

Writing Subcontracts With Partners: Are They Necessary?

Dr. George L. Harris, C.P.M., CPCM
President
gharris@calyptusgroup.com

This paper discusses: (1) the necessity to document the details of an agreement between business partners; (2) a proposed method of determining the extent and use of contractual instruments for purchases of products and services; and (3) an outline of a partnership's business terms will be given for use by contract professionals.

If you ask any purchasing professional, legal counsel, or contract manager for their opinion on whether subcontracts or purchase orders should be in place for suppliers or subcontractors, their answer will be a resounding "Yes." Almost everyone agrees that a definitive and written contract should be agreed upon by the parties. The Statute of Frauds mandates written contracts for purchases of products over \$500. In fact, most contracting professionals are in the business of providing contract advice and assistance in the development and negotiation of these contracts. Contracts and purchase orders for services are also drafted and negotiated. Most people agree that contracting for services requires more effort, since there are substantial financial and performance risks involved. Through our consulting and training practice, we have learned that the only exceptions are due to company philosophy, cultural differences, and lack of focus and personnel.

Company Philosophy

Some companies (and their contract professionals) share a common philosophy that formal contracts are wasteful because, ultimately, the reputation of the parties is at stake; and, if there is contract default, few companies will take the poor performer to court due to the high cost of doing so.

Cultural Differences

Cultural differences play a major role as well. For example, while working with a Japanese company, we learned that written contracts with suppliers are not used, even when those suppliers are sole source providers, and the company represents 100% of the supplier's business base. Typically, these relationships have been established over the long-term, and the failing party would lose "face" in the business community.



Lack of Personnel and Focus

Lack of personnel and focus may also result in few written contracts, particularly in small start-up companies where informal systems have benefited the organization in developing new products and meeting customer demands.

These contracts, established to protect the interests of the parties, describe the limits of risks, required terms and conditions, and indicate the terms if a contract is canceled or terminated. In the typical purchase, both parties maximize their positions in the negotiation process and sometimes settle for win-lose solutions depending on their negotiating power and prowess.

There is disagreement, however, on the extent to which there should be rigorous contracts between “partners.” Partners are entities which contract with each other to satisfy mutual market objectives, such as when a electronic distributor contracts to manage the planning and purchasing of all electronic components used by a manufacturer. In this case, the buyer is able to free up administrative resources to manage more significant purchases and the supplier grows its business base by being a full service provider.

In our discussions with subcontract, purchasing, and contracts professionals, and through our training efforts, we have developed a template for evaluating the necessity for rigorous contract terms and conditions. Consider the following model:

		Risk	
		Low	High
Expenditures	Low	Use Standard Purchase Order Terms	Use Standard Purchase Order Terms, plus add clauses pertaining to acceptance, inspection, monitorship, approvals, and termination
	High	Use Standard Purchase Order Terms, plus add clauses pertaining to cycle-time, quality, and delivery reduction and performance	Draft and Negotiate Specialized Contract (Partner)

Expenditures would include both the direct out of pocket costs but also the administrative time required to manage the supplier relationships. Risk would include



technical, financial, possibility of failure, and time/schedule as well the number of potential suppliers for the product or service.

Low Risk – Low Expenditures. These are typically low dollar one off purchases and include off the shelf and standardized products/services. Standard terms and conditions included on the back of the purchase order should be used. This assumes that these terms are adequate and include any necessary customer flowdown conditions.

Low Risk – High Expenditures. These purchases are for commodity products, MRO materials, generic electronics, and computers. Protection should be provided to the buyer for delivery, ongoing quality, and cycle/lead times. In these cases, specific terms defining responsibilities of the supplier in these areas should be detailed along with the standard purchase order terms and conditions.

High Risk – Low Expenditures. These are for complex one of the kind parts and include purchases of focused services for software maintenance and security services. For these purchases, the use of standard purchase order terms plus specific coverage for inspection and acceptance, monitoring and approvals, and termination rights should be included.

High Risk – High Expenditures. These would include turnkey contracts, outsourcing projects, specialized software, and advertising. Formal and detailed contracts should be used to describe the roles and responsibilities of the parties. These are the contracts with partners.

I do recommend that formalized contracts be signed between partners. My reasoning, based on nearly 24 years of experience in materials and contracts, is as follows:

1. Rarely, the parties negotiating and signing the contracts are involved in the management of the contract over its life.
2. There is typically turnover in staff during the life of the agreement
3. The contract is tangible evidence of the relationship between the parties and many of the obligations survive the duration of the contract.
4. The contract is a living document which should be used by the parties to improve the product/service in terms of price, delivery, quality, and cycle time.

The partnership agreement should be a record of the discussions and negotiations between parties. The key terms of this agreement, in addition to key customer flowdown clauses, would include the following:

1. Costs
 - Target Cost
 - Value Engineering
 - Cost Reduction



2. Pricing
 - Initial
 - Targets
 - Sharing of Reductions
3. Design and Development
 - Integrated Product Development
 - Prototypes
 - Joint Development
 - Technology Sharing
4. Quality
 - Standards
 - Parts Per Million (PPM) Defects
 - Continuous Improvement
 - Certification
 - ISO/QS 9000
5. Delivery
 - On-Time Delivery
 - Just-In-Time
 - Deliverables
 - Worldwide Contract
 - F.O.B. Points/Issues
 - Forecasts
6. Financial
 - New Products
 - Payment
 - Electronic Funds Transfer (EFT)
 - Responsibility for Non-Recurring Engineering
7. Status
 - Reviews
 - Reporting
8. Ethics
9. Confidentiality
10. Duration of Contract
11. Sharing of Information
 - Technical
 - Management
12. Exclusivity
 - Percentages



- Causes for Variation in Quantities
- Forecasts
- 13. Termination
 - Convenience
 - Disputes
- 14. Disputes
 - Venue
 - Location
- 15. Release of Orders
 - Method
 - Tracking
 - Reporting

This list includes most of the business conditions of a partnership, some of which have legal connotations. It is important that both the business and legal conditions be evaluated and negotiated by experienced personnel of both parties to the contract. Be prepared to spend at least 3-6 months ironing out the details of the agreement. Because of the contract's implications, the parties will want to ensure that each side receives equality. That's the way to negotiate with partners.

In summary, formal agreements that document the terms and conditions of a partnership are important, due to their impact and duration of performance. Oftentimes, specialized contracts are negotiated even though the parties may be protected through other means. In the case of partnerships, however, the critical business terms must be delineated and the critical measures must be incorporated into a contract.

