5TH ANNUAL STATE OF AUTOMOTIVE RECALL AND WARRANTY SUMMIT: LEGAL TRENDS AND RISK MANAGEMENT STRATEGIES

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Introduction

- There once was a “Big Three”

- Evolution of the automotive supply chain
  - Tiers
  - Lean practices
  - International focus
Macro issues

- Downward pressure on commodity prices
- Section 232 Tariffs for aluminum and steel
- Oil prices low, but increasing since 2016
- Acquisition activity
- Plateauing volumes
  - OEMs feeling the pressure of increased incentives, warranty exposure and competition
  - Enhanced productivity, currency adjustment, and other “pricedown” requests

(Source: Center for Automotive Research)
State of the Industry

- North American volume estimates
  - 2016 - 17.8M
  - 2017 - 17.4M
  - 2018 - 17.5M
  - 2019 - 17.7M
  - 2020 - 18.4M
  - 2022 - 18.1M
  - 2024 - 18.0M

(North American light vehicle production. Source: IHS Automotive)
State of the Industry

■ Good news:
  - Interest rates; cheap gas; vehicle prices up

■ Bad news:
  - Risk of supply shortages and capacity constraints
  - Stress on capacities of sub-suppliers
  - Volume fluctuations
  - Increased warranty and recall claims
State of the Industry

Major supplier considerations

- Cadence is faster
  - Increased complexity – shorter cycles
- Launch readiness is crucial
- Global platforms
  - Ability to design and manufacture in key markets
- Cost controls
  - Enhanced OEM oversight

(Source: IHS Automotive)
State of the Industry

Warranty & Recall Issues

- Warranty has always been a tension point between customers and suppliers.

- Exponential increase in publicity and cost associated with OEM recalls, service campaigns and warranty repairs.
  - Increasing complexity of components and systems.
  - Large global platforms and volumes.
  - Higher expectations of safety, quality, performance and reliability.
State of the Industry

- OEMs are more aggressively seeking to push these significant costs to Suppliers

- Warranty and recall are becoming much larger dollar risks and risks that are harder to anticipate, project and manage
## State of the Industry

Warranty can be categorized by: (i) Occurrence/Timing, (ii) Root Cause, (iii) Incident Rate and (iv) Severity of Failure Effect

<table>
<thead>
<tr>
<th>Factory or Zero Mile Warranty</th>
<th>Ordinary Warranty</th>
<th>Special Warranty</th>
<th>Recall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower Cost</td>
<td>Moderate Cost</td>
<td>High Cost</td>
<td>Highest Cost</td>
</tr>
<tr>
<td>Manage via quality process</td>
<td>Manage via quality process and warranty agreement</td>
<td>Manage on engineering and commercial basis</td>
<td>Manage on engineering and commercial basis</td>
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<td>Potential for arbitration and litigation</td>
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<td>Insurance may be an option</td>
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State of the Industry

The Automotive Supply Contract

- Purchase Order, OEM Terms & Conditions
- PO terms that are highly OEM-favorable are standard in the auto industry
- Exceptions and limitations are hard to negotiate absent unique circumstances or non-auto products
- Suppliers generally accept unlimited liability for a broad range of costs resulting from non-conforming parts
State of the Industry

- Most OEMs have standard warranty agreements and programs that supplement the PO terms
  - Suppliers pay costs under a formulaic agreement if ordinary warranty rate exceeds target threshold but is not a spike or special cause
  - Procedure to review returned parts, cause analysis as well as related trouble/repair codes
  - Often some cost sharing or incentive arrangements

- OEMs set standard processing fees, mark-ups, labor rates, etc. which are used to establish cost recovery for ordinary warranty but also special warranty and recalls
Recently, OEMs have begun to increase warranty burden and repair costs (ordinary and special warranty)

- Warranty period is increasing (up to 5 years)
- Mileage limitation is increasing or being eliminated (time only)
- Processing fees going up (per vehicle)
- Higher mark-ups for internal processing and handling costs as well as cost of commissioning 3rd parties (up to 45% of the spare parts cost)
- Higher labor rates
Contract Formation in the Supply Chain

RFQ/RFP (Buyer)

Quotation (Seller)

Purchase Order (Buyer)

Acknowledgement (Seller)

Issue: Battle of the forms (UCC 2-207)
Risk Management Strategies: Contract Level

- Include state-of-the-art terms and conditions with contract documents
- Cannot be any “battle of the forms” if you do not have a strong set of terms and conditions of sale
Risk Management Strategies: Contract Level

- **Seller Strategies:**
  - Warranty – scope/time
  - Limited remedies
  - Damages disclaimers
  - Damages caps
  - Indemnity – nexus
  - Termination rights and obsolescence
  - Protect yourself on the buy-side by requiring supply base to sign up to the same warranty protections were given away on the sell-side

- **Buyer’s strategies will be the reverse**
Many conditions or circumstances may be a cause or contributing factor; what is “root cause?”

Non-conformance (fault) is not a simple determination:
- Many issues stem from system and vehicle integration, not an isolated component problem
- Design and integration responsibility often not clearly delineated in sourcing agreements and specifications
- OEMs argue that they rely on the “expert” Supplier to anticipate conditions and issues
- OEM-directed design or subcomponent may be cause or contributing factor
- Transport, handling and assembly may also be factors
Risk Management Strategies: Root Cause Investigation Stage

- React quickly to identify root cause
- Contain problems and establish clean points
- Clearly document the root cause and corrective actions with support
  - Resolution is an iterative process that is adversarial and collaborative at same time
  - An element of mistrust exists and OEMs do not always engage with Suppliers up front and/or provide complete data transparency
OEMs have begun to pursue recovery for warranty and recalls conducted well in the past.

An array of skill sets is required to reach resolution while preserving the ongoing business relationship.
Risk Management Strategies: Company-Wide Approach

- Develop a company strategy for dealing with warranty problems
  - Input from Engineering, Procurement, Sales, Quality, Finance, etc.
  - Periodic training of sales, procurement and engineering professionals regarding contracting and root cause analysis best practices

- Survey where past breakdowns in contract relationships have occurred

- Update contracting practices, including current documents

- Establish an ongoing proactive review of warranty data and returns for spikes, trends, recurring issues, severe failures, etc.
Risk Management Strategies: Proactive Litigation Management

- Consider efficient service solutions
  - Testing, retrofits, and modifications may be just as effective as total replacement

- Consider arbitration or bundling of commercial issues; year-end “true-ups”

- Negotiate settlement based on award of additional business
Risk Management Strategies: Proactive Litigation Management

- Identifying and bundling commercial issues has been the key to crafting “win-win” deals to resolve special warranty and recall claims
  - Recently, OEMs have shown more openness to separately arbitrate with Suppliers concerning warranty and recall liability
  - Increasing number of international arbitrations

- Recall insurance is more readily available, especially in North American market
  - Small but growing number of Suppliers carry the coverage; many pitfalls
  - Recall insurance is required under current BMW terms, although specific expectations are not yet clear
Vanessa L. Miller is a litigation partner with Foley & Lardner LLP and chair of the Detroit office’s Litigation Department. Ms. Miller has successfully managed, litigated and tried cases in state and federal courts, as well as handled appellate proceedings. She has significant experience handling supply chain disputes, breach of warranty claims and complex international arbitrations for automotive and other manufacturing clients in various venues, including the Court of Arbitration of the International Chamber of Commerce (ICC), American Arbitration Association (AAA), JAMS and the Singapore International Arbitration Centre (SIAC).

Ms. Miller is the author of numerous articles on the subjects of contract, UCC and arbitration. She also is the co-author of the forthcoming *Law of the Automotive and Manufacturing Supply Chain: A Handbook for Success.*