

Executive Summary

Yet another shock to the supply chain has emerged from the US/Israel/Iran war, which has quickly expanded to include Iranian attacks on Bahrain, Cyprus, Jordan, Kuwait, Oman, Qatar, Saudi Arabia and the UAE.

Linked to all of this is the impact on the ability of all affected countries to export oil via the Strait of Hormuz (currently closed). There are also expected impacts on all maritime trade that flows through the Red Sea and the Suez Canal, as well as all air cargo that flies across the Middle East and via hub airports in the Middle East.

As with many other supply chain shocks of recent years, the speed and scale of the escalating situation across the Middle East have taken many businesses by surprise, although tensions had been rising. This is not dissimilar to other major events, whether they be natural disasters affecting major industrialised countries, Brexit, COVID-19, the Russia/Ukraine conflict or the global cost of energy crisis, which have all had and, in some instances, continue to have major adverse impacts on the ability of companies to source, manufacture and sell raw materials, commodities, components, finished goods and services.

The occurrence of these events has placed businesses under extreme pressure for a considerable period of time as the events continue for months or years, rather than being a one-off occurrence. These events are often compounded by other issues relating to tariffs, energy prices and changes in tax, employment and other policies of national governments.

The impact of all “unexpected” events is that they must be managed simultaneously by businesses and, as such, the effects of these events may be difficult to separate from other supply chain shocks. For example, the impact of digitisation, artificial intelligence and “as-a-service” business models is also having a dramatic effect on the nature of what many companies produce, as well as how companies bring the goods that they produce to market.

As a result, existing supply chain contracts may require renegotiation if businesses are to remain viable, while greater care will be needed to ensure that new contracts provide appropriate protection when dealing with fast-changing conditions.

This note considers some of the key contractual issues that businesses (particularly those involved in the manufacture, distribution and sale of products) need to consider as they assess their critical needs, vulnerabilities and protections alongside their ability to mitigate risks, both under existing contracts and as they develop new contractual arrangements.

In addition, many of the practical tips apply equally well to businesses that may need to look to renegotiate failing contracts, particularly where one party finds itself under financial pressure, either generally or as a result of an existing contract that is either onerous, or that does not provide adequate protection as regards supply chain issues.

What Are the Immediate Contractual Issues Following a Supply Chain Shock?

- In recent years, several major events have arisen without warning. When dealing with any such shocks, businesses will need to consider the following points:
- Which contracts and supply chains are the most affected, either directly or indirectly?
- What is the impact of the shock on all affected contracts, whether directly or indirectly, i.e. if a supply chain partner cannot deliver a component, then a company further up the supply chain may not be able to produce those products that incorporate that component?
- Is the shock a single event (such as a tsunami), or is the event likely to continue for a considerable time (such as a war) with much wider and expanding implications regarding those who are affected?
- What rights, remedies and reliefs (such as *force majeure*, frustration, relief events and/or material adverse changes) may arise as a result of the supply chain shock?
- How should the business respond to notices that it receives from suppliers and customers who may seek to avoid or cancel contracts following a supply chain shock, particularly where the underlying contracts are significant to the business?
- Are such requests reasonable, or should the affected party have been able to take steps to mitigate the issue?
- Which contracts need to be renegotiated or terminated?
- What is the scope for reducing volumes or suspending/cancelling purchases under contracts with suppliers, and are there any rights to suspend payments?



- Are there any notice requirements that have been, or may be, triggered, i.e. if *force majeure* rights are to be claimed, such rights usually must be exercised within a few days of the event arising?
- Are there alternative means to perform contractual obligations, or proactive steps that can be taken in relation to anticipating and/or reacting to the potential future effects of the supply chain shock?
- Is any insurance coverage available, such as for business interruption?
- What are the disaster recovery procedures in any affected contracts?
- Is there any government relief available to those affected by the supply chain shock?
- What is the impact of material contract defaults on financial covenants and maintaining regular contact with financial backers?
- How can contracts be varied following a supply chain shock, and how can any appropriate change requests be issued?
- How can companies best work together to support each other through the crisis on the basis that there may be more to gain in the long-term by pulling together, rather than by enforcing contractual remedies?

What Contractual Issues Need To Be Considered as a Business Starts To Plan a Return To Normal After a Supply Chain Shock?

Regardless of the nature of a supply chain shock, matters will start to return to some sort of new reality. With this in mind, businesses may need to consider:

- How quickly can operations restart and, contractually, what arrangements need to be made with customers and suppliers to enable this to happen?
- Will demand levels bounce back to previous levels, or will volumes be lower, which, in turn, may lead suppliers to seek adjustments to volume-based pricing or result in breach of minimum purchase obligations?
- Will some products not be manufactured again, particularly if they were getting towards the end of line and/or are low-selling, and, if so, what are the consequences of early termination on associated supply chain contracts?
- Assessing (and, where applicable, implementing additional) supply chain risk management measures. Here, all businesses should:
 - Maintain good lines of communication with key suppliers, logistics providers and end users, and inform them on a regular basis as to what you are doing and steps you are taking, particularly where operations are restarting on a gradual or staged basis: i.e. a business may opt to restart by initially producing lower volumes and/or a limited range of product lines.
 - Consider the ongoing risk posed to the supply chain, particularly in relation to those supplies and suppliers (both direct and indirect) who are most at risk. In particular, even if legal or contractual relief are available at the inception of a supply chain shock, these reliefs will not necessarily continue in the longer term.
 - Obtain information from suppliers on measures they are taking in relation to their supplies and, if appropriate, consider whether procuring supplier agreement to minimum standards of conduct is necessary.
 - Consider whether auditing suppliers and reviewing the steps that they have taken in relation to disease and virus control/ minimum standards of conduct are necessary/appropriate.
 - Consider whether to give preference to certain suppliers and customers, being mindful to not do so unlawfully.

- Fully review the terms of all standard terms of business and all key/critical contracts for risk and potential contractual protections, including:
 - Amending their own terms and conditions of purchase and sale to include wording for material adverse change, *force majeure* clauses, liability limitations and/or other fall-back clauses that work for the business
 - Dealing with the ongoing risks associated with the longer-term continuation of the supply chain shock
 - Considering how contracts might be interpreted in different jurisdictions
- Meet with corporate peer groups to share good/best practices (being mindful of competition law issues that could arise from information-sharing between competitors outside of specific areas approved by regulatory authorities).
- Check insurance arrangements in detail review policies, liaise with brokers and potentially notify circumstances/claims. For example, does insurance cover economic loss during the period of the supply chain shock?
- Maintain records and evidence to assist any future supply chain claims/defences: Have a good audit trail.
- Consider the scope of work involved in switching suppliers and/or dual source products. For example:
 - Are there any easy access alternatives
 - Can alternative supplies be arranged in the longer-term: e.g. sourcing microchips from new facilities away from the Far East
 - Can products be modified by substituting different components or suppliers, and how may this affect contractual commitments to customers, certifications/approvals, etc.
 - Be mindful that if there is a shortage of raw materials/components, suppliers may be compelled to use alternative materials to meet customer demand. Such materials may not be quality-tested, or they may even be out of specifications. In addition, any such options may also affect commitments in customer contracts, downstream product certifications/approvals, etc.
 - Logistics companies may not be able to deliver on time and/or freight rates may also increase considerably because of the impact of the disruption.
 - Consider liquidity issues, as businesses will need to fund the cost of restarting operations weeks and months before revenues start to be received. Be particularly mindful of the liquidity of suppliers and customers, and consider whether more use should be made of financial monitoring and reporting requirements, waivers to exclusivity arrangements if a supplier's financial health deteriorates bonds, guarantees and the like.

What Issues Need To Be Considered When Negotiating New Contracts And/or Varying Existing Contracts?

All businesses need to carefully consider how to deal with the ongoing impacts of any supply chain shock. For example, businesses should consider:

- Varying supply chain/contractual arrangements to deal with a gradual and/or phased restart of operations.
- Providing for increased flexibility within the contract and, in so doing, assessing:
 - The appropriateness of unqualified exclusivity (particularly in the event of supply chain disruption or where dual sourcing may give greater supply chain security)
 - The appropriateness of agreeing to minimum volume commitments and the ability to amend them in particular circumstances
 - Flexibility to amend specifications to allow use of alternative components/materials where necessary
 - The ability to partially terminate supplies where only certain types of services continue to be required
- The extent to which particular customers can be preferred where supplies are restricted.
- Price and supply variation clauses that are triggered if there are significant supply chain shocks.
- Provisions requiring full supply chain transparency (and, potentially, greater control over subcontracting and more extensive audit rights), including early notification of potential supply chain issues.
- Terms addressing the increased risk of insolvency/financial deterioration on the part of customers and suppliers, including termination rights, rights to amend payment terms, retention of title to goods and other security for payment.
- Better *force majeure* and disaster recovery provisions that give proper consideration to the scope and impact (e.g. suspension, alteration and termination, etc.) of such events.
- The practical workability of dispute resolution/jurisdiction and choice of law provisions, now that they are much more likely to be invoked.

What Are the Longer-term Contractual Issues To Consider?

Looking further ahead to the future and to more strategic decisions, additional factors to be weighed include:

- How should businesses proactively consider the appropriate allocation of risk of supply chain shocks?
- What is the longer-term impact of such shocks on global supply chains? In particular, will “near sourcing” and “multisourcing” become more attractive than finding the cheapest source of supply?
- Consider whether components should now be sourced from suppliers who can produce components in different parts of the world, or should component supply be split among multiple suppliers in different parts of the world, in order to reduce the dependency of a business on a critical supplier in one country?
- Should more components be manufactured locally or, at least in the same geographic regions, to reduce the risk of delays related to transport difficulties?
- Will some of the recent disasters drive businesses to invest more in smart factories that are not dependent on staff working in proximity to each other on the production lines?
- Will businesses look to reduce their dependency of supplies from one part of the world,, by investing more in local supply chain options?
- Should greater use be made of additive manufacturing techniques (such as 3D printing) to localise supply chains as far as possible?
- Is it possible to make greater use of digital routes to market, particularly for retail, and what are the consequences regarding the need for retail space, warehousing and logistics capability?

How May Contracts Be Interpreted From a Legal Perspective?

We have already touched on the need to consider provisions relating to *force majeure*, frustration, relief events and material adverse change in the above sections. However, these are all complex issues, and they merit some further explanation as to how they may affect different contracts in different ways.

Generally, an English court will look to:

- Follow the natural language of the contract, even if the results of doing so may be disastrous for a party.
- Take a restrictive view on the interpretation of implied terms. Essentially, any interpretation either will have to be so obvious as to go without saying or be necessary for business efficacy rather than as a rescue from non-commercial terms.

The most likely contractual remedies will relate to questions of:

- *Force majeure*
- Frustration
- Material adverse changes
- Other options, such as disaster recovery



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Force Majeure

Will *force majeure* apply? Typically, the purpose of *force majeure* provisions is to provide relief by suspending performance because an event arises that is beyond the reasonable control of the obligated party and that delays or prevents performance (or, in some cases, that makes performance substantially more difficult or costly). Then, typically, if the event continues for a period of time, one or both parties may be able to exercise termination rights. Often (and mistakenly) overlooked as boilerplate, the extensive impact of some supply chain shocks is likely to bring such provisions into sharper focus over the coming months and years. However, all is not clear-cut, and the following questions will arise:

Does the contract actually contain a *force majeure* provision?

- If so, does the *force majeure* clause look to give relief for all events beyond the reasonable control of the affected party (examples sometimes are given), or is relief only given in respect of specific named events, such as a natural disaster, war, a fire or a flood? If specific events are listed, arguments can arise over whether a particular event is included.
- Absent specific contractual provision, English law will not, by default, protect a party from liability due to events beyond their control. If a party wants such protection, they are expected to reserve it for themselves in the relevant contract. However, if the contract is not governed by English law, the actual governing law will be important to consider because other laws do provide some statutory protections.
- There is no recognised definition of "*force majeure*" under English law. Rather, the parties to a contract are expected to define exactly what they consider to be "*force majeure*". In particular, does the *force majeure* wording only apply where an event "prevents or delays" performance, or does it purport to give relief where performance is "hindered" or made more expensive/uneconomic, etc.?
- Is the actual event excluded from the scope of *force majeure* by other provisions in the contract (e.g. by any obligation to have taken prudent steps to avoid disruption, exclusions of liability where risks are insurable, the impact of business continuity and disaster recovery provisions, etc.)?
- Difficult issues may arise in relation to the interpretation of wording. For example, the difference between an epidemic and a pandemic caused issues in relation to Covid-19. Here, "epidemic" is generally regarded as being "a widespread occurrence of an infectious disease in a community at a particular time", whereas a "pandemic" is defined as a disease "prevalent over a whole country or the world" or as "a global outbreak of a disease".
- Taking COVID-19 as an example, if the contract does not specify either an epidemic or a pandemic as a qualifying *force majeure* event, a party seeking to use COVID-19 as the basis of *force majeure* may need to persuade its counterparty, an arbitral tribunal and/or a court that COVID-19 falls under the usual generic events described, such as a "natural disaster".
- More important, one must also consider the actual "event" that is preventing performance. Again, taking COVID-19 as the example, is it because of:
 - COVID-19 itself (e.g. the workforce has fallen ill and is unable to work)?
 - A restrictive government order enacted due to COVID-19? In particular, governments across the globe have been vigilant in enacting protective, and/or containment measures in response to COVID-19 that prevent the performance of contractual obligations, such as closing shops, venues and the like; preventing travel, save for "essential" reasons; or preventing ships from docking at ports to offload cargo?
 - A company's own internal precautionary measures, such as where decisions have been taken to close factories due to supply chain difficulties or a drop in demand from COVID-19-related fears?
 - Something else (directly or remotely) related to COVID-19?

The answers to these questions may require a close look at the relevant contracts. Some contracts may specify that government actions preventing performance qualify as *force majeure*. Some contracts may, instead, specify that some such events present a risk to one of the parties. Some contracts may even be silent on such events, as contracts usually are with respect to a company's own internal policy or business decisions in connection to a *force majeure* event.

- What steps is the party who is claiming to be affected by *force majeure* required to take to mitigate the effects of *force majeure*?
- Is *force majeure* relief mandated, or is it discretionary? If it is discretionary, commercially, does the business want to invoke *force majeure* where invocation is not automatic?
- If notice has to be given by one party to the other, how quickly must notice be given following the occurrence of the event? Here, many *force majeure* provisions require the party seeking protection to follow a prescribed process, often requiring formal notice to be served as soon as that party becomes aware of the existence of a potential *force majeure* event. For a party wanting protection, following such a process is critical. If any specified process is not followed, then there is a risk of jeopardising any subsequent claim for protection. Here, for many contracts, time may have passed and further issues will arise with regard to any second waves, as these may well be regarded as "to be expected".

- Consider whether the consequences of invoking *force majeure* are appropriate. In addition to excluding liability for non-performance, many *force majeure* provisions will trigger rights and remedies for the other party. Typically, the option to suspend its obligations and/or to terminate the contract. These risks should always be factored into the decision as to whether to claim *force majeure* protection. As the different types of remedies may result in drastically different consequences, parties should be careful about invoking or reacting to *force majeure* events before fully exploring and understanding the relevant remedies, as well as implications associated with the relevant contract and applicable law. In so doing, it is important to realise that the short-term benefit of claiming protection can be outweighed by longer-term consequences.
- Other options may exist. Even if a contract is silent (or unhelpful) on *force majeure*, it may contain other helpful general provisions. For example, the contract may provide a right to terminate for convenience, which then avoids a dispute over whether the supply chain shock is, or is not a *force majeure* event.
- Typically, cases of *force majeure* arise from specific events that affected only one party (e.g. a war affects the shipping routes, a building burns down or a ship sinks, etc.), whereas other events such as a spike in energy prices affects businesses globally at all stages of the supply chain, and for long periods of time. As such, an affected business may find customers and suppliers more willing than normal to adopt a “we’re in this together” mindset when formulating solutions. However, care needs to be taken in any such discussions to avoid goodwill gestures being used against you in the future, or leading to the loss of valuable contractual rights and protections.
- The potential options and consequences in pursuing, and/or defending *force majeure* claims based on a supply chain shock can differ drastically, based on the relevant contract, as well as the law applicable to the contract, transaction, and/ or project. For example, English courts are likely to the view that the event must make the obligation impossible, rather than more costly/difficult to perform, if the *force majeure* wording is based on “prevent/delay” wording, but are likely to take a more generous approach if the wording is expressed to give relief where performance is “hindered” or has become “uneconomic”.
- Regardless of the occurrence of an event of *force majeure*, many difficult issues can arise in working out the obligations of the parties leading up to the event of *force majeure*, including how partially completed work is valued.

Frustration

Will a party’s obligations under a contract be “frustrated” by a supply chain shock? As with *force majeure*, frustration will not give relief for inconvenience or hardship. Rather, the English courts are expected to take the view that the obligation will need to be impossible or illegal to perform. Also, frustration will not apply where parties have allocated risk of an event occurring to one or the other party (for example, by including a suitably drafted *force majeure* clause). As a result, companies that are adversely affected by a supply chain shock may not be able to benefit from frustration as a means of avoiding their contractual obligations unless the contract becomes illegal to perform. Interesting questions will doubtless arise following the forced shutdown of businesses as a result of an event in the supply chain that makes it impossible to produce whatever the affected party produces. As such:

- The frustration of a contract will only occur when a contractual obligation has become incapable of being performed “because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract”.
- If a party is able to perform part of the contract, then the performance of the contract will not be frustrated. Thus, if it can be shown that action could be taken to enable performance, for example, by obtaining a new or different licence or complying with a different regulatory regime, the contract will not be frustrated.

Other jurisdictions may have a similar legal concept to frustration, or the concept of hardship that may apply to a particular contract. These concepts may mean that courts in that jurisdiction have the ability to reopen the contract, and to adjust it in some way to mitigate the frustrated element or hardship. Applying English governing law clauses may go some way to alleviate concerns that the contract can be adjusted in such a manner, but this will be subject to the enforcement of any such judgment from the English courts in any such country, as well as any foreign jurisdiction principle that their concepts of frustration or hardship are mandatory and, therefore, override express choice of law.



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Material Adverse Change

Some contracts contain express “material adverse change” wording that provide express financial relief in relation to, for example, cost increases over a threshold. Here, it will be critical to assess whether the supply chain shock is the real cause of business difficulties, or if it just tipped things over the edge for a business that was already facing difficulty. As such, for a business to get relief under a material adverse change clause, the supply chain shock must be the real cause of the issue. Much will also depend upon the wording of any clauses and, in particular, whether the relief is mandatory or discretionary. In addition, typically, the change in question cannot be fleeting or transient. In other words, it must have an enduring impact on the capacity of the business to meet its obligations under the contract.

Other Options

In most cases, it will be necessary to consider whether the contract itself provides any other provisions that may give some relief from the adverse consequences of supply chain shock. For example, what provisions exist in relation to:

- Price adjustments
- Change in law clauses where relevant laws are changed as a result of the supply chain shock
- Change control clauses
- Breach of contract relating to late deliveries, for example
- Any disaster recovery obligations and remedies that oblige the affected party to continue the performance of a contract by alternative means
- Any ability on the part of suppliers to pass on additional costs, and/or additional delivery charges

In addition, the following clauses are likely to be of use in resolving any disputes without recourse to the courts:

- What does the contract say regarding such matters as delays, and any resulting liquidated damages and/or liability for line stops?
- Are there any rights of audit and validation regarding such matters as costs?
- What are the governance, escalation and dispute resolution provisions?
- What are the remediation provisions?
- Are there any transitional provisions on termination to ensure continuity of supply for a period?

Finally, English courts may be prepared to grant injunctions to prevent suppliers from simply ceasing to supply products or services.

What Are the Options?

With regard to existing contracts, consider what the party seeking to enforce a contract wishes to achieve. For example, does either party want to:

- Enforce an existing contract on a supplier, regardless of the supply chain shock
- Renegotiate the contract
- Get out of a contract

Doing nothing may be an option, but remember that:

- Each party remains liable to perform in full, regardless of adverse changes
- It is possible that the performing party may quickly be in breach of contract

Doing nothing may be a valid option in the following circumstances:

- The benefitting party wants to demand compliance with current favourable terms after the supply chain shock
- The performing party is confident of ability to perform on the basis of current terms
- The risk of opening up a debate may be a greater risk to one party than the other
- The contracts are short-term, close to expiry or terminable on short notice

For new contracts, determine:

- Who takes the risk?
 - Should one party assume some or all of the related risk, i.e. the supplier has to continue supplying at the same cost and to the same time scales, or should the buyer be expected to take all related risk of cost increases and delays?
 - Should costs stay where they lie?

- Can prices be varied? Here, any buyer will want to make sure that any costs are shared among all the supplier’s customers.
- What is the ongoing impact of supply chain shock on the global economy and all new contracts that are entered into? Impacts may include:
 - Spiralling costs
 - Delivery issues
 - Exchange rate volatility
 - Other negative supply chain factors
- The following options regarding hardship implications should be considered:
 - Negotiate rights to vary the contract, and/or prices in the light of any actual material adverse changes due to ongoing supply chain issues. However, this only kicks the can down the road. On the other hand, if a negotiation process is used, consider what will happen if the parties cannot agree. For example, does that then give rise to one or both parties having a right to terminate, does the agreement continue on its existing terms or will the issue go to a form of escalation procedure followed by alternative dispute resolution, such as expert determination or mediation? If alternative dispute resolution is selected, it may be that some methods will lend themselves better to disputes arising from supply chain issues than others, and the choice of “expert” may be crucial to an acceptable result being achieved.
 - Agree upon specific consequences arising out of the effects on the ability to perform, such as varying prices and delivery time scales.
 - Determine to what extent relief clauses should apply.
 - Consider more robust disaster recovery options.
 - Determine whether any supply chain disruption would be sufficient to trigger termination.
 - Consider how the adverse cost implications arising from supply chain issues should be dealt with and validated.
- Are any structural changes to the supply chain required?
- Consider the use of dispute resolution mechanisms.
- Include noncontractual obligations within the scope of governing law clauses to avoid the risk of the law of the country that the tort occurred being applied.
- Consider the use of arbitration provisions, rather than the use of courts in contracts with EU companies.

Next Steps

From the above analysis, several practical and contractual actions exist that all businesses can consider implementing to better protect the continuity of supply in the event of a supply chain shock.

While some of the considerations may feel somewhat remote when negotiating a new contract for the supply of critical components, the long-term disruptive impact of some recent supply chain shocks demonstrate that the issues considered in this paper are very important, as they will often have a significant impact on all affected businesses, regardless of their place in the supply chain.

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