Top Ten Tips in Negotiating Service Agreements

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There is little doubt that the landscape for IT service providers is quickly changing. Demand for their services has continued to grow as client organizations streamline their operations and look to leverage technology's capacity for innovative solutions. The result is a dynamic business climate with challenges and opportunity. In these conditions, there is considerable value for service providers in the protection afforded by a well-drafted service agreement.

This is important for two reasons. First, those agreements help the service provider in its day-to-day business of providing services and getting paid. Second, agreements that protect the service provider’s business and assets make it a more desirable target for investment or acquisition.

Like any contract, the service agreement should be clear on the fundamental business terms: who is doing what, and when, where and how are they doing it? These terms may be directly addressed in a single-purpose services contract, or may be addressed in a master services agreement with multiple project-specific work orders or statements of work entered into from time to time. Regardless of the contract structure, however, all service agreements should address the ten important issues discussed below. Note that this article is written from the service provider’s point of view – customers reviewing service agreements may be concerned about different issues, and may have different perspectives on the issues discussed below.

1. Define the scope, specifications and service levels. Clearly identify the services that the service provider will provide and any specific deliverables or end results, as well as any interim or final timetable or delivery schedule. If necessary, clarify whether the service provider will be creating or developing all of the deliverables, or whether some deliverables will be third-party equipment or software. Also clearly identify all applicable specifications, metrics, key performance indicators and service levels, so that deliverables and performance can be measured against objective goals.

2. Have a clear and workable acceptance mechanism. There should be a clear mechanism for addressing how deliverables will be tested and accepted. Acceptance should be tied to the objective specifications, so that a failure to meet those specifications is the only basis for rejecting a deliverable. The customer should have a limited period in which to reject a deliverable, and should have to give detailed reasons for any rejection. If the customer does not reject a deliverable within the applicable period, the deliverable should be deemed accepted.

3. Be clear about payment. Clearly set out the invoicing and payment terms. The service provider should not wait until the end of the assignment or agreement to invoice the customer, but should bill on a monthly basis or upon achieving certain milestones. Billing on a timely basis will help cash flow and establish expectations. Requiring an up-front deposit will also help with cash flow, and will help screen out customers who are unlikely to pay in the end. Also, be clear about what
additional expenses (third-party assistance, travel, accommodation, etc.) the customer is expected to bear. The service provider should require payment within, for example, 30 days following the invoice date.

4. Include protection in case the customer does not pay. Include contractual protections to help the service provider if the customer doesn’t pay. For example:

a. Reserve the right to charge interest on overdue payments. Under the *Interest Act*, the right to charge greater than 5% interest must be specified in the invoice or contract, and interest rates must be stated as an annual rate. Typical interest will be charged at 6-12% annually, calculated daily, and will accrue from the date that the payment was due until the date that all outstanding amounts (including interest) are paid in full.
b. Make the customer responsible for repaying collection expenses (such as legal fees).
c. Reserve the right to suspend services if payments are late, and clarify that any such suspension does not breach the agreement. If the agreement doesn’t address this point, the service provider could be forced to continue to provide services even while not being paid.
d. Obtain security where appropriate and possible. For example, if the customer takes possession of property before paying for it (e.g., because the customer can pay in arrears), the service provider should take security in that property in case the customer does not pay.
e. If the customer is a shell company with few assets or is thinly capitalized, consider requiring a guarantee from its parent company or another shareholder. Guarantees may be difficult to obtain, but the benefit of having one warrants exploring the possibility, especially for substantial contracts.

5. Keep an eye on the clock. A missed deadline can have important consequences. Build in some protection by clarifying that the service provider is not responsible and not in breach for missed deadlines caused by the customer (for example, by the customer’s failure to provide timely information or instructions or necessary access to facilities or equipment, or to communicate in a timely manner or to otherwise not cooperate under the agreement).

6. Clarify who can terminate, for what, and what happens on termination. Both parties should be able to terminate for a material breach that is not cured within a specified period (usually 30 days). It is also common to allow one party to terminate if the other party becomes bankrupt or insolvent. Termination for convenience is more problematic, and may not always be appropriate. If the customer can terminate for convenience, consider whether there should be a cancellation fee to compensate for the loss of the bargain or to at least cover out-of-pocket expenses, or whether the customer forfeits any pre-paid amounts. Finally, clarify what obligations apply on termination – for example, the customer should immediately pay for services performed up to termination for which the service provider has not been paid.

7. Limit representations and warranties. Carefully review any representations and warranties requested by the customer to make sure the service provider can provide each one. Where appropriate, add knowledge, materiality, or other qualifiers to appropriately limit the scope of a representation and warranty. Only give limited performance warranties regarding the products or software provided (that originate from the service provider – the original supplier’s warranty should apply to third-party products).

8. Consider liability issues carefully. One of a contract’s most important functions is to allocate risk and liability between the parties. Disclaimers, indemnities, insurance and limitations of liability all relate to risk allocation, as follows:

a. Disclaimers: Representations and warranties can be deemed or implied by statute or at common law, even if they are not expressly set out in a contract. It is good practice to set out whatever representations or warranties the service provider wishes to give with respect to its products or services, and expressly disclaim all other representations or warranties so that they cannot be imputed into the contract.
It is also good practice to limit the service provider’s monetary liability for breach to direct damages by expressly excluding indirect, special, incidental or consequential damages arising from breach (for example, business interruptions, lost profits, etc.). Customers may try to carve out exceptions – for example, damages flowing from breach of confidentiality are likely to be mostly or all consequential, and so a customer concerned about confidentiality would want to exempt those breaches from the disclaimer.

b. Indemnities: An indemnity is a contractual obligation by one party to be responsible for certain loss, damage or liability incurred by the other party. Indemnities are often heavily negotiated, and as matter of course the service provider should try give as few indemnities as possible (the customer will always be able to try to sue at common law for losses suffered even if there is no indemnity). Try to limit any indemnity that the service provider does give by carving out liability arising from the customer’s own negligence or intentional misconduct.

Customers will often expect an indemnity against claims that its use of the service provider’s services or deliverables infringes third-party IP. This is not unreasonable, but limit exposure by reserving the right to address the issue (e.g., by procuring the right for the customer to continue using the impugned deliverable or by modifying the impugned deliverable so it is not infringing) and by carving out liability that should not be attributed to the service provider (e.g., the customer’s failure to use the impugned deliverable in accordance with the service provider’s instructions or applicable documentation). Also clarify that the specified remedies are the customer’s exclusive remedies with respect to IP infringement matters, so that if the infringement claim is fully addressed the customer cannot still seek other remedies for breach.

c. LOL – limitation of liability (no laughing matter): The service provider should cap its total liability under the agreement. Cap mechanisms vary – it can be a fixed amount, a variable amount (e.g., total fees paid under the agreement, or fees paid in a specific period or under a specific statement of work), the insurance maximum, etc. If possible, make the limitation of liability apply to all liability arising under the agreement, including indemnity obligations. However, some customers may push for uncapped liability for certain situations such as IP infringement claims and confidentiality breaches, and for personal injury and tangible property damage.

d. Insurance: Insurance clauses are not necessarily standard, but they are not unusual. Customers may wish to specify what insurance is required, and in what amounts, for comfort that the service provider can meet its indemnity obligations. If the agreement requires insurance, make sure the specified coverage and amounts are reasonable ($1-2 million general liability and errors and omissions should be sufficient in most circumstances). Review the insurance provisions carefully, and seek feedback from the insurer.

9. Protect the business. Intellectual property, confidential information, personnel and business relationships are important parts of a business, and the service provider should protect them all.

a. IP ownership: Depending on the nature of the parties and the services, IP ownership can be a touchy subject. Each party will want to retain its existing IP (and the service provider should make sure that it specifically carves out its pre-existing IP and residual knowledge from anything owned by the customer), but what about new IP created during the relationship? If the customer is paying for the IP to be developed, it may expect to own the IP (though its ownership should only vest once the service provider has been paid in full). On the other hand, if the new IP relates primarily to the service provider’s business then perhaps the service provider should own it (and may have priced the project on the expectation that it would be able to use the IP with other customers in the future). These issues, among others, should be considered and addressed from the outset, and there is no one-size-fits-all solution. That said, avoid joint ownership of IP if at all possible, as it creates a host of complex issues.

b. Confidential information: If the parties will be exchanging or will have access to confidential business information, include provisions about the protection and use of that confidential
information, the types of information that are excluded from those obligations, what happens if the recipient is compelled to disclose the other party’s confidential information, and the term of the applicable obligations. If the services may also involve the disclosure or use of personal information, then the agreement should address applicable privacy laws.

c. Personnel and business relationships: Consider a non-solicit provision that prohibits the customer from hiring away the service provider’s employees, contractors or agents during the agreement or for a given period after termination. Also consider broader provisions prohibiting the customer from soliciting the service provider’s customers or potential customers for the purpose of competing with the service provider’s business. Customers may ask that these sort of restrictive covenants be mutual.

10. Mind the boilerplate. Standard legal provisions (i.e., the “boilerplate”) are important but are sometimes overlooked. Some key standard provisions to consider are:

a. **Entire agreement**: This clause forestalls claims that promises, representations and warranties were provided outside of the written agreement.

b. **Assignment and change of control**: Resist assignment and change of control restrictions, as they affect the service provider’s marketability and ability to reorganize its corporate structure. If the customer insists on an assignment restriction, sometimes the concern is that the service provider will simply outsource its obligations; if so, clarify that the customer will not unreasonably withhold consent to an assignment, and include an exception allowing the service provider to assign the agreement without consent in association with the sale of all or substantially all of its business.

c. **Law and jurisdiction**: To avoid the customer raising defences not known to the service provider, and to ensure that judgment can be obtained and recognized in a known manner, clearly specify that the laws of the service provider’s jurisdiction apply to the contract and that the parties submit to the jurisdiction of its home courts. That said, clarify that either party can apply to any court for any equitable relief such as injunctions.

d. **Dispute resolution**: Consider whether a dispute resolution clause is appropriate. This can be as simple as stating that the parties will try to resolve any disputes amicably and in good faith before escalating to court, or as complex as requiring non-binding mediation to be followed by binding arbitration, if necessary.

e. **Force majeure**: This clause specifies that the parties are not responsible for their failures to perform due to causes beyond their reasonable control. Carve out the customer’s payment obligations so that the customer cannot try to rely on the force majeure clause to excuse missed payments.

Service agreements do not have to be complex documents, but considering the various issues discussed above will help service providers make sure that their service agreements are thorough and provide the necessary protection.

This article is meant to be a general discussion and is not legal advice. You should not use or otherwise rely on its contents without obtaining qualified legal advice.

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