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The Prohibition of Sudden termination of long standing commercial relationships

under French law

LMBE

SUMMARY

Under Article L.442-6 I 5° of the French Commercial Code, it is prohibited to suddenly terminate long standing ("*established*") commercial relationships, wholly or partially, that is to say without providing the other party with a reasonable notice period that shall be computed on the basis of the overall duration of the commercial relationship at stake.

In case of infringement of such a rule, the party taking the initiative to terminate commercial or contractual relationships may be liable to pay damages to the other party.

These damages shall mainly consist in the gross margin that the « victim » of this sudden termination might have achieved during the notice period.

The need to observe a prior notice period is not required when the termination is based on serious misconduct from the other party. However, this exception is construed in a very restrictive fashion by French Courts.

SUMMARY

According to authoritative precedents from the French Supreme Court, this civil liability falls within the scope of the law of torts.

In other words, abruptly terminating an agreement may be remedied by the award of damages on the basis of the law of torts.

Such a liability may be incurred even if the notice period specifically provided under the agreement has been fully observed whenever such a notice period appears to be insufficient with respect to the factual elements of the case and the overall duration of the commercial relationship.

SUMMARY

This rule is obviously applicable to commercial or contractual relationships specifically governed by French law.

There is still a debate between the Chambers of the French Supreme Court as to whether Article L.442-6 I 5° of the French Commercial Code should be construed as an overriding French public order rule ("*loi de police*") with the effect that it should be implemented by French Courts, irrespective of the foreign law chosen by the parties, whenever the damage resulting from the avoidance of a notice period would be actually sustained on the French soil.

SUMMARY

The French Supreme Court recognizes the enforceability of foreign jurisdictional or international arbitration clauses so that a French plaintiff would have to lodge its complaint on the basis of this rule before the foreign court or the foreign arbitration tribunal/organization designated by such clauses to rule on the disputes arising from the agreement.

This may limit the risk that the relevant foreign courts or arbitration tribunals might consider that French law should be applicable even it is not the law chosen by the parties to govern the agreement.

SUMMARY

For minimizing legal and financial exposure that may result from this French rule, it is advisable for foreign investors in France or French subsidiaries of international groups of companies :

(i) To challenge the "established" nature of a commercial relationship through the organization of calls for tenders to argue that there is no continuity in the relationship.

(ii) To be very specific in the drafting of jurisdictional or arbitration clauses so as to include any and all disputes arising from or in relation to the termination of the relationship that may have existed between the parties, under the relevant agreement or otherwise.

The rule

L.442-6 I 5° of the French Commercial Code reads:

"*Entails the liability of his/her author and obliges him/her to repair the harm caused the fact, by any producer, trader, manufacturer or a person registered in the trade register […]*

To suddenly terminate, even partially, an established commercial relationship without a written notice taking into account the duration of the commercial relationship and observing the minimum determined period of notice, with reference to usage of trade by inter-professional agreements. […] The foregoing shall not preclude the right of termination without notice in the event of non-performance by the other party of its obligations or in the event of force majeure."

The origin of this rule

The prohibition of sudden termination of long standing commercial relationships has been introduced into French law in 1996.

The text has been slightly amended in 2001.

Since then its implementation has given rise to extensive case law from French courts.

Initially, this text was aiming at fighting against practices committed by the purchasing entities of chains of supermarkets consisting in the immediate delisting of suppliers.

This rule is however drafted in very general terms so that it is applicable to all economic sectors.

The objective pursued by this rule

The objective is to allow the partner who will be "evicted" from a stable and regular commercial relationship time to reorganize its business before the termination of this relationship becomes effective.

This text has become very "fashionable" due to the economic crisis.

It is very often raised when the alleged victim has filed for bankruptcy following the termination of the commercial relationship.

This rule is raised by French plaintiffs to request either an extension of the notice period provided under the agreement that is being terminated (such notice period may extend to one or several years for commercial relationships having lasted for decades) or financial compensation.

Most of the time, legal proceedings based on this rule are launched several months or even years after the termination has become effective.

The statute of limitation under French law (both for actions based on torts or contract law) is 5 years from the time when the holder of a right should have known the facts that would have enabled him/her to assert such a right (Article 2224 of the French civil Code).

This rule does not infringe the French Constitution

The issue of compliance of Article L.442-6 I 5° of the French Commercial Code with the French Constitution has been raised.

According to a change in French law, which has come into force as from 1 March 2010, an application for a preliminary ruling on the issue of constitutionality ("*question prioritaire de constitutionnalité*") may be lodged by a party involved in legal proceedings for the purposes of arguing that a specific statutory provision infringes rights and freedoms guaranteed by the French Constitution.

The finding as to whether a specific statutory provision complies or not with the French Constitution is exclusively reserved to the Constitutional Council who must be referred the relevant application by the French Supreme Court, in civil and criminal matters, provided the latter determines that certain cumulative legal conditions are met for such referral.

Three conditions are set out under Article 61-1 of the French Constitution for such preliminary ruling:

- the challenged statutory provision must be applicable to the legal proceedings or be the basis of such proceedings;
- the challenged statutory provision has not previously been found to be in compliance with the French Constitution by the Constitutional Council;
- the legal issue raised in the application is a new one or a serious one.

The constitutionality of Article L.442-6 I 5° of the French Commercial Code was challenged for infringement of Article 8 (principle that penalties may only be provided by law) and Article 4 (principle of contractual freedom) of the Declaration of the Rights of Man and of the Citizen dated 26 August 1789.

In a decision dated 5 April 2011, the Commercial Chamber of the French Supreme Court dismissed the application for a preliminary ruling on this matter before the Constitutional Council.

The French Supreme Court determined in essence that the legal issue did not entail serious concern with regards to its compliance with the French Constitution.

First, the alleged infringement of Article 8 of the Declaration of the Rights of Man and of the Citizen was rejected on the ground that the civil liability set under Article L.442-6 I 5° of the French Commercial Code was governed by clear and unambiguous conditions.

Second, the alleged infringement of Article 4 of the Declaration of the Rights of Man and of the Citizen was also rejected on the ground that this prohibition of abrupt termination of long standing commercial relationships did not affect the freedom to terminate a contractual relationship but set a limit to such a freedom when damage was sustained by another party as a result of an abusive exercise of this freedom.

The prerequisite: an established commercial relationship

A commercial relationship

The word "commercial" does not mean that such a relationship shall have been developed between two merchants ("commerçants").

On the contrary, this notion is used in very extensive manner to include any form of business relationship concerning the sale of products/services between two economic traders including activities that are considered as civil activities under French law (for example architects).

A commercial relationship

The only exceptions lie with the relationships developed by certain legal or medical professions such as doctors or notaires (lawyers specialized in real estate matters) for which it has been judged that they are prohibited by their codes of ethics to engage into commercial activities.

This reasoning also applies to “avocats” (attorneys at law) who may not rely on this specific provision to claim damages against clients terminating long standing relationships.

An established commercial relationship

The notion of "established commercial relationship" refers to a situation in which a commercial relationship is devoid of insecurity insofar as:

- it continued without interruption or in a stable manner for many years,
- the other party suffering the termination could legitimately expect a continuation of the commercial relationship (particularly when this relationship takes the form of an indefinite term agreement instead of a fixed-term agreement excluding a tacit renewal),
- no uncertainty existed as to the continuation of the commercial relationship (which would be the case if this relationship was only initiated as a result of a tender).

An established commercial relationship

The notion of "established" commercial relationship shall therefore cover:

- Indefinite term agreements
- Definite term agreements that have been successively renewed
- The situation where there is no specific written agreement (relationship solely based on orders and invoices)

This relationship shall have lasted for a certain period of time to be viewed as being “established” while there is no minimum period of time provided by French law.

However, one may not expect that a commercial relationship having lasted less than a year may qualify as an “established” one.

A termination that may only be partial

This notion of partial termination is difficult to handle in practice.

A significant decrease in business shall qualify as a « partial termination » as long as it may be proved that it was deliberate and that it may not be explained otherwise.

In a judgment rendered in 2013 (the "Caterpillar" case), the French Supreme Court has ruled that whenever the decrease of business that is criticized on the basis of this rule is explained by the decrease of the orders from the own clients of the alleged author of this termination, there is no tort.

In other words, you are not obliged to continue purchasing products at a similar level in the event that you are not in a position to resell such products.

This is common sense but the clarification brought by this decision was more than welcome considering some abusive actions lodged by certain suppliers against purchasing entities in the supermarket sector, contending that they should be entitled to have the same level of sales from one year to the other, even if the demand for such products by consumers dramatically decreased (for instance wall paper).

A sufficient notice period

The notice period is assessed regarding the total duration of the commercial relationship involved.

A position of economic dependency of the party suffering the termination is, according to case law, an aggravating factor that has the effect of increasing the notice period the party taking the initiative of the termination shall give to his partner that he wants to terminate.

Any contractually agreed notice period may be rendered ineffective if it turns out that this notice is not sufficient regarding the total duration of the commercial relationship involved.

This “neutralization” of contractual terms agreed between the parties is justified by the fact that the liability incurred by the author of an abrupt termination of commercial relationships, according to authoritative case law of the French Supreme Court, falls within the law of torts as opposed to contractual liability.

Examples of what is a sufficient notice period

There is no mathematical rule or linear correlation to assess the length of notice to be given regarding the total duration of the commercial relationship involved.

"Trends" however emerge from case law. By simplifying, we can thus estimate:

- a 6-month notice would be enough for a 5-year relationship at most;
- a notice between 6 and 9 months should be granted for a relationship which lasted between 5 and 10 years;
- a notice of at least 12 months should be granted for a relationship which lasted for more than 10 years;
- a notice of at least 18 months should be granted for a relationship which lasted for more than 20 years.

The notice period shall be doubled for private label products.

A serious breach is necessary to avoid giving a prior written notice of termination

Although the text of Article L. 442-6 I 5° of the French Commercial Code mentions a simple "non-performance by the other party of its obligations", authoritative case law considers that only a serious breach by the partner suffering the termination enables to escape from the obligation to grant him a notice.

This concept of serious breach is assessed restrictively by case law so that the alleged fault against the other party must be of such a seriousness that it justifies terminating the commercial relationship immediately.

Damages that may be claimed by the plaintiff

Only the damage resulting directly from the abruptness of the termination and not the damage resulting from the termination itself may be compensated on the basis of Article L.442-6 I 5° of the French Commercial Code.

The main compensable damage for the abrupt termination of established commercial relationships is the gross margin lost by the "victim" during the notice period which should have been granted.

The gross margin is often calculated through an average over the last three full years of the commercial relationship involved, then multiplied subsequently by the number of months corresponding to the notice which should have been granted.

The legal action from the French Ministry of Economy

Apart from the legal action for damages that may be lodged by the « victim » of an abrupt termination of an established commercial relationship, Article L442-I 5° of the French Commercial code provides that the Ministry of Economy may lodge judicial proceedings against the author to have him/her condemned to pay a civil fine (of a maximum amount of 2 million euros).

This action from the French Ministry of Economy is based on the assumption that this behavior is disruptive of the economic public order in France.

This action from the French Ministry of Economy may take place:

- At his own initiative

- When he is put on notice by the plaintiff (through the service of a copy of the plaintiff' writ of summons against the defendant).

There are been very few cases where the French Ministry of Economy has decided to lodge a distinct judicial proceeding or to join proceedings lodged by the plaintiff.

Several judgments have condemned the author of a sudden termination of established commercial relationships to the payment of a fine (but never up to 2 million euros).

A rule applied by specialized courts in France

The litigation related to the abrupt termination of established commercial relationships is assigned to specialized courts (Article D. 442-3 of the French Commercial Code), including the Commercial court of Paris and the Paris Court of Appel which has jurisdiction over the entire territory of France.

This means for instance at the appeal level that the procedure may take at least two years before a decision is rendered by the Paris Court of Appeal.

Enforceability of jurisdictional and arbitration clauses in international litigation

Regarding international litigation, it is possible to challenge the jurisdiction of the specialized French courts on the basis of an authoritative precedent from the1st Civil Chamber of the French Supreme Court (specialized in international private law), namely the "Monster Cable" decision dated 22 October 2008.

In this decision, the French Supreme Court ruled that the clause providing exclusive jurisdiction to a California court (contained in an agreement signed between a US company and a French Company and governed by the laws of California) shall be applied.

In a subsequent decision dated 8 July 2010, the same Chamber of the French Supreme Court ruled in a similar way concerning an arbitration clause contained in an international commercial agreement.

Thank you

Speaker

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