Incoming Goods Inspections in the Automotive Supplier Industry: a Liability Trap

By Dr. Ekkehard Helmig, Wiesbaden

The author is a lawyer specializing in the law governing the automotive supplier industry.

helmig@helmig-regula.de

The following essay was translated from German into English by Charlotte P. Kieslich.

charlotte.kieslich@web.de

The discussion on whether, and the extent to which, incoming goods inspections are to be conducted has always been one of the most delicate issues in the automotive supplier industry. The majority of contracts tend to burden the supplier with the responsibility and liability for buyers who, mostly for cost-saving reasons, omit incoming goods inspections of purchased components. This shortsighted approach is not compatible with superior European Union law and ignores severe liability risks to buyer and seller resulting therefrom.

1 The Incoming Goods Inspection under German Commercial Law

Under German commercial law, the incoming goods inspection, as laid down in Section 377 of the German Commercial Code (HGB), constitutes a non-enforceable duty (Obliegenheit) on the part of the buyer which is subject to the disposition of the parties, i.e. not mandatory. According to established case-law of the German Federal Court of Justice (BGH), the incoming goods inspection can at least not be entirely excluded by means of General Terms and Conditions or standard contract terms.¹ In practice it is relatively easy to loosen the strict provisions regarding the immediate performance of the incoming goods inspection as well as the immediate notification of discovered defects. In this respect the law itself provides sufficient indications as the question of “when” can be adapted to the inspection’s feasibility in the “ordinary course of business”. This is appropriate and in most cases depends on the product in question. Especially with regard to technical branches, products can only be examined in the course of their processing. Hence, it might be useful to speak of incoming goods inspections upon delivery and, equivalent thereto, of inspections during the earliest possible stage of processing (in-process inspections), if the freedom from defects can indeed be tested in the course of the purchased part’s functionality inspection. The Austrian Business Enterprise Code (UGB), which also contains a section corresponding to the German Commercial Code Section 377, therefore reasonably requires that the

incoming goods inspection be carried out at an “appropriate” time. In order to do so, buyer and seller have to make specific agreements.²

However, the discussion on “whether” and “how” neglects the fact that leaving the incoming goods inspection undone is extremely risky. Whoever omits the inspection accepts the possibility that an undetected defect may be maintained throughout the value chain, thereby rendering the final product defective.

This is why the Higher Regional Court (OLG) Nuremberg, in an extraordinarily well reasoned decision³, has found that buyers who take the risk of omitting the incoming goods inspection are liable for damages to their customers. Trying to justify one’s omission of the inspection by assuming that the outgoing goods inspection of the supplier (seller) makes up for the omission and renders a second inspection unnecessary cannot withstand the court’s reasoning. According to the court, this applies at least to cases where buyer and seller have established certified and effective quality management systems (QMS).⁴ This approach is not far-reaching enough since it cannot be ruled out that defects are overlooked despite the most rigorous outgoing goods inspection. Outgoing and incoming goods inspections are not congruent.⁵ It is for this reason that, in practice, an adequate distinction between verification and validation is made. Prior to dispatch, verification on the part of the manufacturer (seller) confirms that the product to be delivered corresponds to the agreed quality (specification). Validation provides this confirmation at the next processing level, i.e. on the part of the buyer, and also includes testing the agreed functionality at the next system level.⁶

Apart from that, another aspect already mentioned above can be drawn upon to argue against the equivalence between outgoing and incoming goods inspection or in-process inspection: In most cases, the outgoing goods inspection does not

² For further details see: Helmig, „Die ISO/TS 16949 steuert den Sachmangelregress in der automotiven Zulieferkette“ (ISO/TS 16949 controls recourse claims on grounds of material defects in the automotive supplier industry), in PHI 2011, p. 82 ff., or online: http://www.ra-helmig.de/de
³ OLG Nuremberg, judgment of 25.11.2009, 12 U 715/09 BeckRS 201, 00067
⁵ A real-life example: Heat treatment is to be carried out during a given production process. The container with the components for heat treatment does reach the oven. Yet, due to unclear reasons in retrospect, a night shift forklift operator takes the container in question directly to the dispatch area and the components, the lacking heat treatment of which cannot be seen externally, are dispatched in spite of incorrect accompanying documents. The components’ recipient does not deem an incoming goods inspection necessary. As a consequence of the components not having received heat treatment, a recall of the vehicles concerned has to be issued which generates costs in the single-digit millions.
⁶ Verification and validation are terms used in ISO 9000:2005 - 3.8.4 (Verification) and 3.8.5 (Validation).
allow for functionality testing during which defects could be detected. The incoming goods inspection is precisely meant to control the residual risk of the outgoing goods inspection, which can never be ruled out completely. Where, in the buyer's production process, buyers are delivered defective components, this does not automatically mean that the seller is responsible. During shipping and especially due to improper handling by the buyer, defects or errors can arise which may be discovered by the buyer, but the causes of which cannot be clearly attributed to the seller. For instance, defects are often caused by corrosion or damage to printed circuit boards and sensors due to insufficient protection against electrostatic discharge (ESD prevention) on the part of the buyer.

### 1.1 Contract Practice in the Automotive Industry

Applying this logic to the supply chain in the automotive industry, it is not unreasonable to assume that a large part of the ever increasing number of recalls could be avoided if effective incoming goods inspections were carried out at the respective interfaces between components of different suppliers.

In the German as well as the international automotive supplier industry, most contract terms reduce the buyer's incoming goods inspection to assessing the product's identity, packaging, externally visible defects, and discoverable damage due to shipping and transport. As to when to inspect, the incoming goods inspection is frequently shifted to the manufacturing process and limited to samples without any statistical significance. Not seldom do contracts require that the supplier undertake to vouch for the delivered component's immediate use in the buyer's processing without prior inspection. As a consequence, the seller assumes a processing guarantee with unlimited liability. Whether or not such terms are valid under German law shall be left open at this point. Many aspects argue against their legal validity. This cannot be discussed in greater detail in this essay.

### 1.2 Incompatibility with European Union Law

At least as regards the European automotive supplier industry, omitting or limiting the incoming goods inspection is inconsistent with EU law and is not at the disposition of contracting parties. Europe is characterized by a distinct safety culture. Article 169 TFEU states:

“(1) In order to promote the interests of consumers and to ensure a high level of consumer protection, the Union shall contribute to protecting the health, safety and economic interests of consumers, as well as to promoting their right to information, education and to organise themselves in order to safeguard their interests."

Numerous provisions derive from this basic Union law rule, which are directly linked with European product safety law and product liability law. The vehicle type-
approval Directive 2007/46/EC of 5 September 2007 of the European Parliament and the Council is the basis with respect to the issues investigated in this essay.\textsuperscript{7} According to Article 4 (1) of the Directive, Member States shall ensure that vehicle and component manufacturers comply with the Directive’s provisions.

Article 12 of the Directive stipulates:

“(1) The Member State which grants an EC type-approval shall take the necessary measures in accordance with Annex X to verify, if need be in cooperation with the approval authorities of the other Member States, that adequate arrangements have been made to ensure that production vehicles, systems, components or separate technical units, as the case may be, conform to the approved type.”

Annex X of Directive 2007/46/EC was updated by Commission Regulation (EU) No 371/2010 of 16 April 2010\textsuperscript{8} and requires that vehicle and component manufacturers maintain a certified quality management system (QMS) in accordance with DIN EN ISO 9001:2008 as a condition for type-approval. According to Article 12 (1) of the Directive, Member States shall verify the QMS’s effectiveness. This harmonized standard constitutes the foundation of the Technical Specification ISO/TS 16949:2009\textsuperscript{9} which supplements ISO 9001 with specific requirements for the automotive industry and which is binding – in most cases also by contractual agreements – in the global automotive industry.\textsuperscript{10} ISO 9001:2008 sets out a closed system of interdependent processes, none of which makes any sense without the other or could be neglected without neglecting another. Each of the standard’s processes optimizes the next in order to achieve the goal of avoiding defects within the entire value chain.\textsuperscript{11}

2 Incoming Goods Inspection in the Quality Management System

An effective quality management system is a precondition for reliably organizing the production of the mass-produced product “car”. Such organization, being fun-


\textsuperscript{8} OJ of the European Union, L 110/1 of 1.5.2010.

\textsuperscript{9} For further details see: Helmig/Regula, „Quality Assurance Agreements under ISO/TS 16949 – Liability Risks and Avoidance Strategies“, online: http://rahelmig.de/uploads/media/2012_phi_QSV_eng.pdf The German original, „Qualitätssicherungsvereinbarungen unter der ISO/S 16949 - Haftungsrisiken und Vermeidungsstrategien“, was published in PHe 2012, p. 184ff., also available online: http://www.ra-helmig.de/de/

\textsuperscript{10} Ibid. footnote 9.

damental safety organization, is required by legislators – at least in Europe – as
guarantee for the compliance with legislative safety provisions. European legisla-
tion adopts those contents in its legal provisions which were offered to this end by
the industry itself: All standards are initially created by private-law standardization
organizations and business representatives of their respective specialized
branches.\footnote{For further details see: Helmig, „Relevance of the European Union Law: Prod-
uct Liability Law and Safety Law Put to Test.“, online: http://ra-
The German original, „Die Maßgeblichkeit des europäischen Unionsrechts –
Produkthaftungs- und Produktsicherheitsrecht auf dem Prüfstand“, was pu-
blished in PHi 2014, p. 2ff., also available at http://www.ra-
helmig.de/de/} The industry’s interests are incorporated into these standardizing pro-
cedures where technical as well as legal lobbying take place. The European legis-
lators take these standards, ennoble them by their publication in the Official Jour-
nal of the European Union as EN standards (“harmonized standards”)\footnote{See http://ec.europa.eu/enterprise/policies/ European-
standards/faq/index_de.htm.}, and adapt them accordingly in binding legal provisions such as Regulation No 371/2010 for
quality management. Thus, the industry itself contributes to creating binding legal provisions\footnote{For further details see: Helmig, op. cit. footnote 12.} by means of suggesting requirements for these provisions and at the
same time by almost always including the compliance with statutory regulations
into its standards.

Contrary to the legal provisions it helped draft, the automotive industry, as it
seems throughout the entire supply chain, does not apply these standards to one
key area, i.e. the in-process inspection of incoming goods according to
ISO 9001:2008 – 7.4. With the exception of BMW\footnote{The BMW Group’s International Terms and Conditions for the Purchase of Pro-
duction Materials and Automotive Components (IPC), effective as of 30 March
2014, stipulate: „Buyer shall conduct an incoming goods inspection only in re-
spect of externally visible transport damages, the quantity of containers accord-
ing to the loading list and in regard of deviations in identity of the delivered
Goods from the Goods specified in the shipping documents and notify Seller of
any such deficiencies without undue delay. Apart from that, Buyer shall conduct
an inspection of incoming Goods, which is in compliance with the technical
specifications ISO/TS 16949 ‘Quality management systems, particular require-
ments for the application of ISO 9001:2008 for automotive production and rele-
vant service parts organizations’ (hereinafter called ‘ISO/TS 16949’) and notify
any deficiency of Goods once the deficiency has been discovered by Buyer in
the ordinary course of its business.”}, all contracts of vehicle manu-
facturers and suppliers known to the author\footnote{ISO 9001:2008 -7.4.3} limit or
entirely leave out the commer-
cial-law duty under Section 377 HGB as well as the statutory obligation to “verifica-
tion of purchased product”\footnote{ISO 9001:2008 -7.4.3}. The supplier is usually burdened with the risks en-
suing. Whether this is acceptable from a General Terms and Conditions law point of view cannot be discussed in greater detail at this point.\footnote{17}

The inspection as laid down in ISO 9001:2008 – 7.4 constitutes an obligation, not a non-enforceable duty at the parties’ disposition. In contrast to the German commercial-law inspection duty of the buyer, the ISO obligation is not subject to the strict requirements of immediate inspection upon delivery or immediate notification in the event of defects, but to safety-oriented avoidance of defects. This results from the different objectives of the two provisions: The goal of the immediateness under Section 377 HGB is to assure the seller within the bilateral contractual relationship of the commercial deal’s successful execution as quickly as possible. The objective of the obligatory inspection within a multilateral value chain according to ISO 9001:2008 – 7.4 is the prevention of defects: Avoiding a potential damage cascade in the upstream value chain is at the center, so as to avoid that a detectable, yet undetected, defect in a purchased part subsequently affects further systems, components, or assemblies and thus affects the final product, i.e. the car.

The absolute necessity for this multilateral defect prevention stems from the complexity of the technology used in car manufacturing for the approximately 40,000 parts and components in a family car. It becomes all the more urgent the more tasks fall to a single supplier. Vehicle manufacturers and big suppliers (so called TIER 1) are reducing the number of their suppliers dramatically. But since, in spite of the reduced number of suppliers, the number of parts and components needed for vehicle manufacturing is not decreasing, but rather increasing, fewer suppliers are bound to apply ever more complex technologies for which they often lack experience and expertise: Suppliers of plastic injection molding products, for instance, who so far only produced containers for hydraulic fluid, now have to process and inspect electric or electronic components as well as assume full responsibility for the products although they are not prepared for such tasks. Their customers’ willingness to define risks or agree on explicit interfaces, including appropriate inspection procedures, methods, and measures, is rather low, as experience has shown, and usually falls victim to the customer’s interest in cost savings. In addition, more and more suppliers manufacture components which are not primarily intended for vehicles. This goes in particular for infotainment components and connected vehicles. This practice follows a market trend with yet unknown consequences for the overall safety of the vehicle.

3 Recalls and Limited Incoming Goods Inspections

The current dramatic recall situation in the global automotive industry bears eloquent testimony as to the actual risks: Within the first four months of 2014, more

\footnote{17 For further details see: Helmig, op. cit. footnote 2.}
than 20 million vehicles were recalled in the world. This is more than ten times the amount of all vehicles produced in Germany within the same period of time\textsuperscript{18} and approximately one third of all vehicles manufactured worldwide in 2013.\textsuperscript{19}

The reasons for recalls are manifold.\textsuperscript{20} Yet, hardly any recall was unavoidable. The vehicle manufacturers display humility, try to appease their customers, or blame their suppliers. None of them, as it seems, has invoked unavoidability. Pointing their fingers at the suppliers, however, implies their having neglected their own inspections at the validation level. Recalls are probably quite often the result of failing purchased parts, the latter having been deficient or insufficiently validated as early as during development, i.e. having been insufficiently evaluated as to their function and functionality in the vehicle. A purchased part which fails in the field, however, does not necessarily have to have been defective when it was delivered. It may have become defective as a result of processing or certain operating circumstances in the field, the root cause of which might not always be identifiable.\textsuperscript{21}

Not seldom do cases occur in which components of inferior quality are put up with for cost-saving reasons.\textsuperscript{22}

The big General Motors recall in March 2014 is at the center of the public debate. This case could serve as a blueprint for systematic problems when it comes to analyzing the causes of recalls. In the General Motors hearing before Congress, these deficiencies were openly addressed. According to an article by the German online newspaper \textit{Handelsblatt-Online} of 12 April 2014, documents published by a congressional investigation committee reveal that over the past years, the engineers of the biggest U.S. automaker are said to have repeatedly rejected eliminating a defect in the ignition switches which was deemed the cause of a deadly series of malfunction and accidents. GM employees are said to have been well aware of these severe problems. But they still decided against repairing or replacing the ignition switches. Apparently, they referred to business management rea-

\textsuperscript{18} c.f.: https://www.vda.de/de/zahlen/monatszahlen/
\textsuperscript{19} c.f.: http://de.statista.com/themen/1140/automobilproduktion/
\textsuperscript{20} Examples: General Motors recalled approx. 6.5 million vehicles due to failing ignition switches; in early April, BMW recalled approx. 250,000 vehicles due to faulty camshaft bolts.
\textsuperscript{21} For further details see: Helmig, „Functional Safety in accordance with ISO 26262 and Product Liability for No Trouble Found Events“, online: http://rahelmig.de/uploads/media/2012_001_ISO26262_englisch.pdf The German original, „Funzioneale Sicherheit nach ISO 26262 und Produkthaftung für No-trouble-found-Fälle“, was published in PHI 2012, pp. 32ff., also available at http://www.ra-helmig.de/de/
\textsuperscript{22} The German newspaper \textit{FAZ} reports that many vehicle manufacturers do not achieve profits and therefore have to slash costs, even if it is at the detriment of safety. According to figures released by the University of Duisburg-Essen, FIAT, Renault, Seat, PSA, General Motors/Opel, and Ford Europe suffer heavy losses per vehicle; \textit{FAZ} of 12.4.2014, p. 20.
sons to explain their actions. The chairman of the Energy and Commerce Committee of the House of Representatives, Fred Upton, said that the internal documents of GM, the ignition switch manufacturer Delphi, and the traffic safety agency NHTSA indicated “failures in the system”. Other Members of Congress recently raised the question of whether GM has rendered itself liable to prosecution. Congress is investigating why GM waited until 2014 before it issued the recall of 2.6 million vehicles although the problems surrounding the ignition switches had been known for more than ten years. The defect is said to have caused at least 13 deaths. The ignition key can switch back to the “off” position while the vehicle is traveling, which can shut down the engine and turn off power assisted steering, brake booster, and airbags. GM faces a wave of lawsuits and serious loss of trust. Moreover, the group anticipates additional costs in the amount of 1.3 billion Dollars within the first quarter for repairing the faulty switches.23

What is striking about this case is that General Motors’ reacted by suspending those engineers held responsible. It seems that this personalization is rather uncommon and exposes the engineers concerned to personal liabilities, be it with good cause or as pawn sacrifice.24

With all due caution and without generalization the findings of Congress reveal that statutory safety requirements applicable to and set out by effective quality management systems, including in particular the verification of purchased products (in-process inspection of incoming goods according to ISO 9001:2008 – 7.4), were neglected – which contract practice has shown – or failed. In this respect, Europe is no different from the United States. In any case, both neglect and failure are violations of European Union law which can be prosecuted. Article 32 of the type-approval Directive 2007/46/EC links the compliance with all provisions in force applying to the automotive industry, including establishing an effective QMS, directly to product safety law as set out in the Product Safety Directive 2001/95/EC. Where the manufacturer’s actions in the event of a recall or to avoid recalls are insufficient, type-approval might even be withdrawn, although this measure has not yet been resorted to as far as the author knows. Article 32 (3) of Directive 2007/46/EC stipulates:


The German original, „ISO 26262 Funktionale Sicherheit in Personenfahrzeugen, zur Verantwortlichkeit der Funktionalen Sicherheitsmanager“, was published in InTER 2013, p. 28ff., also available at http://www.ra-helmig.de/de/
“(3) If the measures are considered to be insufficient by the authorities concerned or have not been implemented quickly enough, they shall inform the approval authority that granted the EC vehicle type-approval without delay.

The approval authority shall then inform the manufacturer. If the approval authority which granted the EC type-approval is itself not satisfied with the measures of the manufacturer, it shall take all protective measures required, including the withdrawal of the EC vehicle type-approval where the manufacturer does not propose and implement effective corrective measures. In case of withdrawal of the EC vehicle type-approval, the concerned approval authority shall notify the manufacturer, the approval authorities of the other Member States and the Commission by registered letter or equivalent electronic means within 20 working days.”

May the consequences in terms of liability be even more severe in the USA than in Europe or Germany: a liability trap under superior European Union law still exists at any rate. Whoever omits in-process inspections as provided for in ISO 9001 or ISO/TS 16949:2009 – 7.4 in spite of contractual and statutory requirements and thus accepts potential defects risks losing their recourse claims against suppliers. Under German law, the supplier can invoke violation of the duty to mitigate damage and contributory negligence according to Section 254 of the German Civil Code (BGB). Apart from these sanctions, there is the risk of losing insurance protection due to exclusion clauses. Vehicle dealers, too, who ought to be able to detect or know defects, are liable according to Section 6 of the German Product Safety Act (Section 280 BGB). Where the preventive incoming goods inspection is neglected and, thus, risks posed to the final consumer are accepted, the manufacturer’s declaration of conformity is false, the former two aspects being one of the defect’s causes. Behavior of this kind, as in the case of the General Motors recall, borders on deception of the customer, as the German industry newspaper Automobilwoche put it.25

4 Conclusion

The German commercial-law incoming goods inspection according to Section 377 HGB is a non-enforceable duty (Obliegenheit) on the part of buyers. Where they omit the inspection, they accept the risk of not discovering a possible defect; this alone renders them liable for damages to their customers. Their suppliers can invoke violation of the buyer’s duty to mitigate damage.

The in-process inspection of purchased parts as laid down in ISO 9001:2008 – 7.4 constitutes an obligation under European Union law, the compliance with which as well as the limitation or omission of which are not at the disposition of contractual parties of a value chain in the automotive industry due to its direct link with European product safety law. Neglecting this statutory duty is incompatible with the provisions of type-approval law under Directive 2007/46/EC and Regulation No 371/2010 and constitutes a direct breach of superior EU product safety law. Ac-

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according to Article 32 (3) of Directive 2007/46/EC, type-approval may even be withdrawn.

Contractual limitations of the in-process inspection as set out in ISO 9001:2008 – 7.4 and burdening subordinate suppliers with the ensuing liabilities are illegal and may affect insurance coverage due to the contractual extension of liability lying therein.

The omission of in-process inspections gives rise to direct claims of vehicle buyers who were misled. The omission is a liability trap of unforeseeable extent.