CUSTOMER CONTRACTS: HOW TO SEAL THE DEAL WITHOUT COMPROMISING YOUR INTERESTS

The lifecycle of a startup includes many milestones – your first strategy meeting, your first investment round and, at some point, the first customer to take a chance on your product or services. After spending countless hours perfecting their pitch and wooing customers, some startups are so keen to seal the deal that they either fail to sufficiently document their arrangements or agree to the customer's terms with little-to-no negotiation.

This **guide** explains the importance of clearly documenting your customer arrangements, key considerations when preparing and negotiating customer agreements and some practical tips on how to structure, and what to include in, your customer agreements.

MYTH 1: TIME IS OF THE ESSENCE, AND NEGOTIATING AN AGREEMENT IS AN UNNECESSARY ADMINISTRATIVE BURDEN

Myth buster: Although reviewing and negotiating a contract may take some time, ensuring that both you and your customers are on the same page from the outset will ultimately minimise delays caused by misunderstandings in the future.

Your agreement should outline each party's expectations as to:

- who is providing what to whom (and in what manner);
- any payment arrangements;
- what each party needs from the other in order to fulfil their obligations;
- how each party can get out of the contract;
- the risk allocation as between the parties; and
- how any disagreements in the future will be settled.

Some of the key concepts to be covered in your agreement are set out in more detail below. And remember, your agreement should be succinct, unambiguous and easy to understand (no one speaks Latin anyway!).

MYTH 2: HAVING A DOCUMENTARY TRAIL OF CUSTOMER ARRANGEMENTS IS NOT IMPORTANT IN THE EARLY STAGES OF YOUR STARTUP

Myth buster: Although investors may be keen to see your product up and running, savvy investors will want to conduct due diligence before committing any funds. Having a written record of all your customer arrangements to provide to prospective investors enables you to demonstrate the stickiness of your customer base and can help to reassure investors that key issues (such as intellectual property ownership and risk positions) have been considered, mitigated and agreed between the parties.

MYTH 3: A CONTRACT WON'T CAPTURE THE FLEXIBILITY AND ORGANIC ARRANGEMENTS THAT WE NEED TO OFFER TO OUR CUSTOMERS

Myth buster: Careful contract drafting and the correct contractual structure can give you the flexibility you need to both reflect your intended arrangement and provide scope for expansion or adjustment to the commercial terms in the future. Below are some commonly used contractual structures.

If you're looking to pilot your product or service with a customer: Proof of concept agreements are well-suited to short-term pilots, particularly where the pilot is being conducted in a trial (non-live) environment and/or uses dummy data. A proof of concept agreement can help you to demonstrate to a customer that your product or service is successful and viable, without requiring a commitment to purchase that product or service beyond the trial period. A key benefit is that customers may be more likely to agree to your terms without insisting on some of their usual more onerous terms, on the basis that this is a low-risk arrangement. A typical proof of concept agreement includes a project plan, which sets out the key objectives, milestones to be met, materials provided by either party and any requirements for acceptance testing.

If the customer intends to make multiple orders: A master services or supply agreement is structured to contain the key legal terms (for example, the intellectual property and confidentiality arrangements, warranties and indemnities, dispute resolution process and termination mechanisms) up front, with commercial terms for each separate order agreed in separate order forms. Each time the customer requires additional, or different, products or services, the parties can agree the commercial terms in an order form without having to renegotiate the risk allocation or other legal positions. The parties can also agree 'special conditions' in the order form which vary, or add to, the key legal terms for specific orders as required.

If your customer is the end user of a website or app: A terms of use agreement typically outlines an end user's rights and responsibilities in relation to their access to or use of a website or app. Typically, these terms disclaim or limit the liability owed by the service provider to users for any damages incurred as a result of their use of the website or app. You can download our free template Website Terms and Conditions as part of our A-Suite and customise it to suit your business needs.

MYTH 4: I SHOULD JUST AGREE TO THE TERMS PROVIDED BY THE CUSTOMER – NEGOTIATING OR USING OUR OWN TERMS WILL ONLY SCARE OFF THE CUSTOMER

Myth buster: Particularly when supplying goods or services to large corporate customers, you should expect that customers will propose that the supply be subject to their own standard customer terms. Often these terms are drafted with large-scale suppliers in mind, and they may not be appropriate for what your startup is willing or able to offer. Without having your own standard terms ready, you may either feel compelled to accept their standard terms, or face a long and costly negotiation to get your proposed amendments over the line.

Some of the potential benefits of having your own standard terms are:

- your customer agreements can be prepared quickly and cost-effectively and in a manner that more accurately reflects the nature of the product or service that you are providing;
- your increased familiarity with those terms will mean that you will be in a better position to explain them to your customers and, where necessary, negotiate them in a manner that still protects the interests of your startup;
- you will be able to more efficiently and effectively manage your customer contracts (and the positions and processes within them), particularly as the volume of customers that you sign up starts to increase; and
- you can demonstrate your commercial sophistication to prospective investors by showing them that your startup is prepared for the common legal engagements that lie ahead. Prospective investors will also be able to conduct due diligence on your customer arrangements quickly and confidently.

MYTH 5: THE POWER IMBALANCE ARISING WHEN CONTRACTING WITH LARGE CORPORATE CLIENTS OR INDIVIDUAL CONSUMERS NECESSARILY RESULTS IN UNFAIR CONTRACT TERMS

Myth buster: When drafting your own standard terms or attempting to negotiate the standard terms of your counterparty, you should consider whether any of the clauses could be considered 'unfair', based on any power imbalance between the parties.

Under Australian law, 'standard form contracts' between a business and an individual or, from November 2016, a small business of less than 20 employees, must not contain any 'unfair terms'. A 'standard form contract' is a contract prepared by one party and offered to the other party who has little or no opportunity to negotiate.

A court will determine whether a term is 'unfair' by considering whether the clause causes a significant imbalance between the rights of the supplier and consumer (or small business), whether the clause is necessary to protect the supplier's legitimate interests, whether, if the clause was enforced, it would cause the consumer (or small business detriment) and whether the clause is transparent. If the court determines a term is unfair, the term is void but the rest of the agreement will continue to be valid and to operate.

WHAT KEY INFORMATION SHOULD YOU INCLUDE IN YOUR CUSTOMER CONTRACT?

1. **Roles and responsibilities** – Your agreement should specify the services or products that you will supply, other deliverables and milestones, fees payable, invoice and payment arrangements and any materials or information that a party is required to provide to the other party to enable that party to fulfil its obligations.
2. **Intellectual property** – When considering the intellectual property arrangements, make sure you turn your mind to any intellectual property owned by either party prior to, or created independently of, the agreement (*Pre-Existing IP*), intellectual property created by one party in accordance with the agreement (*Generated IP*) and intellectual property that the parties co-create under the agreement. It is common for each party to continue to own their Pre-Existing IP and to grant to the other party a limited licence to use that Pre-Existing IP. It is also common for a supplier to own all Generated IP, and to grant the customer a limited licence to use the product or materials for the term of, and in accordance with, the Agreement, but this is an area that tends to be negotiated and that very much depends on the nature of the arrangement. Where the supplier is developing a product or materials for the customer specifically, the customer may require the supplier to assign the intellectual property rights in such Generated IP to the customer.
3. **Access to data** – Where the agreement covers the collection and analysis of data (which may or may not include personal information), the agreement should outline each party's rights to access, use, reproduce and derive insights from the data both during and after the term of the agreement. It is important to also consider the confidentiality obligations of the parties, as these may restrict either party's right to use or disclose that information.
4. **Warranties, indemnities and risk mitigatiton** – Parties typically rely on warranties and indemnities to allocate risk between the supplier and customer.

   A warranty is a contractual statement of fact – for example, a party may warrant that it has full corporate power to enter into the agreement. If the party granting the warranty (the ***grantor***) breaches that warranty (that is, the statement of fact is no longer, or never was, true), the grantor may be required to pay damages of an amount that puts the claimant in the position it would have been in had the warranty been true.

Typically, if either party breaches a term of the agreement, the other party can seek compensation by suing the breaching party for damages in court. An indemnity is a promise by one party (the ***indemnifying party***) to the other party (the ***indemnified party***) that it will hold the indemnified party harmless against, or make that party good for, any loss sustained if a particular event occurs.

Indemnities often covers losses suffered as a result of issues or events that are not expressly prohibited in an agreement (for example, losses suffered as a result of personal injury, death, fraud by the other party or breach of intellectual property rights claimed by a third party). Because these acts are not commonly expressly prohibited in an agreement, a party cannot sue for breach of the agreement in the event that such events occur. Having an indemnity that covers losses sustained as a result of a particular event means that if that particular event occurs, the indemnified party can be compensated without having to pursue legal action. Unlike a contractual action for damages, there is no obligation on the indemnified party to mitigate their losses.

Another tool to mitigate risk and liability is to cap the extent to which either party is liable to the other for breach of the indemnities, warranties or agreement in general. A liability cap is often expressed as a fixed amount or as a percentage of total fees paid or payable by customer to supplier.

5 **Term and termination** – Your agreement should expressly outline the length of the agreement and the date on which the agreement expires (unless terminated earlier). The term does not need to be for a fixed period – for example, a term may be perpetual, or may be agreed for a fixed term and subject to an automatic, or elected, extension period.

Your customer contract should also outline the circumstances in which a party may terminate the agreement, whether the terminating party has to notify the other party of their intention to terminate in advance and the consequences of termination (for example, whether certain materials or data should be returned to the other party, and whether the customer can continue to use the products or services).

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