

Supply Chain Dispute Resolution in the US

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This Practice Note describes how to avoid legal disputes between supply chain participants and how to manage supply chain legal disputes that arise. This Note gives an overview of contracting practices that supply chain participants can employ prospectively to minimize or eliminate supply chain legal disputes. It also discusses how best to defend and pursue supply chain disputes that become intractable.

Disputes between supply chain participants often arise because of poor contract management at the outset of supplier-buyer relationships. Supply chain participants often make the mistake of allowing purchasing or contracting personnel to draft supply chain contracts in isolation, without input from the operating units within the organization that perform the contract, primarily, engineering and finance, which then must live with the financial results.

Supply chain participants also often over-rely on standard forms, terms and conditions, which may contain boilerplate provisions ill-suited to a particular supply chain relationship. While boilerplate contracts or purchase orders may be appropriate for small or commodity relationships, for high dollar or strategically important supply chain relationships, it is usually better to individually negotiate the terms.

Supply chain disputes can arise when supply chain participants begin contract performance without regard to the supply chain contract's terms. It is surprisingly common for engineering personnel to begin product development or manufacture in ways that are contrary to a supply chain contract's terms, often because they do not know the terms of the supply chain contract. A party may permit this, sometimes for years, before it or the other party becomes dissatisfied with the relationship and then tries to enforce the contract terms as written.

Once disputes between supply chain participants arise, they can be difficult and expensive to manage. Supply chain disputes often:

- Concern relationships that have been in place for years.
- Affect and involve multiple business functions, including:
 - engineering;
 - contracting;
 - quality assurance;
 - finance;
 - business development; and
 - executive management.

Supply chain disputes typically become costly to pursue, even if there is only a relatively small amount of money in dispute. Therefore, early dispute resolution becomes important.

This Note provides practical tips for managing litigation with supply chain participants. It discusses how to:

- Avoid supply chain disputes by:
 - taking into account all relevant perspectives when drafting contracts;
 - customizing important supply chain contracts; and
 - adhering to the contracts.
- Develop strategies for managing supply chain disputes during the following stages of litigation or arbitration:
 - the initial pleadings stage;
 - discovery (document production);
 - discovery (depositions);
 - expert witness retention and other expert issues;
 - summary judgment;
 - trial; and
 - doing business in the midst of a supply chain legal dispute.

For a general discussion of commercial dispute resolution, see *Practice Note, Avoiding and Managing Commercial Disputes in the US: Overview* (<http://us.practicallaw.com/4-502-9001>).



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AVOIDING SUPPLY CHAIN DISPUTES

This Note discusses three principal strategies for managing supply chain relationships, to prevent disputes from developing (and that can minimize them if they do develop):

- Encouraging broad participation in the supply chain contract drafting process (see *Take into Account All Relevant Perspectives during Contract Drafting*).
- Avoiding excessive reliance on standard forms for large or strategically important supply chain contracts (see *Customize Important Supply Chain Contracts*).
- Ensuring that contract performance adheres to the terms of the supply chain agreement, as negotiated (see *Adhere to the Supply Chain Contract*).

TAKE INTO ACCOUNT ALL RELEVANT PERSPECTIVES DURING CONTRACT DRAFTING

The contracting function of a supply chain entity often does not have intimate knowledge of what is required from the company's engineering function to make a contract successful and profitable. Particularly if a supply chain contract has a research and development (R&D) or developmental component, management must ensure careful attention to the contract negotiation and formation process to ensure that a supply chain contract makes money and is achievable. The company should include engineering and financial personnel in all major supply chain contract negotiations, to ensure the numbers and the proposed contract are consistent with the company's profitability goals.

Unless the negotiation of contract terms is coordinated with the functions of the company responsible for performing the contract, it is all too possible for contracting personnel to agree to terms that are unworkable in practice. The terms of these relationships should not be left just to the contracting, purchasing or business development functions.

The non-exclusive list of corporate functions listed below should be considered in the formation of important or strategic supply chain contracts:

- Purchasing.
- Supply chain.
- Engineering.
- Safety.
- Quality.
- Finance.
- Tax.
- Business development.
- Manufacturing.
- Government relations and compliance.
- Legal.
- Executive management.

CUSTOMIZE IMPORTANT SUPPLY CHAIN CONTRACTS

Supply chain contracts have lagged behind other types of corporate contracts (for example, mergers and acquisitions) in terms of the legal review and executive attention they receive. A \$100 million corporate acquisition is typically staffed with outside counsel and consultants to ensure the viability and success of the proposed deal.

In contrast, supply chain contracts of comparable value often receive no more than cursory, if any, attention from in-house counsel, outside legal specialists and executive management. Supply chain contracts instead tend to over-rely on buyers' or suppliers' standard forms, whether these are either:

- Related to a request for proposal (RFP).
- Simply one or the other party's purchase order terms and conditions (or purchase order acknowledgement terms and conditions).

Standard terms and conditions can be an effective way to streamline the contracting process for commodity or low-value supply chain purchases (see *Standard Documents, General Terms and Conditions for the Purchase of Goods and Services (Pro-buyer)* (<http://us.practicallaw.com/6-598-9966>) and *General Terms and Conditions for the Sale of Goods (Pro-seller)* (<http://us.practicallaw.com/6-520-2354>)). However, relying on the same terms and conditions for high-value or strategically important supply chain relationships can lead to legal friction later in the relationship, or at the very least, frustration when the standard terms are inconsistent with the parties' priorities. A company's standard terms may not be equally appropriate for all important supply chain relationships.

At the outset of a transaction, counsel should consider the contract's governing law because the law chosen includes substantive rights and obligations of the parties. If the chosen law is not US law, a lawyer experienced with the relevant country's law should be closely involved in the drafting process. If US law governs, the law of a particular US state is usually specified that either:

- Has a well-developed body of law in a particular area.
- Is one where a party's lawyer is accustomed to practice.

The UN Convention on Contracts for the International Sale of Goods (CISG) automatically becomes the substantive law governing sales contracts between parties residing in the US and any other signatory country of the CISG unless the parties exclude or vary the CISG's application in the contract. When deciding whether to opt out of the CISG, the parties should consider the substantive differences between the Uniform Commercial Code (UCC) (if the law of the US state otherwise applies) and the CISG (see *Practice Note, UN Convention on Contracts for the International Sale of Goods: Key Differences between the CISG and the UCC* (<http://us.practicallaw.com/2-523-2126>)). For a sample choice-of-law clause, see *Standard Clause, General Contract Clauses: Choice of Law* (<http://us.practicallaw.com/9-508-1609>).

Of the contractual terms, warranty and indemnity provisions typically allocate the greatest amount of liability. For large transactions, the standard warranty and indemnification terms may or may not match up with the parties' revenue and profitability expectations or needs. (For a discussion of warranty and indemnification terms, see *Practice Note, Risk Allocation in Commercial Contracts* (<http://us.practicallaw.com/4-519-5496>)).

Dispute resolution is another area where the standard language does not serve supply chain participants' needs. Some supply chain relationships are simply too important to allow a dispute to interrupt them. For these relationships, practitioners must pay careful attention to the contract provisions that govern how disputes are to be resolved.

When drafting dispute resolution provisions, counsel should at the least list the place of resolution and the arbitral institution's rules to be used. Arbitral institutions, such as the American Arbitration Association (AAA) and the International Chamber of Commerce (ICC), have readily available, easy to use model clauses. (For drafting guidance, see *Standard Clauses, Standard Arbitration Clauses for the AAA, ICDR, ICC and UNCITRAL* (<http://us.practicallaw.com/6-502-3569>) and *General Contract Clauses, Alternative Dispute Resolution (Multi-tiered)* (<http://us.practicallaw.com/9-555-5330>).)

Arbitration clauses should also provide for:

- A general and broad scope (for example, "any and all issues or disputes arising out of or relating to this Agreement").
- Severability, so that a court can strike a problematic part of the arbitration clause and preserve the remainder of the agreement to arbitrate.
- The power of arbitrators to determine their own jurisdiction and consolidate related proceedings arising from different contracts.
- The seat of arbitration in a country that has signed the New York Convention (which provides for the easy enforcement of arbitration awards internationally) with courts supportive of arbitration.

Issues can also arise with exclusive or limited-supplier supply chain contracts. For these contracts (for example, where the work of a supplier cannot realistically be performed by any other potential supplier), the buyer wants to ensure greater protections for its supply. Exclusive arrangements can have anti-trust implications (see *Practice Note, Exclusive Dealing Arrangements* (<http://us.practicallaw.com/2-523-2602>)). It is best to negotiate in a customized fashion these types of supply chain relationships:

- Customized damages limitations.
- Forum non conveniens.
- Excuses for performance.
- Late penalties.

A non-exclusive list of terms that supply chain participants should consider customizing for high-value or strategically important relationships includes:

- Warranty.
- Indemnification.
- Rights to inspection.
- Dispute resolution.
- Damages for delay/ liquidated damages clauses.
- Forum non conveniens or other excuse provisions.
- Assignment or delegation.
- Ownership and rights to necessary tooling or other equipment.
- Damages limitations.
- Right to pursue immediate injunctive relief.

- Procedure for amendment of contract.
- Insurance.
- Record retention.
- Forecasting requirements.
- Technical specifications.
- Visibility and audit term.

For information on the terms used in supply chain contracts, see *General Contract Clauses Toolkit* (<http://us.practicallaw.com/9-518-4339>). For sample sale of goods agreements, see *Standard Documents, Sale of Goods Agreement (Pro-seller)* (<http://us.practicallaw.com/2-518-9260>) and *Sale of Goods Agreement (Pro-buyer)* (<http://us.practicallaw.com/5-541-6567>).

ADHERE TO THE SUPPLY CHAIN CONTRACT

Engineering and other constituencies that are involved in performing a supply chain contract are often not involved in the negotiation of the terms of the supply chain contract. When this happens, the engineers and others on the ground often do not adhere to the terms of the supply chain contract in their performance. This can cause real problems, whether it is because either:

- Those engineers and others do not know or understand the terms.
- The terms do not support the parties' expectations or needs.

It is typical for a divide between supply chain contract terms and performance to emerge almost immediately after a supply chain contract is negotiated. Many times, neither party complains immediately. It is often not until years down the road, after a pattern of nonconforming performance occurs, that one or the other party complains, many times because it has become unhappy with the supply chain contract for other reasons.

Supply chain contracts using terms inconsistent with the parties' performance provide fertile grounds for disputes. Disputes sometimes arise because one supply chain participant honestly wants performance to match up with the negotiated contract terms. Other times a dispute about non-conforming performance is a pretext for some other unhappiness. Parties can avoid needless legal disputes by ensuring that supply chain contract terms, as negotiated, are performable by both parties without undue burden to either of them.

MANAGING SUPPLY CHAIN DISPUTES

Unfortunately, not all supply chain disputes can be avoided and almost any supply chain dispute inevitably disrupts business and implicates nearly every business function in a manufacturing company. The procedures used are similar, regardless of whether a dispute is adjudicated in litigation or in an arbitration setting. There are specific strategies that may be used to manage supply chain disputes during the various stages of litigation or arbitration.

THE INITIAL PLEADINGS STAGE

Supply chain litigation or arbitration starts out the same way any litigation begins, with a complaint (see *Practice Note, Commencing a Federal Lawsuit: Drafting the Complaint* (<http://us.practicallaw.com/5-506-8600>)) or a demand for arbitration (see, for example, *Practice Note: AAA Arbitration: A Step-By-Step Guide: Elements of the Demand for Arbitration* (<http://us.practicallaw.com/9-502-6707>)). Both complaints and demands for arbitration state:

- The legal claims of the complaining party.
- The facts on which those legal claims are based.

Supply chain litigation poses some unique challenges at the complaint or demand for arbitration stage. Attorneys pursuing a supply chain legal dispute often cannot ensure that they know all of the relevant facts at this early stage of the proceeding because:

- The relationship and sometimes the facts in dispute that underlie a supply chain legal case often span years.
- Those most intimately familiar with the disputed facts typically do not have a legal background.

This is less true with disputes that involve simple commercial terms and more true with disputes that involve either:

- Product performance.
- Integration into the end-product.
- Engineering issues.

In supply chain litigation, facts often become known during discovery that may have a material impact on the parties' legal claims and defenses. For this reason, drafting an initial pleading that accurately captures all of the relevant facts can be a challenge. Fortunately, in most jurisdictions and under most arbitration rules, pleadings can be amended as more information is discovered. However, it is often wise to plead factual allegations sparingly during the early stages of the litigation.

Outside litigation counsel should give each constituency at the client company who was involved in drafting, negotiating or performing the supply chain contract at issue a chance to review and comment on the allegations stated in the complaint or demand for arbitration. Finance personnel are often familiar with facts that the engineers are not familiar with and vice versa. A multi-tiered pleading review helps ensure accuracy.

Ensuring accuracy is doubly important if a company in a supply chain dispute seeks any sort of emergency or expedited relief, which is typically available under all court and arbitration rules in certain situations (see, for example, *Practice Notes, Preliminary Injunctive Relief: Procedure for Obtaining Preliminary Injunctive Relief (Federal)* (<http://us.practicallaw.com/3-520-9724>) and *Interim, Provisional and Conservatory Measures in US Arbitration* (<http://us.practicallaw.com/0-587-9225>)).

Where there is no arbitration agreement, most supply chain litigants prefer federal court to state court because:

- Federal court is more uniformly administered.
- Federal judges tend to have more experience with sophisticated commercial disputes than do state court judges.

Parties do not have the option to choose US federal courts where either:

- The disputes do not concern violations of federal law (federal question jurisdiction).
- The parties are from different jurisdictions (diversity jurisdiction).

For a further discussion on why parties may prefer federal court, see *Practice Note, Removal: Why Remove?* (<http://us.practicallaw.com/2-533-3069>)

Counsel must also consider that federal courts require a unanimous jury verdict. State law may sometimes be more plaintiff-friendly than the federal rules in this regard. In New York, for example, juries are comprised of six persons and a verdict may be rendered by five jurors (*N.Y. C.P.L.R. 4104 and 4113(a)*).

If the supply chain contract requires arbitration, the filing party likely has little if any choice on how and where the case must be filed. Arbitration clauses generally dictate the institution that will administer the case and the location where the arbitration will be held.

If you are the party defending a supply chain dispute, drafting an answer requires the same detailed attention as drafting a complaint (see *Practice Note, Responsive Pleadings: Answering the Complaint* (<http://us.practicallaw.com/2-521-6409>)). Employees from each of the groups within the company involved with the negotiation, drafting and performance of the supply chain contract at issue should be invited (required, if possible) to review the draft answer to ensure accuracy.

DISCOVERY (DOCUMENT PRODUCTION)

The most costly and cumbersome component of supply chain litigation is typically document discovery. Document discovery refers to the process, available in litigation and under almost all arbitration rules, by which parties request from each other the documents that support or refute their claims and defenses.

Document discovery is far reaching. It typically includes:

- Production of all contract documents.
- Finance records.
- Engineering work.
- Email correspondence.
- Enterprise resource planning (ERP) information.
- Other documents relating to the disputed supply chain project.

These documents are typically found in every department of a manufacturing company. Discovery rules typically require company employees to preserve and isolate records from their emails to be turned over to the opposing party. Finding all of the relevant and responsive materials is a labor intensive process. It is common for parties to continue to locate responsive documents throughout the period of time in which a supply chain dispute is being litigated. For more information of document discovery, see *Practice Note, Document Responses: Document Review* (<http://us.practicallaw.com/9-582-4525>).

Document production is now handled almost exclusively electronically. It has become extremely rare to exchange actual, paper documents. Because of the proliferation of email and other electronic forms of communication, many supply chain disputes involve more than a million documents. For more information on electronic document discovery, see *Practice Note, E-Discovery in the US: Overview* (<http://us.practicallaw.com/1-503-3009>).

However, collecting documents is only half of the equation. Therefore, documents collected from other parties must also be reviewed (see *Practice Note, Document Requests: Performing the Document Review* (<http://us.practicallaw.com/0-519-6332>)).

In supply chain disputes, document review can be extremely time consuming and cumbersome. However, companies typically use outside contract attorneys to do most of the first-round document review work. These contract attorneys are usually not law firm associates or other law firm employees but instead are outside contractors obtained from an outside counsel company, often charging fees as little as \$50 per hour.

Using outside contract attorneys can provide a major cost savings in supply chain litigation, but they must be given concrete and constant guidance. In-house counsel often make the mistake of asking the contract reviewers to simply assign a level of relevance, such as, "hot good" or "hot bad," to documents that are reviewed, without adequately explaining the underlying legal issues. It is often more effective to assign the contract reviewers the task of looking into specific factual issues and create appropriate search terms to aid their work.

Sometimes parties or outside practitioners propose using intelligent discovery software programs as a low-cost way to expedite the document review process. Intelligent discovery programs create algorithms to find relevant and responsive documents, based on what is tagged to be relevant and responsive in a small, sample group of documents. While they are often useful in many types of litigation, in supply chain litigation, however, they often prove less helpful because the issues involved often evolve over long periods of time and are multifaceted and complex. If possible, it is better to use targeted human review.

Although less expensive contract reviewers can perform an adequate first-run review of produced documents, eventually the participants and associates running the case must review the most relevant. Even after a first-round review, this may involve thousands of documents. It is, however, vitally important that the attorneys running the case know the case and the documents.

In addition to requesting documents, parties in supply chain disputes may also submit to each other:

- Interrogatories, which are written requests for information.
- Requests to admit, which requires the responding party to admit or deny factual allegations posed by the requesting party.

However, some arbitration rules do not allow for interrogatories or requests to admit.

DISCOVERY (DEPOSITIONS)

After documents are exchanged and reviewed, parties in supply chain litigation typically depose each other's principal witnesses. Depositions can be challenging in supply chain disputes because the witnesses are often mid-level engineering, procurement or finance employees who are not used to testifying. For this reason, adequate deposition preparation becomes crucial.

Witnesses should all be asked to review any documents found important before their deposition. They should meet with attorneys for an amount of time sufficient for them to understand the legal issues in the case. Insufficiently educated witnesses are likely to make mistakes. While depositions are typically available in US litigation, arbitration rules often do not allow for depositions or allow for only a limited number of depositions.

For more information on depositions, see *Deposition Toolkit* (<http://us.practicallaw.com/3-532-3606>).

EXPERT WITNESS RETENTION

Supply chain litigation frequently requires that parties retain one or more expert witnesses to aid in the prosecution or defense of their cases. Common disputes in which expert testimony is likely include:

- Engineering experts to offer opinion about a product's quality or performance.
- Supply chain management or procurement experts to offer opinion on the sufficiency of a supplier's performance.
- Experts in global procurement practices in a dispute over foreign manufacturing practices.
- Accountants or economists to quantify or dispute a claim for damages.

For more information on retaining expert witnesses, see *Practice Note, Experts: Locating and Retaining an Expert* (<http://us.practicallaw.com/7-566-2595>).

SUMMARY JUDGMENT

Supply chain litigation often presents issues appropriate for dispositive resolution by using a summary judgment motion. In a summary judgment motion, a court (without the aid of a jury) decides the dispute as a matter of law using the undisputed evidence. For example, when the dispute involves contract interpretation, the issue can be resolved in a summary judgment.

The availability of summary judgment is often perceived to be a major advantage in litigation over arbitration. Although the major arbitral institutions in the US do not prohibit dispositive motions (see AAA, JAMS and CPR Comparison Chart for US Domestic Arbitrations: *Dispositive Motions for Summary Judgment* (<http://us.practicallaw.com/5-557-1285>)), arbitrators are less likely to grant dispositive motions, increasing the likelihood that a claim proceeds to hearing.

Some issues arising in supply chain litigation that can often be resolved by summary judgment include whether:

- Warranties asserted by a buyer have been validly limited or disclaimed by a supplier (see, for example, *Iron Dynamics v. Alstom Power, Inc.*, No. 1:06-CV-357, 2007 WL 3046430 (N.D. Ind. Oct. 15, 2007); *Monarch Nutritional Laboratories, Inc. v. Maximum Human Performance, Inc.*, No. 2:03CV474TC, 2005 WL 1683734, at *10 (D. Utah Jul. 18, 2005); *Myrtle Beach Pipeline Corp. v. Emerson Elec. Co.*, 843 F.Supp. 1027, 1038 (D.S.C. 1993)).
- Lost profits or similar damages are barred by contract provisions prohibiting the recovery of consequential damages or limiting available remedies to repair or replacement of the defective part (see, for example, *Pinova, Inc. v. Quality Mill Serv., Inc.*, No. CV 213-144, 2015 WL 1224611, at *3-4 (S.D. Ga. Mar. 17, 2015); *NavCom Tech., Inc. v. Oki Elec. Indus. Co.*, No. 5:12-CV-04175-EJD, 2014 WL 991102, at *10-12 (N.D. Cal. Mar. 11, 2014); *Transp. Corp. of Am., Inc. v. Int'l Bus. Machs. Corp., Inc.*, 30 F.3d 953, 959 (8th Cir. 1994)).
- A breach of supply chain action has been brought within the four-year period provided by the UCC's statute of limitations (see, for example, *Apex Digital, Inc. v. Sears, Roebuck & Co.*, 735 F.3d 962, 966-67 (7th Cir. 2013); *Badwey Oil, Inc. v. ConocoPhillips Petroleum Co.*, 352 Fed. App'x 276, 280 (10th Cir. 2009); *Thein Well Co. v. Dresser Pump*, 1996 WL 285828 (8th Cir. May 30, 1996)).

Other supply chain legal issues tend to be intractably factual and are most likely to require a trial on the merits to resolve them. These issues include whether a supply chain agreement has been validly modified concerning:

- Whether the performance of a component has satisfied the buyer's technical specifications.
- The likely cause or causes of product failure in highly engineered products.

TRIAL

Taking a supply chain dispute to trial or arbitration is a major undertaking. The trial of a major supply chain dispute can last several weeks. Trial requires:

- Careful witness preparation.
- Logistical coordination.
- The introduction of evidence that is often technical or scientific to a lay judge, arbitrator or jury.

Trials are costly and disruptive, no matter what the venue is and no matter the amount of money in dispute.

Supply chain disputes present some interesting trial challenges, including:

- There is often the challenge of presenting highly technical information to a jury or to a panel of lay arbitrators. Expert witness assistance is often needed to do this effectively.
- The facts involved in supply chain disputes can span not just years, but decades.
- When supply chain disputes involve highly engineered products, the question of what factor or factors caused a component or product to fail can be hotly contested between the parties, often with equally plausible evidence. For example, in a dispute involving the failure of an aircraft engine component, the supplier and buyer disputed whether the component failed because of poor engineering (the buyer's position), or whether unforeseen and undisclosed environmental factors caused the failure (the supplier's position).

DOING BUSINESS IN THE MIDST OF A SUPPLY CHAIN LEGAL DISPUTE

The most complex aspect of managing a supply chain legal dispute is often managing the business aspect of the supply chain relationship despite the ongoing legal proceedings. Not all disputes occur after a supply chain relationship has ended. They can emerge while the parties are still doing business with each other and often when they must continue doing business with each other. It can be a challenge to keep the business relationship moving in the right direction when there is a legal dispute pending.

Supply chain participants involved in litigation with each other often find it best to delegate point people for the business aspect of the relationship. In these cases, both supply chain participants typically understand that the point people exist for the sole purpose of getting business done, have nothing to do with the litigation, and must remain unaffected by anything going on in the litigation. Sometimes, supply chain participants agree that any statements made by the appointed business point people are not admissible in the legal proceeding.

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