



## **Purchase Contracts: Best Practices for Buyers and Sellers**

*"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way."*

It is ironic that Charles Dickens' famous words from "A Tale of Two Cities", written over 150 years ago, could so accurately describe so many conversations taking place today when company leaders try to make sense of broken business deals, uncollected revenues, rejected sub-standard or nonconforming shipments, or unwanted litigation situations. This is especially troubling in times of economic crisis when every piece of business counts.

Every company is at some time both a buyer and seller of goods and services. Negotiating and signing clear and balanced purchase contracts is the most effective way to protect your company's reputation, revenues, markets and customer relationships. The market is the most effective teacher of "best practices", and if you learn from the mistakes of others, you will be wiser and wealthier.

Preparing a good purchase contract should embody that old saying of "an ounce of prevention is worth a pound of cure." Investing time and expertise in a good purchase contract is one of the most important revenue-generating tools to avoid liabilities, future trade disputes, uncollected accounts receivables, reputation-damaging publicity, and claims of breach of contract and poor quality control. These can be easily avoided with a small dose of preventive attention in advance.

Whether acting as a buyer or a seller, the same basic common sense rules apply to protect your business. They boil down to a few basic principles:

1. Ensure that the purchase/sale contract is clear about ALL the major terms and conditions without any room for different interpretations
2. Ensure that the purchase/sale contract is clear about the responsibilities and obligations of ALL the parties without any room for different interpretations
3. Ensure that the purchase/sale contract reflects the realities as understood by ALL parties without any room for different interpretations
4. Ensure that ALL payment, legal title and delivery terms are reasonable and stated clearly
5. Ensure that the purchase/sale contract is enforceable against ALL the real parties in interest and provides for dispute resolution mechanisms that practically work
6. Build in practical communication and resolution mechanisms to solve problems before costly litigation/arbitration

Below we share some of the "best practices" that should be included in the basic form agreements for every company, even before specific "tailoring" to special needs. These should be useful to help navigate an increasingly complicated and competitive trade, investment and business environment.

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**1. Sign a Non-Disclosure Agreement (NDA) Before Discussions.**

Sign an NDA at the beginning of discussions to prevent unlawful use of trade secrets and/or confidential information (e.g. sales, design, or customer information) by other parties

**2. Sign with the Legal Representative.**

Request that the purchase agreement be signed by the person listed as the legal representative in the company's incorporation documents. If the person signing the agreement is not the legal representative, the other party may claim to not to be bound by the agreement and refuse to abide by some or all of its terms.

**3. Discuss Demand Forecasts**

Demand forecasts will often be mentioned in the agreement but are not binding unless stated explicitly. Ensure that forecasts are binding only for a short-term and retain explicit rights to modify the forecasts to allow future flexibility.

**4. Determine Whether Orders Can be Cancelled, Re-scheduled, or Modified.**

By default, orders are binding and cannot be modified or cancelled without liability unless explicitly stated. To allow flexibility and fairness to both parties, set specific bounds (dates and volumes) for when orders can be cancelled, re-scheduled, or modified.

**5. State Explicit Payment Terms and Penalties for Delayed Payment.**

The agreement must clearly state the payment terms. For example, it is better to ask for payment "10 days after shipment," instead of "on receipt of products." The agreement should clearly define a lump sum, a daily/weekly/monthly penalty, and/or an interest charge in the event of delayed payment. As with other penalties, a fixed figure must be agreed on in advance.

**6. Determine When to Transfer Title of the Goods.**

As a buyer, make sure that title to the goods is transferred upon shipment. If the seller transfers goods to you, but files for bankruptcy before you pay for them, the goods will be considered part of the seller's assets and liquidated.

As a seller, title to goods should be transferred upon payment. If you transfer title to the goods before payment and the buyer then files for bankruptcy protection, the goods will be considered part of the buyer's assets, and will consequently be liquidated.

**7. Payment After Acceptance.**

The agreement should ask for payment to be made within a reasonable period of time after the products have passed acceptance tests. This ensures that defective products are not bought and safeguards against later refund disputes.

**8. Have the Right to Audit.**

As a buyer, incorporate a clause that permits audits of the seller's financial data and visits to the seller's factory (with prior notice) to guarantee that the seller is not unlawfully manufacturing the same products for other uses.

### **9. Most Favorable Price.**

A most favorable price term should be incorporated into the agreement to ensure that other buyers will not be able to make an equivalent purchase for the same goods for a lower price in the future.

### **10. Define Clear Quality Control Mechanisms and Specifications.**

Ensure the agreement provides clear, detailed, and previously agreed upon quality specifications, as well as a description of the inspection process (i.e. who will inspect the product, when, and how). The seller should provide sample products for reference and records. Make sure an independent and local third party conducts quality control inspections during production or before shipping the goods to the buyer. State that the results of these inspections are binding. It is common practice for the buyer to select and pay for this service provider.

### **11. Clearly State Warranties.**

The objective of spending time and energy drafting a purchase agreement is to minimize your liability in all transactions. Reasonably state everything you need in the warranty clause, and do not simply rely on your insurance policies.

### **12. Sufficient Indemnifications.**

Claim sufficient indemnifications in order to cover your potential losses in any future disputes, including the attorney fees you may be required to spend.

### **13. Define Clear Mechanisms to Handle Returns.**

Specify deadlines to report product defects and returns (e.g. 10 days after shipping). Make sure the term “defect” is clearly defined and understood by both parties. Document customer complaints and require products to be inspected by you or a mutually agreed upon third party to be deemed defective. Have clear deadlines and procedures to reduce misunderstandings and pass liability to the other party if they fail to adhere to the established system.

### **14. Right to Offset.**

As a buyer, make sure you have the right to offset any amount owed by the seller against the product payments. This must be clearly stated as the right is not usually granted.

### **15. No Right to Outsource.**

As a buyer, make sure the seller is forbidden from outsourcing the function of manufacturing and/or supplying to a third party to ensure the quality of the products unless prior written consent is given.

### **16. State Termination Rights.**

State very clearly the circumstances under which the agreement can be terminated. These usually include mutual consent and breach of specific clauses by one of the parties.

### **17. Select the Governing Law That Better Protects Your Rights.**

Remember that any jurisdiction can be used as long as both parties agree. Even though your first impulse may be to use the jurisdiction where your company is located, you should check with your lawyer to explore other options on a case-by-case basis. In some cases, choosing the other party’s jurisdiction may better facilitate seizure of assets in case of a dispute.

**18. Prepare a Standard Agreement in Advance.**

As Louis Pasteur once said, “Chance favors the prepared mind.” The best way to ensure your interests are protected in every transaction is to develop your own template agreement with the assistance of an experienced commercial lawyer and use it as a baseline during negotiations.

**19. Sign with a Real Party of Interest, Not a Paper Company.**

Ensure the other party has assets for future enforcement if a dispute arises. Remember that purchase agreements are only binding for the entities that sign it, regardless of who actually receives the product. If the agreement is signed with a “paper company” that holds no assets, you are left with little or no legal recourse in case of a dispute.

Always request that the agreement be signed by the global or regional headquarters, and be very suspicious if one party suggests using an offshore entity. Whenever possible, conduct a background check to make sure the signing entity has a previous track record of successful sales and assets (real estate, production facilities, bank accounts, etc.) that can be seized in case of dispute.

In the case of a representative office, obtain an authorization letter from the real party of interest, naming the office as its representative. The authorization letter should state that the real party of interest is responsible for payment of orders placed in their name by the representative office.


**20. State Explicitly Any Geographic Limitations for Distribution.**

If product distribution is to be limited to a specific geographic area, this should be negotiated beforehand and stated clearly in the agreement. Any penalties for breaching this restriction must also be stated as a fixed amount, which should also be negotiated in advance.

**21. State Explicitly When Prices Can Be Negotiated.**

This is particularly important in industries where prices for key components or commodities increase/fluctuate seasonally, or depend on global/local supplies.

For further information, please contact:

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