Auto Suppliers Prepare for Barrage of Recalls

With the recent high-profile recalls involving Toyota and GM, auto suppliers are anticipating a spike in recalls and asking themselves how to prepare for this inevitability.

As a start, auto suppliers need to understand National Highway Traffic Safety Administration (NHTSA) procedures and regulatory concerns. Auto suppliers also need to consider the fact that liability is no longer limited to civil penalties and lawsuits, as the U.S. Department of Justice has turned its attention to potential criminal liability related to these recalls. Suppliers should take steps to ensure that their responses to recalls and potential defects are efficient, transparent, thorough, and timely. Auto suppliers need to remind themselves of best practices in contracting, particularly with respect to warranty provisions. Finally, suppliers must have pre-litigation protocols in place, including document and product preservation procedures, among others.

Foley has prepared this information to help suppliers make the necessary preparations and take steps to minimize liability as recalls in the industry increase and expose suppliers to significant risk.

Supplier NHTSA-Regulatory Concerns

» Supplier’s Independent Defect Reporting Obligation. In the typical case, the vehicle manufacturer initiates and leads the investigation into a potential safety defect involving original equipment installed in its vehicles. However, the original equipment supplier is a manufacturer of “motor vehicle equipment” and, therefore, has an independent legal obligation to identify and report safety defects to NHTSA. Suppliers should invoke and apply their internal safety review procedures for this purpose. In the event the supplier makes a safety defect determination concerning its component, it must notify NHTSA, unless both (i) the part or component is supplied to only one vehicle manufacturer and (ii) the vehicle manufacturer elects to report the issue to NHTSA. If the part is supplied to more than one vehicle manufacturer or distributed in the replacement/aftermarket, the supplier must submit its own defect report to NHTSA. Suppliers should review and update their safety review policies and procedures, and ensure that all key personnel are trained.

» Consult the Relevant Provisions of the OEM and Purchasing (Lower-Tier) Contracts. It is important to understand the contractual framework of the supplier’s cooperation with, and potential liability to, OEMs. Likewise, in situations where a potential defect may involve components supplied by lower-tier suppliers, it is critical that the supplier review all relevant purchasing contracts. In both cases, the focus should be on provisions related to recall decision-making and reporting, cooperation, design responsibility, and allocation of recall responsibility (cost recovery). Suppliers should update their purchase order terms and conditions to ensure they contain appropriate contractual protections.

» Document Sharing and Confidentiality. If NHTSA has commenced a defect investigation involving a manufacturer’s vehicles, it is likely the OEM will be asked to submit supplier confidential information (e.g., design and engineering documents, test data, and so forth) to NHTSA. Such documents may already be in the OEM’s possession, or the OEM may ask the supplier for such documents in
order to respond to NHTSA’s information request. In either case, the supplier should consider the confidentiality of such documents and demand that the OEM seek confidential treatment in accordance with NHTSA’s regulations. This requires marking the documents as “Confidential Business Information,” providing an executed certificate in support, and setting forth the basis for confidentiality under the relevant FOIA exemption(s).

» **Prepare to Advocate the Supplier’s Position.** The supplier should develop its own position concerning whether the vehicle or the supplied component contains a safety-related defect within the meaning of the Safety Act and NHTSA’s regulations. In doing so, the supplier should consider past NHTSA recalls and investigations involving similar components, as these can provide useful guidance in determining whether a recall is warranted under a particular set of circumstances.

» **Monitor NHTSA Developments.** Suppliers should regularly monitor NHTSA-related developments and communicate those developments to appropriate supplier personnel. At a minimum, suppliers should monitor new recalls and investigations (including manufacturer submissions related to those actions) and regulatory developments that may affect the supplier or its products, such as proposals for new safety standards or amendments to existing standards.

**Recognizing Criminal Exposure and Limiting Potential Criminal Liability**

In addition to traditional civil liability arising from product recalls, such as warranty and products liability claims and civil penalties imposed by NHTSA, suppliers now face potential criminal exposure. In March 2014, the U.S. Department of Justice announced it had entered into a deferred prosecution agreement with a major OEM for one count of wire fraud and imposed a staggering $1.2 billion penalty.

Criminal investigation and potential prosecution associated with product recalls is a huge risk that could result in prison sentences for executives and large fines for the supplier. The intangible effects of a criminal case, such as damage to the supplier’s reputation or fleeing of important business partners and customer relationships, are significant.

The government takes the approach that auto companies have a duty to be transparent about vehicle safety issues. Accordingly, government investigations in these scenarios will focus on the following:

» When the auto company had knowledge of a potential defect (including whether executives were willfully blind to the problem)

» Whether the information was disclosed in a timely manner

» Whether the company made misleading statements to the public about vehicle safety

» Whether the company took prompt action to remediate the issue

Suppliers should take the following steps to ensure that their defect evaluation procedures are efficient, thorough, and well documented.

» **Document the Procedures.** Maintain documentation regarding product safety testing and inspection.

» **Encourage Reports.** Encourage all members of the various business units to raise concerns about potential product defects early and often. As in any area of compliance, a tone from the top must be established that encourages employees to speak out and raise concerns when issues arise. An environment in which employees feel comfortable raising issues brings problems to light so that they can be addressed before they become more significant.

» **Establish a Chain of Command.** Have a clear chain of command regarding who is responsible and accountable for decision-making associated with fielding and addressing reports of product defects. When reports come from customers or end users,
there must be a clear protocol about what steps need to be taken to address the report. If there is a written policy about how these reports should be addressed, the policy must be followed. It does not help a supplier to have an excellent written protocol that is not adhered to in practice. In fact, failure to follow your own protocols can be damaging to a supplier in civil and criminal litigation alike.

» **Address Legitimate Reports Immediately.** Suppliers need to understand when a report requires an internal investigation. Similarly, suppliers need to be mindful of when it makes sense to bring in outside counsel because of their experience and ability to conduct investigations pursuant to the attorney-client privilege. Suppliers should also consider bringing in firms that have true independence so that the ultimate findings of the investigation do not create an appearance of bias or impropriety.

» **Document Decision-Making.** Decisions to investigate a report or not investigate a report need to be well documented. The supplier needs to have clear and transparent decision-making and good reasons why certain steps were or were not taken.

» **Remediate.** If remediation is recommended or required, the remediation must be made. An investigation report recommending next steps that are not carried out can be damaging evidence in civil and criminal cases alike.

» **Consider a Government Disclosure.** When suppliers identify a mistake or problem within their organization, they need to work with outside counsel to determine if a disclosure to the government — such as a safety defect notification — is required.

Suppliers may avoid criminal liability by acting in good faith and doing the right thing. Encouraging reports, establishing clear policies and procedures for effective handling of complaints, responding to reports in a timely and thorough fashion, having a chain of command and accountability, documenting decision-making at each critical juncture, conducting thorough internal investigations, bringing in outside counsel when needed, and making the appropriate disclosures to the government as needed are all steps that should be taken.

**Warranty Risk Management**

Warranty risk management can take place on the front end, too, with best practices in contracting and processes.

» **Include Clear Specifications and Disclaimers.** In the contracting process, clearly set the specifications to which the product is to be designed and/or manufactured, and disclaim any inapplicable warranties, including implied warranties outside the scope of design responsibility.

» **Address Alternative Designs.** Consider documenting suggested alternative designs for a more robust or superior-performing product that are declined by the customer.

» **Document Product Testing.** Determine and document the product test procedures and results, as well as who is responsible for which level of testing, establishing the testing and acceptance criteria, and recording results.

» **Consider Dealer Repair Codes.** Understand dealer repair coding and how such codes may apply to the product. Determine protocols for analyzing root causes for repair codes that could implicate the product.

» **Establish a Protocol for Claims.** Determine an express protocol for warranty claims, including product return, inspection, and establishing the root cause for failure.

» **Consider the Length of the Warranty Period.** Understand the warranty period that will apply to the product, when the warranty will begin to run, and the obligations under the warranty claim.

» **Other Risk Allocation.** Consider additional protection from warranty risks through the use of
complementary contract provisions related to insurance, indemnities, and dispute resolution.

**Investigation Into the Underlying Defect**
A critical part of preparing for a potential recall is the investigation. In this stage, the supplier works to determine the root cause of the potential recall, and identifies internal and external experts to assist in the investigation. A proper investigation will go a long way toward preparing the supplier for potential litigation and informing its defenses regarding future demands for reimbursement. Moreover, the thoroughness and diligence of the investigation will be a subject of considerable scrutiny in any subsequent dispute or investigation.

» **Review the Contract.** Review applicable terms and conditions to understand warranty obligations, including applicable warranty periods, express warranties, and indemnification obligations. This is the first step in any recall or investigation. The contract will inform the supplier of its rights and obligations with respect to the recall costs. Also, consider communicating with sub-suppliers regarding their warranty and indemnification obligations.

» **Review Insurance Policies.** Check the supplier’s insurance policies and notify any carriers of potential claims and demands. It never hurts to provide notice, and the failure to provide notice may invalidate coverage.

» **Request the Return of Parts/Assemblies.** Request the return of any parts/assemblies identified as part of a potential recall. It can be difficult to obtain parts or assemblies that exhibit the failure mode, but these are essential to conducting a root-cause investigation.

» **Form a Crisis Management Team.** Identify a small, core team that includes representatives from all major areas of the supplier: executive, legal, finance, engineering, customer service, and so forth.

» **Identify Experts.** Identify both internal and external experts with experience in the investigation of the specific root cause and failure mode. The supplier may start out thinking it needs a mechanical engineer but wind up needing someone with much more specific expertise.

» **Determine the Root Cause of the Failure Mode.** A supplier will likely be informed of the failure mode involving its product (e.g., engine stall) when notified of a potential defect or recall. The purpose of the investigation is to determine the root cause of that failure, which may well involve parts that are not manufactured or supplied by the supplier.

**Pre-Litigation Management and Preservation of Evidence**
Once a supplier is notified about a potential recall, it may feel like it is on the defense. Here, we focus on precautionary measures that the supplier can take before a lawsuit is filed to help reduce the supplier’s exposure for recall or warranty costs.

» **Public Statements.** Avoid making any public statements about the recall or statements to other parties involved in the recall. If necessary, identify a supplier spokesperson for press releases, statements, and so forth and develop key messages to be delivered by the supplier, with talking points regarding the specific product, safety information, and solution for the issue.

» **Retain Outside Counsel.** Identify and retain outside legal counsel to assist in preparing the litigation hold and preparing the supplier for potential disputes.

» **Prepare a Litigation Hold.** The litigation hold instructs employees to preserve all relevant documents regarding the product at issue and documents related to the warranty issue or recall. The notice should include all relevant information regarding the product, contract, issue, and dispute and contains instructions for searching and retaining documents. The instructions should list critical dates/timeframes, departments, employee names/positions, files by name and type, and key parties or search terms.
» **Determine the Distribution of the Hold.** Work with key employees involved in the validation of the product, investigation into the issue, and recall to determine the proper distribution list for the litigation hold notice. There should also be a mechanism for employees to identify additional current and former employees who may have responsive information, but who were not included in the original distribution list.

» **Task Specific Employees to Collect Data.** For each location/facility, identify key employees in each department who will be tasked with collecting and preserving electronic data and information on shared drives or in shared hard copy files. Arrange conference calls with the IT department(s) to ensure that systems are in place to preserve electronic data and hard copy documents, including hard drives of former employees and employees who have switched locations.

» **Monitor Communications With Customers.** Instruct all employees who communicate with customers that they must be careful in what they say to the customers. Any statements made to the customers, verbally or in writing, can be used by the customers in any dispute over which party should pay for the recall costs and expenses.

**For More Information**

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