

COVID-19: PRESSURE POINTS: SUPPLY CHAIN DIFFICULTIES (UK)

09 April 2020 | London
Legal Briefings

The COVID-19 global pandemic is a humanitarian crisis first and foremost. In response to the rapid spread of the disease, governments around the world are taking unprecedented measures to protect the health of their citizens. The economic situation is uncertain; some sectors are seeing vastly increased demand, while demand has fallen away to almost nothing in others. Personnel, transport and logistics issues are at the root of a lot of the pressure. Purchasers are looking for alternative supplies or suppliers where supply cannot be maintained; where demand is high, suppliers may find their products being copied, diverted to other markets, counterfeited even. Supplier liquidity issues risk breaks in supply chains for those who still require their goods or services.

SUMMARY

The consequences of the pandemic and the associated public health measures may pose significant threats to the supply and demand sides of many businesses. Effects include reductions in capacity and output, supply chain failures, drop-offs in demand, and deferrals and defaults affecting payments:

- **Maintaining the links in the chain** - Workers and consumers are being impacted by confinement and self-isolation rules across the globe, leading to disruption in supply and demand. Supplier or customer liquidity may also become a concern, with many

businesses struggling with the sudden and significant contraction in liquidity which has occurred, worldwide, in the past weeks and months. Once the importance of suppliers in the supply chain has been assessed, there are a number of ways in which the position of suppliers can be bolstered, from reducing payment terms to actual financial assistance. In some jurisdictions there may be emergency changes to insolvency law that may assist.

- **Competition law issues** – Competition authorities across the world have given robust responses to seemingly rocketing prices of products experiencing high demand due to the crisis and a number of investigations are ongoing. In a number of jurisdictions competition rules have been relaxed, allowing coordination where necessary to ensure the supply of critical goods and services, but competition authorities will ensure that this approach is not used as a cover for non-essential coordination that may cause harm to consumers or the wider economy.
- **Product-related issues** – In situations where demand outstrips supply or a supply chain fails, product replacements or alternatives may be supplied instead. Imports may be triggered from alternative jurisdictions where products are more freely available or cheaper (but which were never designated for the relevant market), counterfeit products may emerge, or customers may be misled by advertising. At the same time innovation and collaboration, either internally or with third parties – even competitors – may develop to generate new products now needed in the crisis or to replace pre-existing but now unobtainable ones.
- **Suspension and termination of contracts** – Businesses may find themselves unable to meet their contractual obligations to suppliers or customers, or may find that others in their supply chain are unable or unwilling to perform. Key questions will include whether they, or their counterparties, can rely on contractual provisions to suspend their obligations or terminate the contract, and whether the contract may be brought to an end either automatically or by one party becoming entitled to terminate for breach.

We explore each of these challenges in greater detail below and suggest steps that companies should consider in the short term and in the months ahead. We would expect various combinations of these options to be adopted by companies facing a supply chain crunch. In every instance, directors must take particular care to discharge their legal duties to the company and its broader stakeholders.

MAINTAINING THE LINKS IN THE CHAIN

ADDRESSING SUPPLIER OR CUSTOMER FINANCIAL DISTRESS

This situation is almost unique in the regulatory and political support which has been made available to struggling businesses. While the support packages may not be complete, and the hurdles faced by almost all sectors should not be underestimated, the recognition of some of the issues and attempts to address them will hopefully be helpful in any cases.

In these times of uncertainty, with a rapidly changing situation, various government support measures are being announced quickly to address both liquidity and trading issues, and the course of the next few months far from clear, businesses face many competing, complex demands on their time:

- taking care of their staff and responding to official guidance to ensure their well-being;
- running the day-to-day operations of the business and fighting any fires which arise;
- dealing with commercial counterparties and possibly financial creditors if there is a financial covenant breach or other default under financing documents; and
- stabilising the business for the future, maintaining liquidity to withstand disruption and ensuring that output can be maintained in both the short and longer term.

Generally, the earlier signs of financial distress in suppliers and customers can be identified, the more options will be available to resolve issues and ensure supply chain continuity.

One of the significant difficulties is obtaining accurate, timely information about the position of the relevant supplier's or customer's business. Good quality contacts will be key to this, though they may not be aware of all issues and nuances.

Early signs of financial distress can include aggressive cash management; attempts to reopen commercial terms; and a particularly aggressive approach to contractual terms or litigation. There may also be new personnel involved, and new approval processes internally at the supplier or customer which might indicate deeper problems.

Some of these commercial warning signs can also have consequences for other contractual arrangements, such as the supplier's own financing arrangements. For example, a supplier commencing negotiations with creditors as a result of financial difficulties will need to be mindful of insolvency events of default in finance documents and key commercial contracts, and the actual non-performance of supply contracts could also cross-default other arrangements. There may be nuances around the announcements or disclosures made publicly by suppliers which reflect this.

These consequences, and the general contraction in available liquidity in many businesses, will compound the problem unless addressed quickly.

Developing a robust contingency plan will be an important first step; this will be critical to understanding what to do should the worst happen and the supplier fail. It will also inform how far the purchaser – or supplier – may be prepared to go to reach a commercial compromise and help the supplier – or customer – to avoid a failure.

Once that is done, there are a number of options available to purchasers:

- In some cases, purchasers may be prepared to contractually agree to pay their suppliers more quickly to directly assist the supplier's cash flow and also their access to receivables financing arrangements.
- Occasionally, purchasers may be prepared to go even further and provide direct funds to the supplier, by way of taking an equity stake in that company. Where certain assets are being purchased, the purchaser may also provide debt funding to the seller of that asset.
- There are a number of options available to suppliers themselves to maintain their liquidity: obtaining the support of existing financial creditors or alternative debt funding; or seeking an equity injection or asset sale or a broader M&A solution. For more information on approaches to managing liquidity, see [Managing Liquidity](#).
- There are established restructuring tools that can assist in developing creative solutions to address a problem. In some jurisdictions, emergency changes to insolvency law may be enacted to seek to stabilise supply chains.
- There may be a responsive trade credit or credit risk insurance policy at some point in the supply chain. If there is, it is essential that the terms are complied with – frequent slippages occur due to matters such as late notification or renegotiation of supply terms without insurer consent.

Given the unprecedented way in which COVID-19 is affecting the whole market and the level of regulatory and governmental intervention in business, we may see creative combinations of these methods being used to support supply chains over the next few months.

WORKFORCE CHALLENGES

Workers are being impacted by confinement and self-isolation rules across the globe, leading to disruption in supply. Unless businesses or manufacturers have been designated essential, or 'key workers', by relevant national or local authorities, large parts of the workforce are being expected to work from home, which may not be practical for all steps in a company's supply chain. For the latest on measures in place across Europe, see [here](#). Companies will be looking to technological solutions where possible, or sourcing essential products and components perhaps from new suppliers with fewer personnel restrictions because of their local rules.

LOGISTICS CHALLENGES

In addition to challenges with workforces being forced to work in new/different locations in certain industries and sectors, securing transport, particularly air transport in light of the challenges currently faced by aviation suppliers, may add to supply chain disruption and uncertainty. Relaxation of certain regulations around transport, such as the temporary relaxation of drivers' hours rules and lifting of some restrictions on night-time deliveries in the UK in order to secure supply of essential goods and services, may ease the pressure in some sectors.

Warehousing and other storage spaces are also coming under pressure in some areas as companies seek to increase stocks of certain key components and supplies. The combination of this and large scale working from home means that companies are being creative about existing space organisation and use (subject to any relevant local planning or lease restrictions).

Immediate steps

Audit your supply chain and identify key and priority suppliers - understand their COVID-19 contingency plans
Consider how you can support any key suppliers/customers who present in distress
If you need to secure additional supplies of key materials/components, consider storage and logistics issues

Looking further ahead

Monitor government support schemes and any proposed emergency changes to existing rules aimed at alleviating impact of current crisis on companies

COMPETITION LAW ISSUES

RELAXATION OF COMPETITION RULES

Many competition regulators are taking pragmatic steps to seek to assist businesses and preserve supply chains during the COVID-19 pandemic. Some examples of this from Europe/the UK are:

- **Guidance on the approach to exemption criteria during the COVID-19 crisis:** In order to avoid competition law putting the brakes on cooperation between businesses that may be necessary to ensure the security of essential supplies, the UK Competition and Markets Authority (CMA) and the European Competition Network (the EU Commission and competition authorities of the Member States) have adopted [guidance](#) on the application of competition rules to cooperation arrangements aimed at ensuring the supply and fair distribution of essential products and services, indicating they will not intervene in necessary and temporary cooperation between businesses.
- **UK Government adopts Competition Act Exclusion Orders:** On 28 March 2020

three [orders](#) excluding certain types of agreements from the prohibition on anti-competitive agreements under the Competition Act 1998 came into force. The current exclusion orders relate to the groceries sector, the provision of healthcare services and to certain ferry services. For the groceries sector, the exclusion order exempts certain types of agreement between groceries suppliers as well as a number of agreements between logistic service providers. Information sharing relating to costs or prices, or to future business planning (and therefore not related to the current crisis) is not exempt under any of the orders.

BUT STRICT ENFORCEMENT WHERE NECESSARY TO PROTECT CONSUMERS AND MARKETS

- Despite a targeted relaxation of some of the rules, competition authorities will come down hard on any businesses that try to exploit the crisis as a 'cover' for non-essential collusion. In the UK, the CMA has established a COVID-19 taskforce which will, among other things, scrutinise market developments to identify harmful sales and pricing practices as they emerge. This includes businesses seeking to exploit the situation through excessive pricing or making misleading claims about their products. The CMA has written an open [letter](#) to the pharmaceutical and food and drink industries, warning them not to capitalise on the pandemic. Similar warnings have been issued by the competition authorities in Spain and in the USA amongst others, and the French, Spanish and Greek competition authorities are all currently investigating pricing practices for certain COVID-19 related products such as hand sanitisers and disposable masks.

ABUSE OF ECONOMIC DEPENDENCE

- Several countries have pre-existing measures that prevent the abuse of relationships of economic dependence (e.g. Austria, Belgium, Germany, France and Japan). The scope for such abuse could, in theory, be heightened in a more uncertain and difficult economic environment. Thus companies with others dependant on them must not exploit this advantage, e.g. by raising their prices or reducing their supply.

STATE AID ISSUES

- EU State aid law will apply to many of the forms of assistance offered by EU Member State governments, including the UK during the current Brexit transition period. State

aid is essentially financial assistance given by a government to certain companies or other organisations on a selective basis. The aid can be in the form of direct subsidy such as cash grants or subsidised borrowing rates, or forgoing revenue such as tax credits or deferrals.

- Where a measure involves State aid, it cannot in principle be implemented unless it is notified by the Member State concerned and approved by the European Commission. Breach of this “standstill” period could result in the company receiving support being required to repay the aid with interest and can be enforced by the Commission or by complainants in the national courts.
- The EU Commission has indicated that it will take a flexible approach to the State aid rules during the current crisis, and has adopted a [Temporary Framework](#) setting out the types of liquidity support measures and other COVID-19 related measures it will be able to approve rapidly. Nonetheless, in light of the possible consequences for beneficiaries if the State aid rules are breached, advice on State aid law compliance should be sought when considering any Government assistance.

Immediate steps

Beware excessive pricing and unfair terms
Consider whether cooperation arrangements benefit from an exclusion
Order under the UK Competition Act
Consider whether cooperation arrangements benefit from exemption criteria under EU or UK competition regimes

Looking further ahead

Monitor any proposed emergency changes to existing regimes aimed at alleviating impact of current crisis

PRODUCT-RELATED ISSUES

There are a number of issues to consider around the nature and origin of products when supply chains are under severe stress:

ACCESSING RESOURCES/SUPPLIES/COMPONENTS

- Where supply chains fail and it is not possible to source replacement supplies from third parties, purchasers may consider reverse engineering products themselves or supply by providers who have themselves reverse engineered replacement products.
- An increase in demand for certain products, where there is a lack of supply through official sources, may create more opportunity for unscrupulous vendors to supply counterfeits or replacement products (e.g. mis-supply, passing-off or being misled) or distributors assigned to other jurisdictions may start supplying into markets outside their

territory (parallel imports).

- Where the products or components are covered by intellectual property rights these may be able to be enforced to stop such practices.

COUNTERFEITING, MISLEADING ADVERTISING, PARALLEL IMPORTS

- Customs seizures are available to intercept goods at borders.
- Infringement actions can be brought.
- Takedown procedures can be employed through online platforms to remove webpages offering counterfeit and infringing goods, as well as judicial measures to shut down websites.
- Misleading advertising law and regulation will also play a part, enforced through Trading Standards.
- For more on this, see [COVID Counterfeits](#).

INNOVATION AND COLLABORATION

- Approaching supply chain challenges in a collaborative manner may well generate opportunities of course. Collaboration is happening apace across the engineering and medical sectors to meet the demands of the virus crisis on the healthcare system. Collaborations generally require specific consideration in order to establish the ownership of the outcomes including resulting intellectual property and data. Although in the current situation this may not be high on everybody's list, setting up a basic agreement to ensure no future uncertainties or disputes will still be worthwhile. For more on this, see [Innovation and Collaboration hub and client report](#).
- Any such collaboration should also be considered under the competition rules. To the extent that it is taking place in order to achieve essential supplies or provision of healthcare services in light of the COVID-19 pandemic, the collaboration may benefit from an exclusion order or the more general exemption criteria under the UK or EU competition rules (see the changing market regulation section above).

Immediate steps

Examine supply chain continuity
Identify potential product gaps
Heighten awareness of
infringements and misleading
advertising in the market

Looking further ahead

Consider collaborations to ensure continued
production of essential products and generation
of innovations required to combat the crisis

SUSPENSION AND TERMINATION OF CONTRACTS

Counterparties may be seeking to delay or avoid performance (or escape liability for non-performance) of their contractual obligations, or even terminate contracts, either because COVID-19 has legitimately prevented them from performing their obligations, or because they are seeking to extricate themselves from what in the new global circumstances is a bad, or worse, deal. Things to consider include:

SUSPENSION UNDER EXPRESS TERMS - FORCE MAJEURE

A typical 'force majeure' clause will excuse one or more parties from performing their contractual obligations if they are prevented from doing so by circumstances outside their control. In considering whether a force majeure clause can be invoked there are a number of points to consider:

- Do the circumstances fall within the definition of a force majeure event under the contract? So, for example, does the clause cover an epidemic or pandemic, a change of law or regulation, or an act of government? Or is there sweep-up wording to cover other events beyond the reasonable control of the parties?
- If so, has the relevant event prevented, hindered or delayed performance? Typically, a force majeure clause will be triggered only if that is the case. A change in economic or market circumstances which makes the contract less profitable or performance more onerous has not generally been regarded as sufficient to trigger a force majeure clause.
- Are there requirements that must be satisfied before the clause can be relied on? It is common for force majeure clauses to include obligations to notify the counterparty of the force majeure event and to seek to mitigate its effects. A failure to comply with these requirements may mean a party cannot rely on the clause.
- What is the effect of reliance on the clause? It is typical for the parties' obligations (or some of them) to be suspended without liability while the impact of the force majeure event continues. Often there will also be a right to terminate the contract if the force majeure event continues for a specified period of time.

TERMINATION UNDER EXPRESS TERMS OR AT COMMON LAW

Where a contract has become uneconomic or undesirable, a party may wish to limit its losses by terminating the contract. Parties will need to consider:

- What are the express termination provisions under the contract? There may for example be a right for one or both parties to terminate on notice and without cause. Or there may be specific termination rights that are triggered in the circumstances that have arisen (putting aside force majeure provisions, which are considered above). Any contractual machinery, such as notice provisions, should be strictly observed. Parties should also remember that, where a contract is terminated under an express contractual right, there will generally be no entitlement to “loss of bargain” damages for future non-performance.
- Is there a right to terminate at common law? This will arise, most commonly, if the counterparty is in repudiatory breach of contract (i.e. if the breach deprives the innocent party of substantially the whole benefit of the contract) or has clearly demonstrated an intention not to perform the contract in some essential respect. Where a force majeure clause has been triggered, the question of whether the counterparty can still terminate at common law will depend on the construction of the clause.

AUTOMATIC TERMINATION AT COMMON LAW - “FRUSTRATION”

A contract may be ‘frustrated’ – ended at law – if, as a result of the COVID-19 crisis, further performance of the contract has become impossible or illegal or the relevant obligations would be radically different from those contemplated at the time of contracting. A party hoping to rely on frustration to avoid further performance of the contract should remember:

- The doctrine of frustration will not come into play where the contract expressly provides for the event which has occurred, such as under a force majeure clause.
- The doctrine tends to be applied narrowly. Events which make performance more onerous or more expensive will not generally be sufficient. The requirements to establish frustration may be particularly difficult to satisfy in the context of a long term contract, particularly if the disruption is likely to be temporary.
- The effect of frustration is to bring the contract to an end, immediately and automatically. Where the contract is governed by English law, the Law Reform (Frustrated Contracts) Act 1943 provides that parties can recover sums paid under the contract before it was discharged, subject to an allowance for expenses incurred by the other party at the court’s discretion.

OTHER CONTRACTUAL PROVISIONS

COVID-19 may give rise to attempts by counterparties to invoke other contractual provisions, for example:

- Change of law clauses – some contracts may contain a separate clause entitling either party to terminate or renegotiate the contract where a change in relevant provisions under the applicable law makes it impossible or impracticable for a party to perform its contractual obligations (rather than including this under a force majeure clause).
- Price adjustment clauses – parties may seek to adjust all or part of the contract price for a commodity due to increased costs as a result of COVID-19, e.g. due to increased supply chain strain.
- Limitation or exclusion clauses – parties may increasingly seek to rely on limitation or exclusion clauses to limit or exclude liability for non-performance, particularly if there is no force majeure clause or it cannot be invoked.

<p>Immediate steps</p> <p>Identify any agreements where performance is or may be affected</p> <p>Identify relevant force majeure clauses and comply with any notification and/or mitigation requirements</p> <p>Consider any other relief that may be available under the contract or at common law</p> <p>Ensure appropriate records are kept to support your position if a dispute arises</p>	<p>Looking further ahead</p> <p>Consider collaborations to ensure continued production of essential products</p> <p>Continue to review the situation and identify any performance issues</p> <p>Maintain comprehensive and contemporaneous records including the effect on the business and steps taken to mitigate</p>
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[More on COVID-19](#)

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