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# KNOWLEDGE NUGGETS

DIRECT PAYMENTS WITHIN THE SUPPLY CHAIN –  
FINANCIAL SUPPORT OF SUPPLIERS IN CRISIS

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## I. WHY THIS TOPIC IS IMPORTANT

In modern supply chains, companies depend on reliable suppliers. When a company's direct supplier (contractor) starts facing financial difficulties, problems can escalate quickly. If the contractor can no longer pay its own upstream supplier, that upstream supplier may halt deliveries – triggering production shutdowns that cascade through the entire supply chain. This, in turn, may lead to (actually financially sound) downstream companies facing substantial liability exposure vis-à-vis their own customers.

A natural response is for the affected company to step in and make the necessary payments directly to the contractor's upstream supplier, thus preserving its own ability to perform. But caution: If the contractor in crisis nevertheless enters insolvency proceedings later, such direct payments are regularly threatened by insolvency avoidance (*Insolvenzanfechtung*). The insolvency administrator may seek to recover the payments made to the upstream supplier – with interest and, in a worst-case scenario, for transactions dating back up to ten years. This often causes the upstream supplier, as the recipient of the direct payment, to ultimately face financial difficulties, as well.

The good news: With proper structuring, direct payments can be designed to withstand avoidance actions. This allows the parties to maintain their contractual relationships and potentially prevent the contractor's insolvency altogether.

## II. POSSIBLE APPROACH IN PRACTICE

Typically, supply chain relationships are bilateral: one contract exists between the customer and its contractor, and another between the contractor and its upstream supplier. To structure direct payments that withstand avoidance actions, all three parties – the customer, the contractor in financial distress, and such contractor's upstream supplier – must enter into a tripartite agreement. The following requirements must be satisfied:

1. The tripartite agreement must be executed before any performance is rendered between the contractor and its upstream supplier with respect to a specific delivery. The contractor's payment claim against the customer must also not yet be due and payable. In short: the

agreement must govern prospective transactions, not performances already (partially) made.

2. The direct payment to the upstream supplier must constitute a cash transaction (*Bargeschäft*). This means that the customer's payment to the upstream supplier must result in equivalent value accruing to the contractor's estate. The upstream supplier must render the ordered goods or services to the contractor promptly – typically within one to two weeks of receiving the direct payment.
3. The goods or services received should enable the contractor to continue performing its own obligations and to generate revenue for the benefit of all creditors. This demonstrates the economic justification for the arrangement.

## III. RECOMMENDATIONS

- **Act early:** Execute the tripartite agreements before any performance is rendered by the affected contractor in respect of a given delivery and before payment obligations become due and payable.
- **Include all parties:** Ensure that the tripartite agreement is signed by all parties involved – your company, the contractor in financial distress, and the upstream supplier.
- **Ensure a cash transaction:** The contractor must receive equivalent consideration from the upstream supplier (e.g., components, materials, or goods) in close temporal proximity to the customer's direct payment to the upstream supplier.
- **Document thoroughly:** Carefully document the close temporal connection between direct payment and delivery of consideration to be able to prove the cash transaction nature in the event of litigation.
- **Prospective transactions only:** Do not use this structure to discharge the contractor's existing liabilities vis-à-vis the upstream supplier – the prerequisites for a cash transaction will in all likelihood not be satisfied in such scenario.
- **Seek legal advice:** Have the tripartite agreement drafted or reviewed by counsel specialized in restructuring and insolvency law, as the courts have established strict and narrowly defined criteria for transactions to be able to withstand insolvency avoidance actions.

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