

# Sharing Supply Chain Risk

## Torts



Legal departments are making recovery—the practice of proactively pursuing the payment of funds owed to them—a regular part of their operations. They have typically focused on recouping funds from other companies over issues such as IP, antitrust, financial services, and health insurance. But now some are using recovery techniques to mitigate losses stemming from product recall and warranty issues. In addition to mitigating losses, a formal recovery program can help to establish clear supplier expectations and drive desired behaviors.

Such “supply chain recovery” efforts are becoming more important largely because of the increasing complexity of products and the consequences of that complexity. “Products and their component parts are becoming more complicated, given, among other things, their connectivity and the increasing number of features they offer,” says [Rebecca Baden Chaney](#), a partner at Crowell & Moring.

At the same time, products are more likely to be offered in various, and often custom, configurations. “The need to deal with this complexity will only continue to grow in an increasingly digital world, where component part technologies need to interact seamlessly with one another,” Chaney says.

Mastering it all is often more than one company can do on its own—especially at a time when speed to market is key. Thus, manufacturers of both finished parts and complex components have become more and more reliant on ecosystems of suppliers for design, testing, expertise, capacity, and innovation. As suppliers and sub-suppliers play this growing role, the defects that appear in the parts they produce can have a significant impact on their customers’ end products. And, says Chaney, “given the sophisticated nature of today’s products and the emerging technologies involved, there are simply more things to go wrong.”

When product recalls or unacceptable warranty levels emerge, they can create sizable costs for product and component part manufacturers, and being able to identify the point of origin is imperative. “Once one learns where in the supply chain the defect surfaced, there can be an opportunity to use the parties’ supply contracts and, if necessary, tort theories, coupled with the possibility of litigation, to recover some of those costs,” says Chaney. “Legal departments can use their existing knowledge and experience in defending against traditional product-defect matters with customers to act affirmatively to bring dollars in

the door.” Such recovery efforts can offset the costs of recall or warranty issues and protect the bottom line while helping the legal department to be seen as more than just a cost center.

### Creating a Recovery Program

“It is less common for companies to pursue recovery from suppliers for recall and warranty costs,” says Chaney. “But this proactive approach provides a clear avenue for doing so.” For companies at all levels of the supply chain that want to increase recovery efforts

## Product Liability in a Connected Age

Today’s products are increasingly connected through the internet, and directly with one another via Bluetooth and wireless technologies—and the interactions between them are guided by software. As a result, says Crowell & Moring’s Rebecca Baden Chaney, “manufacturers and their suppliers now have to contemplate and guard against a new species of potential product failures and ensuing tort litigation and consider new questions about which partner is responsible or liable for those failures.”

For example, Chaney explains, Internet of Things products require power, and with mobile products, that power usually comes from a battery. Batteries can fail for a variety of reasons, and with connected, complex products, it can be hard to sort those out. “When batteries fail in a product because they don’t communicate properly with other product components, is the cause the battery’s software or the product’s? Determining the root cause and responsible party can be tricky, especially because many parties are likely to have contributed to the design of the product.” And as new features and functions are provided, determining who is responsible for such problems only gets more complicated. “Manufacturers need to be alert to these issues,” she says, “and they need to account for these potential liabilities in the contracts they develop for supply chain partners.”



“A good program can enable an open dialogue setting expectations about what is acceptable in terms of defects and warranty-claim volume.” **Rebecca Baden Chaney**

on this front, having a formal program is essential. A program needs to be tailored to the specific company and its situation. But in general, it should include processes for systematically monitoring supplier quality along with product recalls and warranty costs—a capability that manufacturers often have as part of a supplier management program. This provides a foundation for identifying situations where it is appropriate to ask suppliers to pick up some of the product-defect-related costs. “You can establish metrics for the business to follow to evaluate losses, whether you’re looking at incidents per thousand parts or a dollar figure of warranty claims,” Chaney says. A program can help companies identify more recovery opportunities and, often, do so sooner. This could accelerate the recovery of funds and avoid statute of limitations problems.

In setting up this kind of recovery program, it is important to identify the personnel responsible, act as points of contact with suppliers, and escalate problems as necessary. “Sound contract hygiene needs to be part of the program,” she notes. “Even before an issue develops, product and component part manufacturers should review their purchase contracts with recovery issues in mind. Manufacturers should ensure that their contracts have strong warranties running from the suppliers and sub-suppliers and that there are good venue and choice of law provisions in the contracts.”

Ultimately, such programs can provide a more holistic view of warranty spending as it relates to component parts, which can uncover opportunities that may not have been clear otherwise. When looking at individual products, for example, a given product may not be hitting the threshold for unacceptable defects. But an effective program will let the company see warranty costs across the full set of different parts being provided by a particular supplier, or across the various suppliers whose components are in a product—providing an aggregated big picture that can help uncover opportunities that are worth exploring. It might also allow companies to pursue in the aggregate claims that would not be economically viable to pursue individually.

When recovery opportunities are identified, Chaney continues, “you can decide on a case-by-case basis how to address them. Should it be a business-to-business conversation? Should it involve counsel? Should you pursue some resolution proceeding or litigation?” The point, she says, is that a program can help companies consider more informal ways to recoup losses and potentially avoid the need for litigation.

When litigation is appropriate, a proactive recovery program can help ensure that the company is prepared. In looking at

contracts and products, says Chaney, “you can evaluate whether you need a tolling agreement. When will you need a litigation hold? When do you need to track engineering time that’s being spent on a problem? Or when do you need to engage outside counsel to protect the privilege of an investigation?”

### Making Things Easier

Pursuing downstream recovery—and especially taking a key partner to court—can be unpleasant. As a result, companies often avoid recovery actions against their suppliers. But a formal recovery program can provide a foundation and the supporting facts for discussing warranty-claims problems. “Nobody wants to be seen as targeting a partner, and good supplier relationships are an important aspect of business,” says Chaney. “However, a good program can actually help address that issue by enabling an open dialogue all along the way and setting expectations with suppliers up front about what is and is not acceptable in terms of defects and warranty-claim volume.”

Such discussions can lead to creative solutions that help preserve relationships. For example, rather than getting a large cash payout for recovery, a manufacturer might negotiate future discounts from a supplier. In addition, having a fact-based dialogue and clearly defined expectations might help boost component quality. “If a supplier clearly understands that you are closely monitoring a supplier’s return part and warranty rates and are going to seek to recover costs if its parts do not meet a designated threshold, that supplier is probably going to work proactively to make sure it stays below that threshold,” says Chaney.

With a formal recovery program, the company replaces the traditional one-off or ad hoc approaches to recovery with an established, repeatable process—a recovery “machine,” as Chaney says. “A manufacturer or upstream supplier then has the mechanisms in place to efficiently pursue smaller claims as well as large ones.” This docket approach treats groups of claims as a portfolio to optimize recovery efforts and opportunities. “A company can manage the whole docket, so when small recovery opportunities by themselves may not be meaningful, it can pursue them as a group and cumulatively make it worthwhile.

“These matters come in all shapes and sizes,” Chaney continues. “They can be very small, but collectively they can reach eight or nine figures. By having a good program in place, manufacturers can look at their supplier-caused losses and understand how much it is adding up—and then make the most of recovery.”