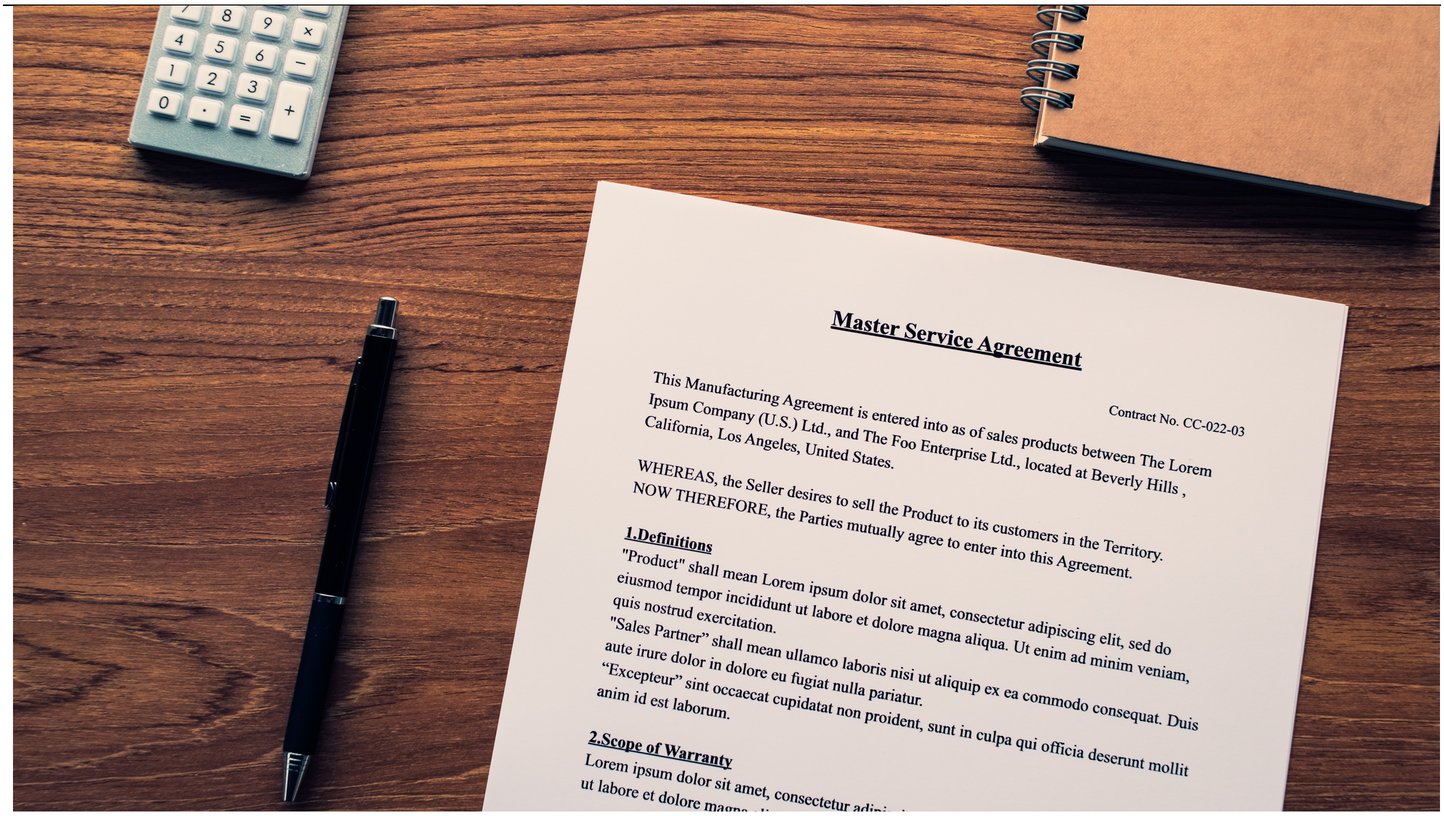
Top 4 Reasons Vendor Agreements Fail

Commercial and Contracts



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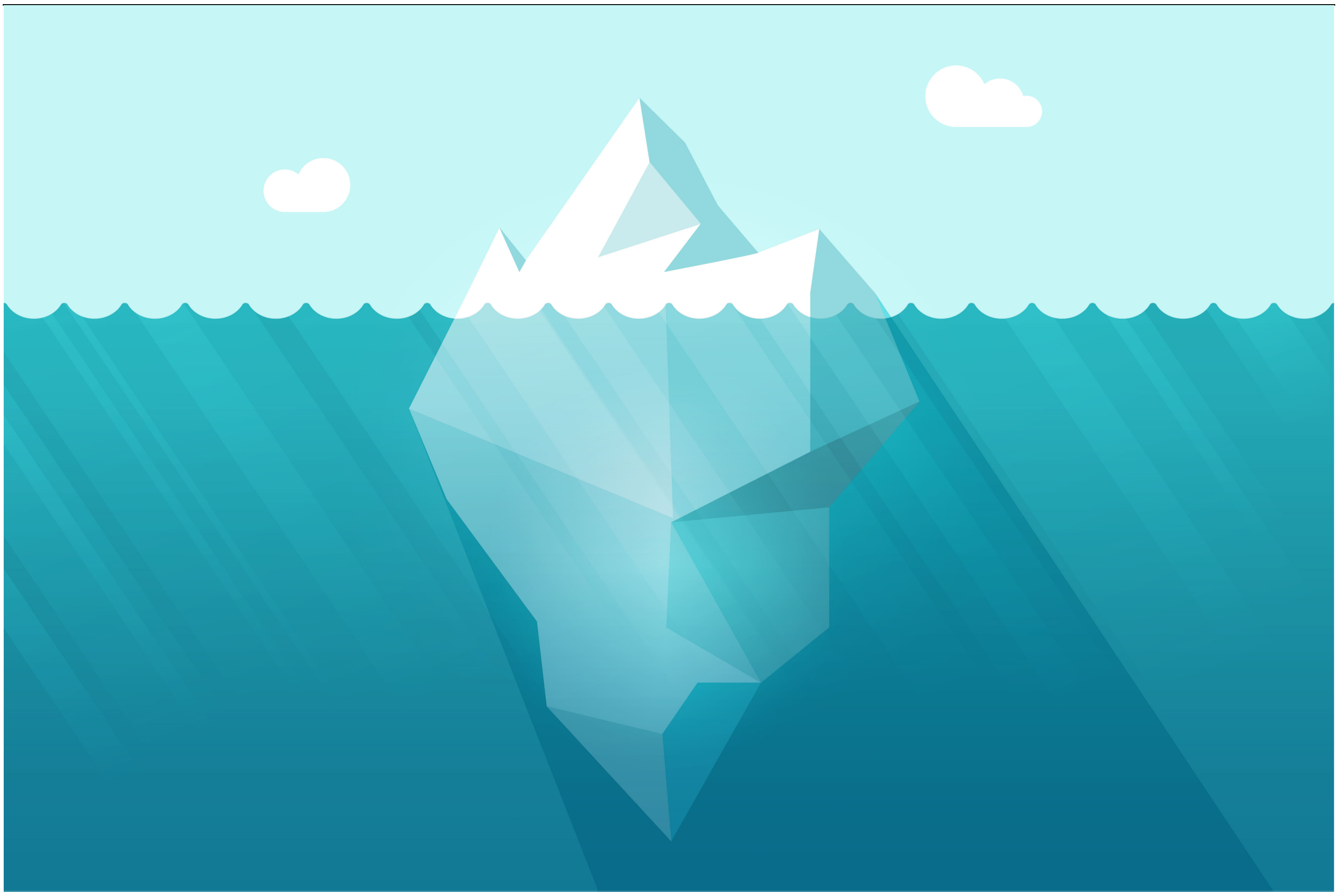
Cheat Sheet

- **Understanding project's cost type**. Know project's cost type to customize agreement and mitigate risk.
- **Statement of work specificity**. A detailed statement of work helps prevent misunderstandings and financial risks.
- **Aligning with end customer agreement**. Flowdown requirements align vendor and end-customer agreements to reduce risks.
- **Defining acceptance criteria**. Clear acceptance criteria in the agreement prevent potential conflicts.

Many lawyers would find the most important terms of any service agreement are limitation of liability, indemnification, and termination for convenience — although a reasonable argument could be made that several other customary terms and conditions are equally critical to the success of the contract. But, for all the time counsel spends painstakingly negotiating exclusive remedies for breach of warranty or IP infringement language, the true measure of a successful vendor agreement is whether the parties have it structured such that those terms never actually come into play in a real-life showdown.



The majority of potential contract issues are found beneath the surface of boilerplate terms and conditions. Artwork by vladwel / *Shutterstock.com*

Successfully engaging the services of a vendor or subcontractor requires counsel to look beyond just boilerplate terms and conditions. Counsel should take a broader view of the reasons the business is engaging with a particular vendor and the consequences to the business if that supplier does not deliver.

The below list is intended to address the larger question at play: What could possibly go wrong?

1. The agreement does not support the project's cost type

Deciding which fee structure or cost model best suits the project undoubtedly requires direction from the business side of the house — but when the parties are negotiating cost-type, there is still an opportunity for legal to ask the right questions. With a more complete understanding of the cost model, counsel can negotiate the rest of the agreement to specifically address the risks associated with the project's specific cost type.

Firm fixed price, for example, is often an appealing cost model to a procuring party, but the business should be thoughtful when choosing this cost type as it requires significant project planning. Counsel may want to examine how the agreement addresses the discovery of cost-altering latent conditions, or what happens when a condition of the supplier's stated pricing assumptions fails. An agreement for a firm fixed price project often requires a provision outlining a change management process for funding and authorizing out-of-scope work. This provision could help the parties avoid a dispute over whether the vendor's performance of the out-of-scope work was authorized.

Aligning fee structure and payment terms

When examining fee structure, counsel should assess how payment terms in the agreement are aligned with that cost model. Will the supplier accept milestone billing for the firm fixed price project, or is the expectation that the fee is split into equally monthly installments for a specified duration? Contract terms authorizing monthly invoicing may not align with milestone billing. Counsel may also want to explore how to mitigate the risk of payments made up front — not only by bolstering breach of warranty remedies, but also by potentially negotiating a fee holdover at the end of performance until final acceptance. A vendor demanding partial upfront payments may also serve as a chance for the business to negotiate a favorable payment offset provision in the event of an invoice dispute down the line.

A vague payment structure in vendor agreements is like navigating without a compass. Artwork by BINK0NTAN / *Shutterstock.com*

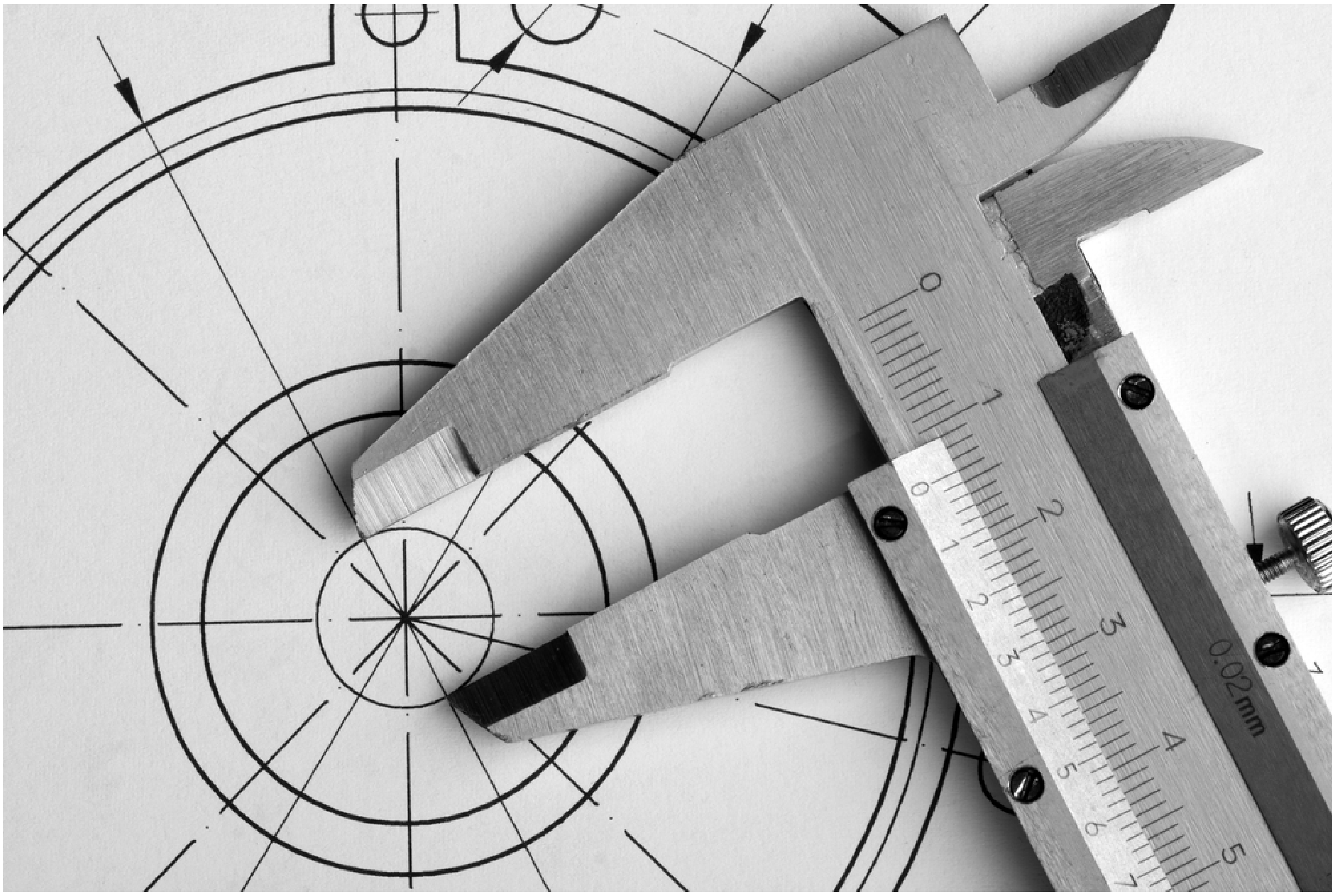
It might also be appropriate for counsel to voice concerns about the cost type itself. For example, some projects are better suited for time and material billing — particularly if detailed project planning is not possible under the circumstances. A different cost type might require counsel to ask new questions, such as whether the time and material project should contain certain not-to-exceed terms, or limit labor hours that would be subject to premium rates (such as overtime or second-shift work).

Counsel has the power to mitigate the risk of project failure by understanding the project's cost type and by customizing the terms of the vendor agreement to specifically support that cost model.

2. The statement of work is not specific

The Statement of Work (SOW), or description of the deliverables, is an opportunity for the parties to determine all the specifications and requirements of the requested orderables. In many instances, it is also where the details are memorialized for how the work is to be performed, how long the project is going to take, and how much it will cost to fund. The SOW will likely include some sort of project delivery schedule, as well as a calendar of any milestones.

When it comes to vendor agreement SOWs, less is not more. Counsel should never assume any requirements are implied. If the vendor is expected to possess a specific business license or provide a certain training to its personnel, the SOW should state which party is incurring the expense for those requirements.



A detailed Statement of Work is the lighthouse guiding both parties. Artwork by Nomad_Soul / *Shutterstock.com*

If the vendor is expected to provide personnel with a specific degree or technical certification, this should be identified in the SOW.

One common question often relates to *where* the work is to be performed. Is the vendor expected to be on-site, or can the project be performed remotely — and if on-site, are there any on-site requirements that must be met? The SOW should also identify which party is providing the equipment and technology devices. When it comes to proprietary information and privacy concerns, the business may or may not want the vendor using its own devices — instead, the business may opt to issue laptops and mobile phones to the vendor.

There can be overlap, or even conflict, between the agreement's standard terms and conditions and terms of the SOW. Often the SOW can serve as an opportunity to modify those standard terms in relation to a particular deliverable. For example, in "work-made-for-hire" situations, it may be necessary to override the master agreement's intellectual property provision if those terms are not aligned with the business's need to own certain IP in connection with that deliverable.

The best written SOWs anticipate out-of-scope performance and plan accordingly.

A period of performance that ends before the project is finished can be financially catastrophic for the business, unless the SOW allows for an extension of the duration of the project at the same proposed rates. Any quantity of time, labor, materials, or other direct or indirect costs and expenses not accounted for either in the SOW, or automatically by the project's cost model, can create an out-of-scope requirement that can financially sink the deal. The best written SOWs anticipate out-of-scope performance and plan accordingly.

3. Gaps with the end customer agreement

Sometimes a business engages a vendor to meet an internal need — a good example of this is an hourly consultant for a corporate issue. However, when a vendor is engaged to support the business's own project with an end-customer, the vendor can be referred to as a subcontractor. The key to a successful subcontract agreement is ensuring the requirements and obligations in the end-customer contract are passed down in the subcontract agreement. This concept is referred to in many industries as flowdown requirements, or simply "flowdowns."

Just as every puzzle piece has its place, so too does every detail in an agreement; filling the gaps ensures a seamless fit.
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Flowdown requirements can be both legal and operational — both categories must be cared for when negotiating the subcontract. Legal flowdowns can include compliance requirements with certain statutes and regulations. An end-customer contract may require the business to comply with federal equal employment opportunity standards. Those standards should be contractually passed down by statutory reference to the subcontractor to the same extent that the business is required to adhere to those standards.

Navigating legal and operational flowdowns

Legal flowdowns are generally less negotiable than operational flowdowns. Typically, in the commercial industry, there is no legal requirement to make payment terms either net 30, net 45, or even net 90, for example. If the subcontractor requires net payment terms that do not match the payment terms of the end-customer contract, the business must be willing to accept paying its subcontractors before the business itself gets paid.

If the end-customer contract allows for termination for convenience, counsel should ensure all subcontracts also allow the business to terminate for convenience without penalty — at least to the same extent the business's customer contract is terminated. The end-customer contract may allow for the extension of services beyond the initial base period without an increase in rates. Counsel should ensure the subcontract also allows the business to extend services up to the same extent with its subcontractor without a rate increase. If the end-customer agreement allows for the suspension of subscription services, the subcontract agreement should mirror the end-customer contractor. If not, the business is likely to suffer a financial loss when the end-customer exercises its right to suspend service.

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A mismatch between the business’s contract with the end-customer and the terms of the subcontract agreement poses both a legal and financial risk. Failing to flow down end-customer requirements to subcontractors puts the business at risk of incurring penalties for noncompliance from regulatory agencies, as well as penalties sought under breach of contract and consequences from a reputational harm perspective. If the customer agreement requires the business to meet a certain cybersecurity standard and its subcontractor will not contractually agree to meet that same standard, the business needs to consider the full spectrum of consequences it might face if its subcontractor experiences a data breach. A subcontract agreement that does not meet the standards required by the business’s contract with the end-customer will inevitably fail — the question is merely to what extent and scale.

4. Undefined acceptance criteria

Acceptance criteria connects back to both the SOW and the end-customer requirements. In an ideal subcontract, the SOW sets forth formal acceptance criteria that is specific, mirrors the acceptance criteria of the end-customer, and requires that the payment for the deliverable is proper only after the end-customer has confirmed final acceptance of the deliverable. The worst-case scenario is that no formal acceptance criteria are identified in the vendor agreement, in which case the vendor might try to take the position that the invoicing is proper upon delivery — or even shipment — without any acceptance testing required.

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Common criteria for formal acceptance can consist of a specified period of time during which acceptance testing is permitted and during which no material malfunctions or failures of the deliverables requiring escalation to remediate have occurred. Counsel should ensure acceptance standards do not permit the vendor to submit an invoice until after formal acceptance has taken place. In some industries, it's common for the business to issue a certificate of acceptance to make it formal, which then permits the issuance of an invoice.

Ensuring success

Whatever the case may be, if acceptance standards are not agreed upon in the vendor agreement and the deliverable is flawed or fails entirely, the business is likely to find itself relying on those dutifully negotiated standard terms and conditions, such as remedy for breach of warranty and choice of law — the surest sign that the vendor agreement did not succeed in preempting the dreaded battle of dueling contract interpretations.

Join ACC

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