compliance & risks

Automotive Supply Contracting

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The global automotive supply chain is, at base, a web of contracts that fuels vehicle development and production. As the automotive industry speeds toward more intricate and advanced technologies—including electrification, autonomous and assisted driving, the use of artificial intelligence, connected vehicle systems and telematics, and enhanced user interactivity and smart car technologies—these contracts have become even more multifaceted and interdependent.

Contract complexities are heightened by world events, including most recently the Covid-19 pandemic, the global semiconductor shortage, weather events in parts of the southern United States and northern Mexico, and right-shoring initiatives (strategically locating operations and supply sources in regions best suited to minimize cost and maximize manufacturing and delivery efficiencies).

More still, the "just-in-time" nature of the automotive supply chain makes supply disruptions, including component part and material shortages, even more acute. Buyers of goods and services are taking a hard look at the risks "just-in-time" imposes and the potential benefits of in-sourcing production and expanding warehousing resources and on-hand inventory, including the creation of safety stocks.

Careful attention must be paid by procurement specialists and counsel to the formation of supply contracts that promote supply chain resiliency and the continuity of vehicle production.

Some key considerations in these contracts include:

Battle of the Forms

The typical automotive supply bid and contracting process involves an exchange of multiple documents including requests for quote, bid packages, supplier quotes, purchase orders and supply agreements, and supplier acknowledgements, often incorporating each party's standard—and conflicting—terms and conditions. This so-called "battle" occurs

when the contracting parties' respective offers and acceptances contain additional or conflicting terms, and the conflict must be reconciled. It is generally in the best interest of buyers and sellers to prevent a potential "battle-of-the-forms" inquiry, which can be highly fact-intensive and unpredictable.

Terms and conditions should therefore:

- Reject conflicting terms contained in the other party's documents; and
- Condition the other party's acceptance of the offer on its rejection of differing or additional terms.

Quantity
Under U.S. law, the expression of a quantity term (the volume of goods to be manufactured and sold) is crucial. Absent a written quantity term, a contract for the sale of goods (over $1,000) will be unenforceable under the statute of frauds provisions of the Uniform Commercial Code.

This requirement can be—and often is—satisfied by a statement that the agreement is a requirements contract, meaning that the buyer will purchase all or a fixed percentage of its "requirements" of the goods from its seller. But where that is not the case, like with one-off purchases such as "spot buys", it is critical to ensure that the agreement express the quantity or volume of goods to be purchased.

Duration
With the exception of "spot buys", contracts should clearly state how long the parties intend for the supply relationship to last. Without an agreed duration, the contract may be terminated by either party on reasonable notice. These types of terminations often follow disputes over proposed changes in pricing, part specifications, and delivery requirements, and create a lack of stability in the supply chain as securing, validating, and transitioning component part manufacturing to an alternative source of supply is often an expensive and time-consuming endeavor.

Force Majeure
Covid-19 has renewed focus on force majeure provisions. A force majeure clause in a contract will, where applicable and properly applied, excuse or permit delays in performance due to events beyond the reasonable control of the party from whom performance is due. Buyers will often push to narrow what constitutes a force majeure event, while sellers will pursue its expansion. Events that are foreseeable or within the control of a party (for example, labor disruptions, the imposition of duties and tariffs, and financial distress) are often excluded from a contract's definition of a force majeure.

The impacted party's obligations (prompt notice and transparency, and the resumption of performance) and the non-impacted party's rights (the ability to procure, or to require the impacted party to procure, substitute goods during the force majeure event, and right to terminate without liability to the impacted party) should be clearly defined.

Warranty
Supply contracts should apportion warranty claim and recall responsibility. This includes assigning design responsibility and liability for component part failure, identifying the

period during which the warranty is given and what circumstances may limit or expand the warranty, delegating which party will conduct a root cause analysis and how it will be performed (and any related audit rights), and prescribing the basis on which the parties' costs and expenses will be allocated, including the determination of a technical factor that sets the percentage share of financial responsibility for warranty costs. Many of these terms often appear in documents outside of the actual supply contract itself, in standard warranty process and procedure statements provided by buyers. These statements should be carefully reviewed by sellers.

As warranty costs are often pushed down the supply chain with each tier of customer looking to its direct supplier for compensation, mid-tier suppliers should ensure that their lower-tiered suppliers sign up to the same warranty protections that they have agreed to with their higher-tiered buyers.

Intellectual Property

The protection of intellectual property (IP) rights, especially with the advent of artificial intelligence and the massive investments being made in the development of emerging technologies, must be carefully addressed. Ownership and grants of licenses in technologies developed by collaborating buyers and sellers, and the injection of non-traditional technology developers into the automotive supply ecosystem, creates both complexities and opportunities.

Supply contracts should reflect a robust IP strategy that carefully protects proprietary interests and accounts for ownership and licensure – both to protect significant investments in IP and market competitiveness, and to enhance the monetization of valuable IP.

Changes

Customer part specification requirements often evolve and design flexibility presents challenges to buyers and sellers, especially with respect to safety requirements. Contracts should carefully address change management including the timing for the implementation of changes and related pricing issues.

The challenges facing automotive supply contracting professionals are significant and complicated. The strategic adage that "the best defense is a good offense" should be set at the pole position for strategic contract negotiation and development.