Key Service Agreement Issues: Service Providers Checklist

BY DAVID J. BARRY

Outsourcing of technology-related services continues to grow. Many service engagements now include an offshore component. These overseas arrangements can reduce the cost of the business activity but they also present different issues for both parties, which need to be addressed in the agreement. Further, there is intense competition among service providers which leads to considerable pressure on pricing and on negotiating the other business and legal terms of the transaction. Many service providers may promise anything to get the deal. You need to try to avoid every deal being a “bet the company” deal. There will always be some risk-taking but the challenge is to balance risk allocation among the parties with the need to stand behind the quality of services. A provider’s credibility and business acumen is visible in its agreements and negotiation positions. A welldrafted and negotiated agreement can lead to a stronger long-term business relationship.

This paper addresses the key agreement provisions from the service provider’s vantage point and identifies the risks and consequences of such provisions. It highlights areas that a service provider should include in its standard agreements to speed up revenue generation and avoid problem situations.

1. Master Agreements. The best business practice is to use a master agreement so additional services or projects can be performed for the same customer simply by adding an agreed-upon statement of work which is signed by both parties. This will lower the cost and reduce the time to document additional deals with the same customer. Any changes in the allocation of risk for a specific project can be made in the applicable statement of work.

2. Revenue Recognition. Avoid broad customer remedies that postpone revenue recognition. For example, if the customer may receive a full refund upon a breach of a performance warranty at any time during the agreement, recognition of the revenue from the agreement may be delayed until the end of the agreement. Another example is a provision that provides a full refund if a software deliverable is not accepted by a customer even if interim deliverables have been accepted and payments made upon such deliveries.

3. Agreement Signing. Make sure the agreement or statement of work is signed by the customer before beginning work. While there are legal theories (quasi contract, quantum meruit) that may provide a means of recovery in the absence of a signed agreement, the best business practice is to have a signed agreement in place. Ignoring the temptation to begin work before an agreement is signed may be difficult but you will be at risk if you start work prematurely.

4. Customer Credit Risk. You may need to do fundamental financial due diligence on the credit risk of a potential customer. Some potential customers may represent they have funding when they do not. While you may need to take some credit risk, do so on an informed basis by having access to basic financial information (such as a D&B report, balance sheet or bank statement) to evaluate this risk.

5. Termination Rights; Payment. Relatedly, be sure the agreement can be terminated or at least work can be suspended within a reasonable time if the customer fails to pay you in accordance with the payment schedule. For example, if payment terms are net 30 days and there is a 30-day notice and cure period before termination is effective, you will have to continue work through at least a 60-day period before termination is effective. At a minimum, this means you have to keep working and have a high risk receivable for the 60-day period before termination can be effective. This period should be shortened to reduce your exposure. Sometimes a customer proposes a provision that provides there is no right to terminate if the payment obligation is disputed by the customer. Such a provision means you have no leverage to be paid and could be obligated to keep working indefinitely. To provide leverage to be paid, assignment of IP ownership to the customer should be conditioned on receiving full payment.

6. Operational Coverage. Ensure the agreement permits delivery of the services in the manner that you operate. For example, if an offshore subsidiary corporation will actually deliver all or part of the services to the customer, the agreement must permit subcontracts so delivery can be accomplished that way. Subsidiaries are separate legal entities and you must have a subcontract in place to cover their responsibilities. Confidentiality provisions are another example. They must permit disclosure of the customers' confidential information to the extent needed to protect all parties in the delivery cycle. The agreement would be breached if confidential information is released to a subcontractor when disclosure is permitted only between the parties to the agreement. Unless expressly allowed, only the parties and their employees (but not subcontractors or consultants) are covered.

7. Service Level/Performance Warranties. Define the level of service performance and schedule as clearly and realistically as possible. The performance level is sometimes referred to as an express performance warranty. Delivery metrics such as response time, service results, network or application downtime percentages, etc. should be defined as objectively as possible to reduce disputes over measurement. Exaggerated claims of performance will be quickly discovered and will destroy the ongoing relationship, so be realistic and precise. When using a master agreement, performance levels can be addressed in the applicable statement of work since requirements may vary by service engagement even for the same customer.

8. Implied Performance Warranties. Disclaim implied performance warranties of merchantability and fitness for a particular purpose to avoid the possibility that there are performance requirements beyond the express warranties. The Uniform Commercial Code ("UCC") is intended to apply to products but you should assume it will apply to a services agreement at least when software or other technology is being developed. For example: "EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN THIS AGREEMENT, SERVICE PROVIDER HEREBY DISCLAIMS ALLWARRANTIES, OF ANY KIND, EXPRESS OR IMPLIED INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE." The capitalized wording should satisfy the conspicuousness requirement of the UCC.

9. Intellectual Property. Make sure you continue to own all pre-existing patents, copyrights, trade secrets and other intellectual property ("IP") before entering into the agreement and also, to the extent feasible, (1) any improvements or derivative works to such pre-existing IP and (2) other IP developed that may be repeatedly used in your business. In addition, to provide leverage to be paid, any assignment of IP ownership to the customer should be conditioned on being fully paid. Sometimes "joint ownership" with the customer without any duty of accounting to the other is an acceptable compromise at least as to the improvements to pre-existing IP. As a practical matter, there will be intense pressure from the customer to own IP. The best practice may be to allocate IP ownership in the applicable statement of work since it may vary by service engagement. The service provider will likely have to bear the risk of any claims of IP infringement or misappropriation in its deliverables.

Service businesses must not ignore their IP. Most service businesses have IP of some type. For example, IP includes the copyright and possible trade secrets in a database of domain knowledge in a technical support business and script in a call center business. It also includes the copyrights, possible trade secrets and patents in software routines that are incorporated into a software deliverable and software tools used in a network support business.

10. Damages Exclusions and Limitations. Economic exposure varies widely depending on the type of service. For example, the exposure from a tax return preparation service is considerably different from a call center business doing outbound sales calls. In all cases, exclude consequential, special, indirect and incidental type damages and, to the extent feasible, cap direct damages. Try to cap direct damages at the amounts paid in a payment period (month, quarter) rather than the total payments made under the agreement. Otherwise, the economic effect is that you have not been paid even for the good service you provided. Following are sample provisions: "In no event will either party be liable for any form of special, incidental, indirect or consequential damages of any kind, even if aware of the possibility of such damages. Service Provider's total liability under this Agreement will not exceed the amounts paid by customer during the three (3) months immediately preceding the date of the applicable claim." The UCC does not contain the conspicuousness requirement for these provisions.

11. Insurance Requirement. Comply with the workmen's compensation and liability insurance requirements of your customer. Work with an insurance broker who fully understands your business. Make sure your insurance covers all parties in the delivery process. For example, a special rider may be needed to cover the exposure of employees of a subsidiary corporation particularly if they are offshore. The named insured on a policy may not extend to these separate legal entities or the actions of their employees.

12. Force Majeure. Use a force majeure provision, particularly for service offerings involving delivery over a network. For example, if you are using overseas affiliates to provide services and there is a disruption in service caused by an earthquake, the agreement should not be terminated. The agreement should provide an opportunity for recovery within a specified period. Termination may occur only if recovery doesn't occur within the period.

13. Governing Law. Choose a governing law to provide more certainty to the interpretation of the agreement and, to be sure it will apply, use the clause: "excluding that body of law known as conflicts of law", following the choice of law. For example: "This Agreement will be governed by the laws of California excluding that body of law known as conflicts of law." The chosen law must have a relationship to the parties or the transaction such as being the state of their principal office or incorporation.

14. Dispute Resolution. Adopt a dispute resolution procedure that elevates the resolution process in an orderly, timely way. The first step could be a discussion between CEOs and the next step, non-binding mediation. Use binding arbitration as the ultimate mechanism to resolve disputes in order to increase the chances of maintaining the relationship. To avoid frivolous claims by either party, designate the arbitration site to be the customer's business location when you request arbitration and your business location if the customer requests arbitration.

15. Entire Agreement. Include an entire agreement provision so that verbal agreements do not become part of the agreement and amendments may only be implemented in writing. The following provisions do so: "This Agreement and the exhibits hereto constitute the entire agreement and understanding of the parties with respect to the subject matter of this Agreement, and supersede all prior understandings and agreements, whether oral or written, between or among the parties hereto with respect to the specific subject matter hereof. This Agreement may be amended only in a writing signed by both parties."

A service provider's credibility and business acumen is visible in its agreements and negotiation positions. Because of the competitive environment there may be a great temptation to accept almost any terms or credit risk in order to get a deal. You need to make sure risk allocation is balanced. Securing a deal on any terms may mean you work for free.