PRACTICAL GUIDE TO LEGAL ASPECTS OF INDUSTRIAL SUB-CONTRACTING WITHIN THE EUROPEAN COMMUNITY

Volume I

The sub-contract

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PRACTICAL GUIDE TO LEGAL ASPECTS OF INDUSTRIAL SUB-CONTRACTING WITHIN THE EUROPEAN COMMUNITY

(I)

The sub-contract

Document

PREFACE

Faced by rapid technological change and competition from companies in the USA, Japan and increasingly other countries, European firms are responding by introducing new organisational and managerial methods in their production processes.

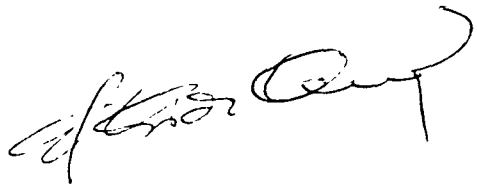
The monolithic firm operating in isolation is rapidly becoming outdated: interdependence among firms is developing rapidly to improve competitiveness. Outsourcing is now part of the enterprise's strategy representing 50 to 60% of the turnover of most leading European manufacturing industries.

Traditionally considered as a simple capacity buffer method, sub-contracting has been evolving for some years towards a more complex type of industrial relationship. This obviously means new requirements for subcontractors, but also deep changes in their relationships with main contractors.

The development of transnational cooperation, favoured by the single market of 1992, will reinforce the need for a clear understanding of each partner's obligations and liabilities. The Commission of the European Communities has contributed to this by producing a practical guide to legal aspects of industrial subcontracting in Europe.

This useful instrument, together with other initiatives at the Community and national level, may help to create an overall framework, more flexible and better adapted to the emergence of subcontracting partnerships at transnational level.

The Commission will continue to launch actions which, excluding direct intervention in the relationships between main- and subcontractors, will improve the environment in which those firms operate.



A. Cardoso E Cunha
Member of the Commission

FOREWORD

The Practical Guide has been divided into two parts.

The main purpose of Part One is to consider in successive chapters major legal issues and problems that will almost always have relevance to the sub-contractor, regardless of its nationality or location. It also states the rights that need to be protected by such contracts and as well the obligations and liabilities which may be incurred by them. Each of the chapters is followed by a list of relevant questions that a sub-contractor may need to ask when considering the terms of a possible contract.

Part Two deals with each Member State in turn and seeks to provide as much information as possible relevant to legal and technical issues in that country that will be of relevance to sub-contractors.

It will be understood that, given the existence of a substantial number of separate legal systems within the Common Market and many different markets and sectors, the preparation of such a Guide in a form to satisfy such varied needs presents many difficulties. Inevitably problems that appear of central importance to one sub-contractor will seem of only marginal relevance to another. Moreover, since its emphasis is on the practical approach to the relevant legal issues, it does not replace the need to obtain competent professional advice on the detailed terms of individual sub-contracts nor is it to be treated as a legal textbook or encyclopaedia. It does not seek to repeat commercial information or advice which is freely available from official sources, such as details about grants or other financial assistance for sub-contractors, or to list schemes for matching or linking sub-contractors and main-contractors across national frontiers. Nor, given the immense variety of sectors involved and the range of possible contracts, does it seek to provide standard clauses or contract forms.

Practical guide to legal aspects of industrial sub-contracting within the European Community

(part I)

INTRODUCTION

Definition of Industrial Sub-Contracting

1. What is industrial sub-contracting? A working definition is that it involves one business, which we shall refer to as the "sub-contractor", being required by another business, which we shall call the "contractor", to provide for the contractor goods or services which the contractor requires for its own commercial purposes, often, though not invariably, by incorporating these goods or services in some form of larger assembly. A distinction can be drawn between (i) capacity sub-contracting when a business places orders for sub-contracts simply because, although it is technically capable of carrying out the work, it is overloaded and has to obtain additional capacity from another source and (ii) specialised sub-contracting whereby the contractor obtains goods or services that it does not (and may not be able to) provide for itself. Within these two categories there are further sub-divisions whereby in some cases the sub-contractor merely manufactures whilst in other cases the sub-contractor also provides detailed design services by special arrangement to the requirements of the contractor. Again, one can distinguish between other species of sub-contracting including product sub-contracting under which the sub-contractor merely makes a component to form part of a larger product or assembly to be sold

by the contractor, equipment sub-contracting where the sub-contractor is manufacturing one or more components of the contractor's production equipment, and finally services sub-contracting where the sub-contractor supplies services to the contractor vital to the operations of the contractor but distinct from its principal activities (for example, the provision of accounting research or maintenance services). In this Guide we shall concentrate on product sub-contracting, though many of the comments made will have relevance also to other types of sub-contracting.

Industrial and other sub-contracting contracts compared

2. Industrial sub-contracting can be contrasted with sub-contracts involved in building or civil engineering projects. These sub-contracts are often set out in standard form documents of considerable length and complexity, approved by the relevant professional bodies of architects and civil engineers and accepted by both contractors and sub-contractors in those sectors to regulate their contractual relationship. By contrast, although some standard forms exist for particular types of industrial sub-contracts, their enormous variety make it almost impossible for any individual form of sub-contract, however skilfully or carefully prepared, to have more than limited application. Such sub-contracts can, however, be found in most sectors of industrial production.

Development Contracts

3. It would, however, be misleading to assume that industrial sub-contracts involve simply the provision by the sub-contractor of goods or services to meet the technical requirements of the contractor. In particular in areas of high technology it is also quite common for the specialised techniques and experience of the sub-contractor to be called upon by the contractor to provide it with guidance at an early stage as to the technical specification appropriate for that particular product. The sub-contractor indeed may be required by the contractor to enter into a preliminary or development contract under which tests are carried out by the sub-contractor to establish whether the anticipated requirements of the contractor can be met and, if so, upon what terms and to what specification. Only after satisfactory completion of development contracts (often paid for on a cost-plus basis) will it be possible for an individual sub-contract itself to be concluded. The level of technical expertise required from the sub-contractor often means that its relationship with the contractor, far from being simply that of supplier and purchaser, will be that of participation in a joint co-operative activity which in spirit, if not in strict legal terms, can be described as a form of partnership.

The Value of Written Contracts

4. Industrial sub-contracts are normally found in written form. It is inadvisable for many reasons for sub-contractors to enter into contractual obligations that are not clearly set out in

writing; the reasons will become more apparent from the contents of the remaining chapters in this first part of the Guide. Whilst the technical specifications of the sub-contract may, however, be recorded in schedules, documents and detailed drawings, it is often a temptation for industrial sub-contractors to pay little attention to the other and more specifically "legal" of its provisions. Indeed, they may take risks in this respect that they would never take with regard to the technical manufacturing or other processes which are to be performed for the contractor. On occasion this may be because of the confidence which the sub-contractor has, based on its own technical expertise and its close control of its own production processes, that no difficulties will arise.

5. Another contributory factor to this attitude of indifference to written legal contracts is that the sub-contractor itself simply has no personnel with the necessary time or training to equip them to consider the legal aspects of the sub-contract, which may be traditionally considered of far less importance than either the production management or commercial aspects of the business. Even though there are in some Member States useful standard contractual documents recommended by relevant professional organisations or trade associations of possible relevance to their needs, many SMEs may not yet belong to such organisations or associations. Whatever the reason, however, for failing to seek adequate legal documentation, one important purpose of this Guide is to remind sub-contractors of the danger

of entering into any contractual commitment without having a clear idea of both the commercial and legal consequences. The responsibilities that industrial sub-contracting places on the sub-contractor are sufficiently substantial even with adequate legal documentation; without such documentation it can become a truly hazardous activity. Moreover, any risk may, of course, be further increased if the sub-contract is made between enterprises in different Member States.

6. The sub-contractor will often, of course, be the smaller and weaker party to the contract, and its bargaining position correspondingly difficult. Nevertheless, it may also possess an expertise in production skills or specialised facilities which are attractive to the contractor, who may, therefore, prefer to seek a contract on reasonable terms and avoid any unnecessary disputes that might risk the smooth flow of supplies and production. Regardless of how satisfactory its personal relationships are with the contractor, the sub-contractor should always seek to obtain a written contract to cover its work.

7. This is especially important in order to avoid the situation where, after inadequate or hurried negotiations, possibly concentrating largely on the technical specification of the items being supplied, it becomes unclear under which contractual conditions the sub-contract is being performed. There may have been an exchange of correspondence involving an exchange of conditions of purchase sent by the contractor and conditions of

sale sent by the sub-contractor, neither having accepted the other's document and uncertainty having been left as to the degree to which either document is applicable. It is likely that each set of conditions will expressly exclude the application of the other's conditions. It is important for sub-contractors not to find themselves in this situation, particularly as standard conditions of sale or purchase are not always directed towards the particular problems of sub-contracts, being drawn up rather with a view to covering relationships under the normal supply of goods of a standard nature.

Subject Matter of Contracts

8. A sub-contractor, however, which by contrast is aware of all the matters with which its written contract should deal should be able to enter into negotiations with far greater confidence. It can then judge more easily whether the contract terms being offered, or upon which it is being asked to quote, are too stringent or restrictive to be acceptable. It is an important aim of this Guide to increase the awareness of sub-contractors of such issues. There are at least ten subjects for consideration in the course of negotiations which are dealt with in the following chapters, as follows:

> Technical specifications (Chapter 1).

> Quality control and contractual obligations relating to quality (Chapter 2).

> Duration, renewal and termination (Chapter 3).

> Tooling (Chapter 4).

- Confidentiality and Exclusivity, Intellectual Property Rights and Knowhow (Chapter 5).
- Determination of prices and methods of payment (Chapter 6).
- Delivery, risk and title to goods (Chapter 7).
- Product liability and insurance (Chapter 8).
- Resolution of disputes: arbitration (Chapter 9).
- Choice of applicable law and jurisdiction of courts (Chapter 10).

CHAPTER 1: Technical Specifications

Preparation of Specifications

1.1. The core of any industrial sub-contract is the technical specification of the work which the sub-contractor is required to carry out. The contractor should so far as possible make clear to the sub-contractor its exact requirements (including their interface with other components or parts of the finished product) especially where the parties are doing business together for the first time. For this purpose, the contractor should supply detailed drawings and specifications which accurately define the product to be manufactured, formed or processed. These will contain reference to such matters as tolerances, dimensions, compositions and required surface qualities. There should be a clear statement as to permissible variations (if any) in dimensions and quantities, and those materials to be used should have their quality, grades, properties and other identifying features fully set out.

Tests Required

1.2. Technical specifications, however, also need to go further and specify the method by which the sub-contractor's production can be tested (before acceptance by the contractor) against these specifications; and the particular method of checking should be set out, whether it is to be carried out by the contractor itself or by the sub-contractor using agreed equipment or by a third party, such as a laboratory. Tests may be necessary (to the

maximum extent economically possible) not only for apparent or obvious defects but also for the non-apparent or latent defects that can so often cause difficulty at a later stage. Much depends on the constraints which the subsequent use of the entire product incorporating the sub-contractor's work will impose. For example, it may be required to work under particularly demanding pressures or temperatures and, if so, more sophisticated tests will be required than for a sub-contract item whose function is relatively inert. The more sophisticated the product, the more likely are the acceptance systems to be highly stringent and, in deciding whether to enter into the sub-contract and in how to price it, it is essential that the sub-contractor takes all these factors into account.

Development Work

1.3. After preliminary discussions over the contractor's requirements, the sub-contractor, from its specialist knowledge, may at this early stage be able to make useful suggestions. For example, it may recommend that development work should be carried out as a preliminary contract before the sub-contract for the production of the item is signed. The advantage of such development work is that the sub-contractor has a preliminary period during which it can decide whether the proposed requirements are within its scope, and whether for any reason it feels that it cannot or should not accept such a contract. In the course of the development work (particularly in advanced sectors such as electronics) it often becomes clear that the

contractor itself is not fully aware of some of the secondary characteristics of the product required to be made by the sub-contractor. The result of the development contract may even be that original proposals are abandoned or substantially modified in the light of the experience. Alternatively, the sub-contractor may itself be given the responsibility of designing a component, which the relevant contract should clearly indicate.

Prototypes

1.4. Often the development work will involve the production of one or more prototypes. This can have substantial advantages for both parties since it means that there is in existence an item which expresses in three dimensional form the agreed technical consensus of the parties as to dimensions, surface finish, etc. to which reference can be made by both parties in the event of a subsequent dispute. It is important that there is a procedure whereby the contractor "accepts" the prototype and that its exact proportions and specifications are themselves incorporated in the relevant written documentation adopted for the sub-contract. The sub-contractor should also ensure that, in its natural desire to obtain the ultimate sub-contract, it does ensure nevertheless that it is properly paid for the development contract. It would be normal for such payment to take the form of the actual costs involved plus a reasonable margin of profit.

Ascertaining "Best Use Value"

1.5. In the course of the development contract the parties will

be collaborating in order to try and find the "best use value" for the product. In other words, a compromise will be needed between the final cost price of the finished product and its ability to meet the actual requirements of use which the contractor must obtain. Such a compromise cannot normally be obtained without setting out a list of relevant criteria which will indicate the pros and cons of any individual possible solution; the sub-contractor may find itself having greater knowledge of the implication of these various alternatives than the contractor itself. Clearly, such an assessment of "best use value" is more likely to lead to a satisfactory result than a hasty contract made under pressure by both parties, where technical difficulties arising from lack of a full mutual understanding of what, on the one hand, is required by the contractor and what, on the other hand, the sub-contractor can actually deliver may well lead to later disputes and product failure. It is also essential for the parties at this stage to ensure that confidentiality agreements have been drawn up before any technical information is disclosed so that in the event of no sub-contract being awarded, neither will have prejudiced their future strategy or commercial position by the disclosure of important technical knowhow or intellectual property rights. This problem is considered in more detail in Chapter 5.

Provision of Materials

1.6. Once the relevant technical problems have been overcome or in cases where there is no need for any develoment work, the sub-

contractor must give consideration to the way in which the necessary working material is to be provided. The sub-contractor may (and often does) provide all its own material or, alternatively, the contractor may provide the material at its expense. It will always be essential for systems to be set up under which the quality and suitability of this material can be checked before use. If the sub-contractor is responsible, as is often the case, for providing all the metal or other material to be used in the work, the contractor may wish to require that this be obtained from specific sources, particularly if it is high value material, with demanding criteria, such as, say, titanium or magnesium. If the main contractor is providing some or all of the material, questions of the ownership of scrap or waste material should be considered and an audit system set up to prevent later disputes.

Processing Contracts

1.7. Another possible variety of sub-contract is one where the manufacturer will deliver materials to the sub-contractor which the sub-contractor simply processes or finishes or treats in some way. Here, the sub-contract is for the provision simply of services rather than goods. It should be mentioned that

Orgalime* have produced a well known form of processing contract recommended for use by its member trade associations.

Responsibility for Design

1.8. Whatever the arrangements made with regard to the material, however, the ultimate responsibility for the design of the product should normally rest firmly with the contractor, which alone has the ability to know the criteria that are applicable regardless of whether the product is well known or one still subject to considerable improvement and development. The sub-contractor, utilising its specialist knowledge in its own field, can draw the attention of the contractor to any risks or difficulties which it anticipates and can propose modifications in order to ensure that these are avoided where possible. The sub-contractor, however, should normally give only advice and should not go beyond that stage by accepting partial or total responsibility for design, unless there is express recognition of this responsibility in the sub-contract itself. The question of responsibility for design is of particular importance in view of the recent changes in the law of product liability discussed in Chapter 8.

*Orgalime is the European trade association for the central engineering and metal working trade associations in a large number of European countries, which provides liaison between them in economic, legal and technical matters

1.9. The proposals that the sub-contractor makes and the advice which he gives must, of course, be free of errors and must be accompanied by any necessary qualifications to the extent that they relate to technical matters not yet sufficiently tested out or for whose implications have not been fully established. The obligation of the sub-contractor should normally be limited, however, to providing that which the technical specification itself requires, not giving a guarantee of specific performance to a particular level. It is also important for the sub-contractor to avoid giving, or accepting, specifications in vague terms such as "of good quality". These concepts will almost certainly not have the necessary degree of precision, especially since, as we have seen, the majority of products have to be a compromise between the requirements of cost and the inherent needs and demands of the overall assembly or product of which they are to be components or sub-assemblies. Often, quality in relation to a product covers a combination of mechanical, electrical and many other characteristics which cannot adequately be covered by simple non-technical expressions.

Changes in Specification

1.10. It is important also that the parties agree how changes in specification during the life of a sub-contract are to be laid down. It frequently happens that as a result of practical experience or for other reasons, some minor change of specification is required. A procedure should be established for ensuring that costs so incurred are borne by the main contractor

and that the basis on which the changes are to be put into effect are established. It is, for example, common in the electronics industry to distinguish between changes that are "retrofit", "rework" or "phase in". In the case of "retrofit", this is the most fundamental alteration permissible since it is applied to all items still under the control of the sub-contractor, including those awaiting delivery that have already passed through its production line process. "Rework" by contrast is of a prospective nature permitting some existing product already manufactured to be shipped, but prescribing a date after which any product delivered must be to the new specification. Finally, the "phase in" alternative is the most gradual basis for change since it means that the changes can be introduced into the manufacturing cycle in a manner causing least disruption. The changes required are not, however, always to product specification and may simply be to the documentation required or the testing to be carried out for the purpose of quality control; the sub-contract should in each case provide the procedure governing the way in which such changes can be effected and by whom the costs should be borne.

Chapter 1: Questions for the sub-contractor

A. 1. Where is the technical specification set out, and is it fully documented and recorded in drawings, etc.?

2. Have I had an opportunity of discussing (and if necessary confirming in writing) the precise requirements of the contractor in terms of the needs of his own customers?

3. What national or international standards (ISO) are prescribed for these products?

4. Will my contract be one for the exclusive supply of goods or services or will there be sourcing from others as well?

5. Am I to be responsible for the design of the product in any respect?

6. Are prototypes of the product to be made?

7. Will materials be provided by the contractor or am I required to provide them all myself?

8. What will these materials cost and, if not freely available, from how many suppliers can I obtain them and in what countries?

9. How will changes in specification during the lifetime of the contract be dealt with?

10. Will these be retrospective or simply prospective?

B. 1. Have I previously manufactured this product?

2. If so, have I encountered particular technical difficulties?

3. If I have not, would a development contract be necessary or desirable and on what terms?

4. How much do I know about the use to which my product (components, etc.) or services is to be put?

5. Have I discussed the question of "best use value" with the contractor?

6. What documentary evidence of my manufacturing processes, tests, etc. will be required?

7. Will I need any assistance (financial or otherwise) in obtaining them?

8. To whom will scrap/waste material belong?

9. How will its use be audited?

N.B. The fact that a question is to be found in the second set of questions in this and following Chapters does not necessarily mean that it is in all cases less important than those contained in the first list. It is suggested, however, that the sub-contractor may find it helpful to consider the questions in the first list (A) before considering those in list (B).

CHAPTER 2: Quality Control and Contractual Obligations relating to Quality

The Importance of Quality Control

2.1. In the previous chapter great emphasis was placed on the importance, from the viewpoint of the sub-contractor, of obtaining highly detailed and precise technical specifications. To ensure that the sub-contracting agreement is correctly executed in every respect, these must be supported by a system of quality control at all stages of manufacture. Traditionally, the responsibility for this control lay with the principal contractor, as the party chiefly affected, so that the sub-contractor was responsible only for checks during its own manufacturing processes.

2.2. This situation has changed; and at all levels and in all sectors there is now a much greater awareness of the importance of quality and quality control. This trend has been reinforced by the fact that consumers of manufactured products now have greater opportunities under the Community Directive on manufacturers' liability to recover damages for injury resulting from defective products both from manufacturers and from their sub-contractors; and as the result of the introduction of systems of quality assurance, the sub-contractor is often himself now responsible for product acceptance inspections. While the contract should provide for the equitable division of obligations in this area, the liability of the sub-contractor increases with

the inspections for which he is responsible under the contract. The sub-contractor should, therefore, give very careful consideration to the quality assurance clauses which the contractor may seek to impose upon him; it should only accept clauses which provide:

- that full information on the principal's exact requirements must be given as the basis for the quality controls; and
- that it is made clear the extent to which the sub-contractor is required to call on outside agencies, such as certified testing houses or laboratories, for the system of quality control.

The Sub-Contractor's Responsibility

2.3. It is obviously wise for the sub-contractor only to agree to quality assurances that it is confident of being able to meet. Normally, a sub-contractor will comply with the standards of his particular industry as then current, in accordance with established practice and in compliance with official safety requirement under national legislation. The sub-contractor must ensure that he accepts responsibility only for the functioning of the part or assembly which he has produced as described in the technical specification; the defect which the quality control system is designed to detect is by definition a manufacturing defect (whether of workmanship or materials) and not a defect of design for which, as we have already seen, responsibility rests firmly with the main contractor under the normal industrial sub-

contract. The sub-contractor is responsible for his work being in conformity with the order.

Quality Assurance Systems

2.4. Clearly, the ideal quality assurance system is one which is objective, independent and certified, and assessed in a way which can be objectively accepted as correct. The increased sophistication of computerised control of production machinery means that quality levels are generally higher. There are now, certainly in many of the more advanced sectors, machines that are themselves capable of checking many of the features of the final product, and of providing a print-out of the reading of tolerances and other features of particular products which can be individually forwarded with the goods as proof that they have passed the quality control tests, and by what margin. Whatever technical methods are adopted for quality control, however, it is important that they are agreed in advance with the contractor.

Categories of Quality Control

2.5. A careful distinction needs to be drawn between two different aspects of quality control. Since checks on individual items are part of the design function, which is the province of the contractor, this question is so important it needs to be considered separately.

Industrial sub-contractors are responsible for two types of control:

(i) Routine manufacturing checks, i.e. those which the sub-contractor must make throughout the manufacturing process to ensure that the material used has the mechanical or chemical properties specified in the order and that the forms required will be produced successfully. These controls are part of a sub-contractor's activity and are covered in the selling price of the items. But these checks do not eliminate the risks of defects in the item itself, once manufactured. At this point special control methods to test the item, rather than the material, are required.

(ii) There may also be "acceptance checks". They are necessary only if the designer of the item considers that they are needed in order to eliminate defective items, depending on the risks they could generate in conditions of use of which he alone has accurate knowledge. It is up to the designer of the items to stipulate the check or checks applicable to the item or parts of the item subject to mechanical stress, and then to set the tolerances for these tests on which the item will be rejected or accepted, depending on the gravity or nature of the defects found.

This is a matter of the greatest importance to the sub-contractor especially because even a small defect in a single component may lead to a serious accident or product failure. The presence of a defect, which may be an ordinary manufacturing hazard, by itself

implies no presumption of fault on the part of the sub-contractor. It is the main contractor's obligation to carry out (or cause to be carried out) non-destructive internal tests on every item before it is put into service, with a thoroughness commensurate with the risks of use. This is the main contractor's obligation because it is fully aware of the uncertainties inherent in the item, and alone is able to assess the risks of use, designate the parts subject to stress and stipulate the type and scale of the checks to which these parts must be subjected.

Tests and Inspections

2.6. This is why the sub-contractor should not be required, unless the contract so stipulates, to do more than check the dimensions and visual aspect of the items delivered. It would be unreasonable for it to be systematically required to carry out unnecessarily thorough controls on the whole item and the entire batch delivered, if only because of the cost. For non-destructive tests are expensive, and must, therefore, be covered by an additional clause to the contract in those cases where the sub-contractor agrees to carry them out in accordance with precise specifications laid down by the customer and for an agreed price. In every case it is up to the main contractor alone to decide whether any defects discovered by the non-destructive checks agreed invalidate the contract. In particular, French Courts have concerned themselves with these

issues, and further details are given in the French national chapter.

Quality Certification

2.7. In most Member States systems of quality control have developed in respect of which individual enterprises are themselves certificated as having quality control systems reaching the required standard for the production of goods in a particular sector or at a level sufficient to meet the demanding technical standards of individual important customers such as government departments or nationalised industries. Regardless of whether the product of the sub-contractor has also to meet national, European or international standards, it is likely that a contractor will wish to know in advance whether a potential sub-contractor has a quality assurance management system recognised under the relevant national standards which exist in many Member States. To obtain such certification, the sub-contractor will have had to satisfy the national authority that it has the human and equipment resources adequate to meet the requirements of contractors in its sector. If the sub-contractor is anxious to obtain business in a particular field, it is essential for him to ascertain whether it is a precondition for consideration that such appropriate quality control certification has been obtained.

Standards

2.8. The standards required of the goods themselves will

frequently be referred to by a national or international standards number in order to avoid having to set out the full detail of the specification in the individual contract. The sub-contractor should, of course, if not entirely familiar with the content of the relevant standards of specification, arrange to purchase these from the national or international authority involved. As well as the specification, however, the sub-contract should specify what is to be regarded as an acceptable tolerance of defective parts. Certainly, the contractor himself will seek to have an inspection system that covers virtually all production items.

Extent of Sub-Contractor's Liabilities

2.9. To the extent that the sub-contractor has accepted contractual liability for certain quality controls, it must be certain also that it has the necessary resources to perform them and should, of course, seek appropriate insurance cover in respect of its liabilities, quite apart from its liabilities to third parties (see Chapter 8 at page 87). Sub-contractors cannot, however, accept responsibility for faults in design or in any materials or tools which have been supplied by the contractor for the purpose of the contract. Nor, in the majority of cases, must the sub-contractor accept liability for a defect that is totally unpredictable or caused by factors outside the knowledge of both parties and particularly where there is no breach of any of the technical specifications set out in the contract. In other words, the sub-contractor should not normally be required

to act as an insurer or complete guarantor that the items provided are both totally free from any kind of defect whether of manufacture or design or capable on an open-ended basis of performing all the functions that a contractor or its ultimate customer may require. Changes in product liability law, however, may produce a situation where both main contractor and sub-contractor are liable to the customer physically injured by the defect in the goods supplied even if the sub-contractor has no contractual liability in such circumstances to the contractor. The process of apportionment of liability will be helped if there has been established by the contract as precise as possible a definition of the obligations of both parties.

Guarantees

2.10. The sub-contractor's liability as a result of a defect for which it is responsible may have the following consequences (in ascending order of severity):

(i) The requirement upon the sub-contractor to replace any parts found defective.

(ii) To have the defects rectified by the sub-contractor or, on occasion, by third parties, with the agreement of the sub-contractor if he cannot replace or repair the items in time.

(iii) The cancellation of part or all the order, i.e. relieving the contractor, if he so wishes, of any obligation to accept a particular batch of items.

(iv) For the sub-contractor to pay damages for the losses caused to the contractor as the result of the defects discovered

and possibly also (and even more seriously) in respect of consequential loss in respect of legal claims which the contractor can show to have followed from its own customers, or relating to its own future loss of profits as the result of the discovery of the defect, possibly only after the product has passed into commercial use.

2.11 If, however, the sub-contractor has agreed to give a specific guarantee or warranty as to quality, this increases his liability to the extent of the terms of such warranty or guarantee, and may constitute an enforceable acknowledgement by the sub-contractor that he vouches for the presence of particular properties in the goods and for levels of performance specified. The inclusion of such a guarantee may, of course, be an important element in inducing the contractor to grant the order to the sub-contractor in the first place. It can nevertheless represent a considerable danger for the sub-contractor even if its own confidence in the quality of its products is justified. The exact content and wording of any guarantee or warranty should normally in any case be discussed with the sub-contractor's own lawyer before final acceptance.

Limitation of Liability

2.12. If claims are to be made, the sub-contractor will normally seek to limit its liability to the minimum and, of course, if insured should not risk avoiding its policies by making admissions of liability to the contractor. In complex contracts,

where many sub-contractors have joined together to provide a variety of items for incorporation in the contractor's main assembly, it may be necessary to have special contractual provisions under which liability of sub-contractors inter se can be dealt with, since their contractual obligations may extend to the production of items that must be technically compatible with each other's products as well as with the contractor's specifications.

Chapter 2: Questions for the sub-contractor

A. 1. What quality control system am I required to operate?

2. To what degree has the responsibility for checking the quality of the goods been made mine rather than that of the contractor?

3. In checking the quality of goods, am I required or expected to use services of outside agents or credited laboratories?

4. What tolerances (if any) are permitted in respect of standards of an individual product?

5. What percentage failures (if any) are permitted in respect of failures within any batch?

B. 1. What rights have the contractor to inspect my premises in connection with quality control matters?

2. What consequences follow if I fail to meet the contractual standards (cancellation of contract, replacement of goods, rectification, damages, etc.)?

3. Am I required to give special guarantees or warranties on particular items over and above the normal contractual obligation?

4. Can I limit my liability in any way?

5. Within what time limits do claims have to be made?

CHAPTER 3: Duration, Renewal and Termination

Fixed Term and Indefinite Term Contracts

3.1. All commercial contracts, whether for manufacturing or sub-contracting arrangements, or for distribution or agency agreements, or for the licensing of intellectual property rights or knowhow, will normally be expressed to have a duration, either of a fixed period (anything from a few weeks or months to a period of several years) or of an indefinite period. If the contract is for a fixed period, clauses governing renewal will often be found, possibly coupled with a right for either party to call for consultations at a fixed date prior to the expiration date. If, however, the contract is for an indefinite period, renewal clauses are logically unnecessary but in their place may be set out the terms upon which notice may be given by either party to bring the arrangements to an end. Often a period of notice of three to six months, or possibly even longer is required. Moreover, in both fixed term and indefinite arrangements, each party will normally reserve the right to bring the agreement to an end in the event either of serious breach by the other of its terms, or if for any other reason (including financial difficulties) the other ceases to be able to perform its obligations.

Fidelity Contracts

3.2. The industrial sub-contractor needs always to have a shrewd idea of the likely business strategy of the contractor with which

it is in contractual relationship. It is the strategy of the contractor which will largely determine the duration of the sub-contract itself. This duration moreover, is closely linked to an important underlying issue, the basic character of the commercial relationships between contractor and sub-contractor. If the contractor has a long term need for stable, reliable, specialist sub-contractors capable of manufacturing to a high technical specification at a competitive price and of delivering these consistently to fit in with the contractor's production schedules, then the mutual advantage of a long term agreement may be great. This kind of agreement, sometimes called a "fidelity agreement", is more often found for example now in the automobile industry where the demands of largescale and highly sophisticated automated production lines place a premium on reliability of supply and upon the existence of a group of sub-contractors able to work very closely on technical development with the automobile manufacturer.

Turnover Targets and Planning Systems

3.3. In an ideal world, a sub-contractor would always look for contracts that offered a reasonable level of stability. It may, therefore, be that in some sectors a sub-contract for a period of say between two to four years, with a substantial minimum volume, would be available; and such a contract period would be of interest to many sub-contractors. As always, however, no one seemingly attractive feature of a contract should be considered in isolation. A key question here is the level of the minimum

turnover for which the contractor is prepared to commit itself for the duration of the contract; however long the contract, if the guaranteed minimum turnover is unsatisfactorily low, then there is a risk that the additional investment which the sub-contractor will have to make in order to fulfil the contract may not be matched by the actual return that he may earn, if the level of orders turns out to be at the minimum, rather than at the higher, anticipated figure. In many such sub-contracts, however, turnover will normally be set between a minimum and a maximum, with production schedules being given first on an estimated basis several months ahead to the sub-contractor, these later being converted into binding orders at an appropriate period in the delivery schedule, often some two or three months ahead of the anticipated delivery date. Such an arrangement may be the best legal solution for the otherwise conflicting requirements of the parties.

3.4. The target for such a sub-contractor must be a formula for the contract sufficiently flexible to accommodate inevitable rises and falls in demand but nevertheless also giving a sufficient minimum "floor" to the contractor's orders to give a degree of security. In some Member States considerable work has been done both by individual large companies and by trade associations on reconciling the needs of contractor and sub-contractor in the establishment of planning systems, designed to give the contractor leeway in adjusting the quantities delivered to its own current requirements whilst still allowing the sub-

contractor to manufacture reasonable quantities on a regular basis. The renewal of existing contracts will be considerably assisted if such a system can be introduced.

3.5. The advantage to the sub-contractor of such systems is that it can determine the optimum economic delivery lot size on the basis of its known costs; it is neither compelled to produce unnecessarily small batches nor take an unreasonable risk on larger batches. Its long term planning becomes more rational and the ability to rely on a future flow of orders is greater. Of course, there are great advantages in such a system also for the contractor. It avoids ultimately having to pay a higher price for variable quantities, as the result of a greater degree of self-discipline under which it is placed with regard to variations in its order.

Advantages and Disadvantages for the Sub-Contractor

3.6. It is obviously in the interest of any sub-contractor to maintain commercial relations with contractors on a continuous and close basis; and this is, of course, much easier where their respective plants are near each other. Indeed, there is a further tendency in some sectors (particularly where the contractor's delivery requirements are extremely stringent) to prefer that the sub-contractor's plant to be within a particular geographical radius of, say, 25 miles of the contractor's main plant. These close relationships will be concerned, probably on a daily basis, with such matters as deliveries, changes in

specification and production scheduling. The sub-contractor must also keep firmly in his mind at all times its overall business strategy, and the timetable for renewing any existing fixed term contracts. It should also seek to avoid committing more than a certain percentage of its output to a single contractor (25% is often stated as such a target).

Termination

3.7. The termination of contracts occurs in two main situations. The first type occurs when the parties cannot agree commercial terms for a new contract, after the old contract has been terminated or has lapsed through the expiration of its original period. The reasons for the disagreement may be many, including price, delivery, specification or a variety of other causes, including non-legal consideration such as personality clashes. Termination, however, may also occur because one party believes the other no longer capable of performing satisfactorily or at all. This may occur because of a substantial breach of the original agreement, perhaps for non-payment or failure to meet technical standards or because of the financial difficulties of one company. Another situation in which termination may be necessary is where beneficial ownership of the contractor has altered during the period of the contract in a manner which, for commercial reasons, renders the continuing of the close relationship by the sub-contractor with the contractor undesirable. Contracts should deal fully with both situations.

3.9. Into whichever category the termination falls, however, it will inevitably raise a number of practical problems for the sub-contractor. First what is to happen to the tooling previously committed to the requirements of the contractor. Can it be retained for use if possible by commitment to other contracts or can it be merely sold or scrapped? Does the contract limit the sub-contractor's freedom to make free use of it (see Chapter 5 for the possible consequences of such restrictions)? Inevitably, at the termination of the contract, there will be claims and counterclaims for payments and the sub-contractor will seek the balance of moneys owing to it, which the termination of the contract may in practice make it more difficult to obtain. This is particularly likely if at the termination of contracts there are still orders outstanding which the sub-contractor has not delivered, with the risk that there will be a greater willingness to argue over perceived defects in the product once the commercial relationship between the parties has ceased. The effects of termination of the contract are normally contained in clauses which the sub-contractor will leave to his lawyer to consider, but nevertheless they are sufficiently important to deserve some prior attention at the time when the contract itself is being negotiated. A consequence of the termination of a contract that may need consideration in advance is the treatment of any surplus material which has been utilised during the contract, particularly if this is not suitable for use in other forms of contract; a requirement upon the contractor to buy this from the sub-contractor at at least its cost price may,

therefore, need to be considered. Finally, the termination of the contract may occur when substantial moneys are still owing, and prior thought must be given to the question of credit insurance to cover this risk (see also paragraph 6.12).

Chapter 3: Questions for the sub-contractor

A. 1. For what definite period have I a contract?

2. Are there any intermediate review points with options to terminate early, etc.?

3. If the contract is not for a fixed period, on what notice can it be terminated?

4. Is the duration of the contract conditional on my achieving specific targets?

5. Is achieving a production minimum level a condition for renewal?

6. In what circumstances can the contractor or myself terminate the contract - only for good cause or simply one party fails to perform or goes into liquidation?

7. Upon termination, what happens with regard to:
(a) orders placed with me but still unfulfilled, or
(b) surplus raw material at the date of termination.

B. 1. How will this contract period fit in with the other contracts which I already have or which I expect to obtain in terms of utilisation of production and resources?

2. Is there a procedure for adjusting order levels in order to avoid unnecessary fluctuations?

3. Are my orders under the contract likely to be

occasional, steady or regular fluctuation?

4. What percentage of my own output will be committed to this sub-contract (the answer should ideally not exceed 25%)?
5. Is the type of production which the sub-contract involves unique to this particular contractor or are there other potential customers for my output of this kind?
6. What proportion of the contract involves the production merely of standard components or parts as opposed to parts or components specifically manufactured for this contractor? (If the answer is 100% then, of course, it is a supply of goods, rather than a sub-contract).
7. Can I terminate if control of the contractor changes?

CHAPTER 4: Tooling

Use of Own Tooling

4.1. There are, of course, some sub-contracts under which the sub-contractor produces components or items for a contractor utilising its existing capital equipment without any need for the purchase of new equipment such as machine tools. The expenditure of the sub-contractor in such circumstances will simply be his normal fixed and variable costs, and these variable costs will include the material to be worked on in the course of the contract. Such a situation may also arise where the sub-contract consists of relatively simple operations performed by the sub-contractor with its own equipment on material provided by the contractor, such as machining and polishing or other processing operations on raw material or semi-finished parts.

Investment in Tooling - choices available

4.2. It is, however, with the more substantial, often long term, sub-contract, almost certain that some investment by the sub-contractor will be required in machinery and tooling needed to carry it out. This equipment may include dies, patterns, moulds, matrices, templates and tools of various kinds, including possibly machine tools of substantial complexity and cost. One of the main decisions to be taken then by the sub-contractor is whether it will itself invest the capital required (whether from its own existing resources or through borrowing) so that it is fully equipped to carry out the sub-contract, or whether it will

permit the contractor itself either to pay the part or whole of the cost involved. Clearly, the main advantage to the sub-contractor in providing its own tools is the considerable and greater flexibility that it should provide for him in the future once the original sub-contract has finished. Indeed, it may be possible without any breach of contract for the equipment to be used for other work even during the currency of the original sub-contract, if the delivery and production schedules of the sub-contract are not so demanding as to prevent it. This is particularly likely in the utilisation of computerised numerically controlled machine tools (C.N.C.) now available, whose output in any 24 hour period can be very substantial indeed. Against these advantages must be set the disadvantage of saddling the business with what may be a heavy initial cost of equipment which may be so adapted to the needs of the original sub-contract that its future application in other fields or for other customers may be doubtful, and which may not even have been paid for by the time the original contract for which they were purchased has been terminated.

Types of Tooling

4.3. The expression "tooling" covers a variety of equipment. In the context of industrial sub-contracting, two main types can be found:

(a) Standard tooling, i.e. that which has a wider use than merely for completing a particular order for a contractor, and

(b) Tooling, by contrast, that is dedicated to a particular contractor's order that has often been made utilising industrial property rights and knowhow of the contractor itself.

Investment by Contractor

4.4. It is more likely that the contractor will pay the cost of tooling if some or all of the following circumstances apply:

- If total expenditure on the tooling is heavy in relation to the probably limited resources of the sub-contractor.
- Where the commercial and contractual relationship between the parties is "mature" and long term (actually or potentially).
- If the adaptation of the new tools to the particular production process required requires a long stage of "productionising" and development which may itself be expensive.
- Where the sector has traditionally regarded the provision of tooling as the natural responsibility of the contractor,
- Where the tools are specifically designed to meet particular individual requirements and specifications of the contractor and cannot easily be applied for other end uses.
- Where the contractor prefers to keep control over the tooling in order that it can remove it at a future date if for any reason it has to terminate the contract with the original sub-contractor.

If the contractor pays for the tooling, the sub-contractor should

ensure that firm dates for payment are laid down in the documentation. Moreover, the sub-contractor should always be aware if it is required to check whether tooling provided by the contractor has been manufactured in accordance with the contractor's working drawings and specifications, a task normally only carried out if specifically requested by the contractor.

Investment by Sub-Contractor

4.5. By contrast, the sub-contractor is more likely to pay for the tooling if for example:

- The tools are not considered to put a particularly great burden on its financial resources.
- The relationship which it enjoys with the contractor is not yet a mature or long term one.
- The tooling itself can be quickly adapted for use for other contracts.
- In new industries where no tradition as to provision of tooling has yet been established.

Part Cost Arrangements

4.6. Another possibility, of course, is that the expense of tooling is shared between the parties on a "part cost" basis. In this case, the contractor pays a percentage of the total tool cost which will often correspond to the basic expense of tool design and manufacture. The sub-contractor will pay the balance corresponding to the cost of proving the tooling in the production process and to its development. In the event of any

"part cost" solution, it is clearly essential that the contract sets out in detail what is to happen upon termination of the contract.

Development Costs

4.7. If the sub-contractor itself pays for the tooling, then it is likely also to take responsibility for ordering and commissioning the tooling and for ensuring that it is working and capable of producing the sub-contract items. The cost of commissioning the tooling in this way and of adapting its operations to the needs of the particular contract should be taken into account in calculating the price quoted for the sub-contract. Clearly, however, the sub-contractor must in any case do this development work in close conjunction with the contractor to ensure that the requirements of the technical specification have been fully complied with, and to prevent the contractor later raising queries about the way in which the tooling is being used. Once the tooling is in use, its value will be depreciated in the books of the sub-contractor in the same way as any other capital investment at a rate which will correspond to its anticipated useful life. In choosing and negotiating a policy for tooling, the parties must always take fiscal considerations into account which may have an important influence on its final choice.

Maintenance

4.8. Once the sub-contract has commenced and the delivery of

parts made on the capital equipment has started, the tooling itself will require regular maintenance. The normal rule is that the owner of such machinery will be responsible for meeting these expenditures, of course, in any case the costs of maintenance will have been taken into account by the parties in assessing the price to be charged for the items being supplied. In any case, however, it will be the sub-contractor which has physical control over the equipment and will, therefore, be responsible for keeping it in good working order whether or not the expense of doing so is ultimately borne by it or by the contractor. In some sub-contracts the use of the machinery is not continuous, for example, where the contract provides for substantial deliveries only at certain times or seasons of the year. It is not unusual in such circumstances for the tooling then to be lent by the sub-contractor to the contractor if the contractor can make alternative use of it. Alternatively, the contractor may be willing to allow the sub-contractor to make use of it at its own plant if the sub-contractor itself has alternative uses available for it.

Repairs

4.9. It cannot be assumed that the tooling purchased will remain in working order for the entire life of a sub-contract, especially if the sub-contract is of a long duration and involves a heavy volume of production. Not only will repairs be needed during this time but replacement may even be necessary once machines, dies or plates, etc. are worn out. It is advisable in

such circumstances to provide in the original contract what is to happen if a replacement of all or part of the original capital equipment is required during the lifetime of the sub-contract. Normally replacement would be on the same basis as the original investment, but clearly a contractor will be less willing to provide the full cost of this if the need to replace has not been anticipated during the original negotiations. The sub-contractor should keep in mind at all times in whose ownership is the tooling and also whether it has itself any intellectual property rights in it which need contractual protection. The sub-contractor should also make clear in the documentation on whom is the risk of accidental loss or damage for any cause under the sub-contractor's control.

Effect of Termination of Contract

4.10. When the sub-contract comes to an end, the normal rule is that the party which has paid for the equipment will retain it, although it is often the contractor who has an option to acquire the tooling from the sub-contractor. This may be so even where the sub-contractor has paid the part or whole of the cost, upon reimbursement to it of the moneys which it has laid out, less any reduction for depreciation in the value of the equipment which the sub-contractor has already recovered by an element in the charge for items supplied to the contractor. If the contractor such as a motor manufacturer is operating a principle of "dual-sourcing" for its supplies, it may well wish to place the equipment at another site and is very likely, therefore, if it

has not paid for the original equipment, to exercise such an option, quite apart from its possible wish to prevent the sub-contractor from making use of the equipment in the future, possibly for one of the contractor's competitors. For this reason, the sub-contractor should consider carefully at the time of negotiating its original contract whether it is prepared to agree to grant such an option to the contractor to remove equipment that the sub-contractor has paid for, if the practical effect will be to prevent the sub-contractor from undertaking further work of that particular kind for other companies.

4.11. If the sub-contractor, however, is allowed to retain the tooling after the expiration of the contract, it may be placed under some form of restriction by the contractor as to the use which it can make of it, as also mentioned in the following Chapter 5. In any case, however, the contractor may place a positive obligation on the sub-contractor to retain the tooling for a period of say up to three to five years (or even in some cases for up to ten years) in order to produce the quantity of spare parts required for the products ultimately sold by the contractor, as availability of spare parts is always a major difficulty for contractors who make substantial use of sub-contractors.

Chapter 4: Questions for the sub-contractor

A. 1. Do I already have all the required tooling?

2. If not, how will its purchase be financed?

3. To what extent will the contractor pay part or all of the cost and by what instalments?

4. Will ownership be wholly or partly in the contractor?

5. Will ownership be in myself but with an option for the contractor to acquire it at the end of the contract and, if so, upon what depreciated value?

6. Who is responsible for the maintenance and repair of tooling or for its insurance?

7. Who is responsible for replacement of tooling in whole or part if it becomes worn out during the life of the contract?

B. 1. If contractor pays the whole or part of the cost, do I have any opportunity of being involved in its ordering and commissioning?

2. How long a period of commissioning will be needed?

3. Will the contractor make a contribution to this even if not paying for the tooling itself?

4. What technical assistance is available from the contractor with the installation of the tooling?

5. Can the contractor call for use of a tool that is in my premises on loan if not required at a particular time for my purposes?

6. If I retain the tooling at the end of the contract, am I under any restriction as to its future use, e.g. for competitors of the contractor?

7. Am I required to keep the tooling for a fixed term after the contract, e.g. five or ten years, in order that I can be called on to provide spare parts?

CHAPTER 5: Confidentiality and Exclusivity: Intellectual Property Rights and Knowhow

The Need for Disclosure

5.1. From what has already been said, it is clearly in the interests of sub-contractors that their commercial relationships with contractors should normally be far closer than would be the case simply between suppliers and purchasers of goods, and should be considered as a form of quasi-partnership or co-operation to which each contributes from its experience and technical resources. Such a relationship will inevitably mean that from an early stage in negotiations between them and at all later stages both parties will become involved in the exchange of confidential information. As a result the sub-contractor will almost certainly acquire from the contractor more knowledge than it originally possessed about the practical problems of the manufacturing or other processes involved and of the components or other items required to be produced. Likewise, the sub-contractor may itself have to disclose similarly confidential technical information and experience to the contractor in the course, prior to signature of any sub-contract, of satisfying it of its own competence to carry out the contractor's requirements.

Predisclosure Agreements

5.2. It is, therefore, to be anticipated that the contractor will seek to obtain a written confirmation at an early stage in negotiations of complete confidentiality on the part of the sub-

contractor in respect of all these matters prior to signature of the sub-contract. Such a predisclosure contract will govern the obligations of the sub-contractor if the discussions fail to lead to the conclusion of a sub-contract, though of course the predisclosure document should itself be reciprocal in view of the fact that the exchange of confidential information is almost certain to be on a two-way basis. Apparently in high technology areas such as electronics, the use of predisclosure agreements is standard, whilst in more traditional areas it is less common. From the viewpoint of the sub-contractor, however, it is a wise precaution to adopt in any case if the negotiations will involve the disclosure by it to the contractor of any information regarded as essential to be kept confidential.

Confidentiality Clauses in Sub-Contracts

5.3. When the sub-contract is itself being entered into, a similar clause should be included protecting all the confidential information provided by both parties to each other. This clause should also cover any drawings and other documents supplied by the contractor, so that they can be utilised by the sub-contractor during the life of the contract and then returned to the contractor at its termination. Again, the sub-contractor should ensure that the obligations are expressed as reciprocal. The important thing for the sub-contractor to bear in mind is that the obligations of a confidentiality document, whether by way of predisclosure or as part of the sub-contract for manufacture or processing, are essentially negative, preventing

the party receiving the information from using it except for the actual purposes for which it was given. It should moreover be borne in mind that a proven breach of the obligation of confidentiality can in certain Member States be regarded not only as a breach of civil obligation leading to the normal civil remedies of damages but also as a criminal offence leading to the imposition of criminal fines and other penalties.

Intellectual Property Rights

5.4. Now the information provided or the documents lent to the sub-contractor under the terms of the contract may either be knowhow not protected by any individual proprietary intellectual right recognised by the law of the relevant Member State (but nevertheless of technical and commercial value) or, alternatively, may be protected by one or more forms of intellectual property right. These may include copyright (which often applies to the relevant drawings and written specifications), registered design, or patents. In the event that the information is protected by one of these specific intellectual property rights, the sub-contractor will require from the contractor the formal grant of a licence either incorporated in the sub-contracting agreement, or as a separate legal document, authorising it to make use of the information and/or documents for the purposes of the contract.

Licences

5.5. The contents of this licence are of great importance to the

sub-contractor. It will be concerned with the purposes for which the information provided can be utilised, e.g. in connection with a supply of goods to third parties and whether it can itself grant sub-licences to its own sub-contractors. Responsibility for monitoring infringements of the licence will also have to be allocated, the entitlement to use of any improvements made to the protected manufacturing processes clarified, as well as a variety of other related matters (see the list of questions at the end of this chapter).

Exclusivity of Licences

5.6. The most contentious issue that usually arises under such licences, however, is whether they are granted on an exclusive or a non-exclusive basis. If the right to use this information is granted on an exclusive basis, then the sub-contractor alone is entitled to produce the items protected in this way and the contractor itself is unable to give that right during the term of the agreement, at least to any other licensee or sub-contractor. The granting of an exclusive right in this way to a sub-contractor is clearly of great importance, and a step that a contractor would not undertake without careful consideration of its consequences. It is more likely in such cases that the licence will be of a non-exclusive nature meaning that, subject to the other terms of the sub-contract, the contractor could authorise other manufacturers to carry out similar processes on its behalf. If, however, the licence granted is exclusive, then it goes beyond the purely negative obligation of the

confidentiality agreement and confers positive rights of commercial value on the sub-contractor.

5.7. It may be, however, in practice that the most sub-contractors can normally expect is exclusivity for a limited period, possibly the period of the agreement or some part of it. Nevertheless, in view of its importance, the contractor may expect something in return if the sub-contractor insists on exclusivity, and other terms of the contract including the price may by way of adjustment be made correspondingly more onerous upon the sub-contractor. Alternatively, the contractor may insist that exclusivity for the sub-contractor will automatically cease if the sub-contractor fails to achieve demanding performance targets. This could, of course, enable the contractor to bring in other competing sub-contractors, which would obviously in turn put pressure upon the performance of the original sub-contractor. In the course of its work, the sub-contractor may, of course, itself contribute intellectual property rights or knowhow to the successful completion of its collaboration with the contractor, especially now that sub-contractors have become more specialised in their particular field of activity. What has been stated above about the care required for appropriate licensing of the contractor's intellectual property rights and knowhow applies equally, of course, to the sub-contractor itself.

5.8. If exclusivity is granted to a sub-contractor, it is likely to be accompanied by restrictions on it in favour of the contractor in order to reduce the potential of the sub-contractor to enter into direct competition with the contractor. Any kind of restriction in this category may be subject to the provisions both of national law which may regard them as restraints against trade and unenforceable in part or whole, and also under Article 85 of the Treaty of Rome which deals with agreements that restrict trade between Member States and may have the effect of restricting competition between enterprises.

The 1978 European Commission Notice

5.9. The Commission issued in December 1978 a Notice* setting out its assessment of the validity of certain clauses within sub-contracting agreements and this Notice remains in effect and relevant to the concerns of this Guide. The Commission made it clear in paragraph 1 of the Notice that it accepted that sub-contractors may have to make use of particular technology or equipment provided by the contractor in order to carry out their obligations and that the contractor might wish to limit the use of such technology and equipment by the sub-contractor to the particular application required for the purpose of the agreement.

*OJ.EC. C1 3/1/79 p.2.

5.10. The Commission went on to state that the use of the technology, knowhow or equipment provided by the contractor for purposes of a sub-contracting agreement may be limited by contrast to use in respect of that agreement only and not allowed to be made available to third parties (provided, however, that the relevant technology, knowhow or equipment is necessary to enable the sub-contractor under reasonable conditions to carry out its contractual obligations). These conditions will normally be satisfied where the property rights of the contractor are in the form of copyrights, registered designs, patents or utility models or comprise secret knowledge or manufacturing processes or knowhow, relevant documents, dies, patents or tools or any other necessary equipment (whether or not protected by industrial property rights or containing an element of secrecy) which permit the manufacture of goods for the contractor, which have their own specific identity and are distinct from other goods upon the market.

5.11. Such restrictions are not, however, approved by the Commission without qualification. They could indeed be in breach of Article 85(1) if the sub-contractor had at its disposal (or could under reasonable conditions obtain) access to that particular technology, equipment, etc. and this is normally the case when the contractor for its part provides no more than general technical information describing how the work is to be done rather than any of the specific items (tangible or intangible) referred to above. The Commission is aware that

(5)

allowing restrictions to be imposed when the contractor has not actually provided the relevant equipment, secret knowledge, etc., could deprive the sub-contractor of the possibility of later developing its own business in the fields covered by the agreement, and treats these qualifications, therefore, to the general rule permitting restrictions on the sub-contractor with some strictness.

5.12. The Commission have also indicated in the same Notice that other restrictions may be imposed, without breach of Article 85(1), on the sub-contractor which have the effect of:

- A normal confidentiality agreement applicable during the term of the agreement and thereafter so long as the information is not already public knowledge.
- An undertaking by the sub-contractor to pass on the contractor (provided it is on a non-exclusive basis) any technical improvements made by the sub-contractor during the currency of the agreement or in respect of a patent to grant a non-exclusive licence in respect of inventions covered by it. Such an undertaking by the sub-contractor could also be allowed, though exclusive in favour of the contractor, if the improvements or inventions made by the sub-contractor during the currency of the agreement are incapable of being used independently of the contractor's own secret knowledge or information, since this restriction would not itself constitute an appreciable restriction of competition. The contractor is not, however, entitled to give such an

undertaking where such results are capable of being used independently since such a restriction could restrain competition; and the existence of the sub-contracting relationship would not itself be a sufficient justification to displace the ordinary rules of competition as to the use of industrial property rights or knowhow.

Effects of the 1978 Notice

5.13. It is clear from the above Notice that while the sub-contractor can be prevented by the contractor from using the contractor's information and knowhow during the term of a contract for any non-approved purpose and also for any purpose at all after the contract is terminated, the manufacturer cannot stop the sub-contractor after the termination of the contract from providing services or manufacturing goods for other contractors simply because those contractors are in competition with the original contractor or operate in the same sector or in related fields. Nevertheless, the sub-contractor should still be careful when seeking new business after the termination of a sub-contract to check that the work it will carry out will be done from its own knowledge and experience, or based on data in the public domain (in addition to any to be obtained from its new contractor) and is not covered by any of the previous restrictive clauses contained in the earlier sub-contract, to the extent that they are legally valid.

Trade Marks

5.14. Another sensitive problem concerns trade marks. Recently it has become increasingly common for contractors to attempt to require sub-contractors of components to put the contractor's own trade mark on the product supplied and to omit the sub-contractor's trade mark (and at the same time the sub-contractor is usually prohibited by contract from selling these products to third parties).

There is a danger that this practice will do serious damage to the sub-contractor since its status as a producer will not be recognised and so he will be excluded from the market (in particular the market in spare parts).

It may also create a state of confusion in the mind of the ultimate purchaser. Thus for example, on the one hand, identical products manufactured by the same sub-contractor for different customers, or for one customer, and also by the sub-contractor himself for the spare parts market may appear on the market under different trade marks (which means that instead of serving to identify the manufacturer the trade mark becomes the only distinguishing feature for products of identical origin and quality). On the other hand, similar products supplied to the contractor by different sub-contractors (and thus of different origin and sometimes of different quality) may appear on the market under the same trade mark.

This practice may, therefore, raise difficulties under both national and Community law and sub-contractors should always seek legal advice if it is put forward as a term of a sub-contract.

Chapter 5: Questions for the sub-contractor

A. 1. Am I providing the contractor with confidential information of any kind?

2. Do I require a predisclosure agreement in respect of our initial discussions?

3. Once the sub-contract is signed, have I ensured the reciprocal confidentiality obligations in the contract in respect of all information, drawings, etc. handed over?

4. If intellectual property rights are involved, will the contractor grant me a licence to use it for the purposes of the sub-contract?

5. If so, will it be on an exclusive or non-exclusive basis?

6. For what purposes may I use the information provided?

7. Does it relate only to products supplied to the contractor or can it also be used for supplies to third parties?

8. If I use it for supplies to third parties, am I required to pay a licence fee or royalty to the contractor, and how much will it be?

9. Have I the right to grant a subsidiary licence to a third party?

10. What restrictions, if any, are there in the licence as to my activities for competitors of the contractor during the contract or after it?

11. In particular, are there any restrictions in any document which might be in breach of Article 85(1) or Article 86 of the Treaty of Rome or any provision of national law and have I taken legal advice upon them?

B. 1. Can I be certain as to which of the information supplied to me is simply knowhow and which is covered by intellectual property rights, e.g. patents?

2. Will my exclusivity terminate if the sub-contract is not performed up to target levels?

3. Will I be allowed to sub-licence information and processes covered by the original licence?

4. Am I responsible for bringing an infringement action if it appears that a third party is infringing the rights of the contractor as patentee?

5. In the latter case, is the contractor required to give me an indemnity in respect of the costs or breaches of right involved?

6. Who will own the rights to any further industrial property rights, improvements, etc. created as the result of product development by myself?

7. With regard to trade marks, are the goods to be produced to bear my trade mark or the trade mark of the contractor, both or neither?

8. Can goods of the type covered by the contract be sold freely by us to third parties either during contract or after and, if so, under what trade mark?

CHAPTER 6: Determination of Prices and Methods of Payment

Price Negotiations

6.1. Questions of price are among the most sensitive matters to negotiate. Even if the contractor and sub-contractor are combining successfully on the technical side, there is always likely to be a conflict of interest in their approach to the pricing clause. The contractor will tend to prefer a price that is essentially fixed, so that its own input costs can be more easily controlled. The contractor will also want the price to last for a reasonably long period, at least 12 months, and be subject to as little variation within that period as possible.

6.2. The normal requirements of the sub-contractor by contrast are different. Although it may have had to quote a fixed price in order to obtain the contract, it would prefer that this price apply only if the total order placed by the contractor reaches a target figure, and would like to be able to increase the unit price if only a lower figure is finally ordered. Whilst it will accept that its prices will have to be held in respect of cost changes that are substantially within its control, e.g. labour costs, it may not be so willing to accept all the risks that may arise through circumstances outside its control. Of these, exchange rates and changes in raw material prices are the most significant.

Exchange Rates

6.3. Exchange rates in particular can cause major difficulties in transnational contracts. If a contractor has entered into a contract to purchase components at a price of DM.100 each from a contractor whose costs are established in sterling, the variation in the DM/pound exchange rate will alter the balance of expectation between the parties so that either the sub-contractor is making a more extensive profit, or correspondingly is operating on tighter margins, than originally anticipated. Whilst to some extent this may just be a "fact of life" with which the parties may have to contend, it is generally accepted that if the variation in the exchange rates is more than say 5%, then adjustment to the contract price to allow for this may be permitted. If the parties can agree a contract price in European Currency Units (ECU), however, the risk of variations over the life of the contract can be reduced. Another ground on which alteration to the original price is sometimes allowed is where raw material prices are a substantial element in the sub-contractor's costs, and have varied to a considerable extent since the date when the contract was signed or the last price change agreed. This will be particularly likely where the costs have themselves been affected by exchange rate variations, e.g. in the case of some foreign commodities or raw metals or materials. The sub-contractor needs also to be alert to the distinction between the "currency of account" and the "currency of payment". The former represents the substantive obligation that measures the contractor's liability to pay, e.g. "100,000

French francs". The latter represents the currency in which that obligation is to be discharged, e.g. "payable in Italian lire".

Price Reviews

6.4. The sub-contractor should try to ensure that all extended or indefinite period contracts contain price review clauses, at dates well before the date at which notice of termination can be given, so that adequate negotiating time is left. It should enter such negotiations fully armed with not only its cost data, but with up to date information on recent changes in prices of both raw materials and finished products in the relevant sector, and also on changes in appropriate price indices.

The Basis for Pricing

6.5. Whilst it may seem surprising, sub-contractors have on occasion lost substantial sums of money through ambiguities or mistakes concerning the unit of quantity for which their price was quoted. The sub-contractor must always be exact, therefore, in such quotations, whether they refer to individual numbers of items or components or pieces or, alternatively, may be expressed simply in weight or volume of product or number of processes carried out at the sub-contractor's premises on the contractor's material as recorded and certified. Also important is the question of whether the price quoted includes all packaging, even that of a special nature required by the contractor and whether any taxes or handling charges involved are also included in the price. Prices may also vary according to the method of delivery,

e.g. whether in a large container or in a large number of small packages. It is also important for the contract to lay down the specific prices for any spare parts to be supplied, and the rights of the sub-contractor to recover from the contractor any additional costs incurred if goods are not collected in accordance with contractual provisions.

Terms of Payment

6.6. Having established the total sums payable in accordance with the calculation based on the agreed price for the goods or services supplied, the sub-contractor's priority must be to ensure that the terms of payment agreed to in the contract are strictly adhered to. Delay in making due payments is a problem widely encountered in most Member States: if it is unavoidable, the sub-contractor should seek to build in the additional costs involved as part of the contract price.

6.7. The essential points with which the contract must deal are respectively the preconditions for payment, the due date and place for payment and the method of payment. The precondition for payment is normally the tender or delivery of the goods or the completion of the relevant process or service provided by the sub-contractor. In some cases, however, this alone is insufficient since, possibly for regulatory or technical reasons, the sub-contractor must also deliver certain certificates of fitness or chemical analysis certificates or other official documents to the contractor before any obligation to make payment

arises. The sub-contractor must, therefore, ensure that all this paperwork is done promptly and correctly; failure to do so may mean that due delivery of the contractual obligations of the sub-contractor has not legally been effected even when the goods themselves have been physically handed over or the service or process completed.

Remedies for Non-Payment

6.8. There are, of course, a number of well known remedies which are in principle available to a sub-contractor (and which can be inserted in the contract) in the event of non-payment or delayed payment by the contractor. The most obvious of these is the right to charge interest. Many standard conditions of sale and some specific sub-contracting agreements contain provision for the payment of interest in the event of delayed payment. In some Member States national law provides that interest is automatically imposed on a debt if payment is late. In practice, such interest is rarely collected since the sub-contractor is unwilling to risk offending the contractor by pressing for it. In some cases, however, non-payment of accounts is merely a method of applying pressure to the sub-contractor to deal with complaints, perhaps alleged deficiencies in the goods or services provided. The better, however, the procedures set up jointly by the contractor and sub-contractor for investigating complaints, the less likely that this will occur; it should be part of normal investigation procedures that the completion of the investigation brings with it prompt payment of any sums held up pending the

complaint being resolved. Sub-contractors should not, however, accept the argument that alleged deficiencies in merely a small number of components or other items supplied provide a justification for non-payment for the remainder supplied.

6.9. The only other remedy available to the sub-contractor, apart from its fundamental right to claim to terminate the whole agreement on grounds of non-payment, is the use of the well known device of the retention of title in goods supplied. Whilst this may be, to some extent, valid under the laws of a number of Member States, there are often considerable limitations as to its effectiveness. Thus, the sub-contractor would need to be able to identify the actual goods which it had supplied to the contractor and these would need to be in their original form (or merely to have had some identifiable additional item added or inserted to them), and not to have been converted into another form of product altogether as will often have been the case, e.g. bricks converted into a wall or chemicals (or other raw materials) converted into a proprietary drug or solvent liquid.

Discounts

6.10. There is no easy answer to the problem of obtaining prompt payment of sums due. One possible assistance to prompt payment of invoices, however, may be to offer a discount for prompt payment. This may need to be sufficiently attractive in order to appeal and may take the form of allowing a discount of, say, 2% for any invoice paid within, say, 14 days of the date of delivery

of the product. This type of incentive tends to be more successful than the contrasting remedy of adding interest charges in respect of payments that are contractually late. The sub-contractor also needs to get across its message to the contractor that ultimately the sub-contractor's costs can only be kept competitive if the contractor does pay its accounts reasonably on time; consistent failure by the contractor to do so may ultimately lead to additional costs being incurred by the sub-contractor which it will have to pass on to its customers, including the contractor.

Factoring and Forfaiting

6.11. Whenever the due date for payment, it is advantageous from the sub-contractor's viewpoint that the method of payment is one which enables it to discount the contractor's obligation to pay at an earlier date with a banking institution or other financial body by utilisation of factoring or forfaiting. This may be possible either if the contractor settles its accounts by bills of exchange. More often the sub-contractor can merely assign its outstanding claims on the contractor to a financial institution in order to obtain a substantial advance on the face value of the claims. Some contractors seek to exclude the right of a sub-contractor to assign claims in this way to third parties. The sub-contractor should resist such a contractual provision excluding its rights, bearing in mind that the sub-contractor may well require at short notice to obtain additional working capital for its current operations, and that the utilisation of its

outstanding claims as security for advances from a bank or other lending institution may be its only method of raising funds at short notice.

Credit Insurance

6.12 Finally, mention must be made of the need for the sub-contractor to consider obtaining insurance protection against non-payment of its invoices. This protection may, of course, be obtained to cover local contracts, where trade protection societies and similar organisations can usually offer on commercial terms a degree of protection through insurance against the non-payment of debts, provided that the sub-contractor is itself of good standing and deals only with contractors themselves having a satisfactory credit rating. Such protection, however, is even more essential for transnational contracts, where the actual hazards and causes of non-payment are more varied and the risk of non-payment substantially greater. In each Member State, the sub-contractor should make itself familiar with either commercial or Government institutions offering protection for transnational contracts and should ascertain the qualifying conditions which they may impose and level of protection which they offer.

Chapter 6: Questions for the sub-contractor

(a) Prices.

A. 1. Is the contract price fixed or variable?

2. If fixed, for how long a period am I committed to it?

3. If variable, in what circumstances can I obtain an increase?

4. Is the payment of account, i.e. the currency in which my entitlement to payment is calculated, payable in the currency in which my costs are incurred?

5. If not, what can I do to protect the value of the currency of account if it seriously depreciates?

6. Can I minimise exchange risk, e.g. by express term allowing variation in the price if currency rates vary or by arranging for payment to be in a currency less subject to fluctuation, e.g. ECU's?

7. Does my price incorporate appropriate Incoterms, e.g. c.i.f. or f.o.b., etc. so that I will know exactly when my obligations are at an end with regard to insurance, etc.?

B. 1. Is the review date the same in respect of all types of cost, e.g. materials, labour rate, overheads, etc.?

2. What units , size of package, etc. do my prices refer to?

3. Is there any ambiguity in the description of these units?

6)

4. What happens if the contractor fails to collect the goods?

(b) Payment.

A. 1. In what currency am I to be paid and what steps can I take to minimise any risk of currency depreciation?

2. What is the contractual date for payment?

3. What is the contractual place for payment?

4. Are there are preconditions for receiving payment, e.g. delivery of relevant certification or official documentation?

5. What is the required method of payment (cash, cheque, banker's draft, bill of exchange, etc.)?

6. Is the method of payment in a negotiable form?

7. Is the method of payment in a form that can be discounted, e.g. by factoring or forfaiting?

B. 1. Is the credit period (whether short, medium or long) one which I can accept without damage to my own cash flow?

2. Have I made all necessary banking arrangements to cover any cash flow problem that I may encounter?

3. Can I claim interest from the contractor if the due date of payment is not adhered to?

4. Can I refuse to supply further goods if the due date of payment is not met for earlier orders?

5. Is an effective retention of title possible for the goods which I supply to the contractor?
6. Will any such clause be ineffective (a) because of the nature of the goods I supply or (b) for legal reasons in one or more relevant Member States?
7. Can I identify the goods I supply if I wish to enforce a retention of title clause?
8. Can I request special terms for payment because of the close relationship my business necessarily has to have with the contractor, e.g. under "just-in-time" arrangements?
9. Can I obtain credit insurance to cover part or all of the credit risk which I inevitably have to take?

CHAPTER 7: Delivery of Goods to the Contractor by the Sub-Contractor

Incoterms;

7.1. Every sub-contract should set out clearly the delivery arrangements for the product which it covers. The method of delivery (whether by rail, container load, on roll on-roll off vehicles, etc.) will be stated as well as the obligations of the supplier in terms of payment for freight and insurance. There will almost certainly be utilisation of one of the numerous Incoterms such as f.o.b. (free on board), f.a.s. (free alongside ship), or c.i.f. (costs insurance freight). The moment at which risk passes from sub-contractor to contractor will also normally be determined by the relevant Incoterm. If, however, Incoterms are not utilised, it is important that the contract makes absolutely clear the extent of the respective obligations of the parties as to delivery and the moment at which risk is to pass. This is, of course, not necessarily the moment when goods reach the contractor's premises and may indeed be at an earlier time or date. Moreover, the method of making delivery, e.g. by bulk load or by container (and of what size) or by packages of particular dimension, should also be specified in reasonable detail.

Delivery Schedules

7.2. The sub-contractor may simply be required to deliver a fixed number of units at regular intervals over the contract period, possibly on a daily, weekly or monthly basis; alternatively, the

contract may call for "call-offs" to be placed by the contractor at short notice within a general framework of advance estimates, with perhaps also overall minimum and maximum targets. Clearly, the sub-contractor should provide its contractor with an incentive for regular orders leading to regular delivery obligations; whilst offering such flexibility as is possible within the framework of its manufacturing capacity the sub-contractor should make clear that late orders cannot always be accommodated.

Delivery Dates

7.3. Another point which the sub-contractor should always bear in mind is whether time has been made "of the essence" for delivery dates specified in the contract, i.e. whether delay by itself will constitute an actual breach of contract. In some contracts, the contractor has made it clear that the sub-contractor's adherence to delivery dates, even possibly to time of delivery on particular dates, is absolutely critical to its operation and sums of financial compensation have been agreed which have to be paid by the sub-contractor who fails to comply with its obligations. The justification put forward for this by the contractor is that its own production line may itself be held up by the late arrival of components and substantial costs thereby incurred. The sub-contractor should never, of course, accept such a clause without being satisfied that the compensation payable does in fact reflect the likely damage to be incurred by the contractor, and with full awareness also of the consequences

of such a stringent clause upon its own operations and profitability.

Force Majeure

7.4. Not all, however, contractual requirements for delivery are as strict, and the sub-contractor should always seek to obtain contractual provisions that require it merely to use its best endeavours to deliver according to the schedule but without incurring financial penalties at least for minor delays. "Periods of grace" and some tolerances in quantities to be delivered are customary in many sectors and should be incorporated in any written sub-contract wherever possible. The sub-contractor should also ensure that a widely drawn clause is included absolving it from any penalty for late delivery or claim for damages in the event of any of the delays in delivery being caused by force majeure. Such a clause would normally cover a sub-contractor's inability to deliver on time for a variety of reasons (including Governmental decree or emergency regulations, strikes, adverse weather conditions, natural catastrophes and possible failure of its own suppliers to deliver essential items). Although one often finds out the items or events included in "force majeure" set out in a long detailed list it may not under applicable national law be necessary for each such event to be specifically set out. A general reference to "all circumstances outside the control of the sub-contractor" may be sufficient, and this is a point of national law to be checked. It is, however, particularly important that the sub-contractor is

aware of the relevant clauses in its own contracts under which it acquires its materials and bought in parts from its suppliers. It may be that the sub-contractor itself should seek to obtain the insertion of a form of financial compensation from its suppliers who prove unable to comply with their contractual supply arrangements. Whilst adequate "back to back" arrangements may well be difficult, especially because of the fact that the majority of the sub-contractor's suppliers may not be supplying under long term arrangements, the sub-contractor should not overlook any opportunity to provide safeguards against its own undue exposure to financial risk as the result of late delivery to its contractor. At least the sub-contractor should increase its chance of being able to recover damages for any breach of contract by its suppliers, by ensuring that they are made aware in writing at the time the contract is placed with them that the sub-contractor may be rendered in breach of its own obligations if there are contractual breaches by its suppliers.

Delays

7.5. If a sub-contractor becomes liable to pay compensation for its own late deliveries to the contractor, it is important that its obligation to do so is dependent, under the contract with the contractor, upon the contractor itself having given all necessary help and information and the fullest degree of co-operation to it, especially in the important period immediately preceding the commencement of production by the sub-contractor. For example, if delays in delivery were occasioned because the contractor has

delayed without apparent cause in approving technical data which had to be jointly agreed before tooling could be fully utilised by the sub-contractor, or if details of the final technical specification of the product are still awaited from the contractor, then the sub-contractor should consider whether these failings by the contractor may have substantially contributed to any delays, and therefore authorise an extension of its delivery times. Moreover, in all cases, the sub-contractor should seek to limit the damages payable either to a nominal figure agreed in advance or to the actual damage incurred by the contractor as the result of the late delivery (taking into account where available any contractor's duty under national law to mitigate its own losses).

Just-in-Time Systems

7.6. So far, we have discussed what may be called the traditional relationship between contractor and sub-contractor where the contractor will hold at any one time a reasonable amount of the sub-contractor's deliveries in stock. In many sectors, however, and particularly those involving high technology, this traditional relationship has now been greatly changed as the result of the influence of the "just-in-time" philosophy originally developed in Japan but now increasingly prevalent in both Europe and the United States of America. Sub-contractors need to be fully aware of the significance of this new philosophy both in its narrow and in its broader application to their legal obligations for delivery of products. In its narrower sense,

this expression refers simply to a tight delivery schedule imposed by a contractor on its sub-contractor, under which deliveries have to be made at very precise intervals so that the contractor is unlikely to hold much, if any, inventory on its own premises relying on regularity of deliveries from the sub-contractor. In the broader sense, however, it refers to a philosophy of close co-operation between contractor and sub-contractor embracing not only the delivery schedule but also many of the areas of joint concern such as quality control and technical specification, which have already been discussed in earlier chapters of the Guide.

7.7. The mere existence, of course, of a "just-in-time" obligation or relationship with a contractor does not remove the need for the sub-contractor to pay careful attention to the terms of his contract. A "just in time" relationship to which both contractor and sub-contractor contribute, and in which the contractor combines an insistence on such strict obligations on the sub-contractor with a fair treatment especially in terms of technical co-operation and prompt payment in accordance with contractual terms, can prove extremely valuable for both sides. The sub-contractor should, however, always be alert to prevent the relationship becoming one-sided, when the contractor insists on the one hand on meticulous observation by the sub-contractor of its precise obligations, but fails for its part to provide the necessary degree of technical co-operation and allows its own

contractual obligations to be either inadequately performed or ignored.

Chapter 7: Questions for the sub-contractor

A. 1. Have appropriate terms as to risk, insurance, etc. been fully agreed? Are they standard, e.g. Incoterms, or specially negotiated for this contract?

2. At what point does my risk terminate?

3. Is the delivery schedule fixed in advance or is it variable subject to advance notice of "calloff"?

4. Is the period of "calloff" notice adequate?

5. Am I liable to pay compensation for late deliveries and, if so, on what basis?

6. Am I prepared and technically competent to enter into a "just-in-time" commitment with the contractor?

7. What are the advantages and disadvantages of doing so? Do, for example, these include more frequent deliveries in smaller quantities, little or not allowance for variation in delivery quantities?

B. 1. Are there minimum and maximum ranges and are they reasonable in the light of my production facilities?

2. Is there an adequate force majeure clause in the contract to cover major emergencies such as strikes, fires, storms, etc.?

3. Am I being sufficiently paid for the additional costs of operating on such a basis?

CHAPTER 8: Product Liability and Insurance

Responsibility for Defects

8.1. In Chapter 2 there has already been emphasized the importance of ensuring that the sub-contractor complies with the quality requirements of the contract, and the possible consequences of failure to do so. A further important reason for taking every step to ensure that there are no defects in its product is to minimise the risk that any person may be killed or injured as a result of a defect in the goods when they are later marketed incorporating the sub-contractor's component. If, however, a defect in a component does escape notice at the time when it is supplied to the contractor for incorporation in its product or assembly and later is alleged to have been wholly or partially responsible for an accident causing death or injury to a user or purchaser of the item, (perhaps a car, aircraft or household electrical appliance) a claim may be brought by or on behalf of the purchaser or user against both contractor and sub-contractor. Thus, to quote a wellknown example, a person injured by glass from a shattered car windscreen was held entitled to sue not only the car manufacturer, but also the producer of the glass (a sub-contractor) for its alleged negligence in manufacturing it.

8.2. Defects which cause death or injury are either defects of design or of manufacture, or involve a combination of such defects. Normally a sub-contractor will not be liable either to

the contractor or to a third party in respect of a defect in design alone, as the technical specification generally makes it clear that this is to the manufacturer's or contractor's final requirements even though the sub-contractor may well have provided technical assistance to the contractor, in arriving at the specification. The essential point is that it is the contractor or manufacturer's own total requirements (both commercial and technical) which essentially determine the final specifications, not those of the sub-contractor who plays inevitably an important but ultimately subordinate role in the consultations. If, unusually, the sub-contractor were to have to accept responsibility in legal terms for defects in design of the components which it supplied, this should always be specifically referred to in the sub-contract. The importance for the sub-contractor of not accepting responsibility, save in the most unusual circumstances, for the design of components supplied by it to the contractor's requirements cannot be overemphasized.

8.3. A responsibility of the sub-contractor to third parties normally arises on the other hand because there is a defect in manufacture of the component, either because it has not in fact complied with the technical specification of the contract or, although apparently doing so, is suffering from a latent defect which the contractor and sub-contractor alike failed to identify. As a matter of contract law, therefore, if the contractor, as the result of the sub-contractor's failure to manufacture to specification, has itself been successfully sued by an injured

third party (purchaser or user), then the contractor may under national law be able to recover its loss from the sub-contractor by reference to a breach of the contract between them. It is not by any means clear, however, if the contractor would be able to bring such a claim successfully in the event that the defects in the component were not the result of failure to comply with specification; the sub-contractor may well argue successfully that it has complied with all its obligations to the manufacturer by producing components in accordance with the technical specifications, which determine its obligations, even if it later transpires that these may prove inadequate. Often the sub-contractor has little idea of the exact circumstances in which its component is to be utilised and the requirements which will be expected from it, unless these are fully set out in the sub-contract specifications. It would nevertheless be unwise for the sub-contractor to assume that total adherence to the contractor's technical specifications absolutely prevents any form of claim against it by an injured third party. The sub-contractor must always be conscious of its additional general duty not to act in a way which may expose a third party to a risk that is greater than the risk inherent in the use of the relevant final product. For example, if the product is likely to come into contact with the consumer's skin, the sub-contractor may be liable if it uses materials that are harmful on contact with it, even if the technical specification is itself silent on this point.

The Limited Availability of Claims under Contract

8.4. Claims for breach of contract, however, under the law of the majority of Member States can only be made by persons party to that contract, though this right sometimes may be extended to those with whom the contracting purchaser has a close connection, e.g. to their immediate families or employees. When injury is caused as a result of defects in goods supplied by the sub-contractor or contractor to a person who is not a party to the relevant sale contract, in such situations the injured party has no alternative but to bring a claim under tortious or delictual principles. In many Member States, this could have involved the injured party in having the difficult task of proving a causal link between the injury sustained and a defect in the product caused by negligence of the manufacturer.

The 1985 Product Liability Directive

8.5. This longstanding requirement, however, for the injured party to prove negligence against the manufacturer of defective products led increasingly to widespread consumer and political demand that liability for defective products causing death or personal injury should be made strict, in order to make easier the task of injured parties in recovering damages in these circumstances from the manufacturer. In 1985, therefore, after extensive consultation and negotiations, the Council of European

Communities adopted a Directive (No.374/85)* requiring Member States to introduce not later than the end of July 1988 equivalent laws providing strict liability in cases where personal injury had been caused by defective products. The national law adopted by each Member State for this purpose will obviously not be identical in all details but in principle, as a matter of Community law, it is required to embody all the mandatory provisions of the Directive. They will come into effect on different dates in the various Member States as the necessary national legislation is enacted. Moreover, the effect of the Directive is not to replace existing national laws or code provisions relating to third party claims, but to supplement them by reducing the burden of proof on the injured third party.

8.6. The Directive makes a producer of goods, including a sub-contractor, strictly liable for damage caused by defects in products manufactured by them. The injured party has only to prove that death or personal injury has occurred or that damage exceeding 500 ECU in total has occurred to property (other than the defective product itself) which is of a type ordinarily used for private use or consumption and was actually being so used. The claimant does not have to show negligence or fault by either the main producer or the producer of any individual components.

*OJ.EC. L210 7/8/85 p.29.

If more than one producer is liable for the damage, then national law will determine the apportionment of it between them and this, for example, could apply when both manufacturer and sub-contractor are claimed to be liable in such circumstances.

8.7. The Directive does provide a number of defences which may be applicable both to manufacturers and sub-contractors. These include the fact that the defect which caused the damage did not exist in the product (or component) at the date when it was put into circulation, or that the defect was due to compliance of the product with mandatory Community regulations ,or that the state of scientific and technical knowledge at the time the product was put into circulation was not such as to enable the existence of the defect to be discovered. In the latter case, however, this defence will not automatically appear in national legislation since Member States were given the option by the Directive of either including or excluding it as a possible defence. This defence, known as the "development risks" defence, is controversial and its adoption by individual Member States is optional. Another defence of value, however, to sub-contractors is that contained in Article 7(f) of the Directive which reads:

> "The producer shall not be liable as the result of the Directive if he proves in the case of a manufacturer of a component that the defect is attributable to the design of the product in which the component has been fitted or to the instructions given by the manufacturer of the product".

The "producer" in this context can clearly include a sub-contractor.

Apportionment of Liabilities between Contractor and Sub-Contractor

8.8. For further details of the Directive, reference should be made to legal textbooks as this Guide can only provide an outline of the complex legal issues. Even from this brief outline, however, of the new obligations of sub-contractors it will be clear that the issue of product liability should be jointly considered with the contractor at the time when the terms of the sub-contract are being negotiated. The contractor and sub-contractor have to accept the basic principle that they cannot legally exclude their product liability obligation to third parties by any form of agreement between them. All they can do is apportion any liability established upon them on a basis which appears fair in the particular circumstances and after establishing the respective areas of responsibility. This means that responsibility for the production of the sub-contract part in accordance with the requirements of the sub-contract's own technical specification rests with the sub-contractor. On the other hand, however detailed the requirements of the contract and however much co-operation has been given by the sub-contractor in arriving at the final technical specifications, it should again be emphasized that liability for the design of the part should be clearly imposed by the terms of the sub-contract on the

contractor, save in the rare case where the sub-contractor has explicitly accepted this responsibility.

Indemnities

8.9. The additional obligations which the new legal situation places on both contractors and sub-contractors make even more essential than previously the closest technical co-operation between them both before and during the contract's life, and underlines the importance of agreeing accurate technical specifications and quality control systems as already discussed. If, therefore, a sub-contractor feels that the basis upon which the contractor's end product is being produced does contain an unacceptable hazard or risk, it should reconsider its position. In an extreme case, the only safe course for a sub-contractor may be to refuse to participate in the contract, or only to do so if the contractor is prepared to provide a full indemnity. In most cases, the contractor is unlikely to be willing to give such an indemnity. Indeed, even an indemnity is not a total protection for the sub-contractor since at the time, probably years later, when the claim is made by an injured user of the final product, the manufacturer may have gone into liquidation or be otherwise unable to meet any claim awarded against it.

Insurance

8.10. The new exposure to strict product liability, however, makes even more important that each sub-contractor considers carefully the extent to which it requires insurance cover against

third party claims. The contractor needs, probably with the assistance of its insurance broker or adviser, to identify the risks that it actually faces, and then to consider the best way in which to secure this cover at minimum cost. It is clear that some sub-contractors will have difficulty in obtaining cover or cover on reasonable terms, if the nature of their product makes it difficult for insurers to assess the likelihood of claims or the amount of claims that may be brought. Insurance companies find it difficult to quote accurate premiums without access to records of claims made over a reasonable period. In particular sectors, particularly where the product is of advanced technology this data may not be fully available and so the availability of cover may be doubtful and its cost particularly high. On the other hand, some trade associations have been able to negotiate appropriate coverage for their members, either applicable to all claims including those made under the new strict liability principles, or incorporating a clear statement as to the specific risks excluded from an otherwise comprehensive cover, so that the sub-contractor is made clearly aware of its position.

Recall Procedures

8.11. The extent of coverage may also raise difficulties since it should be obtained in principle not only for the full liability for damages and costs to third parties making successful claims in respect of the defective product, but also to the major expense of withdrawing a defective product from circulation by a "recall" procedure, and by its replacement by new products.

Indeed, experience shows that the "recall" operation, coupled with the necessary administrative and management time devoted to it, may prove far more expensive than the actual settlement of all the individual claims by injured third parties. It is possible that insurance companies will place important conditions on the grant of insurance cover which may require the introduction of particular quality control systems adopted so that the chances of a defective product are reduced if not eliminated. It may well be necessary for businesses that carry particularly substantial risks as sub-contractors to arrange that these operations are carried on by separate companies which alone would be affected by any substantial product liability claims.

Chapter 8: Questions for the sub-contractor

A. 1. What are the hazards and the risks of the particular products that I produce?

2. Have I discussed them fully with my insurance broker/insurance company and obtained the necessary cover?

3. Have I adequate cover sufficient both to cover the relevant risks and also in terms of the sums payable by the insurance company if a successful claim is made against me?

4. Have I sought an indemnity clause of any kind from the contractor either to cover all claims or merely claims either in respect of workmanship/materials/design?

5. To what extent (if any) have I agreed to accept responsibility for design?

B. 1. Has a procedure been agreed with the contractor for investigating any claims that might affect liability of either of us either under contract or under product liability of a strict nature?

CHAPTER 9: Courts and Arbitration

Introductory

9.1. All of the issues so far considered in the Guide have been of more or less practical importance to the operation of the sub-contract, and whilst in handlingthem an adequate understanding of the legal issues is useful, they can in many cases be satisfactorily negotiated on the basis of industry experience coupled with a strong element of commercial commonsense. The issues to be considered, however, in these last two Chapters are of a more strictly legal nature in a technical sense; the sub-contractor may, therefore, wonder why it is in a "Practical Guide" is being asked to give consideration to them. The reason is that much of the value of an otherwise satisfactory sub-contract may be lost if the interpretation of its clauses is conferred upon an inappropriate forum (court or other form of tribunal), which is required to apply a national law, under which the sub-contractor may find it more difficult to obtain what it regards as a fair outcome to a dispute, than might have been the case had another method of resolving the problem and applying a different national law been chosen.

Courts of Law

9.2. The first technical issue which has to be considered is how disputes between the parties are to be resolved. The normal and traditional answer would be the courts of law. A Judge in those courts may well not be already familiar with the particular

8)

subject matter of the case but he will normally be quick to learn enough about it in order to render a rational judgment on the basis of the expert and other evidence, and in the light of the arguments taken before him on behalf of the parties. Publicity for the hearing and for the Judge's decision may, however, be unavoidable and moreover appeals may also be taken from the original decision to higher courts. There are inherent delays in any court system, even for commercial cases, and this may mean that several years can pass before any dispute is finally resolved. Moreover, the resolution of disputes through the court system is inevitably costly, not only in financial terms but also in terms of the management time necessarily devoted to the cases given the extended period over which the cases may last and in terms of permanent deterioration of commercial relationships with the other parties. Courts indeed have a definite advantage as a system of resolving disputes when either the party utilising them requires a quick immediate order (either to preserve the status quo or prevent some act occurring of substantial prejudice to it), or alternatively where the case is a relatively clear one for the payment of money owing, the other side has little or no defence to the claim, and the enforcement machinery of the court is needed for compelling payment of the sums owing. But Courts also have their disadvantages, in terms of both time and money, as a means of resolving complex technical disputes between commercial organisations.

Arbitration

9.3. On the other hand, given these obvious disadvantages of court proceedings for resolving such commercial disputes, including those that could arise between the sub-contractor and the contractor, one would have supposed that arbitration would have become a natural substitute in nearly all such cases, gradually taking over much of the jurisdiction originally held by courts. Arbitration after all involves the application of the same legal rules as a court would apply, but within a procedural framework that in principle offers greater speed and informality, and without the delays apparently inherent in court procedure. Moreover, arbitration can be conducted by arbitrators chosen for their specialised expertise and knowledge either by the parties direct or by reputable national or international institutions such as the International Chamber of Commerce. The costs of arbitration do, of course, have to be paid by the parties involved, as well as the fees of any institution responsible for providing the arbitrator, though the winning party may receive an award which obliges the loser to bear at least a substantial part of the costs and fees involved.

9.4. Notwithstanding, however, the apparent advantages of arbitration for resolving commercial disputes, it does appear from available evidence that its advantages have not so far proved universally recognised, particularly for the kind of disputes that may arise from commercial relationships between contractor and sub-contractor. It seems to be widely felt that

although arbitration is often well suited to cases which involve issues that are themselves highly technical, e.g. the quality of a commodity such as soya beans or timber or the issue of whether, say a particular metal supplied had the required proportions of individual elements, it is less well suited to dealing in a prompt way with complex contractual disputes which require an analysis of events occurring over a long period of time as well as interpretation of legal documents. The resolution of such disputes through arbitration may take even longer, and be even less ultimately to the satisfaction of the parties, than the use of the courts of law for this kind of dispute. There have been many examples where the arbitration process has dragged on even longer than would equivalent court proceedings. One reason is that in arbitration the conduct of the proceedings and its timetable is in theory more under the control of the parties, who may have their own reasons for not hastening on with the case. The procedural rules affecting arbitration may likewise be almost as complex as court rules. Moreover there are great difficulties under many systems of national law in making an appeal from an arbitrator's decision even on matters of law whereas, of course, this can normally be done without difficulty in the case of court judgments. Of course, the inability to appeal in many cases from the arbitrator's decision may be regarded by sub-contractors as an element of finality to be welcomed.

A Third Way - Mediation

9.5. The third alternative method of resolving dispute arising

from sub-contracts, which has become quite popular especially in the United States and in some Member States, is that of appointing an independent third party to act not as a formal judge or arbitrator, but as an informal mediator and leader of negotiations between the parties in dispute. This third party has the double task both of suggesting ways under which the immediate dispute could be resolved, and also of maintaining the relationships between the parties for the future which, by the end of the protracted court action or arbitration, are often likely to have been irreparably damaged. There may well be scope in seeking to resolve disputes arising under the sub-contract by using such informal resolution of disputes by third party mediators of unquestioned integrity and independence, perhaps to be appointed by relevant trade associations if the parties themselves cannot agree on the choice. Of course, if such efforts at informal resolution or mediation should fail, the parties remain free to go to the courts or to arbitration in the usual way. The great advantage of resolving disputes in this way, apart from the saving in time and expense, is the greater opportunity it offers for preserving commercial relationships between the parties, in spite of the dispute.

Chapter 9: Questions for the sub-contractor

A. 1. If disputes arise which cannot be settled by negotiation, by what type of institutional procedure do I want them resolved (court, arbitration, informal procedure)?

B. 1. Can any help in resolving disputes be given by a relevant trade association?

CHAPTER 10: Applicable Law and Jurisdiction of Courts

(A) Applicable Law

Introductory

10.1. An assumption that has so far been made in this Guide is that both parties know the system of law which is to apply to their contract. This is an easy assumption when both parties operate largely in the same country, but it is not so once we are dealing with transnational contracts. Here, very often it happens that when parties face the problem openly they find it difficult to agree which country's law should apply; alternatively, they do not face the issue and leave uncertain the relevant system of law (hoping that no disputes over the sub-contract will arise), an approach which is itself potentially dangerous to both of them.

Normal Method of Choosing Applicable Law

10.2. The basic objective for a sub-contractor is that the law governing the sub-contract should be one with which it is familiar. Given, however, the normal bargaining position of a sub-contractor seeking to obtain a contract from a larger contractor, it is unlikely that the sub-contractor in a transnational case will often be able to obtain the agreement of the contractor that the sub-contractor's own national law shall apply. Normally, the contractor will insist that the law most favourable to itself, usually its own national law, is to govern,

though occasionally the choice may be that of the law of a third country. This is particularly likely to be so if there are a large number of sub-contractors participating in a major project for a single contractor; or if the sub-contractors (perhaps from more than one Member State) have entered into regular relationships with a major contractor whose base of operation is in one country, when clearly the contractor would expect its own national law to govern all the sub-contractors regardless of their separate nationalities.

10.3. The effect of this is that it will be essential for a sub-contractor to ensure that the sub-contract document does contain not only appropriate clauses to cover the various issues dealt with in earlier chapters but is also considered (prior to finalisation) by a lawyer competent to advise on the foreign law that is to be applicable. If the sub-contractor has made use of this Guide, it will be aware of many of the relevant questions to ask; but a competent local lawyer will be needed also have to be able to give confirmation that the contractual clauses actually proposed for adoption are sufficient to protect the interests of the sub-contractor. A local lawyer should be able to put a sub-contractor in touch with a suitable foreign lawyer in the country where it will be doing business though it may also be desirable, if it plans to make transnational contracts on a regular basis, that its own local lawyer also becomes as familiar as possible with the problems of doing business in other Member States of the

Community, so that he too learns to understand the important questions to ask.

International Conventions on Applicable Law

10.4. In practice, therefore, the sub-contractor rarely has the option of choosing the applicable law since the contractor will normally insist on its own national law applying. It, therefore, appears unnecessary to set out at length the European legal rules and Conventions applicable to the choice of law. Several international Conventions deal with the sale of goods (and could apply also to most industrial sub-contracts), for example the Hague Convention of 1964(1), the Rome Convention of 1980 (2) and the Vienna Convention of 1980(3). In view of the complexity of the position, however, the only sensible source for a sub-contractor when the matter is negotiable is not to rely on the provisions of these individual Conventions, but to discuss and agree an appropriate applicable law in advance, and to include this choice in the agreement with the contractor.

(1)known as the Uniform Laws on the International Sale of Goods, adopted on 25th April 1964.

(2)known as the E.E.C. Convention on the Law applicable to Contractual Obligations, adopted on 19th June 1980.

(3)known as the United Nations Convention on Contracts for the International Sale of Goods, adopted on 11th April 1980.

(B) The Jurisdiction of Courts

The Brussels Convention

10.5. Whatever the applicable law to be chosen, the sub-contract should also specify the court which (assuming that no other method of resolving contractual disputes has been chosen) is to have jurisdiction and to apply the relevant law. This court is not necessarily of the same country as that of the relevant applicable law. It is important to note that in this matter, the parties to the contract have less freedom of choice than in the question of applicable law. The legal position is governed in nearly all cases involving Member States by the 1968 Brussels Convention which is applicable at present in all Member States except Spain and Portugal which also have, within the reasonably near future, under the terms of their Treaties of Accession, to adopt the Brussels Convention as part of their national law. Whilst the terms of the Brussels Convention do preserve the right of the parties in contractual cases to choose the courts which are to have jurisdiction, this choice is limited to the courts of a Member State and the contract should provide that the choice of contract has been made by both parties and not unilaterally laid down by one party (presumably the stronger in bargaining power) for its own benefit. If, however, the parties have not made a valid express choice, then the rules of the Convention come into effect.

10.6. The basic rule of the Convention is that the defendant individual or company, has to be sued in the place of its domicile which, in the case of an individual, means its normal place of residence and, in the case of a company, means its seat, normally the place either where it is incorporated and has its registered office or official address or, alternatively, where its management and control are exercised. There are also a number of cases of special jurisdiction where courts in Member States may nevertheless have jurisdiction even when the defendant is not necessarily domiciled there. These include some special cases which may be relevant in the case of sub-contracts including:

- The place of performance of the contract (this will usually be at the business premises of the sub-contractor where the contract work is being carried out).
- In claims for tort or delict, in the place where the harmful event occurred or is likely to occur. The European Court has confirmed that this may be either the place where the original act of negligence occurred or also the place where its harmful effects took place.
- Claims against a Community domiciled party as defendant or third party in a case involving counterclaims or when joined as additional defendants to a case. This could well occur in product liability cases if the contractor is sued in one country and the sub-contractor is then joined as a party into the same case by the contractor.

10.7. The position, therefore, appears to be that in transnational sub-contracts, if a sub-contractor wishes to sue the contractor for payment of sums owing, then it will normally have to do so in the courts of the country where the contractor is domiciled or, alternatively, where the contract was to be performed. If, for example, a Spanish company, therefore, has carried out sub-contract work in Spain for a French company, it would be able to sue the French company either in Spain or France. Moreover, once a case has been brought by one company, it is open to the other company to counterclaim in respect of other matters arising between the parties in the same court.

Chapter 10: Questions for the sub-contractor

A. 1. What law would I prefer to govern the sub-contract?

2. Regardless of my preference, what law is likely to be insisted upon by the contractor?

3. Do I know what my responsibilities would be under such law?

4. What courts will have jurisdiction over the contract?

B. 1. Do I have a lawyer who is himself familiar or capable of becoming familiar with its requirements?

2. If not, should I obtain such a lawyer in the relevant Member State?

3. Does the contract incorporate provisions of the Hague Convention of 1964, the E.E.C. Convention of 1980 or the Vienna Convention of 1980?

4. Does any form of tribunal exist (not necessarily a court) to deal with contractual disputes which I would regard as having a familiarity and understanding of sub-contracting?

5. Is it better to confer exclusive competence on a single court (or other form of tribunal) or allow a choice to be made between a number of different courts?

6. Have all possible steps been taken in drafting the contract to ensure that the preferred court will actually accept jurisdiction?

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