

Need a Manufacturing Facility, but Don't Want to Own One? Try Contract Manufacturing and a Comprehensive Agreement

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Developing and marketing products is your expertise, not owning and operating a manufacturing facility. You want to engage a third-party manufacturer to manufacture your products, freeing you up to pursue the aspects of your business that you do most efficiently. If that is the case, you need a well-drafted written Manufacturing Agreement.

It might surprise some people to find out just how many companies selling their own products do not actually own a manufacturing facility. This is not at all uncommon today,

and is true for both large and small companies and across all industries, including pharmaceutical, food, electronics, biotechnology, automotive parts, and medical supplies. Owning and operating a manufacturing facility requires a company to purchase or lease equipment, raw materials, tooling, and space; and to establish an entire additional level of management, logistical support, and administration. To eliminate these disadvantages, you can rely on third parties, often called "contract manufacturers," to manufacture your products.

A contract manufacturer can manufacture your company's products to your specifications and with your name and label. If your company doesn't own and maintain warehouse and shipping operations, the contract manufacturer can also ship your products directly to your distributors, retailers, or consumers. Negotiating a well-crafted agreement ("Manufacturing Agreement") with the contract manufacturer is important for ensuring that each party clearly understands its rights and obligations, and will help you to avoid the disputes that commonly arise as a result of a poorly defined relationship. It would be impossible to cover in this article every issue to be addressed in a Manufacturing Agreement, but it will highlight a few of the more significant issues that should be covered.

Product Specifications

Unless your contract manufacturer is going to manufacture its own product for you to sell under your name (often referred to as "private labeling"), you will need to establish in the Manufacturing Agreement the product specifications to be used in the manufacture of your products. This is where you will set your expectations regarding the functionality of your product; its quality, appearance, dimensions, design, features, and characteristics; and whether specific components or raw materials will be required. You will provide your contract manufacturer with drawings, schematics, photographs, models, or other demonstrative examples of your product. Your product specifications can also be set out in a separate document that can be incorporated into your Manufacturing Agreement and modified from time to time during the relationship without the need to amend your Manufacturing Agreement itself.

Warranties

Your Manufacturing Agreement should also establish the warranties being provided to you by the contract manufacturer with respect to your product. There are some warranties implied by law, such as the implied warranty of merchantability (i.e., the goods reasonably conform to an ordinary buyer's expectations), the implied warranty of fitness for a particular purpose (i.e., when a purchaser relies on the seller to select the goods to fit a specific request), and the implied warranty of title (i.e., the title to the product is good and the product is delivered free from any security interest or other lien or encumbrance of which the purchaser has no knowledge). These implied warranties may be specifically disclaimed by the contract manufacturer in the Manufacturing Agreement.

However, some common express warranties you might receive from a contract manufacturer include warranties that:

- Your products are manufactured in accordance with the specifications provided by you;
- Your products comply with all applicable laws; and,
- Your products are new, safe, and free from defects in materials, manufacture, and assembly.

Depending on the particular circumstances of your Agreement, these warranties are not unreasonable, particularly if the contract manufacturer is manufacturing a product to your specifications.

Exclusivity/Minimum Purchase Orders

The issue of exclusivity and minimum required purchases is overlooked in many Manufacturing Agreements. It is important that this issue is addressed in your Manufacturing Agreement even if it only involves adding a provision clarifying that the parties are not entering into an exclusive contract or that no minimum orders will be required. A contract manufacturer might be reluctant to invest the time and money necessary to up fit its equipment and facilities and train its employees to manufacture your product if the manufacturer is not assured that you will order all of your needs from it or at least order a minimum quantity of your product. A contract requiring that you order all of your product from the contract manufacturer is referred to as a "requirements" contract. If you agree to a requirements contract, you will not be able to contract with any other manufacturer for your product, even if the other manufacturer offers you a lower cost, a better quality, and better service.

Intellectual Property

One of the more valuable assets that your company may own is its intellectual property portfolio, commonly referred to as its "IP." Your company has spent a great deal of time, effort, and money to develop its IP and it may be necessary for you to provide your IP, or a substantial part of it, to the contract manufacturer in order to manufacture your product. Your Manufacturing Agreement should clarify your ownership of any IP to be used during the manufacturing process.

It also is important to address ownership of any IP that might be created during the contract relationship, including any improvements to your product. Sometimes this new IP is created separately by the contract manufacturer or you. Other times the improvements or new IP might be created jointly by both of you. Your Manufacturing Agreement should clearly define ownership of newly created IP, including improvements to your product. The law that applies to ownership of jointly-developed IP, or to IP created by improvements to another's IP, is complex. It will be worth your time and effort to address these issues when entering into your Manufacturing Agreement.

Liabilities and Disclaimers

When negotiating your Manufacturing Agreement, you should give attention to the negotiation of liability allocations and disclaimers. By relying on another party to manufacture your product, you are giving up some level of control over the manufacturing process.

A defect in your product as a result of a manufacturing error could have a significant negative impact on your company, particularly if someone is injured. Your business also could be damaged if the contract manufacturer fails to comply with its obligations under the Manufacturing Agreement, such as failing to deliver products timely to one of your large retail customers. The Manufacturing Agreement should address who is responsible, and to what extent, for damage to third parties and to each other, including economic or reputational damage.

Your contract manufacturer may desire to disclaim certain liabilities, including liability for damages such as your lost profits, consequential damages, and for punitive damages. These kinds of damages, if not disclaimed, could be significant under certain circumstances. An alternative for you to consider when faced with a contract manufacturer that wants to disclaim liability is to offer to cap the contract manufacturer's potential damages, either to a specified amount or to an amount not exceeding the amount you have paid to the contract manufacturer.

Conclusion

There can be significant advantages to using a contract manufacturer, including lowering the cost of your product; reducing your liabilities; and avoiding the need for you to equip, train, and manage a manufacturing division. The importance of negotiating and preparing a comprehensive Manufacturing Agreement cannot be stressed enough. You sometimes have only one chance to clearly establish the rights and obligations of each party when entering into a manufacturing relationship. Failing to address these issues at the beginning of the relationship may result in a greater likelihood that you will find yourself in a damaging dispute.

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