Guest Article

Warranty Cost Sharing:
A Framework for Resolving Disputes[1]

William J. Kohler, Esq. – Clark Hill PLC – wkohler@clarkhill.com
Linda M. Watson, Esq. – Clark Hill PLC – lwatson@clarkhill.com

The Industry Context

The burden and allocation of warranty costs has been an enormous issue within the automotive industry for as long as warranties have been offered with the purchase of a vehicle. Carmakers and suppliers have always been aligned in their wish to diminish warranty costs to improve their financial performance, and they have each sought to do so through quality programs that operate within their own organizations and that are required of their respective suppliers – to varying degrees of success.

But carmakers, being on the front line of warranty liability, have also been acutely aware of the improvement to their bottom lines and balance sheets that could be achieved through the allocation of warranty costs to suppliers. They have, therefore, sought to make such allocations – sometimes fairly and sometimes unfairly – but always with appropriate diligence that reflects the financial imperatives of big business. Just as responsibly, suppliers have resisted the efforts of carmakers to share warranty costs with them.

Three major factors have, in recent history, caused carmakers to intensify their efforts to shift warranty costs to suppliers.

The first factor is the decline of their fortunes, which first became precipitous soon after the turn of this century, and then became catastrophic when the nation's economy collapsed in 2008.

The second factor is the rise of a sizable number of suppliers that, while not as immense as the carmakers, are certainly large enough to survive the imposition of significant warranty costs. Importantly, these outsized suppliers have been given tremendous responsibility for the engineering, design, and development of major components, such that their accountability for warranty claims and associated costs can be more readily identified and asserted.

The third factor is the increasing sophistication of analytic tools that allow for tracking warranty claims, determining their root causes, and identifying the suppliers associated with implicated parts. Some of these tools were, in fact, effectively legislated by the TREAD Act, which requires significant reporting to the National Highway Traffic Safety Administration of defects, as well as injuries and deaths relating to automotive products.

[1] A version of this article first appeared the OESA Comparative Analysis OEM Warranty Programs publication in November 2011.

The Framework for Disputes

Terms and Conditions

Although the technical bases of warranty claims and resulting costs are highly variegated and shifting over time, the legal and technical frameworks within which warranty cost allocation disputes arise is fairly static.

The legal framework is normally contractual, and the starting point for understanding it is in the carmakers' terms and conditions. In this respect, all carmakers reserve broad warranty rights in their terms and conditions. Generally, they require that the supplier warrant that parts:

- Are free from defects in materials and workmanship
- Conform to specifications, drawings, and sample
- Are free from design defects
- Are merchantable
- Are fit for the carmaker's intended use of the parts

Under these contractual arrangements, a supplier's liability is "fault based." Contractually, the manufacturer must prove both a defect and causation to support recovery. Therefore, as more fully discussed below, the determination of the root cause of a field failure – for example, whether the supplier's part or the OEM's vehicle system is the root cause – is a key factor in determining liability.

Whether the carmaker's claimed costs have actually been incurred by it and properly allocated to the supplier is another key factor in determining the extent of liability. In this respect, manufacturers typically seek 100 percent of broadly defined costs, which may be sweepingly defined in their terms and conditions and, therefore, part of their contracts with suppliers. Claimed costs may include substantial sums associated with allocated fixed costs, overhead, administration, warehousing, service part markups, dealer costs, and other items beyond parts and labor. In addition, manufacturers sometimes seek investigative and testing costs.

Warranty Cost Allocation Programs

Over the past several years, an increasing number of manufacturers have introduced warranty cost allocation programs. They are typically implemented under documentation separate from carmakers' terms and conditions.

Like terms and conditions, these programs represent contractual obligations when they are "incorporated by reference" into the OEM's terms and conditions or affirmatively accepted by a supplier. Accordingly, they may take the form of, or be found in, newly introduced warranty policies or quality manuals that a carmaker's term and conditions state must be complied with by its suppliers. Or, the carmaker may expressly request the supplier's acceptance of a new warranty cost allocation program.

When the implication is that suppliers must participate in a program because their terms and conditions require that they do so, then suppliers will often pose the legal question: Must we participate if we were not aware of the terms of the program when we accepted the carmaker's terms and conditions? When a supplier is requested to accept a new program, then the supplier will often ask: What are the legal and commercial implications if we do not? The legal analysis in response to these questions is frequently complex, and resulting conclusions are not always unfavorable for suppliers.

These questions are raised by suppliers with a degree of gravity because carmakers' cost-sharing programs tend – in practice – not to be fault-based; in lawyers' terms, they impose "strict liability" within defined parameters upon suppliers.

For example, a program may require that a supplier bear a fixed percentage of warranty costs when a supplier's part is implicated in a warranty claim, regardless of any determination of causation; and the percentage may be based upon the degree of responsibilities, such as design responsibility, that the supplier has for a specific component. Such programs may contemplate the supplier's input into the manufacturer's determination of causation, and perhaps even a period of negotiation as to the costs to be allocated to the supplier, but they will typically leave the manufacturer with a trump card: the right to finally determine the amount of warranty costs allocated to the supplier.

The Occasional Absence of Express Warranties

While a carmaker's terms and conditions and warranty allocation programs will normally govern its relationships with suppliers, in the absence of such express contracts, warranties will nonetheless be applicable under Article 2 of the Uniform Commercial Code ("UCC") and common law.

Under Article 2, promises made by a supplier may be deemed an express warranty that is enforceable. Indeed, a supplier does not need to use the term "warranty" or "guarantee" because a simple affirmation that the part or component will be of a certain quality or perform to a certain standard can create an express warranty. Moreover, words themselves are not necessary; reference to a blueprint, model, or sample may be sufficient to create an express warranty. Therefore, suppliers may create an express warranty without intending to do so.

At the very minimum, even if an express warranty has not been made, Article 2 imposes an implied warranty that parts are "merchantable" because suppliers have specialized knowledge as to the automotive parts or components they produce. "Merchantable" means that the goods sold must be of average quality in the industry in which they are sold and fit for the ordinary purpose for which they are to be used. In addition, if the supplier "has reason to know any particular purpose for which the goods are required" and that the buyer (whether a carmaker or another supplier) is relying on the supplier's skill

or judgment to furnish suitable goods, then Article 2 imposes an additional implied warranty that the parts shall be fit for a particular purpose. However, these implied warranties may be disclaimed under the UCC.

To exclude an implied warranty of merchantability, the disclaimer must mention "merchantability" and, in case of a writing, must be conspicuous, such as in all capital letters, or large or bold type. To exclude an implied warranty of fitness for a particular purpose, the disclaimer must also be conspicuous, but it must in addition be in writing.

As an exception to the above relating to cross-border transactions, the warranty provisions of the United Nations Convention on Contracts for the International Sale of Goods ("CISG") would be applicable unless expressly made not applicable. The CISG was adopted in 1980 to provide uniform rules for the international sale of goods, and as of 2010 had been ratified by 76 countries. Historically, American carmakers and suppliers have opted out of application of the CIGS in the express provisions of their agreements. However, in the absence of express terms and conditions, the warranty provisions of the CISG would pertain instead of those of the UCC discussed above.

Legal Analysis and Options

The preliminary legal analysis as to a supplier's responsibility under a carmaker's terms and conditions or, when applicable, a warranty cost allocation program, includes the following checklist of potential defenses:

- The parts met prints and specifications provided by the carmaker to the supplier
- The non-conformity had no consequence such that there is lack of causation
- The supplier's part failed due to a system or vehicle level issue
- The failure mode was unforeseeable
- The failure mode could only be detected and addressed at the vehicle development level

A supplier may have good arguments, such as those above, but the carmaker will typically attempt to force resolution of a dispute in its favor by threatening to withhold future awards of business until the supplier acquiesces to an allocation of warranty costs. And it might unilaterally debit allocated warranty costs against amounts owed to suppliers, even as the supplier is protesting all or a portion of an allocation on the basis of arguments such as those above.

Commercial negotiations of warranty cost issues are rarely resolved quickly, and they may drag on for many months, or even years. While commercial negotiations may lead to a mutually satisfactory resolution of a debate, they may not, and in that case, a supplier will normally assess its legal options, especially if the manufacturer has unilaterally implemented a debit against amounts owed to the supplier.

Beyond well-intentioned negotiations, the general legal options available to a supplier are to demand adequate assurances that its customer will return debited monies, declare the contractual relationship between the parties to be terminated, stop shipments of the affected parts, and then litigate a breach of contract claim against its customer for its unilateral debits. The higher the stakes – that is, the greater the threat to a supplier's survival – the more likely there will be a lawsuit; although, lawsuits against customers remain an extraordinary event in the automotive industry.

William J. Kohler, Esq., is a lawyer and member at Clark Hill, PLC, and Co-Chair of the Automotive Practice Group. He has extensive domestic and international experience in mergers and acquisitions, joint ventures, distribution arrangements, supply arrangements, supplier and customer workouts and bankruptcies, intellectual property arrangements, and general commercial arrangements and corporate matters. He can be reached at +1.313.965.8667 or wkohler@clarkhill.com.

Linda M. Watson, Esq., is a lawyer and member at Clark Hill, PLC, and Co-Chair of the Automotive Practice Group. She has extensive commercial litigation experience in business and contract disputes, supply concerns, warranty matters, employment issues and intellectual property disputes. She represents small to large privately held business entities, as well as public corporations both at the trial and appellate level of federal and state courts. She can be reached at +1.248.988.5881 or lwatson@clarkhill.com.