DISRUPTION PROTECTORS

COMPANIES CAN TAKE THREE STEPS TO MINIMIZE THE COSTS OF A SUPPLY CHAIN INTERRUPTION. BY JONATHAN M. COHEN AND JOHN J. GIRGENTI

Supply chains have grown increasingly complex. Each link in the chain presents the potential for a problem, and any disruption may cause costly consequences throughout the supply chain. Adopting a proactive solution now might minimize the financial costs to a company in the future. There are three immediate steps that any company can take to protect against the high costs of a supply chain disruption.

SUPPLY CHAIN RISK TRENDS

According to the Business Continuity Institute's 2013 "Supply Chain Survey," 75 percent of surveyed companies reported at least one supply chain disruption in 2012, and 15 percent reported annual losses of more than $1.4 million because of these disruptions. The most reported and high-impact disruptions were caused by IT/Telecom outages,

adverse weather and outsourcer service failures in manufacturing and production. For manufacturing companies, product quality incidents and transport network disruptions are the most prominent causes. Although the majority of supply chain disruptions occurred as a result of a direct supplier's problem, 42 percent were caused deeper down the supply chain by a supplier's supplier or even that supplier's supplier.

The World Economic Forum's 2013 "Building Resilience in Supply Chains" found that four of the top five disruption triggers from 2011 to 2012 remained constant. This finding suggests that the causes of supply chain disruptions will remain reasonably stable, at least over the near term, which makes them relatively predictable for now and thus easier to prepare for.

Notwithstanding the short-term stability of the supply chain disruption causes, two other recent trends suggest a continuing evolution. First, due in part to the nature of transportation and just-in-time production, even a problem with the smallest supplier can lead to a magnified impact throughout the supply chain. Second, the increase in global suppliers and long supply chains has increased the risk to supply chains because of potential quality control issues and because a longer supply chain is more susceptible to the most common types of disruptions.

MITIGATING DISRUPTION RISKS

There are three things every company can do immediately to protect against the costs of a potential disruption to their supply chain.

The causes of supply chain disruptions are relatively predictable for now.

Plan ahead by understanding risks – First, plan ahead. Before a crisis occurs, prepare and follow a business plan. Understand what the risks are, recognize the protections already in place and implement them in a manner consistent with this plan. Conduct a risk and insurance audit. This includes having an outside professional – often an attorney – identify and evaluate potential risks; and then review the insurance policies, customer agreements, indemnifications and insurance requirement provisions that your company and its customers are relying on for protection. Ensure that the breadth and scope of the company's protections and those it gives to others are consistent with your business strategy and willingness to take on risk. Implement an effective cost-tracking system to trace dollars spent in responding to a supply chain crisis in a way that matches each dollar to the specific insurance policies or other sources of recovery that is designed to pay that type of expenditure.

Understand and evaluate contract-based protections – Second, know which protections are available and how they apply. There are three key types of contractual risk-spreading devices in the supply chain context. Together, these protections form a mosaic that should comprehensively cover an array of risks. Companies, though, must recognize any gaps in these protections and make judgments as to how to address them.

The three contractual components to a supply chain risk mitigation program include indemnification provisions, which often appear in supply or customer contracts, obligate a party to compensate another party for losses, liability or damages that might be incurred, separate and apart from any other contractual obligations (such as warranty or guaranty obligations) or tort damages. There are numerous potential limitations as to how effective an indemnity may be, including questions of: How broadly is the indemnity written? Does the indemnitor have the resources to indemnify? Is the indemnity enforceable as a matter of law? Is the indemnity bilateral? Is there any monetary cap on the amount of the indemnity? If there is a defense obligation, how does it apply? Things may become complicated, so it is critical to consider

carefully the legal and practical implications of the contract language.

Many supplier or customer agreements will contain terms that require the supplying company to procure and maintain certain levels and types of insurance coverage, as well as dictating specific terms of coverage. These requirements may include provisions that require the recipient to be an additional insured under the supplier's policy. The specific contract language in each agreement may determine how effective these types of requirements can be, both for the party taking on the obligation and the party getting the benefit of the obligation. Parties taking on an insurance obligation should be careful to ensure that they can satisfy these requirements, and parties relying on a supplier's insurance should ensure that they have procedures in place to confirm the terms of coverage, including access to the policy itself rather than solely a certificate of insurance.

Another type of protection is found in a company's own insurance. Companies generally have an array of different kinds of coverage that may apply depending upon the specific type of, and cause of, supply chain losses and liabilities. Most companies have general liability policies that cover certain third party claims for bodily injuries and property damage. Companies also may have a business interruption policy, which can cover your company's loss of profit resulting from both from covered damage to your own property and from damage to your customers' or suppliers' property. Directors and officers policies sometimes contain broad catch-all coverage that can indemnify against a company's own liability for a wrongful act. Finally, specialty policies such as recall or contamination insurance, may cover costs attributable to specific types of disruptions. That might be limited or excluded under other types of standard business policies. Because of the ever-evolving body of law relating to how these types of insurance policies apply in the context of supply chain disruptions, as well as exclusions built into all insurance policies, a company must ensure that its insurance policies actually provide the benefits and protections that it expects.

Recognize and prepare to take immediate early steps when a crisis occurs – Third, be prepared to take immediate action when a problem arises. Many contracts and insurance policies contain requirements regarding what a company must do when an incident occurs, and failure to meet those requirements can adversely affect whether and how much a company may recover. Before a problem arises, know these requirements – by the time a crisis occurs, there may not be time to begin that process. Upon learning of a problem, make sure to comply with those requirements. This almost always means giving prompt notice of a claim to all insurers with any potential for coverage and all potential indemnifiers. It can also mean keeping these parties informed as events transpire, providing insurers with timely proof of any loss, cooperating with insurers or indemnitors, and coordinating efforts to mitigate the damages arising from these disruptions.

In supply chain risk mitigation, taking modest steps today can prevent or solve bigger problems later. Being prepared, exercising appropriate diligence before any problems arise, and implementing the kinds of strategies and steps that will be necessary upon a problem occurring can be instrumental in minimizing the ultimate cost of a disruption. ❑

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