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**Chalimbana University**

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**BCM 4101: Contract Management**

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**1.0 Introduction to Contract Management**

A significant element of the procurement and supply function is based around the contracting process. To be successful, contracts must be clearly defined, contain key terms and condition, and take account of the legal framework within which they sit. They must also accommodate the reality of the business environment, which means that with limits there must be a degree of flexibility allowed.

This module is designed for those working in procurement and supply, or otherwise involved in responsibility for the development and use of legally binding contracts, with suppliers. Although aimed at those involved in the formation of contracts, it will also be useful will also be useful to those whose function involves contract management.

On completion of this module, you will be able to describe the key elements and legal aspects of formal commercial contracts and be able to analyses and interpret the fundamentals of specifications and key performance indicators (KPIs) included in contractual arrangements.

* 1. **Analyse the documentation that can comprise a commercial agreement for the supply of goods or services**

This section looks at the elements that make up the contract documents. In practice, these may be produced as separate documents that become ‘linked’, so that there is a core document with a number of attached schedules, or they may be combined into a single document.

When talking about ‘the contract’, this means the totality of the agreement between the parties as evidenced by the contract documents. When using a format that involves a core document and a number of separate schedules it is useful to remember this concept of the ‘whole agreement’.

Remember that the contract as originality signed is likely to allow for variations, so at any point in time ‘the contract’ may well be different from that of the originallysigned and sealed. There is a tendency to think of the contracts in an archaic sense as something fixed and unchangeable. Modern commercial contracts are designed to accommodate the fact that the change is inevitable. Therefore, it is important that there is a mechanism I place to ensure that ‘the contract’ the current, up to date agreed version of the agreement is easily accessible.

**Invitation tender to or request for quotation**

**Difference between estimate, quotation and tender**

In law, when considering the contractual process there is no difference between a quotation and a tender. The legal basis for this is discussed in section 1.2 (which covers offer and acceptance) and you should revisit this section once you have completed section 1.2.

For now, just be aware of the following.

* An estimate has no legal standing: it is merely a supplier’s best guess of what the supply might cost. In commercial contracts, estimate should be avoided.
* A tender and quotation (sometimes quote) are essentially the same thing they are both a firm offer to do something for the quoted price or at the quoted rates, although a tender will be more comprehensive and detailed.

In procurement and supply, a distinction is made between quotations and tenders, but it is a fairly artificial one.

* **Quotation** is normally used when the only variable is price. The process for arriving at the quotation will often be simple, perhaps even informal, but generally it will involve a buyer describing in precise terms what they wish to buy, and a supplier offering a price at which they are willing to supply it. The terms and conditions are (in poor practice) often not specified in requests for quotations, which can lead to the infamous ‘battle of the forms’ (see section 1.2). quotations should only be used in any of the following situations.
* for low value, low risk purchase
* where the specification and delivery terms are fixed
* where suppliers have been pre-qualified
* where a framework or dynamic purchasing system has locked down the contract terms and price is the only variable
* **Tender** is normally used when there is potentially more than one variable. This is not always only case: tenders can be used where everything other than price is already locked down, but this is becoming less and less common. The process leading to a tender will be quite formal. It will require sealed bids not to be opened before a specified deadline. The format of responses will be dictated by the purchaser. The contract terms will be specified in the invitation and required to be accepted as part of the tender offer. Tenders should be used in the followings
* For complex projects
* For high value or high risk purchases
* For projects where quality and price need to be assessed
* Where access to unknown suppliers is required and a need to either pre-qualify them as part of a two stage process, or to assess their suitability as part of a single stage open tender process

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| Remember  An estimate is not a firm offer. A quotation and a tender are both firm offers. Tenders are more detailed than quotation and will include quality aspects as well as price. |

**Request for quotation (RFQ)**

Request for quotation (RFQs) are often misused, e.g., where a purchaser simply asks for a price without adequately determining the contract terms and specification. However, they do have a valuable function when their use is properly controlled. They work well under framework agreements where the contract terms are already fixed. Table 1.1 sets out the main features of RFQs, along with the advantages, risks and controls.

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| **Feature** | **Risks** | **Advantages** | **Controls** |
| Degree of formality | Unless the organization has its own strict rules and standards documentation there is a risk that RFQs may be done via a simple phone call.  Potential lack of an audit trail of the basis for the quote you asked for/we quoted for disputes.  Possible lack of transparency-potential for collusion or bribery if quotes are opened at different times. | Reduces administration costs where specification is clear e.g., all quotes to central point and to reference to make and model number or supplier product code.  Frees up professional resource for more complex requirements.  Small and known supplier pool. | Set maximum value limits.  Set minimum acceptable formality, e.g., all quotes to central point and to remain sealed until specified deadline. Use ‘quick quote’ e-tendering platforms.  Issue standard terms and conditions with all requests.  Monitor usage.  Train staff in possible risks. |
| Speed | If price is the only variable, turnaround times can be short.  Quick implementation is sometimes unavoidably necessary. | Not always appropriate for price to the only variable and may be used in the wrong circumstances.  Temptation to seek quick quotes when a more considered approach to aggregated spend is indicated.  Notional compliance with internal rule, without understanding the wider procurement landscape.  No thought given to contract terms.  No thought given to supplier vetting. | Use category management approaches to aggregate spend.  Set up framework agreements to ensure contract terms are fixed.  Only permit quotations to be sought from pre-qualified suppliers. |
| Relationship to contract documents |  | Having no cross-reference to contract on the order risks a lack of clarity as to the contractual nature of the request.  Quotes often issued on suppliers terms and conditions. | Ensure terms and conditions are included in request and reiterate them at the point of order.  Cross-reference any information provided in the request with the order. |

Table 1.1 main features of RFQs

**Invitation to tender (ITT)**

Tenders are more formal sourcing exercises than RFQs, which means more thought is given to the selection of suppliers and the working up of contract documentation. They are sometimes also called requests for tender (RFTs).

The tender process is well-developed in most organizations, in sectors where procurement is regulated by law (e.g., the public (or state) sector and the utilities sector), the permitted processes are out in regulations. Some sectors may also have their own codes of practice. For example, the UK construction industry has a ‘Practice Note’ published by the joint contract tribunal-a body set up to include various stakeholder groups from both constructing and client side of the industry.

Tender returns (or submissions) are generally more detailed than quotations, including variables such as method statements, timescales or other quality aspects of the delivery, as well as price. In open tenders, where suppliers have not been pre-qualified, there will generally also be supplier vetting information.

There are still risks, however, as shown in table 1.2.

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| **Feature** | **Advantages** | **Risks** | **Controls** |
| Formality | Full audit trail, especially if electronic platform used.  If process is robust, can provide transparency, reducing risks of bribery and corruption.  Potential for wider market engagement. | Requires specific documentation.  Process-driven tender exercises risk a lack of project-specific thought.  Can create unnecessary administrative burdens.  May be regulated by law creates risks of challenge by suppliers if rules are not followed. | Clear process, including options appraisals, reporting and accountability.  Ensure processes match legal requirements.  Audit random sample for compliance.  Train staff on formal processes. |
| Lack of speed | Proper understanding of the time needed to deliver a tender process can drive improvements in forward planning. | Perceived or self-created urgency can drive poor practice.  Lack of understanding in the appropriate use of tenders.  Poor documentation leading to prolonged clarification processes and/or poor results. | Ensure the forward plan is robust.  Have a clear authorization process for urgency, e.g., a tender waiver process standardize documentation wherever possible.  Train staff in processes to ensure efficiency. |
| Relationship to contract documents | Clear and robust response schedules can easily be inserted into formal contact documents if the draft contract is properly designed to accommodate them. | Inserting full tender response document into formal contract can create inconsistencies, especially where clarification exercises have been necessary. | Design the tender return documents and the contract documents to ensure ease and clarity of use. |

Table 1.2 main features of ITTs

**Real-world comparison of quotations and tenders**

The issues are summarized on the previous pages, but here are some points to consider in a real-world context.

**Process administration cost**

Sourcing (seeking tenders and quotes) is a resource-intensive activity, as submitting bids in resource intensive. It is in the interests of both buyers and suppliers to keep these administrative costs within limits that are proportionate to the value and/ or risk of the contract under consideration.

Purchasers should be aware that cost and risk are not the same thing. A relatively low-value contract could be sufficient to bring a business to a standstill if it collapses. Conversely, a high-value contract may have little impact on failure if the supply need can easily be failure from other sources.

Naturally, the account of documentation issued with an RFQ or ITT increases the costs of preparing the request and the suppliers costs in responding to it. However, these upfront costs are repaid during the contract process by having a clear, concise, mutually understood contract. Costs to unsuccessful bidders are not recouped, but simplicity and clarity of documents can reduce the costs of bidding and the risks of accepting a contract, so it is still in the suppliers (even the unsuccessful potential suppliers) interest for these to be fully scoped at the outset.

**Audit trails**

An audit trail is the written or electronic record of what was done, when and by whom. Audit trails are important for the following reasons.

* They reduce bribery, corruption and collusion by increasing the likelihood of being caught.
* They provide solid evidence in the event of such activity occurring.
* They improve accountability-even where there is no criminal or fraudulent intent, staff members tend to take more care when they know the actions can be traced back to them as individuals.
* They help trace errors, e.g., identify skills and knowledge gaps and/or procedural weaknesses which can be used positivity for personnel development and systems improvement.
* They provide solid evidence of the facts of a situation when disputes arise, particularly in relation to specification and/or offers of service.

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| Remember  RFQs are useful in that they are quick and informal, but they carry the risks that they only look at price not quality, and they may not be tied adequately to contract documents. ITTs are more formal and take longer, but they have full audit trails, consider quality aspects as well as price, and are usually more closely reflected in final contract documents. |

Quotations often have weak audit trails, but with the increasing use of e-tendering systems for quick quotation purposes, this risk should now be on the decline.

This is no reason why a quotation cannot have a robust audit trail.

Tenders have always been more formal and therefore have always been more formal and therefore have some auditability built in automatically. But there is still scope for this to be breached, so again, electronic systems vastly increase robustness in the tendering process.

**Transparency of process: controlled opening of offers**

Whether quotations or tenders are being sought, it is important that both buyers and suppliers can trust the process: it must have transparency. Suppliers will not be willing to expend the time and effort needed to prepare offers, unless they believe they have a fair shot of winning the contract.

If the system allows for bids to be opened on receipt without a deadline or witnesses, there is a risk of early offers being shared with those yet to submit.

The latter may then have an advantage and be able to reduce their price, or conversely (if they have colluded with the early bidder), to increase their price as a way of either driving up price overall or simply determining who wins the contract. Either way, the buyer will not be getting the value deal. The use of e-tendering systems ensures that fixed deadline are set. Most systems ensure that that not further bides can be submitted via the system once the electronic vault has been opened.

**Urgency and speed**

Good category management and market awareness should of the need for immediate-action scenarios. Most procurement should be properly planned and timeline. Even the best of organizations will occasionally have urgent needs which have arisen due to a sudden change in circumstances.

The process for selecting a replacement supplier must still be controlled. The organizations interim rules must include a section which sets out when normal supplier selection processes can be waived. This tender waiver process requires high-level authority (normally a director) and must include a full business justification for not using the normal process. The waiver process should include a requirement to state what has been learned from the situation and how (if) that can be built into operational improvements.

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| **Case Study** |
| Waiving the tender process  A regional organization employing nearly 2000 staff had its payroll managed externally by a well-known facilities and business services provider. All employee records were held by the provider, who managed all the individual salary payments and tax and pensions deductions at an annual cost of approximately 150,000. For business reasons of its own, the provider decided to pull out of payroll provision. It gave two months’ notice. Clearly there was no time to carry out a full tender process. The new provider had to be contracted, on-boarded and ready to go live in eight weeks.  This case clearly illustrates why there is sometimes a need to act quickly whatever the normal rules of engagement, could the situation have been avoided? The contract allowed the supplier to give only two months’ notice but even if that had not been the case, the supplier was a multi-national company and the contract was low value; it is possible that the supplier could easily have carried the risks of simply defaulting. |

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| Apply  Consider tables 1.1 and 1.2. write a list of types of purchases for a particular organization (e.g., a manufacturing company, hospital or any other organization with which you are familiar).  For each type of purchase, state whether a quotation or a tender would be more appropriate and why.  Is there any circumstance where you might need to waive normal tender or quotation rules for each of those purchases? |

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| Remember  Tender process must be transparent. If there is a reason for normal processes to be waived, this must be fully documented and approved at a high level. |

**Specification**

The specification is absolutely central to all commercial contracts. Any ambiguity, misunderstanding, lack of clarity or confusion about the specification will result in the following issues.

* Poor bids being received-either overpriced or underpriced
* Claims for extension of time or additional payments
* Administration costs resulting from contract clarification orders
* The potential for goods or service being delivered that do not serve the desired purpose, or being delivered in the wrong place, at time or in the wrong quantities
* The potential for goods or services being delivered which do not meet the required standards, which may be written in law, putting the purchaser, end users or the general public at risk

The specification is the document which sets outs the detailed requirement for the goods, services or works that you procuring. The specification will normally be incuded as a schedule to the contract.

Defining what you want to buy can be one of the most difficult stages of the procurement process. There are risks at both extremes of detail.

* Describing exactly what you want in miniscule detail can make you miss out on opportunities for change and innovation.
* You may write a wish list that the supply market cannot meet or that is too vague for you to enforce contractually.

Clearly the aim has to be find the middle ground between the two.

**Types of specification**

There are two main types of specification: performance specifications and conformance specifications (sometimes called prescriptive or technical specifications). A third approach would be to use an outcome-based schedule of outcome requirements. This is looser and more flexible than a specification and often encourages the use of innovative approaches to meeting the procurement need. However, care should be taken as the terms ‘output’ and are often confused.

The key differences between performance and conformance specifications are shown in table 1.3.

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| Performance specification | Conformance specification |
| Focus on outputs  Sets out result to be achieved  The ‘what’, not the ‘how’  Gives supplier flexibility to present solutions that the buyer may not have considered | Focus on inputs  Gives specific methods, processes and materials  May identify specific manufacturers or components  The ‘how’ as well as the ‘what’  Ties supplier to set details |

Table 1.3 comparison of performance and conformance specifications

Using a central heating system as an example, a performance specification would simply require a system capable of maintaining a temperature of 21°C when the external temperature is zero, with the additional capability of being time-programmable and having the facility to vary the temperature between individual rooms. A full conformance specification would detail the make and model of the boiler, set out how many radiators (of which size, make and model) should be in each room, the type of thermostats to be used, where they should, and much more additional detail besides.

In practice what is likely to be used is a specification which says that the system is to be gas-fueled, using an A-rated boiler, giving the temperature to be achieved and desired level of programmability and controllability. For reasons of compatibility with existing installations-and the impact that has on maintenance costs-it is likely that a specification would also specify a preferred make of boiler. In other words, the specify would be a hybrid between a performance specification and a conformance specification.

There is one further problem, however. It is possible that what sounds like a conformance(technical/prescriptive) specification is actually a hybrid-and a hybrid specification opens up the possibility of compliance which does not actually deliver the intended result.

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| Case study |
| Permeability is no proxy for durability  As information provided by the American national ready mixed concrete association illustrates, it is possible to comply with what looks like a conformance specification without achieving the desired outcome.  The industry uses a w/cm ratio: a water-cementitious ratio. This has to do with the permeability of the concrete and is sometimes used as a proxy measure for durability.  However, low w/cm ratios might increase the potential for shrinkage, when the intention is to reduce it. The problem is that a low w/cm ratio can be achieved by different means, only some of which will achieve the durability required. The NRMCA’s website indicates the that different mixtures, all using the same w/cm ratio, could achieve strength values as different as 3800 psi, 5000 psi and 6000 psi (psi=pounds per square inch).  Clearly, the difference between 3800 and 6000 psi tolerance is significant enough to show that specifying a w/cm ratio does not ensure a certain durability will be achieved. |

This provides a clear demonstration as to why procurement professionals must engage with technical stakeholders when designing or agreeing specifications.

This does not mean that the procurement team should simply defer to the technical personnel from the commissioning department when it comes to producing the specification. Technical specifying can easily become locked into ‘what we know’ or ‘the way we have always done it’. While no specification starts from a blank piece, it is helpful to go back to first principles.

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| Remember  Procurement professionals have a role in challenging specifications. Technical experts can get things wrong and asking naïve questions can be useful in bringing these to light. |

**Designing a specification**

**The specification as a contract document**

It is important to be clear from the legal perspective that the specification is only a contract document if it is. A specification issued with an RFQ or an ITT will not be fully incorporated into the contract unless care is taken to ensure that it is. For example, changes to the original specification might arise as a result of queries during the tender process, or through post-tender negotiations with the winning bidder. It is also possible that the supplier has qualified the specification in its offer, and if this has not been picked up, then there could later be disputes as to which version of the specification is the contractual version.

The simplest method us to ensure that a final and agreed version of the specification is reproduced and appended to the core contract document as a schedule, clearly referenced from the contract terms.

**Potential problem**

If care is not taken to fully incorporate the specification into the contract, but instead reliance is place on the fact that it was set out in the invitation document, the problems that can result include the following.

* Any total agreement clauses in the contract will invalidated anything not actually laid down in the contract documents, including anything included in the tender information.
* Any clarification or amendments taken during the tender process are likely to be omitted. This could potentially undermine the whole contract, as the parties may be agreeing to something different to what they believe they are agreeing to. At the very least, it creates scope for dispute and the costs of dealing with uncertainty and ambiguity.

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| Remember  Construct the contract documents as a single package. Make sure all of the cross-references work. Ensure all schedules are referenced in the main agreement terms. |

**Key performance indicators (KPLs) and performance management frameworks**

A specification sets out what is to he delivered, but there must then also be a mechanism for comparing actual delivery against what has been specified. It is a fact that commercial life is complicated and things can go wrong. Some of those things can be controlled, others cannot. A performance management framework can manage this.

A performance management framework is a series of standards and targets to be achieved by the supplier, definitions of how those standards will be measured, and actions to be taken on the basis of the measurement results. Its aim is to promote the best control possible things that can be influenced, and to ensure the best possible outcomes against agreed measures.

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| Remember  These are the key components of a performance management framework.   * Key performance indicators (KPLs)-what are measuring * Target-the performance level to be achieved * Consequences-what happens if the measures are not achieved and/or if they are exceeded |

The design and use of KPLs is explored in detail in section 2.2. The focus here is on the nature of the the documentation and its status as part of the contract.

**KPLs**

**Are KPLs necessary**

It is still surprisingly common to find contract with no stated performance indicators. With good suppliers, a strong relationship and good luck this might not matter. The job will get done to the desired standard-more or less-and the few issues that do arise will be amicably resolved. However, it is still worth investing the time and effort to set up and measure KPLs for the following.

* ‘more or less’ is never good enough. The contract sets a standard that should be a minimum standard. You cannot know whether that standard is being consistently met unless you measure it.
* You cannot rely on good luck.
* Even the good relationship that you know to exist at the beginning of the contract cannot be guaranteed to continue. The suppliers own operating environment could change, making it more difficult for them to provide the level of service that you are accustomed to. The share of the supplier’s business which the purchaser has can shift, making them less important to the supplier. Personnel changes can erode the basis for good working relationships.
* Measuring performance demonstrates whether it is stable, improving or deteriorating-each of which can should provoke a response.
* **Stable** performance might sound like a good thing but could mean that opportunities for improvement are being missed.
* **Improving** performance should be analyzed to understand why. What is working well on one contract might be transferable to others. It is important to learn from success as well as failure.
* **Deteriorating** performanceshould be analyzed to understand why. Orica understood, action can be taken to halt the decline. Lessons can then be learned for other contracts: perhaps the issues can be designed out at the pre-procurement stage?

**Do KPLs need to be contractual?**

Many organization seeks to manage KPLs outside the contract. This is poor practice. Unless the KPLs are within the contract, tied to firm targets and set consequences (for both worsening performance and improvements), then there is no leverage.

Where fundamentally, KPLs should be an intrinsic part of the specification. In agreeing to pay a given price, the purchaser expects a defined service level and/or quality of goods supplied. That is that cost-benefit balance which has been achieved either through a tender process or a negotiation. If KPLs are subject to a side agreement and not included within the contract, it can be difficult even to enforce the management aspect. It will vary from one measure to another, but much of the data required will need to come from the supplier. Unless there is a firm contractual requirement to provide it, the costs of doing so may make the supplier reluctant to engage.

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| Case study |
| Introducing performance management  A service organization worked for many years on contracts that operated without any performance measures, although there were regular or random checks against specifications (depending on the nature of the contract). Standards were met, costs remained largely within budget, and there were few disputes and no early terminations. This was only possible because they were working with a number of small suppliers, for whom they were a key client. Keeping the business was very important to those suppliers.  As they started to professionalize procurement, the following became apparent.   * Staying within budget did not necessarily mean getting good value. * There was no incentive either to drive down costs (e.g., through eliminating waste) or drive up quality.   Carrying out reviews of the available suppliers in each product and service category lea to larger contracts with larger suppliers. This meant the client status changed, and buying power was effectively reduced. (it seems counter-intuitive that combining spend can reduce buying power, but it can have that effect by taking the purchaser from one supply market into another, in which it has much less influence, e.g., from small local suppliers to large national or international suppliers.) goodwill was no longer a good enough incentive there was a clear need to measure and manage. |

**Targets**

A KPL is merely an indicator of a level of performance. It may, for instance, show that end user satisfaction levels are85%. That sounds like a high figure but, much like exam scores, it is meaningless on its own. You also need to know that ‘pass mark’.

In a sector where satisfaction scores in the high 90s are regularly achieved, 85% would be cause for concern. If market research has shown that average satisfaction rates hover around 80% then, despite that fact that you still have 15% dissatisfaction overall, your score does not look quite so bad.

Therefore, whenever KPLs are set within a contract, they must also be linked to a target.

Both the indicators and the targets should be developed as part of the overall contract design. In negotiated contracts it may be possible to revisit them during the negotiation, but for tendered contracts they must be part of the original tender invitation package.

As with the specification, KPL targets can affect the following.

* A potential supplies ability to actually perform the contract (e.g., they may simply not be able to resource next-day delivery)
* A potential suppliers interest in the contract (e.g., they may be able to resource it, but cannot do so cost effectively, or they have other more profitable opportunities, perhaps with lower targets)
* The price at which the supplier is willing and able to perform the contract

**Consequences**

Finally, the contract must set out the consequence of meeting or not meeting the KPL targets.

If there are no direct consequences, there may still be incentives or disincentives embedded in the nature of the KPLs themselves. Simply bringing the information into the light and

reporting on it enables lessons to be learned. An enlightened supplier will use the KPL information for its own its own purposes, outside of the contract in which they are set. If, for example, purchaser a is reporting that 10% of deliveries are incomplete against order, then the probability is that this is common to all purchasers. The supplier will be very aware thatthis could affect future business and will want to address the problem. However, the supplier has a choice on how to address the problem, especially if A is the only purchaser actually complaining.

* **Option 1:** manually intervene to ensure that all of purchaser A’s orders are correct. This will take additional resource, especially if the delivery times are not to be affected.
* **Option 2:** investigate and resolve the root cause of the problem. This is a sensible approach, but might take some. If the supplier continues to operate as before while the problem is being investigated, purchaser A will not immediately benefit from the process.
* **Option 3:** do both options 1 and 2.

The purchaser will want a speedy resolution to its own position and will care somewhat less about the suppliers underlying issue. If they can get their orders delivered correctly, it will not matter to them that this only happens because the suppliers are manually intervening to check every single order that goes to them, rather than addressing the root cause.

To ensure that either option 1 or option 3 is chosen- i.e. an option which immediately addresses purchaser A’s problem, whether or not it also looks at the root cause-there has to be a contractual remedy or incentive. This usually means either a penalty for failing to achieve the targets or a bonus for exceeding them. If there is no explicitly contact clause setting out what will happen in the event of targets being missed, then the purchaser has no grounds to seek redress-unless the failing is so bad that it can be considered a fundamental breach of contract under other clause (e.g., non-compliance with specification, fitness for purpose).

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| Remember  The KPLs and performance management framework are only contract documents if they say they are. Information issued with an RFQ or an ITT may not be fully incorporated into the contract unless care is taken to ensure that it is. The simplest method is to append it to the core contract document are a schedule, clearly referenced from the contract terms. |

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| Check  What are the potential problems with relying on the information sent out with the ITT as a means of making a specification or performance management framework contracting binding? |

**Contractual terms**

The contractual terms (sometimes referred to as “terms and condition”) male up the main body of the contract document. They are might be thought of as the ‘core contract’.

Although the expressions core and main are used here, in practice the contract terms often comprise the smallest part of the contract and will not be understood without the schedules and other supporting documentation that sit alongside them.

Key terms are considered in more detail in section 3.2. at this point, it is important that you understand the nature and purpose of contract terms and how they are established.

**Formal contracts**

At the simple level, a formal contract is any contract or agreement which is evidenced in writing and is intended to be legally binding. Generally speaking, you have a formal contract under the following circumstances.

* The terms are set out in detail.
* The parties have agreed the terms and want to be able to enforce the agreement, with the power of the law if necessary.
* The evidence of this is that the parties have written down these terms, and signed, or signed and sealed, the document.

Remember that these are the conditions for a contract to be considered formal (see section 1.2 for the conditions that must be satisfied for a contract to exist and be legally binding). While formal contracts are generally written down, it is possible for a contract to exist without being recorded in writing. You should also bear in mind that a contract might go by another name, such as an agreement, a commission, a letter of appointment, (be careful with this last term because it means different things in different contexts).

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| Remember  The contract is total agreement and may consist of a number of different documents. It may not actually be labelled contract but might be called agreement commission or appointment. |

**The use of templates or standard terms**

Few contracts are written from scratch (i.e. starting with a blank sheet of paper). Most commercial contracts will either be industry standard forms or based on a template developed by the organization itself, its legal advisors, or some other body such as CIPS, a government department or a commercial procurement consultancy.

There are a number of advantages to using standard or template forms to draft a contract but, as always, there are also potential hazards for the unwary drafter of the contract.

There are several things to consider when deciding your approach to drafting contract terms. Table 1.4 and 1.5 show the advantages and disadvantages of using standard templates and bespoke contract forms respectively.

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| Advantages | Disadvantages |
| All of the key risk areas will be set out and therefore unlikely to be missed.  Standard clauses prompt drafters to think about relevance to current contract.  The legal meaning of expressions and words will have been fully considered, possibly even tested in the courts, leaving less room for misunderstanding and misinterpretation.  Standard list of schedules to be attached prompts their inclusion.  Focuses thought on the precise needs of the procurement.  Avoids the risk of using standard terms. | Potential to use inappropriate template, e.g., supply of goods form for a services contract.  Can result in complacency on the part of drafters resulting in a tendency to only check the clauses which normally need amendment and not think about the specifics of the current procurement.  Failure to cross-checks references between clauses or section (e.g., where one clause has been delated but is still referred to elsewhere) creating nonsensical requirements or conditions.  References to legislation and standards may become obsolete or not updated.  Schedules may be appended with no firm reference to them in the contract terms, so they are not properly incorporated into the contract.  Definitions used in schedules might differ from those in the standard contract, creating ambiguity and the potential for dispute.  Language may be inconsistent with established legal interpretation.  Potential to omit less obvious areas of risk.  Potential to identify risk and remedy but not consider wider consequences (e.g., consequences of termination). |

Table 1.5 advantages and disadvantages of using bespoke contract forms

**The importance of selecting the correct template**

Although there are clear advantages in template forms, there is a risk of the wrong template being used. There is limit to the degree to which a commercial organization can standardize its purchase and supply contracts. The consideration applicable to, saya building or works contract for consultancy services will be very different to those of catering services, which will differ again from those for provision software as a service.

If organizations have a bank of standard contact form for use in different circumstances, it may be necessary to create a decision tree or flow-chart to guide personal to the appropriate in each case

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| The limit of standardization |
| When a public sector organization set out to standardize its contract terms, it discovered that is was not as simple of having one form of work, for good and one for services. Industry standard in various aspects of its work had to be taken into account. A first analysis of the types of contract that might be required suggested that 12 types might be needed, as follows.   * Works contracts for self-contained (designed in-house or appointed designer) * Works contract for self-contained (on a design-and-build basis) * **Term contract** for works (with frequent low-to-medium value core offs) * standard supply of service contract * short-form service contract low value/low risk) * technical consultancy appointments (in relation to building contract) * management and other consultancy appointments (low value/low risk) * software as a service * catering and other concession contracts * equipment hires contracts * general terms and conditions for use with low value one off purchase orders   the organization could have simplified the list, but it discovered that its suppliers were reluctant to accept overly generic forms which strayed too far from what they were used to. |

**The section of the contractual terms document**

Many contracts (though not all) follow an established format which is summarized in table 1.6.

|  |
| --- |
| 1. the ARTICLES. These comprise the very basic agreement: a summary. They state that party A (e.g., the purchaser) is entering into a contract with party B (e.g., the supplier). Party B agrees to provide the goods or services and party A agrees to pay it for them. They set out exactly who the parties are by reference to their full legal entity names-usually registered company names and registration numbers where applicable-and their registered office addresses.   In each case they will also give the terms by which each party is known throughout the rest of the contract. This will either be by a generic function (‘the purchaser’ the supplier; etc.) or less helpfully by a shortened form of the full name e.g. (,Blogs’’ for blogs commercial and industrial cleaning company Ltd).this clarifies the purpose of contract and who the parties are, while at the same time making the drafting of the clauses slightly simpler, by not having to ensure that the party names are inserted repeatedly   1. The RECITALS. These provide the context. they set out the facts that surround the situation in which the contract happens .in some agreements it is a very simple re- statement of the facts that the purchasers want to acquire Xand supplier has agreed to provide it .in some contracts (particularly building contracts) there will a number of other factual statements covering who will perform other roles necessary for contract work.   By convention they start with the word ‘whereas’ (which means ‘given this…’) and are followed by, it is now herby agreed on the site’ (or something similar). If any in the recitalssaid:’ whereas ABC property company is seeking to build 20bungalow known as Dogs Lane...’when what they actually wanted was a 100-flat tower block at cats Roads, then regardless of what the rest of the contact said, the courts  would have a basis for taking the view that the whole premise was undermined and there  was fundamental ground for disagreement. |
| 1. Some forms of contract ,particularly standard forms, will also have a CONTACT PARTICULARS section .this sets out some of the specific variables, such as required data of completion and any specific insurance requirements.it is mechanism for writing terms and condition without having to amend clause, It works by creating a schedule of common variables which can be filled in, and to which the detailed terms refer back, |
| 4 The full TERMS AND CONDITIONS are the detail. These cover the ifs, buts, may be and what will happen in respects of X if ABC happens to Normally they will be in standard wording, with specific meanings set out in a DEFINATIONS AND INTERPRWTATION clause for avoidance of doubt. They will cross-refer to the contract particulars and the schedule |
| 5. the SCHEDULES. These set out project-specific detail either as designed by the purchaser (e.g., KPLs) or as submitted by the supplier (e.g., pricing). |

***Table 1.6 common contract sections***

***How contact terms are established***

The process for establishing the contract terms in a form formal contract is shown in fig1.2.

Figure 1.2.

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| Purchaser designs contract (procurement team in consultation with Stakeholdersand legal advisors) |

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| Contract terms refined |

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| Draft contract discussed with potential suppliers as part of pre-market engagement. |

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| Draft contract issued with RFQ, ITT or invitation to negotiation |

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| --- |
| Quotes on tenders received on the basis of started terms (subject to any clarification needed) or terms amended as part of negotiation process. |

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| Quote/tender/final negotiated, offer, accepted, including, confirmation of/agreed, terms |

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| --- |
| Formal contract documents produced and signed (on signed and sealed) |

Figure 1.2 finalizing contract terms.

It is good procurement practice that the purchaser takes the lead role in establishing the contracting terms, that the terms and conditions are part of the RFQ/ITT, and that bidders are required to agree to these or be excluded. The degree to which these can be imposed, however, will depend on the professionalism of the procurement team, the robustness of the procurement process, the relative buying power of the purchaser in the target market, the competitiveness of that market, and the sourcing process.

Be aware of the following.

* The lower the purchaser’s market leverage, the easier it may be for the supplier to negotiate changes to the terms, either as part of the tender process or even after the contract has been signed. Both purchasers and supplier must be aware of the opportunities and threats that this creates.
* In regulated procurement (e.g., public sector), once the opportunity has been advertised it is difficult to perused purchasers that the terms be changed. Some public sector purchasers might insist that this cannot be done at all once the process has commenced. This is not true. Provided that all potential suppliers are aware of the changes and, where appropriate, periods for responding to invitations to tender are extended, there is no reason why a purchaser cannot take on board rational comments from potential suppliers and review or change the proposed terms of contract.

It is crucial, therefore, that procurement personal fully understand the proposed form of contract and why each of the terms exist. Every contract term is designed to do one of the following.

* Protect the supplier
* Protect the purchaser
* Balance the protection between them

Key terms would cover pricing, payment terms, risk allocation, insurance requirements, timescales, health and safety, and actions and remedies in the event that one party defaults. A certain balance will be achieved across the contracts as a whole between the purchaser’s interests and those of the supplier. This may not necessarily be an equitable balance: one party may be favored more than the other. What is important is important is the agreed distribution of benefit and cost, protection and risk.

A change to any single clause will shift that balance to a greater or lesser degree. It is part of the procurement and supply professional’s role to understand exactly how that shift might play out in practice in their business environment and whether it matters on a case by case basis. This can only be done by fully understanding the contract, both on a clause by clause basis and by understanding how the clauses relate to both each other and to the contract-specific schedules.

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| Remember  Contracts should protect both parties, but the degree to which they do so will reflect the bargaining positions of the purchaser and the supplier and their ability to influence the contract terms. |

**Informal contracts**

There are well-established legal rules that determine whether, in the absence of a formal set of contract documents, a contract exists.

If a quotation has been requested and then provided, and an order has been issued on the basis of it, there is an intention to create a legal relationship. The purchaser clearly expects the goods or service to be provided on the terms set out in the RFQ and/or the order issued (although remember that these might not agree with each other). The supplier also clearly expects to provide the goods or services on the basis of the quotation (which might not agree with either the request information or the order). There is a signification risk of divergence between what the purchaser thinks they are buying and what the supplier believes they are to supply.

It disputes over such matters reach the courts, it is likely to be found that a contract does indeed exist, even if nothing was written down (e.g., if the whole discussion had been by telephone). The difficulty is in establishing what the terms of the agreement are.

There might be ways of establishing these on a balance of probabilities.

* If the parties had contracted previously, the terms of those agreements might be assumed to apply again.
* If there are normal sector expectations about certain aspects of the delivery, they might be assumed to apply.
* Either of the above could be discounted if there were any evidence suggesting that either party had indicated that other circumstances should apply in this particular case.

Clearly this is not a very satisfactory way to proceed. Both purchaser and supplier are exposed to unconsidered risks in the event of the arrangement not being successful. Those risks could far outweigh the time and cost of putting in place at least a simple formal contract.

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| Apply  Consider situations with which you are familiar where formal contracts are not used. What potential risks can you see for the purchaser? And for the supplier? |

**Pricing and other schedules**

A schedule to a contract is simply an appendix to the body of the contract form. Schedules are used as a way of making it easier to incorporate project-specific information in a contract without having to amend the wording of the main body of the document clause by clause. It allows for the standardization of terms and conditions, which then simply cross=refer to the detail in the schedules.

The benefits of this approach are as follows.

* Drafting the contract is simplified, and therefore quicker and more cost effective.
* Within the purchasing organization, clauses for similar contracts have identical wording, avoiding the risk of different approaches across the organization.
* The contract and the procurement documents can be drawn up in such a way as to allow direct incorporation of a suppliers tendered offer, reducing the risks of misinterpretation.

**Pricing schedules**

Any contract that does not involve a single fixed-fee payment on completion will have a pricing schedule. This will effectively set out how the price is to be calculated foe each invoice. It may include various rates or simply confirm the total fee and the proportions payable at key stages. The degree of complexity in the pricing schedule will vary hugely depending on the nature of the contract.

We will look at pricing schedules and pricing arrangements in more detail in section 3.3.

**Other schedules**

There is no limit to the number of other schedules that might be included in a contract.

Where template or standard forms of contract are used, they will be supplemented by a standard list of schedules. Not all schedules will be applicable on all contracts, but building the full lists into the template document acts as a concluder at the drafting stage to consider the specific nature of the purchase.

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| Remember  A schedule attached to a contract has no force unless it is referred to within the terms and condition. The schedules provide detail to explain, amplify and/or ;limit the areas covered by the terms and conditions. |

The most common types of schedules are described in table 1.7.

|  |  |
| --- | --- |
| **Schedule** | **Key features** |
| Specification | The most important schedule to any contract is the specification, setting out exactly what is to be delivered.  It might be a conformance/technical specification or a performance specification, but it must be clear and unambiguous.  It enables the purchaser to cost, and therefore price, delivery properly.  It provides the purchaser with a ‘checklist’ to ensure it gets what is being paid for.  It should ensure that any compatibility or interface issues are catered for at source. |
| Preliminaries or contractual/operational matters | The expression preliminaries are often used in the construction industry, particularly in the UK and is often abbreviated to prelims.  Other forms of service contract might refer to contractual or operational matters.  They explain the context in which the contract has to be performed.  They can be an over-arching schedule which encompasses all those indicated as separate schedules in this table.  Usually included in tender documents, so that a single line on the pricing schedule can be used to cover all associated overheads and risks. |
| Performance management framework | The full framework including KPLs and targets, the assessment scheme and incentives, disincentives, bonuses and penalties.  Unless clearly linked to clauses in the body of the contract that enable penalties, service credits, bonus payments or other consequences, it will serve very little positive purpose.  In term contracts, this should include a mechanism for enabling adjustment of the targets and/or changes to the actual indicators to be measured. |
| Sit lists, maps and plans | Factual information in list or map form to assist in the clearly of identified points of delivery.  If a very precise place of delivery is critical, even a full postal address may not be sufficient. A plan can assist in avoidance of doubt (e.g., GIS mapping).  Particularly relevant in facilities management where external areas are involved, or where only parts of buildings come under the purchasers jurisdiction (e.g., if they only lease a single wing of a building). |
| Health and safety | For construction, this may include specific pre-construction information required to be provided by law (e.g., under construction (design and management) (CDM) regulations in the UK).  In the absence of regulation, goods practice would still require providing area, such as potential for asbestos, hazardous chemicals, and physical issues such as heat, noise or fumes.  Risk assessment forms in respect of the delivery of the contract itself may be included, such as use of chemicals, working at height, lone working, etc.  These schedules may be live contract documents(i.e. completed prior to signing the contract but required to be updated at regular intervals as part of the normal contract management). |
| Method statements | Describe how the desired result is to be achieved, particularly, important where performance specifications are used.  May be included as separate schedule or incorporated into the specification  The contract need to be clear as to whether the method statement provided is approved or merely accepted. Approving or embedding a suppliers method statement in the specification shifts some of the liability for the method from the supplier to the purchaser and unnecessarily fixes on one potential method as a contractual requirement, whereas flexibility during the contract might be useful. |
| Supply chain | Can include subcontractors and/ or approved manufacturers of components, but might equally simply set out the process for agreeing and/or approving the supply chain. This could be to purchase buying power to be leveraged down the supply chain, or to control ethical issues in the supply chain (e.g., source of materials, labour rights or payment terms).  Increasingly, large organizations are subject to public and governmental scrutiny of what occurs within their supply chains. Getting this wrong can have reputational and financial impacts.  The contract needs to make provision for sanctions, remedies or other actions if these schedules lay down minimum requirements. Suppliers development might be a more appropriate response than suppliers sanction, but the contract needs to allow for worst-case scenarios. |
| Advancing agreements | A contractual mechanism, e.g., for requiring subcontractors or co-contractors to work with a main contractor or the purchaser in setting up joint supply chains.  More common in framework agreements than term contracts.  Useful if the combined buying power is greater than the sum of the parts.  Risks undermining any exiting arrangements that any of the parties already have in place.  Possibly only of use in very high-value contracts. |
| Core list or exclusions list | Where schedules of rates are based on national schedules of rates or catalogue prices, they are often quoted on the basis of a percentage discount against the schedule or catalogue price. The discount may not apply to all possible call-off items. In these cases, it is necessary to specify one of the following.   * Which items it does apply to, which are normally those most frequently purchased (known as the core list or core items) * Which items it does not apply to, such as unusual or specialist items (known as non-core or excluded items).   The price schedule should cross-refer to any core items or an excluded items schedule, or the two should be combined. The price schedule should indicate how non-core items are to be priced. This ensures that the pricing mechanism for all potential call offs is clear. |
| Suppliers staff | Where the provision of services is specifically dependent on the skills and qualities of individuals, there may be a requirement to set out key personnel who are material to the contract, such that the contract may be terminated without their continued participation-or at least without their replacement by personnel of proportionately similar skill and experience. That skill and experience may need to be set out in detail if it is to have any force.  Where the service involve contact with children or vulnerable adults, or where there are defense or security implication and there may be a need to set out specific staff-vetting |
| Code of conduct |  |
| Data management | If not included within the body of the contract, there may be a need for any or all of the following.   * Non-disclosure requirements to protect intellectual property on commercially sensitive information * Commercially confidential information in general-contracts may have generic clauses relating to this, but what avoidance of doubt a schedule can set out precisely what information is deemed to fall under this generic heading * Minimum cyber-security standards * Rules regarding processing, management and storage of any personal data which may need to be shared in the context of the contract (e.g., the European union (EU) has recently updated its data protection rules under the General Data Protection Regulation (GDPR), which applies to data relating to any person within the EU, even if not a citizen of the EU) |

Table 1.7 common contract schedules

Contract variations

There is a tendency to think of a contract as a fixed and finite thing, but purpose and supply contracts have to allow for change. Changes may occur as a result of unseen circumstances such changes in regulations, or a foreseeable need for change such as price adjustment over time. Change may be necessary because of external events or be requested by one or other party to the contract and might be to the benefit of both parties.

Simple matters such as KPIs can became absolute if they are so easy to achieve that measuring them cease to add value, while other areas which have become more important are not being monitored. Technology also changes rapidly: without the ability to adjust a specialization (by agreement) within a contract, both parties could become locked into outdated products or services with no alternatives other than to terminate the contract.

If the contract does not have change a mechanism, at best it risks stagnation, and at worst it’s risks ineffectively delivery or early termination.

The change process should therefore be set out within the contract and should include the following.

* Who can request a change
* Who can authorize a change
* Who can accept a change
* The mechanism for agreeing price adjustment in respect of such a change (if possible with reference to the existing price framework)
* The implications for the contract if a variation order (also known as change order) is rejected

Actually, the format for a variation order will be set out as a schedule or appendix in the contract. A sample format is set out in figure 1.3.

VARIATION ORDER Number Issue Date:

This variation order is issued pursuant the contract in place between xxxxxx and xxxxx

1 Details of the contract

|  |  |
| --- | --- |
| Title |  |
| Form |  |
| Client |  |
| Contractor |  |
| Contract date |  |

The above contract is varied as set out below

|  |  |  |
| --- | --- | --- |
| Ref: | Item |  |
|  |  |  |
| Price change: |  |  |

Signed: ………………………………………………………………… Date: ……………...

On behalf of [insert name of client]

Print Name

And Job Title: …………………………………………………………

Accepted: ……………………………………………………………… Date: ……………….

On behalf of [insert name of service provider]

Print Name

And Job Title: ………………………………………………………….

The variation order must include a statement of any price impact on the contract value. where the nature of the change is such that it requires the change to the timescales for delivery, these should be noted, confirming any changes to the date for completion of the contract, or amendments to standard timescales laid down within the contract.

All change order should reference both the clause allowing for the change, and any clauses schedules which it changes.

Copies of all change orders should be held with the original contract documents. The orders themselves do not need to be signed and sealed: authority for them to be valid is delegated under the terms of the contract, provided that they are issued in accordance with those terms (e.g., signed by someone with the relevant authority such as the contract manager or contract administrator). But they do have the impact of actually changing the agreement.

Where contract registers are used, those changes may need to be refracted in the register, especially with regard to price and or timescales.

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| Remember  Contracts can be amended during their lifespan. Any contract expected to last for more than a very short period of time should include a mechanism for a variation which sets out who can authorize changes and any limit to those changes. |

Analyze the legal issues that relate to the creation of commercial agreements with customers or suppliers.

This section looks the law surrounding contracts. Much of what follows has been developed through the uk legal system, but the price is generally accepted elsewhere.

The basic rules for contract formation

In order for a contract to come into being, there are five conditions.

* Offer
* Acceptance
* Consideration
* Intention to create legal relations or intention to be legally bound
* Capacity to contract

In this section, a number of legal cases are described. they are headed by names under which they are known and their dates, such as fisher v. Bell (1961). Many of them are very old, often dating to the 1800s, this is the way the law evolves in countries with common law legal system, such as the uk, the USA and Australia. Each of the cases demonstrates how the rule was established or clarified. When reading them, think about how the scenario might apply in the modern world.

Countries with a civil law system (e.g. Austria and Poland) do not rely on case law, but only on is actually written down in statutes and regulation. Other countries like south Africa have mixed system which is partly civil law and partly common law.

The civil law countries are more likely to have updated regulations to take an account of modern communication methods than those still basing rules of contract on case law. Case law is only updated in two situations.

…… relevant case comes to trial

When the governing authorities decide to change the law by statute, officially terminating the rules which have previously involved

Rules relating to offer and acceptance, consideration, intention to create legal relations and capacity to contract offer.

An offer is a full statement of what the offer or is willing to provide and the terms by which they are willing to provide it.

Understanding what an offer is requires good understanding of what is not.

Something is not an offer then by definition it cannot be accepted, even if someone appears to accept it, no contract is created.

Defections of offers which are not offers have evolved through case law. Table 1.8 sets out things which are not offers in the legal sense. The case law establishing the principles is old but still holds.

Remember these rules have been established under English case law. They will only definitely apply where the relevant law is that of England and wales. However, the principles are very similar in many other jurisdictions. The buyer should always check which jurisdiction the contract is agreed in.

|  |  |
| --- | --- |
| **Not an offer** | **Relevant case law** |
| **Invitation to treat (or invitation to negotiate)**. This states that a person or organization is willing to enter into discussions about the possibility of a deal, but does not confirm a willingness to be bound by any terms mentioned.  Catalogues and goods on display are invitation to treat: invitations to a buyer to offer to buy, but the seller can always refuse to sell.  Similarly, ITTs-even though they set out the proposed contract terms in finite detail-are still only invitations to treat. The offer is made by the firms submitting the bid. In this case, the buyer can decline to buy. Indeed, where there is more than one tender, they will have to decline most of the offers received. | Fisher v. Bell (1961)3  A flick-knife was displayed in a shop window. The shopkeeper was charged with offering an offensive weapon for sale (a criminal offence). He was acquitted on the basis that the display was not an offer, but only an invitation to treat, which at the time was not an offence.  Pharmaceutical society of Great Britain v. boots cash chemists (1953)4  The pharmaceutical society of Great Britain alleged that the supermarket-style operation breached rules on the sale of controlled pharmacy products, it was held that the display of the products on the shelves was an invitation to treat, and the offer to buy was made when the purchaser took the products to the cash desk to pay. Provided there was a pharmacist present at the cash desk, the rules were complied with. |
| **Declaration of intention.** this is defined as an aim or a plan. By its nature it is not definite and cannot therefore be seen as an offer. | Harris v. Nickerson (1872)5  An auction sale was advertised, but then cancelled. This plaintiff had travelled to the sale and tried claim his expenses. It was held that the advertisement was not an offer that he could accept by making the journey. |
| **A ‘mere puff’ (or boast).** The is anything which is not intended to be taken literally or too seriously, such as many advertising slogans. There is a questionable line, however, between what is merely a boast and what a reasonable person might expect t take seriously. | Carlll v. carbolic ball company (1892)6  The carbolic smoke ball company placed an advertisement stating that they would pay 100 to anyone who caught influenza after using their smoke balls, and as evidence of good faith they had placed 1000 on deposit at a named bank. Mrs. Carlill used the product but still caught influenza. She claimed her 100, which the company declined to pay. One of the defenses put forward was that the advertisement did not constitute an offer. It was held that a reasonable person would take the promise seriously and therefore it was indeed an offer which bound the company. |
| Provision of information | Harvey facey (1893)7  The plaintiff sent a telegraph asking will you sell us bumper hall pen? Telegraph lowest price. The reply was lowest price for bumper hall pen 900. It was held that this was merely an answer to a request for information and not an offer to actually sell at that price. In essence, it was an indication simply that they would definitely not sell for any less-they could still seek to get more. |

Communication of an offer

An offer can only exist if it is communicated to the other party. The nature of an offer is that it is capable of being accepted or declined. Clearly a party cannot make that choice if they unaware of the offer. To the case of Taylor v laird (1856), a case captain resigned in a foreign port and his employers were duly notified. He later worked on the ship on its return home, but the company decline to pay him. It was held that were entitled to withhold any since his offer to assist had been communicated and they had not had the option of decline.

DURRUTION OF AN OFFER

There are six ways in which an offer will end, i.e. cease to be capable being accepted.

Withdrawal (or revocation). The offer can simply decide not to proceed and withdraw the offer. an offer can be withdrawing at any time up to the point of acceptance, even a promise to keep it open for a specific length of time. If the agreement to hold the offer open for a given period is a contract in as own right (i.e. There has been consideration paid for it, as happen when an option is purchased), it is still possible to withdraw the offer, but in this case doing so would be a breach of contract. it is unlikely that an action for specific performance would succeed but damages may be awarded. For example, in Routledge v. Grant (1828), Grant offered to buy Routledge’s house and gave him six weeks in which to accept. Before the period elapsed he withdrew the offer. It was held that he was entitled to do so. Like the offer itself, withdrawal must be communicated. However, that communication does not have to be direct. The communication can be by virtue of an action such as selling to someone else. It can be communicated by any reliable source.

During another prospective house sale (Dickinson v. Dodd’s (1876)10), the defendant had offered to sell the house, but before the plaintiff had accepted, he sold it to another party. The plaintiff heard of this from a friend. It was held that because the source of information was reliable, the offer had been revoked and could not now be accepted.

Lapse, if a time limit is set for acceptance and the offer is not accepted within that time it will lapse: that is, cease to be valid. For example, if an ITT states that offers must be held open for three months and the purchaser takes longer than that to complete the evaluation and internal authorization processes, strictly speaking the tenders are no longer available for acceptance.

In practice, what would happen in these circumstances in that the purchaser would, as the expiry data approached, seek an extension to the validity period (which the tenderers could decline), or they would choose to accept the offer anyway. If the seller agreed to go ahead in the latter case, it could not mean that the contract would be invalid, but simply that the offer and its acceptance had switched direction. Rather than the seller offering to provide the goods or services and the purchaser accepting that offer, it would create a situation where the purchaser was offering to buy and the seller was accepting that offer.

Where no express expiry limit is stated, an offer will lapse after a reasonable time. What constitutes ‘reasonable’ will depend on the circumstances.

In Rams gate Victoria Hotel v. Montefiore (1866),11 Montefiore offered to buy shares in the company in June. He had no response to his offer until November, by which time he was no longer interested. It was held that the offer had lapsed and he was not obliged to purchase the shares.

* Death, the death of either party before acceptance will terminate the offer. By analogy it is probably also true, though not actually tested in the courts, that the winding up of a company would have the effect.

Rejection, once a party has rejected an offer, they cannot later decide to accept it. A counter offer is a rejection. If Company A offers to provide services at $90 an hour and Company B states that it will accept but only at a fee of $85 an hour, it has rejected the original offer and made a counter offer. Company A is no longer obliged to hold its original offer open.

This was precisely the scenario in Hyde V. Wrench (1840) there was an offer to sell the farm at 1000. A counter offer of 950 was made but it was rejected. The buyer tried to revert to the original offer of 1000 but it was held that the seller could reject this since the original offer had been rejected.

Any acceptance made subject to conditions other than those originally offered is also a rejection. In a sense, this is actually a counter offer being disguised as an acceptance.

In Neale v Merrett (1930) the defendant offered to sell a parcel of land for 280. The plaintiff accepted the offer and paid 80, promising to the rest in 50 instalments.it was held that there was no contract because the offer did not include such credit terms.

Like an offer and a withdrawal, rejection must also be communicated. If a rejection was sent in writing, but then the party changed its mind and telephoned to accept, provided the phone call was made prior to the letter arriving, the acceptance would stand. However, it is hard to see any practical impact of this in modern commercial dealings and electronic communications.

In financing ltd v. Stimson (1962) Stimson offered to take a car on a hire purchase agreement. Before the offer was accepted, the car was stolen and damaged. Financings accepted the offer, but it was held that it could no longer do so, because there was an implied condition that the car being hired would be in substantially the same condition at the point of acceptance as it was when the offer was made.

Acceptance, once an offer has been accepted it comes to an end. This may appear obvious, but an offer may be made to a group of people but only be capable of being accepted by one of them (e.g., because it relates to a single item). Once one person has accepted the offer, it ceases to be available to the others. By extraction, if a liquidator is selling the stock of a bankrupt company, any fixed offer it makes to do so may be communicated to a number of interested parties, but their ability to accept the offer will lapse once all of the stock has been sold.

|  |
| --- |
| Remember:  The six ways in which an offer ceases to exist: withdrawal (sometimes called revocation), lapse, death, of the person making an offer, rejection (including counter offer), failure of conditions, and acceptance. |

Acceptance

As already discussed, acceptance is subject to the following conditions.

* Acceptance can only occur while the offer is open.
* It must be absolute and unconditional.
* It cannot be made by someone with diminished capacity.

This raises the question of the validity of things which look like an acceptance, but are headed subject to contact – in particular, letters of intent, which are often conditional acceptance letters.

Subject-to-contract letters, which are often used in the purchase of land, are clearly intended to indicate that there is not yet a contract being created.

Letters of intent have been the subject of much debate, particularly in the construction industry where they are common. The current view is that they have the same status as subject-to-contract letters (i.e. they are a clear statement of ……….) But if – as shown above- a declaration of intention is not sufficient to create an offer, it logically follows that it is not sufficient to form an acceptance.

A further principle of acceptance is that, logically, it creates the contract. Therefore the place of acceptance may be important in determining which jurisdiction the contract falls under, in the event of any dispute. With the growth of global trade and electronic communications, including the increasing use of electronic contacts, this concept of 'place' in contractual terms becomes somewhat unclear. It is important, therefore, to avoid any unintended implications of this by categorically stating within the contract terms which legal and judicial system shall apply by reference to the relevant country's courts.

Acceptance does not need to be explicit. It can be implied by actions – this is known as acceptance by performance. If a purchaser uses the goods supplied, it can (and will) be implied that it has accepted the terms on which they were offered. However, if the purchaser does not use, or otherwise Interfere with, goods that it has not ordered, then its silence on the fact of the delivery cannot imply that it has accepted them. No payment can be demanded.

Likewise, a buyer cannot assume title to goods (i.e. treat them as their own) if the seller is silent about an offer made, even if the buyer has made a payment – particularly if that payment did not require action on the part of the seller (e.g., if the payment was made direct to the seller's bank account). It would be different if the buyer had sent a cheque and the seller had paid it in. In that latter case, it could be argued that the seller's actions in banking the cheque amounted to acceptance.

In felthouse v. Bindley (1862) after some ongoing negotiations regarding the sale of a racehorse, the plaintiff eventually wrote: 'if I hear no more about him, I consider the horse mine at £30 15s.’ As it turned out, he did indeed hear ' no more'. Nevertheless, and despite the fact that the seller had actually fully intended to sell at that price, it was held that there was no sale completed.

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| Remember:  An offer can only be accepted if it is still open. The acceptance must be unconditional. |

Exceptions to acceptance rules regarding communication

There are two rules which override the need for acceptance to be communicated.

* The person making the offer can simply dispense with the need for a formal acceptance (decide they do not require it). In many call-off contact, there will be a written requirement for the supplier to acknowledge call-off orders, but in many others there is no such requirement. All that is required is for the seller to fulfill the order.
* There is little real difference between this and acceptance by performance as outlined in the previous page. The seller is accepting the offer by their action in fulfilling the order.
* There is a specific legal rule known as the mailbox rule. This principle holds that if a letter accepting an offer has been properly posted (i.e. stamped and handed in to the postal authorities), then it will be effective from the date of posting, even if it never arrives.

There are two conditions for this rule to apply.

* It must have been obvious to both parties that the acceptance would be sent in this way.
* There must be evidence of posting.

Note that the mailbox rule only applies to acceptance. It does not apply to offers or withdrawal of offers. This creates a potential problem in itself.

The case of Byrne & Co v. Leon Van Tien Given & Co (1880) involved a firm in Cardiff selling tin plate to a company in New York. The negotiations were all done by letter. Having made the offer to sell, the seller then sent another letter withdrawing it. While the second letter was in transit, the purchaser sent a letter accepting the offer. It was held that the acceptance was valid because it was sent before the withdrawal was received.

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| **Apply**:  Review the 'postal rule’ in the context of tender processes with which you are familiar and explain why its importance is diminishing. |

**Mailbox rule regarding electronic communications**

Strangely, the postal rule was never applied to the use of telephone or Telex (an early electronic form of communication). In both of those scenarios, where the communication is virtually instantaneous, it is usually held that it is not effective until it is received.

In Entores v. Miles Far East Corporation (1955), an acceptance sent by Telex from Amsterdam was held to be effective only when it arrived in London. A cynical view might be that this departure from the accepted rule -that an acceptance was valid when sent -was the result of a desire to have the acceptance take effect in London which would bring the contract within the jurisdiction of the English courts.

Does the mailbox rule apply in respect of e-mails? Or is the rule in Entores more relevant? The courts have not yet ruled on this. Arguably, they may never need to do so. The growth of international trade and the near-instant modes of communication available mean that the two main problems of when and where acceptance is effective are pre-empted within the normal operation of business. This is due to two main reasons.

* The problem of withdrawals and acceptances crossing in the post (i.e. one being sent before the other is received) is now very remote. Business transactions happen much more rapidly. In the context of e-mail being used, the circumstance in Byrne v. Van Tien Hoven would require both emails to have been sent at the very same moment, and/or for one or other of them to have been delayed in the electronic system. For this to happen at the crucial point is not impossible, but it is rare.
* Familiarity with international trade has led to the now near-universal practice of stating within the contract itself which courts shall have jurisdiction. Thus a contract between a company in London and one in New York will state whether it is subject to the English legal system or the American one.

**Mailbox rule in civil law jurisdictions**

The mailbox rule does not apply in countries with civil law codes. These take a more logical view that acceptance, like offer and withdrawal, can only be effective……. Communicated, although some (Germany and the Netherlands) soften this by adding a proviso that the lack of communication must not have been the fault of the person making the offer. This means that one party cannot revoke an offer if the only reason it did not receive the acceptance was because (either deliberately or unintentionally) it prevented itself from receiving it.

**The Vienna Convention on the mailbox rule**

The United Nations Convention on Contracts for the international sale of Goods (CISG), often known as the Vienna Convention, complicates matters. It states that the postal rule does not generally apply (as a means of establishing when and where the contract was concluding) but it does not retain the part of the sent whether or the acceptance is received.

Ability to agree rules between the parties

Given the potential for different legal rules to apply, depending where the parties are located and how the communication between them is being conducted, particularly when dealing internationally, it would seem sensible for the parties at the outset of negotiations (in invitation letters) to be very clear on how acceptance of offers will be communicated. This could be done by setting out deemed receipt protocols. An example might be as follows.

* The tender will be accepted by an e-mail copy of a letter duly signed by the authorized signatory.
* The acceptance will be effective on receipt and in the absence of evidence of receipt, shall be deemed to have been received within one hour of being sent, unless a non-deliverable message has been received by the sender.
* The original of the letter will be sent by registered mail, but for avoidance of doubt, the e-mail acceptance shall be effective irrespective of receipt or otherwise of the hard copy.

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| Remember:  The rules regarding when offers and acceptance become effective are complex and can be different depending on which legal system applies. It is sensible to be explicit in stating which country's system has jurisdiction and to include precise terms regarding receipt and acceptance of tenders when inviting offers. |

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| Check  The rules on acceptance are complicated. work through the text slowly and answer the following questions.   * Can an offer be accepted after it has lapsed? * Does acceptance have to be explicit (in words or in writing)? * Can silence signify acceptance? * Describe the mailbox rule and explain the problems it might create. |

**CONSIDERATION**

In legal terms, contracts are bargains: one thing given in exchange for another. The thing given in exchange is known as **consideration.**

In commercial contracts, consideration can be thought of as the payment for the goods or services being provided. It will normally be a financial payment, but in legal terms it does not have to be. Payment in kind (i.e. in goods or services) can be consideration. This barter type of exchange –one service for another – had gone out of fashion but with the ability of the internet to connect people, it is making something of a comeback in contracts between individuals. It is, however, rare in commercial contracts, where the consideration is almost invariably money.

For a contract to exact there must be consideration and it must have value. No consideration means no contract.

As with offers (see table 1.8), consideration is another concept where to understand what it is, you need to understand what it is not. Again, the definitions have been established through case law. Table 1.9 sets out things which are not consideration in the legal sense, with warnings about some exceptions which are consideration.

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| Consideration or not? | Relevant case law |
| **Past consideration**. Something which has already been done or given **cannot** act as consideration.  Suppose a local council decorates paint fences belonging to private property company by mistake, and the private company then agrees to pay for work. If the private company defaults on that payment, the council has no legal claim.  Because the private company already has the benefit of the freshly painted fences before promising to pay, they gain nothing in exchange for promising to pay. The benefit would remain in the absence of the promise.  If instead of painting the fences the council had planted trees in the garden and agreed they would remain if the private company paid (but in absence of payment they would be removed). There would be consideration because the benefit can have retracted. | Eastwood v. Kenyon (1840)  Eastwood had been a guardian of a young girl spending money on her education and general wellbeing. When she came of age she promised to repay her guardian when she married Mr. Kenyon he repeated the promise. No repay was made. It was held that Eastwood could not recover cost because the consideration for them was in the past. Mrs. Kenyon had been brought up and educated without any promise of recompense.  Roscorla v. Thomas (1842)  Roscorla bought a horse from Thomas after the purchase Thomas promised that it was sound and free from vice. It turned out the horse was vicious. Roscorla sued. He lost the case because no additional consideration had been given in exchange for the warrant that the horse was well behaved. He had already complicated the purchase in the absence of that assurance. |

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| Consideration or not | Relevant case law |
| Implied Consideration. If the detail of a promise to pay is expressed after the provision of goods or services but, there is an implication that such a promise would be forthcoming, this may be depending on the face be valid consideration.  Is to use previous example, the private company had asked the decorators to paint the senses while they were working in the area, there could be an implied promise that the council for the decorators themselves would be paid a reasonable sum for doing so. | Stewart v. Casey (1892)  Stewart was joint owner of some patents. He asked Casey to promote them, which he successfully did. After the work was done, Stewart promoted Casey a share in the patents in payment. It was held that this was enforceable, because the original request for the work carried an implied promise to pay for it, and a letter indicating that payment would be solely by way of shares set the detail on the payment.  It is worth noting that not all legal commentators agree that the approach taken was correct in this case, which is why the text here says only that there may be implied consideration. Commercially, it is not an assumption to be relied on. |
| A promise to perform an existing obligation. If the existing obligation is a legal one, it must be performed whether or not the goods or services at issue are delivered, so it cannot be said to be in exchange for them.  The standard case quoted see right does not……. this very clear, but the argument is that Rees was under an obligation to pay the full amount. In effect, he promised to pay some of it if the builders stopped chasing him. In making that payment, he was only performing part of what he was already obliged to do, so had given nothing in exchange for the builders ceasing to pursue the debt. They could continue to do so. | D & C builders v. Rees (1966)  Rees owed £482 to D & C for building works, which he was refusing to pay. Eventually the builders agreed to take £300 in full payment. The courts held that they were still entitled to sue for the remaining £182 because there had been no consideration for the promise to settle for less. |
| A promise to perform over and above an existing obligation. This is consideration see right. A modern analogy would be police presence inside football grounds before, during and after matches, which has to be paid for by the football clubs. Conversely, any police presence outside the ground is at the discretion of the force and comes under its existing public order duties. | Glasbrook bros v. glamorgan county council (1925)  Glamorgan police were offered £2200 to provide a special guard for a coal mine during a strike. Glasbrook brothers the mine owners then refused to pay. It was over held that payment was due because the guard was over and above the police forces normal duties to protect property. |
| A promise given to a third party. This is not normally consideration, and is based on a concept known as private of contract, namely that a contract is a private arrangement between the parties to it. Anyone who is not a party to the contract, even if they are a beneficiary of it, cannot sue if the terms of the contract are breached.  We have used the word normally in this case because most lawyers are uncomfortable with the idea that someone who is intended from the outset to be the beneficiary of a contract cannot enforce its terms. | Tweddle v. Atkinson (1861)  John twaddle’s son, William, was engaged to Mr. guy’s daughter. Both fathers agreed in writing between them to pay sums of money to William twaddle. Mr. guy died before payment was made and his executors refused to pay. William twaddle sued, it was held that because he was a third party to the original contract between his father and Mr. guy he had no rights to enforce it. |

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| Apply  Look back at the case of D & C builders v. Rees in table 1.9. think about what implications this might have for contracts with stage payments. It is common practice for final accounts on such contracts to be signed as being in full and final settlement. Do you think this could be overruled on the basis of the D & C builder’s case?  There is no fixed answer here, it would depend on the facts of the case, and underlines a need for contracts to set out clear rules around the agreement of variation orders and any cost adjustments (up or down) associated with them. |

**Adequacy and sufficiency of consideration**

The law makes a distinction between sufficient consideration and adequate consideration.

Sufficient consideration means that consideration is capable of having a monetary value and does not fall into any of the categories in the table 1.9 that are defined as being “not” consideration. Consideration is therefore sufficient to meet the test of the law if it meets the following requirements.

* It must be present or future consideration (not past)
* It must be something which the provider is not already obliged to perform or provide.
* It must be provided from one of the contract parties to the other.
* It must have (or be capable of having) monetary value.
* It must be more than a vague promise.

Adequate consideration relates to whether or not the payment is a reasonable or fair amount to be given in exchange. Generally, in commercial contracts, the law will not intervene in this area. If there is a reasonable balance of power between the parties, they are free to make a bad bargain.

Governmental and legal authorities may seek to intervene where the balance of power is clearly not equal, particularly in contracts between large companies and individual consumers. In UK, recent examples of this include caps on price rises by public transport companies and energy companies.

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| Remember  Consideration must be given directly in exchange. It cannot be something already done, or something that is already an existing duty (unless it goes above and beyond that duty). It cannot be a vague promise and it must be given from one party to the contract to the other party (not to third party). It must be specific and it must have (usually monetary) value. It does not, in legal terms, have to give good value for the exchange. |

RIGHTS OF THIRD PARTIES

Concern about the inability of beneficiaries to enforce contracts that they are not party to have been partly to have been partly addressed in England and Wales by the contract (rights of third parties) act 1999. This gives third parties the right to enforce a contract; the contract itself does either of the following.

* Gives them the right to do so.
* States that it is intended to confer a benefit on them.

There is similar legislation in New Zealand (now incorporated into the contract and commercial law act 2017).

Other countries have not followed this lead. This is not surprising because the overriding commercial response, in the UK at least, has been ensure contracts include terms which stipulate that the contract is specifically not intended to confer any rights on third parties.

COLLATERAL WARRANTY

A **collateral warranty**is an agreement under which a subcontractor guarantees to a third party that it will fulfill its obligations under a contract. It is only legally binding not executed as a deed (see the following page).

Let us look at an example without collateral warranty. Figure 1.4 shows a contract between a building company (A) and a structural engineer (b). the purchaser (C) separate contract with the building company.

The contract between company A and company B states the following.

* Company B (the structural engineer) promises to design the foundations and key structural elements of the factory in accordance with the law, regulations, good practice, etc.
* Company A (the building company) provides consideration by way of fees (i.e. monetary payment).
* Company C (the eventual owner) benefits from the work of the structural engineer but cannot enforce any of the terms of the engineer’s contract with the building company.

If there is a problem with the engineering design, such as faulty foundations, and the building collapses, company C may be able to claim against A under its separate contract, but can it also or as an alternative claim directly against company B?

In the normal course of events this might not matter. Company C could claim against company A which in turn could claim against company B. but what if company A had become bankrupt in the meantime and had been wound up? Company C could no longer claim against it because it no longer exists, it would then want to be able to claim against company B, could it do so? The answer is complicated.

* Under the promises to third party/private of contact doctrine, the answer is No. Company C cannot claim against company B because there is no consideration from company C to company B carrying out its duties effectively.
* Under the contracts (rights of third parties) act similar legislation, the answer would also be yes, if the contract listed it as being able to do so.
* If a deed of collateral warranty exists (with the appropriate terms), the answer would be yes, and because this type of deed creates a direct legal relationship designed expressly for that purpose. this is illustrated in figure 1.5.

WHERE CONSIDERATION IS NOT REQUIRED

The major exception when consideration is not required to form a contract is where the promise is made by way of a deed. There used to be a rule that a deed needed to be sealed, but more recently it is generally accepted that a document is a deed if it says it is, and has been signed by the parties and witnesses to their signature. In the commercial world, if and organization has a company seal, it will be required to attach it to deeds. Some forms of organizations have a company seal; it will be required to attach it to deeds. Some forms of organizations, such as partnerships, will not have a seal, but this does not prevent them from entering into deeds.

As shown here, collateral warranties generally do not involve consideration; therefore, they are only effective if executed as deeds.

Some warranties will introduce a minimum consideration (e.g. a very small amount of money) to avoid the need for them to be deeds. The reason for this is that most contracts have a liability period of six years, but those executed as deeds carry 12 years’ liability.

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| Remember:  When the promise is made by way of a deed rather than a contract, consideration is not required. A document is a deed if it explicitly says it is. |

INTENTION TO CREATE LEGAL RELATIONS

A further requirement for a contract to exist is that it intended to be a contract. There has to be a mutually agreed intention that the agreements set out are to be enforceable. It seems extreme to say that a contract is intended ‘to have the force of law’ but that is essentially what an intention to create legal relations means; that the promises made (i.e. the contract) are legally binding and legally enforceable- through the courts is necessary. The expressions intention to **create legal relations** and **intention to be legally bound** mean the same thing and are used interchangeably.

Commercial arrangements are generally assumed to be intended to be enforceable, while purely domestic agreements are thought not to be. The following two cases are commonly used to illustrate the difference in a largely domestic setting.

Balfour v. Balfour (1919), Mr. Balfour promised his wife an allowance when he had to work abroad. After a while, the payments stopped. The courts held that this was not a contract and Mrs. Balfour could not insist that they be continued.

Simpkins v. Pays (1955), three people shared a house; the owner, her grand-daughter and a paying lodger. Every week they entered a newspaper competition. Although the entries were in the same name of the house owner, all three contributed to the entries, and it was understood that they would share any winnings. When an entry did win, the house owner refused to share. The courts held that this was in the nature of a contract that was intended to be binding.

In the commercial setting, it is assumed that there is an intention to be bound, unless there is strong evidence to the contrary.

The case of Rose and Frank v. Jr. Crompton and Bros Ltd was an agreement for an English company to use a New York firm to market its carbon paper in America. The agreement included the wording: this arrangement is not entered into …as formal or legal agreement, and shall not be subjected to the legal jurisdiction in the law courts’. When the English firm withdrew, the American company found that it could not enforce the contract.

In Appleson V. h little wood ltd (1939), appleson claim to have won on the football pools (a form of betting on the outcome of football matches) and sued to recover his money. The courts held that little wood ltd did not have to pay because the entry form included the word ‘binding in honor only’. This meant it had a strong moral obligation to pay, but no legal obligation.

Capacity to contract

A person has the capacity to contract, which is sometimes referred to as legal capacity or legal competency, if there is no legal reason why they cannot enter into a contract. The following categories of people do not have capacity to contract.

* Infants/minors (those under the age of maturity, which is 18-year-old in most countries).
* People suffering from mental health issues
* People under the influence of drugs

If a person without capacity enters into a contract, it will not be legally binding on them, it may, however, be binding on the other party. The reason for this is that the purpose of the rules on capacity are to protect those who may be capable of making an informed assessment of the agreement being entered into.

Some countries make exceptions to the rules on consent. For example, contracts in respect of housing, food and other life essentials are more likely to be considered binding, if it can be shown that the person entering the contract fully understood it.

Note that all of these rules apply to natural persons (i.e. human beings). They do not apply to companies or public authorities. All commercial entities are deemed to have a capacity to contract.

Ultra vires

There is a similar provision in the commercial world- applying to public sector bodies – where the organization may only legally be able to contract to do certain things. These are known as the ultra vires rules, a Latin term meaning beyond powers.

Public sector organizations often have the limits of their duties and obligations set out in law. Acts of parliament, or the equivalent, will describe the following.

* What the body is intended to do
* What the body is required to do
* What the body is able to do in order to meet the need of the two points above.

These rules may limit the areas in which the organization can and cannot contract. Any contract which the organization enters into to do something beyond these limits will not be capable of being enforced against it.

Risk the supplier’s terms will seek to limit the supplier’s risk.

The to-and – fro of those different sets of terms is known as the battle of the forms. Each set of terms is fighting to take precedence over (or overrule) the other. How is it possible to determine whose terms actually apply, or which contract terms take precedence?

Each issue of a set of terms is in effect a counter offer, which rejects the previously issued terms. So the sequence might be as follows in 1.6. And at some point in the chain, an acceptance will be issued.

Purchaser issue request for quotation, setting out terms purchaser’s terms apply

Seller provides quotation on headed paper with its own terms and conditions printed on the back sellers terms apply

Purchaser issue order with its own terms and conditions attached. Note under contract law this not an acceptance of the quotation but a counter offer. Purchasers terms apply

Either or

Seller fulfils order with no attached terms. In law this is an acceptance of the counter offer. Purchasers terms apply

Seller fulfils order with delivery note stating supplied on the attached terms. This is a further counter seller’s terms apply

Purchaser accepts and pays for goods. This is acceptance of the last counter offer terms apply

In butler machine tool co ltd v. ex-cell-o Corporation (1979), butler offered to sell using its own standard terms. Ex-cell-o placed an order using its terms (which were different from butlers). That order from had a tear-off slip which the supplier had to return. That slip acknowledged the terms of the order. The courts held that the return of this slip was an acceptance of the terms and created the contract.

In this case, even if butler had then included its own terms on the delivery note and required a signature for ex-cell-o accepting those terms when receiving the goods, it would have had no impact because the contract had already been formed.

It is often said that the battle of the forms is won by the person who ‘fires the last shot’. Clearly from this examination of the butler case that is not so. Shots can continue to be fired after the battle has already been won and lost.

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| Remember  In the battle of the forms, it is usually the most recently issued set of terms and conditions that will take precedence |

**Precedence and contract of terms**

Commercial agreement is rarely simple. They can consist of numerous documents and schedules. At the very least, they will be made up of a number of different sections. Each of these deals with specific aspects of the contract and may therefore be drafted by different specialists. As a result, it is easy for mistakes to occur so that not all of the terms, clauses and schedules agree with each other. Also, things may have been agreed prior to signing the contract which, for some reason, are not reflected by the wording of the contract itself.

It is important to understand how the law deals with these anomalies and inconsistencies. Typically, anything explicit in a contract overrides anything implicit or previously agreed. The one exception to this is where terms are implied into a contract by statute law or legal regulations.

**Matters not reflected in the contract**

Most contracts will have a ‘full agreement’ clause. This explicitly states that anything discussed prior to the final drafting and signature of the contract shall be ignored and that the contract itself represents the full agreement of the parties.

In the event of a dispute, this clause will be followed to the greatest extent possible. If it is possible for the courts to determine exactly what the written contract says and what (using the normal **rules of interpretation)** that must mean, then the courts will uphold that. However, if what the parties were trying to say cannot be determined from a reasonable interpretation of the contract, then the courts will look at the pre-contract context to try to establish the intentions of the parties.

**Standard forms and attached schedules**

Many market sectors use standard documents with general clauses, which are made more specific by amendment or attachment of schedules. Some organizations will also have similar standard templates.

It is obvious that direct amendment of clause wording overrides the pre-printed standard format, but what happens when something in one of the schedules appears to contradict the standard wording without specifically stating that it is an amendment to it?

The first thing the courts will do is check whether there really is an inconsistency or ambiguity. If they can come to an interpretation of the various clauses which makes all of them valid, then they will assume that such an interpretation is what was intended.

If they cannot find such a position, there is a general rule that specific clauses override general ones. The logic is clear: if the people drafting the contract have taken the trouble to write detailed requirements, then these must be more important than those to which they have paid less attention.

**Hierarchy of clauses or order of precedence clauses**

Many contracts will have a hierarchy of clauses or order of precedence clause which explicitly sets out which terms take the lead. For example, it might say that in interpreting the contract, anything in the contract clauses (i.e. the main document) shall take precedence over anything on drawing or schedules attached to it.

Only where the discrepancy is blatant-such as one section requiring something to be painted white and another section requiring it to be painted black-would the order of precedence clause be taken into account. This suggests that it will only be used in rare case.

This does not mean, however, that order of precedence clauses should not be included, but it does mean that procurement personnel drafting contracts and contract managers operating them should not rely on such a clause as a get out of jail free card. Potentials could include the following.

* Falling to ensure placement of the clause in the right contract document, so that it does not itself become subject to different document.
* Using industry standard forms that already have such clauses which might not agree with what the parties want on this particular contract.

Example of is a definite conflict that cannot be resolved by any sensible reading of the contract, the courts will rely on the order of precedence clause.

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| Remember   * General, a term drafted for a specific contract will take precedence over a standard term. * Express terms will override implied terms, unless the implied term is created by a statutory regulation’ * The fairness of holding parties to the written contract will be considered; that is, it will be assumed, unless there is very strong evidence to the contrary, that the parities knew what they were agreeing to. (Note that this is not a judgment on whether the contract itself is fair – parties are free to make a bad bargain – merely that having made the agreement, it is fair that it be upheld.) * All of the contract documents will be reviewed and an attempt made to determine the true intentions of the parties, but it will be difficult to override a very precise express term. |

In Butler Machine Tool Co Ltd V. Ex-Cell-O corporation (1997), Butler offered to sell its own standards teams. Ex-Cell-O placed an order using its terms (which were different from Burler's). That order form had a tear off slip which the supplier had to return. That slip Acknowledged the teams of the order. The courts held that the return of this slip was an acceptable of the terms and created the contract.

In this case even if Butler had then included its own terms on the delivery notes and required a signature for Ex-Cell-O accepting those terms when receiving the goods, it would have had an impact because the contract had already been formed.

It is often said that the battle of the forms is won by the person who ‘fires the last shot'. Clearly from this examination of the Butler case that is not so. Shots can continue to be fired after the battle has already been won and lost.

**Precedence of contract terms**

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**Matters not reflected in the contract**

Most contracts will have a full agreement clause. This explicitly states that anything discussed prior to the final drafting and signature of the contract shall be ignored and that the contract itself represents the full agreement of the parties.

In the event of a dispute, this clause will be followed to the greatest extent possible. If it is possible for the courts to determine exactly what the written contract says and what (using the normal rules of interpretation) that must mean, then the courts will uphold that. However, if what the parties were trying to say cannot be determined from a reasonable interpretation of the contract, then the courts will look at the pre-contract context to trey to establish the intentions of the parties.

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If they cannot find such a position, there is a general rule that specific clauses override general ones. The logic is clear: if the people drafting the contract have taken the trouble to write detailed requirements, then these must be more important than those to which they have paid less attention.

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In Butler machine Tool Co Ltd v. Ex-cell-O corporation (1997), Butler offered to sell its own standards teams. Ex-Cell-O placed an order using its terms (which were different from Burler's). That order form had a tear off slip which the supplier had to return. That slip Acknowledged the teams of the order. The courts held that the return of this slip was an acceptable of the terms and created the contract.

In this case even if Butler had then included its own terms on the delivery notes and required a signature for Ex-Cell-O accepting those terms when receiving the goods, it would have had an impact because the contract had already been formed.

It is often said that the battle of the forms is won by the person who ‘fires the last shot'. Clearly from this examination of the Butler case that is not so. Shots can continue to be fired after the battle has already been won and lost.

**Precedence of contract terms**

Commercial agreements a really simple. They can consist of numerous documents and schedule. At the very least they will be made up of number of different sections. Each of these deals with specific aspects of the contract and may therefore be drafted by different specialists. As a result it is easy for mistakes to OK so that not all of terms, clauses and schedules agree with each other. Also things may have been agreed prior to signing the contract which for some reason are not reflected by the wording of the contract itself. It is important to understand how the law deals with these anomalies and Consistencies. Typically, anything explicit in a contract overrides anything implicit or previously agreed. Usually, anything explicitly set out in a contract will override anything implied into a contract by statute law or legal regulation.

**Matters not reflected in the contract**

Most contracts will have a full agreement clause. This explicitly states that anything discussed prior to the final drafting and signature of the contract shall be ignored and that the contract itself represents the full agreement of the parties.

In the event of a dispute, this clause will be followed to the greatest extent possible. If it is possible for the courts to determine exactly what the written contract says and what (using the normal rules of interpretation) that must mean, then the courts will uphold that. However, if what the parties were trying to say cannot be determined from a reasonable interpretation of the contract, then the courts will look at the pre-contract context to trey to establish the intentions of the parties.

Standard forms and attached schedules

Many market sectors use standard documents with general clauses, which are made more specific by amendment or attachment of schedules. Some organisations will also similar standards templates.

It is obvious that direct amendment of clause wording overrides the pre-printed standard format, but what happens when something in one of the schedules appears to contradict the standard wording without specifically stating that it is an amendment to it?

The first thing the courts will do is check whether there really is an inconsistency or ambiguity. If they can come to an interpretation of the various clauses which makes all of them valid, then they will assume that such an interpretation is what intended.

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| --- | --- | --- |
| Feature | Good for purchaser? | Good for supplier? |
| Quick access to a market of reliable and vetted suppliers for either direct purchasing or limited tendering among a small number of firms. | Yes-r educes tender process costs and speed to supply.  No- limits number of potential providers so could miss the best or most appropriate provider. | Yes- better chance of winning tenders when number able to bid low.  Yes- potential for high turnover of low-value orders for known client.  No- no access if not on the list/framework. |
| Familiarity- using a known client/supplier | Yes- ability to build trust through regular work. | Yes – ability to build trust through regular work. |
| Keeping list up to date with complete, current and accurate information on supplier status (e.g. financial standing, health and safety policies, procedures and declarations, data management protocols, insurances, environmental policies and actions, equality and diversity matters, changes in structure and ownership, licenses and industry accreditations.) | No- this can be resource intensive as all documentation needs to be checked. | No – this can be resource intensive as documentation may need to be provided separately for many databases. |
| Open access to the list whereby suppliers can apply for inclusion at any time or at regular intervals, not just in response to a single advert (unlike formal framework agreement). | Yes – ability to include newly discovered potential providers.  No – resource requirement for vetting new suppliers.  No – risk of the lists becoming large and unmanageable. | Yes – ability to target potential customers without constraints of tender timescales.  No – risk of lists becoming large and reducing likelihood of winning work. |

CHAPTER SUMMARY

* There is a difference between an estimate, a quotation (or quote) and a tender. An estimate is ‘best guess’ of likely cost and has no legal standing. A quotation is a fixed price that must be adhered to, it will normally cover price (and not any possible variations or options with regard to quality) and it may be submitted via formal or informal process. A tender is a detailed quotation submitted via a formal process. A tender may cover price only, but usually it also covers aspects of quality.
* When deciding whether to seek quotations or tenders, the costing of administering the process, must be considered. The process should be proportionate to the cost and risk of the purchase; there should be a robust audit trail; the process should be transparent and equitable. Estimates should be avoided.
* Key things to consider when drafting specifications include purpose, type, perspective, relevance, scope, performance, innovation, clarity, compliance with regulations and the environment which the contract is to be delivered. Specifications can be conformance (technical), i.e. based on inputs, or performance, i.e. based on outputs. Most are a combination of the two, setting minimum technical standards but allowing scope for suppliers to determine how best to meet the requirement above and beyond the absolute minimum.
* KPIs, the way in which they will be measured and the consequences of not meeting them should be embedded in the contract terms so that they can be enforced.
* A contract is a total agreement between the parties, not just a document. Key terms in the contract set out the rights and responsibilities of each party (what it can do and what it must do) and the remedies available to it if the other party does not meet its responsibilities. They include the specification and the pricing schedule as key parts of the agreement.
* Contracts may need to be amended during their life. It is important that they contain terms that explain when this is permitted and the process for ensuring that changes are contractually binding.
* For a contract to exist there must be an offer, acceptance, consideration, intention to be legally bound, and capacity to contract. There are complex issues which have been determined by extensive case law.
* The ‘battle of the forms’ is a situation where the terms and conditions of the purchaser and the supplier are sequentially are superseded one by the other, as requests for quotations, orders, delivery notes, etc., are passed between the parties, each one declaring that it operates on the terms of the party issuing it. It is best managed by having formal contracts.
* Express contract terms are those which are written down and explicitly agreed between the parties. Implied terms are not written within the contract but implied by either case law, custom and practice, or through statute law. Unless an implied term is created by statute and the statute makes it clear that it cannot be overridden, then parties are free to contract in a way that excludes implied terms.
* The Vienna convention is a United Nations convention relating to the international sale of goods that seeks to establish a common legal framework within which to interpret contracts. It only applies to international contracts and to goods (not services). The convention allows for the states signing up to it exclude some of its application, either in terms of which goods it covers or by excluding certain geographical areas. The convention includes provisions on when risks passes from buyer to seller, but these are generally excluded in favor of the incoterms produced by the International Chamber of Commerce, which are more flexible; the UK is not signatory to the convention. Any explicit terms in individual contracts will override anything implied by the Vienna convention.
* Misrepresentation is a false statement of fact made by one of the contracting parties before, or at the time of entering into the contract, which led or encouraged the other party to contract. It can be fraudulent, negligent or innocent. In the case of fraudulent or negligent misrepresentation remedies are rescission of contracts or damages or both. For innocent misrepresentation the remedy is rescission of contract or damages not both.
* The differences between one-off purchase contracts, informal panels and approved lists, formal frameworks agreements and term (or call-off) contracts can be summarized as follows.
* A one-off contract is for single specific deliverable. It may be simple (a piece of machinery) or complex (a housing development), but is self-contained.
* An informal or approved list is not a contract, it is merely a list of suppliers who have been checked and deemed appropriate to contract with. The process of checking is known as qualification, prequalification or due diligence. Such panels are generally open for suppliers to apply for inclusion either at any time or at periodic intervals.
* A formal framework agreement is a closed list of approved suppliers arrived by means of a tender process. The agreement includes the terms on which any contracts under the framework with those suppliers will be awarded, including a mechanism for determining price.
* A term (or call-off) contract is a contract with a specific supplier for a specified period of time under which a number of orders (call-offs) may be place. It is used for periodic purchases where the nature of the individual call-off varies but the terms applying to all of them can be agreed. It will normally include a schedule of rates for pricing individual call-offs.
* The term call-off can be confusing. A ‘call-off’ under a framework agreement will result in a contract. That contract maybe a one-off purchase contract or it may be a term contract. A call-off under a term contract is a specific order which does not create a new contract.
* A higher contract (often called ease contract) is one where the ownership of the goods involved does not transfer: the purchaser merely pays for the ability to make use of the goods for a period of time. Common applications are vehicle fleets and photocopiers.

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| ***End of Chapter Assessment***   1. Describe the key sections in a standard contract for the supply of goods or services and appraise the relative advantages and disadvantages of using separate schedules for some elements rather than embedding all aspects a single continuous document. 2. Explain the ‘mailbox rule’ on acceptance of an offer and analyze the extent to which it still makes sense in the context of modern communication. Suggest how parties might mitigate any risks associated with this. 3. Appraise the usefulness of the Vienna convention on contracts for the International Sale of goods, paying attention to what the rules do and do not cover. 4. Compare and contrast frameworks agreements with term contracts, showing the relative merits of each. |

References

1. NRMCA (n.d), What is a prescriptive Specification [online]. Retrieved from: [www.nrmca.org/research-engineering/P2P/.htm[Accessed](http://www.nrmca.org/research-engineering/P2P/.htm%5bAccessed) on: 10 October 2018).
2. Fisher v. Bell (1961) 1 QB 394.
3. Ibid.

**CHAPTER 2**

***Specifications & Key Performance indicators***

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| By the end of this chapter you will understand the fundamentals of specifications and key performance indicators that are indicated in contractual arrangements made with suppliers. |

Learning

Outcome

**Chapter Overview**

2.1 Analyze the content of specifications for procurements

You will understand:

* Drafting specifications and developing market dialogue with suppliers
* The use of standards in specifications
* Typical sections of a specifications
* Standardization of requirements versus increasing the range of products
* Including social and environmental criteria in specifications
* The role of information assurance in developing specifications

2.2 Appraise examples of key performance indicators (KPIs) in contractual agreements

You will understand:

* Defining contractual performance measures or key performance indicators (KPIs)
* The use of service level agreements (SLAs)
* Typical KPI measures to asses quality performance, timeliness, cost management, resources and delivery

**Introduction**

Specifications and key performance indicators were introduced in section 1.1, which set out how these concepts become embedded in the contract documents. In this chapter, each of them is considered in more detail from the perspective of what needs to be included and how procurement and supply professionals design and/or negotiate that content.

Throughout the chapter, whenever something is considered from the purchaser side, you are encouraged to question what that might mean from the supplier side. In some scenarios, purchasers have a free hand in designing their specifications and KPIs. In many others, they are the result of negotiations between purchaser and supplier. In some cases, they can be dictated by the supplier, particularly where the supplier`s bargaining power exceeds that of the purchaser.

**2.1Analyze the Continent of Specifications for Procurement**

Section 1.1 showed that the specification was the most important document or section within a procurement project. Any ambiguity, misunderstanding, lack of clarity or confusion about the specification will result in a failure against one or more of the five rights of purchasing.

1. Quality
2. Quality
3. Time
4. Place
5. Price

This section looks at how to design specifications to ensure that each of those rights are reserved.

Note that the concept of the original Five Rights is a very a basic, transactional approach to purchasing, which could easily be extended into further ‘Rights’ to cover the source, approach to ethics, and environmental and social impact, to name a few. Modern professional procurement and supply is such more about operational risk management, stakeholder engagement, supplier relationship and regulatory compliance, than it is about the transactional aspects of individual purchases or contracts. These aspects also need to be taken into account when drafting specifications.

**Drafting specifications and developing market dialogue with suppliers**

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| *Check*  What are the key areas to think about when designing a specification? Review figure 1.1in section 1.1 if you are unsure. |

**Project Management**

It is the initiation, planning, execution and control of inter-related pieces of work, normally carried out by a team of people, to achieve a specified aim by a specified time.

The information in figure 1.1 of section 1.1 provides a checklist against which the emerging design of the specification can be monitored, but it offers little help in how to go about it. For example, where should the procurement professional start?

Any well-run procurement exercise should be run along project management lines. These may be formal or informal depending on the size, value and complexity of the procurement itself, as well as on the size and complexity of the procuring organization. The principles should apply even if they if they are informally applied.

One key aspect of a project management approach is that it includes a scooping stage. This sets out (among other things) the objectives of the exercise (in our case, the procurement); the limits and the constraints (e.g. anything which is not included, any budget limits or legal requirements); possible and /or preferred processes; and the roles and the responsibilities of the project team. The project team ca be thought of as those people directly involved in the procurement exercise at any stage, whether or not they are formally identified as a team.

**Scooping stage questions about the specifications**

1. Who is responsible for producing the first draft of the specification? This could be the procurement department, the commissioning department or ongoing contract manager, or an external expert. Factors which influence this decision include the following.
2. The structure of the org
3. The level of skill and knowledge within the relevant departments
4. Whether this is a re-procurement (i.e. replacing an existing contract) or something completely new.
5. Current workloads
6. Time scales

It is important to remember here that the question relates purely to the first draft. All relevant stakeholders should have an input into the specification design. Ultimately, it needs to be approved and owned by the department responsible for managing the contract.

The expression ‘department’ (as in procurement department or commissioning department) is used in a loose sense here. It could be a formal department or division of the org, but equally it could be a small team of people or business unit.

1. Is there an existing specification?
2. If so, how well does it achieve what is needed?
3. What are its identified shortcomings?
4. If there is no existing specification, what are the broad objectives to be achieved?
5. Is there an already defined minimum quality standard? What is it?
6. Are there quality aspirations above that standard?
7. Are there any technical constraints (e.g. physical constraints on where equipment has to be located, technology constraints requiring electronic systems to be able to ‘talk’ to each other, input factors such as availability of power or water)?
8. Are there any environmental and/or social requirements or aspirations?
9. Who are the stakeholders that need to be consulted? Note that these stakeholders will have views on questions 1 to 9 above, as well as the first draft of the specification, so be prepared to bring them in at as stage as possible.

With this basic information in hand, it should be possible to start designing the specification.

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| *Remember*  A good procurement exercise needs to be project managed. The first key in project management is the scoping exercise. Scoping questions relating to specification include who will produce the draft, whether there is an existing basis for a draft and if bot, what fundamental objectives need to be achieved. It is also important to understand who the relevant stakeholders are: who may need to be consulted about the specification? |

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| *The important of stakeholder consultation in scoping specifications*  An estate management company issued an invitation to tender for the servicing of fire and security services across the whole of its regional portfolio of properties and estates. The fire and security systems included fire alarms, sprinklers, intruder alarms, door entry systems, warden/nurse-call systems, etc.  Many of these systems were already interlinked, for example, fire alarms and door entry systems operated on a common electronic interface. In many cases the fire alarms were also linked to emergency lighting systems.  However, there also a number of developments, with a total of 2000 properties, where the only relevant installations were security lighting with motion sensors. These had never previously never been included on a fire and security contract and so were overlooked. They were not included in the tender. The relevant service charge consultation exercise was not carried out, so they could not be included at a large stage.  Arrangements were put in place to resolve the issue, but at extra cost and with significant amount of extra administration. This could have been avoided if all of the relevant stakeholders had been involved in the scoping exercise and all of the right questions had been asked. |

**Writing the first draft of the specification**

Specifications rarely start from a blank piece of paper. The vast majority of goods and services purchased commercially already exist in the marketplace, which means that someone somewhere is already buying them and therefore specifications already exist. A good place to start is by assembling a number of comparable specifications from different sources.

There should naturally include those already used within the organization itself, but also variants used by other companies in the same sector and other companies in different sectors.

The case or difficult of obtaining sample specifications will from sector to sector and category to category. The more competitive the sector in a given category, the less likely it is that purchasing org will be willing to share. Public companies and third sector charities are more likely to share, but arguably, in many cases they are less likely to be at the forefront of specification development.

Suppliers will always be willing to assist in specification development, as this is one in which they can seek to influence the design to favor their own products.

In all cases, purchases need to be aware of intellectual property issues. A no-disclosure agreement will certainly be requested by most of those willing to share specifications.

Any specification acquired, whether from within the purchasing organization or outside it, must be treated as a starting point only. It should then be subject to a robust analysis and challenge by stakeholders. If several variants are being used as a starting point, the pros and cons of each of them must be identified. This will be an iterative process; the ten key aspects of specification design should act as a guide to ensure that the options are considered in the light of the following points.

* What are you trying to achieve?
* Any preference for conformance or performance specification
* Varying perspectives of different stakeholders
* Relevance and avoiding the inclusion of anything not actually needed
* The limits and constraints of the scope of the procurement
* Performance standards to be achieved
* Improvements sought
* The expected operating environment

Remember that the starting-point specification will have been designed for situations where one or more of these key aspects is very different from yours. It is useful to know what those differences are. This can help those reviewing the options form options regarding anything in the sample specifications which is unexpected (either additional requirements or requirements not included). For example, if a specification includes provisions for machinery to operate in extreme temperatures, but the purchasing org will never need it to do so, there may be scope for adjustment of those requirements.

Similarly, business environments create different priorities in different companies. For example, a high-tech company committed to innovation may be willing to make a high initial outlay on the basis that they expect to replace equipment after a short life as a new technology emerges. In this case, at the contracting stage, it may wish to add an equipment buy-back agreement to the specification. On the other hand, a different company may require its equipment to last much longer and wish to spread outlay over the expected long life of the machinery. In this case, when contracting it may wish to add a long equipment warranty to the specification. It is important, even at the earliest specification stages, to consider the whole life cost of your acquisition, and what should happen at the end of the contract or product life.

Unfortunately, a lot of information will not be directly available. Procurement personnel will need to challenge the sample specification by relating it directly to their business scenario and seeking to understand the different scenarios that might account for things which do not appear to fit. Simply changing anything which does not appear to it is a dangerous approach. The features may have been included for reasons which do in fact apply within the purchasing organization but have not yet been specially identified.

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| *Remember*  A previously used specification must always be robustly challenged to see how well it fits the proposed circumstances. Aspects which appear not to fit should be analyzed to understand why they were included in the sample specification and whether this changes the view on whether or not they should be omitted or changed. |

**Advantages and disadvantages of starting from a pre-written specification**

There are a number of advantages but also a number of disadvantages or risk; of starting with a pre-existing draft specification. These are listed in table 2.1.

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| **Advantages**   * It is always easier to critique than it is to create. A blank page is never a starting point for a discussion. * Most of the necessary elements will be covered, acting as a prompt to insure they are considered and a conscious decision made to include or omit. * Using more than one sample provides more ideas and options regarding different potential options. * Using more than one sample specification is a good way of understanding the quality variations not available. Remember: the ‘gold standard’ is rarely required and there is always a trade off between quality and price. * If you are able to obtain price brackets for the various quality levels, a more intelligent conversation can be had about the specification in a full-business context (taking into account budgets, cash flow, likely lifespan, etc. * Cross reference to legislation, international standards or codes of practice act as prompts to check what you need to comply with. * The sample specification(s) may suggest ways in which innovation can be promoted or captured during the life of the contract. * The sample may be drafted to align with a standard form of contract, ensuring consistency of format and terminology. | **Disadvantages**   * Time can be wasted discussing irrelevant aspects. Good project management skills are needed to close out these areas quickly. * Some elements relevant to your org may not be included and could be missed if the sample totally relied on. * Trying to combine aspects from different sample specification can create inconsistency and ambiguity, especially if different parts of specification for the same thing. * The sample specification(s) may require a higher quality than your organization either needs or can afford. * It can be difficult to understand why the sample specification is the way it is, and therefore the degree to which its operating environment matches your own environment. * References to legislation, international standards or codes of practice may be outdated or obsolete. * The difference in the length and formats of the contracts can either lead to the inclusion of things you do not need and may suggest that items which are potentially value adding are not possible in your scenario.   There is no risk that if the specification is looked in isolation (i.e. on the basis of assumed form of contract) then such opportunities may simply be disregarded. The procurement role is not only to challenge the specification. It should also raise the possibility that if such innovation would add real value to the organization, then it should not be automatically omitted from the contract, even if it will not be acceptable under a different contractual approach. Instead, the whole contractual approach should be reviewed in that light.   * Changing the specification to align a different form of contract may create inconsistencies. |

*Advantages and disadvantages of using pre-written specification*

The specification must not be drafted in isolation from the rest of the contract documents. The whole package ahs to mesh together. It could be that discussions about specification mean that the proposed contractual approach needs to be changed.

**Shortcuts of the specification**

There are a number of shortcuts that can be taken when drafting the specification.

These include the following.

* **The use of brand names:** In regulated procurement, this is generally prohibited unless an alternative equivalent is permitted or the branded product has already been sourced in a compliant fashion.
* **The use of recognized standards:** (This is considered further later in this chapter).
* **The use of samples:** relatively rare in large commercial contracts, this could be useful if either the product or the supplier is new to the market and the contract is a short pilot progromme with a view to the supplier proving it is sustainable over a longer period (e.g., in the context of textiles or agriculture).

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| ***Check***  Compare the benefits and the risks of writing a specification from scratch with those of using sample specifications obtained from suppliers or other purchasers. |

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| ***Apply***  Assume that you are working for an events company or a govt or a local authority with responsibility for tourism. You are required to source a supplier to provide sound and lighting for a major event. How would you go about designing a specification? |

**Developing a market dialogue with suppliers**

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| ***Remember***  One of the starting points for developing a specification to meet an identified need is to use sample versions already in the existence. |

While sample specification may be accessible through other purchasers in the same sector, suppliers will be much more willing to share. It is therefore important that the procurement officers open and maintain a dialogue with suppliers in the relevant market. For some procurement professionals this will become a category specialism. In many other orgs, particularly in smaller ones, procurers are expected to be generalists without the luxury of becoming subject experts, but they still need to understand the areas of supply in which they work.

The only way for procurers to understand what is happening on the supply side of the market is to talk to suppliers. Happily, the reverse is also true. Supply professionals are just as keen to talk to purchasers to understand what is happening in their customer marketplace.

From the procurement side, this market dialogue should not be a time limited conversation which is tied to a specific procurement exercise, but must be an ongoing exchange of views and ideas, so that both parties gain insight into how the relevant industries or sectors are developing. Both parties gain from this dialogue. Procurers gain insight into product development road maps and potential supply opportunities, but as trust builds between the parties, they will also be able to access knowledge relating to supply side risks. In exchange, suppliers receive knowledge of the client road map which might need to influence their own future plans.

**How to develop dialogue**

There is nothing complicated about opening a conversation with a potential supplier. It is as simple as finding a telephone number and name, and making a call. Before you do that, however, you need to be very clear about the following.

* What you wish to achieve through the conversation
* What you are willing to divulge about your own plans in order to get the information you want
* Any conflicts of interests that might exist and how you may protect against them.
* Any intellectual property issues and how you protect intellectual property
* Whether the conversation is procurement-led conversation or a technical/operations led conversation

ideally, meetings with suppliers and potential suppliers should involve both procurement and technical/operational personnel. These two key perspectives will cover most of the issues that wider stakeholders will be interested in. bringing other stakeholders into supplier/purchaser meetings can broaden the discussion and may provide additional insight, but this makes the meetings harder to arrange and more costly to run, because more people are involved. There is also a greater risk of commercial confidentiality being breached: again, because there are more people involved, but also because not all stakeholders will understand the constraints of the discussions.

There are a number of approaches which can be taken to engage with suppliers, as shown in table 2.2

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| ***Approach to Dialogue***  General networking (e.g., talking to suppliers at events or via social media)  One to one meeting.  Group visits (i.e. either supplier to buyer or buyer to supplier.  Meet the buyer events (group events where suppliers can talk to purchasers about future programmes or specific upcoming contracts.  Formal negotiation or competitive dialogues on a contract-specific basis | ***Advantages***  Establishes personal connection, useful as a starting point.  Can provide the basis for more in-depth conversation.  Most likely to deliver the following;   * Supplier-specific product development information * An insider`s view on risks to the supply chain * Direct input into specification development   Allows for people from different teams to make their counter parts and understand the challenges from the other side of the fence.  Useful for ensuring suppliers understand the purchaser`s requirements.  If held as general (rather than project specific) events, could help inform the supply market as to the product/service development being sought by purchasers.  Useful for refining a draft specification or schedule of requirements into a fully agreed and jointly developed contract specification | ***Disadvantages***  Unlikely to deliver very specific information.  Risk of creating the perception of ‘too close’ a relationship which might raise suspicion of conflicts of interest.  The supplier may favor its own product or service.  The supplier may be silent on or understate features where it is behind its competitors.  There is a risk of only getting part of the story depending on which officers from each side are meeting (e.g., procurement, sales and operations).  There is only a tendency in some orgs for the outcomes of such conversations not to be adequately shared across departments.  May involve personnel not accustomed to such engagement and therefore unskilled in managing the information flow (how much to disclose or not disclose).  Often held to too late to influence specification development.  Traditionally focus more on process.  Holding such events outside of the planning of specific procurement exercises could be more useful.  Time consuming and can be resource intensive.  Usually only permits a limited number of participants. |

**What kind of dialogue?**

In any commercial exchange it is important to be clear on what the objectives of the conversation are. Are looking to find about a particular supplier`s ability to meet your needs, or is it a general conversation about developments in the sector? Is it related to a particular contract due to be tendered or negotiated in the near future, or are just keeping your knowledge up to date?

Knowing what you are trying to achieve helps to keep the conversation professional and productive for both parties.

It also ensures that the relationship is not soured as a result of, say, the supplier thinking it was potentially being offered a contract when all the purchaser was doing was establishing market capacity.

**How do you manage market dialogue?**

Being clear on what your objectives helps you to design the best approach to the dialogue (see table 2.2).

All meetings should be documented. A note should be made of who was present, the areas discussed, the insights gained, and any follow up action that might be useful, such a revisiting proposed specification, revisiting the timeline for procurement exercises, or checking the latest risk register in that category. Market dialogue is not purely about specification, but also about contract terms, buyer-supplier interactions generally, learning from mistakes and preparing for the future. A conversation with one supplier can inform the questions you ask of another.

Respect commercial confidentiality. Although insights gained from one conversation lead to questions in another, you must be very careful not to allow this to happen in a way that breaches the confidentiality of the conversation. Many market dialogue conversations will happen on the basis of trust between the individuals. Many others will require a memorandum of understanding/non-disclosure agreement, which formally binds the parties not to use the information in away that undermines the commercial interests of the party avoiding the information. These agreements are usually mutual, so that the supplier undertakes not to disclose the purchaser`s information, just as the purchaser agrees not to disclose the supplier`s information.

**Market dialogue in regulated procurement**

There has long been a false belief that market dialogue cannot occur in areas where procurement is regulated. Generally, the only restriction in regulated procurement is that such dialogue must halt once a specific procurement process (i.e. the tender exercise) has commenced, unless that exercise is itself based on informal dialogue or a competitive negotiation procedure authorized by the regulations.

Outside of a specific exercise, procurement professionals working in the public sector or other regulated environments should be engaging in market dialogue to the same extend as their private sector colleagues. Arguably, because they often cannot do so once a contract opportunity has been advertised, it is more important that they do so on an ongoing basis outside of that precise scenario.

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| ***Remember***  Market dialogue is an ongoing conversation between suppliers and purchasers. It can be used (among other things) to assist in developing current and future specifications. Care must be taken to ensure that the supplier bias does not creep in as a result of using a single supplier to produce a specification. All information must be treated as confidential. |

**The use of standards in specifications**

Is it possible, on this KPL, to exceed the requirement? A negative accident would be a freak event which left the party involved healthier than they were prior to it. This is unlikely in any commercial situation.

Where a numerical measure is used, the range of results falling within each of the scores 0, 1, 2, 3 and 4 has to be determined. This is a value judgment on the part of the designers of the KPL and depends on these factor.

* The severity of the consequences for inadequate performance (scores 0 and 1)
* The degree of tolerance or otherwise against the specification (score 2)
* The targets set for improvements (scores 3 and 4)

**Tolerance against specification**

In some organisations there is a tendency to misunderstand the relationship between the specification and KPLs, and as a result to misuse the KPL concept. KPL measures can undermine the very point of the specification.

For example, suppose the following.

* The specification states that all deliveries must be made within 28 days or order.
* There is a KPI to measure how many deliveries are made within 28 days.
* The KPI target is 95%.

This creates a contractual conflict. The contract says all within 28 days; the KPI suggests that ‘all’ only means 95%

This underlines how important it is to clear on what elements of the specification are absolutely mandatory and that there is tolerance or option. Where tolerances are allowed, the specification should refer to the KPI targets.

**Setting targets**

Part of the purpose of having KPIs is to drive improvements in performance. Therefore, targets should be set against criteria that any such improvements can be compared with. This is essential if incentive payments are to be used.

It is now a common business concept, bit worth recapping, that any target used must be SMART (see table 2.8).

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| SPECIFIC | For example, the measurement of timeliness of deliveries could be any of the following.   * The actual number of missed delivery dates * The percentage of deliveries on time * The average time from order to receipt   Whatever is used must be a specific number. |
| MEASURABLE | Targets must be capable of being measured, even where what is being measured is the user’s perception. It is important to set out exactly what the measure is and how it will be determined. |
| ACHIEVABLE | The purpose of the target is to drive performance. It cannot be too easy to achieve, or it will serve no purpose.  On the other hand, if it is too difficult, then it will be counter-productive. It may well disincentivise efforts to improve performance, since any effort expended will still be met with a negative response. |
| RELEVANT | The target must be relevant and relate to something which matters in terms of the objective to be achieved. |
| TIME BOUND | Time bound (sometimes expressed as time-limited) refers to the time period within which the relevant level must be achieved, or the deadline by which it must be achieved. |

Other considerations to bear in mind when setting targets include the following.

* What value will an improvement in a particular KPI deliver to the business? Ideally this should be able to be converted to a cash value (either in savings, cost avoidance or increased sales).
* What will it cost to deliver the improvement and who will bear that cost? There may need to be capital investment, such as new machinery with a greater capacity or speedier output, or additional labour input. These are costs which the supplier is likely to seek to recover or at least in part through the contract. There may also be internal costs. For example, in order for the supplier to improve on the order-to-delivery time, the purchaser need to alter its ordering processes.
* Are there likely to be any unintended consequences? If the supplier diverts resource to one aspect, will it cause detriment in another? Requiring ever shorter delivery times for non-urgent items can increase the costs of delivery, putting pressure on pricing. It may be more important for the support personnel to be able to fully resolve the query on the first call, than for them to be able to answer the phone within 30 seconds.

**Five steps to defining KPIs**

This information has been summarized into five steps for defining KPIs in figure 2.2

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| STEP ONE |  | Remember the IPA rule and focus on the most important things, the things which indicate potential improvements or potential problems and the things you have the ability to change: ask yourself the following.   * What are the risks? * What can go wrong? * What are the opportunities? * What can we improve? |
| STEP TWO |  | What data are you going to use? Does that data already exist, or will it need to be specifically created? A goods returned log will show how many orders were over-filled or inaccurate but how many were delivered short.  What type of measure is most appropriate? Pass/fail or numerical? Finite number or percentage? If there is any subjective input, how are you going to capture, analyse and use it? |
| STEP THREE |  | The outcome of the KPI measurement is a matter for discussion and agreement between the purchaser and the supplier. The question is: who will collect the data and provide the initial analysis?  Logically, this should be the party with easiest access to the data. However, they may have an interest in under-reporting. The cost data collection have to be weighed against the level of trust in the other party’s information. Ideally there should be a shared data source. For example, an electronic procure-to-pay system, correctly designed and used, should show all orders that required returns, were only part-filled or were late. |
| STEP FOUR |  | There are things to think about in timing.   * How often do you measure? * How often do you score?   In other words, if you measure quarterly, do you allow an excellent result in one quarter to offset a poor result in the next? |
| STEP FIVE |  | A measurement is meaningless you can define ‘what good looks like’. Questions to answer to include the following.   * What does the specification require? * Can we allow any tolerance/at what level will we penalize? * Can we reward excellent/at what level do we pay bonus? |

**The use of service level agreements (SLAs)**

By attacking KPIs to a concept of ‘what goods look’, KPIs can be converted into scores which indicate the degree to which they meet the specified requirements.

Targets – either with or without bonus payments – can be set to drive performance levels to improve above the baseline required by the specification. Penalty clauses or service credits can be used to compensate the purchaser if targets are not met.

The detail of how KPIs will be monitored and the actions or consequences resulting from scores achieved must be documented and agreed between the parties. This detail may be embedded in the specification or the main body of the contract, or it may be set out in a service level agreement (SLA).

**What is a service level agreement (SLA)?**

An SLA means different things to different people.

* It can refer to a non-contractual agreement between different divisions or departments within a single organization.
* It can also refer to a single document within a suite of documents that make up a contract.
* It is often incorrectly used to mean the entire contract.
* In some circumstances it may be a side-agreement, which is not part of the main contract itself, but which is still intended to be legally binding.

When talking about SLAs, it is important to know which of these is meant, so that all parties have a common understanding of the status and application of the document under consideration.

The nature of an SLA does not, however, fundamentally change, whatever its status might be. It is always an agreement between the provider of a service and the recipient of that service, setting out the quality standards of various aspects of the service, actions to be taken if those standard are not achieved, the consequences if such actions do not resolve the problem, and (where applicable) the consequences of such standards being exceeded. To understand this fully, see the details in figure 2.3.

**Key clauses that are included in formal contracts**

**Chapter overview**

Analyze contractual terms for contracts that are created with external organisations

You will understand:

* The use of express terms
* The use of standard terms of business by both purchasers and suppliers
* The use of model form contracts such as NEC, FIDIC, IMeCHe/IET

Recognise examples of contractual terms typically incorporated into contracts that are created with external organisations

You will understand:

* Key terms in contracts for liabilities and indemnities, insurances subcontracting, guarantees and liquidated damages
* Terms that apply to labour standards and ethical sourcing

Recognize types of pricing arrangements in commercial agreements

You will understand:

* The use of pricing schedules
* The use of fixed-price arrangements
* Cost-plus and cost-reimbursable pricing arrangements
* The use of indexation and price adjustment formulae
* The use of incentivized contracts
* Payment terms

**Introduction**

This chapter delves deeper into commercial contracts to analyse some of the most common terms that are used. This includes why express terms are needed; how, when and why standards terms and conditions are used; and the role played by standard (or model) form contracts. Section 3.2 considers the detail of typical clauses, and section 3.3 looks at how aspects of pricing are dealt with within contracts.

When analyzing contract clauses it is important to consider them from both the purchaser and the supplier perspective. Each party will seek to protect its own position via the inclusion of specific wording, but the contract will function most effectively if there is a balance between purchaser and supplier interest.

**Analyse contractual term for contracts that are created with external organisations**

This section looks at express terms 9by contrasting them with implied terms), and it considers standard terms of business and the use of model forms of contract.

**The use of express terms**

A contract term is any provision of a contract. Each term gives rise to a legal obligation either to do something or to refrain from doing something, or to do something in a specific way. Breach of these obligations will have specific consequences which may be enforced through legal action or litigation.

Note: both the expressions ‘contract term’ and ‘term of a contract’ are used to mean two different things. In a legal sense they both mean the provisions of the contract, as defined in the paragraph above. However, the expressions are also used to mean the time period during which the contract is in force. For example, ‘the contract term for the provision of catering was three years’ or ‘the term of the vehicle spares contract was four years’. In this section, the expressions are used in the legal sense, not the time period sense.

**Understanding express terms by contrasting them with implied terms**

Express terms are those that are specifically and clearly ‘expressed’ in words. They are specifically stated either orally or in writing and set out the definitive agreement between the parties.

Express terms can be contrasted with implied terms, which are provisions or conditions that are assumed to form part of a contract even though they are not stated by either party. Terms can be implied into a contract in a number of ways. One such way is what is often called ‘custom and practice’. If it is normal in a given locality or a given industry, or potentially even between two parties who regularly contract with each other, for things to happen in a certain way, a requirement for that to be so might be implied into the contract. This would normally only happen if the contract itself was silent on the matter. If the contract includes a term that goes against custom and practice – or if there is a specific side contract deliberately created to set out different conditions – then the implied term will not hold. An express term in a contract will normally override an implied term.

An express term in a contract will normally override an implied term, but there is one circumstance where it might not be permitted to do so, and that is where the term is implied by state.

A more common way, nowadays, for terms to be implied into contrast is through statute. For policy reasons, governments may decide that all contracts of a given type will include certain measures. They may enact a law requiring that to be done and stating that even where it is done by means of express terms in the contract, a term will be implied (that is, deemed to be included). In these cases the law itself will state whether or not contracting parties can use express terms to override the implied term.

In a similar way, international agreements may be used as a mechanism to imply terms into a contract (see section 1.2 on the Vienna Convention on the International Sale of Goods). Again, the agreement will state whether the implied terms can be overridden by express terms.

**Why do you need express terms in a contract?**

We have established in the previous sections that ‘a contract’ is not a written document, but rather it is the whole conceptual ‘agreement’ between the parties.

Express terms are used to set out as clearly as possible what that agreement is.

They should do the following.

* Set out the obligations of the purchaser
* Set out the obligations of the supplier
* Set out the rights of the purchaser if the supplier defaults
* Set out the rights of the supplier if the purchaser defaults
* State how the parties will deal with circumstances beyond the control of either party
* Where possible, either confirm or override any potentially implied terms

In respect of the last bullet point, if there is a term that would in any event be implied, it can be useful to include it as an express term. Doing so makes the contract more complete and reinforces the fact that both parties are aware of the implication. For example, the regulation 73 requirement quoted in the previous case study will be implied into contracts falling under the Public Contracts Regulations. It can be useful to state that ‘this contracts is subject to the Public Contract Regulations 2015 and the employer reserves the right to terminate the contract in the event of modifications which fall outside the parameters permitted under Regulation 73.

**Express terms and contract schedules**

To avoid making the wording of the contractual clauses too complicated, they often refer to schedules. Schedules are appendices to the contract which provide more detail – often the technical detail – on the requirements.

The use of schedules in this way helps to clarify the difference between a ‘contract clause’ and a ‘contract term’. The clause is the precise wording in the main document, which will have its own reference number. The contract term is the totality of that part of the agreement and so includes the clause wording and any schedule to which it refers. Anything set out in a schedule to a contract is also considered to be an express term.

**Establishing what the express terms of a contract are**

In light of what has been said, in a well-drafted contract it should be easy to see what the express terms of a contract are. They are set down in black and white in the documents. But not all contracts are well drafted. The following are some of the potential issues.

* There may be no written contract
* The written contract may be based on oral negotiations
* The purchaser may not be aware of the conditions of a written contract at the point of contract

Tables 3.2 – 3.3 discuss issues in more detail. The cases quoted are from English case law, but the principles are generally followed in many other countries.

None of the issues highlighted have a definitive answer. If any contractual disputes of this type were to come to court, they would be decided based on the facts of the individual case. As professional purchasers and suppliers, however, it is best to avoid the issues in the first place.

|  |  |  |  |
| --- | --- | --- | --- |
| Situation | Issues | Legal position | recommendation |
| No written contract, all negotiations and agreements conducted orally. | What was said?  Was everything that was said intended to form part of the contract? | It depends on the facts of the case, but it can be held that express statements were not intended to be contractual warranties. See Oscar Chess Ltd v.  Williams (1957). | Avoid oral contracts. |

|  |  |  |  |
| --- | --- | --- | --- |
| Situation | Issues | Legal position | Recommendation |
| Written contract based on oral negotiations. | How much of the negotiation forms part of the contract? | The longstanding view is that the written word supersedes anything said prior to it. The contract means exactly what it says, regardless of what the parties might have intended.  However, it is now possible to argue that ‘the contract’ is a contract partly in writing and partly oral; or that there were two contracts – one oral and one written. In both scenarios the argument would be that the oral part of the contract can supersede the written part. See J Evans and Son (Portsmouth) v. Andrea Mezario (1976). | Includes an express term in the contract that specifically excludes all prior discussions.  Ensure that a proper contract is produced and signed – do not rely on standard terms and conditions. |

|  |  |  |  |
| --- | --- | --- | --- |
| Situation | Issues | Legal position | Recommendation |
| Written contract where the purchaser may not be aware of the conditions at the point of contract. | Can a purchaser have agreed to conditions that they do not know about? | Surprisingly, yes. The most common application of this is bus or train tickets, which refer to terms and conditions published elsewhere (in a timetable, on the company’s website). Because most of the terms and conditions are held not to be unusual, it has become accepted that they can be enforced.  However, if the conditions are unusual then effort must be made to bring them to the attention of the purchaser.  See Thorton v. Shoe Lane Parking (1970) and Interfoto Picture Library v. Stiletto Visual Programmes ltd (9189). | Use properly constructed contracts and check the conditions carefully. Be clear on what you are agreeing to. If unusual conditions come to light after the creation of the contract, seek to negotiate amendment of them. |

**The use of standard terms of business by both purchasers and suppliers**

Virtually all organisations have their own standard terms of business, often known as standard terms and conditions, which cover all of their transactions except for those that are subject to a speech overriding contract.

Most organisations are both purchasers and suppliers. They buy in materials or components if they are manufacturers, or goods for resale if they are wholesalers or retailers, as well as goods and services to manage their buildings, their staff and their equipment and to generally keep the business functioning. At the same time they will supply goods and services to others, depending on the nature of the business.

Most organisations will therefore have two sets of standard terms: one for when they are acting as a purchaser and another for when they acting as a supplier. Each set will seek to protect and further their interests from the relevant perspective. For instance, the purchasing terms will seek payment terms that are as long as possible (within reason) in order to keep hold of the money for longer, whereas the sales terms will aim to get the money in quickly and so seek shorter payment terms.

**What are standard terms?**

Standard terms aim to be very short form of contractual agreement, normally printed on no more than one or two pages. They try to cover all eventualities for any type of goods or services that the organisations would normally purchase (supply). As a result they very generic and do not allow for the specific circumstances of a particular purchase, this need for generalization means that they only provide a basic level of contractual protection, but this is better than none at all which can be the result if orders are placed orally or purchase orders are issued without any conditions attached.

Standard terms are often written with the aim of them being attached to order forms and/or delivery notes. However, this can normally only be achieved by reducing the text size until it is virtually unreadable (hence the expression ‘the small print’).

With increased use of electronic ordering systems it is possible to avoid this by publishing the terms on a website and providing an electronic link to them on the order. The rules established by Thorton v. Shoe Lane Parking and Interfoto Picture Library v. Stiletto Visual Programmes Ltd would apply in such a case, namely that if any of the terms were unusual or especially onerous then specific attention would need to be drawn to them. This was reinforced more recently in a 2012 High Case in the UK, Allen Fabrications v. ASD Ltd (2012). It is not necessary to understand the detail of this case, merely to note that the rule established by the early cases still holds.

**Non-negotiable**

When an organization is contracting on standard terms, it will normally require the terms to be accepted before the transaction can proceed. They are therefore unilaterally imposed by the purchaser (or in some case the supplier) without having been negotiated with the other party.

**When should standard terms be sued and when are they best avoided?**

Standard terms are generally used for repetitive transactions, particularly those that are low value and low risk. They are standard on nature and should therefore only be used for ‘standard’ transactions.

They ensure that there is at least a basic level of legal protection for those transactions that might otherwise have none.

Any purchase (or supply) that is subject to the rigorous of a full tender exercise with a precise specification and the potential for negotiating variations should have a specific contract and not rely on standard terms.

There is a risk that terms can become outdated, particularly in industries or sectors where regulations or codes of practice are frequently updated, or where technological developments are fast-moving in a way that affect the nature, speed or risk of the transactions. For transactions. For example, if a purchaser’s standard term requires compliance with a regulation or code of practice which has been supersede, it is unlikely that it will be able to enforce compliance with the latest edition. If the regulation is such that the supplier is legally obliged to comply (e.g., a health and safety law), it may be able to claim extra costs for having to do so.

Care must be taken if standard terms are attached automatically to purchase orders and the same purchase ordering system is used to call off items under term contracts. The legal position as to which contract takes precedence can become unclear. To avoid this the standard terms would need to include an express provision that they do not override any formal written contract between the parties. To be safe, such contracts should include a reflecting provision to the effect that said contract does override any standard terms that may appear on or be referenced by either party’s paperwork.

The advantages and disadvantages of using them are set out in table 3.4.

|  |  |
| --- | --- |
| Advantages | Disadvantages |
| Time saved in negotiating individually with many purchasers (or suppliers)  Reduced administration costs – not having to produce a new contract for every interaction  Consistency of approach – all transactions on the same terms; staff understand risks and act accordingly; both parties understand ‘the deal’ | Risk that they do not become effectively incorporated into the contract – legal uncertainty and potential ‘battle of the forms’ (see section 1.2)  Do not allow for contract-specific risks  Can become out of date  Can create conflicts if attached to purchase orders that are also used as call-off orders under term contracts |

**What happens if any of the standard terms are ineffective?**

An ineffective contract term is one which cannot be enforced because of the legal rules of the jurisdiction applying to the contract. Examples of ineffective clauses (depending on which country’s legal system applies) might include the following.

* Exclusion of liability for negligence
* Unusual and unexpected conditions that would not normally apply and to which other party’s attention was not specifically drawn
* Exclusion of liability for death of an individual
* Lack of a warranty of fitness for purpose of the goods (i.e. no guarantee that they will do what they purport to do under normal operating conditions)

What happens in these cases will depend on the legal system applying to the contract. In civil law countries (those that have a fully developed legal code, such as Germany) there may be statutory rules which will be inserted into the contract in place of the ineffective terms. In common law countries (reliant on case law, such as UK, the USA, etc.,) there may also be statutory provisions which will imply terms to replace those found to be ineffective. In the absence of this, the balance of interest will most likely be taken into account, with the courts simply taking a view on what they consider to be a ‘just’ outcome in the circumstances.

**What should be included in standard terms?**

The precise wording of standard terms must reflect the nature of the business being carried out by the organization (for example, whether it deals in goods, services or a mixture of both) and whether the terms are for the purchase of goods or services or the supply of them.

However, there are key areas that must be covered in all cases. Table 3.5 shows these from a purchasing perspective but it could easily be converted to reflect a supplier’s standard terms.

|  |  |
| --- | --- |
| Price | When the price will be stated (normally on the order), how any tax liability such as VAT or other sales tax is treated, what is deemed to be included in or excluded from the price such as delivery charges, insurance, the currency or any discounts that might apply. |
| Invoicing and payment | Requirements regarding invoices (quoting of purchase order number, where invoices should be sent, any cut-off date for invoices); time period within which payment will be made (all references to time periods should make clear whether ‘days’ means calendar days or working days, whether a month is a calendar month or a four-week period etc.); any entitlement to set off outstanding debts against payments due. |
| specification | Cross-reference to where any specification is to found, if not quoted specifically on the order. This must include any references to intended purpose of use, which may be important if implied terms relating to fitness for purpose need to be relied on. This should also include a facility to change the specification or cancel the order, and what the price/payment implications are of doing so. |
| Obligation to comply with the law | This may be included within the specification term or set out separately. It places a specific obligation on the supplier to comply with all laws relating to the specification and supply, and confirms that such compliance (including in the event of a change in the law) is deemed to be included in the price. |
| Delivery and risk | This should include a reference to the order, which will normally set out place of delivery; any time restrictions should be noted unless these vary, in which case they need to be on the order; a ‘time is of the essence’ clause; the point at which ownership and risk pass from supplier to purchaser should be stated, along with any rights to reject the supply at the point of delivery and how defects will be managed. |
| Warranties and liability intellectual property and similar rights | Set out the warranties required from the supplier. These will normally include quality, quantity, description and specification matching those on the order; freedom from defects; fitness for purpose; any services to be performed by appropriately qualified and experienced staff. This will normally also include a requirement for the supplier to carry appropriate insurance cover against such liabilities. |
| Intellectual property and similar rights | There should a requirement to ensure that all relevant rights needed to enjoy the use of the goods or services are provided as part of the supply. |
| Termination | Set out the circumstances in which the contract can be terminated. This may sound like something that is of little practical value to include in standard terms, but it should include cover what happens to goods delivered but not yet paid for etc. |

|  |  |
| --- | --- |
| Confidentiality and use of data | General rules regarding data protection and data management should be included, as well as reference to complying with relevant laws. |
| Ethics and corporate social responsibility | Requirements regarding ethical considerations must be included, at least at the level of complying with international la. More detail may be appropriate depending on the nature of the business and the priorities of the organization. |
| Law and jurisdiction | Sets out which country’s legal framework is applied to the contract and, in the event of disputes, which country’s courts have the power to issue judgments. |

The key features, advantages and disadvantages of standard terms are summarized in fig 3.2.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Form | Concise  Generic  Designed to be attached to  Purchase or sales orders |  | User friendly | Tend to be made to fit on forms by regarding text size almost to eligibility  Will become familiar through repeat use |
| Non-negotiable | Unilaterally created by either purchaser or supplier – the other party cannot influence the terms |  | usage | Low-value, low, repetitive transactions |
| Ineffective terms | May be replaced by implied terms or national legal code rules, or subject to court ‘balance of interests’ judgments |  | coverage | Definitions, relationship to other contracts, formation of the contract, order of precedence, price, invoicing and payment, specification, legal compliance, warranties and liability, ownership and risk, intellectual property, data management and ethics |
| advantages | Basic contractual protection for most common circumstances  Avoids having to create new contracts for repeat business |  | disadvantages | does not allow for specific circumstances  risk of creating battle of the forms  Can create contractual uncertainty if used with purchase orders under call-off contracts. |

**The use of model form contracts such as NEC, FIDIC, IMechIEE**

This section looks at model form contracts, why they are used and how to use them safely.

**Why are contract documents so complicated?**

Drafting contracts is a complex activity. The ability to draft purchase and supply contracts requires knowledge of the purchase or supply category and norms of trading behaviour in that category. For example, how much tolerance might be normal for late delivery, or how big an impact of a 3mm variance against specification of a component? As shown in the previous sections it is crucial to not only get the specification right, but also to understand how to set target around compliance with it. This is part of contract drafting.

The other part of the contract drafting is the substantive set of terms and conditions. The obligations and rights of both parties and the consequences of not meeting those obligations.

Writing these requires a mix of category knowledge and legal knowledge. A common complaint about contracts is the abscure language that is used within them. In common law jurisdictions (those whose law systems rely on case law rather than a full, formal, written legal code), certain phrases and expressions comes to have a specific defined meaning in the content of the contract. It works as follows:

1. A dispute will go to court
2. In the course of settling the dispute the judges will explain how they have made their decisions – known in latin as the racial decidendi. Anything said in this part of the judgment can become a fixed precedent, depending on the theoretical level of the court concerned.
3. The judges may also add other remarks (obiter dicta in latin). These are never binding, but they can be persuasive when future cases are considered.
4. Both the ratial and the obiter are linked to the very precise wording in the case at hand, so if people draft in future contract wants to rely on that contract they tend to use the same wording.
5. Overtime the wording becomes archaic (old are no longer normal usage) and less easy to understand.

It is easy to be cynical and say that this is what keeps lawyers in works but another view is that using fixed terminology that has been tried and tested in the court helps to protect both purchasers and suppliers because the definitions are known. Disputes can be avoided because of the concept known as legal certainty.

Legal certainty means knowing what the law says, what it means, and therefore how the courts will decide in the event of a dispute. It cannot be always 100% certain, but it means that the law is as clear as it can be. Purchasers and suppliers (the parties to the commercial contract) can have a large degree of certainty as to what a court will decide if particular argument is taken through litigation. The main benefit of this is that it stops arguments getting that far, which saves everyone time, money and administrative resource.

The net result is that there will always be a certain amount of ‘legalese’ in contract documentation.

In turn, this means that purchasing and supply professionals need a minimum level of legal knowledge – at least enough to know what they do not know – and they should cultivate strong relationships with their legal terms or external legal advisers.

**Why model forms of contract exist**

When it is decided that standard terms do not offer enough protection for a particular purchase (or supply) the question is: is it necessary to write a fully bespoke contract? Not necessarily. Indeed, it is better to avoid doing so if possible.

Contractual disputes may seem many and varied, but in reality they all hinge on a few variables, commonly: price and payment, timeliness of delivery, fitness for purpose and defects (i.e. quality), management of the contract, data protection and property rights, warranties and guarantees.

Other contractual aspects around ethical considerations tend (rightly) to be dealt with at supplier management level, rather than contract management level. The clauses are written into contracts to provide the ultimate leverage in the event that supplier management engagement does not achieve the desired results.

How those variables play out depends very much on the nature of the industry involved, but within a given sector (e.g., manufacturing, engineering, construction, health care, accountancy) there will normally be a consensus view on the likely problems that the best way of protecting both suppliers in that sector and organisations purchasing from them. Once this is established, it is a relatively short – though not necessarily easy – step to develop a model form of contract to cater for the sector.

A model form of contract is effectively a template. It sets out core wording to cover all of the normal scenarios and problems in the context for which it is developed. This means that anyone choosing to use the model form does not have to start with a blank piece of paper and do this for themselves.

It also means that suppliers tending (or purchasers buying) aginst a model form are likely to have some familiarity with it and therefore be relatively comfortable with most of its terms.

**Examples of model forms of contract**

Some examples of model forms of contract are shown in table 3.6.

The different forms follow a different structure and are designed for specific sectors, but some principles apply across all of the standard forms. These principles are as follows.

* Contract-specific details: parties to the contract, contract subject matter (that is what is being procured/supplied), dates, etc.
* Standard common clauses, covering all of the items listed in table 3.5, formulated in a way that is most applicable to the type of purchase normally expected under the relevant form
* Schedules to cover pricing, specification and nay other contract-specific detail

|  |  |
| --- | --- |
| Model forms of contract | Produced by/used for |
| NEC | New engineering contract – a family of standard contracts primarily used in construction in the UK; includes works, consultants, subcontracts, services |
| JCT | Joint Contracts Tribunal – a family of standard contracts used in construction in the UK; includes works, consultants, subcontracts, services |
| AS | Australian Standard contracts – different contracts for a range of purchase types including construction, consultancy, periodic supply of goods |
| FIDIC | International Federation of Consulting Engineers – Construction industry forms including works, consultants, subcontracts, mechanical and electrical – these are the most widely used forms internationally, including by the World Bank |
| IMechE/IET | Institutional of Mechanical Engineers/Institution of Engineering and Technology – two separate institutes that issue jointly agreed model forms covering the design, supply and installation of electrical, electronic and mechanical plant ‘including special conditions for the ancillary development of software |
| CIPS | Chartered Institute of Procurement Supply – CIPS has developed its own suite of standard forms of contract for IT functions including: supply and installation of computer equipment, support and maintenance of bespoke software, servicing of computer equipment |
| ITC | International Trade Center – contracts specifically designed for small companies doing internal business, covering the sale of goods, distribution, services and joint ventures |

When searching for model forms of contract, the results may show a heavy bias towards the construction sector. There a number of reasons for this.

* It is a sector that has long had professional institutions which have traditionally taken the lead in developing model forms in the interests of protecting their members.
* It is a sector known to have wide scope for contractual dispute and legal action, which can be avoided if good contracts are in place.
* The nature of the procurement is such that the basic contractual requirements are relatively easily reduced to a common formula.

However, the concept of the model form is now expanding beyond construction and many organisations have their own internal ‘model forms’. These are often derived from other forms, suitably adapted to specific circumstances and then checked by legal teams for anomalies, clarity, compliance with the law, etc.

**How model forms of contract are developed**

Traditionally, model forms of contract would be developed by professional institutions with the stated aim of producing a contract which protects the interest of its members. Many of these institutions would be supply-side bodies, representing, building contractors, consultants and the like.

More recently, standards organisations, national governments and independent third parties have started to develop model contracts which are more balanced in representing the interests of both suppliers and purchasers. At the same time, the original professional bodies widened the stakeholder representation on their own development panels so that their models also became more balanced and reflective of the wider interests. This progression ran alongside a general shift in attitudes in procurement and supply generally, away from the old adversarial approach of supplier versus purchaser into more modern world of collaboration, partnership and joint working to improve outputs for all parties.

The institutions and bodies named in table 3.6 – and others doing similar work in different countries and for international organisations – usually have working groups set up who meet at regular intervals to review how well the current forms of contract are working in the real world and to look at possible improvements. Such improvements might about due to the following.

* Changes in national or international law
* A number of legal disputes have highlighted a particular ambiguity or weakness in the contract
* Technological change in the sector creates new problems, risks or opportunities that need to be for within the contract.

Involvement with such working groups can be a useful source of professional development and growing influence for procurement and supply professionals.

**How to use a model form of contract**

There is a danger in using a model form of contract that the person putting it together thinks all of the work has already been done. This is not the case. Care must still be taken to ensure that the contract that results from using the form protects the interests that need to be protected, on both sides, does not create ambiguity or legal uncertainty, and accurately and completely reflects the agreement between the parties.

A model form is just that: a model or a template. Every clause should still be reviewed to ensure that it is applicable in the precise circumstance in which the contract is being used.

In order to carry out this task effectively and efficiently, procurement and supply professionals must be adequately trained in the use of contracts generally and understand the circumstances with which they are dealing. In some cases, in more complex transactions, procurement professionals will need to use legal advisers to help prepare contracts. One of the purposes of using a model is to ensure that the contract can be drafted relatively quickly and easily, but that does not mean blindly or without thought.

Most models will have an accompanying guidance note. This note will highlight the following.

* Blank spaces on the model form which need to be filled in (e.g., with names, contact details, dates, other contract-specific information)
* Optional clauses that may only apply in certain circumstances and should be deleted in others
* Options with a default position. A common example is defects periods: the model might state that defects have to be notified within six months unless an alternative period is stipulated; the default position is then six months, but the contracting parties are free to insert an alternative period, 12 months being common in construction.
* Schedules to be completed or attached

In addition, each organization may have its own standard amendments that it wishes to impose whenever it uses an industry model form. Purchasers may feel that, despite the involvement of stakeholder groups in designing the model, it is still unduly biased in favour of the supplier and requires additional changes. Where these changes are standard to the organization (i.e. they are used on every contract) a model form of amendment can be created which acts effectively as a further schedule to the contract, provided that it is properly referenced by amendment to the main contract clauses.

Of course, there is always the risk that a particular amendment within the standard amendments may not be needed on a particular project, or that other amendments which are non-standard are needed to cater for unusual circumstances.

This underlines the needed for contracts to be considered carefully on a project-by-projects basis by personnel adequately trained to understand both the technical and legal aspects of them.

There is a view that model contracts should never be amended. They will always need the completion of the project particulars and schedules, but (the view holds) the key clauses should never be changed beyond the options that are allowed for within them. This view holds that either a model contract is suitable for the project, in which case it does not need to be amended, or it is not, in which case a project-specific contract should be drawn up. There is no definitive answer to this.

Any change to a model contract creates risks that the internal logic of the contract gets broken (e.g., cross-references between clauses case to make sense if some of them are deleted or changed; or the order of precedence becomes confused; or payment periods say one thing in one circumstance that is not reflected elsewhere).

Changes also alter the ‘balance’ of the contract in favour of either the purchaser or the supplier. This is usually the very reason for making the changes, but the other party may feel that it is a step too far.

The opposing view, which says it is better to amend a model than to write a bespoke contract, rest on the fact the parties will generally be familiar with the model. They are therefore happy to work with it. They understand the mechanisms (for payment, dispute, etc.,) that are embedded in it. This makes for a certain ease in the relationship between purchaser and supplier during both the tender stage and (at least the early) contract stage. It avoids unnecessary resource deployment to review what are familiar and standard clauses ‘just in case’ there is something to worry about. The things that have been amended are ‘knowns’ and only the changes need to be reviewed.

Once the contract is in place, contract management proceeds as it would under any other form, with the exception that is useful to keep an even closer eye on legal developments. Many legal firms offer free newsletters that include recent case law on disputes where standard forms have been used. These can inform how an organization uses them in future.

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| Identify or develop appropriate models for organisation’s common purchases. |  | Identify or develop appropriate guidance for the use of the models, including any standard amendments. |  | Review the model and intended use with legal advisers. |
| Review guidance for using contract and confirm it is indeed appropriate (if not, seek alternative). |  | Select the appropriate model for the specific procurement exercise. |  | Train procurement staff in the use of the model. |
| Complete blanks, options and schedules with contract-specific info. |  | Embed draft contract in the tender/negotiation process in the normal way; agree terms with the supplier. |  | Manage the contract in the normal way. |

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| Continuously review case law which might affect how the model template is being interpreted in legal disputes and how you use of it may be impacted. Continuously review any changes to the model being used, or one that your internally developed model was based on, and review changes needed as result for future use. |

**Advantages and disadvantages of model forms of contract**

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| Advantages | Disadvantages |
| Save time and resource drafting bespoke contracts  Both suppliers and purchasers familiar and comfortable with main terms.  Specific of legal certainty on court’s response to disputes. | Poorly trained staff may use templates incorrectly or choose inappropriate model.  Amendments to published templates can create ambiguity  May become out of date if not reviewed regularly.  May be biased (supplier or purchaser), depending on ownership of the model. |

**Recognise examples of contractual terms typically incorporated into contracts that are create with external organissations**

This section looks at the same of the key terms that are typically included in commercial contracts, in particular those covering liabilities and indemnities, insurances, subcontracting, guarantees and liquidated damages, as well as those relating to labour standards and other aspects of ethical sourcing. All of these will generally be covered in the standard clauses where model forms of contract are used.

**Key terms in contracts**

**Liabilities and indemnities**

Virtually all contracts will include a number of clauses on liabilities and indemnities. The relevant section may actually be headed ‘Liabilities and insurance’ (JCT) or ‘Liabilities and insurance’ (NEC)

First, it is necessary to understand the concepts.

* In the contractual context, having a liability means being legally responsible for something. The person to whom the liability attaches is legally or contractually responsible for paying compensation for any injury, loss or damage that has occurred.
* Some liabilities only come into being if there is some kind of failure by the party concerned, for example, negligence or poor workmanship. Others are set down in law as being absolute without any need to prove fault. The latter are known as strict liability.
* An indemnity is a security or protection against loss. Accordingly, for one party to indemnify another means that it will offer that protection. For example, if the purchaser suffers loss because of a supplier’s product or service, the indemnity provided by the supplier is the contractual obligation to make good that loss, usually by way of financial compensation or reimbursement.

Clearly it cannot always be possible to know in advance the nature of the impossible loss or the extent of the compensation that might be required. It is common, therefore, for the parties to a contract to seek to either exclude or limit (either in scope or by value) their liability.

Table 3.7 sets out the key aspects of liability and indemnity clauses and things to consider when agreeing to them.

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| Liquidated damages | Sets out the circumstances in which liquidated damages may be charged (normally late delivery) and the rate at which they will be charged, e.g., $300 per week. |
| Exclusion of liability, i.e. force majeure | Some liabilities cannot be excluded. Where a strict liability exists in law, or where action is a criminal offence rather than simply a contractual matter, then the contract will generally confirm that neither party excludes its liability to the other party. |
| Negligence of the other party | It would clearly be wrong for one party (say the supplier) to be held legally responsible for consequences that only occurred because of the negligent act of the other party (the purchaser).  If the client’s (i.e. the purchaser’s) action contributed to the event but it was not solely responsible for it, then the contractor’s (supplier’s) liability is only reduced, not fully removed. |
| Indemnity | Indemnity clauses may be included complex language that results from trying to cover all angles. This is more likely in common law countries such as the UK, the USA, Singapore and Australia, than those with the civil law code such as Turkey, Vietnam and most of Europe (except for the UK, Ireland and Cyprus). In the civil law countries, the definitions are more likely to be embedded in the code, making the contract simpler. |
| Financial limit of indemnity | Organisations need to plan how they will meet any liabilities in the event that they should need to. No business would willingly accept an open-ended financial liability. The question is: at what figure should the liability be capped? Commonly, suppliers might seek to restrict it to the value of the fees being paid under the contract. However, the potential loss could far outweigh those feeds. |
| Limiting scope of liability | Indirect losses are virtually impossible to calculate. How can the cost of ‘loss of goodwill’ be measured? (A drop in share price, perhaps?) And over what time period? And if goodwill returns ( and share price rises) is the loss then mitigated such that compensation should be repaid? Where would you draw the line in the remoteness of the indirect consequence, either in time or through a chain of consequences? These are impossible questions to answer. They result in legal and financial uncertainty and are best avoided. Thus: indirect and consequential loss are generally excluded. |
| Transfer of liability – often called transfer of risk | Where goods are being supplied or materials incorporated into works, the contract must state the point at which the liability for the damage to them transfers from one party to the other. The NEC4 contract, for example, includes the following wording:  ‘Client’s liabilities [include]… loss of or damage to any Plant and Materials after they are included in the affected property…  Contractor’s liabilities [include]… loss of or damage to any Plant and Materials before they are included in the affected property.  So, at the simplest level, loss or damage to spare parts for a boiler is the contractor’s (supplier’s) liability until they have been fitted, when they become the client’s (purchaser’s) liability. Note that this is loss or damage to those parts, not caused by them, which would be a different matter.  This may be set out in the ‘liabilities’ section of the contract, or may fall under an ‘ownership and risk’ clause. Note that ownership and risk may not necessarily transfer at the same time. Goods might be paid for in advance so that ownership is then with the purchaser, but the risk (the liability) remains with the supplier until they have been delivered. |

**Insurance**

The concept of insurance is familiar from our domestic and personal lives. It operates exactly the same way in the commercial world.

For those who may not have given it much thought, a definition might be helpful. Insurance is an arrangement where a fee is paid to one party (the insurance company) so that it will accept the risk and meet any costs that would normally fall to the person who has the legal liability for them. Effectively the risk is transferred from the person with the legal liability to the insurer.

To be clear: the legal liability does not transfer to the insurance company (known as the insurer). It merely agrees to meet the costs on behalf of the party with the liability, up to an agreed limit.

Insurance works by way of pooling risk. The insurer takes and agrees to meet any costs consulting from the risk event actually happening, in given circumstances and up to a pre-agreed financial limit. This works because in the scale of the insurer’s business, relatives few risk events will occur, and the fees (premiums) paid together with investment interest earned on that money will cover any payments that do not need to be made.

**Why is insurance referenced in contracts?**

In commercial contracts, where liability, has not been limited – and in many cases where it has – the sums involved are significant and can run into millions of dollars. The impact of having to meet such an exceptional cost, particularly for a small firm, could be catastrophic. The scale of the compensation will undoubtedly disrupt the business of the party having to pay by impacting on cash flow, making it harder to pay bills on time and/or to obtain credit finance, meaning it might not be able to obtain the materials and components needed to full orders, etc. in the worst case scenario it could cause the financial collapse of the business.

This is not just a problem for the supplier concerned. It also becomes a problem for those purchasers with whom it is in contract: both the purchaser on the contract where the problem has arisen, and the others who might find their own orders delayed or unfulfilled.

To avoid this is standard practice for the suppliers to insure against having to make such payments and, indeed, for the contract to require them to do so. The contract will often set out the type and level of insurance cover required.

Clauses relating to insurance normally fall within the section of the contract as those relating to liability and indemnity.

**Types of insurance cover referenced in contracts**the most usual forms of cover are as follows.

* Employer’s liability – a legal requirement for any company that employs staff, this covers the duties of care owned by an employer to those staff; for example, compensation for injury suffered in the course of their employment.

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| Remember  A service level agreement may mean a non-contractual agreement, a schedule or section of a wider contract, the whole contract, or a side agreement. The nature and status of the agreement must be made clear. In all cases it fulfills the same function: to define the standards and provide details of what could happen if they not met and (sometimes) if they are exceeded. |

Supplier-defined SLAs

We have considered SLAs as being part of commercial contracts which have been largely specified and drafted by purchasers. There are also circumstances where suppliers have standard SLAs in respect of their product, which purchasers may have to accept as a standard part of the package. This is particularly common in the IT sector, for example, where a single software product or hosted service is being sold to many purchasers but is subject to a single central methodology for managing faults, bugs, security patches, design upgrades, and so on. Wherever possible purchasers should seek to avoid accepting supplier-drafted SLAs.

Designing an SLA

Having looked at what an SLA is, it should be clear that it closely resembles a specification. This can lead to confusion as to whether certain elements of the requirement should be included in the specification or in a supplementary SLA. Conversely, if you have detailed SLA doo you even need a specification? If your specification is robust and mandatory, is there still a role for an SLA?

There is no definitive answer. As with much else in procurement and supply it can depend on exactly what is being procured and supplied. The core elements of an SLA are set in table 2.9.

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| SLA core element | Key consideration |
| Service definition | What, exactly and precisely, is to be provided by the supplier, is tis set out elsewhere in the contract (e.g., in a specification document).  Do not duplicate information, as this increases the risk of errors arising as the specification evolves and one document is updated but not the other. This gives rise to conflicts which may make contract unenforceable. If the requirement is set out in another document, cross-refer to it. |
| Quality definition | This should cover the following.   * Mandatory minimum standard, failure to reach which is a breach of contract * Unacceptable standards, which may not be immediately considered a breach of contract, but could become a breach if not rectified within stated timescales * Poor standards, which may not ever be serious enough to become a breach of contract, but which warrant compensation by way of penalty payments or service credits * Acceptable or required standards as per the specification * Good (and, if thought necessary, excellent) standards which exceed the specification   This information could be in the SLA or the specification, but not both. If both documents exist, one should cross-refer to the other so that there is only one version of the requirement. |
| KPI details | This section should set out the full details of the KPLs, including the following.   * What is measured * How it is measured * Who measures it * How often it is measured * How measures convert into scores (and any allowable offset of results between reporting periods) * Targets   This information will normally be set out separately from the specification, either in an SLA or a performance management framework schedule to the main contract. |
| KPL management response | This should cover the following.   * Actions and consequences if targets are not reached * Consequences (if any) if targets are exceeded   This information could be in the SLA or on the rights and remedies section of the core contract document, but not both. If both document exist one should cross-refer to the others. |
| Operational performance | Not all performance matters will be covered by a KPL, so this section needs to pick up day to day issues and they how they will be managed. Targets are not relevant here because this is simply the way it should work all of the time.  This section should consider foreseerable operational failure and set out how significant they are, and how quickly they need to be resolved.  Examples might include the following.   * ICT contracts where severity is linked to how many users are affected and the overall impact on the business * Supply of goods contracts where delays in delivery or inaccuracies in consignments can cumulative service credit deductions * Liquidated damages clauses for late completion of works or similar project based contracts.   This information could be in the SLA or in the rights and remedies section of the core contract document, but not both. If both documents exist, one should cross refer to the other. |
| Operational performance management response | As with KPLs the day to day issues also need to be resolved. The SLA should set out the actions and consequences for each performance failure. It should include the following.   * A first response action and a timescale for resolution * An escalation procedure to be implemented if the first response is not carried out or is unsuccessful * A threshold (which could be time or cost of impact, depending on not carried of failure) at which non KPL operational failures because potential breach of contract issues and how these will be managed whether by referral to mediation, arbitration or through the courts   This information could be in the SLA or in the rights and remedies section of the core contract document, but not both. If both documents exist, one should cross refer to the other. |
| Constraints or mitigating factors | This section should set out any circumstances in which the parties agree that normal service levels cannot be maintained, so the requirements should either be waived or eased. This might be equivalent to a force majeure clause in the main contract, but it could also include actions on the part of the purchaser that prevent or inhibit the supplier from meeting its targets (e.g., unclear orders, delivery sites being inaccessible).  This information must cross refer to any similar clauses in the main body of the contract. |

**Ensuring the SLA is contractually binding**

Table 2.9 shows that core elements of the SLA are the management responses and consequences in the event of performance being below that required. Careful consideration must be given to the wording of these element. In order to ensure that the SLA is effective, it must have the same force as any other part of the contract. It must be legally binding. The method for achieving this will depend on the type of SLA being used.

**Between departments of divisions in a single company**

Internal SLAs of this type are not normally contractual. They are not intended to be legally binding. In any event, a single company cannot sue itself.

**Constituting the whole agreement between the parties**

If the SLA is the only document setting out the requirements, it may in effect be the contract. This is a very is a poor approach, since the likelihood is that service levels have been the main, possibly only, focus of the discussions between the parties and many other contractual risks are ignored as a result. However, if this is the approach taken, the agreement should clearly state the following point.

1. KPLs: how they are not to be measured, who measured, who measures them and how often
2. How the measurements convert into scores?
3. Any other service level standards, which may be of lesser importance than the KPLs
4. Minimum acceptable standards or scores in each case
5. Range of scores both above and below the minimum acceptable
6. Any mitigating factors which might apply in the event of poor performance
7. Any time period permitted in which to remedy a situation of poor performance
8. Remedies available to the injured party if the situation is not remedies (e.g., damages, penalties or service credits, ability to terminate the contract)
9. Process to be followed in order to access the remedies (e.g., any formal notices which need to be given, escalation procedures in the event of disputes, mediation or other alternative dispute resolution (ADR) processes to be used in preference to full legal action)
10. How any inconsistencies or conflicts between the KPLs and any standards referred to are to be dealt with

Additionally, the normal rules of contract formation must be followed; that is, it must be clear that there has been an offer, acceptance and that there is capacity to contract, consideration and an intention to be legally bound.

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| Remember  If the SLA is the only form of agreement there is, and it does not include reference to consideration, the agreement must be executed as a deed in order to be legally binding. (review section 1.2 to refresh the rules on formation of contract.) |

**Part of a set contract document**

This is the more usual approach. In this case, the SLA may oy may not be called an SLA. It could instead be called a performance management framework or simply labelled as a schedule or appendix to the contract.

Where this approach is taken, the SLA service level schedule/appendix or performance management framework must be clearly identified as a contract document and should clearly state items 1 to 7 on the list above under constituting the whole agreement between the parties.

Note that if there is a separate specification document, care must be taken to ensure that items 1 to 4 of that list exactly match the requirements of the specification, preferably by cross reference to that document.

The remedies available in the event of poor performance should be set out in the body of the contract, along with those for any other contractual breach. These clauses should be cross referenced in the SLA and (in line with the previous list) should cover items 8 and 9 on that list.

A hierarchy of clauses/schedules may be needed to confirms how any inconsistencies or conflicts, either within the SLA or between it and the specification or any other contract document, are to be dealt with.

**Stand-alone agreement in respect of a separate contract**

This is not a common approach, but can occur in the following situations.

* Where, for reasons of urgency, a contract has been put in place prior to full KPL being established and agreed
* Where there are a number of separate contracts and a single SLA is needed to ensure consistency of approach

In this case, there must be a clear cross reference between the relevant contract(s) and the SLA and the SLA should clearly state items 1 to 6 on the list on the previous page.

Note that if there is a separate specification document, care must be taken to ensure that items 1 to 4 exactly match in the two documents, preferably by cross reference to that document.

The remedies available in the event of poor performance may be set out in either the SLA or the main contract, but not both. These clauses should cover items 8 and 9 on the list on the previous page.

A hierarchy of clauses/schedules may be needed to confirm how any inconsistencies or conflicts, either within the SLA or between and the specification or any other contract document, are to be dealt with.

If the SLA is created after the main contract, it will require additional consideration or execution as a deed in order to be legally enforceable.

Where the SLA exists as a standard document prior to the formation of the contract, there must be a clause in the contract which effectively embeds the terms of the agreement (and any subsequent amendments to it) into the contract.

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| Check  How does the use of an SLA create a potential risk of inconsistency or conflict of terms within a contract? How can this be avoided or managed? |

**Reviewing KPLs and service levels**

The KPLs and SLA should be reviewed regularly. The frequency of such reviews will depend upon the nature of the contract and the KPLs monthly (e.g., timeliness of deliveries) whereas others may be more appropriate once a quarter or even less frequently (e.g., innovation proposals). The review programme should be set out in the original quotation/tender request and firmly embedded within the contract documents. There can be a risk if initial targets are set on the basis of past performance, especially if that was with a different supplier, under different contracting or general economic conditions, with the result that they are less appropriate for the new contract (either because they are now much harder or much easier to achieve).

For example, improvements in technology may make short run orders much more cost effective. Which enables more frequent ordering with shorter delivery times. Alternatively, the inclusion of more environmental objectives could do the reverse and argue for fewer delivery journeys and a move away from lower value orders.

If KPL targets are being consistently exceeded, they clearly need to be strengthened or replaced. There is limited value in measuring something which is consistently good and has no further scope for improvement.

**Typical KPL measures**

Having considered how KPLs are designed and incorporated into contracts, this chapter ends by looking at some common measures which should serve to illustrate the points made so far.

The following tables are purely illustrations that may be useful for future reference. You are not expected to retain the details shown in them.

Tables 2. 10-2. 16 look at sample measures and raise potential issues with the use of the KPL in each case. These costs, risk and unintended consequences will not apply in all cases. They are included to stimulate thought and discussion.

When reading the tables, remember that these are contract KPLs not procurement team KPLs. They are measuring the performance of the individual contract to which they apply.

**Delivery compliance**

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| **Activity description** | **KPL** | **How is it measured?** | **Cost, risk or potential for unintended consequence?** |
| Delivery in full | Quantity supplied matches the quantity ordered and each line of the order has been supplied. | Inaccurate deliveries as a percentage of total no. of deliveries for period. | Time in detailed checking of all orders. Orders may be delayed if part orders will not be accepted. |
| Delivery on time | Delivery to be made within the agreed time. | Missed deliveries as a percentage of total no. of deliveries for period. | None-this should be a basic contractual requirement. |
| Average lead time | Current lead time compares favorably with previous lead time | Improvement of lead time for this period as a percentage of lead time for previous period. | Lead time may be improved by more efficient processes, but can also be achieved by simply increasing up-front resource, which may result in shortfall of resources for later stages. An improvement in lead time on some elements may not necessarily reduce the overall project length. It may also result in increased its own stock holding as items are delivered ahead of need. |
| Average time to fill emergency orders | Time must be in line with agreed contractual turnaround or within pre-agreed timescales for these particular orders. | Average time checked against contract and/or call-off order requirement. Target could be percentage improvement in time over previous period, or percentage improvement on the contract requirement. | Good performance on emergency orders can encourage poor practice on the part of purchasers who come to rely on it, resulting in inefficient ordering practices. |
| Consignment stock availability | Supplier holds adequate range/no. of units of stock to offer a reliable service. | No. of stock outs as a percentage of total no. of requests for consignment stock. | None-stock holding for normal order levels should be a basic contractual requirement. |

**Product/service quality**

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| **Activity description** | **KPL** | **How is it measured?** | **Cost, risk or potential for unintended consequence?** |
| Product/service compliance | Product/service to meet the agreed, documented standard and also be bit for purpose (during whole life cycle) | Acceptable items as a percentage of total no. of items ordered. | Any delivery which is not fully automated will always have potential for error or shortfall; there is a point at which the additional cost of quality control may exceed the gains from fault-free delivery. More stringent checking of orders may delay timeliness of delivery. |
| Reliability/durability | Production/serviced to have been reliable/durable throughout its use. | Number of non-routine service call-outs per period. | Could result in over-specifying routine servicing in an attempt to pre-empt faults which may never have materialized. |
| Usability/user satisfaction | The product is user-friendly | Periodic user survey (0 to 4 scoring) | Costs of surveys. Is the survey sample representative? Is the response rate statistically significant? Are the reasons for poor or good scores also captured? If not, resource may be wasted seeking to address the wrong root cause of poor satisfaction. |
| Technical support | Acceptable quality of technical information/support provided by supplier for goods supplied | Periodic survey (0 to 4 scoring) | As above |
| Supplier response time | Timely attendance on site in response to initial fault report | Agreed response times missed as a percentage of no. of calls logged | Can create a rush to site mentality which reduces the ability to resolve problems on first attendance |
| Repair lead time | Compliance with agreed lead times for repairing the product or restoring service | Agreed fixed or resolution times missed as a percentage of total no. of repairs carried out | Does not necessarily take into account the severity of individual incidents |

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| Health and safety | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequence? |
| Endangering health and safety | Zero reports in relation to the products/service endangering the H&S of staff, visitors, users or general public.endangering the a | Count number of reports. | If only focused on reportable accidents it may not take account of near-misses. |

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| Administration | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequence? |
| No. of credit notes per month | Supplier issues no more than X credit notes per month | Count number of credit notes. | Although aimed at ensuring accuracy of original invoices, may simply delay the issue of due credit notes to keep the monthly figures low. |
| Invoice preparation | Invoice to contain all information required to enable prompt payment. | Number of invoices requiring further detail as a percentage of invoices issued. ation required to enable prompt payment.delay | None – this should be a basic requirement. |
| Provisions of quotations | Quotations requests are turned around within X days. | Total of late & not - are turned around within ercentage of invoices issued.submitted quotations as a percentage of quotations requested. | Most likely used on a framework agreement, could result in ‘cover prices’ being submitted or quotations issued where workloads will not permit effective scheduling. |
| Documentation | Full supporting documentation received for all installations/updates within X days of acceptance of installation/update. | Count number of instance of late documentation. Average number of days late. | None – this should be a basic requirement. |
| Management information | Management information reports provided on schedule. | Count number of instances of late documentation. Average number of days late. | Creates potential risk that information will be provided on time, but will be rushed and inaccurate. |

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| Best practice & continuous improvement | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequence? |
| Supplier innovation | Supplier is proactive in suggesting innovative, workable solutions. | No. of innovations implemented. | Resource might be diverted to seeking innovation rather than delivering on the core contract.implemented. . |
| List of targeted value-added activities | Targeted value-added activities identified in advance. | No. of targeted value-added activities identified in advance. | (As above) |
| Value-added activities | High success rate in bringing value-added activities to fruition. | Percentage of targets achieved. | None if ‘success’ is adequately defined and includes core delivery being maintained at or above target levels. |
| Proactivity | Supplier is proactive in managing its relationship. | Periodic survey (0 to 4 scoring) | Relies on an agreed perception of what ‘proactivity’ means – could result in wasteful contacts and meanings. |
| Responsiveness | Responds rapidly to request for information and support without having to be chased. | Number of times requests chased as a percentage of number of request, | None- this should be a basic requirement. |
| Responsive to change/flexibility | Supplier is flexible in response to purchaser changing requirements. | Periodic survey (0 to 4 scoring). | Risk that the supplier is over-accommodating, purchaser will seek changes which add very little value with the result that the contract becomes incrementally less efficient. |
| Openness and co-operation | Supplier is open and co-operative in its relationship with purchaser, e.g., in terms of joint problem solving. | Periodic survey (0 to 4 scoring). | Very much a ‘perception’ evaluation, can rely too much on personalities. |
| Understanding the accountabilities and responsibilities | Supplier has a clear understanding of its accountabilities and responsibilities under the contract. | Number of rework requested and disputes during period. | Should be a basic requirement – but poor performance may be the result of poorly drafted documents. |

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| Contact center/call center service measures | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequences? |
| Abandonment rate | Percentage of calls abandoned by caller while waiting to be answered. | Calls abandoned as percentage of total calls received. | Resource is dedicated to quick pick-up of new calls at the expense of quality of response and query resolution of calls in progresss. |
| Average speed to answer | Average time it takes am call to be answered (in seconds) | Time taken for each call averaged out over the specified period. | (As above) |
| Time service factor | Percentage of calls answered within a given timeframe, e.g., 90% within 30 seconds. | Number of calls within timeframe as a percentage of total number of calls. | (As above) |
| First time resolution (or first time fix) | Number of problems resolved at the first point of contact. | Percentage of incoming calls that do not require repeat contact. | Provides a better service but at the expense of being able to pick up calls quickly. |

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| Cost management | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequence? |
| Savings | Reduction in unit price. | Percentage reduction of unit price over previous rate. | May not feed through to budget savings if the only reason for the unit cost reduction is higher volumes ordered. |
| Savings | Total cost reduction | Final account sum as a percentage of original contract sum. | Only a true saving if quality and scope are maintained. |
| Cost avoidance | Value of spend avoided by pre-emotive action, e.g., agreeing forward orders in response to likely market-wide price rises. | Estimate of likely spend in the absence of action taken less actual spend. | It is a ‘what if’ measure that can never be accurately verified. The likely spend is subject to debate. The opportunity cost of funds used in the pre-emptive is equally unknowable. |

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| COST MANAGEMENT | | | |
| Activity description | KPI | How is it measured? | Cost, risk or potential for unintended consequence? |
| Transaction cost reduction | Reduction in number of invoices | Number of invoices in previous accounting period less number in current accounting period. | Only valid if order volumes remain constant or increase. Can present a risk to the supplier if invoice consolidation interrupts cash flow. Invoice queries may become more difficult to resolve resulting in poorer purchaser/supplier relationship. |

Chapter Summary

* Previously used specifications are useful starting points for creating new ones but there are risks in doing so, as different circumstances must be taken into account. If more than one sample is used, care is needed to ensure consistency of language. Using samples provided by supplier risks favouring them and undermining free competition.
* Market dialogue between purchasers and suppliers should be ongoing (and not restricted to specific tender opportunities) to ensure early feed-in to specification design. Care is needed to ensure commercial confidentiality is respected. The type of dialogue should vary depending on the specific objective. Options include general open meetings, confidential one-to-one discussions, group visits and formal competitive negotiations.
* Standards, especially international standards, are useful tools for specifications. They can ensure all suppliers know exactly what is required without having to reproduce the finite detail in the specification. Care is needed to endure that there are no conflicts between the standards and other aspects of the specification or SLA. Contract clauses must be clear on whether updates to the standard automatically become embedded within the contract requirements.
* Typical sections of a specification are: title, version control, foreword, scope, definitions, consultation requirements, references to standards and codes of practice, characteristics of the goods or services, timescales, performance, lifespan, packaging, information requirements, implementation, and guarantees and warranties. These will vary depending on what is being purchased.
* Standardisation reduces costs and ensures a consistent quality, but reduces product ranges, which can hinder innovation and the agility to respond to changes in the market.
* Social and environmental criteria are increasingly used in specifications, driven by ethical considerations, consumer demand, stakeholder pressures and economic incentives. The cost of such criteria must be taken into account as well as effectiveness of the measures. Not all such criteria will add cost, but some may.
* KPIs are used to measure performance in order to manage poor performance and drive improvement above specification levels. KPIs should be few and focused on the most important deliverables. The source of data must be easily accessible and verifiable so that they are trusted by both parties. The costs and risks associated with KPIs should be considered when they are being designed.
* SLAs are used to set out how the performance indicators (not only KPIs) will be applied. SLAs may be embedded in a larger set of contract documents or be standalone agreements.

End of Chapter Assessment

1. Analyse the relative importance of a specification level agreement in the context of a contract and explain the problems which might arise where both are used.
2. Appraise the usefulness of international standards in specifications, including any actions that might be necessary to avoid or mitigate potential disadvantages.
3. Suggest three different social and/or environmental criteria that might be incorporated into a specification. In each case, analyse why they are used and appraise the advantages and disadvantages of doing so. (All three do not need to be relevant to the same specification, and you can use different goods or services for your examples.)
4. Compare SLAs which form schedules as part of a wider contract with those which are standalone agreements. Which would you recommend and why?
5. Suggest four KPIs for a contract for the provision of software and ongoing technical support. In each case, explain how you decide on the measure, how you would capture the data, and any problems or conflicts that might arise as a result of using them.

* Public/products liability- sometimes known as third-party cover, this relates to any injury, loss or damage caused by the company’s products, or on its premises, or as a result of the actions of its personnel.
* Professional indemnity cover-this relates to losses that occur as a result of poor or negligent advice that is given it a professional capacity (for example, by accountants or engineers).
* Goods in transit cover-this is for damage caused during the delivery process.
* Works/buildings-this is cover for partially completed building works, or the buildings in which they are being carried out.

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| Employer’s liability | Employer’s liability cover is normally a statutory legal requirement. Although the claims that arise may be completely unrelated to the contract in hand, having evidence that such cover is in place gives comfort that the suppler is running a responsible business and complying with the law, and that one of the potential risks that could disrupt its cash flow (and therefore its ability to meet its contractual obligations) is being properly managed. There is also an ethical dimension in that it indicates that the employer has to some degree considered its duty of care to its employees. Minimum values are normally set by law. |
| Public/products liability | Public liability and products liability are often linked, but depending on the nature of the purchase, it may be that only one or the other is required. A consultant who purely provides a service with no tangible goods being involved is unlikely to need products liability, but may need public liability.  For example, the catering company that runs the office canteen will have liability for the service it provide and equipment within the canteen area(public liability) and also for the food it prepares and sells (product liability), whereas a management consultant who simply comes into the office and talk to senior leaders would probably not need product liability. However, they need public liability cover, as well as professional indemnity cover. |
| Professional indemnity insurance (pll) or pl cover | This covers professional advice which is relied on by the purchaser.it includes services such as legal advice, accountancy, audit, project management, investment advice, and also technical design services such as those provided by architects and engineers.it is important to understand the concept of pll, because the fact that insurance might be required is not always obvious.  It might be clear that a structural engineer needs such cover, but what if an engineer has not been appointed and the design is being produced by the building company? |
| Goods in transit | Whoever owns the goods while they are moving between the supplier and the purchasers, there is a risk of them being lost or damaged reroute? It is sensible for them to be insured against such loss. The relevant clause should set out who is responsible for arranging and paying for such cover, which may or may not be the company that owns the goods at the time they are moving. |
| Works/buildings in which work are being carried out. | The insurance of partially completed works is a complex business. Model forms usually set out a variety of options as to who will insure the building, who will insure party completed works, and any requirement for policies to joint names of both client and contractor (purchaser and supplier). Those working or wanting to work in construction-related sectors could usefully obtain one or other of the standard forms of contract used locally in that sector and compares the different options. |
| Level of cover required | Insurance is provided for a fee. One of the things that influence the level of the fee (or premium) is the level of cover provided in financial terms. Cover for $20 million will cost significantly more than cover for $5 million.  Contract clauses normally stipulate a minimum level of cover needed.  There is no definitive rule on how this is calculated, though purchaser organizations normally have a standard requirement. This should be reviewed periodically to ensure it is still adequate. Specialist advice should be taken.  The key thing for the procurement professional to remember is that there is a cost-benefit analysis at work here. Any decent supplier will have insurance cover. If the purchaser wants a higher level of cover, this will be an extra cost to the supplier, who will seek to recover that cost through its contract pricing. The questions for the purchaser are: what are the risks, how likely are they to occur, what is this likely damage if they do occur, does that warrant the extra contract price? |
| Aggregate or each and every | Insurance clause, when stating levels of cover required, will refer to aggregate cover levels or each and every claim levels. Aggregate cover means that the total claims under that policy or in a given time period (often 12 months) cannot exceed a given level. If there are several claims in that period, the later ones are unlikely to be met.  Each and every claim cover means that the financial limit applies to each individual claim, no matter how many claims are made.  Each and every claim obviously offers better protection but comes at a higher cost. |
| Scope of cover | It is rarely possible to provide finite detail of the cover required within the contract terms, so this will normally be done by the use of expressions such as in respect of all customary risks.  This wording is necessarily vague, so it is important that the procurement and supply professional knows what those risks are and that they are catered for within the cover provided. From the purchaser’s perspective, supplier policies should be checked, not just to see that they are in date, but that they do not include restrictions on things like working at height, working in other legal jurisdictions, methods of transportation or whatever might be relevant to the contract concerned. |
| Auditability of insurance | Having created a contractual requirement for the insurance to be in place, the purchaser should then also ensure that it has a right to access evidence of cover, ideally, the contract should go further and allow the purchaser to put in place insurance itself if it is not satisfied that the contract requirement is met, and to reclaim the costs of doing so,.  Sample wording:  The contractor shall give the client annually upon request and in any event annually upon renewal copies of all insurance policies referred to in this clause or a broker’s verification of insurance to demonstrate that the appropriate cover is in place, together with receipts or other evidence of payment of the latest premiums due under those policies.  If, for whatever reason, the contractor falls to give effect to and maintain the insurances required by the provisions of the contract, the client may make alternative arrangements to protect its interests and may recover the costs of such arrangements from the contractor. |

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| Remember  Insurance is used to make certain that the offending party can meet the financial costs of its liability in the event of a claim. Contract terms should be used to require that subcontractors are also appropriately insured. |

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| Check  Describe the key features of liability and indemnity clauses. How are they used to try to limit the risk? |

SUBCONTRACTING

Commercial contracts are often layered, with a main contractor or supplier appointing other contractors or suppliers to fulfill an aspect of the order. This second contract, sitting underneath the first one, is called a subcontract. For example, a council may contract with a building company for a new school. The building company will likely do some of the work itself but appoint specialist firms to provide some aspects of it, such as the plumbing or the scaffolding. This is subcontracting. There may be several layers with sub-subcontracts and so on. Generally the expression sub-subcontract is rarely used. When talking about a subcontract, it means one that sits underneath a higher one, is directly related to it and often partially governed by it.

The layers of contracts are often referred to as tiers, so a tier 1 suppler is one with whom the purchaser has a direct contract, a tier 2 suppliers is one with whom that direct supplier has a contract, tier 3 would be the next level down, etc.

The contract between the tier 1 supplier and the tier 2 supplier may not be a subcontract. The direct relationship between the two contracts is important. To go back to the example of the builders of the school: the plumbers appointed to install the water and heating systems, etc, are subcontractors. Their contract is tied directly to the main building contract. By contract, the builder’s contract with the suppliers of bricks normally would not be a subcontract. The builder would be buying bricks anyway, possibly a different number, possibly a different type, and certainly for delivery to a different place, but the relationship between one specific building contract and the need for the brick-supply contract is less direct. It would therefore usually be a standalone supply contract. However, both the plumbers and the brick suppliers are tier 2 suppliers.

Note: subcontracting can occur, not just on works projects, but also on those for the supply of goods and/or services. The expression subcontractor is normally used regardless of the nature of the supply, simply because it is easier to say. Sub-supplier is sometimes used in respect of supply of goods contract. On services contracts the term sub-service-provider would never be used. It would always be subcontractor.

WHY IS SUBCONTRACTING REFERENCED IN CONTRACTS?

There are a number of reasons why the purchaser will want to control the supplier’s subcontracting.

* Supply chain: a lot of effort is put into choosing a supplier, ensuring that it is financially stable and can deliver the contract and trade ethically, etc. that work is wasted if the chosen firm simply passes the contract down to a subcontractor who may or may not have been vetted to the same degree. The more layers there are, the less the purchaser will know about the person who is actually doing the work for them. There is a need to control the choice of subcontractor to some degree.
* Contract terms: having agreed the terms of the contract, the purchaser may wish to ensure that these are reflected in the subcontracts. For example, an ethical purchaser may wish to ensure that payment terms in subcontracts reflect those in the main contract. See the case study subcontract payment terms.
* Liability: the purchaser needs to ensure that even if some of the supply is subcontracted, the main contractor remains legally liable for fulfilling the contract. They cannot simply blame the subcontractor for any faults and walk away.

Table 3.9 set out the things to consider in respect of clauses relating to subcontracting.

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| Do you wish to permit subcontracting at all? | There may be valid reasons not to all any subcontracting, particularly if working on contracts that may have security or defiance implications or include commercially highly confidential information on radically new products or processes.  It is normally accepted, however, that properly controlled subcontracting is beneficial for purchasers, suppliers and the economy generally. It allows smaller firms to survive, increases competition, spreads the risk, etc.  The latest public procurement rules in the EU (public procurement directive 2014/24/EU) include a provision that suppliers must be permitted to rely on the resources of others. In other words they must be permitted to subcontract. However, purchasers are permitted to include reasonable rules on how they do so.  Sample wording:  The contractor shall not without the prior consent of the contract administrator subcontract any order or part of an order. Such consent shall not be unreasonably delayed or withheld. |
| How much control over the selection of subcontractors do you need? | In most cases contracts can rely on a generic need for approval and a statement that it will not be unreasonably withheld, but that raises a question as to what unreasonably means. In what circumstances would it be reasonable to withhold consent? Normal requirements will not need to be expressly stated. For example, if a license or qualification is required in order to be able to provide a given service, rejecting a subcontractor without such a license or qualification is clearly reasonable. If certain assurances are required which are not so clear-cut, so that the reasonableness of them might be questioned, it would be better to be explicit,. Specific measures to ensure secrecy might come into such a category. |
| What influence over subcontract terms do you want? | Do you want to ensure that subcontractors are paid promptly? Do you need to ensure that data protection measures included in the contract are also in any subcontracts? Are paid promptly? Do you need to ensure that data protection measures included in the contract is also in any subcontracts? Are the insurance requirements the same?  Sample wording controlling payment (based on template clauses provided by crown commercial service, an executive agency and trading fund of the cabinet office of the uk government –the clauses cross –referred to related to payment within 30 days, prompt notification of queries on invoices, etc.)  ‘specifically where the contractor enters into a subcontract with a supplier or contractor for the purpose of performing its obligations under the contractor shall include in the subcontract provisions having the same effect as clauses 1 to 3 of this agreement; and a provision requiring the counterparty to that subcontract to include in any subcontract which it awards provisions having the same effect as clauses 1 to 4 of this agreement. In this clause 4 ‘subcontract” means a contract between two or more suppliers, at any stage of remoteness from the client in a subcontracting chain, made wholly substantially for the purpose of performing (or contributing to the performance of) the whole or any part of this agreement.  A somewhat simpler sample wording controlling insurance is:  As a minimum, the contractor shall ensure professional indemnity insurance held by the contractor and by any agent, subcontractor or consultant involved in the supply of the services has a limit of indemnity of not less than £5,000,000 for each individual claim or such higher limit as the client my reasonably require (and as required by law) from time to time. |
| Ensure that the main contractor retains liability | Wording must be included to ensure that all legal liability stays with the main contractor.  Sample wording:  The contractor shall be responsible for the acts and omissions of its subcontractors as though they are its own. |
| Beware the impact on price | When deciding how far to control subcontracting bear in mind that any restriction on the main contractor being free to choose its own subcontractors may have an impact on the price paid by the purchaser. Restrictions might limit the number of potential subcontractors, thus driving up price as a result of less competition. It might mean that the main contractor cannot use its normal subcontractors, increasing the administration costs of its subcontract management as well as potentially resulting in a directly higher price. |

Guarantees

A guarantee is a formal written assurance that certain quality conditions will be fulfilled, and it provides a specific remedy are not, for example that product will be repaired or replaced free of charge if it fails within a given time period.

Guarantees could apply to services, but they are much more common in respect of goods, whose lifespan will go beyond the actual contract under which they are provided.

The guarantee outlives the contact. A hotel chain may have a one-off contract for the supply of mini-refrigerators to be installed in guest bedrooms. The contact itself is completed once the refrigerators have been delivered and paid for, but the guarantee could run for two years.

The more complex the product being purchased, the more likely that a guarantee is required; also the longer the purchaser will want the guarantee to last. From the supplier’s perspective, there is a cost to providing a guarantee. Some products will fail within the guarantee period and will need to be repaired or replaced free of charge. However, assuming the supplier has good quality control that number should be very small in comparison to the total numbers being produced and sold. Therefore the value of the guarantee to the purchaser is much greater than the cost of it to the supplier.

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| Do you need a guarantee | How likely is that the product will fall and how much impact does such a failure have? If it is very likely to fall, you should not be buying it at all. If it is not likely to fail but failures are costly to rectify than a guarantee is essential. The numbers of the product you are purchasing should also be taken into account. The more of them buy, the more likely you are to get a faulty one. |
| How long does the guarantee need to be? | Most manufacturers offer a standard guarantee period. Depending on the nature of the product this could be anywhere between two and ten year. Extended guarantee period will be offered but these may be at an additional cost. In many cases it will not be worth paying for the extra period, because the kind of failures covered by guarantees tends to happen early or very late in the life of the product. |
| What needs to be included in the guarantee? | This depends on the nature of the product. In some cases a simple replacement is the easiest and cheapest solution for both purchaser and supplier. However, if the product is a component that has been installed in a building or is part of a larger piece of equipment, it may be more convenient to repair rather than replace it.  If the repair option is the most logical, be careful that it is full part and labour cover. The replacement part might be relatively cheap but fitting it could be expensive. The effect of the guarantee must be to put the product back into good working order.  Thought should also be given to what kind of faults or failures are covered by the guarantee. Accidental or willful damage, for example, will not normally be covered.  Consider response time. The thinking that would go into a repairs and servicing contract should also be given to a guarantee. The more complex the guarantee offer, the longer the wording of it will need to be, and it may be sensible to include it as a separate schedule to the contract, or to embed it as part of the specification. |

LIQUIDATED DAMAGES

Damages is the legal term for financial payments to compensate for a loss of some kind. Damages are paid when it is not possible to place the injured party in the position it was in prior the injury or loss occurring.

Liquidated damages-sometimes also called liquidated and ascertained damages-are damages whose amount is predetermined during the formation of the contract as being payable for a specific breach of contract. They are most commonly used in respect of late delivery.

Liquidated damages are specifically intended to be compensation and not a penalty. The object is not to penalize the supplier, but to redress the loss or extra costs that the purchaser incurs as a result of the lateness of delivery. The figures are either set out by the purchaser as part of the contract terms information provided at tender stage, or they are agreed between the parties during the contract negotiations. In either case they must be a genuine pre-estimate of loss. It is useful to keep a record of how the estimate was arrived at. That document has no legal standing in the context of the contract, but could be useful if the reasonableness of the estimate is subsequently challenged.

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| Which breaches of contract should carry liquidated damages? | Liquidated damages are only appropriate when there is no other suitable remedy. Anything that can be fixed should not carry liquidated damages as a remedy. Quality issues, therefore, must be addressed in a way that improves or rectifies the quality.  They are most usually found in respect of late delivery. Once delivery is late there is no way it can be made ‘not late’, so damages is the only solution. |
| Estimating the sum | The liquidated damages figure must be a genuine estimate. Think about what the impacts of the lateness are and how that converts into financial loss. For example, late completion of a building involves loss of rental income, additional interest on loans which cannot start to be repaid until the rental income commences, salaries for staff who have been recruited but cannot start work until the building is available, lost orders if the building is a factory and cannot go into operation on time, etc. |
| Typing the figure to the degree of lateness | The losses for the purchaser are rarely one-off costs, they mount up as the length of delay increases. The contract term should therefore express the damages as a sum of money for a period of time.  Sample wording:  ‘The rate for liquidated and ascertained damages shall be $3000 per week or part thereof’. |
| Process for claiming damages | The contract should also set out how the damages are to be claimed. This will normally require a specific notice or notices to be given to the supplier stating that delivery is late and that damages are being claimed.  The contract may also need to state whether the supplier must literally pay the money to the purchaser or whether it will be deducted from any payments still to be made on the contract. The latter is common, but it must be made clear that the damages due are to be considered a debt between the suppliers and purchaser – this may enable interest to be claimed if there are unreasonable delays in payment and may also enable a right of set-off against other contracts between the parties. |

**Labour standards and ethical sourcing**

Ethical behavior in contracting is becoming increasingly important. For any business to survive there are two aspects of its reputation that are critical: what investors think and what consumers of its products or services think. If a business is tarnished by association with poor labour standards, either directly or in its supply chain, or other failures in what might broadly be called ‘ethical sourcing’, then one or both of two things is likely to happen: investors will not want to invest so the business capital will become strained, and/or purchasers (commercial or consumer) will not want to buy the products so sales will diminish. The net impact both these is a fall in share price, which undermines confidence in the business further. This could be a vicious cycle that ends in the total collapse of the business.

In practice that rarely happens. It appears that public and economic confidence in businesses, even those that exhibit shocking ethical failures, is relatively resilient. The death of textile workers in Bangladesh makes global news, but the international companies whose garments they were producing seem to recover very quickly from headlines. Nevertheless, those international companies will need to spend significant time, effort and resources dealing with the association.

This underlines the fact that, as much as everyone wants to believe that businesses care about labour standards and ethical sourcing because it is ‘the right thing to do ‘, the reality is that we live in a capitalist society where the ‘right thing’ is a much easier sell to boards and directors if it is also a ‘business beneficial thing’ to do’ in law, the first duty of a limited company is not to the society in which it operates, it is to its shareholders. If those shareholders are overall ethically minded–which is a slowly improving probability- then ethics will have a strong hold on company decision-making. If those shareholders are purely in it for the money, then the ethics angles have to be shown to be value-for-money angles as well.

Procurement and supply professionals are advised to understand the motivators of their own organisations and those of the firms with whom they contract, not because this will change how they behave but because it may need to change how they phrase the message.

CIPS is committed to ethical sourcing and ethical contracting, to the extent that it has introduced its own ethics test, which all members are encouraged to take and all fellows and chattered Professional members are required to renew on an annual basis.

The use of contractual terms to promote and enforce labour standards and other aspects of ethical sourcing is only one of the tools available to procurement personnel. Joint working and education arguably have far bigger parts to play in driving improvements in these areas, but these would be less effective if the supply chain companies who fall below standard did not appreciate that eventually they will lose contracts.

**Terms that apply to labour standards and ethical sourcing**

‘Labour standards’ refers to the terms and conditions of employment workforce, particularly the non-professional workforce who are generally the lowest paid and most vulnerable members of an organisation’s human resource.

In the capitalist economic system that exits in most of the world, the organisations (who are the owners of capital) have much more power than individuals (produce the labour). The rights and wrongs of this are a matter of private conscience and political opinion. The issue for the procurement and supply professional is to ethically manage their contracts in a way that (a) complies with laws and standards in this area and (b) does not unnecessarily exploit labour providers in situations which are not governed by specific regulations or standards.

Of all the ethical considerations in contracting, labour standards is the one with the longest history. Current standards primarily derive from the work of the International Labour Organisation (ILO).

The ILO is an agency of the United Nations, although having been founded under the League of Nations in 1919 it pre-dates the current UN. It has 187 members. The only UN countries who are not members of the ILO are Andorra, Bhutan, Liechtenstein, Micronesia, Monaco, Nauru and North Korea.

The standards laid down by the ILO cover the following:

* The right of workers to associate freely and bargain collectively. This is what many people will understand, as the right to be a member of a trades union and to have that union negotiate their terms and conditions.
* The end forced and compulsory labour: slavery in other words. The current expression is ‘modern slavery’ because ideas related to what constitutes slavery have expanded since the 18th and 19th centuries to include such things as debt-bondage and travel restrictions enforced by the holding of passports or identity papers among other things.
* The end of child labour. The UN declaration on human rights includes provisions that everyone has a right to education and that education to elementary level shall be compulsory. Clearly this can only be made to happen if children are able to attend school, which in turn means that they need to not be in paid employment that impinges on their education.
* The end of unfair discrimination among workers, national origin, religion, gender, gender identity, sexual orientation, or physical or mental disability.

These standards are agreements between nation states who are the members of the ILO. The obligation created by the agreements is for those countries to apply the provisions of the agreements, which is done by creating national laws.

Not all national laws on labour standards derive from international agreements. Some may be wholly home-grown affairs. A common topic in many countries in recent years has been that of a minimum wage. Legally enforceable minimum wage levels exist in the vast majority of UN member states, but they do so in different formats. In some countries the minimum wage only applies to public sector employees, in others it applies to all. In some it varies by age in others more devolved fashion. In the UK a minimum wage is set by the government, with variations according to age and geography (a higher rate applies in the London area), but there is still a long ongoing campaign to raise the legal minimum or, failing that, for employers to pay what campaigners call ‘living wage’.

Similarly, workers’ rights when it comes to free association and collective bargaining vary from place, partly in response to ILO standards but also in response to local history.

From the perspective of the procurement professional, the obligation is two-fold.

* As a minimum, to apply the national laws of the state in which they operate and the laws of any other state that affects the contract, subcontracts and upstream supply chains.
* Wherever possible to seek to encourage higher standards by means of commercial negotiation.

Commercial contracts must require compliance with relevant laws, but commercial leverage can often achieve what the legislators cannot, by applying economic rationale to a public good. In other words, they say to suppliers: if you do not understand or do not agree that this is the right thing to do, then understand that it is economically the most beneficial thing to do. In the vast majority of cases it is both of those things.

However, care must be taken not to be too simplistic in approach. Things are never as simple as they might appear. Let us take one example as an illustration: child labour. Most sensible people would agree that children should not be working, they should be in school, but consider the following issues.

* What is a child? The definition of childhood has changed over the years and varies from country to country. Not very long ago, the age of sexual maturity (a biological function) would have been accepted as adulthood. Few countries now consider 12 years old to be adult. Perhaps unfortunately, no standard age has yet been internationally agree and the somewhat circular phrase now used is the age at which compulsory education cease.
* Do we want to end child labour for families where the only hope of any income is through the labour of the children? In the poorest families in the poorest places, with least access to medical and social care, it is often the case that the children may be the only members of a family capable of earning an income. If they are stopped from doing so, how does the family survive?

There are no easy answers to these societal problems. It is important that procurement and supply professionals recognize this so that they consider the issues in the wider context when deciding how to manage supply chains and individual contracts.

Rather than trying to construct contract clauses that require compliance with treaties, it is much more helpful to set out requirements in terms of local laws and practical application.

The following could be sample wording for setting contractual parameters that support working conditions without directly referencing them, in this case in relation to working hours:

Normal working hours will be between the hours of 7:30 am and 5:00 pm Monday to Friday, and 8:30 am and 12 noon’s on Saturday. Any working outside of these hours must be agreed in advance with the contract administrator.

Any such conditions set out in a contract must be accompanied by a clause which permits the purchaser to carry out unannounced local site audits to verify that terms and conditions are being implemented.

The conditions should also have as their ultimate sanction a right to terminate the contract in the event of non-compliance. That said, the practical response to non-compliance should always be one of trying to understand the reasons for it and ways to improve the situation, rather than simply walking away from the problem.

ETHICAL SOURCING

Ethical sourcing is a broad term which covers a number of different aspects of choosing where supplies and service provision come from. One definition is:

Ensuring the products being sourced are obtained in a responsible and sustainable way, that the workers involved in making them are safe and treated fairly and that environmental and social impacts are taken into consideration.

The impact on the workers involved has already been considered under labour standards.

Embedding this concept into commercial contracts requires multi-strand approach. It needs to consider the following.

* Things the supplier will do directly themselves: how they treat their own labour force, their environmental policies and activities.
* Things that will be done via subcontract arrangements: the need to ensure that the rules flow down the subcontract chain.
* Indirect input: what might be called the upstream supply chain-how the supplier’s act in producing the goods, components and/or services that feed into what the supplier does under the contract.

There are no quick and easy ways to do this. It is not possible to simply contract a few contract clauses that will cover ethical sourcing.

One key aspect is selecting the right supplier in the first place. That is beyond the scope of this study guide, which focuses on the contract once the supplier has been selected, but choosing a supplier with a demonstrated commitment to ethical contracting is the most important starting point. Such suppliers are more amenable to the terms that the purchaser wishes to impose, and they are more familiar with delivering them. This sends a message to those who are not yet on board with this agenda.

Within the contract there are a number of different ways to encourage or mandate ethical sourcing. Which of these is used will depend on exactly which aspect of ethical the purchaser wants to address. Table 3.12 sets out some things to consider.

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| Labour standards | Are there any international, national or local laws or standards that need to be enforced? Can these be cross-referenced by a simple clause requiring compliance? Does the purchaser want, and can it afford, to go beyond the minimum requirements?  A formal statement of commitment to eradicating certain practices (for example, those denoting modern slavery) embedded within the contract and a requirement that the supplier and all those in its supply chain support such actions might be difficult to police and enforce, but it is a solid starting point.  Sample wording from a UK context referencing the modern slavery act is shown below. Similar wording could be used to reference other standards such as those set out by the ILO.  In performing its obligations under the agreement, the supplier shall and shall ensure that each of its subcontractors shall.   1. Comply with all applicable laws, statutes, regulations in force from time including but not limited to the modern slavery ACT 2015; and 2. Take reasonable steps to ensure that there is no modern slavery or human trafficking in the supplier’s or subcontractors’ supply chains or in any part of their business.   The supplier represents and warrants that:   1. Neither the supplier nor any of its officers, employees or other persons associated with it: 2. Has been convicted of any offence involving slavery and human trafficking: and 3. Having made reasonable enquiries, to the best of its knowledge, has been or is the subject of any investigation, inquiry or enforcement proceedings by any governmental, administrative or regulatory body regarding any offence or alleged offence of or in connection with slavery and human trafficking. The supplier shall implement due diligence procedures for its own suppliers, subcontractors and other participants to ensure that there is no slavery or human trafficking in its supply chains. |

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| Environmental impact | What are they? How does the contract impact the environment in the key areas: water and energy use, pollution through process, waste disposal? Think about embedded energy and whole life impacts. Clean production processes can be outweighed if the resultant products are impossible to dispose of safely. Some might feel that nuclear power plants fall into this category.  Having identified the issues there are a number of ways to deal with them, such as express clauses requiring compliance with legal standards, quality or design requirements within specifications including eco-or fair trade labeling, KPLS for improving impacts scores, etc. |
| Social impacts | What are they? How does the contract impact? Some areas to consider might be health and wellbeing of service users, for instance they are safeguarding requirements for children and vulnerable adults? Is the product or service more difficult for some members of society to use or access than others; can that be changed?  As with environmental issues, Having identified the issues there are a number of ways to deal with them, such as express clauses requiring compliance with legal standards, quality or design requirements within specifications including eco-or fair trade labeling, KPLS for improving impacts scores, etc. |
| Fraud, bribery and corruption | Millions of dollars are wasted annually as a result of bribery, fraud and corrupt practices.  Ethical sources and ethical contracting is based on fair and transparent processes, which are designed to prevent such behavior. Even so contract terms must explicitly state that fraud, bribery and corruption are unacceptable in connection with anything that relates to the contract, with the ultimate sanction for such activity being termination of the contract and barring from consideration for future contracts.  Sample wording can be;  The parties represent, warrant and undertake to each other on a continuous basis that they shall comply with all applicable anti-bribery and anti- money laundering laws, rules and regulations of the united states, European union or any member state, the republic of Singapore and any other similar laws in all applicable jurisdiction. These laws include, without limitation, the currently effective of successor versions of the U.S foreign corrupt practices act, the UK bribery act 2010; the UK money laundering 2007; the UK anti-terrorism crime and security act 2002; and the Singapore penal code. The addition the parties present, warrant and undertake to each other on a continuous basis that shall each respectively take no action which would subject the other to fines of penalties under such laws, regulations, rules or requirement. |
| subcontracting | Any conditions that are imposed on the direct contractor/supplier must be covered by a clause requiring similar terms to be included in subcontracts within this; the requirement will become more diluted as it passes downstream through the layers of subcontractors and suppliers. The sample wording for modern slavery given earlier in this table shows how the can be incorporated. |
| Upstream impacts | The potential environment and social impacts may result not only from the contract and its output. Think also about the inputs. Consider where the supplier might be obtaining its energy, timber, minerals, precious and semi- precious metals, etc. does the purchasing organization really want to be associated with decimation of the rainforest or the use of conflict minerals; for example? Alternatively, can it gain from association with fairer trading practices? The only way to avoid one and encourage the other is by contractual clauses that expressly prohibit certain inputs or expressly require others. In both cases this can be helped by traceability certificates from independent third parties.  The methodology for embedding such considerations will vary from contract to contract and may be a combination of specification and express contract terms. |

Table 3.12 things to consider in respect of labor standards and ethical sourcing.

RECOGNISE TYPES OF PRICING ARRANGEMENTS IN COMMERCIAL AGREEMENTS

Understand the use of pricing schedules, fixed-pricing arrangements, cost-plus and cost-reimbursable pricing arrangements, the use of indexation and pricing adjustment formulae, as well as the use of incentives and the importance of clarity over payment terms.

The context of the section is the incorporation and use of these elements in the contractual setting. However, consideration should also be given to how the various models need to be built into the procurement process from the outset. Whether the contract is tendered or negotiated, the following must be very clear from inception.

* Which pricing model the purchaser envisages using
* Whether it is willing to look at other options

It is necessary to know which pricing model will be used in order to be able to evaluate prices offered, i.e to compare pricess from competing suppliers and also with historic or branchmark prices in order to determine whether value for money is being achieved.This can only be done if prices are provided in a consistent format.

If purchasers are willing to look at other options,this allows suppliers to offer other methods if they feel that produces a better offer.

Whatever pricing mechanism is used, a primary objective for the purchaser is that the pricing is transparent. It must be sufficiently broken down into its elements to permit the following.

* Variation or changes to the contract to be adequately costed
* Price adjustments to be applied correctly
* Any recharges or distribution over different cost centres to be accurately produced

Cost and price

Before examining aspects of pricing within contracts, the difference between cost and price needs to be clarified.

* Price is the amount expressed in units of currency (pounds, dollars,etc.,)to be paid by the purchaser to the supplier in order to obtain the goods or services.
* Cost is the total sum of amounts paid by the supplier in order to produce the goods or provide the services.

There is clearly a relationship between cost and price, but it is not always a direct one. For the supplier to make a profit, price must exceed cost. The degree to which it can do so will be determined by the competitiveness of the market, the business strategy of the organization and bargaining power of the supplier and the purchaser.

In some circumstances the supplier may (on a short-term or contract-specific basis)be willing to accept a loss, in which case the price will be lower than the cost. It may do so in order to break into a new market, or to ensure continuity of work for skilled employees who might otherwise leave and leave and be difficult to replace.

THE USE OF PRICING SCHEDULES

Pricing is one of the most important elements of any contract for both the purchaser and the supplier.

In the simplest contracts there may be no need for a schedule. The price will be easy to calculate, it will not change and will need to be split into constituent parts for is so, the contract price clause will simply state that the goods or services will be provided as specified for the total sum of $10, 000 payable upon completion.

Most commercial contracts are more complex.

* Call-off contracts will not have a predetermined total price; it will depend on exactly what is called off, how many orders there are, etc. the price may differ at different volumes.
* Even what the total fee is known, payment might be made in stages as key milestones are reached. This is common in construction, supply of large complex pieces of equipment, and major ICT projects.
* The price may need to be broken down into various elements so that any changes to the contract can be accurately priced, e.g., if more staff are required or more days are needed to complete the work, then the day-rate of staff might need to be shown.
* The price may have to be broken down for accounting reasons. For example, a multi-national firm may need to apportion the costs of a service or system between different localities based on usage; the costs of operating a building may need to be recharged to a number of different tanants.
* There may be changes to the scope or duration of the contract which require variation orders. It will be necessary to be able to accurately assess the cost impacts of these, and therefore calculate whether that needs to affect the price.

It is important that purchasers think about these issues before approaching the market. This cannot be done by the procurement team alone. Other stakeholders (contract managers, finance, income recovery, strategic planners) should be consulted in order to understand what they may need to do with the financial information from the contract. The price schedule should be designed as far as possible to accommodate that.

TERMINOLOGY: PRICE SCHEDULES AND SCHEDULE OF RATES

The terms price schedule and schedule of raters tend to be used interchangeably, but there needs to be a word of caution. A price schedule (sometimes called a fee schedule when it applies to professional or consultancy services) is an appendix to a contract setting out what the prices are. Sometimes it also includes how and when the prices will be charged, although this might be covered in a separate part of the contract if it is particularly complicated. A schedule of rates is an itemized list of component parts within a lump-sum contract, or a list of individual products, giving a price for each unit. Note that the rate may be different for different order volumes.

CALCULATING AND EXPRESSING PRRICE

There are a number of different ways in which prices can be expressed.

UNIT PRICE

The simplest pricing method is unit price. This expresses the price in dollars (or pounds, euros, etc.,) per unit. A unit in this context could be a single item, particularly if it is something large, complex or expensive. Smaller items will be supplied in specified volumes and the unit will be a given number of boxes. For example, a pricing company might buy a single new high-tech printing press; it will not buy one single ream of paper. The paper will still be priced in dollars per unit, but the unit will be say, a box of 10 reams.

If the supplier wishes to charges the same price no matter how many boxes are ordered, this will be expressed as a single line on the schedule. If the company orders one box it will cost $20; if it orders 100 boxes it will cost $2000.

|  |  |  |
| --- | --- | --- |
| Item | Unit | Unit price ($) |
| A3 200gsm paper (green) | Box of 10 reams | 20.00 |

Table 3.13 linear pricing

However, it is more costly for the supplier to ship one box a hundred times than to ship 100 boxes all at once. Therefore, it could insist on minimum orders of, say, 20 boxes, or it could simply encourage purchasers to buy larger quantities by making larger orders cheaper. This will need to be expressed as several lines on the schedule.

|  |  |  |
| --- | --- | --- |
| Item | Unit | Unit price ($) |
| A3 200gsm paper (green) (up to 10 boxes) | Box of 10 reams | 10.00 |
| A3 200gsm paper (green) (11 to 20 boxes)  A3 200gsm paper (green) (more than 20 boxes) | Box of 10 reams  Box of reams | 8.00  6.00 |

Table 3.14 non-linear pricing

The first example (table 3.13) is known as linear pricing the second example (table 3.14) is non-linear pricing.

Unit pricing can be used for goods or services-but it is most commonly used for goods.

HOURLY RATES/DAY RATES

Hourly or daily rates are used for services, where most of the cost is for the person or people providing the service, e.g., consultants, lawyers, training providers.

Although it sounds quite different, this is really just a specific type of unit pricing where the unit is one hour or one day.

There may still need to be a schedule because the hourly rate may differ depending on the seniority or expertise of the person providing the service. See table 3.15 in respect of charges for consultancy service, which reflects the fact that the director will be paid more by his firms but also will have much more experience. The example also sets a minimum charge for work done at the client’s office but allow for lesser charges for work done at the supplier’s base.

|  |  |  |  |
| --- | --- | --- | --- |
| **Free earner** | **$/ day** | **$/half-day**  **( minimum charge for on-site work)** | **$/hour**  **(off-site)** |
| Director | 950 | 475 | 133 |
| Head of service | 815 | 407 | 114 |
| consultant | 550 | 275 | 77 |
| Support office | 350 | 175 | 48 |
| Admin office | 250 | 125 | 34 |

COMBINATION RATES

Where the service being provided is a mixture of goods and services (or parts and labour) a schedule of rates may be produced which combines the two. These schedules are common in repairs and maintenance contracts. A simplified extract is shown in table 3.16, which shows the different unit that might be used, even within a single schedule. This example uses linear pricing, but it could be expanded to use non-linear terms.

|  |  |  |
| --- | --- | --- |
| Description | Unit | Unit price $ |
| Combination boiler | Item | 700 |
| 15mm copper pipework | Metre | 25 |
| 20mm copper pipework | Metre | 50 |
| Wall-mounted thermostat | Item | 85 |
| Repaint disturbed surfaces | Square metre | 10 |

THE USE OF STANDARD SCHEDULES

Just as there are standard forms of contract, there are also standard schedules of for services provided by their members, or they may be produced commercially or by stakeholder interest groups. Some examples include the following.

* ASP (Australian psychological society) recommended fees for various types of consultation.
* HHF (National Housing Federation) rates for repairs and maintenance works to domestic properties (UK)
* DPSA (Department of Public Service and Administration) professional consultancy fee rates (South Africa).

Where standard schedules exist, they are designed to give a reasonable estimate of the price for a given product or service. Negotiations and tenders can then be carried out by reference to that price level.

For example, when contractors were tendering for a term maintenance contract in the UK housing sector, it used to be common practice to ask them to price on the basis of a variation percentage from the NHF schedule (plus or minus). This allowed for very simple pricing and direct comparison between tenders. However, this is a very broad approach and does not allow for the fact that some items on the schedule will be required often and others possibly not at all. Those variations will differ depending on the nature of the housing stock owned by the organization or local authority so cannot be taken into account within the schedule itself. As a result the practice is less common and there is a move towards very specific schedules related directly to the repairs history and likely requirements of the individual contract or in the opposite direction towards a price-per-property approach where inclusive fees are set based simply on the number of properties.

INCORPORATING THE PRICES INTO THE CONTRACT TERMS

Clearly the completion of the pricing schedule is a fundamental part of the tender or contract negotiation exercise. It is critical that once the final version is produced it is properly incorporated into the contract as a contract document. This is normally done by a simple contract term which states that the gods or services will be charged for at the rates set out in the schedule. The schedule is then appended to the main contract.

Where a standard schedule is used it is possible to simply cross-refer to it from the contract rather than reproducing the entire schedule as an appendix. If that approach is taken, the contract must make clear which edition of the schedule (by reference number and/or date) is referenced and also whether that remains the case in the event of the schedule being updated.

Consider the following example.

* A contract is awarded on the basis of the ABC schedule of rates, 8th edition, minus 3%.
* All prices are therefore 3% less than those quoted in the schedule.
* Then a new edition of the schedule is produced with new standard rates.
* The question is whether the contract rates are still 8th edition rates minus 3% or whether they are now 9th edition rates minus 3%. Which outcome is better for the purchaser and which for the supplier would depend entirely on whether the rates in the 9th edition are higher or lower than those in the 8th edition, so there is an obvious opportunity for dispute unless the contract is clear?

There are a number of possible options.

1. The contract might not allow any change to the contract rates at all.
2. It could require the contract rates to remain tied to the original edition (8th edition in the example) and any adjustment of prices to be by way of changing the percentage adjustment.
3. It could require the minus 3% to remain fixed but permit it to be applied to new editions of the schedule as they are published.

Any of these are possible. Option 1 gives price certainty but allows neither side to gain from changes in average rates. Option 2 allows for a free negotiation of any changes between the parties. Option 3 retains the discrepancy from the benchmark rate, but as neither party can influences the standard schedule rates it potentially risk for both purchaser and the supplier.

THE USE OF FIXED PRICING ARRANGEMENTS

One alternative to the schedule of rates approach is fixed-fee pricing or fixed-pricing arrangements.

In the case of goods, the purchaser will simply say they want X amount of a product and will be quoted a fee for that one order. That is the simplest use of fixed pricing.

* It is useful for small to medium scope projects, with short timelines, where what is delivered can be adequately specified and the likelihood of changes to the specification, scope and input costs is limited. The near certainty of both delivery requirements and likely costs of delivery makes the calculation of price a simple matter of arithmetic.
* It can also be used where a service is repeatedly required, but the specifics of which vary slightly on each occasion. It may take a shorter or longer period of time, or may need more or fewer resource inputs.

For these services the fixed-fee approach works if the overall costs even out over time, such that price can be calculated on the basis of an average cost. For this to function effectively certain assumptions may need to be made (for example, how often a particular service will be required every year) and the assumed scope of a service (a summary of the minimum specification)

**Benefits and Risks of Using Standards in specifications**

Standards set by individual companies have little to recommend them – they are in effect no more than a company or contract specific description of requirements. However, there are significant benefits in the use of national and international standards when specifying goods and services. As always is the case, such benefits come with attendant risks. Table 2.4 sets out both the benefits and the risks.

|  |  |
| --- | --- |
| **Benefits of using published standards** | **Risks of using published standards** |
| Specifications are shorter – there is no need to repeat all the detail included in the standard.  Suppliers can understand specifications more quickly – they will know the extent to which their offer meets or does not meet indicated.  Where international standards are used it removes a barrier to trade, in that cross-border suppliers do not have to understand local or national rules but can reply on international definitions and parameters with which they are already familiar.  Use of the standard allows for different approaches to be offered, all of which will meet the desired outcome, without procurers having to second guess what such approaches might be.  Use of the most up to date international standard should ensure that all recent influences (up to a point in time) have been considered. | In house staff (procurement and/or operations) may not be familiar with which standards do or could apply, so simplification opportunities are missed.  Staff may not fully understand the implication of the standards that they quote and inadvertently create conflicts within the specification by drafting precise requirements that do not agree with the standard-without allowing for a precedence of terms facility.  Staff my not fully understand either the quoted standard or their own operating environment and as a result in situations for which they are not designed, thereby possibly adding cost without value.  Insufficient thought can be given to what needs to happen when the standard is updated.  SMEs may not be as familiar with international standards as larger companies, while still being capable of doing what is actually required. This can be disincentive for such firms to respond to advertised opportunities. |

**Typical section of a specification**

At the simplest level, specifications for goods, works and services can be very different in style and structure, not least because goods are more likely to be **off-the-shelf**, whereas works and services are generally much more **bespoke.**

It is clear that a specification for office furniture will be very different in style and structure to the specification for the building of the offices in which the furniture will be placed. Both will also be very different from the specification for the legal services that the organization occupying the building will need to run its business.

Good procurement practice should only make specifications absolutely definitive to the extent that they truly need to be so. Allowing suppliers to achieve the end result by variant means can increase competition and stimulate innovation. The risk for purchasers is that this may lead to a reduction of standardization with their organization, resulting in increased operating costs.

Table 2.5 sets out the key sections which will appear in most specifications and some of the main things to think about in each area. These are derived from a British Standard (BS 7373), produced by the British standards Institutions (BSI). They are common to many specifications which may never have reference to that standard, although the information may be provided within a different format or structure.

|  |  |
| --- | --- |
| Specification section  Title  Version control/issue reference  List of contents  Foreword (or background)  Scope  Definitions  Consultation requirements  References to other documents, standards or CoPs  Substantive requirements | Factors to consider  Be very precise in the title. It needs to be succinct, but it should also reflect not only what is being specified, but the context of the specification. Is it for a specific tender exercise or for wider use? Your organization might want a common specification for or it might need different specifications for factories indifferent parts of the world with different operating conditions.  Think also whether you are writing the specification as a purchaser setting out what you need to be delivered, or as a supplier setting what you promise to deliver.  Specifications evolve over time. Readers of the specification need to be sure they are all using the same version. Project management systems require a version control table, setting out version number date, changes since the last issue and so on. Is this level of detail necessary? That will depend on the complexity of the specification. For simpler projects it will add work with no value. The minimum requirement is a unique identifier to the current edition. This simply needs to be a version number and a date of issue. This can be added as a footnote on the document or embedded in the document title.  It is possible that the document will be used by a number of different people in a different context. Ease of finding relevant diction is key to clarity.  In a well-constructed specification, there will be no repetition of requirements under different headings. If for any reason this is unavoidable, ensure that any cross-reference is also noted in the content’s lists.  Set out the context for the specification. Consider the comments against the title above. A good explanation of context will help the supplier (or maybe the purchaser) understand any assumptions that underlie the descriptions.  Understanding the viewpoint of the author can highlight possible misunderstandings at an early stage, so that they can be removed during the tender/negotiation phase and do not locked into the contract.  Setting the limits of the requirement ensures that the time and money are not wasted on areas that are simply not wanted. The more detail that can be given her, the better, as it enables suppliers to draw on similar experiences on other contracts which were either very successful or not at all successful, seeking to replicate the former and learn from mistakes of the latter.  As with any contract document, terms with precise meanings must be defined to avoid the potential for latter disputes.   * **Terminology-** words or phrases that could have more than one meaning should be defined. * **Abbreviations-** should be defined, no matter how common they are. * **Units of measurement**- should be defined, especially if some units have different meanings in different countries. * **Time**- such as calendar days, four weeks or calendar month, etc., should defined.   If the supplier (or conversely the purchaser) is responsible for ensuring that the requirement (or the offer) is compliant with any national or local legal requirements, this must be explicitly stated.  Failure to do so could create an implied term that the provider of the specification has already checked and confirmed this suspect.  Any documents referred to within the specification must be cleared referenced by their full title and date of publication. Information on where can be obtained must also be included.  It must be clear whether compliance with these documents is mandatory or desirable. There should also be either a hierarchy of compliance in the event of discrepancy between various quoted documents or a procedure to be followed to determine which approach will be taken in this event on a case-by-case basis.  This is the bulk of the specification and sets out exactly what the requirement is (where the purchaser is providing the specification) or what the offer is (where the supplier is doing so). The following should be included.   * **Characteristics**- design, dimensions, ability to interface with other systems or processes, materials (to be used or prohibited), labelling requirements (e.g., eco certifications, safety tested) * **Time scales** – delivery dates or time from order * **Response times**- on failures, defects or repairs * **Performance or reliability**- KPIs, operating conditions to be assumed, testing methods and any independent inspection regimes that apply, margins of tolerance against test or KPSIs criteria, reporting requirements. * **Lifespan/Durability**- required (or offered) useful life in normal use, and definition of what `normal use` shall mean. * **Packaging**- in the supply of goods, protection of goods in transit, removal of waste packaging; may consider environmental consequences of different types of packaging and/or waste disposal. * **Information requirements**- user manuals, operating and maintenance instructions, availability of support or replacement components. * **Implementation**- will there be a need to train staff to use the equipment? Are there integration requirements with other systems or processes? How will this work? What are the timescales? Are detailed method statements required? * **Guarantees and warranties**- what guarantees are available? Are there any restrictions to insure they are not invalidated? |

Table 2.5 key sections of a specification and factors to consider

|  |
| --- |
| ***Apply***  The information in table 2.5 on the typical sections of a specification is only provided by way of example. Seek out real-life specifications either from your own organization from the internet, or through other routes such as local business who might be willing to share information for purely academic use. This exercise will demonstrate the number of different approaches which might be taken. |

|  |
| --- |
| ***Remember***  The key substantive elements to be included in a specification are characteristics of the product or service; timescales for delivery; response times for defects; KPIs relating to performance and reliability; lifespan and durability expectations; documentary requirements for training/user manuals and/or managements information; and any specific requirements regarding implementation. |

**Standardization of requirements versus increasing the range of products**

The standardization of requirements is nothing new. It started with the industrial revolution in the late 1700s and has continued ever since. As technology and trade increase, so does standardization. This does not mean that standardization should be automatically assumed to be a wholly good thing. There are a number of advantages associated with standardization, but there is also disadvantage of that it reduces the range of products available.

**Advantages of standardization**

The advantage includes the following

* **Clarity of specification**: Both the purchaser and the supplier are clear what is required.
* **Economics of scale**: Producing standard goods enables greater automation of production processes and more rapid production both of which increase efficiency and reduce costs.
* **Reliability**: The continuous production of goods to a standard specification enables flaws in materials or production processes to be eliminated, leading to more reliable products.
* **Service enhancement:** in both the production of goods and the delivery of services, the personnel involved become familiar with the standard product and more adept at delivering or producing it. Skill comes with practice.
* **Time saving in the procurement**: using standards reduces the amount of time purchasers needed to write specifications and also the time needed by potential suppliers to understand and respond to them.
* **Accuracy of Quotations**: suppliers will make fewer errors in quoting for a standard product; their familiarity with the standard also reduces the element of pricing for risk.
* **Wider supply market**: using standard products means more suppliers are able to provide them, leading to increased competition and less reliance on a fewer specialist supplier for each item.
* **Narrower supply base**: Although there are more potential providers for a standard product, the number of suppliers actually used can be reduced, by reducing the variety of things purchased. This can improve the bargaining position of the purchaser, as the value of orders per supplier increases. It reduces the costs of managing suppliers (e.g., in ensuring accreditation and insurances are kept up to date, monitoring their financial standing and compliance with ethical and environmental standards). Successful suppliers receive higher vale orders.
* **Inventory savings**: the smaller the range of products, the less warehousing space is required; this applies in relation to goods being produced, but also to spare parts for machinery or vehicles.
* **Reduced risk**: In the event of one supplier ceasing to trade, it is easier to switch to an alternative.

**Advantage of increasing the range of products**

Increase standardization reduces the range of products available, but here might be cases where increasing that range is better option. Advantages of doing so include the following.

* **Breadth:** the more products an organization offers, the more segments of the market it will appeal to, and the more revenue it will generate.
* **Innovation:** reliance on existing standards does not allow for the creation of new products. A new technology or new product can have significant benefits to the firm that is first to bring it to market. Apple is the most familiar example of this, creating products which simply did not previously exist and then developing a market for them.
* **Product differentiation:** there is only so much demand for any given product. Once that level is reached, the market is said to be saturated. At that point, the only way suppliers can increase their share of the demand is to differentiate their products from of their competitors. This may mean producing no-standard products. It is worth noting, however, that increasingly product differentiation is being achieved more through branding and marketing than it is through real differences in the product itself. This can be seen most clearly in the clothing industry, where some brands are deemed more desirable than others even though there`s no real difference between the items.
* **Cultural differences:** increasing the range of products allows access to different markets or improves success within those markets. Differences in customs, associations and tastes may need to influence the product itself, or at least its packaging.
* **Economic factors:** customer wealth varies around the globe. From a supplier`s perspective, this can argue in favor of producing simpler, cheaper versions of a product aimed at less affluent markets, and more complex, more expensive versions for wealthier consumers.
* **Flexibility.** From a purchaser’s perspective, increasing the range of products used may help their company to be better able to respond to changes in the market. These changes could be limiting factors (e.g. where legislative change or economics shifts affect the price of one product more than another) or the change could be positive (e.g. already being in a relationship with a supplier who is bringing an innovation to market).

**Including social and environmental criteria in specifications**

Social and environmental criteria are increasingly being included in specifications. It is important for the procurement and supply professional to understand why this is happening in a generals sense, why it is worthwhile in a business sense, what kind of criteria might be appropriate, and how to go about including them in a specification.

**Increase in the use of social and environmental criteria**

There are a number of driving forces for the increased use of criteria. Some are based on ethical considerations which are commonly accepted, some are consumer driven, some are driven by the demands and policies of other influential stakeholders (such as funders, regulators or governments) and finally, some are driven by direct economic pressures. Table sets out some example under each heading.

|  |  |
| --- | --- |
| Reasons for including social or environmental criteria  Ethics  Labor conditions (including modern slavery, child labour, etc.)  Bribery and corruption  Consumer-led  Changing demands  Willingness to pay minimum prices  Brand reputation  Boycotts and protests in response to damage or injury to property, the environment or people  Stakeholder pressures  International agreements  Government policies  Proposed regulations (not yet implemented)  Internal policies and marketing strategies  Funding agreements  Economic incentives  Cash savings  Process efficiencies  Skills shortages/talent management | Examples of criteria  Compliance with international labour standards.  Support for education programmes aimed at reducing child labour  Adult education programmes aimed at ensuring workers understand their rights  Organic production  Ethical trading labels (e.g., fair Trade)  Environmental labelling (e.g.,  Forest stewardship Council; Marine Stewardship |Council; GHS labeling)  Avoidance of certain inputs, ability to trace raw materials (e.g., conflict minerals)  Waste reduction  Waste separation and recycling  Energy use/carbon footprint measures  Water conservation  Community initiatives  Training and community initiatives  Use of local and/or SME firms in the supply chain  Waste reduction  Energy and water use reduction  Training and apprenticeships |

|  |
| --- |
| ***Apply***  Review table 2.6 and think about your own industry or sector (or one which you wish to work). Consider how the criteria listed might be used. Can you identify any others? If so, which of the motivation factors apply? |

|  |
| --- |
| Remember  Social, environmental and ethical criteria are becoming increasingly important. Driving forces include regulation, consumer and stakeholder pressure, more informed stakeholders, and cost savings from waste reduction. |

**When to define social and environmental criteria**

Although the precise detail of the criteria will need to evolve or be defined alongside the refinement of individuals specifications, this must not be done in an ad hoc manner. The organization should have an overarching strategy or policy which sets out the social and environmental objectives to be pursued via procurement and the supply chain generally. Some of these will be about the specification, but that must be tied into other aspects of the sourcing strategy.

Particular thought needs to be given to supplier selection and monitoring processes and to the normal scope of contracts. For example, a supplier management strategy which favors smaller suppliers will not work well with an environmental approach that requires a significant capital investment by suppliers. Very short-term contracts do not easily support apprenticeships and other training programmes.

It is important therefore that, at a strategic level, all internal stakeholders understand how the various organization aspirations, strategies and policies impact on the procurement decisions and potential outcomes. Naturally, it is equally important that the personnel designing the specifications and procurement processes fully understand those policies and strategies.

Good procurement should involve ongoing study of supply market (and the reverse is true for suppliers who should be keeping watch on their customer base) and for large, high value or high-risk contracts there should be contract-specific market warming or premarket engagement activity.

All of these should include analysis of what is feasible and more importantly, what is effective and efficient in terms of delivering social and environmental gains. Feasible means that it can technically be achieved; effective means that it can deliver the objective; and efficient means that it is technically able to deliver the objective at an acceptable cost.

**Can you really get something for nothing?**

Particularly in the public sector, there is a tendency to think about social and environmental aspects of a contract as being an add-on. The term social value is often used to cover such criteria.

The concept of added value suggests a belief that you are getting something for nothing. This is naïve. Every item in the specification has a cost attached to it. However, it may not necessarily be clear whether that cost is higher or lower than the alternative. For example, if your specification states that 80% of production waste must be refused or recycled, there are costs of collection, sorting and either feedback into use or the recycling process itself. However, that cost might actually be less than the combined cost simply disposing of waste to landfill and suing virgin input materials. In this case, the net cost to the supplier of that specification requirement could be neutral if it is something they are already doing or it could be a saving if this specification is the one that prompts them to do it for the first time.

Other criteria may have additional costs attached. This might be might be true for all suppliers or only for some suppliers. If the requirement will disproportionately affect some potential suppliers, purchasers may want to consider whether that matters. It could simply be a reflection of the efficiency of the marketplace, with competition doing what is intended to do: allowing the most cost-effective suppliers advantage over the less-able ones.

However, there many reasons for wanting to level the playing field by allowing a price adjustment in evaluation for some providers. Such circumstances could include wanting to ensure national supply for supply for reasons of national security or defense, maintaining security of supply for purely commercial reasons or alternatively simply wanting to spread the risk across a number of providers.

Note that the use of such price premiums is not permitted in most public sector procurement regimes, although it is allowing in some circumstances in developing countries.

The need for purchaser insight

Regardless of how the supplier treats the additional cost of such criteria, purchasers should seek to understand what that cost element actually is. Without this information the real value of including the criteria cannot be assessed. There may be other more cost-effective ways of achieving the same objective or the increased cost may be disproportionate to the impact achieved.

**Monitoring social and environmental criteria in practice**

As with any element of a specification, the purchaser needs to know that what is being paid for is actually being delivered. This can be difficult to achieve. Most specification deliverables fall within the purchaser`s sphere of operation as inputs into their own business. Social and environmental elements may not be visible on the surface or in the performance of goods or services, especially if they relate to methods of production. Monitoring these aspects will include audits and site inspections of the supplier`s operation. The detail of how to conduct such audits is beyond the remit of this module, but it can be a complex and costly exercise, especially in global supply chain. If this work is not done, however, there can be no certainty that the specification is being complied with.

Remember

Social and environmental criteria may add to the cost of delivering the specification- but this is not always the case. Purchasers should seek disclosure of costs associated with social and environmental criteria to ensure that costs are not disproportionate to gains, and must monitor suppliers closely to ensure that the requirements are being met. Monitoring is likely to need on site auditing of suppliers.

**Incorporating the criteria into the specification**

Social and environmental criteria should be written into the specification in the same way other aspect of the requirement.

* Use international standards where these exists
* Ensure that the inclusion of the criteria does not create a conflict with other aspects of the specification
* If different aspects are specified by reference to standards, ensure that the standards do not themselves create conflicts
* Include an order of precedence for standards if there are conflicts (or allow for such conflicts to arise if one or more standards is updated during the life of the contract).
* Be clear whether the requirement is a minimum standard, a mandatory level, or an aspiration, or target. This can be important in determining whether failure to meet the standard would constitute a fundamental breach of contract.

**Social and environmental criteria in public sector contracts**

Social and environmental criteria are increasingly encouraged in public sector contracting. Some examples can be seen in the following organizations.

* In the UK: the public services (social value) Act 20124
* In Australia: the state of Queensland, Australia`s Department of Housing and Public Works Social Procurement Guide5
* In South Africa: Professional Procurement Policy Framework Act No. 5 of 20006
* In the USA: Social Economic programs for Small Business7

These are aimed at using public money to create public good, via procurement of goods and services rather than by direct government spending or subsidy.

There is generally a requirement that the social benefit to be achieved must be stated directly to the nature of the contract.

The normal requirements of transparency always still apply and except in cases of set aside or preferential programmes, where the preference is international, the social criteria cannot be used to undermine the equitable treatment of tenderers.

Implementing the policies set out in these guides and regulations (and the many others that exist around the world) requires a combination of tender process design and supplier evaluation methods, as well as direct criteria in specifications. One thing for procurers to remember is that if the process is designed to encourage certain types of firms to tender for requirement, this will be wasted if the specification is framed in a way that they cannot deliver.

**The role of information assurance in developing specifications**

Information assurance (IA) is the name given to the processes used to protect information systems, databases, computer systems and networks, etc.

The five elements of or pillars of IA id as follows.

* Integrity: ensuring that the data is not falsified or tempered with. This includes anti-virus software; policies relating to the use of laptops and external drives such as memory sticks; and codes of practice for users (e.g., in the event of receiving suspicious e-mails). All of these aims to protect against malicious codes entering the system, which could alter or destroy data.
* Availability: ensuring that the data can be accessed by those with the relevant authority when they need it. This includes general maintenance of systems to keep them bug-free and measures to protect against malicious codes entering the system, e.g., those that cause systems to overload, crash or block access.
* Authentication: ensuring that the users are genuine and who they say they are; ensuring messages come from legitimate sources. This includes the use of passwords and other access keys.
* Confidentiality: ensuring that they can only be accessed by those relevant authority. This includes the use of passwords, different access levels by job role, encryption and other access restriction methods; policies relating to screens being closed when not attended.
* Non-repudiation: ensuring that people cannot deny having taken actions which they did. This includes the use of automatic audit trails so that any changes made to information are logged by user, date, time, etc.

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| ***Remember***  IA applies specifically to the technical ICT systems in which data is managed, stored, processed or exchanged. |

IA should sit within a wider context of information governance (IG), which includes the protection of information that is managed outside of such systems and goes beyond the five pillars of IA. Despite the advance of Technology, a lot of information in commercial organization can be found in paper format, either because it is still stored and processed that way or because it has been printed out for a specific purpose, e.g., to be worked or used in a meeting. IA only protects the data and information held in the systems. The wider IG approach includes training and policies relating to general data management, such as these examples.

* A `clear desk` policy, i.e. no paperwork to be left on desks when not in use
* Requirement for all filing cabins to be kept locked.
* Control of visitors to areas where data is being processed.
* Control of the destruction of paper copies

The two key roles of IA and IG in developing specifications are as follows.

* Ensuring that the specification is based on valid and accurate data; for example, that likely usage rate of, spare parts is forecast on good historic information and future projections. If such data is unavailable, specifications may be based on guesswork resulting in over- or under- ordering. If the data has been altered, the wrong technical specifications (e.g., size) might be used.
* Ensuring that the specification itself includes requirements for meeting the necessary standard of IA in delivery of goods or services. The need for this is evident where the goods and services relate directly to ICT hardware, systems or software. But many other contracts also now include elements of computerization, for example. Vehicles and heating boilers now have systems that monitor activity and predict servicing needs ahead of breakdowns. During the development of the specification it is important to consider what information may be collected, used or transmitted and what protective measures are needed.
* IA and IG also have a wider role in the procurement process, especially where electronic tendering platforms are used, in ensuring that the process itself remains unthreatened by potential breaches of the systems.

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| ***Remember***  Information assurance only relates to computer systems and networks. It needs to be supported by a wider information governance framework which covers all aspects of controlling the data, information, knowledge, etc., held within the business. Information governance includes paper documents, control of visitors, verbal communications, etc. |

2.2**appraise examples of key performance indicators (KPIs) in contractual agreements**

Section 1.1 considered the need to include key performance indicators (KPIs) within a contract to ensure that they can be enforced. This section looks at examples of KPIs in more detail with a view to understand how to define and implement KPIs that are actually useful.

**Defining contractual performance measures or key performance indicators (KPIs)**

**The purpose of KPIs**

As already seen, the purpose of the specification is to set out exactly what the purchaser expects the supplier to provide, in terms of the characteristics of the goods or services, timeliness, pricing and delivery: essentially the Five Rights of procurement.

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| ***Check***  Remind yourself of the five rights at the beginning of section 2.1 |

Naturally, it is fir the purchaser to understand what right means in their own context. This will depend on the huge number of factors and influences that define the organization ad its operating environment. The `right` quality for a luxury brand will be different to that for a budget brand.

The purpose of KPIs is to measure how well the contract is performing in delivering those moments. It is important to understand that the performance is a function of the contract, not just a function of the supplier. While the majority of KPIs do measure supplier activity, that activity can be influenced for good or ill by the purchaser`s actions or indeed the structure of the contract itself.

It is worth considering where there also need to be purchaser KPIs. This does not mean procurement team KPIs- as used assessing the effectiveness and efficiency of procurement as a business function- but contract specific KPIs. These are still not common practice, but may be something that suppliers will increasingly seek to have incorporated into contracts. Measures that might be considered included the following.

* Number of payments made within terms (a very common complaint among suppliers is late payment)
* Timelines of orders, e.g., the number of agent orders as a percentage of total orders
* Accuracy and completeness of orders

Performance government, which is the purpose of having KPIs, is not only the means to control poor performance.

**How many KPIs do you need?**

There is a modern affliction of measuring things simply because one can. This creates work without adding value. It takes time and money to collect and interpret KPI data. It therefore makes sense to limit the number of KPIs and only use them to monitor and manage what really matters.

This might go beyond the five rights to take into account other areas of risk (e.g., health and safety) or equally, it might be that one or more of the rights is so fixed (e.g., price) that it does not need to be performance managed.

Author and marketing blogger Laura Tyson describe useful KPIs as falling within the IPA rule. An interpretation of her rule states that each KPI should do the following.

* Be important: there is no point measuring or trying to manage things which neither add nor detract significant value. Remember that monitoring and responding to KPI information is costly in terms of time and money.
* Relate to a potential improvement or a potential problem: if the measure simply confirms an unchanging state which cannot be influenced, the costs of the monitoring are wasted.
* Fall within the authority or ability of the parties to influence the results: monitoring KPIs simply involves looking at what they tell us about performance; in order to manage them, you must act on those results.

Accordingly, if the measure or indicator you are considering is not important, does not relate to a potential improvement or problem, and/or you can do nothing about influencing future results, there it should not be used.

It should not be necessary to have more than five or six KPIs. The word `key` in this context means `most important`. Once you exceed about six measures, you are clearly starting to look at less important things.

An absolute rule of capturing and analyzing the KPI information must never exceed the potential benefits from improvement or likely costs of the potential problems occurring.

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| ***Remember***  KPI measurement is about improvement. The measures must be about things which are important, which relate to potential problems or potential improvements, and which can be influenced. The costs of capturing the information must never outweigh the potential benefit from avoiding the problem or generating the improvement. |

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| ***Apply***  Think about something commonly bought by your organization or one which you would like to work. What are the most important aspects or features of that product or service that you think should be covered by key performance indicators? |

**Types of KPIs**

There arguments for and against both approaches. For example, if variations on a contract meant that the original contract sum was exceeded by 2%, that might not seem too bad. If it was a $25 million contract, however, the figure is significant. Conversely, an overspend of $50,000 might sound like a lot, but that if were on a $25 million, it would be less significant. Any overspend is clearly to be avoided if possible, but the example illustrates how figures are interpreted if they are not contextualized.

* **Quantitative or subjective assessment**: these are pure opinions about how well or otherwise the goods are performing or the service is being delivered. Most often, these will be linked to, or converted into, a numerical measure (e.g., users may be asked to provide ratings of unacceptable, poor, adequate, good or excellent, which means are then converted into a 0 to 4 score). However, such satisfaction, surveys often also include free fields for respondents to explain why they feel they do, and what they might have linked to have been different. It can be difficult to fully incorporate such commentary as part of the KPI itself, but does provide useful context for determining how to manage it.

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| **Remember**  Some of the data captured for KPI measurement may not be directly usable as a measure, but can still provide useful contexts for deciding the correct management response to the performance level being achieved. This is particularly true of qualitative assessments. |

**Sources of data and who controls them**

All KPIs are dependent on the availability of the relevant data. A lot of the information required for the most common KPS already exists in one or more systems.

* Cost data can be derived from both the purchaser`s and the supplier`s ordering and finance systems.
* Delivery of goods and services will be evidenced through ordering and receipting records
* Health and safety records are often required to be kept by law.
* Help desk and complaints departments will remain records of their activity.

It should already be clear that some of this information is acquired by the purchaser, some of it by the supplier. Some of it may be linked systems (e.g., procure-to-pay systems which cover everything from order, through delivery and invoice, to payment). There may also be bespoke systems to which both parties have access and can feed in their share of the data.

Such systems are usually electronic databases and computerized processing systems but, in some cases, records may still be paper based. These records still qualify as a system for the purposes of data collection, but they are highly inefficient and difficult to manipulate.

Using information from existing systems clearly reduces the costs of collection, but their potential problems with this approach. There is a risk a KPIs are designed around the available data, rather than being constructed to measure what matters- even if that means collecting additional information.

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| ***Check***  What difficulties might there be in measuring the following KPIs?   * Number of incompetent orders * Late deliveries * Non-reportable accidents and near misses   Think about the data you will need, who owns it, and how easy it is to access. |

Contractual remedies for enforcing KPIs can only work if the performance level can be determined with a reasonable degree of certainty. To encourage such certainty, it can be helpful for each party to have a right to audit the information used by the other party to determine KPI outputs.

That is not as simple as it sounds, since granting such a right of audit might permit access to some highly commercially sensitive areas of the purchaser`s or supplier`s accounting or operating systems.

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| ***Remember***  KPI data must be easily accessible and capable of being trusted by both parties. |

**Converting a measure into a score and setting targets**

A metric (or measure) alone is not very meaningful. For example, in a given sector, if 87% of deliveries are accurate and on time, is this an extremely good or a rather poor result? What impact does have the other 13% either inaccurate or late or both have on the business concerned?

Converting a measure into a score involves what good means to the organization concerned. A common method of converting KPI measures into performance scores is to use a 0 to 4 scale, as shown in table 2.7.

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| **Score 0 to 4**  1 = poor/below standard  2 = meets the requirement  3 = good/very good  4 = excellent | **Performance or measure**  Breach of contract  A situation which cannot be allowed to continue  Complies with specification, but does not go beyond it  Exceeds the specified requirements, without adding additional costs or creating waste  A significant improvement on the required standard, without additional cost |

Where a binary measure is used, it is commonly stated that the only possible results are 0 or 4- the worst or the best outcome. Another, and perhaps more accurate, interpretation is that the only possible results are 0 or 2. It meets the requirement, or it does not. As an example, where the target is generally zero. One of the following will apply.

* There were one or more accidents, which does not meet the requirement and so scores 0.
* There were no accidents, which meets the requirement and so score 2.