The Michigan Business Law JOURNAL

Volume XXVI
Issue 2
Summer 2006

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Published by THE BUSINESS LAW SECTION, State Bar of Michigan

Contractual Supply Disputes in the Automotive Industry: Lessons Learned

By Thomas S. Bishoff, Benjamin W. Jeffers, and Laura C. Baucus

Introduction

This is a familiar scenario for attorneys representing players in the automotive industry: You receive an urgent phone call from your client, an automotive supplier whose customers are Tier 1s and Original Equipment Manufacturers (OEMs),[1] explaining that its own supplier is threatening to stop shipments of a key component part within two days unless your client agrees to pay a steel surcharge on top of the existing contract price. An interruption in supply would be devastating: the supplier is the sole source for the part, and in this just-in-time industry your client only keeps a couple of days' worth of inventory on hand. Such an interruption could shut down your client's manufacturing process and possibly its customers' operations as well. Your client believes that the price in the agreement is fixed, with no legal justification for a demand to raise it. The supplier, meanwhile, has stated that dramatic increases in the cost of steel have left it with no choice but to demand a price increase. While it is willing to absorb some of the raw-material cost impact, the supplier would lose money on every part it sells unless it passes along the rest. The supplier justifies its demands under several legal theories, including section 2-615 of the Uniform Commercial Code (UCC), MCL 440.2615, which deals with commercial impracticability. The supplier adds that the documents comprising the parties' contract are sufficiently unclear that they insulate the supplier from claims that its demand constitutes a breach.

In an industry in which long-term supply relationships are the norm, such supply disputes have become common. Adverse market conditions have created an environment in which suppliers are willing to breach contracts and threaten interruptions in shipments unless buyers accede to their demands. Buyers in turn are faced with what a judge in a recent opinion aptly described as a "Hobson's choice" — to accept the price increase or face the prospect of a devastating cessation in shipment.[2] This article will describe eight lessons learned from such disputes and provide tips for lawyers on how to guide clients through them.

Lesson 1: Sellers have significant practical leverage, even when they may have a weaker legal position.

Buyers typically hold the bargaining power at the onset of a contractual relationship, and they will use that power to force sellers to accept their standard contract terms and conditions. Such terms often require sellers to supply the particular part through a set termination date or for the life of the part or the "program."[3] Part prices are fixed, and suppliers are not permitted to unilaterally adjust them for any reason, including an increase in production costs. However, although buyers appear to be legally in control, in reality the sellers enjoy a great deal of leverage when it comes to negotiating supply disputes in the automotive industry. There are at least two reasons for this.

First, the stakes are extremely high. Because of the sole-source supply and just-in-time delivery systems used in the automotive industry, a seller's threat to stop shipments leaves a buyer with few options. Comparable parts generally are not available on the open market, and it can take months or even years to validate a new seller's production of the same or similar parts through the industry standard Production Part Approval Process (PPAP). Acceding to the seller's demands may be the only viable way to prevent a costly business disruption and ensure a safe source of supply. Sellers know that buyers are stuck in a difficult position.

The second reason that buyers lack leverage is that time is of the essence when a seller threatens to stop shipments, and obtaining an immediate court order compelling continued performance is not always easy. Buyers must file a lawsuit and seek injunctive relief, first in the form of a temporary restraining order (TRO) and then through a preliminary

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injunction.[4] The burden on the moving party is high, particularly when it seeks so-called "mandatory" injunctive relief.[5] The moving party must demonstrate, among other things, that it will suffer irreparable harm if the court does not grant the injunctive relief and that it has a substantial likelihood of prevailing on the merits.[6]

The ability to demonstrate irreparable harm, i.e., harm that cannot be remedied by money damages, at first seems obvious. The buyer can argue that unless the court issues an injunction and orders the seller to continue shipping goods, the buyer and its customers will have to shut down their plants, causing massive and incalculable damage. Several Michigan courts have recognized the potential harm to buyers that can result from a sole-source, just-in-time seller not shipping parts,[7] and they have granted preliminary injunctions.[8]

Not all courts, however, agree that irreparable harm exists. Buyers may have the ability to pay the increased price demands "under protest,"[9] only to later sue the seller to recoup the difference between the contract price and the new price. Having the practical ability to maintain its source of supply means that a buyer can prevent the very harm that it otherwise claims would be irreparable.

This argument convinced the court in *ThyssenKrupp Fabco Corp v Heidtman Steel Products, Inc.*[10] to deny a request for a preliminary injunction. Because the buyer had "not shown that it was unable to presently bear the cost requested" by the seller, and because the seller was willing to ship at the higher prices, the court found that the threatened harm might not come to pass. The buyer argued that without a preliminary injunction it would be forced to "finance all of its suppliers who demand prices above what their contracts specify." The court was unmoved, however, finding that this was not, in fact, the situation and that this "parade of horribles" had not occurred.[11]

In short, buyers face uncertainty when developing a legal strategy, because obtaining an injunction is not guaranteed. This very lack of certainty when the buyer needs it most may dissuade some buyers from pursuing their short-run legal options.

Lesson 2: Paying the demanded price increases under protest and suing later to recoup the money can be effective if buyers are patient and pick their battles.

Paying the seller's demanded price increase under protest may be the only way to ensure continued supply in the short term. A recent decision confirms that buyers can, in fact, get their money back if they pursue this strategy. In *Chainworks, Inc v Webco Industries,*[12] defendant was a supplier of steel tubing. Despite the existence of a fixed-price supply agreement, defendant demanded steel surcharges from plaintiff due to the dramatic rise in the cost of raw materials. Plaintiff acceded to the demands but expressly stated that it was doing so "under duress and reserv[ing] all rights and remedies."[13] Near the expiration of the parties' contract, plaintiff withheld from its final payment the difference between the prices it had paid under protest and the prices stated in the contract. Plaintiff then filed a declaratory judgment action seeking an order confirming that its behavior had been appropriate. Defendant filed a counterclaim, asserting that it was justified in seeking the price increase and that plaintiff had legally "agreed" to the new prices. Defendant relied on MCL 440.2207 (battle of forms) and 440.2615 (commercial impracticability).

The court disagreed with each of defendant's arguments and granted plaintiff summary judgment on its claims and defendant's counterclaim. The court found that the contract contained fixed prices, that the mere demand for price increases constituted a breach of the contract, and that plaintiff's payment under protest did not amount to an "acceptance" of the new terms.[14] Following a long line of Michigan and federal cases, the court also rejected defendant's argument that financial concerns constituted sufficient grounds to rely on the defense of commercial impracticability.[15] Noting that a "deal is a deal" and that defendant had breached it, the court wholly endorsed plaintiff's legal position. The *Chainworks* case, therefore, provides a road map for buyers who have little choice but to pay price increases under protest and who do not wish to give up their legal rights to recover the money at a later time.

Lesson 3: Buyers should shape the facts early in a pricing dispute.

There are several pre-litigation steps that can make a significant difference in a pricing dispute. Once a seller has threatened to stop shipments, buyers should send a letter seeking adequate assurances that the seller will perform. The letter should explain that the buyer considers the mere demand to increase prices and the threat to stop shipments to be a breach of the parties' contract, and it should solicit the seller's rationale for its position. The letter should also note that the buyer has no other source of supply, and that the seller's threatened actions would cause extraordinary consequences, including irreparable harm both to the buyer and its customers.

Such a letter is important for two reasons. First and foremost, seeking assurance may effectively be a prerequisite to suing for anticipatory repudiation under UCC 2-609.[16] If the buyer eventually needs to seek a TRO, then it likely will do so before the seller actually stops shipments and, depending on the circumstances, bringing a claim for anticipatory repudiation may make more sense than a breach of contract claim. Second, it is likely that the buyer's letter will provoke a written response. Regardless of what justification the seller may give for its position, if the seller simply acknowledges in writing that it has threatened to stop shipments, it will have provided the buyer with a valuable piece of evidence for when it goes to court.

Lesson 4: Buyer's counsel should be prepared to act quickly.

As the lawyer for the buyer facing the shutdown, time is of the essence when you receive the phone call from your client. If the seller is serious about its threats, your client may need to seek a TRO in a matter of hours or days. To be prepared to do this quickly, attorneys should keep on file a list of questions they can e-mail their clients as soon as they learn that a supplier dispute is brewing. Thus the lawyer can quickly identify or obtain the following:

- the documents that make up the contract, e.g., purchase orders, nomination contracts, letters of intent, invoices, releases, and terms and conditions;
- a description of the parts at issue and how they are used by the client's customers, including any facilities that will be affected if there is a cessation of shipments;
- the number of days' worth of inventory the client has of the parts at issue;
- confirmation that the parts are delivered on a just-in-time basis, that the supplier is a sole-source supplier, and that the parts are unique;
- the length of time it would take to get a new supplier to make the same parts, i.e., the PPAP time for the parts at issue;
- all communications between the parties concerning the dispute;
- the name of the individual (usually the purchasing manager) who has sufficient contract knowledge to sign an affidavit and verify a complaint.

At a minimum, being able and willing to go to court immediately will give the buyer some measure of leverage in negotiating a resolution to the supply dispute with the seller.

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Lesson 5: Insist on clarity in the contractual terms to avoid disputes in the first place.

Sometimes, both parties to an automotive industry contract will sign a detailed written supply agreement that contains unambiguous terms. More often in this industry, however, the contract will consist of multiple documents that are exchanged over a period of time and that are not signed by anyone. Unfortunately, ambiguity in the contract documents can be fatal to a short-term litigation strategy, because clarity usually favors the party that wants to enforce a contract in court, particularly where the moving party seeks a TRO and a preliminary injunction. While a "battle of forms" theoretically can be litigated successfully over the course of a lawsuit about damages, such a dispute will usually lessen one's chances of proving that the moving party has a substantial likelihood of prevailing on the merits and will thus weaken the ability to obtain injunctive relief in the short run. The lesson here is right out of Contracts 101: To reduce the likelihood of a dispute during the course of performance, the parties must in the beginning clearly state their intentions in writing. They then must monitor the contractual relationship to ensure that there are no unintended modifications or waivers. Even the most desperate seller may pause before threatening to stop shipments if it cannot proffer a colorable story that the contractual relationship allows for its actions.

Lesson 6: One-sided contracts may not be the answer.

While the buyer may insist on clarity in a contract, it may also be tempted to include its own terms and conditions, with buyer-friendly language and provisions. However, this may create unintended problems. Consider, for example, a contract that purports to bind the seller but that simultaneously gives the buyer unilateral discretion to terminate the deal at will. Such provisions are common in requirements contracts, and they make some sense because the buyer might not know how many products it will need or for how long, since it is subject to the whims of its customers. However, these provisions are potentially unfair to the seller, which will have incurred start-up and investment costs that it might not be able to recoup if the contract is terminated prematurely. Unfortunately, there is no certainty that Michigan courts will enforce a requirements contract that allows the buyer to unilaterally terminate the relationship.

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For example, in *General Motors Corp v Paramount Metal Products Co*,[17] defendants argued that GM's purchase orders were unenforceable as requirements contracts because GM had the right to terminate the purchase orders at will. The court disagreed. It ruled that the contracts were enforceable and were not "unconscionable" as long as GM exercised "good faith" in performing and in deciding to terminate.[18] It appears that the court felt that GM truly intended to perform and buy all of its requirements from the buyer and that a change in circumstances provoked the termination.[19] This was a decision in favor of buyers: the court enforced the parties' deal as is, showing that it clearly understood how business is conducted in the automotive industry.

In contrast, the Michigan Court of Appeals in *Acemco Automotive v Olympic Steel Lafeyette, Inc.*[20] held that a supply agreement between an automotive supplier and its steel supplier was unenforceable because it contained no set quantity to be purchased; instead, the amount would be as requested by the buyer in periodic releases. The court held that the contract was not a requirements contract, even though the contract documents used the word "blanket" and a previous decision by the court of appeals held that a "blanket order" satisfied the "quantity" requirements of the UCC.[21]

A court may also refuse to decide the issue of whether an enforceable contract exists and leave the matter to a jury. In *Schefenacker Vision Systems, USA, Inc v Depco International Inc*,[22] because quantities were set by releases and the buyer could terminate at any time, the court denied a motion for summary judgment and ruled that there was an issue of fact as to whether the contracts were requirements contracts.

The *Acemco* and *Schefenacker* decisions reveal the risks of relying on terms and conditions that allow only the buyer to terminate. To mitigate these risks and obtain a result more in line with the *Paramount* decision, buyers should consider the following:

- establishing a track record of good-faith purchases from the seller before considering termination;
- adding a provision in the terms and conditions that gives the seller time to match pricing if the buyer finds better pricing elsewhere and wants to terminate for that reason;
- including a minimum quantity amount in the contract, with no guarantees beyond that. Thus, if the buyer decides to terminate, a court can rely on the fact that the buyer promised to buy something and that its obligations were not simply illusory;
- making sure that the terms and conditions give the seller the right to make a claim for work in progress and raw material purchases in the event that the buyer terminates.

Lesson 7: Commercial impracticability rarely justifies the seller's actions.

At least one issue in these supplier disputes seems relatively settled: the "commercial impracticability" defense rarely works.[23] Courts in Michigan have uniformly rejected the argument that an increase in raw material prices alone justifies a seller breaching a fixed-price contract. The *Chainworks* case, discussed above, is the most recent example.[24] Indeed, noted commentators White and Summers, in their treatise on UCC law, state that (1) courts have favored buyers on this issue; (2) in their view, "a seller should never be excused from its obligations because of cost increases;" and (3) "an increase in price, even a radical increase in price, is the thing that contracts are designed to protect against."[25]

Lesson 8: Educate your client in advance.

Ideally, lawyers should help their clients understand even before disputes arise how these issues tend to play out. For example, giving your client's purchasing department personnel a short tutorial on how UCC 2-207 (the "battle of forms") works will help them spot issues before they become problems, such as when the other party attempts to incorporate its own terms and conditions into an agreement. Because memories fade and employees leave, clients should also get into the habit of documenting a contractual dispute in correspondence with the other side and creating a record of the issues. Having a written record of your client (1) objecting to the other side's position, (2) giving notice of its own position, and (3) advising the other side of potential breaches will be invaluable if and when the dispute lands on your desk. If litigation is unavoidable, then you as the attorney will be ready to proceed much faster if the client is aware of the issues.

Conclusion

The number of supply disputes over the last several years has risen largely because of the increased cost of raw materials. Even if the markets for steel, resin, and oil were to stabilize, however, these disputes would likely continue. Recent press reports reveal a trend toward downsizing the number of component suppliers that Tier 1s and even OEMs will use,[26] and faced with a lack of future business from a given buyer, a seller might be more willing to bite the hand that had previously fed it.

Litigation, however, is not inevitable. If your clients are knowledgeable about the issues that arise in these supply disputes, they will be in a better position to manage their contracts and personnel in a way that minimizes the risks. Likewise, if their lawyers are ready to react to disputes at a moment's notice, they can help develop a strategy that best matches the client's business objectives. Whether through litigation or arrangements to pay surcharge demands "under protest," it is possible to help a client ensure the continuation of supply while protecting its rights to later recoup improper surcharges or price demands.

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NOTES

1. In the context of the automotive industry, an OEM refers to a company that manufactures and assembles vehicles for sale to dealers and customers, such as General Motors Corporation, Ford Motor Company, and DaimlerChrysler Corporation. Tier 1, Tier 2, and Tier 3 suppliers refer to various levels of suppliers that manufacture products in the automotive industry supply chain. A company that sells goods directly to an OEM is considered a Tier 1 supplier, a company that sells goods to a Tier 1 supplier is a Tier 2 supplier, and a company that sells goods to a Tier 2 supplier is referred to as a Tier 3 supplier.

2. *See Chainworks, Inc v Webco Indus*, No 1:05-CV-135, 2006 US Dist LEXIS *25 (WD Mich Feb 24, 2006).

3. The life of the part ends when the OEM terminates production of the vehicle model in which the part is incorporated or when the part is no longer needed due to engineering changes in the vehicle. In the context of the automotive industry, "program" is a general term used to define a group of major automotive components manufactured and assembled by an OEM, incorporating various products from downstream suppliers.

4. *See* MCR 3.310.

5. *See L&L Concession Co v Goldhar-Zimner Theatre Enters, Inc*, 332 Mich 382, 51 NW2d 918 (1952).

6. *See Fruehauf Trailer Corp v Hagelthorn*, 208 Mich App 447, 449, 528 NW2d 778 (1995).

7. *See, e.g., Kelsey-Hayes Co v Galtaco Redlaw Castings Corp*, 749 F Supp 794, 798 n7 (ED Mich 1990) ("A supplier's failure to make scheduled shipments may have immediate and dramatic consequences.... Thus, a breach of contract in the automotive industry may be more coercive than in other industries"). *See also In re Autostyle Plastics, Inc*, 216 BR 784 (Bankr WD Mich 1997).

8. *See, e.g., Intertec Sys, LLC v Multimatic, Inc*, No 04-CV-73661 (ED Mich Oct 14, 2004) (citing potential shutdown of Ford and Mazda plants if plaintiff did not obtain component parts from defendant); *Key Safety Sys, Inc v Proto Gage, Inc*, No 2004-4173-CK (Macomb Circuit, Oct. 29, 2004) (citing the "domino effect" that could ensue throughout the automotive industry if plaintiff did not obtain parts).

9. *See* MCL 440.1207 (allowing parties to "assent" to a demand made by the other party without waiving their legal rights).

10. No 04-74331 (ED Mich Jan 18, 2005).

11. *Id.* at *9.

12. No 1:05-CV-135, 2006 US Dist LEXIS 9194 (WD Mich Feb 24, 2006).

13. *Id.* at *6.

14. *Id.* at *9–17.

15. *Id.* at *18–23.

16. MCL 400.2609.

17. 90 F Supp 2d 861 (ED Mich 2000).

18. *See id.* at 873–874.

19. *See id.* at 875 (citing *Cardinal Stone Co, Inc v Rival Mfg Co*, 669 F2d 395 (6th Cir 1982) (enforcing termination clause under Ohio's version of the UCC)).

20. No 256638, 2005 Mich App LEXIS 2656 (Oct 27, 2005) (unpublished).

21. *See id.* at *12 (distinguishing *Great Northern Packaging Inc v General Tire & Rubber Co*, 154 Mich App 777, 787, 399 NW2d 408 (1986)).

22. No 03-71183 (ED Mich May 17, 2004).

23. *See* MCL 440.2615 (setting forth the defense).

24. *See Chainworks*, 2006 US Dist LEXIS 9194 at *18–23. *See also Karl Wendt Farm Equip Co v International Harvester Co*, 931 F2d 1112, 1117 (6th Cir 1991) (applying Michigan law; holding that defendant could not assert defense of impracticability to excuse its performance

under a dealership agreement notwithstanding expected losses of over $2 million a day, a drop in the company's standing on the Fortune 500 list from 27 to 104, and possible impending bankruptcy); *USX Corp v International Minerals & Chems Corp*, No 86 C 2254, 1989 US Dist LEXIS 1277 (ND Ill Feb 7, 1989) (applying Illinois law; no evidence that decline in price of ammonia or natural gas was non-occurrence that was a basic assumption on which the contract was based); *Eastern Air Lines, Inc v Gulf Oil Corp*, 415 F Supp 429 (SD Fla 1975) (increase in oil prices insufficient to excuse performance); *Publicker Indus, Inc v Union Carbide Corp*, No 74-2185, 1975 US Dist LEXIS 14305 (ED Pa Jan 17, 1975) (substantial increase in the cost of ethylene, the major cost element of ethanol, did not excuse performance); 4 *Anderson, Uniform Commercial Code* § 2-615:69, 644 (1997) ("A seller's supply difficulties do not excuse the seller's performance by virtue of UCC 2-615 where supply difficulties were or should have been within the contemplation of the seller and no reallocation for this potential problem was made by the contract").

25. *See* 1 White and Summers, *Uniform Commercial Code* 4th ed, § 3-10, 172–173 (1995).

26. *See, e.g., Delphi Will Slash 2,850 Suppliers*, Automotive News, March 13, 2006 (reporting on Delphi's purported plans to cut its supplier base to 750 core vendors).

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