Common Issues Concerning OEM Agreements

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Handling original equipment manufacturing (OEM) contracts in China can be a bit of a minefield, especially for the new-to-China business. Stories of molds and design IP being ripped off and then sold by your own supplier are legendary. Here we provide a basic list of contractual issues to consider when entering into OEM agreements:

1. You will need to determine whether the agreement with your manufacturing supplier will be exclusive or non-exclusive. If you want to grant an exclusive right to manufacture either totally or a subset of your products, you will need to word the agreement accordingly and cater for these different scenarios.

2. You will also need to determine the China supplier's obligation to sell to you. There are essentially two alternatives.

Alternative 1: The China supplier is obligated to produce product under any purchase order you submit and its failure to produce at the agreed price would be a default. However, to demand such a clause would almost certainly require an agreement to purchase a minimum amount of product during a specified period. This approach is appropriate if you want to guarantee supplies and if you want to hold the supplier to their commitment on price and delivery time frames.

Alternative 2: The China supplier is obligated to produce product only for those purchase orders it accepts. This means that the supplier has the right not to accept purchase orders, at its discretion. The advantage of this to you is that it will not require you to purchase any specific amount of product. The disadvantage is that there is no guarantee of supply and there is no way to hold the supplier to any price commitment.

3. Delivery specifications. Typically, OEM agreements provide for a specific port of delivery. However, if you have or are likely to have multiple ports and delivery locations, the agreement should provide that the port or delivery location will be specified in the purchase orders.

4. Domestic and export pricing. If you are dealing with delivery in both China and overseas, it should be noted that domestic product purchasing has different shipping and title transfer rules and is also affected by the lack of VAT rebate. Accordingly, OEM agreements should be structured to have the pricing system set out in a separate addendum. For this, be aware you will probably need to have separate pricing systems for domestic purchase and export products. If the buyer has no presence in China yet requires a China delivery, the OEM agreement will need to provide for how a non-export sale could be affected.

5. Payment terms. Payment terms are advised to be for payment (typically 30 days) after inspection, and not 30 days after shipment. If you will provide for payment 30 days after shipment, you will need to determine when you will inspect the product. It is best to have inspection before payment, but this is not always practical.

6. Warranty periods. The normal contractual term is two years from the date of shipment. One year from the date of sale is not normally used, as there is no way for the China supplier to know when a sale is made. Two year warranties are common because the assumption is that the product will be sold sometime in the first year after shipment from China.

7. Trade secrets and IP protection. We would normally advise for a monetary penalty for breach. It is typical to provide for US$10,000 for a lump sum penalty and 12 percent for the percentage of sales penalty. The penalty is intended to be large enough to cause concern for the manufacturer but not so large as to scare them away.

8. Tooling provisions. It is advisable for tooling provisions to provide for a series of lump sum penalties. Such disputes are amongst the most common in manufacturing agreements and we have found such provisions effective in dealing with this matter. Manufacturing suppliers commonly refuse to return tooling and the most effective way to control this is to provide for a significant lump sum penalty for such a refusal.

9. Bill of materials. This is important to ensure the desired quality of component materials to be used in the product and should form part of the agreement. The bill of materials is simply a list of the components to be used in fabricating the proposed product. A good bill of materials, inserted either as an appendix or addendum to an OEM agreement, should specify in precise detail exactly what the Chinese manufacturer must use in manufacturing the product. A well drafted and precise bill of materials minimizes the likelihood of confusion and future mistakes, and can help minimize product defects and recalls.

10. OEM agreements should also cater for the following to provide for the variable and technical provisions of the manufacturing arrangement:

- List of products
- Performance criteria (specifications)
- Product pricing methods
- Quality control and inspection procedures
- A “no contact customer” list
- Tooling List
- Purchase Order

A sample OEM manufacturing contract can be found on the Dezan Shira & Associates Business Resources Library, **www.dezshira.com/sourcing**.

We recommend seeking professional advice when entering into such contracts.

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