THE 'LAYER CAKE' APPROACH TO CONTRACT NEGOTIATION

By Andrew M. Apfelberg, Greenberg Glusker

Law360, New York (September 24, 2010) -- After working together without a written agreement for over 15 years, ACME Food & Beverage Co. became concerned about its vulnerability to its single-source supplier of raw materials, Main Street Supply.

ACME informed Main Street that it needed to document their relationship in writing. ACME's concerns were valid, particularly because Main Street had developed and owned all of the intellectual property relative to the composition and method of production of 75 percent of ACME's best-selling products. Alternatively, Main Street was concerned that ACME represented a significant portion of its revenue.

After a year of protracted negotiations on a traditional supply agreement, the parties were at a complete impasse, straining the relationship. The companies' co-dependency made it difficult to resolve the fact that both wanted to own the intellectual property. At this point, Main Street retained us to devise a mutually acceptable solution.

Needs vs. Wants

By interviewing Main Street's senior management to identify their needs from ACME, as opposed to what they wanted, and encouraging ACME's counsel to do the same, we soon realized that a plain-vanilla supply agreement was not sufficient. Both parties wanted to own the production formulas of the raw materials that Main Street provided to ACME. But, who needed to own the formulas?

ACME needed Main Street's raw materials to stay in business. If Main Street's relationship with ACME soured, or ACME stopped or slowed down its demand for raw materials, Main Street would need to own the intellectual property to use it itself or sell to a third party. At a minimum, ACME wanted exclusivity and Main Street wanted minimum purchase guaranties.

Four-Layered Solution

To resolve the parties' impasse, we structured an exclusivity covenant onto which was layered: 1) an intellectual property license; 2) a triggered release from an intellectual property escrow; 3) an anti-sandbagging provision; and 4) a 12-month rolling forecast.

Layer 1: Main Street agreed that it would not directly or indirectly use, for its benefit or others, the formulas it had developed or the raw supplies it was producing for ACME, so long as ACME was not in breach of the agreement and met its minimum purchase requirements.
While Main Street retained sole ownership of the underlying intellectual property, it was tied up enough by factors within ACME's control that ACME felt secure.

Layer 2: Main Street granted ACME an exclusive license to use the same intellectual property if certain events were triggered (for instance, the inability to provide ACME with the agreed upon volume of product or the filing of a bankruptcy case). To give ACME an immediate remedy and avoid a delay in supply which could translate into the demise of the company upon such a trigger event, a copy of the formulas and other intellectual property were put into a third party escrow

Layer 3: ACME gave anti-sandbag provisions, eliminating specific formulas and raw supplies from the exclusivity covenant in the event
that: (i) ACME purchased product similar to that supplied by Main Street from a third party, (ii) ACME failed to purchase a minimum volume of product as agreed to between the parties, or (iii) ACME breached the agreement, including the unauthorized use of the intellectual property placed in the escrow.

Upon trigger, Main Street could use the affected product or formula for its own account or for the benefit of a third party and also remove the related intellectual property from the scope of the intellectual property license and corresponding escrow.

Layer 4: ACME agreed to provide a 12-month forecast of the volume of products to be ordered and the required raw materials and ingredients each month. For each forecast, ACME was "locked" into purchasing the quantity specified for each of the first 3 months of the forecast. If Main Street could not supply more than the forecasted amount, it would not be in default.

The forecasts were deliberately set with a 30-day lead-time in order to provide Main Street sufficient time to manufacture and deliver the products. This structure kept ACME from placing a large, one-time order on short notice, which Main Street could not reasonably fulfill, as a means to cause a breach of contract and gain access to Main Street's intellectual property.

Outcome

The year impasse between two companies dependent on each other for success was resolved by using a "needs vs. wants"-based negotiation strategy and baking a four-layer "cake," where each provision was stacked upon the other to meet the business expectations and needs of both ACME and Main Street. The solution involved a cross-disciplinary approach that drew upon the expertise of our corporate, intellectual property, insolvency and litigation departments.

By collaborating internally and with our client, a mutually beneficial contract was successfully developed — and has been working perfectly for a number of years.

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The fact pattern that is the subject of the article comes from a real matter handled by the author and his law firm, Rutter Hobbs & Davidoff. The names of the parties and other identifying factors have been changed. The author represented the party that is referred to in the article as Main Street Supply.

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