Legal aspects of the co-packing relationship

Resource Guide for Co-packing

Alberta

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Introduction

The food value chain is complex

Whether you are a brand owner, a farmer or producer, a processor, a distributor, or a retailer, participating within the chain is universally challenging. The co-packing relationship is one link in the food value chain that continuously arises as a source of frustration for brand owners and co-packers alike. It is temporal, it is stressful, it is difficult to predict, and it is rarely set out on paper.

Co-packing relationships are all different, but they are generally made up of the same common elements: the names of the parties; a description of the product to be manufactured; a way to make an order and determine the quantity and quality of the goods; and a formula for price. As well as a series of rules to help both parties deal with the risks and the terms and termination; forecasting, regulatory assurances, exclusivity and confidentiality, intellectual property protections, and so forth.

On the surface, the co-packing relationship seems simple: divide the labour required to manufacture a product according to knowledge and resources and, just like that, you've got a functioning business. In reality, co-packing relationships can be fraught with legal complexities and uncertainties.

In this document, we discuss core legal aspects of the co-packing relationship that have resulted in problems for both stakeholders. It is recommended that co-packers and their clients will develop relationships based on written agreements that promote stability and clarity. With clear agreements, Canada's brand owners can develop and scale their products faster and more efficiently. Likewise, co-packers can identify partners that are compatible with their expertise and with whom they can collaborate to maximize output.

The co-packing relationship has evolved greatly over the past several decades. During much of the 20th century, a simplified approach to setting out co-packing terms was

Ten legal issues in co-packing

1. Know what you do well
2. Have an agreement
3. Be clear about intellectual property
4. Be proactive about your finances
5. Regulatory compliance isn't what it used to be
6. Traceability matters
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8. Certifications / 3rd party auditors are the future
9. Tech and data are increasingly valuable
10. Build a network of professionals you trust

Co-packers and brand owners share in a remarkably complex relationship both legally and practically.

adopted: stakeholders agreed upon the product's technical specifications, along with volume and value, and the rest naturally sorted itself out in the course of business.

Today, some larger, more sophisticated entities will generally insist on clear terms before entering into business with a co-packer. But for most stakeholders, particularly small and mid-size brand owners and co-packers, the relationship looks something like this: the brand owner submits a purchase order containing its own terms, and the co-packer later renders an invoice with its own terms for payment that are completely different from the brand owner's. In such circumstances, both parties must then decipher the agreed-upon terms.

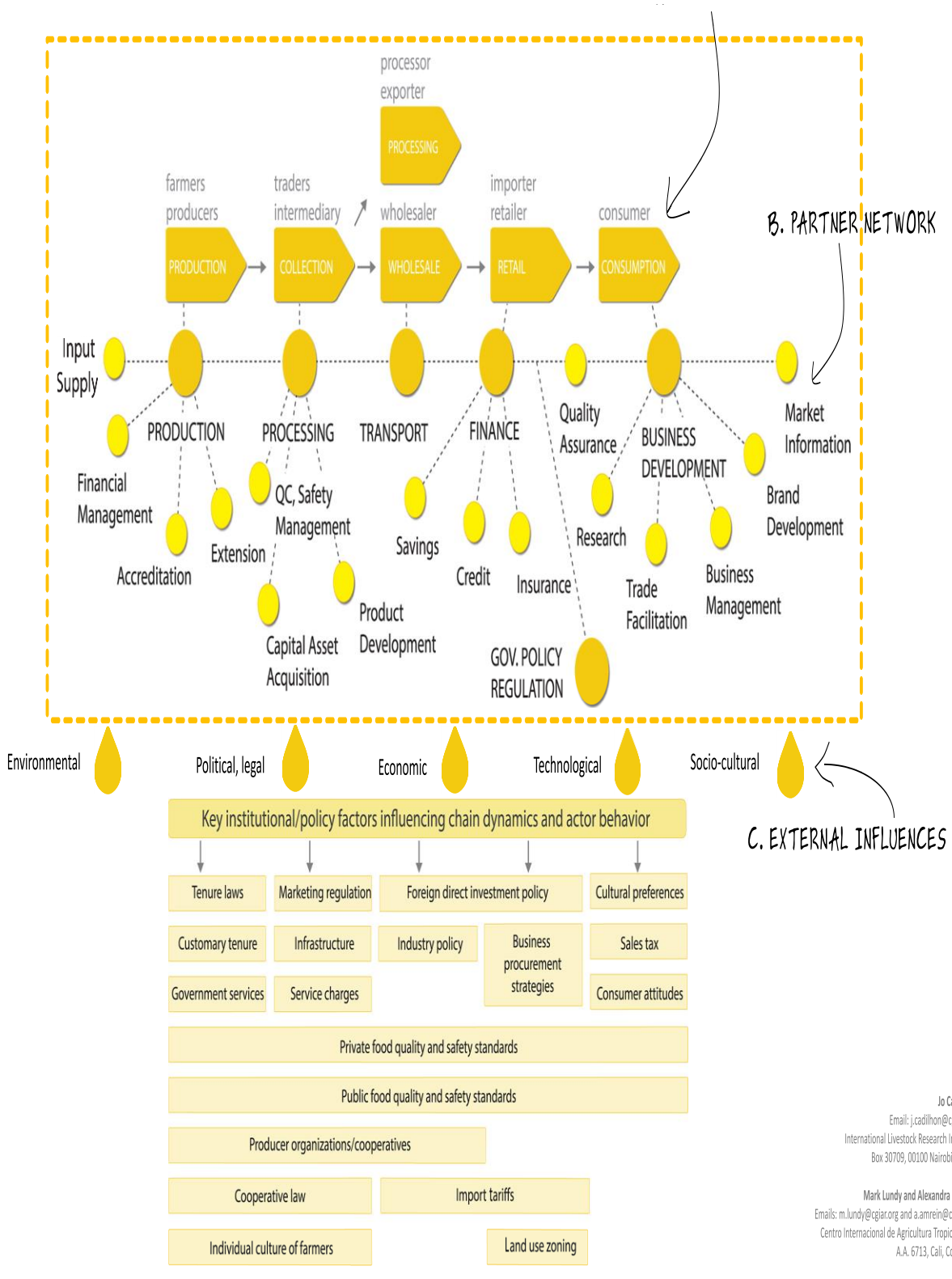
With issues ranging from food safety to brand goodwill, co-packers and brand owners share in a remarkably complex relationship, both legally and practically. Yet, parties entering into an informal co-packing agreement often never discuss even the most basic terms in a manufacturing relationship. Without a solid grasp on the legal issues involved in co-packing, many aspects of the relationship may remain uncertain, and often only get resolved after something has gone wrong.

At that point, parties must consider questions such as:

- Is the right insurance in place to protect us?
- Who owns the intellectual property that we create?
- Can a purchaser reject our products?
- What can a co-packer do if you do not pay?
- Does everyone have the right licenses in place to ensure regulatory compliance?

This guide intends to address these common legal issues (and others) that may arise in the co-packing relationship, and which merit discussion before scheduling a product run.

Model of an agricultural and food value chain



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Know what you do well

Know what you do well and what you need

For many co-packers, the dream is to earn while you learn how to make new products. For brand owners, the goal is to be endlessly flexible. The reality is starkly different: co-packing, in all its forms, is a challenging experience to those who are not ready to get to work on day one with the knowledge and equipment to do the job well. In order to avoid frustrating and costly learning experiences, it is important for co-packers and brand owners to perform a candid audit of their skills as well as their goals before setting up a product run.

In order to reap the maximum benefits of a co-packing relationship, each stakeholder should assess their capabilities and needs before entering into an agreement. Co-packers in particular should take an inventory of their assets and skills to determine what they have and what their organization is missing:

Assess your capabilities and needs before entering into a co-packing agreement.

- What products are you familiar with?
- Are you familiar with building out manufacturing processes?
- Do you have a strong group of personnel who can learn and improve?
- Do you have the patience to teach a business that is new to food production, or to deal with larger, less forgiving and less flexible clients?

These are critical questions to ask to determine a co-packer's appetite and ability to contract manufacture. From there, a co-packer can determine which potential clients are most compatible. Likewise, brand owners should consider where their strengths lay, with specific regard to experience in the food value chain. Then, a brand owner can define what role they have, if any, in the production process, or take steps to verify that a co-packer has experience making relevant products by performing basic commercial due diligence, like requesting references.

Relationship terms

Understand your relationship and be clear: what are you providing or paying for?

The co-packing relationship should be simple, but it is not.

Co-packing is a broadly used umbrella term that, in reality, encompasses a variety of relationships, each with their own considerations. These relationships can range from a brand owner renting space in a licensed and fit-for-purpose facility, to a co-packer developing and privately labelling a product, to a co-packer and a brand owner creating a jointly owned venture. Put simply: there is a spectrum of relationships to consider.

For both the brand owner and co-packer, clearly outlining the respective roles and responsibilities of each party at the outset can reduce the amount of issues that may arise during the relationship. This involves asking both existential questions such as “Are we partners or is this purely transactional?” “Who owns the intellectual property we’re going to develop related to the product?” and “How do we accommodate changes to the relationship along the way?” all the way to granular, process-oriented questions like “Who is responsible for acquiring packaging?” and “Who packages the product?”

Critical aspects of the relationship

- Pricing
- Quality and quantity
- Exclusivity
- Advertising / publicity
- Confidentiality and competitive products
- Intellectual property
- Product warranties and liability
- Dispute resolution
- Termination

Problems often start when existential questions are left undiscussed and the parties begin their relationship amorphously, with everything on the table, and only later look to define the relationship as a partnership, equity ownership, or joint venture, alongside traditional co-packing models. Frequently, this relationship starts with a trial run of a product to see how parties work together, slowly morphing into a more significant commercial relationship.

In situations where a product experiences either massive success or massive failure, the absence of a well-defined relationship can lead to severely mismatched expectations about the sharing of success or costs of failure. Smaller or less experienced brand owners and co-packers may not feel confident enough to establish relationship boundaries with the other party, or to establish its risk tolerance in the context of the relationship. Without being clear about boundaries and

defining both existential and more granular terms early in the process, parties can form competing and unreconcilable expectations that can be hard to correct or leave.

Frequently, without clarity between the brand owner and the co-packer, even the most benign actions by either party can be damaging and interpreted as done in bad faith. For example, price fluctuations, poor yields, or a co-packer producing similar products, absense of an agreement are often entirely reasonable actions that are received by brand owners with deep suspicion. Likewise, co-packers can have product refused for not being within specification, without having a clear idea of what product specification or tolerances existed beyond good manufacturing processes. With an agreement, both parties get the benefit of process: price changes come with transparency, exclusivity is defined, and tolerances are established.

> Clearly outline the respective roles and responsibilities. Know exactly what you are providing or paying for.

Regulatory framework

Understand the regulatory framework and what it means to be compliant

For both brand owners and co-packers, understanding how the regulatory framework interacts with the co-packing relationship is key to optimizing the benefits of their relationship. The most important thing to know is that there are two tiers of regulation of food businesses in Canada:

(1) For businesses that operate within a local area or province, the regulatory framework is set by provincial public health standards and/or provincial agricultural product standards. These frameworks are intended to keep regulation appropriate for a smaller geographical market and to allow for streamlined service of food products to the community. Some parts of the federal *Food and Drugs Act* and *Safe Food for Canadians Act* relating to public health and safety are applicable to these businesses, but the primary source of regulation is the province.

(2) For businesses that sell products across Canada, there are two predominant sources of federal regulation: the Food and Drugs Act and the Safe Food for Canadians Act, as well as the corresponding regulations for both. The Safe Food for Canadians Act came into force in 2019 and is a blend of food standards, labelling, food safety, and trade legislation. It requires most food businesses that operate or sell products federally to file a preventative control plan with the Canadian Food Inspection Agency (CFIA), implement preventative controls, apply for

and maintain a Safe Food for Canadians Licence, and retain significant documentation relating to the traceability of inputs and sales. In short, it is a big deal.

This two-tiered system has worked reasonably well: The federal rules are significantly more onerous than those that apply within provinces, allowing a business to mature into the national marketplace. However, it is less common to find businesses that utilize a co-packing relationship operate solely at a local level. Food businesses today immediately seek to harness the scalability of pan-Canadian e-commerce wholesale and retail platforms are often the first step when marketing a product, meaning that start-up brand owners are required to be federally compliant from day one. Unfortunately, many brand owners are not aware of their regulatory obligations. To make matters more difficult, the *Safe Food for Canadians Act* is a complex body of legislation that is still relatively new as of the time of writing. Because compliance with the Act is based on

Multi-level regulatory governance of food (in B.C.)
Source: A. Brynne, 2017.

actions of both parties, it is critically important that co-packers and brand owners discuss the product market, licensing, traceability, and preventative controls.

In order to determine which regime is applicable to a food business, the first question is whether the business's food commodity crosses provincial or national borders. If it does, then both the *Food and Drugs Act* and *Safe Food for Canadians Act* applies to the entire chain, and the next question is "does the business need a licence?" A key element of the *Safe Food for Canadians Act*, beyond regulating food packaging, labelling, trade, and so on, is the requirement for many food businesses to have licences that allow the business to perform specified activities. If brand owners are not manufacturing, processing, treating, preserving, grading, packaging, or labelling food, then they do not require a licence.

However, that does not exempt brand owners from regulatory obligations altogether: they still need to ensure that any food or food commodity is compliant with the *Safe Food for Canadians Act*, the *Food and Drugs Act*, and regulations flowing from these statutes. So, in an instance where a brand owner sends or conveys food across a border, an activity that doesn't require a licence, it still needs to maintain and retain traceability documentation in a manner satisfactory to the CFIA for two years. Traceability documentation includes key information about the brand owner's suppliers, as well as sales information for any non-retail sales: lot codes, purchase orders, names, addresses and so forth.

A brand owner that intends to convey food across borders also needs to ensure that its co-packer has an appropriate licence for the food activity it carries out, and that the co-packer has filed an appropriate preventative control plan with the CFIA and has implemented these controls. This means that the co-packer and brand owner need to be transparent about how they are going to manage their regulatory obligations together; both parties need to agree on the product market, supply chain, ingredient sourcing, and controls necessary for a food product. More importantly, both parties need assurances that the other party is following their regulatory obligations. For this reason, most co-packing agreements provide for access to records and premises in order for the other party to verify ingredient authenticity or hazard controls. Frequently verification is delegated to a third party auditor to certify a co-packer or brand owner or ensure that production and distribution of the product complies with the agreement.

Regulatory breaches and their enforcement can create immense liability for brand owners or co-packers. Depending on the danger posed to Canadians (as well as other considerations), possible enforcement actions may include recall, product destruction, licence suspension, administrative monetary penalties, and/or fines. Often, co-packing agreements cover indemnification of the other party in the case of damages flowing

> Solid co-packing agreements cover indemnification of the other party in the case of damages flowing from a regulatory breach, an obligation to make the other party whole if they experience any harm.

from a regulatory breach, an obligation to make the other party whole if they experience any harm. If a co-packer's plant loses its licence due to a brand owner's negligent action, the co-packer may bear catastrophic losses and litigation from other brand owners for which it co-packs. These damages ought to be covered by the brand owner. Likewise, if a co-packer's failure to implement good manufacturing processes (GMP) leads to a recall, the brand owner may face significant damage to their brand's goodwill; a co-packing agreement could also protect against this type of loss. It is important that these indemnification provisions are solidified in an agreement before either of the parties is exposed to the complicated process of regulatory enforcement and civil damages.

Be proactive about payment

Be proactive about your property and finances

Brand owners and co-packers should consider—and be proactive about—the financial implications of their relationship with each other. The co-packing relationship can be very hands-off: a simple exchange of money for a product. However, more often than not, it involves specialized equipment, access to a facility, warehousing of packaging, and/or storage of product. There is risk borne by both co-packers and brand owners in every instance that is not a cash-on-delivery, goods-for-money transaction. Being proactive about pricing, fees, reporting and non-payment allows both parties to minimize their financial risk when and if issues later arise.

Fees and Pricing

Production fees are major causes for dispute in co-packing relationships. Naturally, both parties want to be as profitable as possible, so a brand owner will want to seek the lowest price for the cost of its products, seeking to sell them at the highest price the market will bear, and the co-packer will want to maximize revenue. Inputs and labour make up the primary costs for a co-packer, but parties can agree to arrange pricing per unit, per run, or by any other measure. While the choice of fee setting is overwhelming, it is important to remember that inputs in the context of food processing are commodities and thus are subject to fluctuations depending on market forces. During a pandemic, labour cost a premium due to fluctuating overtime and personal protective equipment costs. Parties can choose to consider those fluctuations or can agree to buy ingredients in bulk at opportune times, which prevents either party from being stuck in an unprofitable arrangement.

Production fees are major causes for dispute in co-packing relationships. Determine fees that are satisfactory to both.

From time to time, co-packers also offer services as a distributor, in which case, the co-packer can have a hand in pricing the product. When this is the case, the parties should determine a method for pricing the product that is satisfactory to both: ensuring that the price is not cheapening the product or undercutting other distributors, while ensuring that the co-packer/distributor can still manage to sell the product to retailers.

Reporting

Having robust and transparent reporting practices are another critical aspect to ensuring fair pricing between the parties. Depending on the services offered by a co-packer and the relationship between the co-packer and the brand owner, a degree of transparency over ingredient costs, sales, and yields can be appropriate. For example, yields are immensely difficult to determine and are variable run-to-run, depending on a number of factors from the alertness and experience of staff all the way to ambient weather patterns. If input costs are passed on to the brand owner, data related to yields should likely be provided as well.

Nonpayment

Nonpayment is a frequent issue in co-packing, with troubled businesses (both brand owners and co-packers) occasionally falling behind on finances or becoming insolvent. It is important to think ahead and have a plan in case a party ceases to be able to meet its obligations.

Nonpayment is a frequent issue in co-packing. Have a plan in place in case obligations can't be met.

Co-packers are protected against non-payment by legislation. Across Canada, various Sale of Goods Acts generally give co-packers the ability to withhold goods and cease production when there has been a non-payment by a brand owner. This is an important tool that is frequently relied upon by co-packers across Canada.

Provincial legislation related to personal property security provides an important, if often overlooked, tool for co-packers against non-payment. In many other businesses, security interests are registered against personal property as soon as financial risk exceeds a basic dollar value. A line of credit from a bank or a car loan frequently result in registered security on the borrower's personal property, tagging the property with the name of the lender. But co-packers almost never secure accounts against brand owners, leaving them with limited recourse if they aren't paid.

Registering a security interest may provide the co-packer the ability to secure the brand owner's inventory maintained at different facilities that are not under control of the co-packer, to help ensure that the co-packer is paid what it is owed. It's a classic problem: co-packers occasionally allow accounts to go unpaid until they're owed a considerable sum, and then it can't collect against a brand owner that has fallen on hard times. Worse, inventory that is stored outside of the co-packer's control cannot be recovered unless it is through the courts or the parties come to an

agreement. Inventory that represents significant input costs are often not recoverable once out of the control of the co-packer, representing significant financial risk. Registering a security interest on the brand owner can provide certainty for a co-packer.

Conversely, brand owners frequently store their own machinery, as well as significant amounts of packaging and branded materials, at a co-packer's facility. If the co-packer defaults on its financing or its lease, a brand owner may be faced with the seizure of its own property and may need to convince a lender or a landlord that it retains the rights to its property. To protect itself against such an incident, brand owners should ensure that their equipment is registered, and that their ownership rights (i.e. title) to equipment are clearly set out in a document between the two parties.

Registering a security interest on the brand owner can provide certainty for a co-packer.

Similarly, co-packers often warehouse ingredients or packaging that can be exposed to risk through improper care by a co-packer or seizure by a lender or landlord, a relationship that it governed in most provinces under the respective provincial *Warehouse Receipts Act*. It is important to the brand owner to have an agreement in which it is made clear whether the relevant Warehouse Receipts Act governs the goods or not, and in which it is made clear that the brand owner retains title to the goods. If a brand owner needs to find a new co-packer in a hurry, they will have an immediate need to have packaging on hand to package their products. These approaches should ensure more risk-managed approach to the co-packing relationship.

Confidentiality and exclusivity

Be clear about intellectual property and exclusivity

Intellectual property

Intellectual property, or "IP", presents a challenging problem in the co-packing relationship and in the food business generally. IP is a concern that is top-of-mind for most brand owners when entering into a new co-packing relationship and for good reason: their IP often has significant value, which needs to be guarded in order to facilitate future growth, investment in, or sale of the company. In the co-packing relationship, a common perception held by brand-owners is that extraordinary value placed on product IP is placed in jeopardy when shared with co-packers who are seeking to white-label their products. This is rarely the case, but it serves to highlight how fundamental IP protections are to the co-packing relationship. IP issues can also arise when the brand owner and co-packer jointly engage in the product development process; this may raise

questions such as: how is IP affected if the co-packer makes improvements in product formulation? What if the co-packer develops a new line of flavours, in addition to the brand owner's existing products? How do we manage IP concerns for both parties?

IP is best protected through a well-defined exclusivity provision that is beneficial to both parties and confidential business information.

Counter-intuitively, the best way to protect IP in a co-packing relationship is not through Canada's IP laws. Unfortunately, Canada's intellectual property statutes don't provide much protection for the manufacture of food products: trademarks relate to marketing, not manufacturing, copyrights aren't easily applied to recipes, and patents aren't often used to protect food processes. There is nothing preventing a competitor from taking a product to a lab and attempting to reverse-engineer a recipe. So, in the co-packing context, IP is best protected through a well-defined exclusivity provision that is beneficial for both parties, and by the concept of confidential business information.

Without effective IP protection from Canadian IP statutes, most brand owners and co-packers turn towards a Canadian common law concept known as confidential business information to protect their product. Characterizing information related to the product's manufacture as confidential business information creates a duty of confidence that must not be breached by those who hold the information.

In order to manage confidential business information, it is important to first determine if any information being shared is actually confidential. Generally, in order to be considered confidential business information, the information must not be accessible by outsiders, it must have intrinsic value, it must be novel or unique, and it must be treated as secret. For example, a brand owner may not be able to claim protection under the confidential business information for knowledge relating to the temperature that butter melts or that bread contains flour –in the first example, the information has no intrinsic value; in the second example, the information isn't novel or unique. Conversely, if the information relates to a nuanced combination of process and ingredient sourcing, unavailable anywhere else, and if the co-packer is instructed to restrict access to that information and process documents, then it is likely that there would be protection for a brand owner through the confidential business information concept.

Once the boundary of confidentiality is clearly established, the receiving party is under a duty of confidentiality, which can be managed through contract (e.g. a non-disclosure agreement) or by managing the actions of the parties involved (e.g. limiting access to process documents). A non-disclosure agreement can be helpful in defining the scope of confidentiality, for example, what specifically is considered confidential and the relief a party can seek that may flow from a breach of the agreement or of the duty of confidence generally. Damages are

Clearly establish the boundary of confidentiality.

notoriously hard to establish with any kind of certainty in this context, so a non-disclosure agreement is helpful if it sets out how damages are contemplated and, more importantly, whether the parties can seek injunctive relief, a court order preventing the breaching party from continuing to breach their duty or contractual right.

Exclusivity

Although confidentiality is an important aspect of managing intellectual property in the co-packing relationship, it still may not satisfactorily address a brand owner's concerns—this is where the concept of exclusivity can help. Non-disclosure agreements are common enough that even inexperienced brand owners know they can be tools to manage the risk of a renegade co-packer stealing their "family's generations-old recipe" or novel idea. Nevertheless, practically speaking, non-disclosure agreements may not be effective in breach because damages are so challenging to determine when there is a breach of the duty of confidentiality or contract. If someone shares a brand owner's secret, it is not like stealing a car that has a fixed value. Valuing the loss of confidence of some intellectual property is an involved process that takes time and money for parties (or a judge) to agree upon: often courts look at the amount of time it would take to reverse-engineer a process and then apportion sales amounts to that period of time. While non-disclosure agreements are helpful in many regards, often a brand owner should be seeking an exclusivity agreement to fill the gap left by confidentiality duties and agreements.

An exclusivity agreement can fill the gap left by confidentiality duties and agreements.

Exclusivity covenants allow the brand owner to protect their product by making the co-packer promise not to produce a competing product during the relationship and, often, for a period after the relationship ends. As compared to determining what is considered confidential, this approach gives the relationship clarity and certainty over the ability for a co-packer to transition from a trusted partner into a competitor by having it agree not to do something very clear for a specified period. The time after the termination of the co-packing relationship is important, as it is intended to give a brand owner time to find co-packers or manufacturing solution before the former co-packer can enter their market with the knowledge of how to efficiently make the brand owner's product. This is a delicate conversation: if an exclusivity covenant is too narrow, then it won't provide sufficient protection of the brand owner's IP; too broad and the covenant will restrict the co-packer from working with other brand owners or developing products that are in product segments that are unrelated to the original brand owner's. Whatever the parties decide, having a clear bright-line understanding over how intellectual property is managed is critical to a strong co-packing relationship.

A clear understanding of how intellectual property is managed is critical.

Reputational harm

A lot of this relationship is about reputational harm

The co-packing relationship can present significant risks to both the brand owner's and co-packer's reputation. Questions of liability usually relate to actual, tangible damages, which arise from issues such as when a brand owner does not receive the goods to which they are entitled, or when a co-packer doesn't receive payment per the terms of the agreement. These issues are often resolved through a straightforward mathematical calculation of damages. However, problems that involve intangible property are more difficult to value and resolve. This is particularly true in situations where there has been harm to a brand's reputation or goodwill.

Brand goodwill includes the value of the brand name, its relationships with customers and employees, its image, and its perceived quality or qualities. For many brand owners, the primary value of their business is derived from their brand goodwill—and yet, putting a number on this value can be very challenging. It is also short-lived—goodwill is shockingly delicate.

In the co-packing context, brand value is everything for brand owners who don't produce or package their own food, or who don't have many employees or physical assets. This means that any damage to goodwill will have a significant impact on the viability of a brand owner's business.

In the context of goodwill, quality assurance is paramount: every non-conforming, stale, or mispackaged product creates a significant devaluation risk for a brand, particularly when a premium is attached to it. The most obvious example of potential damage is if a co-packer that fails to meet the specifications required by the brand owner produces food. Every co-packing relationship involves a product and specifications are provided, and co-packers are expected to observe good manufacturing practices. However, no two batches are perfectly alike, so agreeing on the degree of acceptable tolerance levels is an important way to protect brand goodwill. Developing well-defined and operable product specifications in a co-packing agreement avoids non-compliance and potential damage to goodwill by setting out when a product is within or outside specifications. To maintain objectivity, product specifications can be augmented by adopting clear rules on how a product is sampled, reviewed, and rejected.

> Brand goodwill (value) is shockingly delicate.

The risk of goodwill damage depends on the brand owner's degree of reliance on the services of the co-packer. Many co-packers offer a "soup-to-nuts" experience: it can provide a brand owner with product development, labelling and claims guidance, branding consultancy, packaging, and

distribution channels. These more intertwined co-packing relationships expose brand owners to significant goodwill risk in three categories: packaging and storage (assuming a co-packer is involved in the packaging or inventory storage), quality assurance, and management of unsold products.

Developing well-defined and operable product specifications in a co-packing agreement avoids non-compliance and potential damage to goodwill by setting out when a product is within or outside specifications.

Packaging is frequently delegated to co-packers because co-packers often have better knowledge relating to packaging limitations, procurement and regulatory requirements, as well as an understanding of what will work best at their existing facility. This reliance on a co-packer exposes brand owners to some risk relating to cost and safety: a critical component of the product is delegated to the co-packer, using its discretion and judgement. Without direction or emphasis on the importance of packaging to the brand, a co-packer could make a benign but damaging packaging substitution or change without sufficient consultation with the brand owner: an eco-conscious brand has packaging switched to unsustainable boxes, for example. Small changes can significantly alter consumers' perceptions of the product and thus the perceived value – i.e. the goodwill – of the product and the brand owner. A clear, yet efficient, decision-making process about packaging can help align the parties to avoid actions that damage brand goodwill. It can be as simple as "no packaging substitutions without prior written consent" or a certain body certifies a standard of packaging that, for example.

Unsold products also pose a confounding problem for brand goodwill. Even the largest global food brands find their products in unintended places. Referred to as parallel imports, unsold products can be diverted to unintended markets through grey channels. Parallel imports are a significant issue for more international brands that create regulatory and civil liability, alongside damage to goodwill, through the placement of products in unintended markets. For smaller brands that piggyback on a co-packer's distribution network, brand devaluation may occur where these channels are used to divert unsold products to discount retailers or expired products to the marketplace. A logical and seemingly benign act by a co-packer, distributing inventory, could result in unintentional reputational harm. Having an understanding over how unsold inventory is managed can prompt the discussion between brand owner and co-packer, avoiding unintentional damage.

Terms and termination

Sometimes business relationships don’t work

Terms

Sometimes business relationships do not work: a partner is not responsive, there is a lack of trust, or there just is not a fit. That is okay. A critical question then becomes “how do we end this relationship?” These are hard questions to answer, absent some guiding framework. Both brand owners and co-packers form reliance on each other throughout a relationship, so it is often unclear whether a party has to give notice when they are ready to stop working together. Canadian law requires brand owners and co-packers to treat each other in a commercially reasonable manner, but it is hard to determine what that means from case to case.

Contracts are immensely helpful in this regard. There are two tools that can be used to end a co-packing contract to manage these issues: (1) contractually fixed terms, and (2) voluntary termination or termination for breach.

Imposing fixed terms on the co-packing relationship is an important option for termination– used effectively; fixed terms can be an opportunity to assess parties’ compatibility at the time of agreement renewal. Because brands are capable of growing quickly, while co-packers are often constrained by space or capacity, the co-packing relationship may be naturally short-lived: the relationship only works so long as the type and quantity of goods required by the brand owner can be produced in a reasonably efficient manner by the co-packer. By implementing fixed terms, and thus, agreement renewals, the parties build in a natural time to review the relationship and evaluate whether it is sustainable for everyone. If, at the time of renewal, underlying issues exist, the parties have an opportunity to determine whether there is a better path moving forward; and if there is not, a good agreement will provide an exit path for each party, which protects their intellectual property, reputation, employees, and other elements discussed in this document. Terms also protect parties from unilateral breach without sufficient notice, thereby averting potential damages from relying on the continued participation of the other party to an agreement.

Besides fixed terms, the co-packing relationship may be brought to an end through voluntary termination or termination for breach. Voluntary termination can be used in situations where a brand owner or co-packer wants to pivot in a new direction, or where the relationship between the parties is sub-optimal but there has not been a breach of the agreement. On the other end of the spectrum, a relationship may be terminated where there has been a clear breach of the agreement. A frequent problem encountered by both parties to a co-packing relationship is what

to do when there has been a clear breach to their implied agreement, a tough question to answer. Having a developed agreement in place mitigates that uncertainty, determining what constitutes a breach and what a party should do in case of breach.

Termination

Termination in a co-packing agreement should involve a significant lead-time to wind-down production and exhaust ingredient and packaging inventory. A termination fee can be imposed if these wrap-up timelines are not observed. Likewise, the parties should come to an agreement on how to apportion the costs of remaining goods or services, or any advance payments that were not made good. Problems may arise when, upon relationship breakdown, intellectual property, packaging, equipment or personnel are misused or perceived to be misused by one of the parties. A good co-packing agreement should contemplate these issues in advance and mitigates their risk, protecting everyone from damages and further conflict.

When it is time to terminate a co-packing agreement, it is important to ensure that elements of a co-packing agreement extend beyond the life of that agreement. Obligations relating to confidentiality, covenants, and intellectual property typically extend beyond termination by some time. For example, a non-disclosure agreement may run for two-years after termination of the original co-packing agreement. A clear date of termination helps to establish when the clock starts to run on those obligations.

Well-defined termination rights disincentive bad faith termination and allow both parties to manage the risk of a break-down in a co-packing relationship. Getting into a co-packing relationship is straightforward, but often ending the relationship is more delicate. Term and termination provisions allow for a clean break, or for a company to refocus and reevaluate its needs.

Build a network

Build a team of trusted professionals and experts

At the heart of this guide are two key takeaways: (1) the co-packing relationship should be simple, but it is not and (2) you don't know what you don't know. For these reasons, it is of paramount importance to assemble a constellation of trusted professionals whose expertise can complement—and even augment—your own.

Parties may try to manage the co-packing relationship on their own through an agreement, but the fact is that many issues are outside the core competency of either or both of the parties. Co-

packers are specialists at product development and running an efficient line. Brand owners are experts at understanding a market and creating product demand. However, more often than not, neither party is an expert in the complex interplay in a co-packing relationship between regulatory obligations, civil liability, clarity over contractual rights and obligations, and the inherent risks of manufacturing food.

Building a network of professionals and experts, who understand the co-packing business, can help co-packers and brand owners tackle these overwhelming issues effectively, while also helping them to strengthen their relationship and evaluate new opportunities. With the help of accountants, bookkeepers, lawyers, or external consultants, parties can focus their attention on the things that they do best and leave the technical issues to the experts. Importantly, professionals can provide a business with confidence to evaluate its existing relationships, to grow, or to rethink entirely how it does its business.

Build a network of trusted professionals

- You need strong professionals who understand your industry
- Accountants and bookkeepers are critical, as waste and often contract breaches are not evident unless significant controls are in place
- There are food value chain specialists who can bring added value to their advice
- You can access grants, favourable regulatory regimes, other advantages but you need to know where to look

The food value chain has reached a point where even the simplest of activity carries with it significant complexity. Co-packing has historically been a simple relationship of money for goods, but, as the food value chain has evolved to include concepts of intellectual property, secured property, price forecasting, and third-party food safety auditors, it is a good idea to approach the co-packing relationship with caution. This guide is intended to prompt thought and help both co-packers and brand owners think through how they govern their relationship. The hope is that this will lead to more efficient and dynamic relationships that are stable, productive, and long lasting. Co-packing relationships are hard to manage: Brand owners and co-packers are both exposed to risks that can be managed if the parties have the knowledge to discuss how they wish to work together. This guide should help.