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Supply Contracts: Beyond the Basics

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LEGAL SOLUTION

Overview

- The Pre-Contract Phase
- When and Why Supply Contracts Should be Used
- Formation: How to Win the Battle of the Forms (Including the Battle of Your Own Forms)
- Supply Contract Key Terms
- Avoiding Unintended Electronic Contracts
- Litigation Related Provisions
- Dispute Resolution Processes
- Arbitration

The Pre-Contract Phase

The Pre-Contract Phase

- The first line of defense is careful selection of with whom you will do business
- Clearly, your options may be limited depending upon your role in the marketplace



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The Pre-Contract Phase, cont'd

- Information can be found in a variety of sources:
 - SEC filings (if publicly traded)
 - Other financial reports
 - Dun & Bradstreet Reports
 - Experian Reports
 - Organizational documents
 - Lien records
 - Litigation records
 - References
 - Internet



When and Why Supply Contracts Should Be Used

How Do Supply Contracts Fit into How You Do Business?

- A standalone agreement without purchase orders or contracts
- A “master” agreement with purchase orders to be issued
- A part of a group of documents that will define the relationship

Why Use a Supply Contract?

- Long-term arrangements
- Address more complicated issues that are not appropriate for a purchase order
- Define what is included in your “agreement”
- Refusal of the other party to accept your standard terms and conditions

When Not to Use a Supply Contract

- Where you are only restating standard terms and conditions
- When it merely creates an opportunity for the other party to negotiate

Best Practices

- Consider and evaluate how the supply contract fits into the overall business relationship
- Use previously negotiated precedents with caution

Formation Issues: How to Win the Battle of the Forms *(Including the Battle of Your Own Forms)*

“Battles of the Forms”

- Traditional “battle of the forms” issues are easily resolved with a provision that specifies what boilerplate or standard terms and conditions will apply
- The more significant issue is the “battle of your own forms”
 - defining what is included in the “agreement” of the parties
 - how are conflicts treated and order of precedence

Battle of Your Own Forms

What is included in your “agreement”?

- RFQ
- Quote
- Emails
- Term sheets
- Specifications/
drawings
- Statement of work
- Side Letters
- Standard terms and
conditions
- Post-contracting
amendments and
modifications
- Invoices

Conflicts and Order of Precedence

- What document controls if there is a conflict, and in what order of precedence?
 - Supply Agreement
 - Specifications
 - Face of any purchase orders
 - Standard Terms and Conditions
- Do not assume the order of precedence in a form agreement is right for all transactions
- Conflicts clauses may not settle the dispute

Integration or Merger Clauses

- Should the supply contract supersede and replace all prior understandings and agreements?
 1. Case 1: There were pre-contract discussions (memorialized in emails) regarding price adjustments but an integration clause blocked seller from introducing evidence of the discussions that were memorialized in emails
 2. Case 2: Parties agreed that “*if the price of pulp increases significantly during the term of this Agreement, the parties agree to negotiate a price adjustment.*” Court held that the provision was found to be sufficient to force reliance on UCC §2-305(1) (if no price is stated, the price will be a “reasonable price”)

Formation: Additional Best Practices

- Do not address the same subject in two places (for example, in your standard terms and in the Supply Agreement) or be very explicit as to the interplay of the two provisions
- Avoid relying on a conflicts clause when you want to say “ignore the standard provision, this provision controls”
- Do not forget to review and consider the boilerplate
- If standard terms and conditions will be incorporated by reference, identify which version or provide for amendments
- Always be careful when using negotiated precedents

Key Terms of a Supply Contract

Quantity

- Quantity is the only mandatory term
- Fixed Quantity
- Requirements and Output contracts
 - Buyer's requirements and seller's output must be determined in good faith

Quantity, cont'd

- Contract should state that buyer will purchase “all of its requirements” of the goods
- Other terminology may be found ambiguous:
 - As ordered
 - As Released
 - Blanket Order
- Must be mutuality of obligation
- Some courts require exclusivity
 - A minimum may be sufficient, such as a specified quantity or dollar amount or percentage of requirements

Quantity, cont'd

- Important to clearly define the goods
- Example: Does a requirements contract for component part No. 1234 include requirements for future products that could use the part?

Quantity, cont'd

- Must understand the role that estimates play

UCC §2-306:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that **no quantity unreasonably disproportionate to any stated estimate** or in the absence of a stated estimate to any normal or otherwise comparable **prior output or requirements may be tendered or demanded**

- Parties can establish minimums and maximums

Duration

- If no term is stated, the UCC gap filler applies: contract is “valid for a reasonable time.” UCC §2-309(2)
 - Contract may be terminated upon reasonable notice
 - The facts and circumstances determine what is “reasonable”
 - Duty to act in good faith
- Automatic renewal provisions
 - Calendar important notice periods
 - Consider including an optional extension period if the other party gives notice of non-renewal

Duration, cont'd

- Consider provisions regarding post-expiration obligations
 - Turnover of tooling, documents, or other necessary information, sell raw materials, etc.
 - For Buyers: consider requiring cooperation in moving to another source

Upon the expiration or termination of this Agreement, Supplier will cooperate with Buyer and provide all reasonably requested support and information required by Buyer to facilitate Buyer's sourcing of the Goods to a replacement supplier

Termination

- Based on a material breach

- Should you define “materiality”?

This Agreement may be terminated if Buyer materially breaches Section X. For purposes of this Agreement, material breaches will include, without limitation, _____.

- Note the limitation that applies when installment contracts are involved (UCC §2-612) (“Whenever non-conformity or default with respect to one or more installments substantially impairs the value of the whole contract there is a breach of the whole”)

Termination, cont'd

- UCC §2-612 work arounds?

Time is of the essence under this Agreement

versus

Even though this Agreement calls for shipments in installments, a late delivery of any installment will be deemed to be a breach of this entire Agreement

Warranties – A Refresher

- Implied warranties
 - Warranties that are implied by law
 - Examples include:
 - Merchantability
 - Fitness for a particular purpose
 - Title
 - Against infringement
 - Course of dealing
 - Usage of trade
 - Implied warranties are frequently waived. See Practical Law for a discussion on how to accomplish effective waivers

Warranties – A Refresher, cont'd

- Express Warranties
 - No magic words or specific intention is needed if it goes to the essence of the agreement and relates to type, quality, or condition
 - Can be written or oral
 - Can arise before, at the time of, or after the contract is entered into
 - Use merger/integration clauses
 - Use “modifications must be in writing and signed by both parties”
 - Waiving express warranties can be tricky

Warranties – Best Practices and Reminders

- Remember: a warranty is only as good as your remedy for breach
- Do not give away your breach of warranty claims with other damages limitations – watch waivers of incidental and special damages and limitations on liability clauses
- Include conditions that invalidate the warranty (e.g., abuse, misuse, improper storage and handling, etc.)
- Make upstream and downstream warranties mirror each other

Warranties – Best Practices and Reminders

- Consider a contractual statute of limitations
- UCC §2-725 provides:
 - (1) An action for breach of any contract for sale must be commenced within four years after the cause of action has accrued. By the original agreement the parties may reduce the period of limitation to not less than one year, but may not extend it.
 - (2) . . . A breach of warranty occurs when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered.

Disclaiming consequential damages

- “Neither party will be held liable for consequential or incidental damages”
- Left with “general” or “direct” damages
- What are consequential damages?
- May limit damages beyond what is intended

Seller sold components to a aircraft manufacturer that proved to be defective and thus a breach of a warranty. 25 planes had to be idled for 30 days while new part was designed and manufactured and repairs made. Repairs cost \$10,000 per aircraft. Downtime damages were \$25,000 per day.

Disclaiming consequential damages

- Direct damages:

\$10,000 repair cost x 25 planes = \$250,000

- Consequential damages:

25 planes x \$25,000 per day x 30 days =
\$18,750,000

Because of a consequential damage waiver, the buyer/manufacturer could not recover its most significant damages

Disclaiming consequential damages cont'd

- May not give the protection you want. For example, damages to a buyer for delay or lost profits may be “direct” damages versus a consequential damage

Example: Seller improperly terminated its distribution agreement with Buyer and thus Buyer lost sales – the court held that lost profits were direct damages and not impacted by a waiver of consequential damages

- Avoid ambiguities with a carefully drafted damages waiver:

In no event will either party be liable under this Agreement to the other party for any consequential, incidental, indirect, exemplary, special or punitive damages, including any damages for business interruption, loss of use, revenue or profit, whether arising out of breach of contract, tort (including negligence) or otherwise, regardless of whether such damages were foreseeable and whether or not the breaching party was advised of the possibility of such damages

Indemnification Provisions in Supply Contracts

- Indemnification provisions provide that the indemnifying party covers the indemnified party for “losses, liabilities, claims and causes of action” that arise out of the underlying contract
- There are two types of indemnification—
 - Indemnification For Direct Claims
 - Indemnification For Third Party Claims

What's the Difference?

- Direct claims
 - Indemnifying party covers the indemnified party for any breach of the supply contract
 - Indemnification for direct claims is not common
- Best practices for direct claims
 - Language must be precise: clear and unambiguous that the parties are indemnifying for direct claims
 - **Caution:** if the supply contract contains a limitation on liability, consider whether a party should have the right to recover under the indemnity over and above the liability limit. If not, then include a reference to the indemnification clause in the limitation on liability

Indemnification for Third Party Claims

- Arises where a third party makes a claim against an indemnified party that relates to the supply contract
- More common than direct claims indemnification

Magic Language

- Option 1: “Party A will indemnify Party B”
- Option 2: “Party A will indemnify and hold harmless Party B”
- Option 3: “Party A will indemnify, defend and hold harmless Party B”

Preferred Language: Option 3

What's the Difference?

- In Option 2, most courts read “indemnify and hold harmless” synonymously as “indemnification”
- Some courts, however, assign a separate and distinct meaning—requires indemnifying party to advance payment for covered unpaid costs and expenses (e.g., liabilities) as they are incurred
- Additionally, under applicable state law, “hold harmless” may be interpreted as the indemnifying party releasing the indemnified party from claims arising out of the indemnified action

What's the Difference? cont'd

- Under Option 3 (“Party A will indemnify, defend and hold harmless Party B”), inclusion of “defend” obligates the indemnifying party to “defend” regardless of the merits of the underlying claim
- Exists only in the context of third party claims

Carve-outs From Indemnification Clauses

Consider carve-outs and their impact. The following are most common:

- Gross negligence of indemnified party
- Fraud and/or intentional misconduct of indemnified party
- Bad faith failure to comply with the supply agreement
- Misuse and failure to use the products supplied in accordance with the specifications

Interplay with Incidental and Consequential Damage Waivers

- Consider interaction with the incidental and consequential damage waiver
- If the parties intend for the indemnity to cover these types of damages, then carve the indemnification clause out of the waiver
- If the indemnification is not expressly excluded from the waiver, then the result is that the indemnifying party is not required to indemnify for indirect and consequential damages

Liability Caps and Waivers

- Consider whether the indemnification provision should have its own overall caps and internal limitations
 - Overall Cap
 - Thresholds
 - Deductibles
- Also, the general rule is that indemnification provisions should be carved out of the damage limitation unless it is clear that the parties intend for it to be limited

Avoiding Unintended Electronic Contracts

Avoiding Unintended Electronic Contracts

- Negotiations via email, text messages, instant messages, etc.
- The UCC is designed to make contracts easy to form
- After a contract is formed, electronic messages could be construed as:
 - Waiver of breach
 - Offer or agreement to amend
 - Offer or agreement to settle a dispute
 - Evidence of course of dealing or performance

Avoiding Unintended Electronic Contracts, cont'd

- Uniform Electronic Transactions Act (UETA)
 - Electronic records and signatures fulfill requirements for written records and signatures
 - Nearly all states have adopted a form of UETA or enacted a similar statute
 - Applies when parties have agreed to conduct transactions by electronic means
 - Determined from the context and surrounding circumstances, including the parties' conduct (often implied agreement)
- Electronic Signatures in Global and National Commerce Act (E-SIGN)
 - Applies to interstate and foreign commerce

Avoiding Unintended Electronic Contracts, cont'd

- Courts have found electronic-message contracts when
 - Communication(s) set out material terms of the agreement
 - Communication(s) manifest intent to be bound
 - Party sought to be bound “signed” the email
- Need quantity term to satisfy the statute of frauds

Avoiding Unintended Electronic Contracts, cont'd

- What satisfies the signature requirement?
 - Test is whether the recipient believes that the signer intended to authenticate the writing as the signer's own
 - Purposeful, manually typed signature = signature
 - Auto-generated signature block = maybe

Cunningham v. Zurich Am. Ins. Co., 352 S.W.3d 519, 530 (Tex. App. 2011) (declining to hold that signature block satisfied signature requirement); *but see Williamson v. Bank of New York*, No. 3:12-CV-1079-N (N.D. Tex. May 16, 2013) (rejecting *Cunningham* and holding that signature block satisfied signature requirement)

Avoiding Unintended Electronic Contracts, cont'd

- What shows an intent to be bound?

“I accept”

Stevens v. Publicis, S.A., 50 A.D.3d 253 (N.Y. App. Div. 2008) (series of emails satisfied “no oral modifications” clause resulting in amendment of employment agreement)

Avoiding Unintended Electronic Contracts, cont'd

“awesome!”

- CX Digital, a marketing company, received \$45 for each advertising referral for client Smoking Everywhere, up to 200 per day
- In an instant message exchange, CX Digital requested an increase of the cap to 2,000
- Smoking Everywhere responded, “NO LIMIT.”
- CX Digital responded, “awesome!”

CX Digital Media, Inc. v. Smoking Everywhere, Inc., No. 09-62020-Civ (S.D. Fla. Mar 23, 2011)

Avoiding Unintended Electronic Contracts, cont'd

“doable”

- Attorneys negotiating to resolve bank's foreclosure on a home
- Homeowner's attorney makes counteroffer
- Bank's counsel states in an email “that's doable” but a week would be needed to prepare an agreement
- The homeowner fired his lawyer and rejected the settlement

Williamson v. Bank of New York, No. 3:12-CV-1079-N (N.D. Tex. May 16, 2013)

Avoiding Unintended Electronic Contracts, cont'd

“Dope!”

- Monster in an email asks DJ Z-Trip to “approve” a video containing remix of Beastie Boys music before Monster posts it on the Internet
- Z-Trip responded “Dope!”
- Monster posts the video
- Beastie Boys sue Monster for unauthorized publication of songs
- Monster argued Z-Trip authorized use of remix

Beastie Boys v. Monster Energy Co., No. 1:12-cv-06065-PAE
(S.D.N.Y. Nov. 4, 2013)

Avoiding Unintended Electronic Contracts, cont'd

How do you avoid an unintended electronic contract?

1. Implement policies and train employees
 - Avoid terms like “offer,” “agree,” “accept”
 - Promptly correct misinterpreted communications
 - Best not to discuss contract terms via instant messages, text messages, tweets, etc.
 - Consider picking up the phone

Avoiding Unintended Electronic Contracts, cont'd

2. State intent to be bound only by formal agreement
 - State that the party does not intend to be bound until a comprehensive understanding of any agreement that includes all customary provisions is reduced to writing and physically signed
 - NOTE: Need to be clear that there is no present agreement. A mere reference to later documentation might be construed as the intent to memorialize an existing agreement

Avoiding Unintended Electronic Contracts, cont'd

Practical Law sample disclaimer for email signature block:

This e-mail neither constitutes an agreement to conduct transactions by electronic means nor creates any legally binding contract or enforceable obligation in the absence of a fully signed written contract. [Contract terms contained in this e-mail are subject to approval by [PARTY] and are not binding until [PARTY] provides such approval in writing.]

Avoiding Unintended Electronic Contracts, cont'd

3. Expressly State Contingencies
 - "Management approval is required."
4. In completed agreement, require that amendments be in writing and physically signed

Litigation-Related Provisions

- Choice of law
 - without regard to choice-of-law principles
 - if choice of law applies to extra-contractual matters that arise from the contract or all relations between the parties, expressly say so
 - contracts with international parties, must consider the Convention on Contracts for the International Sale of Goods (CISG)
 - To opt out, must specifically and unequivocally do so:
The parties agree that the United Nations Convention on Contracts for the International Sale of Goods does not apply to this Agreement

Litigation-Related Provisions, cont'd

- Choice of forum
 - mandatory vs. permissive
 - forum non conveniens defense waived?
 - transfer and removal rights waived?

Dispute Resolution Processes

- Can be helpful, but must be very clear
 - Escalation clauses:
 - Operational executives
 - Senior executives
 - Mediation
 - Litigation (or arbitration)
 - Include a carve out for emergency relief:
 - Injunction
 - TRO
 - Specific Performance
 - Claim and Delivery (Replevin)

Arbitration

- Private
- Cheaper?
- Quicker?
- Finality - no appeals
- Expert “judge”

Arbitration, cont'd

- Arbitration provision must address:
 - Scope (exceptions must be clear; arbitration is favored)
 - Carve out for emergency relief
 - Administrator and Rules
 - Arbitrator selection process and number
 - Location
 - Discovery
 - Award type
 - Prevailing party entitled to fees and expenses?
- International Arbitration – New York Convention

About the Speakers



Donald F. Baty, Jr.
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Don is a commercial law attorney with a particular focus on secured lending, counseling clients on various matters from loan origination to enforcement in and out of bankruptcy. He also represents purchasers of goods and services in connection with purchasing and supplier issues.

- Significant experience in asset based and structured finance, securitizations, loan syndications and sales of distressed debt
- Advises and represents clients in unusual secured lending transactions and purchasing matters involving "just-in-time" inventory systems
- Representative clients include banks, commercial finance companies and other commercial lenders, corporate purchasing managers and major manufacturers
- Represents major manufacturers in dealing with financially troubled suppliers of critical goods and services where there is significant potential for production interruptions should the supplier become insolvent or cease operations because of financial difficulties

About the Speakers



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Dan concentrates his practice on litigating and resolving commercial, contract and bankruptcy disputes. He has tried and arbitrated several cases and has significant experience negotiating the settlement of complex matters. Dan collaborates with clients to evaluate business and legal options to efficiently resolve disputes both before and during the litigation process.

- Manages and litigates supply-chain disputes, including pricing, requirements contract, adequate assurance of performance, termination for convenience, tooling and mold lien, claim and delivery (replevin), specific performance and injunctive relief matters
- Represents creditors in bankruptcy proceedings, including executory contract, automatic stay, fraudulent transfer, preference, denial of discharge, recoupment and setoff and claim objection litigation
- Negotiates and drafts supply and development agreements (including video game development agreements) to address payment, revenue, intellectual property, deliverable, and project scope and timing issues
- Serves as a member of the firm's Automotive and Social, Mobile and Emerging Media Industry Groups

About the Speakers



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Tricia's practice involves representing original equipment manufacturers and tier one suppliers in the development of strategies when faced with nonperforming suppliers, assisting in contract negotiations, as well as providing analysis and advice regarding maintenance of supply relationships.

- Advises secured and general creditors in phases of commercial bankruptcy cases, including negotiation and drafting of cash collateral and post petition financing orders; analysis of disclosure statements, plans of reorganization and preference exposure
- Broadly represents commercial lenders, including loan restructuring, origination and documentation, with particular emphasis on asset-based lending; analysis of lenders' existing loan documentation and perfection of security interests; and negotiation of work-outs and orderly wind-downs
- Represents purchasers and sellers of assets in and out of bankruptcy, with a special emphasis on automotive-related transactions
- Acts as external general counsel to tier one automotive manufacturers

Examples of Some Referenced Supply Agreement Provisions

Example Provisions

1. “Battle of the forms” avoidance provision

Only terms contained in this document, which incorporates by reference the Quotation, the Standard Terms and the Specifications, along with the purchase orders or releases that may be issued by Purchaser to Supplier from time to time, constitute the terms of the agreement between the parties. Any and all pre-printed, standard, boilerplate, or other terms and conditions that may be attached, referenced or included in any Quotation, Drawings, Specification or other Supplier documents are expressly rejected and excluded from this Agreement.

Example Provisions

2. Conflicts/Order of Precedence Provisions

Example 1: All purchases under this Agreement are subject to Seller's Standard Terms of Sale Rev. September 2012 (the "Standard Terms"), and any agreed updates, changes and modifications to the Standard Terms. All purchase orders, acceptances and other writings or electronic communications between the parties will be governed by this Agreement. In case of conflicts, the following order of precedence will prevail: (1) this Supply Agreement; (2) the Standard Terms, (3) the attachments to this Supply Agreement; (4) individual Purchase Orders; and (5) drawings, specifications and related documents specifically incorporated by reference into this Supply Agreement or a Purchase Order.

Example 2: The terms and conditions of Purchaser's general Purchase Order Terms and Conditions as amended from time to time (the "PO Terms and Conditions") are incorporated into this Agreement by reference. The current version of the PO Terms and Conditions is attached to this Agreement as Exhibit A. PO Terms and Conditions may be modified or amended by Purchaser upon at least 30 days' notice to Seller; continued performance by Seller after the effective date of any amendment or modification will be deemed to be Seller's acceptance of the amended or modified PO Terms and Conditions. In the event of a conflict between this Agreement and the PO Terms and Conditions such that it is impossible to comply with provisions of both documents, the terms of this Agreement will prevail over any pre-printed general terms and conditions of a Purchase Order, and any specific terms that are negotiated as part of a Purchase Order will prevail over the terms of this Agreement.

Example Provisions

3. Integration or merger provisions

Example 1: This Agreement, together with [specify other documents] or [any documents incorporated into this Agreement by reference] and [all related Exhibits and Schedules], constitutes the sole and entire agreement of the Parties with respect to the subject matter of this Agreement, and supersedes all prior and contemporaneous understandings, agreements, representations and warranties, both written and oral, with respect to the subject matter. [The Parties have not relied on any statement, representation, warranty or agreement of the other Party or of any other person on such Party's behalf, including any representations, warranties, or agreements arising from statute or otherwise in law, except for the representations, warranties, or agreements expressly contained in this Agreement.]

Example 2: This Agreement is intended by the Parties as a final and complete expression of their agreement and understanding with respect to its subject matter and supersedes all prior or contemporaneous agreements or representations, written or oral.

Example Provisions

4. Automatic renewal provision with optional extension

Unless terminated under Section X below, this Agreement is binding on the parties for one year from the Effective Date and will automatically renew for successive one-year terms after the initial term unless Supplier provides written notice at least 60 days prior to the end of the then current term of its desire that this Agreement not be renewed. Upon receipt of Supplier's written notice of non-renewal, Buyer will have the option to extend this Agreement for an additional 90 days beyond the then current term by giving notice of the extension to Supplier ("Extended Term") no later than thirty (30) days prior to the end of the then current term. If Buyer requests an Extended Term, this Agreement will terminate at the end of the Extended Term.

Relevant Practical Law Resources

- Sale of Goods Agreements: Avoiding Common Pitfalls
- Drafting and Negotiating a Sale of Goods Agreement Checklist
- Risk Allocation in Commercial Contracts
- Avoiding Key Risk Allocation Pitfalls Under Commercial Contracts Checklist
- Drafting or Reviewing a Commercial Contract

Relevant resources are available with a free, no-obligation trial to Practical Law.
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Questions