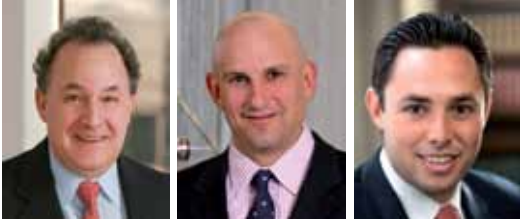


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A trade creditor should be paying close attention to the terms and conditions that govern transactions with its customers. As long as both parties are performing, a creditor might not attach too much importance to the governing terms of their transaction. However, having the right terms and making sure the appropriate person executes the agreement containing such terms is critical to limiting credit and other risk in the event the customer has failed to timely pay invoices owing to the creditor or there is a dispute between the parties.

These important terms and conditions should govern a vendor's sales to its customers. The vendor's goal should be to bind its customer to as many of these terms as possible in order to maximize recovery on its claim and minimize its own risk of liability.

### Switching From Credit to Cash Terms

A vendor selling on credit terms invoices its customer with payment due at some later date. The vendor's terms and conditions should permit a switch to cash in advance terms when its customer fails to timely pay any invoice owing to the vendor or the vendor has a cause for concern about its customer's creditworthiness.

Having the right terms and making sure the appropriate person executes the agreement containing such terms is critical to limiting credit and other risk.

A provision for a change in payment terms can take a variety of forms. As is the case with most terms, a vendor's ability to obtain favorable terms depends on its negotiating leverage. It might prefer the unfettered right to allow or terminate credit terms at its sole discretion. Alternatively, its terms might include the ability to switch to cash terms in the event a customer breaches its contract with the vendor or the customer's financial condition has substantially deteriorated to warrant a termination of credit terms. This provision can also state that all amounts the customer owes the vendor will be immediately due and payable when the seller changes payment terms.

# Mind Your Ts and Cs (Terms & Conditions)



### Setoff Rights

Setoff rights are a significant state law remedy that can help a trade creditor reduce its exposure on a claim against a financially distressed customer. Setoff enables a creditor to net out the amount it owes its customer from the amount the customer owes the creditor. For example, a vendor might be owed \$100 for goods sold to a customer on credit, but the vendor might separately owe \$100 to the customer in connection with an entirely separate business transaction. Setoff allows the vendor to net out and set off the amounts owed which results in full payment of its claim.

Creditors that sell to and buy from their customers can include a setoff provision as part of their terms. A typical setoff provision will permit the vendor to offset any indebtedness owing to the customer against the vendor's claim against the customer.

Therefore, in the example, in the event the customer is unable to pay the \$100 it owes to the vendor the vendor can cancel its \$100 debt to the customer, resulting in a 100% recovery on its claim. In the context of the customer's bankruptcy, a vendor's setoff right is like a secured claim where the vendor could reduce its claim against its customer on a dollar-for-dollar basis by concomitantly reducing its indebtedness to the customer. This contrasts with the vendor being relegated to general unsecured creditor status with a far lower likelihood of recovery of its claim in the absence of any setoff right.

Creditors that do business with affiliated entities might attempt to broaden their setoff rights to allow them to

net their claim against one affiliate to reduce their obligation to another affiliate. This is called a “triangular setoff.” Taking the example, in this situation a vendor is owed \$100 for goods sold on credit to its customer, but the vendor separately owes \$100 to the customer’s affiliate. The vendor can include a term that permits it to offset its indebtedness to its customer or its affiliates against the vendor’s claim against the customer, with the applicable affiliates doing business with the vendor agreeing to be bound by this particular provision. Alternatively the vendor, its customer, and the customer’s affiliates can enter into a separate setoff agreement.

Trade creditors should note, however, that while triangular setoff provisions are enforceable under state law in a non-bankruptcy context, bankruptcy courts have refused to enforce this provision in a bankruptcy setting. Therefore, even in a case where a vendor, its customer and the customer’s affiliate unambiguously agree to grant the vendor triangular setoff rights against the affiliate, the vendor will likely lose its triangular setoff rights upon the filing of bankruptcy by the customer and its affiliated entities. The vendor could minimize the risk of loss of its triangular setoff rights by obtaining the affiliate’s guarantee of the customer’s obligations to the vendor.

### **Buyer’s Obligation to Disclose Change of Name or Legal Status**

A critical part of “knowing thy customer” is for a vendor to know the correct legal name and legal status of its customer. Specifically, a vendor must ensure that it is contracting with the correct party. Otherwise, the vendor might run into a later problem of being unable to collect its claim against a customer that is not identified correctly or has changed its legal status.

The nature of a customer’s legal status will determine whether the customer’s owners are liable for the customer’s liabilities. If a customer is a sole proprietorship, the owner or sole proprietor is liable for the customer’s debts. The general partners of a partnership are liable for the customer’s debts. Where the customer is a corporation or limited liability company, a vendor generally cannot pursue the owners to collect its claim. The owners are only subject to the risk of the loss of their investment in the customer.

A vendor can confirm its customer’s correct legal name and legal status by performing a business name search with the Secretary of State’s office of the applicable state. It is also imperative that a vendor’s terms and conditions account for a subsequent change in the customer’s legal name or status. The terms should require that the customer notify the vendor of a change in the customer’s legal name and/or status and cooperate with the vendor in modifying their contract as the vendor deems appropriate. This would include the customer’s agreement to enter into new agreements with the vendor subsequent to any change in the customer’s legal name and/or legal status.

### **Terms and Conditions in Another Place**

A vendor will often have a set of terms and conditions on its website (or another location). Terms posted on the vendor’s

website or in another place would be binding on a customer if the terms are incorporated by reference in a written signed agreement between the parties. Best practices require that a vendor’s credit application or other agreement signed by its customer includes the customer’s agreement to be bound by the terms and conditions posted on the vendor’s website or other place. A link to the website where the applicable terms and conditions are located should also be included (and the link must actually work as a faulty link would likely result in

*A typical setoff provision will permit the vendor to offset any indebtedness owing to the customer against the vendor’s claim against the customer.*

the provision being deemed unenforceable). It is also good practice to require customers to periodically execute acknowledgments when the vendor updates its terms and conditions to bind the customer to such updated provisions.

### **Interest on Delinquent Invoices and Attorneys’ Fees**

A vendor’s terms should also provide for additional compensation in the event its customer fails to timely pay their invoices or there is a dispute between the parties. The payment of interest on past due amounts and reimbursement for attorneys’ fees will not be read into a contract absent specific provisions requiring their payment.

For example, the customer should be required to pay interest on any past due invoice. This language should state that the customer agrees to pay interest on past due amounts at a rate equal to the lower of a specified percentage per annum or the highest rate permitted under applicable law. This is designed to avoid the risk of the vendor’s violation of applicable usury laws that would result in the unenforceability of any interest claim.

A vendor should also include, as part of its terms, the reimbursement of attorneys’ fees incurred in any lawsuit or through other actions to collect their past due claims or involving any disputes with their customer. The extent to which the vendor will be reimbursed for its attorneys’ fees can vary depending on the vendor’s negotiating leverage.

### **Buyer Modification of Terms**

A customer’s agreement to a vendor’s terms and conditions does not necessarily preclude the customer from subsequently submitting future purchase orders containing contradictory terms that could supersede the vendor’s more favorable terms. A vendor can protect itself from this risk by including, as part of its terms, language that no modification or waiver of any terms by the customer will be enforceable without the vendor’s prior written approval and the vendor’s terms will govern to the extent of any discrepancy between its terms and those submitted by its customer in any sales quotation, purchase order or similar document.

## Limitations on Liability

A vendor's terms should also impose a cap on its liability to its customer. These provisions should limit a vendor's and its affiliates' cumulative liability to the total amounts their customer had paid to the vendor. Any such provision should also confirm that a vendor would not be liable for consequential, incidental, indirect, special, exemplary or punitive damages, third-party claims, loss of revenues, loss of profits or loss of savings.

A vendor should also include a provision that requires its customer to inspect the goods purchased from the vendor and raise complaints within a short period of time. For example, requiring a customer to assert all complaints in writing within seven days of delivery of the vendor's goods and providing for a customer's waiver of claims that were not timely and properly asserted will increase the likelihood of full payment of a vendor's claim against the customer.

## Only those warranties that the vendor and the customer agreed to include as part of the disclaimer should be binding on the vendor.

A vendor should also include language that shortens the statute of limitations for a customer to commence a lawsuit against the vendor for breach of contract and other claims. Article 2 of the Uniform Commercial Code (UCC), which governs transactions for the sale of goods, stipulates that the statute of limitations is four years for any lawsuit asserting breach of contract or breach of warranty claims. However, the contracting parties can shorten the statute of limitations to as low as one year. Therefore, a vendor's terms should state that a customer must commence an action alleging a breach of warranty or any other breach of contract claim within one year after the cause of action arises.

## Limitations on Warranties

Article 2 of the UCC also provides that certain implied warranties will be read into sales contracts, unless the contract waives such warranties. Article 2 creates an implied warranty of merchantability that requires goods sold to be merchantable (i.e., fit for the ordinary purposes for which such goods are used). Article 2 also contains an implied warranty of fitness of purpose where the customer is relying on the vendor's expertise in making sure the goods are suitable for the customer's intended purpose. There might be other implied warranties arising through course of dealing or usage of trade.

A vendor's terms and conditions should include a disclaimer of all implied warranties. Only those warranties that the vendor and the customer agreed to include should be binding on the vendor. Some states allow general disclaimers of all implied warranties, while other states require listing each specific warranty that is being disclaimed.

As a best practice, a vendor's terms should include a disclaimer of all implied warranties of any kind, including, without limitation, warranties as to performance, merchantability, or

fitness for a particular purpose, and warranties arising by statute or otherwise, or from a course of dealing or usage of trade.

Stating that all goods are sold "as is" can serve to alert the customer that the goods are being sold without any implied warranties of any kind. Lastly, a vendor should make sure provisions limiting warranties are in bold font and/or capital letters since the Uniform Commercial Code requires that any provision excluding warranties be conspicuous.

## Liquidated Damages

Liquidated damages are damages that the parties agree will compensate an injured party upon a specified breach. Liquidated damages typically include a customer's damages arising from a vendor's late delivery of goods or provision of services. Liquidated damages clauses are often expressed as a percentage of the overall value of the sale or service in question.

Absent including a liquidated damages clause as part of a vendor's terms, courts will be left to determine actual damages, which is often difficult, and can vary depending on the circumstances. As such, best practice is for a vendor to include a liquidated damages clause in its contracts in order to attain cost certainty in the event of a dispute. While liquidated damages may turn out to be greater than actual damages in certain circumstances, the vendor would at least gain comfort from having a clearer understanding of its overall risk profile.

## Indemnification

A vendor's terms should also include a vendor's indemnification in favor of its customer and vice versa. Indemnification provisions can take several different forms. The vendor's objective should be to have as narrow an indemnity as possible in favor of the customer. Customers often seek to include broad indemnification provisions where the vendor indemnifies its customer for all customer claims regardless of which party is at fault. Despite the fact that these broad indemnification provisions are unenforceable in certain states, vendors should try to narrow their scope at the outset. A reasonable indemnity from the vendor's perspective imposes liability on the vendor to indemnify its customer for actions that are solely the vendor's fault.

A vendor should also seek its customer's indemnity for certain claims that might be brought against the vendor in connection with a transaction. For instance, a vendor might wish to seek protection from product liability claims. The vendor's terms can require the customer's indemnification of the vendor for product liability claims brought against the vendor where the customer's intervening act had caused the product defect. This provision would be beneficial where the customer receives the product from the vendor and the customer's subsequent improper installation causes a malfunction and exposes the vendor to potential liability. The customer should bear the cost where it was clearly at fault.

## Buyer's Obligation to Provide Financials

A vendor's terms should also require that their customers periodically deliver financial statements to the vendor. There

are several reasons why this can be informative. First, a vendor's knowledge of its customer's financial condition by reviewing the customer's financial statements would be helpful in any decision concerning future business. A vendor's review of its customer's financial statements would also assist the vendor in deciding whether to tighten credit terms or switch from credit to cash terms.

A vendor enjoys significant protection if the right terms and conditions are included in a vendor's agreements with its customers. The right terms increase the likelihood of the vendor obtaining full payment of its claim.

### Force Majeure

A vendor's terms should also state that the vendor is not responsible for its failure to perform under an agreement with a customer if such failure is the result of a force majeure event. Force majeure events can include "acts of God," such as floods, earthquakes and hurricanes, as well as other events, such as war, terrorist activities, labor disputes and electrical failures. The vendor's objective should be to define a force majeure event as broadly as possible so as to assign as much risk as possible to the customer.

### Conclusion

A vendor enjoys significant protection if the right terms and conditions are included in a vendor's agreements with its customers. The right terms increase the likelihood of the vendor obtaining full payment of its claim owing by a financially distressed customer. They could also significantly reduce the risk of additional loss, cost and expense in the event of a dispute between a vendor and its customer. ■

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