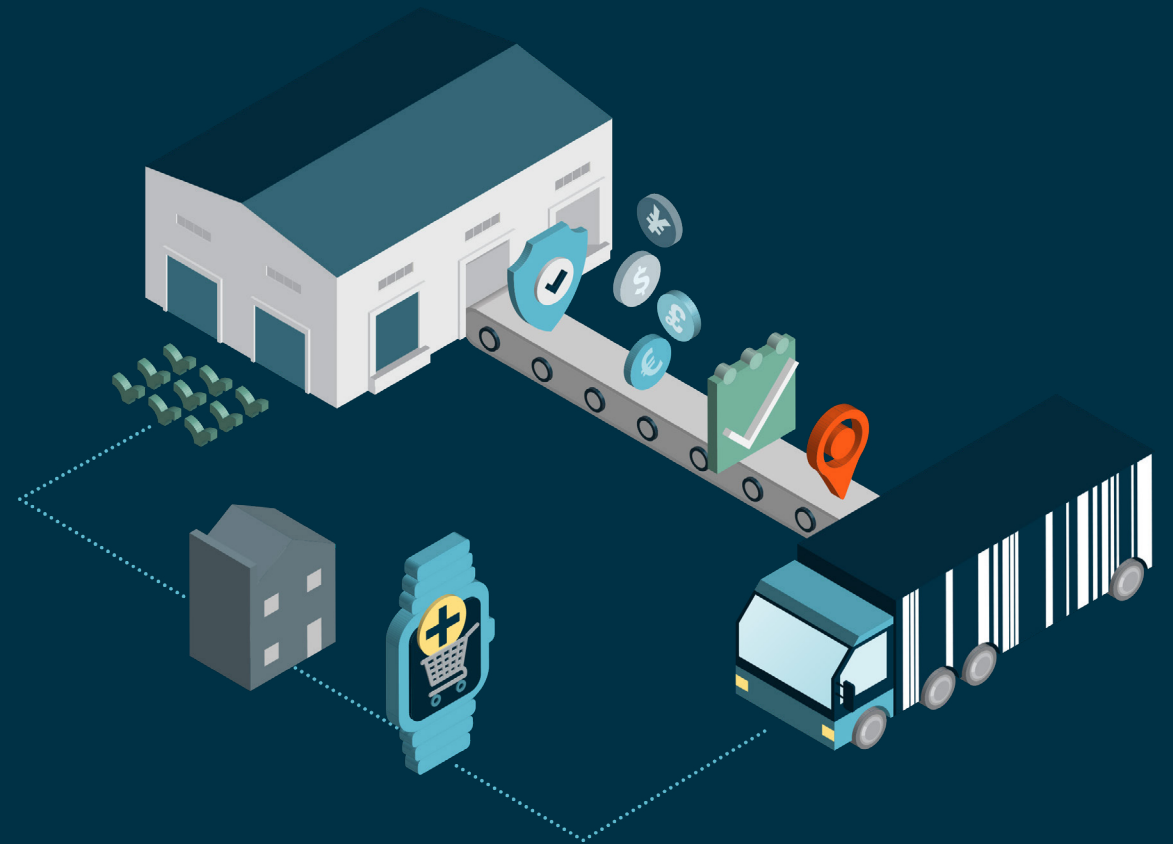


# Distressed Supply Chains

## Managing Risk



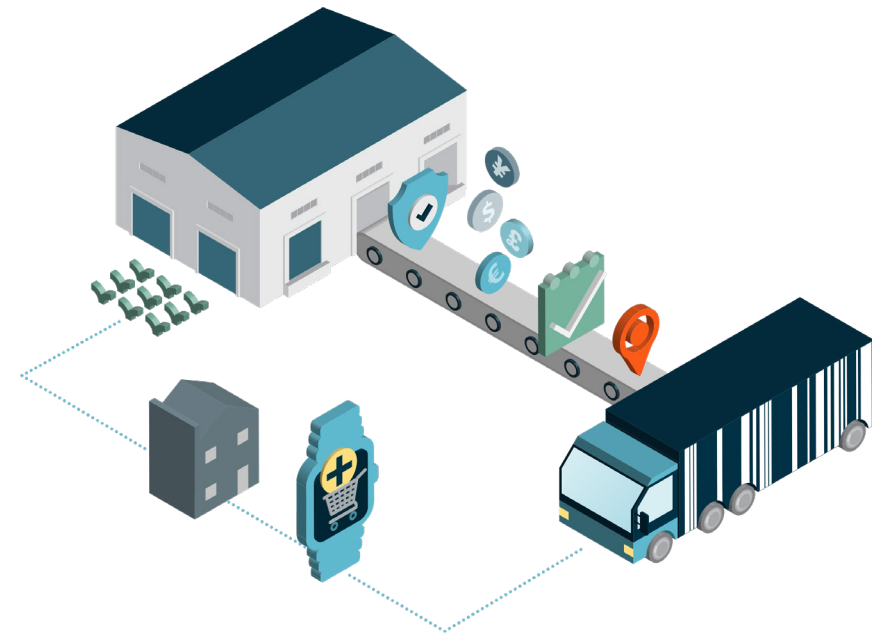
This note forms part of our wider supply chain offering which looks at short, medium and long term considerations for businesses.

## Introduction

Global supply chain challenges have increased the risk of financial and operational distress among suppliers. Financial instability or even insolvency among suppliers has dire consequences on production plans and also leads to increased costs. The same tensions also apply to suppliers of services.

This is leading customers to keep a very close eye on their supply chains and the financial health of suppliers. The financial weakness or failure of a critical supplier can place an enormous amount of pressure on a business and have significant impact on costs, revenue, reputation and sales.

Financial distress is supplemental to the new challenges such as extreme currency fluctuations, commodity movements and availability, modern slavery, bribery, cyber-attacks, ESG issues and significant regulatory reform.



## Due diligence and early warning signs

**All businesses are susceptible to risks in the supply chain and understanding a supplier's situation is critical. Heightened due diligence of supplier finances, supply chain and business continuity arrangements is recommended. The first step is to identify where the risk lies in the supply chain.**

Having your own risk assessment will help identify issues before they arise and to prepare a contingency plan. Considering the future risk means asking:

- Who are your key customers (as you need to think about the longer supply chain) and suppliers?
- If a key customer or supplier faces financial difficulty, how would you replace those revenues, source replacement products/services and how would this impact your profit margin?
- Would you need to take enforcement action? If so, how much would this cost and how quickly would it be resolved?
- Would such disruption cause you to breach other contractual arrangements? If so, what would the impact of these be on you and your wider supply chain?

Carrying out due diligence on your supply chain relationships at the outset is a key starting point. As supply chains become more complex it is increasingly important for businesses to build resiliency into their supply chain as part of their overall risk management strategy. From a legal point of view there are a number of things that can be done to increase resiliency.

Failure in the supply chain normally starts with a period of decline and it's important for close attention to be paid to potential early warning signs. These early warning signs may present themselves in a number of ways, but often there are common themes as illustrated in the next slide. Companies that maintain a high level of communication with their suppliers and customers are often best placed to spot problems and take preventative action. If issues do arise with a supplier action should be taken quickly.



## Due diligence and early warning signs

### 🔄 Change in supply

- Defective goods and/or services
- Missing deadlines and the use of expedited freight and notably less stock
- Limited visible activity or sudden unavailability of goods without reason
- Higher than normal warranty claims
- Withdrawal of credit insurance cover

### 🔄 Other warning signs

- Changes in debt or security structure
- Market rumour or speculation in the press or on social media
- Becoming more litigious
- Engagement of restructuring or financial advisors



### 🔄 Contractual and financial changes

- Requests for price adjustment and accelerated payment terms
- Erratic payments and changes in remittance processes and procedures
- New suppliers or contractors

### 🔄 Public filings

- Profit warnings
- Late public filings (e.g. audited accounts)
- Declining credit ratings and possible notices (e.g. CCJs)

### 🔄 Workforce

- Redundancies or significant employee layoffs
- Departure of key management/directors with evidence of low morale

## Review key contracts and consider amendments

**Assessing if the relationship is salvageable and if you want it to be can be the first step. This may depend on whether alternative suppliers can be sourced.**

If they cannot, a renegotiation or variation of the contract may prove to be the best long-term commercial solution. If so, check what your contract says about variations first and beware of inadvertently changing your contract by informal, unrecorded, discussions with the other side, especially if variations to the contract need to be made in writing.

Consider if you need to consult with other parties, such as other parties in the supply chain. If problems cannot be resolved easily with your supplier, you may wish to start extricating yourself from the contract. There will be a number of issues to consider, including the terms of the contract, and the need to prepare for a dispute. Checking the key contractual terms and exclusions is your starting point. You should check the liquidated damages clause, set-off provisions and force majeure situation but the crucial question will be around the ability to terminate.

Be careful not to get the termination wrong as your supplier can sue you for damages or choose to keep the contract going. If your contract talks about "material breach" the position will be nuanced. Ask yourself if the breaches are having a serious effect on the benefit you get under the contract and make sure that any notices are served correctly.

Be aware of inadvertently giving up your rights. To cut down the risk of rights being lost, make sure that you are not giving mixed messages or leading the other side to believe that you are willing to pardon breaches and non-performance. For example, termination normally means ending the whole contract.

It is suggested that you consult lawyers early and keep a paper trail, making notes of conversations with your supplier as soon as possible. Also start preserving relevant documents and suspending any automatic deletion programmes.

If all else fails, the method of resolving your dispute (if commercially viable) will be critical and this will be prescribed in your contract. Contracts often contain an escalation clause in the event of a dispute that may provide good faith attempts to settle. Understanding the options will be critical and assessing this in the context of the commercial position will be key.



# Put in place contingency plans

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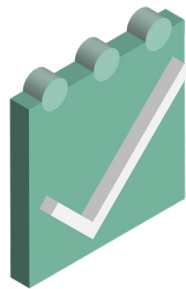
**Contingency planning can significantly reduce the shock of customer or supplier insolvency in your supply chain.**

## Pre-planning

Carrying out due diligence on your supply chain relationships at the outset is a key starting point for contingency planning.

Where possible, contingency planning measures will often include limiting your reliance on a particular supply chain partner, identifying alternative partners and therefore reducing your exposure to risk should a particular supplier or customer experience financial difficulties.

It is also sensible to consider contractual protections for when things go wrong. This could include requiring pre-payments or implementing credit limits, inserting protections in your supply contracts to prevent the transfer of title before payment, including obligations to provide up-to-date financial data and clearly setting out each party's obligations and remedies.



## Ongoing monitoring of your partners and their industry

Once you have conducted your contingency planning analysis, it is important to ensure that it is kept up-to-date. This should include ongoing monitoring of your key relationships, including:

- **Understanding your legal position** – termination, pricing, set-off, step-in, change of control provisions and title provisions are often key. Customers should consider whether the contractual terms can be amended or improved to limit exposure.
- **Considering options available to you** – these should include alternative suppliers, termination, increased pricing and funding. If alternative suppliers are viable, this is likely to be a central action point.
- **Engagement with suppliers** – a high level of communication with critical suppliers and customers should be maintained. This provides a useful opportunity to gather information and identify the likelihood of the distressed business entering a formal insolvency process. Understanding the issues and agreeing a way forward is critical. For instance, we sometimes see operational issues that can be resolved by collaborative working, especially where there is a complex supply chain where say funds are being trapped by another tier in the supply chain.
- **Funding** – accelerated payments, price changes and wider funding may be requested. If so, this needs to be considered with advisors and as part of the process. It is not uncommon for customers to seek contractual variations, more visibility and sometimes input into operational aspects of the supplier's business. Providing funding can sometimes be prudent and sometimes avoid an uncontrolled situation. With the rise in energy tariffs and rising material/labour costs this is becoming more common.

## Put in place contingency plans

- **Monitor financial information available through public filings (e.g. at Companies House), credit agencies and other monitoring services.** Key aspects to monitor include declining revenues, increasing liabilities, re-financing arrangements, changing management structures, financial support from a parent company and discrepancies in the financial data. Note the limitations of such data, such as how regularly it is updated or if it appears unreliable for any reason. If you have contractual rights to do so, seek management information and financial data as this can help to assess the position. Rumours and market gossip should be treated with caution, but they can be an indication of problems.
- **Data, IP and third parties** – consideration needs to be given to any dependencies linked to supply where data may be controlled by third parties or dependent on licences and/or IP rights. In addition, thought needs to be given to other third parties like warehouseman and logistics who may exercise liens or other rights.
- **Action if the supplier goes into insolvency** – advice should be sought urgently as this will be central to understanding the strategy of the process and the impact on the contract. Early engagement with the office holder is needed to understand their strategy and particularly if there is likely to be an early sale (perhaps a pre-packaged administration) and to understand whether there is an opportunity for continued trading post-administration. There will often be contact with key stakeholders and customers before or immediately after an insolvency practitioner is appointed.
- **Distressed M&A** – a typical outcome of administration is a sale of all or part of the business to a third party. Assessing the customer position will vary and checking the ownership of goods will be pivotal and if appropriate, how services will be maintained.

## Taking action early when spotting the warning signs

Once you have your contingency planning in place, and are regularly monitoring your customer and supplier relationships, it is key to take early action when you spot something of concern.

This may include where you notice changes or delays in your supplies, the quality of goods or services provided, or the frequency or method of payments. Market rumour or reputation issues over social media may also indicate issues, but should be treated with caution.

By taking immediate action to protect your business and other supply chain partners, this can mitigate the impact of an insolvency in the supply chain, and such steps may include:

- Closely monitoring payments and performance.
- Enforcing your contractual rights such as liens, set-off retention of title rights and making demand for overdue debt. The insolvency regimes of some jurisdictions contain restrictions on terminating contracts by reason of insolvency, although there may be other breaches that the customer could rely on (such as late delivery).
- Keeping in regular contact to discuss payment issues and/or unexpected delays and attempt to work through a way to resolve them.
- Implementing your contingency planning measures by working with alternative partners to avoid disruption to your own business.
- Make sure all relevant teams are informed of the issues and how they are to be resolved (particularly where your business has large departments or several teams).

## Don't forget about data, IP and services

**Whilst many of the considerations described apply to physical goods there will also be lots of situations where risks arise with suppliers of services.**

The risks connected with the distress of a supplier of services can be very disruptive. It is important to think of this broadly to include IT services, data services, cloud services and services in an infrastructure and project setting. Some of the issues can be acute, particularly if the service provision is specialist and sometimes where a continuity of service is vital.

Doing the same reviews with service providers is important and assessing alternatives may be challenging. In particular, migrating IT services can sometimes take time whilst there is huge reliance on them. There may be a greater focus on step in rights with service providers to infrastructure and projects with a possible requirement for enhanced payments or funding to ensure that continuity has been maintained.





## How can we support you?

Areas where our lawyers have helped clients include **real estate, logistics, digital** (including data, AI and cybersecurity), **manufacturing, energy and employment** and **modern slavery**.

We also assist clients in reviewing, drafting and enforcing contracts and in relation to **disaster/ scenario planning, commercial issues, ESG matters, regulatory requirements** and, where necessary, **disputes**.

Sectors where we have provided advice include **retail and consumer, manufacturing, construction, housebuilding, the built environment, service providers** and **life sciences and healthcare**.

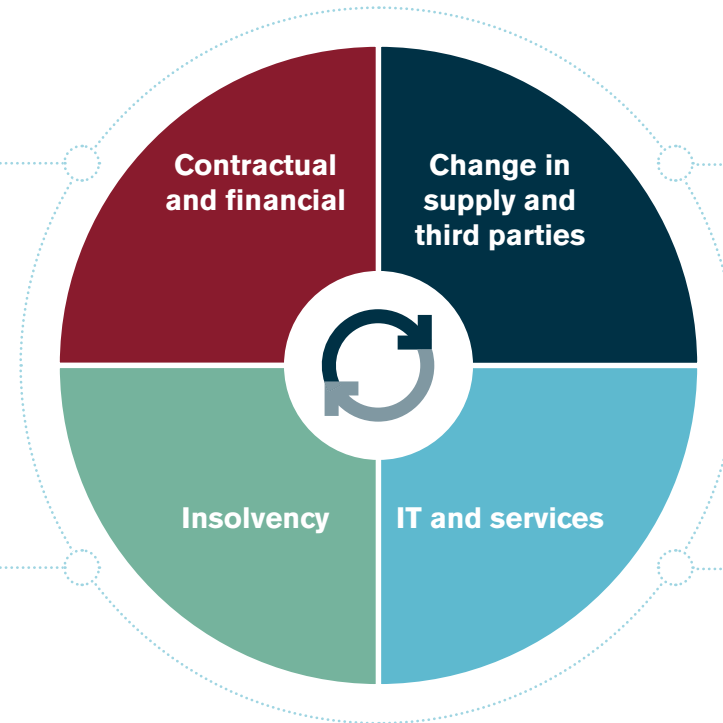
Our lawyers work closely with clients to identify and address supply chain issues early with a view to minimising damage, disruption, loss and claims. We also work collaboratively to address:

### Contractual and financial

- Contract reviews (including bolstering T&C's and supply terms)
- Assistance with financial reviews
- Funding agreements with suppliers in difficulty
- Dealing with ransom requests
- Disputes

### Insolvency

- Advising on continuation where an insolvency practitioner is appointed
- Mitigating risk in “pre-pack” scenarios
- Negotiating with key stakeholders (lenders, hauliers and service providers)
- Dealing with retention of title and proprietary claims



### Change in supply and third parties

- Procurement support and anti-competitive behaviour
- Joint ventures and collaboration strategies
- Warehouse and distribution issues
- HMRC issues

### IT and services

- Escrow arrangements (software/source codes) to maintain continuity
- TUPE and employee incentive plans

# Applying key lenses to your supply chain

## Our approach

Many of today's supply chains were established in relatively benign times in a growing and increasingly global economy where a "just in time" approach became the norm. The pandemic and its aftermath, political change and increasing concern over climate issues have, amongst other things, fundamentally changed the way supply chains are viewed. Whilst short term issues have emerged (such as shortages, price rises and logistical issues), structural supply chain problems now need to be addressed by all businesses.

We have a breadth and depth of legal expertise to help you with all aspects of your supply chain in the short, medium and longer term. We assist our clients with supply chain issues by applying three key areas of focus and then offering services to assist with these:

- Risk & Resilience
- Efficiency
- Sustainability

## Risk & Resilience

In order for a business to continue, supply shortages and stoppages need to be anticipated and resolved quickly. This may include due diligence throughout the supply chain, risk assessment, ongoing monitoring and contingency planning. In consequence, commercial contracts may need to be amended, current arrangements changed and cybersecurity risks assessed.

Whilst resilience may include diversification it may also involve other things, including the use of technology and nearshoring to reduce logistical and political risk. And it can entail taking into account ESG and other factors that might affect suppliers.

## Efficiency

New, more efficient designs for supply chains, including technological advances, should now be considered and deployed. Greater use of data and analytics as well as the introduction of new technologies such as AI and robotics will likely result in greater efficiencies and reduced costs. Understanding the existing and emerging opportunities afforded by improved built environments and logistics are also important. In the current climate of uncertainty and potential supply chain disruption, working smarter is necessary as well as desirable.

## Sustainability

It is increasingly important for companies to improve their sustainability and that of their suppliers to comply with ESG and decarbonisation requirements. Many aspects need to be considered to achieve this such as energy sources relied upon, the built environment in which a business and its suppliers operate and store resources and how digitalisation can support a more sustainable – as well as efficient – supply chain. In taking well-informed steps to implement such changes, businesses can minimise both operational and reputational risk as well as supporting their own, and society's, climate change aspirations and requirements.

# Transformation

**We immerse ourselves in the global issues that are transforming the landscape of how we live, work and do business. Focusing on the transformation drivers that will have the biggest impact on our clients, we use this insight to help you thrive, ensure agility and strengthen the resilience of your business. We are at your side, working closely with you to bring value, share new products and apply digital solutions. Together we'll be ready for what's next.**

[osborneclarke.com/transformation](https://osborneclarke.com/transformation)

Please **contact us** if you would like to discuss how transformation applies your business – and how we can help.

## Decarbonisation

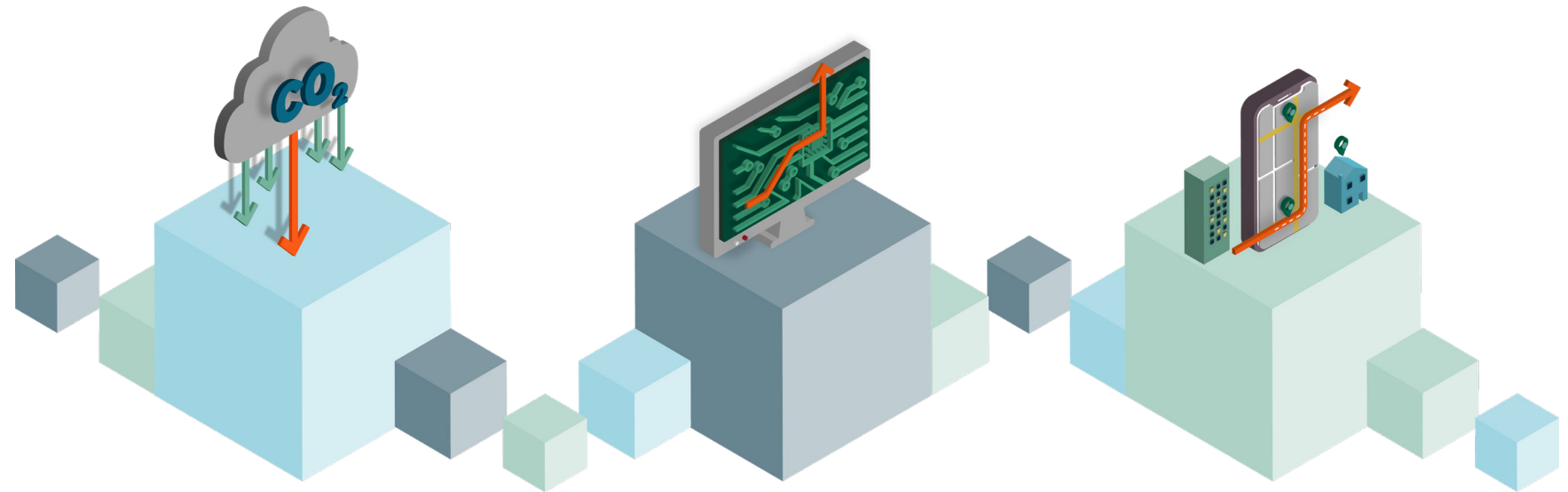
Carbon neutral imperatives are increasingly at the heart of business strategies. This will often require a radical rethink along your entire supply chain, from initial use of carbon all the way through to customer delivery. We will bring our expertise and track record to support you with every step along your decarbonisation journey.

## Digitalisation

Businesses are fast being re-shaped to fully exploit the possibilities of digital technology, but timely delivery is vital. Our lawyers are experts in advising on delivering a digitalisation strategy: from procuring digital infrastructure and technology to implementing a data strategy, or responding to a cybersecurity crisis. We support you as you expand or transform your business through technology.

## Urban Dynamics

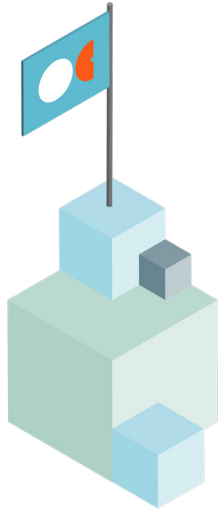
The vast majority of businesses operate in and benefit from the urban environment. The extent to which you understand and engage with urban dynamics will have a significant impact on your continued success. We understand that the way in which cities are designed, built and managed offers extraordinary opportunities. Our legal advice is focused on helping you to realise these opportunities.



## Find out more

For more information on supply chains please visit our dedicated web page:

[osborneclarke.com/insights/topics/supply-chains/location/uk](https://osborneclarke.com/insights/topics/supply-chains/location/uk)



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