

## WING TIPS

### *Commercial Agents' Compensation Claims*

In a landmark ruling last year, the House of Lords, after almost 15 years of uncertainty, clarified the appropriate method for calculating the amount of compensation to which commercial agents in the UK are entitled on termination of their agency agreements. The decision, in *Lonsdale v Howard & Hallam Ltd*[\[i\]](#), will affect most businesses (whether based in the UK or overseas) who use agents to market and sell goods in the UK, and is likely to have a significant impact on the amount of compensation which those businesses must pay to agents on termination of their agency relationships.

#### **Legal background**

Under the Commercial Agents (Council Directive) Regulations 1993 ('Regulations')[\[ii\]](#), commercial agents selling goods in the UK are entitled to a lump sum payment on termination of their agency agreements. Two alternative methods exist for calculation of this lump sum: the indemnity method (which has its origin in German law); and the compensation method (which has its origin in French law).

In the UK, the parties to an agency agreement are free to choose which of the two alternatives apply but, in the absence of an express choice, the compensation method will apply by default[\[iii\]](#). This is significant, as the amount which an agent can recover under the indemnity method is capped at a maximum of one year's commission; the amount which can be recovered under the compensation alternative is uncapped.

The UK courts have struggled with the application of both alternatives, and the (uncapped) compensation method in particular. In some cases, the UK courts have looked to French law for guidance, under which a commercial agent can typically expect to receive twice the average annual gross commission earned under the agreement[\[iv\]](#). Other UK courts have considered that this approach gives agents an unfair windfall, and have sought to bring awards under the compensation alternative into line with the maximum amount recoverable under the indemnity alternative[\[v\]](#).

This lack of consistency has made it difficult for the parties to a UK agency agreement to agree the amount of compensation to be paid to the agent on termination, with the result that many cases have been ended up before the UK courts.

The decision in *Lonsdale* removes much of this uncertainty, and provides principals and agents in the UK with a commercial basis for agreeing compensation payments without the need to resort to the courts for resolution.

### **Lonsdale: facts**

Mr Lonsdale was a commercial agent in the shoe industry. In 1990, he was appointed by Howard & Hallam (H & H) to sell their brand of shoe. H & H found themselves unable to compete on price and quality, and in 2003, due to rising costs and falling sales, they ceased trading and sold their brand to a competitor. Lonsdale's agency agreement was terminated on six month's notice.

The parties were unable to agree the amount of compensation payable, and Lonsdale brought proceedings before the UK courts claiming that, as a general rule, he was entitled to compensation equal to two years' gross compensation. The court at first instance rejected this general two year rule, and held that the correct approach to calculating an agent's compensation entitlement was to value the commercial goodwill of the agency on the open market.

The decision was upheld by the Court of Appeal, and Lonsdale appealed to the House of Lords.

### **Judgment of the House of Lords**

The House of Lords, in the leading opinion delivered by Lord Hoffman, addressed two key issues relevant to the calculation of an agent's compensation entitlement: first, exactly what an agent is to be compensated for under the Regulations; and second, how that compensation is to be valued.

On the first issue, Lord Hoffman found the legislation to be explicit – the agent is to be compensated for “the damage he suffers as a result of the termination of his relations with the principal”. Because the value of an agency relationship lies in the prospect of earning future commission, and the agent's expectation that “proper performance of the agency contract” will provide him with a future income stream, it is that future income stream which needs to be valued.

On the question of how that compensation should be valued, the Lords firmly rejected the notion that the UK courts were required to follow the French law practice of valuing agencies at twice the average annual gross commission. This was for two reasons: first, European case law had established that while the entitlement to compensation was mandatory, Member States had discretion as to the choice of method for calculating the compensation<sup>[vi]</sup>; and second, commercial agents in France operated in market conditions which were different to those in the UK<sup>[vii]</sup>.

Instead, the House of Lords held that the correct method was to value the agency by reference to what a hypothetical purchaser would pay for that agency on the open market. This valuation is to be carried out in the same way as any business would be valued, taking into account any 'real world' factors which would influence the amount that a purchaser on the open market would pay for the agent's business.

Although Lord Hoffman did not give an exhaustive list of factors to be taken into account in making a valuation (on the basis that this should be determined by market practice and conditions at the time), he gave an indication of some of the factors which he thought would be relevant to the valuation (and which are likely, therefore, to be taken into account by courts in the future).

In particular, Lord Hoffman indicated that the valuation should be by reference to *net* earnings (some previous awards had been calculated on gross commission), and, that because a value is being placed on future income, those future earnings should be discounted by an appropriate level of interest. Most significantly, perhaps, the question as to whether the market for products sold by the agent was rising or declining would be a major factor in determining the amount which a purchaser would pay for the agent's business.

The potential impact that this approach could have on the calculation of an agent's compensation entitlement is apparent from Lord Hoffman's view in *Lonsdale* that, because H & H had ceased trading and had closed its business, the commercial agent in that case was not entitled to any compensation.

### **Comment**

The House of Lords decision is to be welcomed in that it cuts through some 15 years of diverging, and at times contradictory, judgments on the appropriate method for calculating the compensation payable to an agent, and finally kicks into touch the notion that, as a general rule, two years' gross commission should be payable on termination. In endorsing the position that it is the loss of the agent's future income stream (in the form of commission) that Regulation 17 is intended to compensate for, and that the correct method of calculation is to look at what a hypothetical purchaser would pay for the agency, taking into account all relevant 'real-world' factors, the decision should provide principals and agents in the UK with a sound commercial basis for reaching settlement on the agent's compensation entitlement, and should, therefore, reduce the number of cases which end up before the courts for resolution.

However, the decision should not be interpreted as meaning that principals will now have to pay less under the compensation alternative than was previously thought to be the case. Although the House of Lords in *Lonsdale* concluded that the agent in that case was not entitled to any compensation, this conclusion was due to the fact that the principal's business had ceased trading. At the other end of the scale, principals whose businesses are highly successful may be required to pay significantly more than two years' gross commission to their agents on termination.

That this is a genuine concern is apparent from the intervention, in *Lonsdale*, by the Wine Federation of Australia (WFA), on behalf of Australian wine growers. These wine growers use agents to sell their produce to UK supermarkets, and were concerned that, with the continuing consumer demand in the UK for Australian wines, they would face potentially crippling compensation payments if they were to terminate their agreements with those agents, since the market value for those businesses is significantly higher than the equivalent of two years' gross commission. This concern was accentuated by the fact that these former agents could, following termination, persuade the supermarkets to switch to the produce of an alternative wine grower.

The House of Lords was of the view that circumstances such as these would be reflected in the valuation process – if there was a risk that all customers would defect to the former agent then it was unlikely that a purchaser would be prepared to pay much for the agency.

It remains to be seen what impact the House of Lords decision in *Lonsdale* will have on market practice in the UK. However, on the basis that businesses which are highly successful could end up paying significantly in excess of two years' commission under the compensation alternative, it is likely that the indemnity alternative (with its one year cap) will continue to be seen as the better option by most businesses who sell through agents in the UK.

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## Notes

[i] *Lonsdale v Howard & Hallam Limited* [2007] UK HL 32.

[ii] The Regulations implement Council Directive 86/653/EEC on the co-ordination of the laws of the Member States relating to self-employed commercial agents.

[iii] For an overview of the approach adopted by other member states, see the European Commission's report on the implementation of the Article 17 of the Directive at [http://aei.pitt.edu/1489/01/commercial\\_agents\\_COM\\_96\\_364.pdf](http://aei.pitt.edu/1489/01/commercial_agents_COM_96_364.pdf).

[iv] In *King v Tunnock Ltd* 2000 SC 424, for example, the Scottish Courts awarded the commercial agent compensation equivalent to the gross commission that he had earned in the two years prior to termination of the agency relationship.

[v] See, for example, *Tigana Ltd. v. Decoro Ltd* (2003) EWHC 23 (QB), where the agent was awarded the equivalent of 14 months net commission.

[vi] Lord Hoffman, relying on *Honeyvem Informazioni Commerciale Srl v Mariella de Zotti* [2006] ECR I-02879.

[vii] In France, for example, when agencies are assigned or sold to a third party, it is common for a premium of twice the gross commission to be charged on the transaction. This has led to some principals in France demanding payment of an estimated twice gross commission in return for the grant of a commercial agency, even if they have to lend the agent that money.