

## WIDESPREAD AND YET CONTROVERSIAL: DISTRIBUTORSHIP AND ITS TERMINATION

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### I. INTRODUCTION

The legal framework of distributorship relationship that has a wide presence in Turkish commercial life is not drawn clearly. The only provision in the Turkish Commercial Code (“TCC”), which is expressly designated to apply to distributorships as well as to agencies, is about the portfolio compensation. Other than this, neither categorically rendering distributorships with distinctive qualities subject to the framework of agents nor leaving it entirely to the parties’ freedom of contract does yield the desired result. Therefore, the scholar authorities have found a midway by applying TCC’s protective provisions originally stipulated for agencies to the distributorships to the extent these business models resemble.

Academic debates over the nature and consequences of unilateral termination of distributorship agreements have been reflected in the Turkish court practice. In the presence of such contentions, while one party of the contractual relationship contemplates whether its declaration would suffice to terminate the contract in the desired way;, the other party, in contrast, seeks after possible remedies such termination would grant and how to use the available ones.

One contentious matter in connection with the questions above is the circumstances under which the portfolio compensation becomes available and how to calculate the quantum. This issue has become under the dominion of quantum experts appointed by the courts during the litigation; however, those who know the available rights and quantification are better to set their litigation strategy at the outset.

### II. LEGAL FRAMEWORK

#### A. In General

Turkish Commercial Code particularly regulates the agency relationships and mostly remains silent with respect to distributorships.

Agencies engage in business with third parties as the representative of the principal. In this respect they, though not engaged within the principal's organization unlike commercial representatives, sales agents or employees, execute the contracts or act as mediator to this end on behalf of the principal within a specific territory.

The provisions set forth by TCC, in particular the principal's fundamental obligations towards the agency including but not limited to remuneration (Art 113 - 120), competition restrictions imposed on agencies (Art 123), termination of the contract and its legal consequences such as portfolio compensation (Art 121-122) cannot be contractually overridden to the detriment of the agencies.

#### **B. Extended Application of Agency Provisions**

Turkish Commercial Code, embracing a protective approach favoring the weaker side of the contractual relationship of similar nature, do apply the agency provisions for those not regarded as agencies in technical terms. Those who are

- acting as commissioners or consignment sellers by conducting a continuous business on their own behalf but in the name of the principals or
- acting temporarily on behalf of the foreign principals who do not possess a headquarter or branch in Turkey

can also enjoy the protection vested by TCC to regular agents.

#### **C. Application in respect of Distributorship Agreements**

There are different terms, too, used in commercial life, as dealership, exclusive dealership and franchise which have a commercial meaning rather than a legal one. These three types of businesses can be categorized as distributorships in the widest sense with a particular focus on their functionality: distributing the principal's goods in a local market. Distinct from the agencies, distributors conduct their business "in their own name and on their own account". In other words, distributors purchase the goods for the purposes of resale. In this sense, the ownership of the goods would be transferred to the distributor from the principal manufacturer.

Due to TCC's concentrated focus on agencies, the statutory rules to be applied to such *sui generis* and thus unstandardized agreements have not been expressly identified, save for one express reference. Accordingly, the provision of portfolio compensation shall apply also in contracts of continuous performance that grant an exclusivity. That being said, TCC's other protective provisions governing the agency relationships may also apply to such distributorship agreements by analogy.

### **III. A CLOSER LOOK AT DISTRIBUTORSHIPS**

While both distributors and agents are positioned as the intermediaries in the principal's distribution network; the existence of distributorship's characteristics determines if and to what extent TCC's imperative protective provisions concerning agencies shall apply. The distributor, as opposed to agencies,

- conducts the business on its own name and behalf; and therefore, its revenues are originated from the third parties instead of remunerations from the principal,
- has a framework contract with the principal governing the individual sales transactions and accordingly a regime regulating the transfer of ownership,
- is expected, by reason of an essential contractual obligation, to sustain and foster the principal's clientele at the designated territory.

The distributorship can be said, in light of the above, is more prone to the financial exposure while enjoying a broader independence. Furthermore, the distributor is not entitled to claim extraordinary expenses from the principal as opposed to an agent.

The parties to a distributorship agreement can derogate from TCC's provisions in relation with the distributorship's characteristics exemplified above. However, the parties' freedom gets restricted regarding the common aspects of distributorship and agency contracts. These aspects often protect the distributor or the agent, who are relatively weaker and dependent on the principal's business decisions. In this respect, it is beneficial to note that distributorship agreements are amongst the innominate contracts and fall out of ambit designated for any specific contract. That being said, the competition restrictions, reporting duties and obligations to transfer the clientele, stock goods and accomplish minimum purchase and sale targets to be imposed under such agreements, render the distributors closely linked to the principal's distribution network. In such cases, the resemblance between distributors and agents becomes evident and increases the likelihood of TCC's protective provisions' application to fill the gaps in the contract.

#### **IV. TERMINATION OF DISTRIBUTION AGREEMENTS**

The termination of distributorship contracts falls within the ambit of TCC's protective mandatory provisions, in view of the similarity to agency contracts in terms of continuity of the performance and financial dependency.<sup>1</sup>

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<sup>1</sup> Ütgen/Helvacı/Kaya/Nomer Ertan; Ticari İşletme Hukuku (Law of Commercial Enterprise), 2019, p. 874.

Other than the expiry of contract term and death/bankruptcy of one of the parties, the termination of the agreement by a unilateral declaration is subject to said protective provisions, the breach of which gives rise to certain legal sanctions.

#### **A. Termination on Just Causes**

A contract, regardless of whether a definitive term is set, may be terminated based on just cause. Just cause needs to be serious enough so that the terminating party cannot be reasonably expected to continue the commercial relationship.

The parties may of course agree on certain circumstances and events to be considered as just cause. In the same vein, it is also possible for the parties to exclude certain events from constituting just cause. No matter what, such contractual contemplations should not be too restrictive that would unreasonably prevent the parties' right to terminate.

Although not expressly stipulated by TCC, the termination needs to be exercised in due time, i.e., without culpable delay after the occurrence of the just cause.<sup>2</sup> Otherwise, the event invoked as just cause is likely to be regarded as being not so serious enough to justify the termination of the contractual relationship.

#### **B. Termination Privy to Contracts with Indefinite Term: Termination for Convenience**

Each party, without the need to establish a justifying reason, may terminate the contract in three months advance (TCC Art 121/1). This period of notice cannot be shortened as a matter of protective provisions of TCC.

Although there is no need to present a justifying reason, this right should not be against good faith principles and exploit the trust previously built up on the part of the counterparty.

It is crucial to note that Turkish law regards consecutive contracts with a definite term collectively as one contract with an indefinite term in Turkish law. In connection with this, it is also noteworthy that the notification period to be granted before the effective date of termination should be at least six months if the distributorship is heavily integrated into the principal's sale and distribution network, unless agreed otherwise. This is the case because, the intensity of such integration, after a point, requires analogous application of ordinary partnerships in the Code of Obligations instead of agencies under TCC.<sup>3</sup>

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<sup>2</sup> Ülgen/Helvacı/Kaya/Nomer Ertan; Ticari İşletme Hukuku (Law of Commercial Enterprise), 2019, p. 875.

<sup>3</sup> Court of Cassation, 19<sup>th</sup> Division, 2016/5707 E., 2016/12723 K. 28.09.2016.

## C. Termination Notification

Notwithstanding which termination method mentioned above is used, the declaration of termination needs to be dispatched to the counterparty in compliance with the formal requirements stipulated under Art. 18 TCC<sup>4</sup>.

Most importantly, the Court of Cassation requires the just cause, if any, to be raised and communicated clearly with the counterparty with this notification.<sup>5</sup>

## V. CONSEQUENCES OF TERMINATION

### A. In General

Termination by a unilateral declaration has a proactive (*ex nunc*) effect, meaning that the rights and obligations that have transpired until then shall be duly enforced as per the contractual terms.

Naturally, the parties would not be entitled to assert any claim from another when they face a termination that validly relies on just cause. This is because, a claim is principally not admissible as per the conventional compensation law regime if the claimant cannot invoke the counterparty's negligence.

The controversial issue that needs to be evaluated in particular is the instances where the termination either fails to rely on just cause or grants an insufficient notice period.<sup>6</sup>; since these instances, depending on the particularities of the case, entitle the aggrieved party to assert various remedies. Similarly, the party who manages to terminate the agreement on just cause is also entitled to assert certain remedies against the negligent counterpart.

Portfolio compensation, however, does not fully comply with these principles, as will be explained hereinbelow. Yet, it may be helpful to highlight its characteristics at the outset: Portfolio compensation is

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<sup>4</sup> Art. 18 TCC: "Notifications and protest letters between merchants for the purposes of rendering the counterpart in default, and terminating or rescinding a contract should be via public notaries, delivery receipt letters, telegraph or registered e-mail system by use of a secure e-signature."

<sup>5</sup> Ülgen/Helvacı/Kaya/Nomer Ertan; Ticari İşletme Hukuku (Law of Commercial Enterprise), 2019, p. 875.

<sup>6</sup> Concerning the debates over whether an unjust termination is effective without the counterpart's consent; see Court of Cassation, 11th Division, 2017/2412 E., 2018/7906 K. 12.12.2018 providing that an unjust termination does not suffice to terminate the contract and thus the counterpart may keep it alive and invite the "terminating" party to fulfill its outstanding contractual obligations; compare this with Court of Cassation 19th Division, 2016/5707 E., 2016/12723 K. 28.09.2016: "*In case the termination notice is shorter than the appropriate notice period for contracts with definite term, the termination is unjust, and the contract should be deemed terminated with immediate effect.*"

- to be awarded only for the agent or the distributor, i.e., the weaker party of the relationship;
- admissible in all cases where the termination is not due to a reason attributable to the distributor.

## **B. Claims in Case of Unjust Termination**

### **1. Compensation for Uncompleted Business (TCC Art. 121/4)**

The terminating party who fails to rely on just cause or provide sufficient notice period as per TCC Art. 121/4 is obliged to compensate the counterparty for the losses incurred due to any uncompleted business. From the distributor's point of view, uncompleted business means the agreements and transactions with third parties in the pipeline but yet to be executed and finalized at the time of unlawful termination. The loss corresponds to the profit which would not have been lost should the contract be duly resumed. If the distributor is relieved from some of its expenses due the termination, the compensation should be reduced accordingly.

Distributor, in such cases, is under the burden to prove the quantum of its deprived income and that the concerned business would have been completed in short term thanks to its efforts should the contract had not been terminated.

### **2. Additional Compensation as per General Provisions of TCO**

#### ***a. Deprived Profit***

To make a projection as the amount and duration of the future profits, the court would first decide until when the contract should be deemed in effect. For this, the court takes into account "*how long would it reasonably take for the claimant to find another business partner in the same business and under similar conditions*".<sup>7</sup> In case the termination is based on convenience rather than just cause, the period for the accrual of future profits would be up to the end of the proper notice period.

#### ***b. Individual Sales Transactions***

Distributorship relationship, which is constructed by a framework agreement, is formed by individual sales contracts imposing reciprocal

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<sup>7</sup> Decision of Court of Cassation 11<sup>th</sup> Civil Chamber, 2015/462 E., 2015/10260 K., 09.10.2015; see also 11<sup>th</sup> Civil Chamber, 2012/10547 E., 2014/1508 K., 23.01.2014; 11<sup>th</sup> Civil Chamber, 2015/7753 E., 2016/1978 K. 24.02.2016.

rights and obligations. In case the relationship is not terminated on just cause, the individual sales contracts principally remain in effect enabling one party to assert claims arising therefrom.<sup>8</sup> It is therefore possible to claim compensation and assert other remedies stipulated by TCO with respect to sales contracts. The distributor, for example, can resort to the principal's defect liability if the conditions are met.

### c. *Negative Damages*

The damages based on investments made in reliance on the future benefits of the contractual relationship may be claimed if said investments turned out to be fruitless due to the actions and/or events attributable to the counterpart that justify the termination.

An investment, in order to be reimbursed, needs to be regarded as a sunk cost. Such investment would be dedicated to the distributorship in question and unable to be reinvested for another business opportunity. What is more, this investment should not have been amortised before the termination. Amortisation is more likely to occur as the relationship lasts longer, the investment is for an exclusive territory<sup>9</sup>, the revenues are above the market levels or the goods are purchased for a low price in the first instance.

According to some scholars, the terminating party should not solely incur all the responsibility for the sunk and unamortized costs. From an equity-based approach, these costs should be apportioned between the parties.<sup>10</sup>

In this respect, long-term advertisement campaigns, rental fees that will be paid even after the termination and costs of fixture and equipment can amount to negative damage items to the extent these have not served for the purpose of earlier contractual performances and benefits.

## 3. Dissolution of the Contractual Relationship

The parties, following the termination of the contract, are required, as a matter of good faith principle, to exchange the inventories and accessory

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<sup>8</sup> Ülgen/Helvaci/Kaya/Nomer Ertan; Ticari İşletme Hukuku (Law of Commercial Enterprise), 2019, p. 909.

<sup>9</sup> Mani Reinert, *Ökonomische Grundlagen zur kartellrechtlichen Beurteilung von Alleinvertriebsverträgen*, Zürich 2004, s. 114.

<sup>10</sup> Bkz. Johannes Vetsch/Hans Caspar von der Crone, *Die Kundschaftsentschädigung in Vertriebssystemen*, SZW 2009, s. 79-93, s. 85.

goods that become idle and useless for the possessor. Given the absence of any express statutory provision in this respect, this issue is often stipulated in their contracts.

#### **4. Portfolio Compensation (TCC Art. 122)**

Portfolio compensation, as opposed to the other items of claims mentioned above, is privy to the agents and distributors as the weaker and dependent side of the contractual relationship.

Portfolio compensation, despite what the nomenclature suggests, is not regarded as compensation in technical terms. Instead, the authorities see it as an “equity-based adjustment” to ensure that the balance of interest does not lean towards the principal, who would continue to reap the benefits of the distributor’s earlier business activities.<sup>11</sup>

Given that it does not serve the same purposes of conventional compensation items, there should principally be no doubt that portfolio compensation may be claimed in addition to the other available positive and/or negative damages. In case the admissibility of portfolio compensation is doubtful in the presence of other remedies, the court would exercise an equity test as will be explained herein below.

The conditions for entitlement to portfolio compensation are as follows:

##### **i. Integration to Sale-Distribution Network**

To get entitled to portfolio compensation which is normally vested to agencies, the distributor should have gone beyond an ordinary reseller and actively gotten involved in the principal’s network as in the case of agency. This is the case because only the distributors who are subject to competition restrictions, purchase and sale targets, stock requirements and reporting obligations are entitled to enjoy portfolio compensation.<sup>12</sup>

##### **ii. Transfer of Clientele**

The fundamental difference between agencies and distributors is the fact that distributors sell the goods purchased from the principal in their own account. This is why the clientele established by a distributor, unlike the case of agency, belongs to the distributor itself, not the principal. Hence, this clientele would not automatically be transferred to the

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<sup>11</sup> Concerning the discussions on legal qualification of compensation portfolio, please see Koray Demir, *Yeni TTK’da Acente (Agency in the new TCC)*, I. Türkiye-Azerbaycan Hukuk Sempozyumu, 01-02 July 2011, İstanbul, pp. 219-259, p. 248 et seq.

<sup>12</sup> Koray Demir, *Tek Satıcının Denleştirme Talebi (“Exclusive Seller’s Portfolio Compensation Claim”)*, Prof. Dr. Sabih Arkan’a Armağan, İstanbul 2019, pp. 400-419, p. 406 et seq.

principal upon termination.<sup>13</sup> Therefore, a distributor is required to already have transferred the clientele to the principal or to do so in order to be entitled to portfolio compensation.

Clientele's transfer to the principal requires the distributor to provide the principal with the names, contract details, consumption habits of the customers and how often they would submit purchase orders.<sup>14</sup>

### **iii. Termination for Causes not Attributable to the Distributor**

The termination, irrespective of whoever exercised it, should not be due to reasons attributable to the distributor.

Portfolio compensation cannot be claimed in case i) the contract is terminated by the distributor without showing a justifying reason attributable to the principal or ii) the contract is terminated by the principal for reasons attributable to the distributor.

The reasons attributable to the principal do not necessarily amount to its negligence or unlawful act. Demanding weekly reports by the principal in a manner despising the distributor's independent existence, for instance, could also constitute a reason for termination that would justify portfolio compensation.<sup>15</sup>

### **iv. New and Long-term Clientele**

The portfolio compensation is deemed justified to the extent of the clientele gained by the distributor from which the principal is likely to continue gaining benefits

- after the termination and
- on regular / continuous basis.

The clientele re-entered or preserved in the principal's portfolio thanks to the distributor's efforts is also regarded as a "new" clientele.

### **v. Equity**

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<sup>13</sup> Christina Fountoulakis, Zur Kundschaftsentschädigung bei Beendigung eines Alleinvertriebsvertrages, recht 2008, p. 224.

<sup>14</sup> Arslan Kaya, Türk Ticaret Kanunu Şerhi, Acentelik, (TCC Commentary-Agency) Güncellenmiş 2. Bası, İstanbul 2016, p. 281

<sup>15</sup> Ülgen/Helvacı/Kaya/Nomer Ertan; Ticari İşletme Hukuku (Law of Commercial Enterprise), 2019, p. 879

The court needs to decide whether the portfolio compensation is equitable given that this is an exceptional payment to distributor due to its reliance to the continuity of the contractual relationship.

In this respect, the court takes into account the benefits granted to the distributor during or following the term of the contract. If these benefits enjoyed by the distributor is above the market standards and more or less matches with what is being claimed as portfolio compensation, then the court is unlikely to consider such an additional claim equitable. In this vein, the principal's marketing efforts and recognition of its brand providing advantage to the distributor are among the decisive factors.

## VI. CALCULATION OF PORTFOLIO COMPENSATION

TCC provides no express guidance as to how to calculate portfolio compensation. It only stipulates under Art. 122/2 that portfolio compensation cannot exceed the average amount of remuneration (annual commissions and other incomes) during the last five years preceding the termination. This provision, however, merely aims at setting a limit to the compensation. It does not explain how to calculate it. Despite this, Turkish courts heavily rely on this upper limit and adjust it for reasons of equity. However, this calculation does not comply with the law. In the simplest term, it ignores various elements sought by the law, such as whether the distributor has developed a long-term clientele. Some scholars suggest adopting the following calculation method by reference to German law:<sup>16</sup>

### Step 1

The calculation of portfolio compensation is primarily based on the distributor's earlier income; particularly the income generated within the last year before the termination. If this income is exceptionally low or high compared to earlier years, the calculation should be based on an ordinary year's financials. The income for this calculation means gross profit on sales i.e., the difference between the purchase price and sale price.

### Step 2

The administrative operating expenses should be deducted from the income generated within the ordinary year. Agencies, distributors, or in the broadest sense resellers, earn some of their income through inventory and warehouse management carried on for the principal. According to German practice, the income constituting

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<sup>16</sup> See for example Arslan Kaya, "Portfolio compensation upon termination of continuous contractual relationships such as agencies and other businesses with exclusivity", TCC Symposium in Its Sixth Year in light of Turkish Jurisprudence, İstanbul, 12.10.2018, p. 24..

the basis of calculation should be reduced by 10% to exclude such elements of income that are not from developing and/or retaining the clientele.

### **Step 3**

Following the deduction of administrative operating expenses, the percentage of the long-term clientele needs to be determined. Compensation would be awarded only for the part of clientele that repeatedly generates revenue. Income volume, business profitability, and list of customers may indicate the existence of a long-term clientele. If the court cannot ascertain the percentage, it may exercise discretionary power. German practice also recognizes the courts' liberty to exercise such power.<sup>17</sup> This discretion, however, needs to pay regard to particularities of the disputed matter and life experiences. It is widely accepted that a business cannot sustainably continue its existence unless it develops a long-term clientele above 50% of its total clientele.<sup>18</sup> Therefore, any further discretionary deduction should be based on this assumption.

### **Step 4**

There should be a further deduction based on the existing clientele. Existing clientele means the clientele from which the principal or former distributor previously benefited. By this token, the distributor pursuing portfolio compensation is deemed to have not contributed to this clientele. However, such a deduction is not needed for contracts that lasted longer than five years. In such long commercial relationships, the preservation of the existing clientele could have been only due to this distributor's endeavors.

### **Step 5**

The calculation then takes into account the customer defection. Customer portfolio would typically be renewed entirely after five years at the latest. Therefore, the principal can benefit from the distributor's clientele for no more than five years. According to the German Federal Court, the portfolio suffers from a %20 loss each year unless proven otherwise. This loss means that i) none of the customers gained by the distributor would remain, and ii) the distributor can have no or otherwise ignorable contribution to the preservation of the customers following the fifth year<sup>19</sup>. Under this projection, the calculated sum should be reduced by 20% for each consecutive year, a total of which would get one step closer to the final sum.

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<sup>17</sup> Saenger/Aderhold/Lenkaitis/Speckmann, *Handels- und Gesellschaftsrecht*, 2011, p. 183.

<sup>18</sup> In some instances, German Federal Court applies 30% reduction instead. (see. Raimond Emde, *Vertriebsrecht*, 3. Auflage, Berlin 2014, p. 420).

<sup>19</sup> Saenger/Aderhold/Lenkaitis/Speckmann, p. 186; Arslan Kaya, *Portfolio Compensation*, p. 23.

### Step 6

The penultimate step is an adjustment for equity. Notably, the brand's strong recognition constitutes a straightforward reason for a deduction. This adjustment, again, falls under the court's discretion and the reduction is often no less than %10.

### Step 7

The last step stipulates, as per German practice, a discount by taking into account commercial interest that would have accrued in the future.<sup>20</sup> The rationale here aims at preserving a balance of interest between the principal who would reap the benefits of the clientele in the future over some time and the distributor who would receive the compensation in advance and cash.<sup>21</sup>

## VII. TCONCLUSION

As the Turkish business environment gets integrated into foreign markets, international businesses increase their existence in the Turkish market. Distributorship stands as the significant business model fostering this existence. And yet, TCC causes ambiguities in practice and jurisprudence by failing to provide provisions explicitly regulating distributorship agreements.

The rules applied to distributorships vary on a case-by-case basis and according to the dynamics of the distribution relationship. Hence, from time to time, it becomes subject to mandatory and supplementary rules designated for any of agencies, ordinary partnerships, and mandates.

This is why it is most helpful if the parties receive legal advice before entering distributorship agreements rather than before terminating them. When terminating the contract, one should also closely scrutinize the implications and legal consequences of actions and intentions on the contractual relationship's fate.

The portfolio compensation privy to distributorships and alike deserves special attention in this context. Given Turkish courts' contradictory practice, knowing what and how to claim makes a tremendous difference for the parties on the eve of a dispute.

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<sup>20</sup> Arslan Kaya, Portfolio Compensation, p. 24.

<sup>21</sup> The discount is based on the Hoffman formula. Accordingly, the sum calculated so far shall be multiplied by 100 and then divided by "the effective interest rate at the time of termination" times "the number of relevant years" added to 100.

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