowed if the independent merchant does in fact

⁷*Id.*, at 47.

⁸Baumbach-Duden at 248.

relinquish his customers, and if as a consequence of such action the principal does receive benefits from such customers. The necessary causal connection is not given (*i.e.*, no indemnity is payable) if and insofar as the principal would have acquired such customers without the merchant's obligation to relinquish the same. This is the case if, for example, due to brand loyalty the customers would have transferred to the principal in any event.

Similarly, if in spite of the merchant's obligation to relinquish customers, such customers remain loyal to the merchant or transfer to another manufacturer, the principal will not receive benefits and therefore no indemnity is payable. The Federal Supreme Court has ruled that the independent merchant's obligation to keep the principal currently informed, with respect to customers is tantamount to the contractual obligation to relinquish customers.⁹ The court assumes that the principal will be able to use such information to his benefit after termination.

3. The independent merchant must be in need of such indemnity protection. This means that in an economic sense the independent merchant must fit the typical model of the commercial agent which the legislature had in mind when it drafted Section 89b HGB. This is often the case where the merchant is small and has little or no bargaining power *vis-à-vis* the principal. This is also true where the commercial agent has little or no capital assets and instead relies on loans from the principal. If the independent merchant conducts his business by himself without the help of employees, the need of indemnity protection may also be indicated.

Therefore, if the relationship between independent merchant and principal meets the above three requirements, the independent merchant may be treated as a commercial agent for purposes of Section 89b HG B.

III. Indemnity Payable to Commission Merchant

If the commission merchant on a continuing basis buys and sells in his own name but for the account of his principal, his function becomes very similar to that of the commercial agent. In fact, he is much more closely related to the commercial agent than is the independent merchant. It follows, therefore, that Section 89b HGB can also be made to apply by analogy to the commission merchant.

The criteria for applying Section 89b HGB to commission merchants are basically the same as those set forth above with respect to independent merchants. That means that 1) the function of the commission merchant should be very similar to that of the commercial agent: 2) the principal

⁹ Küstner at 49.

must benefit from the new customers after termination: and 3) the commission merchant must be in need of the indemnity protection.

The consignee-agent (a sub-category of commercial agent) and the commission merchant differ from each other only insofar as the former transacts business in the principal's name, while the latter transacts business in his own name. Both do business for the account of the principal. The functional similarity between commission merchant and commercial agent may therefore be assumed in most cases.

Since, by operation of law, the commission merchant must relinquish the customers he acquired while acting in this representative capacity for the principal,²⁰ the second criterion is automatically met.

It must be determined on a case by case basis whether the commission merchant is in need of the indemnity protection. Generally the commission merchant will have a much smaller capital investment than the independent merchant, and due to this economically weaker position, Section 89b HGB will be applied to him by analogy much more readily.

As a rule, the commission merchant who has had a continuing relationship to the principal, is entitled to indemnification upon termination of the distribution agreement.²¹ However, it must not be overlooked that, when applying Section 89b HGB to the commission merchant, one does so by analogy, since the legislature did not specifically grant indemnification to this type of distributor. Consequently the facts in each particular case must be carefully reviewed in order to be sure that an analogy is appropriate.

IV. Indemnity Payable to a Broker

If a distributor solicits business on behalf of his principal on a continuing basis, he is a broker-agent and therefore a commercial agent entitled to indemnification. If, however, he is a broker soliciting business on an ad hoc basis, there is no sufficient similarity between him and the commercial agent to permit the application of Section 89b HGB by analogy.²² It is, after all, the benefit/detriment resulting from the distributor's continuing effort on behalf of the principal which justifies indemnification. Whenever such continuing effort is lacking, no indemnification will be payable.

V. Conclusion

American lawyers will look in vain for a discussion concerning the significance of passage of title to goods. United States courts often tend to

²⁰Section 38411 HGB: Baumbach-Duden at 247.

²¹Küstner at 50—52.
~1d. at 43.

describe the principal-distributor relationship in terms of which party has title, dominion and risk of loss.²³ In Germany this relationship is not so much described in terms of internal indicia, but instead in terms of how the distributor appears to third parties, *i.e.* whether he transacts business in his own name, in the principal's name, for his own account, for his principals account, etc.

In summary, it may be said that Section 89b HGB is applicable to commercial agents, whether they be broker-agents or consignee-agents. The sole question which must be resolved with respect to these distributors is whether the individual requirements of the statute are met. The statute does not specifically apply to independent merchants or commission merchants, but if the individual functions of these distributors are sufficiently close to those of the typical commercial agent, Section 89b HG B may be applied by analogy. Such application by analogy is much more frequent in cases involving commission merchants, than in cases involving independent merchants.

The non-German principal using German distributors should always bear in mind that, under certain circumstances a choice-of-law clause in the contract may provide the parties with sufficient freedom to resolve the question of termination compensation as they see fit.

²³ *E.g.*, U.S. v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).