Purchasing Contract Law

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Who Can Form A Contract

• Apparent Authority – anyone!
  – Can result in huge issues
  – Unauthorized employees who contract with 3rd parties can be found *personally* liable by their employer and the third party!

• Real Authority – those who are authorized inside the company
  – Purchasing
  – Corporate Officers
  – Procurement Card Holders
What is a Contract

• A contract is comprised of:

- Offer
- Acceptance
- Consideration
Elements of an “Offer”

1. A promise or commitment

2. Using words or conduct that indicates intent to contract

3. Which is communicated to the other party
Elements of Acceptance

1. Words or conduct that indicate assent to the offer (i.e. intent to be legally bound)

2. Communication to the other party (usually!)
Consideration

1. Something of value for both parties
   - What the parties bargain for

2. An exchange of value
   - Can include promises
Test Your Understanding

• True story:
  A man is in a bar and finds he has a high value winning lottery ticket. In his excitement, he tells the bartender that he will give her $5,000, for which there are many witnesses. He later rescinds this offer and she sues him for the money.

• Who do you think won in court? Why?
What Forms a Contract Can Take

• Oral – least desired format
• Written – does not have to be in formal template or in “legalese” to be legal
• Behavior – your behavior can both create and modify a contract

• Warning! LOIs and MOUs are both contracts
• Warning! All RFX’s should be noted as a solicitation for an offer
  – Otherwise they may be construed as an offer and a supplier can accept! (see Appendix)
UCC Primer

• Uniform Commercial Code, Article 2 has been adopted in some form by all the states
  – Louisiana is only exception

• Applies to purchase of goods only
  – Unless you opt out, in cases where CISG applies

• Common law applies to services
  – Developed based on past court decisions and precedents set by judges, rather than through legislation
CISG Primer


• CISG only applies to international sales between adopting countries (77+ countries)
  – Major exceptions: Brazil, Hong Kong, India, South Africa, Taiwan, & UK

• If international contract with CISG countries, CISG automatically applies
  – Unless the agreement specifically disclaims the CISG from applying
  – “The parties hereby agree that the United Nations Convention on Contracts for the International Sale of Goods will not apply to this contract.”

• Most U.S. companies opt out of using CISG
  – UCC has substantially more case law and most believe it is more purchasing friendly
Long Form vs. Short Form Contracts

- Short Form = Purchase Order
- Long Form = Long form goods, goods & Services, or Services agreements
- Long form contract triggers:
  - High contract value (company specific)
  - Intellectual property
  - Non-standard software
  - Strategic supplier
  - Goods being purchased are high risk (e.g. toxic chemicals)
  - On site services, complex or recurring service arrangements
Using a P.O. as the Contract

• Understanding the “Battle of the Forms”
  – Buyer sends PO with Ts and Cs “no other terms and conditions shall apply” (unless long form contract in place)
  – Seller sends acknowledgement with Ts and Cs “no other terms and conditions shall apply”

• UCC \( \Rightarrow \) conflicting terms are replaced with “gap fillers”
  – Generally favor the Buyer, therefore the risk is less

• Common Law uses “Last Shot” rule

• CISG has 2 scenarios
  – Limitations or modifications = rejection & counter-offer
  – Additional terms that do not materially alter offer = Acceptance (unless offering party objects!)
Insider Secrets!
Free up to 75% of Your Time

• The contract doesn’t “know” what you are buying…
• You must customize the contract to
  – SET expectations, PREVENT excursions, and PRE-DEFINE remedies
• You must do a comprehensive “what could go wrong” analysis with your customer, and any other key stakeholders
  – Step 1 ➔ Reverse engineer these issues into a SOW component, Spec component, or performance criteria and include in contract
  – Step 2a ➔ If objective, set measurement
  – Step 2b ➔ If subjective, state in contract that “purchasing shall have exclusive right to determine if this deliverable was met”
  – Step 3 ➔ If this deliverable is important to you, add language that says “failure to perform to this deliverable to Buyer’s satisfaction shall constitute a material breach of contract”
  – Step 4 ➔ PRE-DEFINE in the contract what the remedy is for breach of this deliverable, including a price reduction if so necessary
Terms & Conditions Review

Risk of contention will be shown for each clause

⇒ this represents the *average expected risk* ⇐
Definitions

• Any terms that are subject to interpretation should be defined in the contract
• Thereafter, those terms should have the first letter capitalized to establish definition
• Supplier’s desire: Define important terms possibly to their benefit
  – Case study will exemplify this!
• Your desire: Ensure all terms that are open to debate are correctly defined
Term of Agreement

• Length of agreement
  – May be backdated or forward dated!
  – Certain clauses may survive the agreement
  – Contract can be evergreen – doesn’t expire
  – Does not need to expire to be renegotiated

• Supplier’s desire: long term agreement

• Your desire: *right* term agreement, with cancellation rights (see: Termination)
  – Along with Survival stipulation on certain clauses
Payment

• Supplier’s desire:
  – Clock starts when they *send* an invoice
  – Clock stops when they *receive* payment
  – Net 30 (usually)
  – **WARNING!** Suppliers that offer steep discount for immediate payment usually cause BIG problems

• Your desire:
  – Clock starts upon receipt of an *acceptable* invoice by AP
  – Clock ends upon *payment transmission* by AP
  – Net 60 + discount options for early payment (e.g. 2/10 Net 60)
Termination

• Termination for Cause
  – Termination may only happen for predetermined reasons

• Termination for Convenience
  – Termination for any reason with written notice

• Supplier’s desire:
  – Bilateral termination for cause only

• Your desire:
  – Unilateral termination for convenience only
  – Unilateral termination for cause to minimize financial exposure (bilateral only for repeated lack of payment)
  – May need to negotiate liquidated damages
Liquidated Damages

• Pre-negotiated damages for predictable occurrences

• Example:
  – 1,000 widgets in a 17 step manufacturing process are cancelled by buyer

• Supplier’s desire: Buyer pays full price for all units

• Your desire: Liquidated damages in place defining cost at each step of manufacturing process
  – With each step defined in the contract!
Direct & Consequential Damages

- Direct Damages (DD) – Happen in close time and proximity to event causing the damages
- Consequential Damages (CD) – Happen following event, but not in similar time & not limited by location
- Supplier position: DD are limited to value of contract and CD are excluded altogether
- Your position:
  - Stay silent on issue of CD/DD in contract
  - Do not agree to limitation of liability clause
  - Red Flag ➔ If supplier does not ask for LOL but wants insurance requirements lowered
Direct & Consequential Damages Example

- $1,000 Electrical surge device on manufacturing floor malfunctions and becomes inoperative
- Causes manufacturing equipment to be seriously damaged and for production to be halted for 1 week
- Manufacturing repairs amount to $50K
- Lost profits amount to $100K
- Labor costs to clean up the clean room manufacturing floor was $1,300
- Which are direct damages and which are consequential damages?
Indemnification

- Indemnification = “Hold harmless”
- Indemnity has someone agreeing to hold another harmless for certain specified claims, losses or damages
- Need to be clear:
  - who is indemnifying whom
  - what is being indemnified, *i.e.*, personal injury, property damage, intellectual property infringement, product defects, attorneys’ fees and costs of defense, economic loss
  - is there a monetary limitation on the extent
- Supplier’s desire: to limit indemnification or to introduce a limitation of liability on said indemnification
- Your desire: Indemnification language in place that
  - protects against claims by third parties, with full risk shifting to supplier for things they should be responsible for
  - ensures that supplier’s insurance company defends your company
Force Majeure/Contingencies

• “Acts of God” that impede ability to perform contractual obligations
• Supplier’s desire: include labor strikes, late deliveries, bad weather, materials shortage, etc
• Your desire: limited only to true disasters that are 100% not in supplier’s control
  – e.g.: war, hurricane, tornado, etc.
  – Clause should be bilateral (buyer payment)
Headings

• States that the headings for each clause have no legal value
• Supplier’s desire: Have pleasant or misleading headings for otherwise undesirable language
• Your desire: Have headings that accurately describe the clause contents
Applicable Law

• Supplier’s desire: Usually, the law of the state in which they are headquartered or are doing business

• Your desire:
  – In order: NY, CA, Delaware, then the state in which you operate, and then any other state except Louisiana
  – Reason: NY, CA, & Delaware are the most likely to make their ruling based exclusively on what’s in the contract

• As opposed to assessing industry practices and course of past conduct ➔ the “4 corners” rule
Demand Forecasts & Liability Management

• #1 Rule: Good faith information transfer
  – Data exchange should be accurate and timely
• Detrimental reliance can arise when forecasts exceed actual
• Never “tell” a supplier to do anything that may involve investment or liability
• Focus on desired outcome, not desired process, ex:
  • Yes: “we need replacement parts available with 2 hours notice”
  • No: “we need you to establish a parts hub next to our plant so we can get parts with 2 hours notice”
INSIDER SECRET!
Demand Forecasts & Liability Management, cont.

• Monitor what % of a supplier’s business your company is and will be

• Rule of thumb:
  – Anything over 25% needs attention
  – Anything over 35% is a red flag

• Always use disclaimer verbiage expressly written on every forecast provided
  – See Appendix
Independent Contractor

- States that the agreement does not create an employer/employee relationship between the parties
- Warning! Not having this clause can put you at risk of a co-employment lawsuit

Temp Workers At Microsoft Win Lawsuit
Dec 12\textsuperscript{th}, 2000 - Microsoft agreed to pay $97 million to settle a class-action lawsuit in which thousands of temporary employees accused the company of improperly denying them benefits.
Mergers, Modifications, Waivers, & Remedies

- Clause states that:
  - This contract is the *entire* agreement between the parties
  - Supersedes all other discussions & correspondence
  - Any amendments must be signed and attached

- This clause is your best friend and worst enemy!

- **INSIDER SECRET!** You may reference supplier’s brochures as part of contractual performance criteria (see [Appendix](#))
Doing Addendums & Amendments

• Addendums: adds new information not already covered in standard contract
  – SOW, specs, pricing, additional clauses, etc
• Amendments: modifies existing information in the contract

• Warning! Do not simply delete and modify the language in your standard contract
  – Option 1: Do an amendment OR
  – Option 2: Modify, but use ‘track changes’ mode so changes are readily evident
INSIDER SECRET!

MFC Pricing

• This clause answers the question “how do you know you got the best price possible?”
  – Saves LOTS of time benchmarking & cost modeling
• MFC = Most Favored Customer, indicates no other customer is getting a better price
• Supplier’s desire:
  – 1st Choice: MFC clause not present in contract at all
  – 2nd Choice: MFC “for like volumes” is present AND
    • no audit rights or long lead time on audit notice
    • ambiguous verbiage that allows supplier pricing leeway

* Depending on MFC type & volume being purchased
MFC Pricing, cont.

• Buyer’s desire:
  – MFC pricing *independent of volume*
  – Audit rights included
    • Audits may be done with “reasonable notice”
    • Buyer pays for audit *unless there are findings*

• Key Notes:
  – MFC – x% is illegal and should not be pursued
  – Supplier may not be asked to exceed GSA pricing, but they can meet it
  – MFC clause can be broken down to raw materials level if custom components are being purchased
Warranty

• A Warranty simply promises that something is true
• Express warranty = terms are expressly written in contract
• Implied warranty = not written, but implied – e.g., a toaster should toast and a car should drive
• Supplier’s desire:
  – Have a warranty that is limited by time, scope, incidental expenditure, and remedy options
UCC Implied Warranties

• Warranty of Merchantability
• Warranty of Fitness for a Particular Purpose
• Warranty of Title
• Warranty of Non-Infringement

Question: What does it mean when the supplier writes a clause in capitalized font?
Warranty, cont.

• Buyer’s desire:
  – Have a **customized** warranty that spells out exactly what is provided, who will pay, and how breach of warranty will be remedied
    • Including supplier response time, who pays for incidental expenses, & total time frame to closure

• What’s wrong with this clause?
  – “Supplier warrants that this equipment will be in good working order for 3 years. If the product should fail for any reason, supplier will make best efforts to remedy.”
New Developments

• Contract clause that covers IP ownership for any new developments that transpire as a result of contract
  – Copyrights, Patents, Trade Secrets

• Train your engineers on how IP can develop!
  – Trigger activities: NRE, technical brainstorming and idea sharing

• Supplier’s desire:
  – No IP clause or supplier friendly IP clause: Buyer pays for the IP and supplier gets to keep and use it
  – Supplier will want ownership for previously developed technologies (implied, but they may want expressly stated)

• Buyer’s desire:
  – If you pay for it, you get to keep it
  – OR you get a steep discount or royalty if you allow supplier to use

Risk of Contention*

* Completely depends on situation
Confidentiality/Publicity

- Describes in what manners both the contents and the existence of the agreement may be disclosed to third parties

- Supplier’s desire: Freely use buyer’s company name in advertising & customer presentations

- Your desire:
  - Control whether or not name can be used in advertising and negotiate price reductions if so
  - All confidential information is transmitted via your firm’s corporate non-disclosure document/process
INSIDER SECRET!
How to Ensure Suppliers Don’t Mark Up Your Contracts

• Send a copy of your standard Ts and Cs with your RFX documentation
• In your RFX Documentation, include a score card that indicates how their response will be graded
• Make “# of requested changes to standard contract” a major category; ex below

<table>
<thead>
<tr>
<th>Bid Response Category</th>
<th>Decision Weighting Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>30%</td>
</tr>
<tr>
<td>Warranty</td>
<td>27%</td>
</tr>
<tr>
<td>Lead-time</td>
<td>18%</td>
</tr>
<tr>
<td># of requested changes to purchasing’s standard contract template</td>
<td>25%</td>
</tr>
</tbody>
</table>
Post Contract Management
Post Contract Management

• You are not done after the contract is signed!
• 1 copy to you, 1 to the supplier
• File is kept in ONE place and managed by ONE person, preferably in a secure online location
• Having a contract database allows free purchasing access and best practices sharing
• Performance to contract can be accessed, measured, and reported on in business reviews
Breach Recognition/Management

• The waiver principle – if you don’t respond, you’ve waived your rights!

• If you’ve “let it slide” in the past and then choose to enforce, courts may rule your past behavior has modified the contract!
  – Document & communicate ALL breaches to supplier

• Define breach type for important areas in the contract:
  – Material breach
  – Minor breach
Breach Recognition/Management, cont.

• Material breach – some major aspect of contract has been breached, destroying substantial value of purchase
• Minor breach – some minor aspect of contract has been breached, not destroying value of purchase
• Anticipatory breach – supplier has not yet breached contract, but you have reason to believe they will
• Which types of breaches are these?
  – Single pane windows are installed instead of dual pane
  – Payment to supplier is made 2 days late
  – Purchasing reads in newspaper that supplier has all manufacturing personnel on labor strike
  – Business cards are printed with logo in wrong color
  – Office supplies delivery is one day late
  – Surgical supplies delivery is one day late
Breach Recognition/Management, cont.

- “Failure to perform to this clause shall be considered a material breach of contract”
- “Time is of the essence” = material breach
- If you know there is a breach, put it in writing:
  - What the breach was, when it happened
  - What part of the contract was breached
  - How the breach is to be remedied
    - Who is to fix, where, when, & who will pay for costs
  - Expectations for future performance and adherence to contract
  - If waiving remedy rights, expressly state this does not change your right to act on future breaches
INSIDER SECRETS!

Best Practices for Key Contract “Gotchas”

• Don’t Leave T’s & C’s for last in negotiations
  – Use RFX matrix and cover contract issues before price if any still linger
  – Tell supplier to give quotation based on your T’s and C’s

• Don’t tie payments to due dates for construction or non-standard software
  – Always tie payment to performance to documented acceptance criteria

• Don’t let Suppliers secretly contract with other divisions of your company, use this clause (Appendix)

• Don’t let contracts get overspent, use this clause (Appendix)

• Don’t say: “Partnership” ➔ Do say: “Relationship”

• Don’t say: “Leverage” ➔ Do say: “Negotiating Strength”

• Don’t say: “Penalty” ➔ Do say: “Price Reduction”
Test Your Knowledge – Case Study

• This is a **real** contract that an unauthorized purchasing employee of a company signed.
• The result of this contract was MAJOR, SERIOUS problems.

• Parties involved in contract ➔

![Diagram showing the parties involved in the contract: Licensor (Seller), Licensee (Buyer), Manufacturer (does not sign contract), Product Shipment, and LB Chip Specs.]
Case Study, cont.

- Get in teams of 3 – 5 people
- Take 60 minutes to read through contract handout
- Identify all issues with this contract
- We will do report out and review
Call to Action

• Spend time upfront to Customize contracts to SET expectations, PREVENT excursions, & PRE-DEFINE remedies

• Spend more time on supplier performance management and less time on supplier excursion management

• Use provided contract INSIDER SECRETS to slash contract negotiation cycle time and catapult results

• Empower yourself with contract knowledge and make the contract your ally!

You have the tools and the knowledge

*Now go off and do something wonderful!*
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Appendix

Useful Contract Clauses
RFX Disclaimer

• “Important notice: This is a solicitation for an offer and is not an offer to contract for goods or services.”
Forecast Disclaimer

• “Supplier understands that this is a non-binding forecast subject to factors outside of Buyer’s control, which may result in actual demand increasing or decreasing from figures provided.”
Supplier Warranty of Performance to Published Specifications

• “Pursuant to Supplier Brochure XYZ (dated x/xx), Supplier warrants that the product/service being provided to Buyer shall meet all of the performance specifications outlined in the above referenced brochure. Failure to meet these specifications shall be considered a material breach of contract.”
Customer Communication

• “Should supplier be contacted by any individual within Buyer’s company with intent to contract with supplier or purchase goods or services outside of the immediate scope of this agreement, Supplier shall immediately contact Buyer and advise him/her of this request and shall not proceed until such time that buyer provides express written approval. In such cases, Buyer reserves the right to renegotiate the contract to reflect this increased business.”
Retroactive Discounts

• “Should the expenditures against this contract for the stated contract term exceed the agreed upon contract value of $_______, Supplier shall immediately notify Buyer, and Buyer reserves the right to renegotiate the contract accordingly. Supplier agrees that any new and lower pricing arrangements negotiated shall then be retroactive to cover any such expenditures by which the contract was overspent, and Supplier shall provide prompt reimbursement or credit to Buyer, at Buyer’s exclusive discretion.”