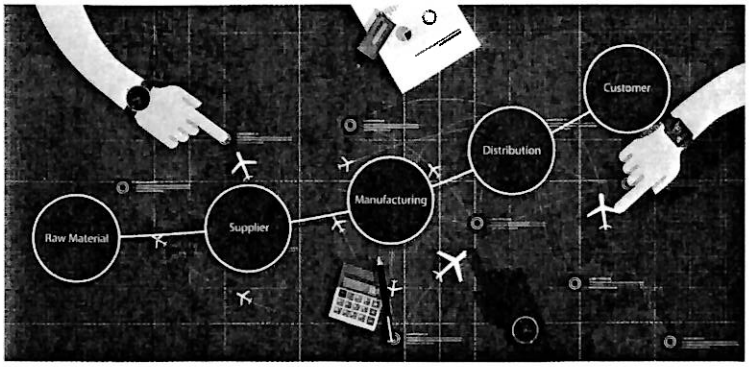
Five Steps to Better Supply Agreements



by H. Alan Rothenbuecher, partner, Benesch, Friedlander, Coplan & Aronoff LLP

Supply agreements serve as the lifeblood of many manufacturing companies. These agreements outline the terms and conditions controlling the supply of goods and services between various parties. Without this framework, many businesses could not meet the pressing demands of the modern-day marketplace.

With so much riding on these agreements, savvy business professionals must pay particular attention to agreement terms. Failure to critically think through options and deal terms often leads to lost profits and liability concerns over the life of a supply agreement.

Parties to a supply chain contract can mitigate their risk by following certain best practices. While no provision in a contract should be overlooked, the five areas discussed in this article are the most important for risk management strategies.

1 Critical commercial terms

The first step in drafting any supply chain contract is to ensure that the written document captures all critical commercial terms of the parties' agreement. Failure to clearly and concisely document the commercial terms of an agreement is an invitation for future misunderstandings and disputes. Failure to agree on a particular term (with the exception of quantity) is not automatically fatal to a contract.

In the absence of an express agreement between the parties on a particular term in cases involving the sale of goods, the Uniform Commercial Code (UCC) permits courts to "fill in the gaps" by reference to default rules and sources such as the prior course of dealing between the parties and usage in the trade. However, if the lack of agreement between the parties on commercial terms is sufficiently pronounced, a court may find that there never was a meeting of the minds between the parties to form any contract at all.

2 Quantity

The most critical term in any contract for the sale of goods is the quantity term. It defines both the volume that the buyer is committing to purchase and the volume that the seller is committing to supply. To achieve a binding contract for the sale of goods, it is essential that the parties negotiate and document the quantity of goods to be purchased.

A written quantity term is the only term that must appear in a contract for the sale of goods. A written quantity term need not be expressly set forth as a number. It is sufficient that there is a writing, signed by the parties, from which a quantity can be determined, even if doing so requires reference to evidence outside of the document. For example, a quantity term may be expressed as the requirements of the buyer or the output of the seller.

3 Duration and early termination

When parties are negotiating a supply chain agreement that they intend to apply on an ongoing basis, the parties must agree on the duration. Absent an agreed duration, a contract may be terminated by either party upon reasonable notice. A seller who may be making a significant investment of capital and resources to supply a product will want to make every effort to lock in a long-term commitment from the buyer.

Related to the issue of duration, parties must consider the impact of provisions that provide a right of early termination. An early termination provision can have significant financial consequences for both the buyer and seller. A party that thinks it is locking its customer or supplier into a long-term agreement will risk losing the benefits of that agreement if it does not pay close attention to early termination provisions. If the contract includes early termination provisions, the parties should consider addressing in the contract the financial consequences of an early termination. For example, sellers should negotiate for the right to recover unamortized capital expenditures incurred in connection with the agreement.

4 Warranties and disclaimers

Warranties are the promises a seller makes regarding goods or services being provided to the buyer. Supply chain contracts typically include express warranties. In addition to these express warranties, the UCC may supply a number of implied warranties that will be considered part of the contract unless they are disclaimed. The most well-known examples of implied warranties are the implied warranty of fitness for a

page 14 ▶

◀ page 12

particular purpose and the implied warranty of merchantability under the UCC.

When negotiating a supply chain contract, buyers should seek to obtain the broadest warranties possible. On the other hand, sellers should strive to limit the warranties they give. When possible, sellers also should seek to disclaim any implied warranties under the UCC. Any such disclaimer must be conspicuous. A disclaimer buried in the proverbial fine print runs the risk of being held unenforceable.

5 Limitation of remedies and damages

Both buyers and sellers should pay close attention to any limitation on remedies or damages contained within the agreement. Although limitations of damages and limitations of remedies share a common goal – shifting of risk – they are different concepts. A limitation of remedy is a tool, most often used by sellers, to reduce the remedies that a buyer may be entitled to in the event of a breach. The most common example is a provision limiting the buyer's rights to "repair or replacement" of any defective goods. A seller that wants to include such a provision in its contracts should take steps to ensure that it is, in fact, willing and able to stand by its offered remedy. If the remedy is found to have "failed of its essential purpose," it will be deemed unenforceable.

In contrast, a limitation of damages seeks to mitigate risk either by capping the damages that may be awarded for a breach or by eliminating certain categories of damages altogether. Buyers and sellers must carefully consider the risk-shifting implications of limitations of remedies and damages.

Conclusion

The supply chain in the manufacturing industry is fraught with risk. Manufacturers can mitigate risk by following best practices when drafting their supply chain contracts. The areas discussed here are critical for risk management. These areas should be the focus of any company seeking to manage risks. ◆

Building assets and business, and then protecting them from capture by others, is Alan Rothenbuecher's forte. He has developed a particular experience in the plastics industry (in general) and additive manufacturing (in particular), enabling him to assess business trends and needs, and provide services via alternative fee arrangements. His industry experience has led to Rothenbuecher being selected to act as general counsel for and serve on the board of industry trade associations, such as the Manufacturers Association of Plastic Processors and the American Mold Builders Association. For more information, visit www.beneschlaw.com.