THE MAN-CAUGHT-IN-THE-MIDDLE

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As a result of recent shipper and broker bankruptcies and the fears of more to come, sophisticated logistics providers are reexamining their roles in the logistics process including their ultimate obligation for freight charge liability and indemnification issues. In this article, these issues will be examined in light of two distinctly different models or paradigms for non-asset based third party logisticians (3PLs).

The two conflicting legal models for the role of a 3PL are the traditional "broker arranger" model and the contractual "principal/provider" model. Under the former, the 3PL functions as a conduit for transportation arrangements which are ultimately made between shipper and carrier. Under the latter, the 3PL by contract assumes the duties and obligations of an asset based motor carrier. The legal distinctions in these two models have important consequences on the duties, obligations and liabilities of the "man-in-the-middle."

The Traditional Broker/Arranger Model

At common law and under federal statute and regulation, a property broker functions as an intermediary, not a principal, in the provision of motor carrier services. Generally, a broker is an agent employed to make bargains or contracts for compensation. A brokerage contract is a "contract of agency whereby a broker is employed to make contracts of a kind agreed upon in name and on behalf of his principal for which he is paid an agreed commission." [Citations omitted.] Black's Law Dictionary (1968) at p. 242.

Brokers are skilled professionals who act as an agent for party who first retains it. They are liable for exercising due diligence and reasonable care in locating willing buyers or sellers of goods and services who then enter a direct contractual relationship with intermediary's customer. The real estate agent or broker markets its customer's real property, locates a suitable buyer and earns a commission from the sale without accepting liability for the condition of the premises or warranting its suitability for the buyer's needs. Similarly, an insurance agent or broker, when retained by the insured, surveys the market, presents proposals on behalf of licensed and qualified insurers and earns a commission from the resulting premium. In the absence of some error, omission, or misrepresentation, the insurance agent or broker accepts no liability for the contents of the contract of insurance or for the settlement of any claim by the insured. This "broker/arranger" analysis extends to stock brokers, travel agents and others who, although clearly "independent contractors" in a separate trade or business from their customer, ultimately facilitate commercial transactions between buyers and sellers of goods and services without accepting product liability or performance obligations for the contracting parties. The professional intermediary owes both parties a duty of expertise, due diligence, and good faith.

Importantly, the "broker/arranger" paradigm is followed in the federal statutes and regulations which defines property brokers as non-asset based arrangers of truck transportation. It is clear that while the regulators understood that property brokers would be independent businesses, they drew a distinction between property brokers as "arrangers of transportation" and motor carriers who are "providers of transportation" and hence, subject to much greater regulatory scrutiny. See 49 U.S.C. §13102(2), (12). The broker regulations provide:

> "A broker means a person who for compensation, arranges or offers to arrange for transportation of property by an authorized motor carrier. Motor carriers or persons who are employees or bona fide agents of motor carriers are not brokers within the meaning of this section when they arrange or offer to arrange for shipments which they are authorized to transport and which they have accepted and have legally bound themselves to transport." See 49 C.F.R §370.1.

Like the common law definition of brokerage, the regulations state that: "Brokerage service is the arranging for the transportation of the physical movement by a motor carrier of property. It can be performed on behalf of a motor carrier, a consignor, or a consignee." See 49 C.F.R. §371.3(c).

Emanating from the agent/arranger model is the concept that the property broker, like the insurance agent, owed a duty of expertise, good faith and fair dealing to both the shipper and carrier.

The property broker is required to separate its accounts so that the revenue and expenses relating to a brokerage portion of its operations are segregated from other activities. See 49 C.F.R. §371.13.

The regulations do not limit the additional duties and obligations that a third party logistician may assume by contract. Yet they clearly suggest that the property broker, like other common law brokers, has a fiduciary obligation to transmit payment from the shipper to the carrier and to maintain a system of accounts which will show inter alia the amount of the freight charges collected by the broker and the date of the transmission to the carrier. See 49 C.F.R. §371.3.

In the freight charge collection area, these regulations and the duty of good faith are at the heart of this so-called "conduit theory" which holds that the 3PL should receive freight charges in trust to the extent same is due and owing to the underlying motor carrier service provider. *Parker Motor Freight, Inc. v. Fifth Third Bank*, 116 F.3d 1137 (6th Cir. 1997).

Under the agent/arranger model, the 3PL's duties are to diligently retain qualified motor carriers and to transmit the shipper instructions, bills of lading, invoices, and payments. The intermediary has errors and omissions exposure including constructive trust obligations, but not freight claims, or freight charge payment obligation in the absence of a contractual undertaking beyond the scope of the bill of lading.

The 3PL as Principal/Provider

Because of marketplace factors and the blurring of regulatory distinctions between brokers, freight forwarders and carriers, the broker/arranger role for 3PLs is frequently altered by logistics contracts that make the 3PL responsible as a principal for providing subcontracted motor carrier services. Under this model, the 3PL accepts primary liability for payment of freight charges, for payment of cargo claims, and for indemnifying the shipper against any loss arising out of the transportation services provided by the contract. 3PLs frequently waive conflicting application of federal transportation rules and regulations under §14101(b) and freely accept broader duties and obligations for transportation services than are required by statute or envisioned as part of the ordinary obligation of professional brokers under the broker/arranger paradigm. (Other than freight forwarders who must offer assembly and distribution services, there is no applicable category for non-asset based principal/providers.)

As a sales tool, the temptation is great for the man-in-the-middle to guarantee the performance of the driver, the condition of the freight upon arrival, and the payment of freight charges to the carrier. The assumption of these duties under the principal/provider model imposes legal risks and obligations beyond the role of the typical professional intermediary.

Freight Charge Liability

Under the traditional "broker/arranger" model, the 3PL is expected to transmit the payment of freight charges from the shipper to the carrier, deducting its commission or margin from the proceeds, but otherwise ensuring that its fiduciary obligation to both parties is fulfilled.

The failure of intermediaries -- whether because of misfeasance or malfeasance -- to transmit the shipper's payment to the underlying motor carrier is the largest credit and collection problem facing motor carriers.

(Consistently year in and year out, two-thirds to three-fourths of the collection cases referred to our firm involve intermediary nonpayments.)

Under the agent/arranger model, the consignor or shipper is ultimately liable in most circuits for the payment of freight charges to the carrier. See *National Shipping Co. of Saudi Arabia v. Omni Lines*, 106 F.3d 1544 (11th Cir. 1997); *Strachan Shipping Co. v. Dresser Industries, Inc.*, 701 F.2d 483 (5th Cir. 1983); *Hawkspere Shipping Company, Ltd. v. Intamex, S.A.*, 330 F.3d 225 (4th Cir. 2003) (results comports with economic reality); *Contship Container Lines, Inc. v. Howard Industries, Inc.*, 309 F.3d 910 (6th Cir. 2002); *Ranger Transportation v. Walmart Stores*, 903 F.2d 1185 (8th Cir. 1990); *Olson Distributing Systems, Inc. v. Glasurit America, Inc.*, 850 F.2d 295 (6th Cir. 1988); and *Inman Freight Sys. v. Olin Corp.*, 807 F. 2d 117, 121 (8th Cir. 1986).

With few exceptions, in the real world the transportation intermediary, regardless of the mode of transportation, functions as the outside traffic department for the shipper with the obligation to retain qualified service providers to handle particular shipments or series of shipments.

In an effort to eschew responsibility for double payment, rather than insist upon increased fiduciary responsibility for transmitting payment, the shipper and broker community has adopted the principal/provider model, insisting by contract that the motor carrier agree to look only to the 3PL as the sole party responsible for paying freight charges, independent of shipper funding. As a practical matter, most 3PLs have embraced the principal/provider model without setting up an escrow or clearing account for the transmission of shipper payments. They view gross receivables (including the carrier portion) as their own accounts receivable, which can be commingled with other assets, without segregation, which can be used as collateral for loans for other endeavors.

Under this model, the carrier's collection rights become merely a general unsecured obligation of the 3PL. Lost is the constructive trust concept of the 3PL's fiduciary obligation. The 3PL who now recognizes and embraces the obligation to pay the carrier, regardless of payment from its customer, now must manage its cash flow on a first-in, first-out basis and has no defense to carrier demands when its customer becomes insolvent.

Motor carriers have long recognized the flaw in agreeing to contractual provisions which make the 3PL the carrier's agent for purposes of collecting freight charges or which require the carrier to surrender recourse to the consignor. Carriers have been accused, unjustly I believe, of trying to taking advantage of the shipper by demanding payment when both shipper and carrier belatedly discover that the intermediary has not discharged the shipper's payment obligations by transmitting the funds entrusted to it.

From the carrier's point of view, the double payment problem would be ameliorated if all parties would simply acknowledge the constructive trust and conduit obligations of the 3PL as a "broker/arranger" and require the payment of freight charges to move through a clearinghouse account from which the 3PL paid the carrier upon receipt, to the extent the 3PL had not become the carrier's assignor by advancing freight charges from the 3PL's retained earnings.

Increasingly, sophisticated 3PLs and their lenders, are coming around to the broker/arranger view with respect to the transmission of freight charges. Recent shipper bankruptcies and the precarious financial condition of many pension heavy shippers makes clear that a sole source logistician can ill afford to accept the principal/provider model and guarantee 100% of the motor carrier payable upon shipper default. As a result, conduit language is re-emerging in sophisticated broker-carrier contracts with 3PLs clearly eschewing payment guarantees.

The tale of two small broker clients demonstrates why the 3PL is better served by the conduit or constructive trust approach inherent in the traditional paradigm. In one case under the principal/provider

model, a California broker, as a matter of course, accepted the role of principal and agreed to pay all carriers in 30 days. When its major shipper declared bankruptcy, the owner was forced to mortgage his house to fulfill his obligations. In another instance, a broker operating under the agent/arranger model lost only its unpaid commission upon a similar shipper default because its payment obligations were limited to the transmission of freight payment upon its receipt and the bankrupt shipper was the sole obligor.

Moreover, any cash management value inherent in prior application of the principal/provider model has diminished as sophisticated lenders have come to recognize that any advance against a 3PL gross receivable is compromised to the extent the collateral represents unpaid freight charges due and owing to motor carriers and other service providers. Most factors who purchase freight charge receivables will not knowingly purchase broker invoices where the supporting bills of lading show an unpaid motor carrier as the contracting party in privity with the account debtor.

Cargo Liability

Under the traditional broker/arranger model, the intermediary is not liable for cargo loss or damage claims. The Carmack Amendment, 49 U.S.C. §14706 makes the carrier in possession and control of the shipment liable for claims and preempts other state law remedies. Cases holding that as a matter of federal transportation law, broker/arrangers have no cargo liability include *Chubb Group of Insurance Companies v. H.A. Transportation Systems, Inc.*, 243 F. Supp. 2d 1064 (C.D.Cal. 2002); *CGU International Insurance, PLC v. Keystone Lines Corp.*, 2004 U.S. Dist. Lexis 8123; *Golden Triad Carriers v. Paco American Corp.*, 1990 Fed. Carr. Cases, 83,515; *New Prime, Inc. v. Professional Logistics Mgmt. Co.*, 28 S.W.3d 898 (Mo. Ct. App. 2000); *Prof'l Communs., Inc. v. Contract Freighters, Inc.*, 171 F. Supp. 2d 546 (D. Md. 2001).

Clearly, the interest of the intermediary is best served by not waiving general principles of federal transportation law and too quickly accepting primary liability for cargo loss or damage. Under the broker/arranger model, it is understandable that a shipper should expect a broker not to entrust its shipment to a carrier who lacks the requisite cargo insurance. For this reason a broker may be contractually obligated to warrant the carriers it retains can pay their valid claims. (Contingent cargo insurance is intended to meet this obligation.)

Yet, frustrated by the difficulty in obtaining prompt and adequate cargo claims adjustment from insurers who sell exclusion ridden policies, shippers have increasingly turned to the principal/provider model and the right of unilateral setoff against the 3PL as an easy way to liquidate a cargo claim which they view as legitimate. As a result, the man in the middle, who had no primary freight payment obligation or claims liability under the traditional paradigm, has now been made liable for both. In the absence of arbitration, the 3PL can be left with an unadjusted or disputed setoff and no means of recoupment, with devastating cash flow effects.

Any 3PL who assumes ultimate cargo liability and allows offset under the principal/ provider model does so at its peril. Permitting an offset is inconsistent with the 3PL's duty under the broker/arranger model to receive and transmit payments in trust. The unilateral offset under the principal/provider model is without respect to the service provider responsible for the loss. Inevitably, a broker is arranging services for a shipper using multiple carriers and when a shipper offsets a claim caused by Carrier A against freight charges billed by the 3PL for Carrier B, C, and D, the concept of a conduit or a constructive trust for freight charges is destroyed.

The intermediary who has accepted payment obligation to its carrier, without respect to receipt of payment from the shipper, can easily find itself unable to meet its current obligations when its cash flow is interrupted by a large unilateral offset. Under the principal/provider model, the 3PL who has promised

payment to multiple carriers with clear delivery receipts has no defense because an unrelated offset for cargo claims interrupted its cash flow.

In this regard, the broker regulations make clear that when a broker acts on behalf of a person bound by law or regulation as to the transmittal of bills or payment, the broker must abide by the laws or regulations that apply to that person. 49 C.F.R. §371.10. Thus, the agent for the shipper is precluded from offsetting the freight obligation to unrelated motor carriers because of a claim caused by another.

<u>"Indemnity" and "Additional Insured" Provisions</u>

Contractual indemnity and additional insured provisions are not typical under the broker/arranger model. The insurance agent does not indemnify the insured against policy loopholes. The real estate agent is not liable for unknown zoning and code violations or other encumbrances and property itself. A stock broker may recommend a stock for purchase, but it does not insure the customer against risk of loss or warrant the stock's performance. Similarly, under the traditional broker/arranger model, unless trumped by a written bilateral agreement, the transportation arrangements merge into the bill of lading at time of pickup when privity is established between the shipper and the carrier.

Under traditional transportation law, carriers were considered to be regulated utilities and the Federal Government, through the ICC, determined which carriers were fit, willing and able to conduct operations. The FMCSA still determines which carriers are safe and authorized, and arguably the shipper and broker are not required to second guess it. The shipper or broker need only to determine from the FMCSA web site, that the hired carrier has insurance and authority, and take reasonable precaution to ensure that the hired carrier is the one into whose custody and control the shipment is tendered.

Correctly seen, the shipper or the third party logistician need accept no more vicarious liability for the acts or omissions of a small truckload carrier they use than any member of the shipping public who uses UPS or Federal Express.

Yet, because a few bad cases and fear of being named as a target defendant under the "deep pockets" strategy of plaintiff's bar, many shippers now insist upon indemnity by their 3PL against vicarious liability for the acts or omissions of the carriers they select. In accepting such carrier-like duties of indemnity and additional insurance, the 3PL is placed in the same position as a carrier who retains a subcontractor. That is a role that any risk manager would eschew. (Best practices for asset-based carriers is to broker excess freight through affiliated brokers for this very reason.) It is elemental that an arranger of transportation should not get its name on the bill of lading as a carrier, allow its authorized service provider to be cast as its "partner" for purposes of joint and several liability, or otherwise, by advertising or shipper contract, assume a duty which plaintiff's bar can then use to embroil the 3PL in litigation.

With respect to vicarious liability, the shipper retaining a qualified 3PL under either model can request a warranty that the 3PL will use only licensed and insured motor carriers as a defense against a negligent entrustment suit against it, but arguably confusing the role of the 3PL as a provider rather than an arranger only further embroils both parties in accident lawsuits in which both have only imputed negligence.

In this regard, shippers frequently misconceive 3PLs as asset-based carriers and require additional insured status on the 3PL's auto liability and commercial general liability policies. Such requests are expensive and unrewarding. The typical auto exclusion in a commercial general liability policy will deny coverage to either the broker or its shipper for vicarious liability resulting from a truck wreck. A non-asset based 3PL does not have a primary personal injury or property damage policy which would extend coverage to "hired trucks." Moreover, even primary auto liability policies typically exclude brokered loads. Contingent auto and excess auto coverage is virtually unavailable for 3PLs. When it is available, it is

expensive and the coverage is incomplete. Thus, assuming a "principal/provider" status with vicarious indemnity and insurance warranties is an unreasonable, if not uninsurable, risk be avoided.

Over 90% of the regulated motor carriers have no safety rating. If the government system worked, all of these un-rated carriers are presumed by the FMCSA to be safe. If their accident or out-of-service ratios were out of line, they would have been inspected and rated. After *Schramm v. Foster*, 2004 U.S. Dist. Lexis 16875 (D.Md. August 23, 2004), it behooves the 3PL to watch what duties it gratuitously assumes by contract beyond tendering the load to a licensed and authorized carrier.

<u>"Arising of out" Indemnity</u>

Emanating from the construction industry is the notion that a prime contractor or principal should indemnify and hold harmless the property owner from all liability or loss "arising out of" the construction contract including, but not limited to, any claim of a subcontractor's workman resulting from personal injury while on the premises.

Over time, shippers have increasingly come to view purchased transportation as a procurement issue and 3PLs like prime construction contractors. As a result, broadly worded "arising out of" indemnity and "additional insured" language frequently appears in shipper-broker contracts under the principal/provider model. This language can extend the 3PL liability beyond vicarious liability and negligent entrustment and can expose the 3PL (1) to liability caused by third parties who are not under contract with it; (2) to back door indemnity obligations for cargo claims; and (3) to obligations to indemnify the shipper against all loss caused by the transportation the 3PL arranges, including shipper's own negligence or contributory negligence.

By signing these types of provisions, the 3PL can be asked to indemnify the shipper when a truck driver is run over by the shipper's tow motor operator and sues. Similarly, if the shipper misloads a trailer and is sued for its acts of negligence in contributing to property damage, the 3PL can be required to offer indemnity even when the 3PL's fault is not an issue. In the absence of auto coverage and with other changes in the contractual indemnity language of general liability policies, both of these examples can result in uninsured losses.

Moreover, such broadly worded indemnification of the shipper cannot be easily laid off on the motor carrier for three reasons: (1) sophisticated carrier cannot and will not agree to such indemnity; (2) carriers lack coverage for third party indemnity; and (3) anti-indemnity statutes increasingly declare carrier indemnity for shipper negligence unenforceable.

By comparison, under the broker/arranger model, the 3PL's tort liability to the shipper is limited to the extent the negligent acts or omissions of the 3PL and its employees cause the shipper harm. The risk under the broker/arranger model is more limited and is more easily insured with contingent cargo and errors and omission coverage.

<u>Bankruptcy Issues Effecting the Role of the 3PL</u>

As discussed above, under the traditional broker/arranger model and the case law which supports it, a 3PL is able to function as a conduit and avoid unnecessary risk in the area of freight charges, freight claims and contractual indemnity by acting as an arranger of services and a conduit for the payment of freight charges. Recent developments in the treatment of 3PL accounts receivable for purposes of priority and preference in bankruptcy also militates in favor of the traditional paradigm.

Increasingly, motor carriers as a group have advanced the constructive trust theory in bankruptcy proceedings to trump the priority claims of secured lenders and to seek recovery of unpaid shipper

receivables to the extent they were due and owing to identified motor carriers. In *Worldpoint Logistics* (Case No. 01-23448, W.D. Wash. 2001), a special creditors committee composed of motor carriers, draymen and rail interests, successfully argued that the carriers' collection rights trumped the rights of Deutsche Bank, the secured lender standing in the shoes of the debtor-in-possession. Carriers successfully traced and recovered a total of over $1,200,000. The secured creditors' recovery was diminished accordingly. In *Worldpoint* the shipper liability for double payment was not litigated and Judge Schneider held the bank got to keep its sweeping of Worldpoint's accounts prior to bankruptcy because Worldpoint did not maintain a segregated trust under the 9th Circuit's *Coupon Clearing* precedent, 113 F.3d 1091 (9th Cir. 1997).

In *Parker Motor Freight, Inc. v. Fifth Third Bank*, 116 F.3d 1137 (6th Cir. 1997) the Sixth Circuit recognized a constructive trust applicable to motor carrier receivables under the interline trust theory and denied te second creditors' claims. See also *In re: Computrex, Inc.*, 403 F.3d 807 (6th Cir. 2005); and *Transportation Revenue Management d/b/a TRM, Assignee of Mastertrans, Inc., et al. v. Freight Peddlers, Inc. et al.*, 2001 Fed. Carr. Cases 84,181.

A third major 3PL bankruptcy involves *In re: Air Cargo, Inc.*, in the United States Bankruptcy Court for the District of Maryland, Case No. 04-37512-JS. In this proceeding, the bankrupt was a combination clearinghouse/3PL established by major airlines, foreign and domestic, who pledged its gross receivables to the bank and squandered the proceeds as well as an influx of capital from Carlisle Partners. The expedited motor carriers which served the brokers have been recognized as a special class of creditors, the bank as a secured creditor has agreed to take a haircut, and if the plan is approved, the remaining shippers will be dunned for all of the unpaid motor carrier receivables regardless of their payments to ACI.

Each of these three cases arises in a different Circuit and each is factually distinguishable. *Worldpoint* involved exempt rail as well as regulated truck transportation; *Computrex* provided payment services as well as logistics services; and *ACI* had a special shippers association like arrangement with its customers. Yet, each of these cases stands for the principle that a motor carrier is something more than an unsecured creditor of the man in the middle and that all parties -- shipper, 3PL, lender and carriers alike -- should recognize the special fiduciary obligation of the 3PL under the traditional broker/arranger model.

Finally, it is submitted that the 3PL fares better in its customer bankruptcies under the traditional broker/arranger model than by assuming the role of the principal/provider. The nastiest surprise effecting transportation service providers in shipper bankruptcies is the preference action. With little more thought than who received checks from the debtor within 90 days of its filing, lawsuits are filed against the debtor's customers seeking refunds. The defenses to preference actions are few. The 3PL who can successfully argue it was not a creditor of the debtor to the extent it received payments intended for the retained service provider, is afforded an important additional defense not available under the principal/provider model.

Conclusion

The duties and obligations of the man-in-the-middle are fundamentally different depending on the paradigm it follows in establishing its holding out under the traditional "broker/arranger" model. The 3PL should receive freight charges in trust to the extent they are due and owing to an underlying motor carrier. It may guarantee payment to a carrier on terms, but that payment, if not made with the proceeds of funds entrusted to it by the shipper, should be made from retained earnings. Payment should not be made from funds otherwise transmitted to the broker and intended for another. Unlike the constructive trust or conduit theory under the traditional broker/arranger model, the principal/provider model views the 3PL's gross receivables as the intermediary's assets. It inevitably leads the commingling of funds and payment of carriers on a first-in, first-out basis. This commingling results in the confusion over the 3PL's status and fiduciary obligations, and in turn leads to 3PL insolvency.

3PLs who accept primary obligation for cargo claims and allow offset as principal providers can vitiate the terms of their contingent cargo coverage and unwittingly permit a shipper to deprive it of withheld funds which are needed to discharge freight payment obligations to unaffected carriers which are due, owing and not contested.

The non-asset based 3PL does not operate equipment or drivers and can ill afford to assume broadly worded indemnification obligation as if it were providing services through subcontractors as opposed to arranging for services to be provided by carriers which the FMCSA certifies as safe.