

## Legally Speaking: Public Procurement's Three Pillars of Risk Management

Richard Pennington, J.D., C.P.M., Of Counsel  
McKenna Long & Aldridge LLP  
303/634-4383, rpennington@mckennalong.com

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**Summary.** Risk management is activity undertaken in an organization to identify and manage threats to achieving organizational objectives. In 2004, the Committee of Sponsoring Organizations published its *Enterprise Risk Management – Integrated Framework* as a structured approach to risk management. Using three pillars of procurement risk management -- procurement planning, solicitation and award, and contract management – this paper will summarize key legal concepts in risk management approaches used in public procurement and relevant to other supply management organizations.

**The Relevance and Meaning of Risk Management.** The strategic goal of the supply function is to provide goods and services that support the overall organizational mission and vision. Financial strategies of supply management organizations commit resources and funds based on, among other things, risk assessments. The specifications for the C.P.M. examination include *risk management* in the body of knowledge for supply chain management, the procurement process, and sourcing analysis. Risk management is relevant to public procurement professionals as well, although the nature of government supply chains differs.

Until 2004, there was little common glossary for discussing – or even defining -- risk management. Project management professionals discussed risk in terms of threats to successful project completion. Financial professionals discussed risk in terms of audit scope and the role of internal controls in insuring integrity in financial reporting. In 2004, a common framework was developed that dovetails with supply management activities.

**The COSO Model of Risk Management.** The Committee of Sponsoring Organizations (COSO) evolved from the establishment of the Treadway Commission in the late 1980s that studied and made recommendations concerning issues about the integrity of financial reporting. COSO is most widely known for its internal controls model, made more prominent with the passage of the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley shined a spotlight on the role of internal controls in providing reasonable assurance that an organization could achieve its objectives in financial reporting.

The publication in 2004 of the COSO *Enterprise Risk Management – Integrated Framework* represented a realization that a common glossary was needed in risk management as well. COSO's risk management framework was intended to be a generalized approach for organizations to assess their appetite for risk (in relation to their strategies), identify the events that represented risk to achievement of objectives, and manage that risk in ways that provided a reasonable assurance that the organization's objectives would be achieved.

COSO described eight components of an effective enterprise risk management system. First, the organization's internal environment sets the tone and defines how risk – to supply chain continuity, for example -- is viewed and addressed. Second, objectives are aligned with the

organization's mission. The third component is the identification of internal and external events that might affect achievement of objectives. Fourth, the risks are analyzed in terms of likelihood and potential impact, largely to aid in setting priorities. Fifth, management selects risk responses – avoiding, accepting, reducing, or sharing risks – that are deployed using specific actions designed to align the risks with the organization's risk tolerance. Sixth, policies and procedures are implemented to ensure that risk responses are effectively carried out through control activities. The last two components emphasize dissemination of information and overall monitoring of the risk management function.

**The Legal Perspective of Procurement Risk.** Traditional liability allocation using contract terms and conditions and appropriate use of bonding and insurance are well known applications of law to risk management – by both governments and commercial organizations. But risk management involves far more than legal considerations. For example, a supplier evaluation project implicates potential risks to supply continuity but may involve little initial concern about legal issues during supply chain analysis.

Yet, while broad-based strategic sourcing initiatives have *soft* implications on supplier relationships, they can also cross the line into contract breach if proper account is not taken of the nature of existing commitments. This paper will focus on key legal concepts directly relevant to procurement risk management. While the public procurement environment is used to integrate the concepts, they are relevant in a commercial environment as well.

This paper stops short of other relevant legal considerations in setting an organization's procurement strategy that are of less importance to public entities. For example, alliances formed in industry to leverage strengths of each partner – joint ventures are an example -- have to abide by legal constraints on collaboration imposed by antitrust and fair trade legislation. And in the case of outsourcing strategies, intellectual property considerations may be of paramount importance in a company's deciding which core capabilities should not be outsourced. In commercial entities, the risk management approaches to these issues are defined enterprise-wide through training and operating procedures that usually are developed with the assistance of in-house legal resources.

This paper will focus instead on fundamental legal concepts central to risk management as a procurement unfolds through the main phases of a public procurement -- planning, solicitation and award, and contract management.

**Procurement Planning: Defining the Nature and Extent of Commitments.** Procurement planning involves a definition of the need or requirement as well as decisions concerning the nature of the contractual commitment that will be established. Procurement planning processes (such as *business strategy* meetings) are often used to assemble the right teams and minimize risks from ill-conceived solicitations. Organizations having robust procurement planning policies and processes make clear decisions about what risk to accept and avoid in the context of procurements.

In strategic sourcing initiatives, in particular, where multiple supplier relationships are involved, procurement planning requires a clear understanding of the nature of existing contracts in order to avoid the risk of breaching them. Public entities often use indefinite delivery contracts to make supply channels (for both goods and services) available to government program

offices. Depending on how these contracts are structured, they may or may not be easily modified or terminated, actions that might be required in a strategic sourcing initiative. These agreements are called different things in public procurement. The GSA calls them *multiple award schedules*, as does the state of California. Often they are referred to as *state contracts* or *price agreements*. In individual agencies and local governments, these flexible contractual relationships sometimes are created using *standing purchase orders*.

Legally, these arrangements become committed relationships in two ways. If a minimum quantity is specified, the government is committed until the minimum is ordered. A more troublesome kind of agreement – from a compliance perspective – is a *requirements contract*. Requirements contracts are enforceable through their term because they involve a promise by the government to order all requirements (the *consideration*) within the scope of the agreement from the contractor. Both types of contracts theoretically provide additional price advantages to governments because contractors can rely on promises of minimum or expectations of estimated quantities (that are provided in connection with a solicitation for a requirements contract). In general, though, these kinds of committed contractual relationships have become less common in state and local procurements, as governments instead opt for the flexibility of multiple contracts with various vendors to provide alternative avenues of supply. But in any strategic sourcing initiative, in particular, a government could face breach claims if existing contracts affected by sourcing decisions were ones in which the government was committed.

**Procurement Planning and Performance-based Contracting.** A legal concept that has reemerged lately in procurement planning involves the difference between design and performance specifications, and the related concept known as the warranty of design. The federal government has moved over the past dozen years towards use of more performance-based contracting in service contracts. This trend has migrated to state and local government contracting as well.

There is a well developed distinction between design and performance specifications. Where a government specifies the design details, it bears the risk that the design will accomplish the intended purpose. In performance specifications, by contrast, where objectives are specified by the government, but the means and methods are not, contractors are free to propose varying methods of performance. In such a case, the theory goes, contract monitoring is easier because the government entity is concerned only with the end results and need not do detailed examination of performance and design details. Further, the contractor ultimately has turnkey responsibility for assuring that objectives are met through performance.

In procurement planning, the distinction becomes important, less from a legal and more from a resource perspective. Sometimes, the government entity is not capable of specifying detailed design and risks failure if it does. On the other hand – design-build construction is an example – a performance approach to specifying requirements often involves different employee skill sets to adequately communicate all requirements. Further, as often happens, requirements tend to be a combination of performance and design requirements (such as required interfaces) that must be specified. The failure by a buyer to specify those requirements may also compromise the success of a project. For this reason, the overall approach to specifying performance objectives, and balancing needed design elements, becomes a complex undertaking not fairly reflected in some of the literature about performance-based contracting. Further, one of the promoted rationales for performance based contracting -- that it also

provides possibilities for financial incentives to contractors who exceed requirements -- is easier to say than to implement. While performance-based contracting is intended to reduce the cost risk from unnecessarily restrictive specifications, use of these more sophisticated procurement techniques requires that the right people are at the table during the planning phases. The approach places more importance on the drafting and negotiation phases of procurements where the definitions of acceptable performance and financial incentive provisions are clarified.

**Procurement Planning and Organizational Conflicts of Interest.** Projects have become more complex, often requiring consultant assistance in developing solicitations. This practical reality has evolved another set of legal issues for federal government buyers, those involving organizational conflicts of interest.

The Federal Acquisition Regulations (FAR) include an entire subpart 9.5 on the topic for federal procurements. But the policies underlying use of organizational conflicts of interest provisions are relevant for any company. That is because a company's supply base may be reluctant to participate if suppliers think that the roles of another competitor give it an unfair, inside advantage in competing for work. In federal acquisition, these policies are invoked when companies assist governmental entities in developing requests for proposals or otherwise occupy unique roles with an agency in terms of their evaluation of contract performance. FAR Subpart 9.5 requires contracting officers to avoid significant potential conflicts before contract award where they arise from special relationships with contractors that prepare specifications or work statements, provide systems engineering or technical direction, provide evaluation services, or that obtain access to competitors' proprietary information in connection with government work.

State and local governments are developing similar policies on organizational conflicts of interest. Their solicitations for consulting services sometimes inform prospective bidders that they may not bid on subsequent solicitations that they help develop, or where they would otherwise have unfair advantages based on their role with the government.

For commercial companies that conduct complex service procurements, the Federal Acquisition Regulation approach to organizational conflicts bears examination. The guidance serves as a useful reference for taking steps to provide fair treatment to suppliers and reduce the risk that existing contractual relationships may prejudice suppliers' willingness to participate.

**Solicitation and Award: Fairness, Objectivity, and *Best Value*.** Public procurement traditionally has placed more emphasis on process aspects of solicitation and award. These practices have ethics underpinnings. ISM's *Principles and Standards of Ethical Supply Management Conduct* includes promotion of positive supplier relationships through courtesy and impartiality. Adherence to the ethical standards promotes supplier interest in furnishing supplies and services, ultimately fostering a more robust competitive environment. In public procurement, the concepts of objectivity extend also to equity, or equal opportunities for companies to obtain public business.

The legal requirements in public procurement sourcing are designed to achieve these objectives. For example, regulations governing bidding commonly are specific about the issue

of timeliness in bids and proposals, addressing the issue about how to treat suppliers when some are asking for more time to respond. Similarly, the concept of bid *responsiveness* is designed to insure that bidders are making offers compliant with the solicitation and not given the opportunity after public bid openings to modify an offer when they may have seen the prices of competitors. And public entities often have specific ethical or standards of conduct rules for employees (governing acceptance of gratuities, for example) that limit the perception that personal interests affect procurement decisions.

Rational procurement processes leading to the selection of vendors are at the heart of equity. In the past thirty years, states have followed the lead of the federal government in promoting use of *best value* procurements, moving away from the *low bid* method of awarding contracts, especially in contracts for services. The concept of *best value* means that other considerations like technical merit and contractor past experience/performance are often as important as price in selecting proposals. This type of procurement mitigates risk by including in award decisions the proposal and vendor characteristics most likely to lead to successful performance. At the same time, these kinds of procurements tend to be more resource intensive, take longer to complete, and in the public procurement environment pose more risk of litigation. But government *best value* procurement practices have evolved under public scrutiny and have led to fairly sophisticated decision modeling tools that integrate technical, experience, and cost considerations.

Industry generally does not deal with the same legal considerations about sourcing as state and local governments. But they have similar interests in assuring that suppliers are treated fairly. Following well established policies avoids the risk of losing once good partners if they decide the playing field is not level.

### **Contract Management: Legal Dimensions of Change, Communication, and Waiver.**

Proper management of contracting relationships is another cornerstone of risk management, shared by commercial and public entities. Performance expectations are derived from the content of the written agreement, but two key legal principles are implicated during the contract management phase of the procurement. One relates to changes to requirements. The other is the concept of *waiver*.

A proposed modification to a contract by one party must be accepted by the other. The federal government for years has used a *changes clause* that permits a contracting officer to direct changes to specifications within the general scope of the contract. The contractor in return is entitled to equitable adjustments in price and/or schedule. These clauses provide a structured way to share risk from changes as they occur throughout a project. Without such a clause, the parties potentially would have to renegotiate the entire contract, and pricing might not fairly reflect the cost of the change.

This approach is commonly used in public procurement contracts in other contexts. Equitable adjustments are used to deal with changes to government-furnished property, for example. The *termination for convenience clause* similarly permits the federal government to terminate a contract entirely where requirements change (a right not granted at common law) in exchange for contractually defined, equitable payments to the contractor.

Another key concept in contract management (not unique to public procurement) is that of *waiver*. The knowing relinquishment of a known right by one party can preclude its later enforcement. In public procurement contexts, this most often arises with respect to schedule in construction or services contracts. The government permits or encourages performance after the passing of a contract milestone and then later seeks to enforce the original schedule. In public procurement cases, courts sometimes find schedules waived. The court decisions permit the government to reestablish an enforceable schedule, but only one that is reasonable given the facts existing at the time it is reestablished.

The prospects of change and the desire to avoid waivers of contract requirements reinforce the need to establish good communications mechanisms to minimize risk. Beginning with post-award meetings, recurring dialogue between government and contractor personnel is required to keep expectations aligned. Not only are issues like *waiver* avoided, constructive communications promote broader objectives of establishing relationships that are more like partnering and less adversarial. In fact, Department of Defense policy over the past 15 years has encouraged use of alternative dispute mechanisms that also are aimed at promoting communications. State and local governments also use partnering or disputes elevation clauses in their contracts.

**Conclusion.** The COSO risk management framework is aimed at events that pose potential risk to enterprise success. Supply management is acknowledged as one of the key functions of an enterprise that involves significant risk. Public entities, like commercial entities, have developed approaches to procurement risk management using three fundamental pillars: planning, solicitation and award, and contract management. While the process of risk management is broader than just legal considerations, key legal concepts in each of those pillars help define approaches to risk management that involve avoiding, accepting, reducing, or sharing risks.

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