



Major Risks in Managing Commercial Contracts™

Identifying and mitigating major commercial contract risks

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This article has been prepared to give participants an insight into the risks they face when managing contracts. This article considers the identification and mitigation of contract risks for both buyers and sellers.

If a contract in law is simply an exchange of commercial promises why then are there so many expensive and bitter disputes? The answer is simple: the contracts are not negotiated and managed properly. The following risks are those that typically arise in managing contracts and are mentioned for education purposes only, and if you need specific advice see a competent professional practising in the area.

Risk No 1 – Poor choice of seller/buyer/partner

You do not need to work with every party who wants to do business with you. Be discriminating. Determine why they have come to see you. Is it because everyone else has dumped them? Check to see whether working with this party will enhance your firm's objectives, or will it do the opposite. Is the party financially sound? Are they high maintenance? If you are the buyer will the party provide value for money and will they be around to honour warranties? If you are the seller will they pay, and will it be on time (and without trauma)?

Risk No 2 – Not getting the agreement in writing

Did you know that a verbal agreement can in most cases be binding? Thus, there is a risk of being bound by a verbal statement. Risks in not getting it in writing include the fading of memories, the other party no longer being around to honour their promises (called the 'terms'), denying the existence of the agreement, or there being a dispute as to what was actually agreed upon (called the 'terms'). Thus, out of prudence most business agreements should be in writing.

Risk No 3 – Not keeping the written agreement simple

Were you aware that only small percentage of contracts end up being litigated, but a large percentage involve disputes? Thus, if you write a contract write it for the small

possibility that it will end up in court and simultaneously to reduce potential disputes between the operational staff that need to administer it. Focus on high risk areas, including those listed in this article. Look closely at whatever ways you can to make the contract simpler and clearer so that the parties know what, when, where, how and why they need to do something. Keep the language simple and relevant to the subject matter, risks and the parties.

Risk No 4 – Not dealing with the person in authority

Seek that the person you are negotiating with has the power to complete the transaction. Unless you have to avoid dealing with a junior person who must have everything approved by a person higher up the ladder who was not involved in the negotiations, and who may decide not to proceed.

Risk No 5 – Not taking time in drafting the agreement

Think things through before signing. Does the agreement enhance your firm's objectives, or will it do the opposite? There is a legal proverb used by drafting solicitors 'Draft in haste, repent at leisure'.

Risk No 6 – Lack of clarity in the agreement

It is vital that the terms are clear and specify what was agreed, and preferably in writing

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for evidentiary purposes. Without the consent of the other contracting party it is extremely difficult to add in extra terms once the contract has been created. In a dispute a judge gives preference to the written terms and looks at the plain meaning of the words (an 'objective' analysis) rather than what the parties thought they meant ('subjective' analysis). If there is an 'entire agreement' clause in the contract then verbal promises will not normally be considered to be part of the written contract.

Risk No 7 – Not specifying key contractual obligations

Key obligations to be determined *before* entering into the contract include:

- *Names of the parties:* Provide the full legal names and ACN of the parties and not just the business name.
- *Payment obligations:* who, how much, when, how etc?
- *Subject matter:* Is it the sale of goods, the provision of services?
- *Termination:* how the parties expect to exit? (This clause is often omitted).

Risk No 8 – Not being specific with the 'deal terms'

Each contract is about a 'deal', that is each party agrees to obligations and benefits. Know your agreed obligations and benefits. Clarity here is vital as it forms the basis of what the parties need to do. Do not sign a contract unless you are clear about what the obligations are. For example, if a building needs to be painted some of the things to specify are:

- What part of the building
- The colour
- The type of paint
- When it is to be painted
- Who is to paint it
- The fee, and when (*including* milestones) is payment required.
- Whether the paint is *included* in the fee.

Risk No 9 – Not understanding your 'fine print' terms

Were you aware that large and bitterly fought contractual disputes are less fought over the deal terms, but more often about

meaning and existence of the 'fine print' clauses? Do not sign a contract unless you know what each term means and how it can affect your organisation if the other party seeks to enforce it. Some of the many fine print terms that could cause problems are:

- *Confidentiality:* how to keep your confidential *information* confidential?
- *Dispute resolution:* how will disputes be resolved? The 'softer' word 'issue' is often substituted for 'dispute'.
- *Entire agreement:* how do we try to make *only* the promises in the document form the terms of the agreement, and seek to exclude all prior verbal and written agreements?
- *Force majeure:* how will temporary interruptions be treated?
- *Guarantees of performance:* what guarantees will you get?
- *Indemnity:* what will the party supplying the goods &/or services do, or not do, if they cause your organisation physical damage / monetary loss in the course of the supply? NOTE: extreme care must be taken here as getting this clause wrong can result in substantial loss.
- *Insurance:* who needs to take it out and what about damage by sub-contractors / *assignees*? This clause should be considered with the indemnity clause.
- *Intellectual property:* who will own the intellectual property, called 'IP' (copyrights, *trademarks* etc), and created under the contract?
- *Jurisdiction:* where will litigation be held and which law *will* be used?

Risk No 10 – Not taking into account potential risks

If risk is the effect of uncertainty on the organisation's objectives, has the necessary preparation and research, (including a due diligence investigation of the background of your contracting party and their finances) been made? Have you considered outsourcing and/or the use of insurance? If you do, see if any new risks have emerged, and what can be done to reduce or eliminate them.

Risk No 11 – Unauthorised variations

Have variations been fully documented and correctly approved by an authorised signatory from the other contracting party? Disputes can be reduced if you correctly complete the paperwork before you start on any variations.

Risk No 12 - Lack of clear understanding as to what is expected from the parties

Both the buyer and the seller need to have a clear understanding of the project, and the obligations of each party. Thus, the project must be thought through carefully and this includes the inclusion of risk reduction strategies. Unless there is a good reason to do so it is foolish to enter into a contract if it does nothing to help meet corporate objectives. The terms (that is, the promises made by each party) of the contract need to be reduced into writing and done so in a way that the written document reflects what the parties intended. It is preferable to use an 'entire agreement clause' to ensure that the entire agreement is only in the written contract, and not in an alleged 'Joe said it was OK' verbal promise.

Risk No 13 - Disregarding the agreement

If you disregard the agreement, you are breaching a promise, called a 'term' by lawyers. The automatic remedy for a



breach of a term is monetary damages. Damages are provided to return the injured/innocent party to the position it would have been in had the contract been complied with by the party

breaching it. If the breach is a breach of an essential term, that is it is a major term going to the root of the contract, then the injured party may also be legally able to walk away from (that is, terminate) the contract. This means that any outstanding or re-work may need to be completed by another party with the defaulting party

having to pay for the completion/rework, which can be costly for the defaulting party.

Risk No 14 - Terms are more onerous on one party than the other

If the terms are more onerous on one party then that party may later seek ways to exit the contract and/or cut corners to make a profit (or to reduce losses). If the party is pushed too hard, it may even collapse financially. This occurred with GMH and Ford with the collapse of Ajax Fasteners in August 2006 where the two auto manufacturers had to fly in parts for the USA to keep their assembly lines moving as there were no other local suppliers of this particular product.

Risk No 15 - Ineffective monitoring

Ineffective monitoring results in deviations from what was agreed upon, and the more ineffective the monitoring often the more pronounced the deviations. Often the greater the duration of the deviations, the harder and more difficult (and expensive) it is to get back to where you originally agreed to be. Thus, buyers need to incorporate milestones into the contract and ensure that they are complied with. Buyers need to formally follow up any non-compliance as failure to do this may be seen by the courts to have been a variation of the contract in favour of the vendor, and this is even if the contract requires all variations to be in writing. This is something that you definitely do not want to occur! Furthermore, the agreement should state that payment will only be made upon deliverables being successfully met.

Risk No 16 - Lack of awareness of enduring terms in the contract

Despite the deliverables in a contract being delivered, the contract often endures for a lengthy period thereafter. This is because of warranties, insurances, retentions, intellectual property and confidentiality clauses. Know what your rights and obligations are with each of these enduring deliverables. Be able to quickly locate documentation relating to these enduring contractual terms.

Risk No 17 – Not getting the best out of the negotiated contract

Contracts and variations need to be negotiated, but often there is a lack of preparation and understanding of the methods of negotiation. Unfortunately, many negotiators do not leave their egos in their offices. It makes no sense in upsetting the other negotiating party, who could be a good client or supplier. Try to be informed and negotiate from a position of strength. Determine who has the bargaining power at the time of the negotiation.

Risk No 18 – Making the same mistake over and over again

Research shows that the same mistake is often made over and over, causing unnecessary expense, loss of profit and waste. What are you doing to ensure that the same mistakes are not repeated?

Risk No 19 – Losing key contractual documents

Are key documents, including the signed contract, filed so at a later time they can be located when required? Will you be able to quickly locate key documents? Is this an electronic system that warns managers of dates, events and problems?

Conclusion

A major problem facing senior management with commercial contracts is the very real possibility of a buyer or seller employee exposing their organisation to potentially catastrophic litigation through everyday commercial contracts. With outsourcing becoming more prevalent this trend is likely to continue. To reduce both the likelihood and consequence of such problems the organisation needs to implement well-planned and monitored risk management program.

The training of staff involved in negotiating, advising on, writing and monitoring contracts is a vital part of this risk management strategy.

Tim Cummins, the CEO of the International Association of Contract and Commercial Managers (IACCM) wrote: *"Organisations which don't manage their contracts*

effectively will be at a tremendous competitive disadvantage". Rephrased he is saying that organisations that have well trained contract management staff and a contract management process in place can save time and money and therefore have an advantage in the marketplace.

About Cyril Jankoff, The Risk Doctor®

Dr Cyril Jankoff is an accountant and lawyer with management and education qualifications. He has been involved in creating, negotiating, writing, managing, terminating and litigating contracts throughout his 30+ year professional career. As a contract risk management consultant and facilitates public and in-house courses at all levels in contract management-related areas such as:



- **Risk Mitigation** for Better Management of Commercial Contracts
- **Negotiating** for Better Management of Commercial Contracts
- **Contract Law** for Better Management of Commercial Contracts
- **Finance** for Better Management of Commercial Contracts
- **Systems and Processes** for Better Management of Commercial Contracts
- **Contract Negotiation and Drafting** risks.

What is the State of Your Contract Management System?

Go to www.TheRiskDoctor.com.au (see the Consulting Tab) for the free Risk Diagnostic to discover your three top contract management risks.

Free e-Newsletter

Contact The Risk Doctor to subscribe to his **free e-newsletter** which contains tips on identifying and mitigating contract management risks

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