

Automotive Supply Chain: Doctrines of Frustration of Purpose and Impracticability

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Being unable to meet contractual obligations due to forces outside their control is no mystery to businesses—particularly automotive businesses up and down the supply chain. The COVID-19 pandemic laid bare the problems related to shutdowns and supply chain disruption. As the economy recalibrates from the impact of the pandemic, the automotive industry continues to face these issues, the computer chip shortage and parts-related delays being one example.[1]

In the wake of COVID-19-related shutdowns, many businesses began to include "force majeure" provisions in contracts, which typically cover what happens when an unforeseen event that did not exist as the party's contract emerges during the business relationship and disrupts one party's ability to perform.[2] Courts tend to construe force majeure clauses very narrowly, and often limit enforcement to the specific events identified in the clause which excuses a party's nonperformance for a given period of time. [3]

Many contracts, however, lack a force majeure clause—either by design or because they pre-date the pandemic. In those circumstances, the legal doctrines of frustration of purpose, impossibility of performance, and impracticability of performance often come to bear. Successfully invoking these doctrines presents a high bar to the party requiring relief from its contractual obligations.

While there are three separate doctrines, they often appear in very similar circumstances. In matters involving Article 2 of the Uniform Commercial Code—which typically governs the terms of the sale of goods—the doctrine is called "commercial impracticability" or "impracticability of performance." At common law, the doctrine is called "impossibility of performance" or "impracticability of performance." In addition, the doctrine of "frustration of purpose"

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provides a very, very similar contractual defense.

Doctrine of Frustration of Purpose

Under the doctrine of frustration of purpose, a party must generally demonstrate:

- the contract must have been at least partially executory;
- the frustrated party's purpose for the contract must have been known at the time the contract was made;
- the purpose must have been frustrated by an event that was not foreseeable at the time of contracting, through no fault of the frustrated party.[4]

The Second Restatement of Contracts emphasizes that "the frustration must be so severe that it is not fairly to be regarded as within the risks [the frustrated party] assumed under the contract" and "the non-occurrence of the frustrating event must have been a basic assumption on which the contract was made."[5] That a transaction will be less profitable or that a party will sustain a financial loss is not enough—the frustration must be substantial.[6] Successfully demonstrating frustration of purpose "involves essentially the same sort of determinations that are involved under the general rule of impracticability."[7]

Impossibility of Performance

A party may assert the impossibility of performance as an affirmative defense to a breach-of-contract claim, which, when proven, excuses performance under a contract because it has been rendered impossible due to the occurrence of an unforeseeable event.[8] "Impracticable" may be enough to demonstrate impossibility.[9] Performance may be impracticable because it may, among other things, involve a risk of injury to a person or property that outweighs the likely result of performance.[10] But, a mere change in the degree of difficulty or expense does not amount to impracticability, as a party is expected to use reasonable efforts to surmount obstacles to performance.[11] The defense may be successful only when performance is impracticable or impossible

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despite the party's efforts to surmount obstacles.[12] If the impossibility of performance arises from contingencies which the parties should have foreseen at the time they entered into the contract, the party seeking relief will be held to its obligation to perform.[13] Scientific or actual impossibility is typically not required—instead, the courts tend to focus on extreme or unreasonable difficultly, expense, injury, or loss that renders the anticipated performance vitally different from what was anticipated at the time the parties made the contract.[14]

Commercial Impracticability

For matters involving the sale of goods subject to Article 2 of the Uniform Commercial Code, the defense has been codified at Section 2-615, and is typically called "commercial impracticability." [15] The defense is typically evaluated the same way that common law impracticability or impossibility is evaluated, requiring proof of extreme or unreasonable difficulty to successfully apply the doctrine.[16] here a seller subject to UCC 2-615 is rendered unable to perform in part, the seller is required to allocate its production capacity among customers in a manner that is fair and reasonable. [17]

Invoking the Doctrine

The burden to avoid performance under a contract under these doctrines is a heavy one. For instance, if a Tier 3 aluminum processor agrees to provide a Tier 2 manufacturer of headlight bulb enclosures with all of its aluminum needs at a fixed price is suddenly faced with a market price increase in the cost of raw bauxite (the basis of processed aluminum), the Tier 3 processor may end up losing money on its contract, or, at best, merely covering its costs. While this may be expensive and financially burdensome on the Tier 3 supplier, nothing has prevented the Tier 3 supplier from meeting its contractual requirement to supply aluminum. Market price changes would certainly be foreseeable at the time the parties entered into the relevant contract. The Tier 3 supplier's failure to tie market price increases to contract price increases—while difficult for the supplier—was something the

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parties could have addressed at the time of the contract.

Changing the scenario a bit, and assume that the Tier 3 supplier cannot supply all of the Tier 2 supplier's orders because an earthquake has shut down production at the largest bauxite mine in Australia. One question that may arise is whether the Tier 3 supplier can obtain the bauxite from another mine. If so, the Tier 3 supplier will like not to be excused from performance for the particular time the shutdown is in effect. If, however, this particular bauxite mine is one of only 3 in the whole world, and there is simply not enough bauxite to meet global supply, then the mine may be forced to allocate its supply, which could put the Tier 3 supplier in the position to either conduct its own allocation among customers or supply its Tier 2 customer with as much as it can if the Tier 2 customer is the Tier 3 supplier's sole customer.

Let's put one additional wrinkle in this scenario, and assume that the area where this large bauxite mine has frequent earthquakes, which have routinely occurred every couple of years. This may result in the Tier 3 supplier being in a worse position if, at the time it agreed to supply the Tier 2 customer, the parties were aware that the source of a large amount of bauxite was environmentally unstable. A court could determine that the Tier 3 supplier should have made provisions in the contract for these potential issues. If earthquakes are very rare or have never happened at this location, then the Tier 3 supplier may have a better chance at taking advantage of the doctrine.

Takeaways

Whether a business will be able to rely on the frustration or impracticability doctrines largely depends on the information and circumstances known to the parties at the time or the contract. To best protect itself, a business entering into a supplier agreement that can have implications up or down the supply chain would be best suited to conduct as much diligence as possible into the circumstances that could prevent its ability to perform. Whether this means a review of the frequency of labor strikes, environmental issues, or government shutdowns, or spikes or drops in market prices, a party can protect itself being put in a defense posture in

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litigation by drafting a contract that addresses such instances in a force majeure clause. In addition, a party would be well-suited to identify replacement sources of raw materials or alternate vendors for particular parts to the extent that it cannot rely dependably on one of these doctrines to excuse performance temporarily.

For more information, contact Payton Bradford or any attorney with Frost Brown Todd's Automotive industry team.

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[1] *See, e.g.,* Auto Industry Continues To Struggle With Supply Chain Issues : NPR; Linamar Sees Supply Chain Issues, Product Shortages Weighing on Revenue, Margins – MarketWatch; Car Part Shortage Continues to Bog Down the Auto Market (msn.com).

[2] *See, e.g., Kyocera Corp. v. Hemlock Semiconductor, LLC,* 886 N.W.2d 445, 447, 451, 453 (Mich. App. 2015); *Kentucky Utilities Co. v. South East Coal Co.,* 836 S.W.2d 392 (Ky. 1992); *Cameron Gen. Contractors, Inc. v. Kingston Pike, LLC,* 370 S.W.3d 341, 344–45 (Tenn. Ct. App. 2011); *Stand Energy Corp. v. Cinergy Services, Inc.,* 760 N.E.2d 453 (Ohio Ct. App. 1st Dist. 2001); *see also United Arab Shipping Co. v. PB Express, Inc.,* 2011 WL 3860639 (Ohio Ct. App. 8th Dist. Sept. 1, 2011) (distinguishing *Stand*).

[3] *Id.*

[4] *Liggett Rest. Grp., Inc. v. City of Pontiac,* 260 Mich. App. 127, 134–35, 676 N.W.2d 633, 637 (2003); *Am.'s Floor Source, L.L.C. v. Joshua Homes,* 2010-Ohio-6296, ¶ 37 (10th Dist.)

[5] *Ligget Rest. Grp., Inc.,* 676 N.W.2d at 637 (internal citations and quotations omitted).

[6] *Am.'s Floor Source, L.L.C,* 2010-Ohio-6296, ¶ 37.

[7] *Id.*

[8] *Lehigh Gas-Ohio, L.L.C. v. Cincy Oil Queen City, L.L.C.,* 2016-Ohio-4611, ¶¶ 15-16 (1st Dist.); *Silsbe v. Houston Levee Indus. Park, LLC,* 165 S.W.3d 260, 265 (Tenn. Ct. App. 2004) (internal citations omitted)

[9] *W. Res. Acad. v. Franklin,* 2013-Ohio-4449, ¶ 26, 999 N.E.2d 1198, 1202 (5th Dist.)

[10] *Id.*

[11] *Id.*

[12] *Id.*

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[13] *See Louisville & Jefferson County Metropolitan Sewer District v. T+C Contracting, Inc.,* 570 S.W.3d 551 (Ky. 2018) ("So if it becomes impossible by contingencies which should have been foreseen and provided against in the contract, and still more if they might have been prevented, the promisor should be held answerable.")
[14] *Nathan v. Brownstone Plastics, LLC,* 511 B.R. 863, 866–67 (E.D. Mich. 2014).
[15] *Kentucky Utilities Co. v. South East Coal Co.,* 836 S.W.2d 392 (Ky. 1992).
[16] *Id.; Schneider v. Byrne,* 2005 WL 2291707 (Mich. Ct. App. Sept. 20, 2005); *Cecil Corley Motor Co., Inc. v. General Motors Corp.*, 380 F. Supp. 819, 840 (M.D. Tenn. 1974).
[17] *Cecil Corley Motor Co., Inc.* 380 F. Supp. at 840

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