SUPPLY CHAIN RISK MANAGEMENT: SEVEN HABITS OF HIGHLY EFFECTIVE MANUFACTURERS

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Introduction

Manufacturers, material and component suppliers, distributors and retailers are all links in the supply chain which carries goods from the design table to the consumer's home. Each party in the supply chain has independent legal obligations, and those obligations are often intertwined with the obligations of the parties above and below it. The supply chain is indeed linked because each party in the supply chain is, to some extent, dependent upon the other parties performing their respective responsibilities. Where one party fails to perform its responsibilities, the consequences can cascade both up and down the supply chain, creating legal and financial exposure for other parties. For example, a retailer in North America may be found liable for a product defect because a small widget supplier on the other side of the world didn't do its job properly.

The question, then, is how should parties in the supply chain allocate amongst themselves risk and liability exposure for problems relating to goods and products? The best solution for risk allocation and mitigation, as in many commercial situations, is through well-considered relationships, proper contracts, adequate insurance, and good business practices and management.

The purpose of this article is to identify some risks faced by supply chain parties, and to suggest solutions for reducing and mitigating those risks. By following some fundamental supply chain principles (the "seven habits"), manufacturers and other parties can manage the risks inherent in the supply chain, and only undertake risks that are commercially reasonable.

Habit #1: Know Thy Supply Chain Neighbour

It is critical for every supply chain party to investigate and know the other parties with whom it is dealing. Manufacturers need to know their component and material suppliers and the businesses that are distributing and selling their products. Distributors and retailers need to know the manufacturers of the products they are putting on their shelves. In any litigation where there is a problem with a product, the supply chain defendant will almost invariably be asked what it did to investigate and confirm that the product (and potentially, its component parts and raw materials) were safe and suitable for the intended purpose. If the defendant has not taken reasonable steps in this regard, it may be found liable.

Parties need to conduct due diligence that is reasonable in the circumstances. For example, if a manufacturer buys a safety-critical part from a supplier, the manufacturer needs to be certain that the supplier is reputable, and that it has sufficient manufacturing and quality control systems in place to safely and consistently supply the part. For some manufacturers, this may mean visiting, inspecting, and even monitoring during production, the manufacturing and quality control facilities and systems of suppliers to ensure that the goods being supplied are

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safe and compliant. Certificates of compliance and product quality audits are other common methods of monitoring and maintaining supply chain integrity. Where the part or raw material supplier is in another country, or is supplied through an intermediary such as a distributor, this type of due diligence can be often be difficult. In these circumstances, as discussed below, contractual protection and insurance become even more important.

Even where it is not possible to visit the other party, it is still worthwhile to investigate the party from afar. Is the party's legal name properly reflected on the documents (a surprisingly common error)? Is it incorporated? Where is it incorporated? Is it private or publicly held? Are there previous recall notices or CPSC directives or consent decrees? Are there any judgments, lawsuits or regulatory investigations or proceedings pending against the company? What type of assets does it have? Where are the assets located? Is there a parent company? What ability does the company have to pay a judgment? What is the management team like? Are the company's technical people qualified? As discussed below, the best contract in the world has little value if the other party doesn't have the technical wherewithal to perform the contract or the money or insurance to pay up if things go wrong. If it looks like company will blow away like a tumbleweed in litigation, beware.

Habit #2: Your Exposure Should Match Your Investment

The overarching concept of supply chain risk management is that a party's risk arising from any relationship or transaction should be equivalent to its commercial investment and upside. Put another way, a supply chain party should not assume liability exposure which dwarfs the profit created by the transaction or relationship. For example, a component supplier making a one dollar profit on a widget should be reluctant to assume unlimited liability exposure for the downstream use of that widget, particularly where the use of the widget is outside of the supplier's control. Otherwise, that supplier has essentially become the world's cheapest insurer of the downstream parties.

The challenge for all supply chain parties is to try and negotiate contracts which allocate risk in a way that is reasonable and commensurate to each party's commercial involvement. Often, the larger party (e.g., the OEM) will seek to force the smaller party (e.g., the parts supplier) to accept risk and exposure beyond the smaller party's commercial benefit. While it is sometimes necessary to accept disproportionate contractual risk in order to obtain business, the challenge is to balance the objective of securing business with the importance of managing contractual risk. Further, simply because you can obtain a favourable contract term through the strength of your bargaining position doesn't necessarily mean you want to do so in every case. Sometimes it may be expedient to agree to more balanced terms for the greater benefit of the commercial relationship, particularly where you are dealing with sole-source suppliers.

As not all jurisdictions permit manufacturers, distributors and sellers of products to impose contractual limitations of warranties and liabilities, it is important to have legal advice in the jurisdictions where you are doing business to ensure that any contemplated contractual terms or limitations are lawful and enforceable. There is no point in negotiating a contract term that won't be enforced by the relevant court.

Where contractual limitations of liability are available, one method is to contractually cap liability to a stated amount, the amount of the contract or other metrics such as annual sales. This makes the liability exposure more predictable and connected to the commercial investment. However, due to inequality of bargaining power, or in some cases, lack of knowledge, supply chain parties often assume liability exposure which far outweighs their commercial involvement.

While it is difficult to resist the lure of getting a deal done when the sun is shining, supply chain parties need to think about the potential downside before making a deal. If the proposed deal potentially creates legal exposure which far outweighs the upside, and could put the company out of business were things to go awry, then it may be prudent to walk away—or at least take additional steps to ensure that you are adequately insured (see below).

Habit #3: Good Contracts Make Good Supply Chain Neighbours

Having good contracts with the supply chain parties with whom you deal is the legal bedrock of the supply chain. Without good contracts, a manufacturer may be fully exposed to liability—without protection and legal recourse against the responsible party—and at the mercy of the laws of other jurisdictions. It is critical that manufacturers and other supply chain parties have comprehensive and robust contracts for key relationships which set out the rights and obligations of the parties in a way that reasonably allocates risk amongst the parties.

Whether and when a contract is required depends on the nature of the relationship and the transaction(s) in question but where the transactions are sizeable and repeated, a master supply contract may be a good idea. Many companies are reluctant to incur the legal cost of contracts for "small" supply chain relationships (for example, small purchases of raw materials), and are content to rely on the parties' "goodwill", sale of goods laws, or terms and conditions for protection. In the event of a product problem, however, nothing will protect a manufacturer like a good contract.

While it is beyond the scope of this article to discuss supply chain contracts in great detail, key contractual terms for supply chain contracts include: product specification and quality, warranties, epidemic failure, pricing, order, payment and delivery, intellectual property, confidential information, recall, limitations of liability, indemnity, insurance; termination, breach, choice of law, and choice of forum/arbitration. While these clauses are important, the "protective" clauses of limited warranty, limited liability, indemnity, insurance, and choice of law and forum are of particular importance and should be considered closely. As noted above, it is important to have local legal advice so you understand the laws of where you are doing business. It may be necessary to revise standard contracts and terms to reflect and comply with local laws.

If the business circumstances do not require or permit a supply agreement, then it is critical that manufacturers and other parties have comprehensive standard terms and conditions which are incorporated into that party's commercial documents (e.g., purchase orders, order confirmations, invoices) in a way that ensures the terms and conditions apply even where the other party seeks to assert its own terms and conditions (i.e., "the battle of the forms"). Standard terms and conditions should include the key contractual terms and be incorporated into common commercial documents and used consistently.

Habit #4: Indemnities—It's Better to Receive than to Give

Indemnity clauses are common and important key terms of supply chain contracts and standard terms and conditions. Simply put, an indemnity is an agreement by one party to protect and reimburse another party in certain events. Typical indemnity clauses require the provider of the indemnity (the "indemnitor") to "indemnify, defend and hold harmless" the other party (the "indemnitee") where a defined triggering event occurs. In supply chain contracts, the triggering event is usually a loss or claim related to the goods supplied under the agreement, or the agreement itself. The object of the clause is to contractually shift liability for losses and claims from the innocent party to the responsible party. While indemnity clauses can be unilateral, it is not uncommon for supply contracts to have mutual indemnity clauses.

Where a manufacturer has downstream (distributors, retailers) and upstream (part and material suppliers) relationships, it should seek to have interlocking indemnity clauses up and down the supply chain. For example, manufacturers sometimes agree to defend and indemnify sellers for claims related to product defects. In such a situation, a seller sued for a product defect would demand defense and indemnity from the manufacturer under the indemnity clause. If the root cause of the product problem was a defective component part, the manufacturer could then seek further defense and indemnity up the supply chain against the supplier of the part. The overall objective of the chain is to protect the innocent downstream parties and allocate liability to the responsible upstream party.

Despite their importance, indemnity (and defense) clauses are often poorly drafted, overly broad and misunderstood. As a result, indemnity clauses should receive special scrutiny in any contractual negotiations. The trigger (and proof of trigger) language is often the linchpin in the clause. The goal should be to have an indemnity trigger that is fault-based (i.e., contingent on claims based on the indemnitor's fault or negligence) and not event based (i.e., contingent on the occurrence of an event which could arise in the absence of the indemnitor's fault). The clause should also distinguish whether a mere allegation of fault (or whatever other trigger is identified) is sufficient to trigger the indemnity or whether there is some higher level of proof required (e.g., a judicial determination of fault). Where there is a duty to defend, the duty must be triggered by an allegation or claim alone otherwise it will not operate. The duty to indemnify can be triggered by varying degrees of proof ranging from the mere incurrence of an expense to a judicial determination of fault. This critical but subtle distinction in the trigger language is often overlooked.

Habit #5: Wear a Belt and Suspenders—Have Adequate Insurance

Every business involved in the supply chain needs proper and adequate insurance. While this would seem axiomatic, manufacturers and other supply chain parties often find themselves uninsured or underinsured in product liability claims and other supply chain disputes. Consumer and food product recalls and class actions can easily create liability exposure in the millions, or tens of millions, of dollars, so it is important to understand and insure for such risks.

Supply chain parties should work with a professional insurance broker experienced in the industry to understand the nature, likelihood and potential quantum of the risks faced by the business, and to understand which risks can be insured and, if so, to what amount. Manufacturers also need to be aware of gaps in coverage and exclusions. The best way to ensure that you are properly insured is to engage a reputable professional insurance broker with expertise in your industry and to work closely with them to evaluate your business and the available options for insurance coverage.

There are numerous types of coverage available to supply chain parties, including property, commercial general liability ("CGL"), manufacturer's errors and omissions ("E&O"), recall, contractual liability, business interruption, bad debt and excess insurance. Each type of coverage is different and may require a separate endorsement or policy. For example, many CGL policies exclude coverage for a manufacturer's losses related to replacing defective products. Manufacturer's E&O insurance is designed to fill this gap. Equally, most policies exclude contractually assumed liability (including, importantly, liability under indemnity clauses). Contractual liability is designed to cover such liability.

Supply chain parties should also seek protection and coverage from their co-party's insurance. Supply contracts with smaller parties should include a term requiring that party to place specified insurance to a stipulated amount. Such "duty to insure" clauses are designed to ensure that the co-party has sufficient insurance for: (i) third party

liability claims (so you don't end up holding the liability bag); and (ii) contractual liability claims, including claims for performance of defense and indemnity obligations under the supply contract. There is little point in obtaining an indemnity from a company that doesn't have the financial wherewithal to pay the indemnity. It is also common for supply chain parties to be named as additional insureds on the other party's insurance. This additional insurance coverage effectively allows one party to piggyback on the other party's insurance policy, at his expense, in certain circumstances. Having responsive co-party insurance in place can be a game changer in a major loss situation.

Habit #6: Seek Home Court Advantage

Dealing with foreign supply chain parties poses particular challenges for North American parties: communication can be slow, gaining access to information and documents can be difficult, product quality monitoring and control may be challenging to implement; you may be exposed to foreign legal regimes and the foreign party may be outside the jurisdiction of Canadian and US courts. All of these factors create increased risk for North American manufacturers.

Where is the foreign party located? Are they are in a "friendly" country which has a good quality legal regime that is cooperative with your country's legal regime? Will that country enforce judgments from your country? Some countries, like China and India, are legally impenetrable to the point that suing in such countries is essentially pointless. Alternatively, there are many friendly countries where there is a good prospect of reciprocal enforcement of judgments. For example, a Canadian judgment against an American company will, in most circumstances, be enforceable in America and vice-versa. The more difficult it is to legally reach a foreign party, the more contractual and insurance protection you will need up front.

The best way to mitigate the risks of dealing with foreign parties is to secure "home court advantage" through choice of law, choice of forum (courts), and/or arbitration clauses in supply contracts or terms and conditions, where permitted by law. This way, any disputes will be governed by Canadian or American law and courts. If arbitration of disputes is preferred, you may be able to contractually mandate arbitration using an agreed-upon law, procedure and location. Having home court advantage in supply chain disputes is often a major strategic advantage, and should be sought aggressively in negotiations. Again, it is important to understand the laws of where you are doing business as numerous North American jurisdictions prohibit or restrict the use of choice of law, choice of forum and arbitration clauses in certain contracts (particularly consumer contracts).

If the foreign party has no assets in North America (or another jurisdiction where they are exigible), you may seek to have some type of security in place. There is little to be gained by a North America judgment over a foreign party if the party has no assets in North America and the judgment cannot practicably be enforced in the party's country. This can be done with domestic guarantors, letters of credit at domestic banks, and/or contractual holdbacks—all of which are designed to facilitate recourse and recovery in the event of a dispute. Further, if the party is from an "unfriendly" foreign jurisdiction, and you are seeking to be named as an additional insured on their policy, it is wise to require that party to place insurance with a North American or UK-based insurer. Trying to enforce insurance coverage as an additional insured against an uncooperative foreign insurer is, not surprisingly, extremely difficult.

Habit #7: Sweat the Small Stuff

Having a good business partner, a good contract, and good insurance will go a long way to reducing and mitigating supply chain risk. However, you still need to pay attention to detail and execute on a daily basis. This means following the contract to the letter, being compliant with laws and industry standards, having good manufacturing, management and operational systems and practices and keeping good records. If your co-party has contractual performance obligations, make sure those obligations are complied with and clearly document any non-compliance. For example, if your co-party must place insurance, make sure you get proof that such insurance has been placed. Breach of insurance clauses is unfortunately not an uncommon occurrence. Equally, if your supplier must provide certificates of analysis or compliance with delivered products, make sure that: (i) the certificates are actually being provided; and (ii) the certificates are accurate through audit.

Ensure that contracts are properly executed and filed, and that all insurance policies, contracts, and commercial documents relating to the purchase and sale of any products, components, or raw materials are organized and preserved. It is not recommended that critical documents related to design, manufacture and quality control be destroyed after one or two years (as is common practice), because product liability claims may occur many years after the product was manufactured and sold. If possible, be able to track products and their component parts and raw materials up and down the supply chain, so you can determine where things came from and where things went in the event of a problem or recall. Good recordkeeping will often make dealing with product defect claims and recalls much easier and cheaper (e.g., if you can pin-point the defect to a particular lot through good records management, the recall can usually be much narrower).

Summary

The global and interconnected nature of the supply chain makes managing supply chain risk complicated and difficult. By considering and taking the fundamental steps discussed in this article, manufacturers and other supply chain parties can manage and mitigate supply chain risk.