FOREIGN SOURCING OF PRODUCTION

KEY ISSUES FOR CONSIDERATION BEFORE SOURCING PRODUCTION ABROAD

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Increasingly in recent years, American manufacturers have looked abroad for the manufacturing of goods to be distributed in the U.S. or for parts to be used in goods to be assembled in the United States, and the recent turmoil in international currency and financial markets is not likely to change the trend.[1] There is nothing new about manufacturers outsourcing part or all of the manufacturing process, however, given the increasing tendency to outsource all or part of the manufacturing process, there are some twists and turns which American companies should be aware of when sourcing from foreign countries. This two-part article will discuss some of the principal issues which arise in any outsourcing from either foreign or domestic sources with specific emphasis on key issues involved in using foreign manufacturers to produce goods for import into the U.S.

Part one of this article will review term and pricing issues, product warranties and products liability insurance, and trade name issues. Part two of this article will address contract enforcement, use of letters of credit and other matters.

Although many of the points may be relevant even if the vendor or supplier is a domestic American company, for purposes of this article, it will be assumed that the ultimate seller is the

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[1] For a discussion of the scope and nature of this trend in China, see James Fallow's excellent article in the July/August 2007 edition of TheAtlantic Monthly, "China Makes, the World Takes".

American company and the vendor or supplier is a foreign company. To put things in perspective, we will point out how certain issues are often addressed in dealing with China.

Costs of Tooling, Duration of Agreement and Pricing. There is usually a tension between the distributor and the vendor as to who bears the initial costs of product development. Product development requires collaboration on the design of the product and the cost of making dies and tools and other machinery to manufacture the part or product in question. The supplier does not wish to invest significant amounts in tooling without some guaranty of return on its investment. The supplier might think this would generally mean that a commitment of several years duration to purchase goods is essential if it is to bear the cost of tooling and otherwise gear up for production. The distributor however may not wish to tie itself to a particular manufacturer if for any reason the product does not sell well in its market. The parties will often agree upon some type of multi-year contract to guarantee that the endeavor is worthwhile for the foreign manufacturer, and agree to some kind of reimbursement of the tooling costs, often a sliding scale, if the agreement does not continue for a certain period of time. Alternatively, the distributor may simply advance all tooling costs at the beginning of the relationship.

If the parties agree to a multi-year contract pricing issues arise. Manufacturing costs are sensitive to material prices and labor rates. It is difficult to craft a formula which will govern the pricing changes from year to year. The parties are often left in the situation where the foreign manufacturer can propose a price change at the end of the year, but the American buyer can reject the price and terminate the contract, which in effect makes the agreement a short-term contract. Therefore, unless the distributor has advanced the tooling costs, some provision for reimbursement of the tooling costs may still be necessary. This issue can arise between domestic companies as well as with foreign manufacturers.

In any event, it is necessary to provide in the supply agreement that, if the American manufacturer pays for the tooling, the tools and fixtures are the property of the American manufacturer and the supplier has the obligation to return the tools and fixtures to the American manufacturer agreement upon termination.

Products Liability and Insurance. The issue of products liability will be important, particularly in those instances where the foreign manufacturer will be producing the entire article to be distributed in the United States. The American distributor will want the risks of injuries to persons or property resulting from use of the product be borne by the foreign manufacturer (or its insurer). The American distributor will also want to be named as an additional insured on the manufacturer's policies. It will also request that the policy provide primary non-contributory coverage. Our experience has been that foreign carriers from jurisdictions where larger recoveries are a rarity may have broader exceptions to coverage than typical American policies.[2]

Ideally, the foreign manufacturer will use an American insurance company for products liability. However, in some countries it may be difficult to shift the burden of obtaining such insurance to the foreign company. For example, in China it is rare for a manufacturer to purchase product liability insurance with foreign coverage and it is even more rare that such insurance is purchased from a foreign insurance company. Many small to medium sized Chinese manufacturers are very likely not to provide any product liability insurance. In such instances, the American company should take the insurance cost into consideration when negotiating price. Many Chinese manufacturers understand the product liability and its significance in countries like the US. However, they usually do not have the knowledge to choose and negotiate a proper and adequate insurance policy, in particular, if it is a foreign policy or with a foreign insurance

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[2] The difficulty in finding foreign manufacturers to sue makes the American wholesaler or importer a preferred target for plaintiff's lawyers. See "Liability Lawyers Struggle to Pierce the Chinese Curtain" by Xiyun Yang, *Washington Post*-July 28, 2007 issue.

company. They would rather have the foreign company purchase necessary insurance and lower the price accordingly if they believe the insurance cost is reasonable.

If the foreign company provides "claims made" coverage, it is important to require that the foreign manufacturer to maintain adequate "tail" coverage, which will continue coverage for a period of time after the termination of the relationship. Since claims could arise after termination of the relationship, the tail coverage can be critical, regardless of who buys the insurance.

If the foreign company obtains the insurance, there should be a provision for a certificate or evidence of insurance to be issued with a requirement of notice of any material change, cancellation of non-renewal to American company. The American company should have the policy reviewed by its own insurance broker.

Product Warranties. While insurance can be used to insulate the American company from liability for personal injury, the warranty that will be delivered by the foreign manufacturer is the key element in terms of dealing with customer claims of defective product. Such claims are not covered by products liability insurance and the American company must look to the vendor's warranty for protection. Often times, the foreign manufacturer will be reluctant to give a warranty for problems resulting from a design defect because the design will have been developed by the American manufacturer either alone or in collaboration with the foreign manufacturer. This may be fair, but the foreign manufacturer should warrant workmanship and materials in any event. Of course, the longer the warranty the better, but at a minimum the warranty should last for a reasonable period of time after the product is sold at retail.

The American manufacturer may give its own warranty if the foreign goods are being incorporated into the final product. In that case, the American manufacturer may want to attempt to limit its liability by disclaiming any warranty as to parts manufactured by others.

Various warranty issues also need to be addressed. For example, who pays for shipping when products need to be returned to the American manufacturer or in some cases the foreign supplier for repair? We attempt to have the warranty cover the losses or potential losses of the buyer including extra cost of buying substitute products, repairing or replacement cost, return cost, cost for recall or disposal of the products, default liability to the customers of the buyer, anticipated loss of profits and expenses of pursuing the supplier. The supply agreement should also clarify that the vendor's liability for the warranty claims involving product delivered prior to the date of termination will not be affected by termination of the agreement.

The American manufacturer will want considerable discretion in dealing with its customers in resolving disputes. There is a tension here, however, and undoubtedly the parties will need to work together when problems arise. This underscores the need to perform thorough due diligence on the supplier to assure one is dealing with a company with a good track record and reputation in dealing with its customer's problems.

Currency Fluctuation Risk. In order to avoid the risk of currency fluctuation, the American manufacturer will want payment to be made in U.S. dollars. This may or may not be agreeable to the foreign manufacturer, and if the transaction is large enough, hedging may be advisable if the purchase price is going to be denominated in a foreign currency.

Trade Names. Often the agreement will provide that the foreign manufacturer will apply the name and logo of the American company to the product. The contract should specify that the rights of the foreign manufacturer to use the name and logo are strictly limited for that purpose

and may not be used in production or sale of any other goods. It is also important to register the trademark in the home jurisdiction of the supplier.

Intellectual Property Issues; Indemnity and Exclusivity. To the extent that the intellectual property is owned by the foreign manufacturer, a warranty or indemnification against third party claims should be obtained. It may also be important to provide that the design or technology will not be used in the manufacture of goods for other customers at least for a period of several years. If the design and/or technology is of high importance and patentable, the foreign company may also want to patent it in the supplier's home jurisdiction.

Personal Jurisdiction. Even with a solid warranty from the foreign manufacturer, the enforcement issues are problematic. Hopefully, the incentives to operate as a reasonable business person and live up to one's obligations will take care of most problems. If legal proceedings become necessary, however, the Hague Convention can be useful in terms of foreign service of process and taking evidence abroad. Unfortunately, not all countries including some key countries like India are parties to the Convention. It therefore may be necessary to litigate in a foreign jurisdiction in order to obtain personal jurisdiction over the foreign manufacturer. Travel expenses and bias in favor of the foreign manufacturer are among the problems with litigating abroad. If possible, the contract should provide for an agent located in the U.S. to be appointed for service of process on the foreign company to facilitate proceeding in the American courts if litigation is required.

Arbitration. We would generally advise our clients to choose arbitration instead of litigation. Many international arbitration forums are available and arbitration may therefore be a preferred method of resolving disputes. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (also known as the New York Convention) is used by many parties to

settle their disputes. Many foreign companies are not comfortable litigating in China, for instance, because of the unsophisticated legal system and the local protectionism. In addition to personal jurisdiction issues, enforcement of a foreign court order in the supplier's home jurisdiction is often times impractically impossible. Very few suppliers have enforceable assets abroad and usually a foreign court order is not recognizable in the supplier's home jurisdiction. Our experience also tells us that few foreign manufacturers agree to arbitration in a western jurisdiction. When a Chinese company is involved, international arbitration in places such as Hong Kong or Singapore is more acceptable. Another popular choice for arbitration in China is the China International Economic and Trade Arbitration Commission ("CIETAC"). CIETAC is a well-established international arbitration tribunal with three branches in China covering major economic centers. One of the advantages of choosing CIETAC is higher efficiency in terms of injunctive reliefs and attachment of assets against the supplier in China. At the time of contracting, it may be advisable to see if the country in question has a similar institution in place to provide arbitration services.

Venue and Forum Clauses. If the contract does not provide for binding arbitration, although it may not solve all of these problems relating to enforcing a judgment against a vendor with no assets in the U.S., the American company would be well advised to obtain the vendor's agreement that all actions will be filed and decided in a U.S. Court.

Judgments. Obtaining personal jurisdiction is only the first step in the process of a legal proceeding. The Hague Convention does not deal with judgments or provide a mechanism for enforcement. Enforcement of an American judgment abroad will depend upon the laws of the foreign country. Before entering into a transaction with a foreign entity, the American company should determine whether the foreign manufacturer has assets in the U.S. which could be

attached. If the foreign company has no assets in the U.S. to attach, it will be necessary to enforce the judgment abroad. Contacting local counsel in advance of the initiation of the proceedings in the foreign country is essential to determine what standards must be met to create an enforceable judgment which can then be transferred to the other nation. In some cases, the fact that the supplier does not have assets in the U.S. or that there is a difficulty in enforcing or obtaining judgments in the foreign country against its own residents may be reasons to reconsider outsourcing to the foreign country. In our experience, most American companies are willing to take this risk. Again, an agreement to arbitrate may ameliorate some of the risk.

Twist with Domestic Importers. The involvement of American importers acting on behalf of the foreign manufacturers raises special issues. The foreign manufacturer may have granted exclusive import rights to the importer in question. Questions arise as to how the funds will flow. In such cases, the supply contract may be between the American manufacturer/distributor and the domestic importer. As in foreign transactions, letters of credit are often a useful device. In particular, where there is an intervening American importer involved, a transferable letter of credit may be a good solution. With a transferable LC, the importer feels secure about getting paid but does not have to divulge to the American distributor the extent of its mark-up over the price charged by the foreign manufacturer. After collecting its mark-up, the importer can assign the letter of credit in part to the foreign manufacture to assure payment to the foreign firm. The following is a sample clause for use of a letter of credit to pay for goods shipped from abroad:

> All payments owing to either party under this Agreement shall be made by check or federal funds wire transfer in United States Dollars. Prior to the beginning of each calendar quarter, Domestco will furnish Importco with an irrevocable,

transferable documentary letter of credit from American Bank in the form attached hereto as Exhibit A ("Letter of Credit"), which may be amended from quarter to quarter in accordance with its terms, in favor of Importco in an amount equal to the Purchase Price of the estimated volume of Products to be purchased by Domestco for the ensuing quarter, the payment of drafts drawn under such Letter of Credit to be conditioned upon, among other things, the presentation of the following documents: (i) a full set of multimodal transport bills of lading consigned to the order of the shipper, endorsed in blank, marked freight prepaid and marked to require the notification of Importco and Domestco ("Bill of Lading") and (ii) a marine cargo insurance policy or certificate of insurance in negotiable form for at least 100% of the CIP commercial invoice value, endorsed in blank and covering the following risks: all risks from warehouse to warehouse (including riots and civil commotions), war risks and strikes. Importco and Domestco shall be listed as assureds therein. All payments made for Products hereunder shall consist of draws upon the Letter of Credit.

Foreign Tax Issues. The tax rules in the foreign jurisdiction may impact the price a foreign exporter is willing to accept for its product. The agreement usually provides that the parties will be responsible for their own taxes and fees payable under applicable laws and regulations. However, in some cases, the change of tax law in a foreign jurisdiction may have an impact on the outsourcing contract between a foreign supplier and a U.S. company. For instance, exporters in China can obtain a tax rebate from the Chinese tax authority for their export products. In the last few years, the Chinese tax authority has greatly reduced the tax rebate rate for Chinese exporters, and for some industries, the tax rebate has been completely

withdrawn. This in general will increase the cost of the Chinese exporters and many of them have requested a re-negotiation for the price of their products. To be in a better negotiating position, the U.S. manufacturers should assess the actual impact of the lower tax rebate rate on the actual cost of the Chinese manufacturers. Some exporters who request re-negotiation of price may not be qualified for a tax rebate at all as the Chinese export tax rebate system has many qualifications on the exporter.

Risks of Loss. It is important to make sure that risks of loss issues are adequately covered. The key here is to make sure the proper insurance is in place particularly if the goods are deemed delivered at the point of the foreign source, rather than at the American manufacturer's plant. This can be covered in the letter of credit provision discussed above.

Competition. The contract should also set forth any restrictions on the foreign manufacturer's ability to produce similar goods for others even if the design belongs to the American company. Depending on the American company's leverage, it may not be possible to prohibit the foreign manufacturer from making similar products altogether; however, the American manufacturer should at least obtain an agreement not to use the tooling developed for the American manufacturer's product. Provisions should be made for return of the tooling to the American manufacturer in any event at the termination of the Agreement if the tooling has been paid for.

Handling of Goods. Other issues which need to be addressed include who will arrange for shipping and procurement of insurance, and how the expenses of processing goods through customs will be allocated. If the goods will be stored in a location not owned by the American manufacturer, the American company should make sure that the warehouse is properly bonded.

Governing Law. If both countries are signatories to the Convention on the International Sale of Goods (CISG), the Convention will apply unless the parties expressly opt out. Whether or not to opt out requires careful consideration. If the parties decide to opt out of CISG, if possible, the contract should provide that the law of one of the 50 states will govern interpretation and enforcement of the contract. The governing law problem should be considered in conjunction with the dispute resolution mechanism as discussed above.

Conclusion. Although there are many other issues which may arise in connection with negotiating a contract with a foreign manufacturer for importing goods for distribution in the United States, the foregoing summary highlights some of the major business issues which need to be addressed and carefully considered before embarking on such a venture.

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