Professional Perspective

Supply Chain Disputes, Defenses to Performance, & Risk Mitigation in Manufacturing

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The Covid-19 pandemic and related supply chain shortages continue to have short- and long-term impacts on companies’ supply chains. The pandemic and ensuing business disruptions also exposed inherent flaws in suppliers’ contracting practices and, particularly, just-in-time (JIT) supply, which needs only one weak link to disrupt the chain. The result: line downs, significant delays, freight issues, ongoing disputes between suppliers and their customers, and ultimately, more costly goods for consumers.

This article addresses key contract terms driving disputes between suppliers, analyzes defenses to contract performance, and identifies trends in recent case law. It also covers lessons learned and considers ways to mitigate the risks of supply chain disputes going forward, with an eye toward how the way we do business may be forever changed.

Contract Terms Driving Disputes

There are several key contract provisions at the center of recent disputes revolving around the effects of the pandemic on the supply chain.

**Delivery Terms.** The delivery terms of a contract identify the requirements for delivery of goods. They typically include the obligations of each party with respect to costs during shipment, transfer of title and risk of loss/damage. In JIT supply contracts, delivery terms often include that time is of the essence, which buyers may rely upon in claiming breach for goods that are delayed. A seller should ensure that they can realistically meet the delivery schedule included in the contract, taking into consideration the possibility of unexpected circumstances arising.

**Warranty.** Warranties are promises that the subject goods will meet specific conditions. This often includes guarantees that the products being sold will be free from defect, meet certain specifications or quality standards, or be capable of particular performance. Contracts also may make what are usually “implied warranties” express warranties by building in the warranty of merchantability and the warranty of fitness for a particular purpose into the warranty provision. It is important for sellers to understand each of the warranties contained in their contracts.

**Indemnity.** Indemnity clauses in supply contracts are risk allocation tools that shift the cost-burden of a third-party claim for damages, often related to IP claims, personal property damages or personal injury, defect, or breach of warranty. They secure one party against loss or damage to the other party’s detriment.

Many manufacturing contracts are drafted even more broadly to require indemnification not only for third-party claims, but also for direct breach of contract or breach of warranty claims. Most indemnification provisions will include a requirement that the indemnifying party will be liable for all damages related to a claim, including costs and attorney’s fees. Indemnity provisions shift damages onto a party upon the occurrence of a particular event. In a properly negotiated indemnity provision, there should be some nexus or tie to a failure, fault, defect in the party’s product, or other breach by the indemnifying party to shift the risk and require indemnification.

Parties in the supply chain often agree to an indemnity provision without fully considering the scope of the damages for which they may be held liable, such as damages relating to supply disruptions and line stoppages that have become common during the pandemic.

**Limitation of Liability.** Limitation of liability clauses may be included in supply contracts, especially where the seller is merely a build-to-print manufacturer or has greater leverage in the contract negotiations due to a unique product or technology. There are a number of ways that parties may try to limit liability in their supply contracts, including consequential damages disclaimers and damages caps.

In addition to limitations on liability, contracts also may contain limited remedy provisions—e.g., limiting available remedies to repair or replacement. Where a recall or supply disruption—particularly in a JIT supply chain—can lead to millions of dollars in damages, a limitation of liability clause or lack thereof can have serious repercussions for the party that is left holding the bill.
**Force Majeure.** Force majeure provisions are contractual provisions allocating the risk of loss if a party cannot perform due to an unforeseeable event that is outside of the party’s control. Force majeure provisions have been front and center of contract disputes between suppliers looking to excuse performance due to pandemic-related issues, including related freight delays and supply chain shortages.

**Choice of Law/Forum.** Choice of law and choice of forum provisions allow parties to agree on the law to be applied to the interpretation of the contract and the forum in which disputes will be litigated. Often, parties do not give proper consideration to what it will mean to litigate a case in a particular jurisdiction and enforce a judgment against a party, particularly where there is a global supply chain, multiple manufacturing facilities are involved, or emergency injunctive relief may be necessary. Once agreed upon, however, it is very difficult to avoid these provisions, and parties, particularly commercial entities, are stuck with the law and forum called for in their contracts.

**Common Theories to Avoid Contractual Obligations**

Parties have used a number of legal theories to avoid contractual obligations during the pandemic, such as force majeure, commercial impracticability, and frustration of purpose. Before the pandemic, these theories were usually relegated to law school textbooks and cases from the turn of the last century. Now they have been thrust to the forefront of our jurisprudence.

Force majeure is a creature of contract. Force majeure provisions are usually the first line of defense in avoiding liability for unexpected supply issues, such as those faced due to the pandemic. Through a force majeure clause, a party’s performance is excused such that the party is not in breach or liable for resultant damages due to line stoppages or delays during the pendency of the force majeure event. Whether a force majeure provision relieves a party’s obligations is largely dependent on the language of the provision itself and the court interpreting that provision. The classic example of a force majeure event is a hurricane or other weather-related catastrophe that immediately prevents a seller from providing products due to destruction of property, loss of power, etc.

For parties who may not be able to rely on force majeure—either because there is no such provision in the applicable contract or that provision is drafted very narrowly—the focus instead is on whether performance under the contract has been rendered “commercially impracticable.”

Commercial impracticability is expressly incorporated in Section 2-615 of the Uniform Commercial Code (UCC), which defines the doctrine and sets forth obligations concerning allocation of limited supply. To successfully invoke this defense, the supplier must show that delivery of all goods required under a contract has been rendered commercially impracticable “by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation.” A typical example of an event that may lead to commercial impracticability of a contract is the inability to obtain essential raw materials needed to manufacture the product.

Finally, parties facing contract compliance issues due to the pandemic have repeatedly relied upon the doctrine of frustration of purpose in an attempt to avoid their contractual obligations. The common law doctrine of frustration of purpose allows a buyer to excuse its non-performance when its purpose for entering into the contract is impeded by an unforeseen event, and the nonoccurrence of that event was a basis for the contract.

To successfully invoke this defense, a buyer must be able to demonstrate that the seller knew the buyer’s purpose for entering into the contract. For example, if a manufacturer agrees to sponsor an event in exchange for brand promotion at the event, but the event was canceled due to the pandemic, the manufacturer may argue that the purpose of the sponsorship has been frustrated due to the event cancellation.

**Supply Chain Litigation Trends & Recent Cases**

As a result of the disputes made common by the pandemic, there are a number of litigation trends that have emerged over the past year. Though many of these cases address contracts more generally, the trends and legal conclusions are equally applicable in supply chain disputes.
**Trend #1: Issues relating to the pandemic usually qualify under force majeure provisions relating to “natural disasters” or “government actions.”**

In *JN Contemporary Art LLC v. Phillips Auctioneers LLC*, No. 20-4370 (S.D.N.Y. Dec. 16, 2020), the parties contracted in June 2019 for defendant to sell plaintiff’s painting at defendant’s art auction in May 2020. In March 2020, New York placed severe restrictions on all non-essential business activities due to Covid-19. Defendant was forced to reschedule the auction for July 2020. On May 31, 2020, defendant notified plaintiff that it was terminating the contract to sell plaintiff’s painting, claiming that the circumstances created by the pandemic satisfied the conditions for defendant’s right to terminate under the contract. Plaintiff brought a breach of contract claim, arguing that the conditions created by Covid-19 did not fall under the force majeure clause, and defendant’s invocation of this force majeure clause was “pretextual” because defendant’s true motive purportedly related to a change in value of the painting.

In analyzing plaintiff’s first argument, the court first cited dictionary definitions of the term “natural disaster” to conclude that the Covid-19 pandemic fell into this express category of events justifying termination. The court then went even further by elaborating that, even without the express inclusion of “natural disasters,” the pandemic itself and the “government proclamations” related to the pandemic would fall under the general category of events beyond the parties’ reasonable control.

Turning to the plaintiff’s second argument—that defendant terminated for motives unrelated to the pandemic—the court quickly dismissed it for two reasons. First, the court implied that it could not be shown that defendant had any particular motive related to the painting in question because the defendant postponed all of its live auctions, not just this auction in particular. Second, the court asserted that if the terms of the force majeure provision were satisfied, then defendant’s motive in exercising its right to termination was irrelevant. Thus, the force majeure provision applied in full and the court dismissed plaintiff’s breach of contract claims.

In *1600 Walnut Corp. v. Cole Haan Co.*, No. 20-4223 (E.D. Pa. Mar. 30, 2021), the tenant sought to withhold rent on its commercial lease. The force majeure clause defined a force majeure event as “strikes, lockouts, labor troubles, the inability to procure materials, power failure, restrictive governmental laws or regulations, riots, insurrection, war or another reason not the fault of or beyond the reasonable control of the party delayed.”

The court held that both the pandemic itself and the government regulations triggered by the pandemic separately counted as force majeure events. “[L]aws or regulations, such as the Governor’s orders, however, clearly are within the meaning of the force majeure clause … [And, t]he pandemic is in the same category as the other life-altering national events listed, such as war, riots, and insurrection.” However, because the force majeure clause specifically excluded unpaid rent as an excusable obligation, the terms of the clause did not apply to this claim.

**Trend #2: Buyers have had limited success in obtaining injunctive relief in the face of supply shortages caused by the pandemic.**

In *JVIS-USA, LLC v. NXP Semiconductors USA, Inc.*, No. 20-10801 (E.D. Mich. Apr. 16, 2021) (order denying motion for a temporary restraining order), plaintiff sought a temporary restraining order (TRO) against the defendant-suppliers of semiconductors after it became clear defendants were suffering semiconductor shortages and unable to meet the volumes allegedly agreed upon.

In analyzing the “likelihood of success on the merits” prong of a TRO analysis, the court noted that, despite there being a battle-of-the-forms dispute as to whether or not the “contract” contained a force majeure provision, there was no need to reach a decision on this point because of the doctrine of commercial impracticability. The court focused on whether the UCC’s impracticability provision provided a valid defense for delayed or non-shipment. The court held that it did, citing “unforeseen shutdowns” caused by “a number of factors,” including that the “global supply chains suffered tremendous upheavals as a result of the Covid-19 pandemic.” Therefore, plaintiff was “unlikely to succeed on the merits,” and its request for a TRO was denied.

The supply agreement required the supplier to transfer technology used to manufacture the product to other suppliers if the supplier was unable to or refused to continue production and shipment according to the buyer’s needs. Due to the pandemic, the supplier was unable to meet the shipment demands of the buyer, which the buyer needed to continue its development of a Covid-19 vaccine.

To support its argument for a preliminary injunction to enforce the transfer provision of the supply agreement, plaintiff argued that irreparable harm would occur from slowing its development of the vaccine. The court acknowledged that failing to issue a preliminary injunction could significantly harm the public interest. However, the court still expressed concerns that a preliminary injunction would harm the interests of the supplier. The court ultimately concluded that the possible harm to the buyer and the possible benefits of an injunction were too speculative to warrant an injunction, and the court denied the petition.

**Trend #3: Whether the pandemic is considered “foreseeable” may depend on the court or your contract language.**

In GAP Inc. v. Ponte Gadea N.Y. LLC, No. 20-4541-LTS-KHP (S.D.N.Y. Mar. 8, 2021), both parties brought breach of contract claims arising out of their contract for the tenant to lease commercial properties from the landlord. As the court explained: “both parties’ claims rise or fall on the resolution of [the tenant’s] theories as to why the parties’ lease terminated (or should be deemed rescinded or reformed) as of March 2020.” The tenant’s theories included that the Covid-19 pandemic and resulting governmental restrictions frustrated the principal purpose of the lease, and that the same conditions made the parties’ performance impossible or impracticable.

The court rejected the tenant’s argument that Covid-19 and the related government shutdowns constituted a frustration of purpose for two reasons. First, the court noted that the doctrine of frustration of purpose discharges the parties’ duties only if the event was “wholly unforeseeable.” The court held that the pandemic and shutdowns were not wholly unforeseeable because the contract’s otherwise irrelevant force majeure provision specifically mentioned “governmental preemption of priorities or other controls in connection with a national or other public emergency.”

Therefore, the court concluded, the parties had contemplated this type of situation and could have contracted terms for the lease’s termination in the event of such an emergency. Second, the court held that even if the pandemic was wholly unforeseeable, it did not render the contract valueless, as required by the doctrine of frustration of purpose. It was relevant to this analysis that the tenant was able to modify its business to allow for curbside pickup from the leased properties. These modified business procedures demonstrated that the tenant was still getting some use out of the property, so that the purpose of the lease was not entirely frustrated.

In UMNV 205–207 Newbury, LLC v. Caffe Nero Americas Inc., No. 2084-1493 (Mass. Sup. Ct. Feb. 8, 2021), the parties contracted for a commercial lease where the tenant operated a café. The lease specified that the tenant was only allowed to use the property to operate a sit-in café. In March 2020, the Massachusetts governor issued an order prohibiting indoor dining, and only allowing takeout. As the tenant attempted to conduct its business in compliance with the government regulations, the tenant paid no rent after March 2020.

The landlord eventually filed suit to recover unpaid rent. The tenant argued that its obligation to pay rent was excused for frustration of purpose. The court agreed, at least during the time period when the governor’s Covid-19 order barred restaurants from serving customers indoors. The court found that all the elements of frustration of purpose were present. First, the court found that the “main object or purpose” of the contract was undisputedly to operate a café with a sit-down restaurant menu. The court relied heavily on the fact that the lease specifically stated that the premises were to be used “solely” for “the operation of a Caffe Nero themed café” and “for no other purpose.”

The court specifically noted that “[i]f [the landlord] had allowed [the tenant] to use the leased premises for other purposes not barred by government order, then the fact that [the tenant’s] intended use was frustrated might not have discharged its obligation to pay rent.” However, the contract made the purpose express and exclusive. Second, the court asserted that it was undisputed that this purpose had been destroyed since the Covid-19 order directly barred the tenant from allowing customers to consume food or drink inside the leased premises. Third, the court determined there was no way the parties could have anticipated “a global viral pandemic coming to Massachusetts and leading to a government order shutting down the entire restaurant industry.”
In AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310 (Del. Ch. Nov. 30, 2020), the court addressed Covid-19’s effect on two contractual representations in the sale of a hotel business. First, the court held that Covid-19 fell within the definition of “natural disasters and calamities” as defined by the parties’ contract. This interpretation resulted in the effects of Covid-19 falling within an exception to a representation made by the seller that the seller had not suffered any “material adverse effect.” As such, though that representation was not inaccurate, it was not grounds for eliminating the buyer’s obligation to perform. However, the court addressed a separate, unqualified representation that the business would continue to operate in the “ordinary course” of business until closing.

The court found that the business had not continued in the ordinary course of business due to the pandemic. Since the representation was unqualified, neither the cause of the deviation nor whether the seller chose to make the deviation were legally relevant. The court side-stepped the issue of whether the seller was forced to deviate from the ordinary course by government action by noting that the seller implemented “sweeping changes” to its business before any government orders went into effect. The court thus concluded that the seller’s failure to make an accurate representation was not excused. Therefore, the buyer’s obligation to perform was extinguished.

In re Condado Plaza Acquisition LLC, 620 B.R. 820 (S.D.N.Y. 2020) provides a helpful contrast. The case there dealt with a similar contract to sell a hotel containing a similar representation that the hotel would continue in “substantially consistent … operation and maintenance” until closing. However, the court there held that the pandemic did excuse the seller’s inaccurate representation based upon two crucial differences.

First, the contract terms required only that the seller make “commercially reasonable efforts” to maintain normal operation—the seller did not make an unqualified representation that the hotel would in fact continue to operate as normal. The court held that there were no commercially reasonable efforts the seller could have made to continue operation of the business due to the pandemic. Second, the seller’s inability to satisfy the representation was caused by government regulations, thus excusing the seller’s obligation.

Risk Mitigation

While supply interruptions and pricing disputes are common occurrences when working in the supply chain, the pandemic has made these disputes not a question of “if” but “when.” There are a number of things that a supplier can do to help prepare for these situations and ensure they are well-positioned to weather any dispute.

Pay attention to key indications of financial distress in your suppliers.

- Late or irregular payments or other tardy performance
- Blaming third parties—e.g., lenders, equity sponsors—for performance results
- Suggesting prosperity for the company is around the corner, but nothing changes or improves over time
- References to the consideration of “strategic alternatives”
- Significant “bet-the-company” litigation in which the customer or supplier is a defendant
- Cutbacks on capital expenditures, R&D, or other expenses as “non-essential”
- Changes in key managers or officers
- Layoffs

Track all damages and costs related to the pandemic, line downs, delays, other freight issues and supply chain shortages.

- Although these may never play out in litigation, we expect there to be opportunities to leverage these costs during commercial negotiations with important customers and suppliers when discussing new business
- The pandemic doesn’t necessarily trigger renegotiations, but some provisions may make sense to revisit
- Consider how your contract may be affected by the “new normal” and which party should bear the risk going forward
  - Extended lead times from suppliers
Expedited freight issues
Uncertain forecasts
Price increases due to decreased volume
Revised force majeure clause

Do not wait until there is an issue to plan for the contingencies.

- Consider qualifying multiple suppliers to prepare in event of shortages and options to dual-source certain products and raw materials
- If the supplier is a sole-source, directed-buy, ask your customer for more than one “directed” supplier
- Have a contingency plan for labor shortages
- Consider whether stocking parts is feasible for your business or whether there is an option to require your supplier to maintain a bank of parts or inventory in a different, nearby location
- Consider whether in-housing certain manufacturing operations or parts is an option for your business

Train your employees regarding how to mitigate risk in the event that litigation becomes inevitable.

- Know what documents constitute your contract
- Know whether your contract contains notice provisions, arbitration clauses, forum selection clauses and/or venue clauses
- Understand the concept of “building a record” with respect to the ongoing supply chain dispute
- Identify key members of the business team with information regarding a dispute, and prepare a chronology of events
- Do not put anything in an email (or text or chat) that you would not want to be read aloud in court
- Understand when the attorney-client privilege does and does not attach to communications and documents
- Track all damages and costs related to supply chain issues

**Conclusion & Lessons Learned**

The long-term effects of the pandemic on the supply chain are yet to be seen. However, the lessons learned from this unexpected, world-altering event are already evident.

If there is one thing that parties to commercial contracts have learned during the course of the pandemic, it is that little-considered contract provisions can have a major impact on the outcome of a dispute. Take time to review these terms in your current contracts, including in your standard terms and conditions of purchase or sale, and revise accordingly. Analyze your contract terms to ensure you are not overlooking provisions that can impact your rights in the event of an unexpected occurrence. Doing this now will help you avoid those terms being used against you in the future.

We expect to see many manufacturing companies revising their force majeure provisions to specifically include terms like “pandemic, epidemic, or disease,” to avoid uncertainty and ensure that any future pandemics that prevent performance are covered by the force majeure provision.

Working closely with sales and procurement to ensure active supplier management and diversification of supply can help avoid supply and pricing issues associated with major world events. Although these strategies may result in certain cost increases in the company’s supply chain, the payoffs with respect to risk mitigation may be well worth the investment.

Training key employees on best practices for procurement, contracting, and preparing for litigation will put you in the best position to be successful in any future dispute that cannot be resolved at the commercial level.

Incorporating these lessons into your supply chain business is now a best practice, and will help mitigate future issues when the next crisis emerges.

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