



## “Best Practices” Newsletter Volume 26, October 2006

**About This Issue** - This October 2005 edition of our newsletter contains more techniques to help our clients & colleagues accomplish their strategic procurement objectives. Please excuse the delay since our last issue, but the significant increase in the number of subscribers necessitated a restructuring in our emailing technology.

Strategic Procurement Solutions is a consulting firm specializing in advanced Strategic Sourcing, Training, and Organizational Improvement services. Robert Dunn, C.P.M. & Mark Trowbridge, C.P.M. are principals in the firm who lead teams of professionals in supporting our procurement clients. More information can be found at [www.StrategicProcurementSolutions.com](http://www.StrategicProcurementSolutions.com).

**Note to Readers:** We are currently scheduling onsite training & consulting with clients for Q4, 2005 and Q1, 2006. Please contact us if you would like to reserve space in our schedule.

**Calendar Notice:** We'll be making a key presentation titled Building the Procurement Superhero...Innovative Practices in Professional Development at the I.S.M. Services Conference, Tempe AZ, December 1<sup>st</sup> and 2<sup>nd</sup>. Please drop by if you plan to attend that conference.

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### **Contract “Choke Points”... by Mark Trowbridge, C.P.M.**

Even though the parties may have agreed upon the basic *business terms* of their proposed relationship, many deals fall apart when negotiations swing around to the *legal terms*.

**This article will describe five “choke points” which are likely to cause a party to walk-away from a potential contract....and some ways to avoid them.**



To set the stage for our discussion, we first need to remind ourselves that a *contract is supposed to be the written expression of the agreement* between two or more parties. Anytime the document doesn't fairly reflect the legitimate business needs of both parties, it creates risk for them.

Rather than the one-sided contracts from the old days of purchasing, *many leading companies are now structuring their procurement contracts to contain fair and balanced*

terms & conditions that reflect a “win-win” relationship (but of course still provide legitimate protections for the buyer).

These agreements have proved to be easier to negotiate in a timely manner...and are helping the procurement organizations to be much more effective in concluding strategic sourcing events.

### Some guidelines to avoid contract “choke points”:

#1

**One-Sided Protections** – You’re guaranteed to have a fight if your contract document is highly one-sided. In reviewing many firms’ contracts for potential improvement, we sometimes find awful examples...in one recent example the client’s document required the supplier to *“obey all governmental laws and regulations affecting this Agreement and the Services provided hereunder”*...but didn’t require the client organization to do the same. A more reasonable approach might be to say *“Both parties will obey all laws and regulations affecting this Agreement”*.

#2

**Limitations on Liability** – Both parties’ potential liability should be limited to reasonable levels. Most companies prefer to limit their liability to **“direct” damages** which are the actual costs of correcting their failure to perform, and exclude exposure to “incidental” and “consequential” damages over which they have no control. *Earlier in my career, I managed a sourcing organization which performed high-dollar procurement negotiations with suppliers. Our employer was one of the largest banking organizations in the country, at the time processing 30 Million checks a day...more than the entire Federal Reserve Region in the Western U.S.* The potential “consequential” damages if a supplier failed to perform for us (due to *more than \$1 Million Dollars* in interest rate float being lost by the bank for *every five minutes of down time*), was more than any supplier could reasonably bear. Most companies are unwilling to be exposed to liability for their customer’s lost profits and should be shielded from such exposure.

#3

**Ownership of Intellectual Property Rights** – Many buyers’ contracts have clauses which transfer to them ownership of the supplier’s IP Rights (patents, copyrights, trade secrets, etc)...in some cases hidden within the document in various places. *For example*, Strategic Procurement Solutions presents our proprietary onsite supply management training programs to private-sector firms and public-sector agencies. Most clients are happy to sign our standard agreement, because it fairly represents both parties’ interests. But recently, a Fortune 100 client sent us their own boilerplate agreement...which contained language giving them ownership of our IP Rights...i.e. the training materials we have worked years to enhance & perfect. That clause, and others like it, had to be rewritten after several rounds of negotiations...but it nearly caused us to walk away from a large engagement.

#4

**Source Code Escrow** – This potential “choke point” is similar to IP Right Ownership above...but has some key differences. This clause specifically is used in software licensing transactions, which typically relate only to “object code” (or machine-readable language). Some licensees want to have a copy of the source code in an “escrow” account just in case the supplier goes out of business...to ensure they can continue to modify and use the software.

**Problems with demanding source code? You bet:**

- The source code is the lifeblood of the software firm’s business. Source code is the family jewels. If their competitors were to receive the source code, their marketplace advantage would be erased.
- Having access to source code greatly increases the odds that the customer will be brought into a lawsuit in the event confidentiality is ever breached (by them or someone else having access). If you never had it, you can’t be sued for releasing it.
- Although legal opinions vary, many experts believe that if the supplier does have financial difficulties the source code won’t be allowed out of escrow by a bankruptcy court (since the code is an asset of the company). Smart companies are now using other techniques to get around this problem.

#5

**Confidentiality** – *Every buyer’s contract should protect their confidential information*, but it is reasonable for the supplier’s own proprietary information to also be protected (since the buyer is exposed to the supplier’s trade secrets too). Some language we review in buyers’ contracts is remarkably unfair on this topic.

Some clauses are so one-sided that a supplier is held to a higher standard than the buyer maintains internally for their own employees who handle the same confidential information. *I once asked a firm’s general counsel if they would sign the same confidentiality language they required their suppliers to accept...and they had to say “no”. A week later, the procurement group received new “balanced” confidentiality language from the Legal Department to include in all their contracts.* Definitely have confidentiality language, but make it possible for your suppliers to honor the contractual limitations. And consider adding language that protects the other party’s own confidential information too...

**Suppliers may react in several different ways when they see a “choke point” in a contract:**

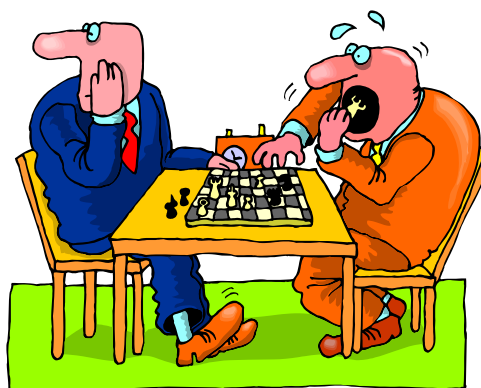
- (1) They may walk away from the deal entirely;

- (2) They may adjust their pricing to mitigate the increased risk;
- (3) They may turn the whole contract over to their own attorneys, who are likely to renegotiate many more sections than just the “choke point”; or
- (4) The supplier may insist on using their own contract as the basis for negotiations.

**As you can see, approaching your suppliers with a fair & balanced contract can improve the success of your negotiations. Talk to your own counsel about structuring agreements to represent the business interests of both buyer & seller.**

Much more information about building balanced contracts is available through **Strategic Procurement Solutions’** onsite training program titled “Strategic Contracting”. Please contact us at [www.StrategicProcurementSolutions.com](http://www.StrategicProcurementSolutions.com) if you’d like an outline of the program’s content.

**Higher Standards Needed – Supply Management Ethics...** by Robert Dunn, M.B.A.



With the implementation of Sarbanes-Oxley (USA) and other similar legislation in other countries, greater scrutiny is being applied to how supply management groups are conducting their businesses.

But this isn’t new. Procurement has always been a career path requiring a high degree of integrity. Anytime you have people controlling of **Millions...or Billions** in expenditures, careful procedures and controls must be in place to govern the organization. **But even more importantly, ethical people must first be working within the organization.**

**This article will examine five categories of “Ethics” exposure every procurement organization faces. We’ll also discuss ways that ethical behavior can reduce the risk your organization may bear.**

#	Ethics Category	Ethical Practices
1	Conflicts of Interest	Care must be taken to ensure no conflicts of interest are present for the personnel who manage supplier relationships. Examples might be (i) owning stock in a supplier company; (ii) having a spouse employed by, or owner in, a supplier company; or (iii) having close relationships with the sales personnel for a supplier company. Your procurement policies & procedures should have guidelines to ensure such conflicts do not occur.

2	Acceptance of Gifts & Gratuities	Different business sectors have varying standards for the acceptance of gifts or gratuities from suppliers. Most public sector organizations are more strict than their private sector counterparts. But one guiding principle should prevail...no gift or gratuity should be accepted which could blur the objectivity that must be maintained by the supply management professional.
3	Honor & Obey Both the Letter and Spirit of All Laws & Regulations	It stands to reason that procurement activities must be carried out in full compliance with the law. But there are other practices which, although they may be legal, are not ethical. These are known as “sharp practices”, and violate the spirit of the underlying legal system. <i>One example of a “sharp practice” might be to knowingly exaggerate purchasing volumes to a potential supplier to extract a lower price.</i> Unfortunately, this particular example occurs far too frequently in today’s supply management environment...but only serves to undermine the professional integrity of the persons involved.
4	Loyalty to the Organization	Second only to obeying the law <u>and</u> maintaining their own professional integrity, is the supply management professional’s responsibility to be loyal to their employer. Ethical compromises occur if the procurement representative improperly takes the side of the supplier or acts to benefit any third party.
5	Carefully Handle Confidential or Proprietary Information	The supply professional must take great care to preserve the confidentiality of both their own organization’s and their suppliers’ proprietary information. Failure to do so can create disasters, both from a financial and liability perspective. Policies & procedures need to be created for the buying organization to guide its handling of confidential information, and to ensure such information is only exposed to those having a valid “need to know”.

The need to focus more attention upon ethics in supply management is just a small part of the larger need for ethical standards in large businesses and public sector organizations. With major accounting & ethical standards bringing down firms like Enron, Worldspan, etc...companies are paying greater attention to the ethical standards they have in place for their operations.

Business Ethics Magazine has reported that the number of “Ethics Officers” in place at high levels within major companies will more than double during the next four years. CFO.com recently surveyed more than 100 senior ethics officers who attended The Conference Board’s Annual Business Ethics Conference, and found the following:

- A majority of ethics officers expect that at least a half dozen more “major” business ethics scandals will emerge during the next 12 months; and some expect more than 20 such cases. “Major” is defined as events causing more than \$200 Million (USD) in lost shareholder value.
- Nearly 60% say that their own board of directors is not engaged enough in ethics/compliance issues.
- 59% believe their ethics/compliance program reduced the likelihood “quite a bit” or “a lot” that a major ethics scandal will take place at their company.

**Does your organization have an enterprise-wide ethics program? *If so*, build your supply chain ethics program to *enforce* those ethical standards with regards to all supplier relationships...and involve your ethics and/or audit officers in the process. *If not*, the procurement organization should still create & enforce strong ethical policies & procedures.**

Members of the Institute for Supply Management (USA) adhere to the organizations’ “Principles and Standards of Ethical Supply Management Conduct”. These principles can be viewed at <http://www.ism.ws/ismmembership/principlestandards.cfm> and are general examples of ethical guidelines for the supply management arena.

For support in developing detailed Ethics Guidelines and content for supply management Policies & Procedures, please feel free to contact **Strategic Procurement Solutions**.

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**Editor’s Note:** **Strategic Procurement Solutions’** objective is to provide top quality supply management services to client organizations in the private & public sector, and to enable those clients to exceed their internal users’ expectations regarding promptness, price, and quality. One means of doing this is through this educational newsletter, which provides bi-monthly articles about “Best Practices” in procurement. Contact us at [www.StrategicProcurementSolutions.com](http://www.StrategicProcurementSolutions.com) for more information about our services, or if you do not wish to receive this newsletter in the future.