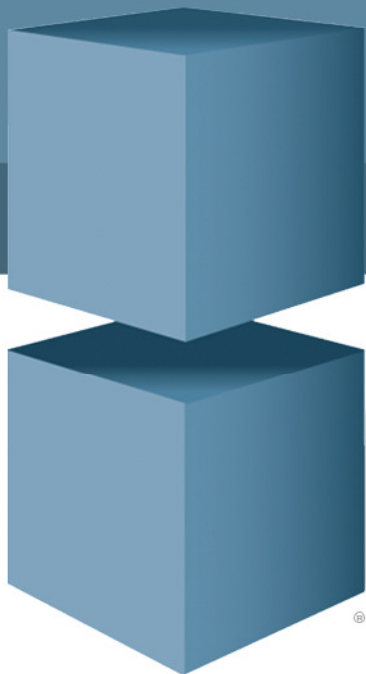




Understanding Legal Rights in Times of Short Supply



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INTRODUCTION

Good news: volumes are up

Bad news: volumes are up

Capacity has been removed from the supply chain

More bad news: Earthquake in Japan

Result: supply shortages and capacity constraints





CAUSE OF SUPPLY SHORTAGES

- Acts of God (e.g., fire, explosion, weather)
 - Sometimes referred to as “force majeure” events, these are events that are outside the reasonable contemplation of the parties at the time of contracting.
 - Must be a risk that was not foreseen, and concerning which the parties did not allocate responsibility.
 - Hurricane Katrina brought force majeure clauses into focus. Now Japan is doing the same.





CAUSE OF SUPPLY SHORTAGES

- Shortages of necessary raw materials or components
 - Not just an increase in the cost of raw materials or components, but rather a true shortage.
 - Typically, supply shortages are caused by lack of supply of materials, such as recent shortages in microchips, aluminum, glass fibers, and plastic resins.
 - Shortages also may result from subsupplier failures, e.g., inability to obtain supply due to bankruptcies/restructurings of smaller suppliers that have yet to right-size.





CAUSE OF SUPPLY SHORTAGES

- Many of these events already have occurred in 2011
 - The snow storms of February 2011 (caused by global warming) forced delays in delivery of component parts to numerous OEM facilities. As a result, GM, Ford, Chrysler, Toyota, and Subaru all were forced to cancel shifts.
 - Shortages in steel (in particular, specialty steels), rubber, and plastic resins have caused OEMs such as Ford, Chrysler, Volkswagen, and Daimler to cancel shifts and curtail production.
 - Shortages in microchips and integrated circuits have forced suppliers to monitor and manage closely their subsupplier relationships.
 - The crisis in Japan





AUTOMOTIVE SALES – PAST 2 YEARS

- From 2000 to 2007, light vehicle sales generally hovered between 16-17 million vehicles per year.
- In 2008, light vehicle sales decreased to just 13.2 million vehicles, and in 2009, light vehicle sales bottomed out at just 10.4 million vehicles – just 60% of the sales in 2000.
- Suppliers were forced to shed all nonessential capacity, equipment, facilities, and workforce.
- Bottom line: across the entire supply chain, capacity has been removed from the supply chain.





AUTOMOTIVE SALES - FUTURE

- Over the next several years, industry analysts such as IHS (f/k/a CSM) predict that volumes will climb back to pre-2007 levels, and level out at approximately 16-17 million vehicles per year.
 - In 2013 alone, North America automakers are expected to launch 42 new vehicle programs – more than twice as many programs as the 20 programs that were launched in 2011.
 - The increased volumes, coupled with a higher-than-normal number of new vehicle programs, will place considerable stress on capacities of suppliers, and also place considerable stress on the capacities of their subsuppliers.





FINANCIAL MARKET

- Financial markets are less accessible to smaller suppliers (tier-two or tier-three), restricting their funding and their ability to increase capacity through capital investment.





KEY CONTRACTUAL PROVISIONS

- Quantity/requirements provisions
- Force Majeure/excused performance
- “Changes” clauses





QUANTITY/REQUIREMENTS PROVISIONS

- Forecasting of automotive volumes is inherently difficult, due to fluctuating customer demand.
- As a result, rather than specify the exact quantities required on specific dates, most automotive supplier contracts are “requirements contracts” in which the buyer is obligated to purchase some quantity or percentage of its requirements from the seller. MCL 440.2306. See *Metal One America, Inc v Center Mfg, Inc*, 2005 WL 1657128, at *4-5 (WD Mich, 2005).
- Rather than guarantee any specific minimum quantities of goods to be sold, these contracts set a price and other terms, and contemplate that subsequent orders (often called “releases”) will be issued by the buyer stating specific quantities. See *GRM Corp v Miniature Precision Components, Inc*, 2008 WL 82224 (ED Mich, 2008) (enforcing contract containing estimated annual quantity with specific orders placed via weekly releases).





QUANTITY/REQUIREMENTS PROVISIONS

- Under the Uniform Commercial Code (“UCC”), requirements contracts such as this are generally enforceable.
 - Michigan courts recognize, and enforce, contractually-agreed-upon minimum and maximum quantities. See *Acemco, Inc v Ryerson Tull Coil Processing*, 482 Mich 999; 756 NW2d 74 (2008) (enforcing agreement under which steel supplier was to supply “33,950,000 pounds ... plus or minus 20%.”).
 - In the absence of a stated maximum, then requirements contracts are enforceable but “no quantity unreasonably disproportionate to any stated estimate or in the absence of any stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.” MCL 440.2306(1).





QUANTITY/REQUIREMENTS PROVISIONS

- But in order to be an enforceable requirements contract, the contract documents must refer to the buyer's requirements or some estimated quantity. *See Aleris Aluminum Canada, LP v Valeo, Inc*, 718 F Supp 2d 825 (ED Mich, 2010) (no requirements contract existed where purchase order did not refer to purchase quantities or buyer's requirements, and buyer provided only non-binding weekly quantity forecasts); *but see Johnson Controls, Inc v TRW Vehicle Safety Systems, Inc*, 491 F Supp 2d 707 (ED Mich, 2007) (purchase order stating quantity term of "AS REL.," i.e. "as released," sufficient to create enforceable contract).



FORCE MAJEURE/EXCUSED PERFORMANCE



- Most supply agreements excuse suppliers from performance in the event of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting.
- The provisions themselves usually set forth a list of enumerated events based on the occurrence of which performance is excused, a list of specific obligations of the supplier upon the occurrence, and a list of specific rights of the buyer if the event lasts for a specific duration.





“CHANGES” CLAUSES

- It is hornbook contract law that one party generally cannot “unilaterally modify” or change a contract. See *Quality Prods & Concepts Co v Nagel Precision, Inc*, 469 Mich 362, 372-73; 666 NW2d 251 (2003).





“CHANGES” CLAUSES

- Even so, OEMs (and suppliers in the relevant supply base) routinely unilaterally modify portions of supply contracts by changing specifications of component parts, and also certain related terms (e.g., shipping, packaging, quality systems).
 - Most standard terms and conditions allow customers to make unilateral changes, in the customer’s sole discretion.
 - Most standard terms and conditions provide for the possibility of price and schedule relief in the event of changes, but restrict the right in various ways, such as: (i) limiting the types of changes that are subject to relief; (ii) imposing tight time restrictions and onerous documentation requirements; and (iii) allowing the customer to unilaterally determine the relief to be granted.





SOLUTIONS/STRATEGIES FOR SUCCESS

- On the customer side:
 - Set capacities at the outset, in both contract documents (Purchase Orders themselves) as well as in specifications, PPAP documents, and other documents.
 - In the absence of an express agreement regarding capacities, you likely will be obligated to adjust your capacity to account for increases, unless those increases are “unreasonably disproportionate” to stated estimates or historical volumes. Real world – as a Tier I, you will have to supply what your OEM customer requests.
 - Where possible, negotiate provisions establishing how to increase/decrease capacity, and who will bear the costs of such increases/decreases.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Negotiate “force majeure/excused performance” provisions that define with specificity that a “capacity issue” excuses performance, at least for some period of time.
- Clarify what types of modifications are included in the “changes” clauses of your supply agreement, concerning which the customer may have the right to implement unilaterally. Also, make sure to clarify the customer’s obligation to pay for such changes, and the timing required for implementation.





SOLUTIONS/STRATEGIES FOR SUCCESS

- On the supplier side:
 - Define in your supplier contracts the specific capacity commitments that are being made by your suppliers, and also define the supplier's obligation to maintain flexibility to increase/decrease capacity, if necessary.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Ensure that, at a minimum, the force majeure/excused performance provisions in your supplier contracts mirror the provisions in your customer contracts.
 - If your customer contracts do not excuse performance in the event of a capacity issue, then make sure that your supplier contracts provide the same.
 - If possible, negotiate favorable force majeure/excused performance provisions that exclude all but actual force majeure events (not just capacity constraints), and specify that the supplier is responsible for interim cost increases (i.e., “cover costs”, expedited freight, etc.) related to a supply failure.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Include in your supplier contracts provisions that require your suppliers to give priority to your requirements in the event of an allocation of raw materials/component parts.
- Include capacity within the definition of “changes” that you unilaterally may require your suppliers to implement.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Engage in preventive maintenance of your supply chain
 - Understand the operational and financial capabilities of your suppliers, their subsuppliers, and all critical parts of the supply chain.
 - Ask suppliers to verify in writing their capacities and their subsuppliers.
 - Require financial information from suppliers.
 - Proactively monitor and track shortage and capacity concerns.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Take prompt actions to address supply shortages/capacity issues once they become apparent. Most OEMs understand the issues associated with supply shortages and capacity constraints, and may be willing to work cooperatively to solve those issues as long as they perceive transparency between the parties.





SOLUTIONS/STRATEGIES FOR SUCCESS

- When faced with the possibility of supply shortages or capacity constraints, consider adjusting your lean, just-in-time inventory systems, or otherwise requiring suppliers to maintain a minimal inventory banks of parts. Even a minimal inventory bank of just a couple of weeks worth of parts may allow you to withstand disruptions caused by supply shortages or capacity constraints.





SOLUTIONS/STRATEGIES FOR SUCCESS

- Do not to sacrifice quality or delivery performance at the expense of meeting capacity needs. When suppliers approach their operational and financial capacities (generally, 80% of actual capacity), critical elements of the customer/supplier relationship – such as quality and delivery performance, or preventive maintenance – often are compromised.
 - In the short run, such compromises may allow the supplier to attain higher volumes and profits.
 - In the long run, however, failure to focus on quality, delivery, preventive maintenance, or other key metrics, will impair your customer relationship and your reputation, possibly beyond repair.





CONCLUSION

- Suppliers that anticipate potential supply shortages and capacity constraints, and take proactive steps to manage them will be better positioned.
- Such suppliers will be able to minimize their potential risk, and may be able to win additional transfer business and/or strengthen their current business relationships.
- In the end, a proactive approach to supply shortages and capacity constraints will ensure that your company is able to adjust and thrive in the always-challenging automotive industry climate.





THANK YOU

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