Professional Perspective

Supply Chain Management and Pragmatic Contracting

Jonathan Todd, Benesch

Bloomberg Law

Supply Chain Management and Pragmatic Contracting

Contributed by Jonathan Todd, Benesch

Supply chain management of the near future will be nimble and effective, but above all else, it will be pragmatic. The Covid-19 pandemic unleashed upon the world a master class in global supply chain management. Professionals across all manufacturers, distributors, and retailers encountered textbook-style sales and operations planning challenges. They overcame once-hypothetical risks of supply interruption, wide demand variance, and even legal uncertainty by applying the best tactical solutions available at each moment in time. Along the way, as C suites and the media watched, rational risk mitigation and tactical execution prevailed over more lofty ideals.

Supply chain strategy remains a highly visible part of any company's value proposition, which will only grow in importance as the world learns hard lessons. This article examines the near future of supply chain management that is being forged from this difficult environment. It contextualizes the starting position for many supply chains, conceptualizes supply chain challenges in a meaningful way, and then identifies the thought process for drafting contracts in response to the newfound practical reality that may temper certain extreme market positions.

Pre-Pandemic Supply Chain Strategies

The character of global supply chains immediately prior to the Covid-19 pandemic was marked by great divergence in strategy. The prior decade saw technology-enabled disruption across nearly every market sector which, in response, fueled a desire to accept risk and implement new ideas across supply chains. This race toward new thinking yielded diverse and contradictory strategies, even within the same industries, during this fast-paced commercial period. The aggressive structural approaches that developed carried their own risks, which remain today.

A central theme of this strategic diversion was the dramatic oscillation between consolidation and deconsolidation across all functional areas. The causal basis for these structural decisions may have been strong, yet many supply chains responded to very similar challenges with precisely opposite visions. One explanation for this divergence trend is that real or implied risk assessments caused leaders to approach the period as one of opportunity with few perceived challenges other than the risk of unforeseen industry-level change in the form of disruption. Of course, the unforeseen macroeconomic risk came in the form of a virus that swiftly impacted all global supply chains across all industries.

Anecdotal evidence of aggressive divergence in supply chain strategy abounds:

Supply Base. So-called "partnering" relationships with single-source suppliers and providers were fashionable while others in the same market segments chose the opposite path of further fragmenting the supply base.

Inventory Diversity. Technology permitted the real or virtual management of a wide number of SKUs, through direct production or third party procurement, in the interest of maximizing customer share of wallet while item-level margin suffered. Conversely, many supply chains shuttered unprofitable items and shrunk inventory portfolios to a selection of fewer more profitable and higher demand items or suppliers.

Distribution Footprint. Decision-makers confronted the balance between overhead cost and the speed of throughput with varying results. Some were keen to consider the real-estate and other cost of their distribution networks with the ultimate determination that optimal throughput and cost containment could be achieved through fewer distribution centers. Still others, particularly in the consumer retail space, radically deconsolidated distribution networks with focus on the speed of throughput to the end user.

Core Competencies. The age-old decision of whether to insource or outsource an operational function, and its impact on core competencies, also saw great divergence in the decade. As an example, many leaders even within the same industry segments decided to bring transportation operations within their organizations while others decided to shed those operations, realizing gains on the sale and divestiture of capital assets followed by redeployment of assets in the core business.

This is the starting position from which all supply chains confronted the global pandemic. Just as classic supply chain management problems had been met with radically different approaches, in an instant it became necessary for those divergent approaches to perform. The combination of critical performance needs and a wildly heterogeneous strategic landscape drives a need for us to reconceptualize supply chain challenges of the near future.

Emerging Internal and External Challenges

One effect of the divergence trend is that each supply chain stands on its own, and must confront its own challenges, here as well as in the foreseeable future. There is no one-size-fits-all playbook. Nearly all supply chains suffered in 2020 and, for those on the ground, tactical excellence won each and every day. Absence of a universal supply chain playbook causes us to look inward for how we will, each and individually, set and implement future strategies.

The chief difficulty is our ability to set and socialize how supply chain strategy informs every other decision throughout the organization, and to execute on each of those underlying decisions with clarity of vision. Future risk assessments and the day-to-day work of all professionals that touch the supply chain will benefit from due accounting for those internal challenges that we can largely control and those external challenges to which we merely respond.

Simply put, there remains a need to carefully assess and mitigate the risks inherent in our own strategic plans particularly when those plans are increasingly extreme in their application. This exercise of recognizing unintended consequences, practical trade-offs, and similar negative effects has shown itself as now more important than ever.

Internal Challenges. The divergence trend is a perfect example of how internal challenges can arise by converting strategic plans into new tactical challenges. Aggressive decisions to single-source supply, expand inventory diversity, consolidate a distribution footprint, or in-source a non-core functionality may be well-reasoned but each has its own implications to consider. One must ask how these positions will be reflected in the company's contracts and other decisions that may, for one reason or another, need to be unwound.

External Challenges. The divergence trend also exemplifies how the effect of industry-wide external challenges may vary widely across an industry. Consider the few functional decision-points explored in this article: supply base, inventory diversity, distribution footprint, and playing to core competencies. As divergence drives companies to unitary positions on these decisions it also creates extremes in ability to respond to or defend against common external challenges.

For example, each is a position of strength or weakness when confronting: changing customer expectations for order initiation and product delivery, interest in social responsibility, continued trade pressures, consolidation of suppliers and providers, tightening of markets for supply and services, and increased insolvency among customers, suppliers, and providers.

Everyone tasked with managing enterprise risk is now, post-pandemic, in a position to think more critically about risk-based best practices than in the past. We must all own our risk playbooks when confronting challenges from diverse and often extreme positions. Those with responsibilities for contracts must therefore soberly assess the intended and unintended consequences of corporate strategic decisions from the perspective of internal and external challenges.

Contracting Best Practices

A number of best practices arise out of the disarray of the global pandemic and, in particular, the unique context from which enterprise entered that period. The juxtaposition of external uncertainty against strong internal positions requires availability of staging, pivot points, and contingency plans to avoid insurmountable structural obstacles. Stated differently, the internal and external challenges that emerge from a highly heterogeneous strategic landscape require mitigation that above all else permit the possibility of change in circumstance.

Supply and services contracts are a natural function upon which to apply those pragmatic learnings. The outset of the pandemic caused an immediate and intensive reading of company contracts, and assessment of relative certainty or available flexibility, like we had not seen since the Great Recession. The difference this time was an intense focus on contractual implications for key supply chain activities.

Parties asked whether force majeure could be invoked, if supply outside of specifications was permitted, if price adjustments were permitted, if volume adjustments were available, and both the means and consequence of termination. Six groupings of contractual considerations capture key considerations when building responsive mitigation techniques into third-party relationships: time horizon, cost variance, commitments, expectations, remedies, and termination effect.

Time Horizon. The present environment is requiring many to look for very short time horizons with relative ease of termination. For example, it is common in some markets for spot prices of goods and services to fluctuate so dramatically that neither side benefits from a long term commitment. A shorter time horizon permits pivoting to alternate counterparties, or alternate strategies altogether, should the need arise.

Cost Variance. Those on the buy-side of a contract will always seek visibility and near cost certainty, while those on the sell-side wish to be protected from unforeseen change. In response, it is increasingly common to state the precise assumption on which cost are based. It is also common to identify the range of circumstances which, if they were to occur, would impact cost and the magnitude of impact. These tools allow the parties to draft a clear roadmap for change so that disputes are minimized if those circumstances materialize.

Commitments. Volume commitments have been difficult to set with great certainty throughout the pandemic. One approach that has been useful in moving forward is to develop a clear cadence and substance for forecasting. Parties can at the very least work together to keep one another apprised of their production and purchasing capacity. If there is a high certainty of a particular volume, with diminished certainty of higher volumes, then tiered pricing and lead times are helpful to navigate possible variance.

Expectations. The use of highly negotiated service level agreements and key performance indicators had grown in favor even before the pandemic, and that trend has increased further. The underlying concept is that parties can agree on those performance metrics that are both achievable and measurable in order to effectively manage the relationship. Depending on relative bargaining power, or mutual interest in the outcomes of a deal, structures are available to allow for bonus and malus incentives where actual performance deviates from certain thresholds beyond an agreed baseline.

Remedies. Many found that they had little recourse for events resulting from the pandemic, in part due to waivers for consequential and incidental damages which had grown to be viewed as "only fair" by business teams. In response, there is increasing interest in effectively converting consequential damages to contractual damages by precisely addressing their possibility and remedy under the contract terms. This often takes the form of a liquidated damages provision.

Termination Effect. While termination is sometimes a useful remedy, the exercise of a termination right can be as disruptive as continuing in an underperforming business relationship. There is now increased focus in identifying the desired effect of termination and any termination assistance that a party, typically the non-breaching party, may enjoy to ensure maximum operational continuity as alternate suppliers and providers are identified.

These contractual approaches to supply chain risk are by no means new. What is new, and will continue in importance, is the need for level-headed contract drafting to suit not only the desired relationship but also the overall corporate supply chain strategy. We must ask ourselves what risks are inherent in the strategy itself, how those risks reflect internal and external challenges that may arise, and then draft for the possibility that the factual circumstance each party anticipates will not reflect the practical reality.

This level of contractual pragmatism is merely a more thoughtful recognition of strategy and how it may manifest in day-to-day tactic. In sum, this is an exercise in better serving internal clients by appreciating the growing extreme of unique risks that may not be contemplated by template agreements.