

## Termination of sales and distribution arrangements in Australia

Will terminating or significantly revising an intercompany sales or distribution agreement result in compensation<sup>1</sup> to the affiliate carrying out the selling/distribution? This is a recurring issue that arises whenever taxpayers engage in steps that significantly change the characterization of a sales affiliate. It is also a valid question for taxpayers establishing new intercompany sales/distribution arrangements when entering a new market through a newly set-up subsidiary or through acquisition.

Current Australian guidance on this issue is embodied primarily in the Australian Taxation Office's Taxation Ruling on business restructuring (TR 2011/1). This ruling states that "where an entity's existing arrangements are terminated as part of a business restructuring, this may give rise to a *legally* recognised right to compensation" (emphasis added). Accordingly, the focus in the Australian guidance is on legally recognized rights to compensation, rather than a purely economic concept of compensation.

When it comes to determining how to establish whether there is a legally recognized right, TR 2011/1 states that "...it is necessary to determine whether the terms of those (intercompany) arrangements relevant to compensation for termination accord with what independent parties might be expected to have agreed when negotiating and entering into those arrangements."

There is therefore a need to establish whether compensation may arise based on (i) legally recognized rights, and (ii) the terms of the intercompany agreement(s) in question in light of what third parties would have agreed to under comparable circumstances. We agree that this is the correct approach. The OECD Guidelines on transfer pricing have as their cornerstone the arm's length principle and so compensation would only be due between related parties if, in a similar situation, compensation would also be paid between unrelated parties.

For guidance on what third parties would have agreed to under comparable circumstances, TR 2011/1 states that: "...data as to the terms of comparable uncontrolled arrangements should be used in evaluating this. Where no such data is available, it is necessary to determine what terms would make commercial sense having regard to all of the facts and circumstances of the arrangements."

To sum up, the analysis of whether compensation is due when terminating an intercompany arrangement involves two steps:

- Determine if there is a legally recognized right to compensation; and
- Ensure that any such right is based on terms of the intercompany agreement, which may be considered arm's length by reference to either third-party agreements or commercial sense.

When considering the consequences of terminating an intercompany arrangement in Australia, it is noteworthy that TR 2011/1 also states that "Not every termination of a legal or business arrangement between independent parties gives a right to compensation to a party that is disadvantaged or suffers detriment or loss as a result." Accordingly, there is no presumption that the mere termination of a distribution arrangement should give rise to compensation.

### Legally recognized rights

There is no statutory right to compensation in Australia when terminating an agent, a reseller, or a franchisee.<sup>2</sup> Further, there is no Australian tax case law, which gives additional guidance to the interpretation of TR2011/1.

Therefore, legally recognized rights to compensation in Australia will arise by reference to contractual terms, supporting a commercial claim. Unsurprisingly, over the years, a number of claims have been brought to the Australian courts in disputes between unrelated parties. Typically, the dispute arises when a supplier seeks to terminate or significantly modify the terms

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1 Compensation should be distinguished from consideration for the acquisition of specific assets. This may, for instance, be relevant if – as part of the termination – the supplier acquires certain identifiable assets from the distributor. These may include tangible assets (accounts receivables, inventory) or intangible assets (customer lists, trademarks, websites).

2 This is contrary to the EU, where the Commercial Agents Directive (CD 86/653) forms the legal basis for such a right, when it comes to termination of commercial agents. Also, some countries extend similar rights to compensation for distributors or franchisees in particular circumstances (see Germany: Section 89b of the German Commercial Code).

of the distributor arrangement. From a review of these cases it is possible to determine the circumstances in which (i) a legally recognized right to compensation exists and (ii) when a compensatory payment would be due between unrelated parties.

### Terminating an Australian distributor arrangement

Our review of relevant Australian case law determined that the majority of such cases relates to distributors claiming that the distribution agreement was unlawfully terminated and seeking damages for breach of contract as a result. The leading case, the principles of which have been extensively cited in subsequent cases, is *Crawford Fitting Co v Sydney Valve and Fitting Pty Ltd (1988) (Unreported, NSWCA)*. This case is analyzed in more detail below.

However, case law in Australia has also considered the specific issue of compensation for loss of goodwill (such as in the case of *Rockwell Automation Australia Pty Ltd v Remtron* – 2010), as well as how to determine damages for breach of contract (*Burger King v Hungry Jack's* – 2001).

In *Crawford Fitting*, a manufacturer terminated an exclusive distributorship that had existed for 15 years, with six months notice of termination. The terminated distributor argued at trial that the reasonable notice period should have been two years.

The two main issues for the Appeals Court were:

- Whether or not the distributors had proved that six months was not a reasonable period of notice; and
- When determining the reasonableness of a period of notice terminating a distributorship agreement, is it relevant to take into account the distributor's expenditure or effort, which has created opportunities for consequential earnings in the future?

The court found that the distributor failed to prove that six months was not a reasonable period of notice for the following reasons.

The court found that the distributor's evidence did not establish that it had outlaid any extraordinary expenditure or effort in the period before the notice was given, nor was the distributor in the course of any negotiations that required longer than six months to come to fruition. Further, the six-month period enabled the distributor to obtain new and significant distributorships. On balance, the distributor did not show that they would have been in a better position to make alternative arrangements with two years' notice than they were with six months' notice. Accordingly, the court ruled that a six-month notice was considered reasonable.

### Principles applied by the court

The main purpose of a notice for reasonable period is to enable the parties to bring the relationship to an end in an orderly way, so that they will have a reasonable opportunity to enter into alternative arrangements and to wind up matters that arise out of their relationship, including carrying out existing commitments, bringing current negotiations to fruition, and obtaining the fruits of any extraordinary expenditure or effort carried out within the scope of the agreement (when appropriate).

The court held that a contract that is not determinable by will<sup>3</sup> and which has no fixed duration should continue by common implication for a reasonable period. It was considered that this gives effect to the reasonable expectations of the parties, because this type of agreement often requires significant initial expenditure by the distributor.

The court considered that expenditure in the initial stages of the agreement provides a ground for implying a term that the business is to continue for a reasonable period (citing *Jack's Cookie Co v Brooks* (1955) 227 F 2d 935 at 938-939:

- *Extraordinary expenditure* at any stage of the agreement is also a factor that must be taken into account by the court in determining the reasonableness of any notice given. The weight to be given to this factor will vary between cases and the particular circumstances.

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<sup>3</sup> The agreement in question had no explicit termination notice period.

- Note that this does not apply for *ordinary* expenditure – inability to reap the benefits of ordinary expenditure or effort incurred during the course of the agreement may be regarded as a business risk a distributor takes when it enters into an agreement that is terminable at any time.
- It was also noted in the case that if the nature of the business produces a lapse of time between effort or expenditure and earning, a certain amount of that effort or expenditure will go unrewarded regardless of the period of notice given.

The court concluded that the prospect of obtaining profits in the future is *not* a relevant factor to be taken into account, except insofar as it is consequential on the incurring of extraordinary expenditure or effort within the scope of the agreement.

*Crawford Fitting*, along with other Australian case law reviewed, therefore supports the notion that a legally recognized right to compensation *may* exist when an Australian distribution arrangement is terminated. However, the evaluation of whether such a right exists is based on the adequacy of the termination period: an unreasonably short termination period gives rise to a legally recognized right to compensation. Our review did not uncover any case in which it was held that a distributor had a legal right to continue in a business relationship without end.

### Termination period

The termination periods claimed by the supplier terminating the agreement range from no notice given<sup>4</sup> to six-months' notice.<sup>5</sup> However, based on court findings, it is reasonable to conclude that termination periods of three to ten months have been accepted by the Australian courts, though any case will depend on its own specific facts.

In *Adrians Transport Pty Ltd and Anor v Pacific Dunlop Ltd (1996)* (Federal Court of Australia, NSW Division), the supplier terminated the distribution agreement with one week's notice. The distributor argued that a reasonable termination period would have been two years, and claimed damages for breach of contract.

The court held that the supplier was in breach of its contract for failing to give reasonable notice of the termination. The court relied on the principles in *Crawford Fitting Co v Sydney Valve and Fittings Pty Ltd (1988)* in considering the matters relevant to determining the reasonableness of the notice.

The parties agreed that one of the factors relevant to the period of notice required to be given is the time necessary to carry out existing commitments and to bring the business to an end in a business-like way.

In this case, that included considerations such as the time required to enable the distributor to terminate its agreements with the owner-drivers it contracted with as a consequence of its agreement with the supplier. The court found that another relevant consideration was whether each owner-driver may seek compensation from the distributor for termination, under the Industrial Relations Act.

The court came to the conclusion that a period of three months was reasonable. That period would be required to obtain advice with respect to the period of notice required to be given to the owner-drivers, to terminate arrangements with them without causing them undue hardship, to settle any claims for compensation that might have been made by the owner-drivers, and to deploy the capital and skills of the distributor to another activity.

*Pacific Products Pty Ltd v Howard [2005] SCSA 290* involved termination of a distribution agreement between a manufacturer of supermarket products and its distributor of those products. The manufacturer terminated the agreement with approximately two-and-a half months' notice.

The Court of Appeal held that 10 months was an appropriate period of notice of termination, taking into account the circumstances outlined below.<sup>6</sup>

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4 This was the case in several of the reviewed cases, including *Iftikhar Husain v O S Holdings (Vic) Pty Ltd* (2005) VSCA 269 and *Fasbert Pty v ABB Warehousing (NSW) Pty Ltd* (2008) (Federal Magistrates Court).

5 The six-month notice was given by the supplier in *Crawford Fitting Co v Sydney Valve and Fitting Pty Ltd* (1988), NSWCA. This was upheld by the court as reasonable notice.

6 The Appeals Court relied on the principles from *Crawford Fitting Co* in its determination of an appropriate notice period.

The court held that the purpose of a termination period is not to reward or compensate parties for their prior contributions, nor is it punishment for wrongful termination. The court specifically stated that, as part of normal business, the distributor held the risk that one day the manufacturer might no longer engage it as a distributor, so this should *not* factor into a determination of the reasonableness of a notice period.

The court also concluded that it needed to look at the relationship between the parties as it stood at the time the contract was terminated, rather than the relationship at the time the contract was concluded.

There was no evidence that the distributor, in the period leading up to the notice of termination, had expended extraordinary funds or effort outside the normal course of running the distribution business.

The court particularly applied *Crawford Fitting* in holding that the notice period must be long enough for the parties to carry out existing commitments and bring current negotiations to fruition. In this respect, the six-month promotional cycle particular to this case was considered relevant: many of the organizational and logistical aspects of the distributorship were tied up with these promotional cycles. This included the commitments and negotiations inherent in each six-month cycle, so a reasonable notice period must be at least this long. However, the court held that an additional period must be added to the six months to reflect the necessary period of negotiation preceding implementation of each six-month promotion. Based on these facts, the court considered a 10-month termination period to be reasonable.

## Compensation

The review of relevant Australian case law revealed that distributors were generally unsuccessful in claiming compensation. Case law guidance as to the level of compensation can only be drawn from those cases where the claimant was successful; but there is still guidance for us to review.

One case discussing the specifics of determining the level of compensation is *Burger King v Hungry Jacks' [2001] NSWCA 187*. The parties had entered into a franchise agreement with a period of 15 years, whereby the franchisee had an unrestricted, nonexclusive right to develop stores throughout Australia, and was required to develop at least four restaurants per year.

Although the issues the court considered were not restricted to compensation for undue termination, its findings are nevertheless instructive. The court awarded damages to the franchisee for the franchisor's breach. The damages were calculated with reference to the following factors:

- **Delay in opening company-owned restaurants** – The Court of Appeal accepted evidence that but for the franchisor's breach, the franchisee would have opened at least 17 restaurants in the relevant period, and considered this when calculating damages.
- **Loss of opportunity to introduce third-party franchisees** – This resulted in the franchisee's loss of the initial service fees, monthly service fees, and ongoing royalties that would have been received but for the franchisor's breach.

In *Fasbert Pty Ltd v ABB Warehousing (NSW) Pty Ltd (2008) (Unreported, Federal Magistrates Court)*, the court concluded that a period of 12 weeks' notice was reasonably required under the contract for the distributor to wind down its operations, to hand over responsibilities, and to redeploy its labor. Since no notice was given, the court held that the distributor was entitled to damages for breach of the implied term of reasonable notice.

The damages were calculated as the amount that should have been paid in lieu of the notice the distributor should have received, which was determined to be \$36,000. The court noted that there should be no reduction in damages for failure by the distributor to take reasonable steps to mitigate its loss. The reason why the damages were not reduced was that the distributor initially made efforts to continue the warehouse management business by pursuing the only avenue available to it. The distributor's employees then sought individual employment in other fields, and the court was satisfied that the steps they took to obtain alternative employment were reasonable, if not successful.

These cases illustrate one particular point worthy of specific note. The question of compensation on termination of a business arrangement is not one restricted to Australia. We are aware of challenges being made by tax authorities in a number of countries, and often an argument is raised based on a concept of "loss of opportunity" or "lost profit". As can be seen from the cases cited above, where a legal right to compensation is found to exist then:

- The “lost opportunity” is a consequence of the infringement of that legal right, not a legal right in itself; and
- The “lost profit” is a measure of the compensation paid in respect of the infringement of that legal right.

## Summary and observations

In summary, our review of Australian case law indicates that while the courts have determined that a distributor may have a legally recognized right to compensation in the event of termination, there is very limited case law wherein the courts have actually ruled in favor of the distributor.

Further, whether a right for compensation exists is directly related to the termination period: in general, an unreasonably short termination period gives rise to a legally recognized right to compensation.

The courts have deemed termination periods of 3-10 months reasonable in specific cases; though any case will depend upon its own facts. The principles that the courts have particularly emphasized, when it comes to determining a reasonable notice period, may be summarized as:

- The purpose of a termination period is not to reward or compensate parties for their prior contributions; nor is it punishment for wrongful termination;<sup>7</sup>
- How long it would take each party to wind up its operations in an orderly manner, including settle matters with its employees, contractors, etc.
- The duration of the distribution arrangement. Specifically, the longer the duration of the arrangement being terminated, the more reasonable is it to expect the distributor to have recouped any investments and made reasonable profits.

The courts have concluded that the prospect of obtaining profits in the future is *not* a relevant factor to be taken into account, except in situations in which a distributor has incurred *extraordinary* expenses in the period before termination of the contract.

These principles are derived from a number of cases, but in particular, *Crawford Fitting Co v Sydney Valve and Fitting Pty Ltd (1988) (Unreported, NSWCA)* is instructive in understanding the courts’ considerations.

Multinationals considering setting up an Australian sales and distribution subsidiary, or contemplating a reorganization of existing Australian distribution arrangements should carefully consider the termination period to be established. While case law indicates that a termination period of 3-10 months has been considered reasonable by the courts, the real measure is to consider whether the termination period “allows each party to wind up its operations in an orderly manner, including settle matters with its employees, contractors, etc.” Consequently, it is perfectly reasonable to assume that termination periods shorter than three months or longer than 10 months could be considered reasonable, based on the facts and circumstances of the particular case.

Our review emphasizes the rule that when it comes to transfer pricing issues that are evolving and have not yet found international consensus, there is a need for detailed local analysis of both the facts and the regulatory environment.

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<sup>7</sup> In *Pacific Products Pty Ltd v Howard* (2005) SCSA 290, the court determined that there could be no attempt to compensate the respondent for his work over the years by allowing an arbitrary period of profits to be recovered.

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