

Borda, Lorenz & Geggie PLLC

LAW OFFICES:

WALTER J. BORDA
JAMES C. CURTISS
THOMAS H. GEGGIE
JOSEPH F. LORENZ
BENJAMIN F. WU
JAMES P. ZIETY

CRYSTAL GLEN OFFICE CENTRE
39555 ORCHARD HILL PLACE
SUITE 370
NOVI, MI USA 48375-5394

PHONE: (248) 735-4985
FAX: (248) 735-0444
EMAIL: JZIETY@BORDA-LORENZ.COM
WEBSITE: WWW.BORDA-LORENZ.COM

Where are my Tools? Part II

**By James Ziety
Borda, Lorenz & Geggie PLLC**

In our last newsletter, the Harbour-Felax Group provided an overview of ways purchasing organizations can improve their cost effectiveness in the purchase of supplier tooling. Just as important as developing and following sound sourcing strategies for tooling are the terms and conditions of the tooling purchase order. Many states have passed special laws that are intended to protect the interest of the tool builder and the tool user. Using Michigan law as an example, this article will reference the Michigan Special Tools Lien Act (“Act”) which has been in effect since 2002, although the laws in other states are similar.

The primary purpose of the Act is to permit a tool builder a means to protect their ability to receive payment for the tool. However, as the purchaser of special tooling, an understanding of how the Act works, and appropriate language in your tooling purchase order terms and condition can protect any payments you make to a tool builder, and help you avoid having to pay twice for the tool.

The remedy that the Act provides to a tool builder is the creation of certain “lien” rights in the tool. A lien is a legal term that refers to an interest that a supplier or a creditor (in this case, the tool builder) has in a particular piece of property which protects their ability to obtain payment for goods or services. It is not a physical thing. A lien is a legal right that the fabricator can enforce in order to receive payment owed by a customer.

The following items are considered special tools for purposes of the Act:

Tools, dies, jigs, gauges, gauging fixtures, special machinery, cutting tools, or metal castings manufactured by a special tool builder.

That means that anyone who supplies your company with these items is entitled to special protection to take measures to make sure they get paid. Producers of plastic injection molds and dies have enjoyed these types of protections in Michigan for many years. In 2002, Michigan adopted the Special Tools Lien Act to extend these types of protections to tools

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used for metal fabrication and stamped metal parts. By way of example, almost all of the special tools used in the automotive industry in Michigan are eligible for these protections.

First, let's look at the protections provided to the tool builder, then we can see how the purchaser of tools (and the end user if different than the purchaser) can use the Act to protect its interests.

Tool Builders Liens

If a tool builder performs fabrication, repair, or modification services for special tools and does not receive payment within ninety days of delivery, the law says that the builder who takes certain measures can come and take those tools back (even after they have been delivered to you and put to use to manufacture goods) if they satisfy certain conditions in the law. Once the builder recovers possession of the tool, the builder is entitled to sell the tool at public auction to recover the amount owed unless the sale would violate a patent or copyright held by the tool owner. If the tool is sold for more than the builder is owed, the excess proceeds from the auction are paid to the former owner of the tool.

But this protection is only available to tool builders that take certain measures to protect their right to take the tools back. First, the Act requires that the special tool builder must permanently record its name and address on each tool before the tools are delivered. Second, the Act requires that the tool builder file a financing statement for that tool. A "financing statement" is a form that the tool builder files with the public records of the local government that shows that the tool builder is owed money for the tool. The tool builder is required to notify the tool owner that a financing statement is being filed, but the tool owner's signature is not required for tool builders to complete their financing statements. If the tool builder has not been paid in accordance with the tool order, the tool builder must give formal notice to the tool purchaser of the default and claim a lien on the tool. If the owner of the tool is not the company that is using the tool, the tool builder has to notify the owner and the user. The notice must include the amount that the tool builder claims is owed for the tool and a demand for payment. If the tool builder has not been paid after ninety days have passed after sending the notice, the tool builder has the right to retake possession of the tool. The lien, once the tool builder has established it, remains in effect until the tool builder has received payment in full from the purchaser, or the tool builder has terminated the financing statement. In addition, if the tooling is being used by a third party parts supplier (end user) to the tool purchaser/owner, the lien would be terminated if the purchaser has received a verified statement from the end user of the tool, that the end user has paid the amount for which the lien was claimed.

How does a tool purchaser protect itself?

If your company purchases tools, you need to protect against your tool builder's ability to retake possession of the tooling under the Act. There are two protections that are available to you:

First, make sure your purchase order with your tool builder contains a waiver of the tool builder lien rights and an agreement that the tool builder will not file a financing statement. Under the Michigan Act, there is no prohibition against a tool builder's waiver of its rights under the Act. Thus, it is perfectly legal for your company to insist in your tool order

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contract that your tool builder agrees not to make use of these remedies. If your purchase order contains those provisions, your tool builder will be precluded from taking the certain measures that the law requires to protect the tool builder's lien. That does not mean that you do not have to pay for the tools. It only prevents the tool builder from coming to your plant and taking possession of the Tools if a payment dispute arises.

Second, make your payment obligation clear, particularly in a situation where several companies are involved in the ordering and use of the tool. You need to avoid giving the tool builder the chance to claim that payment is due before you are ready to make the payment. Many suppliers order special tools on behalf of their customer, and they pay for the tool construction with money that they receive from that customer. If you do not expect to pay your tool builder until you receive reimbursement for tooling from your customer, make it clear in your contract with the tool builder that you are not obligated to pay until you receive payment. If your customer has imposed a condition on its obligation to pay you, such as a run-off of production parts or your customer's PPAP, make sure that your payment obligation to your tool builder contains the exact same conditions. Be clear about who controls PPAP approval. If your company's practice is to award payment for tooling based on certain milestones, put those milestones in writing in your agreement and be as detailed as you can when you describe them. The point here is to use your contract to define the timing for your payment obligation. Make sure that your obligation to pay arises at the time when you are ready to make the payment.

You should also include a provision in your tool order terms and conditions that states title to all tooling work in process passes to your company upon receipt of any progress payments that are made in accordance with the tool order. The payment provision should also stipulate that any payments made to the tool builder by the purchaser are expressly intended to be held in trust for the benefit of any subcontractors used by the tool builder to produce the tools covered by such payments until those subcontractors have been fully paid. This type of provision will ensure that you are protected against liens under the Act from such subcontractors so they cannot effectively cause you to pay twice---once to your tool builder, and then a second time to them if your tool builder fails to pay them. Further, any such work in process tooling while still on the tool builders premises should be covered by a bailment provision that places certain restrictions on the tool builder with respect to the tools or work in process that belongs to your company. Such a provision would require the tool builder to be deemed to be "bailed property" and require certain labeling, restrictions on movement of the tool or work in process and most importantly, placing responsibility for maintaining adequate insurance against loss.

The following section addresses how the Act can be used to protect the company that uses tools to produce parts.

End User Lien

In certain industries, it is common practice for many parts suppliers to use special tools that are owned by someone else. For example, in the automotive industry, automotive manufacturers typically want to be the owner of all of the special tools that are used in the manufacture of parts for their products because they want to protect their source of supply. These manufacturers will arrange to purchase special tools from tool builders and have the

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tools shipped to a parts supplier for use by that supplier during the production cycle. The Act gives the parts supplier, or end user of the special tools, two special legal rights.

First, the end user of a tool has the legal right to retain possession of special tools until the end user's customer pays for parts that the end user produced using the special tools. If the tool owner/purchaser refuses to pay, the end user can even sell the tools at public auction if the end user follows a certain procedure. The procedure requires that the end user send a notice to the tool owner/purchaser that states that a lien is claimed on the special tools and contains an itemized description of the amount that is due and a demand for payment.

If the end user has not been paid the amount due within ninety days after the notice has been delivered, the end user is expected to send a second notice that states that the end user will sell the special tools in sixty days. The notice must describe the special tools, indicate the time and place for the sale, and contain an itemized breakdown of the amount due and a statement by the end user that the product produced with the special tools complies with the quality and quantity of parts ordered. The end user is not permitted to sell the special tools if the sale would violate a patent or copyright held by the customer or if the customer notifies the end user that the product produced with the special tools did not meet the quality or quantity ordered. If the customer provides that notice, the end user cannot sell the tool until the dispute is resolved.

This is an important right that is frequently overlooked. Special tools are critical to support production. If your company relies on a supplier who uses special tools that your company owns, or that your customer owns, that supplier is entitled under the Act to prevent you or your customer from recovering possession of the special tools until the supplier is paid in full. How do you protect against this? Again, you can protect your company by being proactive with your tool purchase order terms and conditions. Make sure your tool purchase order with your parts supplier has a clause that says that the parts supplier waives its lien rights and agrees to surrender possession of special tools upon request. The supplier has other legal rights that are available to protect its ability to receive payment for parts, and the waiver of this particular remedy does not reduce or diminish the supplier's claim for payment. But it protects your company against the situation where a supplier is able to use critical leverage in negotiations. And if you are already operating under agreements that do not contain waivers of this remedy, take immediate action if you receive notice of a lien from an end user. Review the notice to see if it meets the legal requirements, because if the end user does not follow the exact procedure required by law, the end user loses its lien rights. If the user has followed the procedure, arrange payment for the parts. If you do not agree with the claim for payment, give written notice of a payment dispute immediately to the supplier.

So the first right provided to the end user is the opportunity to withhold possession of the tools until the end user receives payment for parts made using the tools. The second right is the end user's right to destroy tools that have been abandoned by the owner of those tools or which the owner has not reclaimed after production ends.

At the end of the production cycle, many parts suppliers are faced with the burden of having to store or maintain special tools for several years even though the parts suppliers are no longer using them to produce income. These tools can be large and heavy and require

significant resources for their storage and care. The end user cannot ordinarily sell or destroy the tools because the end user does not own the tools.

So the Act provides that once three years goes by after a tool is last used by a parts supplier, the parts supplier can send a notice to the owner that requests that the owner come pick up the tool. If the owner of a special tool does not claim possession of the tool within 120 days of receiving the notice, the parts supplier can destroy the tool. The parts supplier is not entitled to sell the tool. In many cases, the notice will cause the owner to come pick up the tool or arrange payment for its storage and maintenance if the owner needs the tool for service and replacement parts. Without this law, many parts suppliers would otherwise be forced to store the tools without compensation.

Protect your company

If your company owns special tools that are held by your suppliers, you can require in your contracts that your suppliers are obligated to store the tools without charge after the end of the production cycle. Your contract should designate a specific person within your company for all notice purposes, so that a notice is not overlooked. And take immediate action if you receive a notice of an intent to sell any tooling. If your customer owns that tooling, you will need that customer's cooperation and there is only so much time available in the notice period.

And don't forget that you can use these remedies to your advantage, if your company is the end user of tools owned by your customer. You can withhold possession to secure payment for parts produced using the tools, unless you have agreed to waive that right in your supply agreement. If you are storing tools longer than three years after last production, consider putting your customer on notice that the tools have to be reclaimed or that your company requires compensation for storage. If your suppliers have these remedies available to them, it is only fair that you make use of them with respect to your customers. And the overall rule is the same—don't get caught in the middle. If your customer requires you to waive your lien rights, get that same commitment from your suppliers. You want to avoid the situation where your supplier has lien rights against your company when your company has given them up with respect to your customer.