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Supply Chain Commercial Impracticability in the COVID-19 Crisis

by Matthew J. O'Hara

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT

This Alert details questions regarding contracts involving the sale of goods during COVID-19. In this dynamically changing situation, for each business confronting supply chain questions involving the sale of goods, nothing can substitute for thoughtful analysis with trusted legal advisors who have accumulated judgments based on many years of experience in this arena.

The COVID-19 crisis has plunged vast numbers of buyers and sellers of commercial goods into situations where they must encounter questions regarding performance of existing supply contracts and fulfillment of pending purchase orders. These questions arise under the common-law rubrics of "force majeure," "impossibility," and "frustration of purpose." Under United States law, Article 2 of the Uniform Commercial Code follows the concept of commercial impracticability. In particular, Section 2-615 of the UCC provides as follows:

Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:

> (a) Delay in delivery or non-delivery 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 non-occurrence 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....

Unfortunately, although the UCC was adopted in the early 1960s, there is relatively little case law giving guidance on Section 2-615 impracticability. That existing case law is far from consistent. One leading commentator describes the state of the law construing this uniform statute rather bleakly: "[i]n spite of attempts by all of the contract scholars and even in the face of eloquent persuasive general statements, it remains impossible to predict with accuracy how the law will apply to a variety of relatively common cases. But the cases and the Code commentary are full of weasel words, such as 'severe' shortage, 'marked' increase, 'basic' assumptions, and 'force majeure.'"[1]

Clearly, the current crisis is not a "relatively common case," and we are in completely uncharted territory. Those cases that do discuss Section 2-615 seem to cluster around events such as the Great Recession, the 9/11 attacks, the oil-price shocks of the 1970s, or more localized events such as weather events, strikes, or war in particular places. Westlaw reference attorneys are reporting a deluge of calls regarding research concerning this issue.

Inherent in the UCC is the concept of good faith.[2] Good faith is also colored by the concepts of course of dealing between two contracting parties over time, and usage of trade, or common practices in a particular industry.[3] Questions under the UCC in general and under Section 2-615 in particular are inherently fact-dependent, even for the same business, and must often be considered one contract or even one transaction at a time. Given the "impossibility" of predicting particular outcomes, some general guidance can nevertheless be supplied.

1 White, Summers & Hillman, UNIFORM COMMERCIAL CODE § 4:22 (6th ed. Nov. 2019 Update).

2 UCC § 1-103.

3 UCC § 1-205.

Is the COVID-19 crisis "the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made"?

While there is no one single answer – note the statutory emphasis on the phrase "the contract" – it is a fair bet that global pandemic with accompanying economic shutdown will be viewed as such a contingency. It is conceivable though that certain contracts will have contemplated such an occurrence – events like "epidemic" or "pandemic" – and specifically assigned the risk to one party or the other. More broadly, while some businesses have been reduced to zero activity as a result of the crisis, others are being called on to drastically increase production. Such businesses may find themselves in a position of not being able to fill orders and find themselves pleading impracticability not because activity is stopped but their raw materials, people, and manufacturing capacities are at their limits.

Does compliance with a government order excuse performance under a contract?

This is perhaps the most clear-cut area under the statute. If a business cannot fulfill an order because it has been ordered to close, that should be a contingency that brings the transaction with the scope of the commercial impracticability doctrine.

What is the effect of commercial impracticability on a contract or transaction?

Breach of contract is excused and there is no liability on the part of the party not fulfilling its obligations to deliver or accept delivery of goods.

Is the existence of commercial impracticability a yes-no question?

Not necessarily. Section 2-615 recognizes that if partial performance is possible, the supplier should allocate deliveries among its customers "in any manner that is fair and reasonable."[4] Delay may be another reasonable response rather than failure to perform altogether.

Does increased cost of performance amount to commercial impracticability?

Generally, no. Fixed-price contracts inherently assign risk, to the seller if the market price of a product or its component parts goes up, and to the buyer if the market price goes down. Nevertheless, the Code holds out the possibility that severe shortages of materials or unforeseen shutdowns of supply causing cost shocks might be within the scope of the statute.[5] Courts have tended to favor buyers on issues of increased cost.

Can buyers also be excused from performance on grounds of commercial impracticability?

In most states, yes. Although the statute is written to provide a remedy to sellers, the official commentary to the UCC provides that Section 2-615 is also a buyer's remedy if the conditions in the statute are satisfied as to the buyer.[6] A buyer always has the option of refusing to accept delivery or refusing to make payment on goods it declared it would not accept. A buyer will then have to defend a claim of breach of contract on the basis that an unforeseeable contingency arose.

When a company has entered into a requirements contract, does it have a duty to stay in business?

A requirements contract measures the quantity to be purchased with reference to the needs of the buyer, for example, "I will buy all of the aluminum I require in the next calendar year from you."[7] Similarly, an outputs contract measures quantity by an amount produced by the seller: "I will sell you all the table salt I process this year." Generally, a party that has entered into such a contract does not have an obligation to stay in business if it is otherwise commercially reasonable for it not to do so. However, there are exceptions to this rule where the making of such a contract caused the other party to take exceptional steps to meet the other party's needs.

Do specific contractual provisions regarding force majeure still apply in contracts involving the sale of goods?

Yes. Section 2-615 is a statutory gap-filler where parties have not addressed a particular contingency and allocation of risk.

Must I give notice of commercial impracticability?

Yes, seasonable notice is required to one's counter-party.[8]

4 UCC § 2-615(b).
5 UCC § 2-615, cmt. 4.
6 UCC § 2-615, cmt. 9.
7 UCC § 2-306(1).
8 UCC § 2-615(c).

What if my counter-party is not in the United States?

Apart from specific agreements on applicable law, U.S. law and the UCC may still apply, and typical choice-of-law analysis will still govern. In addition, the United States is a party to the Convention on Contracts for the International Sale of Goods (CISG). Over 80 other countries have become parties to the CISG, including China and Mexico.[9] The CISG has an analogous provision, providing that "[a] party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences."[10] The CISG provision goes on to expressly enumerate conditions under which failure to perform based on failures of third persons to the contract is excused as well.[11]

Summary

In this dynamically changing situation, for each business confronting supply chain questions involving the sale of goods, nothing can substitute for thoughtful analysis with trusted legal advisors who have accumulated judgments based on many years of experience in this arena. There is no one bright-line answer that will be apparent in most of today's problems that involve expected contract performance.

If you have any questions, please contact Matthew O'Hara (mohara@freeborn.com; (312) 360-6871), or visit Freeborn's COVID-19 webpage.

9 For a list of signatory nations, see https://www.cisg.law.pace.edu/cisg/countries/cntries.html.
10 CISG art. 79(1).
11 CISG art. 79(2).

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Matt is a business trial lawyer who concentrates his practice in the litigation and trial of complex commercial matters in federal and state courts and the representation of law firms and lawyers. He has tried cases involving the federal securities laws, antitrust laws, breach of fiduciary duty, trade secrets, trademark infringement, breach of contract, contract reformation, unjust enrichment, license agreements, executive employment, the Uniform Commercial Code, fraud, and criminal defense.

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