Supply Chain Disruption Survival Guide

PREPARED BY THE FOLEY & LARDNER TEAM IN THE AREA OF:
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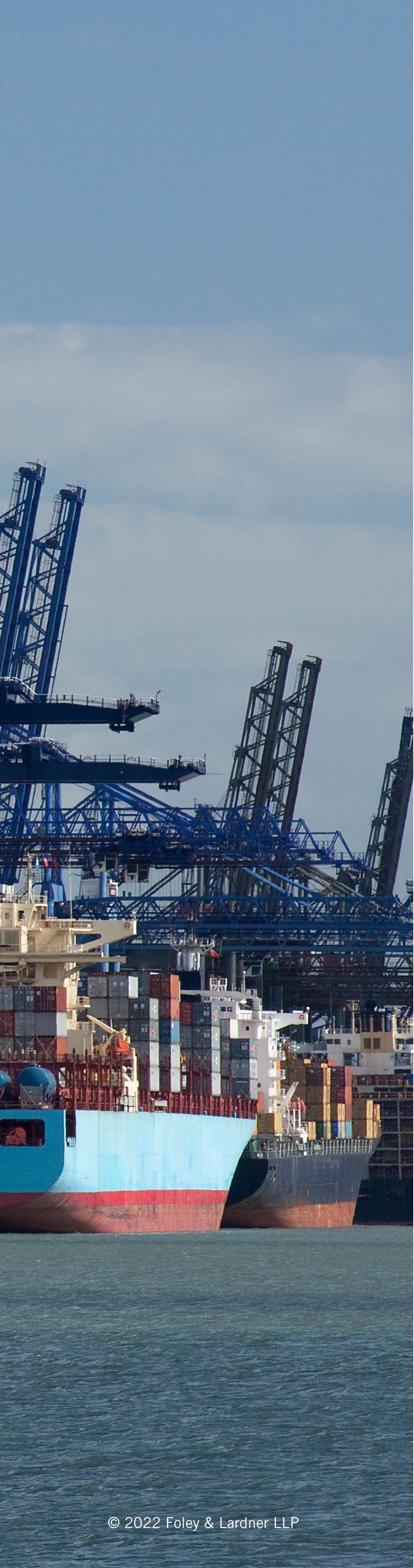
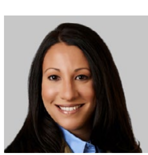


Supply Chain Disruption Survival Guide

Over the last few years, supply chains have been disrupted for many industries around the world. Although the COVID-19 pandemic figured prominently in this turbulence, unrelated events have all played a part in unsettling commodity and component markets around the globe. Faced with this unrelenting economic turmoil, buyers and sellers in the supply chain are encountering new legal challenges at almost every turn.

Foley & Lardner has compiled this Supply Chain Disruption Survival Guide to help you navigate these troubled waters. It provides a comprehensive analysis on some of the key issues facing buyers and sellers when purchasing and selling goods and services around the world. The guide also suggests ways to mitigate risks posed by existing and emerging supply chain hurdles. With the help of this Guide, your company can turn these challenges into opportunities to gain advantages over your competition by increasing the resilience of your supply chain.

Guide Co-editors



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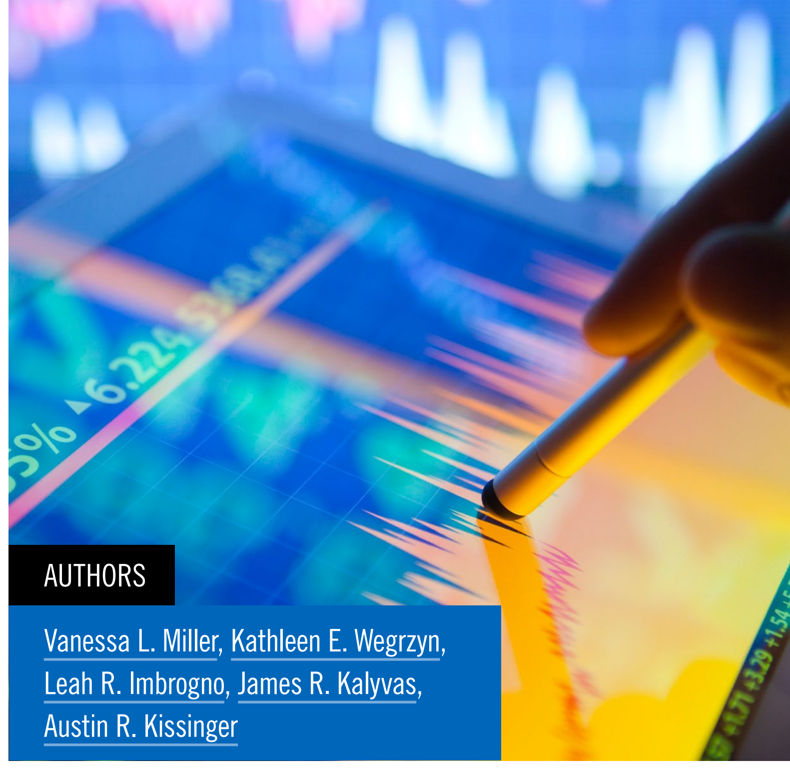
CHAPTER 1

Inflation Woes: Four Key Ways for Companies to Address Inflation in the Supply Chain



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The U.S. economy is grappling with the highest inflation in decades, with extensive inflation in the supply chain affecting companies worldwide. Supply chain disruptions undoubtedly have contributed to this sustained inflation, as extensive delays and rising costs continue to plague many industries.

In September 2022, the consumer-price index (or CPI) — a measure of the prices consumers pay for products — rose at an annual rate of 8.2%. Although that rate marked an improvement over the 9.1% year over year rate recorded in June, it still kept inflation at levels not seen in the United State since the 1980s.[1] Meanwhile, the producer-price index (or PPI) — a measure of inflation meant to gauge the impact on suppliers — similarly rose significantly at an annual rate of 8.5% in September.[2] Finally, the employer cost index (or ECI) demonstrates that, from June 2021 to June 2022, total compensation rose 5.1%, wages and salaries rose 5.3%, and benefit costs rose 4.8%.[3]

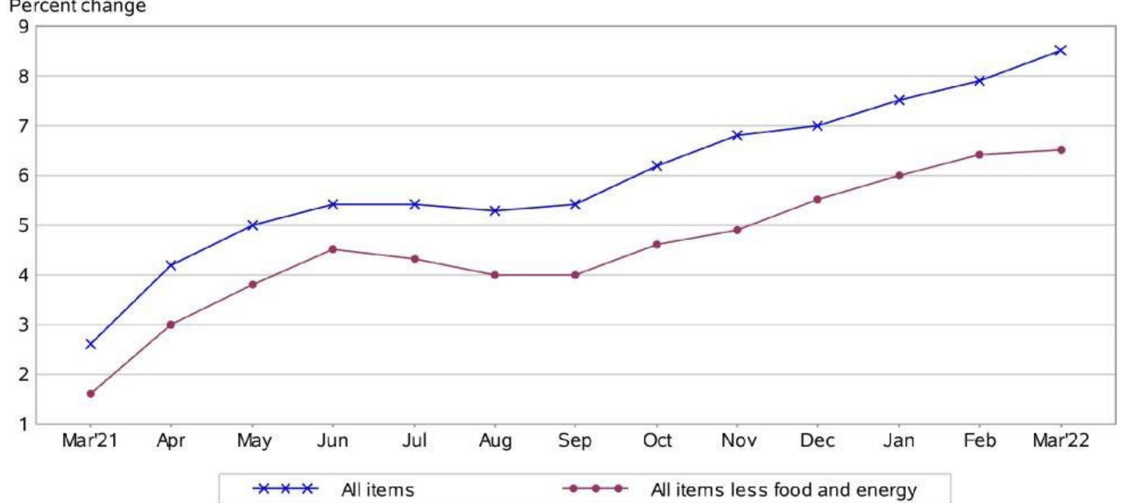
Because inflation increases the prices of goods or services, negotiations about who bears that risk in business partner relationships and the consequences of that risk allocation will have significantly greater

1 https://www.bls.gov/news.release/cpi.nr0.htm (last visited Oct. 25, 2022).

2 https://www.bls.gov/opub/ted/2022/producer-prices-increased-8-5-percent-from-september-2021-to-september-2022.htm (last visited Oct. 25, 2022).

3 https://www.bls.gov/news.release/eci.nr0.htm (last visited Oct. 25, 2022).

FIGURE 1: PERCENT CHANGE IN CPI MARCH 2021 VERSUS MARCH 2022



Bureau of Labor Statistics, U.S. Department of Labor, Consumer Price Index – March 2022, issued April 12, 2022

financial impacts than we have seen in recent memory. As a result, ensuring your business teams are well versed on the impacts of and means of mitigating inflation in new contracts has a direct impact on your bottom line.

In this chapter, we provide ways for companies in the supply chain to address high inflation and alleviate associated pressures, including (1) how to revisit and use existing agreement provisions to address inflation risk, (2) approaches to negotiating new agreements and amendments to existing agreements, (3) approaches to limit inflationary exposure, and (4) strategies for cost reduction.

Four Key Ways to Mitigate the Effects of Increasing Inflation in the Supply Chain

1. Revisit and Use Provisions in Existing Agreements

Companies faced with rising costs must review their supply agreements to determine if they already contain mechanisms the company can use to address inflation. On the buy side, companies should look in their agreements for terms relating to fixed prices. On the sell side, companies should investigate ways to pass increased costs on to customers. Most supply contracts contain a variety of provisions that may assist in combatting inflationary pressures.

(a) Pricing Provisions

From a seller's perspective, a contract may include index-based price escalation provisions, which tie contract prices to one or more indices. The underlying indices may be (i) broad economic indices such as the PPI or "market basket" indices tied to all items and all urban consumers, (ii) targeted indices such as ECI for a specific location, or (iii) tied to the cost of a specific commodity used in the underlying product. Contracts will sometimes incorporate several commodity indices and a formula reflecting the relative importance of those commodities in makingthe product that is the subject of the agreement, in order to reflect the cost of performance more accurately.

Allocations under these pricing provisions vary depending on negotiation power. They could put all of the risk on one party, share the risk equally, or share the risk according to particular percentages. The latter two options represent ways to avoid a "win/lose" approach.

Sellers will want to see whether their agreements allow for periodic negotiations for updated prices and take advantage of those opportunities. A buyer, meanwhile, may look for provisions that allow it the flexibility to limit the quantities ordered, enabling it to reduce costs as necessary or to seek a more cost efficient alternative. A buyer also will want to determine if the contract prohibits the seller from changing prices.

Regardless of the existing provisions, the real impact of inflation is likely to trigger commercial discussions to address rising costs; this is true both for hard goods supply agreements and indirect services agreements with longer terms such as outsourcing and managed services relationships.

(b) Force Majeure as a Mechanism to Adjust Price?

Outside of pricing provisions such as the above, however, a party may look to other contract provisions, such as *force majeure*, to see if its performance under the contract could be excused. Generally, increased costs alone are not enough to constitute a *force majeure* event. In order for a *force majeure* to apply, the increase in costs must be caused by an event that itself is a qualifying *force majeure* event under the terms of the applicable contract (which may include events like a labor strike or pandemic).

Force majeure provisions are intended to excuse performance under a contract but not to act as a pricing adjustment mechanism. However, *force majeure* and its extra-contractual cousin, *commercial impracticability*, can be used as tools to bring the parties to the negotiating table where events beyond either party's reasonable control are impacting the ability to produce and deliver products.

2. Negotiate Amendments to Existing Agreements

To the extent sellers have fixed-price contracts with their customers, sellers should consider negotiating with such customers to adjust these contracts in order to keep the prices they charge their customers in line with their input costs. When entering these discussions, companies that wish to implement a price adjustment, or eliminate fixed pricing entirely, should consider meaningful ways to incentivize their customers to agree to such changes. Would the customer be willing to agree to a price adjustment in order extend the agreement or adjust the quantity? Any items that maintain the relationship between

the parties while also allocating cost increases in an equitable way should be considered.

Conversely, buyers faced with price-increase requests should carefully consider their options:

- First, a customer receiving a price-adjustment request should confirm the request is actually tied to inflation and not just an attempt by a supplier to increase its bottom line. Seek detailed calculations supporting the price adjustments, and require suppliers to demonstrate how much their costs have increased above expectations.
- Second, customers should consider what items they would like to request in return for accepting a given price-adjustment request, such as whether they would like to adjust their quantity or timing of delivery.
- Third, a customer faced with a price increase request should consider whether the request should include the opportunity for the customer to obtain price reductions in the future, in the event there are changes in the pricing environment.

3. Pricing Tied to Indexing and Other Ways to Limit Future Inflationary Exposure when Drafting New Agreements

When drafting new agreements, companies should consider how best to mitigate the effects of inflation.

For nearly 40 years, we have enjoyed relatively low and steady levels of inflation, which explains why existing agreements may not adequately address the allocation of significant and unexpected economic change.

Many of those at the upper echelons of leadership today have never dealt with a high inflationary environment. To put it in perspective, the CEO of Walmart, the No. 1 company on the Fortune 500 list for 2021, turned 19 years old when high inflation last dominated financial news.

In the future, however, we expect far fewer agreements to have long-term fixed prices, as sellers negotiating agreements will want to incorporate a variety of strategies that allow for pricing flexibility and avoid longstanding, fixed prices. One such strategy is tying prices to an index. As discussed above, this could be a general index such as the CPI or PPI or be much more specific depending on the item sold.

There are numerous indices for various products and commodities that parties may use to reflect accurately the costs of producing the goods that are the subject of their agreement. Parties may consider incorporating a mechanism for revisiting these provisions, especially in the event that inflation slows. Caps on inflation risk also may be incorporated as a backstop.

If not tying prices to an index, selling parties will want to shorten the term of their agreements or require the parties to renegotiate prices at set points throughout the duration of their agreements. Alternatively, parties may consider price increases of a certain percentage that are automatically implemented periodically. The seller may even want to leave the pricing open and establish pricing at the time the order is placed.

On the other hand, customers will want to incorporate provisions that cause the supplier to bear the inflationary risk. Principally, this means locking in prices for as long of a period as the seller will accept and ensuring prices are fixed upon the issuance of purchase orders.

If and when sellers push back on extended fixed-pricing provisions, there are a variety of methods parties may use to meet in the middle:

- Pricing arrangements that are tied to one or more indices may be capped to a certain percentage, ensuring the customer will know its upward exposure.
- Include thresholds of index movement such that the price remains static unless and until the percentage threshold is exceeded.
- Allocate increased cost exposure so a certain percentage range of index movement is allocated to one party and then the next percentage range is allocated to the other party. Parties then may share any exposure above those ranges.
- Additionally, index-based pricing can be clarified to include both upward and downward movement, ensuring that customers, while risking inflationary costs, may also receive the benefits of deflationary environments.

4. Think Strategically to Reduce Costs

Aside from considering purely contractual methods to combat inflation, companies should think strategically about ways to reduce costs more efficiently.

- *Streamlining.* In order to pursue this strategy, companies need to determine which areas are driving increased spending and consider ways those areas may be managed differently. For example, companies may consider whether there are different inputs that can be used to lower costs or processes that may be streamlined. Companies can review their inventory management, labor inputs, and other areas to determine where cost cutting may be an option without sacrificing product or service quality. This streamlining might include ending product lines with lower levels of profitability.
- *Technology & Innovation.* In addition, with labor constituting such a high percentage of the cost increases companies are experiencing, a company may want to double down on technology and innovation that reduces headcount. Or, as prices rise, a company may pursue other pricing models. For example, a heavy equipment manufacturer may opt for a pay-per-use model in lieu of the traditional sale model.
- *Diversification of the Supply Chain.* Another method companies may use is diversifying their supply chains, ensuring they provide the flexibility and sustainability needed to weather turbulent periods. Though adding links to supply chains will not lower costs in the near term, it can help ensure a business continues to function smoothly even in the event of price shocks, material shortages, or other disruptions.

The stressors driving inflation are unlikely to be relieved any time soon. Companies should use every resource available to leverage their current contracts and negotiate new terms to address inflation's serious repercussions on their bottom line.

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CHAPTER 2

Going the Distance: Managing Freight Costs and Delivery Delays

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Due to the ongoing global supply chain crisis, companies face an uphill battle managing supply chain-related issues. On one front, companies are encountering frequent and extensive shipment and delivery delays. Although slumping orders for Chinese goods in the second and third quarters of 2022 have improved the situation somewhat, shipping delays and rates for transoceanic shipments from China to the United States and Europe remain high compared to pre-pandemic times. Information from Project44, which tracks global supply chains, reveals that shipment delays between China and major United States and European ports have quadrupled since late March 2022.[1] On the other front, suppliers are enduring sky-high freight costs. The cost of shipping a container on a transoceanic trade route increased seven-fold in the 18 months that followed March 2020.[2] Further, within the last couple of years, several large railroad companies significantly raised rates and demurrage fees.[3] Although a combined index of for-hire trucking, rail, inland waterways, pipelines and air freight has pulled back from pre-pandemic historic highs[4], the United States Department of Transportation's Bureau of Transportation Statistics reported that the Freight Transportation Services Index (Freight TSI)[5] through July of this year is still up 12% above the dip in for-hire freight shipments that occurred during the initial pandemic shutdown in April 2020.[6]

1 He, Laura, Shipping delays are back as China's lockdowns ripple around the world , CNN Business (May 6, 2022).

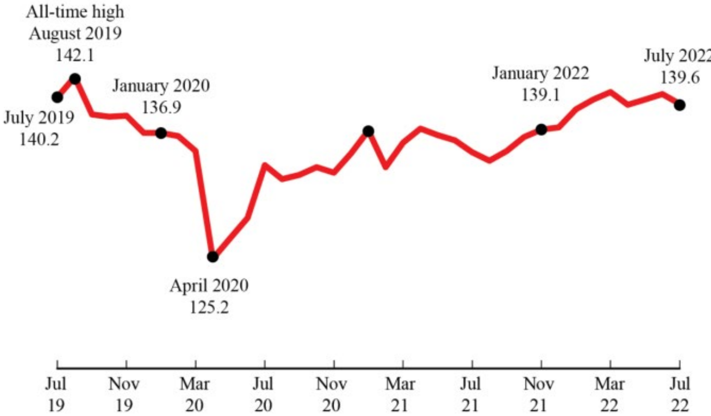
2 Yan Carrière-Swallow, How Soaring Shipping Costs Raise Prices Around the World, International Monetary Fund (March 28, 2022).

3 Finn, Teaganne, Biggest railroad companies profiting from supply chain crisis, watchdog alleges, NBC News (March 7, 2022).

4 O'Neal , Lydia, Trucking Boom Is Hitting the Brakes as Freight Demand Slows, The Wall Street Journal (April 13, 2022).

5 The Freight TSI is a weighted average of data for trucking, rail, pipeline, waterborne, and airborne freight. What the Transportation Services Index, Dow Transportation Index, and Cass Freight Index Tell Us, U.S. Department of Transportation (August, 2019).

6 April 2022 Freight Transportation Services Index (TSI): First decline after 7-Consecutive-Month Growth, United States Department of Transportation (May 11, 2022).



Bureau of Labor Statistics, U.S. Department of Labor, Consumer Price Index – July 2022, issued September 15, 2022

Reasons for Current Transportation Delays and Increased Freight Costs

There are three major issues affecting the state of transportation and related freight cost: the COVID-19 pandemic, the 2022 Russian invasion of Ukraine, and shipping issues in the supply chain.

The Effect of COVID-19 on Transportation in Supply Chains

COVID-19 spurred a number of changes that greatly impacted supply chains, leading to delivery delays and increased freight costs, including:

1. *Increased Demand for Consumer and Commercial Goods.* Consumer demand for goods skyrocketed as circumstances required consumers to reduce spending on vacationing and eating out at restaurants, resulting in more disposable income for making purchases of goods.[7] The appetite for products increased further as the labor force transitioned to work-from-home and spent more on new home offices and improving the home environment.[8] Consumer spending on durable goods rose 30.8% from February 2020 through April 2021.[9] On the commercial side, companies veered away from using just-in-time inventory management due to the delays and inability to get resources during government-imposed COVID-19 restrictions. Eyeing their depleted inventory levels, these companies began ordering more goods to have a bigger buffer stock.[10] The result of this increased ordering of goods from both the consumer and the commercial sides overwhelmed an already fragile supply chain.
2. *Trucking Industry Challenges.* The trucking industry has long been plagued by high turnover rates, an aging workforce, and drivers unsatisfied with the long hours away from home and uncomfortable job conditions.[11] The trucking industry is highly cyclical in nature. For example, in 2019 (pre-pandemic), thousands of truck drivers lost their jobs, and the $800 billion trucking industry dipped into a recession.[12] As the pandemic spread, the shortage of employees due to sickness and quarantines[13] piled atop a recent wave of retirements and attrition,[14] thereby exacerbating the supply chain transportation crisis in the United States. According to the American Trucking Association, in 2021, trucking companies suffered a shortage of more than 80,000 drivers.[15]
3. *Shipping Industry Issues.* Between 2011 and 2018, three shipping alliances increased their share of the shipping container market from 29% to 80%. These alliances currently control 95% of trans-Pacific routes. Consolidations and bankruptcies in the shipping industry made it easier for shippers to increase prices dramatically.[16] In addition, shipping container shortages prevented some companies who had product available from shipping it.
4. *Chinese Factory Closures and Re-Openings.* China reacted to COVID-19 with strict lockdowns that shut down entire cities, including their factories. As various Chinese cities emerge from lockdown, such as China's tech hub Shenzhen (which exited lockdown earlier this year), pent-up cargo has entered supply chain routes, exacerbating the transportation issues and leaving the question as to whether the transportation will be available to move the goods as quickly as needed.[17]

The 2022 Russia Invasion of Ukraine

The Russia invasion of Ukraine also increased the cost of shipping freight. Governments around the world levied embargos on Russian oil, resulting in increased

7 Goodman, Peter, How the Supply Chain Broke, and Why It Wont' Be Fixed Anytime Soon , The New York Times (October 22, 2021).

8 Id.

9 Barua, Akrur, A spring in consumers' steps: Americans prepare to get back to their spending ways , Deloitte (June 28, 2021).

10 Id.

11 FACT SHEET: The Biden-Harris Administration Trucking Action Plan to Strengthen America's Trucking Workforce, the White House (December, 16, 2021).

12 Premack, Rachel, Thousands of truck drivers lost their jobs in the 2019 trucking 'bloodbath.' Here's why the $800 billion industry dipped into a recession, Business Insider (December 30, 2021).

13 Swanson, Ana and Bradsher, Keith, Supply Chain Woes Could Worsen as China Imposes New Covid Lockdowns, the New York Times (January 16, 2022).

14 Ngo, Madeleine and Ana Swanson, The Biggest Kink in America's Supply Chain: Not Enough Truckers , the New York Times (November 9, 2021).

15 Goodman, Peter, The Real Reason America Doesnt' Have Enough Truck Drivers , The New York Times (February 9, 2022).

16 Goodman, Peter, American Importers Accuse Shipping Giants of Profiteering, The New York Times (May 4, 2022).

17 Daniel, Will, 'Companies are beginning to panic': Experts say China's lockdowns will make inflation and the supply chain nightmare even worse, Fortune (April 23, 2022); He, Laura, Shipping delays are back as China's lockdowns ripple around the world, CNN Business (May 6, 2022).

costs for the remaining available fuel for purchase.[18] Gas prices are not the only factor increasing overall shipping costs: the sinking of several ships in the Black Sea in connection with the Russia and Ukraine conflict has spurred insurers to hike premiums to between 1% and 5% of the value of the ship compared to pre-war levels of 0.25%.[19]

The fallout from the Russia/Ukraine conflict and related sanctions cannot be understated. For more information concerning the impact of the conflict on the supply chain, see the chapter 4 in this Guidebook, Managing Supply Chain Disruption in an Era of Geopolitical Risk by David Simon, on page 21.

Miscellaneous Shipping Issues

There are a handful of other issues impacting the cost and timeliness of freight transportation:

- *Labor Shortages.* Widespread labor shortages, exacerbated further by China's zero-tolerance COVID-19 policies, are affecting the cost of transportation for consumer goods.[20]
- *Port Logjams.* Port congestion continues due to perpetuating labor issues, growing container volumes, and quarantine measures in China.
- *Labor Negotiations.* Unionized port workers are cognizant of the indispensable nature of the crucial role they play in global trade. Labor contracts for over 22,000 West Coast port workers (who handle approximately 42% of all US containerized trade with East Asia) are set to expire this summer.[21] Failure to resolve the labor contracts will aggravate the current port logjam issues.
- *Lack of Warehouse Space.* Ship operators have diligently purchased new containers to address the lack of containers that grew out of the COVID-19 pandemic.[22] In fact, ship operators and brokers estimate that they are moving eight million more containers than before the pandemic.[23] This increase in containers led to a shortage in warehouse space to store the containers and inventory, further slowing the movement of goods along supply chains.[24]

Reducing Risk Related to Transportation Costs and Delays

As more fully discussed below, companies can use several approaches to reduce risk related to transportation delays and increased freight costs: (1) companies may try to obtain a more consistent supply by dual sourcing for their purchase of goods using geo-diverse suppliers; (2) companies may consider moving production locations to reduce the distance the product must travel; and (3) companies may evaluate their current insurance policies and commercial contracts to see if such arrangements can be adjusted to appropriately allocate delivery delay risk going forward.

Dual Sourcing

Beyond completely switching to domestic suppliers to obtain more consistent delivery times, companies may also consider dual sourcing (i.e., using one or more suppliers to source a material) to have a more stable supply of materials for their products. Ideally, the suppliers would be located in diverse geographies so that a weather issue or other similar event (whether shipping-related or otherwise) does not impact the supply of raw materials by all suppliers. Although companies must evaluate the cost increases associated with dual sourcing to determine whether it would be financially more beneficial than enduring the delivery delay and freight costs that occur amidst a global supply chain disruption, it is often worthwhile to identify and qualify additional suppliers in preparation for inevitable supply delays.

Onshoring and Nearshoring

Onshoring or reshoring refers to the practice of moving overseas production back to the domestic company's

18 What's Next for Oil And Gas Prices As Sanctions on Russia Intensity, J.P .Morgan (March 10, 2022).

19 Marc Jones, Snarled-up ports point to worsening global supply chain woes – report, Reuters (May 3, 2022); Saul, Jonathon, Ship insurance claims to rise as Black Sea remains high risk area, Allianz says, Reuters (May 10, 2022).

20 Telford, Taylor, Yes, there's a tampon shortage. Here's why ., The Washington Post (June 13, 2022).

21 Saraiva, Augusta and Josh Eidelson, What West Coast Ports' Labor Negotiations Mean for Your Packages, Bloomberg (May 25, 2022).

22 Paris, Costas, Shipping Companies Added Capacity, but Now Containers Are Stuck in Port, The Wall Street Journal (May 30, 2022).

23 Id.

24 Id.

location. Nearshoring refers to the practice of moving overseas production nearby the domestic company's location, usually in a neighboring company on the same continent. Moving some or all production back to consumer markets or to a nearby region almost always results in reduced transportation costs, though those reductions must be balanced against other potential cost increases incurred in connection with moving production. Often companies find that the reliability that comes with onshoring or nearshoring outweighs any associated cost increase.

Samsung, for instance, announced last year that it will build $17 billion semiconductor factory outside of

Austin, Texas, as a way to increase "readiness and stability."[25] Similarly, Micron Technology, which is based in Boise, Idaho, announced plans to invest $150 billion globally to develop its line of memory chips, with production to be established in the United States if tax credits can make up for the higher costs of domestic manufacturing.[26]

Whether onshoring or nearshoring would help allay the impact of supply chain issues depends on whether the benefits of onshoring or nearshoring outweigh the loss of cheap labor provided by an overseas production system.

25 The Associated Press, Samsung says it will build $17B chip factory in Texas, NPR (November 24, 2021).

26 Id.

For a pro/con analysis of reshoring and nearshoring, see Accelerating Trends: Assessing the Supply Chain in a Post-Pandemic World by Ann Marie Uetz, Vanessa L. Miller, James R. Kalyvas and Kathleen E. Wegrzyn.

Insurance Coverage

Companies should evaluate their insurance programs to determine to what extent, if any, they have coverage for goods lost or delayed in transit. When the Ever Given, a quarter-mile-long ship, became lodged in the Suez Canal in March 2021, that blockage prevented $10 billion of cargo a day from moving through the canal.[27] Those companies who adequately insured their cargo were able to submit claims to cover their extensive losses stemming from the week-long delay.

Some types of insurance products that could offer protection against similar supply chain delays include cargo insurance, contingent business interruption (CBI) insurance, and supply chain risk insurance. Cargo insurance generally protects shipments of goods from losses, damages, or theft sustained during transit. CBI insurance generally protects against lost profits and extra expenses incurred as the result of an interruption of business suffered by a customer or supplier. Supply chain insurance generally protects against financial losses arising from your supply chain

27 Motoko Rich et al., Clearing the Suez Canal Took Days. Figuring Out the Costs May Take Years, The New York Time (June 23, 2021); Ever Given: Cargo ship returns through Suez Canal it blocked, BBC News (August 20, 2021).

and covers a broader swath of events than CBI insurance. Some negative events that supply chain insurance could cover include government-related disruptions, pandemics, labor issues, and financial problems.

Commercial Contract Review

Whenever there is a significant change in tide that affects business, companies should consider whether their contracts should be adjusted to adjust the allocation of risk or take advantage of the current business climate. Some points of analysis with respect to addressing delivery delays and freight costs include:

1. *Shipping Terms.* Regardless of whether a company is on the buy side or on the sell side, it should evaluate whether the Incoterms provisions or other shipping terms in its contracts are up-to-date. Common updates to Incoterms provisions include ensuring the Incoterms referenced (a) are the most recent version (Incoterms 2020), and (b) reflect the business' current practice for delivery. If the current business climate supports a shift, companies may evaluate whether the Incoterms provisions could be updated to further minimize risk of incurring unforeseen transportation costs. In an ideal world for buyers, buy-side Incoterms would be Delivery Duty Paid (DDP) at the buyer's destination, meaning that the seller is required to pay all import duties, taxes, execute customs formalities, and pay for all transportation costs.[28] In an ideal world for sellers, sell-side Incoterms would be Ex Works (EXW) at the seller's dock, which places the least burden on the seller, only requiring that the seller make the goods available and suitably packaged at the specified point of delivery.[29]
2. *Shipment Costs.* Every contract for the purchase and sale of goods should explicitly define the extent to which each party is responsible for packaging and shipping costs. Buy-side companies typically seek transportation costs that are either included in the price of the good or are otherwise fixed costs. Sell-side companies typically seek to pass on transportation costs to the buyer, or have transportation costs subject to index adjustments such that overall pricing will adjust as overall transportation cost increases.
3. *Delivery Delay.* Companies should be thoughtful about how they expect delivery delays to be

28 International Chamber of Commerce, Incoterms 2020 88 (2019).

29 International Chamber of Commerce, Incoterms 2020 25-27 (2019).

handled and should update their contracts to reflect their expectations. Some questions companies can contemplate to ascertain whether their contracts should be updated as to delivery delays include:

a. Are delivery dates approximate (as is typically desired by the seller)? Or is time of the essence as to delivery (as is typically desired by the buyer)?

b. Who will be responsible for arranging and paying for expedited freight in the event of a delivery delay?

c. What other remedies should be available to the buyer in the event of a delivery delay? Are these remedies exclusive (as is typically desired by the seller) or cumulative (as is typically desired by the buyer)?

d. Will liquidated damages be imposed in the event of a delivery delay (as is sometimes desired by the buyer)? Is the provision enforceable as a liquidated damage and not as a penalty?

e. Would it be more beneficial to have liquidated damages or contract damages? Although a liquidated damages clause helps provide clarity to the parties on damages, it also acts as a cap on damages.

f. How do limitation of liability provisions affect the recovery of damages in the event of a delivery delay?

4. Force Majeure. Companies should review their force majeure provisions and ensure that the terms address transportation delays caused by continued supply disruptions. Some questions to consider when evaluating force majeure provisions are:

   a. Are transportation delays, inability to obtain goods or materials, and supply chain issues considered "force majeure events"?

   b. Is there catch-all phrasing that would cover transportation delays, inability to obtain goods or materials, and supply chain issues?

   c. In the event of a force majeure event, does the buyer have the right to suspend or terminate any purchase orders, and/or terminate the entire agreement under the force majeure clause? Is there a time period after the seller declares force majeure that the buyer must wait before suspension or termination?

For a deeper dive into force majeure clauses see the ninth chapter in this Guide, Three Key Defenses to Contractual Performance: Force Majeure, Commercial Impracticability, and Frustration of Purpose on page 40.

The Future of Delivery Delays and High Freight Costs in the Supply Chain

It is uncertain when delivery delays and high freight costs will return to baseline. The consensus is clear, however, that disruptions to supply chain transportation and freight are far from over. Victor Meyer, COO of the risk intelligence provider Supply Wisdom, expects U.S. ports could begin experiencing disruptions soon as a result of Chinese port delays.[30] Julie Gerdeman, CEO of Everstream Analytics, a provider of supply chain risk analytics, expects that once the Shanghai lockdown is lifted a surge of exports out of the Shanghai-

Ningbo container gateway will further elongate the timeframe for supply chain disruptions.[31] The CEO of Hamburg-based Hapag-Lloyd, Germany's largest container carrier, expects global supply chains disruptions will persist at least until the second half of this year.[32] Companies would be wise to act now to reduce the risk of financial loss in the event of persistent transportation delays and freight cost increases.

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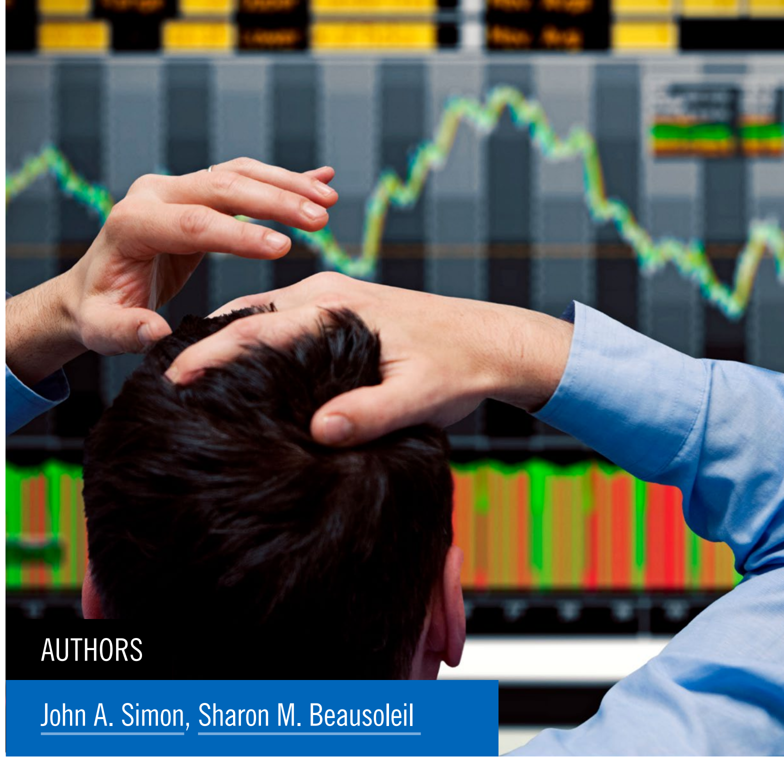
30 Daniel, Will, 'Companies are beginning to panic': Experts say China's lockdowns will make inflation and the supply chain nightmare even worse, Fortune (April 23, 2022).

31 McGregor, Grady, A semiconductor CEO explains how Shanghai's 7-week lockdown is crippling his supply chain and fueling inflation, Fortune (May 14, 2022).

32 Murray, Brendan. Global Shipping Trims the Sails Heading Into Economic Slowdown, Bloomberg (May 12, 2022).

CHAPTER 3

Key Strategies to Protect Your Company's Supply Chain and Mitigate Risks Against Financially Distressed Customers and Suppliers



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As the world expresses a collective sigh of relief that the worst of the COVID-19 pandemic seems to be behind us, a perfect storm of extraordinary factors is creating conditions for financial distress throughout many supply chains. In short, there is a substantial risk that companies obligated to pay you for goods or services or to supply goods or services to you might become unable to do so.In this chapter, we provide you with a toolkit to mitigate your supply chain risks in the face of this expected economic turmoil.

Note: Because these situations are fluid, complex, risky, and involve various potential legal risks in their analysis and implementation, it is important that you engage with bankruptcy/creditors' rights counsel early in addressing them.

Understanding the Impact of a Possible Bankruptcy

To prepare for insolvency-related non-performance by a customer or supplier, it is critical to know the effects of a possible bankruptcy on the obligations owed to you under your contracts or other arrangements with the customer or supplier that would be a "Debtor" in bankruptcy.

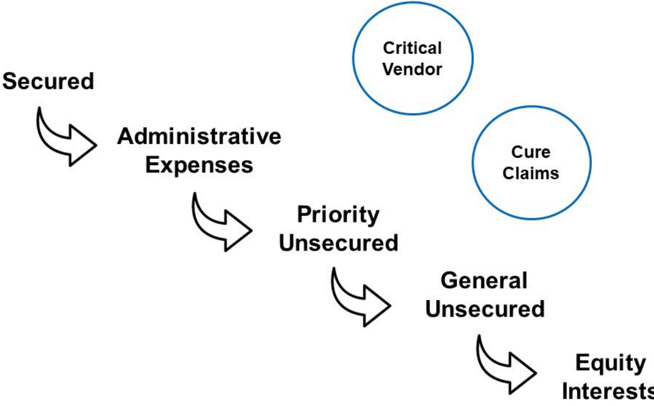
What Type of Bankruptcy: Chapter 11 bankruptcies allow a Debtor's management to stay in control, continue operating and providing goods and services, restructure debts, sell some or all company assets, and confirm a reorganization plan. In contrast, in Chapter 7 bankruptcy cases the Debtor's management is removed and replaced by a bankruptcy trustee, who is responsible for liquidating the Debtor's assets and generally stops operating the business.

Section 362 Automatic Stay: Once a bankruptcy is filed, the automatic stay arises and acts as an injunction against any efforts, including continuation of pending litigation, to collect on any prepetition claim, debt, or other obligation owed by the Debtor, any action to possess or control the Debtor's property (e.g., foreclosure, perfection of liens subject to limited exceptions, seizure of the Debtor's assets), and most unilateral attempts to terminate contracts or execute setoffs. Unless court approval is obtained, acts taken in violation of the automatic stay are void or voidable. Creditors that violate the automatic stay can be liable to the Debtor for damages. Due to the automatic stay, many of your rights as a creditor or contract party will be stronger before a bankruptcy is filed, rather than after.

Priority Payment Scheme: Under the Bankruptcy Code there is a priority payment scheme, which identifies which claims are paid first and requires that the higher level claim must be paid in full prior to any lower level claim receiving a payment. Think of a waterfall: At the top of the waterfall are secured claims (amounts secured by security interests, liens, or mortgages, such as most bank loans), followed by administrative priority claims

(including expenses incurred by the Debtor during the bankruptcy such as its professional fees or amounts for postpetition goods or services), then priority claims (including certain tax claims), followed by general unsecured claims (including most ordinary trade debts), and finally equity interests (see chart below.)

There are a few exceptions to this scheme, including: (a) claims for goods actually received by the Debtor within 20 days prior to the bankruptcy, referred to as "503(b)(9) Claims"[1] that are given administrative priority treatment; (b) prepetition amounts due under assumed contracts and leases that are treated as cure claims which are entitled to be paid in full in cash; and (c) prepetition general unsecured claims that the Debtor obtains Court approval to pay, for instance pursuant to an order authorizing the Debtor to pay vendors critical to its continuing operations.



Executory Contracts:[2] As of a bankruptcy filing, a Debtor obtains significant leverage and additional rights regarding contracts with you pursuant to the Bankruptcy Code. Notwithstanding anti-assignment clauses, a bankrupt Debtor can assume (i.e., agree to perform), and then assign to a third party (subject to demonstrating adequate assurance of future performance), or reject (refuse to perform) any executory contract[3] (subject to limitations for certain personal service, IP and license, and loan or financial commitment agreements). A Debtor must assume[4] or reject[5] executory contracts no later than confirmation of the Chapter 11 plan.

Preference and Fraudulent Transfer Risks: To complicate matters, payments, liens, or obligations made in your favor while the Debtor was insolvent prior to a bankruptcy can potentially be recovered or "avoided" (although it is generally better to receive such a payment and fight about possible avoidance of it with a Debtor or bankruptcy trustee rather than not be paid at all).[6]

Given the foregoing and possible negative aspects of contract rejection (i.e., non-payment/non-performance, little recovery of damages, potential assignment to unknown third parties) and possible positives (cure payment of any outstanding arrearages required for assumption and assignment), you should carefully evaluate with bankruptcy counsel the contract and claim strategy that is optimal for you in dealing with an insolvent customer or supplier and ensure the proper legal requirements are met to enforce your rights.

1 See 11 U.S.C. §503(b)(9).

2 Most contracts will include provisions that the non-Debtor has the right to terminate its contract upon the filing of a bankruptcy (i.e., ipso facto clauses). For most contracts, these are not enforceable provisions and any attempt to terminate such contracts violates the automatic stay. Exception: If a contract is a safe harbor contract and meets the requirements under sections 559 through 562 of the Bankruptcy Code, these clauses are still operative. This chapter does not address the special requirements of safe harbor contracts.

3 Generally speaking, an executory contract is a contract with unperformed obligations remaining on both sides, and can include purchase orders if they have such outstanding obligations.

4 Assumption of an executory contract requires all monetary defaults must be promptly "cured" and adequate assurance of future performance must be given.

5 Rejection of a contract constitutes a prepetition breach under the contract. Whatever property rights the non-breaching party would have outside of bankruptcy law, such non-breaching party maintains. See Mission Prod. Holdings, LLC v. Tempnology LLC, 139 S.Ct. 1652, 1658 (2019). However, the counterparty is left with a general unsecured claim for contract rejection damages, which will be paid in bankruptcy dollars, not dollar for dollar.

6 Preferences (possibly including payments received from a Debtor or liens granted by a Debtor within 90 days prior to a bankruptcy filing (1 year for insiders)) might be clawed back if certain requirements are satisfied. Fraudulent transfers, or payments/property received from a Debtor within 2-6 years prior which were received without the Debtor receiving reasonable fair value, while the Debtor was insolvent (or which rendered it insolvent or undercapitalized or unable to pay debts) are also vulnerable to claw back in a bankruptcy.

Key Strategies for Addressing Financial Distress in the Supply Chain

1. Monitor Your Supply Chain For Warning Signs of Weakness

It is a good practice to establish teams and training in advance with personnel from the engineering, purchasing, sales, finance, and legal teams to routinely monitor for, and handle, possible troubled company situations. Using that team to implement an ongoing practice of due diligence into your customers and suppliers' financial health can provide you with useful tactical intelligence and the ability to execute quickly in advance of a problem becoming a crisis.

This includes conducting a pre-contract due diligence analysis on customer/vendor quality and financial performance and regular evaluation of the customers and companies in your supply chain for warning signs, including:

- Requests for accommodations such as changes to credit terms, increases in credit limits, or accelerated payments
- Use of factoring arrangements to bootstrap liquidity
- Deteriorated working capital ratios and inventory issues
- Slow payments
- Delay or renegotiation of scheduled dividends, bond payments, or loan payments
- Fully drawn lines of credit
- Costly and/or troubled launches of new products
- Impending maturity dates or big-ticket litigation claims (common bankruptcy triggers)
- Quality and delivery deficiencies
- Loss of customers
- Changes in key management
- Retention of financial advisors or insolvency lawyers
- Fraud or securities investigations or restatements of securities disclosures

2. Evaluate and Update Your Contracts and Purchase Order Terms

The strength and terms of your contracts will affect your rights and remedies both before and during any bankruptcy. Some key terms to review include, but are not limited to:

- Credit and payment provisions (how quickly you have the ability to change payment terms, reduce credit limits, or demand additional security)
- Termination (whether there is a termination for convenience provision and what are the notice and cure periods to terminate for cause)
- Term of Contract (considerations on whether to extend a contract or limit term)
- Financial information and other audit rights (right to obtain information or exercise audit rights)
- Offset and recoupment rights (including any contractual limitations on such rights)

Moreover, where your counterparty is a member of a corporate group of affiliates you should consider whether the counterparty has its own material assets or whether such counterparty is more of a contracting "shell" for other companies in that corporate group. The latter is exponentially more risky in the event of insolvency.

You also should update your contracts and terms to include favorable terms to defend against insolvent customer and supplier situations in advance, including terms that give you financial and operational transparency, lien rights, and stronger termination and setoff rights.

3. Evaluate Resourcing Options and Develop a Resourcing Plan

Customers to a troubled supplier should consider whether parts can be sourced from multiple suppliers to decrease the risk of sole suppliers if possible. In addition, customers of a distressed supplier should immediately evaluate resourcing options (cost/benefit and risks of resourcing) and develop a back-up plan and timeline, including a process and decision tree chart, for supply resourcing to enable speedy and decisive action. Building up a parts bank, to the extent possible under your contracts, can also help create a timing cushion to add safety to your resourcing efforts.

4. Perfect Liens to Provide Leverage and a Source of Recovery

You may have rights under your contracts or applicable law to obtain liens and security interests for goods sold or services performed to a financially distressed customer. Examples of these liens include contract rights to Article 9 security interests under the applicable state Uniform Commercial Code (UCC), mechanic's and materialman's liens, mineral liens, tooling or molder's liens, storage liens, and warehouseman's liens. Your contract process should be reviewed for adding these types of rights and following through on meeting any applicable state law requirements, including any timing and notice requirements. For previously filed or otherwise perfected liens and security interests, you may want to confirm that they remain in effect against the appropriate counterparty.

5. Understand the Rights of Setoff and Recoupment

Setoff and recoupment are useful tools that allow parties to withhold or offset such claims against each another, which can protect you against paying any amounts to a party that owes you money. However, there are key differences, especially if a bankruptcy is filed, as it applies to the transactions and parties involved in the exercise of such rights.

Setoff: Unless your contract limits the exercise of your setoff rights, setoff is not limited to one transaction or contract and can be useful to offset various transactions and contracts between the parties to arrive at a net amount. As a sometimes useful tactic, you can try to apply setoff to claims owed by or to related third parties pre-bankruptcy if your contract allows these sorts of "triangular" setoffs.[7]

7 A bankruptcy could cause complications with triangular setoffs. Section 553 of the Bankruptcy Code requires mutuality, and thus triangular offsets and any offsets taken in the lookback periods could be subject to potential avoidance as preferences under Section 553 of the Bankruptcy Code or as fraudulent transfers.

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Recoupment: This is an equitable remedy that is available when amounts due to and from the Debtor arise from the "same transaction" with the counterparty. This "same transaction" requirement is construed narrowly by the courts to mean that the claims must arise from the "same contract" to be recouped.[8]

Once a bankruptcy petition is filed, there are key differences between the treatment of setoff and recoupment rights. The exercise of setoff rights requires relief from the automatic stay by court order and is limited to netting prepetition debts against prepetition obligations or postpetition debts against postpetition obligations. In contrast, recoupment is not subject to the automatic stay, possible bankruptcy setoff pitfalls of preference avoidance, or the prohibition against recouping prepetition and postpetition claims. However, in exercising any recoupment right a creditor must still be mindful of the automatic stay and should, in an abundance of caution, consider seeking court approval.

6. Issue a Demand for Adequate Assurance of Future Performance

When reasonable grounds for insecurity exist concerning a contracting party's willingness or ability to perform a future obligation under a contract for goods, the other party can issue a demand for adequate assurance of performance under section 2-609 of the UCC.

Reasonable grounds for insecurity depend upon the circumstances and may include credit insecurity, late payments, and stated illiquidity (such as news reports showing the counterparty's financial condition threatens their future performance).

8 Some courts have gone further, restricting the applicability of recoupment to a single transaction, even if the same contract covers multiple transactions. The outcome depends on whether the circuit follows the "logical relationship test" (see Kosadnar v. Metropolitan Life Ins. Co. (In re Kosadnar, 157 F.3d 1011 (5th Cir. 1998) and Newberry Corp. v. Fireman's Fund Insurance Co. , 95 F.3d 1392 (9th Cir. 1996)) or the "integrated transaction test" (see University Medical Ctr. v. Sullivan (In re University Medical Ctr.), 973 F.2d 1065 (3d. Cir. 1992) and Conoco Inc. v. Styler (In re Peterson Distrib., Inc.) 82 F.3d 956, 960-961 (10th Cir. 1996)).

The party receiving the demand must provide assurances concerning its ability to perform future obligations, or if they do not provide them, the demanding party can treat the contract as repudiated or breached.

Section 2-609 provides useful rights and leverage to: (a) suspend or modify performance (e.g., change credit terms)[9] if appropriate assurances are not provided; (b) negotiate major concerns and issues before an actual breach occurs; and (c) shore up a position with a distressed counterparty before a bankruptcy filing.

Examples of the types of contract modifications or adequate assurances that might be obtained to protect you include modification of credit terms, payments of arrearages, deposits on account, grants of security interests or liens, or obtaining personal or corporate guaranties or letters of credit to enhance the likelihood you receive the performance due to you.

7. Consider Entering into Access and Accommodation Agreements

Sometimes, if you are a customer, you may not have any source other than a financially distressed supplier for certain goods or services that you need. The failure of a sub-supplier to deliver those goods, particularly if you are a supplier in a "just in time" supply environment like the automotive or defense industry, can have disastrous results. Besides costing you lost revenue from the disruption of your business, such a failure may expose your company to large damage claims from your customers who themselves are losing business opportunities. Meanwhile, a financially distressed supplier may be facing threats that its bank or other secured lender will stop lending to it, resulting in its shut down and failure to supply you.

Access and Accommodation Agreements can be used to maintain the flow of goods or services from such a financially distressed supplier while it is being reorganized, sold, or wound down.

- *Access Agreement:* Permits the customer, under limited circumstances as a last resort, to access the supplier's plant to produce parts pending rehabilitation of the supplier or transfer of the contract and/or facility to a healthier supplier.

9 Changing credit terms could include: (a) reducing when payment is due (i.e., net 30 to net 10); (b) changing payment methods (from check to ACH/EFT or wire); or (c) reducing the credit limit.

- *Accommodation Agreement:* Provides customer accommodations that solidify the lenders' collateral base through protections on inventory and receivables, accelerated payments, and commitments not to take supply opportunities away from the troubled supplier during a designated period absent an event of default. These agreements often provide for waivers of the right of setoff, as well as milestones for a turnaround, sale or wind down process.

8. Withhold/Stop Delivery and/or Reclaim Delivered Goods

Prior to bankruptcy, Section 2-702 of the UCC permits a supplier, under certain circumstances, to withhold deliveries **and** reclaim (recover) goods delivered if it discovers that the customer is insolvent.[10] Reclamation may be subject to rights of a prior lienholder in the inventory or the goods already may have been sold, which limits the effectiveness of a reclamation demand.

Section 2-705 also provides that a supplier "may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent ..."[11]

You can use these rights to leverage payments, including cash in advance, recovery of your valuable goods, or changes to your contract that can be favorable to you.

After a bankruptcy is filed, reclamation demands are permitted if submitted early in the proceedings but often have limited effect in bankruptcy.[12]

In addition, if the Debtor is operating its business and has obtained financing, reclaiming the inventory could affect the Debtor's ability to reorganize.

9. After Breach Occurs, Issue Notice of Default and Take Other Actions

A breach entitles you to exercise your legal and equitable remedies including bringing claims or filing a lawsuit to collect the amounts owed to you. In such a suit, you may seek recovery of damages you suffer due to the breach, injunctive relief, or specific performance of the contractual obligations.[13]

The UCC also provides certain express rights to sellers of goods, including but not limited to, suspending your own performance under the breached contract, stopping delivery, re-selling the goods to another buyer or, in appropriate cases, cancelling/terminating the contract prior to a bankruptcy.[14] And, depending on the circumstances, buyers have various rights under the UCC for non-performance.[15] These include cancelling the contract without further obligations,[16] obtaining specific performance, or taking possession of identifiable goods.[17] In addition, a buyer can bring claims against a non-performing seller of goods for their damages for breach subject to obligations to "cover" or mitigate their losses.[18] Similar rights exist under common law with respect to provision of services rather than goods.

10. Consider Calling an Anticipatory Breach so You Can Exercise the Same Remedies as an Actual Breach

In addition to actual breaches such as non-payment or non-delivery, a party might anticipatorily breach or repudiate the contract if it unequivocally refuses to perform as agreed under the contract. For example, it

10 Section 2-702 of the UCC provides:

"(1) Where the seller discovers the buyer to be insolvent the seller may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery...",

"(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply..."

11 UCC §2-705.

12 As discussed above, a 503(b)(9) Claim would cover the goods received by the Debtor within twenty days prior to the bankruptcy, and would provide a higher priority administrative claim in the bankruptcy.

13 It is common for companies that are distressed to ignore demands unless and until a lawsuit is filed. At the same time, litigation is expensive and there is always a possibility that you will not be able to recover or receive the performance due to you before a bankruptcy is filed or a liquidation occurs.

14 See UCC § 2-703 and § 2-705.

15 See generally UCC §§ 2-711 – 2-716.

16 See UCC § 2-711(1).

17 See UCC § 2-711(2).

18 See UCC § 2-712.

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is not uncommon for financially distressed suppliers or customers to state that they will not perform further unless you as the counterparty agree to some "hostage" type demands such as price increases, further deliveries, or other changes that are not required under your contract. In the event of an anticipatory breach, under the UCC the non-breaching party may await performance for a commercially reasonable time or resort to any remedy for breach even though it has notified the other party that it will await performance.[19] The non-breaching party may also suspend its own performance under the contract, which can provide a means to avoid further losses and enhance the likelihood of a financial recovery.

Similar rights may exist under common law with respect to provision of services rather than goods depending on your jurisdiction.

11. Seek Critical Vendor Treatment or Assumption of your Contract

If you are owed amounts for the provision of goods or services by a company that then files a bankruptcy case, you are not necessarily out of luck. Debtors, particularly in the manufacturing industry, often obtain Bankruptcy Court orders authorizing them to pay prepetition debt to "critical vendors" who are essential to their continued operations. Moreover, if a Debtor proposes to assume your contract in its bankruptcy case, you are entitled to a "cure" of any past due amounts owed to you before the debtor is authorized to assume and/or assign the contract. Developing a strategic approach to possible critical vendor treatment or contract assumption (or even new contract negotiation) in advance before a bankruptcy will provide you with the best chance of obtaining these treatments if a bankruptcy case is filed.

Conclusion

A financially distressed supplier or customer can present significant risks for your company and the supply chain generally. The strategies above, used in concert with formulation of an overall plan with bankruptcy and creditors' rights counsel to increase your leverage and options, can help you achieve the best solutions and results.

19 See UCC § 2-610.

CHAPTER 4

Managing Supply Chain Disruption in an Era of Geopolitical Risk

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Geopolitics have always impacted supply chain logistics, but over the last two years they have played an outsized role that will likely continue for the foreseeable future. While the COVID-19 pandemic demonstrated the risks of just-in-time sourcing strategies and lack of alternate or dual sources in many supply chains, geopolitical risk will remain as a key driver in supply chain decisions going forward. Companies have learned from the response to Russia's Ukraine invasion that Western democracies will use economic sanctions and export controls to punish nation-state aggression and to promote national security interests. Multinational companies have walked away from billions of dollars in investment in Russia's economy and the invasion has disrupted the flow of natural gas, oil, and grain, causing governments and companies around the world to reconsider their energy and food supply chains.

It is unlikely that this dynamic will be limited to Russia or to deterring military aggression. We are already seeing economic restrictions between the U.S. and China that would be unfathomable just five years ago. If this trend continues, the potential disruption to the supply chain will far surpass the impact of the Russia sanctions. For example, in a rare bipartisan effort the U.S. Congress passed and the President signed the Uyghur Forced Labor Prevention Act (UFLPA), which establishes a rebuttable presumption that all goods, wares, articles, and merchandise mined, produced, or manufactured wholly or in part in the Xinjiang Uyghur Autonomous Region (XUAR) are made with forced labor and prohibited from entry into the United States. China in turn has enacted "antisanctions" laws that prohibit Chinese companies from taking actions to comply with U.S. sanctions against China.[1] While Chinese enforcement of its antisanctions laws has been uneven, the omnipresent threat has acted as a powerful deterrent to multinational companies.

This chapter focuses on the disruptions to the global supply chain associated with these two events and discusses strategies for companies to mitigate future geopolitical risk.

The "Global" Supply Chain

Since the fall of communism and end of the Cold War, the "global economy" became synonymous with sprawling supply chains, including just-in-time manufacturing enabled by low cost sourcing and sophisticated logistics. This model requires geopolitical stability and low barriers to trade. Starting with the Clinton administration, the U.S. hoped that China's admittance to the World Trade Organization would enhance geopolitical stability and promote global free trade. But in order for that hope to materialize, countries must be good state actors working toward the global good. The Russian invasion of Ukraine does not further the global good, and Russia's pursuit of Ukraine has caused it to become isolated from the global economy. Similarly, China's use of state subsidies and alleged use of

1 Lam, Jeffie, China's anti-sanctions law: what is it, how will it take effect in Hong Kong and should the business community worry?, South China Morning Post (August 18 , 2021).

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forced labor has caused trading partners to impose protective measures (in the form of antidumping and countervailing duties) and outright bans (in the form of the UFLPA) to protect what they perceive to be their national interest and global human rights. Similarly, Russia's pursuit of Ukraine has caused it to become isolated from the global economy as other countries attempt to use their economic muscle to push Russia to cease its hostilities. As a result of Russia's and China's decisions to act contrary to the interests of Western trading partners, the "global economy" as it has been understood for decades may no longer exist. As Black Rock founder Larry Fink recently stated, "the Russian invasion of Ukraine has put an end to the globalization we have experienced over the last three decades."[2] The fact that the head of one of the largest asset management companies in the world believes as much demonstrates that companies should prepare to operate in an economy that is less global and more regional.

The Impact of Russia's Invasion of Ukraine on the Supply Chain

Since Russia invaded Ukraine, the U.S. government — in close coordination with many other like-minded governments, particularly in the U.K.[3] and European Union[4] — has imposed sweeping sanctions and export controls that target both Russia and Belarus. These measures have been significant in both size and scope.[5] They target Russia's largest financial institutions, prominent Russian individuals in the business world, and in the Politburo.[6] The sanctions and export controls restrict access to U.S. capital markets by the Russian government and many key Russian companies, and restrict access to U.S.-origin technology (and, in some cases, even products utilizing U.S.-origin technology). Although the measures taken to date do not amount to a complete embargo, the net result is that Russia has become a country subject to some of the strictest U.S. economic sanctions and export controls in existence, all on a coordinated basis with most other major economies.[7]

Since the Ukraine invasion, the U.S. has issued additional sanctions, including banning the sale of Russian gold, grounding Russian commercial aircraft, preventing the export of luxury goods to Russia, and cutting off oligarchs and financial institutions from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system, announced on February 26, 2022. As a result of this unprecedented issuance of U.S. sanctions and export controls, every multinational company that sources from, sells to, or operates in Russia or Belarus, or directly or indirectly sells to Russian or Belarussian entities, has had to dramatically alter its business operations. Many U.S. companies voluntarily walked away from billions of dollars of infrastructure, investment, and sales due to opposition to the Russian invasion, to support the Ukrainian people, and in some instances because political pressure to cease Russian operations became too great to ignore.

The supply chain disruptions are even greater in Europe than the United States. European governments and companies are struggling to replace Russian oil and gas supplies, on which they became heavily reliant.[8] European governments now are looking to the U.S., Asia, and the Middle East for fuel supplies they had, until recently, taken largely for granted. By imposing and increasing Russia sanctions, governments have demonstrated a willingness to prioritize national security concerns over economic and supply chain disruption concerns. The U.S. and European response to the Russian invasion will cause companies to re-evaluate existing supply chains and take advantage of opportunities to recalibrate supply chains out of an operational necessity that was not present even one year ago.

2 Li, Yun, BlackRock's Larry Fink, who oversees $10 trillion, says Russia-Ukraine war is ending globalization , CNBC (March 24, 2022)

3 Foreign, Commonwealth & Development Office, UK sanctions relating to Russia (Updated June 24, 2022)

4 European Commission, EU Sanctions Map (Updated June 2, 2022)

5 U.S. Department of Commerce, Bureau of Industry and Security, Resources On Export Controls Implements In Response to Russia's Invasion of Ukraine (Updated June 28, 2022)

6 U.S. Department of the Treasury, Ukraine-/Russia-related Sanctions (Accessed July 11, 2022)

7 Husisian, Gregory et al., Understanding and Coping with the Sweeping New Russian and Belarussian Sanctions & Export Controls, Foley & Lardner LLP (March 14, 2022)

8 See, e.g., Smith, Elliot, Europe's plans to replace Russian gas are deemed 'wildly optimistic' — and could hammer its economy, CNBC (June 29, 2022)

The Impact of China and the UFLPA on the Supply Chain

Despite their geopolitical differences, the U.S. and Chinese economies remain inextricably intertwined. U.S. manufacturers rely heavily on materials, including polysilicon, lithium, and other critical minerals mined in China by Chinese-owned companies. U.S. companies further rely on Chinese companies' ability to manufacture large volumes of lower end products at scale cheaper and faster than anywhere else in the world. And U.S. institutions seek the exponential growth that access to the Chinese consumer market provides. China in turn relies on U.S. technology to advance its own interests. China's policy of military-civil fusion – that any technological advances with a civil application must be shared with the Chinese military – has allowed China to become a global military power.[9] China's acquisition of data, intellectual property, and intellectual capital has allowed Chinese companies to obtain advantages in the global economy. At bottom, the Chinese government can and will unilaterally take action to obtain goods, services, and technology when doing so is in the interest of the Chinese Communist Party. However, China's own internal policies are now hampering economic growth. The ramifications of China's commitment to zero-COVID have created economic losses,[10] and the Chinese Communist Party has intervened on more than one occasion to hamper the growth of technology companies seeking to access the public markets.[11]

China's policies have further isolated themselves from the U.S. and the West. The U.S. State Department recently issued an advisory recommending that U.S. citizens refrain from traveling to China "due to arbitrary enforcement of local laws and COVID-19-related restrictions."[12] And on July 6, 2022, the U.S. and the U.K. gave an unprecedented joint speech warning of the long term risks China poses to the established world order.[13] In light of these unmistakable signs of continued economic drift, companies hoping that supply chains will return to business as usual in the near future will not be as well positioned as their competitors who begin planning now for potentially drastic change.

Perhaps the most telling indicator of this drastic change is the passage of the UFLPA in December 2021. The UFLPA, effective as of June 21, 2022, bans the import of goods produced in the XUAR. Under the law, the following goods are presumed to

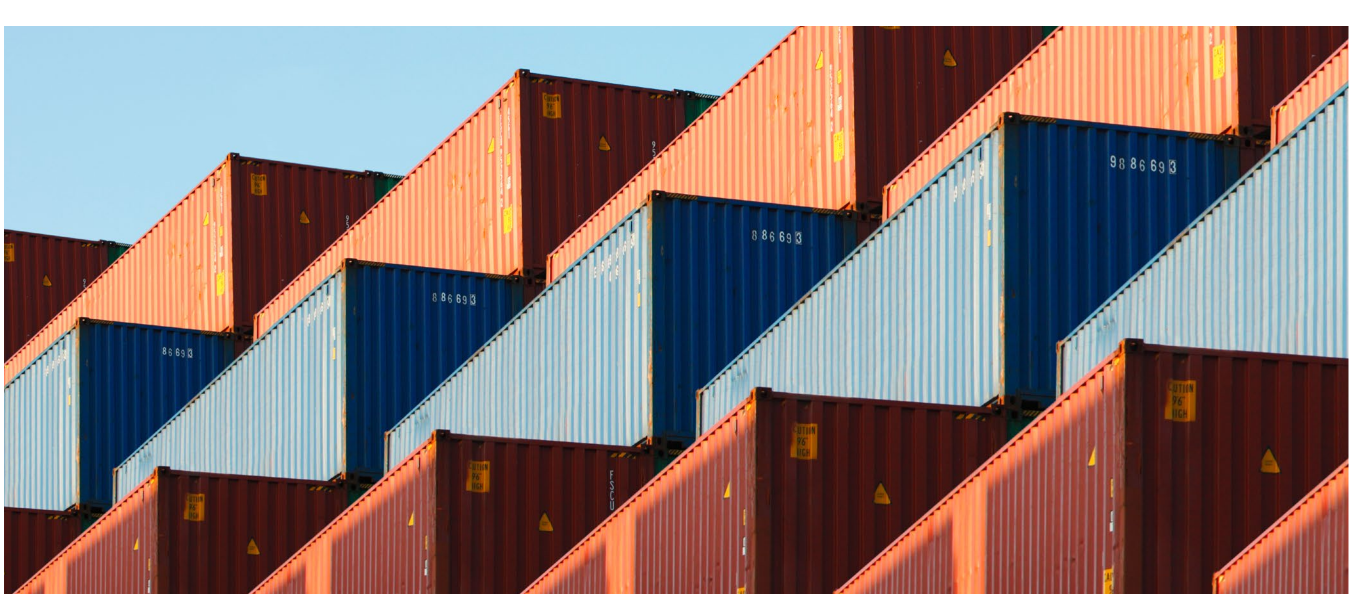
9 U.S. Department of State, Military-Civil Fusion and the People's Republic of China (May 1, 2020)

10 Campbell, Charlie,The Rising Costs of China's Zero-COVID Policy, TIME (May 31, 2022)

11 Reuters, China plans to ban overseas IPOs for tech firms with data security risks –source (August 27, 2021)

12 U.S. Department of State, China Travel Advisory (Accessed July 11, 2022)

13 Millendorf, Steven, U.S. and British Law Enforcement Agencies Issue Unprecedented Warning About Chinese Espionage Efforts, Foley & Lardner LLP (July 11, 2022)



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be the product of forced labor and are barred from entering the United States:

- Goods that are mined, manufactured, or produced in Xinjiang, wholly or in part.
- Goods produced by entities that work with the Xinjiang regional government to recruit, transport, transfer, harbor, or receive forced labor out of Xinjiang.
- Export products to the United States that are (i) made wholly or in part in Xinjiang or (ii) made by entities that work with the Xinjiang regional government to recruit, transport, transfer, harbor, or receive forced labor out of Xinjiang.
- Source material from Xinjiang.
- Source material from persons working with the Xinjiang regional government or the Xinjiang Production and Construction Corps. (XPCC) in connection with government programs that use forced labor such as the "poverty alleviation" and "pairing-assistance" programs.[14]

This presumption is not limited to goods produced by companies that are located in Xinjiang. It also applies to products made by companies based outside of XUAR and outside of China that source material from XUAR or produce even a portion of the product inside XUAR. The law is sweeping in its scope and stacked heavily against importers seeking to release seized goods, but it should come as no surprise to companies that have been tracking U.S.-China relations. In 2019, alleged association with forced labor in Xinjiang caused the U.S. Department of Commerce to place prominent Chinese companies on the Bureau of Industry and Security's Entity List, which prohibits U.S. companies from exporting to entities on the list. Since then, the U.S. government has dramatically expanded the use of the Entity List as a tool to protect U.S. national security.

In connection with its mandate to enforce the UFLPA, Customs and Border Protection (CBP) has begun to inform importers of the level of supply chain due diligence and tracing required to rebut the presumption of forced labor.[15] CBP will require importers to demonstrate that they have serious, enforceable, and enforced supply chain due diligence policies and procedures and require their own suppliers to have them as well. CBP requires importers to provide supply chain tracing information in the form of information on producers, suppliers, exporters, purchase orders, invoices, certificates of origin, payment records, and any other documents that allow an importer to trace the supply chain and demonstrate that it is free of forced labor. CBP has also suggested importers can produce a supply chain map that identifies each entity, worker information (including pay), and audit reports regarding working conditions.[16] Companies that do not have this information about their Chinese supply chains should begin taking steps to obtain it. CBP has made clear that invoking China's antisanctions laws to explain lack of supply chain documentation will not be sufficient to rebut the presumption of forced labor.

If enforced to the letter, the UFLPA can lead to broad disruption in the polysilicon supply chain in particular, impacting solar projects and creating uncertainty similar to that created by the U.S. Department of Commerce investigation into alleged solar panel China duty circumvention in Cambodia, Malaysia, Thailand, and Vietnam. There, the solar industry convinced President Biden to issue an emergency declaration directing the Secretary of Commerce to consider waiving or suspending any cash deposits or duties imposed in connection with circumvention. But it is unlikely the administration or U.S. companies will have the political will to seek a similar type of intervention to prevent the enforcement of forced labor laws.

Planning for the Global Supply Chain of the Future

- ☑ Adapt to and comply with restrictions imposed to achieve geopolitical goals.
- ☑ Make compliance with sanctions a boardroom level issue.[17]
- ☑ Adopt careful scenario planning to evaluate options beyond China.

14 U.S. Customs and Border Protection, Uyghur Forced Labor Prevention Act (Updated June 28, 2022)

15 Husisian, Greg, "Enhanced U.S. Government Scrutiny of Supply Chains Increases Compliance Expectations for U.S. Companies that Source from or Operate Abroad", Top Legal Issues Facing the Manufacturing Sector in 2022, Foley & Lardner LLP (July 6, 2022)

16 U.S. Customs and Border Protection, Operational Guidance for Importers (June 13, 2022)

17 Simon, David et al., "Human Rights Compliance in Supply Chains", Top Legal Issues Facing the Manufacturing Sector in 2022, Foley & Lardner LLP (July 6, 2022)

There are several lessons that U.S. and multinational companies can take from the U.S. response to Russia's invasion of Ukraine and to further steps toward a U.S.-China decoupling and the ongoing regionalization of the world economy:

First, companies must understand that governments can and will use their power to issue sanctions and export controls to punish or prevent geopolitical behavior they find to be intolerable. Western governments turned Russia into a pariah state in a matter of days. The UFLPA was passed on an overwhelmingly bipartisan basis during one of the most partisan times in the U.S.'s history. And as discussed above, China has taken steps to isolate itself from the U.S., and it still has many more tools at its disposal to further isolate itself and keep the West at bay. This means that governments expect companies to adapt to and comply with restrictions imposed to achieve geopolitical goals. While this has been a given in China and Russia, rarely since the Cold War has corporate America been asked to operate under such conditions.

Second, the U.S. government expects companies to treat compliance with sanctions as a boardroom level issue. The SEC has directed companies to identify by name the board members responsible for Russia sanctions compliance. Congress also has required CBP to publish details of all instances in which importers successfully rebut the presumption of forced labor. This means that Western governments expect to hold individuals and companies accountable for furthering their geopolitical objectives.

Third, China has been seeking to expand its global influence for years. From the Belt & Road Initiative in Africa, Eastern Europe, and Asia, to its pursuit of diplomatic relations with Latin American and Caribbean countries that had been aligned for years with Taiwan, China's reach can be felt far outside China. Therefore, when companies evaluate their own geopolitical supply chain risks, they must look beyond China to China's entire sphere of influence. While there is no formula for assessing risks associated with sourcing from allies of an increasingly isolationist power, careful scenario planning should help companies better understand when and how such risks will likely manifest themselves.

Companies that have not begun scenario planning for further global supply chain disruption should start to do so now. They must ensure that senior management understands the existing supply chain in the context of geopolitical risk, and know if they are sourcing materials from XUAR or from other companies that are associated with rights violations in XUAR. Companies should also understand their supply chain exposure to China, generally. Multinational entities should assess the geopolitical risks and exposure of their suppliers and sub-suppliers. If Russia's sights are set on Eastern Europe, companies with operations in Estonia and Latvia may be at risk. Companies must decide whether to source materials and products from elsewhere, or they may wish to assess the feasibility of assisting with relocation. If the relationship between China and the U.S. deteriorates, either country may impose severe restrictions on commercial relationships with the other. Companies should look to the UFLPA guidance document to ascertain whether they conduct the kind of supply chain tracing and supply chain due diligence that CBP expects. This will help companies better understand their own supply chains even if they do not have exposure to XUAR.

Companies should also consider whether and how to incorporate redundancy into their supply chains. Any organization with heavy reliance on China or Eastern Europe can consider reshoring, nearshoring to Mexico or Latin America, or even far shoring in other countries in Southeast Asia or Northern Europe. Finally, companies should consider gaming out geopolitical conflict scenarios to better grasp whether they have material weaknesses that can be mitigated through early planning.

Conclusion

If you have any questions about scenario planning, please contact the author, David Simon. David worked to design and execute tabletop exercises and scenario plans for companies with varying levels of exposure to Eastern European and Chinese supply chain risk, and they would welcome the opportunity to work with you to discuss your company's risk profile and scenario planning needs.

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CHAPTER 5

Threats of Antitrust Enforcement in the Supply Chain

AUTHORS

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With steep inflation and seemingly constant disruptions in supply chains for all manner of goods, the Biden Administration has turned increasingly to antitrust authorities to tame price increases and stem future bottlenecks. These agencies have used the myriad tools at their disposal to carry out their mandate, from targeting companies that use supply disruptions as cover for anti-competitive conduct, to investigating industries with key roles in the supply chain, to challenging vertical mergers that consolidate suppliers into one firm. In keeping with the Administration's "whole-of-government" approach to antitrust enforcement, these actions have often involved multiple federal agencies.

Whatever an entity's role in the supply chain, that company can make a unilateral decision to raise its prices in response to changing economic conditions. But given the number of enforcement actions, breadth of the affected industries, and the government's more aggressive posture toward antitrust enforcement in general, companies should tread carefully.

What follows is a survey of recent antitrust enforcement activity affecting supply chains and suggested best practices for minimizing the attendant risk.

Combatting Inflation as a Matter of Federal Antitrust Policy

Even before inflation took hold of the U.S. economy, the Biden Administration emphasized a more aggressive approach to antitrust enforcement. President Biden appointed progressives to lead the antitrust enforcement agencies, naming Lina Kahn chair of the Federal Trade Commission (FTC) and Jonathan Kanter to head the Department of Justice's Antitrust Division (DOJ). President Biden also issued Executive Order 14036, "Promoting Competition in the American Economy." This Order declares "that it is the policy of my Administration to enforce the antitrust laws to combat the excessive concentration of industry, the abuses of market power, and the harmful effects of monopoly and monopsony... ." To that end, the order takes a government-wide approach to antitrust enforcement and includes 72 initiatives by over a dozen federal agencies, aimed at addressing competition issues across the economy.

Although fighting inflation may not have been the initial motivation for the President's agenda to increase competition, the supply disruptions wrought by the COVID-19 pandemic and persistent inflation, now at a 40-year high, have made it a major focus. In public remarks the White House has attributed rising prices in part to the absence of competition in certain industries, observing "that lack of competition drives up prices for consumers" and that "[a]s fewer large players have controlled more of the market, mark-ups (charges over cost) have tripled." In a November 2021 statement declaring inflation a "top priority," the White House directed the FTC to "strike back at any market manipulation or price gouging in this sector," again tying inflation to anti-competitive conduct.

The Administration's Enforcement Actions Affecting the Supply Chain

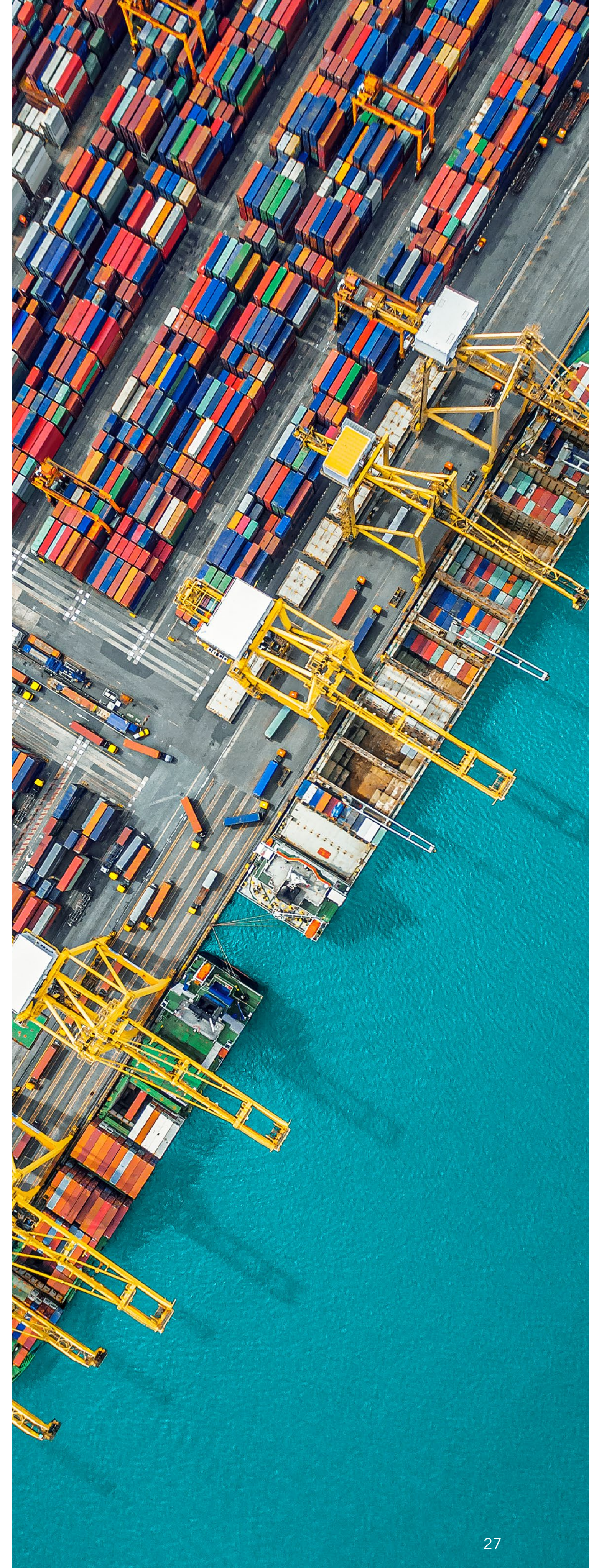
The Administration has taken several antitrust enforcement actions in order to bring inflation under

control and strengthen the supply chain. In February, the DOJ and FBI announced an initiative to investigate and prosecute companies that exploit supply chain disruptions to overcharge consumers and collude with competitors. The announcement warned that individuals and businesses may be using supply chain disruptions from the COVID-19 pandemic as cover for price fixing and other collusive schemes. As part of the initiative, the DOJ is "prioritizing any existing investigations where competitors may be exploiting supply chain disruptions for illicit profit and is undertaking measures to proactively investigate collusion in industries particularly affected by supply disruptions." The DOJ formed a working group on global supply chain collusion and will share intelligence with antitrust authorities in Australia, Canada, New Zealand, and the UK.

Two things stand out about this new initiative. First, the initiative is not limited to a particular industry, signaling an intent to root out collusive schemes across the economy. Second, the DOJ has cited the initiative as an example of the kind of "proactive enforcement efforts" companies can expect from the division going forward. As the Deputy Assistant Attorney General for Criminal Enforcement put it in a recent speech, "the division cannot and will not wait for cases to come to us."

In addition to the DOJ's initiative, the FTC and other federal agencies have launched more targeted inquiries into specific industries with key roles in the supply chain or prone to especially high levels of inflation. Last fall, the FTC ordered nine large retailers, wholesalers, and consumer good suppliers to "provide detailed information that will help the FTC shed light on the causes behind ongoing supply chain disruptions and how these disruptions are causing serious and ongoing hardships for consumers and harming competition in the U.S. economy." The FTC issued the orders under Section 6(b) of the FTC Act, which authorizes the Commission to conduct wide-ranging studies and seek various types of information without a specific law enforcement purpose. The FTC has in recent months made increasing use of 6(b) orders and we expect may continue to do so.

Amid widely reported backups in the nation's ports, the DOJ announced in February that it was strengthening its partnership with and lending antitrust expertise to the Federal Maritime Commission to investigate



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antitrust violations in the ocean shipping industry. In a press release issued the same day, the White House charged that "[s]ince the beginning of the pandemic, these ocean carrier companies have been dramatically increasing shipping costs through rate increases and fees." The DOJ has reportedly issued a subpoena to at least one major carrier as part of what the carrier described as "an ongoing investigation into supply chain disruption."

The administration's efforts to combat inflation through antitrust enforcement have been especially pronounced in the meat processing industry. The White House has called for "bold action to enforce the antitrust laws [and] boost competition in meat processing." Although the DOJ suffered some well-publicized losses in criminal trials against some chicken processing company executives, the DOJ has obtained a $107 million guilty plea by one chicken producer and several indictments.

Most recently, the FTC launched an investigation into shortages of infant formula, including "any anticompetitive [] practices that have contributed to or are worsening this problem." These actions are notable both for the variety of industries and products involved and for the multitude of enforcement mechanisms used, from informal studies with no law enforcement purpose to criminal indictments.

Preventing Further Supply-Chain Consolidation

In addition to exposing and prosecuting antitrust violations that may be contributing to inflation and supply issues today, the Administration is taking steps to prevent further consolidation of supply chains, which it has identified as a root cause of supply disruptions. DOJ Assistant Attorney General Kanter recently said that "[o]ur markets are suffering from a lack of resiliency. Among many other things, the consequences of the pandemic have revealed supply chain fragility. And recent geopolitical conflicts have caused prices at the pump to skyrocket. And, of course, there are shocking shortages of infant formula in grocery stores throughout the country. These and other events demonstrate why competition is so important. Competitive markets create resiliency. Competitive markets are less susceptible to central points of failure."

Consistent with the Administration's concerns with consolidation in supply chains, the FTC is more closely scrutinizing so-called vertical mergers, combinations of companies at different levels of the supply chain. In September 2021, the FTC voted to withdraw its approval of the Vertical Merger Guidelines published jointly with the DOJ the year before. The Guidelines, which include the criteria the agencies use to evaluate vertical mergers, had presumed that

such arrangements are pro-competitive. Taking issue with that presumption, FTC Chair Lina Khan said the Guidelines included a "flawed discussion of the purported pro-competitive benefits (i.e., efficiencies) of vertical mergers" and failed to address "increasing levels of consolidation across the economy."

In January 2022, the FTC and DOJ issued a request for information (RFI), seeking public comment on revisions to "modernize" the Guidelines' approach to evaluating vertical mergers. Although the antitrust agencies have not yet published revised Guidelines, the FTC has successfully blocked two vertical mergers. In February, semiconductor chipmaker, Nvidia, dropped its bid to acquire Arm Ltd., a licenser of computer chip designs after two months of litigation with the FTC. The move "represent[ed] the first abandonment of a litigated vertical merger in many years." Days later Lockheed Martin, faced with a similar challenge from the FTC, abandoned its $4.4 billion acquisition of missile part supplier, Aerojet Rocketdyne. In seeking to prevent the mergers, the FTC cited supply-chain consolidation as one motivating factor, noting for example that the Lockheed-Aerojet combination would "further consolidate multiple markets critical to national security and defense."

Up Next? Civil Litigation

This uptick in government enforcement activity and investigations may lead to a proliferation of civil suits. Periods of inflation and supply disruptions are often followed by private plaintiff antitrust lawsuits claiming that market participants responded opportunistically by agreeing to raise prices. A spike in fuel prices in the mid-2000s, for example, coincided with the filing of class actions alleging that four major U.S. railroads conspired to impose fuel surcharges on their customers that far exceeded any increases in the defendants' fuel costs, and thereby collected billions of dollars in additional profits. That case, *In re Rail Freight Fuel Surcharge Antitrust Litigation*, is still making its way through the courts. Similarly, in 2020 the California DOJ brought a civil suit against two multinational gas trading firms claiming that they took advantage of a supply disruption caused by an explosion at a gasoline refinery to engage in a scheme to increase gas prices. All indicators suggest that this trend will continue.

Reducing Antitrust Risk in the Supply Chain and Ensuring Compliance

Given the call to action for more robust antitrust enforcement under Biden's Executive Order 14036 and the continued enhanced antitrust scrutiny of all manner of commercial activities, companies grappling with supply disruptions and rampant inflation should actively monitor this developing area when making routine business decisions.

As a baseline, companies should have an effective antitrust compliance program in place that helps detect and deter anticompetitive conduct. Those without a robust antitrust compliance program should consider implementing one to ensure that employees are aware of potential antitrust risk areas and can take steps to avoid them. If a company has concerns about the efficacy of its current compliance program, compliance reviews and audits – performed by capable antitrust counsel – can be a useful tool to identify gaps and deficiencies in the program.

Faced with supply chain disruptions and rampant inflation, many companies have increased the prices of their own goods or services. A company may certainly decide independently and unilaterally to raise prices, but those types of decisions should be made with the antitrust laws in mind. Given the additional scrutiny in this area, companies may wish to consider documenting their decision-making process when adjusting prices in response to supply chain disruptions or increased input costs.

Finally, companies contemplating vertical mergers should recognize that such transactions are likely to garner a harder look, and possibly an outright challenge, from federal antitrust regulators. Given the increased skepticism about the pro-competitive effects of vertical mergers, companies considering these types of transactions should consult antitrust counsel early in the process to help assess and mitigate some of the risk areas with these transactions.

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CHAPTER 6

Using Upfront IP Licensing to Reduce Future Supply Chain Disruptions

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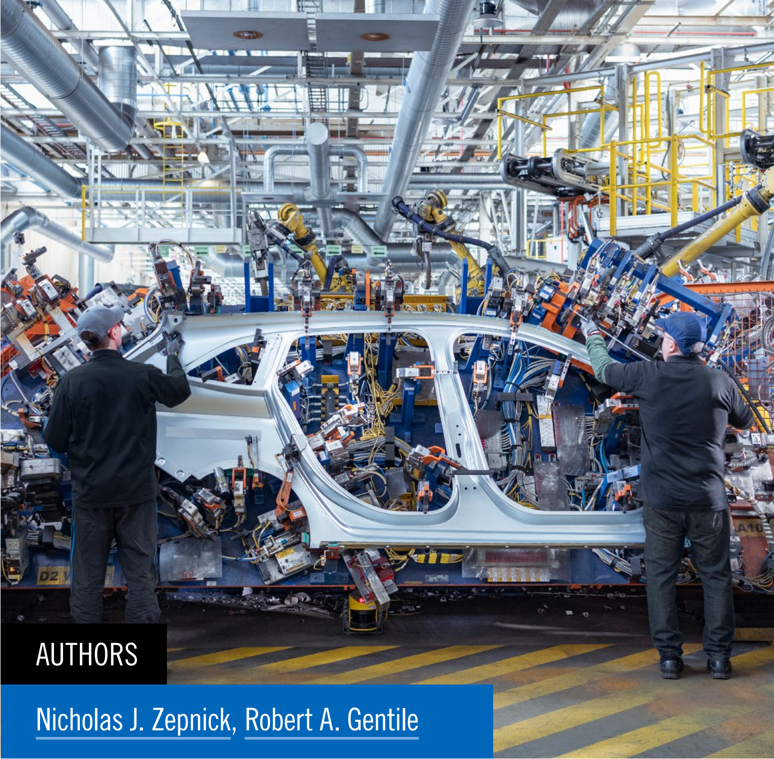

AUTHORS

Nicholas J. Zepnick, Robert A. Gentile

Companies often enter into supply agreements for component parts that are covered by or produced using a supplier's intellectual property (IP) rights, but do not give enough thought to IP licensing. In the face of supply chain disruptions and the associated need to investigate second-sourcing and in-housing options, suppliers may be keen to capitalize on those rights to prevent such production of their proprietary parts. For example, the supplier may assert that the component part is covered by a patent or that second-sourcing or in-housing by the customer would use the supplier's "know-how." As a result, supplier's IP rights, usually an afterthought in the context of ordinary supply arrangements, have now been thrust to the forefront of consideration in many industries.

Especially during and as a result of the COVID-19 pandemic, unexpected supply chain disruptions and delays have arisen, preventing certain suppliers from being able to provide components or materials to customers in a timely manner, the required quantity, or at an agreed-upon price. In some cases, the disruptions substantially impede the customer's own ability to deliver its products on time, on budget, and in sufficient quantities, causing loss of revenue and customer goodwill.

In order to address these supply chain risks, customers should negotiate, as part of the supply agreement or even as a stand-alone document, the ability to utilize their supplier's IP in certain instances where the supplier claims it cannot provide the requisite quantity of the subject component in a timely manner or at an agreed-upon price. Whether through outsourcing the component manufacture to a third party or by in-housing the production, a customer should give itself the option to use the supplier's IP so that there is as little disruption in production as possible. The customer can secure this option through negotiations with the supplier to establish, for example, a conditional license or an intellectual property escrow that permits the customer to utilize the supplier's IP in the event of certain, agreed-upon conditions.

Patents and Know-How Common in the Supply Chain

A supplier may have various IP rights covering a component that it supplies to a customer, including patent rights and rights protecting the supplier's "know-how." Generally, a patent provides the patentee (the supplier, in this instance) with the ***exclusive*** right to prevent others (a customer, third parties hired by the customer, or anyone else) from making, using, selling, offering to sell, or importing the product covered by the patent, absent any agreement to the contrary. Whether or not the component is patented, the supplier may also have an interest in protecting its *know-how* with respect to the component. Know-how can be tangible or intangible, may or may not be patentable, and may or may not be protectable via state-law trade secret statutes.[1] Know-how can include, for example: scientific or technical information, results, and data of any type; trade

1 While this chapter discusses patents and know-how, almost all of its contents apply equally to confidential information, copyrights (e.g., in software code, in engineering drawings, in computer-aided-design models, etc.), and trade secrets to the extent the supplier shares such confidential information, copyrightable material, and trade secrets with the customer (e.g., via a non-disclosure agreement (NDA)).

secrets; practices, protocols, methods, processes (including manufacturing processes), or techniques; component specifications (e.g., dimensions, material selection, bill of materials (BOM), etc.); and engineering drawings and three-dimensional computer-aided-design (CAD) models. A supplier may attempt to withhold from sharing and maintain as secret much of its know-how in a component. But in some instances the supplier may need to share at least some of its know-how with its customer so that the customer can design and produce the end product, such that the component can be integrated as part of the assembly, to generate product drawings and models for production and assembly instruction purposes, etc.

Dilemma: Typical IP Provisions Included in Supply Agreements

Supply agreements typically treat IP as an afterthought, for example when they define the IP rights of the supplier and include only a limited right for the customer to use that IP. Traditional supply agreements may also define and include only a limited right to use the supplier's know-how (e.g., the know-how that is shared with the customer may be used only for specific, enumerated purposes by the customer, the know-how that is shared with the customer may not be widely disseminated, etc.). However, should a disruption in the supply chain or delay in the delivery of the components arise under traditional supply agreements, the customer may face a lose-lose situation: (a) lose revenue and customer goodwill by being unable to meet product demands or (b) run afoul of the supplier's IP rights by having the component manufactured outside of the bounds of the supply agreement.

Answer: Include Conditional License to Patents and Related IP in Supply Agreements

While IP terms in supply agreements were historically limited and sporadic, the current supply environment demands that customers take supplier IP seriously. Supply agreements should include various supplier representations and warranties regarding whether the component being supplied is patented. The supply agreement may also require a covenant that the supplier will notify the customer if anything about the patented status of the component changes throughout the term of the supply agreement (e.g., a patent expires, a new patent issues that covers the component, new patented features are introduced to future generations of the component, etc.). Similarly, provisions for know-how, confidential information, copyrights, and trade secrets should be included, such as a supplier acknowledgement that information is not confidential or know-how unless marked by the supplier as such. These provisions are intended to promote certainty by preventing the circumstance where the customer later wants to second-source the component part but is frustrated to find out a supplier's IP rights will prevent it from doing so.

Knowing about a supplier's patent(s) or other IP is only half of the solution – to avoid disruption, customers should make every attempt to negotiate an upfront, conditional license with the supplier that outlines when the customer may, under certain conditions, either manufacture the component itself (in-housing) or have the component manufactured by a third party (second-sourcing). This typically will come in the form of a license that allows the customer to produce the component without infringing upon the supplier's

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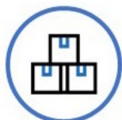
patent rights or misusing the supplier's know-how. The license may also allow for the use of the supplier's drawings, avoiding the cost associated with redrawing components later on. Such a license will allow the supplier and the customer to specify clearly when the conditional license activates, for how long, and what information the customer may use so that the customer can act quickly and mitigate any adverse impacts on the manufacturing of their product.

Many conditions may trigger the activation of such licenses:

IP LICENSING FOR SECOND-SOURCING OR IN-HOUSING SHOULD BE TRIGGERED BY FORESEEABLE EVENTS



Supplier not meeting certain volume delivery requirements

Forecasted demand greater than what supplier can supply

Delay beyond target delivery date

Supplier able to meet demand but only at elevated pricing

Customers pushing for conditional licenses from suppliers need to understand that they will come at a cost. For example, the supplier may demand a royalty payment from the customer for each component that is not produced by them. In instances where the customer has agreed to purchase a component from a supplier and the supplier is prevented from supplying the component to other customers (e.g., due to joint development between the supplier and the customer whereby the supplier can provide the component only to the partner/customer, etc.), the supplier may desire to have such restrictions lifted if the customer is permitted to second-source or in-house the component. Alternatively, suppliers may desire to take their (higher cost) goods to the open market in exchange for the customer being able to second-source or in-house the component. Mutual upfront agreement, however, will reduce uncertainty for both parties and avoid hastened and contentious discussions later when, by definition, product delivery is at stake.

Enforceability

Like many terms in a supply agreement, a conditional license that permits a company to utilize the IP of a supplier should be clear. The contract should expressly recite the terms of the license, including at a minimum providing for the following: (a) how the license activates (e.g., for convenience, only upon certain triggers, etc.), (b) exactly what IP the company can use, (c) how long the license is permitted, and (d) costs associated with the use. The terms should also expressly recite exactly what information, if any, the supplier needs to provide as part of a technology transfer to allow the customer to manufacture the product.

A lack of specificity in the agreement can make it unclear what exactly the supplier needs to provide as part of the IP transfer.[2] Without sufficient contractual terms, courts may be wary to force IP transfers that could undermine the supplier's IP rights (e.g., the disclosure of trade secrets such as proprietary manufacturing processes).[3] In most cases, the preferred remedy for enforcing the technology transfer contemplated by a conditional license in a supply agreement will be a preliminary mandatory injunction. Among judicial remedies, only such an injunction can deliver the timely transfer necessary to avoid significant supply line disruption. But mandatory (requiring affirmative acts of performance) as opposed to prohibitory (prohibiting certain conduct) injunctive relief is particularly difficult to obtain on

2 See Inovia Pharmaceuticals, Inc. v. GeneOne Life Science Inc., Case No. 20-06554, 2020 WL 5047283, at *37–39 (Pa. Com. Pl. Aug. 25, 2020). Noting that the difficulty in determining exactly what is required of the supplier to properly effectuate a technology transfer in compliance with the supply agreement causes problems with administering and enforcing a preliminary injunction requiring performance.

3 See Id. at *24–26. Noting that when considering a request for a preliminary injunction, courts routinely balance harms to both parties and do not disregard harm to the supplier on the ground that such harm is the consequence of compliance with a provision of a contract.

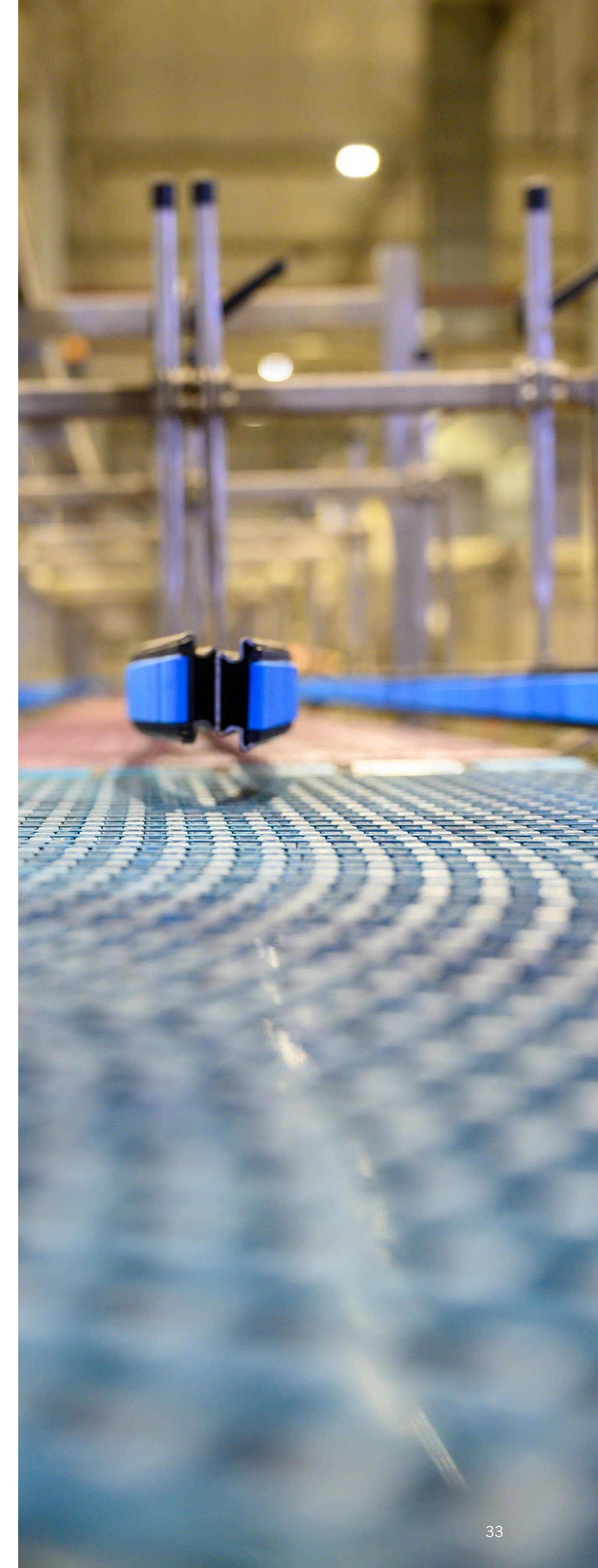
a preliminary basis.[4] For this reason, it is especially important that the terms of a conditional license in a supply agreement be set forth in explicit detail. As an example, such a provision could state that "the supplier licenses patents A and B, engineering drawing C, CAD model D, and bill of materials E for a period of X [days/months/years] at a royalty rate of Y for each component Z manufactured or caused to be manufactured by the customer." To enhance clarity and specificity, one option could be to include each document that would be considered part of the IP transfer in a transfer packet as an exhibit to the supply agreement.

An alternative approach that might enable the parties to avoid the delay and uncertainty associated with court action would be to establish an intellectual property escrow. Such an escrow would require an agreement clearly establishing the material and information to be placed in escrow, and very specific language defining the circumstances and documentation required to authorize an escrow agent to release the escrowed matter to the customer. The escrow agreement could also include language obligating the supplier to provide to the escrow agent any new IP required to perform the supply agreement as it is put into practice. Policing the supplier's compliance with such an updating obligation would be difficult; the customer may have to rely to some degree on the supplier's good faith in disclosing new IP developments as they occur. As a result, even a carefully drafted escrow agreement may not completely displace the need for judicial remedies.

Conclusion

Regardless of the terms, establishing the right to access supplier IP at the outset of a business relationship adds clarity for both sides. Properly utilized, it can eliminate tense discussions in the event that unexpected supply chain disruptions arise.

4 See id. at *10 Noting that the courts have engaged in greater scrutiny of mandatory injunctions and declared that they should be issued more sparingly than injunctions that are merely prohibitory; plaintiffs must show a clear right to relief to obtain a mandatory injunction.



CHAPTER 7

Supply Chain Disruptions in the Energy Industry: Challenges with the Supply of Lithium-ion Batteries

AUTHORS

Craig D. Dillard, Elizabeth P. Nevle

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With the push toward clean energy and increased demand for electric vehicles, manufacturers need batteries — specifically lithium-ion batteries — more than ever. Examples of the accelerating transition to battery powered vehicles are everywhere: the United States Postal Service announced at least 40% of its Next Generation Delivery Vehicles and other commercial vehicles will be electric vehicles, Amazon has begun using Rivian delivery vans in over a dozen cities, and Walmart executed an agreement to purchased 4,500 electric delivery vans. With each of these conversions, the strain on the supply chain for batteries intensifies. This chapter will provide an overview of the lithium-ion battery industry and the current supply chain issues affecting the production and future of these batteries.

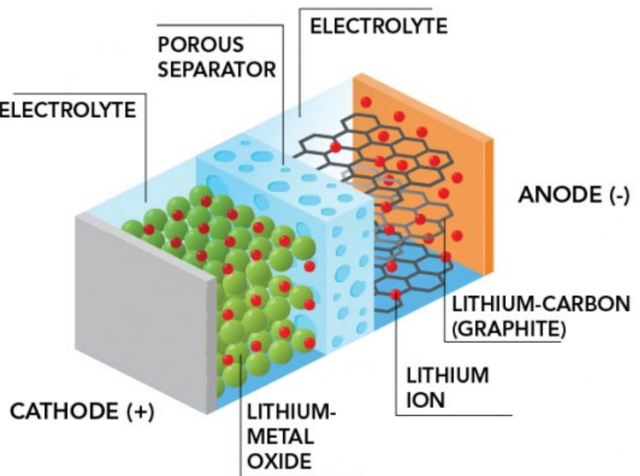
I. Lithium-Ion Battery Overview

The lithium-ion battery industry relies heavily on the mining of raw materials and production of the batteries—both of which are vulnerable to supply chain interference.

Lithium-ion batteries are mainly comprised of four key components: a cathode, anode, separator, and electrolyte, as shown in Figure 1. At a high level, the cathode (the component that produces lithium ions) is composed of lithium oxide.[1] The anode (the component that stores the lithium ions) is generally made from graphite. The electrolyte is a medium that allows the free movement of the lithium ions that is composed of salts, solvents, and additives. Finally, the separator is the absolute barrier between the cathode and anode.

1 Samsung SDI, The Four Components of a Li-Ion Battery (last visited Aug. 1, 2022).

Figure 1: Diagram of Lithium-Ion Battery



The cathode is the critical component relevant to this chapter because this is where supply chain issues are most likely to arise. The composition of the cathode depends heavily on the application of the battery.[2]

2 Spangenberger, Jeff, Introduction to Lithium Ion Batteries (Mar. 22, 2008).

Application	Required Elements
Cell Phones Cameras Laptops	Cobalt and Lithium
Power Tools Medical Equipment	Manganese and Lithium or Nickel-Cobalt-Manganese and Lithium or Phosphate and Lithium

Given the prevalence and continued demand for new cell phones, cameras, and computers, cobalt and lithium are the most valuable raw materials in the production of lithium-ion batteries and are already facing supply chain interruptions today.

There are three crucial stages in the production of lithium-ion batteries: (1) mining for raw materials, (2) refining the raw materials, and (3) producing and manufacturing the batteries themselves. At each of these stages, there are supply chain issues that should be addressed during contractual negotiations rather than waiting for the issues to arise during the course of production.

II. Supply Chain Issues within the Battery Industry

A. Production

China currently dominates the global lithium-ion battery supply chain, producing 79% of all lithium-ion batteries that entered the global market in 2021.[3] The country further controls 61% of global lithium refining for battery storage and electric vehicles[4] and 100% of the processing of natural graphite used for battery anodes.[5] China's dominant position in the lithium-ion battery industry and associated rare earth elements is cause for concern both to companies and governments COVID-19, the war in Ukraine, and inevitable geopolitical unrest will continue to affect global supply chains. Just like any other industry, the energy sector has been and will continue to be impacted by these factors. Cobalt, lithium, and nickel—critical materials in the production of batteries—are exposed to supply chain risks because production and processing are geographically concentrated and dominated by jurisdictions that have been alleged to violate labor and human rights. For additional information, see the fourth chapter in this Guide, Managing Supply Chain Disruption in an Era of Geopolitical Risk, on page 21.

Argentina is also on the forefront of the global scramble for lithium as it currently accounts for 21% of the world's reserves with only two mines in operation.[6] Similar to China, Argentina wields significant power in the mining of raw materials and plans to expand its influence further in the lithium supply chain, with thirteen planned mines and potentially dozens more in the works.

European countries are also increasing their production, with the European Union poised to become the second largest producer of lithium-ion batteries in the world by 2025 with 11% of the global production capacity.[7]

Despite recent efforts,[8] the United States does not have a significant presence in the mining or refining of rare earth metals. Because of this, the United States heavily relies on foreign sources to produce lithium-ion batteries. In June 2021, the U.S. Department of Energy (DOE) published a review of the large-capacity battery supply chain and recommended establishing domestic production and processing capabilities for critical materials to support a fully domestic battery supply chain.[9] The DOE determined that multiple energy technologies are highly dependent on insecure and unstable foreign sources—necessitating domestic

3 Statista, Share of the Global Lithium-Ion Battery Manufacturing Capacity in 2021 with a Forecast for 2025, by Country (last visited Aug. 1, 2022).

4 Cohen, Ariel, America Trails in Global Race for Rare Earth Metals, Forbes (Mar. 21, 2021),

5 Id.

6 Nugent, Ciara, New Lithium Mining Technology Could Give Argentina a Sustainable Gold Rush, Time (July 26, 2022).

7 DW, EU plans millions of e-vehicle batteries, jobs by 2025 (Mar. 23, 2021); Statista, Share of the Global Lithium-Ion Battery Manufacturing Capacity in 2021 with a Forecast for 2025, by Country (last visited Aug. 1, 2022).

8 See Lipton, Eric, Penn, Lithium Mining Race, New York Times (May 6, 2021).

9 The White House, Building Resilient Supply Chains, Revitalizing American Manufacturing, and Fostering Broad-Based Growth —100-Day Reviews Under Executive Order 14017(2021).

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growth of the battery industry.[10] In response, the DOE issued two notices of intent in February 2022 to provide $2.91 billion to boost U.S. production of lithium-ion batteries that are critical to growing the energy sector.[11] The DOE intends to fund refining and production plants for battery materials, recycling facilities, and other manufacturing facilities.

New technology will also change the landscape of lithium-ion battery production. Lilac Solutions, a California-based startup company, offers technology that can recover[12] up to twice as much lithium as traditional methods.[13] Similarly, Princeton NuEnergy is another startup that has developed an inexpensive, sustainable way to make new batteries from old ones.[14] Although this type of new technology will ease the supply chain bottleneck, it does not change the fact that lithium-ion battery production heavily relies on raw source material availability. The bottom line remains that the world's existing lithium production is concentrated in Chile, Australia, Argentina, and China.[15] As indicated in Figure 2 below, the reliance on foreign-sourced materials is likely to continue for the next few years until further development of battery technology that does not rely on rare earth metals.

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10 U.S. Department of Energy, Americas' Strategy to Secure the Supply Chain for a Robust Clean Energy Transition (2022).

11 U.S. Department of Energy, Biden Administration, DOE to Invest $3 Billion to Strengthen U.S. Supply Chain for Advanced Batteries for Vehicles and Energy Storage (Feb 11, 2022),

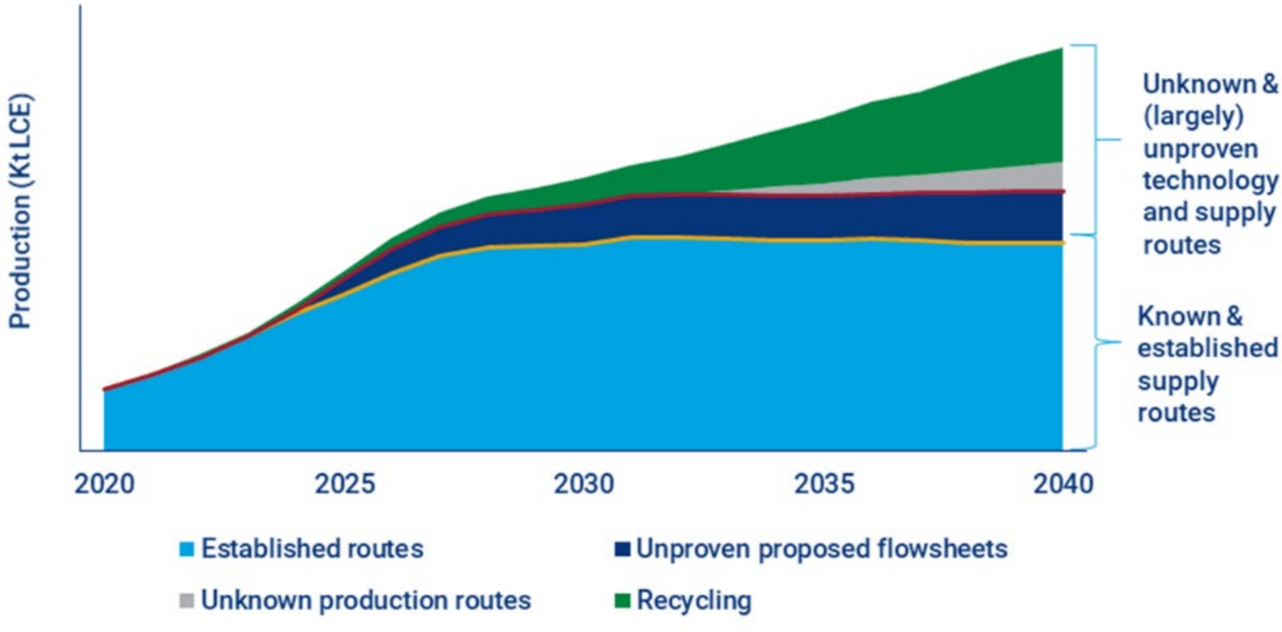
12 Recovery is the process by which lithium, cobalt, nickel, and manganese can be retrieved from batteries that no longer have a useful life. After these metals are recovered, they can be repurposed into new batteries.

13 Id.

14 Seltzer, Molly, A Better Way to Recycle Lithium Batteries Is Coming From This Princeton Startup, Princeton: Andlinger Center for Energy and Development (Mar. 3, 2022).

15 Volkswagen, Lithium Mining: What You Should Know About the Contentious Issue.

Figure 2: Future Lithium Production Sources



B. Price

Since 2021, the price surge of lithium is reflected in the increased battery demands, as costs have risen more than 900%.[16] These price surges continue as inflation remains at an all-time high. The rising costs of lithium-ion batteries, coupled with inflation, have already resulted in increases in the prices for electric vehicles. For additional information on the impact of inflation on the supply chain, see the first chapter in this Guide, Inflation Woes: Four Key Ways for Companies to Address Inflation in the Supply Chain, on page 4.

Decision makers will want to be aware of the impact of inflation on their contracts involving lithium-ion batteries. "In well-established energy storage markets, like the U.S., higher costs have resulted in some developers looking to renegotiate contract prices with offtakers. These renegotiations can take time and delay project commissioning." says Helen Kou, an energy storage associate at the research company BloombergNEF.[17]

C. Transportation/Flammability

Lithium-ion batteries are regulated as a hazardous material under the U.S. Department of Transportation's (DOT) Hazardous Materials Regulations by the U.S. Department of Transportation Pipeline and Hazardous Materials Safety Administration (PHMSA). Unlike standard batteries, most lithium-ion batteries contain flammable materials and have an incredibly high energy density. As a result, the lithium-ion batteries can overheat and ignite under certain conditions, such as a short circuit, physical damage, improper design, or assembly. Once ignited, lithium cell and battery fires can be difficult to extinguish.[18] As a result, companies need to be aware of the potential risks and evaluate the proper precautions when engaged in transactions involving lithium-ion batteries.

To date, there is no conclusive research to determine if electric vehicles are more prone to spontaneous fires compared to traditional vehicles.[19] Research shows that electric vehicles only have a 0.03% chance of igniting, compared to traditional combustion engines at 1.5% chance of igniting.[20] Hybrid vehicles—which have a high voltage battery and an internal combustion engine—have the greatest likelihood of a vehicle fire at 3.4%.[21]

On February 16, 2022, a cargo ship carrying nearly 4,000 vehicles from Germany to the United States caught fire in the Atlantic Ocean.[22] Nearly two weeks later, the cargo ship sank in the middle of the Atlantic. Although there is no official statement as to the breakdown of traditional and electric vehicles on board, the lithium-ion battery vehicles would have made the fires harder to extinguish.

III. Conclusion

As the world moves toward cleaner energy, questions and issues involving the supply chain will grow. These questions should be addressed as soon as possible before executing any contract. If you or your company are involved in transactions where lithium-ion batteries are a material component, there are significant supply chain hurdles that should be addressed early on during negotiations regarding the sourcing of raw materials and pricing issues. In light of the limited availability of raw materials and the complexities involved in developing lithium mines, companies ought to look to alternative avenues for obtaining lithium and other critical components. Companies relying on lithium-ion batteries should evaluate and invest in technology that is economically viable and maximizes the viability and recyclability of these batteries to avoid supply-chain issues. Alternatively, companies can enter into multi-year agreements for lithium. However, given the heavy reliance on rare earth metals to produce lithium-ion batteries, companies ought to heavily consider the sourcing of the metals and other issues that may affect mining and refining, such as geopolitical issues. If you have any questions about issues concerning supply chain issues, please contact our team at Foley & Lardner.

16 Nicholls, Mark, Inflation Bites at the Battery Storage Bonanza, Energy Monitor (June 10, 2022).

17 Id.

18 U.S. Department of Transportation, Pipeline and Hazardous Materials Safety Admin., Transporting Lithium Batteries, (last visited Aug. 1, 2022).

19 Winton, Neil, Electric Car Fire Risks Look Exaggerated, But More Data Required For Definitive Verdict, Forbes (Mar. 2, 2022).

20 Putzer, Mark, Electric Vehicles Catch Fires Considerably Less Than Gas Cars, Motor Biscuit (Feb. 13, 2022).

21 Evers, Andrew, and Kolodny, Lora, Electric Vehicle Fires Are Rare, But Hard To Fight—Heres ' Why, CNBC (Jan. 29, 2022).

22 Franklin, Jonathan, A Burning Cargo Ship Full of Porsches and VWs is Adrift in the Mid- Atlantic, NPR (Feb. 17, 2022).

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CHAPTER 8

Supply Chain Shortages in the Meat and Poultry Industries

Although industries across the board have felt the effects of supply chain disruptions brought on by the COVID-19 pandemic, the meat and poultry industry has been particularly hard-hit. Brought about by a combination of rising costs for feed and fuel, continued labor shortages, and outbreaks of the avian flu, the cost of meat has risen 17% since June 2020.[1] In effort to address these issues, the Biden Administration, in concert with the United States Department of Agriculture (USDA), has moved forward with regulatory actions aimed at easing the supply bottleneck. Whether they will have the intended effect remains to be seen.

In July 2021, President Biden signed an Executive Order on Promoting Competition in the American Economy (the Executive Order).[2] The Executive Order directs 72 different actions across the federal government, including several rulemaking directives to the USDA aimed at increasing competition within the meat and poultry industry. Among other things, the Executive Order directs the USDA to issue new rules defining when meat can bear "Product of USA" labels, to address perceived loopholes in the current rules, and to issue new rules under the Packers and Stockyards Act. Following the Executive Order, the USDA has made progress on these new rules, and recently announced new initiatives to ramp up antitrust enforcement in the meat industry.

(For more on this Executive Order and its implications across industries, see a prior article from our Foley colleagues, President Biden's Executive Order on Competition Could Mean Broad Changes Across a Range of Industries.)

1 https://www.washingtonpost.com/business/2022/08/27/inflation-meat-prices/

2 Executive Order 14036, Promoting Competition in America's Economy, 86 Fed Reg. 36987, July 9, 2021.

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Modernizing the Packers and Stockyards Act

The Packers and Stockyards Act (PSA), enacted in 1921, is a federal law designed to combat labor abuses by meatpackers and processors. Specifically, the PSA makes it illegal for livestock and poultry producers to engage in any unfair, unjustly discriminatory, or deceptive practice,[3] or to give any undue or unreasonable preference or advantage to any person or locality.[4] Congress explicitly intended the protections in the PSA to be broader than those found in other federal statutes, such as the Sherman Antitrust Act.[5] However, the USDA believes the force of the PSA has been reduced by a combination of regulatory narrowing, budget and administrative cuts, and under-enforcement in previous decades. For that reason, the USDA announced three rulemaking actions designed to address livestock and poultry markets as they exist today so the PSA fulfills Congress's goal to protect livestock producers and poultry growers.

The first proposed rule, released in draft form on June 7, 2022,[6] is intended to promote transparency in poultry production contracting by revising the list of disclosures and information live poultry dealers must furnish to poultry growers and sellers with whom the dealers contract. The proposed rule establishes additional

3 7 U.S.C. § 192(a).

4 7 U.S.C. § 192(b).

5 *See, e.g., Wilson & Co. v. Benson,* 286 F.2d 891, 895 (7th Cir. 1961).

6 Docket No. AMS-FTPP-21-0044.

disclosure requirements in connection with the use of poultry grower ranking systems by live poultry dealers to determine settlement payments for poultry growers.

The second proposed rule, released in draft form on October 3, 2022,[7] identifies retaliatory practices taken by regulated entities – which the PSA defines as swine contractors, live poultry dealers, or packers – that interfere with lawful communications, assertions of rights, and participation in associations (among other protected activities), as "unjust discrimination." The proposed rule also identifies unlawfully deceptive practices with respect to contract formation, performance, termination, and refusal. Specifically, USDA proposes to:

- Prohibit, as "undue prejudices," disadvantages and other adverse actions against "market vulnerable" individuals who are deemed to be at heightened risk of adversely differential treatment in relevant markets;
- Prohibit, as "unjust discrimination," retaliatory and adverse actions that interfere with lawful communications, assertions of rights, associational participation, and other protected activities;
- Prohibit, as deceptive practices, regulated entities employing pretexts, false or misleading statements, or omissions of material facts, in contract formation, performance, termination, and refusal; and
- Require recordkeeping to support USDA monitoring, evaluation, and enforcement of compliance with aspects of the rule.

The USDA is presently seeking comments on this proposed rule, with the rulemaking docket open for comment until December 2, 2022. Following the comment period, the third potential rule, which has not yet been released, will focus on certain unfair practices and undue preferences. In addition, the third rule will explain whether and when a showing of harm to competition is—or is not—required under sections 202(a) and (b) of the PSA.

Increased Focus on Antitrust Enforcement

A recurring theme underlying the USDA's recent rulemaking efforts is a perception that existing federal laws aimed at protecting farmers, ranchers, and other agricultural producers have been under-enforced. Earlier in 2022, the USDA and the U.S. Department of Justice (DOJ) jointly expressed a shared commitment to enforcing "federal competition laws that protect farmers, ranchers, and other agricultural producers and growers from unfair and anticompetitive practices."[8] One notable component of this agency cooperation is a new USDA website, www.farmerfairness.gov, which allows anyone to report complaints of potential violations of antitrust laws and the PSA. In addition, the website incorporates existing PSA confidentiality and whistleblower protections against retaliation for those who report criminal antitrust concerns.

In September 2022, the USDA also announced the availability of $15 million in funding to encourage state Attorneys General (AGs) to partner with the USDA on competition issues in the food and agricultural space. The USDA expects to engage state AGs through a combination of renewable cooperation agreements and memoranda of understanding aimed at improving state AGs' ability to conduct on-the-ground investigations of competition issues. The USDA says it will work directly with state AG offices to solicit applications for funding.

These recent agency efforts come on the heels of multiple civil lawsuits alleging price-fixing and other anticompetitive practices by producers across the beef, pork, and poultry industries.

Conclusion

It is too early to say whether the USDA's recent efforts to address competition in the meat and poultry industry will result in lower prices – in part because the effects of the COVID-19 pandemic (e.g., labor shortages, shipping disruptions, and higher prices for inputs like fuel and animal feed) still linger. However, as national and global supply chains begin to return to pre-pandemic operations, consumers can hope for a less expensive meat prices in the future.

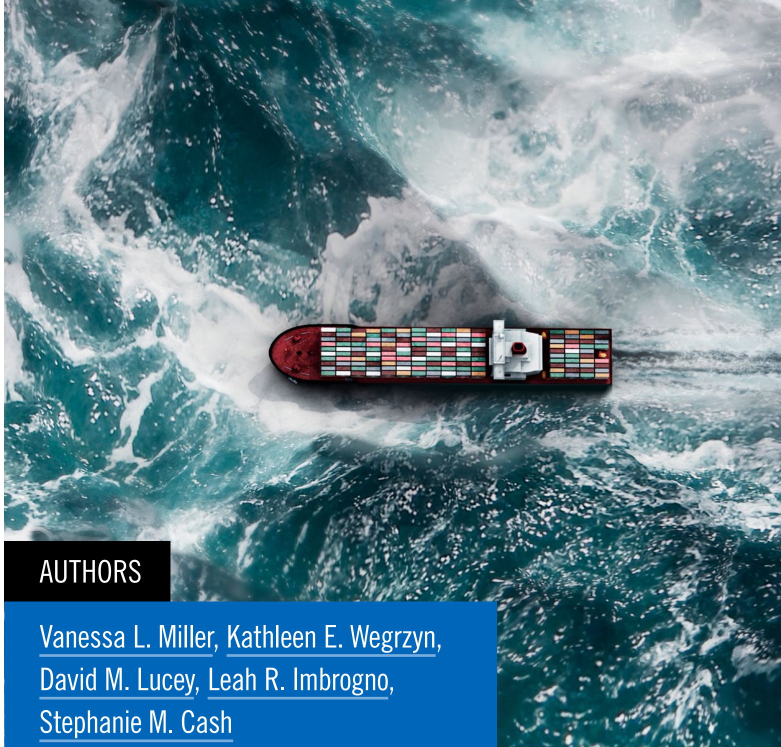
Foley & Lardner attorneys are well-positioned to assist on regulatory and enforcement issues in the food industry, including the meat and poultry industries. Please contact Nathan A. Beaver and Nicholas R. Johnson for additional information.

7 Docket No. AMS-FTPP-21-0045.

8 https://www.usda.gov/media/press-releases/2022/01/03/agriculture-department-and-justice-department-issue-shared

CHAPTER 9

Three Key Defenses to Contractual Performance: Force Majeure, Commercial Impracticability, and Frustration of Purpose



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With disruptions affecting every aspect of the supply chain, companies are increasingly encountering legal arguments offered to justify a failure to meet supply obligations. This chapter will provide a concise summary of the three legal theories frequently invoked to excuse nonperformance of contractual duties.

Force Majeure

Overview

The concept of force majeure (French for "superior force") originates in common law. Today, however, force majeure primarily comes into legal play as a result of an express provision in a commercial contract. This mechanism is used to reallocate the risks of loss associated with a failure to perform if the failure is caused by specified events or occurrences. Force majeure provisions have taken on greater importance given the increased supply chain disruptions, labor stoppages and slowdowns, and freight delays arising directly and indirectly from the COVID-19 pandemic.

Force majeure clauses set forth the circumstances in which a party owing a duty under the contract (the obligor) is excused from all or partial performance of that obligation, typically due to circumstances beyond the obligor's reasonable control. Although state law varies, courts tend to construe force majeure clauses narrowly. If the alleged force majeure event is expressly listed in a contract as an occurrence that excuses performance, the parties obviously contemplated the risk and decided to shift the risk of the specified event to the party benefitting from the obligation (the obligee). If the specified event occurs, the obligor is excused from performance for the duration of the event or for some other time period specified in the force majeure provision. If the force majeure event is not listed or is expressly excluded, however, courts are likely to find that the risk of that event should remain with the obligor.

For any specified circumstances to be excused as a force majeure event, the event must actually prevent performance. In addition, the event must be wholly outside of the impacted party's influence or control, unless otherwise provided in the contract. Stated differently, if an event may be prevented by the impacted party, or if the impacted party did not do everything it could do to avoid the event, it may not constitute a condition excusing performance under the force majeure clause.

Catch-All Provisions

Although courts narrowly construe force majeure provisions, many provisions contain "catch-all" language such as "or any other circumstances beyond a party's reasonable control." Courts in some states construe these provisions very narrowly so that only events similar to the itemized list will be captured under the catch- all provision.[1] Courts in other states

1 This approach follows the doctrine of ejusdem generis (a Latin term meaning "of the same class"). Under this doctrine, general catch-all clauses are construed to include only those unlisted events that are of the same type as the other listed events.

construe these provisions more expansively, focusing more closely on whether or not the event was beyond a party's reasonable control.

Duty to Mitigate

Even if a contract states that a party must mitigate a force majeure event, the scope of the duty to mitigate will vary from state to state. In some states, the duty arises only when mitigation can be done at minimal or reasonable expense or effort. In states that do not have any case law regarding mitigation of damages in the force majeure context, courts generally hold parties to the same general standard of mitigation used in breach of contract cases.

In addition to specifying whether there is a requirement to mitigate under the terms of the contract, parties also may expressly state that partial performance may (or may not) be excused. Courts may consider partial performance, if practical or reasonable, to be an attempt to comply with the common law duty to mitigate damages.

Commercial Impracticability

Overview

If a contract is silent on force majeure or if the event does not meet the definition of force majeure under the parties' contract, a party's performance may still be excused in certain circumstances under the doctrine of commercial impracticability. That doctrine is applied if there is an unanticipated circumstance that has made the performance of the contract vitally different from what should reasonably have been within the contemplation of the parties when the contract was executed. The rationale for the impracticability defense is that the circumstance causing the breach has rendered performance so critically different from what was anticipated, that the contract cannot be reasonably thought to govern the scenario. Impracticability functions as a gap filler, and therefore does not alter the allocation of risk already existing in a contract.

Impracticability is a common law doctrine. In some states, the doctrine is impossibility, rather than impracticability, with impossibility being a higher standard that requires the obligation be impossible to perform, as opposed to only impracticable.

In states that have adopted Article 2 of the Uniform Commercial Code (UCC) to govern contracts for the sale of goods, the doctrine of impracticability has been codified as UCC § 2-615.[2] That section provides that

performance of the contract's obligations may be excused if it is made impracticable either (1) "by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made" or (2) "by compliance in good faith with any applicable foreign or domestic governmental regulation or order, whether or not it later proves to be invalid."[3]

Four Part Test Under The UCC

In determining whether an event renders performance under the contract to be "commercially impracticable" under UCC §2-615, courts employ a four part test, which requires a showing that there was:

1. An unanticipated circumstance.
2. That the circumstance was not foreseeable.
3. The non-performing party did not contribute to the circumstance
4. The non-performing party tried all practical alternatives

The test for whether the event was foreseeable involves consideration of whether the risk of the circumstance, event, or contingency was unusual or unforeseen, and the result so severe that performance would grant the other party an advantage not bargained for in the contract. If a contingency is foreseeable, commercial impracticability is not applicable since the parties may have contemplated the contingency's occurrence in the contract.

Seasonable Notice and Reasonable Allocation Under the UCC

A non-performing party must seasonably notify the other party of delay or non-delivery.[4] If the cause of impracticability only partly impairs a supplier's ability to deliver goods, then the party must allocate production and deliveries among customers and

2 Louisiana is the only state that has not adopted Article 2 of the Uniform Commercial Code. Uniform Laws Annotated (Ed. Note 2021).

3 UCC § 2-615(1)

4 Id. § 2-615(3)

seasonably notify such customers of the estimated quota made available to the customer.[5] In allocating production and deliveries, the non-performing party may include regular customers not then under contract and the party's own requirements for further manufacture, so long as the allocation is fair and reasonable.

Frustration of Purpose

Overview

The legal theory of frustration of purpose excuses performance when the cessation or nonexistence of some particular condition or state of things has rendered performance impossible and the object of the contract frustrated. This theory comes into play when, based on the contract and surrounding context, the parties obviously assumed a particular condition or state of circumstances would continue to exist. If that condition or state ceases to exist, a court may find that the entire purpose of the contract is frustrated.

Unlike force majeure and impracticability, which focus on the ability of the obligor to perform, frustration of purpose focuses primarily on the obligee's ability to enjoy the benefits of the bargain. A simple example illustrates the difference. Sallie contracts with a swim coach to help her prepare for the Olympics. After executing the contract but before the coaching begins, Sallie gets in a car accident and is left quadriplegic. The swim coach may still stand ready to coach Sallie, but Sallie's purpose for entering the contract has been frustrated.

5 Id. § 2-615(2)

Restatement (Second) of Contracts

The Restatement (Second) of Contracts § 265 provides that frustration of purpose may excuse performance when, so long as the language or circumstances do not indicate the contrary: (1) a party's principal purpose is substantially frustrated; (2) such party is not at fault; and (3) the contract was made on the basic assumption that the cause of the frustration would not occur.

Two Part Test

The doctrine is generally given a narrow construction to be applied sparingly. Further, courts apply a "rigorous" two-part test. It must be shown that (1) the frustrating event was not reasonably foreseeable; and (2) the value of performance has been totally or nearly totally destroyed by the frustrating event.

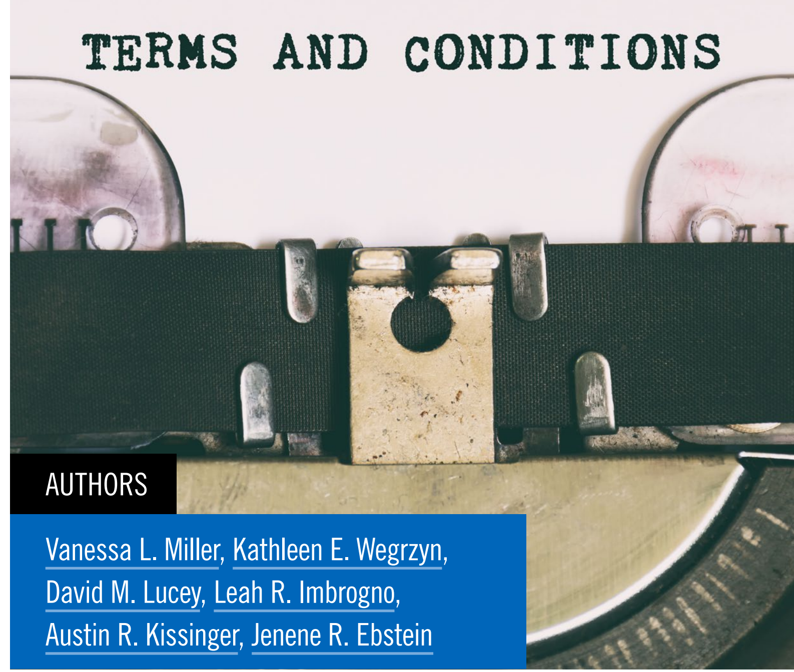
Conclusion

When navigating supply chain disruptions and uncertainties, companies should understand the legal defenses available to excuse performance. Companies can allocate certain risks through express force majeure provisions in their contracts. In the absence of such bargained-for provisions, additional defenses to performance such as commercial impracticability and frustration of purpose may arise under statute or common law.

Legal Theory	Source	Focus	What Events Trigger Excuse?
Force Majeure	Contract	Ability to perform	Listed events
Commercial Impracticability	Common law (services) UCC (goods)	Ability to perform	Unforeseen events
Frustration of Purpose	Common law	Value of performance	Unforeseen events

CHAPTER 10

Key Terms and Conditions for Buyers and Sellers in the Supply Chain



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Commercial forms – such as quotations, purchase orders and invoices – and associated terms and conditions are ubiquitous in the supply chain and often the only contract that exists between a buyer and seller. When used correctly, these forms operate as an efficient way of documenting the parties' understanding regarding their agreement, avoiding the need to negotiate a complicated contract. Often times, however, businesses treat these form sales documents too casually and do not properly consider the implications of the exchange of conflicting printed terms.

As the global economy continues to grapple with labor shortages, supply chain disruptions, and elevated prices, it is more important than ever for businesses to think carefully about their quotations and terms and conditions of sale (for sellers) and purchase orders or terms and conditions of purchase (for buyers). Well-crafted terms help both sides manage risk and avoid unnecessary costs. This chapter provides an overview of some of the key terms buyers and sellers should include in their sales documents to protect their interests.

Key Terms for Buyers in the Supply Chain

Buyers look to their suppliers to be dependable and deliver as promised. Sound contract terms are necessary to protect buyers when problems arise.

1. Disclaim Seller's Terms

One common pitfall a buyer faces is failing to disclaim its seller's terms and conditions. When, as is commonly the case, a buyer and seller both attach their respective standard terms and conditions to purchase orders, invoices and confirmations, ambiguity can arise as to which party's terms apply. In a sale of goods transaction, the Uniform Commercial Code's ("UCC") "battle of the forms" rules will apply and determine the provisions that make up the agreement. A buyer can improve its chances of winning the battle of the forms with two key steps. First, the buyer should expressly disclaim the seller's terms and conditions in its purchase order terms. Second, the buyer should include a statement that the seller accepts the buyer's terms by acknowledging and fulfilling the order.

2. Explicitly State That Time is of the Essence

In todays' difficult supply chain environment, the ability to rely on stable and timely delivery is imperative for a buyer. A buyer in a time-sensitive industry should specify that both time and quantity are "of the essence." A "time is of the essence" clause should indicate it is the seller's responsibility to ensure both time and quantity terms are met using any means necessary (e.g., expedited freight, inventory banks, etc.) in order to ensure the delivery date and required volumes are met. In a sale of goods contract, time is commonly deemed to be "of the essence" regardless of whether the contract says so or not. However, not including a "time is of the essence" clause may provide the seller the opportunity to justify its late delivery or argue that it is not a material breach.

3. Lock-In Your Price or Allow for Price Decreases In the Future

Price is a central term of most contracts and often a negotiation point for both the buyer and the seller. Given today's inflationary environment, a buyer should make sure that prices will remain stable and fixed where possible. Clearly defined pricing minimizes

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uncertainty and allows for more accurate budgeting. A buyer should include language in its purchase order specifying a fixed price, and should also note that the price locks on issuance of the order.

4. Be Clear About What the Price Includes

In order to guard against hidden costs and disputes over what exactly is the amount owed under a given order, a buyer's purchase order should also make clear whether other associated costs are included in the overall price or are additions to the listed price. A buyer should include a term that explicitly states that the purchase price includes all costs associated with the goods, including those for shipping, delivery and expedited freight. Unless a different arrangement is desired, a buyer also should explicitly state that the freight price includes all taxes, tariffs, import duties and any other costs. This language will help guard against a seller adding fees or charging for ancillary costs not anticipated by the buyer.

5. Include Setoff Language

A setoff provision allows a buyer to withhold payments from the seller in the event of a dispute regarding the agreement. If an issue arises, such as a seller's late delivery or a delivery of damaged goods, this kind of language gives the buyer the flexibility to withhold the amounts that are otherwise owed to the seller for a previous order from payments for a later one. Purchase orders can provide this flexibility by including a setoff clause, which should specify that the seller must continue to perform on subsequent orders while the buyer withholds payments for another due to a bona fide dispute. This will not only save the buyer money, it will ensure that the buyer continues to receive its orders, and it will provide the buyer with bargaining power when resolving the disagreement with the seller.

6. Narrowly Tailor the Force Majeure Provision

Force majeure provisions typically benefit the seller, which is the party responsible for delivering goods or services. As recent events have shown, the ability to weather unexpected supply chain interruptions is crucial for companies both large and small. When unexpected events happen, such as natural disasters, labor or supply interruptions or pandemics, the parties to a contract look for a force majeure provision that may excuse their inability to perform to the terms of the contract. Depending on the particular language, the force majeure provision may excuse delays or performance all together.

A buyer can craft force majeure provisions to its advantage and protection. By ensuring that the provision is explicit as to the events that trigger excused performance or delay, a buyer can limit a seller's ability to use catchall language to excuse its responsibility for a risk not explicitly covered in the provision. The buyer should also seek to exclude from force majeure coverage events for which the seller should ordinarily bear the risk, such as labor or material shortages. Doing so will minimize the possibility that a seller will make a force majeure claim for an event that should not, in the buyer's opinion, excuse performance.

For more on force majeure as a defense to nonperformance see our ninth chapter in this Guide, Three Key Defenses to Contractual Performance: Force Majeure, Commercial Impracticability, and Frustration of Purpose, on page 40.

7. Include Strong Warranty Protections

Including strong warranties consistent with the division of responsibility between the parties will provide a buyer with recourse in the event that an issue arises with a given order. At a minimum, a buyer should have the seller warrant that its goods are free from defects, meet buyer's specifications, are merchantable, and are fit for their intended purpose. For a buyer that provides a warranty on goods it resells to its own customers, strong warranty provisions in contracts with its suppliers can enable the buyer to pass along warranty costs incurred from customers' warranty claims.

8. Make Sure You Are Fully Covered

To help protect against a breach of warranty by a seller, a buyer should provide for available remedies in its terms. A common remedy for a breach of warranty is for a seller to repair or replace the goods or, at buyer's sole option, offer a refund for the price of the goods. In addition to this remedy provision, a buyer should include an indemnity provision that requires the seller to reimburse the buyer for any costs flowing from a breach of the warranties by the seller.

A buyer should also ensure that the contract does not prevent the buyer from recovering damages in the event of a breach by the seller. Such a recovery

is especially relevant in the current economic environment due to the numerous potential issues that can result from material and labor shortages. If the seller is unable to deliver and the buyer experiences losses as a result, being able to have a claim against the seller can help ensure that the buyer does not bear the brunt of the seller's non-performance.

More often than not, the seller's terms and conditions will exclude recovery of consequential damages—damages that are not directly caused by a given breach, such as lost profits, third party claims, or interest. For a buyer, because its sole obligation is to purchase and pay, the risk of being at fault is lower than for the seller who is responsible for the majority of the obligations. For this reason, a buyer should avoid agreeing to terms that limit the parties' recoverable damages when possible, even though a mutual damages disclaimer may appear to be a fair approach. If consequential damages are excluded, a buyer may not be able to cover all obligations to its own customers that arose because of a seller's breach. In the event that a buyer cannot avoid an exclusion of consequential damages, the buyer should seek carve-outs for any indemnification obligations, and if possible, for losses arising from the seller's intentional or grossly negligent acts.

9. Give Yourself an Out

A buyer should include strong cancelation terms that allow it to cancel an order for convenience at any time prior to delivery, or permit the buyer to cancel an order at any time if the seller materially breaches the agreement. A buyer should expressly limit its liability in the event of cancelation to the out of pocket costs of the seller. By including cancelation terms, the buyer has an out in the event the relationship with the seller does not go as planned.

Key Terms for Sellers in the Supply Chain

As is likely expected, a seller will look to provide for the inverse of the terms listed above when crafting its terms and conditions of sale. A seller should keep in mind several specific terms before accepting a buyer's purchase orders and when creating its own terms of sale.

1. Reject Buyer's Terms and Conditions

In many situations it is in the seller's best interest to reject the buyer's terms accompanying a purchase order and to dictate that the seller's terms apply to the transaction. In order to accomplish this goal, a seller should include language in its terms of sale expressly conditioning acceptance of such terms by the buyer. Doing so will make clear that the seller does not accept the buyer's properly submitted purchase order terms, and that the seller's form is the new offer. The seller's terms should also state that its terms prevail over the buyer's terms, and that performance by the seller does not constitute acceptance of the buyer's terms or any modification to the seller's terms.

2. Incorporate Price Flexibility

While a buyer will want to lock-in prices to the extent possible, a seller will want to incorporate flexibility into pricing provisions in case input costs increase. Such language not only prevents a seller from being locked into a possibly detrimental sale price, but also can give the seller the flexibility to increase prices when confronted with increased labor and material costs. Price flexibility can be achieved in various ways, such as building in an automatic index-based price adjustment mechanism, shortening the term that prices remain in effect, and providing for other periodic price increases. To find additional information and detail on these mechanisms, see our first chapter in this Guide Inflation Woes: Four Key Ways for Companies to Address Inflation in the Supply Chain, on page 4.

3. Disclaim Warranties

The warranties that sellers grant to their customers differ not only from one company to another, but also based on the product that is being sold. Under the UCC, a buyer can rely on implied warranties unless the seller includes a conspicuous disclaimer in the contract, and that disclaimer is provided to the buyer before the purchase of the goods. Having a conspicuous warranty disclaimer (commonly in all capital letters and bold font), prevents a buyer from claiming a given warranty disclaimer does not apply and, therefore, assists a seller in limiting its exposure to potential warranty claims. Given the high costs that can be imposed as a result of breaches of warranties, an appropriate disclaimer can greatly assist a seller in managing costs. When crafting these disclaimers, however, it is important to keep in mind that a seller's ability to disclaim warranties differs for sales to consumers and sales to other merchants.

4. Include a Broad *Force Majeure* Provision

In today's environment of frequent supply chain disruptions, force majeure provisions are more important than ever. While a buyer will desire to narrowly tailor a force majeure provision, a seller will typically want to have a broad force majeure clause which allows its performance to be excused in a variety of circumstances beyond its control. A seller will want to ensure that there is a "catch all" provision that does not limit the force majeure events to only those listed. Catch all language will help ensure that when unexpected events prevent a seller from performing timely under an agreement (or from performing at all), the seller will not be liable for damages. Selling parties should think carefully about what material risks their businesses face, and include these items in a broad force majeure clause.

5. Limit Your Liability

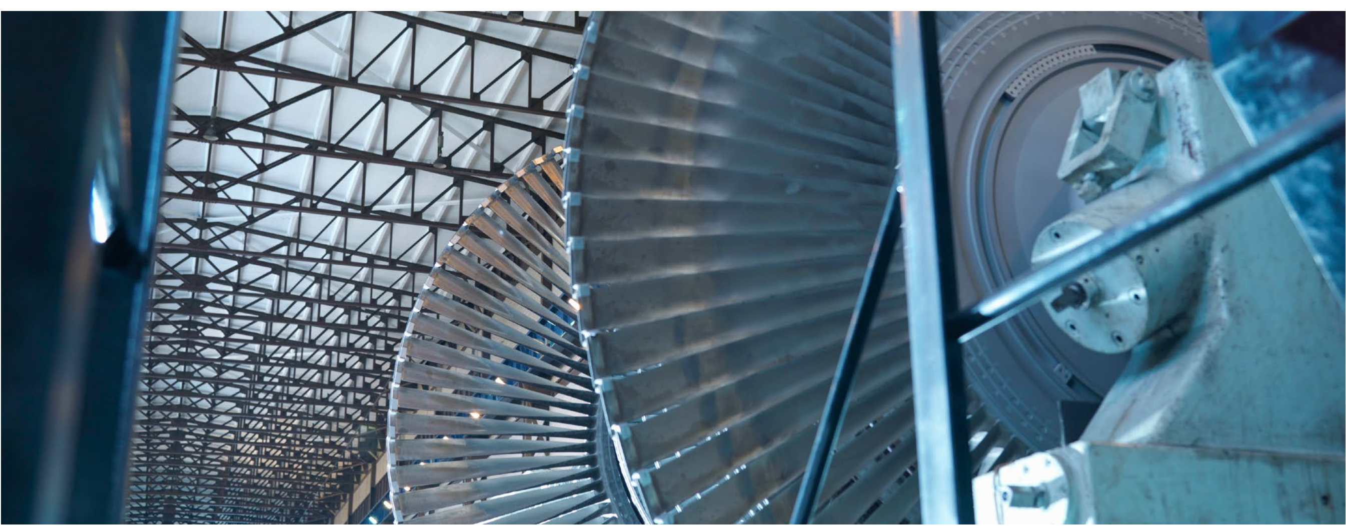
A limitation of liability clause is very important for a seller. In a supply contract, a common provision will expressly exclude consequential, indirect, incidental and/or special damages, and it will often put a cap on the amount of damages the seller (and sometimes the buyer as well) can be required to pay. For a seller of goods, this provision is key in assessing and limiting potential risk exposure. If circumstances arise in which a seller is unable to perform, avoiding paying a buyer consequential damages can make a significant difference in the amount of damages the seller will be responsible to pay. For these reasons, a seller should include a provision to limit liability for damages for as many potential claims as possible.

6. Be Clear About Title and Risk of Loss

The timing of transferring title and risk of loss from the seller to the buyer will vary greatly from purchase to purchase. However, defining when this shift occurs is important because it limits future disputes regarding who is liable if something happens to the goods while in transit. Being clear about the shift in ownership and risk of loss can also help a seller manage costs and avoid unexpected expenses in delivering its product. Today, most businesses look to the "Incoterms" that describe exactly when title and risk of loss transfers from a seller to buyer. Incorporating one of these standard terms can provided clarity for a seller and its buyers and avoid disputes in the future.

Conclusion

While managing interruptions in supply chains, labor shortages, price increases and economic uncertainty, buyers and sellers alike should revisit their sales documents to ensure those documents contain strong terms protecting their respective interests. A thorough review and revision of terms will help to manage risk and keep costs down. Contact the authors of this chapter for more information about how Foley & Lardner can assist your company in this review.



CHAPTER 11

The SEC Focuses on Supply Chain Disruptions: COVID, Russia-Ukraine Conflict and More

Originally published in Manufacturing Industry Advisor on Foley.com

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As public companies across the economic spectrum strive to overcome the supply chain disruptions drastically affecting revenue and profitability, they must not lose sight of how these disruptions impact their disclosure obligations under federal securities laws. The Securities and Exchange Commission (SEC) has demonstrated particular interest in this topic by issuing broad guidelines in recent years designed to encourage transparency with respect to how current events are impacting a company's supply chain, and what that might mean for the business. Given the SEC's focus on supply chain related disclosures, it is important to ensure your company is doing more than simply warning about the potential for supply chain disruptions, if such disruptions in fact presently exist.

This chapter discusses the SEC disclosure guidance on (1) the COVID-19 pandemic and related disruptions, (2) the Russia-Ukraine conflict, and (3) climate-related risks, and provides key takeaways for companies seeking to ensure their disclosures are accurate and compliant. This guidance is only the beginning, however, as the supply chain challenges resulting from any of these events may continue and evolve, requiring that companies redouble their efforts to provide accurate public disclosures to avoid potentially disruptive and costly SEC scrutiny.

The COVID-19 Pandemic and Related Supply Chain Shortages

Companies around the world are still feeling the impacts of the COVID-19 pandemic. When the pandemic began in March 2020, the SEC's Division of Corporation Finance (CorpFin) released guidance regarding risk factors on which companies should particularly focus, and what additional disclosures may be required in light of COVID-19.[1] In this guidance, CorpFin outlines a series of questions companies should consider when determining when it is appropriate or necessary to disclose a COVID-19 related risk. One of the questions relates directly to supply chain challenges:

Do you anticipate a material adverse impact of COVID-19 on your supply chain or the methods used to distribute your products or services?[2]

Since this guidance was first published, nearly every public company has identified risk factors concerning COVID-19 and related uncertainty with respect to potential impact on operations. Although COVID-19 shutdowns and spending shifts generated much of the supply chain disruption companies identified, shortages of many component parts have taken on a life of their own. Nowhere is this more apparent than with semiconductors. Many companies have been hit hard by the semiconductor shortage and blamed their unexpectedly weak quarterly results in late 2021 and 2022 on these shortages. Even as the U.S. manufacturing community has largely moved on from COVID-19, many of the key suppliers to U.S. manufacturers are located in countries, including China, that continue to be dramatically impacted by COVID-19. For more information regarding how China's COVID-19 policy is affecting manufacturers, see our

1 U.S. Securities and Exchange Commission, Coronavirus (COVID-19) CF Disclosure Guidance (March 25, 2020).

2 Id.

fourth chapter in this Guide, Managing Supply Chain Disruption in an Era of Geopolitical Risk, on page 20.

In light of these events, companies must continue to ask: (1) is COVID-19 impacting our business, including our supply chains relating to semiconductors or other components?; and (2) do changing circumstances in countries such as China require changes to disclosures which were made early in the pandemic? Companies should be asking these questions because the CorpFin, specifically its Office of Manufacturing, is already asking them.

A review of numerous CorpFin comment letters demonstrates that CorpFin's focus is on disclosures regarding COVID and semiconductor supply chain issues. One theme is clear, it is not enough to merely identify "risk factors" under Item 105 of Regulation S-K (the SEC's rule that requires, if appropriate, that public companies state why investment in their securities might be speculative or risky).[3] SEC reviewers are asking directly whether public companies are being impacted by supply chain issues and citing semiconductor shortages as an example of such issues. The SEC reviewers also want to know if supply chain risks previously characterized as "potential" or "hypothetical" have in fact become "actual" impacts on the operations of public companies.

3 17 C.F.R. § 229.105.

The same is true with respect to obligations of public companies in Management's Discussion & Analysis (MD&A) under Item 303(b)(2)(ii) of Regulation S-K. This item requires a public company to disclose on a quarterly basis any "known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[4] Item 303 has long been a point of emphasis for the SEC in its efforts to encourage public companies to provide "a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management."[5] Although SEC enforcement actions are rarely brought solely under Item 303, such claims are nonetheless important in assessing enforcement risk because they do not require a showing of materiality or intentional wrongdoing. In today's economic environment, SEC reviewers are asking whether supply chain disruptions have materially affected business goals, results of operations, and capital resources. Further, CorpFin is at times asking companies to quantify such impacts to the extent possible.

4 17 C.F.R. § 229.303(b)(2)(ii).

5 Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8350 and 34-48960.

Many manufacturers, particular those relying on semiconductors, including but not limited to automobile manufacturers, have seen financial results suffer in recent quarters due to an inability to obtain semiconductors and other key components to fill orders. Unsurprisingly, numerous securities class action lawsuits have been filed, claiming that the companies were aware of significant supply chain problems or weaknesses, but failed to disclose them to the public.[6] The SEC's Division of Enforcement undoubtedly is investigating similar disclosures regarding supply chain issues.

Impacts of The Russia-Ukraine Conflict on the Supply Chain

In another widely publicized notice, the SEC has directed companies to evaluate their disclosures in light of Russia's invasion of Ukraine. On May 2, 2022, CorpFin released a sample comment letter providing guidance on public reporting companies' potential disclosure obligations. This guidance provided a variety of direct or indirect impacts the conflict might have on companies with operations or business ties to Russia, Ukraine, or Belarus. As related to supply chain disruptions, the SEC expressed its view that companies should provide detailed information concerning:

- The "direct or indirect reliance on goods or services sourced in Russia or Ukraine or, in some cases, in countries supportive of Russia."[7]
- The "actual or potential disruptions in the company's supply chain."[8]

As the Russia-Ukraine conflict continues, companies with substantial operations outside of the United States and have referenced the Russia-Ukraine conflict in their filings have been asked by the SEC for more information. CorpFin has sought information in comment letters related to disclosures impacted by the Russia-Ukraine conflict, and has specifically requested information regarding "known trends or uncertainties" that have had or are reasonably likely to have a material impact on liquidity, financial position, or results of operations. As a result, issuers should pay close attention to the SEC's guidelines and reflect any elevated risks or changes in its disclosures that are appropriate in light of the ongoing Russia-Ukraine conflict.

Climate-Related Risks to the Supply Chain

Another ongoing, and extremely controversial, area of interest for the SEC is climate-related disclosures. On March 21, 2022, the SEC released a proposed rule to standardize climate-related disclosures and add additional requirements to provide more information about climate-related risks.[9] The rule broadly proposes disclosures regarding both actual and potential negative climate-related impacts on companies' supply chains. It proposes disclosure requirements related to both "upstream" (the initial production activities) and "downstream" (the delivery of the product or service) activities of a company's operations. These requirements call upon companies to look at the present and future risks of not just their direct operations, but the operations of other entities that may contribute to their production or delivery of products or services.

Although the proposed rule has faced fierce criticism from multiple constituencies in industry, government and media and is far from adoption, the SEC nonetheless is issuing comment letters relating to disclosure (or lack of disclosure) regarding climate change and supply chain issues in particular. Relying in large part on 2010 guidance regarding disclosures concerning climate change,[10] CorpFin has inquired into weather-related events that have led to supply chain disruptions as well as climate-related regulatory changes that could impact operations through compliance burdens. Where companies have said in proposed filings that climate change impacts are not material, CorpFin is asking how this conclusion was reached.

6 LaCroix, Kevin, Supply Chain Disruption Leads to Securities Suit Against Mattress Manufacturer, The D&O Diary (December 15, 2021).

7 U.S. Securities and Exchange Commission, Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues (May 3, 2022).

8 Id.

9 U.S. Securities and Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors (Mar. 21, 2022).

10 U.S. Securities and Exchange Commission, Commission Guidance Regarding Disclosure Related to Climate Change (Feb. 8, 2010).

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With climate-related regulation in this country still in a formative state given the recent passage of the Inflation Reduction Act, it is difficult to predict with any certainty where such regulations will eventually land. Nonetheless, companies should start analyzing their climate-related risks with respect to their supply chains and their businesses more broadly.

Key Takeaways - Reassessing Supply Chain Disclosure Best Practices

Current events have caused the SEC to issue unprecedented guidance regarding what disclosures are expected concerning a variety of impacts, including regarding supply chains. Although investors logically know supply chains are vital and subject to risk, the SEC is calling for more discussion on whether the risks are becoming a reality. Now is the time to reassess best practices with respect to potential disclosure regarding supply chain challenges:

Review your company's methods for continuously monitoring current and potential future supply chain disruptions to have an accurate understanding of how current events are impacting your business. An effective review is often a cross-functional and global exercise.

Analyze

When considering the risks that may impact your company, carefully analyze the obvious risk factors concerning supply chain disruption, as well as others. The SEC has indicated other areas that may relate to supply change disruption, including higher operating costs and inflation, may result in additional risks requiring disclosure. Companies should think broadly about what might impact their particular industry and how current events affect other businesses in their supply chain. This is not a problem for mid-level management. Senior executives and, if applicable, disclosure committees should have supply chain issues on their "checklists" of items to consider for disclosure.

Disclose

Disclosing potential risks is not enough. The SEC wants to know if risks are materializing and impacting companies.

For further information regarding SEC disclosures and best practices, please contact the authors of this chapter to be connected with attorneys experienced in supply chain and SEC disclosure.

CHAPTER 12

Supply Chain Disruptions Necessitate Better Contracting Practices: Use of AI to Add Efficiency

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As we have covered in prior chapters within this Guide, with supply chain disruptions wreaking havoc on the ability of companies to get their goods and services to market, the terms of a company's commercial contracts have never been more important. In some cases, losses due to inefficient or ineffective contracting can add up to be a sizeable percentage of the contract's value. As such, getting the contract terms right is extremely important to a company's bottom line. This requires knowledgeable review and is an opportunity to utilize artificial intelligence to add efficiency

One issue, of course, is volume. Companies today can easily have hundreds or even thousands of supply contracts in place, with new agreements, amendments and renewals coming in nearly daily. Each agreement addresses a large number of critical issues, such as pricing structures, termination and renewal terms, delivery, warranties, indemnification, and limitations of liability, among others. Manual review and revision processes place a tremendous strain on the organization, from sourcing to sales, procurement to legal, and in-house and external counsel.

AI-Assisted Review Improves Efficiency and Negotiations

Businesses frequently receive contracts proposed by the other contracting party. Even if the company is able to use its own "paper," the agreements often come back from the other side heavily revised and marked-up. In both situations, the company must review the language and determine whether it is agreeable or needs modifying.

This is where AI-assisted contract review and analysis can help significantly by adding consistency, quality control, efficiency, structure, cost savings and collaboration to the process. AI-assisted contract review can quickly and efficiently identify the key contract issues that are important to the organization. As an example, Foley has launched *Foley Equipped*, an AI tool powered by ThoughtRiver, which provides that efficiency to our clients and includes playbook commentary, negotiating tips, fallback positions and example contract language.

AI Helps with the Contract Revision Process

Newer AI solutions with natural language processing (NLP) and machine learning (ML) capabilities are addressing this use case. Solutions with Microsoft Word plug-ins, like *Foley Equipped*, are particularly useful as they provide the AI results directly in the Word document that is under review. Solutions can also incorporate advice notes, playbook commentary, clause bank language and model template-based provisions.

On the other hand, the tools designed for bulk review of post-execution documents (as is often used in M&A due diligence) typically do not integrate directly with Microsoft Word, because this is not needed in the context of an M&A or other bulk legacy contract analysis.

Issues Lists Created Automatically

AI review tools can automatically create issues lists that can be used by the company to track open issues, the parties' positions, and proposed and agreed upon solutions. Appropriate versions of these lists can also be shared with the other party as a negotiating aid to get the deal done quickly and efficiently.

Machine Learning Adds Another "Eye"

As computers became faster and more powerful with the ability to store and analyze more information, computers have acquired the ability to "learn." For example, through both human training and machine learning, an AI application can learn to determine whether a contract deals with limitations of liability, even though there are numerous – almost countless – different ways to word a limitation of liability provision. AI technology does this by rapidly examining hundreds of example contracts with the assistance of human training by individuals "teaching" the system what to look for. With enough human training combined with complex algorithms, the AI application can then improve its results automatically over time (i.e., machine learning).

With no end to the supply chain crisis in sight, successful companies will find ways to contract smarter, quicker and more efficiently. AI-assisted contract review like *Foley Equipped* can provide a useful tool and helping hand with the contract review, revision and negotiation process to achieve these goals

CHAPTER 13

Case Law Update: Disputes Relating to Supply Chain Disruptions Hit the Courts

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I. Introduction

Over the last two years, the widespread shortages, stoppages, and other disruptions affecting much of the global supply chain have led manufacturers, suppliers, and buyers alike to examine their contract terms for an available excuse for nonperformance. Contract parties have focused in particular on any applicable force majeure clauses. When such provisions have been absent or inconclusive, the parties have turned to the doctrine of commercial impracticability and the legal theory of frustration of purpose.

Presumably, the use of these contractual and legal defenses has increased greatly since the start of the COVID-19 pandemic, but the list of known adjudicated cases is not long. Those that exist, which are reviewed in this chapter, exhibit a trend towards interpreting contracts strictly and granting limited relief under the impracticability and frustration of purpose doctrines—especially when the only harm alleged is increased cost. Disputes over these doctrines usually involve battles over injunctive relief—decrees that compel or restrict specific actions—as opposed to traditional monetary remedies.

II. Recent Cases

A. *BAE Indus., Inc. v. Agrati-Medina*

The trend toward interpreting force majeure clauses strictly and applying the impracticability and frustration of purpose doctrines conservatively is evident in *BAE Industries, Incorporated v. Agrati-Medina, LLC.*[1] The court in *BAE* granted a manufacturer's motion for a preliminary injunction prohibiting the defendant supplier from increasing the prices of specialty parts under a long-term fixed-price requirements contract. The defendant in that case, Agrati, agreed to supply BAE with all the rivets, bushings, pivots and other parts that BAE needed to manufacture and supply auto part components to Tier-1 customers. The Tier 1 customers, in turn, assembled car seats for original equipment manufacturers. However, from 2020 through 2022, the price of steel necessary for BAE's parts rose due in part to COVID-19 lockdowns, steel mill closings, U.S. border restrictions, and the war in Ukraine. As a result, Agrati demanded price increases for its parts, arguing that the spike in steel prices rendered the fixed-price requirements contract commercially impracticable. BAE Industries then filed suit and moved for injunctive relief to compel Agrati's compliance with the terms of the contract.

The court sided with BAE, concluding that an unprofitable contract and an increase in the cost of raw materials does not rise to the level of impracticability as a matter of law. Agrati argued the parties' force majeure provision encompassed cost increases. However, the governing contract expressly stated that cost changes would not give rise to a force majeure event. Accordingly, the Court granted BAE's motion and compelled Agrati to continue supplying parts as originally agreed.

1 No. 22-12134, 2022 WL 4372923 (E.D. Mich. Sept. 21, 2022).

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B. *Isuzu N. Am. Corp. v. Progressive Metal Mfg. Co.*

Similarly, in *Isuzu North America Corporation v. Progressive Metal Manufacturing Company*,[2] a federal district court granted a buyer's request to restrain a seller from raising prices and rejected the seller's force majeure argument based on a labor shortage. Defendant Progressive Metal Manufacturing Company agreed to manufacture component parts in quantities as needed to meet plaintiff Isuzu's yearly requirements. But in June 2021, Progressive sent Isuzu a notice of force majeure, contending that a labor shortage prevented it from producing the agreed-upon parts. Isuzu sued Progressive for breach of contract and sought a temporary restraining order requiring Progressive to continue manufacturing and shipping parts until Isuzu could find an alternative supplier.

During an early hearing, the court took issue with the fact that Progressive prioritized producing components for other customers with whom Progressive did not have similar force majeure agreements.[3] The Court found that Progressive could perform as originally agreed and ordered Progressive to continue producing parts under the parties' agreement but emphasized that the relief was temporary, lasting until the Court held a more extensive hearing on the plaintiff's request for a preliminary injunction.[4] The parties eventually stipulated to an injunction under which Progressive assisted with Izusu's transition to another supplier.[5]

C. *Drummond Coal Sales Inc. v. Kinder Morgan Operating LP*

The judiciary's trend toward enforcing contracts strictly is not limited to the automotive industry. In *Drummond Coal Sales Inc. v. Kinder Morgan Operating LP*,[6] the Eleventh Circuit affirmed a decision holding a coal supplier to its service agreement with a shipping terminal operator. With two years left in its contract, the plaintiff in that case, Drummond, stopped paying defendant Kinder Morgan for terminal services, claiming that recently enacted environmental regulations had dried up the coal market, relieving Drummond of its obligation to pay for those services. Drummond sought to be excused from its obligation to pay Kinder Morgan because the new regulations had allegedly (1) frustrated the purpose of the contract, (2) constituted a force majeure event, and (3) rendered Drummond's performance impossible.

The Court of Appeals adopted the magistrate judge's order, which rejected all three of Drummond's arguments. First, as to the frustration of purpose argument, the magistrate judge reasoned that Drummond merely lost money due to the regulations, which did not amount to a "virtually cataclysmic" event sufficient to frustrate the purpose of the contract. Second, the court declined to apply the impossibility doctrine after finding the regulatory changes were foreseeable. Finally, the court denied Drummond's request for relief under the force majeure clause, which identified government "interventions" or "other civil unrest" as grounds to terminate the contract. Due to the "civil unrest" language and references to blockades and embargoes in the force majeure clause, the court narrowly construed the provision to apply only to events involving civil unrest or military conflicts and not ordinary regulations such as this.

D. *CAI Rail, Inc. v. Badger Mining Corp.*

A federal court rejected similar arguments that pandemic-related market disruptions and financial distress rendered performance impracticable or frustrated the purpose of a rail car lease agreement. In *CAI Rail, Inc. v. Badger Mining Corp.*,[7] the defendant, Badger Mining Corp., leased hopper rail cars from plaintiff CAI Rail to transport sand used for hydraulic fracking. However, Badger fell behind on monthly payments, prompting CAI Rail to sue for breach and eventually move for summary judgment. Badger argued that CAI Rail's claim for breach was barred by the frustration of purpose and commercial impracticability doctrines because the COVID-19 pandemic, related travel restrictions, and reduced economic activity caused oil consumption to plummet and degraded Badger's financial position such that it could not continue to make monthly payments.

The court rejected both arguments for similar reasons. Regarding the frustration of purpose argument, the court emphasized that Badger could not identify a

2 No. 21-12358, ECF Nos. 18, 19 (E.D. Mich. Oct. 19, 2021).

3 *Id.*, ECF No. 19, PageID.354.

4 *Id.*, ECF No. 18.

5 *Id.*, ECF No. 29 (Nov. 16, 2021).

6 836 F. App'x 857 (11th Cir. 2021).

7 No. 20-4644, 2021 WL 705880 (S.D.N.Y. Feb. 22, 2021).

specific government order that precluded it from engaging in the business for which it leased the cars, and a mere economic downturn generally is not sufficient to frustrate the purpose of a contract. The court also rejected the commercial impracticability defense, raised on the same grounds, because (a) Badger was still using the cars; (b) Badger's consulting firm opined that Badger had a viable business but just needed to cut costs due to the economic conditions; and (c) Badger sent CAI Rail a proposal to restructure the lease documents, which would have significantly reduced the rent. The court therefore concluded that Badger could still perform its obligations, even if it suffered for it.

E. *Guilbert Tex, Inc. v. United States Fed. Grp. Consortium Syndicate*

Additionally, those seeking to excuse their contractual obligations under the impracticability doctrine must be sure that their agreements do not provide for alternative methods of performance. In *Guilbert Tex, Inc. v. United States Federal Group Consortium Syndicate*,[8] a federal district court rejected such a defense raised by a seller of N95 respirator masks because the agreement at issue expressly provided that the seller must refund any deposit received if the seller could not deliver masks. The plaintiff in that case sought to buy 3M N95 respirator masks from Datta Holdings, LLC and the United States Fed Group Consortium Syndicate (US Fed). US Fed represented itself as a DC-based trade consortium that only handled orders in the millions. But the buyer only needed about 135,000 masks.

Accordingly, the buyer agreed to purchase masks from US Fed through Datta Holdings, which purportedly bought masks from US Fed for smaller buyers, and submitted deposits for two different purchase agreements. The buyer never received any masks and sued the defendants for breach of contract. US Fed defaulted, and Datta argued that its performance was excused by the frustration of purpose and commercial impracticability doctrines due to "unexpected events or occurrences [that] totally prevented Datta Holdings from performing."[9]

The court rejected both arguments on summary judgment. As to the frustration of purpose argument, the court observed that Datta conflated the defense with commercial impracticability. The frustration of purpose doctrine did not apply to the facts at hand because, regardless of US Fed's performance, the buyer's deposit provided Datta with the same value for which it had bargained. The court then rejected Datta's impracticability argument for two reasons. First, the defendant presented no evidence that it attempted to find an alternative source of masks or that purchasing masks from another source would be prohibitively costly. Second, and more importantly, the agreement "provided for alternative performance: a refund of Plaintiff's [deposit]."[10] Because the purchase agreement made a refund an alternative (and in this case, feasible) form of performance, Datta could not contend that its performance was truly impracticable.

8 No. 20-11420, 2022 WL 1599867 (C.D. Cal. Apr. 22, 2022).

9 *Id.* at *6.

10 *Id.* at *8.

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F. *JVIS-USA, LLC v. NXP Semiconductors USA, Inc.*

Although succeeding under commercial impracticability, force majeure, and frustration of purpose arguments is an uphill battle, it is not impossible. This is particularly true where a party can show it physically cannot meet production demands, as opposed to proving only that it will suffer financially from cost increases. For example, a federal district court recently denied a buyer's request for temporary injunctive relief after concluding that compelling the seller's performance would be commercially impracticable. In *JVIS-USA, LLC v. NXP Semiconductors USA, Inc.*,[11] plaintiff JVIS-USA sought a temporary restraining order compelling the defendant suppliers to continue shipping semiconductors after it became clear the defendants were experiencing supply shortages and could not meet the contractual production volumes. In analyzing the "likelihood of success on the merits," as required for the entry of injunctive relief, the court noted an issue about whether the agreement contained a force majeure provision. The court did not resolve that issue, however, because it held that commercial impracticability provided a valid defense for the non-shipment, citing "unforeseen shutdowns" caused by factors including the upheaval of global supply chains due to the Covid-19 pandemic.[12] The Court therefore declined to compel the defendants to perform as agreed.

G. *Tufco L.P. v Reckitt Benckiser (ENA) B.V.*

Similarly, in *Tufco L.P. v Reckitt Benckiser (ENA) B.V.*,[13] a federal district court in Wisconsin denied a motion to dismiss a breach of contract claim upon finding that pandemic-related labor shortages could justify the plaintiff's failure to produce under a supply contract. In that case, plaintiff Tufco agreed to supply defendant Reckitt Benckiser with name-brand disinfectant wipes under a contract with fixed prices and minimum production quantities. However, in early 2021, Tufco experienced labor shortages caused by rising COVID-19 infections in Wisconsin (where the wipes were manufactured) and the extension of U.S. lockdown orders. As a result, Tufco warned Reckitt that it would not be able to produce the agreed volume of wipes and invoked the agreement's force majeure clause. Reckitt disputed the clause's application and, after negotiations broke down, terminated the agreement. In response, Tufco sued for breach of contract, contending that the termination was premature. The parties primarily disputed the applicability of the force majeure provision, which excused performance for reasonably unforeseeable events. Tufco argued that the pandemic-related labor shortages clearly constituted a force majeure event, while Reckitt argued that the shortages were sufficiently foreseeable to render the force majeure clause inapplicable.

The Court ultimately denied the motion to dismiss, concluding that the parties should engage in discovery before the court could rule on the issue. In doing so, the Court expressly found "nothing implausible about Tufco's allegation that it experienced 'significant and unforeseen labor shortages' as a result of an increase in COVID-19 infections and corresponding legislation."[14] The Court's ruling in *Tufco L.P. v Reckitt Benckiser* demonstrates that the force majeure and commercial impracticability doctrines are much more likely to gain traction where a party can show physical limitations in its ability to perform rather than simple — even debilitating — losses in profits.

III. Conclusion

Although manufacturers and suppliers can take comfort in having legal arguments at their disposal to justify a failure to meet supply obligations, suppliers should also be aware that courts are unlikely to grant such relief outside of applicable contract terms or extreme circumstances. Even during the height of the pandemic and the subsequent supply chain fallout, courts continue to interpret contracts strictly and narrowly. Accordingly, as the recent case law suggests, those seeking to excuse or alter their contractual performance should be prepared to point to precisely drafted and directly applicable force majeure provisions or demonstrate an urgent, pressing need based on truly unforeseeable circumstances.

11 No. 21-10801, ECF No. 24 (E.D. Mich. April 16, 2021).

12 *Id.* at PageID.699-700.

13 No. 21-C-1199, 2022 WL 13826130 (E.D. Wis. Oct. 21, 2022).

14 *Id.* at *4.

Conclusion

It is apparent the COVID 19 pandemic, material and labor shortages, freight delays, changes in the environment and the war in Ukraine have taken an unprecedented toll on supply chains across numerous industries. These challenges have tested the resiliency of not only the supply chain but also company processes as companies have sought to respond to the challenges and delays. While there have been signs of easing the supply chain bottleneck, it will take time to resolve the various disruptions. From anti-trust issues, to environmental challenges and contracting support, the industry teams at Foley & Larder strive to provide you with the tools to navigate these challenges.

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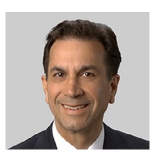

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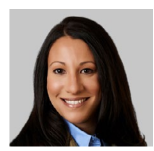

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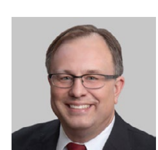

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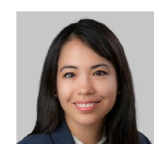

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