

## Contract Writing as a Critical Element of Supplier Risk Management

Ernest G. Gabbard, JD, CPSM, C.P.M., CPCM  
Allegheny Technologies, Inc. - 412-394-2872  
[egabbard@alleghenytechnologies.com](mailto:egabbard@alleghenytechnologies.com)

### 95th Annual ISM Annual International Supply Management Conference, April 2010

The procurement/supply chain profession is clearly transitioning from the historic role of placing purchase orders to the contemporary role of developing and managing comprehensive contracts with strategic suppliers.

For many manufacturing and service organizations, the supply chain presents the most significant risk to economic profitability or even organizational viability. The role of identifying and mitigating supply chain risk has therefore become more visible and prevalent for many organizations.

**PREMISE.** Supply Management contracts should provide an appropriate allocation of the risks between the parties. These risks include the commercial risk associated with the manufacture of the product or performance of the service, as well as the legal risks associated with, or arising from the transaction, such as injury and/or financial loss.

The increased emphasis on supplier risk mitigation and contract writing has created a need for supply management professionals (SMP) to develop and refine our contract preparation and contract management skills. For some of our more complex transactions, there will also be a need to develop contract administration and management skills beyond that which has heretofore been required.

This paper will provide a summary of some key elements of contract writing and contract management which are imperative for risk mitigation in the contemporary procurement/sourcing environment.

**BASIC CONTRACT WRITING.** Volumes have been written on this subject, and it is impossible to completely cover such a complex subject in this limited space. However, the following are a few of the key elements of contract writing, which will apply to virtually any contract, regardless of the commodity/service being procured, or the dollar value of the transaction.

- A. Start at the RFP/RFQ Stage. The procurement process starts with the RFP or RFQ, and the contract drafting process should commence concurrently. It is important to note that any terms and conditions which the purchaser intends to be included in the ultimate contract should be incorporated into the RFP/RFQ. If we attempt to insert substantive contracting terms after proposals are received, suppliers may have to revise pricing or other proposal elements to address such new terms. The key is to consider the end result desired in the contract when drafting the RFP/RFQ.

- B. Consider the circumstances/requirements for each transaction. There is really no “boilerplate” which will provide appropriate language for all of our substantive transactions. Practicality necessitates the use of some standardized clauses; however, this author’s experience indicates that such clauses can be a “trap” if utilized indiscriminately. The sourcing professional should therefore custom tailor clauses for all significant issues that must be addressed in the contract. We will need to look to alternate sources such as our Law Departments or formbooks for appropriate clauses to adequately cover some of the more complex issues. However, never incorporate specific language provided for one contract into another contract without reviewing it for specific applicability. If in doubt, consult the organization’s Law Department.
- C. Use templates – but cautiously. The modern electronic work environment enables us to utilize contracting templates, so we do not have to create each contract from scratch. Such templates can save significant time; however, they can be problematic if not carefully utilized. This author has frequently seen contracts for procurement of services, which contained provisions intended for purchase of a commodity. This is usually because the drafter utilized a template, but overlooked the need to remove inappropriate provisions. Unfortunately, they may have even failed to include important provisions for that transaction by inappropriate use of a template.
- D. Use a checklist. There is a common misconception that checklists are for the novice, rather than the seasoned contracts/sourcing professional. This author has many years of contracting experience and a law degree, yet I would never draft a contract for a significant transaction without a checklist to ensure that all substantive issues are addressed. The important aspect of this recommendation is to find the “right” checklist for your contract drafting. There are many such checklists available in the commercial market. The more valuable checklists provide a discussion of each contractual issue for your consideration, rather than just a title for each recommended clause. As with any checklist, you should be careful to not automatically utilize any/all recommendations without some consideration of the necessity and/or language for your specific transaction.
- E. Is the contract for goods or services? Determining the appropriate form of contract will often depend on whether the transaction is for goods or services or perhaps both. If the transaction is for both, a hybrid contract will be necessary, which covers the relevant issues for the specific procurement. In such a case, the “predominant purpose” for the transaction/contract will determine whether it will be interpreted as a contract for goods or a contract for services. It is therefore important for the SMP to make the contract clear as to the intended “predominant purpose” for the specific transaction
- F. Don’t overlook the specification/statement of work. The author has noted over the years that a substantial majority of the supplier performance problems experienced during the administrative phase of a contract result from inadequate attention to this portion of the RFP and the resulting contract. While most of us consider the specification or statement of work (SOW) to be the primary responsibility of our technical departments, it is incumbent upon the SMP to ensure that this document is clear and comprehensive. Even if we don’t completely understand the technical aspects of the procurement, we must learn enough about the specification or SOW to assure that the supplier is receiving unambiguous direction on how to satisfy the specific requirements of this procurement.

G. Purchase Orders. The most common form of a purchase/sale contract in the commercial environment is the Purchase Order (P.O.) issued by the SMP. Because of its simple form, and the inherent focus on the description of what is purchased on the front of the form, the P.O. is often not treated as a “contract”. All parties must recognize the P.O. as a contract, which creates legal rights and obligations. The T&C which are generally contained on the reverse side of the P.O. form are very significant and should be reviewed with the supplier, wherever possible. As noted before, the standard P.O. T&C for purchase of goods may not be appropriate or adequate for the purchase of services. Therefore, SMP must carefully scrutinize standard P.O. language when it is used for non-commodity purchases.

There are many other aspects to contract drafting. However, this author’s experience indicates that the vast majority of basic “issues” which create contracting and/or legal problems can be traced to the foregoing items.

**ADVANCED PRINCIPLES.** In addition to the basic contracting principles summarized above, the progressive Supply Management Professional must also be conversant with advanced contracting issues, such as how to mitigate cost/price risk during volatile economic times. The volatility experienced during the recent “economic meltdown” of 2007/2008 has punctuated the need to cover such risks in our supply contracts. For example, we must ask ourselves the following questions when requesting proposals, or preparing supply contracts:

- How do we protect both parties during inordinate volatility?
  - fixed pricing
    - 2 years? 3 years? 5 years? 10 years?
  - indexed pricing
    - how to select appropriate indexes?
  - hedging
    - coordination with Finance Organization?
    - counterparties available?
  - other contracting mechanisms?
    - Fixed Price with economic price adjustment (EPA)?
    - Cost plus fee?

If we undertake to utilize forward contracts, hedging, or indexed pricing, we must be consider the following factors:

- What base year should be utilized for adjustment(s)?
  - What circumstances dictate the selection?
  - Is the base year favorable to Purchaser or Seller?
    - who should bear the risk?
- What indices to utilize?
  - are they readily available & widely published?
  - do they provide an objective perspective of economic impact?
  - does Supplier influence or control the indices?
  - should multiple components be used?
    - labor, material, energy?

- consider whether the indices are leading or lagging?
  - what timing of increases and/or decreases?

This is a complex subject, which cannot be covered in this forum; however, such issues are indicative of the need for the SMP to develop more sophisticated contracting skills.

**CONTRACT ADMINISTRATION.** The well-drafted contract will often be of limited value, unless that contract is properly administered or managed to ensure we receive all of the benefits anticipated when it was drafted. Therefore, good contract writing must be accompanied by effective contract administration. Although this is also a complex subject, the following summarizes some key elements of contract administration/management that should be applied to ensure effective supplier performance of the contract requirements:

1. Effective written communication between the SMP and their suppliers is the KEY to effective contract management. All outgoing correspondence should be logged and suspended to ensure timely response is received from the supplier. All incoming correspondence should likewise be logged and suspended to ensure a timely response is sent to the supplier. In the latter case, timely support from other company organizations (Engineering, QA, Program Office, etc.) may be essential to providing responses.
2. Early identification of performance problems is paramount to avoidance of schedule delays, which would ultimately impact our company's ability to meet its obligations. The first indicators of such supplier problems are generally:
  - a. Delayed response to correspondence – particularly correspondence requesting or confirming supplier performance schedules.
  - b. Supplier requests for delays in scheduled performance reports or performance reviews.
  - c. No visible progress on supplier reports and charts during performance reviews.
  - d. When percentage of progress payments exceeds percentage of performance completion. If this occurs, the purchaser loses a significant tool with which to obtain timely contract performance.
3. Immediate written response to any indications of performance/schedule delays is imperative. A supplier must be clearly held accountable for any identifiable delays, up to and including legal/contractual "show cause" and "termination" procedures.
4. Adherence to the contractual milestone schedule. If a detailed milestone schedule is incorporated in the initial purchase contract, it will be easier to withhold progress payments when milestones are missed; thereby maintaining adequate leverage to ultimately ensure timely performance.

5. Create and maintain a master contract file, where original contract documents are secured and controlled. It is imperative that we recognize these documents could someday be critical to prove our legal rights. They should be treated as such.

**CONTRACT AMENDMENTS.** Exceptional contract drafting and administration necessarily requires that any changes of circumstances be documented to assure continuity of the continuing legal rights and obligations of the contracting parties. Such documentation is generally accomplished with a contract modification or amendment. The key to an effective contract amendment is that the drafter devotes as much effort and expertise to the amendment as was utilized on the original contract. This is often overlooked when circumstances necessitate a revision to the contract/P.O.

**CONCLUSION.** As may be noted, effective contract drafting is a complex process, and effective contract administration is an active, rather than a passive process. Implementation of the foregoing principles should assure comprehensive drafting of our contracts and timely management of the resulting supplier relationships.

*Ernest Gabbard, JD, CPSM, C.P.M., CPCM, is responsible for Corporate Strategic Sourcing at the global headquarters of Allegheny Technologies in Pittsburgh, PA, with annualized spend of ~\$4B. He is an active member of the Pittsburgh Affiliate of ISM.*