

Navigating Supply Relationships In The Turbulent World Of Coronavirus Disruption

by John T. Shapiro

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ABOUT THIS WHITE PAPER

Businesses throughout the globe that rely on or service supply chains are experiencing COVID-19's disruptive impact. The altered marketplace should prompt your company to take proactive steps to manage the disruption to its supply relationships. This White Paper highlights key issues and strategies you can use to protect your company and its supply relationships.

The ongoing COVID-19 (“coronavirus”) pandemic is having an unprecedented adverse impact on trade and commerce. Businesses throughout the globe that rely on or service supply chains, whether simple or complex, domestic or international, are experiencing the pandemic’s disruptive effect.

Purchasers and suppliers of goods and services are assessing their rights and obligations toward one another. In determining its strategy for addressing disruptions, it is important for your company to keep in mind that it may be both a purchaser and supplier in the same supply chain. Actions your company may take as a purchaser in response to a supply partner’s inability to fulfill a supply obligation may be taken against the company in its capacity as a supplier if it is unable to fulfill obligations to a subsequent purchaser of the company’s products.

How should your company assess and manage supply relationships and navigate existing and future disruption caused by the coronavirus? No one-size-fits-all solution exists. But, a mix of three primary considerations will allow your company to better control its fortune even where current-day realities render supply relationships uncertain and more difficult to maintain and manage:

1. Understand your company’s existing supply agreement rights and obligations
2. Nurture current supply relationships
3. Heed lessons learned in forming and managing future supply relationships

Each consideration is complex. For many companies, efficient and effective assessment, relationship management, and synthesis and application of lessons learned to future company operations and relationships will require a team approach. This includes seeking input from and the assistance of legal counsel familiar with

supply chain dynamics and experienced at helping to resolve disputes between supply partners.

This White Paper highlights key issues for use by your company’s team in protecting the company and its supply relationships in the turbulent global marketplace the coronavirus pandemic has created.

Step 1: Assess Your Company’s Contractual Rights and Obligations

The altered marketplace should prompt and embolden companies to take proactive steps to manage the business and legal consequences of disruption to their supply chains and relationships. Rote reliance on trust placed in supply partners to offer a remedy is foolhardy. Proactive management starts with understanding your company’s rights and

obligations so that your company can design and implement an informed strategy. Considerations that inform decision-making regarding supply chain rights and obligations include:

Identify Governing Agreements and Law. Your company's assessment of its supply relationship rights and obligations starts with review and understanding of relevant supply agreements. This review should take into account the particular law that governs interpretation of each agreement and relationship. Governing law may differ with respect to particular upstream and downstream parties in a supply chain and compel different strategies for different partners of your company within the same supply chain.

Identify and Analyze Potential Legal Theories that may Afford Relief. No doubt, numerous companies that are unable to fulfill their obligations as a result of the coronavirus hope to claim the pandemic as a force majeure event, provided a force majeure clause is included in their supply agreement. The purpose of a force majeure clause is to excuse nonperformance where circumstances beyond the control of the parties thwart contract compliance.

Whether a supply disruption caused by the coronavirus pandemic will constitute a force majeure event that excuses performance will depend on the particular wording of the force majeure clause. Where a clause includes terms such as "pandemic" or "government act in response to an emergency," a company is more likely to be in a position to assert that the coronavirus is a force majeure event that excuses its non-performance. The World Health Organization has declared the coronavirus a pandemic. And, governments around the world have declared their own emergencies and have implemented quarantines, stay-in-place orders and other measures to stem the virus' spread that have the effect of disrupting supply chains.

In the absence of a force majeure clause altogether or a force majeure clause that does not encompass a coronavirus-related disruption, other performance-relieving legal theories may apply, including under common law, such as impracticability, impossibility and commercial frustration, the Uniform Commercial Code and the U.N. Convention on the Sale of Goods. Generally, these avenues for potential relief consider whether an unexpected, intervening event occurred, the non-occurrence of the event is a basic assumption of the contract, and the event makes performance impossible or impractical or it obviates the purpose of the agreement.

As with the law on force majeure, your company must be weary of legal generalizations and mindful of the numerous permutations to these alternative legal theories, some jurisdiction specific. In the same vein, in some jurisdictions

the inclusion of a force majeure clause in the parties' supply agreement may supersede application of an alternative theory, even if the force majeure provision does not apply to the particular cause of the disruption, the notion being that the parties specifically allocated risk of the type of disruptions that would relieve performance. Therefore, your company should assess each potential avenue for relief under the governing law in determining—and before implementing—its strategy for addressing its inability to comply with its supply or purchase obligations.

Identify and Maintain Evidence. It is important for your company to keep in mind that each potential theory for relief from non-performance sets a high, fact-intensive bar for partaking. Courts and other tribunals typically construe each legal theory narrowly. Identifying relevant facts is vital to assessing which legal theories support your company's situation. So too is maintaining evidence that reflects those facts, especially if your company subsequently has need to prove an applicable defense or justify particular conduct. Because it is reasonable to anticipate a dispute will ensue, your company should implement a hold on information that relates to the disruption and the remedy your company implements.

If your company's supply partner declares that a force majeure or another legal theory relieves it of its obligation to supply the company or purchase its products, your company should not simply accept its partner's word for it. Rather, your company should ask its partner for evidence of its inability to supply or purchase and its efforts to mitigate the disruption. Further, if that supply partner's inability to supply causes the company's own inability to supply product to another supply partner, your company should be careful to document that impact.

Consider Impact of Remedy on other Obligations and Aspects of Operations. The strategy assessment should include consideration of other clauses in the supply agreement and other agreements, such as financing agreements, that may be impacted by a declaration of force majeure or notice of other remedy. In addition, the assessment should include review of insurance policies to determine whether your company is covered for losses arising out of direct interruption of its operations as well as disruption to the company's supply chain, including failures of upstream suppliers or downstream customers to comply with contractual obligations to the company. Insurance coverage for losses related to supply chain disruption may impact the strategy your company ultimately implements.

Mitigate the Impact of Disruption. Your company also should assess its ability to mitigate disruption to its performance, even if mitigation results in a greater cost to the company. Typically, additional cost to comply with a supply obligation alone does not excuse non-performance. But, careful review of the supply agreement, underlying facts, and governing law may reveal a viable argument that additional cost to comply is a hardship that is encompassed by the force majeure clause or other legal theory. Moreover, even if efforts to mitigate are not successful, your company's efforts nevertheless would be relevant to its declaration of force majeure. First, your company would satisfy a mitigation effort should governing law require such attempt before it may rely on a force majeure event to excuse performance. Second, your company's efforts likely would demonstrate that the force majeure event indeed rendered performance impossible.

Similarly, if your company receives notice from its supplier that the company believes is without merit (for example, the supplier's circumstances do not constitute a force majeure event or the supplier should be able to mitigate its non-performance), the company should assess whether it has a duty to mitigate the damages its supplier causes. Whatever the reason your company mitigates, it should keep careful record of its efforts and costs to mitigate.

In the event that your company is able to continue to supply one partner but not another because of the disruption, the company should tread carefully. Supplying one customer but not others with the same or similar products may negate or otherwise undermine the company's force majeure declarations. The terms of your supply agreements and governing law may provide guidance should your company find itself in this situation.

Dispute Resolution. Your company's strategy assessment and design also should include consideration of the venue in which any ensuing dispute would be resolved. As with governing law, your company's approach to addressing a supply disruption may be guided by the ability to litigate or arbitrate in a venue that is familiar and favorable to the company. Conversely, if a lawsuit or arbitration would enmesh your company in a foreign jurisdiction, much less one where the governing law and procedure are unfamiliar or unfavorable to the company, your company's decisions may be guided by the goal of achieving an amicable resolution to the supply disruption.

Duration of Disruption. Even if your company is able to take advantage of a force majeure clause to excuse its non-performance, that excuse may only be temporary in duration, until the disruptive event ends. The company's assessment of strategy should include review of the supply agreement and the law that governs it in order to understand whether

the event allows the company to permanently alter the supply agreement terms or terminate the supply relationship altogether.

Be Mindful of Notice Requirements. A supply agreement or governing law may require that your company provide its supply partners with prompt notice of a disruptive event. Failure to provide prompt and adequate notice, in some cases within a particular time frame, may result in waiver of the right to rely on the force majeure clause or other legal theory. Therefore, your company's strategy assessment must be done efficiently as well as effectively. Of course, if the period of time in which to provide notice is short, your company may be required to provide notice of a disruptive event before it is able to complete assessment of its rights and obligations and applicable defenses. Whenever issued, your company should be careful to avoid unnecessary statements that might harm its position as to one or more other supply partners. The company also should be mindful of providing timely notice to its insurers, and ensure that any notice provided to a supply partner is consistent with notice of a covered loss and any other steps an insurance policy may require.

Step 2: Nurture Existing Supply Relationships in the Face of Disruption and Position Company for Amicable Resolution of Supply Interruptions

Practically, a supply chain is about the relationships amongst the parties who comprise it. Those relationships have a business, as well as a legal, character. Therefore, as it assesses its options and strategies, your company should communicate with and seek information from its suppliers and customers regarding the impact of the coronavirus on their ability to meet supply and purchase obligations.

Before doing so, your company should map its supply chain. Knowing who its suppliers are and where they are located, and who and where their suppliers are, will clarify with whom the company should focus its efforts, facilitate assessment of information, reveal the potential for further disruption of supply relationships, and serve as a map for pursuit of amicable resolutions and for devotion of resources to find other supply solutions. Your company's suppliers and customers may find themselves facing similar predicaments and, as a result, be willing to renegotiate a supply relationship in a manner that achieves the parties' respective needs without need for further dispute resolution.

Armed with accurate information about its supply chain and with knowledge of its contractual rights and obligations, your company may be able to negotiate with its suppliers and customers resolutions that meet both the company's immediate and longer-term needs and avoid supply disputes that tend to be disruptive themselves and expensive to

resolve. In turn, irreparable damage to your company's important supply relationships may be spared and harm to your company's hard-earned brand reputation avoided.

Step 3: Take Heed of Supply Relationship Lessons this Pandemic Offers

Of course, even with the best planned supply relationships, problems may arise. With increasingly global and complex supply chains, companies of all types face unprecedented challenges in ensuring that they receive from their supply partners the products, services and benefits for which they bargain. Recent national and global events – natural disasters, terrorism and war, changes in governmental regulations, market instability, epidemics and, now, the coronavirus pandemic – underscore the critical need for your company to assess the impact of risks on its supply chains and relationships – “what ifs?” – both foreseeable and unforeseeable.

Risks inherent in a particular supply relationship can be managed through proactive assessment and careful contracting that addresses business and legal issues unique to the relationship. Critical considerations (each worthy of its own alert) include:

- Careful assessment of supply chain risks and vulnerabilities;
- Thoughtful preparation for, and careful negotiation of, the supply relationship in light of business needs and risks and vulnerabilities identified, including careful consideration of terms that afford your company protection should the supplier falter;
- Precise drafting of supply agreement terms that reflect the parties' obligations and expectations;
- Vigilant management of the supply relationship;
- Specific mechanisms for efficient dispute resolution; and
- An exit plan, including broad termination rights.

One consideration – precise drafting that reflects the parties' obligations and expectations – warrants further mention here given this White Paper's focus on how to navigate supply relationship disruptions caused by the coronavirus pandemic. A well-planned and well-written force majeure clause is critical to protecting your company's interests. Often, companies relegate the force majeure clause to boilerplate, adopting a clause used in a different supply agreement or agreeing to a clause proposed by the would-be supply partner. Although certain concepts pertinent to your company's business may permit use of boilerplate in its supply agreements, for some situations and relationships boilerplate, and any poorly-conceived list of unforeseeable and uncontrollable events or syntax carried over, can backfire.

Consider, for example, the Iowa Supreme Court's 2008 opinion in *The Pillsbury Company, Inc. v. Wells Dairy, Inc.* Wells produced ice cream for Pillsbury until Wells' plant exploded. Wells claimed it was excused from its further performance under the following force majeure provision:

FORCE MAJEURE: Neither party will be liable for delays or suspension of performance ... caused by acts of God or governmental authority, strikes, accidents, explosions, floods, fires or the total loss of manufacturing facilities or any other cause that is beyond the reasonable control of that party (“Force Majeure”) so long as that party has used its best efforts to perform despite such Force Majeure.

The trial court found the clause ambiguous because it was susceptible to differing meanings depending on the language modified by the phrase “that is beyond the reasonable control of that party.” If the phrase modifies “acts of God or governmental authority, strikes, accidents, explosions, floods, fires or the total loss of manufacturing facilities or any other cause,” the trial court found that the explosion would not excuse Wells' nonperformance if the explosion were not beyond Wells' reasonable control. But, if the phrase only modifies “any other cause,” Wells' non-performance would be excused even if the explosion were within Wells' control.

The Iowa Supreme Court reversed, holding as a matter of law that the phrase “that is beyond the reasonable control of that party” modifies all of the events the parties identified in the force majeure clause. The Court found that the clause must be interpreted in light of the purpose of a force majeure clause, the allocation of risk if performance becomes impossible or impractical as a result of an event that the parties could not anticipate or control. The Court noted that the parties did not negotiate what events would constitute a force majeure event, which rendered Wells' post-explosion interpretation of the clause unreasonable. The Court reasoned that if Wells had wanted the parties to deviate from the typical purpose of a force majeure clause, it should have bargained for and negotiated such deviation. Further, the Court noted that allowing Wells' negligence to excuse its performance would defeat the purpose of the supply relationship, for Wells to provide Pillsbury a specific amount of ice cream within a defined period of time.

The Iowa Supreme Court's admonition regarding negotiation is prescient. Unanticipated events beyond the parties' control that prevent performance occur. Your company's negotiations with its supply partners should account for such possibilities, including pandemics and government actions to stem their spread, and clearly allocate the parties' respective risks, rights and obligations.

Conclusion

The nature and scope of the adverse impact of the coronavirus on supply chains and relationships continues to evolve. Far reaching disruptions are inevitable. In the coming weeks or months, many businesses are likely to receive notice from a supply partner that the coronavirus, or government-ordered action to stem its spread, constitutes a force majeure event that excuses the partner's performance. Whether notice of a force majeure event, or assertion of another legal theory excusing performance, will succeed will depend on the particular terms of the supply agreement and the particular facts and circumstances giving rise to the disruption, the foreseeability of the disruption at the time at the time the supply relationship was formed and governing law. Practically, whether such notice disrupts your company may depend on your company's relationship with the supply partner and preparation for disruption. Proactive management of supply relationships, understanding rights and obligations between supply partners, and seeking practical solutions to supply disruptions are likely to be the best medicine with which to protect your company against the ill effects should the coronavirus take hold of its supply chain.

If you have any questions, please contact John Shapiro (jshapiro@freeborn.com; (312) 360-6389) or visit [Freeborn's COVID-19 webpage](#). Freeborn has published multiple alerts regarding the effect of COVID-19 on businesses, and would be pleased to advise you on your company's specific supply agreements, insurance coverage, and other aspects of its operations.

ABOUT THE AUTHOR



John T. Shapiro

Partner

Chicago Office
(312) 360-6389

jshapiro@freeborn.com

John focuses his practice on solving clients' complex business disputes, including through litigation, counseling clients on regulatory, business and employment issues, drafting supply and related agreements, providing general corporate and management advice, and assisting clients to establish and maintain productive business relationships that further clients' business interests. As Leader of Freeborn's Food Industry Team, John provides ongoing legal and business counseling to a variety of food and beverage clients. Among other areas, John focuses on food safety, regulatory compliance, supply chain management, recall and other crisis management, and litigation. John believes that keys to success in the food and beverage industry include establishment of productive supply chain relationships and careful contracting that memorializes those relationships, identifies, allocates and mitigates risk, and accounts for the applicable regulatory regimen and other governing law.

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CHICAGO

311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

NEW YORK

230 Park Avenue
Suite 630
New York, NY 10169
(212) 218-8760
(212) 218-8761 fax

SPRINGFIELD

217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

RICHMOND

901 East Byrd Street
Suite 950
Richmond, VA 23219
(804) 644-1300
(804) 644-1354 fax

TAMPA

1 Tampa City Center
201 North Franklin Street
Suite 3550
Tampa, FL 33602
(813) 488-2920

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