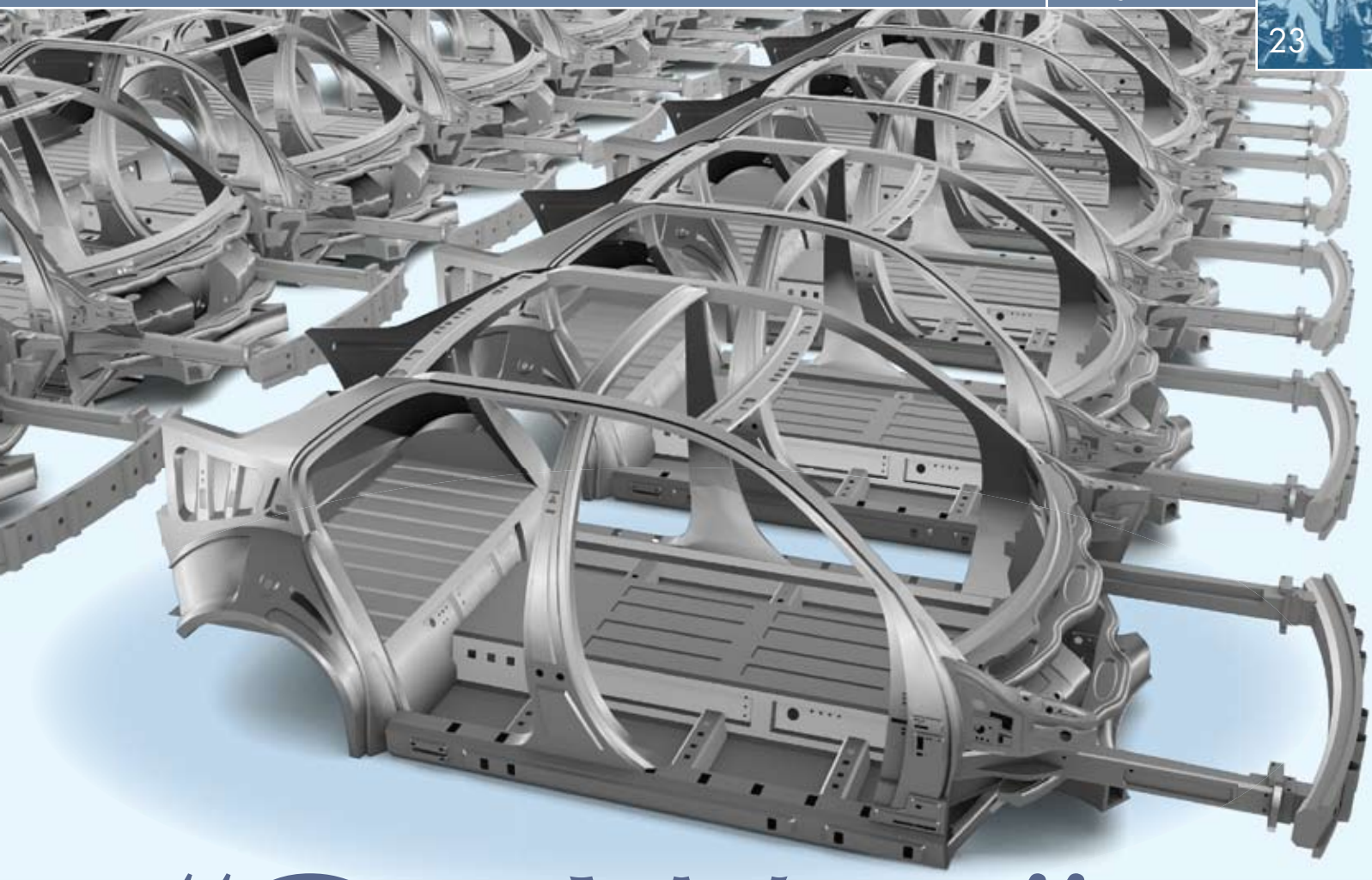


# The "Car Wars" in Court

## *Steel, Plastics, Terms, and Other Fronts in Automotive Supply Litigation*

By Daniel N. Sharkey

### Fast Facts

Higher raw material prices and "just-in-time" inventory have increased tensions and litigation throughout the automotive supply chain.

Supply-chain disputes involve many issues governed by Article 2 of the Uniform Commercial Code and contractual terms and conditions.

By specifically negotiating agreements on commercial terms and documenting those agreements thoroughly, much of the legal uncertainty caused by the industry's traditional dependence on boilerplate forms can be avoided.

The automotive supply chain's amazing strides in efficiency over the past generation have also made it increasingly vulnerable. The just-in-time system has reduced inventories to the point that they are often measured in hours. In the span of a few days, raw material is manufactured into a part, integrated into a sub-assembly, and installed in a vehicle.[2] To avoid dealing with multiple suppliers and to leverage economies of scale, nearly all components are sourced to a single supplier.

But eliminating excess inventory and redundancy means that one supplier's refusal to ship parts can shut down entire vehicle assembly operations as soon as the following day. As the labor strikes earlier this year attest, supplier shutdowns can cause the automakers (known in the industry as original equipment manufacturers, or OEMs) to almost immediately shut down their assembly lines and can have a cascading adverse effect on the

entire supply chain. Today, even a mom-and-pop tool-and-die shop can threaten to quickly wreak havoc on an entire vehicle platform's production.

The industry's production part approval process (PPAP) compounds this vulnerability. To re-source a part, a supplier must obtain possession of the tool used to make the parts, move it to a new supplier, have parts made, and submit the parts for the PPAP, which can take weeks or months, requiring a bank of parts to bridge the gap during the tool move. The PPAP hinders suppliers from crossing the proverbial street to buy parts elsewhere, thereby increasing dependence on the incumbent supplier.

> The allocation of risk in cases like this involving so-called "just in time" inventory management will probably continue to be the subject of continuing negotiation and litigation.
>
> —*Metal One America, Inc v Center Mfg, Inc*[1]

## Increased Raw Material Costs Lead to Increased Supplier Litigation

Over the past few years, two incendiaries dropped into this tinderbox of vulnerability: the worldwide steel crisis and skyrocketing oil prices.[3] Leading steel market indicators nearly doubled in 2004, and again increased more than 50 percent in 2008.[4] And, as you likely recall from trips to the pump just a few months ago, petroleum, the primary composite for plastic resins, hit all-time record highs. Hurricanes Katrina, Rita, and Ivan only accelerated the increases.[5]

These increased raw material costs have dramatically increased tension in the supply chain. The dynamic often plays out along the following lines. "Tier 1" suppliers supply sub-assemblies (brake, steering, instrument panel, etc.) directly to the OEMs and purchase sub-components from their own suppliers, "Tier 2s." The purchase order contracts vary in length, but tend to last from one to five years, usually less than the expected length of the OEM vehicle platform. Purchase orders contain set prices for at least one year, and often call for annual percentage price decreases. Tier 2s normally buy raw materials from their suppliers, "Tier 3s," on a "spot buy" basis, which means they essentially pay prices that fluctuate with the market.

OEM vehicle programs typically last five to six years, during which the price of raw materials will inevitably fluctuate. When Tier 3s advise Tier 2s that raw material prices will increase, Tier 2s are effectively "sandwiched" between those increasing costs and decreasing revenues from their customers (Tier 1s) based on the annual price decreases. This reduces, and often eliminates, the Tier 2s' profit margins and their ability to recover their initial capital investments. In drastic, negative-margin situations in which raw material costs exceed the piece price, suppliers lose money on every part they make.

Like Tier 2s, Tier 1s often commit to annual percentage price decreases to the OEMs. Theoretically, a Tier 1 supplier's margin should be covered because it has obtained equal annual percentage price decreases from its Tier 2s. But often Tier 2s threaten to stop shipping unless Tier 1s grant large price increases, leaving the Tier 1s similarly sandwiched.

If the Tier 1s grant the Tier 2s' requests for price increases, the Tier 1s' profit margins will often disappear. Tier 1s face several unpalatable choices: (1) pay the increase and lose money, (2) refuse to pay the increase and shut down entire OEM vehicle assembly lines, (3) pay the increases under protest and sue the Tier 2s to recover the money, (4) refuse to pay the increases and seek court orders compelling Tier 2s to continue shipping, (5) demand assurances that Tier 2s will continue shipping, or (6) ask the OEMs to accept a "pass along" of the increase on the sub-assembly price.

If Tier 1s refuse to increase the price, pointing out that their own prices with the OEMs are fixed, and insist that Tier 2s ship at the purchase order price, then Tier 2s face a dilemma: honor the Tier 1s' purchase order contracts and suffer the loss, or threaten to stop supplying absent price increases?

The supply chain is rife with these tensions. Suppliers and OEMs are between the rock of rising raw material costs and the hardplace of an inability to increase vehicle prices in a globally competitive environment. Something has to give, and the rash of recent supplier bankruptcies attests that it already has.[6] These tensions have also dramatically increased litigation among suppliers.[7]

## Common Legal Issues in Supply-Chain Disputes

Automotive supplier litigation presents many complex legal issues. It is beyond the scope of this article to discuss each issue arising in supply-chain disputes, but here is a sampling of the more common issues:

- If its customer is in financial trouble, can a supplier demand cash-on-delivery or cash-in-advance payment terms? (demand for adequate assurances, UCC 2-609; insolvency of buyer, UCC 2-702)
- Do rising raw material prices excuse the obligation to supply? (commercial impracticability, Uniform Commercial Code[8] 2-615)
- May a supplier obtain a price increase, or "surcharge," based on increasing raw material prices?[9]
- If the OEM drastically decreases production volumes, how does that affect suppliers' obligations? (requirements contracts, UCC 2-306)
- Must a contract have a definite quantity term to be enforceable? (also UCC 2-306)[10]
- Will courts order suppliers to resume or continue supplying? (specific performance, UCC 2-716)
- Which terms and conditions control—the customer's terms of purchase or supplier's terms of sale? (battle of the forms, UCC 2-207)[11]
- If the purchase order has no expiration date, how much notice does the supplier have to provide its customer before ceasing supply? (reasonable time for alternate supply on contracts of indefinite duration, UCC 2-309)
- If the customer has reserved the right to terminate the purchase order for its own convenience at any time, can the supplier do the same? (mutuality of obligation)[12]
- When re-sourcing parts, can a customer move a tool from one supplier to another, or do the Molder's Lien Act, Moldbuilder's Lien Act, and Special Tools Lien Act prevent the customer from doing so?[13]

Automotive supply contracts are notoriously messy. Engineers agree on product specifications, purchasing and sales agree on prices, but there is rarely a true "meeting of the minds" on the entire commercial arrangement.

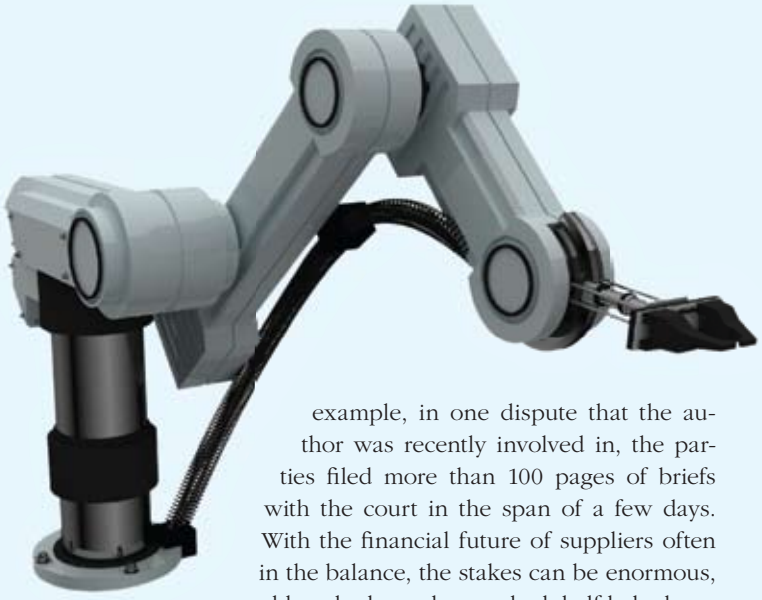
- Can a supplier enforce its customer's verbal promise to issue a new purchase order at a higher price? (statute of frauds, UCC 2-201)
- In the absence of a specified quantity, as in most automotive supply contracts, does the contract satisfy the statute of frauds? (UCC 2-201)
- How does vehicle program cancellation by an OEM affect the suppliers' obligations? (frustration of purpose)
- If the parties begin engineering work and build prototype parts before reaching an agreement on price, is the contract still enforceable? (UCC 2-305)[14]
- If the purchase order says one thing but the supplier and customer have been doing another, which controls? (course of dealing, UCC 1-205, and course of performance, 2-208)
- Does an e-mail exchange suffice to change the purchase order? (modification, UCC 2-209)
- Which controls—the long-term agreement, the purchase order, or the terms and conditions?
- Rather than shut its customer down, can the buyer pay the supplier's requested raw material surcharge under protest? (reservation of rights, UCC 1-207)[15]
- In a just-in-time supply relationship, how soon must one party provide the other notice of breach? (UCC 2-607)[16]
- When can a supplier invoke a force majeure clause?
- Can a buyer take a setoff for costs incurred because of supplier's breach? (setoff, UCC 2-717)
- When can a buyer terminate a supplier that has stopped shipping? (repudiation, UCC 2-610)

Even this partial list is dizzying, and most of the issues listed could themselves be the subject of an entire article.

## Unclear Contracts, Hasty Decisions, and Uncertain Caselaw Muddy the Waters

Adding to the complexity posed by the many issues involved is that automotive supply contracts are notoriously messy.[17] Engineers agree on product specifications, purchasing and sales agree on prices, but there is rarely a true "meeting of the minds" on the entire commercial arrangement. Instead, the contracts are usually unsigned and composed of quotes and purchase orders that pass each other as ships in the night.[18] The governing terms and conditions have become increasingly onerous for suppliers.[19] In a triumph of hope over experience, suppliers often ignore those terms, at great risk.[20]

Further complicating things is the need for speed. The just-in-time inventory system requires immediate adjudications, making automotive supplier litigation akin to an emergency fire drill. For



example, in one dispute that the author was recently involved in, the parties filed more than 100 pages of briefs with the court in the span of a few days. With the financial future of suppliers often in the balance, the stakes can be enormous, and largely depend on rushed, half-baked records. Although the customers generally have the stronger legal position based on their governing terms and conditions, the suppliers generally have tremendous short-term practical leverage because they hold the parts.[21] Regardless of how egregious the apparent breach, many courts are loathe to grant injunctive relief compelling suppliers to continue shipping, observing that irreparable harm is missing because the disputes are ultimately about money.[22]

Nor have the courts provided clear rules of law. On several key issues regarding automotive supply contracts, the caselaw is all over the proverbial map. A detailed discussion of the contradictory caselaw is beyond the scope of this article, but the following are just a couple of brief examples of the uncertain legal landscape that suppliers encounter.

First, offer and acceptance: several decisions hold that the customer's purchase order is the offer and the supplier's performance is acceptance,[23] but several others hold that the supplier's quote is the offer, and the customer's purchase order is acceptance.[24] It is difficult to synthesize any lessons from the caselaw when the cases differ sharply on which documents constitute the contract in the first place.

Second, there in no uniformity regarding which words may be used to establish a requirements contract that functions as an enforceable quantity term. The word "blanket" may suffice as a quantity term,[25] but it may not.[26] "As released" (which is virtually synonymous in the automotive industry for "blanket") may suffice,[27] but premising the quantity requirements only on production releases to be issued in the future may not.[28]

Third, Michigan's federal courts have criticized decisions of Michigan's state appellate courts regarding several fundamental Article 2 issues arising in automotive cases, including requirements contracts and the statute of frauds.[29] This disarray gives both sides in supply disputes ample authority for their arguments, either to convince a court or to credibly make a ruckus in commercial negotiations.

## Recommendations

Given this uncertain legal environment, what should a supplier do to prevail in (or better yet, preclude) legal disputes? Despite the muddy waters, several fundamental lessons emerge:

- If you must have a term, bargain for it. Do not bet that the term will apply because you will ultimately prevail in the "battle of forms."[30]
- Figure out what cards you hold. Scrutinize long-term agreements, purchase orders, terms, and correspondence to evaluate your rights and obligations.
- Do not seek excusal of performance based only on increased raw materials costs. It will not work in court.[31]
- Negotiate and execute specific agreements regarding key commercial terms, and specify that they supersede the boilerplate in the purchase orders and governing terms and conditions.
- If you want a requirements contract, use the word "requirements"; do not risk another word being construed as something else.
- Get it in writing, and object in writing (the oldest saws). Undocumented oral discussions, without more, are unenforceable. This applies with equal force across the contract life cycle: formation, performance, breach, and termination.
- At the beginning, think about the end. Consider carefully, and document, those issues often at the center of litigation: duration, expiration, cancellation, and termination.

## Conclusion

While just-in-time inventories, single-sourcing, and production approval processes have streamlined the supply chain for maximum efficiency, they have also made it vulnerable. To minimize supply interruption risk and increase chances for raw material cost increase recovery, companies must proactively manage their entire contracting process, both with customers and suppliers. As noted by the courts, the tension in the supply chain will only continue. ■

*Daniel N. Sharkey is a shareholder in Butzel Long's Bloomfield Hills office. He is chairman of the Commercial Litigation Committee of the State Bar Business Law Section and has significant experience in automotive supply-chain disputes and UCC issues. He was recently voted a "Top 10 Speaker of the Decade" by the Original Equipment Suppliers Association. Mr. Sharkey was previously a captain and trial counsel in the U.S. Army Judge Advocate General's Corps and special assistant U.S. attorney.*

## FOOTNOTES

1. *Metal One America, Inc v Center Mfg, Inc,* 2005 WL 1657128 (WD Mich, 2005).
2. The just-in-time, or "JIT" system, is focused on eliminating inventories. Jose Ignacio Lopez de Arriortua, vice president of purchasing at General Motors in the early 1990s, championed JIT. To eliminate shipping and packing costs, Mr. Lopez went so far as to require GM's larger sub-assembly suppliers to build facilities next to GM plants and assembly lines. Levin, *Is the Auto Plant of the Future Almost Here?,* New York Times, June 14, 1993, available at <http://query.nytimes.com/gst/fullpage.html?res=9F0CE3DC103FF937A25755C0A965958260>. All websites cited in this article were accessed November 11, 2008.
3. Samuelson, *Let's Shoot the Speculators!,* Newsweek, July 14, 2008, available at <http://www.newsweek.com/id/143786/output/print>. ("[R]aw-material prices have exploded across the board[,]" citing increases of 177 percent in oil and 117 percent in steel from 2002 to 2007).
4. Sherefkin & Barkholz, *Suppliers: Chrysler Jury a Worry; New Unit Aims to Deal with Rising Raw Material Costs,* Automotive News, September 22, 2008 ("prices for cold rolled steel are up 51 percent" in 2008).
5. Simchi-Levi, Nelson, Mulani & Wright, *Crude Calculations: Why High Oil Prices are Upending the Way Companies Should Manage their Supply Chains,* Wall Street Journal, September 22, 2008, at R8, available at <http://online.wsj.com/article/SB122160061166044841.html>.
6. Since 2001, the following auto suppliers having assets over $100 million have filed for bankruptcy (the number following the name is revenue in thousands for the year listed): Federal-Mogul—$6,914 (2007); ANC Rental—$3,163 (2001); Hayes Lemmerz—$2,130 (2007); Harvard Industries—$330 (2000); Exide Technologies—$2,939 (2007); Daewoo Motors—$3,500 (2002E); Budget Group—$2,161 (2001); Venture Holdings—$1,700 (2002E) and again in 2008 as Cadence Innovations, LLC; Intermet—$731 (2003) and again in 2008; Oxford Automotive—$1,000 (2004E); Amcast—$424 (2003); Tower Automotive—$2,816 (2003); EaglePicher—$685 (2003); Meridian Automotive—$1,000 (2003E); Collins & Aikman—$3,784 (2003); Delphi—$27,000 (2005E); Dana—$8,700 (2007); Dura—$2,350 (2005); Citation Corp.—$714 (2007E); Remy—$1,129 (2007); American LaFrance—$166 (2007E); and Plastech—$1,400 (2008).
7. Beene, *Material Cost Hikes Bring Lawsuits,* Crain's Detroit Business, September 7, 2008.
8. The law that governs sales of goods such as automotive parts in the United States is Article 2 of the Uniform Commercial Code, codified in Michigan at MCL 440.2101 *et seq.* While international contracts are governed by the Convention for the International Sale of Goods (CISG), virtually all automotive terms and conditions affirmatively exclude the CISG and invoke the state law of the buyer's location.
9. *Chainworks, Inc v Webco Industries, Inc,* unpublished memorandum opinion of the U.S. District Court, Western District of Michigan, issued February 24, 2006 (Docket No. 05-135) ("The form which the increase takes, whether a surcharge or price increase, is irrelevant.").
10. See Bishoff & Miller, *The enforceability of requirements contracts in the automotive industry: Do your agreements pass scrutiny?,* 28 Mich Bus L J 2 (Summer 2008), p 18.
11. See Ben-Shahar & White, *Boilerplate and economic power in auto manufacturing contracts,* 105 Mich L R 953 (2006) ("We could not find reference to a single legal dispute on the battle of the forms with an OEM.").
12. *General Motors Corp v Steel Dynamics, Inc,* unpublished memorandum opinion of the Oakland County Circuit Court, issued August 4, 2004 (Docket No. 04-056983-CK); *Acemco, Inc v Ryerson Tull Coil Processing,* ___ Mich ___; 756 NW2d 74 (2008) (reversing Michigan Court of Appeals holding that contract unenforceable for lack of quantity term because "may" does not require buyer to buy anything).
13. See Molder's Lien Act, MCL 445.611 *et seq.;* Special Tooling Lien Act, MCL 570.541 *et seq.; Gateplex Molded Products Inc v Collins & Aikman Plastics, Inc,* 260 Mich App 722, 726; 681 NW2d 1 (2004) (liens are only enforceable against owners, so if OEM owns the mold or tool, Tier 2 cannot enforce against Tier 1).
14. See also Boettcher & Gerish, *Enforceable contracts without agreement on price: Avoiding potential pitfalls of the incomplete deal,* 84 Mich B J 35 (June 2005) ("[T]he digests are replete with examples of courts enforcing contracts where the parties have omitted or failed to agree on price.").
15. *Eberspaecher NA, Inc v Van-Rob, Inc,* 544 F Supp 2d 592 (ED Mich, 2008) (request for injunction denied because of lack of irreparable harm: "[buyer] can pay [seller] its requested prices and pursue a breach of contract action against [seller] for money damages").
16. See Klein, Malone & Luce, *Long-term contracts, breach, and the Uniform Commercial Code's notice requirement,* 86 Mich B J 28 (May 2007).
17. Trentacosta & Menges, *The much-maligned purchase order,* 86 Mich B J 32 (May 2007).
18. See, e.g., *Wiseco, Inc v Johnson Controls, Inc,* 155 Fed Appx 815 (CA 6, 2005) ("As with many contract disputes, this one would not have fueled such long and costly litigation had the parties adequately memorialized their intentions.").
19. See, e.g., *Foamade Industries v Visteon Corp,* unpublished opinion per curiam of the Michigan Court of Appeals, issued March 4, 2008 (Docket No. 271949) (supplier's e-mail to customer, sent two weeks after receiving purchase order, objecting to T&C as "overreaching, burdensome, and inappropriate").
20. See, e.g., *Bosch Corp v ASC, Inc,* 195 Fed Appx 503 (CA 6, 2006) (applying Michigan law) ("ASC fails to explain why no one bothered to pick up the phone to seek clarification.").
21. See Bishoff, Jeffers & Baucus, *Contractual supply disputes in the automotive industry: Lessons learned,* 26 Mich B L J 11 (Summer 2006).
22. *Eberspaecher NA, Inc v Van-Rob, Inc, supra* ("[Buyer] can pay [seller] its requested prices and pursue a breach of contract action against [seller] for money damages."); *Mando America, Inc v Coupled Products, LLC,* unpublished memorandum opinion of the Oakland County Circuit Court, issued August 14, 2008 (Docket No. 08-093726-CK) ("[Buyer's] claim of irreparable injury is of its own doing, as [seller] is willing to continue to supply [buyer]—as long as [buyer] accepts the price increases.")
23. *Mantaline Corp v PPG Industries, Inc,* 225 F3d 659 (CA 6, 2000); UCC 2-204; see also ¶ 1 of virtually every set of OEM and Tier 1 set of terms and conditions of purchase.
24. *Bosch Corp v ASC, Inc, supra* (applying Michigan law); *Foamade Industries v Visteon Corp, supra.*
25. *Great Northern Packaging, Inc v General Tire & Rubber Co,* 154 Mich App 777, 787 ("[T]he term 'blanket order' expresses a quantity term, albeit an imprecise one.").
26. *Detroit Radiant Products Co v BSH Home Appliances Corp,* 473 F3d 623 (CA 6, 2007) (applying Michigan law) ("A blanket purchase order does not oblige [the seller] to manufacture or ship any parts." Internal quotations and citations omitted). See also *Acemco, Inc v Olympic Steel Lafayette, Inc,* unpublished per curiam opinion of the Michigan Court of Appeals, issued October 27, 2005 (Docket No. 256638) ([T]he term "blanket" in a referenced document outside the purchase order contract was not sufficient to act as a quantity term to form a requirements contract.).
27. *Johnson Controls, Inc v TRW Vehicle Safety Systems, Inc,* 491 F Supp 2d 707 (ED Mich, 2007).
28. *Mando America, Inc v Coupled Products, LLC, supra* ("the quantity term remains uncertain because [buyer] agrees to purchase only so many parts as it choose to purchase. This is no promise at all and renders the purchase orders unenforceable.").
29. *Johnson Controls, Inc v TRW Vehicle Safety Systems, Inc, supra* at 717. ("*Ace Concrete, Acemco* and *Dedoes* minimally advance the statute of frauds' purpose to provide a basis for believing a contract exists while at the same time damaging the UCC's other substantive goals of liberally incorporating trade usage, custom and practice, course of dealing, and course of performance into parties' agreements in fact." (Citation omitted.) These cases "conflict with the UCC's goals and confuse the issue of whether the quantity term is sufficiently definite to enforce the contract with the issue of whether there is a written quantity term for the purposes of satisfying the statute of frauds.") See also *GRM Corp v Miniature Precision Components, Inc,* unpublished memorandum opinion of the U.S. District Court, Eastern District of Michigan, issued March 8, 2007 (Docket No. 06-15231-BC) (Ludington, J.) (making similar criticism).
30. A leading treatise gives similar guidance: "Under the present state of the law we believe that there is no language that the lawyer can put on a form that will always assure the client of forming a contract on the client's own terms. . . . If one must have a term, that party should bargain with the other party for that term; a client should not get it by a lawyer's sleight of hand. . . . If a seller must have the term to reduce its liability but cannot strike a bargain for it, the only answer may be to raise the price, buy insurance, or—as a last resort—have an extra martini every evening and do not capitalize the corporation too heavily." White & Summers, Uniform Commercial Code (4th ed), § 1-3.
31. A "gale of judicial opinions" rejects claims for increased costs as a basis for a finding of commercial impracticability, and concludes that "an increase in price, even a radical increase in price, is the thing that contracts are designed to protect against." White & Summers, Uniform Commercial Code (4th ed), § 3-10 (noting more than a dozen cases).