

Contracts demystified

Risk management is not just about loss avoidance, but a source of value creation, writes Peter McGee of insurance adviser Victual.

THE word contract seems to be a dirty one. The mere mention sends shivers down the spine of many who ponder pages of legal speak with lawyers billing in six minute blocks (disclaimer – I’m not a lawyer).

The reality is contracts are the basis for all your commercial relationships.

As someone who delivers hundreds of enterprise risk reviews, clients often ask me whether there is one common area where businesses are exposed. The response is surprisingly easy – yes, it’s contract management.

No doubt I’ve had clients at either end of the spectrum. Some believe contracts are the work of the devil and refuse to use them, while others try their best but get confused by legal speak and spooked by legal bills.

CONTRACTS AS A RISK MANAGEMENT TOOL

Contracts are a tool for defining the rules around a relationship. In many respects they define how risk is shared. For this reason, contracts, and their effective management, become a vitally important tool in any proactive risk management process. It’s not until the contract defines the boundaries that a business can truly understand where it is exposed.

Consider one of our clients, which grew a very successful food manufacturing business based on handshakes with contract manufacturers. Our enterprise risk review obviously highlighted that a contract would be a good idea, but it wasn’t until we started talking supply chain risk that this really hit home. These suppliers were critical to their business. So too our client was a critical customer for the contract manufacturer. Relationships were good, but if they couldn’t supply, for whatever reason, what would

happen? How resilient was their business to cope with delays? Had they indicated they are our sole suppliers? Could they go elsewhere? It wasn’t until a contract was signed that all parties clearly understood their responsibilities.

INSURANCE IMPLICATIONS

Even the more risk mature businesses we deal with often miss the potential detrimental insurance implications of certain contracts. We have identified uninsured exposures in contracts, even if they’ve had a legal review. The reason is the lack of understanding of the insurance policy coverage.

ALMOST
100%
OF RETAILERS HAVE BEEN WORKING WITH SUPPLIERS ON THEIR GSA

For example, a claim was recently brought against a client that had been supplying ingredients to a contract manufacturer which was in turn supplying their end customer. This customer claimed the manufacturer’s product was contaminated – from which the contract manufacturer sought to make a claim against our client.

However, the contract manufacturer had signed a contract containing a full indemnity clause, meaning they were unable to make a claim against my client, saving them and their insurer a six figure sum. The compounding problem for the contract manufacturer was their failure to notify their insurance provider that they had signed an indemnity clause. The manufacturer is now facing



a six figure claim without insurance, as their insurance policy contained a common Contractual Liability exclusion.

GROCERY SUPPLY AGREEMENTS

Many food companies are immersed in the process of renegotiating Grocery Supply Agreements (GSAs). In recent times, the ACCC has brought a number of actions against the major retailers under Australian Consumer Law. In response to industry pressure, these retailers have signed a Code of Conduct and have begun renegotiating their GSAs. This provides a great opportunity to bed down your relationship and understand your risk. Clients who spend time on their contract management workflow realise the benefits in their business. *

ABOUT THE AUTHOR

Peter McGee is the co-founder of risk and insurance adviser Victual. He delivers risk management solutions for the food and beverage industry and is passionate about risk management as a source of value creation, not just loss avoidance.



CHECKLIST

WHERE TO START?

For the sophisticated procurement function there will be a range of defined processes and most likely software tools to deliver consistency and efficiencies. But for those wondering where to start, the first point would be a simple contract register to understand what contracts are in place, with whom, the key conditions of these contracts and when they are due for review.

From this point we consider the contract negotiation, approval and management workflow to define what processes are in place.

Not every contract will warrant a high level of scrutiny. For many contracts it’s as simple as understanding what conditions have been agreed to. For those key contracts, apply your HACCP principles to the contract management workflow and you will soon identify where it can go wrong, i.e.

- Who has reviewed?
- Do we need external review?
- Who is authorised to sign?
- Once agreed, what impact does this have on our business?
- How do we monitor performance against the contract?