Distressed supply chains - how can suppliers protect their position?

There is currently no shortage of global events imposing pressure on businesses' supply chains. There is no stopping the rise in raw material prices, which is driving price lists up to exorbitant levels. Nor does the shortage of raw materials seem to be anywhere close to resolved.

The phenomenon, originally triggered by the COVID-19 pandemic, has seen its escalation exacerbated by the conflict between Russia and Ukraine. The war in Ukraine has significantly impacted the performance of some contractual obligations by, for example, creating supply shortages and catalysing rising energy prices.

In order to understand this phenomenon, which is heavily influenced by geopolitical factors, it is necessary to consider its impact on the distribution chain, an impact that ultimately makes businesses increasingly vulnerable.

This critical situation stems, *on the one hand*, **from more complex supply chains that involve international scenarios** and, *on the other*, **from the volatility of raw material prices and discontinuity in the supply and procurement of the same**, we are witnessing the onset of ***contractual imbalances that lead to increased costs and to a consequent failure to perform contractual services***, heavily compromising their original legal-economic structure and their regular execution.

In the absence of specific clauses agreed upon by the parties, the management of the impact of contingencies on the interests originally established by the parties may take place within the scope the laws of the legal system applicable to each individual contract. The remedies provided by the legal system for this purpose are subdivided into remedies for the avoidance of defects and remedies for the preservation of rights and can differ according to the case in point.

The risk of so-called "contractual contingencies" can be managed *conventionally and preventively* or, alternatively, *legally and subsequently*.

Conventional risk management usually takes place at the time the contract is concluded, through the inclusion of special clauses aimed at renegotiating, rebalancing and adapting the contractual synergies to any changes in the context.

The best practice in drafting business contracts therefore contemplates the insertion of:

1. Drafting unambiguous contracts;
2. "Force majeure" clauses;
3. "Hardship" clauses;
4. „P.A.C" price revision clauses;
5. "M.A.C." clauses ("material adverse change clauses");
6. Penal clause;
7. Doctrine of frustration;
8. Caps and exclusion of liability;
9. Compliance clauses.

1. Drafting unambiguous contracts

Parties should always aim to trade on clear and unambiguous terms, and this applies more so now than ever. The recent cases demonstrates how issues can arise to bite suppliers where contractual requirements related to delivery and timing are not sufficiently tied down.

2. Force majeure

In order to rely on a right to suspend or delay performance as a result of an event beyond our reasonable control, one need an express force majeure clause in the contract (or wording to the same effect) that will give these rights to parties.

Force majeure is an entirely contractual construct and the concept will not be implied into a contract.

If the contract does contain such a clause, then the drafting of the clause must be carefully analysed, looking at the words the parties have used, rather than considering the parties' general intentions: has the supplier genuinely been prevented or delayed from performing its obligations by reason of the event? The fact that the event has made a contractual obligation commercially unacceptable, impracticable, uneconomic or even unprofitable for a supplier (for example, as a result of rising energy prices or increased raw material costs) is unlikely to be sufficient.

Generally, force majeure clauses allow a party affected by an event beyond such party’s control to suspend performance of its obligations. A detailed assessment of the specific wording of the force majeure clause is critical in multiple respects, such as the question whether a certain event qualifies as an event beyond such party’s control in the first place. Another key aspect is the question of the specific legal consequences of force majeure, such as a temporary or permanent suspension of obligations, with or without the obligation to make up suspended performance once the event which qualifies as force majeure has ceased.

In order to qualify as a force majeure event, the following criteria generally are included as requirements:

(i) the event **must** be an ***“external” event***, which in principle includes actions by uninvolved third parties (such as authorities);

(ii) the event must be ***“unavoidable”*****,** meaning the event cannot be avoided by economically justifiable means; and

(iii) the event must be an ***“extraordinary” event***, meaning an event that could not be expected in the normal course of events. Especially with regard to the last two criteria, meeting the evidentiary requirement is often particularly difficult, especially if contracts were concluded, amended or extended only shortly before such an event.

3. The Hardship Clause

Several national laws, as well as international instruments like the Unidroit Principles on International Commercial Contracts, deal with the issue of hardship, by establishing rules which intend to protect the disadvantaged party in case of events that have rendered performance more onerous than could reasonably have been anticipated at the time of the conclusion of the contract. This trend, developed mainly in recent years, has given rise to legal solutions which substantially differ from country to country.

While the basic principle that hardship must imply an unforeseen event that substantially upsets the equilibrium of the contract, the remedies foreseen when such situation arises may be substantially different. The first step in many laws is to invite the other party to renegotiate the contract, but the most controversial issue arises in case of failure of the renegotiation.

In this case some laws only recognize the right of the aggrieved party to terminate the contract, while other laws entitle the aggrieved party to request the judge or arbitrator to adapt the contract or to declare its termination.

4. „P.A.C” price revision clauses

Also known as Economic Price Adjustment, Cost Adjustment, Escalation Clauses, Price Indexing.

First, the supplier should take a close look at the **supply contract** and at the supplier’s **General Terms & Conditions of Sale** (***GTCS***) if the latter have been accepted by the customer and thus also apply to the contractual relationship.

Economic Price Adjustment consists of providing contractors with protection against materials, and fuel price increases that may occur during the execution of the work through the use of Price Adjustment Clauses (PACs). Under these provisions, the party accepts the risk for increasing prices by offering a PAC that will compensate the contractor for any increase above the bid price or a trigger amount of a specific material.

Price review clauses commonly contain the following features:

- a trigger event,
- a procedure for arriving at the adjusted price,

- a description of the factors or guidelines to be taken into account when adjusting the price,
- the consequences if an agreement on price is not reached, and
- a description as to how the adjusted price is to apply under the contract.

Price review clauses can be non-prescriptive (eg a clause based on an agreement to negotiate in good faith an equitable revision to the price if market circumstances have changed) or explicit and prescriptive (eg a clause requiring arbitration with adjustments only to be made with reference to pre-defined criteria). Often a buyer will prefer to make it as hard as possible to revise the price (on an assumption that the price trend is increasing), while a seller will prefer a formal and binding mechanism to permit price increases.

5. MAC or MAE clauses

MAC clauses, which originate from the Anglo-American legal system and have always been widely used there, usually grant the purchaser the right to, in the event of a material adverse change (Material Adverse Change or "MAC" for short), either under certain conditions withdraw from the already signed but not yet closed purchase agreement or to assert corresponding guarantee claims.

MAC clauses are to be distinguished from Material Adverse Event clauses (or "MAE clause" for short): While the MAC clause is based on the occurrence of a change between the signing and closing of the purchase agreement, MAE clauses generally also cover circumstances that already existed before the purchase agreement was signed but only become effectively apparent afterwards.

Material adverse change or material adverse effect clauses aim to protect the parties generally from unforeseen circumstances that have a material impact on the rights and/or obligations of one or more of the parties. Whether the materiality threshold is reached is often highly disputed and in many instances also depends on how close the circumstances which cause the change of effect are related to the parties. Here, too, foreseeable events are usually not covered by a MAC / MAE. On the other hand, foreseeable events can also be covered if the clause is formulated in an appropriately broad manner, for example for the reduction of export quantities and an accompanying drastic price increase that is not merely temporary without corresponding substitutability. MAC clauses are also found in many contracts as a condition for completion or execution, so that with a MAC / MAE there may not only be rights to change prices or conditions, but also the right to withdraw from contracts that have not yet been fully executed. It also is possible to draft MAC / MAE clauses so that they are triggered with a time lag at the various product and delivery and trading stages.

6. Penal Clauses

In order to maintain the contractual relations stability, what happens usually is that both parties of a contract agree on setting a penalty clause that applies in the case if one contracting party breached the agreement or didn’t commit to its contractual obligations, the reasons Behind setting and drafting such clause is for the contractors to guarantee that the opposite party will commit to its obligations, as this commitment is not always guaranteed, laws and regulations allowed the parties of a contract to agree on the compensation amount one party deserves in the case of a contractual breach, jurisprudence and courts call this amount the penalty clause or the contractual compensation.

A penalty clause is an express provision in a contract. It places an obligation upon the party who has breached the contract to provide compensation to the aggrieved party affected by the breach. Receiving compensation is not as straightforward as it may seem, and it may be very complex and difficult in certain situations.

A penalty clause can be enforced if there is *a legitimate purpose, it is proportionate, and the clause is not a primary obligation*.

Primary obligation - this is a condition that is imposed upon a party which states that it is a requirement that the party performs the condition since it is a main condition of the contract that it is contained within the agreement.
Secondary obligation - this is an obligation which is incidental to the main/primary obligation or arises when the main/primary obligation cannot be satisfied.

7. Frustration

The doctrine of frustration means that a contract may be automatically discharged (or frustrated) if something occurs after the formation of the contract:

- which renders it *physically or commercially impossible* to fulfil the contract; or
- which transforms the obligation to perform into a *radically different obligation* from that agreed on entering into the contract.

But the doctrine operates within very narrow confines, partly due to the fact that the courts do not want to permit parties to use frustration as a way of escaping a bad bargain. Broadly speaking, it seems unlikely that a contract will be frustrated as a result of the current pressures on supply chains: impracticability is not normally a ground for frustration. And suppliers are likely to be required to consider how else or where else they could obtain similar or substitute products before they could consider frustration.

It is also worth noting that wrongfully claiming that a contract has been frustrated could itself constitute a repudiatory breach of contract. Arguing frustration can therefore be a risky option for suppliers.

8. Caps and exclusions on liability

Another key consideration for suppliers is ensuring that the liability they accept under a supply contract is as tightly drawn as possible. Suppliers should look to manage their liability by excluding certain heads of loss where possible, avoiding giving indemnities or including drafting safeguards and a conduct of claims clause where an indemnity is given, and including an express financial cap on all liabilities that are accepted.

In order to preserve ongoing contractual relationships and in compliance with the general principle of contract preservation, both jurisprudence and doctrine have then identified in the legal basis of a general obligation of the contracting parties to renegotiate and/or revise the contract, with the requirement to conduct themselves in good faith and fairness in the execution of the contract, in cases of significant alteration of the contractual balances originated by unforeseeable and sudden external causes. Legal experts with finding solutions with respect to the contractual imbalances connected to COVID-19—observed that the contracting party that refuses to renegotiate the contractual terms may commit a breach of contractual balance, stigmatizable in terms of penalties.

One need only think of Article 79 of the 1980 Vienna Convention on the International Sale of Goods (CISG) which expressly regulates the hypothesis of a non-performance which is justified and not attributable to the debtor, providing for the exemption of the non-performing debtor from liability to the creditor.

Not to be forgotten are Articles 7.1.7 and 6.2.2 of the UNIDROIT Principles of International Commercial Contracts which, in the event of an alteration of the contractual balance, grant the disadvantaged party the right to request a renegotiation of the contract and, in the event of non-fulfilment due to an impediment attributable to unforeseeable circumstances beyond the non-fulfilling party's control, exempt the latter from liability.

Finally, the so-called PECL (Principles of European Contract Law), which provide, in addition to the obligation to renegotiate, for the power of the court to order the party who refuses to do so or does so in contempt of fairness and good faith, to pay damages, are also particularly relevant.

9. Compliance clauses

Compliance clauses in contracts, such as compliance or non-compliance with sanctions, are designed to prevent or limit trade with individuals and entities which are subject to global sanctions regimes. Finance agreements often include obligations for mandatory repayment in non-compliance scenarios which may lead to defaults of borrowers. Lenders and borrowers are well advised to examine provisions, which are usually considered standard clauses without a concrete scope of application, especially for such clauses and their effects in the current environment.

10. Conclusions

DISTRESSED SUPPLY CHAINS

As the recent evolution of events has shown, the geopolitical situation is constantly evolving and is bound to have a very strong impact on the economic and legal frameworks of contractual relationships, including and especially international ones.

Unfortunately, legislative measures in this area so far have not proved sufficient to tackle the problems posed by the crisis in the distribution chain.

In the light of the above considerations, it is therefore recommended that the risk of contractual contingencies be conventionally managed by including specific and detailed clauses in contracts which may avoid or at least reduce conflicts between the parties.

In the absence of specific contractual provisions, it is advisable to inform the other party promptly of any problems or impossibility to perform the agreed services in order to be able to initiate, in compliance with the principle of good faith, a renegotiation of the contractual clauses and thus safeguard the existing commercial relationship. If this is not the case, as has been said, recourse may be had to the remedies available under the legal system.