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Insights

Tips for Negotiating Supply Agreement Terms and Conditions in an Uncertain World

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Supply agreements govern the relationships between suppliers and customers regarding the exchange of goods and services and serve as a key component of success for many businesses. Whether you are a seasoned procurement professional or a business owner just starting out, understanding the concepts, terms, and conditions in a supply agreement is crucial, especially in today's economy where supply chain issues continue to disrupt commerce and the timely delivery of goods.

Supply agreements come in many different forms, from heavily negotiated agreements between global and domestic juggernauts, to the exchange of simple purchase orders and invoices between local suppliers and small businesses. But the fundamentals of a supply agreement in any particular transaction remain the same.

A well-drafted supply agreement will address as much of the transaction as possible including specifics of the goods or services being provided, how and when a buyer will be expected to pay for the goods or services (for example, by normal trade terms, COD, special financing, or a letter of credit), how and when delivery will be handled, how relevant risks will be apportioned between buyer and seller, how priority will be determined in the event of production shortfalls, and how the parties will settle disputes that arise. The agreement may also define what corporate responsibility trends, such as raw material sustainability and other enviro-social conscionability policies, may affect the supply relationship and how to demand adequate assurances that the parties' obligations under the supply agreement will be performed. While these are but a few of the many deal points, negotiation of these terms will be nuanced and can be further complicated by a number of other factors.

Negotiating Supply Agreements

Before entering into any negotiation, it is imperative to have a clear understanding of your organization's needs and objectives. This involves a thorough analysis of your supply chain requirements, quality standards, budget constraints, and delivery timelines. Identifying your "must-haves" and "nice-to-haves" will give you a strong foundation for negotiating terms that align with your business goals. Buyers should also complete routine due diligence on potential vendors. In conducting their due diligence, buyers should examine the vendor's history, financial condition, references, and disputes in which they have been involved. A good portion of this inquiry can be done using free sources of public information, while other information may only be available from fee-based sources.

Avoid Common Contracting Mistakes

Breakdowns in the supply chain can cause breakdowns in the relationship between the parties, which can lead to costly and lengthy supply interruptions, production slowdowns or shutdowns and even litigation, especially

where the parties fail to adequately address and allocate important commercial and legal risks and responsibilities.

One of the most significant commercial risks in any supply agreement relates to pricing. For example, commodity pricing can be impacted by significant market swings. Therefore, to maximize its transaction value and avoid disputes, each party should take price fluctuation risk into account when drafting and negotiating the agreement. These can include cost protections like fuel surcharges, inflation adjustments and currency risk protections from the supplier side and pricing protections for the buyer, such as longer term pricing provisions, volumetric discounts and year-over-year pricing reductions.

Parties may also want to consider competitive pricing provisions, such as a most favored customer clause and continuous improvement provisions. Pricing policies by the vendor should also consider legal constraints to avoid risking anti-competitive practices. Consideration of these provisions can help reduce the possibility of disputes between the parties.

Carefully drafted indemnity and dispute provisions can help assure appropriate risk allocation and protection. Dispute resolution procedures can address bilateral disputes but can also address third party issues, such as product liability claims and product recalls.

Avoid the Battle of the Forms

With the focus in today's economy on speed, efficiency, and cost reduction, many buyers and vendors do business by exchanging documents with standard "boilerplate" terms and conditions instead of negotiating agreements at arm's length. While this method is common and usually helps to reduce costs and increase expediency, these benefits are not without a downside. In a sale of goods transaction, conflicts between the forms exchanged between the parties during the contracting process will often arise. For example, a buyer will send a purchase order or request for quotation along with its standard terms and conditions and, in response, the vendor will accept the order by issuing an invoice with its own terms and conditions, which may be inconsistent with the buyer's standard terms. This all-too-common scenario can put the legal positions of the parties in direct conflict from the very start of a relationship. The business side of the relationship most likely started off on the right foot, with the conflict surfacing only when things start to go wrong.

Where both parties have exchanged documents attempting to impose their own separate and inconsistent standard terms into the contract, difficulties arise in determining which terms prevail. In a sale of goods transaction, this "battle of the forms" is generally governed under the terms of Article 2 of the Uniform Commercial Code, which seeks to resolve these issues before they devolve into disputes. Under Article 2 of the UCC, a definite and seasonable expression of acceptance or a written confirmation generally operates as an acceptance even though it states terms additional to or different from those offered or agreed upon. But Article 2 also contains exceptions to this rule and may be applied differently depending on many factors, including the parties' course of dealing, whether the parties are merchants (as defined in the UCC), and whether the conflicting terms are subject to any conditional acceptance.

In our market economy, the prevailing rule still embraces a "buyer beware" approach. The buyer can protect its business from commercial and legal risks in a supply transaction by doing more than just sending or accepting a simple purchase order or invoice. Managing this risk involves a comprehensive review of the transaction, consultation with the right experts in crafting an agreement, negotiating and documenting that agreement, and a continued adherence to the terms of the deal.

Standard forms, when buttressed with the backing of the UCC, can be efficient and effective for most transactions, particularly those that fall more into the ordinary course of business, where the key points of negotiation usually are limited, such as price, payment terms, delivery arrangements and the like. As the supply relationship becomes more significant due to size, the critical nature of the goods and services being

provided or other factors, negotiated provisions will become more important to assure that the economics and associated risks best reflect the specifics and nuances of the relationship.

Conclusion

We at Krieg DeVault often support our clients by preparing supply agreements that help navigate the complex legal and factual issues to minimize risk and maximize the prospects for client success. If you have any questions regarding the negotiation of a supply agreement, or are having issues arising from one, please contact **George C. Lepeniotis** or **Alex C. Bowman** or any member of our **Business, Acquisitions and Securities Practice**.

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