

MULTIMODAL

Globalisation of International supply chains

While global markets increase a company's ability to maximise sales and profits, they also increase the level of potential risks. Effective management of global supply chains is increasingly important. Lawyers have a vital role to play in drafting the complex contractual arrangements underpinning such chains.

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A NEW ERA DAWNS

Over the past decade the international economy has shed its national and regional boundaries and transformed itself into a 'global market'. This is not just a media cliché - but something that is profoundly important to international business. Many international companies have become 'virtual' companies - entities whose main asset is their corporate identities (fiercely protected through brands and other intellectual property rights). Such organisations pull together different elements of the economic chain, on a global scale, to bring international-quality products to the market-place. Many aspects of the operation are outsourced to countries that have a competitive advantage. Nike, Wal-Mart, Woolworths, British Airways and McDonalds are examples of companies that have successfully adopted this 'global' philosophy.

Satisfying customer requirements across national borders requires a very different supply chain capability to that needed to support local operations. Effective management of global supply chains will be fundamental to maximising opportunities and minimising associated risk. Lawyers have a vital role to play in ensuring that the complex contractual arrangements necessary to underpin such chains are put in place.

A good example of this new approach is provided by Capespan, in the temperature-controlled produce sector. Capespan recently brought back under shared control many of the operations wholly farmed out. Capespan has had to adapt to a market place that has undergone radical structural changes. The UK market is now dominated by the multiple supermarkets that purchase enormous quantities of imports and dictate stringent service levels as well as price caps. Companies can only survive by meeting their operational and cost specifications.

Wholesale outsourcing of elements of the supply chain was previously fashionable - however, if a transport or storage provider lets a company down this can mean the loss of a vital contract with, say, a large supermarket. Supply chains are only as strong as their weakest links. While wholesale outsourcing was not considered a viable proposition, for quality control

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▶ sharing mechanisms; plant and equipment contributions; share transfer rights, as well as deadlock and exit provisions.

v) Service Level Specifications

Clear arms-length service level specifications must be incorporated into the legal framework and particularly the service agreement. These agreements should set out the back-to-back service level specifications ("SLSs") first identified in the ITT and provide for them to be 'cascaded downstream' to sub-service providers. As noted above, the principal provider will effectively be made responsible.

vi) Key Performance Measures

The SLSs must give effect to the customers' operational service levels and the key performance measures ("KPMs") by which the services will be measured. Users' KPMs will vary, but usually focus on: delivery timescales, order fulfilment, damage/wastage levels, realisation of cost savings, handling and storage standards, documentation management (e.g. bills of lading and proof of deliveries), compensation triggers and levels for default, response times and contract monitoring and review.

vii) Variation Procedures

In addition to ensuring the supply chain is able to respond swiftly to market forces, variation procedures must be incorporated to ensure that service specifications remain flexible. This flexibility must be applied back-to-back to downstream operations, and cover all services: management & coordination, quality control and assurance, stevedoring, RH&D, warehouse/coldstore, transport or otherwise. The potential risk for principal service providers is clear and must be minimised by appropriate upstream indemnities.

viii) Information Technology ("IT") Arrangements

Improvements in supply chain performance have largely been facilitated by developments in IT, facilitating information flow and 'real

time' control. As for the principal service agreements, IT procurement contracts must provide for detailed ITTs incorporating SRSs, detailed procedures for acceptance testing, maintenance and support, updates and enhancements. In addition, they should provide for access to source code and escrow arrangements in the event of the IT supplier's breach or liquidation.

ix) Warehousing and Infrastructure Facilities

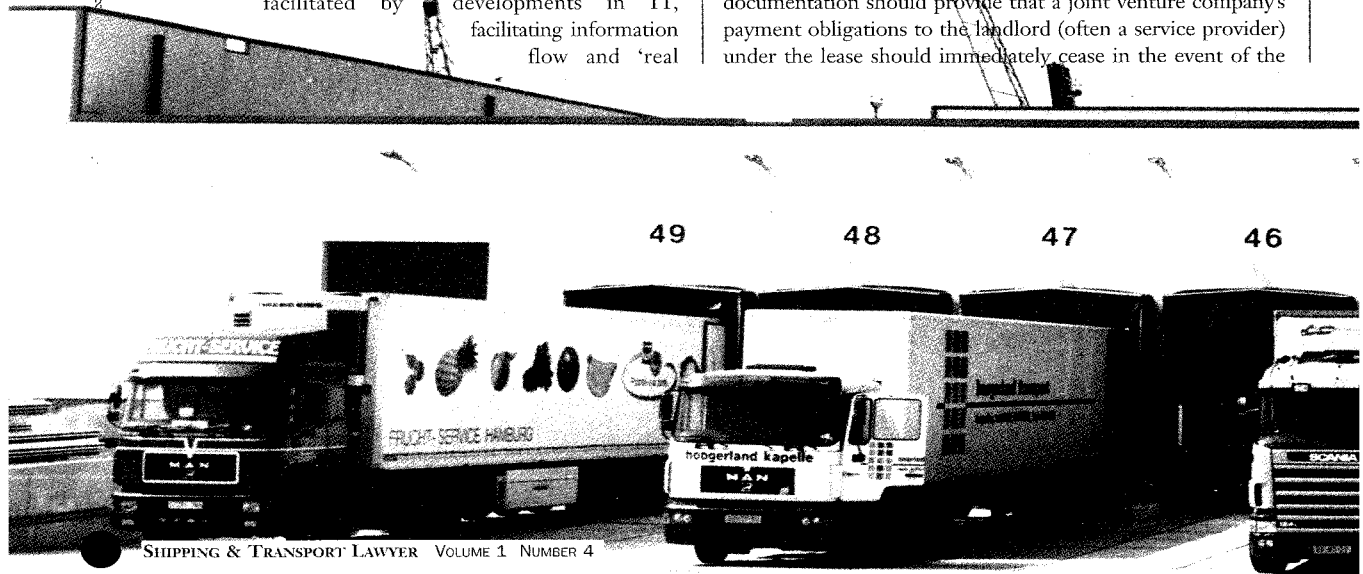
Frequently, global supply chain solutions will involve the development of dedicated warehouse and other infrastructure facilities. During the relatively long lead times associated with the design and building of such facilities, the contractual arrangements, are frequently managed by the service providers who will ultimately be responsible for providing the relevant services. Service users should retain the contractual right to intervene and appoint chartered surveyors or supply chain consultants where appropriate during the construction phase. This may, for instance, be necessary where the build deviates from the design specification, or to reflect a change in the user's operational and handling requirements.

x) Interrelationship between the Agreements

Whether the contracts centre around a formal joint venture, outsourcing contract or conventional service agreements, the interrelationship between agreements is critical. Detailed drafting of the key principles, first outlined in the ITT, will incentivise ongoing compliance with long term operational objectives to the benefit of service users and providers alike.

xi) Exit Arrangements

User/provider and inter-provider relationships can break down as with any partnership and the termination mechanisms for each interrelated principal and downstream contract will require careful drafting. For example, facility leasing documentation should provide that a joint venture company's payment obligations to the landlord (often a service provider) under the lease should immediately cease in the event of the



reasons, major suppliers like Capespan were reluctant to bring complex supply chain activity, including transport and storage operations fully 'in-house'. This reluctance arose from a lack of operational global-supply-chain expertise and associated investment costs. The answer for Capespan and others has been to enter a number of strategic alliance partnerships with trusted service providers. These partnerships are placed under the management of a principal joint-venture service provider.

In a global environment few individual service-providers will have the capability to offer a truly full service, crossing national boundaries. This will be the catalyst both for supply chain consolidation (e.g. Deutsche Post's \$3bn worldwide acquisition programme, P&O's acquisition of ITO, P&O Containers & Nedlloyd Lines) and partnerships between service providers operating at different levels in the supply chain and across national boundaries.

I) ADVANTAGES OF CONTROL AND INTEGRATION OF SUPPLY CHAINS
Some of the Advantages are as Follows:

i) Squeezing inefficiencies out of the supply chain to key customers is essential to maintain market share and can help to enhance companies' profit margins. The customer's buzz phrase is "least cost distribution". By realising efficiencies in the supply chain to key customers, suppliers can be proactive in complying with just-in-time and continuous replenishment regimes. In turn, this improves product flow and reduces inventory levels and costs.

ii) Providing the customer with a 'one-stop' shop. A fully integrated supply chain with a single point of customer contact can mean that the receiver only has to pay one invoice.

iii) Strictly controlling the quality of the supply chain enhances a brand's reputation. Integrated supply-chain techniques lead to a constant service level, which key customers demand, and allows for closer relationships between service users and providers. The development of these closer links should lead to overall improvements in efficiency.

II) GLOBAL CONTRACTING - THE LAWYER'S ROLE

Structuring the contractual framework for any pan-European or global solution will be complex. It requires a detailed understanding of a user's business, cargo movements and the overall supply chain operation from production to delivery. In turn, this requires close coordination between lawyers, logistics managers and any supply chain consultants.

i) The Importance of Confidentiality

The most effective solution will be based on a full understanding of market demand and manufacturing flow. This requires the disclosure of much sensitive commercial information by the user. It is, therefore, vital that users obtain confidentiality undertakings from service providers which are invited to tender.

ii) Invitation to Tender

Only those providers capable of achieving specific service



levels (whether individually or jointly with partners) and managing and/or integrating product movements across national boundaries should be invited to tender. The preparation of a comprehensive invitation to tender ("ITT") is invaluable. The document should crystallise expectations in terms of volume throughput, pricing, anticipated returns on investment, open book accounting, responsibilities, contract terms and service levels.

iii) Downstream Providers

The ITT must clearly specify that obligations and service level criteria will apply back-to-back given the need for 'downstream' service providers involved under the terms of sub-service agreements. It is vital that downstream providers operations are audited and that they are fully involved in contributing to the detailed response to the ITT. For example, a forwarder contracting in Hong Kong must ensure that the design and performance of the warehouse operator's facility at the port of discharge (including detailed racking, temperature control and stock tracking performance) satisfies its customer's global service level requirements by including reference to verified downstream operations in the response document.

iv) Outsourcing and/or Shareholders' Agreement

These contracts must create a legal framework for the provision of the various principal and sub-service agreements. This may vary from a tightly defined outsourcing arrangement to the inclusion of a new joint venture company. Key matters to be addressed in the shareholders' or outsourcing agreement are the parties' respective management responsibilities; the provision of human resources; funding; incentivised profit sharing & open book accounting; cost saving incentives and

ITT: Invitation to Tender

SLS: Service Level Specifications

KPM: Key Performance Measures

Cascade Downstream/Upstream:

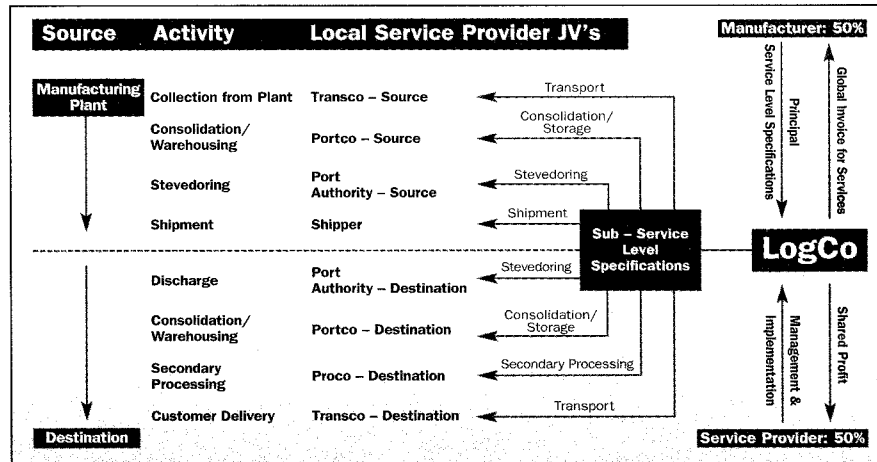
Global supply chains include operations close to the source of supply ('upstream') and conversely the operations are described as 'downstream' as the goods near their destination.

IT: Information Technology

Rdc: Regional distribution centre

termination of a user's principal service agreement.

Where the service provider intends to make a substantial investment, a guarantee may be necessary to ensure a secure quality of income supported by contractual volume. As a result, the parties will need to agree a sensitive balance between the desire of the service provider, or other investor, for ongoing contractual commitment, and the service user's need to exit without further liability where service levels fail.



III) SOME POTENTIAL PITFALLS

i) National & EU Competition Law

Early consideration should be given to the various national and EU competition law rules which may impact on large scale supply chain arrangements involving cooperation between parties, especially where market share thresholds are material. One consequence may be that the arrangements precipitate technical filings with the national competition authorities and/or the European Commission.

ii) The Insurance Conundrum

Responsibility for losses, and insurance provisions generally, will remain an important issue in the development of 'packaged' global supply chain solutions. A problem, which frequently occurs in practice, is the unacceptably high incidence of double insurance in relation to risks previously insured earlier in the chain. Accordingly, investment in a single contract with back-to-back service provision covering all movements and expressly allocating risk with a single tier of cover makes commercial sense.

GLOBAL SUPPLY CHAIN STRUCTURE:

The diagram above depicts the legal framework for a global supply chain scenario. To be effective logistics management and coordination must be centralised: 'LogCo' will be responsible for cascading the principal service agreement and SLSs downstream. This is the rationale behind dedicated SLSs at each downstream stage of the supply chain: the operational obligations imposed on LogCo by the customer will apply back-to-back to the port authority, PortCo, ProCo and TransCo. IT systems will coordinate each product movement from the points of customer demand back to manufacture. The IT interface must extend into the end customers' operations to give effect to just-in-time, efficient consumer response and continuous replenishment regimes. The scenario provides for the development of dedicated warehousing and processing facilities with rights of intervention for LogCo where design or operational performance needs to be revised. The rental of the warehousing and processing facilities would cease in the event of a failure to comply with the relevant SLSs, incentivising compliance. The scenario is simplified: in reality materials and components are often sourced from more than one country prior to manufacture, and assembly itself will frequently be geographically dispersed.

