

The Fracturing of the Global Supply Chain: How to Protect Your Company

While COVID-19 has created an unprecedented global health crisis, an equally serious economic threat looms on the horizon that will engulf the United States over the next six to eighteen months. The global supply chain is broken. No facet of the domestic or global economy will emerge unscathed. Each year, \$5.3 trillion worth of goods transit through the South China Sea to customers around the world, with \$1.2 trillion of that total destined for the United States. The devastating impacts of the coronavirus on China and other Asian countries will cripple this vital trade artery. In just the first two months of 2020, around 250,000 Chinese companies declared bankruptcy. This number will only grow in the coming months. No business large or small will be immune to the challenges posed by the fractured global supply chain.

What is the Global Supply Chain?

Simply, the global supply chain is the complex worldwide network which companies everywhere rely upon to purchase goods or services. Every business, no matter whether it is a supplier, manufacturer, or seller of consumer or business products, is dependent on the smooth and uninterrupted operation of the global supply chain. For example, if you manufacture a product which is composed of ten component parts sourced from several different countries, you are intimately familiar with the challenges of the global supply chain. You know that if the factory tasked with the production of Part 3 has shuttered its doors, your operations come to a halt. It doesn't matter if you have the other nine parts; you cannot manufacture your product if you cannot obtain Part 3.

Even if you are not in the manufacturing business, your company is dependent upon the global supply chain to survive. Your suppliers are dependent on component parts obtained

somewhere along the chain. Our advice is that you act now to ensure your company will weather the impending economic fallout caused by the pandemic. By taking measured steps today, you will improve the odds of your company successfully emerging even stronger on the other side.

How the Pandemic Affects and Weakens the Supply Chain

Challenges to the successful operation of the global supply chain have always existed. Natural disasters, wars, and political upheavals in the past have all caused interruptions to varying degrees. However, the sheer scale of the COVID-19 pandemic has caused a sudden and widespread systematic disruption of the global supply chain.

In the past, your company may have been able to survive the break of a single link in your supply chain, but it is much more challenging now. Much like the intense strain on the healthcare system due to so many people falling sick at the same time, entire swaths of the global supply chain beginning in China will degrade over the coming months. Few companies (domestic or foreign) have the sufficient capital or inventory cushion necessary to survive long-term breaks in the supply chain.

Further, with so many elements of the supply chain degrading in China, once companies around the world start to realize the enormity of this crisis, they will all simultaneously try to find solutions and will consume what modest capacity exists in functioning companies. While many companies do maintain some existing capacity to facilitate production and customer orders, that capacity is not infinitely elastic, and with the coming months many companies will see that capacity entirely consumed.

It is also important to understand that the shift over the last half century from an inventory-based system to a “just in time” approach exacerbates these problems. In the mid-20th century, manufacturers stocked component parts in warehouses they owned and could easily access. Today, most companies order parts and inventory on an as-needed basis, with the products arriving at the factory right before production. This method leaves no cushion for delivery delays. “Just in time” was the brainchild of financial analysts to save money for companies by eliminating inventory. Unfortunately, they didn’t foresee the potential risks.

How COVID-19 Fractured the Chinese Supply Chain

The COVID-19 outbreak could not have come at a worse time for the Chinese supply chain. The virus began to take hold in early January 2020, at about the same time as the Chinese New Year celebration, when literally hundreds of millions of people leave their factory jobs and travel to visit family and friends within and outside of China. Chinese factories located in cities like Wuhan, the Pearl River Delta and Shanghai are often staffed by younger workers whose hometowns are hundreds, if not thousands, of miles away. These factories shut down for the New Year celebration and workers crowd themselves onto public transit to travel home to spend time with their families and friends.

Due to concerns over contagion of the virus, the Chinese government forced many factories to extend the holiday shutdowns for an extra week or two, which then stretched on much longer than expected. Workers found themselves stranded in complete lockdown in their distant hometowns. Others able to travel locally were denied the opportunity to return to their factory jobs. Needing a source of income, workers found alternate employment, and are unlikely to ever return to their factory jobs.

In a typical year, Chinese factories anticipate a loss of 10% to 15% of their workforce after each New Year’s celebration, as many workers decide to find work closer to home. In 2020, that figure is likely to be closer to 40% due to the complicating factors of quarantines and lockdowns. Even if the factories can find people to replace their diminished workforce, those new employees will need to be trained, which leads to production bottlenecks. Factories will be racing to get finished products out the door to fulfill orders and get paid. With almost half of the workforce being new hires, quality suffers.

On top of all of this, many Chinese companies are in desperate need of cash. Benefits to workers are limited; thus, both companies and workers alike often survive paycheck-to-paycheck. Having missed several weeks of payments from customers when they were unable to ship due to quarantine, Chinese companies are anxious to restart production. However, that brings us to the next problem in the chain -- COVID-19 seeped out of China and spread across the world.

COVID-19 swept into Europe, closing down many local economies and shuttering purchasers of Chinese component parts. Just as the Chinese factories were starting back up, they found that their buyers were shut down, could not accept shipments, and could not pay for them. This was the death knell for countless Chinese factories. Then, six weeks later, COVID-19 struck America, and things got even worse.

Past Solutions to Solving Supply Chain Disruptions Will Not Work

If you or your company experienced disruptions to your supply chain in the past, perhaps you attempted to assist your supplier by purchasing additional inventory, increasing the price you paid, easing payment terms, or investing in the company. These strategies assumed that (1) your company had extra working capital available, and (2) your supplier’s issues were only temporary.

But now, due to the effects of the COVID-19 pandemic, it is likely that your own company is experiencing or will experience cash flow or other capital issues, and the duration of this interruption will stretch on for months, if not years. There are a variety of legal strategies that you might consider implementing as the supply chain breaks down.

Fourteen Business/Legal Factors

The breakdown of the global supply chain brings with it a myriad of business and legal challenges for purchasers and suppliers alike. The following are some of the major issues that your company must consider.

1. **Contracts and Legal Arrangements.** The global supply chain is based on a daisy chain of contractual relationships (both formal and informal) between suppliers, buyers, and customers. In some circumstances, suppliers are independent, and other times are partially or wholly-owned by their customers. A complete understanding of the documents governing these relationships is the first step to determine what remedies and defenses exist when obligations are not met.
2. **Unique Contractual Provisions Governing Supply Chain Relationships.** In addition to standard contract clauses regarding quantity, price, and delivery, supply chain contracts commonly address the following:
 - **Intellectual property** – Trade secrets may need to be shared with manufacturers in order for them to create your product. These provisions should address who owns the intellectual property and what the ramifications are for improper disclosure.
 - **Liability for shipping costs, insurance** – Specifies which party is responsible for shipping costs and whether (and what types of) insurance is required for the goods in transit and/or storage.
3. **Protection of Intellectual Property in Supply Chain Contracts.** Supply chain contracts typically address the ownership and use of intellectual property. Oftentimes, it will be necessary for your company to share its trade secrets or patented information with your manufacturers in order for them to create your product. For example, you may have shared the secret design of a product component with your manufacturer in China, who then spends months creating a machine tool to manufacture that component. If that Chinese company is forced to close its doors due to the pandemic, what happens to that machine? How will you protect your design? Keep in mind that from time to time the protection of intellectual property will also extend to physical property that reflects those
 - **Warranties and disclaimers** – These may include express and implied warranties for goods provided.
 - **Force Majeure** – These clauses typically address unforeseeable circumstances that prevent someone from fulfilling a contract.
 - **Default** – Defines what consists a violation, or breach, of the contract in a supply chain relationship.
 - **Conflict resolution** – Will dictate the governing law of a conflict and the forum in which conflict will be resolved.
 - **Damages** – Damages may be limited to the cost of goods sold, or could include lost profits resulting from the breach. This clause may also require a party to attempt to mitigate their damages and reduce the recovery possible from their adversary if they fail to do so.
 - **Termination** – Define how the relationship can be ended and the penalties for same.

unique designs and trade secrets. For example, if specific fixtures and jigs were built custom to your product manufacture, they comprise part of your intellectual property. The same is true for injection molds for plastic that may both have unique designs as well as your company logo or trademark incorporated into that mold. To the extent feasibly possible, if the supplier is no longer in business and unable to supply the parts, these elements should be retained and retrieved if that can be done.

4. **Financial Issues Related to Supply Chain Contracts.** Your supply chain contract must clearly address payment terms. Typically, payment for goods is due upon delivery or inspection. These terms must be carefully reviewed. Some companies on the brink of failure may be unable to fulfill orders without prepayment. What are your remedies if the supplier takes your money but cannot deliver?
5. **Transportation and Shipping Issues.** Your supply chain contracts almost certainly will include a delivery time requirement and should address the ramifications of late (or failed) deliveries. Most global supply chain contracts provide for payment only upon inspection or upon receipt of the product at the customer's location. Who is responsible for failed or delayed inspections, or stolen or lost cargo? If your contract does not specifically address these issues, the laws governing your transaction must be reviewed to determine whether you have any remedies.
6. **Tax Implications.** When switching suppliers from one country to another, you may face new tax issues due to variations in taxing structures. Therefore, you are well advised to review the tax implications of doing business in each country to understand its impact on the price you pay and to ensure you are in compliance.
7. **Termination of Supply Chain Contracts.** Your supply chain contract should address the process by which it can be terminated. You may need to fulfill certain formal notice requirements or allow the supplier to cover before the relationship can be terminated. Alternatively, your supplier may seek to terminate their relationship with you because they are going out of business or simply unable to complete orders. Any remedies you may have in that situation will be defined by the contract or applicable law.
8. **Conflict Resolution.** Most international supply chain contracts will dictate whether commercial disputes are subject to arbitration or resolution through the court system and which country's laws govern the dispute. Non-U.S. companies typically prefer arbitration over the courts. In the event of a dispute with another party, you should carefully review your dispute resolution clause and the applicable jurisdiction's laws to determine your rights, remedies, and obligations.
9. **The Application of Force Majeure Clauses in Contracts.** As translated from the French language, a "force majeure" clause literally means "superior force," but more often is known to mean an "Act of God." It is a common provision in international contracts. Force majeure will typically address unforeseeable circumstances that prevent parties from fulfilling a contract. These clauses and their specific interpretations will be the subject of heated litigation as the economic impacts become worse. Some commercial contracts specifically exclude a "pandemic" as an unforeseeable circumstance. However, there may be other ways to invoke the force majeure clause, like nationwide quarantines, government-imposed shutdown of certain businesses, or "social distancing" measures which lead to the closing of factories. You will need to review the specific language of each of your

contracts to determine if a recovery may be made (or claim defended) under that clause.

9. **Immigration Issues**. With immigration bans being imposed due to COVID-19 and the increasing trend toward nationalism, it will become more difficult to find skilled workers to staff your company (or your vendor's company). As you consider the supply chain's effect on your business, do not forget to consider your employment pipeline.
10. **Tariffs and Taxes**. As a result of the pandemic and its effect on the American economy, the U.S. government continues its trend toward more protectionist economic policies, including increased tariffs on certain countries to encourage domestic growth. These tariffs not only increase the cost of goods from the targeted country, but they also have a ripple effect as other nations realize that they can raise their prices to match.
11. **How Asian Countries View Supply Chain Contracts**. Standard form contracts may vary between countries in Asia (and between companies). Companies located in different countries may require you to make payments in different ways, or to resolve disputes through arbitration that takes place in that country. Therefore, you must have an understanding of the laws of the new countries in which you plan to do business.
12. **Inspection Issues**. Due to decreased staffing, there has been a delay of shipments of goods from overseas as fewer inspections take place in the local plants. The cargo must again be inspected when it arrives at port, causing further delay.
13. **Noncompliance with Pandemic-Related Regulations**. As economies across the globe reopen, companies may attempt to accelerate production in order to fulfill contracts. In doing so, they may defy social distancing or other pandemic-related, government-

imposed restrictions. Depending on local regulations, the company could suffer large fines or even be shut down due to failure to follow these restrictions, completely eviscerating their ability to supply goods. You could find yourself without a supplier just when you thought you had solved your problem.

14. **Specific Provisions to Consider in Future Contracts**. If your existing contracts lack any of the provisions discussed in this article, it is incumbent on you and vital to the survival of your company to revise those contracts now, and include them in any contracts with new vendors.

What Must You Do Now?

How can you position your company to survive this collapse? We recommend immediately taking the following steps:

Step 1: Review your Existing Contracts. At a minimum, it is vital that you carefully review your existing contracts so you are aware of your rights, obligations, and remedies moving forward. This task should not be left to the purchasing department alone. The potential adverse economic impact of the collapse of the supply chain is so staggering that the CFO and senior operations managers of your company should be involved.

Step 2: Realign. Diversify your offshore providers. If you have one supplier in China, at a minimum seek out multiple sources from different regions of China. Consider entering into agreements with companies in other Southeast Asian countries and even other parts of the world. If you then lose one of your suppliers, you will already have relationships in place to increase production elsewhere. This will allow you to be much more agile than you would be if starting a new relationship from scratch. The oversight of having multiple suppliers will absolutely require

more energy on your part, but this is a much better alternative than your business coming to a screeching halt.

Step 3: Reshore. Consider using factories located in the United States to reduce shipping costs and speed delivery to your door. As Asian countries have transitioned over the past decades from human labor to automation, you may find that shifting production to the U.S. will be of similar cost to foreign manufacturing, especially combined with the saved expenses of shipping and other logistics. Since Mexico is both physically and politically tied to the U.S., look to Mexico as a potential supply chain location.

Conclusion

Numerous supply chain relationships and contracts have been, and will continue to be, severely damaged due to the effects of COVID-19. Companies relying primarily on China as a sole source of supply are particularly at risk. Your

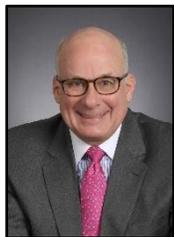
company must make decisions about its future course.

First, at a minimum, companies currently relying on suppliers in China need to seek out multiple, not single, suppliers in China.

Second, seriously evaluate the need for significant realignment of supply chain needs out of China and into other countries. The countries most likely to benefit are in Southeast Asia (Philippines, Vietnam, Cambodia, Malaysia, Indonesia), but there will also be realignments to South America and Mexico. India also has some unique advantages.

Third, there will be significant reshoring of American supply chains from Asia back to the United States. This will result in significant legal challenges for companies as they move through the process.

Fourth, contracts governing supply chain relationships must be intensely scrutinized to determine where the risk of loss lies.



The attorneys at Meyer Unkovic & Scott LLP have represented businesses in over 60 countries over the last half century. We understand global supply chain issues. Dennis Unkovic was interviewed on [CNBC's 'Power Lunch'](#) to discuss how supply chains are being disrupted and his predictions on what it will mean for the future.

Please contact **Dennis Unkovic** (412-456-2833 or du@muslaw.com) or any other Meyer, Unkovic & Scott attorney with your questions or for more information on how we can help your business survive this storm.

Meyer, Unkovic & Scott COVID-19 Resource Center

For updates on this and other legal matters associated with COVID-19, please visit our Coronavirus Legal Resource Center at: <https://www.muslaw.com/coronavirus-covid-19-resource-page/>

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