Arnall Golden Gregory LLP

Legal Insight

Form Drug Distribution Services Agreements May Not Be Formulaic

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Vanilla-looking form agreements may contain or omit terms that are important to one or both parties. We were recently reminded of the danger of entering into form pharmaceutical distribution services agreements. Although these agreements often have a similar structure and contain many standard provisions, we reviewed a form agreement that omitted key provisions and contained burdensome obligations and terms that merited consideration. Here are a few issues we highlighted:

Most Favored Nation Provisions

Embedded throughout the form agreement were permutations of what are commonly referred to as “most favored nation” or “most favored customer” provisions. These provisions generally require that a party receive the most favorable pricing, payment terms or discounts (or something similar) that are given to any other party. Because pricing and profit margins often differ between customers, complying with these provisions can be very burdensome, and violations may occur without a party’s knowledge of the violations or their consequences. Here’s how these provisions can work in practice:

- Let’s assume a large drug distributor has a most favored nations clause it its agreement with a manufacturer. If the manufacturer’s salespeople offer promotional discounts and extended payment terms to lure a new distributor, the manufacturer must offer the same terms to the large distributor. But offering these terms to the large distributor may consume the manufacturer’s profit margin.

- For a different angle, let’s assume a manufacturer pays a large drug distributor a 7% distribution services fee under a distribution services agreement. If the manufacturer and a small distributor later entered into a distribution services agreement with a most favored nation provision in the small distributor’s favor, the manufacturer must now pay the small distributor a 7% fee, even though the economics of that deal and the potential upside may be dramatically different than the deal with the large distributor.

If you can’t negotiate a most favored nation provision out of your agreement, make sure it’s appropriately limited—i.e., qualify it carefully so that violating it isn’t so easy.

Distribution Services Fees

In the form agreement, the distributor’s distribution services fee was calculated based on its *gross* monthly purchases, instead of its *net* monthly purchases. Calculating the services fee on gross purchases means the manufacturer pays a services fee on dollars it never received: the effect of chargebacks, returns, discounts and allowances are *not* taken into account. Because chargebacks represent the single largest deduction from gross sales for most pharmaceutical and healthcare products companies, failing to take them into account can be costly. To account for chargebacks and other potentially significant reductions to gross sales, calculate the distribution services fee on net monthly purchases.

Indemnification

Unsurprisingly, the form agreement required a party to indemnify the other for certain losses (e.g., losses caused by the manufacturer's violating the Federal Food, Drug and Cosmetic Act). However, the indemnifying party wasn't always permitted to assume the defense of, and control litigation relating to, indemnifiable losses. Without that right, the indemnified party may incur exorbitantly high legal fees and has no reason to control costs, knowing that it will be reimbursed in the end. Further, the indemnified party could sometimes settle indemnifiable claims without the indemnifying party's consent. This unqualified settlement right encourages the indemnified party to settle a claim at any cost and on any terms because it will not be footing the bill. Consider revising provisions like these to align the parties' interests as best as possible.

Damages

Assuming the indemnification obligations described above come into play, what should each party be able to recover? The agreement did not prohibit a party from recovering punitive damages and consequential damages, such as lost profits from the other party, nor did it cap damages. Parties commonly exclude punitive and consequential damages from indemnifiable losses in a direct claim (e.g., a claim by a party for breach of contract). These exclusions reduce contingent liability and uncertainty in the parties' agreement—helping avoid costly surprises. For example, excluding consequential damages may preclude one party's claim that the other party is liable for profits that would have been earned absent that party's breach. Damages caps (i.e., a limit on the amount recoverable for certain claims), though less common in this context, may also be negotiated. Carefully consider adding exclusions and limitations on damages.

Bottom Line

Entering into a form pharmaceutical distribution services agreement can cause unexpected headaches—the expensive kind. So carefully review the entire agreement, assessing the risks in what's present and, more subtly, what's not.

Although we encountered these issues while reviewing a pharmaceutical distribution services agreement, they show up in commercial agreements used in the medical device, food and cosmetics industries, as well as many others.

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