AUTOMOTIVE PRODUCT RECALL

The automotive industry is no stranger to product recall and despite original equipment manufacturers’ (OEM) strive to reduce costly recalls, the industry is still paying a very high price. To mitigate heavy losses, automotive part suppliers are put under scrutiny and bound by tougher contractual obligations with OEM.

PRODUCT RECALL CASES – HISTORICAL EVENTS

While most OEMs try to operate quick and silent recalls in an effort to minimise any brand damage, some recalls make it to the front page and others may take many years before they are completely settled. Recall reasons could vary between:

- pre-emptive recalls such as a British manufacturer’s in 2011 for a software update
- external causes such as a Japanese manufacturer whose plant was infested by spiders in 2011
- health and safety reasons which are the most important (examples are given below):

<table>
<thead>
<tr>
<th>Year</th>
<th>OEM Type</th>
<th>Vehicles</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005/2009</td>
<td>American OEM¹</td>
<td>14 million</td>
<td>Cruise control deactivation switch</td>
</tr>
<tr>
<td>2009-2010</td>
<td>Japanese OEM²</td>
<td>8.5 million</td>
<td>Slipping floor mats, accelerator, hybrid braking</td>
</tr>
<tr>
<td>1999-2004</td>
<td>American OEM</td>
<td>3.6 million</td>
<td>Pick-ups recalled for replacement tailgate cables</td>
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<tr>
<td>1995</td>
<td>Japanese OEM</td>
<td>3.7 million</td>
<td>Seatbelt-related issues</td>
</tr>
</tbody>
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In 2005, two German OEMs were successful in limiting damage to their brands after they recalled around 51,000 cars, because a German top tier supplier had recognised that the provided fuel pumps were faulty³.

Despite the media traction that recalls usually get, some OEMs try to defend their brand and position the recall as a positive move towards ensuring quality and that safety standards are a priority to meet⁴.

¹ Ford Recall History Puts Toyota Recalls in Perspective, US recall news, February 2010
² Toyota recalls across the world: full list so, The Guardian, February 2010
³ Toyota recall lessons, Logistics Manager, March 2011
⁴ History states that Toyota will weather this storm, by Martin Kahl, AutomotiveWorld.com, February 2010
CONTRACTUAL OBLIGATIONS TRENDS

Auto recalls are increasing, as OEMs become more sensitive to adverse publicity. Therefore, OEMs seek to push the liability for the cost of a recall campaign back to suppliers through contract conditions. These conditions vary, from simply making the supplier liable for third party recall costs, to requiring the supplier to show evidence that they have recall insurance to a specified limit.

Many OEMs are proceeding with caution and making concerted efforts to minimise supply risk. Each OEM’s purchasing terms and conditions provide certain contractual obligations that must be met by suppliers in order to be awarded new business and retain existing business. Recently, in order to manage risk, certain OEMs have focused their work on termination clauses articulated around:

- **Financial stability clauses**: the contract is terminated in the event of the supplier becoming insolvent or financially unstable. Many OEMs now require the supplier to provide quarterly and annual financial statements to assess the supplier’s financial stability.

- **American OEMs**: Cancellation for Default. (a) a specific American OEM may cancel the whole or part of this order without liability...upon the occurrence of any of the following specified events...Seller (i) becomes insolvent or generally fails to pay, or admits in writing its inability to pay its debts as they become due.

- **American OEMs**: Insolvency – The buyer may terminate the purchase order, in whole or in part, upon written notice to the supplier, if the supplier: becomes insolvent... Also, the manufacturer has the option to charge the supplier 50 per cent of recall expenses if they feel that the supplier is responsible for the faulty parts.

- **German OEM**: Warranty Agreement – in cases of “No Trouble Found” the manufacturer and supply partner share 50/50 of all the costs of a recall campaign.

- **American OEM**: Terms and conditions state that they have the option to charge the supplier 50 per cent of recall expenses if they feel that the supplier is responsible for the recall and no proof is necessary.

- **Cost competitiveness**: to ensure that the OEM is receiving the best possible price, quality, delivery and general performance from each of its suppliers.

- **German OEM**: Buyer may terminate all or any part of the order, without liability to the seller, if seller...(v) fails to remain competitive with respect to quality, technology, delivery, service or pricing of the supplies.

- **Changes in ownership and control**: to minimise supply risk. This would allow the OEM to terminate the contract if the supplier sells a significant portion of its assets.

- **American OEM**: Buyer may terminate this contract upon giving at least 60 days notice to the seller, without liability to the seller, if the seller (i) sells, or offers to sell, a material portion of its assets, or (ii) sells or exchanges, or offers to sell and exchange, or causes to be sold or exchanged, a sufficient amount of its stock that affects a change in the control of the seller.

OEMs have modified terms and conditions of purchasing contracts, in a way that gives them more options to terminate a contract when facing a supply risk.

Furthermore, Marsh is seeing a growing trend, particularly in the American and European markets, in pushing recall campaign expenses to suppliers and thus splitting those costs 50/50 between the OEM and the supplier.

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5 Terminators: Critical Financial Clauses in OEM Contracts with auto suppliers, SRR, 2011
HOW IS A RECALL REGULATED?

Within Europe, the framework for Consumer Protection is in place in the form of the General Product Safety Directive 2001/95/EC and each European member state will have domestic legislation in place to address this.

In the United Kingdom the regulator for Automotive Safety Recall issues is the Vehicle and Operator Services Agency (VOSA). They play a clear role cooperating with manufacturers and ensuring all needed measures are put in place for safety recalls. This work has led to a 92.5 per cent success rate in the UK for safety recalls on vehicles and the trend is continuing to rise. In 2011 VOSA have had influence in 24.9 per cent of all safety recalls.

Guides to assist manufacturers and consumers with recall matters in the UK are available on VOSA’s website:

http://www.dft.gov.uk/vosa/onlineservices/vehiclerecalls/vehiclerecalls.htm

http://www.dft.gov.uk/vosa/onlineservices/vehicledefects.htm

Top European countries per car sales – Regulators’ websites

• Germany – Verband der Automobilindustrie (VDA)
• France – Comité des constructeurs Français d’automobiles (CCFA)
• Italy – Associazione nazionale fra industrie automobilistiche (ANFIA)
• Spain – Asociación Española de Fabricantes de Automóviles y Camiones (ANFAC)

HOW MARSH CAN HELP

Marsh has a team dedicated to product recall that assists automotive clients throughout the supply chain.

We can assist our clients in understanding their contractual obligations to their OEMs surrounding recall, and provide risk transfer and risk management solutions and options.

Our ultimate objective is to match our client demands and needs with the right solution, and to make sure it is the best and most competitive product in the market.

It is not the size that makes a recall bad, but the damage it does to the reputation of a company’s products.

It is not just the ‘safety net’ of an insurance policy that we provide, but a full range of risk management and prevention services, including, but not limited to:

• Supplier audits
• Compliance and regulation review
• Recalling planning
• Recall simulations
• Batch coding and traceability review
• Quality control audit and assessment
• Potential exposures quantification
• Recall recovery strategies

OUR INSURANCE SOLUTIONS

The insurance market has a comprehensive standalone solution, that not only covers the supplier’s own recall costs but more importantly the third party recall costs of their customer. There is also the option to include third party financial loss, which includes business interruption and loss of sales.

Insurers have been writing this class of business for nearly 30 years and the coverage has evolved to closely match typical contract conditions. Suppliers can find cover for any of the 40,000 components that make up a car, including safety critical parts.

Coverage is worldwide whether that’s exports or domiciled manufacturing. Suppliers can also select cover for specific contracts only if they feel they are particularly exposed to one customer.
The information contained herein is based on sources we believe reliable and should be understood to be general risk management and insurance information only. The information is not intended to be taken as advice with respect to any individual situation and cannot be relied upon as such.

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