Customers and Suppliers – Friend or Foe?

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Are customers and suppliers on your side when you have a business interruption loss? Possibly not!

An organisation that has suffered an event that interrupts its business is exposed to the risk that its suppliers and customers will take advantage of its predicament. This article reviews some sources of this exposure and suggests that pre-loss contractual certainty may be an under utilised safeguard.

A business should not only try to protect itself against its competitors, but also consider carefully the risks posed at the time of loss by its own suppliers and customers. The possible reactions and actions of this important group have often not been adequately or explicitly identified at the pre-loss stage.

As suppliers and contractors consider how the changed circumstances affect them, there are a number of reasons for their actions which create this risk exposure:

1 Survival
2 Shareholder value maximisation
3 Competitive advantage
4 Opportunism
5 Business continuity management
6 Contracts

For the business, each of these causes has the effect of producing behaviour in customers and suppliers which may well result in:

- An increased BI loss (insured and uninsured)
- Failure to recover pre-loss market position
- Reputation impairment
- Loss of subrogation opportunities

The underlying explanation for the selection of the six friend or foe issues is as follows:

1 Survival

Asked for an explanation of what business is all about, many managers and advisers, especially liquidators, will say that the main objective of a business is survival. In the long term, the company must earn profits that cover its cost of capital.

At the time of a serious loss to a business, the main concern of its customers and especially its main suppliers will be to establish if the consequences of that loss will threaten their own ongoing existence. Searching for a new customer or supplier to replace that business to maintain sales and solvency will become a top priority. Realistically, therefore, any loyalty to the company will be severely tested by the actions necessary for the customer and supplier organisations to survive.

2 Shareholder value maximisation

Although there is debate about the responsibilities of an organisation to its wider stakeholder community, the Anglo-American model generally gives priority to the maximisation of shareholder value. This is not only a fundamental tenet of capitalist theory, but also a legal responsibility.

As the late expert on corporate law, Professor John Parkinson, wrote in his 1993 book *Corporate Power and Responsibility – issues in the theory of company law*, "Therefore, it can be seen that management are obliged to consider any opportunity to benefit the shareholders. When Organisation X is weakened or disabled as a result of a loss event, the management of its suppliers or customers have an opportunity to maximise value by, for example: re-negotiating prices; delivery times; and/or longer term contracts.

"It is questionable, but legitimate to ask in fact whether the management of all suppliers and customers to Organisation X are obliged to consider how their companies can 'promote the success of their business venture' as a result of Organisation X's loss event. Failure to do so might expose the management to criticism or claim from their shareholders."

3 Competitive advantage

The customers and suppliers to the business will be trying hard to grow their own businesses. Seeking competitive advantage is a natural and normal strategic approach in any well managed business. When Organisation X suffers a loss, that event will interrupt an established value chain and present a window of opportunity.

It is possible to envisage a situation where a supplier may decide to move along the vertical value chain and commence supplying the business' customers. Also a supplier, having to find alternative customers to replace lost orders from Organisation X may supply and support, albeit out of necessity, a competitor of the business.

Discussing "offensive strategy" in his 1985 book *Competitive Advantage*, Michael Porter, an early strategy guru, proposes that a challenger should seek an opportunity when the leader is "disinclined or constrained from protracted retaliation against the challenger ... because of the leader's own circumstances."

So, for example, a supplier or customer can become an unwitting accomplice to a market assault from a competitor making the most of Organisation X's circumstances of incapacity. The result is likely to delay recovery of Organisation X's turnover, possibly beyond the indemnity period. The costs of regaining market share by dislodging the competitor will be expensive, and potentially not recoverable under the BI policy. It could also be hampered if the previous suppliers or customers of Organisation X are drawn into long term supply contracts with the competitor.

4 Opportunism

Here the customer or supplier will be going beyond the legitimate issues summarised above and will be displaying "self-interest with guile", as defined by the transaction cost theorist, Oliver Williamson, in the *Economic Institutions of Capitalism* in 1987: "Opportunism more often involves subtle forms of deceit. This includes but is scarcely limited to more blatant forms, such as lying, stealing and cheating."

Organisation X may find itself hampered, handicapped and possibly held to ransom by a self-seeking customer or supplier, especially if records have been destroyed.

5 Business continuity management

The business continuity process is principally concerned with how an organisation will itself react to a disruption, not how it will react to a disruption at another organisation. As defined by the 2007 Business Continuity Institute Good Practice guidelines, it is an holistic management process that "... provides a framework for building resilience and the capability for an effective response that safeguards the interests of key stakeholders, reputation, brand and value creating activities."

Customers and suppliers are mentioned almost in passing, although they do feature in the British Business Continuity Management Standard BS25999 diagram which hints at the possibility of a value chain business continuity plan.

It could be argued that in a competitive world it is difficult to reconcile the needs and priorities of one business with another. There is a potential for a well organised supplier or customer organisation with a robust business continuity plan and clear strategic objectives to survive the effect of Organisation X's loss event in a fitter and stronger form.

6 Contracts

It is often the contractual, rather than the physical issues, which present the greatest hindrance to post-loss recovery and subrogation.

The risk surveyor from the insurer or the broker often seems to overly focus on the physical processes and supply chain issues. However, sale, supply or purchase contract terms, limits of liability, retention of title clauses, dispute resolution procedures and non-competion clauses are all relevant. Terms relating to the expected arrangements in the event of a loss with customers and suppliers are not usually contained in the supply and purchase agreements.

This often means that only at the time of loss are the contracts looked at closely. It is at this stage that the way in which a customer or supplier has negotiated or "served" its contract wording becomes critical. There seems to be little ongoing requirement, from either a business continuity or policy wording perspective for a company to be vigilant and careful regarding the terms of contracts, despite the fact that limitations and exclusions may greatly reduce any possible subrogation potential, for both insured and uninsured loss items.

Contingent arrangements for temporary premises, equipment and services are not often recorded as clear, signed contracts in advance of a loss, even though this would be better for more balanced negotiations on price as well as performance guarantees.

Competitors may sometimes assist a loss affected organisation, but they rarely agree to express contingent pre-loss co-operation arrangements in the form of contracts.

Currently, the contract issue is largely below the radar of the risk and insurance procedures. It receives far less attention than the physical risk issues and results in a variable protection for the business that suffers the loss event, and its insurers.

The risk of *contract uncertainty* could perhaps be more clearly treated as an independent factor, as it represents both a shield for the business that has suffered a loss and a sword for its suppliers and customers.

This short discussion paper has sought to demonstrate that there are a number of strategic, financial, risk and contract issues which influence and protect the actions of customers and supplier organisations. Taken together, they support the proposition that customers and suppliers are not automatically on the side of an organisation that has a BI loss event. A pre-loss friend may be obliged to become a post-loss foe.

There are steps that could be taken, particularly in the pre-loss contract negotiation and monitoring area. Perhaps IRM might wish to encourage its members to more openly air these issues and to stimulate debate as to potential improvements that will help to minimise the extent of insured and uninsured loss after a BI event.

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