

## **Contracting for Services**

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#### *Criticality of writing services contracts*

There are several aspects of services contracting which should be considered by the Supply Management professional:

1. Contracts define and allocate RISK among the parties. The Sarbanes-Oxley Act (SOX) and recent experience of both public and private companies have punctuated the need to identify, report and mitigate such risk to operations. Services contracts can represent one of the most significant exposures to risk that the Supply Management organization encounters.
2. Service providers often perform on the Supply Manager's premises, and there is significant potential liability exposure to the Supply Manager's organization. The service contract provides clear allocation of the risk of liability for the both parties.
3. The performance of services contractors can affect the ability of Supply Manager's organization to meet its obligations to both internal and external customers. If the service provider does not perform adequately, the purchasing organization needs the protection afforded by a comprehensive contract.

#### *Distinctions*

The most appropriate way to address the uniqueness of services contracts is usually to differentiate them from the more familiar contract for procurement of commodities. The legal distinction between these two categories of procurement is substantial, and creates special challenges. Let's review some of the more substantive distinctions and challenges:

The most significant difference is that contracts for services are not governed by the Uniform Commercial Code (UCC), or your state's commercial code version thereof. Such commercial codes apply only to contracts for "goods". So, what law does apply to the contract for services? Since there is no equivalent to the UCC for services contracts, a state's common law of contracting or some other state code will apply. Unfortunately, these laws are unique for each state, and there are significant differences between the states.

What is the relevance of this distinction for Supply Management and Contracting professionals?

1. Since the UCC does not apply, and the law is so different between states, the prudent Supply Manager must include services-specific contractual clauses to ensure adequate coverage and protection of their rights. Some of these are discussed below.

2. The so-called “buyer-favored” provisions of the UCC will not be available. Examples are:
  - a. Warranties – most state versions of the UCC provide “implied warranties” of merchantability and fitness for a particular purpose. These warranties are provided as a matter of law for commodities contracts. While it may not seem important to “warrant” services, the Supply Manager should consider the impact of having a service inadequately performed, e.g: what is an adequate definition of the service, and what are Supply Manager’s remedies in the event that the service does not meet the definition? Since the commercial codes do not apply to contracts for services, the parties must ensure that such warranties are adequately covered in the contract.
  - b. Damages – Most state versions of UCC provide the purchaser with incidental and consequential damages as a matter of law. These damages provisions establish extensive remedies for the purchaser in the event of damages caused by the seller. Since UCC does not apply to services contracts, no such coverage is available at law; therefore, the Supply Manager must clearly cover the liability of both parties in the contract.
3. The well-known “battle of the forms” which results from the exchange of conflicting terms & conditions between purchaser and seller is covered by the state versions of UCC. The state code generally provides a legal basis for determining which party’s terms & conditions will govern in the event of a conflict. However, since the commercial code does not apply to services, the SM must reach agreement with the Seller on the governing T&C before contract performance commences. Failure to do so may result in the Seller’s T&C prevailing over those of the Supply Manager.
4. Performance of services under such contracts seldom takes place on the Seller’s premises, as is generally the case with the performance of commodities contracts. This can create significant legal issues regarding the liability for damages and/or injury on another’s premises. These issues must be addressed in the contract for services.

### Creating or reviewing the Services Contract

It is important to note that most purchase order (P.O.) terms & conditions are designed for the purchase of commodities/supplies, and not for services. For these reasons the “standard” P.O. utilized by many organizations will be inappropriate for the procurement of services. P.O. T&C for services will need to address many items which are either not necessary, or not as critical for commodity purchases. Some examples of these are:

Performance Standards – what criteria will be used to judge the adequacy of Seller’s performance? The Supply Manager and service provider must agree in advance on what will constitute acceptable performance, and who will determine whether the required standards were met. Absent such agreement, state law may only require Seller to utilize their “best efforts”, and the Supply Manager might be stuck with less than desirable results. It is also important to identify the event(s) which constitute completion, and what remedies will be available to Supply Manager in the event of failure to complete performance in a timely manner.

Changes – what will happen if the Seller encounters unexpected conditions in the performance of contractual services? UCC does not apply, and there is not generally a common law right to make unilateral changes; therefore, the parties must provide a contractual mechanism to bilaterally make any necessary changes to the price and/or completion date. It is also critical that the parties agree on what will constitute a “changed condition”, and what will constitute an increase or decrease in the contractual scope of work.

Behavioral Issues – what standards govern a service contractor’s employees when on Supply Manager’s premises? It is important to require contractor’s employees to agree to follow the rules of the purchaser organization when on our premises, for such issues as:

1. eating or drinking on premises
2. drug or alcohol possession and use
3. sexual harassment
4. workplace security

Absent agreement to follow Supply Manager’s policies & procedures, the contractor’s employees may be held to a less-than-desirable standard.

Subcontractors – most service providers are selected for both price and the expertise they provide. Therefore, the contract should clearly provide the purchaser with the right to review and approve any subcontractor which may perform services under the contract. Absent such agreement, the law might allow Seller to employ subcontractors who would otherwise be totally unacceptable to the Supply Manager.

Dispute Resolution – what process will be utilized to resolve any disagreement which may arise during contract performance? Unless the parties agree otherwise in the contract, they will likely have to resort to litigation in a court of law. This can be an expensive, time consuming, and lengthy process. Therefore, it may be more appropriate to agree to utilize some alternate form of dispute resolution, such as mediation or arbitration. These will generally be more efficient, cost effective, and less destructive to the parties relationship than litigation. Legal Counsel should be consulted before incorporating such provisions in the contract.

These examples should punctuate the need to ensure that the services contract includes clauses which may be more relevant to performance of services than they might be to delivery of products. In this respect, it is important that the Supply Manager include all appropriate clauses which are pertinent to the service being procured. Since each type of service may require different coverage, this author recommends that a comprehensive checklist be utilized to ensure that an important provision is not forgotten. Such checklists are available from many commercial sources. However, it is critical that the purchaser utilize the right checklist for the service being obtained. As may be expected, the list of clauses needed for repairing a roof would be considerably different than the clauses needed for performing software development, or for installation of capital equipment.

### Critical elements of the services contract

As noted above, there are many differences between the procurement of commodities and the procurement of services. Therefore, it is important for the contracting parties to assure that critical elements are included in the services contract. It should be recognized that every contract may require some unique provisions to cover the circumstances. However, it is this author's experience that several elements should be included, in some form, in almost all contracts for services. Exhibit A provides the author's summary of some of these critical elements.

### Services Contract Management

As the reader may conclude, the process for the procurement of services may be significantly different than for the procurement of goods. Because of the different laws which govern, and the other variables mentioned above, active management of the contract is even more critical to services contracts than it may be with the contract for procurement of goods. The Supply Manager should therefore place appropriate emphasis on the performance stage of the contract, and not wait until a performance issue arises.

CONCLUSION – Many significant differences exist in the procurement of services, which necessitate a unique approach to contracting and contract management. The contemporary Supply Manager should understand these differences to adequately protect his or her employer during the contract creation and contract performance stages. A critical review of factors affecting services contracts should be made prior to formation, and should be followed with comprehensive management of the resulting services contract.

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**Exhibit A**  
**Service Contracts**  
**Unique Contractual Considerations**

- ✓ Scope of work
  - ✓ More frequent performance issues necessitate more comprehensive coverage
  - ✓ How to describe the requirement? *e.g.: paint a room*
- ✓ Changes
  - ✓ What will constitute an increase or decrease in scope?
  - ✓ What will be the acceptable impact on price and/or delivery?
- ✓ Work disruption
  - ✓ What will happen if service provider is interrupted?
    - By Purchaser?
    - By others?
  - ✓ Contract should provide for this possibility!
- ✓ Environmental Issues
  - ✓ What is service provider's responsibility? *e.g.: creation of hazardous waste, or environmental damage?*
  - ✓ Liability protection (indemnity) is needed?
- ✓ Liability to third parties
  - ✓ Who is responsible/liable in event of damage or injury?
    - Employees of purchaser?
    - Employees of contractor?
    - Invitees/bystanders?
    - Subordinate subcontractors?
  - ✓ Require indemnification and/or insurance!
    - Especially important where performance is on Supply Manager premises
- ✓ Warranty
  - ✓ No UCC implied warranties available
  - ✓ How to judge the quality of work? What criteria?
  - ✓ What will be the remedy if work is unsatisfactory?
- ✓ Subcontracts
  - ✓ Require approval of any subcontractors
  - ✓ Ensure they provide required expertise!
- ✓ Payment
  - ✓ Progress payments needed?
  - ✓ Assure that subcontractors are paid in timely manner
  - ✓ Require indemnification against mechanics liens

- ✓ Contractor employees
  - ✓ OSHA and other regulations will apply; therefore, who will assure compliance with rules & regulations?
  - ✓ Contractor employees committed to follow Supply Manager's safety rules when on our premises?
- ✓ Behavioral issues – *Contractor on your premises*
  - ✓ Drug possession or use
  - ✓ Sexual harassment (*definition?*)
  - ✓ Smoking or drinking on premises
  - ✓ Ensure clear, written organizational policy
  - ✓ Require that contractor and subcontractor employees agree to comply as condition to admission on our premises
- ✓ Taxes
  - ✓ What tax liability for services?
  - ✓ Determine classification of the contractor
    - ✓ Employee versus independent contractor
    - ✓ Considerably different tax liability
- ✓ Termination
  - ✓ What conditions warrant default termination of contract?
  - ✓ How to replace contractor in event of termination?
  - ✓ Are there alternate service providers?
  - ✓ What is contractor liability if termination is required?
  - ✓ Liability if our organization defaults?
- ✓ Unexpected conditions
  - ✓ Adjustment mechanism in event of unexpected conditions?
  - ✓ Criteria for renegotiation?
- ✓ Completion
  - ✓ What event(s) constitute completion?
  - ✓ What rights/obligations if performance not complete?
  - ✓ Advisable to provide for liquidated damages in event of failure to perform in timely manner
    - ✓ Agreed upon cost of non-performance?
- ✓ Dispute resolution
  - ✓ What is the process in event of disagreement?
  - ✓ Avoid litigation! (ADR clause for arbitration?)