EVERSHEDS SUTHERLAND

Industrial Compass for General Counsel

Supply chain risk and cost management

Why is this an important issue for Industrial companies?

Industrial businesses face far greater expectations than ever before. Their customers expect faster time-to-market, reduced defect rates and customized products. The pandemic continues to disrupt every aspect of the global supply chain. The supply chain is the invisible system that gets goods manufactured, mined, or grown to where they are consumed. International shipping rates are at all-time highs, and continuing parts shortages (e.g., semiconductors) could lead to disruptions lasting until 2023, meaning companies in the sector will need to tighten up the management of their supply chains.

Commercial pressures we are currently seeing in the Industrial supply chain

Exposed supply chain "fault lines" – things that disrupt the flow of materials and products that companies need to produce the products they need to have to sell to their customers.

Disputes may occur if the contract price is linked to an indexed price or is a fixed price.

Termination of key contracts which cease to be financially viable for suppliers, whether or not the termination is permitted by the contracts. Causes disruption for the wider supply chain.

Insolvency of entities where the customer is financial exposed (i.e. payments made in advance or on account for long lead time items).

Suppliers seeking to establish minimum order values for shipping and delivery or demand a price increase.

Caselaw has shown that anticompetitive behavior (collusion) between competitors increases in times of economic stress and therefore, we may start to see new investigations.

What are Industrial companies doing to manage the legal and commercial impact?

Boards are questioning what their companies should be doing to address how supply chain issues are impacting their operations and bottom-line profitability.

1. Review of internal processes for contractual provisions relating to excused performance, including provisions involving reasons for non-performance, notice requirements, and dispute resolution mechanisms.

2. Review supply contracts to assess whether your business can change price consequent on increased supply chain costs. If there are no levers, are there any grounds on which to bring the contract to an end so that we can renegotiate the price?

3. Monitor and manage new contracts more closely - are all foreseeable reasons for non-performance, including failure of suppliers to supply the product in question, adequately covered within force majeure provisions?

4. Identify any exclusive supply or minimum supply commitments that may become unlawful if other suppliers in the market cannot supply, thus putting your business over the 30% threshold. This could lead to your company being subject to challenge/investigation.

General Counsel awareness

- Are any supply chain issues so severe and unexpected that a **force majeure argument may exist?** Are internal processes in place to adequately respond to notifications from suppliers that they cannot perform because of force majeure or some other contractual reason?"
- Have **customs duties and VAT been addressed** in contracts within the entire supply chain? Who will pick up the costs, if additional customs duties are payable?

  Although there are many international free trade agreements, duties will still be payable if the origin of the goods cannot be appropriately verified or evidenced.
- If the supply chain has to change, are **provisions made to ensure that goods are not held up** because of unnecessary failures in properly managing VAT and customs duties?
- Do any other companies in the supply chain (perhaps customers) have **leverage to negotiate better prices** for logistics services (i.e. better prices than the supplier can secure itself)?
- **How tough does the end customer want to be** with suppliers on requested price increases? The contract may provide for fixed prices, but does this risk pushing the supplier into insolvency? What other suppliers could pick up the slack in that scenario?
- Practical ramifications through the supply chain – consider **scenarios where you cannot supply your customers** because your suppliers stop supplying.
- **Do you need to stockpile certain products** to manage key contract obligations?
- An option to avoid the fluctuating risks involved in supply chain price rises and decreases is to **agree on an "open book" or "cost plus" strategy with the customer or supplier**. In this case, premiums are fixed and agreed on between the parties, and an "open book" review process is agreed to whereby all supply chain costs are disclosed and recovered on a $ for $ basis.
- What **levers are there in supply contracts** to change price due to increased supply chain costs? If there are no levers, are there any grounds on which to bring the contract to an end so that the price can be renegotiated?
- If there are shortages, then **exclusive or minimum supply clauses may now be unlawful** – these types of clauses are usually acceptable under competition law

  where the market shares of both the buyer and supplier are less than 30%. However, if the overall market size has now decreased, market shares may well have changed, and this will impact the competition law analysis, potentially leaving the clause open to challenge and/or investigation. If challenged successfully, the clause could be "blue lined" from the agreement, making the whole agreement unlawful and/or leading to fines.
- You may face **increased bribery and corruption risks** to obtain lower fuel costs in high-risk jurisdictions.
- Do your products require **reverse logistics**? This is the requirement to plan the flow of surplus or unwanted material or equipment back through the supply chain after meeting customer demand.
- That surge in container rates could send consumer prices**1.5% higher over the next year**, according to a report from the United Nations Conference on Trade and Development (UNCTAD).
- In the medium to longer-term, the maritime supply capacity will also be affected by the industry's transition towards **zero-carbon shipping**.
- Costs will **vary significantly based on the mode of transport**. Airfreight will be far more expensive than sea freight; however, obviously, delivery lead times will also vary greatly. Changes in freight costs may create an opportunity to reconsider whether to increase sea freight volume at the expense of longer lead times and higher stock on hand but reduce the airfreight volume and, consequently, the aggregate supply chain cost.

Questions for General Counsel to use in the Boardroom

1	What products and divisions in our portfolio could be divested to reduce costs within our supply chain?
2	Is there a risk that suppliers may terminate key supply contracts which have ceased to be financially viable for the suppliers to perform? What disruption might this cause?
3	Can we enter into shorter payment terms to reduce carrier costs, compared to agreeing to terms of 60 days, 90 days, or more, as these will be reflected in our rates?
4	Does our freight budget quantify how CODE RED conditions in the marketplace impact our freight costs? Does our budget reflect these types of increases?
5	Can we utilize bonded warehouses to improve cashflow by avoiding advance duty payment on products that may remain in stock for months?
6	Can we vertically integrate parts of our supply chain into our operations?
7	Should we consider using air freight options as they are faster, despite being more expensive?
8	Do we need to consider shoring up capital to set up our own delivery infrastructure, so we are not beholden to shipping price fluctuations?
9	Do we need to reduce our exposure in China through outsourcing manufacturing closer to our primary markets?
10	Do we need to take a more formal approach, e.g. joint-ventures (JVs) or partnerships at corporate level?