THE EFFECT OF MERGERS AND ACQUISITIONS ON REQUIREMENTS CONTRACTS

A supplier usually encounters a requirements agreement at two critical points: when it enters into it and when the contract fails to produce the results supplier hoped for.

The typical requirements agreement is a one-sided exclusivity agreement: the purchaser agrees to buy a product from only one supplier (an exclusive relationship), but the supplier can supply both the customer and any other customers (a non-exclusive relationship).

For the sales representative who brings in a requirements agreement, he or she is relatively certain that the customer will not be dealing with supplier's competitor, at least for that product, and that he or she has obtained all the customer's business for that product. To be meaningful, supplier must be certain that the description of the subject product is broad enough that a minor variation will not permit the customer to purchase a functionally equivalent product from another supplier. But at the same time the supplier can be certain that it is not foreclosing its ability to sell the same product to the customer's competitor. Supplier's main concern may be that it is able to fulfill the customer's orders.

While there may be other areas of concern to supplier, such as adjusting the price for various volumes, allocating its production in times of great demand and limiting its damages if it breaches its obligations, the time when the parties to a requirements contract give it greatest scrutiny are when the requirements themselves go up or down dramatically.

This article focuses primarily on the behavior of a requirements agreement if customer's requirements drop dramatically or even to zero in the context of a sale of customer's relevant line of business. In particular, what is required of a customer who sells off a line of business (or its total business) involving a requirements contract? Is the customer still obligated to purchase the product?

Although no aspect of US law is free from doubt, Section 2-306 (a) of the Uniform Commercial Code and related case law seem to permit the customer to sell its business without the requirements agreement, leaving the supplier with an agreement but no sales or claim for damages. The problem for the customer is that the outcome turns on its "good faith", which may well be a question for the jury. The risk of having a jury decide this question may be enough to cause the customer to pay to settle the resulting dispute with a litigious supplier.

Section 2-306(a) states in relevant part:

> A [contract] term which measures the quantity by ... the requirements of the buyer means such *actual ... requirements as may occur in good faith, ...*

Section 2-103 (b) define "good faith" as follows:

> "Good faith" in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.

This definition by itself does not answer the question whether a merchant may enter a requirements agreement and then change its business so dramatically that it has no more requirements.

The Official Uniform Comment supplements Section 2-306(a) stating in part:

> 2. Reasonable elasticity in the requirements is expressly envisaged by this section and good faith variations from prior requirements are permitted *even* when the variation may be *such as to result in discontinuance.*

So discontinuance is permitted if it is based on good faith. But what does that mean? Developing guidelines is left to the judges. It is beyond the scope of a short article to cover the case law of 50 states. However an extensive search of these cases has produced some helpful guidelines, some important cases and identify some areas for concern.

- Many courts have held that the seller in a requirements contract situation takes the risk of good faith variations in the buyer's requirements, even to the extent of the customer's determination to liquidate or discontinue the business. The customer does not assume an implied obligation to stay in business or to continue selling the goods which require the product supplier sells. Putting the proposition more directly, "The point of a requirements contract is that the buyer is not locked into buying a fixed quantity; the buyer does not assume the risk that the seller fails to appreciate this elementary principal of commercial dealing." (Dienes v. LIRR)

- However, "good faith" is a question of fact, a question of customer's subjective motives. The customer's decision to reduce or discontinue its purchases must be independent of the terms of the contract or any other aspect of the buyer's relationship with the supplier. Of course the customer may not purchase the product from another supplier.

- What then are some examples of bad faith? If the customer had no legitimate business reason for reducing its orders (other than to avoid the requirements contract), a jury may find bad faith; or a jury may decide that the change in the customer's business was motivated by a desire to avoid the obligations of the requirements contract. In one case, the customer started looking for a buyer of its assets only a month after entering a significant requirements contract. The judge determined that it could be a case of the customer's having second thoughts about the contract and hence constitute bad faith.

- The good news for the customer is that the supplier has the burden of proving the customer's bad faith, the absence of a plausible good faith explanation. However the bad news is that questions of fact are for the jury, and the results are unpredictable. This unpredictability may force a customer to seek a settlement. A customer will try to get the judge to come to the conclusion – as judges sometimes do – that no reasonable jury could find bad faith and therefore decide the matter him or her self.

So how do these rules apply to the case where the customer sells its assets to a third party but keeps the requirements contract. Here the results are not so clear. _____recent cases merit some discussion.

Empire Gas vs. American Bakeries (1988) seems to be the leading case, written by prolific Judge Posner. It does not involve the sale of assets, but is frequently cited by other cases that do. EG distributed propane and sold converters to enable normal cars and trucks to use it instead of gas. AB signed a requirements contract for conversion and propane supply, but within days decided not to convert its fleet of trucks. Judge Posner noted that AB's reduction of purchases to hurt EG would clearly be bad faith. But

> ...it was not acting in bad faith if it had a business reason for deciding not to convert, *independent of the terms of the contract* or any other aspect of its relationship with Empire Gas, such as a drop in the demand of its bakery products that led it to reduce or abandon its fleet of delivery trucks. A harder question is whether it was acting in bad faith if it changed its mind about conversion for no (disclosed) reason.

Judge Posner proceeded to conclude that changing one's mind was not consistent with good faith. He contrasted a requirements contract with an option to purchase, noting that a requirements contract created a greater obligation for the customer. He noted the reliance the supplier could reasonably place on the obligation. AB did have a change in management after signing the contract, but entered no evidence to explain the change in policy. At this point, Judge Posner took the matter in his own hands and decided that any jury would find that AB acted in bad faith. The dissent focused on this point, noting that after the majority found that EG had the burden of proving AB's bad faith, it went on and assumed that EG had fulfilled that burden.

In *NCC Sunday Inserts vs. World Color Press* (1991), after trying to sell its business to World Color, NCC sold its assets to GFV Communications, a company which had its own source of the product to be supplied by World Color (newspaper coupon inserts). NCC kept the requirements agreement, but had no further requirements for the inserts and terminated the agreement. World Color claimed that NCC had sold its business only to avoid the requirements contract and had an obligation to stay in business.

The court stated that the seller in a requirements arrangement assumes the risk of all good faith variations in the buyer's requirements even to the extent of a determination to liquidate or discontinue the business. But there is no established standard as to what constitutes "good faith." At this stage of the proceedings, the court was unable to determine whether NCC's decision to sell the business had been in good faith. This was in part because NCC had painted a rosy picture of its prospects when trying to sell the business to World Color and then claimed to the court that it was facing economic disaster. NCC might have sold the business solely to avoid the contract. [Jury?]

Diversified Prods. vs. Tops Mkts. (2001), raises similar questions. There Diversified sued Tops claiming breach of a requirements contract in an asset sale situation. Diversified distributed glasses and optical accessories. Tops operated grocery stores and Vix drug stores. After entering into the requirements contract with Diversified, Top sold the Vix assets to Drug Emporium but kept the requirements contract. Drug Emporium had its own suppliers for eyeglasses and did not know about the Vix contract. In its defense, Tops claimed the right to reduce its requirements to zero and rejected any obligation to assign the agreement to Drug Emporium. The court noted Top's knowledge that Diversified would not profit from the contract during the sale-shortened term and found that a jury might find a breach of the general duty of good faith imposed by the UCC. The decision *was* given to the jury.

In *Koch Materials Co. v. Shore Slurry Seal, Inc.* (2002), SSS agreed to buy its asphalt requirements from Koch. Then SSS sold all its assets to Asphalt Paving Systems. SSS refused to say whether it assigned the

requirements agreement to APS and did not get the required consent from Koch to any such assignment. The court found that the sale of the assets would not necessarily be in bad faith. But the transaction structure, apparently permitting Asphalt to purchase materials from sources other than Koch, "would almost certainly exhibit bad faith on the part of a party to a requirements contract." Koch Materials Co. v. Shore Slurry Seal, Inc. (USDC, D NJ, 2002) 48 UCC Rep Serv 2' 157. Although the court did not find bad faith, it hinted strongly that it existed and left the matter open for the trier of fact.

Wiseco, Inc. v. Johnson Controls, Inc. 59 UCC Rep Serv 2d 884 (USCA 6th Cir 2005), did not involve an asset sale but is still instructional. There Johnson Controls was permitted to reduce to zero its requirements of a headrest part sourced from Wiseco for use in Jeeps. Johnson Controls attributed the decline to changes at DaimlerChrysler, which produced the Jeep. DaimlerChrysler asked Johnson Controls to change the headrest part in several ways. Johnson Controls' engineering department requested further small changes, too. Wiseco claimed that the two parts – before and after the changes - were essentially identical. The court found that Wiseco had not met its burden of proof of bad faith on Johnson Control's part. Johnson Controls also noted that production had been moved (presumably by Johnson Controls) from a location close to Wiseco to one in Canada. Johnson Controls cited both increased efficiencies through buying the somewhat different part from a rd party and production problems Johnson Controls had with the Wiseco arrangement. The court was persuaded that Johnson Controls had acted in good faith and denied Wiseco's claim. See also *Brewster of Lynchburg vs. Dial Corporation* also involving an internal restructuring which resulted in requirements dropping to zero.

Although these facts do not constitute Johnson Control's sale of a line of business, they are closely parallel. With impetus from a third party (DaimlerChrysler), Johnson Controls made small changes to a part permitting it to claim that its requirements for the similar part had ended. The court found that these changes were not made in order to avoid the terms of the Wiseco agreement. That separation of Johnson Control's motive from the terms of the Wiseco agreement seems to have constituted good faith and justified the reduction of requirements to zero. By simple analogy, Johnson Controls would be able to take voluntary action – such as the sale of a related line of business - without being required to transfer the requirements agreement along with those assets, at least so long as its motives were not to avoid the agreement.

The lesson of these cases seems to be that the court will look closely at asset sales that turn out badly for the seller in a requirements contract. If the buyer's motives are truly free from any desire to avoid an onerous requirements contract, it should be permitted to cut its requirements to zero. But if the court feels that the customer has behaved badly or the supplier has ended up with a worse result than it reasonably counted on, it will permit the jury to do rough justice.

So, what should the customer bear in mind in selling off its assets without the requirements contract? First, the customer should closely examine its motives. To what extent are they influenced by the requirements contract? The greater the influence, the more the customer should be prepared to pay to get out of the agreement.

Second, it is not enough to act in good faith, one must "appear" to be acting in good faith. How big a part does the requirements contract play in the customer's business? Is the requirements contract onerous? Has the customer tried to transfer the contract to the asset buyer? If the buyer has resisted, is it because the contract is on nnfavorable commercial terms or for other reasons, such as buyer having its own internal source of supply or a different formula for the product? Did the impetus for the asset sale come from some outside source?

When in the life of the requirements contract does the sale occur? Did the customer have any interest in selling at the time it entered into the requirements contract? Did the customer know that supplier was going to rely on the contract in making special expenditures. Was the customer forthcoming regarding any plans for an asset sale.

Third, beyond its own knowledge and motivations, the customer should also closely examine any evidence – notes of conversations, memos, correspondence – which are in the hands of the supplier or could be discovered and could either support or contradict the customer's position. Could perfectly innocent and disconnected events be strung together by the supplier to fabricate an apparent pattern of disregard for supplier's reasonable expectations?

Add to this set of considerations the fact that the supplier may bear the burden of proving bad faith but probably has little to lose other than time and legal fees in bringing suit against both its customer and the asset buyer. Bringing suit will permit supplier to subject the defendants to discovery. Any document which complains about the terms of the requirements contract will increase the likelihood of getting to the jury and forcing a settlement.

The other player in this scenario is the purchaser of the customer's assets. What is its role and what are its duties? If the requirements contract is a real asset, in the sense that the contract is advantageous to the customer, the question is the right to assign the agreement and the possible increase in quantity. Then the shoe is on the other foot and beyond the scope of this short article. Certainly if the agreement is on beneficial terms for the customer, the supplier will not complain that it has been cancelled. Also, a jury is unlikely to find that the customer tried to avoid it.

If the agreement is burdensome, any buyer who learns of the customer's requirements contract will refuse to take it and negotiate an indemnification from the customer against suit by the supplier. But the supplier sometimes attempts to turn the requirements contract's "successors and assigns" language into an obligation of the asset purchaser to honor the customer's requirements contracts, even when the purchaser has not explicitly assumed the agreement.

The UCC deals with this issue by not dealing with it. Comment 4 to Section 2-306(1) states:

> *Assuming* that the [requirements] contract continues, the requirements in the hand of the new owner continue to be measured by the actual good faith ...requirement under the *normal operation of the enterprise prior to sale.* The sale itself is not grounds for sudden expansion or decrease.

The Comment specifically avoids the question of whether the buyer of the enterprise is bound by the contract.

In *World Color Press* discussed above, the same requirements contract purported to bind the parties and their "successors and assigns." WCP argued that GFV was obligated under the requirements contract as successor to NCC. The court rejected this theory, saying that, "As a general rule, the purchaser of another's business assets for cash does not assume the seller's debts of obligations." 759F.Supp.1004 at 1013. There are exceptions to this rule, but they involve variations on the concept of merger, fraud, bad faith or formalities over reality. WCP failed to show that the asset sale fell into any of the exceptions. As to bad faith, WCP could show that GFV knew about the requirements contract and that NCC did not demand that GFV assume it. But

even if NCC acted in bad faith, WCP did not show bad faith on GFV's part. By agreement with GFV, NCC remained liable for any obligations under the requirements contract. Mere knowledge of the requirements agreement did not make GFV liable for it.

As stated in *World Color Press,* the purchaser of a company's assets does not, as a result of the purchase, normally become liable for the seller's debts or obligations. The standard exceptions to this rule are:

1) the purchaser expressly or impliedly agrees to assume the seller's liabilities,
2) the transaction amounts to a consolidation or merger of the two companies,
3) the purchaser is "a mere continuation" of the seller, and
4) the transaction is entered into fraudulently to evade liability for those debts.

The first exemption is relatively simple to spot. We presume purchaser of the assets does not also assume the requirements contract.

While no precise rule governs the finding of implied liability, the conduct or representations relied upon by the party asserting liability must indicate an intention on the part of the buyer to pay the debts of the seller. Fletcher, *supra §* 7124. The presence of such an intention depends on the facts and circumstances of each case *(Ladjevardian v. Laidlaw-Coggeshall, Inc., 431 F. Supp. 834, 838 (S.D.N.* Y. *1977).*

A finding of an implied assumption is more likely in the case that the creditors have been left without a remedy as a result of the transfer of the assets. This is unlikely in the case where the predecessor seller continues as a viable entity *(Ladjevardian v. Laidlaw-Coggeshall, Inc.)*

A successor would normally succeed to the duties under the contract in a statutory merger but also in a so called *de facto* merger, i.e. a transaction, although not in form a merger, is in substance 'a consolidation or merger of seller and purchaser' *(Washington Mutual Bank, FA v. SIB Mortgage Corp. d/b/a Ivy Mortgage, 791 N.Y.S.2d 874, quoting Cargo Partner AG v Albatrans, Inc., 352 F.3d 41, 45 [2d Cir],* quoting *Schumacher, 59 N* Y *2d at 245)."*

The four criteria necessary to find a de facto merger are: [1] a continuity of the selling corporation, evidenced by the same management, personnel, assets and physical location; [2] a continuity of ownership in which the shareholders of the acquired corporation have been compensated with an interest (usually shares of stock) in the acquiring corporation; [3] a dissolution of the selling corporation; and [4] the assumption of liabilities of the acquired corporation by the purchaser *(Washington Mutual Bank, FA v. SIB Mortgage Corp. d/b/a Ivy Mortgage, 791 NY.S.2d 874, quoting Arnold Graphics Indus. v Independent Agent Ctr., 775 F. 38, 42 [2d Ci], quoting Ladjevardian v Laidlaw-Coggeshall, Inc., 431 F. Supp. 834,* 839 [SD NY]; *see also Cargo Partner AG v Albatrans, Inc., supra,* 352 F. *at 46; Schumacher v Richards Shear Co., supra,* 59 NY.2d *at 245; Fitzgerald v Fahnestock & Co., 286 A.D.2d 573, 574, 730 N.Y.S.2d 70 (1st Dep't, 2001); Employee Relations Assocs. Inc. v Xperius, 196 Misc.* 2d 485, 486, *764 N.Y.S.2d 537 (Sup. Ct., Monroe Co.,* 2003)).

A *mere continuation* "envisions a common identity of directors, stockholders and the identity of directors, stockholders and the existence of only one corporation at the completion of the transfer" *(Caballero Spanish Media, Inc.* v. *Betacom, Inc. and Betacom of Phoenix, Inc. (1987 U.S. Dist. LEXIS 8531).*

Although the issue of successor liability for a requirements contract may justify closer scrutiny, the foregoing discussion should give some comfort to the parties to the asset sale.

In summary, the company which is buyer under a requirements contract should closely review its relationship with the seller before selling its assets to a buyer who does not want to assume the requirements contract. The company should explore whether the buyer of the assets might be willing to assume the contract and the reasons it has not to. Even in the best case, the company may face a suit by the seller under the requirements contract. In the worst case, it may be deemed to have acted in bad faith, making it subject to a damage claim.

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