

Manufacturing - Automotive - Advisory

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Dealing with the Aftershocks of the Disaster in Japan

The disruptions to the automotive supply chain caused by the cataclysmic events in Japan are likely to continue for some time and become increasingly severe. Even suppliers that are not directly or immediately affected likely will experience some disruptions to their supply chains as the difficulties encountered by many tier 2 and tier 3 suppliers continue to ripple upward. As OEM plants reduce their production schedules to contend with parts shortages, purchasing forecasts could be sharply reduced and, in some instances, even suspended, causing ripples back downstream. Buyers and sellers, OEMs and suppliers, with and without a physical presence in Japan, with direct supply relationships or multi-tiered relationships with Japan are absorbing the shocks. Prudent suppliers will proactively review their contractual rights and obligations at the earliest opportunity, before situations become critical.

This Alert addresses two issues concerning the impact of the events in Japan on the automotive supply chain: (1) whether suppliers¹ that are unable to supply are in breach of their contract; and (2) whether insurance may cover some or all of the losses.

Are Disrupted Suppliers and Buyers in Breach?

Nearly all automotive supply contracts include force majeure provisions that address extraordinary unanticipated events, such as earthquakes and tsunamis that make it impossible or impracticable to perform. Even when the written contract is silent, background principles of contract law also address such events. For U.S. contracts, the most important of the contract law principles are Sections 2-615 and 2-616 of the Uniform Commercial Code ("UCC"). For foreign contracts, the Convention on the International Sale of Goods (Article 79) may apply.

These contractual and legal principles will usually excuse suppliers that are unable to supply as a result of the events in Japan, but this general rule is subject to significant limitations and obligations.

First, the supplier must provide prompt, written notice of actual or potential delivery difficulties. Written force majeure provisions may include particular notice procedures or other requirements, which should be followed. Proper notice must include identifying whether there will be a delivery delay or nondelivery. The notice should also be updated as circumstances warrant.

Notices from downstream suppliers should trigger prompt analysis of the recipient's inventory and forecasting, and corresponding notices should be passed upstream to customers as quickly as possible. Prompt notice allows parties to act quickly, to examine alternatives, and to mitigate

losses. Parties who fail to provide timely notices and updates could compromise the protections they might otherwise have.

Second, it is essential to carefully and promptly review applicable contractual force majeure provisions, because there are significant variations between them that can expand or limit contractual rights. For example, the GM terms purport to allow it to recover any extra costs of purchasing from a replacement source during a disruption. Other terms establish specific time limits and processes for giving notice, and some contracts allow buyers to pass on cover costs. Each specific contract must be examined and followed carefully.²

Third, a supplier's performance will be excused only if there are no reasonable alternatives for performance. For example, there may be disputes as to whether the disaster is preventing performance or simply making it more difficult to perform. As we get further away in time from the disaster in Japan, there likely will be disputes as to whether the supplier could have found a way to resume supply. General rules of contract law and many contract provisions require the supplier to make reasonable efforts to restore supply. Performance might be possible at dramatically increased costs, or by arranging for an alternate source of supply. In general, higher costs do not excuse performance, but truly extraordinary costs may. Similarly, some suppliers may be able to supply some, but not all, of their customers' requirements. In such cases, suppliers generally must allocate supply among their customers in a "fair and reasonable manner."

Finally, even if performance is excused, that does not mean that there might not be adverse consequences for the supplier. For example, under some circumstances the customer may be able to terminate the agreement or pass on some or all of the extra costs it incurs. The legal rules in this area are complex and very fact specific. If a customer attempts to take such action, consultation with counsel is prudent.

We recommend that suppliers openly discuss these issues with their suppliers and their customers early and often, to attempt to come to shared understandings regarding various alternatives, feasible timetables, realistic forecasting, and allocation of costs. It is far more desirable to have an understanding on these topics in advance, as opposed to a dispute later about what efforts should have been undertaken and what costs should have been or, conversely, need not have been incurred.

Insurance Coverage

Impacted suppliers should review and identify insurance policies (particularly business interruption policies) that could potentially afford coverage for resulting commercial losses. Businesses with a facility or equipment that has been physically damaged by the Japanese earthquake or tsunami may be covered for any lost profits due to these events under their insurance policy's "Business Interruption" ("BI") provision. BI coverage, which is often included in a comprehensive insurance policy, can operate to reimburse the insured for profits it would have earned if the covered event had not occurred.

Businesses that are economically impacted by the Japanese disaster but which did not maintain facilities or equipment that were directly damaged by the disaster may possibly recoup losses if they maintained "Contingent Business Interruption" ("CBI") coverage. CBI coverage is designed

to protect the earnings of the insured as a result of physical loss or damage to the property of the insured's suppliers or customers rather than its own property. CBI losses may be triggered not only by actual property damage but also by the loss of information technology, communications equipment, or utility services resulting from the earthquake and tsunami. For entities whose policies do not afford coverage for CBI losses, the Japanese disaster serves as an unfortunate reminder that such coverage is available and may be worthwhile.

Prompt notice is required under any insurance policy. Notice should be provided even if coverage is uncertain, or even unlikely. Consult with an experienced agent for additional advice regarding coverage questions.

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¹ The typical in automotive supply requirements contract gives a buyer virtually unlimited discretion as to the timing and volume of its purchases, so a buyer unable to buy is not likely to be in potential breach of its contract.

² The force majeure provision for each North American OEM is summarized at pages 132- 138 of the OESA 2011 North American Production Purchase Order Contract Terms and Conditions Comparative Analysis and the full text of most OEM terms may be found on Butzel Long's website at <http://www.butzel.com/purchase-orders-resource-centers>.

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