Sailing Through the Bermuda Triangle of Contracting

30-SECOND SUMMARY Contract manufacturing involves negotiation between two parties: the manufacturer and the brand name owner. For commercial purposes, the arrangement works well. Each party is able to focus on their core competencies. For example, a contract manufacturer for Hershey's will combine the milk purchased from a dairy farm with ingredients purchased from other suppliers, and will then sell the finished candies to Hershey's to sell under its own brand name. In an effort to best manage its supply chain, Hershey's decides it needs an agreement directly with the dairy to ensure they provide the highest quality milk possible. But, when the lawyers sit down to hammer out the contracts, problems often arise. Three strategies can resolve these contractual issues: the one-to-one contracting model, agreements in tandem, or a Joinder, which brings the contract manufacturer under the terms of the Master Agreement.

You may not think you are familiar with the world of contract manufacturing, but it would be nearly impossible, unless you are living off the grid, to avoid the products assembled by them. If the names IBM, Hewlett-Packard or Dell Computers mean anything to you, or if you have purchased a medical, electronic or even confectionery product in the past decade, then you have bought something that was made by a contract manufacturer. According to industry publications, over 90 percent of notebook computers are actually designed and manufactured, not by their brand name owners, but by outsourced companies in Taiwan.[1]

By Sasha Glassman and Stuart Zigun

From medical devices to pharmaceuticals[2], computing[3] to food manufacturing and automobiles, the contract manufacturing process works like this: The supplier, also known as the manufacturer, manufactures parts or components for its customer, the brand name owner (BNO). The BNO doesn't want to put all the pieces of its product together itself, and so it outsources this function to a contract manufacturer (CM). The CM then takes the supplier's component(s), along with those from other suppliers, uses the specifications from the BNO, puts the pieces together, and ships the product to the BNO (or to the BNO's customer) who then puts its brand on the product and markets it for sale.

If you find yourself negotiating an agreement as a supplier, BNO or CM, you are going to run into a frustrating scenario we have dubbed the CM Bermuda Triangle, where many a contract has been lost forever.

A confectionery example

The process works like this: The BNO (i.e., the brand name that actually sells the product to the retail market — for example, let's say Hershey's), decides it no longer wants to enrobe its chocolate-covered candies itself. Since the process isn't particularly proprietary, and it's messy anyhow, Hershey's decides to leave that job to someone else. So, Hershey's hires a contract manufacturer (CM), or co-packer, as they are known in the food products industry, to cover its candies in Hershey's chocolate.[4] The co-packer, most likely located in a low-labor cost locale, will need the milk, along with many other ingredients that will go into the candies, so they will source from a dairy (known as a supplier or manufacturer in other industries).[5] The co-packer will combine the milk purchased from the dairy with other ingredients purchased from other suppliers, and will sell the finished candies to Hershey's to sell under its own brand name.

In an effort to best manage its supply chain, Hershey's decides it needs an agreement directly with the dairy to ensure they provide the highest quality milk possible. Additionally, Hershey's would like the dairy to sell to the co-packer just as if the dairy were selling directly to Hershey's. In other words, Hershey's will want preferential payment terms, quality assurances and delivery commitments (just to name a few clauses) included in its agreement with the dairy. To this end, Hershey's will negotiate a full-fledged Master Supply Agreement with the dairy, with the expectation that the co-packer will be entitled to all the benefits of that agreement. The dairy, wanting to be responsive to such a large customer, will entertain Hershey's request to enter into a full Master Supply Agreement, even though it is the co-packer that will actually be purchasing the milk.

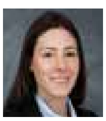
For commercial purposes, the arrangement works well. Each party is able to focus on their core competencies. But, when the lawyers sit down to hammer out the agreements, each party seems to have a different idea of where the contractual obligations should run. The dairy wants to contract and be obligated only with the co-packer since that is their customer. However, Hershey's, attempting to best manage its supply chain, would like a contract in place directly with the dairy, as well as with the co-packer, to ensure they are getting the best deal possible. The co-packer finds itself caught in the middle, squeezed from both sides. Hershey's will want the candy maker to sign up to many obligations — from delay penalties to price guarantees. The co-packer will then try to flow those down to the dairy, along with its other materials suppliers, but the dairy will likely not accept those obligations, especially since the co-packer doesn't have the negotiating power that Hershey's does. After all, Hershey's decides who the suppliers will be, so the co-packer can't shop around or decide not to purchase from the supplier. In this scenario, the candy maker may decide it is better off not having a formal agreement in place with the dairy at all. That way, the candy maker can avoid clauses that the dairy will insist upon, like a cap on liability or an exclusion of consequential damages.

If you find yourself in the CM Bermuda Triangle, you will need some creative ideas to negotiate your way through it.

A quick history

Outsourcing, or employing another for that which one does not wish to do himself, has a history as old as mankind, but modern-day contract manufacturing is most often traced back to the 1980s.[6]

Since the mid-1980s, and particularly since the early 1990s, large and well-known American (and more recently, European) electronics companies such as Apple, IBM, NCR, Philips, AT&T, Hewlett Packard, Digital Equipment and Ericsson have been abandoning their internal manufacturing operations



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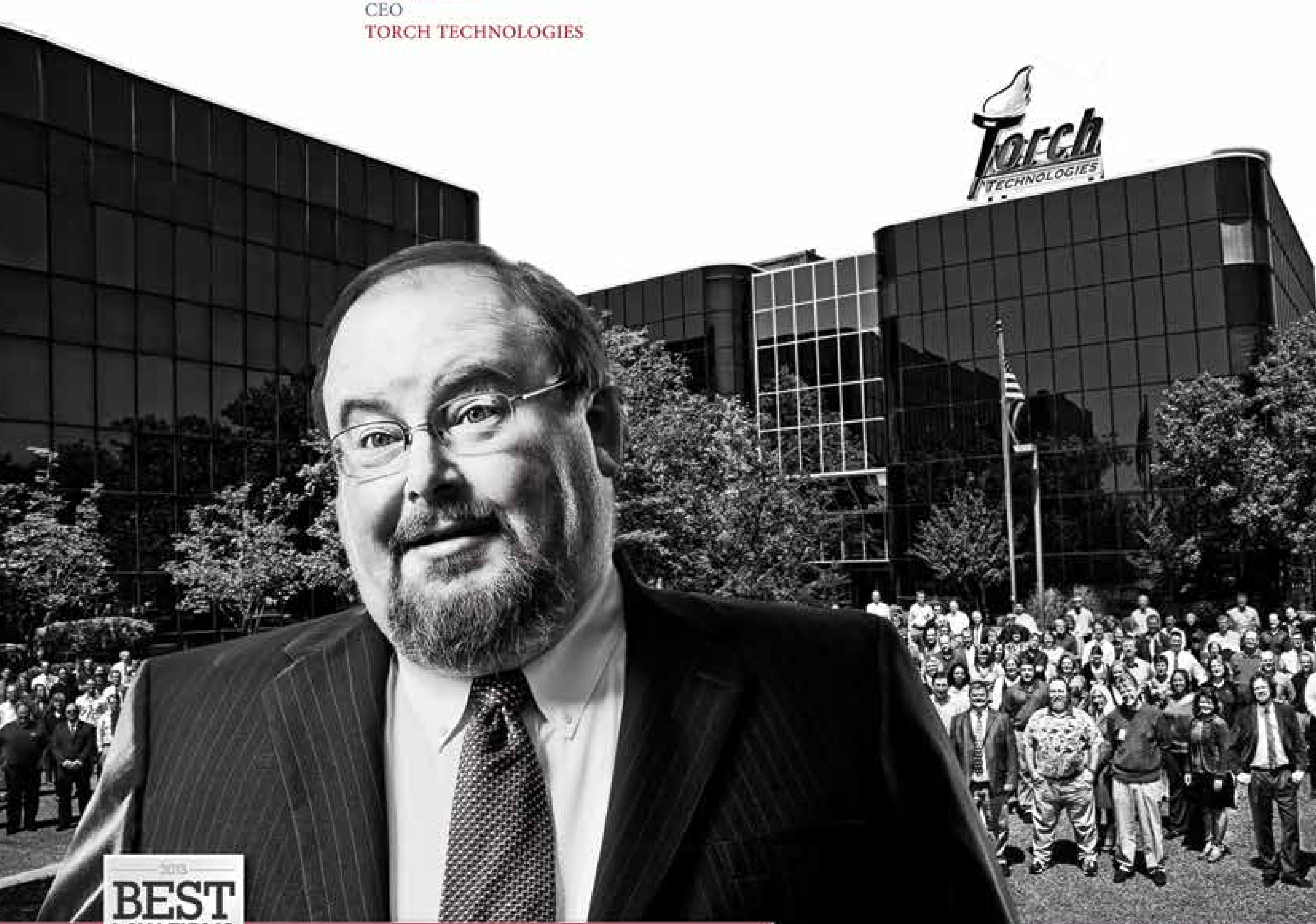

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Figure 1: Sample product supply chain (dashed outline signifies optional parties)

en mass and turning to contract manufacturers to build their products.[7]

And it isn't just large companies that use contract-manufacturing services; small business can also find the arrangement advantageous in reducing cost, increasing output and shifting liability.[8] However, even today, with contract manufacturing having been in place for a substantial period of time, most consumers are unaware of the practice, leading *The New York Times* to dub the practice "stealth manufacturing."[9]

Since the 1990s, the electronics contract-manufacturing market has consolidated, and there are now two primary players: Foxconn/Hon Hai and Flextronics, both based in Asia.

Although Asia, and Taiwan specifically, now lead the electronic contract-manufacturing services market, domestic contract manufacturing can still be found in the United States and the European Union. Particularly in the case of chip manufacturing, companies such as Intel and others have invested in US manufacturing plants.[10] Contract manufacturers located in high labor-cost locales are able to compete by offering what some term "high-level assembly services" that require advanced levels of engineering and specialization.

The traditional contracting model (i.e., each party would contract only with the party to which it had a direct relationship) has only begun to change in the past decade. BNOs have become increasingly interested in having full-fledged master agreements in place with their suppliers, whether or not they place any direct orders with that supplier, or if all purchases will in fact go through a contract manufacturer.

The issues

This new scenario gives rise to a number of contractual issues:

1. What happens when the CM attempts to flow-down terms from the Contract Manufacturing Agreement to the supplier to which the supplier is not obligated per its Master Agreement with the CM? A good example of this type of term is a late-delivery penalty or liquidated-damages clause for deliveries made past the delivery date. The BNO, in many cases, has successfully negotiated such a clause with its CM that requires the CM to pay the BNO if it delivers product late. However, the BNO may not have been so successful in negotiating such a clause in its Master Agreement with the supplier. This, of course, makes sense because the BNO is not all that interested in whether the supplier delivers late, but in whether the CM delivers late. So, when the CM then attempts to flow-down the late delivery penalty clause to the supplier, the supplier is unwilling to sign up to such terms, pointing out that it was not required to do so under the Master Agreement.
2. What happens when there are overlapping and inconsistent obligations? Given that the agreements between the BNO and the supplier and between the CM and the supplier both cover the same leg of the supply chain, the potential for inconsistent and overlapping obligations arises. For example, the BNO may negotiate 30-day payment terms, expecting that these terms will be extended to the CM. However, when the CM is not willing to join in the supplier/BNO agreement, and instead negotiates

Keeping the parties straight

SUPPLIER
Also known as the manufacturer, the supplier makes a component that it then sells to the CM.

CONTRACT MANUFACTURER (CM)
Also known as a co-packer (food industry), Original Design Manufacturer or Electronics Manufacturing Services (electronic industry), Contract Manufacturing Organization or Contract Development and Design Organization or Loan License Manufacturer (Pharmaceutical Industry), or Turn Key Product Manufacturer, the CM takes the components from the supplier and combines it with other parts to create a completed product for the BNO.

BRAND NAME OWNER (BNO)
Also known as the Original Equipment Manufacturer (electronics industry), the BNO takes the product from the CM and sells it to the marketplace, whether through distribution or other channels, under its own name.

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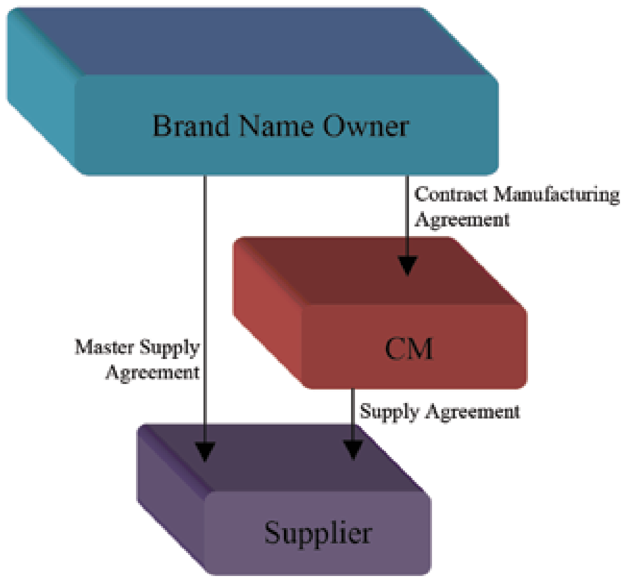
Figure 2: Current contracting practice between the BNO, CM and supplier



its own full-fledged Supply Agreement, the supplier may only extend 45-day payment terms. Thus, the BNO is not getting the benefit out of the Master Agreement it went to so much trouble to negotiate and, in effect, is left with only a post-sale obligations agreement. This also does not work well for the supplier who has seemingly overlapping and potentially conflicting obligations to the BNO and the CM. The supplier is often most concerned with the limitation of liability clause, which limits the supplier's exposure under agreement. The CM and BNO agreements will understandably contain differing caps on liability for the supplier. This happens for a number of reasons: 1) The CM does not have the bargaining power that the BNO enjoys; 2) the potential for liability really arises once the product has reached the BNO's end customer, not in the interim steps; and 3) the CM is likely buying in much smaller quantities than the BNO does. With differing caps on liability, the supplier has no assurance that one or the other will apply, or if they would be obligated to both caps on liability in the aggregate.

Initial attempts to bring the contractual obligations between the parties in line with each other have focused on signing CMs up to the Master Agreements through mechanisms, such as Joinders, that bring the CM under the terms of the Master Agreement. Once joined, all the supplier's obligations under the Master would now be obligations to the CM, and vice versa. Often, payment terms will be explicitly not included when joining the CM to the Master Agreement, and the Supplier and CM will be left to negotiate their own payment terms.

These efforts have been rebuked by both CMs and BNOs on a number of grounds. The CMs understandably want to negotiate their own agreements, rather than be bound by a contract they did not participate in crafting. To use the late-delivery penalty example again, why would the CM want to sign up to an agreement that did not require the supplier to pay them a late-delivery penalty, when the CM has to pay such a penalty to the BNO? Given this concern, CMs, in large part, have refused to sign Joinders at all.

Recommendations

Given that this initial attempt at resolving this contractual conundrum has been less than adequate, we recommend three different strategies: 1) You can attempt to return to the simplified, one-to-one contracting model in which each party contracts only with those it has a direct buy/sell relationship with; 2) you can attempt to negotiate the agreements in tandem, so that all obligations between the parties are sorted out at the same time; or (3) you can pursue the "Joinder scenario" described above if the parties are amenable.

A return to the olden days – the direct, one-to-one contracting model

Under the direct contracting model, contracts would only be in place between parties who have a direct buy/sell relationship. This model has a number of advantages. One, it is simple. The BNO, CM and supplier will easily be able to understand their obligations under each agreement with no overlap. The BNO can take an active part in negotiating the CM/supplier agreement by requiring that the CM flow-down certain provisions of the BNO/CM agreement. The BNO can also directly communicate to the terms it requires the supplier to agree upon with the CM.

Tandem negotiations, risk-based pricing and cumulative caps

Under this scenario, the BNO and the supplier would still have a Master Agreement in place, covering all terms and conditions of sale, including forecasting obligations and liabilities that the BNO has to the supplier.

There would also be contracts in place between the parties who have a direct buy/sell relationship (e.g., supplier to CM, CM to BNO). See Figure 2 for a visual representation.

Here, the key to achieving mutually advantageous agreements largely lies in the timing, both from a commercial perspective and a contractual one. On the business side of things, the product must have some revenue-generating future. In other words, sales should either be flat or increasing, but certainly not heading toward end of life. This is because considerable time, effort and patience will need to go into achieving final agreements between the parties, and no one is going to be motivated to expend such energies for a product that has limited future viability.

The second key to tandem negotiations is that the parties must all be negotiating their agreements at the same time with a goal of closing them together. This way, all parties are incentivized to reach an agreement. For example, if the supplier refuses to close its agreement with the BNO until its agreement with the CM is finalized, the BNO is more likely to push its CM to come to an agreement with the supplier.

Another tool that suppliers can use to encourage CMs to negotiate is differential, risk-based pricing. Risk-based pricing is an extension of the idea that price should always contain all the costs of doing business — from the cost of materials to management costs, transportation, taxes and all the other costs that go into producing a product. However, prices often fail to vary based on the element of risk. The insurance industry is, of course, founded on accurately being able to assess and price risk, but this same model can be applied to any product or service. For example, if a product is being sold to a party who refuses to enter into a sales agreement, that would be a riskier sale than one that already has an agreement in place, assuming that agreement contains such standard risk-limiting provisions, such as exclusions of consequential damages and limitations of liability. Thus, the supplier can motivate the CM to enter into a formal Supply Agreement by pricing the product and/or service higher when there is no agreement in place.

A supplier can also remedy the multiple-cap-on-liability issue by inserting a clause such as the following:

> For all claims arising hereunder, whether from a CM, subcontractor, agent, etc. … the cap on liability is X. In the event that Supplier's liability exceeds the cap with the CM, Brand Name Owner must indemnify Supplier.

Additionally, the supplier can use the following wording in its CM agreement:

> CM cannot make a claim for compensation or indemnification from Supplier on the same subject matter that is or may be subject to a claim by Brand Name Owner.

In this way, the supplier avoids having two, possibly cumulative, limitations on liability.

Contractual Joinder

Although we have described the "Joinder scenario" as ineffective in most contexts, there are certain situations in which joining the CM to the agreement between the supplier and the BNO may be the best course of action. For example, certain CMs may wish to save the time and expense of negotiating their own agreements, and rather sign up to what has already been negotiated by the BNO. This does not mean that amendments between the CM and the supplier cannot be made. Indeed, those parties often will want to negotiate their own payment terms, and the CM will want to be sure to flow-down any penalty clauses from its own agreement with the CM.

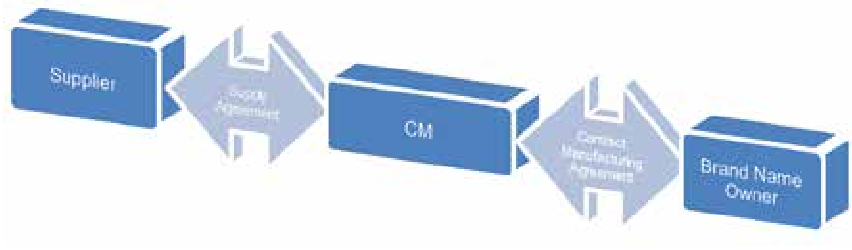
The BNO may also prefer this scenario as it gives the BNO more

Update: Contract manufacturing agreements in the pharmaceutical industry — draft guidance

As you might guess, due to the highly-regulated nature of their industry, use of contract manufacturers in the pharmaceutical space must comply with many requirements. Just as Federal Acquisition Regulations (FAR) require that government contractors flow-down certain provisions to their suppliers, the FDA has similar requirements for drug makers.

To that end, in May 2013, the FDA issued draft guidance on the Quality Agreements that drug manufacturers are required to have in place.[11] Specifically, the draft guidance notes that "Quality Agreements are not commercial or business agreements; they do not cover issues such as general business terms and conditions, confidentiality, pricing or cost issues, delivery terms, or limits on liability or liquidated damages." A Quality Agreement should cover these basic areas: purpose/scope, terms, dispute resolution, responsibilities (including communication mechanisms and contacts), and change control and revisions. Areas of responsibility include: quality unit responsibilities, facilities and equipment, materials management, product-specific requirements and responsibilities, laboratory controls, and documentation. The final section offers hypothetical situations that illustrate common problems in CMO arrangements, along with the FDA's thoughts on possible resolutions, including actions that may be taken against the owner and the contracted facility.

Figure 3: The direct contracting model



oversight over its supply chain and the contracts governing it. For this reason, the BNO may wish to take an active role in assuring that their CMs contract with the suppliers. Our recommendation, for purposes of simplicity, is for the BNO, once an agreement has been reached with a Supplier, to send that agreement to the CM, requiring the CM to sign that agreement between the CM and the Supplier. Some items, such as payment terms, can be left open to negotiation, but the vast majority of terms will have already been decided upon. Additionally, the BNO can redact any clauses that are not pertinent to the CM and that it wishes to keep confidential.

The BNO will need to address the CM's concern regarding penalties. For example, if the BNO has not insisted upon a late-delivery penalty in the contract with the supplier, then it would not make sense to insist that the CM be on the hook for late deliveries caused by the supplier.

This route addresses a number of concerns for the CM. For example, it limits the amount of time their legal department must dedicate to negotiating agreements, thereby keeping the costs of contracting low.

Here is a sample clause to be inserted into the Master Agreement between the BNO and the supplier:

> The entities entitled to purchase Products under this Agreement ("Buyers") include (i) Brand Name Owner, and its respective affiliates, and (ii) any, subject to creditworthiness reasonably acceptable to Supplier, agents, distributors, subcontractors or third-party contract manufacturers listed on Exhibit X or otherwise designated by Brand Name Owner and agreed by Supplier in writing. Buyers may place Purchase Orders with Supplier that incorporate the terms and conditions of this Agreement by reference. In such cases, the term "Brand Name Owner," as used in this Agreement,

shall be deemed to refer to such Buyer. Each Buyer will be responsible for its own obligations, including, but not limited to, all charges incurred in connection with such Purchase Order. Brand Name Owner shall not, under any circumstances, be responsible for any acts or omissions of any other Buyer, including, without limitation, any forecasts, nor shall any other Buyer be responsible for the acts or omissions of Brand Name Owner. Brand Name Owner may immediately suspend or cancel the rights of any Buyer to place Purchase Orders hereunder by written notice to Supplier. Purchases by Buyers who are agents, distributors, subcontractors and third-party contract manufacturers shall be limited to purchases for the benefit of or for sale to Brand Name Owner, and Supplier shall make no sale under this Agreement to any such Buyer unless such Buyer certifies in writing that all Products to be purchased are for the benefit of or for sale to Brand Name Owner. Notwithstanding anything to the contrary in this Agreement, Brand Name Owner shall be a third-party beneficiary of all Purchase Orders placed by other Buyers, and Brand Name Owner shall be entitled to all rights under this Agreement (including, without limitation, indemnity, epidemic failure and warranty protection) for Products purchased by other Buyers as if Brand Name Owner had purchased such Products directly from Supplier. In consideration of Supplier's agreement to deal with Buyers as described herein, Brand Name Owner will inform other Buyers that Supplier is an "Approved Supplier" of Products to Brand Name Owner; provided that Brand Name Owner may, at any time and for commercially reasonable cause, as determined in Brand Name Owner's reasonable discretion, notify Buyers that Supplier is no longer an "Approved Supplier" of Products.

ACC EXTRAS ON… Contract manufacturing

ACC Docket

Implementation and Use of Electronic Contracts (Sep. 2013). *www.acc.com/docket/elec-cont_sep13*

Forms and Policies

Sample Manufacturing Services Agreement (Feb. 2005). *www.acc.com/forms/manu-agree_feb05*

Sample Manufacturing and Supply Agreement (Oct. 2011). *www.acc.com/forms/mnfctrng&spply_oct11*

Custom Manufacturing Agreement (July 2008). *www.acc.com/forms/custom-agree_jul08*

Manufacturing and Supply Agreement (Jan. 2013). *www.acc.com/manu-agree_jan13*

Quick Reference

Key Issues in a Manufacturing Agreement from the Manufacturer's Perspective (Oct. 2011). *www.acc.com/manu-agree_oct11*

Presentation

Using Risk Analysis and Creative Negotiation in Contract Negotiations in Manufacturing or Product Agreements (Oct. 2011). *www.acc.com/risk-contract_oct11*

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Conclusion

With these tools on board, these three ships can successfully navigate the Bermuda Triangle of stealth manufacturing to arrive safely on the shores of a solid agreement. **ACC**

NOTES

1 *www.prnewswire.com/news-releases/global-and-china-laptop-and-tablet-pc-industry-report-2011-2012-152524185.html.*

2 *www.bloomberg.com/news/2013-03-01/glaxo-sues-hospira-over-quality-of-flu-vaccine-supply.html.*

3 *www.circuitsassembly.com/cms/component/content/article/6-current-articles/12716-ems-top-50.*

4 *www.prnewswire.com/news-releases/hershey-announces-global-supply-chain-transformation-57933727.html.*

5 For purposes of simplicity, this example consolidates the supply chain into only three parties, where most supply chains would contain many more.

6 *www.ifs.uni-frankfurt.de/people/luethje/luethje_e_elconman.pdf*

7 *www2.ucsc.edu/globalinterns/cpapers/sturgeon.pdf.*

8 *www.smallbusinesscomputing.com/tipsforsmallbusiness/3-small-business-manufacturing-tips.html.*

9 William Dutton, ed., *Transforming Enterprise: The Economic and Social Implications of Information Technology*. (MIT Press. 2005).

10 *www.time.com/time/magazine/article/0,9171,2028089,00.html.*

11 *www.contractpharma.com/contents/view_breaking-news/2013-05-29/fda-issues-draft-guidance-on-contract-manufacturing-agreements/#sthash.pcFRstop.dpuf.*