FUNDAMENTALS OF

CONTRACT AND COMMERCIAL MANAGEMENT

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Fundamentals of Contract and Commercial Management

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Colophon

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Foreword

Study the headlines from around the world and you will rapidly grasp the significance of contract management. Stories abound of multi-billion losses in whatever currency you choose to name—$30bn from weaknesses in US defense contracts, €140bn from failed European software projects, £300 million each year on UK Government service contracts. Cancelled projects, failed development initiatives, even losses of human life are increasingly attributed to poor contracts.

However, the real failing is not the contract, but rather it is poor contracting practices. It is people who decide on the form, structure or terms of a contract and the way it will be managed. As business people we all have a role in ensuring that contracts are designed, developed, negotiated and managed in a way that is 'fit for purpose'.

Today's trading relationships are in many ways more complex than those of the past. Factors such as globalization, increased regulation, innovative technologies, and the speed of change have all contributed to an environment in which it is often difficult to define and manage the many factors involved in a successful contract. This has led many organizations to see the contract primarily as an instrument of control, where rigid standards are imposed and negotiation is restricted to specialists. Unfortunately, this thinking has led to many business people stepping away from their role in the process, viewing the contract as a purely legal or procedural requirement. The consequences of this are reflected in the headline losses mentioned above.

This book seeks to provide insight to the good contracting practices that will contribute to business success. As a simple introductory example, let's look briefly at the way that today's sales and purchasing practices have contributed to poor contracts and resulted in avoidable losses.

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Procurement organizations have been tasked with saving money. They perceive suppliers trying to undermine these efforts through specific techniques:

- Forming relationships with the business people and thereby working around Procurement.
- Exaggerating product or service performance to justify a higher price.
- 'Bundling' products or services into 'solutions' that make competitive price comparisons difficult.
- Offering a low initial contract price, but with contracting practices that mask incremental charges or expensive change procedures.

Procurement has developed a variety of methods to protect against these techniques:

- Controlling or forbidding direct conversation with the business people
- Onerous performance penalties in the form of damages, service level credits and other 'penalties'
- An approach known as 'commoditization', which seeks to unbundle a supplier's offering to allow direct competitive comparison.
- Growing insistence on the use of their own standard terms and conditions, leading to a low-value 'battle of the forms'.
- A more adversarial approach in post-award performance management to restrict price or charge increases and overruns.

The combination of these techniques and methods has a negative impact on contract formation and the results achieved. This can be avoided only through patiently forming a positive, multi-tiered relationship that includes developing the right contract structure and terms. A supplier must help its customers appreciate that constraints on conversation, imposition of ill-suited standard contracts or the unbundling of genuine added-value solutions is detrimental to their own interests, but this can be done only by tackling these issues at the right levels, with the right experts and at the right time.

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Introduction

Why do I need to know anything about contracts?

That's a question many people ask and which this book will answer. Contracts are fundamental to a business and its value. Just think for a moment how much you would be willing to pay for a business that had no contracts? Or why it is that investors flee from companies that show themselves unable to manage or enforce their contracts?

Most adults have managed a contract without even realizing it. Take the example of a man looking out of the front window of his house on a snowy day. He sees a young man walking by with a snow shovel. The young man sees him in the window and raises his shovel with a quizzical look on his face. The older man reaches into his pocket and pulls out his hand with money in it. The young man holds up ten fingers. The older man nods, steps away from the window, and the young man shovels the walk. After the young man finishes the walk and rings the bell, the older man opens the door, surveys the walk, and pays him ten dollars.

Expending minimal effort and time, these two men have completed a business transaction and actually managed a very simple contract from initiation to completion without the use of a single word or piece of paper. Business transactions demand more formal communication and record-keeping, but most commerce in our world follows that same process. Understanding the process and how to facilitate its important elements is fundamental to driving business objectives and success.

Making and managing contracts can be hard work, or it can be easy. A goal of this book is to combine commercial process knowledge with an understanding of the roles in the buyer/seller relationship to make contracting both efficient and effective.

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Even the simple example of the snow shoveler highlights the fundamental questions that all business people have about any transaction:

- Is it clear what is wanted, and when?
- Will it be at an acceptable price?
- Can what is promised be delivered?

As the situation becomes more complex, so do the questions we ask:

- Is what is promised what the customer thinks they're going to get?
- Does the contract offer an acceptable return?
- Does the contract make the best use of available resources?
- Do I understand the risks involved and my part in managing them?
- When things change, what happens?
- If it all goes horribly wrong, what are the consequences?

Most business people ask these basic questions routinely. Asking, answering, and documenting these questions is the most fundamental level of contract and commercial management, and it is this that makes almost everyone a contract manager, whether consciously or unconsciously.

Beyond this statement is the professional reality that contract or commercial management is often one of the least defined positions in the corporate hierarchy. Consequently, individuals with many different titles perform some or all of the elements of the process we will talk about within this book as the commercial transaction process. Whether the reader's job title is Managing Director or Accounting Clerk, that position touches the transaction process, and understanding the value added by the contract manager enables each to function more effectively. It also means we have a collective responsibility to make the contracts in our organization contribute to its success rather than become a source of poor performance and loss.

Readers can work through each chapter of this book in sequence or select individual chapters of interest that relate to a specific job function. This is not designed to be an operational guide or give detailed instructions in the duties of contract management. Its purpose

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is to provide a broad commercial audience with an overview of the fundamental functions of contract management, the unique perspective and skills that dedicated professionals can bring to the transaction process. It is also designed to challenge the reader to facilitate business through understanding the process and improving its function as individual abilities and situations permit.

Part One: Essentials provides a general overview of the transaction process and the types of relationships encountered; the main elements of a contract; cost, pricing and payment; and negotiation principles. This Part concludes with an overview of the commercial transaction process. These early chapters contain checklists and questions the reader can use to identify key issues.

Part Two: The contract management lifecycle takes the reader through each of the five phases of the lifecycle, starting with initiation of a project, bidding, developing and negotiating a contract. The remaining chapters in this Part address the Manage phase: contract implementation, managing day-to-day performance and issues that must be addressed to move the project forward to a successful completion rather than a costly dispute. Questions and checklists have again been provided to aid in issue identification.

Case studies are included throughout the text to demonstrate the real-world application of the issues. Appendices are included that contain relevant supplementary information.

Each step of the commercial transaction process is covered, including a description of the step and the critical duties that must be performed. Perhaps more important is a discussion of the reason why the step is important to the business and the value that a professional can add to the process.

This book will enable readers to approach this process with greater knowledge, confidence and understanding, providing them with the edge to improve performance.

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PART 1

ESSENTIALS

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CHAPTER 1

COMMERCIAL RELATIONSHIPS: BUILDING A FOUNDATION

Business is not just doing deals; business is having great products, doing great engineering, and providing tremendous service to customers. Finally, business is a cobweb of human relationships.

Ross Perot

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1.1 The relationship continuum

The business world is full of relationships, with the most pervasive or critical being the one between buyer and seller. Every individual, regardless of title or other duties, is at some point involved with or affected by these relationships. Career and business success or failure can often be attributed to these interactions

Business relationships reside in a complex universe with infinite variables. While many have tried to document these, there is no global standard that applies across industries, geographies and types of product or service. One way to express this is as a continuum in terms of relative depth and complexity (Figure 1.1).

At the far left side of the continuum is the purchase or sale of a commodity item, which is generally executed with a simple transaction that may be repetitive. At the far right side of the continuum is the purchase or sale of products, systems, or services that are critical to business performance. These sales are generally the result of a relationship that is built and developed through several transactions between the buyer and seller.

Business efficiency demands that the right amounts of effort and resources are invested in each transaction. Understanding the big

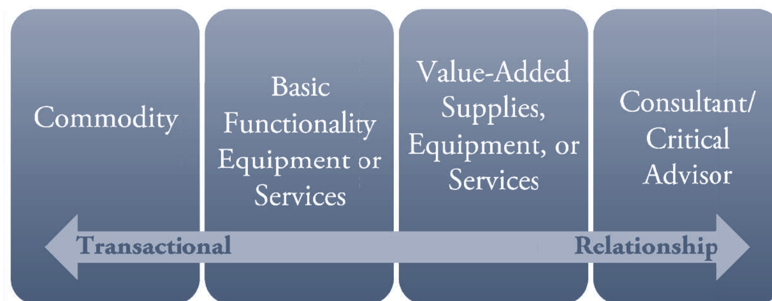

Figure 1.1 The relationship continuum

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picture and where we fall on the continuum as both buyers and sellers enables us to properly focus our energies.

The relationships can also be seen as a pyramid, where there are numerous relationships at the lower levels and few at the top (Figure 1.2).

To provide an illustration of the different buyer/seller relationships, let's look at a common item such as office supplies. At the first level we could consider a supplier of common items such as light bulbs, pens and paper. While variety and cost may be extensive, we are basically looking at a commodity where comparisons of value are easy to make. Commodities are generally considered to be consumable and are not usually capital expenditures.

Moving beyond a strict commodity we go to a category where some corporate standards are imposed. These purchases are usually of a higher value or considered capital expenditures. There will potentially be questions around functionality and fit. Following the office supplies

Figure 1.2 Customer relationship levels

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example, this might be the standard office equipment of desk and chair, filing cabinets, floor coverings etc. Any supplier meeting the standards could provide the item.

Transactions and suppliers move from this category of functional to value-added through exceptional performance or through additional services that are harder to copy or replicate. In the previous example, a supplier of the basic functional furnishings may move to this tier by offering free delivery, assembly, or design services, or through providing customized upholstery including corporate logos.

The final step of the continuum is that of consultant/critical business advisor. This relationship stands apart because of its role in the success of the business or some aspect of it. This supplier is often in a position to prevent or resolve other business problems through its understanding of the customer's operations and creatively positioning its services and solutions to meet those needs. Continuing with the original example, this could be a designer or marketing professional who helped develop a corporate identity and translated that through to office designs, particularly in corporate space, or it might be an outsourced provider who takes full responsibility for minimizing cost and maximizing productivity through a customized office supplies service.

Suppliers of a commodity: In this relationship a supplier's product is viewed by the customer as being exactly the same as several (or perhaps many) other products that meet the same specifications, grade and quality. Price and availability are the traditional differentiating factors in trading of commodities. Other examples might be paper goods, heating oil, hardware or any other product where there is little differentiation and no services are provided.

Suppliers of functioning equipment/systems: The seller is seen as a supplier of functioning equipment or systems with quality and reliability and a service that meets the customer's minimum standards. Examples might include suppliers of computer servers, large-scale copiers, or corporate vehicles.

Value-added products/systems and service: The seller is viewed as a reliable and value-added supplier of products and services. Contractual

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arrangements are fulfilled on time, products are provided conveniently, and additional services may be provided such as training, technical or financing support. At this level, price remains important, but may not be the main criterion. The customer becomes less likely to shop around with competitors and the cost of switching may be high. Suppliers who are unwilling or unable to provide the extras cease to be competitors. Examples might include suppliers of integrated technology, engineering or construction services.

Consultant/critical business advisor: This relationship is based on not only providing value-added products and systems and extra service, but on helping the customer to deal better with some of its important business issues. The seller's contribution is made by understanding the customer's business situation and objectives, by generating workable ideas for solving problems, taking advantage of opportunities, jointly planning with the customer, being sensitive to the customer's organizational issues, and being viewed by the customer as a business partner. Examples include large outsourcing relationships, especially in an area such as business process outsourcing, or high-value strategic consulting.

Looking across the continuum it is easy to see that the relationship within each category is different. On the transaction side, the costs and risks associated with switching suppliers are minimal and customer loyalty is generally low. Moving across the continuum those costs and risks increase exponentially along with the investment by both buyers and sellers.

We can see how these relationships are changing over time, with emerging needs for business success (Figure 1.3).

A business relationship may begin with a transaction buyer purchasing a commodity and progresses through time to a relationship buyer purchasing strategic supplies and solutions. A supplier may foster this relationship evolution by offering volume purchasing incentives or partnering with other vendors to provide enhanced solutions. When a buyer recognizes the additional benefits and business value that can be achieved, it assists this transition by discussing its overall needs with suppliers so that they can better respond to an increased requirement.

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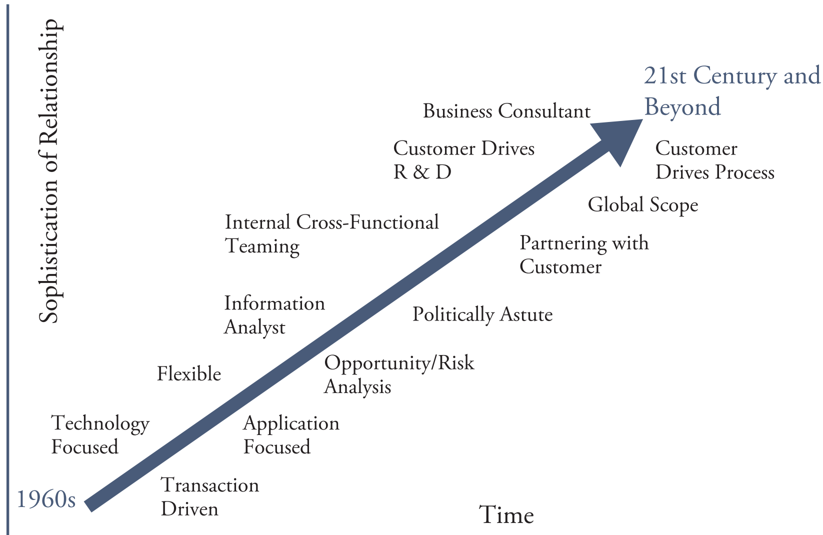

Figure 1.3 How business relationships are changing

The transaction buyer: This customer can easily switch all parts of its purchasing from one supplier to another. There are low internal costs of switching between suppliers. This makes it easy for a new supplier to penetrate the customer base and harder for an incumbent to defend. Price, features, support, and delivery intervals are important decision criteria. Timeframes between purchasing decisions are usually short. For the buyer, making comparisons between suppliers is easy and they can maximize their negotiating power; for this reason, many buyers try to 'commoditize' every purchase.

The relationship buyer: This customer faces high costs of switching suppliers and changes suppliers reluctantly, because changes require substantial investment. Due to the critical nature of the product and/or service to the customer's business, the perceived risk of changing is high. The customer is concerned about issues such as the supplier's focus on research and development (R&D), product continuity and future business health. This customer base is difficult for the outsider to penetrate, but easier for the incumbent to defend. It also changes the

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relative power of the supplier and customer during negotiation and performance.

Differences in the goods and services being bought and sold and the relationship required to do it effectively determine the contract terms.

1.2 Using contracts to document commercial relationships

Modern commercial enterprises operate in a world of rapid change. Expectations are rising, pressures to reduce costs are escalating, and high standards of quality and service are now entry-level requirements for a supplier of goods and services. Many different types of commercial relationship are formed to serve these needs, and that means different contracts are required. Some frequently used types of relationships or agreements requiring contractual arrangements include:

- Teaming and partnering agreements
- Franchises, distribution agreements
- Agency and representative agreements
- License and right to use agreements
- General sales agreements
- Service agreements
- Outsourcing agreements
- Engineer, build and install agreements
- Professional consulting agreements
- Standard purchase orders

All of these types of business arrangements require specific understanding of the roles and responsibilities and the expectations from each party. There are some who argue that today's fast moving business environment has reduced the importance of the contract. They say, "It's the relationship that matters". In reality, the extent of change and the need for speed actually increase the importance of a foundational agreement that accurately records the underlying business objectives and associated commitments. This understanding of the

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rights and obligations of both parties provides a framework for the management of change, whether due to altered business conditions, new technologies, evolving requirements or regulations, or resulting from a merger or acquisition.

Benefits of effective contract management

- Improved quality of service and customer focus
- Greater value for money and cost control
- Reduced crisis management
- Decreased level of risk
- Effective implementation in relation to changes or development in the market
- Continued improvement through incentive based contracting and risk sharing
- Early identification and resolution of poor contract performance and associated problems and disputes
- Controls over performance, costs and standards
- Identification of things that worked well and not so well to inform and benefit future contracts

Few businesses stay the same. Contracts and relationships must evolve along with the business to reflect the current environment and risks. They should be tailored so that the level of effort to establish and maintain the agreement/relationship is commensurate with the value received.

1.3 Choosing the best tool for the job

Contracts are often seen as negative and a source of contention and delay. This perception is valid in some cases, but it can be avoided through effective and efficient commercial management. Failure to avoid this perception handicaps the business through the loss of a critical management tool.

The problem begins with the fact that many professionals (including those in the customer's procurement organization) are intimidated by the words 'contract' or 'agreement' or 'commitment'. They believe that the creation of these documents should be left to lawyers. This approach is a recipe for disaster as it removes business people from the business document that underpins the relationship. It also frequently

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leads to contract discussions being left until it is too late. The only way a contract can effectively represent and support the desired relationship is if it is created with input from the business people involved. Starting to consider and structure contract principles from the very earliest interactions not only reduces eventual cycle times, but also results in a sustainable agreement.

Looking back at the continuum, on the left-hand side the business involvement is not intense or burdensome, even though it is important. Moving across to the right, the input from business professionals becomes critical and is often the difference between success and failure. Indeed, inaccurate or incomplete requirements and scope are the most frequent sources of contracts failing. These are closely followed by poor management of change.. Essentially, if we are unsure what we want or what we are committing to deliver, and we have not properly defined how changes will be managed, it should come as no surprise when relationships go wrong.

Developing appropriate and valuable input to contract formation is a skill that is honed throughout a business career, but lack of experience is not a good excuse for ignorance. An understanding of some basics gives anyone the chance to think about the necessary elements in the agreement.

In business, everyone is focused on their problems—competitive edge, revenues, profits, cash flow, market share, or earnings per share. Public bodies are looking to improve performance at reduced costs. Keeping that focus in mind will assist in understanding what type of contract or contract clause can help resolve the issues a customer or supplier really cares about and will help achieve a business objective. Remember both problems and opportunities, and do not lose sight of strategic issues and priorities.

Approaching this process first from a seller's perspective means that a seller must think about buyer needs. From the results of surveys done around the globe, sellers find that customers focus on three major needs.

- **Customers want to narrow their focus to the few things they do best and outsource the rest without the added overhead costs of supervising their suppliers.**

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This means that the contract must also change focus from product (an input) to benefit or business result wherever it can (an output or outcome). Grandiose products and services with more capacity, features and options than required are often just seen as overpriced. Products and services must be presented as simple to use and manage, either in their own right or because the seller manages the complexity as part of the process. The focus must also change from 'price and delivery' to utility and ease of use, not only of the product but also in doing business with the seller. The seller of choice will take responsibility for managing the relationship or the 'partnership' between seller and customer.

- **Customers want their sellers to know their business well enough to create products and services they wouldn't have been able to design or create themselves.** A supplier fulfills this role by developing its business knowledge and using what it knows to identify needs and solve problems. Some ways of accomplishing this include making certain the contract achieves the following:
    - Focuses on the big picture, not just on details. An example would be to ensure that the contract addresses the regulatory environment and is not simply a pro-forma model unrelated to industry, geography or product or service specifics.
    - Identifies issues and needs at all levels (i.e., overriding business issues, organizational issues and priorities, functional issues and needs, individual issues and needs) and addresses them with appropriate terms. Although most commonly such issues may affect areas such as service levels, customers will also want to see direct incentives placed on the supplier to perform in these critical areas. This may include 'negative incentives' in the form of performance undertakings or liquidated damages.
    - Makes recommendations on the basis of the customer's long-term needs, not on just the current sale—structuring the contract and its terms to enable easy change and adaptability. A longer-term commitment will often affect the price or charging structure, resulting in the supplier sharing in risk by making recovery over time.
    - Elicits information from customers that helps define and strengthen the direction of the agreement. For example, the customer may plan overseas expansion or alliances that would

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require altered approaches to licensing terms or distribution rights.

- **Customers want evidence that their supplier has added value in excess of price.** A supplier who fulfills this role coordinates all selling and service related activities and facilitates communication among the key players in the customer account team and in the customer organizations. In doing this, they should make the following recommendations for the contract:
    - Seek information and potential issues from others across the customer organization.
    - Initiate the coordination necessary to meet future as well as current needs.
    - Adopt a problem-solving and preventative approach to production, delivery and service problems.
    - Assist the contract drafters to develop best statements of the products and the added services that highlight customer value while minimizing risk.

Gathering the customer information can also help develop an adequate basis for contract recommendations. Understanding the world from their perspective goes a long way toward developing a contract that will make sense from their perspective.

Case study: Spotting opportunity

Very Large Software Company (VLSC) was a worldwide corporation with offices and support teams in more than 80 countries. CC Enterprises (CCE) was a major customer, based in the US, but with operations in almost 200 countries.

CCE had issued an RFP to acquire more than $250 million of licensed software for use in its offices worldwide. VLSC was struggling to develop a response because of the difficulty of establishing prices in all the relevant countries and the risk that CCE would object to the price variations. So they offered to supply all the products in the US, at US prices, so long as CCE then shipped relevant materials to its overseas locations.

This solution raised many issues, including one they had not anticipated . . .

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ASC was a major competitor of VLSC. They had been trying to grow their presence in CCE and had periodic meetings with the head of IT Procurement. One of those meetings occurred shortly after the deal with VLSC had been signed. The meeting was interrupted by an urgent phone call trying to resolve CCE's problems in exporting VLSC's software: "Something we aren't familiar with". The Sales Manager from ASC said: "Maybe we can help—we ship software all the time".

The result of this conversation was that ASC won a contract to manage the distribution of its competitor's product. Based on this, CCE appreciated their flexibility and commercial creativity and steadily, ASC started to win more and more business.

Approaching this process from a buyer's perspective means that new approaches must be evaluated to enhance value. Since most customers have already maximized their savings from 'commoditization', the next logical step is to look for greater value through building stronger relationships with key suppliers—but which suppliers and what kind of relationship?

Another way to think about relationships with suppliers, and thus the types of behaviors that would be most appropriate, is to assess the extent to which the supplier relationship would be suitable for partnering. Table 1.1 shows the main factors to take into account when considering partnering rather than the traditional relationship where a service is simply provided for an agreed price.

Table 1.1 Factors affecting suitability of a partnering relationship

Factor	Suitable for partnering	More suitable for traditional relationship
Strategic importance	Business critical	Support service
Benefits sought	Business value	Cost savings
Requirements focus	Outcome based	Resources based
Purchasing approach	Long-term arrangement	Standalone transactions
Payment type	Shared benefits	Fixed charges
Type of relationship	Trust	Formal
Likelihood of change	Liable to change/uncertain	Unlikely to change/stable
Definition/measurement	Difficult to define/measure	Easy to define/measure

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Developing a more significant relationship requires greater initial effort and additional attention to maintain, but future synergies and harnessing the creative efforts of a suitable partner will generate higher profits for both parties.

A contract is a business document that must make sense for both parties and cannot be created in a vacuum.

1.4 Summary

With all the changes in the way that customers view suppliers and the shifts in what suppliers of commercial goods and services have to do to get and retain business, the contract becomes more significant than ever. Flexibility in terms and conditions, creative contractual agreements, being easy to do business with—these are all areas of importance for both buyers and sellers. Effective commercial management can bridge the interests of both parties and balance rewards and responsibilities. It can also protect both parties from unintended commitments and from making agreements that cannot be fulfilled.

Checklist: Understanding the buyer's perspective

- ☐ *Where does the item I am buying or selling fit on the relationship continuum?*
- ☐ *What is the current relationship with the vendor or customer?*
- ☐ *Is there increased value to be gained by investing in the relationship?*
- ☐ *Is there a cost or risk associated with not improving the relationship?*
- ☐ *Will changing this relationship impact other corporate relationships?*

Sellers always need to understand their buyers. The following questions can be helpful to encourage thinking from a buyer perspective:

- What are the customer's business goals and objectives? Are there plans and activities taking place that support the goals and objectives?

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- What are their most recent sales and profit figures? What are their trends? What is happening in the marketplace in which the customer operates? What share of the market does this customer supply?
- What changes are occurring in the customer's organization? Are they centralizing? Decentralizing? Re-organizing? Who seems to be getting the upper hand? Marketers, production people, technical people, financial people? Marketing people tend to pursue revenue, sales growth and market share. Production people focus on costs and schedules. Technical people focus on having the newest, fastest, state-of-the-art equipment wanted in their particular market. Financial people are primarily concerned with profit, return on investment and control.
- Where are existing customers located within the customer's organization? Do potential customers exist who are not being called upon? Where are these potential customers located?
- What are the customer's problems, needs and wants as related to the products and services being offered? Are the problems or needs recognized or unrecognized?
- How do specific customers within the account make purchasing decisions about what the supplier sells? How do they evaluate and rate the supplier's products and services versus direct competition or versus suppliers of alternative offerings?
- What is their decision making process? Does the process vary across customers within the account? Who is the primary decision-maker? Who influences the decision? Are influences external or internal to the organization?
- What should be learned or remembered from any previous bids or contracts with this customer? For example, are there specific regulatory issues that must be addressed in the contract? Do they have a good payment record? Do they commit the necessary skills and resources to support implementation or share in performance oversight? Are there particular risks that must be covered, or areas of relationship strength that should be acknowledged?

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CHAPTER 2

ESSENTIAL ELEMENTS OF A CONTRACT

Simplicity is the ultimate sophistication.

Leonardo da Vinci

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2.1 Overview: what is a contract?

What is a contract and when does a domestic or international contract actually come into being? The answer is not always simple.

A contract is a binding legal obligation between two or more parties. It is enforceable in a court of law. All contracts involve the principles of offer, acceptance, and consideration, but the rules and principles vary from one country to another.

Basically one party makes an offer and the other party accepts it. The offer and the acceptance have to match for the contract to be formalized. In the simple snow-shoveling example the young man's act of raising his snow-shovel with a questioning look constitutes his offer. The older man nods his head as acceptance after establishing the price, or consideration.

Offer

When a potential customer puts out a request for tenders or alternatively, a Request for Proposal, he or she is inviting a seller to make an offer. When a seller issues a tender or proposal document in response, which is an offer to the customer. This tender could become the contract if it is accepted by the customer 'as is' and either:

- The customer signs it, or
- The customer places an order on the terms of the seller's offer

This is a straightforward and intentional exchange to create a contract, but many other customer interactions have the potential of becoming a contract. Requirements for a valid contract vary from one country to another. It does not necessarily have to be in writing to be considered a contract. In some countries, a contract may be established via a series of faxes, an exchange of messages between computers, or simply an oral agreement during contact at a trade fair—or even through the actions of the parties as if a contract is in place, often referred to as 'through performance'.

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Acceptance

Acceptance is voluntarily agreeing to the terms of an offer and results in the creation of a contract. Perhaps the most common business scenario is the exchange of standard forms. The seller will submit standard terms of sale to the buyer who will respond with a pre-printed purchase order containing conditions. Both parties agree that they want a contract, but they do not agree as to what terms should govern. This sets up what is known as the 'battle of the forms'. If a dispute arises when there has been this type of exchange and there is no clear agreement, courts will generally rule that the last form exchanged before performance is the governing contract.

Looking at another example on the principle of acceptance, a customer sends in an order for a tractor, including its own purchase order terms and conditions. This is the customer's **offer** to buy. The seller may either ship the goods, in which case the seller has accepted the customer's offer, or they may send back a confirmation of the order, referencing the seller's own terms and conditions, in which case they have made a **counter offer.** Offers and counter offers may be exchanged any number of times until an agreement is reached.

Scenario

A salesperson is staffing a booth at a trade fair. He tells a potential customer that his company is offering a special price on a solar powered gadget if it is ordered before such and such a date. He gives the customer a brochure. Later the salesperson finds out that the price he told the customer was wrong. The brochure had the correct price, so he doesn't worry about it. The customer sends the company an order at the price the salesperson stated, referring to their conversation at the trade show.

Is there a contract?

Maybe, maybe not. Under some legal systems, the salesperson had made an oral offer and the customer had accepted the offer under the conditions stated. If the salesperson had called the customer to withdraw (take back or correct) the offer before the customer sent the order, there would not have been a contract. In

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Eastern European countries, contracts must be written documents in order to be valid. Other countries require written documents for contracts over a certain monetary value. For example, in the US, contracts worth over $500 must be in writing to be enforceable. Under most legal systems, the offer (written or oral) must be clear, definite and specific enough so that a court of law could determine the intention of the parties.

Consideration

The third element in forming a valid contract is the principle of **consideration**. This means that a valid contract must provide value to both sides. One party provides the goods and the other party pays, or offers to pay. Consideration can also take the form of some other value. In forming a joint venture agreement, one party may provide technology and a patent license. The local partner may provide land and office space, local influence and personnel. The consideration is the **value** that each party is providing.

If the elements of an offer, acceptance, and consideration are present it is likely a contract has been formed, whether intended or not.

2.2 Different types of agreement

This section outlines the commonly used agreements relating to a contract:

- Non-disclosure agreements (NDAs)
- Preliminary agreements
- Sale of goods only
- Sale of services only
- Sale of goods and services
- Licenses
- Leases

More complex and specialized agreements are discussed in the subsequent section.

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Case study: The right contract saves time

One global provider of services and technology has identified eight core relationship types, ranging from a commodity sale to a joint venture. As soon as a new opportunity is identified, the sales team enters details into the Customer Relationship Management system, which automatically identifies the most appropriate contract model. The system also identifies whether internal experts will be required to support the bid and automatically alerts them to its existence. This process has resulted in an average reduction to the bid and negotiation cycle time for complex agreements of more than a third; it has also resulted in an improved project success rate of almost 25 percent.

Non-disclosure agreements

Non-disclosure agreements (NDAs) are often the first formal contractual relationship between two parties and their use has become far more extensive in the last ten years. They govern the protection of information that is shared and fall into two general types, unilateral and mutual. A unilateral form protects the information of one party and places obligations on the other. A mutual form protects the information of both parties and places the same obligations on each.

The nature and type of NDA should reflect the business needs and information sensitivities and not simply reflect the respective market power of the parties or a "we always do this" attitude. Key questions to consider include:

- What do we want/need to do with the information received?
- What do we need the recipient of the information to be able to do with it (for example, talk with potential subcontractors)?

NDAs are discussed in more detail in Chapter 10.

Mutual non-disclosures are generally seen as more fair and balanced than unilateral forms simply because the same obligations are imposed on both parties.

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Preliminary agreements

It is often wrongly assumed that the individuals involved in preliminary discussions are free to negotiate without having to worry that their actions, written communications or phone calls may have legal consequences. In fact, legal obligations can take effect in pre-contract situations when the elements of a contract are present. Similarly, these interactions may be deemed part of any eventual contract that is created. If there is an eventual dispute, all communications can become material in its resolution.

Preliminary arrangements can take many forms. From the time the initial customer contact is made until the moment a contract is signed by both parties, there are many different preparatory or preliminary arrangements that take place. These can be:

- Oral discussions or agreements
- Exchanges of information, marketing materials, product descriptions
- Price estimates
- Exchanges of letters, emails, text messages
- Memorandums of Understanding/Letters of Intent

It is important when having these preliminary discussions for both sides to be upfront and honest about their intentions, their authority or lack of authority, and whether these are exploratory discussions only. Contractual liability can arise whenever suppliers and customers exchange technical and commercial information.

Four common challenges occur during or as a result of preliminary discussions. Consider these four challenges, the type of liability that may arise in each case, and how it could be avoided:

- There may be errors in the information provided. The customer may take some action based upon the information that proves to be incorrect.
- The supplier might inadvertently make an offer, or the customer may think the supplier has made an offer. The supplier might not be able to follow through with the entire offer, or with some details of the offer.

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- Either party may have no real intention of entering into a contract on the project or with this other party. Perhaps a party lacks the proper approvals to proceed. If one party relies upon the other party's representations and forgoes some other prospects, a binding legal obligation may arise, regardless of a party's actual intent.
- The customer may insert an 'Entirety of Agreement' clause into the final contract, specifying that all prior communications are material to their decision and therefore form part of the agreement. The IACCM surveys of 'Most Negotiated Terms' show that this is an increasingly contentious issue and the legal discovery process (in the event of litigation) frequently involves digging into every communication between and within the parties—so great caution is needed.

Both parties should make it clear whether they do or do not wish to incur obligations on behalf of themselves or the other party and in either case should be cautious about the nature of any communication that might imply an intention to buy or supply.

Sale of goods only

Contracts for tangible goods are generally simpler than for those involving service as well as goods or intellectual property. Purchase contracts contain three basic elements. They:

- Define what is being bought
- Specify a price and payment terms
- Outline the delivery conditions

Warranties and performance issues should be spelled out, as well as any intellectual property governed by the contract. Termination and remedies are also normally delineated. In any contract that crosses international borders, customs clearance, delivery and insurance obligations must be clearly understood. Typically the relevant internationally recognized Incoterm definition is used, which enhances clarity and avoids possible confusion. The Incoterms rules are also known as International Commercial Terms. These terms are a series of pre-defined commercial terms published by the International Chamber of Commerce. They are widely used in international commercial transactions.

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As previously explained, the absence of a written agreement or of certain key clauses does not mean there is no contract or that those missing terms do not apply. The legal system within whatever jurisdiction the trade has taken place will provide the missing components, which may or may not generate a favorable result. In some jurisdictions (in particular those which follow principles of Statute Law) it may not be possible to alter certain provisions, even if both parties are willing negotiators. Most countries have specific laws that protect consumers and cannot be overridden.

Ensure that these critical aspects are clearly defined in the contract. A person with no knowledge of the transaction should be able to pick up the contract, read it, and understand these basic facts.

Sale of services only

Services contracts have additional issues that are of importance to the buyer and the seller. In the supply of services, the contract frequently represents the only tangible item that will be delivered and establishes procedures for the delivery of services.

Service contracts can take many shapes and cover a multitude of services from office cleaning or website support to consultancy services or business process outsourcing. Their success is typically defined in terms of an output (for example, an architectural drawing) or an outcome (for example, a germ-free operating environment). A contract for the supply of services is required whether obtaining professional advice and guidance from a consultant or engaging a service provider's labor force, but is made more complicated because of the need to agree a mutually acceptable definition of 'success'.

These contracts can be relatively brief but defining certain elements is essential for an effective and efficient relationship. These include:

- Scope of the services/work to be provided
- How the service performance will be measured
- How the relationship between the service provider and service recipient will be managed

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- Timescale for performance, including handling delays
- What the charges are and how they are to be applied
- How payment will be made, specifically if it is tied to milestones
- Liability
- Intellectual property rights, if any
- Termination

Control over any engineering, development, or design is a unique issue to service contracts. These terms often vary by situation but must be considered carefully by both parties for a successful relationship.

Service contracts define a relationship and its obligations. They will normally specify an output or an outcome that forms the basis of the value to be delivered.

Sale of goods and services

A contract for services may include products, in which case the same issues as previously discussed must be addressed. Frequently this is simply done as a matter of convenience when a single supplier supplies both products and services, but the drive for differentiation has caused many suppliers to examine their offerings and accept greater performance responsibilities by bundling both products and services into 'package' offers. This is taken a step further when 'solutions contracts' are offered, which carry substantial responsibilities for performance, interoperability of components, and suitability for the customer's end use. These arrangements go significantly beyond the scope of a simple product/services offer and are discussed in more detail under the section on complex arrangements.

There tend to be significant industry variations in the extent of 'bundling'. Some buyers push for complete separation on the basis that this increases the extent of competitive bidding.

Combined contracts address the issues of supplying products and services together.

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Licenses

Licenses are similar in many ways to contracts for the sale of goods, but the property is intangible and there is generally no transference of ownership (legal judgments have determined that there is transferability in certain circumstances). In a license arrangement the person who actually 'owns' the property grants a license to authorize a specific use by a licensee of the product. The licensor usually grants this for a specific period of time and often for a specific location, item of equipment or number of users. The license usually restricts the use of the product, especially in terms of its geography.

Intellectual property licensing has assumed a more significant role in the global economy as technology has advanced. It plays a major role in contracts beyond IT or telecommunications, because business practices such as franchising, publishing, and merchandising rely on the same principle of intellectual property protections. Equally, the extension of patent and copyright protections to business methods and processes means that businesses are now anxious to protect—or avoid breaches—in many areas of their possible activities.

Given the scale and impact of licenses, it is important to understand what happens if the license terminates either because of a breach of the license agreement, such as non-payment, or because the license period ends. Failure to understand this can have a catastrophic effect on a business if the licensed item is an essential element of the licensee's business.

A license permits use of something but does not transfer ownership.

Leases

A lease is a contractual arrangement for a user or lessee to pay an owner for the use of some asset. It is similar to a license in that there is no transfer of ownership to the user during the term of the lease (though some lease agreements may enable transfer when they terminate, or offer a buy-out option). A lease generally provides for regular payments throughout its term and has a specific end-date. Leases are often used as a means of financing, avoiding capital expenditure or for managing tax liabilities.

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The terms 'lease' and 'rent' are often used interchangeably, although a lease tends to be for a longer period, with a specified end date, and may (as noted above) lead to an eventual transfer of ownership. Leases and rental agreements generally apply to tangible property, although there are exceptions such as radio frequencies.

As with licenses, it is essential to understand what happens when the lease ends.

Leases are commonly used in real estate and as a means of financing capital expenditure.

2.3 Other business relationships

A relationship between businesses does not always involve the selling of goods and services to each other. Contracts play a different role in these relationships as they define how the companies will work together, for example to either 'sell through' one another (a distribution or sub-contract relationship) or 'sell with' one another (a co-marketing agreement).

Because of this fundamental difference the terms in these contracts have significant variations from those in sales contracts. However, the key elements for these agreements still rely on a clear description of purpose, of exactly what each party will do under the agreement, of the financial commitments of the parties, and of how the success of the relationship will be evaluated.

The global nature of business today has expanded the need for agreements to sell through or with others, particularly in certain areas of the world. Many companies use agents, representatives and distributors to help in generating sales beyond their borders. Others are obliged to enter into formal partnerships or joint venture arrangements with local entities as a condition of doing business within that country. Some benefits of these relationships include:

- Familiarity with business practices, cultural customs and ways of conducting business in a particular market.

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- Previously established relationships with customers to help open up sales opportunities for suppliers.
- Preference to buy from locally owned and known entities rather than from a foreign company.

However, there are also potential risks and drawbacks, which include:

- Potential for corrupt practices, such as bribery, or ownership by government officials.
- Local laws may create significant protections for an agent or distributor, making their termination difficult and expensive.
- These relationships can inhibit future freedom of action, for example if markets change or new products are introduced and require a different approach.

Case study: Everyone has to win something

HOC was a major supplier of complex technology to the oil and gas industry. It developed integrated solutions at its consolidation centre in Houston, Texas, before shipment to customer locations worldwide.

SCC was a manufacturer of mainframe computers with a worldwide distribution network. HOC wanted to acquire SCC products in the US and, after integration, ship them to the locations of its end-user customers. It then wanted SCC to provide local support, including installation and warranty services.

This represented a major challenge for SCC. Its network of distributors provided local support and many of these contracts included undertakings that the distributor had exclusive rights to supply within their market. Although the SCC sales team initially agreed to sell the products, the local distributors refused to handle them unless they had significant compensation. It seemed like there was an impasse.

But SCC's commercial team realized that the contract structure was wrong. They advised that SCC equipment should be sent to HOC on a consignment basis; it would then be shipped by SCC as an integrated product and imported by the local distributor.

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This had a further beneficial effect because total costs were reduced, on average by almost 25 percent, primarily due to reduced export and import taxes and duties. And because final sale was now by the local distributor, they were incentivised and happy to provide local support. The US Sales team lost some of their commission, but retained a valuable customer and received a bonus for their creativity.

2.4 Complex and specialized agreements

As business relationships evolve and become more complex, contracts tend to do the same thing. There are often very complex and specialized agreements that are prepared for unique situations, but may then find applicability in other situations and industries. Examples are shared risk agreements that found their origins in the construction industry, or agile development contracts that started in software.

Recent trends toward outsourcing have added a complexity to relationships and contracts as businesses seek to have tasks performed by suppliers that were previously done internally. The issues of service quality and control are often pitted against price and set the stage for conflict. It is not unusual for these contracts to extend for five years and beyond, and establishing ground rules is essential for effectiveness.

Outsourcing has been accompanied by a more general trend for suppliers to take greater responsibility for the performance of their products and services. Until recent times, most business-to-business contracts operated on the principle of 'let the buyer beware'. In other words, it was the buyer's responsibility to ensure that the goods or services being procured were broadly 'fit for purpose'. Of course, suppliers could not actively misrepresent their goods. But today, driven by a combination of buyer and competitive pressure, many suppliers take direct responsibility for the value that is achieved from their goods or services. For example, a manufacturer of telecommunications equipment no longer simply sells the equipment; they often sell an infrastructure service using this equipment to major telecommunications providers such as China Mobile, Vodaphone, AT&T or Telefonica.

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Situations also arise where business between two companies expands in the natural course of dealings. Customers may begin as casual buyers and progress along the relationship continuum. In other cases customers may want to become dealers of a product or become a local service provider as they gain expertise. There can be a tendency to try to make a single contract serve many purposes. Occasionally this will work; but more often than not the competing interests will result in conflicting terms that leave exposure to significant risks in some area of the business.

Case study: Acting in good faith—or not

Hungry Jack's was the largest franchisee of Burger King outside the US, operating 168+ restaurants. Over time Burger King had increased its interest in the operations of Hungry Jack's; there had been numerous disputes, which led to four new contractual agreements.

The Development Agreement required Hungry Jack's to open four new stores each year in Australia. An additional clause made the opening of any new restaurants subject to Burger King's operational and financial approval.

The disputes came to a head in 1995, when Burger King withdrew all approval for third-party franchisees, and stopped granting financial or operating approval to proposed new stores, which meant that Hungry Jack's was unable to open four restaurants per year, as required by the new agreements.

In November 1996, Burger King attempted to terminate the agreement, on the basis that Hungry Jack's had not opened the required number of stores. Hungry Jack's sued Burger King, alleging that Burger King had no right to terminate the agreement, and also challenging the validity of the new extension agreements. They argued that the Development Agreement included an implied term of good faith (that is, that the parties must act in good faith when exercising their rights under the contract), and that Burger King had breached this term by denying the financial and operating approval to new restaurants, leading to Hungry Jack's failing to meet the minimum stores requirement.

Hungry Jack's was successful at trial: the judge found that Burger King had not acted in good faith; rather, their actions were efforts to harm or hinder the other party. The judge awarded Hungry Jack's nearly $AU 71 million in damages.

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When more diverse relationships are contained in a single contract the risk increases of inappropriate and conflicting terms.

Checklist: Questions to ask about what type of 'contract' to use

Will the document being used:

- ☐ *Describe the transaction completely?*
- ☐ *Assure the customer they will get what they expect?*
- ☐ *Assure the supplier they will get paid?*
- ☐ *Provide both parties with the protection they need?*

2.5 Summary

While relationships can become extremely complex, to be effective, the contract should thoroughly address the basic business, contractual and technical elements of the purchase. In general, the more simple and straightforward the contract is, the more likely it will achieve its purpose.

Keep in mind the nature of the product or service for which the contract is being prepared. Not all situations deserve the same level of contracting. Not every contracting term applies in every situation.

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