CLIENT ALERTS & INSIGHTS

# Contracting for Geopolitical Risk

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Featured Industries: Transportation & Logistics, International Trade & Supply Chain Management

Geopolitics are impacting supply chains at an incredible speed and magnitude right now. It is no wonder that geopolitics and supply chain risk have become top concerns for Chief Legal Officers. Every second is a challenge when in a single moment you find yourself staring down kinetic wars in both Europe and the Middle East, dramatic leadership changes in the Western Hemisphere, global trade wars, evolving sanctions programs, and treaty reviews all at once.

Risk-appropriate contract terms are now just as essential as the strategic approach procurement teams take when going to market. Far too often teams will simply "dust off" contract terms when going to market. The days of using boilerplate purchase orders as the only documentation for a purchase or sale are over. Many of those were not negotiated let alone reviewed. Instead, there is now a need for clarity between contracting parties on exactly what expectations will be due to geopolitical risk. On its most basic level this involves determining how shocks to the system will be communicated between parties and what the effect will be. This is similar to the root cause analysis and corrective action plans developed in some technical trading relationships - although focused on outside factors rather than performance alone. Certain clear risks also merit their own provisions. Those include the risk of U.S. Customs detention and seizure, the risk of dramatic change in duty rates, and the risk of a party's swift appearance on denied parties lists.

**This Time It's Different**

There is no one-size-fits-all supply chain, but there are a number of historic business practices that were commonly deployed and are now under threat. Changes in business practice are just as important to appropriate contract terms as are the news headlines. Today, the staggering breadth of product portfolios is no longer efficient leading many companies to reduce the variance of raw inputs and volume of finished goods SKUs. Even product categories, service lines, and markets are being rationalized in some verticals with a renewed focus on core competencies and profitability. Inventory management is challenged by tariff burden, the loss of de minimis for low-value imports to the US, and inbound logistics disruption, leading to a trend of holding higher inventories closer to the point of use. The "partnering" approach of selecting single-source suppliers is no longer viable for critical supply or in single non-US countries, leading to increases in supplier diversity.

**How to Think About Geopolitical Supply Chain Risk**

The ways in which threats manifest in supply chains all have one thing in common - irregularities against expectations. Certain occurrences are commonly suffered across supply chains regardless of industry or geography that prevent companies from performing as expected under normal operating conditions. The consequences of these occurrences impact the bottom line but also spread up and down the supply chain with a so-called bullwhip effect. Risk assessments and strategic planning are two of the primary tools in the practitioner's toolbox for anticipating these risks. Procurement practices, and active supplier or vendor management, are the tactical tools for managing risk together with strong contracting practices.

Compliance Variance Risk - Suppliers, service providers, or products may be found to fall out of compliance with applicable laws or regulations. Examples include recognition mid-relationship that items cannot be entered through US customs because of allegations that inputs were produced with forced labor. Recognition that a supplier or provider is, or has become, listed on denied parties lists or has become subject to sanctions program is another increasing challenge in this environment.

Cost Variance Risk - Increased costs to land products or fully receive a service is a unique type of financial risk. It does not prevent the purchase, but it does challenge the commercial viability of continued procurement. Severe variance will destroy margins and, as we've seen recently, even challenge the financial viability of a company. Examples of this type of risk include the recent worldwide reciprocal and universal tariffs imposed on most imports. Landing product in the US became cost-prohibitive for many companies and forced negotiations or downstream notices. Significant challenges were also experienced by equipment or raw input suppliers who may have had lengthy production cycles for essential purchases that were, only in the end, subject to multi-million-dollar tariff exposure.

Availability Variance Risk - Product supply can be short and services may be unavailable which immediately impacts company production and sale. Examples include the inability for a supplier to deliver as contracted due to upstream raw materials constraints from cost or availability. Sometimes these variances have nothing to do with the quality of supplier or service provider. The occurrences may be entirely outside the control of our contracting party such as force majeure events or acts of government authority. Still, the impacts can be significant particularly in operations with low safety stock.

Quality Variance Risk - Products or services that fail to meet industry quality expectations, or those agreed upon in purchase contracts, have immediate negative consequences for operations and customer experiences. Examples can range from failure to meet specified dimensional or color specifications or, in the extreme, failures in special conditions or handling that yield total loss. These variances essentially amount to a purchaser's failure to receive what was agreed upon for purchase, but the magnitude of impact (and availability of damages) can vary greatly depending on the particular type of variance, its circumstance, and contract terms.

**Procurement Best Practices for Managing Risk**

Supply chain disruption risks are sometimes unavoidable. Still, professionals can approach relationships in ways that prevent unforeseen risks as best as possible and that place companies in the best positions if those events arise. Procurement professionals and their legal teams are most commonly tasked with developing go-forward strategy for keeping supply lines humming. Not to be overlooked, this is also a very challenging time for sales professionals and business operations teams. Each have best-in-class approaches available for meeting this moment.

Preparing to Go-To-Market - The first step to managing supply chain disruption risk is to gain a practical understanding of critical nodes in the supply chain. Many companies today are performing “supply chain mapping” to determine as best as possible the entire upstream value chain across companies and countries. This has become essential for companies with forced labor risk but it is also a valuable exercise for other complex supply chains. Doing so allows for risk assessments of key nodes and identification of where visibility, or documentation, for third-party operations may be low if not clearly risky. Risk-appropriate measures may then be implemented to address those known concerns.

Bid Processes and Supplier Management - Procurement teams then use these learnings when going to market for new goods and services. Risk assessments often yield specific RFP or RFQ questions, more discrete populations of potential suppliers, and tailored onboarding processes. These are all tools for supplier and provider due diligence, which is fundamental from a lawyer’s perspective. High impact review points may have serious implications for whether a supplier moves forward in the process and how the relative risks among suppliers are weighted. Those meaningful points often include party screening against sanctions lists, determination of trade compliance risks for the country or region, sectoral compliance risks for the product or industry, maintenance of required licenses and permits, and more traditional financial diligence. Targeted written confirmation of diligence questions are often implemented as part of onboarding processes. Periodic certification can occur throughout the relationship life cycle.

Preparing to Sell into a Market and Deliver Product - Sales and business operations teams are also on the front lines of risk arising from the downstream supply chain. Serious challenges can emerge very quickly around the customer, the customer’s customer, company products, and delivery routes. Building processes around best-in-class customer onboarding and management are essential. There is no reason to pursue accounts if we are prohibited from doing business with them or if they are prohibited from paying us. Onboarding questionnaires are key to obtaining required information for sanctions screening and financial diligence as well as commercial diligence. Depending on a customer’s role and risk profile then additional questions and periodic certifications may be appropriate to verify ongoing compliance. The other critical activity is order fulfillment. Operating procedures are available so that customer names are screened daily or at the time of fulfillment and export control numbers, as well as the necessity of license, are validated for every shipment.

**Risk-Appropriate Contract Drafting**

The fundamental aspect of contract law is that expectations between buyer and seller need to be established. Framing risk around these tangible concepts and then managing those under contract will accomplish that task. These items 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.

Compliance and Risk Tools - Compliance variance risk is top of mind for both product or service specification and legal compliance. Today, thoughtfulness in contract structures allows for use of ancillary documents such as Purchase Orders and Supplier Codes of Conduct that allow for dynamic change as the risk assessment evolves. Distinct terms can be used to reasonably address every identified risk. For example, appropriate compliance representations and warranties regarding goods or services are protective particularly when paired with indemnity for breach or third-party claims. Particular focus is required for creating adequate visibility to the lawfulness of third parties and their banks (sanctions risk), as well as end uses and ultimate end users (export controls risk), or upstream suppliers and the absence of forced labor for the inbound supply chain (import compliance risk) in this environment.

Creative Pricing and Payment Terms - Cost variance risk has been particularly challenging in recent years. Dramatic variances in landed costs (such as tariff impact) and the cost of service (such as inbound ocean carriage) have emerged in this decade. Creative tools are available as appropriate to address these problems such as required visibility to inputs, clarity on shared costs, and indexing of commodity good or service prices. Payment terms can be equally creative based on the fact pattern and relationship, including periodic payments based on performance or timing milestones. Some variance may be unavoidable depending on the market but setting expectations for future credits or debits, and even discounting here available, may may be creatively negotiated to balance the risk dispersion across parties.

Operational Forecasting - Availability risk is one of the more difficult obstacles to overcome in highly volatile commercial environments. We have seen times when goods are physically unavailable (COVID pandemic) or physically cannot be moved (Russia-Ukraine invasion) or cannot be sold and purchased at a price that accommodates the customer market (US reciprocal tariffs). Building a cadence of periodic forecasting for supply- or demand-side expectations can greatly benefit both parties in managing inventories and production. Setting expectations for how parties will address variance, including through management meetings followed by root cause analysis and implementation of corrective actions, can establish a reasonable path forward for managing through uncertainty. Ultimately, applicability of terms such as force majeure provisions and the precise triggers and processes for invoking those will be essential for tailoring contract terms to potential risk.

Relationship and Performance Management - Quality variance risk is one of the most frustrating challenges facing supply chain organizations. Contract performance happens within time and space so, even if both parties have best intentions, the lived experience of performance can raise serious challenges to production and sales. Two of the most commonly used tools for addressing this risk are tailored Service Level Agreements and Key Performance Indicators. These go beyond typical Product Specifications by addressing things like order accuracy, inventory accuracy, claims ratios,

and customer complaint frequencies. Parties can actively manage against those terms by agreeing to participate in periodic management meetings, requiring root cause analysis for failures, implementing corrective action plans to avoid reoccurrence, and even including bonus / malus provisions to incentivize desired performance.

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.

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