

## New rules on payment terms

New rules which control the payment terms in most contracts involving European Union businesses are now in force. This note summarises the effect of the EU rules.

### 1. What is the new law?

The EU Late Payments Directive (2011/7/EU) replaces a previous directive. It builds on existing rules to give significantly enhanced protection to suppliers.

### 2. When it is effective?

As a directive, the new law does not directly apply in individual EU Member States. Each Member State was required to implement the Directive into its national law with effect from **16 March 2013**.

In most Member States the new law is now in effect, although in some implementation will only be complete in the next few weeks.

#### When could existing contracts be caught?

Even where (as in the UK) the new rules are not retrospective, they can still potentially apply to some existing contracts. For example:

- an existing framework agreement where orders are placed, or subsidiary agreements reached, after the rules take effect.
- existing standard terms where orders are placed on those terms after the rules take effect.
- an existing agreement which is renewed after the rules take effect.
- existing agreements which are novated (i.e. transferred from one party to another) after the rules take effect.

In addition, individual EU Member States can apply the rules retrospectively.

### 3. Are the rules the same everywhere in the EU?

As the rules derive from EU law, in principle they should apply in a similar way across all EU Member States although there are some differences in the way in which the rules are being implemented in individual countries.

This note is primarily focused on the EU wide rules. In addition, a summary of how the rules work specifically in the UK is also attached.

### 4. What contracts are covered?

The rules apply to:

- contracts between business suppliers and business buyers ("**B2B Contracts**");
- contracts between business suppliers and public authority buyers ("**B2P Contracts**").

The application of the rules is not restricted to standard terms - they also apply to negotiated, complex or high value contracts.

The rules apply to contracts under which goods and/or services are provided even if part of a broader transaction. Contracts which **only** cover other subject matter will not be caught.

Will the rules apply?	
Supply, manufacturing or distribution contract	Yes
Acquisition of a business, shares or real property which includes stock or equipment	Yes
Services, Transitional Services or Financial Services agreement	Yes
Futures, foreign exchange or other purely financial transactions	No
Acquisition of shares or real property with no ancillary elements	No

### 5. Must debts be paid within a maximum period?

The rules impose statutory maximum periods, within which debts must be paid. The periods are:

- 60 days for B2B Contracts; and
- 30 days for B2P Contracts.

### 6. Can I contract out of the statutory maximum?

The parties to a B2B Contract can only extend the period for payment beyond the statutory maximum if that extension is both "expressly agreed" and not "grossly unfair" to the supplier.

#### Extended payment period – how explicit?

The rules require any payment period longer than the statutory maximum (60 days for B2B contracts) to be "*expressly agreed*".

There is no guidance on what is required by "*expressly agreed*" - it may well be more than just including a period for payment which is longer than the statutory maximum.

To be safe, any extended payment period should include a phrase such as "*and the parties expressly agree that this period will be longer than the maximum period provided for under the law.*"

The rules provide that in deciding whether an extension is "grossly unfair" three questions need to be asked:

- Is the extension a gross deviation from good commercial practice and contrary to good faith and fair dealing?
- Is the extension associated with the particular nature of the goods or services in question?
- Does the buyer have any objective reason to deviate from the statutory maximum?

The onus is on the buyer to show that the extension is not "grossly unfair".

### Grossly unfair?

The following are examples of the way in which the concept of "grossly unfair" might be applied in assessing a payment period which is longer than the statutory maximum:

Lower risk of being "grossly unfair"	Higher risk of being "grossly unfair"
<ul style="list-style-type: none"> <li>Industry payment periods universally exceed statutory maximum for an objective reason</li> <li>Primary driver is particular feature of commercial context (e.g. a wider transaction)</li> <li>Where some payments are made early and some are made late</li> <li>Buyer is a re-supplier of goods into a non-EU market where it faces market norm of extended terms</li> </ul>	<ul style="list-style-type: none"> <li>No settled approach to payment periods in the industry</li> <li>Primary driver is commercial benefit of the buyer</li> <li>Where all payments are made at the same time</li> <li>Buyer is end user of goods</li> </ul>

#### 7. Does a buyer have to pay interest?

If the rules apply, a buyer will automatically have an obligation to pay the supplier interest if it does not pay when it is supposed to.

Except where an alternative contractual remedy which complies with the rules is provided (see paragraph 10), this obligation will arise whatever the contract says and whether or not the supplier demands interest.

#### Reviewing Payment Policies

A "one-size-fits-all" policy to pay suppliers later than 60 days risks being overturned even if suppliers agree expressly the payment period.

Unless there is a particular objective reason for the buyer always to override the statutory maximum (for example, because of very particular industry characteristics) it will be difficult to show that terms reflecting that policy are not "grossly unfair" according to the tests set out in the rules.

Buyers should review their payment policies in this context. The policy should only insist on extension in those particular circumstances where there are good objective reasons to insist on extended payment terms.

#### 8. From when does statutory interest run?

Interest starts running on unpaid amounts from the day after the payment date in the contract. For this purpose, the payment date cannot be later than the end of the statutory maximum payment period.

If the contract does not include a payment date (for example, where there is no written contract) the rules include a formula to calculate the date from which interest runs.

The rules are complex but, in summary, interest will start to accrue 30 days after the later of:

- the day on which the obligation of the supplier to which the debt relates is performed; or
- the day on which the buyer is notified of the amount of the debt claimed; or
- the day of completion of any contractual acceptance or verification procedure for the goods or services.

#### 9. Is there additional compensation for suppliers?

The rules also provide for the supplier to receive compensation for the costs of recovering the debt and interest.

#### 10. Can you contract out of statutory interest?

Any attempt to replace the statutory right with an alternative contractual right will be subject to similar principles to those applicable to contracting out of the statutory maximum payment periods.

#### 11. How are international contracts covered?

All contracts between EU businesses will be covered by the rules. Contracts which have no connection at all with any EU member state will not be caught.

The position will be less straightforward for international contracts between an EU entity and an entity from outside the EU.

The precise outcome will depend upon the countries involved and the nature and drafting of the contract. However, it will generally be difficult for a non-EU buyer to impose extended terms on an EU based supplier.

#### 12. Why have doubts been expressed?

In theory the new rules substantially enhance protection of suppliers against late payment. They have wide support from the EU Commission and Member States.

However, some commentators are expressing doubts as to their practical impact. Reasons for this scepticism include:

- The rules do not specifically force buyers to make payment within the maximum payment period. Instead they give suppliers automatic rights to claim compensation for late payments;
- Suppliers may not want to jeopardise on-going trading relationships by claiming interest to which they are in theory entitled;
- Enhanced regulatory protection is not a substitute for good credit management; and
- The directive anticipates that organisations will represent suppliers in challenging buyers' practices or contract terms but some Member States (including the UK) have not reflected this in their implementing laws.

### 13. Are the doubts justified?

Whilst there is some reason to be cautious about the impact of the rules, it would be dangerous to ignore them. They are likely to have a number of very practical impacts.

- *Commercial negotiation:* There is now a clear justification for suppliers to argue the case for payment terms within the statutory maximum;
- *Compliance culture:* Many buyers will comply either because of an internal policy of compliance or external pressures (e.g. lending covenants to comply with laws; public sector purchasing policies only to deal with compliant companies);
- *Relationship breakdown:* Suppliers may decide not to claim interest from customers with whom they have a good relationship. If a relationship sours they may try to make a substantial accrued claim for "back interest" as a lever in negotiations;
- *Insolvency practitioners:* Liquidators or administrators of suppliers may seek to use the rules as a way of enhancing assets (including by pursuing unclaimed historic balances);

#### Supply Chain Finance

Providers of supply chain finance should assess the impact of the rules. Any finance scheme under which a supplier is effectively charged the cost of receiving payment within the statutory maximum period risks being incompatible with the rules.

- *Vultures:* Lawyers or "vulture funds" may seek out suppliers with potential substantial accrued rights to claim interest and seek to benefit from them;
- *Accounting:* Given the maximum payment period and interest are automatic, companies will need to consider whether they must reflect the interest in their accounts even if not formally claimed;

#### Intra-group contracts

The rules impose interest automatically. Although companies within a group may opt in practice not to claim statutory interest from each other, careful thought should be given to the way in which this is done with regard to the various corporate and tax rules relating to intra-group transactions.

- *Funding:* Buyers who do not comply with the rules may find funders and investors are wary of the associated risks; and

#### Lenders, Funders and Investors

Anyone looking to acquire or invest in a company which is subject to rules on late payment should carry out due diligence to assess the potential amount of compensation due or owing for late payment:

- This will be a useful indicator of the target's debt collection and payment policies and practices;
- It may reveal a potential asset (compensation due) or liability (compensation owed).

- *Intervention:* Some Member States may implement the rules in a way which provides a mechanism for regulators or industry bodies to take steps to ensure compliance.

### 14. What immediate steps should I consider?

Buyers should consider the following:

- Do standard terms and/or standard payment policies and/or procedures need amending?
- Should it change the approach to bespoke negotiated contracts?
- How might it impact on contracts which are part of wider transactions?
- Are there any implications for accounting or internal trading arrangements?

Suppliers should consider the following:

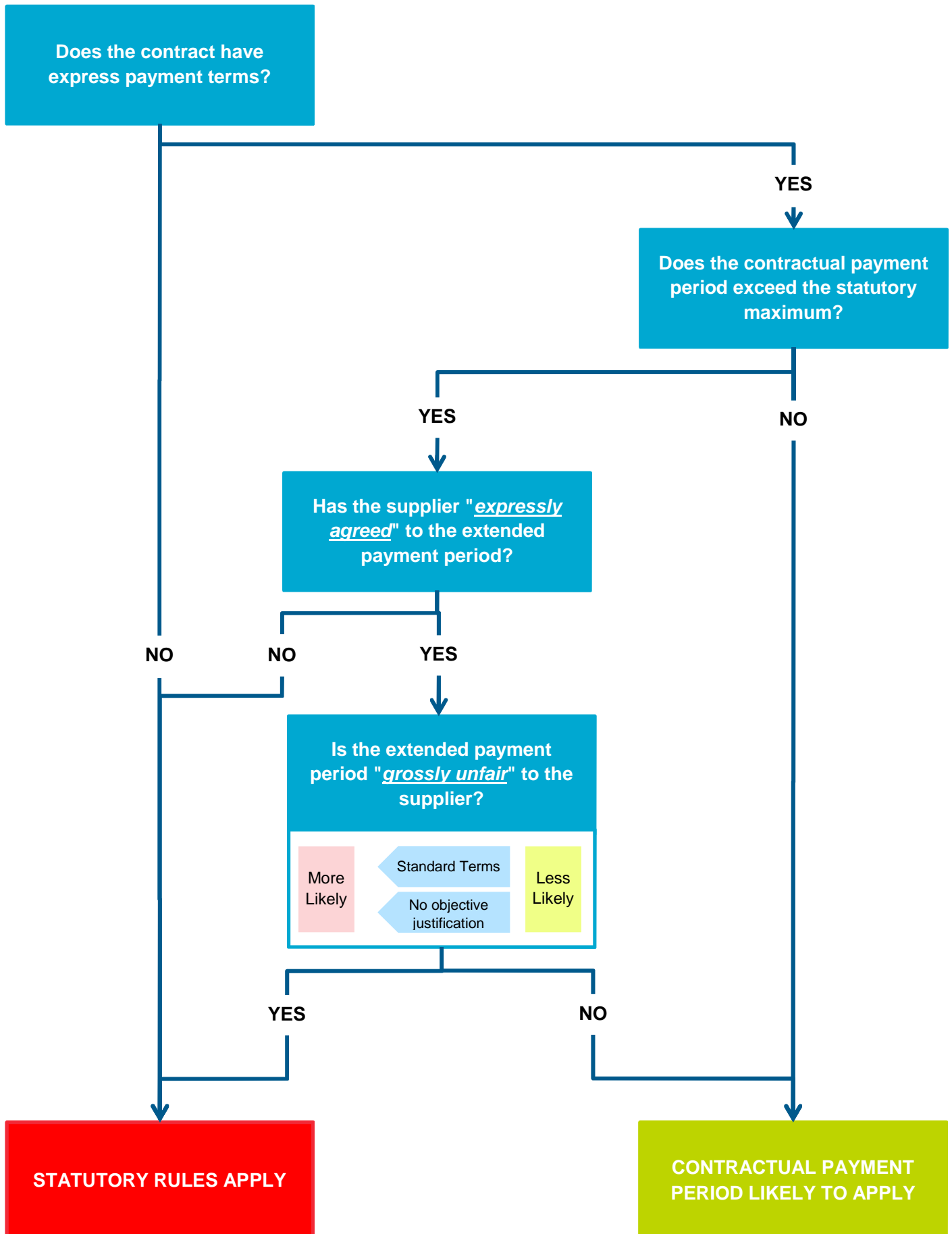
- Standard terms presented by buyers;
- Invoicing and collection procedures; and
- The approach to bespoke negotiated contracts.

#### Using standard terms of purchase

A buyer will find it difficult to use standard terms of purchase to impose a payment period longer than the statutory maximum. Reasons include:

- a court might not interpret buyer acceptance of standard terms as "express agreement" to the extended payment period; and
- when using standard terms, it will be difficult for the buyer to argue that the particular transaction objectively justifies the blanket extension, i.e. that the extended period is not "grossly unfair" to that supplier.

In practice, if using standard terms a buyer should assume it will always face the burden of justifying an extended payment term.



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