Best Practices for Drafting Supply Chain Contracts

By John R. Trentacosta and Nicholas J. Ellis

The supply chain in the automotive and manufacturing industries is fraught with risk. Parties to a supply chain contract can mitigate their risk by following certain best practices. While no provision in a contract should be overlooked, the five areas discussed in this article are the most important for risk management strategies. For some of these issues, the buyer and seller may be in agreement. If so, the most important factor is to ensure that the written agreement is consistent with the parties' intentions. In other areas, the interests of the buyer and seller are diametrically opposed. These areas typically are the source of heated negotiation.

Critical commercial terms

The first step in drafting any supply chain contract is to ensure that the written document captures all critical commercial terms of the parties' agreement. For example, what exactly is being supplied? When and where must it be delivered? At what price? What are the warranties?

Two common issues can arise with respect to the inclusion of critical commercial terms. First, there may be circumstances in which the parties have agreed on a commercial term but failed to properly document their agreement. Failure to clearly and concisely document the commercial terms of an agreement is an invitation for future misunderstandings and disputes. Parol evidence will be required to discern the parties' intent.

The second common scenario is that the parties simply failed to discuss or never reached agreement regarding a particular term. This leads to even more uncertainty in the dispute process. Failure to agree on a particular term (with the exception of quantity) is not automatically fatal to a contract. In the absence of an express agreement between the parties on a particular term in cases involving the sale of goods, the Uniform Commercial Code (UCC) permits courts to "fill in the gaps" by reference to default rules and sources such as the prior course of dealing between the parties and usage in the trade.[1] The law even permits courts to supply a price term in cases where the parties never reached agreement on a final price.[2] However, if the lack of agreement between the parties on commercial terms is sufficiently pronounced, a court may find that there never was a meeting of the minds between the parties to form any contract at all.[3]

Quantity

Although sometimes overlooked (for example, in "blanket purchase orders"), the most critical term in any contract for the sale of goods is the quantity term. It defines both the volume that the buyer is committing to purchase and the volume that the seller is committing to supply. To achieve a binding contract for the sale of goods, it is essential that the parties negotiate and document the quantity of goods to be purchased.

A written quantity term is the only term that must appear in a contract for the sale of goods.[4] Absent a written quantity term, any contract for the sale of goods over $1,000 is unenforceable under the statute of frauds provisions of the UCC.[5] A written quantity term need not be expressly set forth as a number. It is sufficient that there is a writing, signed by the parties, from which a quantity can be determined, even if doing so requires reference to evidence outside of the document. For example, a quantity term may be expressed as the requirements of the buyer or the output of the seller.[6]

Duration and early termination

When parties are negotiating a supply chain agreement that they intend to apply on an ongoing basis, the parties must agree on the duration. Absent an agreed duration, a contract may be terminated by either party

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upon reasonable notice.[7] In industries where securing an alternative source of supply is an expensive and time-consuming process—most notably the automotive industry—the ability of a supplier to opt out of a contract by giving reasonable notice creates a significant risk for the buyer. Similarly, a seller who may be making a significant investment of capital and resources to supply a product will want to make every effort to lock in a long-term commitment from the buyer.

Related to the issue of duration, parties must consider the impact of provisions that provide a right of early termination. An early termination provision can have significant financial consequences for both the buyer and seller. A party that thinks it is locking its customer or supplier into a long-term agreement will risk losing the benefits of that agreement if it does not pay close attention to early termination provisions. If the contract includes early termination provisions, the parties should consider addressing in the contract the financial consequences of an early termination. For example, sellers should negotiate for the right to recover unamortized capital expenditures incurred in connection with the agreement. The primary concern for buyers regarding an early termination provision is whether it provides the buyer with sufficient notice to obtain an alternative source of supply. Before agreeing to a contract that allows for early termination, both buyers and sellers must carefully consider the impact on their business if the provision is exercised.

Warranties and disclaimers

Warranties are the promises a seller makes regarding goods or services being provided to the buyer. Supply chain contracts typically include express warranties. In addition to these express warranties, the UCC may supply a number of implied warranties that will be considered part of the contract unless they are disclaimed. The most well-known examples of implied warranties are the implied warranty of fitness for a particular purpose and the implied warranty of merchantability under the UCC.[8] However, depending on the subject matter of the contract and the governing law, other implied warranties also may apply.

When negotiating a supply chain contract, buyers should seek to obtain the broadest warranties possible. On the other hand, sellers should strive to limit the warranties they give. When possible, sellers also should seek to disclaim any implied warranties under the UCC. Any such disclaimer must be conspicuous. A disclaimer buried in the proverbial fine print runs the risk of being held unenforceable.[9]

Limitation of remedies and damages

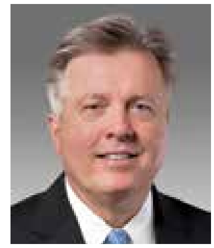
Both buyers and sellers should pay close attention to any limitation on remedies or damages contained within the agreement. Although limitations of damages and limitations of remedies share a common goal—shifting of risk—they are different concepts.

A limitation of remedy is a tool, most often used by sellers, to reduce the remedies that a buyer may be entitled to in the event of a breach.[10] The most common example is a provision limiting the buyer's rights to "repair or replacement" of any defective goods. A seller that wants to include such a provision in its contracts should take steps to ensure that it is, in fact, willing and able to stand by its offered remedy. If the remedy is found to have "failed of its essential purpose," it will be deemed unenforceable.[11]

In contrast, a limitation of damages seeks to mitigate risk either by capping the damages that may be awarded for a breach or by eliminating certain categories of damages altogether.[12] Buyers and sellers must carefully consider the risk-shifting implications of limitations of remedies and damages.

Conclusion

Manufacturers can mitigate risk by following best practices when drafting their supply chain contracts. The five areas discussed here are not the only important provisions of a supply agreement, but they are the most critical for risk management. These areas should be the focus of any company seeking to manage risks in its supply chain and to enhance the operational efficiency and value of its supply chain.[13] ■



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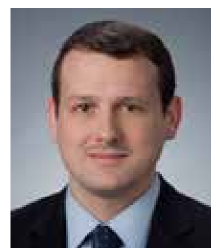

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ENDNOTES

1. MCL 440.1303.
2. MCL 440.2305(1); *SC Gray, Inc v Ford Motor Co*, 92 Mich App 789, 801; 286 NW2d 34 (1979).
3. *Reed v Vander Zalm*, 336 Mich 1; 57 NW2d 304 (1953).
4. *Trost v Trost*, 525 Fed Appx 335, 345 (CA 6, 2013).
5. MCL 440.2201(1).
6. MCL 440.2306.
7. MCL 440.2309(2); Trentacosta & Kashcheyeva, *Risks and Strategies with Contracts of Indefinite Duration*, 32 Mich Bus Law J 13 (Fall 2012).
8. MCL 440.2314 and 440.2315.
9. *Allen v Chrysler Group LLC*, unpublished opinion per curiam of the Court of Appeals, issued March 23, 2010 (Docket No 284687), pp 23–24.
10. MCL 440.2719(1)(a).
11. *Kelynack v Yamaha Motor Corp*, USA, 152 Mich App 105, 111; 394 NW2d 17 (1986).
12. MCL 440.2718.
13. For a more detailed discussion of these topics, see Trentacosta, Michigan Contract Law (2d ed).