

# NO SUPPLIES IN THE CHAIN

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The world's supply chains are crumbling. Manufacturing companies are struggling to catch up with surging demand as the global economy begins to recover from the pandemic-related impacts on production across all industries. Prices for resources such as magnesium, silicon, and iron ore and other industrial raw materials are skyrocketing as a result of depleting inventories. Shipping container rates have increased fourfold. Ports are congested, trucks are without drivers, and warehouses are empty. Against this backdrop, suppliers and buyers find themselves facing off over the allocation of risks, including increasing production costs and delivery shortfalls, brought on by persistent delays and disruptions. Commercial terms that might once have been considered to be “boilerplate”—such as force majeure or commercial impracticability—have taken on heightened importance.

Now, as power outages rage across China, manufacturers around the world are bracing for further widespread, indefinite raw material shortages. In this environment, rapid risk assessment and mitigation is a mission-critical exercise.

## ASSESSING RISKS

Raw materials are becoming increasingly scarce, and your capacity to fill orders is rapidly declining. What can you do to weather the storm? *First*, carefully review and triage your existing contracts. Many commercial contracts contain flexibilities that may allow delayed or minimized production. *Second*, keep your customers informed. Informed customers are better positioned to take action to mitigate their downside risk and, in turn, less likely to take action against you.



*Finally*, know your rights and obligations in the event you cannot deliver. Force majeure provisions and the Uniform Commercial Code (U.C.C.) can guide your business decisions with an eye toward maintaining customer relationships and the proactive avoidance of litigation.<sup>1</sup>

## LEVERAGING FLEXIBILITIES

Even if your commercial contracts contain fixed price and volume commitments, there may be options to mitigate your risk. Look to see whether your contracts contain **price escalation provisions** allowing for periodic equitable

increases or adjustments when triggered by a defined event, such as when a particular price index indicates a certain percentage increase. Additionally, your contracts may contain provisions that provide for:

- **Delayed deliveries.** Does the contract provide that schedule or lead times will be determined at the time of the order, or, if specified in the contract, are subject to change based on then-available capacity?
- **Limitation of quantities.** Does the contract provide that order acceptance or production quantities are subject to available capacity at the time of the order?
- **Lesser shipments.** Does the contract provide that all orders are subject to a shipping tolerance of +/- a certain percentage?

Importantly, a manufacturer's options under any such contractual provisions may require exercise of commercially reasonable efforts to allocate production capacity among similarly situated customers in a fair and reasonable manner. This is where knowing your rights and obligations before implosion of the supply chain will prove useful.

## KNOWING YOUR RIGHTS AND OBLIGATIONS

### Commercial Impracticability

Commercial impracticability is a defense to nonperformance where an unexpected event renders performance of the contract commercially impracticable. In most instances, market shifts and increased costs do not support application of the defense, but some courts have allowed it where the price increase was considered severe (e.g., tenfold). Material shortages, on the other hand, more frequently support an impracticability defense.<sup>2</sup>

A manufacturer contemplating nonperformance based on commercial impracticability should be mindful of its obligation under U.C.C. Section 2-615 to fairly and reasonably allocate production among its customers.<sup>3</sup> *Unless* a manufacturer's contracts expressly permit allocation within the seller's sole discretion or based on considerations other than equitable treatment of similarly situated customers, an allocation plan should take account of the following guidelines:<sup>4</sup>

Party	Allocation
Contracted customers	<b>must</b> receive a fair and reasonable allocation.
Regular spot purchasers	<b>may</b> —at the seller's election—receive a fair and reasonable allocation.
The manufacturer	<b>may</b> retain a fair and reasonable allocation to maintain production capacity.
Other parties	<b>must not</b> receive an allocation.

In addition, manufacturers should be careful *not* to allocate production to high-paying customers to the detriment of others absent supporting contractual grounds.<sup>5</sup> Finally, a manufacturer employing Section 2-615 should provide timely notice to its customers.<sup>6</sup>

### Force Majeure

Whereas U.C.C. Section 2-615 is available in the absence of an express contractual defense, a force majeure clause excuses performance in the face of events expressly contemplated by the parties on the face of the contract. Courts typically interpret force majeure provisions narrowly based on a plain reading of the provision. Generally, market shifts and increased costs are not force majeure events. Materials shortages, however, could be a triggering event if expressly included in the force majeure clause.

Importantly, a manufacturer's declaration of a force majeure event does not terminate a contract. Rather, it excuses performance until the earlier of (a) resolution of the force majeure event, or (b) expiration or termination of the contract. Manufacturers considering declaration of a force majeure event as to one customer should be mindful of their treatment of similarly situated customers, including avoiding situations where preferential treatment of one customer might lead to a material shortage for another. Remember, a force majeure event is one outside of a party's control.

## FUTURE CONSIDERATIONS

Now is the time for manufacturers to consider whether their contracts sufficiently protect them against future supply chain disruptions:

- Can your standard force majeure provision be made stronger by express inclusion of material shortages or commercially unfeasible prices?
- Have you updated your force majeure provision to include pandemics and communicable disease outbreaks, as well as cyber-related disruptions, such as ransomware and other cyberattacks?
- Do you reserve the right to adjust delivery time and production volume based on your capacity at the time the order is placed?
- Is the right to allocate capacity left to your sole discretion?
- Do your contracts contain price escalation provisions triggered by defined market shifts?

With a careful and prompt response to supply chain disruptions, and some proactive prevention steps, manufacturers can better control risks—and even come out stronger on the other side.

## FOOTNOTES

<sup>1</sup> Contract interpretation and available defenses differ across jurisdictions. Many contracts contain choice of law provisions governing all claims arising out of or relating to the contract. The within information should be considered under the law of your governing jurisdiction.

<sup>2</sup> See U.C.C. § 2-615, cmt. 4 (1951) (enacted by statute in most states).

<sup>3</sup> § 2-615(b).

<sup>4</sup> *Id.*; see also § 2-615, cmt. 11.

<sup>5</sup> See § 2-615, cmt. 11.

<sup>6</sup> § 2-615(c).

## KEY CONTACTS



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