ENTERING A NEW CONTRACT

POUNTS TO CONSIDER

Contracts are put in place to set out the nature of the relationship between the parties and to govern how the relationship operates. When you enter into any contract there are certain fundamental issues that will always need to be included. We refer to these as 'red flag' issues.

Liability Cap

One of the key areas any agreement should deal with is setting out the parties’ exposure and liability to one another.

You should check what liability caps are in place. Note, there may be different caps for different categories of loss. Identify any areas where liability is unlimited, consider the implications of this and, if necessary, negotiate an appropriate cap. It is common to see liability caps linked to a percentage of the agreement value. This ensures that a party’s liability under the agreement is proportionate to the value of the agreement, which can change as the business grows.

Indemnities

An indemnity is an obligation to provide compensation on a pound for pound basis for a particular loss suffered by the other party. The value of such indemnities in part relies on the liability caps (see above) but also on the breadth of the indemnity. Sometimes these will be drafted to include not just direct losses (e.g. loss that directly occurs as a result of a particular hazard, such as flood damage) but indirect and consequential losses (e.g. when your business cannot sell its merchandise due to a fire at its premises) as well. You need to consider what range of losses are appropriate or necessary. For example, other losses such as loss of profit or goodwill may also be included and where the agreement is business critical you may consider these appropriate.

You should always consider the scope, value and likelihood of any indemnity that you provide or may seek to rely on.

Termination

Termination rights may seem obvious, but it can be surprising the number of agreements that fail to provide for this at all. When considering the termination provision you need to ask yourself:

• when and how can i exit the agreement?
• when and how can the other party exit the agreement?
• can you terminate when the other party goes insolvent or performs some other detrimental act?
• does either party need to provide notice to the other in order to terminate and is this a reasonable amount of time?

Term

It is important to understand your termination rights in order to help understand the term of the agreement. Is this a fixed term agreement for 12 months, will it automatically renew or are you tied in until a termination event occurs? This is an important consideration as it may effect your bargaining position in the wider commercial negotiations. For example, if you agree a fixed price to supply goods for a fixed term of 3 years this could potentially be a loss making agreement. You have no control over external economic events and may not know if you can commit to that price for the full 3 years.

It is also important to note any break clauses, whereby you can offer notice at certain agreed intervals to terminate a contract. You should always keep track of these in case you want to rely on one. In addition, these should be reasonable for the term of the agreement; there is little value in a break clause 11 months into a 12 month contract.
Price and payment

Negotiating the price or value under any agreement is very much a commercial matter; however, it is important to understand the payment mechanisms and how these affect your cash flow, which may have an impact on the return you expect under the agreement.

For example, an agreement may make provision for invoices to be sent in the month following delivery of any goods, with payment terms of 60 days. The effect of this is to potentially increase your payment terms to around 90 days from the date of delivery. Does your business have enough liquidity to manage such payment terms? Alternatively, where your business is purchasing goods the supplier may ask for all sums due upfront for the next 12 months. This can provide the opportunity to ask for a discount on the price as the supplier receives the benefit of that cash in their account. As well as paying for goods or services you don’t yet own, you lose out on the benefit of any interest accruing on that cash and reduce your reserves for cash flow.

In addition, where you are the party receiving goods or services, are you able to withhold payment if there is any delay, or while you inspect the goods to check they are in good order and fit for purpose? This helps you to stay in control until you’re happy the goods or services are as promised.

General

As a final check you should confirm:

- **Jurisdiction**: Ideally this should be England and Wales or the jurisdiction to which the agreement relates. Sometimes you will see jurisdiction clauses that state the agreement will be governed in accordance with the laws of a US state or France for example. This can have vast implications to the way the agreement is interpreted and is normally beneficial to the party proposing the jurisdiction. If the agreement is between two companies based in England and the jurisdiction is a foreign country, you should push back on this.

- **Assignment**: You should check the assignment provision, can you assign the agreement to another party but more importantly can the other party assign their obligations? If they can, is this acceptable to you and should they be able to do this given the nature of the agreement?

- **Change of control**: Often agreements will contain a change of control provision which allows the other party to terminate the contract if you undergo a change of ownership. Depending on how this is drafted this could include any change in equity. As a growing business this may often not be appropriate if you’re looking to bring further investors on board. Change of control provisions can allow the other party an opportunity to renegotiate the agreement when it occurs. You need to consider if this is appropriate given your business plan and model.

Price and payment

When reviewing an agreement, this is always best being done in full, as the above highlights how various aspects of an agreement interlink or have a knock on effect to other provisions. It will also be necessary to understand the way the agreement operates in the context of the commercial arrangement you are trying to reach.

There may be other areas that are critical to you. If you are a digital agency processing large amounts of data then the relevant data protection provisions may be your number one priority. Or maybe your business relies heavily on intellectual property, in which case you will need appropriate provisions to ensure your work is protected. However, the red flag issues are fundamental to any agreement and should always be reviewed.

Get in touch

If you have any agreements you are entering into, or seeking another party to enter into an agreement with and are unsure of the implications of certain terms, or how best to represent your position, then give Kirsty a call. We would be happy to assist you in understanding how any agreement affects your business and to carry out a full report, red flag review or negotiate the terms on your behalf.

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