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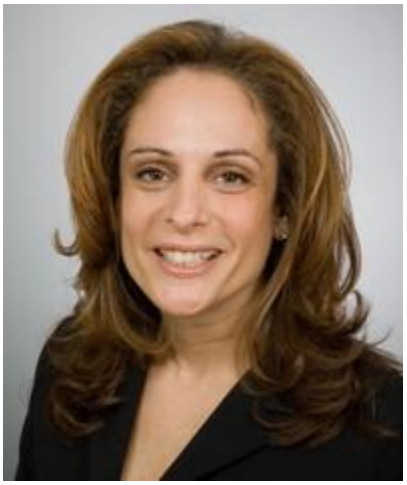
Dry Times: How To Deal With California's Drought



Law360, New York (May 05, 2014, 1:04 PM ET) -- On Jan. 17, 2014, California Gov. Jerry Brown declared a "state of emergency" in California due to the severity of drought conditions across the state. Since then, the California drought continues to be severe and unprecedented in recent years, and is taking a pervasive toll on California residents, businesses, farm land, foliage and wildlife.

Despite recent rainfall, local water districts and the state have called for voluntary, and in some locales, mandatory reduction in consumption of water. After considering the severe human toll, anyone doing business with an entity located in California (or other western states experiencing similar drought conditions) that requires water for any business purpose, particularly farmers in Northern and Central California where there are fewer alternative sources of water, must be concerned about inventory and the impact of the drought on its supply chain.

Can my California contract counterparty fulfill its obligations to produce sufficient quantities of produce, dairy products, steel, flowers, honey, etc., to meet my contract needs? Waiting for a delivery that never arrives, is delayed or arrives in lower quantity or, worse yet, quality, is not a viable option. The key is to be prepared to find an alternative supplier so that production goals can be timely met.

Successful navigation of these issues requires careful contract drafting and contemplation in advance of new agreements, and critical analysis of existing contracts. This article highlights the pertinent legal mechanisms at work and options for your business.

Section 2-609 of the Uniform Commercial Code follows the long-standing common law-derived principle of allowing the concerned recipient of supplies to demand adequate assurance of its supplier's ability to perform. The law adopted in most states provides that "when reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return."

For purposes of Section 2-609, “reasonableness” will be “determined according to commercial standards” between merchants. A failure by the recipient of a justified demand for adequate assurance to provide such assurances within a reasonable time, not to exceed 30 days, will be treated as a repudiation of the contract.

The key for those seeking assurances of performance is to describe with as much specificity as possible the reasonable grounds for “insecurity.” In the case of the drought, one does not have to look far to find news articles describing the historic drought in significant detail and showing the hardest-hit regions.

The form of the demand need not be a formal lawyers’ letter, but can be a friendly request to a good, long-term vendor asking for assurances that product of the quality and quantity the recipient has come to expect will continue to be delivered within the time expected. Setting a reasonable time frame for a response to the demand is also important and will depend upon the imminence of the need for or expected receipt of goods.

The form and clarity of the response will be key and is often heavily litigated. Anything short of a prompt promise by a supplier to meet delivery and production obligations is a red flag and may be grounds for termination of an existing contract to purchase goods from that supplier; however, an unjustified early termination of contract rights is a breach, so a party considering terminating a supplier under an agreed contract should consider the risks of termination, particularly where the supplier is attempting to retain the right to supply.

Further, before demanding adequate assurance, the recipient may wish to investigate an alternative supply chain in case the response is insufficient and goods need to be reordered from another source.

Significantly, a supplier in dire financial straits that ends up in bankruptcy may still be the recipient of a demand for adequate assurance of its ability to perform. Indeed, asking a debtor in bankruptcy for adequate assurance of its ability to perform its contractual obligations is a prudent business approach, though the ability of the nondebtor contract party to terminate is limited (proceeding by motion before the bankruptcy court to terminate is often the appropriate option if adequate assurance is not received or if a debtor confirms that it cannot perform).

Where a contract calls not just for supplies but for services, contract parties should look beyond the UCC to the Restatement (Second) of Contracts. Section 251 of the Restatement provides in part that “where reasonable grounds arise to believe that the obligor will commit a breach by nonperformance that would of itself give the obligee a claim for damages for total breach,” then the “obligee may demand adequate assurance of due performance and may, if reasonable, suspend any performance for which he has not already received the agreed exchange until he receives such assurance.”

In the Restatement, as in the UCC, failure to provide such assurance within a reasonable time is treated as a repudiation of the contract.

From the other perspective, a supplier who fears that it will be unable to meet the terms of its contract

to supply goods in sufficient quantity, quality or price, particularly where the costs of producing have markedly increased due to the impact of the drought, may attempt to invoke a claim of force majeure.

Many contracts have a force majeure provision that excuses performance (or nonperformance) upon the occurrence of events such as (1) acts of God (e.g., severe droughts and storms) and (2) man-made events (e.g., wars or certain acts of governments). Employee strikes may also be viewed as a basis for a finding of force majeure in some contracts.

For the purposes of California law, the California Supreme Court gave the definitive definition of a force majeure in Pacific Vegetable Oil Corp. v. CST Ltd., 29 Cal. 2d 228 (1946). The court explained that "'force majeure,' or the Latin expression 'vis major,' is not necessarily limited to the equivalent of an act of God. The test is whether under the particular circumstances there was such an insuperable interference occurring without the party's intervention as could not have been prevented by the exercise of prudence, diligence and care." Id. at 238.

Additionally, acts of God can be involved in related "impossibility" scenarios. For example, in Squillante v. California Lands Inc., 5 Cal. App. 2d 89 (1935), the California Court of Appeal excused a grower from having to deliver a full quantity of grapes under an excuse of impossibility due to drought conditions.

There, the contract stipulated a certain quality and variety of grape. The drought made it impossible for that grower to grow grapes of the sufficient quality and variety, and therefore the court held that the grower could not be compelled to perform impossibilities and that it could not be held liable in damages for its failure to comply with the contract because the failure resulted from no fault of its own. (The court also stressed the importance of the "grower" not being a "dealer" of grapes, in that they suggest that a dealer may not have been so excused.) While this case dates from 1935, it is apparently still good law.

The scenarios above do not address the situation where a supplier is not necessarily prevented from supplying, but the cost of supplying increases so significantly higher than anticipated, that performance under the contract becomes commercially "impracticable."

While related to the concepts of force majeure and impossibility, impracticability is a distinct problem. Section 2-615 of the UCC provides that, absent a supplier assuming a greater obligation, "delay in delivery or nondelivery in whole or in part by a seller ... is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid."

A successful defense of impracticability also requires that seller "notify the buyer seasonably that there will be delay or nondelivery," and, in the case of reduced or limited capacity to perform, that the seller then allocate production and deliveries among his customers in a "fair and reasonable" manner.

In the official comments to UCC Section 2-615, the American Law Institute explained that generally, "increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover.

"But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, *local crop failure, unforeseen shutdown of major sources of supply or the like*, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section" (emphasis added).

Whether a defense of impracticability rests on the increased cost resulting from shortages of water or other inputs affected by the drought, or from a governmental regulation or order limiting access to water, impracticability clearly represents an intractable problem absent clear contract drafting and advice.

Contract drafters have several tools at their disposal to more clearly delineate the parties' risk allocation. For example, properly constructed force majeure clauses should address the risk of supervening events expressly in the agreement. Additionally, "hell or high water" provisions make it clear the parties' intend to implacably bind themselves despite any contingencies.

When problems raising impossibility, force majeure or impracticability issues arise, the key will be managing expectations. If buyers suspect there are delays or other issues on the horizon, they should not hesitate to seek adequate assurances of performance from their suppliers. Likewise, if there are substantial additional costs or problems in maintaining the quality or quantity or the timing of supply, suppliers should notify their buyers as soon as practicable to adequately manage the relationship in the near term and maintain the relationship as the drought subsides and production gets back on track.

Think ahead when drafting important supply contracts. Read your contracts closely when a problem arises and reach out to counterparties early to address potential problems before they arise or worsen.

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