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Strictly Speaking

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Product Liability Prevention: Contracts 101 for Product Liability Defense Lawyers

by Kenneth Ross

Introduction

The supply chain for many products can be fairly complex, especially products that have many component parts which contain many subcomponent parts. On the manufacturing side, we talk about Tier 1, 2, 3 and sometimes Tier 4 suppliers. On the distribution side, we can have importers, distributors, dealers, manufacturer's representatives and retailers. All of these relationships are governed by implied or express contracts. As a result, contracts can have a significant impact on the liability of all entities in the chain of production and distribution.

Every entity that buys a component, raw material, finished product or service is a buyer and needs to consider what risks it is willing to assume and what obligations it wants to impose on the seller. However, every buyer is also a seller and when they are a seller, they have different interests.

In addition, the buyer and seller in a particular purchase are adverse to each other and there may not be a meeting of the minds as to the duties and obligations involving this purchase/sale. It is hard enough for courts to interpret clear contracts that have been agreed to by both sides. When there is a "battle of the forms" and arguably no clear agreement, it is impossible to absolutely know whose contract governs the purchase. In that situation, the courts have a much more difficult time.

Therefore, the surest way to understand the deal is to have a clear contract that has been signed by both parties. Unfortunately, this is not realistic for many companies and I bet happens infrequently. Either one entity issues a purchase order and the seller just agrees to it, or the seller sends their terms and conditions and the buyer agrees to it by paying the invoice.

This article will discuss the terms and conditions that buyers and sellers should be interested in obtaining and how a contract should be entered into.

Purchasing

Before a manufacturer manufactures its product, it buys raw materials, component parts and subassemblies, usually from entities outside their company. Each of these purchases is governed by some kind of contract. Sometimes the contract is express and signed by both parties. Sometimes it is nonexistent and the law must supply the terms of an implied contract. Sometimes each party to the transaction sends a document with terms and conditions that they think will govern the deal. In all of these situations, a contract is most likely formed and the terms and conditions that result could affect potential liability if the product causes injury, damage or loss.

When a manufacturer buys raw materials, component parts, and services, it wants the strongest warranty from the seller and the least exclusions, limitations and disclaimers. For example, if the manufacturer provides a 1-year warranty with its product, it should buy component parts that have at least a 1-year warranty.

It should try to get the supplier to warrant that the product meets specifications

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and all applicable laws and regulations, agree to repair or replace any defective or non-compliant product, and pay for all costs of recalling or repairing the product, including labor if that is required.

The manufacturer wants to protect itself from a supplier who sells them a component that is defective and causes harm to the ultimate user or requires them to recall the product. One way to do this is to include an indemnification clause in the purchase order where the supplier agrees to indemnify the manufacturer for all product liability costs and consequential damages to the extent that defects in the components caused the injury, damage or loss.

The same philosophy can apply to any purchaser down the chain – a dealer, distributor, retailer, etc. How can they purchase a product and hold the manufacturer responsible for any harm arising from the manufacturer's acts or omissions? They do this usually by having the manufacturer agree to an indemnification agreement. In this case, the dealer wants as broad an indemnification as possible against the manufacturer and the manufacturer wants a narrow one. The goal is to apportion the risk consistent with the desires of the parties. Unfortunately, both parties want something a little different.

For example, a retailer may want to be fully indemnified against product liability. However, the way the provision is written, it may protect the retailer even if they are negligent when selling the product and this negligence causes harm.

Next, the purchaser may ask the seller to name them as an additional insured under the seller's insurance policy so any claim or lawsuit can be sent directly to that company for handling, no questions asked.

So, when the manufacturer or supplier negotiate the purchase of components or a finished product, they need to evaluate their own potential liability and what is a fair apportionment between the parties. This will not always work, especially if the more powerful party wants more than they should get.

Another contentious area involves who pays for recall costs and what costs are reimbursable. If I am an OEM and buy components, I would want to be protected in case a defective component requires me or someone else down the chain to recall the product. And I would want the supplier to pay for all recall costs, including any administrative costs for implementing the recall. The trouble is that most suppliers would balk at such a requirement or could not pay for it if it occurred. So they might agree with it on the assumption that the OEM would never try to get them to pay for it or they can blame someone else if a recall occurs because of a defect.

Sales

The seller of a product or component is on the other side and wants to limit its warranty, disclaim all implied warranties, limit its remedies and disclaim all indirect and consequential damages. It may also want to be indemnified for injury, damage or loss that is caused by someone else down the chain.

So it is almost a mirror image of the purchaser's desires. As a result, it is impossible to accommodate everyone's desires and each side has to negotiate a contract that allocates the level of risk that the parties are willing to accept.

However, there is one other provision that a seller should be interested in obtaining. It is a clause whereby the buyer agrees that the seller's terms and conditions will be passed through and not altered in the buyer's contract with their customer. So, let's say that the seller disclaims all consequential damages and the buyer agrees to it. But then the buyer sells their product to a purchaser and does not obtain a similar agreement by their customer to a disclaimer of consequential damages. Then the product fails. Both the manufacturer and their supplier could be liable for consequential damages even if the component seller's contract had such a provision. This clause has been referred to by some as a "transfer clause." It is important but widely ignored.

Entering into contracts

In reality, most purchases and sales are made pursuant to what is known as the "battle of the forms." What that means is the purchaser and seller send paper back and forth, each with its own terms and conditions on the back and at the end of the process, no one knows with certainty what terms and conditions govern the contract.

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An example will be helpful. ABC Company sends a Request for Proposal to XYZ Company and on the back are terms and conditions and a statement on the front that these terms and conditions will govern the purchase. XYZ sends a proposal and on the back are their terms and conditions and the proposal makes it clear that these govern the sale.

ABC sends a purchase order to XYZ for the goods with their terms and conditions on the back. XYZ acknowledges the purchase order with their own acknowledgment form with their terms and conditions. Finally, XYZ ships the goods and sends an invoice with their terms and conditions.

Whose terms and conditions govern the deal? It can be said with great certainty that no one really knows for sure. Not the parties, not the lawyers for both parties, and not even the courts. The area of law governing the "battle of the forms" is one of the most confusing and vague provisions in the law. The only way we would really know is for a judge to rule on the question.

This situation should be avoided if possible. While most purchases are not made with a contract signed by both sides, it is very easy to have a master set of terms and conditions and then send purchase orders based on the master agreement. If your purchasers do not normally have terms and conditions on the back of their contracts, then you should win.

So, each entity needs to evaluate their own situation in this chain of production and distribution, determine how much risk they are willing to assume and how much to spread elsewhere, and establish contracting procedures that match this determination. Contracts are usually only needed when something goes wrong. And, good relations between contracting parties can go bad when something goes wrong. So, it is dangerous to have a fuzzy contract or, worse, sell products or buy products "on a handshake" and rely on your prior good faith dealings to solve any problems that arise.

Dealers, Distributors and Retailers

Agreements between a dealer or distributor and a manufacturer are a little different than the normal sale. Dealers or distributors have rights and responsibilities that go well beyond those of a normal entity in the chain of distribution. For example, they may agree to provide warranty service, to give safety orientations and training to purchasers, to provide normal maintenance and to provide repair services outside of the warranty.

They have divided loyalties because they are an advocate for their customer to the manufacturer but also a representative of the manufacturer. Again, as before, the contracts should reflect the rights and responsibilities of both sides and clearly allocate the risks between the parties.

In that regard, the dealer will usually agree to indemnify the manufacturer if they do anything during the sales process that causes or contributes to a loss. On the other hand, many manufacturers will agree to indemnify the dealer or distributor against losses attributable to product defects that existed at the time the product left the manufacturer's control. These mutual indemnifications are fair, although sometimes it is impossible to clearly define the risk allocation. It is almost an agreement to allocate liability after the case is brought and the facts are discovered.

Again, the goal is for the party at fault to pay for the loss and protect the party that was not at fault. Many times, there may be shared responsibility or there may be no one at fault. In that case, each of the parties may need to defend themselves.

Over the years, I have had problems with retailers who want to be indemnified and held harmless for all product liability claims and litigation even if the retailer's personnel did something that caused the accident. This is unfair and should be avoided if possible. However, many retailers are aggressively unreasonable and basically say that if you want us to buy your product, you will agree to these terms.

In addition, I have been having issues recently on recalls where the retailer is being unreasonable and demanding a large reimbursement even if the retailer decides to do more a more expansive recall than what the government requires. This can occur in communicating to the consumer, if their identity is known and to provide a remedy in excess of what the government thinks is appropriate. And, provisions in retailer's terms and conditions are usually very broadly drawn and have no limits. It is a potential minefield for any manufacturer who sells to a large

retailer.

Without contracts describing the rights and responsibilities of each party to the contract, everyone is left to wonder what they have to do and what happens if a loss occurs. Some contract that sets forth basic guidelines as least gives each party an idea of the parameters of the relationship.

Conclusion

Despite the view of contracts as legal boilerplate and usually unimportant, they are important when something bad happens. Then you will wish your client had clear contracts that reflect their acceptance of risk.

Also, while the contract does contain some legal terminology that business people may find hard to understand, they should understand what the contract provides and be sure they agree with the terms, whether the terms are theirs or the party on the other side.

The legal language in the contract should clearly represent what both sides believe are the rights and responsibilities in the deal. You do not want to litigate the meaning of a contract – you have the opportunity to have a true meeting of the minds before you sign the deal or ship the products.

And, lastly, even if you have a good contract that protects you, don't fully rely on it. You still want to prevent problems from occurring. Relying on a contract or indemnification clause or purchaser's insurance policy to protect you may work, but still could cost the client a great deal to enforce.

Kenneth Ross *is a former partner and now Of Counsel in the Minneapolis, Minnesota office of Bowman and Brooke LLP where he provides legal advice to manufacturers and other product sellers in all areas of product safety, regulatory compliance and product liability prevention including contracts and warranties. Mr. Ross can be reached at 952-933-1195 or kenrossesq@comcast.net. Other articles authored by Mr. Ross can be accessed at www.productliabilityprevention.com.*

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