Avoid the risks of using foreign manufacturers

Brands such as Wal-Mart and Mattel have suffered from problems caused by foreign manufacturers. **Oliver Herzfeld** and **Richard Bergovoy** provide some guidance on how to minimize the risks

It's a brand owner's worst nightmare. You spend decades building the good will of your brand. Then, suddenly, headlines appear – gradually at first, later in a deafening crescendo – alleging wrongdoing in a factory halfway around the world with which the owner has no direct contact, but with whom a licensee has contracted to manufacture goods bearing the owner's trade mark(s). Child labour, lead paint, adulterated or unsafe ingredients .... virtually overnight, all of the owner's good will vaporizes in a cloud of litigation, congressional hearings, and angry editorials.

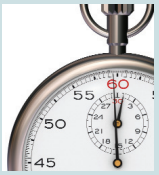
Such nightmare scenarios were once rare occurrences, but in recent times they have become a frequently recurring reality. The first major incident was in 1996, when allegations surfaced that the Kathie Lee Gifford apparel line licensed to Wal-Mart was manufactured under sweatshop conditions in a Honduran factory. Although Wal-Mart had selected the factory, it was Kathie Lee who was reduced to tears on national television defending herself against accusations that she was personally responsible for worker mistreatment. And in 2007, a series of reports surfaced about unsafe toothpaste, pet food and, especially, children's toys, manufactured in China, leading to massive recalls and balance sheet write-offs by US brand owners. Mattel alone recalled 20 million units of Chinese manufactured toys, and took a $40 million charge.

We will set out and discuss steps a brand owner can take to limit damage caused by a licensee's use of an irresponsible foreign manufacturer, especially damage arising from (1) unsafe products or ingredients; and (2) worker safety and unfair labour practices.

The trend towards foreign manufacturing of goods purchased by Americans is accelerating. US product imports are expected to top $2 trillion for 2007, double the figure for 2002, but only one-third of the total estimated by the US government for 2015. Of $22 billion of toys sold annually in the US, 87% are produced abroad, with 74% of that total coming from China.

However, safeguards and oversight for goods manufactured in developing countries are usually much less rigorous than for goods manufactured in the US. In fact, last year the former head of the Chinese State Food and Drug Administration was convicted for dereliction of duty and bribe-taking in connection with the approval of deadly sub-standard medicines. As a strong signal that the Chinese government intends to correct its oversight lapses, the official was sentenced to death.

One-minute read



In a brand owner's worst nightmare, goodwill that has taken years to generate can disappear in a flash with publicity about wrongdoing in a factory half-way around the world, which is contracted to manufacture goods by a licensee. Such wrongdoing typically takes the form of unsafe products or unfair labour practices. While legal liability risk may be low, brand damage can be high. Victims include the Kathie Lee Gifford apparel line licensed to Wal-Mart as well as toy company Mattel. But brand owners can limit their damage caused by incorporating safeguards in the licensing agreements and manufacturer's agreements. These should set out the responsibilities of both the manufacturer and the licensee. They should also include provisions on what to do if and when any problems arise. Taking these steps at the contractual phase should help minimize damage to your brand.

Contractual safeguards against manufacturer problems

The manufacturer section of the standard boilerplate licence agreement should prohibit the licensee to outsource manufacturing without prior review and written approval by the brand owner. This enables the owner to identify and reject known bad guy manufacturers, and also prevent sub-subcontracting, where problems and abuses are more common.

Boilerplate licence agreement

The boilerplate licence agreement should also contain a form of manufacturer's agreement, to be executed by the licensee and each of its approved manufacturers, and which the licensee is obligated to provide fully executed to the brand owner, normally within 30 days of execution of the master licence with the owner. In the agreement, the manufacturer should promise the licensee:

- to maintain fair and safe labour conditions in its factories, in compliance with the fair labour code (see box);
- to comply with applicable environmental laws and regulations;

Current legal framework

What legal and contractual standards apply to licensed goods produced by foreign manufacturers?

Labour standards

In the wake of the Kathie Lee Gifford sweatshop controversy, several sets of voluntary fair labour standards were developed, mainly by organizations affiliated with the apparel industry. Some are just free-standing codes (such as the Fair Labor Association Code of Conduct), while others combine both a code with an inspection and certification regime offered or sanctioned by the sponsoring organization (such as Social Accountability International and its SA8000 standard). Most of the voluntary codes cover the same issues, prohibiting slave and child labour and requiring reasonable working hours with overtime pay, worker rights to organize, safe and healthy working conditions and freedom from harassment and discrimination. They are usually attached as an exhibit to the licence agreement, with the stipulation in the main body of the agreement that if the licensee is permitted to employ manufacturers, then those manufacturers must comply with all features of the fair labour code.

Product testing

In the products safety field, in the wake of the 2007 China recalls, there is now momentum from governments, retailers and manufacturer organizations for voluntary but meaningful at-source product testing and certification protocols.

Wal-Mart and Toys R Us, the first and second largest toy sellers in the US, now impose on their toy suppliers strict limits on lead and phtalates content in toys that go beyond what is required under US law, and also require pre-import testing of ingredients.

Pending legislation to reform the US Consumer Product Safety Commission (CPSC) will almost certainly require pre-import, at-source laboratory safety testing for toys. Both houses of Congress have passed CPSC reform bills with overwhelming bi-partisan support. The House version, which passed 407-0, requires the CPSC to establish protocols and standards for safety certification of all consumer products, and prohibits importation of children's products lacking certification from an accredited third party laboratory. The Senate version, which passed by a 79-13 margin, makes mandatory the current voluntary toy industry safety standards and requires pre-import third-party safety certification of children's products. The bills will need to be reconciled in committee, but it is highly likely that some form of at-source safety testing will be required for toys.

Also in reaction to the 2007 China recalls, the Toy Industry Association (TIA) and the American National Standards Institute (ANSI) have set up a voluntary safety certification programme for toys regardless of manufacturing location. This programme is more comprehensive than either of the congressional proposals, addressing not only safety testing of the final products, but also audit and rating of factory quality control procedures. Manufacturers and OEMs that choose to comply with the programme would be entitled to display a "safe toy" certification mark on their products.

The strongest push for at-source safety testing is now in the toy industry, but just as fair labour standards started in apparel and spread throughout other industries that use foreign labour, so are at-source testing rules and procedures likely to spread outward from the toy industry.

Product liability

The law of products liability usually places the liability for defective products squarely on the manufacturer. The brand owner generally does not assume liability merely by allowing the mark to appear on the licensee's products. The exceptions are where: (1) the owner actively participates in selling or distributing the products (usually referred to as the Apparent Manufacturer Doctrine); or (2) the owner exercises "substantial control" over manufacture or sale of the products, for example by imposing detailed manufacturing specifications (usually referred to as the Enterprise Theory) (see *Torres v Goodyear Tire and Rubber Co*, 786 P2d 939 (Ariz 1990)). The standard licence transaction business model does not trigger either of these exceptions.

But while the risk of legal liability to brand owners may be low, the risk of reputational damage, from unfair labour or unsafe product accusations, can be enormous, and can damage the brand for years afterward, as demonstrated by the Kathie Lee and China Recall incidents.

- to manufacture safe products free from defects in design and workmanship, and in compliance with the law of the source country and the licensed territory;
- to respect the brand owner's IP rights, for example by not selling pirated goods produced on a so-called fourth shift, nor attempting to register the owner's trade marks as its own in the source country;
- to permit entry on to its premises by the brand owner or its agents, and to produce documents to confirm its compliance with fair labour or product safety standards;
- to comply with all provisions of the main licence agreement between the brand owner and the licensee that could conceivably apply to the manufacturer; and
- to make the brand owner an intended third party beneficiary of the manufacturer's agreement. (Note that some owners enter into manufacturer's agreements directly with manufacturers, but that is not recommended because most licensees resist direct communication between the owner and their manufacturers. Moreover, as a practical matter, it is easier for the licensee to get a manufacturer's signature on the agreement because it has the existing relationship with the manufacturer.)

In addition to the manufacturer's agreement between licensee and manufacturer, the main license agreement should require the licensee:

- to ensure that its manufacturers comply with all terms and conditions of the licence agreement that could also apply to the manufacturers, for example the requirement to manufacture safe products in compliance with all US and source country laws; and
- to assume full liability for damages arising from a manufacturer's activity if the licensee would have been liable for the same activity, backed by the licensee's indemnity and insurance obligations.

Furthermore, in order to give the brand owner the tools it needs to avoid repeats of the 2007 China recalls, the agreement should contain a provision requiring the licensee, in cooperation with its manufacturers, to perform pre-import safety testing of licensed goods through an owner-approved independent testing organization, or allow the owner to perform its own testing, with charge-back of costs to the licensee. As mentioned above, this kind of provision is about to become standard for toy industry licences, due to pending congressional legislation, and is likely to be adopted in other industries as well, as a measure to prevent the kind of reputational damage incurred by the toy industry in 2007.

Termination provisions

The licence agreement should also contain termination provisions tailored to deal with manufacturer problems. For exam-

ple, the brand owner should be able to require the owner to stop a particular manufacturer from manufacturing licensed goods (while continuing the overall licence) if the owner determines in its discretion that the manufacturer is engaging in certain "beyond the pale" activities, such as pirating. And the owner should be able to terminate the entire licence with the licensee on little or no notice if the licensee breaches any of the manufacturer-oriented obligations in the agreement.

Finally, the licence agreement should address what happens if, despite the best efforts of the brand owner and the licensee, a problem with foreign-manufactured licensed goods threatens to hit the headlines. Specifically, the licensee should be required:

- to immediately notify the owner of a critical health or safety problem, preferably within 24 hours;
- to formulate a crisis response strategy for the owner's review and approval; and
- to agree not to implement a crisis strategy, issue press releases, or respond publicly without prior review and approval by the owner.

For its part, the brand owner should work with its public relations or crisis management firms to develop a crisis response plan that is ready for implementation, long before a nightmare scenario can become a living nightmare for the brand owner.

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