

A thick, braided rope, likely made of natural fibers, is shown against a dark blue background. The rope is positioned horizontally, with its left end being a neat, braided section. The right end is frayed and unraveled, with many loose fibers sticking out, suggesting it has been pulled or broken apart. The lighting is dramatic, highlighting the texture of the rope.

**Simple, practical, and useful
information about commercial
contractual risk issues that you
can use as you engage in commercial
contractual risk review activities.**

By JOHN E. MILLER

**MANAGING
CONTRACTUAL**

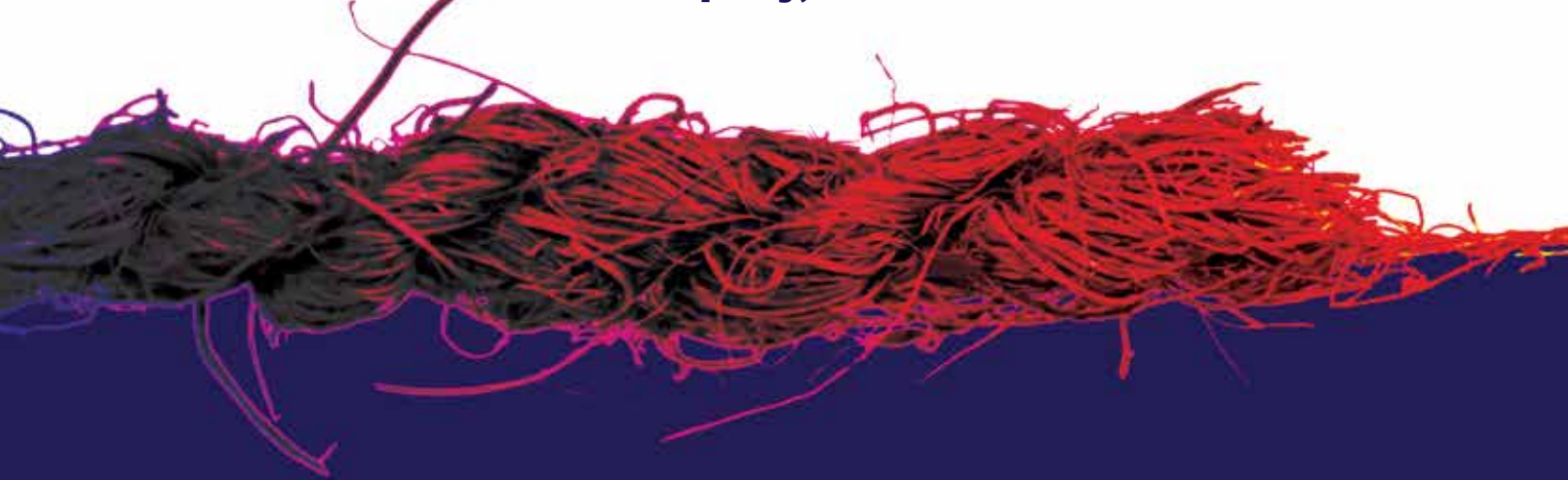
RISK

ISSUES

**in COMMERCIAL
CONTRACTS
MANAGEMENT**

We have a tendency to worry about risks. It's only natural. For example:

There is a story about a monastery in Europe perched high on a cliff several hundred feet in the air. The only way to reach the monastery was to be suspended in a basket which was pulled to the top by several monks who pulled and tugged with all their strength. Obviously the ride up the steep cliff in that basket was terrifying. One tourist got exceedingly nervous about half-way up as he noticed that the rope by which he was suspended was old and frayed. With a trembling voice he asked the monk who was riding with him in the basket how often they changed the rope. The monk thought for a moment and answered brusquely, "Whenever it breaks."¹



The old and frayed rope was clearly a risk that needed to be better managed.

Risk management is an important concept that mainly aims at identification, assessment, and prioritization of events that may have an adverse impact on an organization.² Risk management is defined as the logical development and carrying out of a plan to deal with potential losses.

A risk is a potential for a loss. The loss is the realization of that negative potential. A risk is running across a busy street blindfolded. A loss is getting hit by a car while doing that.³

The purpose of the risk management program is to manage an organization's

exposure to loss and to protect its assets.⁴ Napoleon is credited with saying:

I am used to thinking three or four months in advance about what I must do, and I calculate on the worst. If I take so many precautions, it is because it is my custom to leave nothing to chance.⁵

Business leaders understand as well as anybody that if nothing is ventured, nothing can be gained. At the same time, successful capitalists are seldom willing to take anything but well-understood and adequately managed risks. Publicly traded companies must report their potential operating risks every quarter when they report their results. Thus, risk management is a huge focus of any major corporate operation and encompasses

many different topics and approaches—as many as there are types of businesses.⁶

Risk management is quite broad in its overall scope and covers many varieties of risk, such as the following:

- Financial risks,
- Credit risks,
- Investment risks,
- Liquidity risks,
- Market risks,
- Operational risks,

“Perhaps the single-most important duty of contracts management personnel regarding a commercial contract is the accurate identification and proper treatment of commercial-related risk issues.”

SAVE THE DATE! FOR WORLD CONGRESS 2014

WORLD CONGRESS



July 27–30, 2014
Washington, DC

CALL FOR PRESENTATION PROPOSALS NOW OPEN!

Submit your presentation proposal for NCMA's World Congress 2014 and share your expertise, gain recognition as a leader in the profession, and earn continuing professional education (CPE) hours. Join other contract, acquisition, and procurement professionals; explore hard-hitting issues; and capture the best practices that shape smarter processes.

Proposal submission is simple. Visit www.ncmahq.org/wc2014/presentations for online applications and guidelines. The deadline for submission is February 3, 2014. Second-party submissions will not be considered.

**SEE YOU IN
WASHINGTON, DC!**

TIMELINE

February 3, 2014:

All presentation proposals must be received online.

March 7, 2014:

Notification of proposal selections by e-mail.

June 6, 2014:

Provide additional co-presenter names by e-mail (if applicable).

June 20, 2014:

Complete and submit NCMA World Congress registration and make hotel reservations at the Gaylord National Hotel and Convention Center.

June 30, 2014:

Final PowerPoint presentations and speaker permission form due by e-mail.

**LEARN MORE TODAY AT
WWW.NCMAHQ.ORG/ATTENDWC2014**



National Contract Management Association • 21740 Beaumeade Circle • Suite 125 • Ashburn, VA 20147 • www.ncmahq.org

“To survive and thrive in today's challenging business environment, all contractual parties need to increasingly make commercial contractual risk management a very high priority.”

- Fraud risks,
- Process risks,
- Time risks,
- Information technology risks,
- International risks,
- Political risks,
- Intangible risks,
- Human risks,
- Security risks,
- Healthcare risks,
- Physical risks,
- Legal risks,
- Ethics risks,
- Tax risks,
- Compliance risks,
- Government contract risks, and
- Commercial contract risks.

The scope and focus of this article only addresses commercial contractual risks within the broad topic of risk management. Although this article does not address government contractual risk management, many of the concepts presented in this article are adaptable, to some extent, to government contractual risk management.

Perhaps the single most important duty of contracts management personnel regarding a commercial contract is the accurate identification and proper treatment of commercial contract-related risk issues. In your commercial contracts management activities supporting the seller or buyer of products and/or services (or other contractual parties), it is absolutely certain that you will be required to identify, review, analyze, evaluate, mitigate, manage, neutralize, and/or eliminate the contractual risks of an agreement.

In my contracts management career, I have performed such a commercial contractual risk review many times. The purpose of this article is to provide some simple, practical, and useful information about commercial contractual risk issues that you can use as you engage in commercial contractual risk review activities.

BACKGROUND

Companies and other entities must take contractual risks.⁷ As Mark Twain (allegedly) said:

Twenty years from now you will be more disappointed by the things you didn't do than by the ones you did. So throw off the bowlines, sail away from the safe harbor, catch the trade winds in your sails. Explore. Dream. Discover.⁸

However, you still need to manage the risks as you pursue those explorations, dreams, and discoveries. According to Theodore Roosevelt: “Risk is like fire: If controlled, it will help you; if uncontrolled, it will rise up and destroy you.”⁹

There are a couple of broad categories of commercial contractual risks:

- *Liability risks*—e.g., breach of contract issues, claims, warranty problems, terminations, intellectual property infringement charges, alleged confidentiality disclosures, disputes, and litigation; and
- *Business risks*—e.g., poor relationships, failure to obtain objectives, bad public relations, declining morale, instability, weakening of brand integrity, loss of goodwill, and reduced revenue or profits.

DEFINITION OF COMMERCIAL CONTRACTUAL RISK MANAGEMENT

Commercial contractual risk management involves the calculated actions to reduce the severity, frequency, and unpredictability of damages, losses, and claims. However, it also involves, to some extent, managing the occurrence of those other negative business events. Such risks could be anything that threatens business operations. Commercial contractual risk management can be strategic (systematic and ongoing) or operational (single transaction).

WHO NEEDS TO KNOW ABOUT COMMERCIAL CONTRACTUAL RISK MANAGEMENT?

The following entities need to be involved in commercial contractual risk management:

- Sellers,
- Buyers,
- Licensors,
- Licensees,
- Lessors,
- Lessees,
- Prime contractors,
- Subcontractors, and
- All other parties to a commercial agreement need to understand and practice good commercial contractual risk management.

To survive and thrive in today's challenging business environment, all contractual parties need to increasingly make commercial contractual risk management a very high priority.

TYPICAL COMMERCIAL CONTRACTUAL RISK MANAGEMENT DUTIES

Generally, the typical commercial contractual risk management duties include guidance, support, management, and leadership to accomplish the following:

- Assist your entity's management in understanding the risks,
- Develop and implement effective risk management strategies,
- Perform request for information/request for quotation/request for proposal risk management analysis,
- Be proactive in proposal participation regarding risk management,
- Perform contract negotiation to control risks,
- Engage in contract execution to manage risks,

Membership 101

Ever thought of joining the NCMA Board of Directors? Would you or someone you know be interested in joining this elite group? NCMA is accepting nominations through February 1, 2014.

Visit www.ncmahq.org/cm/board to find out more details and nominate yourself or someone you know today!

NCMA
NATIONAL CONTRACT MANAGEMENT ASSOCIATION

“In an increasingly volatile and uncertain marketplace, the high-performing entities will require good commercial contractual risk management.”

- Direct contract modification to address risks,
- Be persistent in contract administration to minimize risks,
- Perform effective contract management best practices regarding risks,
- Execute contract closeout to handle risks,
- Be innovative in risk management lessons-learned activities, and
- Engage in other related activities to control risks.

BENEFITS OF COMMERCIAL CONTRACTUAL RISK MANAGEMENT

Effective commercial contractual risk management often results in the following:

- Protecting assets,
- Improving stability,
- Improving long-term profitability,
- Safeguarding business reputations,

- Reducing insurance claims (as well as reducing premiums), and
- Protecting future opportunities.

AN APPROACH TO USE IN ADDRESSING COMMERCIAL CONTRACTUAL RISKS

Commercial contractual risk management should provide a clear, structured approach in addressing contractual risks. Also, such an approach is quite cost-effective in saving resources such as time, assets, income, and people. Commercial contractual risk management should be:

- Practical,
- Proactive,
- Clear and unambiguous,
- Systematic, and
- Be an integrated part of the entire broad range of risk management activities of an entity.

TYPICAL STEPS OF COMMERCIAL CONTRACTUAL RISK MANAGEMENT

Typically, commercial contractual risk management involves the following sequential actions (as appropriate):

- 1 | Identifying commercial contractual risk management issues using an appropriate multi-domain team (e.g., business, operations, sales/marketing, technical, contracts, legal, finance, etc.);
- 2 | Evaluating/estimating commercial contractual risk management issues (i.e., likelihood of risk and consequences of risk)¹⁰;
- 3 | Implementing risk avoidance (i.e., rejection of certain types of high-risk work, if appropriate);
- 4 | Engaging in risk reduction (i.e., selection of lower-risk clients that are financially sound and nonlitigious, as well as selection of lower-risk projects, if appropriate);
- 5 | Considering risk sharing by subcontracting/outsourcing (if appropriate);
- 6 | Using insurance to control risks;

- 7 | Applying risk mitigation by avoidance, elimination, transfer, or bearing the risk (if appropriate);
- 8 | Executing risk neutralization;
- 9 | Monitoring/controlling risk; and
- 10 | Consistently using well-prepared agreements/contractual provisions.

MANAGEMENT ASPECTS OF COMMERCIAL CONTRACTUAL RISK

Such risks can often be contractually managed to acceptable levels by using the following:

- Well-crafted, professional, specific contractual provisions suitable to the applicable agreements;
- Excellent contracts that are appropriate and targeted to the need;
- Commercial contracts risk management technology; and
- Appropriate contractual risk management processes.

TOP COMMERCIAL CONTRACTUAL RISK MANAGEMENT PROVISIONS

Of course, all aspects of an agreement can affect commercial contractual risk management; however, the following are the top commercial contractual risk management provisions of an agreement:

- Statement of work;
- Contract type (e.g., firm-fixed-price, time and materials, cost reimbursement, etc.);
- Compensation;
- Term/period of performance;

- Schedule;
- Inspection/testing;
- Acceptance criteria;
- Free-on-board point;
- Changes;
- Limitations of liability with issues such as monetary caps on liability and enforceability;
- Waivers of consequential, indirect, and incidental damages;
- Intellectual property indemnifications;
- General indemnifications with issues such as proportional, limited, intermediate, broad, reciprocal, enforceable, and first-party versus third-party indemnities;
- Insurance and bonds required (e.g., bid, payment, performance, warranty, etc.);
- Warranties and disclaimers;
- Standard of care (service levels);
- Termination (for default and for convenience);
- Confidentiality;
- Intellectual property use and ownership allocation;
- Work product use/ownership;
- Confidentiality;
- Force majeure;
- Antitrust compliance;
- International trade compliance;
- Dispute resolution;
- Price;

- Payment;
- Revenue recognition;
- Delivery and acceptance criteria;
- Quality;
- Safety;
- Health;
- Choice of law;
- Taxes/duties;
- Assignment;
- Written modifications only provision; and
- Entire agreement clause.

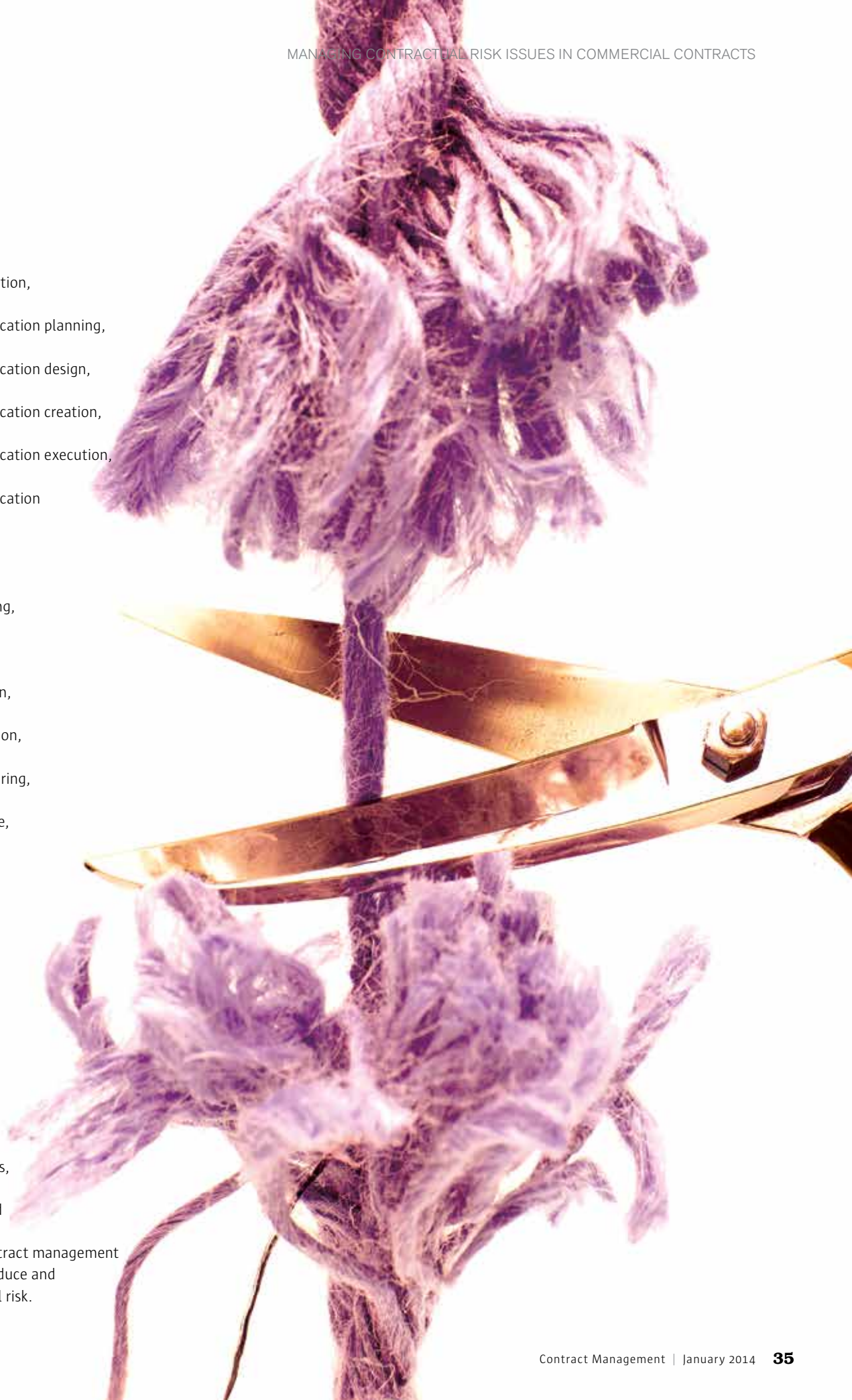
The language in each of these provisions needs to be very carefully crafted to ensure appropriate commercial contractual risk management. Attention must be given to the contractual and legal substance of these provisions as well as the form and format of the language of these provisions. Both are important.

COMMERCIAL CONTRACT MANAGEMENT TECHNOLOGY

Technology has its place in commercial contractual risk management. It is often a very quick return on investment to use one of the better commercial contract management software products to assist with contractual risk management. Commercial contract management software (whether hosted at your entity or set up online) can typically provide drafting assistance, scan, centralize, organize, search, track/monitor, create “ticker” alerts, create needed reports, and archive contracts. Commercial contract management software can also help reduce contractual risk when dealing with the following:

- Contract planning,

- Contract design,
- Contract creation,
- Contract execution,
- Contract administration,
- Amendment/modification planning,
- Amendment/modification design,
- Amendment/modification creation,
- Amendment/modification execution,
- Amendment/modification administration,
- Changes control,
- Subcontract planning,
- Subcontract design,
- Subcontract creation,
- Subcontract execution,
- Subcontract monitoring,
- Contract compliance,
- Budgets,
- Financial tracking,
- Checklists,
- Calendar,
- “Tickler” reminders,
- E-mail alerts,
- Scheduling,
- Tracking deliverables,
- Desired reports, and
- Cradle-to-grave contract management services that will reduce and manage contractual risk.





COMMERCIAL CONTRACTUAL RISK MANAGEMENT PROCESSES

It is vital to create, maintain, and improve good commercial contractual risk management processes such as the following:

- Use of good checklists;
- Consistent use of contract management best practices;
- Ongoing use of risk status scorecards (e.g., “red,” “yellow,” and “green”); and
- Application of other commercial contracts risk management processes that are also very important in efficiently managing commercial contractual risks.

Checklist PROCESS

The routine use of good checklists for the review, creation, and modification of agreements is critical. Checklists help you to consistently consider all the relevant issues. Good document review checklists and drafting checklists offer the benefits of ensuring consistent quality, providing a sense of completeness, and concurrently being a training tool for others.

A good checklist is also quite a time-saver in reviewing and drafting documents. Checklists must be continually updated and enhanced. The proper use of checklists can be vital in commercial contractual risk management.

Best Practices PROCESS

The ongoing use of the following commercial contract management best practices is vital:

- Contract content summaries,
- Contract content presentations,
- Correspondence management,
- Change management,
- Quality management,

- Managing deliverables,
- Service-level agreement management,
- Schedule management,
- Subcontract/vendor management,
- Intellectual property management,
- Confidentiality management,
- Insurance compliance,
- Tracking the status of and proactively managing issues and risks,
- Dispute management,
- Contract closeout,
- Contract assessments, and
- Lessons-learned activities.

These are all extremely important in managing commercial contractual risk in a professional manner and proactively mitigating commercial contractual risk matters.

SCORECARD PROCESS

The use of periodic risk status scorecards starting from the initial contract review/negotiation stage and continuing through to the contract performance completion/expiration/closeout stage (using “red” for high risk, “yellow” for moderate risk, and “green” for low risk status determinations, or some other scoring process) really helps. It keeps the focus on commercial contractual risk management.

Scorecards quickly inform management of the risk levels at various stages of the applicable agreements. If you can measure it, you can manage it. The effective use of contractual risk management scorecards can go a long way in reducing and communicating contractual risks.

Other Important Processes to Use

In addition to the checklist, best practices, and scorecard processes, the following additional contractual risk management processes can be applied:

- Establishing a contractual risk management team to meet regularly and manage contractual risks;
- Designating specific “owners” on the contractual risk management team to manage each specific contractual risk;
- Establishing early warning signs (triggers) for each contractual risk;
- Developing and implementing up-front preventive actions once the trigger becomes evident for a contractual risk;
- Developing and implementing a post-contingency plan for each contractual risk in the event the contractual risk is not cured with preventative actions;
- Establishing a contractual risk management register specifically describing each contractual risk, risk probability, risk impact, risk detectability, triggers, preventive actions, and contingency plans; and
- Conducting a debriefing that assesses the contractual risk matter and summarizes the lessons learned.

IMPORTANCE OF COMMERCIAL CONTRACTUAL RISK MANAGEMENT TRAINING

It is important to educate your staff on the fundamentals of commercial contractual risk management. They need to understand the purposes and benefits of contractual risk management. Such training can also address loss analysis from the past, reduce future potential losses, and identify contractual risk management successes.

INSURANCE CAN BE PART OF YOUR COMMERCIAL CONTRACTUAL RISK MANAGEMENT SOLUTION

Discuss with your insurance broker or your insurance companies the insurance strategies necessary to reduce commercial contractual risks. Insurance, in itself, is not contractual risk management. However, insurance can be a valuable risk-financing tool.¹¹

SUBCONTRACTING CAN POTENTIALLY HELP TO MANAGE SOME ASPECTS OF COMMERCIAL CONTRACTUAL RISK

Subcontracting might use one of the following models:

- *Onshore subcontracting*—Subcontracting a portion of the work by the prime company to the subcontractor company within a country.
- *Nearshore subcontracting*—Subcontracting a portion of the work by the prime company to the subcontractor company in countries with a close cultural, legal, and geographical relationship to the prime company’s country, such as between the United States and Canada or between the UK and Ireland.
- *Offshore subcontracting*—Subcontracting when an overseas subcontractor is engaged by the prime company to perform a portion of the work. The offshore model can offer a substantial economic advantage (for example, working with Indian companies might substantially decrease labor costs and the Indian market has skilled professionals), but the entire offshore project must be analyzed to determine the total actual cost savings because communication issues and other challenges may diminish the theoretical gain.

There are a lot of business motivators for subcontracting, such as cost reduction, flex-



THE ULTIMATE ACCESSORY

Expanded, refined, and designed to set the standard for contract management.

Isn't it **TIME** you picked up the latest edition?

www.ncmahq.org/cm/newCMBOOK



ibility, engineering/work specialization, and faster completion time. However, there are also some potential commercial contractual risk management advantages to consider when subcontracting, such as the following:

- Some of the legal and liability risks facing the prime company might be contractually transferred to the subcontractor.
- Indemnity provisions in a subcontract might be drafted so as to allocate the risk of harm for a portion of the work to the subcontractor who is actually performing that portion of the work and who is most able to control the work and reduce the risk of harm. A subcontractor might agree to indemnify the prime company from loss or damage caused by the subcontractor's work.
- The prime company might be able to contractually leverage some of the subcontractor's insurance or bonding to offset certain risks.
- The subcontractor might actually be able to perform a portion of the prime company's work better than the prime company, thus reducing performance risks and improving quality.

GOOD, OLD-FASHIONED COLLABORATION

One of the best ways to manage commercial contractual risks is the old-fashioned way. If the contract parties will make an ongoing, solid win-win effort to fully collaborate in all areas of the contract and its performance, it will go a long way in effectively managing the risks.

THE FUTURE OF COMMERCIAL CONTRACTUAL RISK MANAGEMENT

Wayne Gretzky once said: "You miss 100 percent of the shots you don't take."¹² So, take those shots that you think are appropriate, but manage the risks.

Proper commercial contractual risk management is necessary for success now and in the future. Ongoing successful company revenues, profits, and reputations can be wiped out quickly by ignoring or not discovering contractual risk threats.¹³ Conversely, if an entity is protected from contractual risks and threats, it can effectively concentrate and focus on its business without distraction.¹⁴

In the future, commercial contractual risk management will increasingly play a more vital role in an entity's success. In an increasingly volatile and uncertain marketplace, the high-performing entities will require good commercial contractual risk management.

CONCLUSION

Every commercial domestic or international contractual risk management review, analysis, evaluation, and management activity has some unique aspects that may not be addressed in this article. However, if you routinely use this article as one of several resources when you perform commercial contractual risk management activities, you will be pleasantly surprised with the large number of substantive, material, risk reduction, performance-improvement, and cost-savings issues and ideas that will be surfaced for proper evaluation.

Just remember, "a stitch in time saves nine"¹⁵ and "an ounce of prevention is worth a pound of cure."¹⁶ **CM**

ABOUT THE AUTHOR

JOHNNY MILLER, CPCM, is a Texas and Missouri attorney and a contract management consultant who has worked in the field of contract management for many companies in the last 30 years. He is a member of the Greater San Antonio Chapter of NCMA. His website is www.con-tracts.com. He can be reached at johnny@con-tracts.com.

Send comments about this article to cm@ncmahq.org.

ENDNOTES

1. See "Worries About a Risk", available at www.ahajokes.com/reg50.html.
2. See Dilip Chandra, "Risk Management and the Types of Risk Management," *Hub Pages* (May 18, 2013), available at <http://dilipchandra12.hubpages.com/hub/Risk-Management-and-Various-Types-of-Risk-Management>.
3. "CSQA Risk Management Training," available at http://csqa.info/risk_management_training.
4. See Chandra, *op cit*.
5. "CSQA Risk Management Training," *op cit*.
6. See Joseph Nicholson, "How Do American Companies Manage Risk?" available at www.ehow.com/how-does_4927441_american-companies-manage-risk.html.
7. See Helena Haapio, "Contractual Risk Management: Not Just a Matter for Lawyers!" *Risk Consulting Journal* (February 2007): 23-25, available at www.if-insurance.com/web/Industrial/SiteCollectionDocuments/Risk%20Consulting/rm2_2007s1-32eng.pdf.
8. "Directory of Mark Twain's maxims, quotations, and various opinions," available at www.twainquotes.com/Discovery.html. This quote has been attributed to Mark Twain, but the attribution cannot be verified. The quote should not be regarded as authentic. The earliest documented publication of the quote is in H. Jackson Brown Jr.'s *P.S. I Love You* (Rutledge Hill Press, 1990). Brown's book is a collection of quotes and maxims attributed to his mother.
9. See "CSQA Risk Management Training," available at http://csqa.info/risk_management_training.
10. See Tobias Mahler, International Association for Contract and Commercial Management (IACCM), Contracting Excellence Newsletter, "How Can We Analyze Contractual Risk?" (June 2008), available at www.iavvm.com/contractingexcellence.php?storyid=606.
11. See Insurance Bureau of Canada, "Controlling Costs with Risk Management" (January 2010), available at www.ibc.ca/en/Business_Insurance/Risk_Management/.
12. "Quotery," available at www.quotery.com/you-miss-100-of-the-shots-you-dont-take/.
13. See Risk Center, "Risk Management's Future in the Corporate World" (February 7, 2008), available at www.riskcenter.com/story.php?id=15997.
14. *Ibid*.
15. Thomas Fuller, "Gnomologia, Adagies and Proverbs, Wise Sentences and Witty Sayings, Ancient and Modern, Foreign and British," available at www.phrases.org.uk/meanings/a-stitch-in-time.html.
16. Ben Franklin, available at www.ushistory.org/franklin/quotable/quote67.htm.