

Contract Manufacturing Agreements: The Importance of Allocating Outsourcing Risk Fairly

Businesses increasingly look to contract manufacturers (CMs) as a way to improve efficiency in their production processes. The allure of outsourcing all or part of a manufacturing process is the chance to lower the cost of bringing a product to market. For CMs, contract manufacturing engagements represent an opportunity to utilize their capital and workforce more productively. Competition among CMs to land lucrative contract manufacturing engagements can be fierce. And the drive to land an engagement can influence how aggressively a CM pushes back on contract terms and conditions proposed by potential customers. Understanding key contract terms and how they allocate risks between parties to contract manufacturing relationship can help a CM's management make better decisions regarding its contract manufacturing commitments.

When a business explores outsourcing the production of a product or component of a product, the analysis tends to focus on how the decision will affect quality. Because the quality of a business' products is integral to a business' brand, it should be no surprise that contract provisions addressing the quality of deliverables are reflected throughout the terms and conditions. Terms and conditions address the risk that a CM relationship will affect the quality of products delivered in two primary ways: risk mitigation; and risk transfer.

Risk mitigation provisions are designed to limit proactively the chances of problems occurring in the future. In a contract manufacturing agreement, risk mitigation provisions tend to describe reporting requirements, product inspections processes and auditing of production methods and environments. The goal being to identify possible problems in manufacturing processes or the output from those processes prior to product hitting the market. While these sorts of provisions tend to be located in the 'boilerplate' of contract manufacturing agreement forms, giving thought to the balance between the costs associated with these sorts of quality assurance protocols and the benefits gained from increased initial product quality can be an opportunity to achieve greater efficiency. Even with thoughtful quality control measures reducing the risk of future problems, the potential for product defects remains a concern.

Risk transfer provisions allocate responsibility between the parties if a problem arises. In a contract manufacturing agreement, key risk allocation terms include the warranty and indemnity provisions. At their simplest, a warranty is an assurance regarding the quality of a deliverable and an indemnity is a mechanism to ensure that an injured party is made whole if a warranty proves to be untrue. Warranties may be implied at law and or given expressly through written contracts. Where warranties regarding the quality of products are implied at law, the Uniform Commercial Code (state statute) allows written contracts between businesses to expressly disclaim enforcement of any implied warranties. For CMs, the warranties in their agreements with their customers plus any implied warranties created by state law form a measuring stick against which the quality of the products they deliver are measured.

Translating an understanding of how warranty and indemnity provisions allocate risk between parties into better contract terms for a CM is more art than science. Ideally, warranty and indemnity terms would only hold a CM responsible for failures that are within the CM's reasonable control. For example, if a customer provides a CM with a set of specifications for a batch of deliverables and the CM's deliverables meet those specifications in all respects, does it make sense to hold the CM responsible for product liability or product warranty issues which may arise when the deliverables are ultimately introduced to the market? Unless the warranty provision distinguishes between compliance with specifications and deviations from those specifications and the indemnification provision allows for the

indemnification of the CM where the proximate cause for defects is in the specifications themselves, the CM has exposure for aspects of the relationship it does not control.

The more thoughtfully terms and conditions spell out (1) who bears responsibility for which elements of the manufacturing process and (2) who makes who whole in the event something goes wrong, the more smoothly the relationship should run when problems arise. Tailoring contracts for each relationship takes time and money. And managing a supply chain with a set of highly tailored contract manufacturing agreements can increase administrative costs for the business customer. So, many times CMs are faced with the choice of accepting broader risk under a customer's standard form contract terms and potentially missing out on a key piece of business. Pricing the additional risk into the CM's cost of manufacturing the contract deliverables being sold is critical to ensuring a successful contract manufacturing engagement. Not fully appreciating how the risks are allocated between the CM and its customer can sour an otherwise profitable contract manufacturing engagement very quickly.

Contact our business legal team with your questions at 574.232.3538. We are open 8 a.m. to 5 p.m. Monday through Friday, and all our attorneys are available to assist you via phone and virtual meetings.



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