SUPPLY CHAIN DISRUPTION: PROTECTING YOUR POSITION IN THE FACE OF GLOBAL CHALLENGES

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Empty petrol stations, rising energy costs, chaos at container parks, and electronics and toys missing from the shops at Christmas. Some reports suggest that the United Kingdom could run out of warehouse space. Individuals and businesses alike are being affected by a continuing disruption to global supply chains, including a lack of raw materials, a shortage of microchips and other components, extraordinary increases in the cost of energy, bottlenecks at major ports, and a shortage of HGV drivers. A perfect storm of events (including the COVID-19 pandemic, Brexit, trade tensions between the United States and China, severe natural disasters, the list goes on) has resulted in a shortage of key materials and labour, increased costs, and unpredictable delays.

All this disruption may point to possible breaches of contracts. So what can businesses do to protect themselves against the legal consequences of supply chain disruption?

WHAT IS THE CONTRACTUAL POSITION?

First and foremost, businesses need to review their contracts to see how ongoing disruptions are impacting them. For example, a supplier might fail to deliver goods in strict accordance with the contract, the business itself might fail to fulfil orders due to increased costs or a lack of parts, or a customer might refuse a delivery of goods due to a lack of storage.

Contractual Reimbursement/Indemnification Mechanisms

There may be mechanisms in the contract to ensure that money is returned to the 'innocent' party as a result of delay or failure of performance. If you are the innocent party, do your contracts contain provisions entitling you to a refund, or an indemnity for losses incurred as a result of the breach? If you are the party having difficulty meeting your obligations, consider whether you have agreed limitations to your liability and/or insurance that might cover any claims asserted against you.

Contractual Extension/Suspension

Can the time limit for performance be extended, or performance of the contract more generally be suspended? This may be a more attractive option for all compared to terminating the contract, as it provides scope for successful commercial relationships to continue into the future.

Frustration

If the contract has become impossible to fulfil, without fault of either party by reason of an event that has not been expressly provided for in the contract, the contract may have been 'frustrated'. When that happens, the contract is

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automatically discharged (so its affect is not suspensory), and the parties are released from their future obligations (although they are obliged to perform obligations incurred prior to the frustrating event and there are special considerations to apply in respect of benefits and costs already incurred).

Force Majeure

The contract may expressly provide for suspension of contractual obligations if a force majeure event occurs. The effect of a force majeure event will depend on the drafting of the clause but, typically, obligations are suspended while the force majeure event continues, and the non-performing party has no liability for non-performance or delay. The contract is re-activated when the force majeure event comes to an end, although either/both parties often have the option to terminate the contract if the force majeure event continues for a specified period of time. Force majeure provisions should be carefully considered. Is the specific event impacting the ability to perform included in the scope of the force majeure clause, and is it the only effective cause of the breach? Does COVID-19 qualify as a force majeure event, or is there a separate framework to deal with Covid-19 that applies instead (as is increasingly the case for agreements negotiated in the last 18 months)? Businesses should note that a mere change in economic or market circumstances that makes a contract less commercially attractive will generally not be considered a force majeure event.

Contractual Common Law Rights to Terminate

Consider the contractual termination provisions and the circumstances in which either/both parties are entitled to terminate the contract. At common law, a party may terminate on the grounds of a repudiatory (very serious) breach of contract. In certain circumstances, where it is clear that a counterparty has no intention of performing the contract, a party may even treat the contract as repudiated as a result of an anticipatory breach of contract, before the time for performance has expired.

IS THERE SCOPE TO NEGOTIATE AMENDED TERMS?

Disruption to supply chains affects all businesses differently. Many parties will be looking to re-negotiate contracts to help them deal with the immediate uncertainty, costs, and delay arising out of the disruption. If faced with a counterparty that appears to be in breach of contract, or in circumstances where your business is at risk of committing a breach, consider whether there is scope to negotiate amended terms. It may be that a mutually beneficial amendment to the contractual terms can be agreed. Longer term, businesses should develop contractual review mechanisms embedded in their agreements such that they protect their interests going forward, in case of future disruption (for example, agreeing certain contractual triggers for rate reviews).

OPTIONS FOR RECOVERING LOSSES

With prima facie breaches of contract arising out of the ongoing disruption to global supply chains, the usual remedies for breach may be available. These might include:

Contractual Damages

The usual measure of damages compensates the injured party and puts it, so far as is possible, in the position it would have been if the contract had been performed. Further, Section 51(3) of the Sale of Goods Act 1979 provides that, in the event of a failure to deliver goods for which there is an available market, the measure of

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damages will be ascertained by the difference between the contract price and the market or current price of the goods. In times of supply chain disruption, this could result in substantial potential liabilities for a non-performing party, as the increased energy costs, transport disruptions, and raw material shortages are likely to increase the costs of goods in the available market. Be aware that contractual damages may be limited by exclusion and/or limitation clauses in the contract, although any such clauses may be subject to statutory restrictions.

Liquidated Damages

Some contracts may provide that a fixed sum, or a sum calculated by a set formula, is to be paid on breach. This gives the parties more certainty than trying to assess the amount of potentially recoverable damages on the usual English law principles. In some circumstances, though, liquidated damages can be struck down by the courts because they represent a penalty rather than compensation.

Restitution

The courts will also prevent the unjust enrichment of one party in the event of a failure of performance. For example, where a party has paid for goods that have not been delivered, this may give rise to a restitutionary claim for the monies paid over, arising from a total failure of consideration.

Insurance

Always review your insurance policies to ascertain whether your insurer might cover additional expenses and other losses incurred as a result of a disruption to supply chains. If there is a chance that a loss is insured, it is vital that a notification is made to the insurer very promptly.

AMELIORATING THE SITUATION

Businesses can take steps to ameliorate the situation. Communication is often key. Parties should communicate with their counterparties both up and down the supply chain.

Communication with suppliers will help to get a handle on the scale of the disruption, and the likely time period in which the disruption is expected to last. A cooperative relationship with a supplier might also help to ensure that your supplies are prioritised or re-sourced, compared to a third party who has been less proactive in maintaining a good relationship with its supplier. It may also be possible to find operational workarounds to mitigate the impact of the disruption.

Clear communication with customers, as well as being good customer service practice, will aid your customer in mitigating its own risks and losses, some of which it may seek to recover from you.

FUTURE CONSIDERATIONS

Once steps have been taken to deal with the business risks arising out of the current disruption, it is important to make use of what has been learned to make the necessary changes to protect yourself against future disruption.

Businesses would do well to plan for crises so they have contingency plans in place to lessen the impact of future disruption. In addition, consideration should be given to key contractual terms (for example, providing flexibility as to price and quantity in the event of significant market disruption, termination rights, force majeure clauses, limitations on liability and indemnity provisions) so these can be negotiated (or re-negotiated) in future to protect

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the business's position against any forthcoming uncertainty. Taking a balanced approach when developing such terms is likely to gain more traction because if you are impacted then your counterparty is likely to be impacted also. Building in some mutuality and good faith discussions based on objective criteria and data will likely yield the best results.

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