Commercial Impracticability

AND FAIR ALLOCATION UNDER UCC 2-615

By John R. Trentacosta

When the economy makes its long-awaited turnaround, there undoubtedly will be stresses and pressures on the supply chain. At many companies, production has been at less than full capacity for years. As the ramp-up takes place, there will be shortages at various points in the supply chain. What if a supplier simply cannot procure enough raw material to meet customer demand?

Section 2-615 of the Uniform Commercial Code (UCC) sets forth the scope of the defense of commercial impracticability.[1] This defense is available to a supplier of goods that is unable to make delivery as required by contract, either whole or in part. If a supplier can show that delivery of all goods required under a contract is commercially impracticable but the supplier can make partial delivery, UCC 2-615 mandates that such deliveries be allocated among customers in a manner that is "fair and reasonable." This article discusses the application of UCC 2-615, including the question of what is a fair and reasonable allocation.

Statutory Authority

Section 2-615 of the UCC[2] governs commercial impracticability. In relevant part, UCC 2-615 provides:

> (a) Delay in delivery or nondelivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence 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 or order whether or not it later proves to be invalid.
>
> (b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.

FAST FACTS

A seller that is unable to perform its contractual obligations may, under appropriate circumstances, assert the defense of commercial impracticability.

Under UCC 2-615, nonperformance may be excused if performance has been made impracticable by a contingency, the nonoccurrence of which was a basic assumption of the contract.

If the supplier can supply some, but not all, of what is required under the contract, the supplier must allocate on a fair and reasonable basis across its customer base.

Commercial Impracticability Generally

When the parties have allocated certain risks by contract (e.g., force majeure clauses), courts tend to defer to those contractual terms.[3] However, in situations in which the parties did not allocate such risk by contract, UCC 2-615 acts as a "gap filler" when the unexpected occurs. A number of courts have applied a three-part test in analyzing whether the definition of commercial impracticability under section 2-615 is available to a nonperforming seller:

(1) The seller must not have assumed the risk of some unknown contingency;

(2) The nonoccurrence of the contingency must have been a basic assumption underlying the contract; and

(3) The occurrence of that contingency must have made performance commercially impracticable.[4]

Foreseeability is a major factor to consider in any commercial impracticability analysis. If the contingency was foreseeable, the parties should have made their contract with the expectation that such contingency might occur. If an event was foreseeable, it was not "a contingency the nonoccurrence of which was a basic assumption."[5] Consequently, if a seller foresees a risk but does not include a contract provision against assuming that risk, that will be evidence that such risk is assumed.

Decisions Finding a Defense of Commercial Impracticability

The following is a summary of representative cases in which the court held that the doctrine of commercial impracticability was applicable.

Selland Pontiac-GMC, Inc v King

In *Selland Pontiac-GMC, Inc v King,*[6] the court applied the commercial impracticability defense when a contract required the seller to use a specified supplier and that supplier ceased business operations. The seller contracted with the buyer for the sale of four school bus bodies to be manufactured by a specified supplier. The specified supplier ceased operations due to financial difficulties, and the bus bodies were never manufactured. Both the seller and the buyer testified that they had no knowledge of the supplier's questionable financial circumstances when they contracted. The court held that, where supply of a single, mutually contemplated source was a basic assumption on which the contract was made and the seller had no reason to know of the supplier's inability beforehand, the seller was entitled to avail itself of the defense of commercial impracticability.

Asphalt International, Inc v Enterprise Shipping Corp, S.A.

In *Asphalt International, Inc v Enterprise Shipping Corp, S.A.,*[7] the court upheld a commercial impracticability defense to the performance of a charter contract when a tanker was damaged to the point that cost of repair exceeded its precollision fair market value. The plaintiff chartered a tanker from the tanker's owner. The tanker sustained extensive damage when it was struck by another vessel. Under the contract, the defendant was responsible for routine maintenance, including minor damage repairs, but there was no allocation of risk for major damage. The cost of repair was $1.5 million, which was twice the precollision value of the ship. The plaintiff instituted a breach of contract claim for failure to repair the tanker. The court held that, although certain risks were allocated by contract, the extensive damage to the tanker was a contingency, the nonoccurrence of which was a basic assumption of the parties at the time of contracting. Therefore, the defendant's duty to repair was commercially impracticable.

Aluminum Company of America v Essex Group Inc

A cost increase brought on by regulatory changes was held sufficient to invoke a commercial impracticability defense in *Aluminum Company of America v Essex Group Inc.*[8] The buyer and the seller entered into a toll conversion service contract under which the buyer would supply the seller with alumina. The seller would convert the alumina by a smelting process into molten aluminum that would then be picked up by the buyer for further processing. In the mid-1970s, new regulations for oil and pollution control dramatically increased the seller's smelting costs and would have caused the seller to lose more than $75 million during the life of the contract, while the buyer conversely stood to gain a windfall profit. The court found that regulatory changes of this sort were an unforeseen supervening circumstance, not within the contemplation of the parties at the time of contracting. To the relief of the seller, the court found that the seller's performance became commercially impracticable.

Mishara Construction Company, Inc v Transit-Mixed Corp

The commercial impracticability defense was successfully invoked when an unforeseen labor dispute disrupted performance in *Mishara Construction Company, Inc v Transit-Mixed Corp.*[9] The plaintiff was a general contractor on a housing project for the elderly. The plaintiff contracted with the defendant to supply

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ready-mixed concrete to be used on the project. The defendant was obligated to supply all the concrete needed on the project at a specified price, with deliveries to be made at the times and in the amounts as ordered by the plaintiff. An unexpected strike disrupted work on the job site. Although work resumed, a picket line was maintained on the site until the completion of the project, preventing the defendant from delivering the concrete. Throughout this period, with very few exceptions, no deliveries of concrete were made by the defendant. The plaintiff sued for breach of contract. The court upheld the defense of commercial impracticability, finding the labor dispute was unforeseen.

Federal Pants, Inc v Stocking

In *Federal Pants, Inc v Stocking,*[10] the court applied the commercial impracticability defense when a supplier terminated a seller's dealership rights, thereby making it impossible for the seller to deliver products to the buyer. The seller, an authorized purchaser of Nike goods, had agreed to sell Nike goods to the buyer. The buyer would then resell Nike goods at discounted prices. When Nike learned of the contract between the seller and the buyer, it terminated the seller's dealership rights. The court held that Nike's unexpected termination of the seller's rights constituted a contingency, the nonoccurrence of which was a basic assumption on which the contract between the seller and the buyer was made. Therefore, the occurrence of this contingency made the seller's performance impracticable.

The foregoing cases demonstrate that the defense of commercial impracticability may be available to a seller under a variety of circumstances. The key for the seller is to establish that the nonoccurrence of a problematic event was a basic assumption of the contract, and that the occurrence of the problematic event rendered performance commercially impracticable.

Decisions Rejecting a Defense of Commercial Impracticability

The following is a summary of representative cases in which the court held that the defense of commercial impracticability did not excuse a party's nonperformance.

Bernina Distrib, Inc v Bernina Sewing Machine Co

A cost increase due to currency fluctuations was held insufficient to invoke a commercial impracticability defense in *Bernina Distrib, Inc v Bernina Sewing Machine Co.*[11] That case concerned a contract between the defendant, an importer, and the plaintiff, a distributor of sewing machines. The importer purchased the machines from a Swiss manufacturer and paid in Swiss francs. The distributor then purchased the machines from the importer and paid in U.S. dollars. When the dollar was devalued as a result of currency fluctuations, making the machines more expensive for the distributor to purchase, the distributor attempted to invoke commercial impracticability as a defense. Notably, the importer had sent a letter to the distributor weeks before the contract execution, referencing a previous devaluation of the dollar in relation to the franc. The court held that the letter showed currency fluctuation was a foreseeable event, thereby foreclosing any claim of commercial impracticability.

Alamance County Bd of Educ v Bobby Murray Chevrolet, Inc

In *Alamance County Bd of Educ v Bobby Murray Chevrolet, Inc,*[12] the court held that the commercial impracticability defense did not excuse a dealership from its failure to supply a school board with bus chassis because there were alternative sources of supply from which the dealership could have purchased and sold the bus chassis. The dealership contracted to sell a specified number of bus chassis to a school board. The dealership intended to purchase the chassis from a single manufacturer, GM. Weeks after the contract was executed, GM informed the dealership that it would not accept any further chassis orders. The court held that, because the contract did not contain an agreed-upon manufacturer and no clause conditioned the dealership's performance on its ability to obtain bus chassis from a specific manufacturer, the dealership's performance was not excused.

Steel Industries, Inc v Interlink Metals and Chemicals, Inc

The reasoning of the *Alamance County* case was applied in *Steel Industries, Inc v Interlink Metals and Chemicals, Inc,*[13] which held that commercial impracticability was not a valid defense when a supplier of steel was faced with a shortage of supply from its current supplier. The supplier purchased steel from a Russian mill at a discounted price and sold the steel to the manufacturer. The supplier passed its discount down to the manufacturer by charging less than it would had it purchased steel from a U.S. mill. When the Russian mill experienced resource cost increases, it notified the supplier that it would no longer deliver at the reduced prices. The supplier contacted a number of Russian mills to ascertain whether they could deliver the steel, but never sought out any other sources. The court held that the supplier did not explore all reasonable means of fulfilling its contractual obligation and bore the risk of its chosen supplier's nonperformance.

Roth Steel Products v Sharon Steel Corp

The court also rejected a commercial impracticability defense in *Roth Steel Products v Sharon Steel Corp*[14] when the seller continued to accept an unprecedented volume of purchase orders even though it knew that raw materials were in short supply. The seller was an integrated steel producer that sold steel to the buyer at agreed-upon prices that were substantially lower than the seller's published prices. When federal price controls discouraged foreign producers from importing steel and conversely led domestic producers to export steel in an effort to avoid the price controls, substantial increases in the cost of steel resulted. The seller tried to withdraw its price concessions. The court held that the seller knew raw materials were in short supply and was therefore precluded from asserting the affirmative defense of commercial impracticability by accepting many more purchase orders than it was capable of fulfilling.

The preceding cases are representative situations in which the party to a contract that could not perform failed to escape liability with the defense of commercial impracticability. The defense is not easy to establish, nor should it be. The circumstances under which a nonperforming party should be allowed to escape culpability should be limited to truly extraordinary unforeseeable circumstances.

Fair and Reasonable Allocation Generally

Assuming that the event of commercial impracticability does not result in the complete inability of a party to supply, we turn to the issue of fair and reasonable allocation. The supplier will look to allocate its limited supply across its customer base. But what is "fair" and what is "reasonable"? UCC 2-615 is silent on the question. However, Comment 11 to Section 2-615, in part, provides:

> An excused seller must fulfill his contract to the extent which the supervening contingency permits, and if the situation is such that his customers are generally affected he must take account of all in supplying one....Customers at different stages of the manufacturing process may be fairly treated by including the seller's manufacturing requirements....However, good faith requires, when prices have advanced, that the seller exercise real care in making his allocations, and in case of doubt his contract customers should be favored and supplies prorated evenly among them regardless of price.

Allocation Schemes Deemed "Fair and Reasonable"

The following is a summary of representative cases in which the court held that a supplier's allocation scheme was "fair and reasonable."

Intermar, Inc v Atlantic Richfield Co

In *Intermar, Inc v Atlantic Richfield Co,*[15] the court held that a gasoline supplier's method of allocation was fair and reasonable. The defendant supplied gasoline to both service station dealers that leased their premises from the defendant ("lessee-dealers") as well as dealers that either owned their own premises or leased their premises from a third party ("independent dealers"). The defendant initiated a "control procedure" whereby it limited the gasoline that it would supply to its customers to a certain percentage of gasoline supplied to those customers during the comparable calendar month of the prior year. In the event that a recent customer lacked sales history for the comparable calendar month of the prior year, the defendant limited its supply of gasoline to that customer by that customer's estimated yearly consumption divided by 12. The plaintiff, an independent dealer that owned and operated a retail gasoline station in contract with the defendant, experienced a curtailment of its supply of gasoline from the defendant that caused it to eventually shorten its hours of operation and reduce its number of employees. At the same time, the defendant's lessee-dealers located in the same area as the plaintiff experienced no curtailment. Nonetheless, the court ruled that the control program was a fair and reasonable allocation of gasoline, finding there was no arbitrary or discriminatory conduct by the defendant.

Terry v Atlantic Richfield Co

A second case involving Atlantic Richfield is also instructive. In *Terry v Atlantic Richfield Co,*[16] the court affirmed the lower court's holding that a gasoline supplier's system of allocation was fair and reasonable. In that case, the plaintiffs were not satisfied with the allocation scheme the defendant selected in response to the gasoline shortage of 1973. The defendant distributed gasoline

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to its dealers in 1973 based on the dealers' monthly volume for the corresponding month in 1972. The allocation system provided for hardship adjustments, but the plaintiffs did not meet the criteria. All dealers, including contract dealers, lessee-dealers, and stations operated by defendant-owned subsidiaries, were treated alike. Unlike other stations, the plaintiffs exhausted their gasoline allotment in the first week of each month. The court held that the existence of an alternate scheme that may have benefited the plaintiffs did not require rejection of the adopted scheme. In accord with comment 11 to UCC 2-615, the court also held that allocating supply to both pre-existing contractual customers and regular customers not under contract did not make the allocation scheme unfair or unreasonable.

Cecil Corley Motor Co, Inc v General Motors Corp

The use of past sales figures as a basis for allocation was approved in *Cecil Corley Motor Co, Inc v General Motors Corp.*[17] The defendants' allocation system consisted of distribution of vehicles on the basis of past sales history, i.e., dealers receive a pro rata percentage of those units based on their past sales so that the more vehicles a dealer sells, the more units it will receive. This effectively divided production equally among dealers and was deemed to be fair and reasonable.

These cases demonstrate that in order to prevail on defense of a "fair and reasonable" allocation of goods, there must be a logical and credible plan for the allocation. A seller should therefore attempt to document that a plan was developed after much thought and deliberation. While the plan generally must be reasonable, there is no requirement that every party be treated equally.

Allocation Schemes Not Deemed "Fair and Reasonable"

The following is a summary of representative cases in which the court held that a supplier's allocation scheme was not fair and reasonable.

Roth Steel Products v Sharon Steel Corp

The court disapproved of advantageous self-dealing in a supplier's method of allocation in *Roth Steel Products v Sharon Steel Corp.*[18] The parties in that case entered into a fixed-price contract for steel products pursuant to which the defendant was to supply steel to the plaintiff in varying monthly quantities. In early 1973, however, several factors influenced the steel market that diminished the defendant's ability to supply steel products as required under the contract. The plaintiff sued the defendant for damages for breach of contract and the defendant asserted the defense of commercial impracticability. In addressing the defendant's allocation scheme, the court focused on the defendant's establishment of a wholly-owned subsidiary to which the defendant had diverted steel while curtailing shipments to the plaintiff. Most importantly, the court noted that the subsidiary was neither under contract nor a regular customer of the defendant at the time the allocation system was established. The court concluded that the defendant's plan failed to allocate its production and deliveries in a fair and reasonable manner.

Chemetron Corp v McLouth Steel Corp

Such self-dealing was also rejected in *Chemetron Corp v McLouth Steel Corp.*[19] In *Chemetron,* a supplier of liquid oxygen

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and liquid nitrogen could not fully meet the needs of its customers and implemented an allocation scheme. In addition to supplying liquid product to the plaintiff, the defendant supplied liquid product to its own steel mill. The court held that the allocation scheme was not fair and reasonable, noting that the defendant supplied the plaintiff with only one-third of the plaintiff's needs while there was no evidence that the defendant supplied its steel mill with anything less than 100 percent of its requirements.

Haley v Van Lierop

The court applied the same principle prohibiting unfair self-dealing in *Haley v Van Lierop.*[20] In *Haley,* a supplier of gladiolus bulbs could not meet the plaintiff's requirements because of an unforeseen crop shortage. The defendant proceeded to allocate bulbs to its customers on a pro rata basis. One of the customers to which bulbs were allocated was a partnership in which the defendant was one of the two sole members; another customer to which bulbs were allocated was an employee of the defendant who worked for a salary and returned all profits to the defendant. The court ruled that these two customers could not be included in the calculation of gladiolus bulb allocation on a pro rata basis. The court concluded that since the defendant was self-dealing for the purpose of realizing a profit, such prorating was therefore inequitable.

Cosden Oil & Chemical Co v Karl O. Helm Aktiengesellschaft

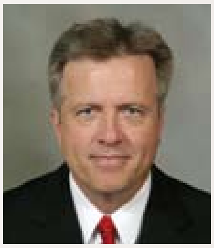
An allocation scheme that resulted in a complete cessation of shipments to a disfavored buyer was rejected in *Cosden Oil & Chemical Co v Karl O. Helm Aktiengesellschaft.*[21] The court affirmed the jury's finding that, while a shortage of polystyrene products caused by plant shutdowns was a sufficient basis for a commercial impracticability defense, the seller's method of allocation was not fair and reasonable because the seller simply stopped supplying the product to the buyer altogether. The record showed that the seller supplied polystyrene to other customers during the period in dispute and, despite the difficulties that the seller was experiencing, it had inventory and production capability with which it could have provided the buyer with an allocation of polystyrene. Under these circumstances, the seller could not successfully invoke a commercial impracticability defense.

In re F. Yeager Bridge & Culvert Co

The court rejected an allocation scheme as unreasonable in *In re F. Yeager Bridge & Culvert Co.*[22] The supplier asserted a commercial impracticability defense premised on certain steel price controls that had been implemented by the government. The supplier also contended that its failure to supply the contracted-for quantities of steel was excused because it subsequently entered into "reformed" contracts with the buyers for lesser quantities of steel. The buyer disputed the supplier's claim and sued for damages as a result of the supplier's failure to supply the contracted-for steel. The court held that because the "reformed" contracts were not formed until after the supplier had already surpassed its steel quota, the seller had acted unreasonably.

Conclusion

UCC 2-615 presents an opportunity for a breaching party to excuse its nonperformance. While the bar is high, in appropriate circumstances commercial impracticability is a defense that can and should be raised by a seller that experiences an unforeseen shortage. In the event that a shortage leads to an allocation scenario, the seller's allocation must be "fair and reasonable" but need not always treat all buyers equally. Self-dealing likely will not be allowed. A scheme that attempts to "fairly and reasonably" deal with a difficult circumstance should be permitted. ■



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FOOTNOTES

1. See, e.g., Trentacosta, Michigan Contract Law (ICLE).
2. MCL 440.2615 (section 2-615 of the UCC has been adopted by Michigan in its entirety).
3. 1 White & Summers, Uniform Commercial Code, §3-10 (5th ed).
4. *Iowa Electric Light & Power Co v Atlas Corp,* 467 F Supp 129 (ND Iowa, 1978).
5. MCL 440.2615(a).
6. *Selland Pontiac-GMC, Inc v King,* 384 NW2d 490 (Minn App, 1986).
7. *Asphalt International, Inc v Enterprise Shipping Corp, S.A.,* 667 F2d 261 (CA 2, 1981).
8. *Aluminum Company of America v Essex Group Inc,* 499 F Supp 53 (WD Pa, 1980).
9. *Mishara Construction Company, Inc v Transit-Mixed Corp,* 310 NE2d 363 (Mass, 1974).
10. *Federal Pants, Inc v Stocking,* 762 F2d 561 (CA 7, 1985).
11. *Bernina Distrib, Inc v Bernina Sewing Machine Co,* 646 F2d 434 (CA 10, 1981).
12. *Alamance County Bd of Educ v Bobby Murray Chevrolet, Inc,* 465 SE2d 306 (NC App, 1996).
13. *Steel Industries, Inc v Interlink Metals and Chemicals, Inc,* 969 F Supp 1046 (ED Mich, 1997).
14. *Roth Steel Products v Sharon Steel Corp,* 705 F2d 134 (CA 6, 1983).
15. *Intermar, Inc v Atlantic Richfield Co,* 364 F Supp 82 (ED Pa, 1973).
16. *Terry v Atlantic Richfield Co,* 72 Cal App 3d 962; 140 Cal Rptr 510 (1977).
17. *Cecil Corley Motor Co, Inc v General Motors Corp,* 380 F Supp 819 (MD Tenn, 1974) (decided under Michigan law).
18. *Roth Steel Products v Sharon Steel Corp,* 705 F2d 134 (CA 6, 1983)
19. *Chemetron Corp v McLouth Steel Corp,* 381 F Supp 245 (ND Ill, 1974).
20. *Haley v Van Lierop,* 64 F Supp 114 (WD Mich, 1945).
21. *Cosden Oil & Chemical Co v Karl O. Helm Aktiengesellschaft,* 736 F2d 1064 (CA 5, 1984).
22. *In re F. Yeager Bridge & Culvert Co,* 150 Mich App 386; 389 NW2d 99 (1986).