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Managing Contract Risk with Suppliers and Distributors

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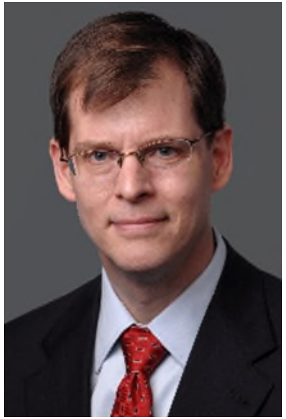

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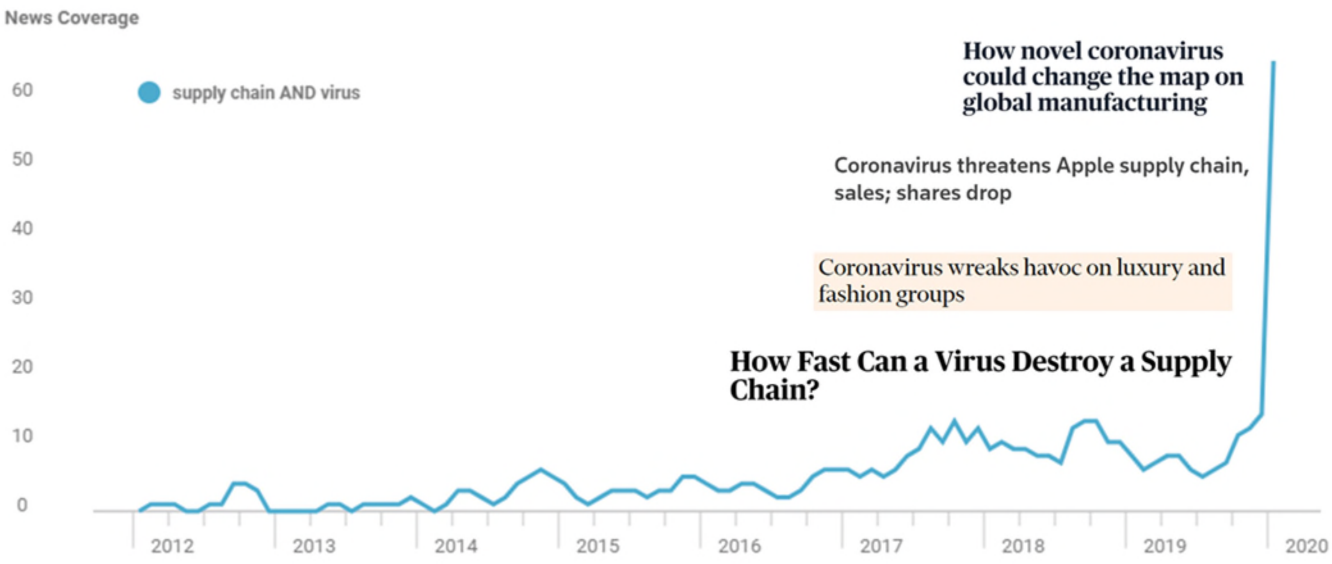
In 2020, Supply Chains Made News

Media discussion of **supply chain** and **virus** skyrockets



CBINSIGHTS

Sources: CB Insights, Bloomberg, Financial Times, Reuters, PBS

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Expect Further Supply Chain Disruptions

"**Since 2000, the value of intermediate goods traded globally has tripled to more than $10 trillion annually.** Businesses that successfully implemented a lean, global model of manufacturing achieved improvements in indicators such as inventory levels, on-time-in-full deliveries, and shorter lead times.

"However, these operating model choices sometimes led to unintended consequences .... Intricate production networks were designed for efficiency, cost, and proximity to markets but not necessarily for transparency or resilience. Now they are operating in a world where disruptions are regular occurrences. **Averaging across industries, companies can now expect supply chain disruptions lasting a month or longer to occur every 3.7 years**, and the most severe events take a major financial toll."

– *Risk, resilience, and rebalancing in global value chains,* McKinsey Global Institute, August 6, 2020

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Supply Chain & Distribution Lawyers Help Clients To:

1. Strengthen supplier and distributor relationships.
2. Manage risk of financially challenged suppliers and distributors.
3. Address potential and actual disputes.
4. Prepare for business continuity and disaster recovery.
5. Anticipate and address customs, tariffs, and other trade regulations.
6. Address compliance risks and advance CSR/ESG goals.
7. Optimize tax efficiency.
8. Protect IP rights.
9. Comply with antitrust and competition laws.
10. Leverage AI, platforms and other technology to innovate and adapt.

Topics for Today

Establishing high-value contracts for critical goods, services, data and technology

Leveraging intellectual property laws and collaborations to create stronger bonds

Managing disputes to achieve favorable outcomes while limiting damage to—or even improving—relationships

Making supply chain relationships more flexible, collaborative, agile, innovative and resilient

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Establishing high-value contracts for critical goods, services, data and technology

Key Supply Chain Value Drivers

- **Delivery** – on time, correct quantities
- **Quality** – as specified, without defects
- **Budget** – for a reasonably firm all-in price, without hidden costs
- **Innovation** – providing competitive advantage
- **Compliance** – meeting regulatory, legal and market expectations
- **Resilience** – continuing supply despite supply chain shocks
- **Relationship** – collaborative, agile, and productive

Contract Risk Management Provisions

- **Commitments** to provide specified goods, services, technology and data at firm prices allow planning and avoid the risk in spot-market purchases
- **Options** to flex, change or terminate allow adaptation to new circumstances
- **Incentives** to innovate both in improving performance and in preparing for shocks, going beyond the commitments and options
- **Alignment** on how to work together, including governance and information rights
- **Understanding** on where and how the supplier will provide the goods, services, technology or data

Three Supply Chain Contracting Methods

	LEGAL CONTRACTS	MANAGERIAL CONTRACTS	RELATIONAL CONTRACTS
WHO	Legal and Procurement	Technical. Operational and Compliance	Business and Supply Chain Management
WHY	Legally enforceable obligations with remedies	Efficiency, consistency, reliability, integration	Generating profit with changing people, costs, markets and other factors
HOW	Drafting, reviewing, and negotiating	Promulgating, auditing and inspecting	Update meetings, check-ins, escalations, and top-to-tops
WHAT	Agreements, amendments, change orders, formal legal notices	Policies, procedures, standards, technical requirements	Letters, email messages, meeting minutes, and reports

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Three Steps for Managing Contract Risk

STEP ONE
Assess Current Contracting

STEP TWO
Plan Contracting Approach

STEP THREE
Contract to Manage Risk

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Contracting to Manage Contract Risk
STEP ONE: ASSESS CURRENT CONTRACTING

- Understand your broader supply chain
- Align with the other teams
- Align on what the value drivers are and how contracts should mange risk
- Identify how contracts are documented and modified in practice
  - Are the contract documents fit for purpose?
  - Are the legal, managerial and relational contracts working effectively together?
  - What is the user experience for your contracts?
    - "**Principle 1: Build Innovations Around Experiences.** Experience can be defined as 'the act of living through events.' Although the term 'user experience' (or UX) has become associated with the software and information technology industries, user experience is a key factor in the success of any type of offering." *101 Design Methods: A Structured Approach for Driving Innovation in Your Organization*, V. Kumar, (J. Wiley & Sons, 2013).

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Contracting to Manage Contract Risk
STEP TWO: PLAN CONTRACTING PROGRAM

- Seek a budget for investing in innovation in contracting
  - If bad contracts reduce the value of $1b of spend by >5% or create a 10% risk of a $500m loss, it's worth $50 to solve that problem
- Clarify decision rights and supplier relationship management
- Reconsider standard provisions, *e.g.* for supply chain disruptions
  - Consider *force majeure* not as a boilerplate clause but as a discussion of the most efficient allocation of the obligation to address the problem
  - Create mechanisms and mandates for reviewing, reconsidering, renegotiating and reinvigorating the contract following a shock
- Design for the users

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Contracting to Manage Contract Risk

STEP THREE: CONTRACT TO MANAGE RISK

- Focus on the “five Ps” of business deal –
  - Product
  - Performance
  - Price
  - Place
  - Powers
- Design contract governance for a strong, well-funded team on both sides with executive support and effective personal networks
- Use the contract mechanism that is best for each type of contract risk
- Draft the formal legal terms to incorporate and support the full contract
- Make the entire agreement communicate effectively to the users

Leveraging intellectual property laws and collaborations to create stronger bonds

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Collaborations Can Mitigate Supply Chain Risk

- Companies increasingly rely on suppliers and distributors for critical innovations
  - Few companies can survive with a “not invented here” mindset today
  - Global commerce requires local insight
- Collaborative contracts allow the parties to leverage their joint insights and capabilities to address supply chain shocks and mitigate other risks
- Common contract structures include strategic alliances with distributors, joint development agreements with suppliers, and joint ventures with industry participants

Does a Collaboration Make Sense?

- The key threshold question should always be whether a collaboration is the right business solution.
- The goal is to generate greater commercial value than either of the two organizations could achieve independently.
- Collaborations are more likely to succeed when deployed in one of three scenarios:
  - **Market Expansion** – Capturing new market opportunities, e.g., geographic expansion, new distribution channels, new product development
  - **Investment Affordability** – Pooling investment funds to create value that each party could not afford, e.g., technology development, cost reduction / consolidation
  - **Risk Sharing / Portfolio Expansion** – Sharing risk and enabling each partner to make a portfolio of investments

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Before Contributing Intellectual Property

Clarify how the existing IP assets will be shared.

Agree on the value of the contributed IP assets and balance contributions.

Confirm that background IP remains the property of the contributing party to the exclusion of all others, including the other collaborators.

Plan to assess regularly the parties' respective responsibilities and royalties to adjust and maintain successful business collaboration.

Remember that JVs often operate like startup businesses, incorporating similar uncertainties and risks.

Key IP Considerations

- Allocation of responsibility for developing new IP rights. One party may have better infrastructure to support development activities.
- What is the scope of rights to be licensed? Is it limited by field of use? Territory or market for use of licensed IP?
- Who can exploit the newly developed IP outside of the scope of the collaboration?
- What about sublicenses? Distributors? Contract manufacturers?
- What controls are maintained by the licensor? With trademarks, a licensor clearly wants to protect the goodwill associated with the marks.
- Who is required to defend against third party claims of infringement?
- Who pays for registrations / maintenance?

Covertech Fabricating, Inc. v. TVM Building Products, Inc., |Case No. 15-CV-3893 (3d Cir. 2017)

- **Facts**: Manufacturer of protective packaging Covertech entered into verbal exclusive distribution agreements with distributor TVM for TVM to sell and market Covertech's products using unregistered trademarks. TVM, without informing Covertech, used the trademarks to sell non-Covertech products.
- **Holding**: Affirmed that Covertech is the rightful trademark owner, under McCarthy test rather than First Use test, and that TVM is liable for infringement.
- **Practice Tip**: In the absence of a contract, in a distributor-manufacturer context, there is a rebuttable presumption that the manufacturer is the rightful trademark owner. Whether the parties jointly developed and used the mark is only one factor.

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Avoiding Pitfalls in the Agreement

- Clearly define the ownership of contributed IP and joint IP, including post-termination rights.
- Clarify that the use of joint IP includes the right to use contributed IP of each party solely as embedded in or necessary to use the joint IP.
- Allocate joint IP among different fields of use or geographies, if appropriate.
- Specify whether parties are obligated to account to each other for profits from use of joint IP.
- Allocate to the contributing party the IP it created in the course of the collaboration that is ancillary to or separate from the central purpose of the collaboration and is derivative of its contributed IP ("derivative IP").

Default Joint IP Ownership Laws

- If involved in a patent litigation, most countries require all joint owners to join as plaintiffs or consent to the suit.
- Top patent filing jurisdictions are China, Japan, Korea, the US, France, Germany, and the UK; they are top global destinations or sources for collaboration and R&D activity.
- IP law is territorial, i.e., countries enact their own IP laws, and (absent certain limited treaty obligations) these IP laws have no application or force outside the applicable country.
- Without agreements between the parties, courts look to default laws to determine what constitutes joint IP and each party's rights related to that IP.

Managing disputes to achieve favorable outcomes while limiting damage to—or even improving—relationships

Managing Disputes in the Supply Chain

- Topics
  - Common areas of dispute in the supply chain
  - Dispute resolution options
  - Approaches to handling disputes
  - Tips for handling supply chain disputes

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Common Areas of Dispute in the Supply Chain

- Factors that make supply chains susceptible to disputes – before and during COVID:
  - Global and complex
  - Multiple "moving parts" – logistical and legal
  - Multiple parties and jurisdictions involved
  - Competing/changing regulatory environments
  - Cost and time pressure

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Common Areas of Dispute in the Supply Chain (Cont'd)

- Differences between technology and goods related disputes
- Common areas of dispute in technology contracts (but can also apply to goods):
  - Deal Structure is too one-sided. For instance:
    - Desire to "win the deal" on the part of the supplier, and/or customer pushes too hard on price, making the deal too marginal
    - Unrealistic Implementation timetable driven by commercial pressures
  - Unrealistic internal expectations as to the likely savings or profits from deal
  - Legal/scoping issues
    - Vagueness of scope or agreement to negotiate
    - Failure to allow for market developments in areas where technology can develop rapidly
    - Poor management of change control processes
    - Failure to address or resolve minor disputes at an early stage

Common Areas of Dispute in the Supply Chain (Cont'd)

- Common areas of dispute in goods related contracts (but can also apply to technology)
  - Product quality issues:
    - Can be difficult to identify fault/often will require expert input
    - Essential to have clear specifications in place throughout chain, and to retain samples/records from batches/deliveries for later analysis
    - Tension between regulatory obligations and contractual position
  - Uncertain/incomplete contracts
    - Work starting prior to contract completion
    - Exchanges of standard terms
    - Key points left "hanging"
    - Uncertainty as to which law/jurisdiction applies

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Common Areas of Dispute in the Supply Chain (Cont'd)

- Goods related contracts (cont'd)
  - Changing scope/price
    - Particular issue in long term agreements.
    - Also where contract involves volatile end markets or raw materials with volatile pricing profiles.
    - Contracts which are marginal for one or both parties can exacerbate this issue.
  - Inability to supply/late supply
    - Particularly topical in light of COVID but not a new issue
    - Serious weather events and political disturbances are not uncommon (e.g., Brexit)
    - Cyber attacks and other IT issues
    - Parties "stuck in the middle" of supply chains – pressure from both ends

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Dispute Resolution Options

TIERED GOVERNANCE PROVISIONS → EXPERT DETERMINATION → MEDIATION → LITIGATION/ ARBITRATION → COMBINED OR ISSUE SPECIFIC APPROACH → NEGOTIATION

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Approaches to Dispute Resolution

- When a dispute or disagreement arises:
  - Investigate the facts and understand the legal merits/options
  - Consider if there is a “plan B”, such as alternative supply arrangements
  - Define objectives and determine strategy
  - Commercial and legal teams should work closely together
- Use of dispute resolution mechanisms at an early stage and as a tool to achieve commercial objectives
- Using parallel tracks and informal escalations
- Complex governance provisions: do you have the resource/time to adhere to them?

Tips for Handling Supply Chain Disputes

No “one size fits all” approach

Business continuity is key: consider a short term “fix” with parties reserving rights, but document it properly and comply with any contractual notification requirements

Risks of ignoring disputes or allowing them to fester

Communicate – internally and externally

Consider what evidence needs to be retained/tested, particularly for product quality issues

Use dispute resolution mechanisms at an early stage and as a tool to achieve commercial objectives – and even enhance the relationship

Be conscious of taking inconsistent positions up and down the supply chain

In Summary

Supply chains are often complex and increasingly brittle as a result of external events

Higher likelihood of supply chain “shocks” and related financial impact

COVID has provided impetus for businesses to recognize the complications, challenges and impacts of existing supply chains

A holistic and collaborative approach to supply chains is likely to create value and “win-win” partnerships

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Questions?

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- We help clients on supply chain and distribution contracting, compliance and disputes across the globe
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- For more information, visit www.mayerbrown.com and search "Supply Chain"

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- We regularly advise clients on with digital transformation, including the use of emerging technologies such as artificial intelligence, robotic process automation, platform agreements, SaaS, big data and blockchain, among others.

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Chambers 2004-2020

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