Sale of Goods Agreements: Common Pitfalls

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Practice Note discussing select causes of disputes and other liabilities that parties commonly overlook when drafting, negotiating and executing their sale of goods agreement. This Note describes certain steps buyers and sellers can take to avoid, identify and mitigate troubled manufacturing, supply and other sales contracts. This Note relates only to business-to-business transactions, and does not present a comprehensive list of all possible contracting pitfalls. It is merely a guide to assist parties to avoid critical, but commonly overlooked, areas of liability in sale of goods transactions. This resource includes drafting and negotiating tips.

Disputes often occur in agreements under which goods are sold, including manufacturing agreements and supply agreements (collectively, sale of goods agreements).

Typically when a sale of goods agreement breaks down, a past mistake, sometimes one that occurred months or years before, is the cause. Parties should therefore identify, avoid and mitigate common but often overlooked sale of goods transaction mistakes and breakdowns.

This Practice Note covers some of the most significant and commonly overlooked mistakes, including:

- The buyer’s pre-contract mistakes.
- Contracting mistakes.
- Relationship mistakes.
- Termination mistakes.


COMMON BUYER PRE-CONTRACT MISTAKES

Breakdowns can be caused by mistakes the buyer makes before entering into the contract, including:

- Issuing an inadequate request for quotation (RFQs) (see Draft Clear, Comprehensive and Concise RFQs).
- Inadequately performing seller due diligence (see Perform Adequate Seller Due Diligence).

Draft Clear, Comprehensive and Concise RFQs

Buyers commonly choose their sellers by using an RFQ process, in which:

- The buyer issues an RFQ to prospective bidders.
- Each bidding seller responds to the RFQ with a proposal, which typically includes:
  - the seller’s qualifications;
  - the specifications of the goods or services; and
  - the price.

Sellers are more likely to meet the buyer’s expectations and buyers are more likely to reduce uncertainty and risk of conflict when buyers:

- Draft a clear, comprehensive and internally consistent RFQ.
- Include all requirements, including seller qualification requirements, in the RFQ.
- Include in the RFQ the terms and conditions:
  - according to which the RFQ will be awarded; and
  - under which the seller will be bound.

Perform Adequate Seller Due Diligence

To avoid uncertainty and potential dispute, buyers should complete routine due diligence on potential sellers after RFQ process completion, but before seller selection. In conducting their due diligence, buyers should examine the seller’s:

- History.
- Financial condition.
- References.
- Disputes.

To obtain this information, buyers can access many free and paid sources of public information, including:

- Credit checks.
- Financial statements.
- SEC filings on EDGAR (for publicly traded companies).
- Public records reports, including Uniform Commercial Code (UCC), tax and judgment lien filings.
- News and blog searches.
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- Intellectual property (IP) portfolio databases. Buyers should note that due diligence of IP documents may require specialist review (see Practice Note, Intellectual Property Rights: The Key Issues: Getting Information on Issued and Pending Patents, Getting Information on Registered Trademarks and Getting Information on Registered Copyrights).
- The seller’s websites.

For more information on seller due diligence, see Practice Note, Due Diligence in Outsourcing Transactions: Due Diligence of Potential Suppliers and the Chosen Supplier.

COMMON CONTRACTING MISTAKES

Mistakes that one or both parties make in drafting or negotiating the contract can cause a dispute. These mistakes generally fall into two categories:

- Contracting process mistakes (see Common Contracting Process Mistakes).
- Contracting substance mistakes (see Common Contracting Substance Mistakes).

COMMON CONTRACTING PROCESS MISTAKES

If parties fail to follow the proper contract formation process, then the contract may be unenforceable or enforced in a way that one or both parties did not intend. Commonly overlooked but important issues include:

- Contract formation process mistakes (see Implement and Follow a Clear and Comprehensive Contract Formation Process).
- Battles of the forms (see Avoid a Battle of the Forms).
- Recordkeeping and record retention mistakes (Adhere to a Good Recordkeeping and Retention Policy).

For more information on contract formation, see PLC Cross-border, Making contracts online country questions: US.

Implement and Follow a Clear and Comprehensive Contract Formation Process

Parties that fail to implement and follow a clear and comprehensive contract formation process are more likely to enter contracts with unknown or unfavorable terms and conditions. For example, parties often use e-mail to negotiate an agreement, typically in violation of their company’s contract formation procedures. While parties can form valid contracts using e-mail or other informal procedures, these agreements may lead to disputes based on:

- Allegedly lacking mutual assent and intent to be bound.
- Uncertainty over terms and conditions.
- Omission of certain terms and conditions.

For an example of how the use of e-mail can be deemed to form the essential terms or conditions of a contract, see Legal Update, Texas: E-mails Read Together Construed as One Contract.

A party can help make its contract formation process clear and comprehensive by including procedures covering:

- The proper documenting of important transactions using key contractual terms.
- Internal business owner review and approval for certain terms and conditions. For example, a procedure requiring the specified authorized officer to review and approve all licenses of the company’s most coveted intellectual property.
- Signatory authorization for contract execution limited to certain individuals.

Avoid a Battle of the Forms

In a battle of the forms, one party attempts to impose its own terms and conditions that are inconsistent with the other party’s standard terms and conditions. For example, a buyer can issue a purchase order containing certain terms and conditions and the seller accepts the purchase order by issuing an invoice with conflicting terms and conditions.

Under sale of goods transactions, battles of the forms are generally governed under the terms of the UCC, as enacted under the laws of the state governing the transaction.

The use of conflicting terms and conditions generally increases the risk of dispute. To avoid or mitigate this risk:

- Neither party should hastily accept the other party’s document without a comprehensive review.
- Either party should notify the other regarding any objection to the other party’s document within a reasonable time after receiving the document.
- The buyer should ensure that its purchase order, RFQ or other documents expressly limit acceptance to the terms of the offer.

For more information on battle of the forms issues related to purchase orders, see Standard Document, General Purchase Order Terms and Conditions (Pro-buyer): Drafting Note, Contract Formation and the Battle of the Forms.

For more information on battle of the forms under the UCC, see Practice Note, UN Convention on Contracts for the International Sale of Goods (CISG): Battle of the Forms.

Adhere to a Good Recordkeeping and Retention Policy

To avoid uncertainty and disputes, each party should have a centralized, robust, thorough, documented and audit-ready recordkeeping and retention process where each contract (including amendments) is:

- Given a standard title, to the extent possible.
- Assigned a unique contract number.
- Filed and retained in a centralized and accessible document repository for which an employee or group of employees is responsible and accountable.
- Audited and updated on a pre-determined periodic schedule.
COMMON CONTRACTING SUBSTANCE MISTAKES

Contract drafting mistakes commonly cause breakdowns in the relationship between the parties, especially where the parties fail to adequately address and allocate important commercial and legal risks, such as where the parties:

- Overlook or hastily review standardized or boilerplate provisions that can affect the agreement’s operative terms.
- Use prior transaction documents as precedent for the current transaction agreements and fail to revise or update the agreements to reflect the current transaction-specific facts.

The parties should address certain significant but commonly overlooked contract substance mistakes, such as:

- Upstream and downstream product warranties and disclaimers (see Common Product Warranty Mistakes).
- Remedy exclusions and caps (see Common Contractual Remedy Mistakes).
- Commodity price fluctuations (see Failure to Address Commodity Pricing Fluctuations).
- Competitive pricing (see Failure to Consider or Include Competitive Pricing Provisions).
- Exclusivity scope and exclusions (see Exclusivity Scope Mistakes).
- Tooling ownership rights and remedies (see Failure to Adequately Address Tooling Ownership, Rights and Remedies).
- The amount and timing of relief under dispute resolution provisions (see Common Dispute Resolution Mistakes).

Common Product Warranty Mistakes

While most sale of goods agreements include product warranties, these warranties do not always sufficiently protect the parties against liabilities. For example, parties often fail to:

- Ensure that the product warranties have the appropriate scope, considering:
  - the nature, type, quality and condition of the goods, assets or services central to the agreement’s subject matter; and
  - the market’s expectation, which is typically limited to warranties for defects in material and workmanship.

For information about standard sale of goods agreement product warranties, see Standard Clauses, General Contract Clauses: Product Warranty and Disclaimers).

- Mirror or harmonize upstream and downstream warranties to avoid giving broader rights than they receive.
- Give or get an appropriate warranty disclaimer (for example, excluding the implied warranties of merchantability and fitness for particular purpose).

For more information on warranties and disclaimers, see Standard Clauses, General Contract Clauses: Representations and Warranties and Practice Note, Representations, Warranties, Covenants, Rights and Conditions.

Common Contractual Remedy Mistakes

Parties often mismanage their risk by failing to adequately adjust the scope of the sale of goods agreement’s remedies. For example, the parties often fail to:

- Ensure that the remedies are:
  - proportional to the nature, type, quality and condition of the goods, assets or services central to the agreement’s subject matter; and
  - not unfavorable as compared to the market’s expectation, which is typically limited to repair or replacement of defective goods (see Standard Clauses, General Contract Clauses: Acceptance of Goods).
- Mirror and harmonize upstream and downstream remedies to avoid giving broader rights than they receive.
- Make the customary or appropriate remedy exclusions or set the appropriate caps. For example, if the parties do not:
  - make the customary exclusion of incidental, consequential or other damages, then seller may be unduly exposed to liability;
  - cap damages, then the seller may be unduly exposed to liability; or
  - set the damages cap to a reasonable or appropriate amount, preferably tied to the contract in some fashion (for example, the full contract value), then either party may be unduly exposed to liability.

(See Standard Clauses, General Contract Clauses: Limitation of Liability.)

- Appropriately adjust the scope of the indemnification. For example, if the parties do not:
  - allocate responsibility for defense costs; or
  - apportion the right and responsibility to make decisions regarding the settlement of indemnified claims.

For more information about adjusting the scope of an indemnification provision, see Practice Note, Indemnification Clauses in Commercial Contracts and Standard Clauses, General Contract Clauses: Indemnification.

For more information on drafting sufficiently protective contractual remedies, see Practice Note, Risk Allocation in Commercial Contracts and Interaction between Indemnification and other Contractual Remedy Provisions Checklist.

Failure to Address Commodity Pricing Fluctuations

Commodity pricing is often subject to significant market swings. Therefore, to maximize its transaction value and avoid dispute, each party should take price fluctuation risk into account when drafting and negotiating the sale of goods agreement. Parties should also consider lesser known commodities that might be found in small, but material, amounts in certain parts, notably electronics.
For more information on pricing adjustment terms, see Standard Clauses, General Contract Clauses: Pricing Terms (Sale of Goods, Pro-buyer): Section 1.4 and General Contract Clauses: Pricing Terms (Sale of Goods, Pro-seller): Section 1.4.

Failure to Consider or Include Competitive Pricing Provisions
The buyer should consider including one or more clauses requiring the costs or price to be competitive, such as a most favored customer clause (MFC clause) (see Standard Clauses, General Contract Clauses: Most Favored Customer). However, before agreeing to a MFC clause, parties should:
- Include means and methods for monitoring whether the cost or price is competitive.
- Be aware that MFC clauses can implicate US antitrust laws (see PLC Antitrust, Practice Note, Most Favored Nation Clauses).

Exclusivity Scope Mistakes
Parties to a sale of goods agreement commonly use exclusivity provisions to allocate risk, for example, when:
- The seller is a sole-source seller.
- The distributor is an exclusive distributor.

However, parties often fail to accurately specify the scope of their exclusivity rights or obligations, which can lead to uncertainty or a dispute. To avoid uncertainty and disputes, the parties in an exclusive relationship should:
- Specifically define the scope of the exclusivity (for example, by reference to a product’s part number).
- Consider exceptions to the exclusivity. For example, a buyer may want the right to terminate the seller’s exclusivity if the buyer acquires a third-party manufacturer that has the same capacity as the seller to supply the goods.

If including an exclusivity provision, the parties should be aware that exclusive dealings can trigger US antitrust laws (see Practice Note, Distributors and Dealers: Exclusive Dealing and PLC Antitrust, Practice Note, Exclusive Dealing Arrangements).

Failure to Adequately Address Tooling Ownership, Rights and Remedies
Parties to a sale of goods agreement (typically in a manufacturing or supplier agreement) commonly buy, sell or loan tooling to enable the manufacture of the goods. Tooling can be expensive and time-consuming to produce and validate. Therefore, tooling ownership, in addition to the tooling’s value, provides the owner with significant bargaining power. To avoid uncertainty and dispute, parties should:
- Conspicuously and permanently mark the tooling as property of the buyer or seller, as applicable.
- Maintain inventories of all tooling to establish ownership.
- Delineate tooling ownership in the sale of goods agreement.

If the buyer owns the tooling, the buyer should also consider:
- Limiting or prohibiting the seller’s right to use the tooling to manufacture goods for other customers.
- Giving the buyer the right to:
  - take possession of the tooling at any time and for any reason; and
  - inspect the tooling.
- Requiring the seller to insure the tooling for full replacement value.
- Assigning risk of loss to the seller while the tooling is in the seller’s possession.
- In cases where a buyer is purchasing tooling as part of its payment for the goods:
  - specifying that the price of the goods was calculated, in whole or in part, using the seller’s cost to produce tooling for buyer-specific goods; and
  - providing that the tooling becomes buyer-owned on payment.
- Specifying the process and procedure for decontaminating (if applicable) and removing the tooling, including reasonable times for retrieving it.
- Devising specific, emergency-relief tooling re-acquisition procedures for use when the seller refuses to return the tooling.

Common Dispute Resolution Mistakes
Parties to a sale of goods agreement should include dispute resolution provisions to:
- Provide a predictable path to recourse.
- Limit the scope of potential disputes.

However, if the parties incorrectly or poorly draft dispute resolution provisions, the provisions may instead encourage a dispute by denying timely or adequate relief. For example, a dispute resolution provision may itself lead to a dispute if a party drafts or negotiates it without:
- Understanding or anticipating potential disputes.
- Including a process that permits timely relief. For example, an agreement with a lengthy or burdensome dispute resolution process may prevent a buyer with a core, sole-source seller from receiving necessary emergency relief.
- Including a process that permits adequate relief.

To draft a dispute resolution provision that affords it maximum and timely relief, a party should:
- Identify every type of significant and likely transaction-related dispute and ensure that the dispute resolution provision has procedures that allow favorable resolution of each. Different disputes may be amendable to different kinds of dispute resolution procedures.
- For disputes that need timely relief, such as those involving sole-source or just-in-time suppliers, ensure that the dispute resolution provision allows for the immediate use of emergency litigation procedures, like temporary restraining orders and
preliminary injunctions, without required dispute resolution processes involving executive meetings or mediation.

- Ensure that the dispute resolution provision maximizes its relief, for example, by requiring the parties to settle disputes:
  - in a favorable forum; and
  - under favorable governing law.

For a dispute negotiation and escalation provision, see *Standard Document, Distribution Agreement (Pro-seller): Section 21.18.*

For more information on dispute resolution provisions, see *PLC Arbitration, Practice Note, Hybrid, multi-tiered and carve-out dispute resolution clauses* and *PLC Arbitration, Standard Clauses, Standard Arbitration Clauses for the AAA, ICDR, ICC and UNCITRAL.*

**COMMON RELATIONSHIP MISTAKES**

Once the contract is signed and the work begins, a mistake by one or both parties can impair the transaction. To avoid mistakes, as well as uncertainty and dispute, parties should:

- Appoint an internal owner (see *Appoint an Internal Owner*).
- Understand the contract (see *Understand the Contract*).
- Respond to issues (see *Respond to Issues*).
- Enforce contract terms (see *Enforce the Contract Terms*).
- Monitor performance and promptly resolve problems (see *Monitor Performance and Resolve Problems*).

**Appoint an Internal Owner**

On or before the agreement’s effective date, each party should designate an internal employee (designated transaction owner) to be responsible for the success or failure of the sales of goods agreement and relationship. Designated transaction owners can help the company to mitigate or avoid liability because they typically:

- Project a unified, singular voice for the company. This helps avoid inconsistent messages within the relationship.
- Have incentive to:
  - preempt, identify and avoid mistakes; and
  - favorably resolve disputes.

**Understand the Contract**

Often the designated transaction owner did not negotiate or sign the agreement. In this case, the designated transaction owner is less likely to understand the contract’s meaning and scope. Designated transaction owners must understand the contract’s terms and conditions to help ensure that:

- Each party complies with its contractual obligations.
- Breaches and disputes are unlikely to occur.

**Respond to Issues**

Many relationships break down over inadequate communication. To avoid disputes caused by poor communication, each party should:

- Quickly and meaningfully respond to the other party’s questions and concerns.
- Immediately attend to potentially contentious issues.
- Memorialize points of contention in writing.
- Understand and follow the agreement’s notification procedures.

**Enforce the Contract Terms**

A party should not hastily overlook the other party’s errors, omissions or breaches, however minor. While a party may find it unnecessary or impractical to require compliance with every minor contract term, by overlooking a breach, the party may:

- Create a bad precedence.
- Set a course of dealing inconsistent with contract terms.
- Waive the party’s right to enforce the contract’s terms.

**Monitor Performance and Resolve Problems**

Parties can reduce the likelihood and impact of disputes if, at the outset of the relationship, they:

- Determine the parameters by which they can measure the seller’s performance.
- Impose controls to monitor the seller’s performance, including internal reporting to routinely address relationship issues.

Warning signs of trouble include:

- Missed, late or short payments.
- Low-quality shipments.
- Stretched payables or calls from the seller’s vendors about missed payments.
- Lack of profitability.

Once a buyer detects a problem, it should try to limit the scope of the problem and mitigate the impact on the transaction and the relationship by:

- Timely addressing the problem.
- Regularly communicating, both externally with the seller and internally, to try to resolve the problem.
- Thoroughly documenting issues to preserve evidence, especially in drawn-out disputes.
- Sending the seller a notice warning of anticipatory breach and demanding adequate assurances, if desirable (see *Practice Note, Anticipatory Repudiation and Adequate Assurances of Future Performance*).
- Memorializing all agreements in writing signed by both parties. Each agreement should:
  - identify the problem and the resolution;
  - detail all amendments to the contract, including to compensation; and
  - be consistent with the contract to the extent the parties do not intend to amend the contract.
COMMON TERMINATION MISTAKES
Almost all relationships, including relationships between buyers and sellers, eventually end. In some cases, one party executes its rights under contract or law to terminate the agreement before the expiration date. In this case, a well-executed termination may help a party retain as much value from the transaction as possible.

To preserve value and limit liability at the relationship's termination, parties should:

- Follow the sale of goods agreement's termination procedures (see Follow the Contractual Termination Procedures).
- Try to retrieve their property (see Retrieve Property).
- Enter into a termination agreement (see Enter Into a Termination Agreement).

Follow the Contractual Termination Procedures
To terminate an agreement, the terminating party usually relies on the power granted under the agreement's terms and conditions. An agreement's termination provisions commonly permit termination for any of the following:

- Convenience, which sometimes involves a fee (for more information on termination for convenience, see Standard Document, Notice of Termination: Drafting Note: Contract Termination for Convenience).
- Cause (for more information on termination for cause, see Standard Document, Notice of Termination: Drafting Notes: Contract Termination for Cause and Termination Under the UCC). If the harmed party (terminating party) seeks to terminate for cause, it should:
  - gather the documents and evidence that support the contractual or legal definitions of “cause”; and
  - terminate in a timely fashion, especially if the terminating party is terminating for quality issues.
- Convenience and cause.

Contracts typically require the terminating party to give notice to the other party for termination to be effective. A party who tries and fails to give proper notice may suffer material negative consequences, for example, being locked into an extended renewal term. Therefore, before drafting and sending a termination notice, the notifying party should review the agreement, including documents incorporated by reference, and carefully consider the impact of any termination provisions, including any related:

- Renewal rights.
- Notice provisions (see Reasonableness, Materiality and Other Qualifiers).
- Cure periods (also called grace periods).
- Obligations, penalties, costs, fees or expenses.
- Other conditions precedent to executing a termination right (see Reasonableness, Materiality and Other Qualifiers).


Reasonableness, Materiality and Other Qualifiers
Often a party's termination rights are subject to reasonableness, materiality or other qualifiers. Unless specifically defined, qualifiers require a subjective determination that increases the likelihood of dispute. For example, the termination provision may:

- Require the terminating party to give reasonable notice for termination to be effective. In this case, the terminating party should notify the other party as early as possible to avoid a dispute.
- Include a termination for cause that is defined as:
  - a material breach of a contract provision;
  - a breach of a material contract provision; or
  - a material breach of a material contract provision.

In these cases, the terminating party should preempt or, if necessary, defend against a wrongful termination claim by thoroughly documenting and communicating all facts substantiating its position that the nature or the subject matter of the breach was material. For more information about contract termination for cause, see Standard Document, Notice of Termination: Drafting Note: Contract Termination for Cause.

Retrieve Property
Often, at a sale of goods agreement's termination, one party keeps the other party's tangible property (like tooling) or intangible property (like intellectual property). Parties who keep another party's property may do so:

- Based on lack of motivation to return the property.
- To give the other party incentive to continue the relationship. For example, a seller may keep the buyer's tooling to try to retain the buyer as a customer.
- To offset the party's termination-related losses with the property's value.

To help ensure that it retrieves its property, a party should:

- Promptly work with the other party to retrieve the items.
- Involve legal counsel as soon as a problem arises.

Enter Into a Termination Agreement
To ensure that all aspects of an agreed termination are clear and enforceable, parties should enter into a written termination agreement (sometimes called an exit agreement). Many termination agreements:

- Include newly-negotiated termination- or post-termination-related rights and obligations.
Modify or eliminate provisions of the underlying agreement that otherwise survive its termination. Termination and post-termination obligations are highly transaction-specific and the parties must customize this language to address the facts and circumstances of the particular termination agreement. For example, a termination agreement may include:

- The seller’s obligation to:
  - transfer tooling and intellectual property to a new seller; and
  - sell remaining raw materials to the new seller.
- The buyer’s obligation to purchase the seller’s remaining inventory.

Parties should draft a clear, comprehensive and concise termination agreement to avoid:

- Ambiguity.
- Future disputes and related costs.
- Supply chain interruption.

For a sample termination agreement, see Standard Document, Termination Agreement.

For the links to the documents referenced in this note, please visit our online version at http://us.practicallaw.com/5-525-2962.

For more information, search for the following resources on our website.

Topics
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- Supply of Goods and Services (http://us.practicallaw.com/topic0-103-1128)

Practice Note: Overview
- Supply Chain Overview (http://us.practicallaw.com/0-523-6390)

Standard Documents
- Bill of Sale (Quitclaim) (http://us.practicallaw.com/8-521-8716)
- Bill of Sale (Warranty) (http://us.practicallaw.com/8-524-4193)
- General Purchase Order Terms and Conditions (Pro-buyer) (http://us.practicallaw.com/3-504-2036)
- General Terms and Conditions for the Sale of Goods (Pro-seller) (http://us.practicallaw.com/6-520-2354)
- Manufacturing Supply Agreement (Pro-seller) (http://us.practicallaw.com/8-520-6860)
- Termination Agreement (http://us.practicallaw.com/7-523-5113)

Checklist
- Drafting and Negotiating a Sale of Goods Agreement Checklist (http://us.practicallaw.com/1-520-6298)

Articles
- Due Diligence of Supply Chain Contracts in M&A Transactions (http://us.practicallaw.com/7-525-5455)
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