Managing Supplier-Direct Agreements

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Session Title: Managing Supplier-Direct Agreements

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I. Introduction

Government regulations, supply chain disruptions, COVID-19 (the “pandemic”), and the war in Ukraine (“Ukraine war”) have challenged everyone in the construction industry. These challenges must be managed in an environment with labor shortages, cybersecurity risks, a struggling real estate market, inflation, and rising interest rates. The construction industry also must anticipate and plan for the influence of evolving technology and on its use on capital facilities. Therefore, it is not surprising that major participants in the construction process attempt to manage these risks—and assert control—by entering into direct agreements with construction suppliers.

The increasing use of supplier-direct agreements requires owners and contractors to evaluate and attempt to manage risk in ways that deviate from risk management under more conventional supply models. This presentation will address risk under supplier-direct agreements and contract terms, best practices, insurance, and letters of credit that can be used to allocate and manage such risk.

II. Project Delivery & Risk Management

The decision to use supplier-direct agreements can be industry specific and is frequently influenced by the size and ultimate use of a construction project.

For example, the design-bid-build model is common for building, road, and infrastructure construction. On a design-bid-build project, the owner influences procurement through plans and specifications prepared by its architect or design engineer. If an owner wants a specific product, that product is specified as a “name brand” requirement or owner-furnished item. In this situation, the owner warrants the suitability of the specified product and assumes the risk that it will satisfy the project’s needs. In doing so, it gives up rights it might otherwise have against its contractor and design professionals.

Engineering, Procurement and Construction (“EPC”) is at the opposite end of the risk allocation spectrum from design-bid-build. EPC is most commonly used for larger construction undertakings such as oil and gas, power, and large-scale industrial projects. Given the scale and risks involved, EPC contracts allocate design responsibility and procurement risks to the contractor. The owner influences procurement decisions by stating its objectives during design development, but provides the EPC contractor with substantial flexibility for procurement within the owner’s stated “design basis.” When an owner takes control by procuring a specific item under a EPC Contract, the owner relinquishes the contractor from responsibility for that item. This alteration of the typical paradigm can have a ripple effect that extends beyond the specific item being procured.

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The design-build approach, which is used for all types of construction, falls between design-bid-build and EPC with respect to risk allocation. Under a design-build contract, the contractor agrees to design and build the desired construction project using owner-provided design parameters. The design-build contractor has flexibility with respect to procurement to the extent that the items procured accomplish the objectives set forth in the design parameters. Similar to an EPC contract, if the owner decides to procure a specific item, it assumes responsibility for that item. Again, this decision can impact many elements of the design and construction process.

Hybrid contracting models also influence risk with respect to supplier-direct procurements. For example, the wind industry uses multi-contract strategies with up to eight to ten packages for design, manufacturing, and installation. In fact, some project developers in the wind industry leverage their competitive advantage by dealing directly with the supply chain (through supplier-direct agreements) to drive down project costs. Other wind developers opt to work with a few large suppliers, limiting exposures to lower tiers of the supply chain. While the solar industry has relied heavily on EPC delivery in the past, labor shortages for EPC professionals may bring owners and contractors to consider different forms of project delivery in coming years. This variety shows how different project delivery systems span different industries.

Regardless of the delivery model, the contractor is typically responsible for cost and schedule during construction and functional performance after a project is complete. Supplier-direct procurement can alter this dynamic. If material or equipment procured under a supplier-direct agreement is delivered late or with missing components, the party responsible for that procurement could have liability for related cost increases and delays. Similarly, if items procured through a supplier-direct agreement negatively impact the project’s functional performance, responsibility for warranties and performance guarantees may shift to the procuring entity.

Of course, responsibility for cost, time and performance in construction is heavily dependent on specific contract terms and laws in the jurisdiction governing the contract. Given their potential significance to risk allocation, responsibility for items procured under a supplier-direct agreement should be addressed in all related design, procurement and construction agreements. Failure to do so can result in expensive disputes and litigation.

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3 Id.
4 Id.
Supplier-direct agreements also present risks for suppliers and vendors. Depending on the terms of its underlying contract, the supplier or vendor may become directly or indirectly at risk to the contractor, owner, and other entities. This risk also may extend to government regulations and product liability laws. Care must be taken in allocating these risks in all of the relevant agreements.

III. Supplier-direct Agreements: When does it make sense to use supplier agreements?

To properly manage risk under supplier-direct agreements, owners and contractors should understand the roles and responsibilities of different parties in project delivery. Generally, a “supplier” provides materials or products. A “vendor” sells finished goods or products to an owner or contractor for a project. The project owner hires a “contractor” to handle the project within a defined scope and timeline. Depending on the contract model used, the supplier, vendor, and contractor may be different entities, but the contractor may be responsible for all three vis-à-vis the owner.

The roles and responsibilities of each party vary based on what type of project delivery system an owner and contractor select for a project. For example, a direct agreement with a supplier (“supplier-direct agreement”) allows an owner or contractor to buy directly from a supplier of a material or product.\(^6\) This direct purchasing structure has benefits and risks when compared to indirect purchasing, where an owner or contractor subcontracts for materials from a third-party vendor.

Two main scenarios in construction involve direct purchasing. First, an owner can directly contract with a supplier and then furnish materials to a contractor for project delivery (owner-supplier-direct agreements). Second, a contractor can work directly with a supplier, bypassing the use of a third-party vendor, to procure materials for an owner’s project (contractor supplier-direct agreements).

a) Direct Purchasing: Benefits & Risks

Supplier-direct agreements provide several advantages for a customer, whether the customer is an owner or contractor. First, for specialized or unique products, supplier-direct agreements place the customer in direct contact with an expert, who best understands the design, features, and details of the product. For example, when a customer purchases solar products or batteries directly from a solar product manufacturer, the customer gets to work with a supplier who has intimate

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knowledge of solar products from design to delivery. This enables a customer to seek specialized advice beyond what a third-party distributor may possess.

Second, manufacturers may be able to supply products that best suit a customer’s specific needs. Working directly with a manufacturer as a supplier can expand a customer’s leverage in negotiating customized options or upgrades. Further, if a customer’s staff is trained to operate a particular manufacturer’s product, procuring any other product would require extensive training with the downside associated with the attendant learning curve. Supplier-direct agreements provide the customer with predictability and consistency. Switching manufacturers could limit product choices for the end-user, result in supply chain disruptions, and cause significant training and restructuring costs.

Third, by entering into a direct agreement with a supplier, the customer cuts out the middleman (retailers or wholesalers), reducing transactional costs and facilitating direct communication with the supplier. Rather than pay a vendor to deal with a third-party distributor, a customer has direct visibility into the procurement.

Fourth, if a customer has a positive relationship with a manufacturer, this relationship may insulate the owner from supply chain disruptions, as the customer can use social capital to ensure it receives priority. This closer relationship may also provide a customer with greater input and oversight of quality control. During the pandemic, relationships became more important as contractual provisions bent and broke in the face of unprecedented supply chain disruption. A long-term, consistent relationship with a supplier helps facilitate cooperation that could be needed to overcome market volatility. In other words, an owner or contractor may be able to obtain a market advantage by maintaining a positive direct relationship with a long-term supplier where others could not.

At the same time, supplier-direct agreements often come with limitations and risks. Some suppliers, when working directly with a customer rather than through a vendor, will require significant purchase volumes for an owner or contractor to qualify as a customer. Products may also come from limited geographical locations, thus restricting a customer’s shipping and transport options. For example, China will have more than 80% of the world’s solar manufacturing capacity through

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7 Id.
8 Id.
9 Id.
10 Id.
11 Id.
13 Id.
The geopolitical and logistical implications of this situation are significant. Additionally, global and regional disruptions like pandemics, natural disasters, strikes, and war inevitably impact supply chains and pricing for products coming from China. Having a supplier-direct agreement with a single supplier based in China puts the underlying project at risk with respect to how quickly that supplier adapts to potentially destabilizing world events.

Also, contract provisions controlling material pricing in volatile markets or providing contingency alternatives place the customer at risk to the supplier’s whims in determining pricing and response. While supplier-direct agreements may suit a customer’s needs, such agreements also shift responsibility and risk, usually carried by vendors or third-party distributors, to the customer. Owners and contractors are in different positions to take on such responsibility and risk.

\*b) Direct Purchasing by Owners vs. Contractors\*

In an owner-supplier-direct agreement, the owner assumes the administrative burden for furnishing and ensuring timely delivery of materials to the contractor (customer-furnished materials), where ultimate project delivery involves a contractor. Customer furnished material ("CFM") is any material supplied by the owner, rather than the contractor. This may include materials, equipment, components, or tools needed to complete the project.

While CFM provided through owner supplier-direct agreements may provide the owner with the benefits described above, they place the owner at risk to the contractor for late deliveries and potential cost increases. For many owners, these risks outweigh the benefits of CFMs. The owner also assumes responsibility for monitoring the quality and fitness of CFMs, which can heavily impact later construction stages. Among other impacts, problems with CFMs expose the owner to liability for cost increases, material delivery delays, lower-than-planned site productivity, or an owner’s failure to effectively interface between subcontractors, trades, management, and joint venture partners.

Contractors take on similar responsibilities and risks in contractor-supplier-direct agreements. However, contractors often have more resources, experience, and...
industry connections to manage procurement administration and logistics. Despite this advantage, owners and contractors have started to adopt project delivery systems where owners increasingly use owner-supplier-direct agreements or close variations.

IV. Why are owners increasingly using direct purchasing, and how does this impact contractors?

Historically, construction owners desired lump-sum, turnkey contracts to manage risk. A guaranteed price from a single point of responsibility is appealing to owners because it provides greater cost certainty and minimizes risk. Contractors manage risk associated with lump sum construction agreements by including contingency in their estimates as a cushion from cost overruns and potential means to profit from well-managed projects. Removing the contractor’s ability to manage supplier performance away from the contractor through a supplier-direct agreement disrupts risk allocation and management under the traditional fixed-price contract structure.

An examination of supplier-direct agreements under EPC contracts helps illustrate this point. Under a lump-sum, turnkey EPC contract, the contractor is responsible for all phases of the construction process and guarantees schedule, cost, and performance. This structure benefits owners by allocating procurement risk to the contractor, establishing fixed pricing and timing for the project, and creating a single point of responsibility in the EPC contractor.

In recent years, the construction industry has transitioned away from lump-sum, turnkey EPC contracts for several reasons. Losses experienced on large fixed-price EPC projects have made contractors reluctant to assume the significant risks imposed by traditional lump-sum, turnkey EPC contracts. Also, labor shortages, supply chain disruptions, inflation, and price volatility have made lump-sum pricing unreliable or too difficult to predict up front. Faced with such obstacles, some owners considered whether owner-direct purchasing could reduce costs, insulate project schedules from supply chain disruption, and reduce risk. The EPCM (engineering, procurement, and construction management) project-delivery model was identified as a method that could help facilitate the owner’s use of direct purchasing on large-scale projects.

In broad terms, EPCM is similar to “agency construction management.” In this regard, EPCM is created through a professional services agreement rather than an EPC contract. The EPCM contractor is responsible for advising the owner on design and procurement, and provides oversight and management for the design, construction, and supply contracts. The owner, however, enters into separate contracts directly with engineers, suppliers, and contractors.

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22 Id.
23 Id.
24 Id.
25 Id.
26 Id.
In theory, direct purchasing using an EPCM benefits the owner by providing greater flexibility. Owners who chose this approach believe it reduces owner costs by providing the owner with the ability to work directly within the supply chain, choose the most cost-effective supplier, negotiate favorable pricing, and avoid contractor markup. However, the owner assumes significant management risks under this model. For example, the owner must negotiate with manufacturers and suppliers, take responsibility for risks associated with loading, shipping and preservation, monitor quality control, be responsible for manufacturer progress, and employ additional administrative and logistical resources.\textsuperscript{27}

Conversely, the EPCM contractor benefits by shifting risks associated with vendor performance, cost increases, transportation, and delays to the owner.\textsuperscript{28} EPCM contractors exchange potential margin that can be realized from traditional lumpsum EPC contracts for protection from market risks and supplier performance. Of course, the contractor who actually performs the design and construction work has to address risk considerations associated with suppliers who have direct agreements with the owner and additional oversight created by a third-party EPCM.

Under this scenario, the owner, EPCM, EPC contractor, and supplier must consider the reallocation of traditional risks. The goal of any contract negotiation is to allocate risk to the party most able to control the risk. As between the owner and contractor, performance risks under a supplier-direct agreement should, in most situations, be allocated to the owner. This means that the owner should flow down those risks to the supplier and obtain adequate security and insurance. Of course, this is not always achievable.

While the preceding discussion addresses EPC contracts, the basic concepts apply to any project delivery model. The primary point is identifying the party that controls the risk and allocating responsibility appropriately. Accomplishing this objective with respect to supplier-direct agreements can be a challenge.

For example, owners frequently attempt to reallocate responsibility for supplier performance by assigning supplier-direct agreements to the contractor. These assignments provide benefits, but have significant risk implications for everyone involved. For example, the owner benefits from being able to choose its suppliers and negotiate favorable terms, but may be responsible to both the contractor and supplier unless these responsibilities are transferred by contract. The contractor benefits if the owner retains responsibility for the supplier, but many assignments require the contractor to manage and guarantee the supplier's performance. The supplier benefits from having a direct relationship with the end user, but must perform work for a contractor with whom it did not negotiate and be exposed to

\textsuperscript{27} Id.
\textsuperscript{28} Id.
schedule and performance risks it did not anticipate in the supplier-direct agreement.

Payment is another issue. When a supplier-direct agreement is assigned to the contractor, the supplier may require the owner to retain the obligation to secure payment. Of course, the contractor may want additional compensation for managing an unfamiliar supplier and require indemnification or other protections from the owner if the supplier or vendor does not meet the contractor’s schedule and performance requirements.

The scenarios described in this section are relatively basic. More complicated direct purchasing relationships exist. For example, certain owners in the energy sector mix and match various aspects of direct purchasing into bespoke contractual arrangements. Whether owners and contractors will pursue one of these multi-contract-based delivery models will depend on market conditions, each parties’ risk profile, resources, capacity to negotiate with manufacturers, ability to manage schedule and logistics, and other factors.

V. Insurance & Letters of Credit: How can parties better allocate risk when working with foreign suppliers?

Additional risks can arise from supplier-direct agreements with foreign entities. International trade involves parties that speak different languages and are subject to different laws and regulations. Legal rights may not be enforceable against foreign suppliers, particularly those from countries that do not have bilateral trade agreements with the country in which the work is being performed. Political, economic, and logistical instability also can become a factor.

Common tools for managing risk presented by supply agreements are insurance and using letters of credit. Specific issues arise when the insurance or letter of credit is issued by a company from a foreign jurisdiction.

a) Types of Insurance

A comprehensive discussion of the types of insurance that could cover material and equipment on construction project is beyond the scope of this presentation. However, a high-level overview of the types of insurance that are currently available in the United States market is instructive.

Supplier risks, particularly those involving materials and equipment manufactured overseas, was a prominent topic during the pandemic. After the pandemic, the construction industry evaluated whether existing insurance covered costs and losses associated with international supply transactions. For example, Trade Disruption

29 Garton & Strickland, supra note 20.
(“TD), and Supply Chain Risk (“SCR”) insurance were evaluated in the context of international supply agreements.

TD insurance covers specific segments of the supply chain, such as delivery of materials between contracting parties. TD coverage triggers at the occurrence of an insured peril along an insured’s supply chain that causes a delay in movement of materials from a point of departure to a point of destination. “Perils” include embargoes, expropriation, nationalization, natural catastrophes, or other interferences with the supply chain. An owner or contractor with TD coverage can collect certain costs or expenses incurred from such perils. SCR insurance includes coverage for costs arising from government related disruptions, natural disasters, labor issues, and public health emergencies.

Other traditional construction insurance products provide coverage for materials and equipment provided by overseas suppliers, including Builder’s Risk (“BR”), Business Interruption (“BI”), and Commercial General Liability (“CGL”) insurance. BR insurance covers a contractor’s loss or property damage resulting from certain defined events, including fire, theft, and weather-related events. This coverage may include lost rent or income caused by construction delays that are attributable to a covered event. Often referred to as “all risks or all perils” coverage, BR insurance frequently excludes events arising from pandemics, epidemics, viruses or public health emergencies.

BI insurance provides coverage for lost revenue that would have otherwise been earned if the business remained open. Sometimes referred to as “business income coverage,” BI insurance covers wind, fire, lightning, and falling objects. Claims for BI coverage may be challenging in the context of supplier-direct agreements given policy exclusions and applicability of other types of insurance.

CGL insurance covers the insured’s business from third-party claims. Functionally, this means CGL insurance protects the insured against claims involving property damage or bodily injury to third persons. Thus, requiring suppliers to include CGL coverage as part of a supplier-direct agreement can protect owners and contractors from third-party claims.

31 Id.
32 Id.
33 Id.
34 Managing Supply Chain Disruptions in a Crisis, Practical Law Practice Note w-024-5011.
36 Id.
37 Id.
38 Id.
39 Id.
40 Id.
Because BR, BI, and CGL insurance collectively cover physical losses and injury suffered by the insured and third parties, and TD and SCR insurance insulate the insured from cost related to external, nonphysical, defined disruptions in a project’s progress, owners and contractor should contact an insurance professional to provide advice on each of these policies in the context the project for which insurance is required. They should also require suppliers to furnish proof of insurance in negotiations and consult well-versed brokers to determine whether their project requires special coverage. Consideration should also be given to project specific needs. Discussing with brokers whether other insurance policies, like marine cargo policies or civil authority coverage, may also help fairly allocate risk.

Specific consideration should be given to coverage provided from insurers in foreign countries that have not consented to jurisdiction in the United States. While principles of comity may apply, attempting to enforce insurance rights in a foreign jurisdiction can be time consuming and expensive. Also, attempting to enforce such rights in some jurisdictions or take too long to be a practical remedy. Therefore, consideration should be given to requiring the supplier to obtain insurance from reputable insurer in the United States or requiring a letter for credit issued by a financial institution in the United States.

b) Letters of Credit

Letters of credit are typically on-demand instruments that secure the performance of a specific act or acts. A letter of credit serves as a guarantee of payment where the bank issuing the letter of credit is substituted for the guarantor’s credit risk. The issuing bank will perform due diligence on the guarantor and require some form of security to be sure that the bank will not incur a loss if it honors a draw on the LC.

From the creditor’s standpoint, letters of credit are preferable to bonds or insurance because fewer prerequisites need to be established to draw on letter of credit. While banks issuing a letter of credit may have documentary conditions that trigger payment, the creditor is not required to establish liability or overcome defenses presented by the bank before making a draw. This stands in stark contrast to bond or insurance claims, which are typically subject to bond and insurance defenses, policy exclusions, and extensive investigations before payment is made.

If a letter of credit cannot be obtained, certain alternatives are available that may require the supplier, contractor or owner to bear more risk. For example, under cash-in-advance payment terms, the supplier receives payment before material

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42 Id.
transfer to the customer, making the customer face the risk of never seeing the goods. ⁴³ Likewise, under open account terms, goods are shipped and delivered before payment, so the supplier bears the risk of nonpayment. ⁴⁴ Letters of credit reallocate risk from the customer and supplier to the bank, guaranteeing payment to the supplier without obliging the customer to make payment until the goods arrive. Shifting risk away from the customer and supplier makes letters of credit particularly suitable for international transactions.

A customer can obtain a letter of credit in the country where the manufacturing take place, or in the United States. International letters of credit have proven useful in situations where collection is a challenge, but present enforceability issues that might not be encountered in the United States. For example, in one study, researchers showed that Turkish exports insured by letters of credit exhibited greater resilience during the pandemic. ⁴⁵ However, letters of credit issued by financial institutions in the US provides obvious benefits for projects in the United States.

VI. Conclusion

The foregoing discussion covers basic elements of supplier-direct agreements and the risk implications they present. Like any contract-based legal analysis, rights and liabilities for supplier-direct agreements should be evaluated in the context of the specific project being performed and contracts being impacted by the direct purchase. We recommend that you consult with an attorney and insurance professional when negotiating and administering supplier-direct agreements to be sure that you obtain adequate protection.

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⁴⁴ Id.
⁴⁵ Id.