

The Enforceability of Requirements Contracts in the Automotive Industry: Do Your Agreements Pass Scrutiny?

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Introduction

The automotive industry supply chain historically has been structured on long-term supply agreements with either fixed-price terms or scheduled price reductions over the life of a part or program. As the supplier base continues to experience eroding profit margins, however, suppliers are finding it more difficult economically to maintain production under those agreements. Faced with this problem, suppliers increasingly are asserting legal challenges to the enforceability of their long-term agreements, typically seeking to have those agreements declared invalid to force negotiation of new agreements with higher prices. One issue that has gained considerable attention recently is the validity of open quantity “requirements” contracts under Michigan law.

The example of a supplier looking to invalidate an agreement due to rising raw material costs is illustrative. Your client, a Tier 1 supplier of automotive suspension components, calls you and presents the following factual scenario:

The client manufactures a suspension assembly that it sells to its Original Equipment Manufacturer (OEM) customer for use in a popular sport utility vehicle under a fixed-price long-term agreement. The client purchases various steel components included in the assembly from its Tier 2 supplier, which, in turn, purchases raw steel from its own supplier. The client is one year into a multi-year fixed-price purchase order contract with its Tier 2 supplier, which includes an open “blanket” quantity term and obligates your client to purchase parts only upon the issuance of periodic production releases. Due to increases in the cost of steel, the Tier 2 supplier faces significantly higher production costs and has approached your client seeking to pass along steel surcharges. Knowing that its OEM customer would be reluctant to

absorb a corresponding price increase, your client rejects the Tier 2’s proposal, citing the parties’ fixed-price agreement. In response, the Tier 2 threatens to stop accepting additional production releases and cease production. Despite having performed for a period of time, the Tier 2 argues that the contract is invalid because it does not define a specific quantity of goods and obligates the Tier 2 to produce only the quantities specified in the individual production releases it accepts. Faced with the prospect of not being able to meet its supply obligations to its customer, your client asks for a legal analysis of the supply agreement’s enforceability as a long-term requirements contract. What issues do you consider and advice do you give?

This article examines these questions, focusing on Michigan law as it applies to the enforceability of requirements contracts. It also considers common arguments made by litigants seeking to invalidate requirements contracts and lessons learned from reported decisions for those drafting or negotiating automotive supply agreements. Although this article examines these issues in the context of the automotive industry, the legal analysis is applicable to any requirements contracts under the Uniform Commercial Code (UCC).

The UCC Authorizes Parties to Contract for a Requirements-Based Quantity of Goods

One consequence of utilizing long-term supply agreements that follow the life of a part or program is that parties cannot adequately predict the quantities of parts that will be required to meet OEM production demand over time. Part demand naturally fluctuates with vehicle demand, which is notoriously difficult to predict. After all, it may not make sense for an OEM to enter into a ten-year agreement to purchase 10,000 ethanol-fuel engines for a truck line when consumer

demand might quickly shift to electric hybrid or other alternative energy platforms.

The UCC provides an alternative that allows parties to enter into binding long-term agreements that account for fluctuating demand. Under UCC 2-306, parties to a sale of goods contract are authorized to define quantity in a supply agreement as the buyer's good faith "requirements" (or, alternatively, as the seller's good faith "output") for the goods:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.¹

Because requirements-based quantity terms are uncertain and often moving targets, parties looking to challenge the validity of a purported requirements contract increasingly have asked courts and arbitrators to scrutinize quantity language. Such legal challenges routinely call into question whether an enforceable quantity term exists and, if so, whether that term supports mutuality of obligation. Other forms of legal challenges concede the enforceability of a requirements contract on its face but assert breach claims premised upon a party's actions to evade performance of the obligation to meet the buyer's requirements.

The Statute of Frauds as the First Line of Defense

Satisfying the UCC statute of frauds is a threshold issue to the enforceability of any contract for the sale of goods, but one that typically does not carry much teeth. Under UCC 2-201, a contract valued in excess of \$1,000 satisfies the statute of frauds as long as it is in writing and contains an express quantity term.² The Michigan Supreme Court has held that "Section 2-201 does not require that the terms of a contract for the sale of goods, *other than the quantity term*, be expressed in writing."³ Accordingly, a supply agreement that defines quantity but leaves all other terms open, including price, delivery terms, and payment instructions, should pass muster under the statute of frauds. The UCC provides that open terms other than quantity

can be added subsequently by a court, either through the UCC's enumerated gap-filling provisions or by parol evidence of usage of trade, course of dealing, and course of performance.⁴

Because the statute is satisfied where a quantity term is stated, a disputed issue is often whether a term qualifies as a quantity term. As to this issue, the burden is minimal. Only where a written contract is totally silent as to quantity will the contract be held *per se* unenforceable under the statute of frauds.⁵ A contract that contains some statement of quantity, even one that is ambiguous, generally satisfies the statute of frauds.⁶ For example, the Michigan Court of Appeals held that the word "all" in a contract defining quantity as "all wood sawable" was sufficient to satisfy the statute of frauds by stating a quantity.⁷ In addition, the term "blanket order" has been held sufficient to connote a quantity in an automotive supply agreement, although ambiguous as to the scope of its obligation.⁸ Similarly, a term defining quantity according to individual production releases has also been held sufficient.⁹ Given the minimal burden imposed by the statute of frauds, purported requirements contracts rarely rise or fall on this issue.

A Requirements-Based Quantity Term Must Support Mutuality of Obligation

The more challenging and heavily-litigated issue is whether an express quantity term is sufficient to satisfy the obligations imposed by UCC 2-306 for a valid requirements contract. As the Michigan Supreme Court has held, "[a] writing that satisfies [the statute of frauds] does not prove the terms of a contract; such a writing merely removes the statutory bar to the enforcement of the contract...."¹⁰ An enforceable requirements contract must contain a quantity term that not only satisfies UCC 2-306's definition for such a contract, but also is specific enough to support consideration and mutuality of obligation.¹¹ In other words, enforceability depends on whether a quantity term is sufficient to impose a binding obligation on the seller to sell and the buyer to buy its requirements for the goods at issue during the term of the contract.¹² Absent a firm obligation on both parties, the contract may be deemed illusory and unenforceable.

All things being equal, a contract that defines quantity as "100% of the buyer's re-

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quirements” expresses the parties’ unambiguous intent to enter into a requirements contract. Requirements contracts are routinely upheld where the parties use unambiguous “requirements” language. For example, in *Plastech Engineered Products v Grand Haven Plastics, Inc*, the court held that purchase orders stating that “[s]cheduled Purchase Order to cover 100% Johnson Controls requirements” were enforceable as requirements contracts.¹³ Similarly, in *QC Onics Ventures, LP v Johnson Controls, Inc*, a quantity term stating that the “scheduled Purchase Order to cover 100% requirements” was likewise held to support a valid requirements contract.¹⁴

Unfortunately, parties in long-term automotive supply agreements often fail to use similarly unambiguous language to define quantity. Instead, parties often rely on blanket quantity purchase order contracts. Such contracts typically define quantity as a “blanket quantity” and provide, either within the purchase order or in separate incorporated terms, that the seller is obligated only to deliver parts when the buyer realizes demand for specific quantities and issues individual production releases. This practice faced less scrutiny when the supply chain enjoyed healthier profit margins. Increasingly, however, sellers have begun to question whether blanket-quantity contracts actually impose the mutuality of obligation necessary to enforce a requirements contract. The last ten years have seen numerous courts consider this issue with mixed results.

Michigan Law Applying UCC 2-306 Is Not Well Settled

Michigan law is not well-settled on the enforceability of purported requirements contracts with ambiguous quantity terms. Many courts have recognized that requirements contracts are the norm in the automotive industry and have addressed legal issues with that frame of reference. *Chainworks, Inc v Webco Indus, Inc* is a leading case.¹⁵ In that case a steel supplier sought to evade performance under an unprofitable, fixed-price blanket purchase order contract by arguing that the purchase order itself did not constitute a contract but, rather, individual contracts were formed each time the supplier accepted and shipped against production releases. The court rejected that theory, holding that the purchase order constituted one requirements contract for its entire duration.¹⁶ The court recognized that the produc-

tion releases did not define the scope of the parties’ obligation, but only provided the mechanism for delivery. Therefore, the contract language referring to the production releases was not a quantity term. The court found that the quantity term stating, “[t]his is a requirements based blanket order,” was sufficient to express the parties’ intent to enter into a requirements contract.¹⁷

Similarly, in *General Motors Corp v Paramount Metal Products Co*, the seller sought to invalidate purchase orders governing the supply of automotive seat frames arguing, among other things, that the purchase orders lacked mutuality of obligation because they were not exclusive and only became enforceable on the acceptance of production releases.¹⁸ The court rejected both arguments. It held that nothing in the UCC mandates that requirements contracts be exclusive and found no contract language evidencing an intent that the production releases, rather than the purchase orders themselves, would define the quantity obligation.¹⁹

While not an automotive industry case, *Metal One America, Inc v Center Manufacturing, Inc* is in accord.²⁰ In this case the seller sought to enforce a purported requirements contract after the buyer closed its plant and unilaterally sought to terminate the contract. Like many other courts before it, the court rejected the theory that individual contracts were formed as each production release was accepted. Instead, the court found an enforceable requirements contract based principally on parol evidence, including the parties’ course of performing under the broader supply agreement and the buyer’s history of purchasing all of its requirements from the seller.²¹

As the heading of this section suggests, however, there is a body of caselaw finding to the contrary. These cases have more closely scrutinized the express contract language and have held that more is required to support a finding of mutuality of obligation. For example, in *Acemco, Inc v Olympic Steel Lafayette, Inc*, the court held that a supply agreement stating “[d]uring the term of this Agreement, the Seller agrees to sell to the Buyer such quantities of the Products as the Buyer may specify in its purchase orders, which the buyer may deliver at its discretion” did not contain a quantity term of any kind, ambiguous or unambiguous, and, therefore, was not a valid requirements contract.²² The court found the purported quantity term

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to be discretionary and consideration to be lacking.²³

In *Advanced Plastics Corp v White Consolidated Indus, Inc*, the court rejected the argument that the following default term included in the buyer's general terms and conditions was sufficient to support a requirements contract because it gave the buyer discretion in its performance: "Seller agrees to furnish Buyer's requirements for the goods or services covered by this Purchase Order to the extent of, and in accordance with, the delivery schedule set forth therein, or, if no such schedule is set forth, then pursuant to Buyer's written instruction."²⁴ The court found this default term insufficient because the contract documents expressly provided that the buyer was only obligated to purchase those parts for which it issued production releases or other instructions. There was no quantity language obligating the buyer to "purchase all of its needs or requirements from" the seller.²⁵

The unreported decision in *Schefenacker Vision Systems, USA, Inc v Depco International Inc* goes even farther. That decision held that purchase orders are, as a general rule, offers to purchase that are only accepted once a production release is issued.²⁶ The court held that where a supply agreement does not expressly define the quantity obligation as the buyer's requirements but, instead, specifies that quantities are to be determined according to production releases, the agreement is not enforceable as a requirements contract.²⁷ The *Schefenacker* decision has not been cited with approval in any reported case.

The most recent decision to address these issues and consider all of the foregoing cases is *Johnson Controls, Inc v TRW Vehicle Safety Systems, Inc*.²⁸ Judge Zatkoff of the Eastern District of Michigan was faced with cross motions for summary judgment regarding the enforceability of purported purchase order requirements contracts. The court first held that the blanket purchase orders defining quantity simply as "AS REL," which was intended to designate quantities as specified in production releases, were sufficient to satisfy the statute of frauds.²⁹ The court then held that while the language could evidence a requirements contract "in light of the practice among automotive suppliers to enter into long-term, just-in-time production arrangements that rely on a fixed-price and a variable quantity, and provide flexibility to adjust to changing commercial conditions,"

the interpretation of the quantity term was properly left to a jury and parol evidence.³⁰

Some Lessons Learned from Cases Considering Facial Challenges to the Enforceability of Requirements Contracts

Despite the thorough analysis of the issues in *Johnson Controls*, the law on facial challenges to ambiguous quantity terms remains unsettled. Nevertheless, several lessons can be learned from the caselaw that may help parties avoid similar disputes. The following should be considered when negotiating a requirements contract in the automotive industry or when faced with a legal challenge to an agreement.

Lesson No. 1 – Be Specific and Use "Requirements" Language

Open, ambiguous, or "blanket" quantity terms not tied specifically to "requirements" in supply agreements are easy targets for litigation. The clear lesson from the caselaw is that, while not mandatory for enforcement, quantity terms that specifically use the word "requirements" and do not include language providing either party discretion on performance go a long way towards minimizing the risk that a court may find a purported requirements contract invalid. There is ample authority holding that an agreement that specifies quantity as "100% (or some other defined percentage) of the buyer's requirements," is enough to support a finding of a valid requirements contract, even where delivery terms for shipments may be specified individually on production releases.

Lesson No. 2 – Document Your Contract Interpretation Position

Under the UCC, parol evidence is admissible to explain or supplement, but not contradict, contract terms.³¹ In construing the enforceability of purported requirements contracts, courts regularly rely on parol evidence to define the intent of the parties. Course of performance is often considered the best evidence of the parties' intent. Accordingly, prior to and during performance of a requirements contract, parties should include language in correspondence that evidences their understanding of the contract as a valid and enforceable requirements contract. Letters, e-mails, and other documents may be critical evidence in a subsequent action where the

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parties are asking a court or arbitrator to rule on the validity of a contract.

Lesson No. 3 – Utilize Over-Arching Supply Agreements

Frequently, purchase orders are at the heart of contractual supply arrangements in the automotive industry. Increasingly, however, parties are entering into over-arching supply agreements that provide greater detail regarding their rights and obligations than would typically be included in a purchase order. Such agreements are especially helpful where parties in a long-term relationship operate pursuant to numerous separate purchase orders or other contract documents that could be read together as constituting one contractual relationship. They are also helpful in addressing head-on issues that tend to be litigated in the context of the “battle of the forms.”

Lesson No. 4 – Include Default Quantity Terms in Standard Terms and Conditions

Parties to supply relationships often incorporate standard terms and conditions into their purchase orders or other contract documents. To avoid ambiguity regarding the quantity obligation, sophisticated parties increasingly are including default or fallback quantity terms in their standard terms. Johnson Controls is an example of a Tier 1 supplier that has modified its Global Terms of Purchase to include the following default provision on quantity:

Quantities listed in each [Purchase] Order as estimated are Buyer’s best estimate of the quantities of Supplies it might purchase from Seller for the contract term specified in the Order. If no quantity is stated or if the quantity is stated as zero: (a) Seller is obligated to supply Buyer’s stated requirements for the Supplies in quantities as specified by Buyer in Material Releases; (b) unless expressly stated on the face of the Order, Buyer is not required to purchase Supplies exclusively from Seller; and (c) Buyer is required to purchase no less than one piece or unit of each of the Supplies that are goods and no more than those quantities identified as firm orders in material authorization releases, manifests, broadcasts, or similar releases (“Material

Releases”) transmitted by Buyer to Seller....³²

While *Advanced Plastics, supra*, teaches that such a default provision will not always substitute for a well-defined and unambiguous requirement-based quantity term, when the scope of the quantity obligation is in question, a default quantity provision declaring quantity to be the buyer’s requirements may constitute critical parol evidence supporting an intent to enter into a requirements contract.

Conclusion

Given the financial challenges faced by the automotive industry, it is reasonable to assume that legal challenges to the enforceability of long-term requirements contracts will continue. Parties wishing to cut-off such challenges before they develop into litigation, or at least strengthen their position in the event a lawsuit is filed, would be wise to avoid ambiguous quantity terms and, instead, negotiate quantity terms that support mutuality of obligation based on the buyer’s requirements. Although the appeal of a quantity term that provides maximum flexibility to respond to market fluctuations may be advantageous at the time of contract formation, it is significantly less so when a court finds the contract containing such a quantity term to be illusory and unenforceable, and your client is faced with the prospect of having to absorb raw material price surcharges.

NOTES

1. MCL 440.2306.
2. MCL 440.2201(1); *see also id.* at Cmt No 1 (“The only term which must appear is the quantity term which need not be accurately stated but recovery is limited to the amount stated. The price, time and place of payment or delivery, the general quality of the goods, or any particular warranties may all be omitted.”).
3. *Lorenz Supply Co v American Standard, Inc*, 419 Mich 610, 614-15 (1984) (emphasis added); *see also In re Frost*, 130 Mich App 556, 561 (1983).
4. MCL 440.2202.
5. *In re Frost*, 130 Mich App at 559.
6. *Id.*
7. *Id.*
8. *Great Northern Packaging, Inc v Gen Tire & Rubber Co*, 154 Mich App 777, 787 (1987) (“We conclude that the term ‘blanket order’ expresses a quantity term, albeit an imprecise one. Parol evidence may be taken on what quantity is intended by that term.”); *see also GRM Corp v Miniature Precision Components, Inc*, 2007 US Dist LEXIS 16345, at *6 (ED Mich March 8, 2007) (holding that “blanket order” is a sufficient quantity term); *but see Acemco, Inc v Olympic Steel Lafayette, Inc*,

2005 Mich App LEXIS 2656, at *11-12 (Mich Ct App Oct 27, 2005) (holding that the term “blanket” on its own was not a quantity term because the term only appeared on a document that described the goods to be purchased, not in the agreement itself).

9. *Johnson Controls, Inc v TRW Vehicle Safety Sys*, 491 F Supp 2d 707, 717 (ED Mich 2007).

10. *Lorenz Supply Co*, 419 Mich at 615-16.

11. The Comments to UCC 2-306 make clear “a contract for output or requirements is not too indefinite since it is held to mean the actual good faith output or requirements of the particular party.” MCL 440.2306 at Cmt No 2.

12. MCL 440.2306; see also *General Motors Corp v Paramount Metal Prods Co*, 90 F Supp 2d 861, 873-74 (ED Mich 2000).

13. *Plastech Engineered Prods v Grand Haven Plastics, Inc*, 2005 Mich App LEXIS 853, at *17-21 (Mich Ct App March 31, 2005).

14. *QC Onics Ventures, LP v Johnson Controls, Inc*, 2006 US Dist LEXIS 45189, at *24-28 (ND Ind June 21, 2006) (applying Michigan law).

15. *Chainworks, Inc v Webco Indus, Inc*, 2006 WL 461251 (WD Mich Feb 24, 2006).

16. *Id.* at *6.

17. *Id.*

18. *General Motors Corp v Paramount Metal Prods Co*, 90 F Supp 2d 861 (ED Mich 2000).

19. *Id.* at 873-74 (“The statute and official comments simply do not support Paramount’s assertion that all requirements contracts are exclusive requirements contracts; a requirements contract may exist where ‘all or some of the purchaser’s requirements are purchased from the seller.’”) (quoting *Precision Rubber Prods Corp v George McCarthy, Inc*, 872 F2d 187, 188 (6th Cir 1989)); see also *id.* (“A promise to buy of another person or company all or some of the commodity or service that the promissory may thereafter need or require in his business is not an illusory promise and such a promise is a sufficient consideration for a return promise.”) (quoting Corbin, 1A Corbin on Contracts § 156 (1963)).

20. *Metal One America, Inc v Center Mfg, Inc*, 2005 US Dist LEXIS 40304 (WD Mich July 14, 2005).

21. *Id.* at *14.

22. *Acemco, Inc v Olympic Steel Lafayette, Inc*, 2005 Mich App LEXIS 2656, at *11-12 (Mich Ct App Oct 27, 2005) (holding that not only did quantity term fail to evidence a valid requirements contract, but it also failed under the statute of frauds because it “grants complete discretion to the buyer to deliver purchase orders containing any amount or no amount at its discretion without any other limiting feature”).

23. *Id.*

24. *Advanced Plastics Corp v White Consol Indus, Inc*, 828 F Supp 484, 486 (ED Mich 1993), *aff’d* 47 F3d 1167 (6th Cir 1995).

25. *Id.* at 488 n.1.

26. *Schefenacker Vision Sys, USA, Inc v Depco Int’l, Inc*, Case No. 03-71183, Order Denying Plaintiff’s Motion for Partial Summary Judgment at 8-9 (ED Mich May 17, 2004).

27. *Id.* at 10-11. See also *General Motors Corp v Steel Dynamics, Inc*, Case No. 04-056983, Ruling on Motion for Summary Disposition (Oakland County Cir Ct, Mich Aug 4, 2004) (holding that seller had no obligation to continue supplying steel to General Motors because alleged supply agreement failed under statute of frauds and had no mutuality of obligation); *DeDoes Indus, Inc v Target Steel, Inc*, 2005 WL 1224700 (Mich Ct App May 24, 2005) (holding that obligation set forth in price quotation for seller to supply the buyer’s “steel needs” was insufficient for supply agreement to satisfy the statute of frauds).

28. *Johnson Controls, Inc v TRW Vehicle Safety Systems*, 491 F Supp 2d 707 (ED Mich 2007).

29. *Id.* at 717.

30. *Id.* at 719-20.

31. MCL 440.2202 (“Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented (a) by course of dealing or usage of trade (section 1205) or by course of performance (section 2208); and (b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement.”)

32. Johnson Controls’ Global Terms of Purchase can be found on its Web site, <http://www.johnsoncontrols.com>.



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