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Does a Termination for Convenience Clause Really Mean What It Says?

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The standard purchasing terms and conditions of essentially every Original Equipment Manufacturer and Tier One supplier contains a termination for "convenience" provision. This clause states, in sum, that the buyer can terminate the contract at any time, at its option and in its sole discretion. These clauses typically state that if the customer chooses to terminate, it will only be responsible for finished products already ordered, usable work-in-process and other discrete costs. This can seem harsh and potentially unjust, particularly when the supplier was anticipating a long-term agreement, agreed to per-part pricing to reflect that understanding and has sunk hard costs into its manufacturing facility. But if the supplier takes a deeper look at the contract terms and conditions with its customer, more than likely it will find this provision included in the contract.

Despite the straight-forward language of a termination for convenience provision — that the buyer can terminate for any reason or no reason at all — this can run counter to other aspects of the law governing supply agreements. This is where the law can get a bit muddled.

Many supply agreements are set up as "requirements" contracts. These contracts are recognized as enforceable under the Uniform Commercial Code (UCC) even though there is not a set quantity that the buyer must purchase. The UCC recognizes the practical reality — particularly in the automotive world — that a buyer may not always know how much product to order. So under a requirements contract, the buyer commits to a per-part price to purchase all (or a percentage) of its requirements for that part from the seller. However, while the buyer has flexibility to only order what it needs, it must still order products in good faith. This means that the buyer must operate and conduct its business "according to commercial standard of fair dealing ..." (UCC 2-306, Comment 2). For example, "a shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not." *Id.* As some courts have observed, to satisfy this good faith duty, a buyer cannot simply have second thoughts about the terms of the contract and stop ordering products to get out of it. But, if the buyer has a legitimate business reason for eliminating its requirements, as opposed to a desire to avoid its contract, the buyer acts in good faith. See *Empire Gas Corp. v. American Bakeries*, 840 F.2d 1333 (7th Cir. 1988).

But, what if a requirements contract also contains a termination for convenience clause, and the buyer simply decides to terminate the contract? Is that decision a failure by the buyer to order products in good faith, or merely one party utilizing an agreed upon provision to end the contract? The law is unclear, with courts answering this question differently.

In *Metal One America, Inc. v. Center Manufacturing., Inc.*, 2005 WL 1657128 (W.D. MI 2005), the court considered whether Center's termination for convenience of a requirements contract constituted a breach. The court found that it did and concluded that Center chose to end the contract and stopped ordering parts, not for lack of orders but because Center was attempting to "curtail losses." In the court's view, this constituted a bad faith breach of the contract. The court was also swayed by the fact that the parties had an established course of performance. Center regularly placed orders for products and then abruptly terminated after placing its most recent order.

In contrast, the court in *Q.C. Onics Ventures, LP v. Johnson Controls, Inc.*, 2006 WL 1722365 (N.D. Ind. 2006) (applying Michigan law) took the opposite view. In that case, JCI was sued because it terminated a requirements contract, pursuant to a clear termination for convenience clause. The plaintiff argued that because the contract was a requirements contract, JCI could not terminate for convenience, and was required to exercise good faith when determining its requirements. The court flatly rejected this argument and concluded that the obligation to buy in good faith on one hand, and the contractually agreed upon right allowing JCI to terminate for convenience on the other, were two separate concepts. JCI was not claiming in bad faith that its requirements were now zero, but was instead relying on the termination clause for its decision. JCI was required to order its requirements in good faith while the contract was in effect, but it could properly end the contract for any reason. In reaching its decision, the court rejected the analysis in *Metal One America*.

There have been few other decisions on this topic. So where does that leave suppliers? As the *Q.C. Onics Ventures* case recognized, it is difficult to conclude that a clear termination for convenience provision means something other than exactly what it says. A termination done the right way — with payment of costs and appropriate advance notice, none of which was done in *Metal One America* — will be much more defensible in court.

But each situation is very fact specific. When deciding whether to terminate a supply agreement or face a situation where your supplier or customer is threatening to end the contract, it is prudent to examine the contract documents very carefully before making any decisions. Do you have a "requirements" contract? Are applicable terms and conditions properly incorporated into the contract and, if so, what do they say regarding termination? What was the parties' course of performance and how will that impact the interpretation of the contract? The answers to these questions will dictate how to proceed in a way that makes the most business sense while complying with your legal obligations.

NHTSA Reporting: The Agency is in Flux but Suppliers Must Be Proactive

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Before the Trump administration took over in January, the National Highway Traffic Safety Administration (NHTSA) had just come off its most aggressive three years of recall and reporting enforcement. The agency was on a roll. Mostly under the watch of Administrator Mark Rosekind, NHTSA recalled over 150 million vehicles and issued hundreds of millions of dollars in civil penalties. The agency also made it clear that suppliers must independently report noncompliance and safety defects to NHTSA or face penalties. Since the election, NHTSA has been relatively quiet and the President has yet to appoint a new Administrator. Speculators last predicted the appointment of an industry insider, some suggesting the likes of GM CEO Mary Barra. While we wait, the agency continues to be run by Rosekind appointees and career civil servants. And, several vehicle manufacturers continue to be surveilled by independent NHTSA monitors implanted within the companies as part of previous penalties. Expectedly, these manufacturers continue to abide by the "when in doubt, report" mantra. As a result, suppliers must be more astute in recognizing and possibly reporting safety issues. So, what should suppliers be doing now?

Understand NHTSA reporting duties. To avoid enforcement, suppliers must know when to report product safety issues. Under 49 CFR 573:

- If a supplier's component is installed in vehicles of more than one manufacturer, the supplier must independently report to NHTSA any noncompliance with a safety standard or defect related to motor vehicle safety regardless of whether a vehicle manufacturer has reported the issue.

- If a supplier's component is installed in vehicles of only one manufacturer, the supplier must report to NHTSA any noncompliance with a safety

standard or defect related to motor vehicle safety unless the vehicle manufacturer has already reported to NHTSA. If the vehicle manufacturer has reported, the supplier need not report.

These reports must be made within five working days of the supplier's determination that a noncompliance or safety defect exists. The more difficult and subjective question in both scenarios is how to define "defect related to motor vehicle safety." NHTSA's definition is not much help: any defect that could in the future "cause an unreasonable risk of accidents or an unreasonable risk of death or injury in an accident." But NHTSA considers some issues as "per se" safety defects, e.g. defects involving failure of a critical component, vehicle fire, loss of vehicle control and/or one that suddenly moves the driver away from steering, accelerator or brake controls.

While this adds some clarity, most potential safety issues are not that clear-cut and will involve analysis of the likelihood of potential consequences, injuries and sometimes interaction of the component with other vehicle parts. Because reporting to NHTSA creates its own snowball of effects with the agency and the vehicle manufacturer, it is critical for the supplier to properly analyze issues before doing so. Often, the sky isn't really falling and experienced regulatory counsel is invaluable to help make that determination.

Understand contractual duties. Several vehicle manufacturer terms and conditions require suppliers to affirmatively report potential safety issues to the manufacturer regardless of whether an NHTSA reporting duty exists. Many of the recent large-scale recalls involving supplier components have been followed up by manufacturer allegations of damages caused by the supplier's failure to inform the vehicle manufacturer of known safety issues in a timely manner.

Understand potential product liability risk. Failure to report and recall safety defects can result in product liability exposure. The supplier must understand the law to evaluate its potential risk.

Have a written plan. Suppliers should, along with counsel, prepare and implement a formal written product safety/recall plan. The plan should: (1) identify a coordinator and other members of a product safety/recall team charged with identifying, investigating and possibly reporting/recalling product safety defects; (2) require employees and divisions to report all potential product safety defects to the safety/recall team for evaluation; and (3) provide a procedure for the safety/recall team to investigate potential product safety issues.

Aggressively investigate potential issues. Don't wait for the vehicle manufacturer to direct the investigation or request an 8D report. Upon learning of a potential safety issue, suppliers should immediately and diligently conduct their own independent investigation. Be proactive and have answers to the hard questions at-the-ready when the manufacturer or agency asks.

Engage outside counsel early in the process. To protect your investigation and related communications, suppliers should involve outside counsel early in the process. By doing so, suppliers can take advantage of certain privileges to protect information and communications from disclosure to third parties. Failing to involve outside counsel may leave your communications open to discovery by the agency, the manufacturer and product liability plaintiffs.

Be careful about internal and external communications. Employees should be trained (and regularly retrained) to avoid sending "bad documents" that could later be used against the company. Bad documents often include emails or reports that contain unnecessary exaggeration, incomplete or inaccurate information and/or statements made outside of one's expertise.

Chris Predko is a partner and member of the Automotive Industry Group and is Co-chair of the firm's Regulatory and Compliance Practice Group. He regularly counsels suppliers regarding NHTSA obligations and other product safety issues. Call or email him directly (616-752-2190 or cpredko@wnj.com) to discuss your product safety questions or contact other members of the Automotive Group.

Don't Let Disruptors Disrupt Your Best Practices

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Everywhere you look, industries are being turned on their heads due to "disruption." So far in 2017, there have been ten major retailers that have filed for bankruptcy, mostly due to online options such as Amazon disrupting the traditional brick and mortar retail industry. Airbnb has disrupted the New York hotel market by capturing 8% of the market share. Uber, Lyft and half of Silicon Valley are continually written about as disruptors to the traditional auto industry players — even a CEO of a profitable OEM was recently replaced for not embracing autonomous vehicle and mobility trends fast enough.

And if that's not enough to keep you up at night, there are still the traditional cyclical pressures on the auto industry to worry about. Production is plateauing, causing stress on those in the supply base who have been dependent on continued growth, not to mention the typical payment term challenges and supply chain disputes.

While it's important to keep an eye on current and future trends, it's also important to not get too distracted by "disruptors" in the industry, such that you become lax with core "best practices" to keep your business well-positioned to survive and prosper during these rapidly changing times.

"Airbnb has disrupted the New York hotel market by capturing 8% of the market share.

FOCUS ON THE BASICS

- Keep a close eye on your accounts receivable. If a customer's good payment history begins to creep beyond your contractual payment terms, start investigating your customer. A simple Google search might reveal negative statements or media reports about the company or its cash flow which could form the basis of making a demand for adequate assurance of performance under Section 2-609 of the Uniform Commercial Code.

- Review your contractual documents to make sure they are in order. Are your quotes, purchase orders and change orders executed by the counterparty? Are the applicable terms and conditions adequately incorporated into the governing documents? It's common to overlook these items during the sales process, only to have them rear their ugly heads when problems arise later.

- Take advantage of ways to become a secured creditor. Leverage is nearly always increased when a creditor has a lien or a security interest in the underlying collateral that is the subject of the parties' contractual relationship. Liens on tooling, molds and other types of special machines may be available under certain circumstances which could make the difference between you getting paid in full versus receiving pennies on the dollar if your customer is experiencing insolvency issues.

Changes in the auto industry are much easier to navigate with strong financial and operational controls in place. The foundations of such controls are simple, straightforward best practices that provide stability, regardless of the traditional pressures or "disruption" in the auto industry. Warner Norcross & Judd's Automotive Industry Group is highly experienced in helping clients fine-tune their best practices — whether it's dealing with a customer whose payment history appears to be getting worse, reviewing contractual documents and terms and conditions to make sure everything is in order or pursuing lien rights on tooling and molds. Contact Dennis Loughlin or your Warner Norcross attorney for further assistance in these areas.

Michigan Mold Lien Act Under Fire

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SEJASMI INDUSTRIES CASE UPDATE

Michigan's Mold Lien Act, MCL §445.611 (MLA), protects mold builders with a lien on any mold they construct that requires third parties relying on the mold to respect the mold builder's original purchase agreement.

By following the procedures set forth in this Act, mold builders are protected — or so they thought. Recently, the Michigan Court of Appeals (COA) threw this protection into doubt with its ruling in *Sejasmi Industries, Inc. v. A+ Mold, Inc. et al*, Macomb County Circuit Case No. 14-004273-CB, Court of Appeals No. 328292, Supreme Court No. 153625, wherein the COA essentially stripped the mold builder of the security interest in its own mold.

SEJASMI CASE

In *Sejasmi*, Takumi Manufacturing Co. (customer) hired Quality Cavity (mold builder) to build a mold, which was delivered to Sejasmi Industries (molder). Sejasmi, in turn, used the mold to make parts for the customer, Takumi. Sejasmi paid Takumi for the mold, but Takumi never paid the mold builder, Quality Cavity, who retained a lien on the mold pursuant to the MLA. Sejasmi then brought suit to invalidate.

Quality Cavity's lien on the mold claimed that the lien was discharged when Sejasmi, as the molder, notified Takumi that it had "paid" the amount for which the lien was claimed, as required under the MLA.

This decision has enormous impact on the mold building industry, essentially depriving mold builders of meaningful protection under the MLA.

Sejasmi relied upon the language of MCL § 445.619(5)(b), which provides that a mold builder's lien may be invalidated if the customer (Takumi) receives a verified statement from the molder that it has paid the amount for which the lien is claimed. The provision does not specify to whom the amount must be paid for the lien to be extinguished. Though Quality Cavity, the lien holder, was never paid, the COA ruled that serving Takumi with a verified statement, that the amount Sejasmi paid was at (or more than) the amount of Quality Cavity's lien, had extinguished the lien under the MLA. Currently, all interested parties are awaiting a decision on whether the Michigan Supreme Court will hear this case.

POSSIBLE IMPACT

This decision has enormous impact on the mold building industry, essentially depriving mold builders of meaningful protection under the MLA. Under this ruling, any Original Equipment Manufacturer wanting to invalidate a mold builder's lien rights under the MLA—so as to not worry about possible disruption of its supply of parts by a mold builder threatening to repossess the mold for non-payment—could certainly attempt to structure its transaction in accordance with the facts in *Sejasmi*. Further, should this interpretation of the MLA stand, it would set precedent that could apply to the rest of the tooling industry. Michigan's Special Tools Lien Act, MCL § 570.541, which provides tool builders with lien rights, was enacted at the same time as the MLA, uses similar language to the MLA and could well be interpreted to deny tool builders of their lien rights, even if they have yet to be paid for their work. For now, both the mold building and tooling industry eagerly await the ultimate outcome of the *Sejasmi* case.

With the support of 18 distinct participants, both national and international, Warner Norcross & Judd LLP has filed a motion with the Michigan Supreme Court for leave to file an Amici Curiae Brief in support of Quality Cavity's Application for Leave to Appeal. This brief provides a strong showing of the importance of this appeal to the tooling industry and will undoubtedly get the attention of the Michigan Supreme Court.

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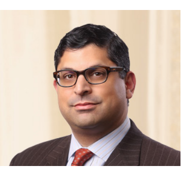

The Automotive Industry Group at Warner Norcross & Judd is comprised of more than 50 attorneys who provide timely, cutting-edge services to automotive suppliers of all sizes.

Unlike almost all other law firms, we do not represent the OEMs—so we are always focused on what's best for auto suppliers.

If you prefer to receive our newsletters in an electronic format, please contact us at **editaddress@wnj.com**.

Check out **wnj.com/aheadofthecurve**, the definitive law blog for navigating the automotive supply chain.