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Business Counselor Update

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SUPPLIER SELECTION AND MANAGEMENT

I. COUNSELING THE PURCHASING FUNCTION

Purchasing strategies and procedures, including management of business and legal relationships with key suppliers, are now recognized as essential element of any company's overall business strategy. Purchasing involves a wide variety of different activities relating to the production and support of a company's products and services and the maintenance and repair of the company's physical assets, including facilities and equipment. As with manufacturing, purchasing has matured into a distinct professional discipline that now demands skills and expertise in negotiations and contracting, technology assessment, and finance and accounting. Done well, the purchasing or procurement function can help the company realize significant savings with respect to the direct costs of acquiring the needed goods and services and can also help manage the expenses associated with having to maintain inventories of raw materials and other supplies until they are needed for manufacturing and related activities.

Here are a few scenarios that illustrate why it's so important to keep track of who your third-parties are and to monitor what they are doing:

Export controls: Let's say you're a US company that sells its household products in Europe through a French subsidiary. That French subsidiary sells your product to a Spanish distributor, who you think is selling your product in Spain and Portugal. Later you find out the distributor is re-exporting some of your products to Cuba because he can make higher profit margins. For the Spanish distributor, there is no prohibition on selling to Cuba. But for you, a US company, it constitutes selling to an embargoed country, which carries criminal penalties of up to 20 years in prison and $1 million in fines, not to mention civil penalties of up to $65,000 per violation.

Data protection: You're a financial services company that uses call centers and data hosting providers in countries such as Costa Rica, the Philippines and India to handle customer inquiries and transactions. Those workers and providers collect and process sensitive financial data about thousands of customers. One of your providers uses a public cloud vendor to host its data, which means your customer data could be hosted on any of hundreds of servers owned by the vendor's subcontractors around the world. You later learn that a server owned by a subcontractor in the Philippines experiences an unauthorized intrusion. But because the public cloud environment makes it difficult to quickly determine which customer data resided on that server, you face a tough decision about breach notification. You may need to notify all potentially affected customers, as well as a wide range of state attorneys general and data protection authorities—a much more extensive and costly process than if you had been able to pinpoint exactly which data was compromised. After the notification, you may also face inquiries from the authorities about whether you failed to fulfill your obligations to protect sensitive personal data under applicable data security and privacy regulations by using a public cloud arrangement.

Product recall: You're an electronics company that discovers that some of your mobile phones on the market have faulty batteries. You must quickly determine which of your suppliers in China manufactured that battery, how long you've been sourcing from that factory, how many phones it affects and where those phones have been distributed to customers. The challenge is that you source batteries from several different Chinese suppliers who may have outsourced the manufacturing of your batteries to their own vendors. If you can't trace the faulty batteries to the exact factory, batch and shipment, and contain the problem quickly, you may be subject to a mandatory recall, a more disruptive and costly process than being able to pull your product voluntarily. You may also be prevented from shipping any more mobile phones until you can demonstrate to regulators that you've fully addressed the issue.

In this Business Counselor Update I'll cover a variety of issues associated with counseling companies regarding their purchasing activities.

II. ROLE OF THE PURCHASING MANAGER

Purchasing strategies and procedures will vary depending on the activities of the company. If the company is involved in the direct manufacture of its own products, purchasing focuses on development and management of supplier relationships for parts and manufacturing equipment. On the other hand, if the company elects to outsource most or all of its manufacturing requirements, purchasing management will emphasize pricing, product availability, quality control and the protection of intellectual property. In either case, the purchaser manager must fulfil a wide range of duties and oversee a number of activities for the company. Among other things, the manager must tend to production planning, inventory management, sourcing, capital equipment purchases, procurement of technical and professional services, contract administration, and the development and management of the company's purchasing plan. In developing and managing the company's purchasing plan, the purchasing manager must focus on development and management of effective supplier relationships; making "buy or build" decisions that lead to a competitive cost structure for the company and maximize the quality, performance and reliability of the company's products; making optimal use of the company's available capital investment funds; and coordinating effectively with other departments that need the services of the purchasing department.

III. ROLE OF COUNSEL

You may be asked to become involved in a variety of different transactions that are related in some manner to the purchasing function and its business goals and objectives. Examples of the issues that might arise include:

- Negotiating and documenting contracts with suppliers to provide materials that can be used by the company in its internal manufacturing activities;
- Assisting purchasing professionals with the preparation of requests for bids, purchase orders and standard terms and conditions that can be used in connection with isolated, or one-time, purchases that do not require a long-term contract;
- Working with purchasing professionals and company engineers and designers on customized procurement contracts pursuant to which suppliers provide parts and materials that are built to meet the company's unique specifications;
- Guidance on compliance with laws and regulations applicable to the purchasing function, including the law of sales, antitrust laws, product-testing requirements and the like; and
- Negotiation and documentation of contracts for assets and services ancillary to the purchasing function, including transportation, storage, and inventory management.

You can also provide assistance in other areas relating to the purchasing function. For example, when the company is evaluating a potential outside supplier for a long-term relationship, you can participate in the legal and business due diligence investigation of the proposed supply chain partner. You can also be extremely valuable when the company is looking to use foreign supply partners, which is a common strategy for reducing production expenses by taking advantage of lower costs of labor and materials in foreign markets. In that situation, you may actually find that the best method for proceeding is formation of a joint venture, a process that raises it own unique set of legal and regulatory issues.

IV. ORDER AND FULFILLMENT PROCESS

Most of your time assisting the purchasing function will be spent working on long-term supply arrangements, which I'll discuss in a moment. These arrangements are generally quite complex; however, they nonetheless begin with a fairly simple order and fulfillment process that follows a common general flow:

- First, the originator--the department in need of the goods—communicates a request, or requisition, for specific goods to the department or other business unit responsible for purchasing and procurement, which I'll call the "purchasing department.

- The purchasing department determines whether or not the requested materials are already covered by an existing purchase order or contract.
- If an existing purchase order or contract is not in place, a determination must be made as to whether competitive bids will be required in order to fill the request. In most cases, the dollar value of the request will determine the need for competitive bids and whether such bids need to be written or oral.
- If competitive bids are required, the purchasing department should prepare and disseminate a “request for quotation,” or "RFQ," in accordance with departmental procedures to qualified suppliers.
- Once the competitive bidding requirements, if any, have been satisfied, the purchasing department evaluates and selects a supplier and places a purchase order for the required goods.
- The purchase order is maintained in an “active” file until the goods are received in full and all inspection and acceptance procedures have been completed.
- After the goods have been received, the purchase order is closed and maintained in a “closed” file. Purchase orders that have been “closed” should nonetheless remain readily available for audit and for consultation in the event that defects are discovered and warranty claims must be made to the supplier.

Long-term supplier contracts may include their own customized order procedures, including the documentation that the company will be required to use when placing orders. Whenever possible, an effort should be made to make sure that any order requirements conform to the procedures that are normally followed by the purchasing department. This eases the overall recordkeeping process and reduces the additional training requirements for department staff.

V. TERMS OF SUPPLY AND PURCHASE CONTRACTS

Many of the purchases made by a company are single, isolated purchase-and-sale transactions. In these situations, a simple purchase order is the suitable form of contract to document the key terms and conditions and you should be sure that your clients have their own “standard form” of purchase order that they can use for all transactions. You should either draft the form yourself or review it closely to be sure that it includes all of the provisions that are favorable to your clients.

In those instances where it is clear that the company will be purchasing significant volumes of products from a supplier over an extended period of time, it will be necessary to negotiate a more detailed purchase and supply contract. At the extreme, this type of contract will launch a long-term supply arrangement and the supplier may eventually become a major business partner of the company. On the other hand, a contract of some sort is also warranted where the supplier will simply be fulfilling two or more orders for an item over a three- to six-month period. Of course, in the later situation, the company will normally not expend that much time and effort on the contracting process, often simply relying on the standard terms and conditions that apply to a purchase order and including a brief description of re-order procedures. A long-term supply agreement is similar in form and content to a manufacturing agreement with a contract manufacturer. The main difference, of course, is that the agreement in this context relates to products manufactured by the supplier that will either be used in the company's own finished products or in the company's manufacturing process.

Obviously, each party to a long-term supply arrangement has its own specific goals and objectives in the contracting process. For example, a pro-purchaser agreement will include inspection and acceptance procedures and liberal cancellation and order deferral provisions. In addition, any purchaser with significant leverage will attempt to shift insurance and shipping costs to the supplier. Likewise, a large supplier dealing with a smaller customer will seek to limit the purchaser's inspection rights, demand payment within fairly short periods of time, and transfer risk of loss to the purchaser before the goods are shipped from the supplier's facilities. In addition, many suppliers will impose minimum volume purchase requirements on smaller customers.

A long-term supply agreement should provide the foundation for what inevitably becomes an extensive and complex relationship between the parties and one that will hopefully remain in place for a number of years. While companies should certainly seek appropriate long-term partnerships with reliable supplier, they should realize that they might need to provide assistance to the supplier in order to make the relationship work and flourish. For example, the company may need to invest capital and human resources to provide engineering support and training to the supplier and may even make an investment to fund R&D by the supplier that is customised to the requirements of the company. On a more general level, representatives of the company need to be prepared to communicate regularly with the supplier about day-to-day issues surrounding scheduling and deliveries.

Every supply arrangement raises its own unique set of issues and concerns and the priorities of the parties will evolve over the term of the agreement. Nonetheless, it is fair to say that the agreement will almost always deal in some detail with a core set of issues, including: the scope and specifications of the goods covered by the agreement; ordering procedures and preparation of forecasts; shipping, delivery and other logistical matters; pricing and payment terms; warranties and indemnities; and term and termination. The agreement may be accompanied by various schedules that address electronic exchanges of information regarding orders, specifications and warranty and repair services. It is recommended that each of the parties designate a management-level representative to oversee the arrangement and ensure that adequate internal resources are being allocated to making sure that the relationship between the parties is successful and that communications flow easily and quickly between the parties.

VI. SUPPLY CHAIN MANAGEMENT

Supply chain management ("SCM") relates to the management of the entire chain of raw material supply, manufacture, assembly and distribution to the end customer and includes not only logistics issues but also the satisfaction of the needs of customers for features associated with the finished product that they value including technical information and support. SCM is important for satisfying customer demand and companies must devote attention and resources to SCM to gain efficiencies from procurement, distribution and logistics; make outsourcing more efficient; reduce transportation costs; and address competitive pressures caused by globalization and the need for shorter development times and more customized products. SCM is challenging because it involves so many parties—manufacturers, suppliers, logistic providers and distributors—and each of those parties has their own goals and objectives that are often at odds with others (e.g., manufacturers prefer longer production runs and schedules to reduce production costs and enhance product quality while distributors want lower inventory levels and customers want shorter order lead times).

VII. SUPPLY CHAIN MANAGEMENT ACTIVITIES

Key supply chain management activities include the following:

Strategy and Planning

- Identification of key customers or customers group deemed critical to achievement of company's overall business mission and goals
- Negotiation of produce and service agreements with target customers that establish required levels of performance
- Establishment of customer relationship management process including processes for performance evaluation and assessment of customer profitability
- Establishment of demand management processes with appropriate balance between customer requirements and the company's supply capabilities in order to reduce uncertainty and improve overall efficiency of supply chain
- Establishment of customer order fulfillment process taking account the company's manufacturing, distribution and logistics plans and resources
- Development of overall supply chain management strategy and plan including identification, vetting and selection of supply chain partners
- Establishment of environmental scanning capabilities to continuously monitor global investment opportunities for improving supply chain capabilities

Manufacturing

- Establish manufacturing processes with flexibility necessary to respond to customer needs and market changes
- Implement changes in manufacturing flow process to reduce cycle times
- Identify prospective manufacturing partners and structure integration of those partners through contracts (i.e., "contract manufacturing"), joint ventures or merger/acquisition
- Consider feasibility of establishing foreign manufacturing capabilities through direct investment

Product Development and Design

- Incorporate supply chain capabilities into product development and design processes
- Identify development and design partners and outside sources of technology and other intellectual property rights
- Establish procedures for protection of statutory intellectual property rights and trade secrets in relationships with supply chain partners
- Incorporate compliance with product safety requirements into product development and design process and contracts with supply chain partners
- Integrate key customers and suppliers into product development and design process
- Provide for consultation and cooperation by product managers with: (1) customer relationship management to identify customer needs; and (2) sourcing and procurement for selection of suppliers and materials
- Ensure that product development plans include specific strategies for implementing the most effective supply chain flow to move product quickly from development to market

Sourcing and Procurement

- Establish processes for identifying, vetting and selecting suppliers
- Develop standard contracts for supply arrangements and provide training to contracting officers
- Identify candidates for long-term strategic alliances with core group of suppliers who would be closely involved with product development and design activities
- Establish and maintain "state-of-the-art" communications mechanisms with suppliers that support electronic data interchange and rapid and efficient order placement
- Establish a dedicated sourcing and procurement function with adequate resources and ongoing education and training for managers and other personnel

- Consider becoming an "authorized economic operator" ("AEO") and limiting key supply partners to organizations are also AEO certified

Import/Export Compliance

- Establish procedures for compliances with customs law and import duties
- Develop capability for understanding and tracking relevant trade agreements
- Establish procedures for complying with export controls, trade sanctions and antiboycott law
- Incorporate INCOTERMS into cross-border transit contracts
- Establish procedures for complying applicable tax regimes (i.e., VAT obligations)

Distribution, Logistics and Marketing

- Establish procedures for identify, vetting and selecting sales agents, resellers, distributors and logistics partners
- Develop standard contracts for distribution and sales arrangements and provide training to contracting officers
- Establish procedures for complying with applicable packaging and product labeling requirements
- Establish advertising and marketing plans for all products and services and procedures for ensuring that advertising and marketing complies with applicable laws and is suitable in light of local customs and practices
- Establish procedures for protection against counterfeiting and prosecution of claims against alleged counterfeiters
- Establish procedures for complying with consumer protection, data privacy and anti-bribery laws and regulations in each of the markets where products will be offered for sale

Post-Sale Support and Returns

- Establish policies and procedures for warranties, maintenance, support and repairs and ensure that all personnel are properly trained
- Establish procedures in advance to respond to product recalls and products liability lawsuits from governments and customers
- Establish procedures for complying with applicable laws and regulations relating to recycling and disposal and waste management
- Establish policies and procedures for managing returns and collecting information that can be used to identify opportunities for improving product design and/or features

Compliance and Risk Management

- Ensure that personnel and other resources are available to handle compliance issues arising throughout the supply chain (e.g., anti-bribery, tax, environmental, competition law, labor and employment)
- Establish procedures for monitoring and participating in development of industry-specific standards
- Establish procedures for conducting due diligence on prospective supply chain partners and auditing the activities of partners once they are under contract including compliance with covenants included in contracts
- Ensure that all personnel involved in supply chain activities are adequately training with respect to the activities and issues associated with their job responsibilities
- Establish procedures for monitoring and analyzing information about supply chain partners to ensure that they are not creating reputational risk to the company

VIII. EVALUATION OF PROSPECTIVE SUPPLIERS

While a company may have a definite idea about the specific benefits that it is looking to achieve in establishing a long-term supply relationship, the ultimate success of the arrangement will depend on the chosen supplier and its performance under the contract. Accordingly, it is essential for the company to conduct a thorough and complete evaluation of potential suppliers. As with any other important business partner, selection of a key supplier should always be preceded by an intensive due diligence review, including meetings with the supplier's key personnel, visits to the supplier's facilities and interviews with other customers of the supplier. Among the factors that should be considered in making the decision are the following:

- The technological competence of the supplier should be carefully investigated, particularly the supplier's track record with respect to meeting the expectation of customers with respect to quality and performance of the supplier's products. If possible, the company should interview the managers and engineers from the supplier who will be involved in the company's projects.
- Price is an important, albeit not the only, factor in selecting a supplier. The days of pure price competition through bidding have largely passed, except in the case of small orders for generic products, and the current trend is to achieve a balance among price, quality and service.
- Service is often a key distinguishing factor among prospective suppliers. The company must determine if the supplier will be able to meet deliveries in a timely fashion, work with the company to develop "just-in-time" capabilities and respond quickly to queries and problems.

- The overall business and financial condition of the supplier should also be considered, particularly when a long-term relationship is contemplated. The company must have a comfort level that the supplier will be able to continue in business for the duration of the contract and fulfil its obligations to the company.

The first step in the supplier due diligence process is to confirm the accuracy of the information that was provided by the prospective supplier in their responses to the RFQ and should address the following:

- Company profile, strategy, mission and reputation;
- Financial status through review of financial statements and credit reports;
- Customer references, preferably from customers that have contracted for similar products and services;
- Management qualifications, including criminal background checks;
- Process expertise, methodology and effectiveness;
- Quality initiatives and certifications;
- Technology, infrastructure stability and applications;
- Security and audit controls;
- Legal and regulatory compliance, including any outstanding complaints or litigation
- Use of subcontractors;
- Insurance; and
- Disaster recovery, security and business continuity policies.

In order to ensure that the due diligence process is performed in an orderly fashion and that all necessary information is collected and reviewed the company should prepare a supplier due diligence checklist that covers all of the information listed above. Many companies have different checklists for specific types of goods and services. For example, when selecting a supplier to provide information technology services the checklist should focus on collection of information on issues such as physical security, network security, systems security, staff security, security policies and procedures, privacy/confidentiality of data, and support and training. Information should also be collected regarding the supplier's overall business model to gain a better understanding of the supplier's own long-term strategic objectives and how they might impact goods and services offered in the future. Business model analysis is usually done through a combination of document request and interviews with the principals of the supplier. Copies of the supplier's standard contracts and service guarantees should be obtained in advance even if the parties intend to prepare a customized service agreement. Documentation and training materials used by the supplier should also be evaluated before a contract is signed.

In the case of a local supplier, consideration should be given to a visit to the supplier's facilities. Visits provide valuable insight into the supplier's products, technologies, operations, and general business environment. Visits to the supplier's facilities create opportunities to evaluate the condition of the supplier's plan and equipment and the types of quality control systems that have been implemented by the supplier to avoid defects and other performance problems. Facilities visits, or other meetings with supplier representatives, should be used to gather information on the supplier's interest in entering into a relationship with the company; the condition of the supplier's plant and equipment; the general financial and business condition of the supplier; the degree of innovation associated with the supplier's manufacturing processes and contemplated research and development; and other customers of the supplier and their degree of satisfaction with the supplier's performance.

As noted above, interviews with key personnel at the supplier are an important part of the overall due diligence process and allow the company to evaluate the following key issues and concerns:

- How long has the supplier been in business and who are the principal owners and managers of the supplier? It is important to get a sense of the depth of experience that the supplier has as an organization and within its management team. If the particular supplier is relatively new it is important to pay attention to the skills and background of the managers and the resources they have brought to the business. For suppliers that have been in business for a significant period of time it is useful to gather opinions on the major trends in their activities over the last three to five years as well as opinions on future developments.
- Who are the supplier's major customers and are they willing and available to provide references for the supplier? Whenever possible, interviews should be held with representatives of the supplier's major customers to verify information that the supplier has provided regarding those relationships.
- What interest does the supplier have in developing a lasting partnership? Potential partners generally will be willing to share long-term plans and provide information on product costs. Senior management involvement is also a strong sign the supplier is willing to consider a special relationship.
- What has been the supplier's historical delivery performance? Delivery performance is generally measured as a percentage of on-time delivery against agreed delivery dates. Information should also be collected regarding the current backlog and delivery lead times.
- How do the supplier's prices compare to competitors? While the days of pure price competition through bidding have largely passed, except in the case of small orders for generic products, price is still an important selection factor. Preference should be given to suppliers that consistently are willing to match or beat the lowest price

available in the market for comparable goods and delivery terms. Information should be collected on the supplier's history with respect to pricing changes.

- What cost savings initiatives have been adopted by the supplier? Attractive partners will share information on plans and strategies that are used to reduce production costs and corresponding prices to customers. Long-term partnerships should involve constant communications on cost saving ideas.
- How has the supplier used technology in its operations? The technological competence of the supplier should be carefully investigated, particularly the supplier's track record with respect to meeting the expectation of customers with respect to quality and performance of the supplier's products. If possible, the company should interview the managers and engineers from the supplier who will be involved in the company's projects. Related questions include analyzing the supplier's level of investment in new technologies over the last few years.
- What are the supplier's requirements with respect to lead times for placement of orders? Some companies are unwilling to agree on short lead times or provide flexibility for customers to adjust their orders. Other companies offer lead times that are consistently less than competitors and are willing to respond to unforeseen deadlines. The company should also determine if the supplier would be able and willing to work with the company to develop "just in time" capabilities and respond quickly to order queries and problems.
- What has been the supplier's historical performance with respect to the quality of delivered products? Poor partnering candidates consistently deliver orders that have a material level of defects. On the other hand, other companies will meet or exceed performance expectations and will take steps to insure that defects are not repeated. It is important to under what types of quality control systems have been implemented by the supplier and how effect those systems have been in avoiding defects and other performance problems.
- What is the quality of the supplier's customer service and support function? While some companies offer little or no help with customer problems, potential partners will be eager to provide immediate investigation and take all necessary steps to correct problems and provide suitable compensation.
- What is the quality of the supplier's delivery documentation? Supply partners should be able and willing to provide comprehensive and accurate delivery documentation customized to the needs of the customer, including lot numbers and weights.
- What is the quality of service provided by the supplier's account representatives? In some cases, account representatives fail to make regular contact with the customer and invest the time necessary to understand the customer's needs. On the other hand, prospective partners will train their representatives to be well informed, easily available and empowered to enable the supplier to meet its obligations.

In addition, the overall business and financial condition of the supplier should also be considered, particularly when a long-term relationship is contemplated. The company must have a comfort level that the supplier will be able to continue in business for the duration of the contract and fulfill its obligations to the company.

IX. SELECTION OF SUPPLIERS

The information from the RFQ and due diligence process will eventually be used to select the supplier. The criteria used for supplier selection will obviously vary depending on the product or service; however, the following are generally among the key factors in almost every selection decision:

- The supplier must have adequate *financial resources* to perform the contract, or the ability to obtain them;
- The supplier must be able to comply with the *performance schedule*, required or proposed delivery, taking into consideration all existing commercial business commitments;
- The supplier must have a satisfactory *performance history*;
- The supplier must have a satisfactory *record of integrity and business ethics* including satisfactory compliance with laws related to taxes, labor and employment, environment, antitrust, and consumer protection;
- The supplier must have the necessary *organization and skills*, experience, accounting and operational controls, and technical skills, or the ability to obtain them; and
- The supplier must have the necessary technical *equipment and facilities* for production or construction, or ability to obtain them; and
- The supplier must be otherwise *qualified and eligible* to receive a contract under applicable laws and regulations and special requirements of the specific RFQ.

X. STRUCTURING AND DOCUMENTING

The following principles should be followed when structuring and documenting supplier relationships:

- Establish the primary goals and objectives of the relationship and use those findings to identify the legal and operational risks that need to be covered in the contract.
- Develop in advance a set of model provisions for key aspects of the contract that are based on varying levels of risk tolerance. The library should include “preferred” contract language and compromise provisions that can be accepted in appropriate circumstances and should also identify those areas in which the company cannot accept anything less than minimum protections (e.g., warranties, indemnities and limits on liability).

- Establish objectively clear requirements regarding the quality of the goods to be provided by the supply partner including testing and inspection rights. Pay particular attention to steps that can be taken to identify potentially counterfeit goods.
- Before contracting to transfer personally identifiable data of employees, customers and/or other individuals make sure that the scope of the data is fully understood, potential internal and external risks to security have been identified and the experience of the supply partner and its subcontractors with regard to privacy and data security has been thoroughly vetted. The contract itself should include extensive covenants regarding privacy and data security and permit the company to audit the partner's records and inspect the partner's facilities to check compliance.
- Include requirements that supply partners will make their books, records and facilities available for audit and inspection and that their employees will submit to compliance training and adhere to the company's code of conduct.
- Include strict covenants in the contract mandating compliance with all applicable laws by the supply partner and requiring that the partner conducts its operations in a legal, responsible and ethical manner. The scope of the covenants should extend beyond bribery and corruption laws to include import/export laws and health and safety, non-discrimination and child labor laws. If the company has a code of conduct it should also be included as one of the metrics of supply partner compliance.
- Make sure that the contract includes a covenant from the supply partner to retrain from purchase or sale transactions with embargoed countries or restricted parties.
- Include provisions for notice of breach of covenants and ensure that supply partner is financially able to pay any penalties and take all reasonably anticipated remedial actions
- Include rights to review and approve contracts with subcontractors providing goods and services to the supply partner and require that partner provide regular updates regarding subcontractors involved in the project covered by the master contract.
- Make sure that the contract includes a detailed plan for terminating the relationship that is in place before performance under the contract begins. The plan should allow for orderly winding up of the relationship while not unduly impairing the company's ability to offer goods and services to its own customers.
- When dealing with supply partners in foreign countries make sure the contract has been translated by professional legal translators and that the meaning of key terms is absolutely clear and the contract stipulates which language will govern interpretation.
- Select dispute resolution procedures that are fair and transparent to both parties and which have the best chance of being enforced by courts in the local jurisdiction where the supply partner is located. For example, consider requiring arbitration in a reputable international forum in the region where the supply partner is located based on a legal system that is similar to the one applicable to the partner.
- Include incentives for good performance and behavior by supply partners rather than simply loading up the contract with penalties. One possibility is offering bonuses for

continuously meeting schedules and/or delivering products that exceed objectively defined quality standards.

- Conduct regular reviews of standard contracts to ensure that they are up-to-date and track current versions of all applicable domestic and international laws, rules and regulations. A system should also be established to review all contracts currently in-force to determine if amendments are necessary to take into account changes in laws and regulations and/or the scope and type of products and services provided under the contract. Review can/should be prioritized based on the age of the contract, the location of the supply partner and the type of products or services covered by the contract.

XI. SUPPLIER MANAGEMENT

Once a strategic supplier has been selected attention should turn to smoothly launching and managing the relationship. Activities at this stage should include:

- Preparing a formal policy that describes the procedures for managing supplier relationships
- Establishing procedures for continuous assessment of suppliers' product or service quality
- Requiring suppliers to acknowledge and comply with other company policies
- Requiring suppliers to establish their own procedures for activities related to their performance of their obligations under their contract with the company
- Establishing supplier certification and credentialing programs
- Assessing extension of company compliance programs to suppliers

A. POLICIES AND PROCEDURES

Companies that contract with a significant number of outside suppliers should prepare a formal policy that describes the procedures for initiation and management of supplier relationships. These procedures should cover the selection process and establish guidelines for using approved supplier lists and active management of supplier relationships including continuous assessment of product or service quality and amelioration of problems through formal corrective action procedures. All suppliers' requirements and performance should be reviewed on a regular schedule as part of the company's internal audit process. As appropriate, suppliers should also be required to acknowledge and comply with other company policies and establish their own procedures for activities that are related to their performance of their obligations under the contract with the company. For example, suppliers should be expected to have a written code of business ethics and conduct, an employee business ethics and compliance training program, and an internal control system that is suitable to the size of the company and facilitates timely discovery and disclosure of improper conduct in connection with contracts to which the supplier is a party.

B. TRAINING

With regard to training, consideration should be given to the following:

- Establishing training programs for managers and employees working with supply partners that are based on the specific duties and roles that such persons will have when interacting with partners.
- Making sure that procurement officers are training in techniques necessary to undertake and complete effective due diligence investigations of prospective supply partners.
- Making sure that sales personnel are trained in the contents of standard contracts and understand the importance of including required provisions relating to compliance and other legal issues.
- Conducting regular meetings with supply partners, no less frequently than annually, that includes substantial compliance training conducted in the native language of the employees of supply partners.
- Recognizing the training programs are opportunities to monitor and evaluate how well your employees and the employees of supply partners understand the compliance procedures that you are trying to implement. Questions raised during the programs are good opportunities to identify potential weaknesses and areas in which further training might be necessary and appropriate.
- Making sure that necessary persons receive some form of "in person" training; however, take advantage of webinars as a means for efficiently reach large number of supply partners and their employees.
- Making sure that everyone conducting training sessions are well trained in the core compliance principles and that they have the skills necessary to communicate the content effectively. Content of training programs should be continuously reviewed, assessed and updated by qualified legal professionals.

C. MONITORING AND EVALUATING

Steps for monitoring and evaluating include the following:

- Conducting regular assessments, no less frequently than annually, regarding the status of supply partners and the steps they have taken to meet their compliance obligations.
- Using questionnaires to collect information from supply partners regarding changes in ownership, completion of required paperwork, maintenance of books and records, changes in subcontractors and completion of compliance training for their employees.

- Incorporating a checklist of the major duties and responsibilities of supply partners in their questionnaires and ask the partners to certify compliance and provide information regarding circumstances that amount to a variance from the agreed duties and responsibilities.
- Paying particular attention to the procedures used by supply partners to protect company information or personally identifiable information of others that may be transferred to the partners in the course of the relationship. Partners should be required to complete third party audits of their security procedures and provide reports of the results of such audits to the company.
- Making sure that your monitoring program is tailored to the specific risks associated with your industry and the particularly supply partner relationship. For example, pharmaceutical companies will want to take special steps to ensure that their distributors do not engage in activities that violate anti-bribery laws and regulations while they are engaged in sales activities with local regulators and health care providers.
- Providing for audit and inspection rights and make sure that they can and will be enforced in the local jurisdiction in which the supply partner is located and operating. Courts in some countries will limit or restrict such rights regardless of what has been agreed to in the contract.
- Making sure that the audit rights included in the contract are actually used and take advantage of rights to conduct inspections without notice.
- Making sure the audit and inspection teams are well-trained and consider using outside counsel and other experts to assist in review of the records of supply partners and inspection of partner facilities to determine whether the partner is complying with laws relating to working conditions, health and safety and protection of intellectual property rights.
- Closely reviewing the company's own books and records to identify questionable transactions relating to supply partners that may trigger compliance issues. Examples include expenses and commissions associated with sales activities.
- Establishing a comprehensive system for scanning for relevant business and financing information relevant to the company's supply chain and the participants in the supply chain. Sophisticated tools are now available for accessing information from a wide range of news sources that can allow supply chain managers to flag potential risks and quickly initiate investigation of possible problems before they become a crisis.
- Joining relevant industry and trade groups such as the Supply Chain Council to get access to best practices and tools that can be used to monitor and evaluate supply chain performance. Models developed by the Supply Chain Council facilitate measurement of various metrics including on-time delivery performance, lead time for order fulfillment, fill rate (i.e., proportion of demand met from on-hand inventory), supply chain management cost, warranty cost as a percentage of revenue, total inventory days of supply and net asset turns.

- Making sure the monitoring plan is accompanied by action plans for reacting quickly to problems with activities of supply partners, remedying such problems and making sure that they do not reoccur. Remediation plans should be included in the contract with the supply partner.

D. SUPPLIER CERTIFICATION PROGRAMS

The process of selecting a small group of trusted suppliers is often formalized through implementation of a supplier certification program. Such a program includes a thorough and objective analysis of a prospective supplier based on quality and overall performance standards. Suppliers that are willing, and able, to successfully complete the certification process would have opportunities to receive a significant amount of the purchaser's business, thereby providing the supplier with the resources and flexibility to make ongoing investments in improving its own products and services.

In most cases, the supplier certification program will be based on evaluation and rating of prospective suppliers based on the criteria that are of greatest importance to the purchaser. In order to keep the process simple, yet meaningful, managers should limit the number of criteria that are used. For example, it is common for to base the assessment on quality, price, delivery performance, service, and technical assistance. Once the criteria have been selected, a "weight" should be assigned to each factor. In most cases, quality and price are deemed most important (e.g., 30% to 35%), while less emphasis is placed on service and technical assistance (e.g., 5% to 10%). The final step is developing a set of measures that can be used to assign a rating or grade for each criterion. In the case of "quality," a comparison might be made of the number of certain-sized orders without defects to the total number of such orders.

Obviously, executing a supplier certification program is much easier when the company has substantial experience working with each of the suppliers and a track record of performance on each of the criterion is readily available. If that is not possible, the company should ask each supplier to "prove their competence" through references to other customers and verifiable data available through surveys conducted by trade associations and independent research groups. Extraordinary competence with respect to certain criteria, such as quality, can be demonstrated by reference to recognized standards, such as ISO certification.

Supplier certification should be an ongoing and continuous process. Suppliers should be reviewed periodically to determine whether there have been any material changes in their performance. Moreover, the needs and goals of the company may change over time. For example, small businesses may place substantial weight on the physical proximity of suppliers as the company is developing and growing. However, once such firms reach a certain level of activity, local suppliers may no longer be able to meet their requirements.

E. SUPPLIER CREDENTIALING PROGRAMS

While supplier certification programs focus on the quality and performance of the goods that are the subject of the supply arrangement a supplier credentialing program is a formal and organized effort to verify the business and financial strength of prospective suppliers. A supplier credentialing program involves development and administration of a process for obtaining critical information about a potential supplier's capabilities, business history, financial stability, insurance compliance and criminal background. Supplier credentialing should be done before any contracts are signed and the supplier is provided with access to the company's physical assets, facilities, personnel and confidential information. Supplier credentialing should be thought of as an important tool in a company's overall risk management program. Key advantages of a supplier credentialing program include the following:

- Suppliers are informed of the company's expectations that they will abide by the business practices and ethical standards established by the company.
- The company is able to collect and evaluate complete and accurate information about the resources, background, financial health and reputation of prospective supplier partners.
- The company develops standardized procedures and rules relating to the type of background information that is collected and how it is stored and made available for internal review by all necessary parties.
- The company establishes cost-effective procedures for continuously monitoring supplier compliance with the requirements established by the company during the contracting process.

A number of outside providers are available to support a supplier credentialing program and offer a variety of services such as management of liability insurance certificates; government watch list searches to ensure that suppliers are in compliance with applicable federal laws (e.g., the Patriot Act, export controls, customs regulations etc.); and national background and sex offender searches. These providers can also conduct due diligence searches on corporate suppliers (e.g., corporate status verification; business, financial and credit information (Dun & Bradstreet); bankruptcy, lien and judgment checks; insurance verification; management of W-9 documents; and business license verification) and on principals and associates of suppliers (e.g., social security number verification; national background and credit history checks; and professional or trade license verifications).

F. EXTENDING COMPLIANCE PROGRAMS TO SUPPLIERS

An issue that is coming up more frequently in the context of supplier relationships is whether or not companies should insist that their suppliers and other parties involved in their supply chain process should be subject to specified elements of the company's own global compliance rules and procedures. It is clear that with increased use of rapid communications technologies and sophisticated logistics tools, companies are becoming more dependent on the skills and actions of outside firms and persons who are not their employees. As such, it is understandable that companies may be concerned about whether their domestic and foreign partners are adhering to ethical principles and obeying applicable laws. However, before extending the scope of their compliance programs to their suppliers companies must carefully evaluate the legal consequences associated with that decision, including the possibility that they will be held responsible for liabilities arising from supplier legal problems.

In addition to legal considerations companies are also becoming increasingly sensitive to how the business practices of their partners, particularly foreign suppliers, may reflect on how they are perceived by regulators, customers and investors. For example, U.S. companies have come under strong criticism when it is disclosed that they have used overseas suppliers that have used child and/or forced labor in their manufacturing activities on behalf of their U.S. customers. In light of how the business conduct and practices of third parties can expose companies to legal liability and/or have an adverse impact on their image and reputation it comes as no surprise that they are considering and implementing various strategies for making sure that the rules and principles in their corporate compliance programs are applicable to their business partners (i.e., suppliers and contractors performing various activities such as customer service and maintenance).

One basic step that should always be taken is to include standard language in every agreement with an outside supplier that creates a contractual duty on that party to comply with all applicable laws and regulations and spells out specific areas of concern (e.g., the FCPA in the case of foreign parties dealing with local government officials). Beyond that, however, companies are beginning to create their own standards for supplier activity and integrating those into how they create and manage their supplier relationships. For example, a company may promulgate a social and environmental responsibility policy for its suppliers. This policy becomes a public statement of the values and business practices that the company seeks in its supplier group and a de facto checklist for the due diligence that company personnel are expected to do before entering into a relationship with a new supplier. The requirements and expectations in such a policy can then be made a part of the formal contractual arrangement between the parties through the use of a supplier social and environmental responsibility agreement.

Company policies regarding social and environmental responsibility are often derived from industry-wide efforts to develop, and build a consensus for, standards for socially responsible business practices that would apply to all participants in a supply chain regardless of their size or where they are located. An example of such an approach is the Electronic Industry Code of Conduct released in October 2004 following collaboration by some of the major manufacturers in the electronics industry. This Code of Conduct becomes the basis for company-specific policies that include standards for labor, health and safety, environmental matters, and business ethics. In addition, companies electing to comply with the Code of Conduct would be expected to establish and maintain an acceptable system of internal controls and procedures to ensure that they carry out their business activities in a manner that meets or exceeds the specific standards in each area. The Code of Conduct has been updated and revised several times since its initial release and the latest version can be accessed through the website of the Electronic Industry Citizenship Coalition.

While imposing compliance standards on partners in the supply chain seems to make a lot of sense, and may have actually become a mandate to fulfill specific legal obligations, a word of caution is in order for those companies adopting such an approach. One obvious potential problem, especially with suppliers in remote foreign countries, is making sure that adequate resources are invested in actual monitor of supplier activities and enforcement of the standards set forth in policies and supplier agreements. One of the reasons for including third parties within a compliance umbrella is the ability to represent to regulators, customers and investors that the company is indeed a good “corporate citizen” and deals only in goods and services that have been produced in accordance with the highest legal and ethical standards. If it turns out that their suppliers fail to follow those standards the company runs the risk that its own reputation will be tarnished, particularly if it can argued that the company did not adequately monitor a supplier's activities. It is important therefore for companies to use their contractual audit rights and take other reasonable steps to monitor their suppliers including regular visits to supplier facilities to observe the effectiveness of the supplier's efforts to adhere to labor and environmental standards. In fact, failure to do so might even be perceived as a breach of an unexpected duty to a third party such as a customer injured by products provided by the supplier or even employees of the supplier. Potential problems of this type should be managed by including language in policies or supplier agreements that expressly deny that anything therein is intended to create duties to and rights in favor of third parties.

About the Author

This article was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters' Westlaw, the world's largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his websites at alangutterman.com and seproject.org (Sustainable Entrepreneurship Project).

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