Overseas Market Information

A General Guide to Industrial Subcontracting in Europe

Introduction

Definition of industrial subcontracting

What is industrial subcontracting? It can be defined as a transaction by which one enterprise, called the "subcontractor" is commissioned by another enterprise, called the "main contractor", to provide the latter with goods or services that he will use for his own commercial purposes, often, but not always, by incorporating these goods or services into a whole. It is possible to distinguish between :

(a) volume subcontracting, when an enterprise commissions a subcontractor because, while technically able to carry out the operation, it is overloaded and has to obtain additional capacity from another source, and

(b) specialist subcontracting, when the main contractor obtains goods or services which he does not produce or is not able to produce himself.

These two categories can be further subdivided depending on whether the subcontractor simply carries out a manufacturing operation or whether he also designs and plans the project under an agreement setting out the main contractor's requirements.

A supplementary distinction can be made between :

- subcontracting agreements relating to products, where the subcontractor manufactures only a component forming part of a product or range of products sold by the main contractor;
- subcontracting agreements relating to equipment, where the subcontractor manufactures one or more components of the main contractor's production equipment;
- subcontracting agreements relating to services, where the subcontractor supplies the main contractor with services essential for the main contractor's work, but separate from his main business (for instance the supply of accounting, research or maintenance services).

While this guide focuses on subcontracting agreements for products, many of the comments made also apply to other types of subcontracting agreements.

Subcontracting agreements may also specify that the main contractor will supply materials to the subcontractor and that the latter will simply process them, complete them or use them in one way or another. In such cases, subcontracting agreements relate more to the supply of services than to the supply of products.

Technical and legal specifications

If the contractual relationship is to be successful, the rights and obligations of each of the parties must be defined as clearly as possible when the contract is concluded. For this purpose, parties should ensure that their agreements are concluded in writing.

This written document will include, on the one hand, the technical specifications of the contract. These may, where appropriate, be contained in plans, documents and detailed drawings annexed to the actual contract.

The technical specifications of the work that the subcontractor is commissioned to undertake for the main contractor form the core of any industrial subcontracting agreement. The main contractor should specify his requirements in as much detail as possible to the subcontractor, and in particular their relationship with other elements or parts of the finished product, especially when the parties are entering into a business relationship for the first time. The main contractor must, for this purpose, supply detailed plans and specifications which precisely define the product to be manufactured, produced or processed, setting out, for instance, requirements in respect of tolerances, dimensions, compositions, areas, etc. The agreement should specify, where necessary, what tolerances and variations are admissible for dimensions and quantities as well as levels of quality, degrees, properties or other aspects of the materials to be used.

On the other hand, the parties should not neglect the legal terms governing the subcontracting agreement. This guide is intended to draw subcontractors' attention to the main legal questions that arise during the formulation of a subcontracting agreement. This should improve their position, in particular during negotiations.

Preliminary agreements

Industrial subcontracting agreements do not necessarily relate to the supply by the subcontractor of goods and services that are in keeping with the technical requirements imposed at the outset by the main contractor. In advanced technological sectors, in particular, the main contractor will often be calling upon the subcontractor's expertise and experience. The main contractor may invite the subcontractor to enter into a preliminary or a development agreement under which the subcontractor will undertake research to ascertain whether the main contractor's requirements can be satisfied and, if so, under what conditions and using what specifications. It is only when this preliminary agreement, also known as a development agreement, reaches a successful conclusion that it is possible satisfactorily to conclude the actual subcontracting agreement.

The conclusion of the actual subcontracting agreement will be preceded by negotiations, or possibly by the conclusion of preliminary research agreements.

After initial discussion of the main contractor's requirements, the subcontractor may be able, because of his specialist knowledge, to make useful suggestions. He may recommend, for instance, that certain research work is undertaken under contract before the actual subcontracting agreement is signed. Research work of this kind has the advantage of providing the subcontractor with a preliminary period during which he is able to decide whether it is feasible for him to meet the main contractor's requirements or whether, for whatever reason, he considers that he cannot or should not accept the contract. Research work, especially in sophisticated sectors such as electronics, often highlights secondary features of the product to be subcontracted of which the main contractor himself was not aware. In some cases, the outcome of the research agreement is that the initial proposals are abandoned or substantially amended in the light of prior or preliminary experience. In parallel, it may be that the subcontractor is given responsibility for designing a component. In this case, the agreement should clearly specify this task.

Research work often includes the manufacture of one or several model components or prototypes. This may have substantial advantages for both parties. There is an actual product in this case which expresses, in a three-dimensional way, the technical consensus of the parties about dimensions, surface finish, etc., and both parties can refer to it in the event of a dispute. It is essential to establish a procedure for the "acceptance" of such model components or prototypes by the main contractor and to incorporate their exact proportions and specifications into the written documents approved for the purposes of the subcontracting agreement. Despite his natural desire to obtain the final contract, the subcontractor should also ensure that he is appropriately paid for the research contract. This payment should normally cover his actual costs plus a reasonable profit margin.

Establishing "optimum worth"

At the research contract stage, the parties should jointly endeavour to establish the "optimum worth" of the product. In other words, a compromise has to be found between the final retail price of the finished product and the product's ability to meet the main contractor's actual requirements of use. A compromise of this type cannot, as a general rule, be reached without a list of criteria indicating the advantages and drawbacks of any particular solution. In this respect, the subcontractor may well be more aware of the implications of the various options than the main contractor himself. Evaluating "optimum worth" therefore makes it possible to obtain a more satisfactory result than a contract concluded in haste under the pressure of both parties. A lack of mutual understanding of the main contractor's requirements or of the subcontractor's actual capacity may give rise to practical problems and lead to conflicts and defective output. It is also crucial that the parties ensure at this stage that confidentiality agreements have been concluded before any technical information is disclosed in order to prevent, if a contract is not concluded, the disclosure of expertise or the use of intellectual property rights from prejudicing their future strategy or their commercial position.

Supply of materials

Once technical problems have been resolved or if research work is unnecessary, the subcontractor should examine how the materials that he requires are to be supplied. In many cases, the subcontractor may himself supply all the materials but the main contractor may also supply these materials at his own expense. It will always be necessary to set up systems to check the quality and suitability of materials before they are used. If, as is often the case, the subcontractor is responsible for supplying the materials to be used, it may be that the main contractor indicates a preference for specific sources of supply (in the case, for instance, of precious metals subject to very strict conditions such as titanium or magnesium). If the main contractor provides part or all of the materials, the parties should settle questions relating to the ownership of residues or waste and a monitoring system should be set up in order to prevent disputes at a later stage.

The parties should in particular decide in advance what is to become of materials left over at the end of the contract, especially when they are not suitable for use under other contracts. It may be envisaged to give the main contractor formal notice that he must buy these materials back from the subcontractor at their cost price at least.

Liability for design

Whatever agreement is reached as regards materials, however, final liability for the design of the product normally lies with the main contractor. Only the latter is aware of the criteria applicable, irrespective of whether the product is known or whether it can be substantially improved or developed. The subcontractor's specialist knowledge may help him to draw the main contractor's attention to any risks or problems and he may be able to propose modifications so that these can be avoided as far as possible.

The subcontractor should normally, however, limit himself to giving an opinion and should not go beyond this by accepting partial or total liability for the design of the product, unless the subcontracting agreement makes express provision for the recognition of such liability.

The subcontractor's proposals and advice obviously cannot contain any errors and must be accompanied by the necessary reservations if they relate to technical problems which have not been adequately examined or whose implications have not been fully established. The subcontractor's obligations should normally be limited to providing what the technical specifications require, without guaranteeing a specific additional result. The subcontractor should also avoid issuing or accepting specifications worded in vague terms such as "of good quality". These notions are not sufficiently precise, largely because most subcontracted products have to be a compromise between cost requirements and the requirements of the product or range of products of which they form components or sub-assemblies. The quality of a product often relates to a combination of mechanical, electrical and other properties; simple expressions of a non-technical nature cannot take appropriate account of these.

Changes to specifications

It is important for the parties to lay down methods for any changes that may be made to the specifications during the term of the subcontracting agreement. Minor changes are often made to specifications in the light of practical experience or for a whole range of other reasons. A procedure ensuring that any costs incurred in this way are borne by the main contractor needs to be established and the conditions under which changes are to be implemented need to be specified. In the electronics sector, for instance, a distinction is often made between retrofit, rework or phase in changes. A retrofit change is the most fundamental alteration that is admissible, given that it applies to all the articles which are still under the supervision of the subcontractor, including articles that are awaiting delivery and have already left the production line. In contrast, a rework change is of a forward nature : some products that have already been manufactured can be delivered but beyond a certain date any product delivered must be in keeping with the new specification. Lastly, a phase in change is the most gradual modification, since changes can be made to the production process in a way that entails as little disruption as possible. The changes required do not always relate, however, to product specifications but merely to the documents required or to the checks to be carried out for the purposes of quality control. In all cases, the subcontracting agreement should specify how these changes are to be made and by whom the costs are to be borne.

Tools

The subcontracting agreement may specify that the subcontractor is to produce components or articles using his own equipment, without having to purchase new equipment such as machine tools. In this case, the subcontractor will merely have to bear his normal fixed and variable costs; these may also relate to the materials to be processed during the term of the contract. The same applies when the contract specifies the performance of relatively simple operations on materials supplied by the main contractor such as machining, polishing or other operations to process raw materials or semi-finished products.

Larger-scale subcontracting agreements, however, often long term, generally make provision for investment by the subcontractor in machines and tools. This equipment may include casts, patterns, moulds, dies, plates and tools of different types, including very complex and very costly machine tools. In this respect, one of the main decisions that the subcontractor will have to make is whether he will himself invest the necessary capital either from his own resources or by contracting a loan so that he is fully equipped to perform the contract, or whether he will allow the main contractor to cover part or all of the costs. Using his own tools gives the subcontractor a great deal of flexibility when the initial contract expires. He will be able to use the equipment, without breaching the contract, for other purposes, even during the term of the contract, provided that the constraints imposed by delivery and production programmes are respected. This is in particular possible when using numerically controlled machine tools operating on a 24-hour basis. A drawback of this option is, however, that the enterprise has to make a substantial initial investment in equipment which is adapted at this stage to the requirements of the initial contract and whose use in other sectors or for other customers will be uncertain, with the risk that the subcontractor fails to recoup the investment before the initial contract expires.

The term "tools" covers a whole range of equipment. In the context of industrial subcontracting, there are two main types of tool :

(a) standard tools, i.e. those whose use is not just limited to the performance of a particular order and,

(b) tools intended for a particular order, often manufactured under the main contractor's industrial property rights and making use of his expertise.

The main contractor will often bear the cost of tools in the following cases :

- the total expenditure on tools would be a substantial burden on the subcontractor's resources, which may well be limited;
- commercial and contractual relationships between the parties are well established;
- adapting new tools to specific manufacturing processes would require a long and potentially costly period of development and refinement;
- it is traditionally considered, in the sector in question, that the main contractor is responsible for supplying tools;
- the tools are specifically designed to meet the main contractor's needs and specifications and cannot be readily used for other purposes;
- the main contractor prefers to retain control of the tools so that he can remove them at a later stage if, for whatever reason, he has to terminate the contract binding him to the initial subcontractor.

If the main contractor is paying for the tools, the subcontractor should ensure that the contract specifies the mandatory payment dates. In addition, the subcontractor should always ascertain whether or not he is responsible for ensuring that the tools supplied by the main contractor conform to the latter's drawings and specifications, as this task is generally conferred upon the subcontractor only at the express request of the main contractor.

The costs of tools are more likely to be borne by the subcontractor in the following cases :

- the subcontractor does not consider that the tools represent a particular burden on his financial resources;

- his relations with the main contractor are neither well-established nor long term;
- the tools may be readily used for other contracts;
- this is a new industrial sector where such tools have yet to enter established practice.

It may of course be that expenditure on tools is split between the parties. In this case, the main contractor often pays the percentage of the total costs represented by expenditure on the design and manufacture of the tools. The subcontractor then pays the balance represented by the costs of testing of the tools in the production process and their refinement. In the case of "shared costs", it is crucial for the methods by which the contract can be assigned to be specified in detail in the contract.

If the subcontractor is paying for the tools, he will undoubtedly also be responsible for ordering and commissioning them and ensuring that they are appropriate for the manufacture of the subcontracted products. The costs of commissioning and adapting the operation of the tools to the operations set out in the contract should be taken into account when calculating the agreed price for the contract. The subcontractor should obviously carry out this research in close cooperation with the main contractor in order to ensure that technical specifications are respected and to avoid any subsequent disputes about methods of using the tools. As soon as the tools are commissioned, their value will be depreciated in the same way as any other equipment, at a rate corresponding to their predicted useful service life. When deciding on their options as regards tools, the parties should also bear in mind aspects of taxation that may have an impact on their final choice.

Maintenance

Once the contract has come into effect and delivery of the components manufactured using the equipment has started, the tools will require regular maintenance. In general, the proprietor of the machinery is liable for this expenditure. In any case, the cost of maintenance needs to be taken into account when evaluating the price for the articles to be supplied. As the subcontractor is supervising the equipment, however, he will be responsible for maintaining it in an operative state, whether the expenditure is borne by him or by the main contractor. In some subcontracting contracts, machinery is not used on a continuous basis, for instance when the contract makes provision for large deliveries only at certain periods or during certain seasons of the year. It is fairly common in this case for subcontractors to lease tools to the main contractor, if the latter can use them for other purposes. Conversely, the main contractor may also allow the subcontractor to use the machinery himself, if the subcontractor can use it for other purposes.

Repairs

The tools purchased should not be expected to remain operative throughout the term of the contract, especially in the case of a long-term contract for a high volume of production. It will not only be necessary to carry out repairs, but undoubtedly also to replace tools if machines, dies, plates and other components wear out. It is therefore in the subcontractor's interest to specify methods for the partial or full replacement of the initial equipment in the contract. The replacement should normally take place on the same basis as the initial investment. The main contractor will, however, be less inclined to bear the full cost of the equipment if the need for replacement has not been specified during the initial negotiations. The subcontractor should in all cases ensure that he knows who owns the tools and if he himself has intellectual property rights that must be protected by contract. He should also make sure that the contract specifies who bears the risks of accidental loss or damage due to circumstances attributable to the subcontractor.

What happens to equipment at the end of the contract ?

Once the contract has reached completion, the equipment generally remains the property of the person who has paid for it, although the main contractor often has an option to purchase the tools from the subcontractor. Even if the subcontractor has borne all or part of the costs, any sums already disbursed by the subcontractor may be reimbursed, less any amount for depreciation of the value of the equipment that the subcontractor has already recouped as an element of the cost of the articles supplied to the main contractor. If the main contractor, an automobile manufacturer for instance, is using the "double source of supply" principle, it may be that he wishes to install his equipment on another site and will undoubtedly take up this option if he has not paid for the initial equipment because he may wish to prevent the subcontractor from using the equipment subsequently, for instance on behalf of one of his competitors. For this reason, the subcontractor should decide, during negotiation of the initial contract, whether he is willing to offer such an option to the main contractor when the practical effect of this option will be to prevent him from undertaking work for other enterprises.

If, however, the subcontractor is authorised to retain the tools after expiry of the contract, the main contractor may impose some restrictions on their use. In any event, the main contractor may impose a positive obligation on the subcontractor to keep the tools for a period of three to five or even ten years, in order to produce the quantity of spare parts required for the manufactured products finally sold by the main contractor. The availability of spare parts is always a major problem for main contractors making substantial use of subcontractors.

(Source : EEPC Duesseldorf Office)