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Indemnity for Goodwill and Termination of Distribution Contracts under Swiss Law

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According to a new decision of the Swiss Federal Court, a distributor is entitled to indemnity for goodwill contributed by it to a supplier if the distributor's situation is comparable to an agent. Another recent decision seems to suggest that a distributor can seek specific performance of a contract terminated by its supplier in breach of the contract's terms.

As trade is becoming increasingly international and sophisticated, producers regularly use the skills and efforts of other independent economic actors to bring their products to the market. Vertical agreements, such as commercial agency, franchise and distribution contracts are the legal backbone of modern production and distribution chains.

A distribution contract can be defined as a contract under which the supplier agrees to supply the distributor with products on a continuing basis and the distributor agrees to purchase them and sell them on its own behalf. The distribution is often made "exclusive", i.e., the supplier undertakes to supply its products to only one distributor in a certain territory. Accordingly, distribution contracts allow the supplier to make use of the market knowledge and infrastructure of the distributor, while shifting the economic risk to the widest possible extent to another independent business. This, in particular, distinguishes distribution contracts from commercial agency contracts under which the agent acts on a continuing basis as an intermediary of the principal but the latter remains the contractual partner of the end customer.

Distribution contracts under Swiss law

Swiss contract law does not contain specific provisions for distribution contracts. Rather, a distribution contract is considered a so-called "innominate contract" which combines, among other things, elements of a sales contract, a commercial agency and a mandate agreement. If the distribution agreement does not regulate a specific issue, the statutory provisions relating to these three types of contracts may, however, be applied by analogy as default rules to the extent suitable in a given case.

The scope of the distributor's independence in conducting its business will depend on the degree of its integration in the supplier's sales organisation. In practise, distribution contracts often include additional commitments by the distributor, allowing the supplier to retain a certain control over the distribution channels (e.g. provisions regarding marketing and advertising, annual minimum purchase quantities and stocks, customer service, etc.). The greater the degree of integration and the distributor's relationship-specific investments are, however, so also is the risk that protective mandatory rules will be applied or that competition law issues will arise. In particular, if the extent of vertical integration is such that the distributor is similar to a commercial agent, this may trigger an analogous application of the mandatory rules provided by articles 418a *et seq*. of the Swiss Code of Obligations ("CO") for the protection of the agent.

Indemnity for goodwill

In a case decided by the Federal Court on 22 May 2008 (Case No. 4A_61/2008), an exclusive distributor for various brands of perfumes brought an action for the indemnification of goodwill against the supplier who had terminated their long-term distribution contract. The Federal Court reviewed its position adopted in a decision rendered in 1962, in which it held that a distributor may not avail itself of article 418u CO. This provision provides for an agent to receive indemnity for goodwill if (i) the agent substantially increased the principal's customer base, (ii) the principal continues to substantially benefit from such goodwill after termination of the contract and (iii) the termination is not a result of the conduct of the agent.

Observing a general trend to increased vertical integration, the Federal Court held that an exclusive distributor is – subject to the above requirements set forth in article 418u CO – entitled to indemnity for goodwill if its situation is economically comparable to an agent. This is the case if (i) the distributor is closely

integrated into the supplier's sales organisation and (ii) the generated goodwill remains with the supplier after termination. However, these requirements must be examined on a case-by-case basis and the burden of proof lies with the distributor.

The Federal Court found that the first requirement was fulfilled as the distributor was contractually bound to, among other things, order an annual minimum quantity, accept unilateral changes in sales prices and conditions, invest in advertising for the brand's products, periodically report on its sales and provide the supplier with information about its customers. Regarding the second requirement, the Federal Court emphasised that in the case of typical, branded consumer goods such as perfumes, there is an expectation that customers will continue to buy the supplier's brand of goods rather than to follow the distributor upon the termination of the contract. Hence, in the case of branded consumer goods, the goodwill generated by the distributor will almost always remain with the supplier.

The Federal Court accordingly granted the claim for the indemnification of goodwill contributed to the supplier by the efforts of the distributor, and, more generally, further held that the right to such indemnity is mandatory and cannot be validly waived in advance.

The amount of the equitable compensation due is determined by the judge in line with article 418a CO, taking into account all relevant circumstances. The compensation, however, may not exceed the distributor's average net earnings for one year.

Ineffectiveness of unjustified notice of termination on long-term contracts

In another recent decision (BGE 133 III 360), the Federal Court had to decide on the legal consequences of an anticipated unilateral termination of a licensing agreement; in particular, whether the lower court correctly applied the law when finding that a long-term contract, essentially based on co-operation and mutual trust, is effectively ended by the principal's notice of termination, even if given in breach of the contract's terms, thereby leaving the aggrieved party with damages as the only remedy.

The Federal Court repeated the general principle that all long-term contracts may be prematurely terminated for important reasons, i.e., for such grounds which would render the continuation of the contractual relationship unacceptable and unreasonable. Rejecting the cantonal court's finding, the Federal Court emphasised that, absent such important reasons, a premature termination is without any legal effect. Consequently, both parties remain bound to perform the contract and the aggrieved party may seek specific performance. Only if statutory law provides for an express exception to this general rule will a notice given in breach of the contract's terms nevertheless terminate the contract.

It should be noted, however, that the Federal Court held in an earlier decision on a commercial agency contract that the agent is limited to damages as a remedy for an unjustified termination by the principal (BGE 125 III 14). Similarly, the above decision differs from the solution retained in the Principles of European Law on Commercial Agency, Franchise and Distribution Contracts, which provide that the non-observance of a reasonable notice period entitles the aggrieved party to damages only. Hence, the law may not be finally settled on this issue as regards distribution agreements.

Conclusion

Despite their fundamental economic importance in modern commerce, Swiss law does not provide a specific statutory regime for distribution contracts. Therefore, suppliers and distributors are well advised to comprehensively regulate their relationship through a written agreement. As regards contract termination, the parties may wish to expressly specify certain circumstances which they mutually consider to constitute an important reason for ending the contract, or they may agree on the nature of relief available if a termination notice is given in breach of contract. In light of the new decision summarised above, suppliers in particular must be aware when planning their distribution network that the specific arrangements may create a non-waivable right of a distributor to indemnity for the goodwill it has contributed to the supplier.

The ww&p NewsLetter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this NewsLetter should seek specific advice on the matters which concern them.

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