A growing number of manufacturers over the past decade have elected to produce or source their products, components, and raw materials in low cost regions. While the economic advantages of such a strategy can be obvious, the risks must be carefully evaluated and managed. Issues with foreign suppliers can lead to large losses and damage cash flow, working capital, and brand reputation.

Although market conditions are currently highly favorable, insurance carriers are more focused than ever on underwriting profit. Recent well publicized losses have also highlighted the dangers associated with foreign supply chains and underwriters are closely scrutinizing and pricing for the adequacy of the controls around the exposure.

There is nothing new about manufacturers outsourcing part of the manufacturing process; however, there are some unique issues which companies should be aware of when sourcing from foreign countries.
1. Contractual Language

Many companies rely on their standard contract language to ensure foreign suppliers meet certain standards, assume liability, and provide acceptable levels of insurance. Ultimately, however, such efforts can fall short as contractual protections outside the US are not always well enforced. Furthermore, even if the supplier has provided evidence of local liability insurance coverage, it may be difficult if not impossible to actually collect after a loss. Companies who have attempted to bring suit for defective products in China, for example, generally find it is both ineffective and cost prohibitive. The local politics and inconsistent application of law frequently present a high bar to recovery.

2. Supplier Qualification Practices

During the supplier qualification process, many companies fail to perform investigations of their potential suppliers to verify their performance records. For example, a US company should begin by reviewing any information available from the US and foreign regulatory bodies with authority over the supplier. Rigorous inquiry should also be made of the use of subcontractors, manufacturing practices, adverse-event reporting, and other mandated procedures. Frequent in-person inspections are needed to ensure ongoing compliance.

3. “Last Man Standing”

Ultimately, companies may be held responsible for any products liability claims which arise from goods provided by foreign suppliers. When a product causes injury, all members of the product’s supply chain are subject to being named in the lawsuit brought by the plaintiff. As a practical matter, the importer of the finished product—the company which puts its logo on the product’s packaging—is most likely to be the first party named in the suit. The legal complications involved in suing a foreign company in a US court may allow a foreign member of the supply chain to escape liability altogether.

When a product causes injury, all members of the product’s supply chain are subject to being named in the lawsuit brought by the plaintiff.
4. Quality Control

Despite best intentions, companies can sometimes be surprised to learn their suppliers have enhanced profits by taking shortcuts, substituting material, adding fillers, or using cut-rate subcontractors. The results of such actions can be tragic, resulting in death, injury, and damage to the brand. Even when there is no bodily injury, substandard product and components can often lead to business interruption or increased warranty claims.

5. Supply Chain

Many well-established brand names have been surprised to discover their supply chain is more diverse than anticipated. Behind the scenes subcontracting—without authorization—is routine and can lead to unexpected losses. The recent flooding in Thailand, for example, left many companies without critical components despite supposed controls. Similarly, over-reliance on key suppliers can result in costly delays if one of them goes down. Civil strife, politics, terrorism, and natural disasters can also have an impact.

6. Cash Flow

It usually takes more time to deal with foreign companies than domestic ones. This means cash will go out earlier for advance supplier payments and be tied up for longer periods before overseas buyers pay—especially when the latter demand extended payment terms. This can erode liquidity and working capital. In a worst-case scenario, the supplier may abruptly go out of business. The use of trade credit insurance is becoming more common as companies better understand the risk.
7. Regulations

In recent years, global regulations have impacted international trade in a significant fashion. In both the UK and US, for example, stringent anti-bribery statutes present heightened liability risk for companies, directors, and individuals. A company can quickly find itself in trouble if an employee, subsidiary, agent, or service provider bribes another person, anywhere in the world, to obtain or retain a business advantage.

- Similarly, the US Office of Foreign Assets Control (OFAC) also poses significant challenges to international trade. The economic and trade sanctions administered by OFAC are directed against thousands of charities, entities, persons, and companies considered threats to US national security. It can also extend to trading in or financing the purchase of any materials which may provide economic benefit to such parties.

- Finally, global regulations around property rights, repatriation of cash, taxes and environmental issues continue to change and should be carefully considered.

8. Qualifying Process

Qualifying vendors before ordering anything is a must. Due diligence should include a careful investigation of their technology, products, reliability, solvency, and quality management. Do they perform full, partial, or random testing? Is “close enough” acceptable? What are their record keeping practices? All contracts, warranties, purchase orders, warning labels, instruction manuals, and advertising should be in clear English and reviewed by legal counsel well versed in product liability law. Companies should also look into how business is conducted to ensure that bribery is not part of the accepted local custom. Strong, up to date, and effective anti-bribery policies and systems are critical. Finally, there should be careful research to ensure that any vendor, its officers, directors, beneficial owners or any members of management are not under government sanction or dealing in banned materials.
9. Contracts

There are numerous best practices related to contracts but few more important than establishing the appropriate law and jurisdiction that will apply in the event of a dispute. Companies must clearly understand they are operating in a global marketplace where international treaties, local customs, or court decisions can have a very significant impact on how contracts are interpreted. Where there is doubt about the rules that will apply, the parties cannot be sure of their rights and obligations. A US company may seek to designate New York law or select a US forum for arbitration while vendor may insist on local or international law. For example, the United Nations Convention on Contracts for the International Sale of Goods (CISG) is frequently cited as it has been adopted by the United States and most of its major trading partners, including Germany, China, and Russia. The CISG contains rules governing the making and interpretation of international contracts for the sale of goods. It also provides rules governing obligations and remedies of the parties to such transactions. The CISG provides a statutory authority from which contract provisions are interpreted, fills in gaps in contract language and governs issues not addressed by the contract. While this sounds reasonable, it is important to understand that parties electing to be bound by the CISG may face unexpected challenges. The CISG has very different terms around when a contract becomes binding. It may also contradict and supersede the clear words of a signed written contract by testimony and other evidence showing that the written contract is not consistent with the real agreement between the seller and buyer.

- For this reason, it is important that the parties engage experienced counsel who clearly understands international law and can recommend both the appropriate jurisdiction and global venue for arbitration of disputes. Singapore, for example, is a popular arbitration venue for companies contracting in Asia as the courts have a strong tradition of upholding enforceable contracts and arbitration agreements.

- Regardless of the jurisdiction, clear expectations and rigorous discipline around the contract helps establish expectations for quality controls, post event responsibilities, and indemnification. Requiring that such obligations be backed by US based insurance policies, written to good standard, may also help.
10. Monitor Suppliers

Ongoing review of suppliers is essential for making sure they remain cost-effective over time and continue to meet quality standards, not only for products but also for services such as punctual delivery. US companies should use ongoing audits to verify suppliers continue to meet quality and design specifications.

- An audit program should be risk based—meaning the extent of the risk associated with the product should determine the audit procedures used to keep tabs on its quality and production. If the potential risk for a product is low, then supplier-conducted surveys (i.e., self-audits) may be appropriate. For higher-risk products, US companies will often use independent third parties to evaluate materials, compliance, and risks associated with the product. In some instances, a US company may choose to locate personnel in the supplier’s plant to provide ongoing, independent analysis of their adherence to contractual standards.

11. Assess and Mitigate Risks

Evaluation of erratic/declining quality should be an ongoing process. When a risk increases, corrective action should be taken immediately and documented. Ongoing issues should lead to expanded testing and focused attention. If the problem does not improve or cannot be solved, another supplier should be found to mitigate the risk of loss.
12. Foreign Supplier Liability Insurance

Foreign Supplier Liability Insurance is designed for companies that purchase or distribute completed products or component parts from foreign suppliers. It insures both the company and designated foreign suppliers against product liability claims arising from sale or distribution of foreign sourced or manufactured products. Such insurance can be used to ensure foreign suppliers have a basic, accessible level of insurance and provide a firewall to the company’s own insurance program. It also provides a straightforward mechanism for charging product liability premium directly to the supplier. Organizations with high SIRs or deductibles also avoid getting hit with a product liability loss resulting from a defective product manufactured overseas.

The techniques and practices outlined in this document form the cornerstone of sound risk management with regard to foreign suppliers. While price is always an important consideration, it is clear any potential savings has to be carefully weighed against the risk of loss. The level of protection sought will vary with the degree of risk, and we recommend experienced product liability counsel be closely involved in any foreign supplier negotiations.
Our Mission

To be the worldwide value and service leader in insurance brokerage, employee benefits, and risk management

Our Goal

To be the best place to do business and to work

www.lockton.com