

Negotiating Requirements Contracts With Suppliers

Assigning Contractual Risks, Navigating Differing Court Interpretations of UCC Section 2-306

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NEGOTIATING REQUIREMENTS CONTRACTS

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PRESENTATION OVERVIEW

- When to consider entering into a requirements contract
- Best practices for drafting
- Avoiding common mistakes
- Most critical “red flag” provisions
- Warranty and recall
- Monitoring and compliance
- Common breakdowns & disputes

IS A REQUIREMENTS COMMITMENT THE BEST TOOL?

Requirements commitments are often used when one or both parties don't want to determine or commit to specific volumes, but mutual commitment is critical.

Consider using when:

- Volume is uncertain, but you want to incent favorable pricing, capacity or other terms
- Volume might decrease or increase rapidly
- Product might be discontinued
- You are receiving a meaningful benefit in exchange for the commitment

IS A REQUIREMENTS COMMITMENT THE BEST TOOL?

Requirements contracts should not be used if the purchaser:

- Is not confident of Supplier's ability to produce to its quantities and on its timetable
- Is uncertain that Supplier has adequate capacity for expanded production
- Does not have an adequate crisis plan and/or alternate source of supply
- Is already making a volume commitment

IS A REQUIREMENTS COMMITMENT THE BEST TOOL?

A requirements commitment is a significant obligation.

Ask yourself:

“Do I have everything I need?”

“Did I get a benefit that is worth committing all of my requirements to one supplier?”

IS A REQUIREMENTS COMMITMENT THE BEST TOOL?

Setting Yourself Up for Success & Avoiding Common Mistakes

Many common disputes and liabilities can be avoided if you carefully consider:

- The definition of “Product” and the use of incorporated specifications
- Price
- Capacity
- Exceptions/Out Clauses
- Formulaic Damages & Penalties
- Force Majeure

DRAFTING A SUCCESSFUL CONTRACT

The definition of “Product” determines which items are subject to the requirements obligation

- The purchaser should define the Product as narrowly as possible
- Carefully consider how specifications are linked to the “Product” definition
- What is a revised specification vs. a new product?
- Do you have enough flexibility to innovate and/or pivot?
- Does your contract impact other business units in your organization? Have you tailored the contract to apply only to your market, channel or customer type?

DRAFTING A SUCCESSFUL CONTRACT

Pricing Considerations

- Never enter into a requirements contract without clear pricing
- If fixed pricing is not possible or desirable, you should establish a pricing formula that yields predictable and unambiguous results
- If the pricing formula presents the potential for any ambiguity, establish an upper limit at which you may exit the contract
- Address how price may change in response to a revision of product specification
 - Best practice: changes only permitted for actual and documented increase in supplier's costs

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Capacity & Obligation to Supply

- **Capacity.** Supplier should commit that it has *and will maintain sufficient capacity* to meet existing and forecasted demand through the term of the agreement
- **Obligation to Supply.** Supplier should commit that it will fill all POs by the specified delivery date subject to standard lead times
- **Exception provisions are not adequate.** Many contracts permit a purchaser to break the requirements obligation if a supplier fails to supply or has inadequate capacity – this is not enough unless the product at issue is readily available on short notice from other suppliers

DRAFTING A SUCCESSFUL CONTRACT

Exceptions & Out Clauses

- Inability to supply and/or to supply on the required timeline
- Inability to meet expanded capacity
- Unacceptable price advances
- Improved pricing, innovation or product quality opportunities that arise in the marketplace
 - Usually only accepted when supplier has right to receive notice and submit competing bid
- Innovation & product discontinuation or phaseout
 - While these often appear as exceptions, they are best handled with proper product definitions and language addressing the lack of numeric volume commitments
- Other material breach

** Exceptions do not replace the importance of properly defining the “Product” and the scope of the requirements obligation.*

DRAFTING A SUCCESSFUL CONTRACT

Formulaic Damages & Penalties –

beyond liquidated damages

- Formulaic penalties or upcharges sometimes offer the parties a path to continue the relationship under changed circumstances without terminating the entire contract or engaging in a dispute
- Pre-negotiated penalties, upcharges, or capital repayments can help maintain relationships (and continued supply) in the event of product discontinuation, unanticipated volume declines, or product innovation favoring another supplier

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Force Majeure

- “Any condition or event out of the supplier’s reasonable control” is too broad.
- Increasingly invoked to: (i) avoid events leading to higher supplier costs; or (ii) shift the burden for Supplier’s poor planning
- Purchasers should consider excluding:
 - Labor disruptions or shortages
 - Transportation interruptions or shortages
 - Unanticipated changes in trade rates, laws or policies
 - Shortages in inputs that could have been avoided through supply chain diversification
 - Higher ingredient, parts or input costs
 - Any event or disruption that could be avoided by making a higher payment

DRAFTING A SUCCESSFUL CONTRACT

Common Mistakes to Avoid

- Unreasonable duration (longer terms = more conflict)
- Pricing determined with reference to markets or cost fluctuations
 - unless you have a clause imposing a ceiling or triggering an exit right
- Pricing adjustments per the “mutual agreement and good faith negotiations”
- Any other aspect of pricing that is ambiguous or unpredictable
- Requirements commitment without capacity and obligation to supply
- Poorly defined “Product”
- Broad force majeure
- Terms that are not reasonably sustainable for *both* parties

MOST CRITICAL “RED FLAG” PROVISIONS

- Intellectual Property
- Warranty & Indemnification
- Limitation of Remedies
- Limitation of Damages
- Duration, Termination & other “outs”

MOST CRITICAL “RED FLAG” PROVISIONS

Intellectual Property

- Buyer’s T&Cs – include “irrevocable” “worldwide” and “non-exclusive” license
- Ensure you take affirmative steps to protect your IP
- Consider Non-Disclosure Agreement
- Consider License Agreement
- Restrict access to your intellectual property and secure with confidential designations

MOST CRITICAL “RED FLAG” PROVISIONS

Warranty and Recall

Suppliers generally accept unlimited liability

- Warranty will always be a tension point
 - Costs have increased
 - Complexity of components and systems
 - Software defects increasing
 - Global platforms and volumes
 - Higher expectations by OEMs and focus by NHTSA on safety and reliability
- In 2018 – there were 341 Light Vehicle Recalls– most ever recorded in the U.S.
 - *Source: Stout Risius Ross 2019 Automotive Defect & Recall Report*
- OEMs aggressively recovering warranty and recall costs

MOST CRITICAL “RED FLAG” PROVISIONS

Warranty & Indemnity

- Express Warranties
 - Quality; durability; performance; workmanship; comply with specifications, drawings, standards
- Implied Warranties
 - Most OEM and Tier 1 T&Cs turn implied warranties into express
- Fitness for particular purpose (UCC 2-315)
- Merchantability (UCC 2-314)
 - UCC 2-313 (all technical specifications, materials standards and certifications, drawings, reports, PPAP, are in play during litigation)

MOST CRITICAL “RED FLAG” PROVISIONS

Warranty & Indemnity

- Ensure indemnity provisions are:
 - Fault based
 - Actual defect vs. allegation of defect
 - If you are the seller – ensure the buyer must prove nonconformity and causation
 - Define categories of costs supplier will be liable to pay
- Draft objective express warranties tied to specifications and agreed performance criteria
- Limit warranties in time and scope
- Conspicuously disclaim any implied warranties under the UCC 2-316

MOST CRITICAL “RED FLAG” PROVISIONS

Limitation of Remedies (UCC 2-719)

- Limitation of Remedies (UCC 2-719)
 - Unpaid and accepted parts
 - Undelivered finished parts (per release schedule)
 - Documented work-in-process
 - Agreed raw material costs
 - All subject to audit rights of Buyer (records, facilities, WIP at your facility and your supplier’s facility)
- Typical express exclusions
 - Claims exceeding authorized releases fab auth, or aggregate contract price
 - CapEx, depreciation, allocation of fixed costs, raw materials price increases
 - program volume decreases (or increases)
 - currency fluctuation, changes to specification

MOST CRITICAL “RED FLAG” PROVISIONS

Limitation of Damages (UCC 2-719)

- Consequential damages
- Indirect damages
- Repair and replacement of non-conforming goods
- Limitation on categories of damages to mitigate risk by one or both parties
 - Define specific categories
 - Common damages disclaimers inserted by buyers: loss of anticipated profits, loss of business, loss of goodwill, loss of reputation
- (Seller) Consider damages caps tied to annual sales, aggregate volume, contract price.
- (Seller) Limit buyer’s categories of damage and remedies

MOST CRITICAL “RED FLAG” PROVISIONS

Duration

- Make sure your contracts are aligned
- Does the LTA have a termination date?
- Life of the Program
- Indefinite duration?
- Commercially reasonable notice
- Suppliers typically have practical leverage at or near the program's end

MOST CRITICAL “RED FLAG” PROVISIONS

Termination

- Termination for Convenience?
- Generally enforceable if exercised in “good faith.”
- Most OEM & Tier 1 Suppliers T&C’s contain a standard termination for convenience clause.
- Early Termination Provisions
 - Commercially reasonable notice
 - Suppliers typically have practical leverage at or near the program’s end
- Limit other contract “outs”
- Force Majeure = “superior force”
 - Must be unable to perform
 - Double or triple the expense does not excuse performance
 - Tariffs; government actions

MOST CRITICAL “RED FLAG” PROVISIONS

Manage Termination Risks

- Ensure your negotiated LTA amends the buyer’s T&Cs to allow only for termination for cause.
- Ensure most-favored customer/competitiveness provisions are based on objective criteria and not solely in the opinion of Buyer
 - E.g. same volumes, same region/country of origin, same finishing/technical processes and specifications
 - Request all supporting documentation and opportunity to review/audit sample
- Manage termination risk on the front end
 - Agreement on CapEx & R&D, development costs
 - Amortization strategy for supplier owned tooling
 - Ensure sufficient material and component part authorizations

MONITORING COMPLIANCE

- Relationship mistakes
- Attorney-client privilege mistakes
- Waiver
- Claim management

MONITORING COMPLIANCE

Relationship Mistakes

- Lack of due diligence
- Failure to verify financial history, litigation filings, references
- Different entity than entity that will actually perform, has assets, etc.
- Foreign entity with jurisdictional issues

MONITORING COMPLIANCE

Attorney-Client Privilege Mistakes

- Failure to properly invoke attorney-client privilege during commercial disputes, warranty, quality, or recall issues
- Failure to involve in-house or outside counsel early in dispute
- Forwarding attorney-client privileged advice to your customer or supplier

MONITORING COMPLIANCE

Waiver & Modification

- Failing to respond to customer communications
- Failing to enforce contractual provisions
- Failure to provide timely notice of breach (*American Bumper & Mfg. Co. v. Transtechnology Corp.*, 252 Mich. App. 340 (2002)).
- Creating a course of dealing inconsistent with contract terms or rights

MONITORING COMPLIANCE

Waiver & Modification cont'd

- Generally you can contract by email
- Courts can find a waiver or modification even if the contract expressly prohibits such modification.
- Make sure you know you are doing it and do not do it if you can avoid it.
- MCL 450.831
- Federal E-Sign Legislation 15 USC 7001

COMMON BREAKDOWNS & DISPUTES

- Common claim management issues
- Dealing with alleged breaches
- Termination mistakes
- Stated estimated quantities or forecasts?
- Minimum and maximum quantities
- UCC gap-filling provisions

COMMON BREAKDOWNS & DISPUTES

Claim Management

- Failure to understand the contract and contract rights
- Failure to monitor performance metrics or respond to issues in a timely manner
- Failure to designate an internal owner to maintain all key commercial documents and communications, including a complete execution version with all attachments, documents incorporated by reference, and amendments
- Failure to print or maintain a copy of then-applicable terms and conditions (yours and your customer's)
- Failure to follow dispute resolution, notice, termination or forum provisions in the contract

COMMON BREAKDOWNS & DISPUTES

Dealing with Alleged Breaches

Commonly Litigated Issues

- Competing purchasing documents (LTA; scheduling agreement, inventory agreement, PO T&Cs, etc).
- Incorporation by reference (what is in and what is out)
- Termination due to breach
- Claims of failures to act in “good faith”
- Who pays tariffs and other pricing disputes

COMMON BREAKDOWNS & DISPUTES

Termination Mistakes

Termination can lead to:

- Supply-chain interruptions and hold ups
- Price increases
- Tooling disputes
- Litigation
- Consider Exit Agreement
 - Negotiate terms for wind-down of your supplier
 - Obtain a waiver of claims
 - Ensure your tools are not held hostage
 - Consider stay bonus to ensure continuity of supply
 - File your UCC financing statements for all tooling and inventory

COMMON BREAKDOWNS & DISPUTES

Minimum and Maximum Quantities

- Requirements Contract (UCC 2-306)
 - Quantity of output = actual requirements that occur in good faith
 - Some courts hold that exclusivity is not required
 - You bear the risk of volume fluctuations as the supplier!
- What about volume estimates or forecasts?
 - Most OEM and tier one T&Cs will state that any quantities are non-binding forecasts and buyer only agrees to purchase buyer (or buyer's customer's) actual requirements.
 - (Seller) document RFQs, quotes, and insert forecasts into LTA
 - Tie forecasts to pricing and/other givebacks
- Integration clause?

COMMON BREAKDOWNS & DISPUTES

Minimum and Maximum Quantities

- Usually best to avoid
- Specific quantities should be used in the context of a non-binding forecast
- Capacity commitments are still appropriate in the absence of volume commitments on minimum and maximums
- In some circumstances, tiers, penalties or up-charges are appropriate for significant swings in volume

COMMON BREAKDOWNS & DISPUTES

Forecasting

- “Non-binding” and for “planning purposes only”
- Build these concepts into your process, the people providing the forecast are not reading your contract
- Be as accurate as possible. Non-binding forecasts can still lead to disruption and potential liability
 - Inventory
 - Capital investment
 - Inability to produce on time
 - Plant downtime
- Provide notice of volume changes as soon as possible

COMMON BREAKDOWNS & DISPUTES

UCC Gap Filling Provisions

The only term the UCC requires is a “quantity”

- No price (UCC 2-305)
- No specified place of delivery (UCC 2-308)
- No specified time for performance (UCC 2-309)
- Quantity defined as output or requirements (UCC 2-306)
- Notice of Termination (UCC 2-309) = Reasonable time
 - If you are a downstream supplier, tie to OEM notice provisions.
- Modification, Rescission, Waiver (UCC 2-209)
- Adequate assurances of performance (UCC 2-609)



QUESTIONS/COMMENTS?

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