Contracting for Risk in Supply and Services Procurement

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Supply chain leadership are today keenly aware of the risks to their supply, production, logistics, inventory management, and distribution functions. Many lessons were learned following the COVID-19 global pandemic, including the challenges of sole source supply and lean inventory management. However, it is less common to hear a clear conceptualization of risk in a way that is actionable for day-to-day practice.

Recognizing that supply chain challenges often amount to the risk of variance is helpful in both risk assessment and deployment of tools for active management. We have observed a few categories of acute variance experienced across many, if not all, industry sectors. Specifically, supply and service relationships suffered from interruption due to variance in: (1) Quality; (2) Availability; (3) Cost; and (4) Time.

The theme across these four occurrences is unforeseen irregularity in performance. Each prevent the impacted supply chain from performing as it should under normal operating conditions, let alone optimal conditions, which triggers further consequences down the supply chain as well as for the enterprise's bottom line. Careful risk assessments and contract drafting can address each of these variance types for the respective supply or service.

The four supply chain risks and drafting tools are explored below:

1. Quality Variance Risk - Products that do not meet quality expectations have immediate negative impact on supply chain operations and their output. Examples include failure of a purchased item to meet dimensional or color specifications that prevents its use in production or sale. Services that do not meet quality expectations can have similar detrimental effects. Examples include the absence of special handling requirements that may lead to total loss or failure to correctly process an item requiring reworking later in the production cycle.

The contract drafting tools available to address quality variance begin with clear expectation setting around the desired quality or special features for a good or service. This is often achieved through reasonable Key Performance Indicators (KPIs) or Service Level Agreements (SLAs) agreed-upon under the terms of purchase. If those terms are breached, then the question is whether—and how—the supply chain irregularity will be remedied, followed by the question of how the buyer will be made whole.

Drafting “meet and confer” type language in agreements can set the expectation for incident-based management meetings. These provisions may describe the level at which meetings will occur, the agenda, the need, if any, for root cause analysis reporting, the circumstances under which escalation will occur, and any follow-up tracking or reporting through resolution. Such roadmaps for how relationships will proceed following a disruption eliminate confusion and add to the speed of identifying a solution for implementation.

Remedies may also be agreed upon in advance. If a well-structured KPI or SLA is in place then malus remedies can be included, allowing for percentage or whole figure discounts upon breaching a threshold for those metrics (conversely, bonus structures are available for exceeding metrics beyond the agreed threshold). Another increasingly common remedy is the opportunity to purchase replacement goods or services from a third-party with the failing supplier or service provider bearing the difference in cost. This, in theory, allows the buyer to proceed with its production or sale at the same benefit of bargain, but with some inconvenience.

An additional option is to require reworking of goods or reperformance of the services at no additional charge. Where performance occurs over a period of time, drafting to prevent rolling breach is also helpful to avoid allowing a failing provider to cure breach followed by successive breaches of the same kind.

Finally, if a supply or service is critical, then express contractual liquidated damages can be within reason. Doing so brings clarity to the remedy and incentivizes cooperation through resolution, although executing on collection may be detrimental to the relationship.

2. Availability Variance Risk - Supply or service that is short, or wholly unavailable, yields an immediate negative impact on production and sale within the supply chain. Examples include the failure to deliver supply or inability of a service provider to traffic or process that supply. This variance may not be the direct result of a counterparty's actions or inaction, since it could result from earlier in the supply chain, force majeure events, or even acts of a government authority. Regardless of the cause, it triggers dramatic operational challenges, particularly in an environment with low safety stock.

Contract drafting tools addressing availability risk are very similar to those addressing quality risk. Expectation setting can be valuable and may include circulating periodic forecasts of purchasing needs or production capacity to help in avoiding surprises. If an agreed-upon supply or service delivery period is not achieved, then established rules around management meetings, root cause analysis, escalations, and resolutions help to reduce confusion or dispute following the failure. Additionally, terms around notice upon the first sign of delay followed by periodic updates can align operations teams around both expectations and contingencies necessary to mitigate the impact of failure.

Contractual remedies for availability risk may include termination rights for the order or the entire agreement if delivery does not occur within a certain period of time. Malus structures for failure to meet KPIs or SLAs are, of course, available. Replacement remedies could also be agreed upon so that the option to source

through an alternate supplier or provider will cover for the difference in cost.

It is critical to bear in mind that the parties likely waived consequential and incidental damages as part of the agreement boilerplate. This can be problematic for availability variance, as well as time variance, because the harm is not that a good was ultimately defective or not delivered, but simply that it was not available or delivered timely as agreed. Liquidated damages provide a solution to what would otherwise be waived by converting those damages to direct contractual damages. Under the right circumstances, a stock-out or slow production scenario may be appropriately met with liquidated damages to offer a collectable financial remedy for the occurrence. The added benefit of arriving at a metric for the loss also serves the parties' mutual interest of creating a purely economic path forward rather than a factually intensive dispute.

3. Cost Variance Risk - Increased cost to land product or fully receive a service is a unique risk, because it does not always prevent production or sale. Cost variance does, however, have severe impact on the margin for operations, even to a degree impacting enterprise value. As an example, during the early days of the COVID-19 pandemic, the cost of a trans-Pacific ocean container shipment rose tenfold for the transportation service alone. Those fees, together with all ancillary fees once goods reached port, dramatically eroded profit margins on the respective goods.

The traditional drafting tool for cost variance is to require that all amounts are inclusive of costs and expense, or in the alternative, that those ancillary items are clearly defined. If some degree of periodic increase is anticipated, then of course the common approach is to draft a ceiling percentage, monetary figure, or a not-to-exceed index, such as the Consumer Price Index, the Producer Price Index, or an industry-centric publicly available index. These tools are well-tested and may be sufficient to avoiding surprise.

We often hear that both parties wish to accommodate change although neither party expects to put the other party out of business by holding it to overly restrictive contract terms. This attitude is a result of our increasingly complex and fast global supply chains. A strong solution is to take the "meet and confer" approach specifically around the issue of price. For example, a party may call out a particular cost driver such as local labor and agree that the parties will meet to mutually agree upon cost adjustments if labor exceeds a reported percentage of cost change in the respective market. This sets the assumptions upon which pricing was based, expectation that the assumptions may change, a clear roadmap for addressing that change in assumption. Parties will sometimes agree that the previously determined price will remain in full force and effect absent an agreement to amend, although termination rights may be accelerated in the event of non-agreement.

4. Time Variance Risk - Delays in production or service delivery are also unique among the set of supply chain risks because production or sale may not be impacted, depending on magnitude of the event, its frequency, and operational planning. If a shipment is late, then there may be sufficient inventory on hand to cover customer demand, but if not, then sales will be lost and reputation will be harmed. If a service is late, then it may be merely a customer service failure without impacting sale or production, but failure to receive essential goods at the agreed-upon time may indeed shutter production.

Many of the tools available for other types of risks are also suitable for time variance. Practical process-oriented contract language is often appropriate, such as forecasting, periodic reporting, management meetings, and root cause analysis for systemic failure. However, in our experience, the number one challenge is in converting what would otherwise be waived damages to actionable remedies under contract. Delay can be converted to pe diems, flat liquidated damages, or reimbursable expenses. Doing so establishes expectations while avoiding defenses around waiver of consequential or incidental damages. The concept of rolling breach can be another great challenge where suppliers and providers repeatedly breach a timing expectation. Malus provisions under a KPI or SLA metric can help to manage those behaviors. Accelerated termination rights may be another option. Finally, time variance is often an opportunity to argue contractual force majeure. This can be addressed by identifying the categories of triggers that do or do not qualify as force majeure while also drafting termination rights where the force majeure circumstances do not yield within a defined period of time.

Risk-Appropriate Drafting to Identified Risks

Framing risk around these tangible concepts and managing those under contract will set expectations between buyer and seller of the good or service. They also provide a framework for active management of suppliers and providers. Doing so allows each party to use its best efforts in operational planning, and even contingency planning, in the interest of maintaining strong, mutually beneficial relationships. Every enterprise has a unique supply chain with its own risks and operational demands that require tailored language and approach. This is achievable and it produces clear articulation of those principal concerns requiring attention for best results over the lifecycle of the relationship. Also, for in-house counsel, this approach yields the pragmatic business-focused counsel that most internal clients desire above all else from their legal teams.