

Managing Key Supplier Responsibilities in a Manufacturing and Product Development Outsourcing Contract

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Many brand marketing companies (“brand companies”) that source their products from China have, over the past few years, moved from simple third-party manufacturing to specifications-manufacturer relationships to a new model that has the manufacturer involved early in the production process to develop new products. This expanding role by manufacturers into product development (including even conception and design) has often come about as a natural progression in the relationship between customer (brand company) and provider (supplier or manufacturer), as manufacturers have grown in their capabilities and sought to expand their footprint into new value-add areas. These developments provide benefits to brand companies as well, including increased speed and efficiency in product development and savings through reduced capital investment and lower employee headcount.

In fact, in many cases this evolution in functions—the emerging product development outsourcing model—has developed so naturally, that brand companies have failed to fully grasp its significance. They have consequently failed to identify and address some of the risks that have come with the

benefits. Both advantages and constraints in the evolving value chain should be fully recognized and addressed.

Brand companies that utilize their manufacturers for functions beyond manufacturing invariably face a new reliance on the supplier and may fail to clearly delineate responsibilities. Delineation of responsibilities was easier in the narrower, simpler sole-function manufacturer model. The increasing reliance of brand companies on their manufacturer has created new constraints; some are rather obvious and others less so, as customers find it more difficult to obtain the most competitive best “total cost” pricing when they are married to the same supplier for the manufacturing development and other deep supply chain functions.

The reality is that some of the most capable development suppliers do not offer the best manufacturing costs—in essence, because of their customer’s heavy reliance on their resources, have enabled them to move their pricing model from the traditional OEM “cost-plus” model to a “value-based” pricing model. Indeed, from a business model perspective, this is often precisely the objective of the manufacturer;

while there is absolutely nothing wrong with this objective, the danger is that a brand company may find itself utilizing the model, but without the appropriate safeguards to maintain a proper level of control over its product destiny.

What is required by the responsible brand company is a clear cooperation framework that allows the company to benefit from the manufacturer's value-added services, but not at the expense of important customer protections. This article will explore key supplier responsibilities in a product development and manufacturing relationship and how advanced purchasing mechanisms incorporated into the sourcing agreements can help to mitigate and manage the inherent risks.

An Up-Close Look at the Responsibilities

The first step for responsible supplier engagement is for the product company to perform appropriate pre-contracting due diligence into the potential manufacturer's ownership, financial stability, quality and engineering systems, manufacturing and commercial abilities.

After establishing supplier capability and viability, next there are many supplier responsibilities that must be considered in a manufacturing and development services contract. As the role of manufacturers expands into what is, effectively, service provision, the classic issues faced in services outsourcings arise. Key among these issues are defined scope and deliverables, pricing and productivity, lead times and service levels (including quality) and product development. A brand company's failure to properly manage any of these areas in the sourcing relationship can, and has, proved costly later in the engagement.

We will look at each of these key areas of responsibility in turn and discuss how companies should manage them through effective contracting. Brand companies can and should leverage heavily from the accumulated learning of services outsourcing over the past 20 years, as the business model for outsourcing has evolved to provide sophisticated customer protections through the contract, nuanced in some cases to account for the product environment in which these issues arise.

Product Pricing and Productivity

Product pricing and productivity means the ability of a manufacturer to offer, maintain and improve the best total price over the course of the product life cycle in light of challenges from material, labor and currency markets. Best total price does not mean necessarily the lowest purchase price to the customer from the manufacturer, but the best final net cost to customer through the end of the product life cycle—taking into account the costs of product returns and warranty costs borne by the company to end-consumers.

Best total cost can only be achieved when supported by confidentiality, sharing of best practices and transparency as critical elements of the relationship. Sourcing agreements for manufacture often require that the parties work from a "cost plus" basis using an itemized Bill of Material (BOM) for products. To support accurate, full information-sharing between the parties, sourcing agreements should have bilateral confidentiality provisions.

Manufacturer that only purchase commodity materials from spot markets when they receive an order will always be vulnerable to commodity fluctuations and will have little ability to maintain stable pricing for their customers in volatile markets. One method supporting lower commodity costs by assuring production levels is to include a contractual customer commitment to purchase a carefully defined portion of forecasted volume of products. This commitment allows a supplier to purchase input commodities at troughs in the market throughout the commitment period.

Pricing provisions within manufacturing contracts should require that the manufacturer make transparent to the customer the actual prices paid for input commodities. With such accurate information, the weighted-average price of a product commodity can form the basis of a commodity-management mechanism in the contract. This type of commodity-management mechanism introduces a regular review rhythm to the parties and requires that they share commodity price increases or decreases on a scheduled basis. The advantage of such a mechanism is that it removes the emotion, risk and impact of constant requests for price

increases and reduces the threat of the manufacturer stopping product shipment due to financial constraints. Furthermore, such mechanisms can capture decreases in the commodity market and align the interests of both manufacturer and customer.

Productivity improvement means net reduction in standard cost for a product. Ideally this measure is based on year on year reductions. In the face of constantly rising commodity and labor costs, manufacturers should be required to find ways to reduce costs through process improvement (waste elimination exercises such as Kaizen¹) and tasked with suggesting ways to improve costs through changes to the product specification. Sourcing contracts should align the interests of both customer and manufacturer through shared savings from provisions that govern such tools at value-added engineering (VAE), use of customer commodity contracts and collaborative Kaizen activities.

Lead Times and Service Levels

A manufacturer's lead time is the time required for the manufacturer to deliver products from receipt of a customer's order. Shortened lead times allow the customer to lower their inventory levels, offer faster response times to the companies' customers and be more responsive to "drop in" sales opportunities. Manufacturer lead times are typically dictated by production line availability and the amount of time it take in all the necessary in all component materials.

Services level refers to metrics for the measure of performance, such as the percentage of product delivered to the customer (or their carrier) on the agreed purchase order delivery date. This ability to measure performance is very important when the customer faces a "back-to-back" purchase order from their end-client that include a narrow shipping window and potential late delivery penalties.

Manufacturer delivery key responsibilities can be dramatically improved through use of tools such as "ship-to-stock" rather than "ship-to-order" production and inventory systems. Under the "ship-to-stock" system, the manufacturer maintains pre-agreed levels of inventory for certain products at all times. These provisions give the manufacturer the freedom to build product when labor is underutilized—thus avoiding

overtime costs for workers during peak periods—and deliver product to the customer the day after receiving the purchase order at potentially much lower cost. Contractual provisions providing these mechanisms must be carefully developed in advance and built up over time as the customer and manufacturer get to know one another and product life cycle-related volumes are taken into account.

If ship-to-stock provisions are not practicable, alternative contractual assurances such as liquidated damages clauses for late delivery and "service level" credits for early delivery on demand may provide important customer protections to assure service performance. Leveraging a wide range of service level practices and techniques borrowed from service outsourcings can provide effective management tools for the manufacturing relationship.

Product Quality

Product quality measures the extent to which products that are delivered to the customer according to pre-agreed product specifications. With the close integration of the manufacturer in the product development process, responsibility for materials, workmanship and design can be become blurred. It is important that sourcing agreements take into account these three key drivers of total product quality and assign responsibility for each of them.

Effective agreements must provide an effective specification modification process (Engineering Change Notice or ECN). In the event that a product is found to be defective, either in the warehouse or during distribution (even halfway around the world from the place of manufacture), the customer should maintain a range of quick and efficient options that include both personnel and financial backing from the manufacturer. Product-quality provisions should set thresholds for acceptable returns and epidemic fault and provide solutions for those products that are found to be defective in the field.

Finally, product liability insurance and appropriate indemnity obligations can serve as important tools to give the customer needed protections, especially on a back-to-back basis for market liabilities connected to product quality.

Product Development

It is extremely important to operate on the assumption that all work done in collaboration with a supplier is valuable—not only product designs and patents, but concepts and all supporting work. The customer should use the sourcing contract to carefully detail ownership of the actual work done and all derivative works in the future.

Many (if not most) manufacturers service multiple product markets and customers. The customer's prospects in a future market may often be hurt from potential competitor's unauthorized use of the collaborative work. Further, many Chinese manufacturers aspire to sell products at home and in overseas markets. In some cases, work for a particular project may stop because the economics of the project failed for the intended market, yet there is potential for the work to have "second life" later for another market or customer.

Development provisions in sourcing agreements should work to align the manufacturer's activities with the customer's own internal development process. There should be regular reviews within the project to assess all protectable work. Sourcing agreements should carefully describe rights (if any) to derivative works that result from collaboration.

Finally, if a manufacturer will retain title to manufacturing tooling (or other assets) that incorporate any customer or jointly owned intellectual property, the customer should be sure to license that intellectual property to the manufacturer for use during the period of their cooperation only. Customers should be able to maintain control of their intellectual property through a revocation of that license at the end of the product's life cycle to prevent use of the tooling for other customers.

Conclusion

The new manufacturing and development sourcing model brings with it a variety of competitive advantages for the customer as well as a host of challenges that arise during and after the product production cycle has concluded. Companies that hope to effectively address the challenges need to proactively arrange for and manage these issues through their sourcing framework. Companies should be mindful of the shifts that have taken place in their value chains and stay alert to accommodate further advances in their sourcing relationships. ♦

Endnotes

- ¹ Kaizen is a quality improvement program from Japan that focuses on continuous improvement and waste elimination.

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