Managing Risk in Supply Agreements

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Abstract. One of the key objectives of any supply agreement is to allocate risks between the supplier and the purchaser. Managing risk in supply agreements requires the ability to identify and assess potential risks in the particular arrangement, and to negotiate specific risk allocation provisions to address which party will be responsible for losses arising from such eventualities. Yet, risk allocation provisions can be among the most complex and difficult to negotiate terms in any agreement. The first part of this paper will provide an overview of risk assessment and risk allocation provisions. The second part of this paper will examine ways to manage and mitigate risks in supply agreements.

Identifying Contractual Risks. “Risk” means exposure to potential injury or loss. When we speak of “contractual risk” we mean the potential injury or losses that one or more parties may suffer due to an event or condition arising out of the performance of the agreement. This injury or loss may result from a breach of the agreement by a party (by defective performance, delayed performance or non-performance), a party’s negligence (including a negligent act or a negligent failure to act), an accident, an unforeseen event or condition, or a claim made by some third-party. Risk assessment generally involves three basic questions:

• **What can go wrong?** This will vary depending upon the type of product or service involved, and may include such things as the project being delayed, the product being defective, the software infringing a third party’s intellectual property, a passer-by being injured by a falling object, etc.

• **What are the possible consequences?** Think of the “domino effect” of what might happen if something goes wrong. For example, suppose that you purchase a piece of production equipment that turns out to be defective. In addition to requiring repair of replacement of the equipment, what could happen as a result of the defect? Perhaps the equipment may fail during the production of a batch of some product, causing the loss of labor and materials. Your production line may be down for an extended period due to this defect, causing your company to lose sales of products. Maybe the defect can cause an electrical short that starts a fire, resulting in damage to other equipment and to your facility. Suppose that the fire also causes damage to your neighbor’s property. Suppose that someone is injured as well. As you can see, the potential injuries and losses may extend far beyond cost to repair the defective equipment itself.

• **What is the probability of occurrence?** The greater the likelihood that an event may occur, the more important it is for the parties to address the risk. However, be cautious not to ignore events that have a low probability of occurring, because often these are the more catastrophic events. Although these events may not occur very often, if and when they do occur, the losses can be substantial.
Allocating Contractual Risks. Once you understand the risks involved on your particular arrangement, you need a strategy for negotiating the allocation of the risks between the parties to the agreement. In theory, one would think that reasonableness and fairness dictate that whoever is responsible for the injury should bear the risk for all of the resulting losses. In practice, however, this is often not the case. Each party wants to minimize its risk so as to maximize the value of the transaction and, as a result, risk allocation provisions are usually heavily negotiated. Many factors are involved in determining which party is responsible for the various risks, including:

- **Whose acts or failure to act cause the loss or injury?** Generally, the party at fault should be responsible for injuries it causes. However, some of the factors that follow may override this general principle.

- **Is one party relying upon the other to control/mitigate the risk?** For example, the purchaser typically looks to the supplier to assure the quality of its own incoming materials and components, and relies upon the supplier to assure that non-conforming or defective materials do not make their way into the finished product.

- **Who is in best position to control/mitigate the risk?** For example, a construction contractor is in a better position than the owner to control the risk of accidents at the jobsite, since the contractor is generally responsible for directing and controlling construction and jobsite safety activities.

- **Who is in the best position to insure against the risk?** For example, the supplier is generally in a better position to insure against losses arising out of its performance of the agreement. However, the property owner will typically carry all-risk/builder’s risk insurance covering damage to the property under construction, and may at times accept responsibility for damage to the building that arises out of the contractor’s performance.

- **What is the customary industry practice?** Some industries have well-established practices regarding risk allocation, and it is often difficult to negotiate for something different than what is generally accepted in the industry. For example, you would likely be hard pressed to get a software licensor to accept the risk for a licensee’s consequential losses due to a system crash.

- **Who has the bargaining power?** Negotiating leverage plays a key role in the negotiation of most contract provisions, and it certainly weighs heavily in risk allocation. Often, as the saying goes, you get what you can negotiate, and reasonableness and fairness go by the wayside.

Risk Allocation Provisions. A number of contract provisions can affect the allocation of risk among the parties to an agreement. Thus, it is important to carefully negotiate all of the provisions of the agreement in order to have a complete picture of the allocation of risk. However, the following provisions are the most commonly used contractual risk transfer provisions:
**Warranties.** A warranty regarding goods or services is a promise or assurance from the supplier regarding the quality or condition of the goods or services to be provided. In the USA, warranties for the sale of goods are governed by the applicable State’s version of UCC Article 2, and warranties for services are governed by the common law of the applicable State. There are two basic categories of warranties: (1) Express Warranties (warranties expressly agreed to by the parties in their agreement); and (2) Implied (or Statutory) Warranties (warranties that automatically become part of the agreement by law unless “disclaimed” - or excluded - by express language in the agreement). Implied warranties for goods include the following:

- Merchantability (UCC §2-314);
- Fitness for a particular purpose (UCC §2-315);
- Freedom from encumbrances (§2-312(1)(b));
- Non-Infringement (UCC §2-312(3)); and
- Good title (UCC §2-312(1)(a))

It may seem unusual to think of a warranty provision as a risk allocation provision, but warranty provisions may serve to transfer risk in a number of ways. First, by not including the appropriate warranties in the agreement, the risk of non-conforming or defective products or services may be shifted from the supplier to the purchaser. Second, the supplier is likely to negotiate to include a disclaimer of certain implied warranties. This effectively transfers the applicable risk to the purchaser. Third, often as a result of the negotiations, warranty provisions may become complex. Language may be added that serves to limit the warranties or to provide limited remedies for breach of the warranties. This also serves to transfer some of the applicable risk to the purchaser. Be wary of the following warranty “gotchas” that transfer risk from the supplier to the purchaser:

- Warranty disclaimers
- Limited warranties
- Limited warranty durations
- Warranty periods “disguised” as notice periods (e.g., the product is warranted to be free from defects provided that the purchaser provides the supplier with notice of the defect within thirty days of delivery – this is only a thirty day warranty)
- Warranty provisions that provide exclusive remedy for breach of warranty (e.g., liability for breach of warranty limited to repair or replacement)

**Indemnification.** The indemnification provision is one of the key risk allocation provisions in any agreement. Indemnification refers to the shifting of risk of financial loss to the party who is primarily responsible for that loss. Indemnification provisions typically require the indemnifying party to hold the indemnified party harmless from losses (including court costs and attorneys fees) arising out of certain specified events. To “indemnify” or “hold harmless” means that the indemnifying party must reimburse the indemnified party for the specified loss. Indemnification provisions typically also require the indemnifying party to defend claims brought by a third party against the indemnified party. For example, suppose the supplier indemnifies the purchaser in the event that the goods sold infringe the patent of any third party. Patent law prohibits anyone from making, selling or using infringing products. Thus, a third party prohibits anyone from using the infringing products. Therefore, a third party with a claim of infringement can bring a suit against the purchaser as well as against the supplier, and the purchaser may be held liable to the third party. An appropriate indemnity provision will require the supplier to defend the lawsuit against the purchaser (including paying legal defense fees and court costs), and to
pay any damages assessed against the purchaser. Typically the indemnified party has the right to participate in the defense, at that party’s own expense. Also, the indemnified party typically is required to provide prompt notice of claims and to provide reasonable assistance in the defense. The events for which the supplier will indemnify the purchaser will vary depending upon the nature and scope of the agreement. Some common indemnities include:

- Seller’s breaches of representations, warranties and covenants
- Negligence or willful misconduct of seller
- Seller’s failure to comply with applicable laws and regulations
- Infringement of the intellectual property of a third party
- Personal injury or property damage caused by seller
- Claims against the purchaser by seller’s employees and subcontractors

Many States will not enforce an indemnity provision which provides indemnification of a party for losses arising from that party’s sole negligence. Therefore, it is important to draft the provision appropriately or a court may disqualify the entire provision. Be wary of the following indemnity “gotchas:”

- Conditions to indemnity obligations (e.g., notice of claim must be provided within in X days for indemnity to apply)
- Limiting indemnity obligations to a specified duration
- Limited indemnities (or indemnities based on limited warranties)
- Limiting indemnity obligation to circumstances where seller is solely responsible (rather than to the extent seller is responsible)
- Subjecting indemnity obligations to a dollar cap on liability
- Inappropriate reciprocal indemnities

• Limitations on Liabilities. A “remedy” is a means to redress an injury, and “damages” are a remedy in the form of a sum of money awarded as compensation for injury caused by a breach of contract. Damages are intended to put the injured party in the position the party would have been in if the contract had been performed. There are two general categories of damages: (1) direct (or general) damages (those damages directly referable to the breach, such as the cost to repair a defective good); and (2) special (incidental and consequential) damages. Incidental damages include costs to handle, store and ship damaged goods back to the supplier. Consequential damages are damages caused by the breach which are not a necessary result of the breach. The most common form of consequential damages is the purchaser’s lost profits on sales lost due to the supplier’s failure to deliver the goods.

Limitation on liability provisions place limits on the damages that are recoverable in the event of a breach by a party to a contract in two ways: (1) by limiting the types of damages that are recoverable by the non-breaching party (typically by excluding special/consequential damages from the agreement); and (2) by placing limitations on the amount of damages that recoverable by the non-breaching party. Liability limitations may also be found in many other provisions in the agreement, such as in the exclusive remedy provisions mentioned above or in a liquidated damages provision. “Liquidated damages” are damages for a specified breach that are agreed to by the parties in advance. They are not a “penalty” and, if liquidated damages are specified in the agreement, then those damages will be the only damages recoverable in the event of the specified breach.
In circumstances where you agree to limitations on liability, it is common to include certain carve outs (exceptions) to the limitations (i.e., circumstances when the limitations do not apply and there is no limit on liability). Some common carve-outs include:
- Obligations to indemnify for third party claims
- Damages caused by gross negligence or willful misconduct
- Breaches of confidentiality obligations
- Personal injury and property damage

Finally, be wary of the following liability limitation “gotchas:”
- Exclusive remedy provisions
- Caps on liability based on purchase price
- Limiting liability to insurance proceeds
- Liability limitations that extend to third-parties
- Not including appropriate carve-outs

**Insurance.** The insurance provision assures that there will be sufficient financial resources to back the supplier’s indemnities. You should assure that the insurance coverage types and amounts are sufficient to cover the potential risks in the particular agreement. It is common to require the supplier to provide a certificate of insurance naming the purchaser as an “additional insured” which will enable the purchaser to make a claim directly with the insurance company. You should also require the supplier to keep certificates current. The certificate should specify that the insurance company will notify the purchaser of any changes in coverage or the cancellation or expiration of coverage.

**Risk Mitigation Provisions.** A number of contract provisions can be used to provide the means to mitigate risk. Rather than transferring risk, these provisions require the parties to take certain actions to minimize losses in the event of a certain event. Following are some examples of this type of provision:

**Transitional Support.** This provision requires the supplier to assist in the transition to an alternate source in the event that the supplier fails to perform under the agreement. It is important to define what is meant by “failure to perform” and to define the level of support that must be provided, which may include transferring know-how, providing technical assistance, transferring materials, etc.

**Business Continuity.** This provision requires the supplier to have a business continuity plan in place in order to recover quickly from a disaster such as the loss of a plant.

**Conclusion.** Every transaction involves risk, but with the appropriate negotiation of risk allocation provisions, the purchaser can assure that the supplier assumes the appropriate level of the potential risk. In addition, appropriate use of risk mitigation provisions can help to minimize the potential risk to the extent practical.