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Careful Contracts Reduce Risk

A contract with watertight insurance provisions can save retailers, distributors, and importers expenses that result from recalls of defective Chinese products

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Defective products imported from China have caused alarm on Capitol Hill and among US consumers and businesses. Mattel, Inc.; Menu Foods, Ltd.; and other US and Canadian companies have incurred huge costs for recalls and suffered massive losses in revenue, profit, stock price, and reputation. Besides

shouldering recall costs, these companies are burdened by expensive class action lawsuits and other legal costs.

Retailers, distributors, and importers can no longer treat recalls that result from defective Chinese products as remote possibilities that will not happen or that will go undetected. That retailers, distributors, and importers are not manufac-

turing the defective goods does not shield them from US regulators that hold them responsible for protecting consumers from defective products nor from product liability, tort, or class action litigation. As the deep-pocketed last links in the supply chain before a product reaches consumers, these retailers, distributors, and importers are the most likely to be hauled into US courts by plaintiffs or fined and penalized by US regulators. One strategy to mitigate such risks is for the contract to require the Chinese manufacturers to procure product liability and recall insurance policies with acceptable scopes and provisions of coverage and that these policies also cover the US buyers.

Negotiating a good supply contract

Negotiating a good purchase and sale or supply contract with the Chinese supplier is essential. A good contract sets the legally required quality standards for the product as well as the legal recourse that the US buyer has against the Chinese supplier if there is a breach in quality requirements. The Chinese supplier and US buyer must vigilantly monitor and test the quality procedures, materials, and products for adherence to the contract’s quality requirements.

A good supply contract will set forth the covenants, representations, and warranties related to product quality, design, specifications, prototypes, samples, inspections, and testing—all of which will impose on the Chinese supplier obligations to manufacture and deliver quality goods without safety defects. Concurrently, contract provisions related to defects, product liability insurance, recall insurance, and indemnification will provide for legal recourse against the Chinese supplier for a contract breach; they will also allow US buyers to make claims against the Chinese supplier’s insurer if product liability and recall coverages were required under the contract and are effective at the time of recall. Ultimately, the legal recourse will allow the US buyer to recoup costs, first from the insurance company under the policies or, if necessary, from the Chinese supplier under the indemnity—if the Chinese supplier remains solvent after the recalls. Thus, the US buyer, as part of its supplier due diligence, should select financially strong suppliers with clean track records for delivering quality products.

Whether US buyers can hold a Chinese supplier responsible for the costs of product liability lawsuits and recalls depends on whether the Chinese supplier agreed to be liable for these costs under the supply contract.

The responsible party

Product liability lawsuits and product recall costs that stem from safety defects in goods imported from China should be the responsibility of the party that caused the

defects. In most cases, the responsible party will likely be the Chinese manufacturer (or its subcontractors or material suppliers) unless the defect is a design defect for which the US buyer was responsible. Contractually, the Chinese manufacturer should represent and warrant that the product is free of any defects and complies with its (or the buyer’s) intended design and quality standards. If the contractual responsibilities of the Chinese supplier are not upheld and the products contain defects that are the supplier’s responsibility, the supplier will have breached the product warranty and will become liable for the damages and costs that arise from the defect. The US buyer could then make claims under relevant provisions of the contract such as product warranty, recalls, insurance, and indemnity.

Quick Glance

- Companies should draw up comprehensive contracts with Chinese suppliers.
- The contract should be with a financially sound supplier.
- The contract should require the supplier to have product liability and recall insurance that also covers the US buyer.

Product liability insurance

The contract should mandate that the Chinese supplier deliver to the US buyer a certificate of insurance affirming that the supplier has purchased the agreed amount of product liability insurance, which must provide US or worldwide coverage. The policy should name the US buyer as an additional insured, include a waiver of subrogation (whereby an insurer relinquishes the right to hold a third

party accountable for a loss suffered by an insured), and require that the US buyer receive advance notice of any cancellation or non-renewal. The contract provision should also state that the supplier is responsible for any deficiencies or gaps in coverage or deviations from the specified insurance terms. The supplier’s product liability policy should cover the legal costs incurred by the insured—both the US buyer and Chinese supplier—in defending product liability lawsuits. It should also require the insured to pay damages and claimants’ costs and expenses that result from bodily injury or property damage arising from the insured’s defective product.

A US buyer of Chinese imports typically has its own comprehensive liability coverage, which commonly includes product liability coverage. To manage risk, the US buyer should require the Chinese supplier to have product liability coverage on products sold and exported from China. Product liability coverage is available to Chinese manufacturers, but they rarely buy it unless it is a contractual requirement. During the contract phase, explicitly addressing the insurance coverage that the Chinese supplier must have helps the US buyer assess the risks it is taking and make wise commercial decisions about whether to proceed with a particular Chinese supplier.

Recall insurance coverage

Ideally, recall insurance coverage should also be required of the Chinese supplier. This is usually a stand-

alone policy in addition to the product liability or general liability policy, but it can also be obtained as part of a combined product liability and recall policy. Unlike a product liability policy, a recall policy need not name the US buyer as an additional insured or contain waiver of

Chinese suppliers may resist having to obtain recall insurance coverage under the supply contract. The US buyer should thoroughly explore the insurance angle of protection against defects in Chinese imports before concluding whether to require it and what types and levels of

A good contract sets legally required quality standards and the legal recourse that the US buyer has against the Chinese supplier if quality requirements are breached.

subrogation language. Under a recall policy, the recall cost of the Chinese manufacturer and of the US buyer and its customers are covered. The costs of replacing and repairing recalled products are also covered. It is important to remember, however, that liability assumed under contract by the insured and recall expenses in a forced recall by a governmental authority are not covered.

insurance to require. To date, US buyers have not consistently required Chinese suppliers to have product liability coverage. Recall coverage is much more complex and, as a practical matter, has rarely—if ever—been imposed on Chinese suppliers. The need to rethink this practice is clearly evident after the many recent recalls of Chinese imports. What is absolutely clear is that no US buyer should waive

Selected US Inspections/Recalls of Chinese Imports, 2007

Date	Recall
November 7	The US Consumer Product Safety Commission (CPSC) announces the recall of 4.2 million sets of Aqua Dots, a product sold by Toronto-based Spin Master Ltd., because their coating contains a chemical that can be toxic if ingested.
October 9	Seattle-based Starbucks Corp. issues a recall for 250,000 plastic children’s mugs that are easily broken when dropped, presenting sharp edges and a choking hazard.
October 4	CPSC announces the recall of more than 635,000 products made in China, including 555,000 products recalled because of excessive lead. Affected products include key chains, rattles, bookmarks, water bottles, and wooden toys sold in a variety of retail outlets, including Toys R Us, Sports Authority, and Dollar General.
September 26	CPSC jointly announces seven recalls of Chinese-made toy products because of excessive amounts of lead paint, for a total of roughly 600,000 toys. These include metal jewelry, puppetry sets, more than 350,000 gardening tools and lawn chairs sold at Target and Jo-Ann Fabrics, and more than 200,000 Thomas the Tank Engine Toys made by RC2 Corp.
September 4	Mattel Inc. announces a third global recall of products manufactured with lead paint, including 848,000 products sold under the Barbie and Fisher-Price labels. It also announces a new three-step check system for lead paint on all of its toy products.
August 14	Mattel announces a global recall of 18.6 million Chinese-made toys, including the recall of: <ul style="list-style-type: none"> • 18.2 million toys containing magnets that, if swallowed, could cause intestinal blockage or perforation. The products are a risk because of a design flaw. • 436,000 toy cars (featuring “Sarge” from the movie Cars) made using lead paint.
August 2	Mattel’s Fisher-Price division issues a global recall of 1.5 million plastic Chinese-made toys—including toys featuring popular characters such as Elmo, Big Bird, and Dora the Explorer—because of lead paint hazards.
July 29	California Department of Public Health warns consumers not to eat fresh ginger from China because of insecticide residue.
June 28	The FDA blocks imports of several categories of Chinese seafood, including catfish, eel, and shrimp, citing contamination by carcinogenic antimicrobial drugs.
June 27	The National Highway Traffic Safety Administration orders New Jersey-based Foreign Tire Sales, Inc. (FTS) to recall 450,000 Chinese-made light truck tires because of missing components that made the tires unsafe. FTS does so on August 9, issuing a product recall for roughly 255,000 tires.
June 1	The FDA issues an import alert for Chinese-made toothpaste sold under various brands because of the presence of diethylene glycol, a cheap substitute for glycerin. FDA also announces it has detained at least one shipment of toothpaste at the border.
May 14	RC2 Corp. announces a recall of about 1.5 million Thomas the Tank Engine toy trains and components manufactured in China because of lead paint contamination.
March 16	Canadian pet food importer Menu Foods Ltd. issues a precautionary recall of some of its dog and cat food because of melamine contamination, beginning the first in a series of recalls of more than 100 brands of dog and cat food across the United States between March and April.

Source: US-China Business Council

either the product liability or recall insurance coverage requirement without compelling commercial reasons or without having searched seriously for other suppliers.

Recovering costs of recalls from the supplier

When the Chinese supplier lacks product liability or recall insurance, the US buyer must impose reimbursement responsibility for product liability and safety recall costs and liability through contract provisions that explicitly state the supplier's obligations.

When a safety recall—even a voluntary one—occurs, the contract should obligate the Chinese supplier to reimburse the US buyer for all costs of the recall, including defending lawsuits. The rationale for the supplier to be responsible for the costs of a recall makes legal and business sense since the intent of such a contract provision is to place the responsibility for safety defects squarely on the party that caused the defect or must deliver quality products under the contract. If the contract does not explicitly or adequately address reimbursement from the Chinese supplier for costs of a recall, an innocent US buyer—even a vigilant one with stringent safety standards—will have little or no chance of recovering recall costs from the supplier.

An indemnity obligation

A strong indemnity obligation from the Chinese supplier to the US buyer for product defects is recommended in a supply contract. Even under ideal circumstances in which the US buyer obtains the insurance coverages it wants from the Chinese supplier, there could be deficiencies and gaps in what the insurance covers and in the scope of the obligations the US buyer wants to impose on the Chinese supplier under the contract. These gaps are best covered by an indemnity provision from the Chinese supplier to the US buyer that provides the US buyer with legal recourse against the Chinese supplier for costs and liabilities not covered by insurance, or as a backup to the insurance.

An international arbitration clause

Another essential provision in a cross-border US-China supply contract is an international arbitration clause. In the

event of a dispute with the Chinese supplier, the US buyer may need to pursue the Chinese manufacturer to enforce the contract. It is important that the supply contract mandate that disputes be resolved through international arbitration governed by US law. Preferably, the parties will have agreed to international arbitration somewhere in the United States using the International Rules of the International Dispute Resolution Center, the international arm of the American Arbitration Association. If the parties cannot agree on arbitration in the United States, the US buyer should insist on US governing law with the arbitration in a

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neutral jurisdiction, such as London, Paris, Vancouver, Sydney, Hong Kong, Singapore, Tokyo, or Seoul, administered by an arbitral body such as the International Chamber of Commerce or the arbitral body of the selected neutral jurisdiction.

A fundamental reason for providing for international arbitration is that China is a signatory to the New York Convention on Foreign Arbitral Awards, which requires signatories to recognize and enforce foreign arbitral awards. (In contrast, China has no obligation to recognize and enforce US court judgments.)



will not give the US buyer legal recourse against the Chinese manufacturer.

When a US buyer is dealing with a US sales subsidiary of a Chinese manufacturer, the US buyer could do one of three things. It could require the Chinese manufacturing parent company to be the contract seller, ignoring the US sales subsidiary for purposes of the contract. Alternatively, the buyer could require the Chinese parent to be a contract party in addition to the US sales subsidiary, making the supply con-

tract a three-party agreement with both the Chinese parent and the US sales subsidiary jointly and severally liable. Finally, the US buyer could sign the supply contract with the US sales subsidiary but require that the Chinese parent guarantee the performance of its subsidiary. In most cases, the financially strong counterparty will be the Chinese manufacturer with a factory and other assets in China, not its US sales subsidiary.

The financial strength of a contract party matters a great deal in the event of product liability lawsuits and recalls if the US buyer wants to seek reimbursement of these costs and liabilities from its supplier. There is no question that major recalls have in some cases put the US buyer and the Chinese manufacturer out of business. The US importer, Foreign Tire Sales, Inc., filed for bankruptcy after the recall of 250,000 tires it purchased from a Chinese tire manufacturer. In the case of toy recalls, hundreds of Chinese toy manufacturers have had their business licenses in China revoked, putting them out of business.

Legal recourse

The legal recourse that a US retailer, distributor, or importer has against its Chinese supplier depends on the contract terms between the US buyer and the Chinese supplier. Careful contract negotiations, agreements, and documentation on all the terms and conditions of the agreement, including those that deal with product defects and recalls, are essential to ensure the availability of legal recourse. Supply contracts, however, often consist of a purchase order with or without terms and conditions. And, even when there are terms and conditions, they may be unsuitable for the cross-border, US-China context, or they may be superseded by the seller's confirmation order, which may have its own terms and conditions. This sets

Other international legal provisions

International legal provisions, in addition to international arbitration, are required in the cross-border, US-China context. International contracts cannot be treated like domestic contracts, even when the domestic contract is comprehensive, well-drafted, and carefully considered. Provisions that may require different treatment or that may need to be added in the cross-border, US-China context include governing law (which country's law will govern the terms of the contract and any disputes), importer of record, customs, shipping terms, foreign currency, governing language, and translations.

Contract with the appropriate party

Contracting with a credible and financially strong Chinese supplier is critical. This fundamental legal and commercial principle is often violated in the China context because foreign firms typically contract with a "middleman" or "shell entity" that has little or no assets. US buyers often contract with a third-party sourcing company, unaffiliated with the Chinese manufacturer. This results in a situation where the contract seller is not the manufacturer of the goods, and when a product defect is uncovered, the US buyer has legal recourse only against the contract party, not the Chinese manufacturer. All too often, the contract party is a third-party supplier that has no assets and offers no risk mitigation for the US buyer.

In some cases, the US buyer may be dealing with a US sales subsidiary of a Chinese manufacturer. These entities exist solely for marketing and sales purposes and typically have few or no assets in the United States. A contract with the US sales subsidiary of a Chinese manufacturer

up the classic legal “battle of the forms,” an expression that characterizes the exchange of written communications between the contract parties in which each party presents its own terms and conditions, making it difficult to determine whose terms and conditions actually apply.

have conducted—as part of the underwriting process—some risk assessment that involves the Chinese supplier, factory, production processes, and product inspections for the insurance coverages, adding a layer of quality assurance and risk management. US companies today, more than

When a safety recall—even a voluntary one—occurs,
the contract should obligate the Chinese supplier to
reimburse the US buyer for all costs of the recall.

By entering into a comprehensive supply agreement, the US buyer and the Chinese supplier will avoid a dispute over what constitutes the contract terms and delineate clear and enforceable rights and obligations.

A clear contract reduces risk

Clear contract terms and product liability and recall insurance policies provide risk-mitigating benefits. First, specific contract terms related to product liability and recalls in a supply contract with international terms will offer the US buyer legal recourse for product defects. Second, if insurance coverages are provided, the insurer will

ever, are aware that purchasing decisions should not, and cannot, be made solely by purchasing managers without the input and approval of both international lawyers and risk managers. With a good supply contract and insurance coverages in place, the executive in charge of global procurement will be able to sleep at night. 完

Grace Parke Fremlin is a partner at Steptoe & Johnson LLP in Washington, DC, and specializes in global sourcing, procurement, distribution, sales, and cross-border mergers and acquisitions. She wishes to thank Willis Group for information on product liability and product recall insurance, especially as these coverages relate to China.