

Supply Chain Disruption – Before the Breach and How Best to Protect

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Due to COVID-19 concerns and government-imposed restrictions, many businesses have endured and are likely to continue to endure unprecedented supply chain disruptions. Manufacturers, materialmen, wholesalers, processors, logistics brokers, as well as purchasers, all are experiencing interruptions (or likely will) in the way that business is normally conducted which will require modifications to how they conduct business. While COVID-19 has not fundamentally changed the legal remedies available to parties in a contract dispute, these disruptions have highlighted the need for contracting parties in the supply chain to work cooperatively to innovate new solutions rather than relying on litigating their disputes. Attempts at renegotiating contracts or understandings should necessarily be the first approach whenever possible so that parties can maintain and preserve their supply chain relationship. It is prudent, however, for all parties involved to not only simultaneously consider and model different scenarios to best position themselves in the event of a contractual default, but to also employ new technologies to avoid losses from future disruptions.

Anticipatory Breach of Contract

It should come as no surprise that these disruptions will lead some parties to not be able to perform their obligations under existing contracts. This inability to perform may be shown in many forms, but the law is clear that before the other party seeks to take legal action the repudiating party must have made its inability to perform clear through its words or actions. In the law, these words and actions showing a party's inability to perform is known as anticipatory repudiation. These words or acts immediately create a cause of action for breach of contract in favor of the non-repudiating party to the contract. By declaring an anticipatory breach of contract, the non-repudiating party has the benefit of beginning legal action as soon as the repudiating party demonstrates its intention to break a contract rather than waiting for the actual breach to occur. Of note, however, a party cannot stop performance or file suit simply because it assumes the other party will not be able to perform its duties under a contract. Establishing a record, along with demonstrating flexibility, before putting a contracting party on notice of an anticipated or actual breach will pay dividends in the event litigation follows.

Prior to declaring an anticipatory breach, a party should carefully re-examine its existing contract(s) to see if it contains relevant *force majeure* clauses – contract provisions that excuse a party's inability to perform its obligations under the contract if an unforeseeable event prevents such performance. The analysis of whether a *force majeure* clause may be employed to excuse performance is based on the facts of a specific case and the language of the applicable *force majeure* clause in question.

Mitigation of Damages

Before instituting litigation, a party claiming an anticipatory breach or contractual breach should make every effort to mitigate its damages. Efforts to mitigate damages may include possibly halting supply or payments to the repudiating party and minimizing the effects of an anticipated breach by finding third parties to perform the repudiating party's contractual obligation(s). In short, in order to be reimbursed for a consequential damage, it is necessary to demonstrate that an effort to provide or obtain replacements at a reasonable cost under current market conditions has been made.

Uniform Commercial Code Implications for the Sale of Goods

If the anticipatory repudiation or breach of contract involves the sale of goods, the duties and obligations under Article 2 of the Uniform Commercial Code, which has been adopted in nearly every state of the country, will be invoked. The Uniform Commercial Code prescribes the binding principles for most contractual disputes involving the sale of goods within the United States.[1] See U.C.C. §2-102. Accordingly, Article 2 delineates the rights and obligations of parties that are experiencing disruptions in the supply chain, including those caused by the novel coronavirus, in relation to the sale of goods.

Article 2 recognizes the rights of contracting parties to renegotiate the terms of their agreement. See §2-209. Renegotiation can take many forms, including changes in the terms of the agreement, discounts or supply of a lower quantity of goods. As businesses are well aware, some of the most valuable resources that they maintain are the relationships with customers and supply chain partners. Opting to renegotiate the terms of the contract in these unstable times rather than instituting legal action will likely further engender good will and understanding between the parties and may better align their businesses in the future. Thus, when faced with disruptions in the supply chain, open communication between the parties is essential and can help, at times, maintain those relationships, while allowing the parties to continue functioning as viable entities.

Parties who are reasonably unsure of whether their contractual partners can meet their obligations have the right to demand adequate assurance of due performance under §2-609. Should a party who received the demand fail to provide such assurances adequate under the circumstances in a reasonable amount of time, not to exceed 30 days, a repudiation of the contract occurs. While awaiting the reassurances, the demanding party, if commercially reasonable, can suspend any performance that it has not already received the agreed return.

Naturally, however, open communication and renegotiation is not an absolute panacea for disruption of the supply chain. Parties may inevitably be faced with irreconcilable conflict. In such an event, Article 2 provides contracting parties in the supply chain of goods with the ability to institute litigation and recover consequential damages from a breach of contract. However, before instituting litigation, Article 2 also provides guidance for the steps parties should take to conduct a cost-benefit analysis of any potential litigation.

Purchasers of Goods in the Supply Chain

As to purchasers, there may be limited situations where a purchaser cannot find an additional supply line and thus will incur damages, sometimes substantial. In these circumstances, the cost-benefit analysis will most often favor consideration of the litigation model. However, in many situations an additional or alternative supply line exists. Under §2-715, a purchaser's consequential damages are limited to the difference between the loss that they incur from the supply failure and the amount that they could have prevented by purchasing the goods from another supplier. Before instituting litigation or triggering arbitration, purchasers should first seek out an additional supply line (and record efforts in this regard) to determine their actual damages. While Article 2 does not impose a legal obligation on a purchaser to do so, such a strategy makes business sense. It allows the business to continue providing its customers with the goods or services that its customers have come to rely on. Simultaneously, it provides the purchaser with the information it needs to conduct a proper cost-benefit analysis on the actual damages it can hope to recover in instituting litigation. Thus, seeking out a different supply line can help serve the interest of the business in at least two distinct ways. At a minimum seeking answers of a certain level of supply is advisable regardless.

Sellers of Goods in the Supply Chain

As to sellers, there also may be limited situations where a seller cannot find an additional purchaser. However, in most situations, a seller can find an additional purchaser that opens a new customer base for the firm or strengthens an already existing customer base. Where the goods can be resold, the seller should do so prior to instituting litigation. By doing so, sellers can similarly conduct a proper cost-benefit analysis on the actual damages it can hope to recover by instituting litigation, as the seller's damages in the litigation will be limited to the difference between the contract price and the market price of its goods, in addition to any incidental damages it incurred. See §2-708(a). Only where the seller cannot find a new purchaser for its goods does Article 2 provide the seller with an alternative calculation for its damages. See §2-708(b).

Planning for Future Disruptions

While the magnitude of the effects of COVID-19 on the supply chain could not have been predicted, parties can better insulate themselves in the future by employing current technologies. Parties should begin the exploration or increase the use of technologies that will assist them to enhance their supply chain visibility, supply chain flexibility, and supply chain automation.

Parties can increase supply chain visibility by instituting programs or employing others to better track the status of other parties' progress in completing the performance or obligations contracted. If parties are able to increase visibility as to the status of their supply chain, they will be able to better position themselves to spot anomalies, disruptions, or other concerns that they may be able to rectify or minimize prior to experiencing an actual disruption. Should a disruption be unavoidable, the increased notification will, at the very least, afford a party more time to plan their next steps or mitigate losses.

Parties can increase their supply chain flexibility by collaborating with others that provide on demand warehousing, when necessary. The models of only having "just in time" inventories are highly susceptible to market disturbances and can easily falter when supply chain disruptions occur, leaving parties with little or no alternatives to litigation to recoup losses.

Parties can increase supply chain automation by using or increasing the use of artificial intelligence or robots in their businesses. Unlike human labor, artificial intelligence is not affected by disruptions related to health or emotion. Lowering reliance on human labor will increase a party's efficiency, as well as consistency, to deliver on their contracted obligations.

In sum, while COVID-19 has in many ways changed the world in which we live, it has not changed the well-established fundamentals of contracting parties. Instead, it has emphasized the need for contracting parties to determine the contours of their agreements, work together to find novel solutions to problems effecting both parties, and employ technologies to insulate themselves from future disruptions.

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As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates [here](#).

[1] Article 2 of the Uniform Commercial Code does not apply to the international sale of goods.

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