Risk in outsourced logistics contracts

An insider's perspective

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Logistics outsourcing is a firmly entrenched element of business strategy in most industry sectors. Companies are almost always able to adequately define their business needs, and can usually manage the tender process to select their preferred third-party logistics provider (3PL). When it comes to agreeing contractual terms, however, companies are usually poorly equipped to negotiate on an equal footing with the 3PL. This, in turn, creates business risk which can significantly impact the business case for outsourcing. In this article, we examine the most common reasons for this situation and discuss the contractual areas which can have the most impact on the overall business case.

Once operations have been outsourced, most managers will support the view that a collaborative approach with their 3PL typically creates more value than a "we win / you lose" attitude. However, there is no avoiding a stark reality – this approach does not hold true during contract negotiations. Some elements of pricing mechanisms, such as gain-sharing, can indeed encourage collaboration and foster "win-win" scenarios. That said, most companies are unaware that appropriate pricing mechanisms are only the tip of the commercial iceberg. In many contractual areas, the wording of a given clause is one party's gain to the other's loss.

Imbalance of power

Most companies have little or no in-house repository of knowledge of best practice in logistics contracts. If a company is undergoing a first-time outsourcing, it is natural that they will never have negotiated a logistics contract with a 3PL before. Even if the company is moving from one provider to another, the situation is not much different – outsourcing contracts typically last for three to five years, so the last negotiations are a distant memory and the people involved may have moved to other positions or left the organisation.

The customer's organization often suffers from a competence gap between the logistics, purchasing and legal departments. Companies' logistics teams are typically focussed on operational matters, as this is their day-to-day responsibility. Purchasing departments, especially in small and medium-sized companies, often lack cross-category depth of knowledge and do not have the time to strengthen their awareness of complex commercial issues in logistics contracts. Finally, few in-house legal departments (and even fewer external law firms), have specific knowledge of the business issues involved; their input is usually restricted to ensuring the document is appropriately set into the local legal context.

On the other side of the table, the 3PL negotiates tens of highly similar contracts every year, giving them the immediate advantage of significantly better knowledge. Additionally, unless

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the client has a template contract already prepared, negotiations will start from the 3PL's template and thus - from their best case commercial position.

Organisations place themselves in an even weaker position by a poor choice of timing for contractual talks with the 3PL. In the vast majority of cases, these only start after the tender has been completed and the business effectively awarded. The project clock is already ticking and the Board is expecting to see the business case benefits start to hit the bottom line. Even though contractual values can often run into tens of millions of euro and entail commitments of five years or longer, few managers have the self-confidence to insist the project be paused or even stopped if appropriate contractual terms cannot be agreed. In this context, it is no surprise that 3PLs have a relatively easy time during talks. Good practice calls for the customer to draw up a contract before the tender is issued and require 3PLs to agree to its terms (or at least indicate their material objections) as a pre-condition of tendering.

Lowest price = best deal?

Pricing and performance criteria are clearly the most operationally relevant commercial terms to be agreed, and usually by far the most emphasis is placed on these areas during talks. If we assume that our relationship with the 3PL will always be idyllic and free of dispute, then the above approach would indeed be justified. However, experienced negotiators will often repeat that "a contract is for the bad times". Ensuring appropriate remedies for poor performance, controlling (and ideally minimizing) potentially significant costs of termination and codifying the scope and limits of the 3PL's liability are all areas where the original business case can be ruined if the relationship turns sour.

A few examples of potential real-life situations follow. Consider whether your current contract adequately covers your company's interests in these cases:

- You have defined target KPI levels for your 3PL to achieve, and perhaps even agreed some motivational bonus/penalty system for over- and underperformance. But do you have the right to say "goodbye" if the 3PL's performance nose-dives?
- You have just terminated your logistics contract with immediate effect due to the 3PL's underperformance. Your goods are still stored in a warehouse your former 3PL is renting, on a five-year contract with three years left to run. What should happen to the warehouse rental contract? Can you oblige your former partner to comply?
- If the warehouse is flooded due to heavy rains, most contracts typically give the 3PL some relief from their obligations under a *force majeure* clause. But what if the flooding is caused by one of your 3PL's subcontractor's lorries hitting a sprinkler tank next to the warehouse? And what if the tank is hit by an off-duty employee of the 3PL in his car?
- Your 3PL is re-labelling some of your food products as part of their contractual services. By accident, a batch of your baby food is wrongly labeled and this batch enters the market. As a result, one baby dies, several more are in hospital and you are faced with potentially crippling lawsuits and negative publicity. Will your 3PL cover your losses?

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Secure a level playing field

There are several ways in which companies can better protect their interests during negotiations. Start contract talks and sign heads of terms before awarding the business. Larger organisations will have regional or global centres of excellence, which collate best practice from multiple markets and re-distribute it to business units who need support. If yours doesn't, consider the value in establishing one. There is a regular flow of managers from 3PLs to customers' organisations, which can effectively fill more tactical knowledge gaps; having a 3PL's former business development or commercial director on your side can be invaluable during talks. For more short-term needs, external consultancy can provide the required knowledge without long-term cost commitments.

For every organisation I have faced during negotiations which was well-prepared for the talks and fought hard for the protection of their interests, at least three could have done much, much better. Take the time to consider whether the benefits of your outsourcing business case are adequately protected by a well-prepared contractual framework, shielding your organisation from undue risk.

About the author:
Adam Chazanow is Managing Partner at Graphene Partners, an advisory firm specializing in logistics project management, M&A and contract negotiation. Prior to setting up Graphene Partners, Adam spent over ten years at Managing Director and CEO level with global 3PL and courier firms including DHL, CEVA, Exel, and DPD/GeoPost.

Based in Warsaw, Adam regularly advises leading companies from various manufacturing sectors and private equity investors in Europe, North America and the Far East.

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