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When might compensation be better for a principal than indemnity?

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Under the Commercial Agents Regulations, an agent will generally be entitled to compensation or an indemnity payment on the termination of their agency contract. Unless the agency contract specifies an indemnity payment, the default position is that compensation will be payable.

The decision about whether to elect for compensation or indemnity has to be taken at the time the agency contract is entered into. At this point in time, before the agency relationship has started, it can be difficult to predict how successful the agent is going to be in generating business for the principal. In most cases, an indemnity payment will be the cheaper option for the principal because it is calculated on the basis of the average annual commission received by the agent in the last five years of the agency (or a lesser period if the agency has not been in existence for five years). This operates to cap the principal's liability on termination and gives the principal certainty of the maximum exposure they will have to their agent on termination.

Mr Warren was successful. In his claim for "pipeline commission" on the £230,000 orders placed after his retirement, he was awarded £5,771 under regulation 8. In addition, Mr Warren was awarded £18,800 under regulation 17 of the Regulations as compensation for the damage suffered by the termination of his agency. In deciding on the sum of £18,800 as compensation for termination the Judge considered what a reasonable hypothetical purchaser would have paid for the agency.

In contrast, the compensation payment is calculated by reference to the value of the agency business if it was sold to a theoretical third party at or immediately before the date of termination of the agency.

This valuation process can be quite complex, particularly with large and/or highly successful agencies, but generally the calculation will involve assessing the annual (or monthly) income of the agency, deducting the annual (or monthly) costs of running the agency and then multiplying that annual (or monthly) "net earnings" figure by an appropriate multiplier to reach the compensation figure.

There is no cap on the compensation figure so where, for example, an agent builds up a very successful and sustainable agency from a zero or very low base (think Pandora or Crocs), the compensation payment due on termination could be very large.

However, it might be possible for the principal, at the start of the agency relationship, to have a clear idea of how the agency is going to progress and, therefore, whether compensation might be preferable to indemnity. One example might be where a sales agent has previously been employed by the principal but the parties have agreed to change the relationship so that the former employee is appointed as an agent. In that situation, the principal would probably have quite a clear view of the likely level of sales that the agent would generate, at least at the outset. If the market is a fairly stable one, the principal might be comfortable enough to compare the likely compensation v indemnity payments to determine which option is preferable. However, there is an element of risk here because if the principal misjudges the market and the agency is more successful than anticipated, opting for compensation over indemnity could be an expensive mistake.

Another example where indemnity could be preferable to compensation is where the agent is likely to saturate the market quite quickly, with sales then reducing quite significantly. This could occur where the product offered by the principal is likely to be a one–off purchase for the customer rather than a repeat purchase.

It is worth noting that if sales levels do reduce significantly over time, then the sum payable to the agent as compensation or indemnity would also reduce. The principal would need to be quite certain about the level of sales that would be generated by the agent, the amount of commission that would be earned and how long it is likely to take to reach that saturation point for them to assess whether compensation would be a better option than indemnity.

If there is any doubt about how the agency might perform, it is probably safest to elect for an indemnity payment in the agency contract. That will give the principal certainty of their maximum exposure if the contract has to be terminated and will allow them to plan accordingly.

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