SHUMAKER®
Shumaker, Loop & Kendrick, LLP

The Customer Triangle: Who's At Risk

Business Information for
Clients and Friends of
Shumaker, Loop & Kendrick, LLP

November, 2015

David Conaway ‖ dconaway@slk-law.com ‖ 704.945.2149
Manufacturing • Customers • Vendors • Supply Chain
Insolvency • Litigation • Commercial and Financial Contracts • Cross-Border

COMMON SALES TRANSACTIONS: SELLER AND BUYER

The most common commercial sales transaction involves a supplier of goods and a buyer of those goods. The risk of non-payment to the supplier usually arises in two scenarios:

- There is a problem with the goods or the delivery.
- There is some form of financial distress of the buyer that impacts the ability to pay.

It is rare that an issue with the goods delivered is not preemptively resolved by the supplier with a credit memo. By contrast, the supplier has little control over the buyer's financial distress, so managing risk of non-payment in this scenario is more challenging.

VARIATION ON THE THEME: A CUSTOMER TRIANGLE

The sales transaction becomes more complicated when a third party is also involved. For example, in the packaging industry (but in many other industries), it is common for branded products companies ("customers") (see graphic) to utilize "co-packers". A supplier of packaging could invoice or "bill to" the customer, but "ship to" the co-packer, who in turn packages the product for delivery to a retailer or the customer's distribution center. Alternatively, the customer could "request" the supplier both "bill to" and "ship to" the co-packer, who then is the supplier's customer.

Often the customers are large global companies (Coke, General Mills, Nestle, P&G, Unilever), while co-packers are smaller, non-public companies. Typically orders are based on the customer's requirements for quantities and manufacturing specifications, and the price and delivery requirements are negotiated with the customer. Nevertheless, in the "bill to" and "ship to" the co-packer scenario, the co-packer has the legal obligation to pay. The customers certainly prefer this scenario which shifts the payment obligations and the risk of non-payment to the co-packer and the supplier, and also reduces the customers' accounts payable and administrative overhead due to fewer vendors.

This customer confusion could create unexpected credit risk, and an unanticipated loss in the event the co-packer becomes insolvent or for any reason does not pay invoices owed to the supplier.

Typically a supplier will protect itself with the best sales documentation (order confirmations, invoices, terms of sale, supply agreement or sales contract) that it is able to obtain. Also, suppliers often seek to minimize the credit risk with collateral or third party credit enhancement (letter of credit, guaranty or credit insurance) when they have the leverage to demand these protections. In the customer and co-packer scenario, a supplier naturally seeks the credit enhancement from the customer.

ISSUES THE SUPPLIER SHOULD CONSIDER

1. Shift the Risk.

- Assuming the credit risk of the customer is low and the credit risk of the co-packer is comparatively higher, or not as easily determined, the supplier should push the "bill to" to the customer, and "ship to" to the co-packer. Indeed, the co-packer was selected or engaged by the customer in the first instance.

2. Guaranty of Payment.

- If shifting the risk is not an option, a supplier could seek a guaranty from the customer.

- Such guaranty should be a **guaranty of payment** (and not of "collection") to ensure the supplier can seek payment from the customer immediately upon the co-packer's default.

- The guaranty should also include provisions for **interest and attorneys' fees** to protect the supplier if invoices are not paid, and to give the customer incentive to use its relationship with the co-packer to pay the supplier's invoices. If the payment obligation increases, and the customer could be on the hook for the supplier's attorneys' fees, a favorable resolution is more likely.

- In addition to covering payment of the supplier's invoices, the guaranty should also cover the **supplier's "inventory" claim.** Often the supplier is left with inventory that was specifically manufactured to the customer's specifications, which likely cannot be sold to any other party. The risk of loss for custom-made product should be shifted to the customer.

  The customer should specifically agree that the supplier's inventory claim is valid, whether or not purchaser orders exist, provided the manufacture of product was in reasonable reliance on the customer's requirements. In the absence of purchase orders, and to avoid the risk of proving the inventory produced are **"specially manufactured goods"** compliant with the Uniform Commercial Code, written documentation or communications from the customer confirming the need for goods is advisable.

- The guaranty should also include any exposure the supplier may have in the event the co-packer files for Chapter 11, and its bankruptcy estate forces the disgorgement of monies paid to the supplier in the 90-day period prior to the Chapter 11 filing as a **preferential payment**.

3. Delegation of Performance.

- For the guaranty challenged customer, an alternative is a delegation of performance agreement. Section 2-210(1) of Article 2 of the Uniform Commercial Code (which governs the sale of goods) provides:

  > A party may perform his duty through a delegate unless otherwise agreed or unless the other party has a substantial interest in having his original promisor perform or control the acts required by the contract. No delegation of performance relieves the party delegating of any duty to perform or any liability for breach.

- Based on this, the supplier and the customer could enter an agreement where the customer delegates its payment obligation to the co-packer, which the supplier accepts as an accommodation to the customer, on certain prescribed conditions. For example, a key condition could be if a payment default is not cured within 30 or 60 days, the payment obligation reverts back to the customer.

- A delegation of performance agreement allows the customer to shift the obligations and risks to the supplier and the co-packer, but the customer, appropriately, remains ultimately responsible to insure the supplier is paid.

4. Patents and Trademarks.

- Often specially manufactured goods are subject to a patent or bear the trademark of the customer or a third party who owns the brand.

- We recently advised the contract manufacturer for a well-known designer of ladies' shoes. The designer and manufacturer collaborated on the designs, and the manufacturer produced the shoes, which bore the designer's "label." The manufacturer's "bill to" was the designer, and the "ship to" was directly to retailers.

- When the designer failed to pay invoices, could the manufacturer sell the branded inventory to minimize its losses?

- Ideally, an agreement between the parties would provide the manufacturer a license to sell the inventory to usual customers if the designer defaults.

- In the absence of an express license, courts have ruled the manufacturer has an implied license to sell the inventory. Unlike "knockoff" cases, it is a sale of genuine goods to normal retail customers to mitigate the supplier's breach of contract claim. The designer cannot use its patents or trademarks to avoid the consequences of breach of contract prescribed by Article 2 of the Uniform Commercial Code.

We hope you found this useful and informative, and feel free to share this with others in your company. Please contact us if you have any questions about this, or any other matter.

David Conaway ‖ dconaway@slk-law.com ‖ 704.945.2149
Manufacturing • Customers • Vendors • Supply Chain
Insolvency • Litigation • Commercial and Financial Contracts • Cross-Border

The contents of this newsletter are offered as general information only and are not intended for use as legal advice on specific matters.