

CLIENT ALERT

Business Disruption in a Pandemic: Allocating Limited Supply

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The COVID-19 pandemic is disrupting performance of contracts throughout the business world. Supplies are locked down, deliveries are disrupted or delayed, and shelter-in-place orders are keeping products and services from reaching customers, all along the supply chain. These changes bring a host of vexing challenges and a common and crucial one is this: Where a business is able to supply some but not all of its customers' demand as a result of COVID-19 disruption, how does it decide who among its customers gets limited inventory? Buyers, in turn, will have to evaluate whether any of its orders will be impacted, to what extent, and, if so, whether it can effectively challenge its own allotted allocation. This alert offers five practical pointers central to most allocation efforts.

1. Consult the contract.

One should start, as always, with the contract(s). Some contracts may expressly address allocation, in provisions governing priority or that designate certain customer as "most favored". Sales and supply contracts in some industries often give sellers broad discretion in the event allocation is required. And other contracts are silent.

Your search for provisions on allocation may reveal terms like this:

- **Most Favored Customer Status:** "Priority allocation status given ... for Materials which are in short supply."
- **Force Majeure Clauses:** "Seller shall use commercially reasonable efforts to allocate the available Product equitably between Purchaser and Seller's other Purchasers."
- **Discretion is Given to Seller So Long as it is Equitable:** "...in such manner as Supplier deems proper."
- **Continuous Supply and/or Capacity Commitment:** "at all times during the Term, Provider shall ensure that it has the capacity to supply Company..."

2. Check Governing Law.

Whatever the supply contracts might say on allocation, statutes and regulations may step in and define the rules of priority. Defense contracts sometimes give priority to the government. Public health authorities may likewise earn preferential treatment. Other laws might similarly determine who's first in line in allocation settings.

3. Be fair and reasonable.

Legal principles have developed on allocation, tied largely in the United States to the Uniform Commercial Code, and in particular the UCC provision governing the defense of "commercial impracticability," Section 2-615. Unless a relevant contract

says otherwise, a seller forced by an unexpected, unforeseeable contingency to allocate its resulting limited supply is generally expected to do so in a way that is “fair and reasonable.” While the “fair and reasonable” standard is undefined, courts read it generally as giving some discretion to the seller to allocate its remaining inventory as long as the distribution is equitable.

Examples of allocation methods that have been found “fair and reasonable” include:

- Giving top priority to contract customers.
- Allocating an equivalent proportion to each customer based on its purchases from the prior year.
- Honoring orders based on the timing of when they came in.
- Prioritizing customers at various levels in the supply chain in various industries, or based on “Tier I” or industry-critical supply needs, *e.g.*, military or aerospace.
- Including in the allocation regular, loyal customers who do not have a contract.
- Including the seller’s own requirements for manufacturing of downstream products (but no self-dealing – see below);
- Creating an allocation ranking system which considers and values such factors such as customer loyalty, past performance, customer needs, the relationship between the business and its customer, and business projections of potential future sales to the customer.

While there may not be one right way to allocate, there are some wrong ways. Courts frown on profiteering – on the allocating party seeking self-gain or unfair commercial advantage. Allocation based on pricing is likewise often considered suspect, as it may indicate an intent to achieve windfalls through the misfortune of supply shortage to the detriment of lower-price buyers. And ignoring contract requirements altogether is similarly susceptible to attack as not fair and not reasonable.

4. Give proper notice.

Timely and clear communication with customers about the need for allocation and their place in the allocation plan can avoid disputes and best position the supplier if disputes become inevitable. Moving in a timely fashion to notify customers of the commercial impracticability, or the force majeure condition, is good business and pre-litigation practice.

Some contracts require notice “promptly” or on a specific timeline when a party allocates its remaining resources. The UCC speaks of “seasonable” notice as the standard. Courts tend to support sellers who give good faith notice of the problem and then keep buyers updated until working out a final allocation.

Then there’s the question of what information is to be provided when providing notice. The rules on this can vary by contract and state. The UCC, and many courts, speak in terms of providing customers notice that the allocation is occurring, and of that customer’s allocated share. The underlying goal is to enable the buyer to plan around the force majeure event and mitigate its impact.

5. Protect Your Allocation.

A business developing an allocation formula and distributing its remaining inventory should prepare to defend its method against challenge. Among other things, consider (1) keeping clear records; (2) establishing a written plan detailing the allocation formula, and (3) including a deviation or appeals process for buyers who may want to dispute their distributed portion. A well-

documented allocation methodology in particular may both help deter litigation from customers upset with their allocation and vindicate the reasonableness of the allocation plan in any later dispute.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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