

AUTOMOTIVE MANUFACTURING

RISING RAW MATERIAL COSTS - WHAT HAVE WE LEARNED?

by Richard M. Apkarian, Jr.

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In 2004-2005 and again in 2007-2008, suppliers to the automotive and other manufacturing industries faced sudden and dramatic increases in raw material costs, primarily steel. The increases were so extreme that most suppliers could no longer sell goods containing these raw materials at a profit. As a result, many suppliers demanded increased prices or surcharges from their customers to offset their higher costs. Of course, many of the affected customers were themselves sellers in the supply chain and had no ability to grant price relief unless they could obtain corresponding price increases from their customers. The result was a ripple effect with each supplier asking its customer for increased prices to offset increased costs. And what may have seemed like one supplier's problem - an increase in its raw material costs - touched virtually every company in the supply chain.

During these periods, it became clear that existing supply contracts did not adequately address the problem of spikes in raw material costs, leaving the parties to negotiate the issue with little or no contractual framework. Many of these negotiations quickly deteriorated, with suppliers stopping shipments and customers facing production interruptions and plant shutdowns. As a result, many customers sued their suppliers to force the continuation of shipments at previously agreed contact prices and also to recover any monetary losses incurred, including lost production damages.

In 2011, suppliers and customers will face similar issues, as steel prices have already begun to rise and are expected to rise further. The Wall Street Journal reports that "steelmakers have increased prices six times, for a total increase of 20% to 30%, since November on basic flat-rolled steel." It also notes that, "Higher costs for steel, which are expected to continue well into this year, are hitting bottom lines of companies and prompting additional price increases."¹ These cost increases are not limited to steel, but also impact other raw materials, such as plastic.²

What have we learned from past experience?

The best way to avoid disputes over rising steel costs is to address the issue in the supply contract. This can be accomplished in one of several ways.

First, the parties can include a price warranty in the supply contract, providing that prices are fixed for the life of the contract and that the supplier bears the burden of any increase in the price of raw materials.

Second, if a full price warranty is not realistic, the parties can draft a formula for apportionment of raw material cost increases or state that the customer will accept a pass through of raw material cost increases only if the customer's customer is willing to provide corresponding relief.

Third, if the customer has a raw material purchasing program, it may elect to require the supplier to join the program as a condition of getting the customer's business. An in-house raw material purchasing program can provide significant advantages for the customer. If the customer is substantially larger than the supplier, which is often the case, the customer may have more bargaining power and be able to obtain more favorable, volume based pricing than the supplier. This is especially true if the customer purchases large quantities of raw material for use by many of its suppliers. Also, a raw material program provides the customer with some level of control over raw material costs. When costs increase, the customer is able to negotiate directly with the raw material supplier. This also eliminates the risk of suppliers being less than forthright regarding their raw material supply situation and cost structure.

What if the existing supply contract doesn't address raw material costs, or the supplier just stops shipping?

If the supply contract does not address rising raw material costs, or worse and perhaps more likely, the supplier chooses to ignore the contract and simply stops supplying goods, the customer has several options.

First, the customer may negotiate a new contract with the supplier, with each side sharing some of the increased cost. This, however, can set a dangerous precedent. It could embolden the supplier, and perhaps other suppliers, to continuously demand higher prices every time costs rise.

Second, the customer can re-source the goods to a new supplier. This, unfortunately, is easier said than done. Typically, the goods are highly specialized, manufactured to exacting tolerances and single-sourced. In these instances, the customer may not have an alternative supplier. Re-sourcing usually requires new tooling and validation of the new supplier's production processes, tasks which can take several months to accomplish.

Third, the customer can sue its supplier to enforce the contract. If the supply contract is clear and the supplier has simply stopped performing because it is no longer satisfied with its profit margin, the customer has a good chance of prevailing and obtaining a judgment against the supplier.

When should the customer file a lawsuit and what results can be expected?

When contemplating a lawsuit, the customer should evaluate both long-term and short-term goals. The short-term goals are to resume shipments and maintain production, while the long-term goals are to enforce the supply contract at existing prices and recover any monetary losses caused by the supplier's breach.

The reality of the typical supplier dispute is that the customer's long term goals often take a back seat to its short-term goals. In these cases, the customer must ask the court for a preliminary injunction compelling the supplier to resume shipments while the underlying legal issues between the parties are resolved in court. When the customer makes such a request, it is faced with three possible outcomes.

The court may issue the preliminary injunction and require the supplier to produce goods during the pendency of the underlying lawsuit on the supply contract. This is, obviously, the best possible outcome for the customer.³

The court may deny any form of injunctive relief, in which case the customer is often left with no choice but to negotiate the best possible deal with the supplier in order to quickly restore supply.⁴

The other possibility is that the court fashions a compromise, whereby the customer is required to pay the higher price, under protest and on an interim basis, while the underlying legal issues are litigated.⁵ This allows the customer to obtain critical goods and maintain its rights to seek the difference between the contract price and the higher price as damages in the underlying lawsuit. From the supplier's side, cash flow is improved and the supplier continues to sell the goods at a profitable level, at least pending the outcome of the underlying litigation.

Ultimately, the key to success at the preliminary injunction phase is proving irreparable harm. This consists of damages that are not compensable or easily quantified, such as potential plant shutdowns, worker layoffs, loss of good will and even insolvency.

Summary

Another wave of supplier disputes based on rising raw material costs is on the horizon. The question is whether customers have learned from past experience and are better prepared to deal with this issue. While specifically addressing raw material costs in supply contracts is always the best way to avoid supplier conflict, preserving one's rights in court is often necessary.

¹ Mathews, Robert Guy. "Steel-Price Increases Creep Into Supply Chain," Wall Street Journal, February 3, 2011, <http://online.wsj.com/article/SB10001424052748704775604576120382801078352.html>

² Shingler, Dan. "Manufacturers Adjust as Raw Materials Prices Rise," Crain's Cleveland Business, February 7, 2011, <http://www.craincleveland.com/article/20110207/SUB1/302079981>

³ A preliminary injunction which requires a resumption of shipments at previously agreed upon prices may require proof that the customer cannot afford to pay the supplier's higher prices during the pendency of the lawsuit. See *Almetals, Inc. v. Wickeder Westfalenstahl, GMBH*, 2008 U.S. Dist. LEXIS 87403 (2008) (E.D. Mich 2008)

⁴ See *Eberspaecher North America, Inc. v. Van-Rob, Inc.*, 544 F. Supp 2d 592 (2008) (E.D. Mich 2008) (court dissolved preliminary injunction because customer could pay higher prices under protest)

⁵ See *Key Safety Systems v. Invista SARL, LLC*, 2008 U.S. Dist. LEXIS 70117 (E.D. Mich 2008)

FOR MORE INFORMATION, PLEASE CONTACT:



Richard M. Apkarian, Jr. is a member in Dickinson Wright's Bloomfield Hills office and can be reached at 248.433.7215 or rapkarian@dickinsonwright.com.