

Supply chain disruption in the face of the COVID-19 pandemic

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Authors: [Andraya Frith](#), [Wendy Gross](#), [Shira Dveris](#), Shira Dveris

The COVID-19 pandemic has raised significant challenges for the global supply chain. This is a result of unprecedented demand for goods paired with ongoing restrictions on travel and production. While the global business community is slowly beginning to emerge from COVID-19, the supply chain disruption caused by the pandemic continues to be front page news. Whether it is ongoing labour shortages, factory and plant closures, semiconductor chip scarcity, container shortages and port delays, or lumber and other commodity supply volatility, the interconnectedness of global business and the fragility of the supply chain that underpins it have never been more apparent.

Despite the gradual easing of pandemic-related restrictions, the disruption to the supply chain is far from over. Supply chain uncertainty and delays are predicted to continue to create challenges for Canadian businesses well into 2022. As businesses have become more attuned to these supply chain risks and the vulnerability inherent in certain traditional approaches to supply chain risk management, they have begun to re-evaluate their contractual rights, processes and remedies in the event their own supply chain is affected.

We discuss some of the contract-related steps that businesses should be proactively taking to help mitigate these risks.

Thorough due diligence

COVID-19 has exposed significant gaps in the supply chains of many Canadian businesses and highlighted the importance of having a strong and dependable supply chain, from the manufacturing source right through to the customer. Understanding the supply chain and identifying potential “weak links” in the chain can assist a business in addressing underlying risks. Undertaking comprehensive end-to-end due diligence of suppliers in advance can identify these risks and potentially mitigate their impact should a supply chain failure occur.

We often see clients perform extensive due diligence in relation to their immediate suppliers, without a clear understanding of the dependencies upon which the supplier itself relies in order to meet its own customers’ demands. In many cases, intermediate suppliers may not perform any due diligence further down the supply chain beyond their immediate supplier. A robust due diligence process should extend beyond the business’s immediate suppliers to include every step in the supply chain.

The due diligence process should be multi-faceted, assessing the supplier’s strength and reliability through a variety of lenses. In particular, thorough due diligence should include, at a minimum, an understanding and assessment of

- the corporate structure and the financial strength of not only the supplier counterparty

with which a business is contracting, but also relevant parent companies or affiliates

- the operational viability of the supplier
- potential regulatory risks
- business continuity and disaster recovery plans and processes
- information security standards, policies and processes
- litigation risk relating to the services to be provided
- key subcontractor risks

Understanding how a supplier has serviced its customers is also of the utmost importance. A thorough due diligence process should include meaningful reference checks. Ideally, this should extend to both current and former customers of the supplier, including, if possible, a customer who terminated its relationship with the supplier.

Due diligence can be particularly challenging where the supplier, product or service is new to the market. In those circumstances, it can be difficult to assess the risk associated with the supplier, product or service, as there may be little or no assets, performance history or customer experience to draw on. Where proper due diligence is not possible, additional contractual protections to mitigate the risks associated with a new or untested supplier, such as additional insolvency protections, are especially important.

Suppliers should consider improving their own vetting and due diligence processes of their intermediate vendors. They should also consider updating and documenting their internal business continuity plans and processes. These proactive efforts will put suppliers in a better position to respond to requests from customers. Moreover, having robust diligence processes and disaster recovery plans could create a competitive advantage over a less proactive supplier.

Due diligence may not be able to identify global supply chain failures arising from a global pandemic, but ensuring a robust supplier due diligence process is in place can mitigate other risks. For example, it can allow for a customer to appropriately plan for the worst by including redundancies in its supply chain.

In our article [White-collar defence: Increasing risks and corresponding enforcement activity](#), we discuss a number of other supply chain considerations involving compliance with laws.

Flexible contracting

Traditional approaches to contracting have been rigid, with substantial reliance on template agreements that are not customized for the context of the particular arrangement. The pandemic has demonstrated that this approach, which may be suitable in static circumstances, fails to address ways in which a relationship might need to change over time. The changing circumstances of the pandemic have highlighted the value of a flexible contractual framework. Customers and suppliers are well-advised to review and update their supplier agreements to build in the requisite flexibility with a view to enabling them to withstand changes both within the relationship and more broadly.

Examples of key changes and terms that should be considered and discussed include

- a shift away from longer-term agreements that lock parties in with little recourse in favour of agreements with shorter terms, paired with unilateral renewal rights that give the customer greater flexibility and optionality
- the addition of specific termination rights tied to clearly measurable events of non-

performance

- the inclusion of termination for convenience rights
- the addition of detailed termination assistance services
- the elimination of exclusive supply commitments
- the inclusion of robust, detailed terms relating to business continuity planning and disaster recovery
- the inclusion of more robust audit rights, access to information and rights to perform ongoing due diligence
- the inclusion of robust governance and dispute resolution processes that facilitate transparency, communication and a proactive approach to identifying and resolving issues

While these provisions are largely customer-friendly, they are important topics of discussion between suppliers and customers. Fostering a mutually beneficial relationship that works for both parties is key to building a resilient supply chain. Suppliers, while initially reluctant to change long-standing historic contracting practices, are recognizing that market changes and increased risks that customers are now facing must be addressed going forward.

Where there is a concern about the financial stability or viability of a supplier, additional contractual protections are advisable. It should be noted, however, that protections and remedies that are tied to a supplier's insolvency, such as a termination right, may not be enforceable in many jurisdictions. Accordingly, it is important to engage local insolvency counsel to work through creative and enforceable protections.

Maintaining relationships: Supplier and contract management

Too often, clients enter into agreements with suppliers and then promptly put the contracts "in a drawer." The pandemic has further reinforced the importance of ongoing management of the supplier relationship, including the contract with the supplier. This should occur in the post-contract formation period to make sure that the processes, rights and remedies that are included in the contract to mitigate risks are considered on an ongoing basis and leveraged appropriately as a tool to manage the customer-supplier relationship at a business level.

Whether it is through regular monitoring of the financial health of the supplier or relying on the rights and remedies included as part of the contract, it is important that businesses find an appropriate balance between enforcing the terms of the contract and maintaining their ongoing business relationship. The contract terms can and should be used as a critical tool in supplier relationship management.

Technology

The pandemic has accelerated the implementation of, and reliance on, supply chain logistics technologies. Whether to assist with supply chain communications or to support the back-end processes or order management, artificial intelligence (AI) platforms and software are being leveraged globally to improve supply chain efficiency.

Many traditional supply chain contracts do not include sufficiently robust terms and conditions relating to the use of technology in the supplier relationship. If a customer and supplier are using technology to manage and facilitate their relationship, it is important to ensure that appropriate terms relating to the use of such technology are incorporated. Such terms include licence rights and restrictions, technology support and maintenance obligations, data use rights, data security obligations, intellectual property rights and risk

allocation terms.

These terms can be particularly tricky where the parties are deploying AI as part of their supply chain operations, as traditional contract terms relating to data use and intellectual property rights are unlikely to be suitable. It is therefore important that businesses carefully consider the specific facts relating to the use of technology in their supplier relationships and include appropriately tailored terms to address this use.

Looking forward to 2022

The pandemic has reinforced the importance of taking a flexible and context-specific approach to supply chain contracting that will withstand the uncertainty of the future. We can expect the existing disruption to the supply chain to linger, but eventually disappear. However, we believe that the lessons learned from the challenges to supply chain management that the pandemic has brought to the fore represent best practices that customers and suppliers should continue to adopt, even as we emerge from the pandemic and the supply chain issues it has caused.