Beyond Industry-Wide Disruption: Some Aspirational Strategies for a More Fault-Tolerant Automotive Supply Chain

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It is not an easy time to be an automotive parts supplier. One asks a supplier, "How's it going?" with trepidation. The optimistic supplier is likely to answer, "So far I haven't shut down my customer." The less optimistic responses are best not put in writing.

As every supplier understands, the source of the current circumstance is a fusillade of supply chain disruptions and stresses up and down the chain. Many of the latest problems involve shortages of materials: microchips, of course, as well as resin and intermediate petrochemicals, steel and aluminum, rubber and other raw materials. And then there are port delays, other transportation bottlenecks, and labor unavailability. Often these resources are unavailable and, if available, only at much higher prices.

The causes of many if not all of these pressures are diverse and interrelated. COVID-19 itself and its second order effects — government responses to COVID-19, fluctuating and unpredictable customer and consumer demand — are among the significant contributors. So too, for petrochemicals, were the multiple severe weather events on the Gulf Coast. The result is that numerous OEMs have been forced to shut down plants or have allocated their limited resources to their most profitable vehicles.

This volatility in the supply chain impacts suppliers of all types, not simply those dealing in products impacted by a particular shortage. Indeed, when OEMs suspend or limit (or conversely, restart) production due to a single factor (*e.g.*, chip shortages), suppliers of *all* parts for that vehicle are often affected. At the same time, solving one problem, such as chips, doesn't make the other constraints on ordinary operations go away.

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In a broader perspective, the current situation is a consequence of the basic structure of the modern supply chain, which is built on long-term, just-in-time, fixed-price, sole-source requirements contracts for highly engineered goods that cannot be quickly or cost-effectively resourced. When that chain operates as intended, it is a wonder to behold. But it is also remarkably fault intolerant. This fault intolerance is not a "bug" that can be fixed; it is inherent in the model. And the model also shifts onto the supplier key commercial risks, including rising input prices and customer demand shortfalls.

Although the current situation may be unprecedented in the number and breadth of the failures, it is not the first time that a supply chain failure has caused significant problems. Recall, for example, the Japanese tsunami of a decade ago. And each time a breakdown occurs, there is talk in the industry of changing the current model.

To date, little has come of this talk — the model remains largely unchanged. But this time might be different. There is serious talk at the highest levels of the industry of the need to build fault tolerance into at least some portions of the supply chain.

The purpose of this Alert is to provide a brief sketch of the underlying legal principles applicable to supply chain contracting and some possible future-state contracting practices as part of a fault-tolerant, risk-sharing supply chain. To be clear, it is necessarily speculative. And we are under no illusion that much of this is currently achievable for most suppliers. In other words, do not expect to send this Alert to your customer tomorrow and ask for corresponding contract changes. Nevertheless, we believe this discussion is useful to begin to think about what a future state might look like.

The Basic Requirements Contract Model and Customers' Broad Discretion in Defining their Required Volumes

This problem of erratic customer demand is especially great for suppliers under requirements contracts, which is the usual contract structure for the automotive industry. Requirements can be unpredictable and unstable, and quantities do not become firm until specified in a release. Mere forecasts beyond the firm release period generally are not binding. Many customer contract terms also lack any express capacity and fluctuation parameters, instead making suppliers responsible for timely delivering all required quantities, whatever they may be.

Still, a customer's discretion in defining its requirements is not unlimited, particularly under Article 2 of the Uniform Commercial Code (the "UCC"), which governs the sale of goods and has been adopted throughout the United States with relatively minor variations. Under the UCC, particularly § 2-306(1), a buyer's requirements must be determined in good faith and cannot be unreasonably disproportionate to "any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements." To be clear, the UCC's "unreasonably disproportionate" threshold constrains spikes in demand. Moreover, whether in fact short-term spikes in demand are constrained turns on the particular contract, relationship, and facts at issue, and neither the UCC nor these more case-specific considerations lend themselves to a bright-line test.

There is no meaningful constraint on the downside of a customer's requirements, even if the buyer's requirements are low, or even zero, so long as they are in good faith. For the supplier, this effective lack of a downside constraint has both short-term and long-term effects. In the short term, a dip in requirements leads to inefficient and costly resource under-utilization. The long-term effects are even greater, at least when the supplier has made large upfront investments in the project, which typically are unrecoverable if volumes or program length disappoint.

Some Potential Contracting Strategies to Re-Allocate the Risks of Volume Fluctuations

Although the UCC itself provides limited and imperfect protection to the supplier, that is not the end of the matter. UCC § 2-306, and virtually all other provisions of the UCC, may be modified by contract. Stated differently, each section is implicitly preceded by "Unless modified by contract,…." Although hypothetical contract provisions are limited only by the imagination, some modifications are probably not contractually achievable, because they conflict with important customer commercial needs. For example, a person unfamiliar with the automotive supply chain may think the solution is obvious: contractually commit to minimum and maximum volumes, with limits on short-term fluctuations. However, it is quite unlikely that an automotive buyer will agree to purchase more goods than it requires, for the obvious reason that it has no need for the goods and no place to store them. And it is equally unlikely that a buyer will agree to purchase fewer goods than it requires, subject to actual short-term capacity constraints.

The balance of this Alert addresses sellers' commercially plausible contractual strategies to better protect themselves going forward. Of course, for *existing* contracts, parties' respective obligations will remain fixed absent a commercially negotiated modification. For *future* contracts, however, at least where a supplier enjoys sufficient commercial leverage to raise these possibilities, some aspirational strategy suggestions and considerations follow below:

- **Extending the Firm Release Period:** Under the typical automotive contract, the firm order period is limited and typically measured in weeks. At the same time, customers frequently disclaim the obligation to pay for purchases or work beyond firm authorized volumes. A longer firm order or release period, therefore, reduces a seller's economic exposure in the event of an unexpected change in volumes or termination, and it likewise affords suppliers a greater ability to offer enhanced economic security to sub-suppliers facing these same risks.
- **Tying Volume to Compensation and Making Volume Estimates More Consequential:** Under the typical contractual framework, customers assert that volume estimates in any number of contexts, whether in the initial request for quotation or in post-award forecasts, are for planning purposes only and are not binding. All the while, pricing generally is to remain fixed (or subject to adjustment only at pre-determined times or for pre-determined reasons). Sellers may wish to make volume estimates more meaningful, such that an excessive difference between estimated and actual volumes will entitle the seller to some form and level of compensation for the disparity. For instance, parties may agree to condition pre-determined price discounts (or premiums) on the achievement of agreed volumes. Ascribing more consequences to estimated volumes also offers value for a separate reason: where the contract does not otherwise specify short-term or long-term volume

parameters, volume estimates can serve as a contractual "center" if and when the "unreasonably disproportionate" analysis becomes necessary under the UCC.

- **Remedies Specific to Volume Spikes:** Parties may also agree to financial or other seller remedies specific to excessive volume increases. Such remedies may be tailored to the extent and duration of the increased demand. For instance, parties may agree that the seller will be entitled to reimbursement for overtime, freight, or other cost increases associated with meeting short-term order spikes, or parties may agree to good-faith negotiations for cost-sharing (which is less certain and likely less desirable, although perhaps more commercially achievable), or to requiring or permitting the customer to re-source the excess goods if and when feasible.
- **Remedies Specific to Volume Reductions:** Parties also may choose to address the risk of good-faith *decreases* in requirements in a host of ways. As examples, sellers may seek to obtain a minimum notice period for substantial decreases in volume, an increased minimum purchase level or, if applicable, an increased termination payment by the customer. In some circumstances, an extension of the contract until anticipated volumes are reached may be desirable, as may a right of the seller to terminate the agreement, or a preferred award status for the seller for future business with the customer (*e.g.*, with a pre-award or a discount applied against the supplier's actual bid when determining the low bidder).
- **Compensation for Inventory Banks:** Inventory banks can serve as a highly effective safeguard against a supplier's inability to meet a customer's production schedule, especially where necessary inputs are in short supply. At the same time, inventory banks come with meaningful costs and risks, including (among others) financial carrying costs, storage costs, higher input costs if purchases occur while demand is high, and the risk that purchases beyond the firm release period will go uncompensated in the event of a drop or cancellation in orders. For these reasons, whether to build a bank necessarily is a business decision, but it is one that may warrant exploration with the customer to determine how to share and minimize the risks to each side.
- **Reexamining Force Majeure Provisions:** Many suppliers have been surprised and disappointed to learn that *force majeure* usually does not protect them from the extraordinary pressures that have been roiling the supply chain. But *force majeure* is largely (though not solely) a creature of contract, and the surprise and disappointment can be avoided thorough purposeful contracting. As a starting point, recognize that *force majeure* is an excuse — *e.g.*, it excuses a contracting party from its obligation to perform (*e.g.*, deliver goods) — without which the party would be in breach. At least as typically written and interpreted by courts in the United States, *force majeure* is binary: if a party qualifies, it is off the hook; otherwise, its non-performance is likely a breach. With considerable over-simplification, the excuse is available only if two inter-related things are true. First, the underlying event must have prevented performance. Second, the event must be in the nature of an act of god or other extraordinary event, with the particulars generally defined by contract. With respect to the first element, performance is prevented only if it is impossible (or nearly so). The fact that performance has become crushingly expensive does not mean that performance is impossible. So, the supplier that wants protection (likely in the form of shifting or sharing extraordinary costs, rather than a complete excuse from performance), must specifically provide for that in the contract. With respect to the second element, while most customer contracts contain *force majeure* provisions,

many of these provisions refer to various concepts only generally, and these provisions often pre-date many of the recent supply chain disruptions. In part that is probably inevitable — it is notably hard to foresee and document the next unprecedented act of god — so some generality is necessary. Nevertheless, suppliers should consider the value of negotiating modified *force majeure* provisions that excuse performance in the event of disruptions like those at issue now. For instance, certain pandemic-specific causes of disruption (*e.g.*, resulting labor shortages) may be beneficial to include, and so too may causes relating to material or part shortages, transportation backups (*e.g.*, the recent port backups), or shutdowns of other suppliers within the supply chain. To be sure, today's causes of disruption may not be the causes of disruption tomorrow, but adapting future contract forms to address lessons of the past is something that serves all businesses well.

Conclusion

In summary, the current supply-chain disruptions pose very real financial and legal risks to manufacturers across the world. The causes of the disruptions may change, but most certainly, additional disruptions will occur. While the traditional automotive supply chain contract remains largely unchanged and onerous for many suppliers, now may finally be the time for the adoption of a more fault-tolerant model. While commercial leverage will undoubtedly determine whether and how effectively suppliers succeed in negotiating more protective contracts going forward, these concepts will hopefully prove helpful as a starting framework, even if the points so far remain largely aspirational. Change is often gradual, and, at least in context of the automotive supply contract, it will take a deliberate effort.

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