CLIENT ALERTS & INSIGHTS

Supply Chain Disruption Risk: Legal Perspective for Procurement Functions

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

Geopolitics and supply chain risk have emerged as top concerns for Chief Legal Officers. These factors are shaping strategic plans and competitive advantage as well as day-to-day operations. Along the way, traditional approaches to the supply chain discipline are evolving in response to this time of great change. This article summarizes some of the changes taking place in supply chains, the top risk categories that are challenging supply chain professionals, and ways to help manage those risks going forward.

Historic Practices Under Threat

There is no one-size-fits-all supply chain, but there are a number of historic practices that were commonly deployed and are now under threat. 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.

Acute Supply Chain Management Risks

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. Three parts make up the best approach to managing risks: (1) proper preparation for going to market, (2) thoughtfully managing the bid process and supplier or vendor relationships afterward, and (3) negotiating appropriate contractual terms so expectations are clear along with the roadmap for the relationship.

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.

Risk-Appropriate Contract Terms - Far too often teams will simply “dust off” contract terms when going to market. This risk environment necessitates thoughtfulness in contract structures, ancillary documents such as Purchase Orders and Supplier Codes of Conduct, and every term used throughout those sets. 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. Creative payment structures, clarity around price inputs, and price or cost indexing can be valuable tools for managing price variance. Forecasting and clear force majeure provisions can help manage disruption due to availability variance. Drafting meaningful Service Level Agreements or Product Specifications, and tracking against Key Performance Indictors, will help actively manage quality variance and any claims. Supply chain management tools such as periodic management meetings, root cause analysis, and corrective action plans drive active supplier management. Damages provisions, including liquidated damages, can reduce disagreement over the appropriate remedy for variance.

Every supply chain is different, but clearly understanding risks and calmly deploying these approaches with an eyes-wide-open understanding of potential outcomes will position procurement teams to best avoid disruption and weather storms when they arise.

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