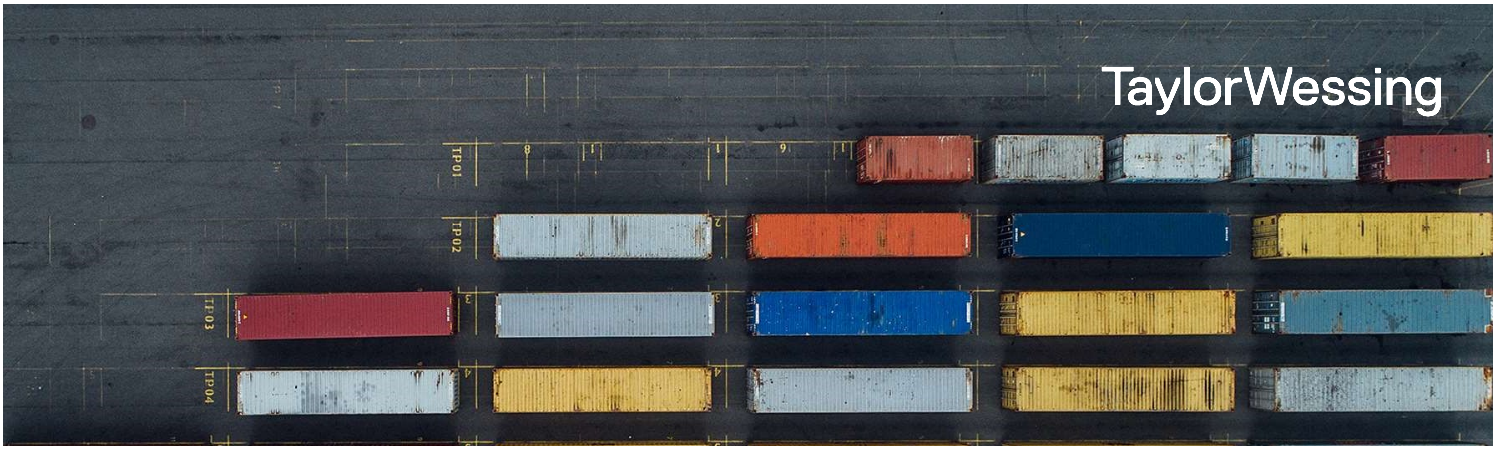


August 2020

Closer to shorter supply chains !?

Next Normal: Supply Chain Management

CONTENT

INTRODUCTION AND SUMMARY

Radical events often trigger transformation processes - a new kind of **unvoluntary disruption**. Global **pandemics** (such as the current one) or the ongoing **economic-political conflicts (Brexit, customs duties, embargoes, etc.)** will lead to the rethinking and changing of cumbersomely acquired patterns and structures of **lean management**, such as **Just-in-Time (JIT)** or **Kanban.** This is especially true for manufacturing companies and their supply chains, both in **purchasing,** i.e. **supply or sourcing**, and in **sales**, i.e. **sales & distribution.** Thus, after sometimes humorous self-reflection[1], new **supply chains** will emerge in order to be prepared for the future. This is sometimes referred to as "**slowbalisation**".

In **supply,** we will have to think about **dual sourcing** and **multiple sourcing, alternatives** and smart **regional and economic-political distribution**; it is questionable whether costs will still be the main focus. In addition, monitoring and information systems - eventually also more **digitalization** - are needed as part of a modern **supply chain risk management,** to probably receive real time information on supply and the estimated arrival time. More **warehousing** via **vendor or customer managed inventories** will also be an issue. It is, in addition to that, about **pivoting supply chains** and – of course – more **risk resilience in global value chains.**

Sales will also focus on **vendor or customer managed inventories** and logically and logistically **consignment, commission** agreements will become more interesting, even if this means that the sales risks will shift.

In **sales (distribution),** more thought will be given to consignment and commission business, and for the **retailer** the topic of **center management (shop in shop, concession)** and perhaps **franchising** will become even more interesting, because responsibility for long and large-volume flows of goods seems rather unfavourable.

This requires some further thoughts.

[1] LBBW economist, Jens-Oliver Niklasch: *"Hätte, hätte, Lieferkette"*, https://de.reuters.com/article/deutschland-industrie-produktion-idDEKBN21P0QP

PANDEMIC - STRESS TEST FOR THE SUPPLY CHAIN

The pandemic will of course have an impact on the supply chain, mostly in the form of delayed deliveries and reduced transport and delivery volumes; but it will also result in productivity losses, reduced inventory availability, supplier failure, price increases and quality defects[2].

Base: Companies in Germany and Austria (n=74)
Source: BMÖ 2020

The **legal questions in** this regard are somewhat unresolved. Although **force majeure** is often referred to, its prerequisites and legal consequences are also unclear in those legal systems in which force majeure is known.

In German law (BGB), force majeure is not stipulated, "only" **impossibility**, **elimination of the basis of transaction** and the **principle of fault in damage compensation law** is applicable. Common law also knows **hardship and frustration**. However, seeking reliable answers for basic questions in German law on pandemic consequences is more than difficult.[3]

IMPACT ON MANAGEMENT

Controlling and optimizing the supply chain is a central task for every producing company. Often, the current value chain is optimized according to lean management principles and processes and activities are strongly interlocked to achieve maximum efficiency.

The end of Lean Management[4]?

Lean management is a corporate philosophy of (down to the smallest detail) omitting all unnecessary operations in production and administration by means of a more intelligent organization.

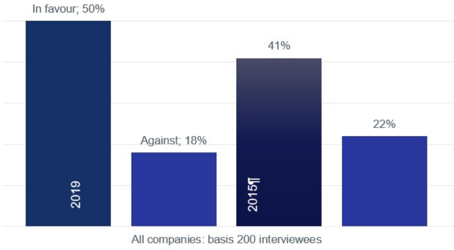
Just in Time (JIT) or demand-based production refers to a logistics-oriented, decentralized organizational and controlwise concept in which only the material is produced and delivered in the quantity and at the time actually required to fulfill the sales orders.

Kanban (originates from the Japanese. - where かんばん (看板) means "map") as a method of production process control is based exclusively on the actual consumption of materials at the point of provision and consumption and allows local stocks of intermediate products near to production to be reduced. The aim is to control the value-added chain at each manufacturing/production stage in a cost-optimized manner by means of asynchronous withdrawals/deliveries from/to buffer storage.

Six Sigma is a management system for process improvement through description, measurement, analysis, improvement and monitoring of business processes with statistical means using the procedure Define - Measure - Analyze - Improve - Control (DMAIC). Six Sigma projects ultimately pursue the improvement of the company result.

However, the streamlining of structures is becoming Achilles' heel in the great crisis - **the new motto should be: more local, more flexible, more transparent and, if possible, doubly secured**[5]. *Crises such as the spread of the new corona virus demonstrate the dangers of excessive dependence on a single supplier or various partners from the same region*.[6]

Already in times before Corona (COVID-19), every second company assumed that its own procurement management would experience a significant tightening of the risk environment in the future[7]:



*However, despite this risk situation, only six out of ten German companies have a holistic **risk management system**[8]. At the same time, **supply chain management** is not yet considered a central corporate function by approximately half of the companies.*[9] People also consider **Pivoting Supply Chains.** And in a McKinsey survey of supply chain executives (May 2020), "***93%** percent reported that they plan to take steps to make their supply chains more resilient, including building in redundancy across suppliers, nearshoring, reducing the number of unique parts, and regionalizing their supply chains".* [10]

This will be a cause for rethinking. With or without **ISO 31000** (risk management system) it will be important to **identify risks** (everyday life and exceptions). Risk objects are e.g. suppliers, states, politics, regions, regulations as well as means of transport – to **evaluate** (assessment of the probability of occurrence and extent of damage of a risk – quantitatively and qualitatively), and to **control** them (via prevention, processes, measures, insurance) and to **monitor** (over time). It is all about **Supply Chain Risk Management (SCRM)** as an element of **Supply Chain Management (SCM)** to improve the long-term performance of individual companies and the supply chain as a whole.

For such **SCRM** and **SCM** often used

[2] https://www.sparkasse.de/themen/mittelstand/supply-chain-management.html
[3] See Rothermel in IHR 2020, p. 89 et seq.: "Ereignisse (Coronavirus, Brexit, Embargos, Zölle, u.a.) und höhere Gewalt, Unmöglichkeit, Wegfall der Geschäftsgrundlage, Hardship, Frustration im BGB und in anderen Rechtsordnungen – braucht es eine Klausel?"
[4] Sources: Wikipedia
[5] Manager Magazine, 16 March 2020
[6] logistics-today.en/news/scm-supply-chains-for-the-time-after-the-corona pandemic-30317.html
[7] https://www.hermes-supply-chain-blog.com/wp-content/uploads/2019/11/hermes-barometer-11-risikopraevention-versorgungssicherheit.pdf
[8] https://www.hermes-supply-chain-blog.com/scm-supply-chain-risikomanagement/
[9] https://www.hermes-supply-chain-blog.com/wp-content/uploads/2019/04/Hermes-Barometer_10.pdf
[10] https://www.mckinsey.com/business-functions/operations/our-insights/risk-resilience-and-rebalancing-in-global-value-chains

tools as **Stochastic Scenario Analysis (Monte Carlo)** and **Business Wargaming** and others can be used. Of course, it also has an interdependence with **Compliance** and good **Corporate Governance.**

SUPPLY CHAIN RISKS

Based on the current situation, it is now necessary to *"quantify the risk over various time horizons and weigh up future scenarios (pessimistic/expected/optimistic). For each potential future scenario, the supply and demand situation must be understood (Can I produce? If I can produce, can my customer consume?*[11]) The question is also: "who is the risk owner?

To this end, the test covers the following topics (purchasing side "*p*" and sales side "*s* "):

- *p:* single sourcing or too few suppliers for certain (preliminary) products (instead of dual sourcing or multi-sourcing) and too many stock keeping units (SKUs)
- *p:* sub-optimal quota regulations for suppliers (keyword 60/30/10 or max. 30, etc.)
- *p:* know-how or raw material or manufacturing or tooling predominance of a single one supplier
- *p:* regional concentration of suppliers
- *p, s:* Just-in-Time (JIT) deliveries, little information and poor transparency
- *p, s:* wide or cheap delivery routes
- *p, s:* low storage capacities at suppliers, in the own company and at customers or distribution partners
- *p, s:* low capital cover of suppliers or the own company.

*More than ever before, **purchasing managers** must think multi-centrally, i.e. work with several suppliers in different world regions and currency areas for many components*[12]. This has advantages and disadvantages. It allows to gain more supply security, have a better position in negotiations, trigger a certain pressure to innovate on the supplier and possibly have a better distribution of quantities and risks. However, it also entails higher ordering and transaction costs, more communication effort and ultimately more effort in **contract management**

Sales managers have to find ways how to achieve decentralized availability of goods and think about new non-physical or non-transport intensive sales and delivery systems. This makes **area or center management** (**shop-in-shop**) and **concession** more interesting for retail chains. In addition, **franchising** may be a stronger option, even if **vertical integration of supply chains** has been a good recipe for great success in the recent past (see Zara et al).

CONTENTS OF NEW SUPPLY CHAINS

With regard to the structural change in the supply chain, the following should be considered (leading to domestic production, more stock, nearshoring, or new rounds of offshoring to new locations):

- **Dual sourcing**, **double sourcing**, **multiple sourcing**, **insourcing** (“***make or buy***”)
- **Alternatives** in raw materials, feedstock, unprocessed material, commodities, semi-finished products
- **Pooling of production resources** - several suppliers have access to raw materials, semi-finished products tools and know-how, so that a change or changeover can take place quickly
- **Regional and political reorganization** - local and political diversity ensure supply chain stability[13]
- **Warehousing** - temporary bottlenecks in delivery can be soft-cushioned by own stockpiling or by buffer storage at the place where the goods are needed; see also consignments (VMI and CMI) and commission
- **Flexibility** of suppliers without ***frozen windows,*** etc.
- **Alternative logistics concepts** to avoid carrier risks
- Partner with flexible concepts in ***demand fulfilment***
- Strong **monitoring** - possibly also **digital** - with detailed reporting obligations of environmental, political or economic influences on the contractual partner in real time
- **Financing models** by the customer for stabilization or bridging (***Supplier Finance***)
- **Supplier pooling** across multiple customers
- **Digitalization** for immediate information about the supply chain

Commission

Commission agreements are characterized by relieving the dealer of his risks of sales, because he acts externally as a dealer, but is entitled vis-à-vis his supplier to pass on the risks to his suppliers in the event of weak sales or of warranty etc. (**in his own name but on behalf of a third party**). Often the commission is linked to **consignment stock** at the dealer's warehouse, which he does not have to purchase but can return (see below).

CONSIDERATIONS ON NEW SUPPLY CHAINS

The factual and economic issues are followed by legal considerations. The reorganization or restructuring of existing supply chains requires creative measures with regard to old and new contracts:

- **Examination and preparation of restructuring**: Are there long-term contracts, are they exclusive, are there minimum purchase quantities? Are these terminable? If so, what notice periods apply? What

[11] https://content.kinaxis.com/disruption/best-practices-disruption?swoffid=pf-disruptions&swmedium=cpc&swgeo=emea&utm_source=google&utm_medium=online-ad&swsource=google&utm_campaign=7011O000003FjPs&swcampaignid=7011O000003FjPs&utm_term=102453369747&swaudience=102453369747&utm_content=pf-disruptions&gclid=EAIaIQobChMI2-DnqeCA6QIV04TVCh0RvQQuEAAYAiAAEgJL7vD_BwE

[12] Marc Kloepfel, Manager Magazine, 16 March 2020

[13] "The classic perspective of a large global factory, in which I can always choose the most favourable location, is increasingly faltering". Nikolaus Lang, Senior Partner, Boston Consulting Group, Manager Magazin, 16 March 2020

are the consequences in terms of raw materials, know-how and tools?

- Based on previous examination - **what needs to be prepared** strategically/tactically?
- **Terminations** within the prescribed period (finding the correct wording, the correct reasoning, fulfilling the correct form and notice period, informing everybody who is concerned correctly, etc.).
- **Selection** of the new/additional supplier (*know your supplier*)
  - Are there requirements for auditing, qualification, certification?
  - Can products be delivered immediately? Are there scarce raw materials, special semi-finished products, long preparations, etc.?
  - Can the necessary volumes and quality requirements be achieved?
  - Where is the delivery coming from? Keywords: delivery routes, import costs, logistics, embargos.
  - Compliance aspects.
  - Supplier Code of Conduct (substantially similar to the company's CoC with key points).
  - Sustainability, Diversity.
- Pooling of know-how, raw materials and/or production resources.
- Delivery obligations, stockholding obligations.
- Setting up consignment warehouses (VMI or CMI) and possibly matching Commission Systems with traders.
- Center management, shop in shops, concessions and franchising instead of distribution and trade.
- Monitoring systems, information obligations, digitalization.
- Adjustment of force majeure clauses.
- …and the usual best practice: e.g. smart contract terms, contractual penalties, liquidated damages and other rights and obligations, as well as appropriate choices of law / jurisdictions clauses.

Regardless of which measures prove to be correct in the end and which new supplier contracts are stipulated: decisions should be taken in a structured and centrally controlled process[14]. And, of course, they need constant review and adaptation.

LEGAL ISSUES FOR NEW SUPPLY CHAINS

"***Pacta sunt servanda***" - existing contracts must be honoured if they cannot be modified or terminated

Problem: Tools, know-how and other exclusivities

The importance of tools (e.g. die-casting tools or injection molding tools, etc.), which the supplier needs for the production of e.g. the desired serial articles in large quantities, should not be underestimated. In the case of a single-sourcing strategy, **tools** often become the supplier's bargaining chip and the problem arises, that the new supplier needs precisely this tool for production. In this case, the new supplier must either manufacture the tool himself (with the corresponding loss of time and costs and provided that the new supplier also has the corresponding **know-how**) or the tool used by the previous supplier is made available to him. Since this tool is naturally located with the previous supplier and the latter could refuse to hand it over for various reasons (e.g. use as a means of pressure), two important questions arise from a legal point of view: Do I have a claim for the tool or the know-how against my previous supplier? And what happens to the tool or know-how in the event of the supplier's insolvency? The answer to both questions depends to a large extent on the legal position of the tools, in other words: who owns the tool or the know-how? Unfortunately, clear contractual regulations are usually missing. Therefore, it is necessary to rely on statutory law and case law.

So far, however, relatively few **court decisions on tools** have been issued. There may be a tendency that if the tool was explicitly paid for (not only by amortization via the parts price), the "tool contract" is classified as a contract for work and materials. Then the provisions of the law of sale are applicable, i.e. the seller has the obligation "to hand over the item to the buyer and to transfer ownership of the item"[15] and the buyer thus has a claim for restitution. In the event of insolvency, it is of fundamental importance who is the owner of the tool. The owner can claim a so-called **right of separation**: the insolvency administrator must hand over the tool to the owner and may not use or sell it. This way the owner is privileged in comparison to other insolvency creditors. However, the tools can be released from the insolvency estate only in cases where the ownership can be proven beyond doubt, so that in the absence of clear contractual provisions, one faces the same problems as with the claim for restitution. In order to secure the position, it is therefore advisable to have clear contractual provisions, especially with regard to the position of ownership, the handover and a supplier's obligation to identify the tools, in order to speed up the separation in the event of insolvency. It should be noted, however, that under the rules of conflict of laws, regulations on ownership are always subject to the law of the country in which the object is located.

The same applies, of course, to **know-how**, although it must be assumed that know-how basically belongs to the supplier unless otherwise agreed. In this case, contractual agreements must be made (e.g. also for licensing the know-how to a third party, etc.).

If the supplier is contractually granted **exclusivity** or promised **minimum quantities** or the **purchase of the entire requirement**, it is of course difficult to switch to another supplier without breaching the contract.

[14] https://content.kinaxis.com/disruption/best-practices-disruption?swoffid=pf-disruptions&swmedium=cpc&swgeo=emea&utm_source=google&utm_medium=online-ad&swsource=google&utm_campaign=7011O000003FjPs&swcampaignid=7011O000003FjPs&utm_term=102453369747&swaudience=102453369747&utm_content=pf-disruptions&gclid=EAIaIQobChMI2-DnqeCA6QIV04TVCh0RvQQuEAAYAiAAEgJL7vD_BwE

[15] See inter alia OLG Köln, judgment of 7 June 1989 - 24 U 49/89; OLG Düsseldorf, judgment of 25 October 1996 - 22 U 56/96; Budde in: Martinek/Semler/Flohr, Handbuch des Vertriebsrechts 4th edition 2016, § 39 Framework supply agreements, para. no. 28

Know-how, raw material, semi-finished products or production equipment pooling agreements are naturally difficult to negotiate. Perhaps **trustee solutions (escrows)** can help, whereby knowledge or production resources are transferred to the customer or other suppliers in certain cases, only. In addition, **antitrust regulations** must be observed in such arrangements, as there is at least an **influence on secret competition** or even **coordination**, which could then be critical, especially for **competitors.**

Vendor Managed Inventory, Customer Managed Inventory, Consignments, etc.

In Vendor Managed Inventory (VMI),[16] the supplier takes responsibility for the stocks of his products at the customer's premises - in contrast to Customer Managed Inventory (CMI). The inventory at the customer's site is completely managed by the supplier. In return, the customer is often granted the full right of return (e.g. also via commission). The basis for the calculation of deliveries are, for example, consumption or sales figures, which can either be recorded during regular replenishment by the supplier or can also be transmitted electronically.

In principle, there are three concepts. In the first form (continuous replenishment), the supplier visits the customer at regular intervals, determines the shortage for the next delivery and delivers the shortages detected during the last visit (typically, for example, for fasteners in industry). In the second form (classic VMI), the customer determines his consumption and transfers this data to the vendor, who uses agreed data to determine when further deliveries will be made. However, no explicit purchase order from the customer is required for this delivery. The downstream commercial processes (invoicing) are generally not changed by VMI. In the third form (consignment inventory), the vendor is in fact the owner of part of the retailer's warehouse, which he can stock as required.

Economic benefits

- fast reaction of the supplier to variations in demand
- higher level of service, avoidance of out-of-stock situations in retail
- higher responsibility and more freedom for the supplier in scheduling deliveries
- cheaper batches
- low unconscious stock levels at the dealer
- increasing sales and reduced return volumes through demand-based subsequent deliveries
- optimization of the supplier's transports
- supplier knows the sales of comparable dealers and can therefore predict demand more accurately than the dealer himself

Economic disadvantages

- high investment costs
- difficult to measure via KPI etc.
- not necessarily applicable to complete assortments but conceivable
- insights into the "internal structure" (including business data) of a company by the supplier
- high dependence on suppliers
- allocation to accounting periods difficult

Legal constructions

A warehouse at the customer's site which is not in the ownership of the customer is legally defined a consignment stock. The following questions, for example, are to be dealt with on a contractual basis:

- Who owns the products in the warehouse at the time of receipt of goods, at the time of removal, in the event of possible return and which insertion and removal rules apply (*first in first out*, etc.), and what is the situation against the background of any *shelf life* periods and the warranty (e.g. inspection and notification of defects, start and end of the warranty period, burden of proof, etc.)?
- Marking of the goods, maintenance of the goods, updates, etc.
- Insurance of the goods
- Taking inventory of the goods

Taxation of the goods in the country where the consignment stock is located (keyword: **permanent establishment**) and the **balance sheet treatment of goods and sales** may be problematic**.** Also, it might be a KPI issue for the incentives within the organisation.

Consignment stock agreements (consignments) are to be examined internationally, among other things, with regard to the **taxable business location issue** and the **effects on the balance sheet.**

In addition, the determination of who is entitled to **ownership** is based on the law of the country in which the goods are located and this can generally be different from German law. In addition, the **rights to separation under insolvency law** vary from country to country.

Supplier Finance is a separate topic, as commercial lending requires approval and regulations must be observed. This also applies to **reverse factoring** and **supply chain finance**.

Commission contracts in the merchant sector are of course sometimes considered economically unpleasant if the seller has to take back the goods (it is often combined with consignment, but are not necessarily linked to it). Nevertheless, these systems also have clear advantages, as they allow much more influence on a sales partner than on a dealer without commission character, because antitrust regulations do not apply to commission contracts (if there are no untypical risks for the commissioner). In addition to that: it might make more sense to fulfil customers' demand via consignment stock and commission agreements with retailers instead of being unable to satisfy customers (even if consignment stock and commissions may not be free from disadvantages). Also, there is constant danger to loose market share in such situations.

If you want to avoid responsibility for supply and availability of goods, **area management (shop in shop), concessions shops** or **franchising** may be a **good option**, as all of them require the partner to take the procurement and delivery risks. However, in most cases, remuneration is to be paid depending on turnover, or some kind of rent is due, which may then fall into a moratorium. Not all products are suitable to **3D printing**[17]. Nevertheless, it would be a great alternative to get goods from place A to place B.

[16] Wikipedia: https://de.wikipedia.org/wiki/Vendor_Managed_Inventory
[17] See our publication "Die vierte Dimension Komplizierte Rechtsfragen im 3D-Druck".

PLEASE FEEL FREE TO CONTACT US!

Taylor Wessing

Isartorplatz 8, 80331 München
Tel. +49 (0) 89 21038 - 0 Fax +49 (0) 89 21038-300

Benrather Str. 15, 40213 Düsseldorf
Tel. +49 (0) 211 8387- 0 Fax +49 (0) 211 8387-100

Thurn-und-Taxis-Platz 6, 60313 Frankfurt a.M.
Tel. +49 (0) 69 97130 - 0 Fax +49 (0) 69 97130 - 100

Your contacts for commercial and distribution law

Dr. Martin Rothermel
Tel. +49 (0) 89 21038 - 121
Fax +49 (0) 89 21038 - 300
m.rothermel@taylorwessing.com

Dr. Benedikt Rohrßen
Tel. +49 (0) 89 21038 - 204
Fax +49 (0) 89 21038 - 300
b.rohrssen@taylorwessing.com

Dr. Michael Kieffer
Tel. +49 (0) 89 21038 - 241
Fax +49 (0) 89 21038 - 300
m.kieffer@taylorwessing.com

Arno Gotting, M.A., LL.M.
Tel. +49 (0) 69 97130-177
Fax +49 (0) 69 97130-100
a.gotting@taylorwessing.com

Michael Wietzorek
Tel. +49 (0) 89 21038 - 296
Fax +49 (0) 89 21038 - 300
m.wietzorek@taylorwessing.com

Giorgia Carandente,LL.M.Eur.
Tel. +49 (0) 89 21038 - 214
Fax +49 (0) 89 21038 - 300
g.carandente@taylorwessing.com

Sebastian Rünz, LL.M.
Tel. +49 (0) 211 8387 - 278
Fax +49 (0) 211 8387 - 100
s.ruenz@taylorwessing.com

Jennifer Pohl
Tel. +49 (0) 211 8387 - 205
Fax. +49 (0) 211 8387 - 100
j.pohl@taylorwessing.com

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