Chapter 1
Protection against future insolvency of a customer or supplier

Protecting a business during difficult economic times requires both obvious and subtler legal measures. This book looks at some of the protective measures companies can put in place to aim to secure their legal position if a customer might go out of business. The notable large customers who have fallen into difficulties such as Woolworths, MFI, Northern Rock and other banks and a raft of other well-known names are simply the tip of the iceberg. Those who thought that by supplying big companies that their revenue stream would not be at risk have been proved sorely wrong.

Obvious measures businesses already put into place include the following:

Payment in advance

1. Require payment in advance

Any change to a contract requires agreement between both parties. However most sales are on one off purchase order terms rather than long standing distribution or supply contracts so new terms can be presented for each purchase. If there is a long-term agreement with payment terms already in place then changes to the agreement can be made if both parties agree. Always look at the terms in place already as they may well set out how variations or changes are negotiated. A typical clause might fix prices or payment terms for a 12 month period and provide for regular reviews.

Some buyers have simply said that suppliers will not be allowed to supply them unless they accept new terms such as longer payment periods in the current economic climate and suppliers desperate for the business have had to accede to such requests. Legally this is simply a matter of commercial negotiation once any fixed payment period/fixed terms period is up. The obvious risk is that not agreeing to an immediate contract change can lead to termination by the buyer and the supplier may not be able to afford to lose that business. If the aim is to keep a buyer afloat so that suppliers have a customer to supply then changing

terms even to the detriment of the supplier may be commercially wise. There are no difficult legal issues in this. The parties simply agree and the document changes accordingly. Ensure they are signed and if there is a pre-existing contract that its variation or change control provisions are followed so far as possible and ensure that the variation to the agreement is kept safely with the original contract.

Currency fluctuation risks

2. Hedge against currency risks or specify fees in sterling

A large number of questions from clients to solicitors of late have been about currency fluctuations, pricing changes, rights to vary a price given the unprecedented slump in the pound and the like. Ensure that all contracts with businesses abroad adequately reflect currency risks. The pound at the date of writing is at the lowest it has ever been against the euro. In some ways this is should help exports but as few people are buying abroad whatever the price it has not to date proved the boon it might otherwise have been.

3. Reduce credit periods if they have to be offered at all

At a time when some big customers with economic power have demanded longer credit periods this suggestion can be difficult but for suppliers who cannot obtain new bank finance reduction in credit periods can be essential to survival. Some companies have had to factor their debts and this is obviously one solution although not favoured by many and does not always give the right impression to customers about the viability of the supplier. Also sometimes there is a customer relations problem if the factoring company then vigorously enforces debts which result in adverse publicity for the original supplier. There have been plenty of press articles recently about council tax payers losing their homes over £1000 council tax debts many of which had been factored to aggressive debt collectors.

4. Look at the important commercial contracts that the business has (whether formal or informal)

Even after 25 years as a commercial lawyer it remains surprising to see that so many new clients have no written contracts at all with key suppliers and customers. Of course it is very hard to change the status quo and if it "ain't broke, don't fix it" is often commercially wise but it may well be possible to tell a supplier or customer that a written agreement is needed to formalise the business arrange-

ment. This might then make it clear that the rights given are "exclusive" whereas before it was simply custom and practice. It may also specify that a lengthy notice period of 3 months or even a year or more must be given to terminate the arrangement. Without that in place, contracts can be terminated on "reasonable notice" at common law under English law, whereas had there been a written contract with a fixed notice period, the business might have had time to find alternative customers or suppliers to plug the gap.

5. Retention of title

Increasing numbers of companies are looking at their terms of business or drafting them if they have none in particular to check they have binding retention of title clauses. The next chapter section examines this in detail.

6. Do a very thorough investigation into the credit worthiness of all suppliers or customers

Request payment up front in cash/by bank transfer / letter of credit in cases where that is appropriate and also obtain director or parent company guarantees of obligations and ensure they are drawn up by lawyers so they are legally binding.

7. Include payment on the basis of results, where possible

Redundancies

8. In some cases it may be necessary to terminate the employment contracts of staff if the overhead cost cannot be afforded

Ensure if people are made redundant that this is done within the law following all procedures. (www.berr.gov.uk has useful guidance from the Department for Business on the procedures to be followed on redundancy and dismissal of employees). In December 2008 Mercer undertook a survey that showed 35% of international firms expected to make substantial redundancies in 2009. The survey was of 1,000 HR and finance professionals. Manufacturing and technology workers appear to be in the worst position with 48% of those responding saying that they expected to reduce their workforce significantly (24% of professional services firms and 28% in retail and wholesale expect cuts). If someone is truly redundant then

they will be entitled to a redundancy payment, although statutory rates are set fairly low. However some employers choose to offer a more generous package particularly when they are seeking to persuade employees to leave. The business will need to engage in consultation in advance in many cases. The steps that must be gone through before terminating an employment contract until 5th April 2009 were set out in The Employment Act 2002 (Dispute Resolution) Regulations 2004. The Employment Act 2008 abolished these steps on 6th April 2009 (see http://www.berr.gov.uk/whatwedo/ employment/Resolving_ disputes/ index.html). The Act abolished the mandatory "three-step" processes for disciplinary and dismissal procedures undertaken by an employer and for grievances raised by an employee. In its place businesses must act fairly and are advised to follow a revised statutory ACAS Code of Practice, which sets out the principles of what an employer and employee should do to achieve a reasonable standard of behaviour in termination of employment. It is generally best to take legal advice before making staff redundant.

Debt recovery

9. Recover debt

Often he who proceeds first recovers money. Consider issuing statutory demands – there has been a huge increase in these of late, starting legal action and pursuing other parties for breach of contract. When money is tight every penny counts. Do not let big debts build up with those who may not be able to pay. Take action. Require payment up front, security or even an equity stake in a business. Refuse to provide goods or services if no payment is forthcoming. Consider paying their customer instead of that customer as a compromise to ensure projects can continue.

10. Look at getting out of onerous contracts that cannot be afforded

Check with lawyers whether legally binding obligations have been formed or not. Consider the cost of terminating the contracts that may be cheaper than continuing.

11. Written conditions of sale

Every seller ought to have written conditions of sale that reserve ownership of the goods (or intellectual property where copyright such as computer software or designs is being written for a customer) until full payment is made.

12. Assess if contracts can be transferred

Some suppliers have been assigning contracts to new subsidiaries with very poor credit records. Sometimes the contract forbids this.

Force majeure

Some companies argue that the current recession/depression could amount to circumstances of force majeure that might entitle them to suspend the operation of the contract. This depends on the clause concerned, where there is one. Force majeure is usually defined to mean circumstances that make it impossible for one party to perform the contract by Act of God, fire, earthquakes, and civil unrest. There has been a very big increase in these cases in 2008 and 2009 on a worldwide scale, caused by the economic instability. Strikes have also gone up although wise buyers always delete strikes and industrial action when negotiating force majeure clauses in contracts. It is conceivable that a failure by a bank could mean that a supplier cannot pay (this happened for a period with those who had savings in the Icelandic banks). Force majeure clauses would need to be scrutinised carefully to see if that would mean a buyer did not have to pay under the terms of the contract. However, often failure to pay is not excused by force majeure – the contract expressly saying it is not and even if it does most customers have other sources of finance they can use so they would not be prevented from paying.

At the end of this chapter are some sample force majeure clauses.

Anti-competitive agreements with competitors about price

Questions from clients on this issue have included whether they can agree with other suppliers to a customer in known difficulties to require this or limit credit periods to a certain level. Under the Competition Act 1998 such collusion could

amount to an anti competitive practice when done by agreement or understanding with other suppliers. When simply taken as unilateral action it is lawful. Similarly collectively agreeing to boycott a customer with competitors is illegal. Information on this area can be obtained from the Office of Fair Trading – www.oft.gov.uk. The EU in 2009 was consulting on its competition law guidelines on horizontal agreements – see www.europa.eu under "Competition".

Rights to vary contracts

In practice most commercial contracts, other than one off sales of goods and services on standard terms/purchase orders, expressly include a clause that states that the terms may not be varied without an agreement signed by both parties. For longer term service agreements there will often be even more detailed change control provisions. However, in law unless the buyer is a consumer instead a long-term contract could give one party the right to vary the terms at will on notice to the other party if that is preferred and if the other party will accept those terms. Most will not accept such an onerous position but it is not unlawful to impose it if the other party agrees at the outset.

Assuming there is no such right to vary without consent, a business that is worried about a supplier or customer falling victim to insolvency and who is therefore seeking to improve contract terms will need to consider how it can agree new contract terms with the other party. In such a case the obvious route is to offer some terms that improve the legal position of the other party in order to persuade them to accept other terms that might be onerous to them. Similarly if one party is in a very strong negotiating position because they know the other party has to have their goods and there are few alternative products available, then they may be able to agree amended terms more easily than would otherwise be the case.

Other contract terms

Consider revising contract terms to check that there are rights to terminate agreements not only when the customer goes into liquidation but also when it cannot pay its debts. In that case the supplier can bail out early without being in breach of contract. Even if the contract requires the supplier to continue with the agreement in appropriate cases it may be best to stop work.

Other credit issues

Good credit control is crucial. Employ good credit controllers and take up references for new customers. The Madoff/Stanford and other alleged frauds/Ponzi schemes coming to light in the recession in 2009 seem to have continued unchecked because people followed the herd and did not undertake their own due diligence. In difficult economic times it is crucial for buyers to undertake regular checks on the credit worthiness of customers before offering credit. Cash up front is demanded in appropriate cases.

After a customer goes out of business

The measures above provide some legal protection in advance of a customer getting into financial difficulties. Once notification is received of liquidation or administration (or for sole traders bankruptcy or other arrangements with creditors) act quickly. Chapter 3 examines this area.

Arrange to retrieve goods subject to retention of title clauses (see the next chapter). No court order is needed and most liquidators once the clause is proven to apply will allow suppliers to enter premises and take goods back. If the goods are locked up then a court order is needed to break down a door but if they are lying on shelves or in a corridor or in a factory a supplier is entitled simply to arrive and retrieve them if the contract says so. Possession remains 9/10s of the law in practice and most liquidators will start by looking at how much money is in the bank to decide which disputes are worth fighting. Also consider negotiating with a liquidator who may need stock and may instead choose to pay sums owed simply to help carry on trading if he or she hopes to sell the business as a going concern.

Example

Pedestrian Thickos Ltd never had any terms of sale. When their best customer went bust they assumed they could recover goods they had sold but for which they had received no payment. They found the goods were owned by the buyer from the date of delivery. They got nothing on the liquidation. In one part of their business they had terms of sale but had contracts on the buyer's conditions of purchase on its purchase order so their terms did not apply. They similarly lost out.

Bright CoSec Ltd had good terms of sale that contained an RoT Clause. They always rejected terms and conditions on purchase orders and imposed their terms of sale. On a liquidation of a customer they were able to enter the premises of the buyer and recover £50,000 worth of stock by enforcing their RoT clause.

Determine if as a supplier the business will be crucial to a liquidator who may choose to pay cash up front if a prospective sale is likely.

Consider making an offer to buy the customer as a means of securing debt. Suppliers often find they are a natural buyer for a customer in financial difficulties. Sometimes a consortium with other suppliers together can affect a sale or put in some funding (perhaps in conjunction with a management buyout).

Check if the debt is secured in any way. It may be that a floating or fixed charge was granted over assets that will put the supplier higher up the list of payees on a liquidator or entitle the supplier to sell the asset over which any charge was granted.

If a company has not yet gone into liquidation be careful about accepting payments where there is a connection in case the rules on preferences are breached or the directors are wrongfully or fraudulently trading. If there is even a hint of an attempt to defraud creditors take legal advice. Not everyone will be the recipient of $1m of jewellery allegedly posted by Bernard Madoff but the corporate equivalent of such an action when the company is on the verge of going out of business is not uncommon and buyers need to be wary of deals that appear too good to be true.

Finally remember that most liquidators and administrators will negotiate and want the affairs of the company settled in a cost effective fashion so do not always

accept the first proposal put forward. Once the company is out of business there may be possibilities to buy back stock, buy assets, parts of the business and even intellectual property.

Companies that are instead wound down and struck off without debts may inadvertently find they still own some assets. These go to the Crown under a principle called Bona Vacantia. Details of this are at http://www.bonavacantia.gov.uk/. Solicitors have experience of buying assets even, computer source code, from that office. However in most commercial liquidations described in this article the company goes into insolvency liquidation and the liquidation would normally dispose of all the assets. Above all think ahead. Do not wait until a problem occurs to wish there were terms of sale with an ROT clause in them or a commercial contract with a long notice period. Seek to negotiate them now before problems arise.

Appendix: Chapter 1

Force majeure clauses

Two examples of force majeure clauses are below:

Example 1: G7 Force Majeure

G7.1 For the purpose of this Condition, "Force Majeure" means any event or occurrence that is outside the reasonable control of the Party concerned, and which is not attributable to any act or failure to take preventive action by the Party concerned, including (but not limited to) governmental regulations, fire, flood, or any disaster. It does not include any industrial action occurring within the Contractor's organisation or within any sub-contractor's organisation.

G7.2 Neither Party shall be liable to the other Party for any delay in or failure to perform its obligations under the Contract (other than a payment of money) if such delay or failure results from a Force Majeure event. Notwithstanding the foregoing, each Party shall use all reasonable endeavours to continue to perform its obligations hereunder for the duration of such Force Majeure event. However, if any such event prevents either Party from performing all of its obligations under the Contract for a period in excess of 6 months, either Party may terminate the Contract by notice in writing with immediate effect.

G7.3 Any failure or delay by the Contractor in performing its obligations under the Contract that results from any failure or delay by an agent, sub-contractor or supplier shall be regarded as due to Force Majeure only if that agent, sub-contractor or supplier is itself impeded by Force Majeure from complying with an obligation to the Contractor.

G7.4 Condition G7 does not affect the Client's rights under sub clause G6.4.

G7.5 If either of the Parties shall become aware of circumstances of Force Majeure, which give rise to or which are likely to give rise to any such failure or delay on its part as described in condition G7.3 it shall forth-

with notify the other by the most expeditious method then available and shall inform the other of the period which it is estimated that such failure or delay shall continue.

G7.6 For the avoidance of doubt it is hereby expressly declared that the only events that shall afford relief from liability for failure or delay of performance of the Contract shall be any event qualifying for Force Majeure hereunder.

Example 2

38.1 For the purpose of the Contract the term Force Majeure shall mean:

(a) War and other hostilities including terrorist activities, (whether war be declared or not) invasion, act of foreign enemies, mobilisation, requisition or embargo.

(b) Rebellion, revolution, insurrection, military or usurped power or civil war.

(c) Riot, commotion or disorder except where solely restricted to employees of the Supplier or its sub-Suppliers.

(d) Earthquake, flood, fire or other natural physical disasters except to the extent that any such disaster is caused by, or its effects contributed to by, the party claiming force majeure.

Force majeure shall not include a general industrial dispute or failure by approved sub-Suppliers.

38.2 If either party considers that any circumstance of Force Majeure has occurred which may affect materially the performance of its obligations then it shall forthwith notify the other in writing to that effect giving full details of the circumstances giving rise to the Force Majeure event.

38.3 Neither party shall be considered to be in Default of its obligations under the Contract to the extent that it can establish that the performance of such obligations is prevented by any circumstance of Force Majeure which arises after the date of the Contract and which was not foreseeable at the date of the Contract.

38.4 If the performance of the obligations of either party under the Contract is so prevented by circumstances of Force Majeure and shall continue to be so prevented for a period less than 38 days then during that period the Contract shall be considered as suspended. Upon the ending of the

Force Majeure event the Contractual obligations of the parties shall be reinstated with such reasonable modifications to take account of the consequences of the Force Majeure event as may be agreed between the parties or, in default of such agreement, as may be determined by an expert appointed by agreement between the parties. Notwithstanding such suspension the Supplier shall use its reasonable endeavours to assist the Client in the performance of the Contract.

38.5 If performance of the obligations of either party under the Contract is so prevented by circumstances of Force Majeure and shall continue to be so prevented for a period in excess of 38 days then the Contract shall be terminated by mutual consent and, subject to sub-Clause 38.6 below neither party shall be liable to the other as a result of such termination.

38.6. If the Contract is so terminated then subject to the transfer to the Client of the benefit referred to in sub-Clause 38.7 below the Client shall pay to the Supplier such reasonable sum as may be agreed between the parties or in default of agreement as may be determined by the expert mentioned above in respect of costs incurred and commitments already entered into by the Supplier at the date of the Force Majeure notice, less the amount of any payments already made to the Supplier at the date of the Force Majeure notice. If the amount of such advance payments made to the Supplier exceeds the sum due to the Supplier under this sub-Clause then the Supplier shall repay the balance to the Client.

38.7 The Supplier shall transfer to the Client the benefit of all work done by it or its approved sub-Suppliers if any and sub-suppliers in the performance of the Contract up to the date of the Force Majeure notice, and if applicable it shall include the rights in any licensed and developed software and licensed firmware so far as the rights in the same have accrued to the Supplier prior to the Force Majeure notice or will do so on the payment under sub-Clause 38.6 above.