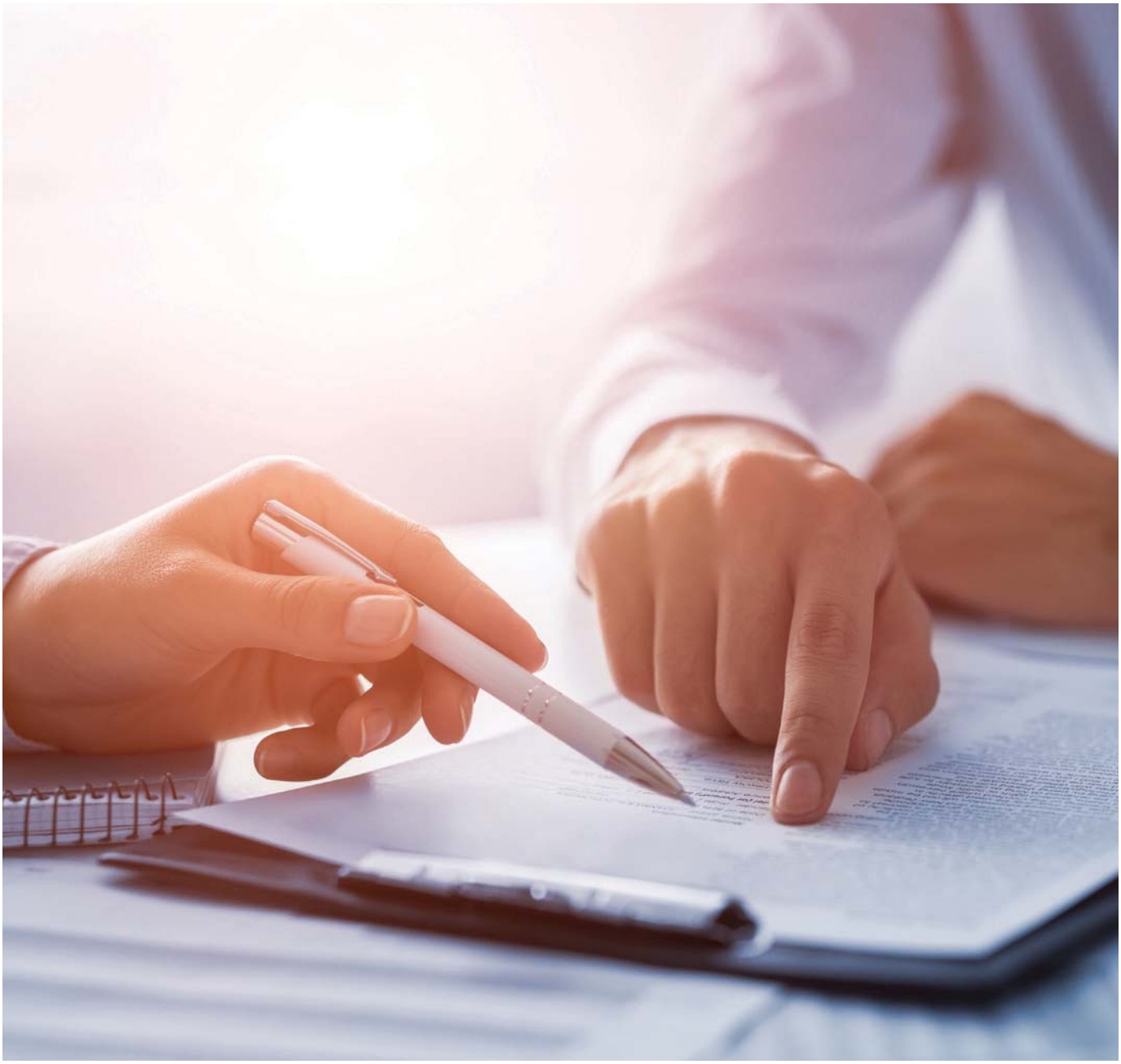
CONTRACTS THAT HELP OR HURT

What Every Engineer Should Know



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By Kenneth Ross

The supply chain for many products can be complex, especially for electrical products that include component parts comprised of many subcomponents. On the manufacturing side, we talk about Tier 1, 2, 3, 4, and sometimes Tier 5 suppliers. On the distribution side, we can have importers, distributors, dealers, manufacturer's representatives, and retailers. All of these relationships are governed by implied or express contracts. As a result, contracts can have a significant impact on the liability of all entities in the chain of production and distribution.

Every entity that buys a component, raw material, finished product or service is a buyer and needs to consider the risks it is willing to assume and what obligations and risks it wants to impose on the seller. However, every buyer is also a seller and, when they are a seller, they have different interests.

In addition, the buyer and seller in a particular purchase have a somewhat adverse relationship with each other and there may not be a meeting of the minds as to the duties and obligations involving this purchase/sale. It is hard enough for courts to interpret clear contracts to which both sides have agreed. However, when there is a "battle of the forms" and arguably no clear agreement, it is impossible to know whose contract clearly governs the purchase. In that situation, the courts have a much more difficult time.

Therefore, the surest way to understand the deal is to have a contract that has been signed by both parties. Unfortunately, this is not realistic for many companies and probably happens infrequently. Either one entity issues a purchase order and the seller just agrees to it, or the seller sends their terms and conditions and the buyer agrees to it by paying the invoice.

This article will discuss the terms and conditions that buyers and sellers should be interested in obtaining, how a contract should be entered into, and what role engineers can play in helping their company evaluate and minimize risks.

PURCHASING

Before a manufacturer produces its product, it buys raw materials, component parts, and maybe subassemblies, typically from entities outside their company. Each of these purchases is governed by some kind of contract. Sometimes the contract is express and signed by both parties. Sometimes it is nonexistent and the law must supply the terms of an implied contract. Or, sometimes each party to the transaction sends a document with terms and conditions that they would like to govern the deal. In all of these situations, a contract is most likely formed and the terms and conditions that result could affect potential liability if the product causes injury, damage or loss.

When a manufacturer buys raw materials, component parts and services, it wants the strongest warranty from the seller and the least exclusions, limitations and disclaimers. For example, if the manufacturer provides a 1-year warranty with its product, it should try to buy critical component parts that have at least a 1-year warranty.

It should try to get the supplier to warrant that the product meets specifications and all applicable laws and regulations, agree to repair or replace any defective or non-compliant product, and agree to pay for all costs of recalling or repairing the product, including labor, if that is required.

The manufacturer wants to protect itself from a supplier who sells them a component that is defective and causes harm to the ultimate user or requires them to recall the product. One way to do this is to include an indemnification clause in the purchase order where the supplier agrees to indemnify the manufacturer for

all product liability costs and consequential damages to the extent that defects in the components caused the injury, damage or loss.

One example of a contentious issue involves who pays for recall costs and what costs are reimbursable. If I am an OEM and buy components, I would want to be protected in case a defective component requires me or someone else down the chain to recall the product. And I would want the supplier to pay for all recall costs, including any administrative costs for implementing the recall. The trouble is that most suppliers would balk at such a requirement or could not pay for it if it occurred. So, they might agree with it on the assumption that the OEM would never try to get them to pay for it or they can blame someone else if a recall occurs because of a defect.

In some industries, OEMs are big and powerful, and they require their Tier 1 suppliers to agree to pay for all recall costs. Then the Tier 2 and lower suppliers who manufacture small and cheap components, most likely will not agree to be responsible for all such costs if their component is defective and causes a recall. The result is that the Tier 1 supplier will have to pay for the recall even if the recall was totally caused by the Tier 2 or lower supplier's component. While this sounds unfair, it makes sense given that the maker of a low-cost component part can't make enough of a profit to potentially be responsible for the full cost of a recall.

So, if you are a Tier 1 supplier in such a situation, what do you do? You can try to buy recall insurance, but that coverage can be expensive and somewhat limited. And the insurance company may take into account that you are responsible for problems you didn't cause. This might significantly raise the price of purchasing such coverage. You can also seek out a Tier 2 or lower supplier that will agree to pay for all recall costs. But that may raise the price significantly, and, if a problem occurs, the supplier may not have the financial ability to meet its obligations.

A better approach is to identify safety-critical parts that will go into your product (this should be done during a typical risk assessment) and take additional measures to ensure that these critical components you are purchasing have been designed correctly, meet specifications, and work correctly in the product into which it is installed. Minimizing the risk of a recall is the best way to protect the OEM and all suppliers.

This is where the engineer can be helpful. The purchasing department can't be expected to evaluate the risks that occur from agreeing to a contract with a supplier and to identify adequate measures that should be taken to minimize future risks. Design and manufacturing engineers need to provide input on whether the risks are acceptable or not and need to consider the cost and difficulty of employing additional quality and reliability testing and inspections or at least requiring the supplier to provide evidence of their testing and inspection procedures. The phrase, "trust but verify," comes to mind in this situation.

The same philosophy can apply to any purchaser down the chain – a dealer, distributor, retailer, etc. How can they purchase a product and hold the manufacturer responsible for any harm arising from the manufacturer's acts or omissions? They usually do this by having the manufacturer agree to an indemnification agreement. In this case, the dealer wants as broad an indemnification as possible against the manufacturer and the manufacturer wants a narrow one. The goal is to apportion the risk consistent with the desires of the parties. Unfortunately, both parties want something that is a little different.

For example, a retailer may want to be fully indemnified by the manufacturer against product liability. However, the way the provision is written, it may also protect the retailer even if they are negligent when selling the product and this negligence causes harm.

Next, the purchaser may ask the seller to name them as an additional insured under the seller's insurance policy, so that any claim or lawsuit can be sent directly to that company for handling, no questions asked.

So, when the manufacturer or supplier negotiates the purchase of components or a finished product, they need to evaluate their own potential liability and what is a fair apportionment between the parties. This will not always work, especially if the more powerful party wants more than they should get.

SALES

The tables are turned when you are the seller of a component or final product. The seller wants to limit its warranty, disclaim all implied warranties, limit its

remedies and disclaim all indirect and consequential damages such as recall costs. It may also want to be indemnified for injury, damage or loss that is caused by someone else down the supply chain.

However, if the buyer such as an OEM has more market power than the Tier 1 supplier, they won't agree to such provisions. They want to be protected from all problems no matter who caused them, even themselves. The result is that it is impossible to accommodate everyone's goals and each side should negotiate a contract which allocates the level of risk that the parties are willing to accept.

However, there is one other provision that a seller of a finished product should be interested in obtaining. It is a clause whereby the buyer agrees that the seller's terms and conditions will be passed through and not altered in the buyer's contract with their customer. So, let's say that the seller disclaims all consequential damages such as recall costs and the buyer agrees to it. But then the buyer sells their product to a purchaser and does not obtain a similar agreement from their customer to disclaim consequential damages. Then the product fails. Both the manufacturer and their supplier could be liable for consequential damages even if the component seller's contract had such a provision.

An example arises from my time as an in-house lawyer at a large electrical manufacturer. This manufacturer sold small electrical components and devices through distributors. The contract between the manufacturer and the distributor limited and disclaimed all the damages that have been discussed above. And the distributor agreed to them. However, the distributor sold the electrical product using a contract that protected them from extra damages but not the manufacturer.

A similar result can occur if a Tier 2 supplier doesn't protect itself in its contract with the Tier 1 supplier and the Tier 1 supplier's contract with the OEM protects the Tier 1 supplier but no suppliers below them.

A manufacturer's contract with its distributors should require that the distributor sell the manufacturer's products using terms and conditions that are consistent with those agreed to by the manufacturer and distributor. By doing that, the manufacturer and the distributor's liability would be consistent and both parties would be protected in case of a problem.

ENTERING INTO CONTRACTS

In reality, most purchases and sales are made pursuant to what is known as the "battle of the forms." What that means is the purchaser and seller send paper back and forth, each with its own terms and conditions on the back and, at the end of the process, no one knows with certainty what terms and conditions govern the contract.

An example will be helpful. ABC Company sends a Request for Proposal to XYZ Company and on the back are terms and conditions and a statement on the front that these terms and conditions will govern the purchase. XYZ sends a proposal and on the back are their terms and conditions and the proposal makes it clear that these govern the sale.

ABC sends a purchase order to XYZ for the goods with their terms and conditions on the back. XYZ acknowledges the purchase order with their own acknowledgment form with their terms and conditions. Finally, XYZ ships the goods and sends an invoice with their terms and conditions. Whose terms and conditions govern the deal?

It can be said with great certainty that no one really knows for sure, not the parties, not the lawyers for both parties, and not even the courts. The area of law governing the "battle of the forms" is one of the most confusing and vague provisions in the law. The only way we would really know for sure is for a judge to rule on the question. The reality is that the parties never really agreed on the terms and conditions, but the court will not say that there is no contract because the product was already delivered and paid for. So, the court has to guess and to "fill in" the relevant provisions of a contract that were not agreed to by the parties.

This situation should be avoided if possible. While many purchases are not made with a contract signed by both sides, it is very easy to have a master set of terms and conditions and then send purchase orders based on the master agreement. Even if the purchase order has terms and conditions on the back, the terms of the master agreement should apply.

So, each entity needs to evaluate their own situation in this chain of production and distribution, determine how much risk they are willing to assume and how much to spread elsewhere, and establish contracting procedures that match this determination.

Contracts are usually only needed when something goes wrong. And, good relations between contracting parties can go bad when that happens. So, it is dangerous to have a fuzzy contract or, worse, sell products or buy products "on a handshake" and rely on your prior good faith dealings to solve any problems that arise.

DEALERS, DISTRIBUTORS AND RETAILERS

Agreements between a dealer or distributor and a manufacturer are a little different than the normal sale. Dealers or distributors have rights and responsibilities that go well beyond those of a normal entity in the chain of distribution. For example, they may agree to provide warranty service, to give safety orientations and training to purchasers, to provide normal maintenance, and to provide repair services outside of the warranty.

They have divided loyalties because they are an advocate for their customer to the manufacturer but also a representative of the manufacturer. Again, as before, the contracts should reflect the rights and responsibilities of both sides and clearly allocate the risks between the parties.

The goal is for the party at fault to pay for the loss and protect the party that was not at fault. Many times, there may be shared responsibilities or there may be no one at fault. In that case, each of the parties may need to defend themselves.

Over the years, I have had problems with retailers who want to be indemnified and held harmless for all product liability claims and litigation, even if the retailer's personnel did something that made the product unsafe, thus causing an accident. This is unfair and should be avoided if possible. However, many retailers are aggressive and basically say that if you want us to buy your product, you will agree to our terms.

In addition, I have been having issues recently on recalls where the retailer is demanding a large reimbursement even if the retailer decides to do a more expansive recall than what the government requires. This can occur in communicating to the consumer, if their identity is known and to provide a remedy in excess of what the government thinks is appropriate. And, provisions in the retailer's terms and conditions are usually very broadly drawn and have no limits. It is a potential minefield for any manufacturer who sells to a large retailer. The seller should evaluate what the retailer expects of them in case of a recall so it can evaluate risk and take any protective measures to reduce the financial ramifications if a problem arises.

Without contracts describing the rights and responsibilities of each party to the contract, everyone is left to wonder what they have to do and what happens if a loss occurs. Some type of contract that sets forth basic guidelines at least gives each party an idea of the parameters of the relationship.

CONCLUSION

Despite the view of contracts as legal boilerplate and usually unimportant, they are important when something bad happens. Then you will wish you had clear contracts that reflect your acceptance of risk.

Also, while the contract does contain some legal terminology that engineers may find hard to understand, they should understand what the contract provides and be sure they agree with the terms, whether the terms are theirs or the party on the other side.

The legal language in the contract should clearly represent what both sides believe are the rights and responsibilities in the deal. You do not want to litigate the meaning of a contract – you have the opportunity to have a true meeting of the minds before you sign the deal or ship the products.

And, lastly, even if you have a good contract that protects you, don't fully rely on it. You still want to prevent problems from occurring. Relying on a contract or indemnification clause or purchaser's insurance policy to protect you may work, but still could cost your company a great deal of money and time to enforce and permanently hamper your relationship with your customer.

The bottom line is that every company should perform a contract audit so that they understand what they are agreeing to for purchases and sales. While lawyers would take the lead on that, engineers have an integral role in identifying, evaluating and minimizing risks.