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Supplier's Revenge: Court of Appeals Confirms that When a Supplier has the Right to Terminate, the Law does not Protect the Buyer from Supplier's Rightful Cutoff Threats

A supplier threatens to terminate a supply contract unless the buyer increases prices. Faced with an imminent supply cutoff, the buyer agrees, and then later argues that its agreement is not enforceable because of the circumstances under which it was made. In *Whirlpool Corp. v. Grigoleit Co., No. 11-2348/2421* (6th Cir. Apr. 12, 2013), the federal Court of Appeals held that **so long as the supplier had the contractual right to terminate its supply contract**, the buyer was entitled to little sympathy and no relief under Michigan law.[1] The Court thus confirmed perhaps the most important reality of the automotive supply chain: Under the typical supply contract, the only time that the supplier has legal leverage is when it has the right to terminate (or not renew) its contract, but when it does have that right, its leverage can be enormous.

In *Whirlpool*, Grigoleit was the long time supplier to Whirlpool. Whirlpool informed Grigoleit that it intended to terminate its purchase orders and, in the meantime, significantly reduced its purchases. Grigoleit responded that it intended to exercise its right to terminate its contracts in 3 months unless Whirlpool agreed to dramatically increase prices and guarantee minimum volumes.[2] Whirlpool failed to either meaningfully negotiate or prepare for a resourcing. On the eve of Grigoleit's termination date, Grigoleit escalated its demands to include retroactive price increases and the payment of unspecified costs. The parties finally reached a revised agreement providing Grigoleit with price increases, a surcharge in lieu of retroactive payments and an additional payment of unspecified costs. Whirlpool later sued, arguing that the revised agreement was unenforceable because it was the product of "economic duress" and was unconscionable.

The Court quickly rejected Whirlpool's economic duress claim because, in Michigan, economic duress requires "illegal action," and threatening to exercise a contractual right to terminate is not illegal. In other words, so long as Grigoleit had a right to terminate, its demands, however unreasonable, were hard bargaining, not duress.

The Court also rejected Whirlpool's unconscionability claim, holding that: (i) both procedural and substantive unconscionability are required for an unconscionability claim under Michigan law; and (ii) Whirlpool could not demonstrate procedural unconscionability.[3] The Court explained that procedural unconscionability turned principally on "(1) whether the relatively weaker party had an alternative source with which it could contract, and (2) whether the contract term in question was in fact negotiable." The Court held that Grigoleit's improved terms were not procedurally unconscionable for a number of reasons, each of which have relevance to many supply cutoff disputes.

[1] The Court recognized that the law of some other states differed from Michigan law on important issues. Thus, the issues addressed in *Whirlpool* must be assessed under whichever state's law applies.

[2] The Court did not discuss the nature of the contractual provision allowing Grigoleit to terminate, but characterized the right as "indisputable."

[3] Because procedural unconscionability was lacking, the Court did not address whether the terms were also substantively unconscionable.

First, the Court reiterated prior law that procedural "[u]nconscionability is rarely found in a commercial context." "This principle is not limited to extremely large and sophisticated buyers such as Whirlpool; it would apply to the vast majority of entities in the automotive supply chain, and thus to the vast majority of supply chain disputes.
Second, the Court found that Whirlpool created its own predicament in two ways: by entering into a sole-source agreement and by failing to respond to Grigoleit's termination threat. The Court's sole-source analysis is especially provocative:

> [S]ole-source arrangements allow Whirlpool to avoid a number of manufacturing and design costs. . . . In exchange however, **Whirlpool inherently accepts the risk that a disagreement with one of its suppliers may cause a manufacturing delay.**

This risk goes to the heart of the automotive supply chain and applies to most every "cutoff" dispute, even if the cutoff threat is wrongful. For example, when a buyer seeks a preliminary injunction to require a supplier to continue supply, the seller may rely on *Whirlpool* to argue that the Court should not relieve the buyer of the consequences of its deliberate business decision.

It also found that Whirlpool was to blame for its own predicament because it delayed until the 11th hour to either negotiate a resolution or prepare to re-source. Although unstated by the Court, the flip side of this is that Grigoleit allowed several months for Whirlpool to protect itself. It cannot be assumed that the outcome would have been different if Grigoleit had not given Whirlpool time to protect itself, but Grigoleit probably acted wisely by doing so. As tempting as it might be for a frustrated supplier to threaten an immediate supply cutoff, doing so may weaken the supplier's position before a court.[4]

Finally, the Court concluded that negotiations were possible, as the revised agreement included compromise terms proposed by Whirlpool.

Lessons

Whirlpool holds important lessons for buyers seeking protection from supplier leverage and suppliers seeking to preserve and maximize their leverage.

The buyer faced with a termination (or non-renewal) threat must first decide whether the supplier has that right. Counsel should be involved in that assessment. If the supplier has that right, the buyer must realistically assess its position and commercial and legal options. Often the buyer's first instinct is to play "chicken." *Whirlpool* illustrates how dangerous chicken can be. Prudent buyers develop alternate sources of supply while negotiations are ongoing, rather than assuming that the dispute will be resolved. *Whirlpool* illustrates the legal perils of not doing so. Finally, and most importantly, the buyer, working with counsel, should protect itself from a rightful supply cutoff threat by giving careful consideration to establishing robust contract terms regarding the duration, termination and wind down of a supply relationship. For example, the buyer should consider whether the contract contains an enforceable duration term? (surprisingly often, the answer is no); should its purchase order be for a calendar time period, a model year or for the life of the program?; should its purchase order "auto-renew" if the supplier does not give advance notice of its intent to not renew?; and should the purchase order give buyer the right to extend the contract to extend the purchase order for several months following termination to allow for an orderly transition? These are just a few of the possible contractual protections available to the prudent buyer. This is not a "one size fits all" answer and no substitute for careful consideration of a range of legal and commercial issues.

[4] Under some circumstances, UCC 2-306 requires "reasonable notification" of termination. Whirlpool does not discuss UCC 2-306 and it is not clear from the facts whether it would apply.

For the supplier, the key is knowing whether, when and how it can terminate (or not renew) the contract. Too often, suppliers involved in an unprofitable or otherwise unsatisfactory supply relationship unwittingly let an exit opportunity lapse by, for example, missing a contractual deadline for giving notice of its intent to not renew. To avoid this, suppliers (and buyers as well) should systematically document for each contract: (i) the expiration date and, if applicable, (ii) the deadline for giving notice of an intent to not renew the contract or other procedural conditions to termination; and (iii) any other supplier termination right. This should be tied to a "tickler" system supporting timely and informed decision making. Again, counsel should be consulted, as the consequences of wrongfully terminating or threatening termination can be severe.

For assistance regarding supply chain contracting, contact Sheldon Klein, Dan Rustmann, Cynthia Haffey or any of the other attorneys in Butzel Long's Automotive Industry Team.

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