Compensation Claims Arising out of Distribution Agreements under Turkish Law Introduction

Introduction

As a sui generis agreement under Turkish law, distribution agreement mainly contains the characteristics of a sales and purchase agreement; however, it also differs from the same since the distributor's role is not limited to simply purchasing the products from the supplier/principal and selling them to customers or end-users. Instead, in a distribution agreement, the distributor is incorporated into the distribution chain of the supplier with having the right and duty to sell and market the supplier's products usually in a specific geographical region on its own behalf.

Like many countries, distribution agreements are frequently used among merchants in Turkey. Especially, because of the increase in the level of foreign investment in the Turkish market during the last decades, the number of distribution relationships with foreign suppliers increased as well. However, in the recent years, we have been instructed by many principles who would like to terminate their relationship with the distributor. For example, the foreign investor may prefer marketing and selling its products directly in Turkey without using a distributor or it simply decides to exit the country based on economic grounds or may decide to change its distributor due to distributor's breach of global corporate and/or compliance rules or simply due to not being satisfied with the sales performance of its current distributor. As a result, upon termination of the distribution agreements due to similar reasons, the suppliers usually face with distributors' high compensation claims.

In some cases, the supplier and the distributor manage to end the relationship through peaceful means by signing mutual termination protocols and agreeing on the termination terms. However, in some others, we see that the distributors resort to the courts or arbitration (according to the dispute resolution clause of the agreement between the parties). Although foreign suppliers tend to terminate the agreements via settlement considering the lengthy and costly judicial process before Turkish courts, sometimes settlement negotiations give no result due to the astronomical numbers requested by the distributors.

Especially due to the contradictive and groundless decisions of the local courts in addition to the judicial process which may last six to seven years including the appeal process, we wanted to write this article to shed light to the suppliers who may face with compensation claims arising out of the termination of distribution agreements under Turkish law.

Accordingly, below we will first summarize the legal nature of the distribution agreements and legal provisions applicable to the same. This section will be followed by the details of the portfolio compensation. Then we will give information as to the potential claims to be raised (in addition the portfolio compensation) upon termination of a distribution agreement.

I. Legal Nature of the Distribution Agreement under Turkish Law and Legal Provisions Applicable to the Same

As briefly indicated under introduction section above, distribution agreements are qualified as sui generis agreements and are not specifically regulated under Turkish law. Although being similar with sales and purchase agreement, it also contains features of various other agreements. It is accepted by the Turkish legal doctrine that especially the provisions of agency agreements as stipulated in the Turkish Commercial Code[1] ("TCC") should be applied to distribution agreements by analogy. Nevertheless, considering that a distribution agreement is actually a debt-credit relationship, disputes arising from distribution agreements may be resolved in line with the general provisions of the Turkish Civil Code[2] ("Civil Code") and the Turkish Code of Obligations[3] ("TCO") in addition to the TCC.

We can say that due to the lack of explicit legislative basis, at present, distribution agreements are mainly evaluated on a case-by-case basis by analogies and particularly in light of the court precedents. Also, court cases arising out of distribution agreements (i.e., loss of profit and portfolio compensation) are not settled yet and there are various debates among the scholars as to the conditions of the compensation and amounts of the same.

II. Portfolio Compensation

A. Legal Background

Portfolio compensation is the primary compensation claim arising out of distribution agreements. Before the TCC became effective on 1 July 2012, portfolio compensation was only recognized by the decisions of the Court of Cassation[4], but it was not set forth by the law.

Portfolio compensation was first regulated in Article 122[5] of the TCC. The mentioned article mainly focuses on agency agreements, however; it also applies to exclusive and continuous contractual relationships such as exclusive sales agreements, exclusive distribution agreements, franchising agreements, and license agreements.

B. Conditions for the Portfolio Compensation

In accordance with Article 122/1 of the TCC, for the distributor to be provided with the portfolio compensation after the termination of the distribution agreement, the following cumulative conditions shall be met:

i) The principal, by virtue of the customers gained by the distributor, shall continue gaining significant benefits also after the termination of the agreement[6].

ii) The distributor, as a result of ending the agreement, loses profits and incur financial losses in relation to potential sales which would have been made by him in near future to the clients gained by himself, if the relationship had continued[7].

iii) When the material facts are examined, the portfolio compensation payment shall comply with the equity principle[8].

Where the distribution agreement is (i) automatically expired[9], (ii) terminated by the principal in line with the convenience clause (i.e., by providing a period to the distributor before the termination) or (iii) terminated by the distributor with just cause, the distributor will be entitled to obtain the portfolio compensation provided that the above-listed conditions are cumulatively satisfied.

On the other hand, according to Article 122/3 of the TCC, the portfolio compensation cannot be requested if the agreement is terminated with just cause by the supplier or terminated without any just cause by the distributor.

C. Calculation of the Portfolio Compensation

Turkish law does not stipulate a calculation method for the portfolio compensation. There is also no detailed explanation in the court decisions in that regard. The TCC only sets up an upper limit for the portfolio compensation in Article 122/2 where it is regulated that the value of the portfolio compensation cannot exceed the average value of the annual commissions or other payments that the distributor has collected as result of its activities within the last five years. In cases where the distribution relationship has continued less than five years, the average during the continuation of the agreement is considered to determine the upper limit.

In accordance with the freedom of contract under the TCO, the parties can determine special calculation methods for the portfolio compensation in their agreements. However, in such a case, the upper limit determined in the TCC cannot be changed to the detriment of the distributor by the parties[10].

Although the Turkish law and the Court of Cassation's precedents do not stipulate the exact calculation method for the portfolio compensation, the scholars have an established view on how the portfolio compensation should be calculated. In their view, the portfolio compensation should be calculated by following the below three steps[11]:

1. In the first step, the supplier's benefit gained from the customers brought by the distributor, and the distributor's loss because of the termination shall be calculated. In German Law, this amount is the net amount of the income acquired by the distributor in the last 12 months prior to the termination of the agreement. The below values shall be considered while applying the first step[12]:

- Former Customers: The income generated from the former customers with whom the supplier was working before the distribution agreement should not be considered.

- The Distributor's Expenses: The expenses incurred by the distributor must be deducted from the total income to find out the distributor's net income.

- Commission Paid for the Expenses: The fees paid by the supplier to the distributor for the management activities, warehouse maintenance, temporary customers, etc. shall be excluded from the calculation. Only the commission paid for gaining customers, entering into agreements, and mediating the conclusion of the agreement shall be considered in the calculation.

- The Supplier's Customer Loss: As the distribution agreement is terminated, it may not be possible for the supplier to work with the customers gained by the distributor in the following years. Meaning that some of these customers will be lost, and this will affect the supplier's benefit. That is why the potential customer loss should also be considered in the calculation. The number of the years and the percentage for this customer loss must be calculated by the court.

2. In the second step, the supplier's benefit and the distributor's loss calculated in the first step should be adjusted as per the equity principle. Reason for the termination of the agreement, the supplier's efforts in the customer portfolio creation, the power of the supplier's trademark, etc. shall be considered and a deduction shall be made from the amount calculated in the first step in accordance with the equity principle.

Moreover, an interest deduction shall also be applied to the total amount as the income to be received by the distributor for the years in which the distributor agreement would continue will be paid to the distributor at once and in advance.

3. In the third step, the total amount calculated as per the first and second step should be subject to the upper limit foreseen in the TCC. In case the calculated total amount is above the upper limit, it should be reduced to the upper limit.

Although this is the calculation method foreseen in the doctrine, in cases where the portfolio compensation is claimed by the distributor, the courts generally obtain an expert report and rule the amount determined by the expert as the portfolio compensation. We cannot say that the local courts and the court appointed experts have a comprehensive knowledge regarding the calculation method adopted by the doctrine. Therefore, in practice, the experts appointed

by the courts during proceedings usually calculate very high compensation amounts which would not be reasonable and equitable at all; thus, which are not acceptable for the suppliers. As a result, court decisions are usually appealed by the suppliers which makes the judicial process even longer.

III. Potential Claims to be Raised Together with the Portfolio Compensation

Upon termination of a distribution agreement, in addition to the portfolio compensation, some other types of compensations stipulated under the TCC and the TCO can be claimed from the principal especially in cases where the principal's termination is deemed unjust.

Accordingly, in practice, the distributors direct the below claims to the principals:

(i) compensation for uncompleted businesses under Article 121/4 of the TCC,

(ii) compensation for loss of profit under the TCO as positive damages, and

(iii) compensation for significant investments under the TCO as negative damages.

Compensation to be requested can vary according to whether the termination based on just cause or based on the convenience clause (i.e., by providing a period to the distributor before the termination) is lawful or not.

A. Termination of Distribution Agreements and Unjust Termination

i. Termination by Just Cause

Distribution agreements with a definite term or with an indefinite term can always be terminated with a just cause at any time with an immediate effect. For this termination to be lawful, the reason to terminate the agreement shall be deemed as just cause by the court considering the material facts of each case. In Turkish law, examples of just cause can be listed as distributor's failure to comply with the provisions of the distribution agreement, destruction of the trust between the parties or the distributor's bankruptcy[13].

In case the reason behind the principal's termination is not deemed a just cause by the court, the termination will be considered as unjust termination.

ii. Termination by Convenience Clause (Ordinary Termination)

Convenience clause in the distribution agreements (with an indefinite term) allows the parties to terminate the agreement with no reason by providing a termination notice period during which the agreement will continue to be effective. There are two cumulative conditions for an ordinary termination to be lawful[14]:

a) The time granted for the ordinary termination shall be in line with the agreement, the TCC and the precedents.

According to Article 121/1 of the TCC, distribution agreements with an indefinite term can be terminated by providing the other party with three months' prior written notice of termination. In line with the freedom of contract, the parties can agree on a longer notice period.

Although the TCC sets forth the minimum period for the ordinary termination, in cases where the parties do not specify a period for the ordinary termination in the agreement, Turkish scholars argue that the judge should determine the length of the termination notice by considering the facts of the concrete case (such as the duration of the relationship, the magnitude of the investments realized by the distributor for the proper performance of the obligations and the time needed by the distributor to tolerate the loss in its commercial operations).

There are also Court of Cassation decisions which -by considering the characteristics of the concrete case- state that the period to be provided for the ordinary termination should be longer than three months[15]. Therefore, especially for relationships which have continued for long years, to be on the safe side, at least six months should be provided to the counterparty for a lawful ordinary termination.

b) The ordinary termination shall not constitute abuse of right.

The ordinary termination may be considered as an abuse of right when the agreement is terminated to harm the distributor or terminated by not observing the interest of the distributor. For instance, the termination constitutes abuse of right if/when the agreement is terminated since the

exclusive distributor did not accept the offer of the supplier (e.g., reducing the discounts granted to the distributor) which would have negative consequences for the distributor.

In a potential dispute, the court will examine the characteristics of the relationship and decide whether the ordinary termination constitutes abuse of right or not.

If the ordinary termination is not realized by considering the period determined in the agreement, in the TCC or in the precedents or if the ordinary termination constitutes abuse of right[16], then the termination will be deemed unjust.

B. Details of the Compensations

Below we provide the list and the explanations of the compensation types that can be requested by the distributor if the supplier's termination is lawful or unjust.

a. If the Principal's Termination is Lawful

If the termination is realized by the supplier based on a just cause and the termination is valid, then the distributor will not be entitled to any type of compensation including the portfolio compensation.

If the termination is realized by the supplier based on the convenience clause and such ordinary termination is valid, the agreement will be deemed terminated once the notification period expires. In such circumstance, the following requests may be raised by the distributor:

1. Compensation for Significant Investments (Negative Damages)

This termination compensation is classified as negative damages under the TCO. Negative damage is the difference between the distributor's assets after the termination and the distributor's presumed assets if the agreement had never been concluded with the supplier. Building or renting premises, expenditure on hardware, showrooms, education of the personnel can be construed as investments. The burden of proof to prove these investments is on the distributor[17].

2. Portfolio Compensation

The distributor has the right to request the portfolio compensation as long as the conditions for the portfolio compensation, the details of which are provided above, are satisfied.

b. If the Principal's Termination is Unjust

In case of an unjust termination, the agreement will continue to exist with its terms and conditions[18]. In this case, the following requests may be raised by the distributor:

1. Compensation for Uncompleted Businesses under the TCC

Under Article 121/4 of the TCC, the principal shall compensate for the works that were initiated by the distributor and were not completed due to the principal's unjust termination. According to the doctrine, uncompleted business reflects the agreements and the businesses which were brought to the execution stage as a result of the distributor's activities but could not be executed because of the unlawful termination[19].

2. Compensation for Significant Investments (Negative Damages)

As stated above, if the distributor proves the conditions for the investments, the compensation for the same may also be requested.

3. Compensation for Loss of Profit (Positive Damages)

The distributor can also claim its loss of profit under Article 112 of the TCO and Article 2 of the Civil Code (i.e. principle of good faith).

Loss of profit (positive damages) under the TCO is the difference between the distributor's current assets and its assets if the agreement had been fully performed. Therefore, to calculate the amount of the loss of profit (positive damages), the circumstances of the case at hand, the parties' fault, the parties' income from this relationship, likelihood for the distributor to establish a similar relationship with a third party shall be considered.

It is worth to mention that Turkish law prohibits to claim positive and negative damages simultaneously for the same period. Namely, the negative damages can only be requested following the termination whereas the positive damages

can only be requested for the period during which the agreement should have continued.

Taking this difference into account between the positive and negative damages:

- If the distributor files a case claiming the invalidity of the termination and wishing the continuation of the agreement, provided that its case is merited, the court will calculate the loss of profit for the period during which the agreement should have continued. To estimate this period, the court will make a hypothetical scenario where the respective distributor would find another principal under the similar conditions and will make the calculation for the positive damages accordingly until this hypothetical termination date[20].
- If the distributor files a case claiming the invalidity of the termination but also wishing to terminate the agreement, the period to be considered for the loss of profit calculation will vary. This termination wish can be explicitly expressed in the plaint petition by the distributor. Alternatively, if the distributor requests both its positive and negative damages together in its plaint petition, then this will be also interpreted as a termination will by the court[21]. In such cases where the termination is invalid, but the distributor prefers to terminate the agreement and request compensation for its positive and negative damages; considering that the positive and negative damages cannot be requested simultaneously for the same period, the distributor can request its positive damages until the case filing date (until when the agreement is valid) and request its negative damages as of the case filing date due to the termination.

In light of the above, the amount of the positive and the negative damages may vary depending on whether the distributor agreed to terminate the agreement or not and depending on the date as of when distributor agreed to terminate the agreement.

4. Portfolio Compensation

Please refer to the details explained hereinabove.

Please note that in both scenarios where the principal's termination is unjust or not, the party to prove the damages is the distributor. In other words, the principal cannot be held liable for the above stated compensations unless the distributor proves that the conditions for each type of compensation have been met.

Conclusion

Principals may choose to terminate their relationship with their distributors due to different reasons. Upon termination, distributors usually claim high compensation from the principals, and this leads to lengthy negotiations and in some cases burdensome and costly legal proceedings which may last six to seven years (including the appeal process).

It is quite difficult to give definite figures and items in terms of the compensations in case of a possible court action since the Turkish court decisions are very conflicting. Unexpected and contradictory decisions of the local courts in terms of the determination of termination by just cause, lack of knowledge on the conditions and calculation method of the portfolio compensation and therefore ruling on unreasonably high amounts render the judicial process even longer since the principals need to appeal those decisions. Although the wrongful judgements of the local courts are rectified during the appeal process before the High Courts to a large extent, appeal request extends the process for another one to two years.

In this regard, we would always recommend our clients to resolve their disputes arising out of distribution agreements via amicable settlement, if possible. However, if parties cannot meet in the middle, dispute resolution before the courts or arbitration institutions becomes inevitable. Unlike court proceedings, in arbitration the parties usually agree on the arbitrator(s), so the arbitrator(s) are selected among persons who are knowledgeable on the dispute matter. Therefore, in light of our above explanations, we think that resolving a dispute concerning portfolio compensation or other compensation claims under distribution agreements through arbitration instead of local courts would be a better and faster option.

[1] Numbered 6102 and in force as of 1 July 2012.

[2] Numbered 4721 and in force as of 1 January 2002.

[3] Numbered 6098 and in force as of 1 July 2012.

[4] Prof. Dr. Arslan Kaya, "Acentelik ve Tek Satıcılık ile Benzeri Diğer Tekel Hakkı Veren Sürekli Sözleşme İlişkilerinin Sona Ermesi Halinde Denkleştirme İstemi", p. 9-10. Please see the decisions of the Court of Cassation 19th Civil Chamber, numbered 1999/7724 E., 2000/3470 K. and dated 04.05.2020; the Court of Cassation 19th Civil Chamber, numbered 2007/9285 E., 2008/2759 K. and dated 21.03.2008; the Court of Cassation 11th Civil Chamber, numbered 1996/6699 E., 1996/9192 K. and dated 25.12.1996.

[5] The model provisions for Article 122 of the TCC are Article 89b of the German Commercial Code, the European Union Directive numbered 1986/653 and Article 418u of the Swiss Code of Obligations.

[6] According to Turkish scholars "gaining significant benefits" is actually not a mandatory condition here, even "possibility of gaining benefits" is also considered when examining the portfolio compensation conditions. Prof. Dr. Arslan Kaya, "Türk Ticaret Kanunu Şerhi, Birinci Kitap Ticari İşletme, Yedinci Kısım Acentelik", İstanbul 2016, p.257.

[7] This condition is only foreseen in the TCC and Article 89b of the German Commercial Code. The European Union Directive numbered 1986/653 and Article 418u of the Swiss Code of Obligations do not require this condition to be met for the portfolio compensation request.

[8] Equity principle is evaluated differently for each concrete case by considering the relevant distribution agreement's provisions and conditions.

[9] Automatic expiration is applicable for distribution agreements with a definite term. Additionally, although the "portfolio compensation" includes the term "compensation", according to the Turkish scholars, portfolio compensation is just an amount paid to the distributor as a result of the termination/expiration of the agreement to balance the loss of distributor and the advantages provided to the principal by the distributor-created customer portfolio. In other words, the portfolio compensation is not an actual compensation. That is the reason why, the portfolio compensation can be claimed even when the agreement term has automatically expired.

[10] It is specified in the preamble of Article 122/2 that the portfolio compensation formula refers to the minimum amount for the distributor. Therefore, accepting that the parties can agree on another formula which may be to the detriment of the distributor may be incompatible with the ratio legis.

[11] Prof. Dr. Arslan Kaya, "Acentelik ve Tek Satıcılık ile Benzeri Diğer Tekel Hakkı Veren Sürekli Sözleşme İlişkilerinin Sona Ermesi Halinde Denkleştirme İstemi", p.21-24, and Dr. Özge Ayan, "Acentenin Denkleştirme Talep Etme Hakkı", Ankara 2008, p.194 – 218.

[12] With the decision of the Court of Cassation 11th Civil Chamber which is numbered E. 2016/12745, K. 2017/4954 and dated 03.10.2017, it was rendered that the policies issued by the agent on behalf of the principal, the terms of these policies, what important benefits the principal receive from the agent-created portfolio and whether the portfolio compensation to be provided to the agent complies with the equity principle or not shall be considered while calculating the portfolio compensation.

Similarly, with the decision of the Court of Cassation 11th Civil Chamber which is numbered E. 2019/2876, K. 2020/3326 and dated 30.06.2020, it was rendered that in determining the portfolio compensation the benefits arising out of the agreement, the sharing of the risks between the parties, the term of the agreement, the income of the agent, the effort and time to fulfil the contractual obligations, non-contractual gains and losses, the relation of the assets and the income of the parties, the number of the customers gained, the effect of the trademark, the reason of the termination, the fault of the parties, etc. shall be considered. Therefore, without considering such matters, it is not lawful to establish a decision on the amount reached by taking the average of the four-year commission amount the agent was entitled to, which is the maximum amount regulated under the TCC.

[13] Termination based on just cause should be realized within a reasonable period following occurrence of the incident which is the reason of the termination. The reasonable period is not defined in the TCC, it will be evaluated by the court by considering the characteristics of the concrete case.

[14] Dr.Özge Ayan, "Acentenin Denkleştirme Talep Etme Hakkı", Ankara 2008, p.42-43.

[15] The Court of Cassation 19th Civil Chamber, E. 2016/5707, K. 2016/12723, T. 28.9.2016.

[16] In Swiss law, in case the parties comply with the notice period in the agreement, the termination is deemed lawful without making any further evaluation on whether the termination constitutes abuse of right or not.

[17] Scholars stress that various conditions should be met to claim compensation for the investments. For example, the investments should be caused by the supplier or it should be impossible for the distributor to use these investments in other relationships.

[18] Prof. Dr. Arslan Kaya, "Türk Ticaret Kanunu Şerhi, Birinci Kitap Ticari İşletme, Yedinci Kısım Acentelik", İstanbul 2016, p.206. For a different view - stating that with the notification of the unjust ordinary termination the agreement will be terminated immediately- please see Dr. Özge Ayan, "Acentenin Denkleştirme Talep Etme Hakkı", Ankara 2008, p.43.

[19] Prof. Dr. Arslan Kaya, "Türk Ticaret Kanunu Şerhi, Birinci Kitap Ticari İşletme, Yedinci Kısım Acentelik", İstanbul 2016, p.216.

[20] Decisions of the Court of Cassation 11th Civil Chamber, numbered E. 2015/462, K. 2015/10260, and dated 9.10.2015; the Court of Cassation 11th Civil Chamber, numbered E. 2012/10547, K. 2014/1508, and dated 23.1.2014; the Court of Cassation 11th Civil Chamber, numbered E. 2015/7753, K. 2016/1978, and dated 24.02.2016.

[21] Decision of the Court of Cassation 23th Civil Chamber, numbered E. 2015/9795, K. 2018/3874, and dated 02.07.2018.