
***Project Business Management*¹**

Contract Risks for Project Vendors²

Oliver F. Lehmann

“What one owns in black and white can be taken home in peace of mind.”

—Goethe, Faust 1³



Summary

In project business management, it is essential for project managers to know the contract. In addition to that, they should have education to understand commercial and legal risks of project business to the depth necessary to perform the projects successfully and satisfy stakeholders, while at the same time protecting the project and the own organization.

¹Editor's note: This series of articles is by Oliver Lehmann, author of the book *“Project Business Management”* (ISBN 9781138197503), published by Auerbach / Taylor & Francis in 2018. See full author profile at the end of this article.

² How to cite this article: Lehmann, O. F. (2020). Contract Risk for Project Vendors, Project Business Management Series, *PM World Journal*, Vol. IX, Issue X, October.

³ (Goethe, 2005)

Case Studies

Project business is high risk business for all parties involved. In addition to the project risks that are present in all types of projects, project business comes with commercial risks and with legal risks.

This article focusses on the side of the vendor, who for a period of time becomes the contractor in the project. Here are some case studies that show exemplary how commercial risks can damage the contractor's business.

Case study #1: Subcontractors get paid when the prime contractor has the money

In a project for a paying customer, a prime contractor awarded work to subcontractors. These subcontractors accepted a clause in their contracts that their payments depend on the payments made by the customer to the prime contractor.

Figure 1 shows the payment process.

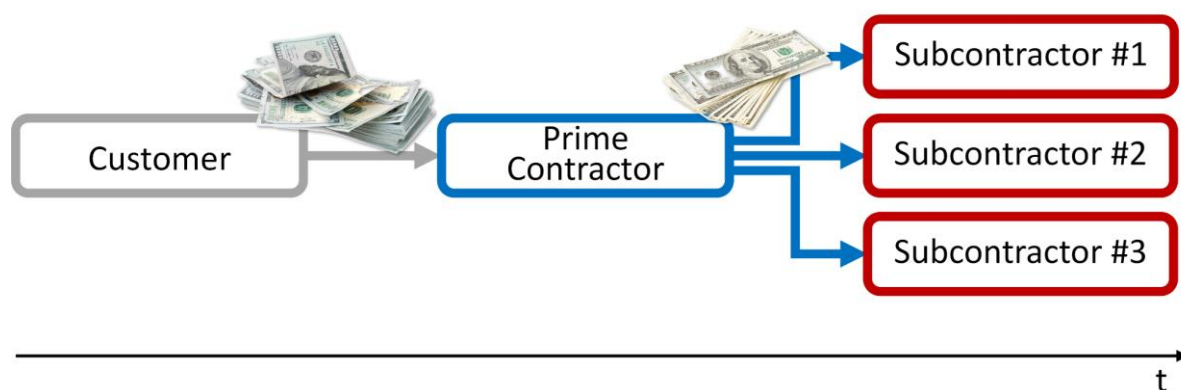


Figure 1: The payment process in Case study #1

Due to reasons outside the control of the subcontractors, the customer repeatedly rejects payments. The subcontractors in turn do not receive their compensations on time, and the longer it takes, the higher the risk becomes that they may not receive them at all, due to unresolvable conflicts or insolvency of parties involved.

Case study #2: Waiting for the customer to do a sign-off

An engineering project to develop and build a custom machine for a client has been mostly finished. The machine has been set up at the contractor's premises for sign-off by the customer. After that, it will be dismantled again, dispatched to the customer, re-erected, and commissioned. The customer has five days to visit the contractor.

During the course of the project, several payments have been agreed upon, triggered by achieved milestones. Customer sign-off on contractor's premises is one of them, and it is the one that triggers the largest payment, as can be seen in the swim lane diagram in Figure 2.

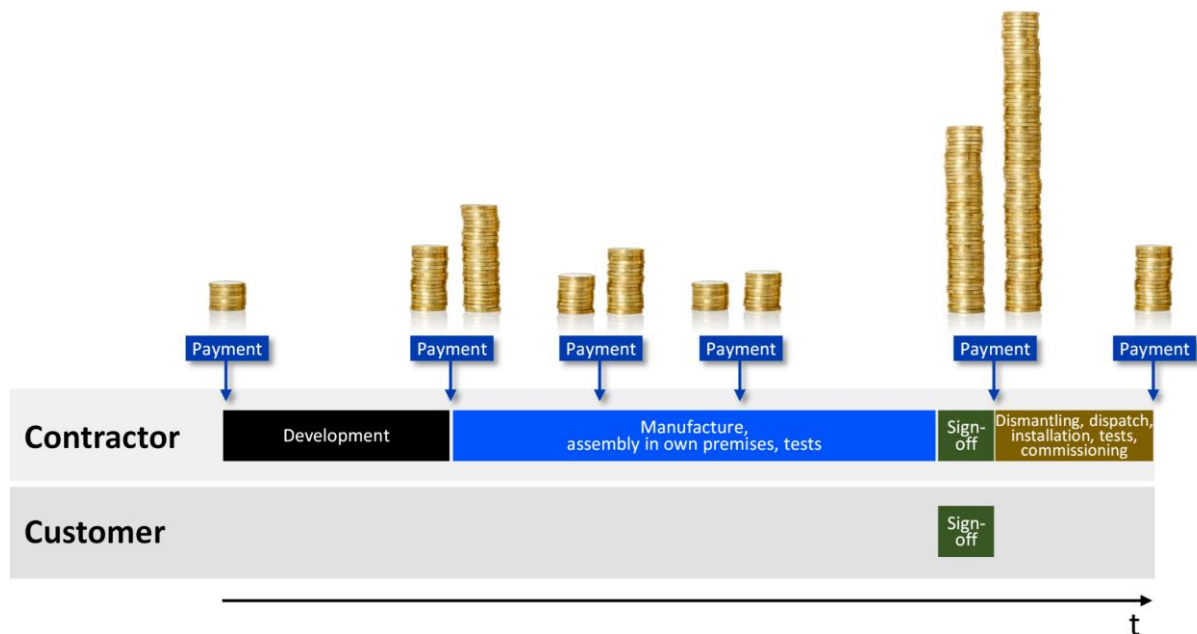


Figure 2: The process of the engineering project and the moments of payment

The customer does not turn off at the premises of the contractor during these five days. This means, the contractor cannot write the invoice and send it to the customer. The contractor is also not able to get the equipment out of the premises, instead it blocks space needed for the next project.

Case study #3: A roll out doesn't take place

A software company developed the solution for a customer that will be rolled out in 50 countries to unify communications and organizational processes across the entire company. The contract includes a clause that the country organizations decide when the software implementation will take place. The software company invested heavily in developing the solution and in customizing it to the needs of the customer. As a freebie project, the investment is expected to pay back when the customer pays for the implementations in each of the countries.

Figure 3 describes the process of costs for the contractor and payments by the customer.

The country organizations are impressed by the software and communicated their wish to get it implemented, but each of them has a good reason to delay the implementation into the next year. This also impacts the payments at the end of each rollout. The software company is unable to realize the paybacks from the investment into the software.

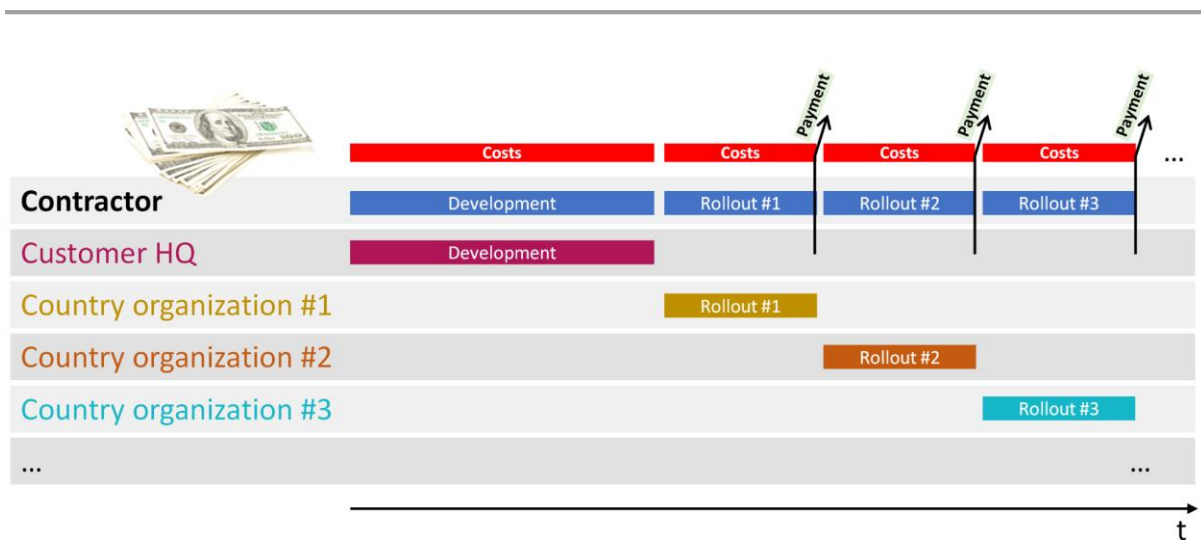


Figure 3: Another swim lane diagram: The process of development, rollout and payments of the project in Case study #3

Case study #4: Payment terms stretch the contractor's liquidity

A contractor has agreed to payment terms that allow the customer to pay two months after receipt and acceptance of the invoice. Almost each invoice gets returned to the contractor with complaints on minor issues such as mistakes in the customer address, missing signatures on timesheets, or alleged errors in the billed services and deliveries.

Repeatedly, the contractor must reissue the rejected invoices and must send them again to the customer, who validates them again. In the understanding of the customer, the moment when this has been finished starts the payment period. This process expands the original payment period of two months to three to four months. Having laid out money for the customer in form of payments to subcontractors and own staff, the project has negative cash flow and the liquidity of the contractor is endangered.

Case study #5: The acceptance of a government agency is needed for invoicing but has not been achieved

A wastewater treatment plant is built, and the final and largest payment has been agreed to follow the acceptance by government agencies. This acceptance relies on the work of the contractor as well as on the customer's contributions to the project.

The part of the project that has been delivered by the contractor has been found acceptable by the public inspectors. Not acceptable are the components provided by the customer. In compliance with the contract, however, the customer rejects the acceptance of the contractor's invoice, because the acceptance by the government agencies has so far not been granted. The contractor waits several months for the money, and during this time, is essentially funding the project of the customer.

Case study #6: The customer is running out of liquid money

The contractor is doing a great job for the customer in another software project. The software has been made available to the client's employees and are happy with the solution. However, the customer has run into a liquidity bottleneck. The money needed to pay the contractors is not available. Contractors are told that they have to wait longer for payments and are at the same time pressurized to reduce their prices by 15%.

They're told the alternative is that the customer will go into formal insolvency and restructuring of debts, which will mean for current creditors that they can write off most of their open bills, possibly all of them.

The majority of the contractors accepts the demands by the customer to protect their business. Nevertheless, the customer files for insolvency some months later and the project has turned into a loss for them.

A common pattern

The six case studies shown above haven't come on that the income for the contractor is not only dependent on the own work but also on things the customer needs to do. When the contract is agreed upon, contractor organizations often do not ask the question what happens, when the revenue from the project depends on activities by the customer and when the customer fails to do them.

Depending on the project business culture of the vendor organization, project managers may be involved in the process of business development or not. The risks from contracts with such dependencies on customer behavior increase, when the project manager does not know the contract and cannot act upon the risks that come with it. But why should a project manager in a customer-facing project not know the contract with the customer?

Do Contractors' Project Managers Know the Project Contract?

There not many things left that are regarded as "sacred" by modern people. One of these last things are contracts.

For the majority of people and organizations in project business, contracts are the rule books for their cooperation as customers and contractors, and when a significant decision must be made, they consult the contract first, to make sure that they do not make mistakes and risk a conflict that in a worst case can turn into a lost lawsuit. Sticking to the rules protects people from conflicts.

Unfortunately, in many organizations, this is pure theory.

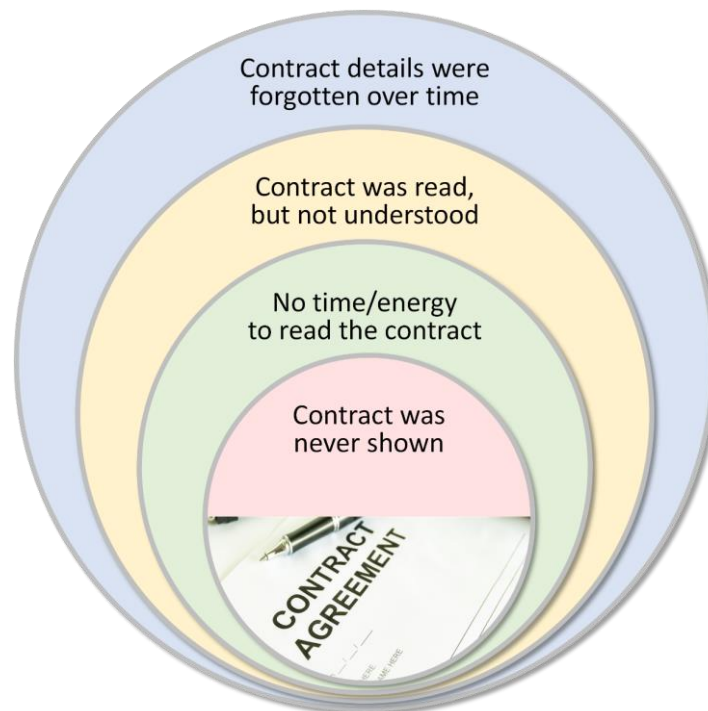


Figure 4: Reasons why project managers may not know the project contract.

Many project managers don't know the project contract. There are several possible reasons, as shown in Figure 4:

- The project contract was never given to the person. Due to secrecy, time pressure, or other reasons, the project manager was not shown the contract, and the person did not successfully insist on getting access to it.
- The contract was given to the project manager, but the person did not find the time and energy to read it. Many activities in a customer project must be done early and consume time and energy.

In many jurisdictions, where no Civil Code of law exists that provides defaults which apply when the contract is silent on certain matters, contracts must cover many details, which makes them lengthy and time-consuming to read.

- The contract was given to and read by the project manager, but he/she did not understand it. The degree of conciseness and clarity of contract language is also different in various jurisdictions, but the legalese often used seems hard to understand all around the world.
- The contract was given to, read by, and understood by the project manager but he/she forgot a lot of it during busy times. A lot is happening during a project, and remaining aware of all clauses, terms, and conditions can be a challenge to a project manager.

The partial or full lack of contract knowledge is true for both sides, customers and contractors, and the effects can be disastrous for project success. Unwitting breach of contract by one side may be perceived as damaging a relationship that needs trust to function and produce timely results.

Project Managers and Legal Knowledge

A project manager is not expected to be a lawyer. The percentage of lawyers managing projects seems to be quite small, most project managers have a different education and are trained in technical and organizational matters, not in legal details. In project business however, a deficiency in legal knowledge can be a problem. Project managers must make a multitude of decisions every day, each of which can have legal implications, and many of them can cause problems in a worst-case scenario: Conflicts in the project cannot be resolved in negotiations and a lawsuit is threatened or actually filed.

One can compare this with driving a car: A driver must make many micro-decisions on the way from one place to another, and each of these decisions may be wrong. Before people can drive cars, they are taught by a driving instructor, and the instructions do not only take account of technical matters, but also include knowledge of and compliance with a body of traffic law. Illiteracy or disregard of traffic law can lead to dangers for life, health, and bank accounts. The driving instructor is not a legal expert but needs to know the rules well enough to be able to pass them on to the learner.

In project business management, the same applies, however the number of instructors is small. People therefore often learn the rules by trial and error. Unfortunately, trial in projects under contract is expensive, and error often even more.

In project business management, the project contract is an expression of the hopes and wills of the two (or more) parties during contract conclusion, but also of their uncertainties, concerns, and fears in this moment. Understanding its relevance is essential for success of any cross-corporate project.

It is therefore surprising, that project managers often don't know the contract, and this is true for both sides, customers and contractors. Time to dig deeper into the matter. Project contracts matter in project business.

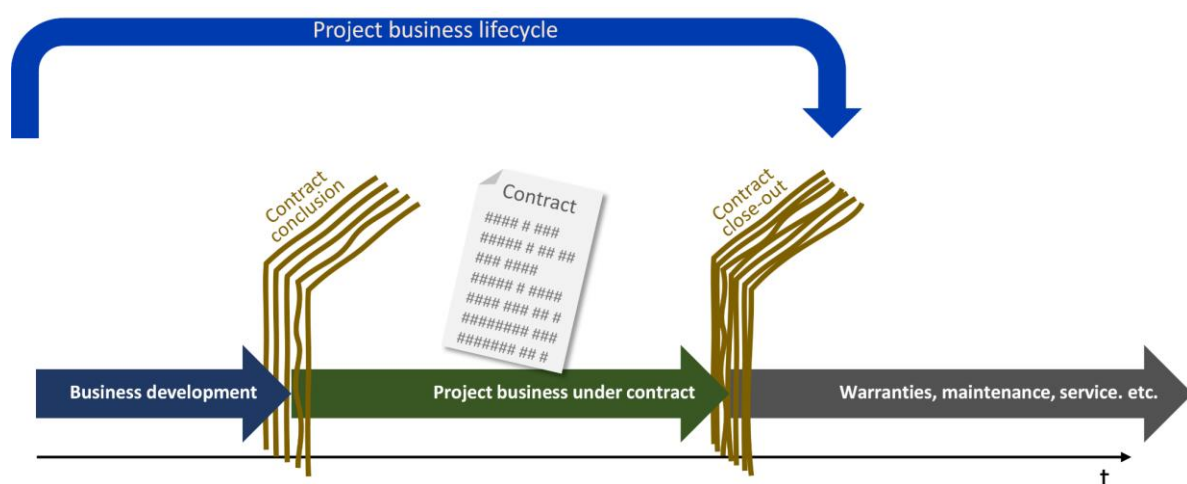


Figure 5: The project contract ends the business development phase and begins the delivery phase.

Why Contracts Matter in Project Business

The core document of project business is the project contract.

Project contracts are different from other project documents. A project schedule binds the project. A project may have a scope statement, an HR plan, a cost plan, and many more documents developed during its lifespan, and all these documents are binding for the project. A contract binds the entire organization.

It is important for success in project business that project managers understand these differences and act appropriately. And that they know the project's contract.

In a typical project business process (see Figure 5), the conclusion of the project contract ends the business development phase and starts the project performance phase. This is in many organizations a classical "over-the-fence" situation: different organizational units and people are involved during the phases, with different skills and success metrics. At one point in time, when the contractual obligations have been completed, the contract can (and should) be formally closed out.

There may be some future obligations, such as warranties or maintenance services, but these are commonly considered external to the project. Contract close-out is often another such "fence".

Contracts are generally a common aspect of daily life. When a person stands at the checkout of a supermarket to pay the goods that he or she wants to buy, when someone puts money into a vending machine and selects an item, or when someone buys or sells goods over the Internet, all these people enter into contracts. Organizations such as companies, government agencies, associations, and others also make contracts with one another and with individuals. We have job contracts, rental contracts, loan contracts and many more. Investors conclude foundation contracts for companies in which they become venturers. There are many more purposes to have contracts.

Contracts are made between at least two parties. Often, a contract has more parties involved, that entered the contract to achieve common benefits as well as individual ones.

Contracts may be implicit or explicit, verbal or in writing, simple or complex and so on. Implicit contracts may be concluded in just seconds by actions (typical for a vending machine). In other cases, it may take months, possibly years to negotiate and finally conclude them.

The core element of a contract is the obligation on the parties to do, or not do, something, to assume certain risks, or to accept some other forms of responsibilities such as taking over costs or assuming responsibilities. In some legal systems, a valid contract can place obligations

on just one party⁴, in others, each party must have obligations, then often called “consideration”⁵, to regard a contract as valid. “Valid” however means in all those cases binding for all parties.

In some jurisdictions, contracts are considered basis for a partnership between the parties, based on “good faith”. In others, a contract rather lays out a battlefield “between its four corners”, where the parties meet and fight, but not have responsibilities for each other beyond what is laid down in the contract.

In any business, contracts are the basis for the activities of the parties. This may be the delivery or a service performed by one party against payment by the other. A contract may also be used to jointly found a company, a joint investment, with the expectation to bring benefits to the investing parties in a narrow or far future.



Figure 6: Elements of contemplation when developing a contract

In project business, the most common type of contract is for the delivery of products or services, or for making resources available. Often, the content of the contract is a combination of such obligations that must be met by a vendor, during the time of validity of the contract also called the contractor. The recipient is then called the customer, and the contract has also obligation for this side. In most cases, the core obligation of the customer is to pay the contractor.

Project contracts tend to be complicated, particular when these contracts govern large projects with high risks for the parties involved. They cover time spans of months, sometimes years, and they represent certain predictions made for such time. The predictions may prove

⁴ For example, Civil Law countries know the concept of a unilaterally binding contract. Common applications are gift contracts and guarantee contracts. See (juraforum.de, 2011)

⁵ This is particularly true for Anglo-American law and for Islamic law. Accepting a disadvantage from a contract is seen as a signal that the party has weighed expected benefits against them and then made a deliberate, a “considerate” decision.

wrong, partially or in full, which is a challenge to the contract parties to do adjustments that suit their joint needs.

Improving the Situation – How?

There are two steps that organizations can take to improve the contract awareness of their project managers:

Solution #1: Include project managers in the process of business development and early contracting.

This is again true for both sides. Often a purchasing department on customer side and a sales department on vendor side takes over the process and projects managers are kept out. For them and their projects, the results of the business development process are *faits accomplis*, when each of the departments involved tell them its “my way or the highway”.

The size of the organization also plays a role. In small organizations, it is considered rather normal that developing the business as a customer or contractor is done by the project manager, possibly with support by the departments. There, project managers are often true project business managers.

In larger organizations, processes are generally more elaborate and operationalized, and have stricter distribution of work among departments. Therefore, these organizations will see more likely the project managers only tangentially involved in the development of the contract, or not at all.

Awareness of the contract and its clauses is generally better, when project managers are actively managing (or at least deeply involved in) business development. This is again true on both sides, customers and contractors.

Involving project managers in contract development will ensure that they know the contract. It will also help develop contracts that support project success.

Solution #2: Have regular project contract reviews

The first review meeting should happen shortly after the conclusion of the contract. To prepare for the meeting the project manager and all other project team members involved should be given the opportunity to study the contract. An outcome of the meeting could be a register of requirements that the own organization has to meet, as well as those for which the other party or parties are responsible.

To avoid forgetting details of the contract and in order to assess conformity of the parties with the contract, such meetings should be repeated in an appropriate frequency.

The Velocity of Trust

The greatest accelerator in project business is trust⁶. Trust simplifies and streamlines processes, reduces overhead, and allows for quick decision making and implementation.

However, trust the wrong people, and they will rip you off. The statement “If you want to be trusted, be trustworthy”⁷ is a core tenet of project business management. Another tenet is to be aware, who one is going to have a contract with. “Contract law—it's only as good as the people”⁸

The contract is the last resort when it comes to a conflict between the parties. So are lawsuits. In project management, it is a good approach to avoid them at almost at any costs. However, when they prove unavoidable, it is best to be prepared. For these moments, good knowledge of the project contract helps protect the project and the own organization.

⁶ Discussed in my book “Project Business Management” (Lehmann, 2018)

⁷ (Covey, 2004)

⁸ (George, 2004)

References

- Covey, S. (2004). *The 7 habits of highly effective people: Powerful lessons in personal change* (Anniversary ed.). New York City, USA: Simon & Schuster.
- George, J. (2004). Contract law—it's only as good as the people. *Emergency Medicine Clinics of North America*(22). Retrieved 5 30, 2020, from <https://www.sciencedirect.com/science/article/abs/pii/S0733862703000944?via%3Dihub>
- Goethe, J. W. (2005). *Faust, Translated into English, in the original metres, by Bayard Taylor*. Project Gutenberg. Retrieved 5 30, 2020, from <https://www.gutenberg.org/files/14591/14591-h/14591-h.htm>
- juraforum.de. (2011). *Einseitig verpflichtende Verträge*. Retrieved 5 30, 2020, from <https://www.juraforum.de/lexikon/einseitig-verpflichtende-vertraege>
- Lehmann, O. F. (2018). *Project Business Management*. New York City, USA: Taylor & Francis. Retrieved 5 22, 2020, from <https://www.crcpress.com/9781138197503>

Copyright Note

Illustrations:

- Oliver F. Lehmann
- Shutterstock
 - o Dmitry Melnikov
 - o New Africa
 - o Pressmaster
 - o TLaoPhotography
 - o Zerbor

About the Author



Oliver F. Lehmann
Munich, Germany



Oliver F. Lehmann, MSc, ACE, PMP, is a project management educator, author, consultant, and speaker. In addition, he is the President of the [Project Business Foundation](#), the home association for professionals and organizations involved in cross-corporate projects.

He studied Linguistics, Literature and History at the University of Stuttgart and Project Management at the University of Liverpool, UK, where he holds a Master of Science Degree. Oliver has trained thousands of project managers in Europe, USA and Asia in methodological project management with a focus on certification preparation. In addition, he is a visiting lecturer at the Technical University of Munich.

He has been a member and volunteer at PMI, the Project Management Institute, since 1998, and served as the President of the PMI Southern Germany Chapter from 2013 to 2018. Between 2004 and 2006, he contributed to PMI's *PM Network* magazine, for which he provided a monthly editorial on page 1 called "Launch", analyzing troubled projects around the world.

Oliver believes in three driving forces for personal improvement in project management: formal learning, experience and observations. He resides in Munich, Bavaria, Germany and can be contacted at oliver@oliverlehmann.com.

Oliver Lehmann is the author of the books:

- ["Situational Project Management: The Dynamics of Success and Failure"](#) (ISBN 9781498722612), published by Auerbach / Taylor & Francis in 2016
- ["Project Business Management"](#) (ISBN 9781138197503), published by Auerbach / Taylor & Francis in 2018.

His previous articles and papers for PM World Journal can be found here:

- <https://peworldlibrary.net/authors/oliver-f-lehmann/>