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News & Types: Commercial, Competition & Trade Update

End-User Makes End-Run to Sue Manufacturer/Supplier of Competing Product

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Practices: Commercial, Competition & Trade, Litigation

One of the issues to be negotiated in a distributorship agreement is the allocation between the manufacturer and the distributor of risks and liabilities to the end-user. The manufacturer makes the product, but the distributor deals directly with the end-user and may be in a better position to contractually limit risks and liabilities. Usually not considered is the manufacturer's liability for the distributor's sale of someone else's products. Should the distributor and manufacturer negotiate these provisions also? Maybe not, according to a recent 7th Circuit Court of Appeals decision. (*American Commercial Lines, LLC v. The Lubrizol Corp.*, 7th Circuit Court of Appeals, No. 15-3242, March 25, 2016)

American Commercial Lines, LLC (ACL) manufactures and operates tow boats and barges for use in U.S. waterways. It is a large company with an estimated value in 2010 of $800 million. Lubrizol manufactures industrial lubricants and additives.

Lubrizol and its distributor, VCS Chemical Corp. (VCS), worked together to persuade ACL to buy a Lubrizol manufactured diesel fuel additive called LZ8411A. ACL was convinced and agreed to purchase the Lubrizol additive, LZ8411A, from VCS.

Unbeknownst to ACL, what ACL was purchasing from VCS was not the Lubrizol additive, LZ8411A, but what ACL claimed was an inferior additive manufactured by Afton Chemical Corp. (which both Lubrizol and ACL called the "Counterfeit Additive"). What happened is that Lubrizol and VCS had a falling-out. Lubrizol claimed unethical conduct by a VCS employee. Lubrizol terminated VCS and, as a result, terminated VCS' ability to sell the Lubrizol additive, LZ8411A. But neither Lubrizol nor VCS told ACL. VCS substituted the Counterfeit Additive. So, unwittingly, ACL was purchasing the Counterfeit Additive.

Of course, ACL sued VCS when it discovered the substitution. ACL settled with VCS (a small company, as noted in the opinion) early in the litigation. But, in the same action, ACL also sued Lubrizol. It was a strange claim to bring against a company that neither manufactured or sold the Counterfeit Additive. But ACL thought Lubrizol should be responsible. ACL had some novel legal theories to support its claim. But, as he is wont to do, Judge Posner (who wrote the opinion) looked at ways ACL could have protected itself through contract, but failed to do so. So ACL lost on its claims.

One of the claims was that Lubrizol was an agent, actual or apparent, of VCS. So Lubrizol should be held responsible for VCS' substitution of the Counterfeit Additive. ACL also claimed that it was a third-party beneficiary of the terminated contract between Lubrizol and VCS. ACL also claimed a quasi-contract with Lubrizol. ACL even went so far as to claim constructive fraud against Lubrizol. (ACL abandoned what the court characterized as the "absurd" claim of tortious interference - that Lubrizol's decision to terminate VCS was motivated by "disinterested malevolence" toward ACL.)

Starting with basic principles, the court noted that a manufacturer has no duty at common law to protect customers of its distributors from misconduct by a distributor. So, based on this principle, ACL loses. Does ACL's claim of agency or of being a third-party beneficiary override this basic principle? No, said the court. The court declined to deem Lubrizol an agent of VCS only because Lubrizol helped VCS obtain the contract with ACL. Nor did ACL's expectations of purchasing the Lubrizol additive make ACL a third party beneficiary of the terminated contract between VCS and Lubrizol. "Otherwise a consumer would be a third party beneficiary of any sales contract between a supplier of a good and a distributor of the good to the consumer," noted the court.

The court dismissed the notion that a distributor is an agent of its supplier.

"A distributor buys from his supplier and resells; an agent works on behalf of a principal and if he acts within the actual or apparent scope of the agency binds the principal. . ."

"The harm of which ACL complains began when VCS substituted the inferior additive, and no one suggests that by doing that VCS was benefiting Lubrizol or acting at its direction – Lubrizol had severed its relations with VCS. ACL claims that Lubrizol held VCS out as its agent, but apparent-agency claims turn on what the alleged principal told the third party, and ACL has disclosed no statement by Lubrizol to it that made VCS out to be more than a distributor."

The court defended Lubrizol's decision not to inform ACL of the termination of the distribution agreement between Lubrizol and VCS. It noted Lubrizol's dilemma – if it did what ACL claims it should have done, namely inform ACL that its distribution agreement with VCS was terminated, it would be exposed to a claim by VCS for breach of the distribution agreement and for interfering with VCS' business with VCS' customers. Indeed, Lubrizol's legal department had concerns that Lubrizol would be sued by VCS if Lubrizol discussed VCS directly with VCS' customers.

ACL was not finished. ACL argued it had a "special relationship" with Lubrizol with imposed a duty on Lubrizol of "good faith and fair dealing." But, as Judge Posner reiterated, ACL could have negotiated a contract with Lubrizol that would have obligated Lubrizol to keep ACL informed of Lubrizol's contract with VCS. "[A]s a sophisticated commercial entity ACL was well-positioned to protect itself against a faithless supplier." The court declined to protect ACL from a situation in which ACL could have, by contract, protected itself.

"A well-drafted contract provides a cleaner basis for a legal remedy than does a nebulous body of jargony legal theories such as "special relationship", "constructive fraud", "duty of good faith and fair dealing", "disinterested malevolence", and "quasi-contract.""

So ACL's last effort was quasi-contract – the court should act as if there was, or should have been, a contract between ACL and Lubrizol. But this was not an appropriate case for quasi-contract. Judge Posner illustrated quasi-contract by a situation in which a doctor finds a person lying unconscious, treats that person, then asks for compensation. A doctor normally would receive compensation, but the unconscious person was not in a position to negotiate and agree to the terms of the medical service. So the court uses "quasi-contract" by constructing a contractual relationship after the fact to enforce the parties' reasonable expectations. Then the court returned to its theme. "But there was no obstacle in this case to ACL's contracting with Lubrizol."

So the lesson in this case is one we have seen in many other 7th Circuit cases. An aggrieved party that wants to use tort, quasi-contract, or some other non-contractual legal theory will also need to critically review its own conduct to see if it could have protected itself through contract. As Judge Posner suggests, courts are more receptive to breach of contract claims, where the parties made a contract that went wrong, than to claims where the claimant failed to use the legal contractual tools that it had available to it to protect itself.