

What a Credit Professional Should Know About Contracts

Federation of Credit and Financial Professionals

Credit and Financial Professional Retreat Day

Elliott Greenleaf

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FEDERATION OF CREDIT and FINANCIAL PROFESSIONALS

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Overview

This presentation will provide an overview of contract law, including the Uniform Commercial Code, and discuss the rights and remedies under state contract law for creditors, and state contract law's relationship to federal law, including but not limited to the United States Federal Bankruptcy Code.

Topics to be covered include the formation of sales and lease contracts (including the validity of electronic and digital signatures and contracts), title and risk of loss, performance and breach of sales and lease contracts, and warranties. The presentation will also discuss essential contract terms and the rationale for including them in your contracts.

Remedies for a breach by a debtor, both inside and outside of bankruptcy, will be discussed. Credit professionals will be provided alternatives to address and identify a breach by a customer before it happens outside of bankruptcy and what to expect for your contract once a business partner or contract party files for bankruptcy.

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Credit Managers and Contracts

- ❖ Contracts, and in particular, the breach of those contracts, is an integral part of the credit function.
- ❖ Contracts are often formed by multiple documents (for example, purchase orders and invoices) and sometimes, these documents are at odds with each other.
- ❖ The possibility of non-payment is something credit managers monitor and there are pre-breach remedies available.
- ❖ Contracts and bankruptcy.

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Butner v. U.S., 440 U.S. 48 (1979)

- ❖ This case has been cited thousands of times, and well known to bankruptcy lawyers.
- ❖ It is important to credit managers because it acknowledges the rights you have as a creditor.
- ❖ Unless there is a specific bankruptcy interest or provision to the contrary, a creditor's rights come from state law and applicable non-bankruptcy federal law.
- ❖ *"[P]roperty interests are created and defined by state law...unless some federal interest requires a different result."*

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Contract Formation

- ❖ Two or more parties.
- ❖ Agreement, which consists of an offer and an acceptance.
- ❖ Can be written, oral, or implied from the conduct of the parties.
- ❖ Requires "Consideration," promise to do something in exchange for something that is a detriment to the other party or a benefit to the first party.

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Types of Contracts

Express Contracts

- ♦ Written;
- ♦ Oral; or
- ♦ Inferred from the conduct of the parties.

Quasi Contracts

- ♦ Even if there is no valid contract that existed, a party can recover in quasi contract the reasonable amount of the value it gave to the other party to avoid unjustly enriching the other party.

Quantum Meruit

- ♦ If there is no valid contract, a party can recover in Quantum Meruit the value of the rendering of partial services or full services. One example is where there was no agreement on price, but a reasonable person would know payment would be expected.

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Offer

- ♦ An offer can't be an invitation to engage in commercial activity, like most advertisements (though if there are certain quantities and limiting language like "first come, first served" you will have a binding offer).
- ♦ An offer can't be preliminary negotiations.
- ♦ An offer has to be more definite.

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Different Terms

"Mirror Image" Rule.

- ♦ If the contract is for services, acceptance has to be on the exact same terms.
- ♦ If it's not the same terms, then it is a rejection of the original offer and a counteroffer.
- ♦ If one party performs, then the "last shot" rule applies, last form is the contract.

U.C.C.

- ♦ The sale of goods is governed by the Uniform Commercial Code ("UCC") **§ 2-207.**
- ♦ Unless the acceptance is expressly conditioned on the offerees acceptance of the additional terms, you have a contract, but still need to address the impact of the additional terms.

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Additional Terms Under the UCC

If you are not merchants, then the additional terms are never part of the contract.

Between merchants, the additional terms become part of the contract, unless:

- ◆ **The offer limits the acceptance to its terms.**

Additional Terms Under the UCC

The additional terms materially alter the contract:

- ◆ Example: Broad indemnification terms are material.
- ◆ The term burdens the party that is opposed to the term.
- ◆ Surprise and hardship. For example, under NY law, an arbitration provision is per se surprise and a reasonable merchant would have never accepted the provision without express assent.

The party that objects to the term must notify the other side in a timely manner.

UCC and the "Knock Out" Rule

- ◆ Company Alpha wants to buy canned and processed foods from Company Omega.
- ◆ Omega sends Alpha its standard purchase order form with various prices and products and its standard purchase and sale terms, but includes a term that requires disputes be brought within 90 days.
- ◆ Alpha sends back a purchase order for several containers of canned peaches, which requires that any disputes must be brought within 2 years from date of delivery of goods.
- ◆ Half the peaches go bad 120 days from delivery date and when Alpha sues Omega, Omega brings up its 90 day claim deadline.

The Battle of the Forms/"Knock Out" Rule

So who wins?

- ❖ Under the UCC , since none of the exceptions applied, the contract is valid, but the two conflicting limitations provisions are "Knocked Out".
- ❖ Article 2 of the UCC will then fill in the gap and UCC § 2-725 sets a default four year statute of limitations.
- ❖ Under the UCC, Alpha loses and Omega wins regarding the limitations issue.

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How to Avoid the "Knock Out" Rule

The UCC does two things with the knock out rule – subject to the the exceptions (which are based on the principles of contract formation discussed earlier):

- ❖ Forms a valid contract, and
- ❖ Provides a default term if the parties failed to reconcile conflicting terms.

Solution

- ❖ Send a quote inviting the buyer to submit an order, but condition the agreement on a sales confirmation signed by both parties.
- ❖ If you are engaged in e-commerce, the seller should expressly state on its website and in its emails that the formation of a contract for sale is conditioned on a signed sales confirmation.

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UCC "Gap Fillers"

The "Gap Fillers" are very Pro-Buyer:

- ❖ Consequential damages apply;
- ❖ Four year statute of limitations;
- ❖ Implied warranties of merchantability and fitness; and
- ❖ No limit on seller's liability.

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Essential Contract Clauses

- ◆ CHOICE OF LAW
- ◆ CHOICE OF VENUE
- ◆ INTEGRATION CLAUSE
- ◆ INDEMNIFICATION
- ◆ FORCE MAJEURE/ "ACT OF GOD"
- ◆ DAMAGES (CONSEQUENTIAL/LIQUIDATED)
- ◆ TITLE PASSING/RETENTION
- ◆ TERMINATION
- ◆ ATTORNEY'S FEES
- ◆ WAIVER

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Choice of Law/Choice of Venue

THESE CLAUSES, WHICH ARE OFTEN COMBINED, EFFECT:

- ◆ Economics of pursuing a case (including geography), and
- ◆ Substantive issues such as the limitations period.
- ◆ Not having these clauses can also add tremendous legal cost.
- ◆ The absence of these clauses requires a detailed legal analysis that is fact driven, which will be expensive.
- ◆ Effects enforceability. That is never of benefit to the credit function, but could be a red flag as to the sincerity of the buyer to honor terms.

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Integration Clause

- ◆ Usually the parol evidence rule (circa 1833) prevents evidence, other writings/notes/etc., outside the contract from changing the terms of the contract.
- ◆ There are ways to get around the parol evidence rule and this is not only another added legal expense, but it can add unwritten non-contractual terms to the contract.
- ◆ An integration clause is there to exclude any exceptions to the parol evidence rule.
- ◆ The clause stipulates that the document is the entire agreement and any prior statements, negotiations, or representations, do not control, and the contract is the universe of the agreement.

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Modifications are Only in Writing

- ❖ Related to the integration clause.
- ❖ Adds flexibility.
- ❖ Only signed written agreement can amend or modify the agreement.

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Indemnification

- ❖ These are risk allocation clauses.
- ❖ Can be used to set fault at a fixed amount, unrelated to actual liability.
- ❖ Protection against being dragged into third party litigation.
- ❖ Protection for third parties (officers, employees, agents, related entities, etc.).

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Force Majeure

- ❖ Examples: Fire, explosion, strikes, riots, terrorist activity, and acts of God.
- ❖ Parties are excused from performance as long as the event continues.
- ❖ After a certain, designated time, if the event continues, the contract is terminated.

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Seller's Point of View

THE ILLINOIS SUPREME COURT NOTED:

What a seller would most prefer, if something goes wrong with a product, is simply to repair or replace it, nothing more. This "repair or replacement" remedy is an outer wall, a first defense. If that wall is breached, because the limited remedy has failed of its essential purpose, the seller still would prefer at least not to be liable for potentially unlimited consequential damages, and so he builds a second inner rampart as a fallback position. That inner wall is higher, and more difficult to scale—it falls only if unconscionable. *Razor v. Hyundai Motor Am.*, 854 N.E.2d 607, 619 (Ill. 2006), cert. denied, 549 U.S. 1181 (2007).

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Direct Damages

- ❖ Natural and necessarily result from a breach;
- ❖ Foreseeable at the time the contract was made; and
- ❖ By a reasonable, ordinary, and prudent stranger to the transaction.

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Damages

INCIDENTAL DAMAGES ARE COSTS INCURRED BY THE NON-BREACHING PARTY:

- ❖ Expenses incurred by a buyer resulting from a rejection of non-conforming goods.
- ❖ Expenses incurred by a seller in connection with the wrongful rejection of delivered conforming goods.

CONSEQUENTIAL DAMAGES:

- ❖ Directly from the breach but might not be obvious without communication of the other party's circumstances.
- ❖ Lost profits are not always consequential- often they are direct in a "B to B" situation where profits are earned in the ordinary course of business.

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Damages/Liquidated/Consequential Clauses

- ❖ Liquidated damages clauses set a fixed sum or calculation agreed to ahead of time by the parties to cover the damages related to a breach.
- ❖ Can be invalidated by the court if punitive.
- ❖ Damages that are commercially justifiable and reasonable are not punitive.
- ❖ Consequential damages can be limited.
- ❖ The UCC has clauses that address incidental and consequential damages.

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UCC

- ❖ The UCC states that "[c]onsequential damages may be limited or excluded unless the limitation is unconscionable." UCC § 2-719(3).
- ❖ If the clause limiting the consequential damages is negotiated as part of an agreement between commercial parties, it is very difficult to find the clause is unconscionable.
- ❖ UCC definition for consequential damages is similar to the stated common law definition.

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UCC – Incidental – § 2-715

(1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

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UCC – Consequential – § 2-715

(2) Consequential damages resulting from the seller's breach include:

- ❖ (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and
- ❖ (b) injury to person or property proximately resulting from any breach of warranty.

Risk of Loss (Outside of a Breach)

- ❖ Risk of loss is covered by UCC §2-509.
- ❖ If the contract ships the goods by carrier and no destination to deliver is designated, then the risk of loss passes to the buyer when the goods are delivered to the carrier.
- ❖ If a destination is designated, then risk passes to the buyer when goods are delivered.
- ❖ Bailments pass the risk of loss to the buyer when either a negotiable document of title is received, or the bailee acknowledges buyer's right to possession, or receipt of a non-negotiable document of title or other written direction to deliver.

Leases and Nonconforming Goods

- ❖ In **ordinary lease**, risk of loss retained by lessor.
- ❖ In case of **finance lease**, risk of loss passes to lessee.
- ❖ If tendered goods are **nonconforming**, risk of loss remains with lessor or supplier until cure or acceptance.

Insurance

An insurance clause that requires your company to maintain insurance in amounts sufficient to cover all claims against either THE BUYER OR SELLER should be included to require insurance in reasonable amounts.

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Termination

- ❖ Termination for cause.
- ❖ Notice period to cure the breach.
- ❖ If breach is not resolved during the cure period, then another notice is required to terminate the contract.
- ❖ Termination once both parties have completed their duties under the contract.
- ❖ Termination for convenience. Provide some time period, for example, thirty days, for termination with or without cause, after notice to the other side of the contract.

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Waiver

- ❖ Failure to enforce a term in the contract does not mean that the term is waived.
- ❖ You can forgive a term for whatever reason and this doesn't set a precedent in how the parties will act in the future.
- ❖ Without this provision, the court could find that your company waived the term once and then it is unenforceable in the future.

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Attorney's Fees and Costs

- ❖ RULE IN THE US IS THAT THE PARTIES PAY FOR THEIR OWN LEGAL COST UNLESS:
 - ❖ Authorized by the contract; or
 - ❖ Authorized by statute.
- ❖ SOME STATUTES LIMIT THE COSTS TO REASONABLE FEES OR PUT A CAP ON ATTORNEY'S FEES.
- ❖ **OFFER OF JUDGMENT** ONLY APPLIES TO COSTS NOT FEES.

UCC Remedies

- ❖ Don't wait until a creditor files for bankruptcy.
- ❖ Options are significantly reduced if you do.
 - ❖ Demand for "Adequate Assurance of Performance."
 - ❖ Macro-economic or industry wide economic news is a basis for such a request, even without a past due arrearage.
 - ❖ Bond payments coming due.
 - ❖ Alternative financing is being used which could be evidence of cash flow problems.
 - ❖ Warning signs also come from the other party themselves.
 - ❖ Payments slow, checks are post dated.
 - ❖ Credit or insurance is withdrawn.

Request for Adequate Assurance under UCC § 2-609

- ❖ Alternative to exposing a credit manager's company to potential breach for stopping delivery or switching to cash advance terms.
- ❖ 2-609 gives the seller the right not to have its expectation of receiving due performance, payment, impaired.
- ❖ Need "Reasonable Grounds" for insecurity.

Insecurity

- ❖ Objective facts.
- ❖ Can be outside the contract (insurer cancels credit insurance).
- ❖ Grounds must be based on actions that have occurred post contract formation.
- ❖ Reasonable commercial standards.
- ❖ Third party sources must be credible (be aware of commercial reasons motivating information from competitors).

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Adequate Assurance

- ❖ Request should be in writing.
- ❖ Should reference UCC § 2-609.
- ❖ Don't water down the language.
- ❖ Explain the basis for insecurity.
- ❖ Demand adequate assurance.
- ❖ State repudiation is the consequence of not responding.

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Types of Adequate Assurance:

- ❖ Post a letter of credit;
- ❖ Switch to cash advance;
- ❖ Third party guarantee; or
- ❖ Request a written confirmation that the buyer's conduct will be corrected.

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Adequate Assurance

- ❖ Once you have issued the request for adequate assurance the seller can suspend performance without breach.
- ❖ Buyer then has 30 days to respond.
- ❖ No response results in the buyer's repudiation of the contract and the seller can now pursue the buyer for breach.
- ❖ Once the request for adequate assurance is issued, the seller can suspend performance without breach.
- ❖ No response results in the buyer's repudiation of the contract and the seller can now pursue the buyer for breach.

Practical Benefits of Adequate Assurance

- ❖ Risk of Loss is minimized.
- ❖ Take steps to cover the loss when it appears your customer is no longer credit worthy.
- ❖ Negotiate instead of litigate a dispute.
- ❖ Exercising repudiation also prevents a debtor in bankruptcy from forcing performance on the seller while the debtor decides to keep or reject the contract.

Getting Goods Back

- ❖ UCC § 2-705 – Allows the seller to stop goods in transit as long as the buyer hasn't taken possession of the goods (must be actual possession, not even risk of loss provisions will change this policy).
- ❖ If a bill of lading is negotiated, and in possession of the buyer, goods cannot be stopped in transit.
- ❖ Notify both buyer and the party in possession (carrier, warehouse, etc.).
- ❖ Seller is responsible for any damages related to stopping delivery.
- ❖ Seller can hold goods until they are paid.

Bankruptcy does not Halt Stoppage

- ❖ Stopping Delivery does not violate the automatic stay.
- ❖ **Careful** not to do any more to force the return of goods outside of bankruptcy remedies.
- ❖ If the seller won't return goods, you will need to file an adversary proceeding in bankruptcy court.
- ❖ You will also need to object to any attempts to limit stoppage of goods without payment by the debtor through motions in the bankruptcy.

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Reclamation of Goods

- ❖ UCC § 2-702(2) authorizes the seller's rights to reclaim or take goods back for which payment has not been made. Once a bankruptcy is filed, § 546(c)(1) governs reclamation rights.
- ❖ Buyer has to be insolvent.
- ❖ Creditor must make a written demand in bankruptcy.
- ❖ Under the UCC you must make a written demand within 10 days.
- ❖ If, however, the credit manager received a statement of solvency within three months of delivery of the goods, then the 10 day period does not apply.
- ❖ Buyer must still be in possession of the goods.

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Anticipatory Repudiation

- ❖ UCC § 2-610 governs when a party communicates that it intends to breach.
- ❖ If a buyer tells a seller that they won't pay for certain goods that are pending delivery, the seller can exercise any remedies it has, including suspension of performance.
- ❖ A buyer can call back a repudiation if the seller has not yet cancelled the contract or relied on the repudiation or declared the repudiation final. The retraction has to be in writing and provide any adequate assurance demanded by the seller. The retraction must provide an accommodation to the seller to make up for the delay resulting from the repudiation.

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Executory Contracts

- ❖ A contract between a debtor and another party under which both sides still have important performance remaining.
- ❖ Examples:
 - ❖ Commercial Real Estate Leases.
 - ❖ Equipment Leases.
 - ❖ Intellectual Property Licenses.

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Assumption, Rejection, Cure

- ❖ Debtors can decide whether they will assume (continue to perform and adopt the contract) or reject (breach and discard the contract).
- ❖ While this decision process goes forward, the non-debtor must continue to perform.
- ❖ If the debtor assumes the contract then it must "cure" or come into compliance with the contract, including paying all pre-petition debts.
- ❖ If the debtor rejects the contract, there is a breach, but damages will be unsecured claims and any unpaid amounts due that were post petition must approved through the bankruptcy process.

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Thank You

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