

Interview with...

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On managing Risk in modern Supply Chain relationships

Hammonds LLP is a leading commercial law firm with offices throughout the UK, Europe and in Asia. The firm provides legal services in a way that is business sector focused, commercial and friendly.

Alex Newman is a lawyer and partner of the Hammonds Commercial & Dispute Resolution practice. In this interview he tells us why it is vital to use contracts properly as part of your risk-management process. It is more than just a tedious form-filling exercise, or you risk having a contract that is not worth the paper on which it is written! Read on for his 6 Key Guidelines that you cannot ignore...

As a business, why would I need a lawyer who understands Supply Chains?

“Sometimes things go wrong, and when they do go wrong, someone somewhere in the supply chain will bear the brunt of it. A lawyer who understands supply chains and the things that can go wrong can help to ensure that the business which suffers the consequences is also the one that caused the issue in the first place – with no argument.

There are potential pitfalls in all aspects of Supply Chain Management. A product specification may not be nailed down properly, which leads to the product, when manufactured and delivered, not being what was needed and expected. The manufacturer or other upstream supplier of the product may be late, which leaves its customer in danger of being sued by their own downstream customer. There may be intellectual property rights in the product which mean that it cannot lawfully be sold without getting a licence from the right-owner. The product might turn out to be defective or otherwise unlawful. All of these risks create financial exposure which needs to be properly managed. We help our clients to do that by helping to identify those risks, and by ensuring that the relationship between supplier and customer is established on terms which allocate those risks to the appropriate party. The right contract will do that, and as a result will ensure that the behaviour of both parties is aligned to each other’s needs.”

So is it just a matter of blaming the supplier?

“No, not at all. Firstly, not every thing that can go wrong is something which can be controlled or managed by the supplier (for example, risk associated with getting a product specification wrong should ordinarily stay with the customer). Secondly, a customer will sometimes only get the price it wants if it agrees to take some of the risk from the supplier.

We all know that different organisations have different cultures. Some are very Gung Ho and take high risks. The important thing is that if they are going to take that kind of approach they need to properly assess the risk and benefit ratio of doing so.

For instance, a customer may decide, on balance, that it can do business with a supplier it is not entirely sure about because it knows that that suppliers is cheap, that it will not have to sign up to any long term agreement, and that there are alternative suppliers who can step into the breach quickly if things go wrong.

On the other hand, organisations that want or need to enter into long-term agreements for the supply of business-critical goods or services are much more risk averse. They will ensure that all risks are properly identified and allocated. This includes unambiguously spelling out the consequences of each anticipated problem and putting robust termination provisions in place that entitles them to exit the agreement if things start to go wrong. They may even “buy” a right to exit even before things start to go wrong.”

Client/Supplier relationships are becoming much more collaborative. How does this reflect in the work you do?

“In today’s environment, what the customer wants at the start of a relationship with his supplier (when we most frequently get involved) is subject to change as their businesses and relationship develops. We cannot legislate for every possible change in the dynamic of a relationship, but we can encourage both parties to sign up to meaningful relationship governance procedures.

These procedures map out clear lines of communication and escalation, and will often include Governance Boards, established between customer and suppliers, which will meet on a regular basis to discuss progress and opportunities for improvement and growth. These mechanisms often include gain-share mechanisms, which provide for both parties to benefit from proposed changes, as incentives for both parties to come up with ideas for improving the profitability of the relationship.

What is your opinion on Service Level Agreements (SLAs)?

“I have a love/hate relationship with Service Level Agreements. Most of the SLAs I see are not worth the paper they are written on from a customer's perspective because:

- the standard of service which the supplier is required to reach is too low (often misleadingly so) meaning that it can deliver a poor service but still demonstrate that it has achieved the required service levels;
- the customer has not built in effective means for monitoring performance against service levels;
- the customer has not built in appropriate sanctions, which include options, for service level failures.

SLAs do not have to be just a stick to beat suppliers with, though. They can also be used to encourage performance by including bonus provisions for excellent service. This often pushes the supplier not only to perform well, but also to put performance monitoring systems in place so that he can prove that he has performed well.”

What are the most common Supply Chain conflicts you are asked to help resolve?

“Most commonly, we are brought in when a relationship has broken down and one of the parties wants to bring the relationship to an end. We are usually used as last resort, because if the relationship is worth saving, then the parties tend to work out disagreements between themselves.

To advise on termination options, we need to identify the termination rights in the contract, and work with our client to understand whether or not any of those rights have been triggered.

I am working with a client at the moment on a dispute with an IT supplier. My client felt that the IT supplier was not doing all that it could to fix serious software issues, and that the level of service it was getting generally was sub-standard and over-priced. When I checked the agreement, it was clear that there were no termination rights in the agreement which could help. Whilst there were the normal termination rights for material breach... there were no measurable service levels against which to demonstrate a breach. The service levels, such as they were, only required the supplier to use “reasonable endeavours” and to “act promptly” in its attempts to meet them. That type of obligation is particularly toothless. A breach cannot easily be proven, and any attempt to do so will inevitably lead to dispute. Yet we see this type of provision in contracts time and time again.

What’s more, the termination provisions effectively locked my client into the relationship for considerably longer than it had intended and realised, because the effective date of termination was different for each site which the supplier was supporting. This meant that there was no prospect of a clean break at all, and that what looked on paper like a 6 month notice period was actually a 2 year notice period.

My client will not make this type of mistake in its contracts again.”

So what are the key legal rules that businesses cannot ignore in modern Supply Chain relationships?

“There are no quick and easy rules, but you would do well to follow these guidelines at least, which are really just common-sense:

- a. Identify and agree the various practical steps in the part of the supply chain relevant to the relationship (e.g. order, quality validation, delivery).
- b. Identify and agree who should be responsible for completing those steps.
- c. Identify and agree what might go wrong, why it might go wrong, what can be done to minimise that happening, and who is responsible for minimising that risk.
- d. Make sure that what you have identified and agreed is recorded in writing in clear and unambiguous terms.
- e. Do not think everything will work out fine and turn a blind eye to what could go wrong. You will end up wishing you had not.

- f. Make sure the contract makes sense to you and that it is properly aligned with the commercial and practical realities of the relationship. If it does not truly capture and address what the parties intend to happen in practice, it is the wrong contract.

Whatever you do, do not simply accept a contract because you find it boring to read or hard to understand. Something written in tiny font does not mean it is not important: we all make this mistake as consumers... even me! We cannot afford to do this in business.”

How do you see Supply Chain relationships evolve in the longer term?

“Regardless of the sector, customers will continue to want their suppliers to be more agile and responsive to their ever-changing needs, without having to pay a premium for that agility. Relationships will therefore need to be established on foundations which can allow that to happen. There is a balance to be struck here, though. If you want your supplier to accommodate your changing needs, you cannot expect him to bear a disproportionate part of the risks associated.

There are hundreds of thousands of relationships out there. As Supply Chain Collaboration and Management techniques become increasingly sophisticated, more and more of these relationships are designed to last longer and grow in complexity and value. Whilst this can bring great benefits to both parties, the stakes will also be higher. There may be more scope for things to go wrong, and the need to get the contract right will therefore be greater still!”

One last piece of advice?

“Don't be afraid to address what might go wrong with your customers and suppliers. The risks are always there, so planning them properly is a positive for both sides, as both will know exactly where they stand. It also shows that you are commercially astute and that you run a tight ship. However, there is no point addressing the risks unless you reach a consensus and document it. So make sure you finish the job!”

Hughenden would like to thank Alex Newman
for sharing his experience and expertise

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