Insolvency Alert: What To Do If Your Distributor or Manufacturer Goes Belly Up

In the current economic climate, all businesses will be on the alert for credit issues and the possible insolvency of business partners, suppliers and major customers. Experts estimate that the full effects of the global credit crunch are yet to be felt by Australian businesses. Nor is the damage to business caused solely by the insolvency of major customers; the liquidation of a major supplier with a long standing business relationship will also have its ramifications.

What should a manufacturer or product distributor do to protect their interests? And what steps should be taken after discovering their customer or supplier is insolvent?

The word "insolvency" is a generic term but usually refers to some form of formal appointment by an external person to the relevant company or its assets. The main appointments are:

- *Appointment of a liquidator*: this can happen voluntarily or by a Court. Liquidation usually occurs when the company is insolvent and cannot pay its debts, although a solvent liquidation is also possible.

- *Voluntary administration*: an external person gets appointed to the company, usually by its directors. Two meetings of creditors are held. Creditors vote either for a liquidation, or a deed of company arrangement (a restructuring of the company's debts), or in rare cases, for the administration to end.

- *Receivership*: a receiver gets appointed over assets of the company, usually by a bank. Unlike a liquidator or voluntary administrator, the receiver does not owe duties to unsecured creditors but looks to recover for the bank only.

Most distribution agreements or other contracts allow the manufacturer or distributor to terminate on the insolvency of the other, including on the appointment of a receiver/voluntary administrator/liquidator. However, termination is usually not automatic; the non insolvent party must choose to terminate and serve appropriate notices.

Deciding whether to terminate will depend on commercial issues such as the whether the business is still trading under the appointment and what rights accrue to the terminating party on termination.

What should manufacturers do if an external administrator (or liquidator/receiver) is appointed to one of their distributors?

- The first step should be to collect stock pursuant to any valid ROT (retention of title) clause. The time to include a valid ROT clause, however, is during the contract negotiation, not later. It is too late to insert an ROT clause once the contract is signed and the distributor insolvent! The best clauses are those which allow the manufacturer to retain title to goods if any invoices (not just those for the specific goods under a particular invoice) are outstanding.

- Consideration should be given to the commercial and legal ramifications of terminating the contract.

- In some jurisdictions legislation exists allowing a warehouse operator storing any goods to retain possession until payment is made. Therefore the manufacturer may need to pay the warehousing costs of the goods to obtain possession.

- Further steps will depend on what the manufacturer is owed, and the nature of the debts. If the distributor has sold product to end consumers and collected receipts for those sales, the manufacturer may have a claim to those receipts as “trust” monies held on its behalf. This will depend on the terms of the contract and whether the distributor has kept the funds separate from its own, and can be a very complex issue. Again the contract should make the trust relationship clear from the outset (and require the distributor to keep the funds as trust funds).

- Otherwise, unless the manufacturer has other security over assets of the business, it will be an unsecured creditor only but with voting rights at the meetings. Proofs of debt must be lodged and the claim particularised. Ultimate recoveries will depend on the course of the liquidation/voluntary administration. If the manufacturer’s unrecovered debt is significant, it may want a representative on the creditors’ committee.

- The manufacturer should also check if the loss falls within an insurance policy maintained by it and make claims accordingly.

What should a distributor do if a manufacturer goes belly up?

- Again, it should review the contractual terms and the commercial/legal ramifications of termination, to decide whether to terminate.

- Any receiver or other appointee will continue to press for collection of unpaid debts owing by the distributor to the manufacturer. Generally the manufacturer’s insolvency will not prevent those debts becoming payable unless the distributor has a claim against the manufacturer which can be set off against the manufacturer’s claim on it.

- The distributor should also be careful before continuing to sell goods supplied by an insolvent manufacturer. This is particularly if the manufacturer will be unable to service contractual warranties. Continuing to supply products subject to contractual

warranties, where the manufacturer cannot meet warranty claims, may place the distributor at risk.

In all circumstances, manufacturers and distributors alike will receive their best result by seeking to protect their interests early, including via appropriate contractual terms.

Further, in the unfortunate event of a formal insolvency appointment occurring, best results will usually be achieved by working collaboratively with external appointees. This may allow the business to continue trading, with better returns for all.

For more information please contact:

Nicole Tyson, Partner
Telephone: +61 2 8915 1017
Facsimile: +61 2 8916 2017
Email: nicole.tyson@addisonslawyers.com.au

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