



CONTRACTPROBE



12 Crucial Clauses Customers Need in Any Supply Contract



Supply contracts come in a variety of shapes and sizes. At one end are contracts for high volume, low price and low risk goods or services. Reams of paper for an office would be an example. At the other end are one off contracts for a single good or service which is very expensive and high risk. Anyone want to buy a space shuttle?

The type of contract which is suitable will depend significantly on what type of supply is being covered. In this eBook we cover some of the features that are common to all supply contracts. However, you will need to consider each time just what type of supply is involved and therefore what type of contract (and how complex) is appropriate.

Many of the issues covered in this eBook will be reported by ContractProbe in a matter of seconds, together with suggestions for fixing the problem. Use ContractProbe to speed up your process for finalising a supply contract while reducing the risk of errors.

1. Scope of supply

It sounds basic, but one of the most important parts of any supply contract is the definition of just what is being supplied.

In a contract for the supply of physical items (referred to as “goods” in this eBook) that will typically be the specification of the items being supplied and will cover matters such as their quality, composition, performance requirements and any standard with which they must comply.

In the case of contracts for the supply of services, the contract needs to contain a comprehensive and detailed statement of the services to be supplied, together with, again, their quality requirements. This will typically be covered in a Service Level Agreement (“SLA”).

Contracts for the supply of both goods and services should contains both specifications and a SLA.

Without a clear definition on the scope of services to goods/services to be provided, both parties are in the dark regarding their fundamental rights and obligations. A thorough and unequivocal definition of the scope will always be required to ensure the parties' expectations are aligned.

Tip for customers: In the case of service contracts, don't forget to specify the performance specifications (how fast, how many) as well as the functional specifications (what it does). The performance specifications are often overlooked and can be critical to your supply requirements. It will be no good for you to receive the services that you require if they are delivered later than needed or not with the frequency you require. ¹



2. The consequences of the supplier's failure to comply with the specification or SLA.

With the scope of the contract established, there must be consequences in cases where the supplies do not comply with that scope.

- In the first case, customers should have the right to withhold payment until the goods or services are properly supplied.
- Liquidated damages (automatic financial consequences) as discussed below should also be considered. Liquidated damages may come in the form of financial penalties or service credits.
- Customers should also allow themselves the option of pursuing the dispute further in the event of a serious default. For example, a certain number of failures within a given time period could permit the customer to terminate the agreement and to seek out a more reliable supplier.

Tip for customers: Always include a right to withhold payment if you dispute that the relevant goods or services have been supplied properly.

3. Clear statement of price

An essential element of any contract is a clear statement of the price owed by the customer to the supplier for the goods or services. Many disputes that arise under contracts are due to lack of clarity as to just what the customer is required to pay.

The customer should also not allow the supplier a unilateral right to change the price over the term of the contract. If the contract is for a long term then ensure that any changes by the supplier are not just at large but are tied to objective external circumstances, such as an industry benchmark.

Tip for customers: Include a right to terminate the contract quickly and without penalty if the supplier changes the price in a way that you don't accept.

4. Payment terms

Even with a clear statement of price, it is important for both parties to know when payment is expected, how payment should be made, and the consequences of delay. In these days of increased interest rates, setting an appropriate payment term is particularly important.

Tip for customers: Make sure the payment terms are long enough for you to be able to inspect the goods or services supplied and ensure they are adequate before you are obliged to make payment under an invoice. It is much easier to resolve a matter with a supplier if you have not already paid for the relevant supplies.

5. Risk and title clauses for contracts involving the supply of goods

Customers should ensure that risk in goods is appropriately allocated during their passage from the supplier.

- Include a clause which clearly states that risk in the goods only passes to the customer upon receipt and contemporaneously with the passing of title. If they fail to do so, customers may be liable for damage to goods which they are yet to receive.
- Include an obligation to package the goods adequately. This will compel suppliers to protect goods properly before placing them in transit thereby reducing the financial risk and inconvenience of receiving damaged goods.
- Ensure that goods are free and clear of any encumbrances (such as charges or mortgages) in favour of the supplier or other third parties. Encumbrances may allow the supplier to reclaim the goods if there is some dispute under the contract.

Tip for customers: If goods are being purchased from overseas, specify that the goods are supplied under the DDP (Delivered Duty Paid) Incoterm; that is an internationally recognised supply basis that puts as much risk as is reasonably possible on the supplier to deliver the goods to the customer for the stated price.

6. Warranties

A warranty of compliance with the specifications is of fundamental importance to any supply contract. It helps the customer uphold their right to receive goods or services which are of the required quality. However, there are some additional warranties which can be used to supplement this fundamental warranty. They include warranties that the goods or services are fit for purpose, free from defects, compliance with relevant industry standards, and delivered with due care and skill. These warranties impose more holistic expectations on the supplier and can help fill in any gaps within the written specifications.

Customers should seek to absolve themselves of their obligation to pay for the goods or services in the event that one or more of the warranties are breached.

Further, customers should be cautious about clauses which exclude all implied warranties. Exclusion clauses have the effect of limiting the customer's warranties to those expressly stated in the agreement, rather than also being able to rely on the warranties which would be implied by the general law. The customer should either remove the exclusion clause or assure themselves that all important warranties are explicitly set out in the agreement.

Tip for customers: Ensure that customers are not required to pay for goods or services that are inconsistent with critical warranties in the contract.

7. Indemnities

Under common law, the supplier will be liable to pay damages to the customer for breaches of the contract. However, the law has established a number of limitations on this remedy, such as requiring the customer to attempt to mitigate its losses and restricting the types of loss that might be recovered.

The restrictions imposed by the common law are often appropriate. However, when you do want to ensure that you will be able to recover the full extent of the loss you suffer then you should consider including an indemnity in the contract for the relevant loss. Indemnities provide comprehensive protection against loss suffered in certain categories, thereby avoiding the typical challenges of proving the quantum of loss.

Customers should, at least, seek indemnities for any claims that third parties make against them arising out of the wrongful acts or omissions of the supplier. This will give them a remedy if the supplier's misconduct results in turn to the customer being sued. Similarly, where the services include software, customers should be indemnified in the event that the software infringes a third party's intellectual property rights.

Tip for customers: Some suppliers will insist on the right to take over on your behalf any third party claims that might come within the indemnity. If the supplier has this right then make sure that it cannot take over the action and then later claim that the action is not in fact covered by the indemnity.

8. Liquidated Damages for Delay or Defective Service Delivery

Another method of avoiding the challenges of calculating damages under common law is to rely on liquidated damages. Liquidated damages are a form of pre-determined remedy owed for certain breaches of the contract. In an ongoing service supply agreement, they might come in the form of service credits, which have the effect of reducing the amount that the customer owes for the services supplied to it.

Liquidated damages are also useful for delays in supply. If the supplier fails to deliver the goods or services on time, the customer will be entitled to an amount which will reduce the cost of the supply.

Make sure that the amount defined as liquidated damages represents a reasonable estimate of the loss you will suffer if the supplier does not perform. If the amount claimed as liquidated damages is arbitrary or excessive then it is likely to be unenforceable at law. Finally, make sure that the amount of liquidated damages is not stated to be your sole remedy for the relevant breach, so you can continue to claim damages under common law if necessary.

Tip for customers: When negotiating the liquidated damages clause, run some likely scenarios through the LD calculations to see just how much will be recovered for a particular service failure. It is not uncommon for these formulas to be impossible to apply in practice or to result in a payment adjustment which is negligible when compared to the loss actually suffered.



9. Limitations and Exclusions of Liability

Customers should review carefully any clauses which limit or exclude the supplier's liability under the contract.

- While it is common for supply agreements to contain a cap on liability, customers should ensure that the cap is appropriate having regard to the price of the contract and the likely impact on the customer's business from the supplier's defaults.
- Customers should be similarly vigilant about ensuring that there remain appropriate exceptions to the limitation on the supplier's liability. Exceptions for fraud, death, personal injury, and damage to tangible property are commonly accepted exceptions.
- Similarly, customers should ensure that the damages payable for indemnified losses are excepted. The comprehensive protection of an indemnity would be significantly undermined if it were allowed to be limited elsewhere in the contract.

Tip for customers: Think carefully about what type of loss you are likely to suffer in practice if the supplier breaches the contract. Ensure that that type of loss will not be covered by the exclusion of loss clause.

10. Subcontracting

While subcontracting is common in many industries, and may in fact benefit the customer by preventing delay or non-performance where the supplier would not otherwise be able to provide the goods or services in a timely fashion, customers should check that appropriate restrictions on subcontracting are in place.

- Customers should ensure that subcontractors are not engaged without their consent. Otherwise, the supplier may engage a subcontractor who is unreliable or disreputable.
- The customer should also ensure that the supplier is liable for the acts and omissions of the subcontractor. This will allow all the contract's protections to apply, albeit indirectly, to the conduct of the subcontractor. It is also likely to encourage the supplier to be judicious in selecting a subcontractor.

Tip for customers: Make sure that consent is a pre-requisite to the engagement of a subcontractor.

11. Choice of law, Jurisdiction and Dispute Resolution

In the event that a dispute arises, it is critical to know the laws which will govern the contract's interpretation and the enforceability of its terms. As regards jurisdiction, the parties will want litigation to occur in an efficient judicial system with an appropriate range of remedies. Moreover, for a judgment to be effective, it must be enforceable against the assets of the party owing damages. If these assets are in a different jurisdiction, judgments in the selected jurisdiction may be difficult to enforce.

Customers are particularly vulnerable to disputes which affect their ability to obtain consistent supply of goods or services. Therefore, before proceeding to litigation, alternative methods of dispute resolution should be exhausted. This way, the parties can ensure that large legal fees are avoided and amounts in dispute get resolved and paid quickly. Further, customers should insist on a right to withhold payments that are in dispute and to withhold payment during periods when the services have been suspended.

Tip for customers: If the Alternative Dispute resolution process refers to the rules of an external body, check that the body exists, that the nominated rules exist and that those rules are appropriate for the type of dispute that might arise under the relevant contract. Too often these clauses come from old precedents that refer to bodies that no longer exist or to rules that are not appropriate for the supply in question.

12. Termination

The ability to terminate allows a customer to pursue its best interests by seeking out alternative suppliers.

- Customers should be able to terminate for cause or, ideally, for convenience. Cause refers to certain kinds of default, usually those which cannot be cured or which have not been cured within a certain time.
- Termination for convenience allows the customer to terminate at its discretion after giving a certain amount of notice. That gives the customer maximum flexibility in always obtaining its supplies from the best provider at the relevant time.
- The customer should ensure that the circumstances in which the supplier may terminate are acceptable. In particular, they should be cautious about allowing the supplier to terminate for overdue payments. This will give the customer some flexibility in the order in which it pays its creditors and structures its cash flow. Without such a clause, customers could be forced to pay a certain supplier to prevent termination of a contract which might be critical to its business. An alternative to termination for delayed payment is to accept an obligation to pay interest on overdue payments.

Tip for customers: Make sure that each party's right to terminate the contract are appropriate. It is often appropriate for a customer to have much broader termination rights than does the supplier. This is a case where mutuality is not always fair!