

# **Distributor Termination: Guide for Preliminary Risk Analysis**

by

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Foreign companies have good reason for selling their products in the Middle East through local distributors; culture, religion and language pose formidable obstacles in the region. These companies also often have good reasons for terminating distributors - unsatisfactory performance, change of marketing plans, sale of the business to another company where both parties have their own distribution network, or even the decision to stop making the product involved. Local laws, however, may make it difficult and costly for foreign companies to terminate distributors in some Middle East countries.

The most significant distributor "protection" is usually contained in the distributorship law of the local jurisdiction.<sup>1</sup> When a foreign supplier considering termination of a Middle East distributor contacts in-house or outside counsel for advice, counsel needs to preliminarily determine the client's *potential* exposure. Although substantially more information is necessary in order to fully assess the client's exposure, a preliminary risk analysis can determine whether the time and expense required for a detailed analysis and consultation with local law experts are justified.

In developing a preliminary risk analysis, it is necessary to analyze the crucial issues and assess the risks of distributor termination under local distributorship laws.<sup>2</sup> Special regulations<sup>3</sup> governing the importation and distribution of certain products and commodities -- for example, those in the public interest, such as public transportation equipment or pharmaceuticals - can make it more difficult for a foreign supplier to terminate an existing local distributor. These more specialized regulations are beyond the scope of this article.

## **In Practice, Two Caveats**

At the outset, before considering the legal aspects of distributor termination in the Middle East, two crucial practical aspects must be emphasized:

- First, a foreign company that intends to terminate a Middle East distributor should almost always seek termination on an amicable or negotiated basis, but with a view toward potential litigation.

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- Second, and related to the above, a literal analysis of the parties' rights (under applicable contract provisions or law) is undoubtedly less important in the Middle East if the distributor has strong influence in local government or commercial circles. A foreign supplier should therefore assess the relative power or influence of a local distributor when considering its liability for termination.

### **Distributor Laws**

For purposes of this analysis, Middle East countries may be categorized into three groups, although, as discussed below, certain countries may not fit squarely within one of the categories:

- countries with protective legislation -- Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, and the United Arab Emirates;
- those with protective practices and customs -- Saudi Arabia and North Yemen; and
- those with less restrictive legislation -- Egypt and Syria.

Two other Middle East countries, Iraq and Libya, present somewhat special circumstances, particularly in light of government domination of foreign trade activities, and are beyond the scope of this article.

### **Protective Legislation**

All the countries in this group have enacted special legislation governing the qualifications, registration and operation of distributorships. For example, these countries reserve "trading activities," including distributorship, to nationals (or local companies wholly or majority owned by nationals) and require distributorship agreements to be registered with -- and, for some jurisdictions, substantively reviewed by -- special government departments.

Moreover, all of these countries provide some form of "dealer protection" in the event a foreign supplier decides to terminate or not renew the locally qualified distributor. For example:

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- Article 18 of Jordanian Law No. 20 (1974), as amended;
- Articles 281 and 282 of Kuwaiti Law No. 68 (1980);
- Article 4 of Lebanese Law No. 34 (1967), as amended; and
- Articles 8 and 9 of U.A.E. Federal Law No. 18 (1981).

Some of the protective laws incorrectly state that a foreign supplier "may not terminate" a distributorship without valid reason. The Bahraini Ministry of Commerce occasionally sends out a standard letter which states, in part, that "it is not possible" to terminate a distributorship. In fact, a foreign supplier has the right or authority to terminate the distributorship, subject to the legal consequences of the protective legislation.

The distributor is usually entitled to compensation or indemnities for the termination or non-renewal, regardless of any contrary provision in the parties' agreement. Such protective legislation usually requires the supplier to repurchase inventory and compensate the distributor for "lost profits" and costs incurred in firing employees working on the distributorship.

In addition, either as a matter of law or practice, government authorities usually will not allow a newly appointed "replacement distributor to register the agreement it has made with a supplier and the former distributor -- at least, a former distributor that is duly registered. The protected distributor is also allowed, in some countries, to request the customs authorities to block the supplier's imports through successor distributors until an amicable or a court-ordered settlement is reached. Examples include:

- Article 4 of Lebanese Law No. 34 (1967), as amended;
- Article 5 of Omani Royal Decree No. 26 (1977); and
- Articles 17 and 23 of U.A.E. Federal Law No. 18 (1981).

Many of these laws and regulations are short and/or ambiguous. Court decisions, if they exist at all, are often not publicly reported and, in any event, are not technically binding as precedent in many of the countries with protective legislation. Questions of the proper interpretation of the legislation will therefore be difficult to resolve.

**Protective Practices And Customs**

*Saudi Arabia*

In Saudi Arabia, local distributors are protected by a mixture of regulations, administrative practice and commercial custom. As part of a mandatory registration process, a Saudi distributor must submit its distributor agreements to the Ministry of Commerce for review and approval. The Ministry carefully reviews the terms of such agreements and refuses to register any agreement it deems to contravene Saudi regulations or public policy.

No Saudi legislation limits or regulates the right of a foreign supplier to terminate or refuse to renew its distributor in the Kingdom, or requires the payment of compensation upon termination or non-renewal. As a matter of practice, however, a Saudi distributor can claim, and is frequently awarded, compensation if the foreign supplier either terminates the distributorship before its term expires or does not renew the distributorship upon expiration of its term.

For example, the Jeddah Chamber of Commerce historically has taken the position that, upon termination or non-renewal of a distributorship agreement, a Saudi distributor has the right to have its inventory repurchased at cost and to be compensated for the "unamortized expenses" incurred in carrying out the distributorship. Although the Jeddah Chamber is not a government entity and its position therefore lacks the force of law, Saudi courts and government departments have found the Chamber's position persuasive and have applied it.

In addition, the Saudi Ministry of Commerce refuses to allow a replacement distributor to register as acting on behalf of the foreign supplier until all disputes with the prior distributor are resolved.

*North Yemen*

North Yemen, like Saudi Arabia, has no special protective legislation for local distributors. Under Article 283 of the North Yemeni Civil Code, however, an "agent" is entitled to compensation if terminated without "justifiable cause" or at an "inappropriate time" (Law No. 39 (1976)).<sup>4</sup>

Terminated local distributors often use this provision to obtain compensation for loss of income, as well as for expenses

incurred in promoting the supplier's business. Moreover, as a "customary" matter, a foreign supplier may have difficulty in appointing a replacement distributor unless an amicable settlement is reached with the prior distributor. It appears that the local chamber of commerce plays a crucial role in protecting North Yemeni distributors.<sup>5</sup>

### **Less Restrictive Legislation**

Egypt and Syria have no special legislation that limits the right of a foreign supplier to terminate, or not to renew, a distributorship, or that obligates the foreign supplier to pay termination or non-renewal compensation to its distributor. A narrow exception to this general rule possibly exists in Egypt, where a foreign company using a "public sector" (government owned or controlled) distributor may be prohibited from terminating that distributor in order to appoint a private sector distributor (Article 4© of Egyptian Law No. 120 (1982)). But in general, in Egypt and Syria, the provisions of the distributorship agreement govern and define the rights of the parties upon termination or non-renewal.

The law of both Egypt and Syria does, however, require that termination be upon adequate notice, which the parties generally agree upon and define in the distributorship agreement.<sup>6</sup> In addition, Egyptian and Syrian law includes the "abuse of rights" principle, under which a court might in egregious circumstances grant a distributor damages for its supplier's abusive exercise of a legal right to terminate the agreement. The "abuse of rights" principle, exemplified in the Egyptian and Syrian Civil Codes, is based partially in tort theory and thus probably cannot be preempted by the provisions of the parties' contract.

### **Dispute Resolution**

Protective legislation in the Middle East countries grants exclusive jurisdiction to local courts or special administrative tribunals to "settle all matters, disputes and complaints concerning the implementation, interpretation and execution of the provisions" of the protective legislation. The quoted passage, which is typical of many protective distributor laws, is from Article 18 of the Omani Commercial Agency Law (Royal Decree No. 26 (1977)); in Oman, the special administrative tribunal is the Authority for the Settlement of Commercial Disputes.

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Although no protective legislation addresses the issue, a foreign governing law clause would not be enforced in any of the protective jurisdictions to the extent such foreign law contradicts public policy, including the rules protecting a local distributor in the event of termination or non-renewal.

Of course, dispute resolution problems in the Middle East are not limited to countries with protective legislation. Consider, for example, the potential problems of enforcing an arbitration clause in an Egyptian distributorship agreement.

Despite the substantial basis under Egyptian law for the enforceability of arbitration agreements, both public and private sector Egyptian parties to arbitration agreements have argued at the time a dispute develops that particular arbitration clauses conflict with Article 502 of the Egyptian Code of Civil Procedure. The argument is that Article 502 requires the disputing parties themselves to select the arbitrator(s) and that, therefore, an arbitral body (such as the ICC) may not make such a selection in the event either party fails to nominate its arbitrator.

More significantly, some Egyptian courts have suspended arbitration proceedings (either provisionally or permanently) if the arbitrators were not selected by the disputants themselves, based on the Article 502 argument. These suspensions call into question the enforceability of many arbitration agreements in Egypt and with Egyptian parties.<sup>7</sup>

### **Preliminary Risk Analysis**

The following outline is suggested as the basis for counsel's preliminary analysis of the issues.

#### **i. Structure of Distributorship**

Counsel should initially obtain information on the client's precise marketing and distribution arrangements for the relevant jurisdiction(s). This means that counsel should request copies of the distributorship agreement and all relevant correspondence.

An examination of the distribution structure usually reveals that the distributor is located in the relevant country, satisfies the nationality and other qualification requirements, and is theoretically protected by local law. Sometimes, however, the client's "Middle East" distributor is not actually located in the Middle East. The distributor might, for example, be a U.S. export

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management company -- a "super-distributor," to which suppliers sometimes give regional distribution rights.

Although super-distributors may be entitled to certain protection in their country of incorporation or residence, they probably are not, upon termination, protected by Middle East distributorship laws because these super-distributors presumably do not satisfy the nationality and other qualification requirements.

There are, however, important caveats to this general statement:

- First, counsel should carefully examine the law(s) most likely governing the distributor's rights. For example, if a Lebanese distributor has been appointed for other markets outside Lebanon, the Lebanese protective legislation allows for termination indemnities computed on the basis of *all* the lost markets resulting from the termination.
- Second, and equally important, if the super-distributor has appointed sub-distributors in any of the Middle East countries, the sub-directors may have certain rights directly against the supplier whether or not the supplier is a party to or authorized such appointments. Many distributor laws in the Middle East require a "direct relationship" between the foreign manufacturer and the local distributor. Two examples are Jordanian Law No. 20 of 1974 (Article 8), and U.A.E. Federal Law No. 18 of 1981 (Article 4). The direct relationship requirement, however, is not always strictly enforced by the responsible government authorities in each jurisdiction. In any event, a distributor's failure to satisfy the direct relationship requirement probably will not preclude the distributor from protective benefits if the distributor is otherwise qualified.

**ii. Other Roles of Distributor**

A local distributor may be providing additional assistance or support for its foreign supplier beyond "simple" distribution of products, and counsel should examine the possible collateral effects if the distributor is terminated.

For example, in Egypt, a foreign company may have opened a local "scientific", "technical", or liaison office in conjunction with its appointment of a local distributor, under Article 7 of

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Egyptian Law No. 120 (1982). The continuing existence of such an office is contingent on the existence of the registered distributorship. Termination of the distributor will require the closing of that office. A supplier terminating a U.A.E. distributor that acts as sponsor for that supplier's branch office in the U.A.E. may also have a similar problem: the branch office might have to be closed.

Another example under Egyptian law: Certain specified products cannot be imported into Egypt unless they are covered by a registered commercial agency or distributorship agreement and a service facility exists in Egypt to repair and service such products (Article 5 of Ministry of Trade Decision No. 1036 (1978)). Annex No. 3 of the Decision describes the products subject to this requirement. The foreign supplier does not necessarily have to establish the service center itself, and it is not unusual for this responsibility to be given to the local distributor. Thus, termination of a local distributor in Egypt might require the supplier to restructure the operation of the local service facility.

Finally, many foreign suppliers second employees to local distributors, particularly skilled technical or other sales personnel. In essence, the seconded personnel are considered (at least for local law purposes) employees of the local distributor, which often has a direct employment contract with them, and which also often sponsors them for visas and work permits. The supplier's termination of the distributorship, therefore, could put the seconded employees in a difficult position.

**iii. Distributorship Provisions**

Counsel must also, of course, carefully review the specific terms and provisions of the relevant distributorship agreement(s). A few of the most important contractual provisions are listed below:

**(1) Exclusivity**

In most Middle East countries with protective legislation, a distributor is deemed exclusive as to the territory and products subject to the distributorship, regardless of any contrary provision in the parties' agreement. A few jurisdictions, however, are exceptions to this rule -- notably, Kuwait and Lebanon, where nonexclusive distributors may be appointed.

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In these two countries, the termination or non-renewal of a nonexclusive distributor will be governed by the agreement of the parties and general principles of local contract law -- but not the indemnification provisions of protective legislation. Therefore, the most obvious means of minimizing the impact of protective legislation in Kuwait and Lebanon would be for a supplier to appoint a local distributor on a nonexclusive basis.

Of course, Kuwaiti and Lebanese courts have some discretion to classify commercial arrangements based on their substance, as opposed to their form. If a foreign company appoints a nonexclusive distributor, but it appears that the distributor is in fact acting in an exclusive capacity, a court or government department might consider the distributor as a de facto exclusive, and thus subject to and protected by local protective legislation.

**(2) Performance Standards**

Counsel should determine whether the distributorship agreement expressly sets forth the specific conduct that the parties agree will constitute "distributor breach" of the agreement sufficient to justify termination or non-renewal. Where a distributorship is terminated or allowed to expire for reasons deemed to be "reasonable" in the parties' agreement -- for example, where the supplier can demonstrate with objective criteria that the distributor's performance has been unsatisfactory -- the supplier will have a better basis for arguing that distributor indemnities should not be applicable or, at least, should be reduced. A local court hearing the dispute, however, will have discretion to decide the sufficiency of the supplier's justification.

The parties may have included a provision in the distributorship agreement calling for a minimum annual sales volume or quota. The enforceability of such quota provisions usually depends on whether the particular jurisdiction has protective or less restrictive legislation. Although, depending on the particular circumstances, a minimum sales quota provision might not often be given effect in the course of a terminations dispute in the protective jurisdictions, the distributor's failure to meet the minimum may be a helpful factor (another arrow in the quiver) in proving before a local court that breach was sufficient grounds for termination or non-renewal.

An interesting contrast is the treatment of such quotas in Egypt and Saudi Arabia.

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In Egypt, government registration officials have informally confirmed that distributor agreements with such minimum quota provisions will be registered. These provisions should, in most circumstances, be enforceable in Egyptian courts and, upon the distributor's failure to reach its performance standard, should provide an objective contractual basis for termination.

By comparison, under recent practice in Saudi Arabia, a number of distributorship and commercial agency agreements have been refused registration because of provisions establishing minimum sales quotas or other such performance standards.

**(3) Termination or Non-renewal**

Counsel should determine whether the distributorship was made for a definite term, and if the supplier could therefore "passively" allow the distributorship to expire rather than "affirmatively" terminate the agreement. In theory, if not always in practice, it may be more difficult for a distributor to claim non-renewal compensation, under protective legislation. Similarly, one could argue that a short definite-term agreement might lessen the distributor's reasonable expectation of future profits.

For example, under Kuwaiti law (Articles 281 and 282 of the Commercial Law, Law No. 68 of 1980), if a supplier *terminates* its exclusive distributor and the latter has committed any breach of "error," then the supplier is obligated to compensate the distributor for "any damage that may occur" as a result of the termination. By contrast, when a supplier chooses *not to renew* its exclusive distributor, the latter is entitled to "fair compensation" if it can satisfy two standards: first, that it has not committed any breach or "error"; and second, that its activities have resulted in considerable succession promoting the product(s) covered by the distributorship or in increasing the number of customers.

**(4) Foreign Governing Law/Forum Clauses**

Counsel should determine whether the distributorship agreement contains foreign governing law and foreign dispute resolution provisions. For present purposes, "foreign" means a jurisdiction other than the distributor's home country.

Although, as noted, there are a number of uncertainties regarding the enforceability of foreign governing law and foreign forum provisions in distributor agreements (at least in countries

with protective legislation), such clauses might have "defensive" value to the supplier in the event the distributor seeks to enforce a local judgment in another country, such as the United States.

#### **iv. Distributor Registration**

For most of the countries with protective legislation, counsel probably should also investigate the registration status of the local distributor under the applicable distributorship law. In some of the countries with protective legislation, the benefits of the protective legislation are contingent upon proper registration by the distributor.

For example, in accordance with the U.A.E. protective legislation, an unregistered distributor "shall not be legally recognized and no claim in respect thereof shall be heard."<sup>8</sup> In practice, such provisions cannot always be relied upon to preclude an unregistered distributor from asserting a claim for indemnities, particularly in situations where equities favor the unregistered local distributor. But in some of the countries with protective legislation (Kuwait and Oman, for example), the registration requirement usually has been strictly enforced and local courts refuse to hear claims by unregistered distributors for termination or non-renewal indemnities. Nonetheless, if an existing but unregistered distributor agreement is in registrable form (signed, notarized and consularized, for example), a local distributor could always register it at a later date, assuming no other local distributor registers first, and would then be protected under local law.

#### **v. Assessing Size of Indemnities**

In the Middle East countries with protective legislation, the types of damages or indemnification usually awarded to a terminated distributor are:

- a multiple of the distributor's average annual profit,
- costs and unamortized expenses incurred in pursuing the distributorship, including existing inventory, and
- compensation for "good will" or other benefits accruing in the market for the foreign supplier's products.

The nature and extent of such compensation or indemnities that would actually be awarded in any particular case is almost

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impossible to estimate since it would depend on an ad hoc decision of the court in light of all the circumstances it believed relevant. Nonetheless, a client often seeks a preliminary estimate, however inaccurate it may be. In light of the typical grounds for assessing damages, attorneys should ask the following questions:

- How long as the distributorship relationship existed?
- What is the recent and long-term sales history of the distributorship?
- What possible justification or cause does the supplier have for terminating or not renewing the distributorship?
- What sales and promotional costs were incurred by the distributor?
- Did the distributor hire additional employees, rent additional facilities, or purchase additional equipment for the distributorship?
- Is the distributorship agreement for a fixed or indefinite term?
- What provisions are contained in the distributorship agreement concerning termination, assignment, and the discontinuation of products or business of the foreign supplier?

### **vi. Advice on Local Law/Practice**

Counsel's job will not be complete until the advice of local law experts is obtained, thereby determining the actual practice and rules for the particular jurisdiction(s) in question. For the reasons given below, counsel should not rely merely on a literal reading of the relevant protective legislation.

In the U.A.E., for example, some provisions in the distributor law are often ignored or not enforced, and the practical significance of some aspects of that law is therefore reduced. Before enactment of the U.A.E. protective legislation, the regulation of distributors had been the responsibility of the individual emirates, and each continues to exert varying degrees of independence on some distributor matters.

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Moreover, in the U.A.E., local attitudes toward termination indemnities diverge from the customary attitudes in other protective jurisdictions. This is particularly true in Dubai. In Dubai, at least, apparently certain government officials and local businessmen recognize that distributor termination and non-renewal indemnities could act as a disincentive for foreign companies, and some local sentiment exists for minimizing the size of such indemnities.

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**ENDNOTES**

1. Although the focus of this article is on distributors (who buy products from suppliers and resell for their own accounts), distributorship laws in the Middle East often also govern commercial agents (who receive commissions on sales).
2. The information in this article is based on materials currently available in our firm's offices. The purpose of this article is generally to summarize and analyze certain distributorship laws, particularly on questions of termination, but it is not intended to provide legal advice on any specific aspect of local law.
3. See, e.g., North Yemeni Law Nos. 6 (1976) and 23 (1975), whereby, subject to certain exceptions, certain products (such as mechanical, transportation, agricultural and road equipment) may only be imported into North Yemen through registered local distributors or commercial agents.
4. See also the Qatari Civil and Commercial Code, Law No. 16 (1971), at Article 305.
5. Ghanem, "Commercial Litigation in the Yemen Arab Republic," Arab Law Quarterly 230 (August 1987), at p.241.
6. See, e.g., Article 158 of the Egyptian Civil Code.
7. See, e.g., Jarvin, "The ICC Court of Arbitration-Recent Developments and Experience Related to Arab Countries," Arab Law Quarterly 280 (May 1986), at pp.297-98.
8. Article 3 of U.A.E. Federal Law No. 18 (1981). See also Omani Royal Decree No. 26 (1977), at Article 11(d).