



IFA LEGAL SYMPOSIUM

Supply Chain Disruption in the COVID-19 Era: Planning for Today and Tomorrow

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Speakers

- **Andraya Frith**, Partner, *Osler, Hoskin & Harcourt LLP*
- **Daniel Janssen**, Partner, *Quarles & Brady LLP*
- **Steve Pattison**, GM & EVP-Franchise Finance Division, *Auxilior Capital Partners Inc.*

Agenda

1. **Overview** of supply chain disruption due to COVID-19
2. **Case Study:** A QSR Franchise System's response to COVID-19
3. **Lessons Learned:** Short-term and long-range strategies

Supply Chain Disruption & COVID-19

- Widespread disruption due to **changes to consumer demand, labour shortages, mandatory shutdowns, export restrictions, new operational requirements** (*i.e.*, sanitation and physical distancing).
- The most commonly affected provisions of supply agreements: **timing of delivery requirements, volume commitments, staffing commitments, location of delivery, payment provisions.**

Case Study

A QSR Franchise System's Supply Chain Response to the Pandemic

Background

- U.S. supply chain for **QSR franchise** (\$3.5 billion annual volume)
- **7200 restaurant locations** in all 50 states impacted.
- Highly integrated supply chain trading partners:
 - **Raw material sources:**
 - Primarily domestic agricultural products
 - Sell to manufacturers on demand
 - **Foodservice manufacturers:**
 - Convert raw materials to finished product in accordance with franchisor specifications
 - Sell to distributors on demand
 - **Foodservice distributors:**
 - Purchase from manufacturers and sell to franchise restaurants on demand
 - **Franchise restaurant operators:**
 - Purchase franchisor-approved products from distributor, cook and sell to consumer

Background (continued)

- Integrated **supply chain trading partners highly dependent** on each other.
- Agricultural inventory has relatively **short shelf life**.
- Foodservice distribution industry experienced challenges in recent years leading up to 2021 pandemic:
 - **Financial stress** from acute driver shortage and inability to pass all costs increases to restaurant customers.
 - **Significant consolidation and capacity rationalization**, leading to little to no alternatives in the event of a disaster.
 - **Increased debt leverage** providing minimum cushion in the event of a pandemic.

Governing Supply Chain Agreements

- **Franchisor/Coop Operating Agreement**
 - Franchisor retains brand standards, trading partner approval and QA
 - Coop executes commercial terms of supply/distribution agreements
- **Franchisor Approval Agreements**
 - Manufacturer – corporate and site specific
 - Distributor – corporate and site specific
- **Coop/Supplier Agreements, including:**
 - Minimum inventory levels
 - Requirements award volume
 - Product pricing
 - Payment terms to distributors
 - Business continuity requirements
- **Coop/Distributor Services Agreement, including:**
 - Delivery fees
 - Delivery frequency
 - Key performance indicators (target and default minimum)
 - Payment terms for franchise restaurants

Pandemic Phase I: The Sudden Crash

- As a result of state and local government mandates, as well as consumer reluctance, most dining rooms were closed, bringing a **sudden demand destruction to the supply chain**.
- Supply chain trading partners were suddenly forced to deal with a multitude of related but distinct challenges:
 - **Inventory obsolescence**
 - **Liquidity issues** due to inability/unwillingness for partners to pay accounts receivable within terms
 - **Manufacturing/delivery performance challenges** due to scale back of production/delivery schedules
 - **Rolling 14-day site closures** among trading partners due to positive employee infections

Application of Force Majeure?

- A force majeure event is **not just about the occurrence** of an event, but rather is about the **effect of that event** on the party claiming to be excused from their performance obligations.
- Whether a force majeure clause will cover the effects of the COVID-19 pandemic is **dependent on the wording of the clause**.

The Typical Force Majeure Clause

“Where a party to this Agreement fails to perform one or more of its contractual duties, the provisions of his Section shall control if and to the extent that party proves: (a) its failure to perform was caused by a condition beyond its reasonable control; (b) it could not reasonably have been expected to foresee the condition at the time the parties entered into this Agreement; and (c) it could not reasonably have avoided or overcome the effects of the condition.

A party invoking this clause shall be presumed to have established the conditions described above based upon the occurrence of one or more of the following conditions: war (whether declared or not), armed conflict or the serious threat of the same (including but not limited to hostile attack, blockade, military embargo), hostilities, invasion, act of a foreign enemy, extensive military mobilization; civil war, riot, rebellion, revolution, military or usurped power, insurrection, civil commotion or disorder, mob violence, act of civil disobedience; act of terrorism, sabotage or piracy; **plague, epidemic, pandemic, outbreaks of infectious disease or any other public health crisis, including quarantine or other employee restrictions;....**” [continued on next slide]

The Typical Force Majeure Clause (continued)

[continued from previous slide]“....**act of authority whether lawful or unlawful, compliance with any law or governmental order**, rule, regulation or direction, curfew restriction, expropriation, compulsory acquisition, seizure of works, requisition, nationalization; **act of God or natural disaster** such as but not limited to violent storm, cyclone, typhoon, hurricane, tornado, blizzard, earthquake, volcanic activity, landslide, tidal wave, tsunami, flood, damage or destruction by lightning, drought; explosion, fire, destruction of machines, equipment, factories and of any kind of installation, prolonged break-down of transport, telecommunication or electric current; general labor disturbance such as but not limited to boycott, strike and lock-out, go-slow, occupation of factories and premises; shortage or inability to obtain critical material or supplies to the extent not subject to the reasonable control of the subject Party (“Force Majeure Event”).

This provision shall become effective only if the party failing to perform notifies the other party within a reasonable time of the extent and nature of the Force Majeure Event, limits delay in performance to that required by the event, and takes all reasonable steps to minimize damages and resume performance”

Pandemic Phase II: Uncertainty Rules

- **Continued performance challenges due to uncertainty:**
 - Manufacturing closures
 - Distributor driver/warehouse labor furloughs
 - Franchise restaurant closures
 - Inconsistent local government mandates
- **Trading partners demonstrating financial stress**
 - One recently emerged from bankruptcy, and another was spiraling towards a filing
 - Financial support considered for some
- **New supply chain challenges emerged:**
 - PPE prioritized to health care, but required for restaurant crew under local mandates
 - Acute shortages of cleaning supplies
 - All protein manufacturers experienced multiple site closures due to infections.

Pandemic Phase III: The Slow Recovery

- Restaurant sales start to recover post-April 2020, but **supply chain sluggish to respond** to increasing demand
- **Distributors** struggled to recover due to:
 - Slow recovery of furloughed drivers and warehouse labor, compounded by government unemployment benefits
 - Hesitancy to build inventory due to ongoing liquidity issues
 - Inconsistent/unreliable delivery windows
- **Manufacturers** struggled to build inventory as safety stock:
 - Experienced labor issues like distributors
 - Inability to source raw materials.
 - Liquidity concerns.

Pandemic Phase IV: The Light at the End of the Tunnel

- Large trading partner filed for bankruptcy, leaving significant unsecured trade receivables behind.
- **“Strategic” trading partners** engaged to rebuild confidence.
- **Financial risk management protocols enhanced** to avoid future supply chain interruption.
- **Some business operations changes made during pandemic will remain permanent** in the foreseeable future:
 - Drive thru will continue to dominate restaurant sales channels
 - Cleaning chemicals will continue to be a supply challenge
 - Delivery is the next big opportunity

Lessons Learned

- The single filter used to make decisions **was do *whatever it takes to maintain the flow of products*** to the franchise restaurant.
- Contracts are important, but during a crisis, **relationships** matter the most.
- **Business Continuity Plans (BCP)** are biased towards individual site natural disasters, not a global pandemic, and need to be revisited.
- **Supply continuity risk** should play a larger role in contract awards, which tend to be biased towards lowest cost.
- **Risk management plans** should be routinely upgraded and include board level committee involvement.
- **Financial stability** is important for all stakeholders in the supply chain.

Going Forward

Short-term and long-range strategies for preventing and addressing supply chain disruptions

Short and Mid-term Considerations

- **Review your supply agreements** so you are aware of the reciprocal contractual obligations and **whether force majeure will apply** in the event of a COVID-19-induced disruption.
- Review your **franchise disclosure documents, franchise agreements and operations manuals** to ensure they **accurately reflect the reality of operating during the COVID-19 pandemic** and make the necessary modifications.

Long-range Strategies

- **Business continuity planning** can be used as a tool by franchisors to ensure both **franchisees and suppliers** are adequately prepared to **prevent or manage future widespread disruptions**, not just site-specific disasters.
- When drafting agreements, establish **clear force majeure events**, ensure **multiple suppliers** and the right to find **alternative supply, limit franchisor liability**.
- Contractual obligations can be used to **allocate risk and attempt to prevent loss/damage**, but ultimately **the business realities will prevail and drive a franchisor's actions** in the face of a major supply chain disruption.

Thank you!

Questions?