SHIPPING & TRANSPORT - INTERNATIONAL

Looking ahead towards a new global trading reality

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The COVID-19 crisis is now several weeks old and the world finds itself in an unprecedented situation both from a health and an economic perspective. This article examines how the shipping industry can manage its supply chain in the current situation.

Three phases

Three phases can be identified from a supply chain perspective.

Phase I concerns the immediate effects of and response to a worldwide crisis which has effectively stopped all cross-border transport and trade.

Phase II deals with the many uncertainties of the current situation, whereby it is unsure how long restrictive measures will remain in effect. This phase is all about the mitigation of financial exposure, finding alternative sources of supply and new markets, with the aim of preventing a prolonged crisis affecting businesses.

Phase III is when business will gradually pick up again. This phase requires planning ahead, as commercial interests must be ready to organise, or perhaps reorganise, their supply chains to meet new demands.

At present, the world finds itself in the transition between Phase I and II, with supply chains still severely interrupted due to the following series of factors:

- on the supply side: unavailability of raw materials and components;
- on the logistics side: limited possibilities to ship goods from A to B and increased costs of carriage (eg, air freight rates);
- on the sales side: serious decrease in market and consumer demand for most products and services;
- challenges to keep cash flow stable due to late payments and financial problems of customers; and
- barriers to get staff from A to B.

These interruptions may result in various players in the chain defaulting on their contractual obligations – including:

- the late or non-delivery of ordered goods and parts;
- failing logistics due to restrictions on international travel and unavailability of ports and terminals;
- buyers not being able to commit to purchase obligations; and
- debtors paying late or not at all.

Practical measures

Such non-performance of obligations must be assessed from a contractual point of view – what is the legal position in case the opposite party defaults – but also from a practical and commercial point of view.

Parties should aim to maintain commercial relationships that were profitable before the COVID-19 crisis for future purposes and will sometimes accept late payment rather than enforcing direct and full payment with the risk of putting their debtor into bankruptcy.

It is important to examine existing contracts and check:

- which obligations they contain;
- which of those obligations are at risk of not being performed correctly;
- whether parties have contractual excuses in case of non-performance; and
- whether parties have contractual remedies in case the other party is not performing.

The obvious short-term advice is to go through existing contact documentation and make an assessment of risks. This would apply not only to main contracts with suppliers, customers and logistics service providers, but also to general terms and conditions and agreements with banks and insurers. Most contracts do not have uniform solutions addressing issues of remedies in the case of non-performance, early termination rights, payment obligations and *force majeure* clauses. The specific text and underlying intention is key to properly understanding their legal effect and there have been interesting discussions about finding a good solution for these problems.

Common problems

Some common problems that need to be addressed include:

- Are there any ongoing commitments as to minimum quantities?
- What is the effect of the shortages in supply and logistics on just-in-time obligations?
- How do various sets of national legislation affect complying with specific Incoterms delivery conditions?
- Do today's circumstances affect the cost price of products or services, and is it possible to forward such extra costs to the customer under the contract?
- Do closed borders or export bans on specific goods affect the availability of goods and staff on site where they are contractually required?

The overall perspective is that current restrictions will be in place for several months to come. In Phase II, it seems that only China has passed the first stage and is slowly reopening production facilities. Europe is nearing the peak of infections and is in a practical state of social and economic lockdown, while the Americas and Africa are about to face serious challenges and are gearing up for an extended increase in infections. Therefore, even if production is starting again in the Far East, as long as consumers in Europe and the United States are not buying, those manufactured goods are not going anywhere.

Globalisation

The COVID-19 crisis is global. The world is interconnected and trade is per definition global too. Therefore, the overall situation for businesses will likely remain the same for the coming months. The performance of obligations entered into before the crisis is nearing completion and few new orders are coming in.

This means that, after having dealt with the first emergency situation, companies now need to find out how to survive a period of substantially decreased supply and demand. Companies are going into a mission-critical mode, focusing only on core business and how to keep that business intact as much as possible. This might be done by cutting costs, laying off employees and getting additional sources of financing or debt relief.

Examining existing contracts during Phase II is also advised. They can serve as a roadmap for negotiations with contractual partners. Having a proper understanding of exact rights and obligations under the contract makes it easier to renegotiate and find alternative solutions if and when necessary, without compromising a company's own position. However, parties should make sure that they carefully lay down in writing any variations to their contract documents. Further, such variations should be explicitly temporary, so that they can be undone when normal business is ready to resume.

Looking ahead

Looking ahead, while it may be difficult to imagine today, there will be a stage where restrictions are lifted, customer demand will pick up again and manufacturing and transport will be available. Although it is not to be expected that the economy will recover entirely in a perfect V-shape, it is recommended to use the coming period to reflect on how to structure the supply chain in Phase III. The next months should ideally be used to plan ahead, assess the lessons learned and consider:

- dependency on customers and suppliers;
- geographic stretch of the supply chain; and
- re-evaluation of contracts in terms of exclusivity, delivery conditions, duration, cancellation options and excusable non-performance.

This crisis has shown the vulnerability of the global trade system. If manufacturing in one country or region stops entirely, finished goods or parts necessary for the assembly of products will simply not be available, and parties cannot comply with delivery obligations towards customers. If no alternative sources of supply exist, from a cost or availability point of view, the business will come to a standstill. It is therefore recommended to look into potential multiple sources of supply and sale, so as to spread risks, even though this abandoning of exclusivity might come at a higher overall cost.

An example of the complexity of the supply chain are companies which manufacture complex machines abroad, requiring sometimes hundreds of components from different suppliers all over the world. Often manufacturing takes place in a country where the product itself is not sold. This means that both the inbound and outbound supply chain is complex and thus vulnerable. Adding to that, governments have imposed legislation preventing certain products leaving their countries, resulting in serious business interruptions. Planning for a post-crisis situation might therefore involve:

- looking at more local manufacturing;
- re-evaluating the outsourcing of certain processes;
- accelerating inventions and new digital developments;
- using web-based platforms for tailor made logistics solutions; and
- considering the advantages of additive manufacturing and 3D printing of parts.

Such new thinking might lead to a necessity to re-evaluate existing contracts. Do they provide the required flexibility to adapt in times of crisis? Are risks properly allocated and are the agreed duration and termination possibilities still in line with possible changes that are to be made in the supply chain? Is exclusivity an absolute necessity, and do any other commitments as to volumes, pricing and quality standards still apply? Further, existing agreements with banks and export or credit insurers should be reviewed in order to have adequate financial backup when it is necessary again in the future. Although contracts are built to provide the parties with legal certainty about their relationship, the current crisis has already shown that some form of flexibility within the contractual system is a useful tool to adapt to rapidly changing circumstances.

In the end, shipping companies should look to build a commercial and contractual structure that is able to maintain commercial relationships with the suppliers, customers and parties supporting their business, that can serve as a stable basis to overcome challenging times as these and prepare commercial interests for a new reality in international shipping and trade.

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