Distribution contract compensation clauses

There are a number of issues which need to be carefully negotiated before a winery signs a distribution contract, **Mark Hamilton** highlights some to pay particular attention to.

THE NECESSITY to get the appointment of overseas distributors right was previously highlighted by some US and UK distributors seeking the inclusion of substantial compensation clauses in distribution agreements with Australian wineries.

These requests were common by US distributors in the pre-Global Financial Crisis (GFC) and UK environment. The GFC in itself saw many distribution agreements terminated through lack of sales.

Distribution and sales by Australian wineries are now potentially re-building, so that negotiation of new US contracts will re-emerge as a challenge.

Substantial anecdotal evidence established that some smaller Australian wine companies agreed to these provisions in the pre-GFC period which can be quite uncommercial and onerous. They may also be potentially void as a 'penalty clause' depending upon which country's law applies.

These clauses typically seek a substantial payment of compensation upon termination of the relationship by reference to the final year's sales, in, often, overseas currency irrespective of how long the relationship has run and how much notice of termination or non-renewal was given.

The compensation is payable in addition to the requirements to give substantial period of notice of termination or non-renewal.

For example, the parties might enter into an agreement along the following lines:

Five year term with automatic five year roll-overs (that is, an evergreen contract) unless one party gives one year's notice of non-renewal prior to the expiry of the current five year term. There are numerous variations of this scenario.

For example a 10% payment may be provided as payable by the winery to the distributor, for example, in US dollars or UK pounds based upon the last 12 months sales if the distribution contract is not renewed.

The terms sought by some distributors vary, however, we are talking here of significant and potentially crippling sums of money, coupled with enormous currency risk.

This may not seem particularly significant to an Australian winery seeking to establish a new market in the US or UK, however, it may take on significant proportions over time.

There is little or no justification for these compensation clauses. The objective of a long term distribution agreement is twofold: To give security to both parties; and to give the distributor a reasonable period in which to obtain a commercial return for the money and time which they have expended in establishing or developing the brand in the marketplace. This is typically considered to be five years.

The requirement under a distribution agreement to give reasonable notice of termination is based on legal principle. Hence, a requirement for a year's notice of termination before the expiry of the five year term is reasonable as it gives the distributor the opportunity to obtain a replacement agency.

There are other considerations. Winemakers and distributors may be a good 'fit' at the commencement of the relationship, but that may well change across five years. For example, the brand has built to the point where it requires a larger distribution network to continue growing and meet the winemakers' long term aspirations.

There is also the risk of the distribution performing to an extent but below expectations. At the minimum, the contract would need to provide for the right of termination by the winemaker without a payment of compensation under certain agreed sales.

Numerous issues arise and need to be carefully negotiated under any distribution contract, including in circumstances where a winemaker was considering agreeing to a compensation clause.

There are numerous distributors in all overseas export markets, many of whom do not require compensation clauses, including substantial well established distribution houses. It would therefore need to be something particularly special about a distributor and its access to the marketplace which would justify taking on a liability of this type.

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