# AIIA Contract Negotiation Guide

## Topic: Acceptance Testing

### Overview

This topic of the Guide addresses the following FAQs –

- What is Acceptance Testing?
- Why is Acceptance Testing important?
- What to look for in Acceptance Testing clauses?
- What are the consequences of failing to pass Acceptance Tests?
- If the Acceptance Tests are passed has the liability for delivery finished?

### What is Acceptance Testing?

Acceptance testing is the process that the parties to a contract use to determine whether a product or service meets the requirements of the contract. There are different types of acceptance tests depending on the product or service being provided.

### Why is Acceptance Testing Important?

Acceptance tests are important because;

- They define whether the deliverables provided by the supplier meet the contract requirements agreed to by the parties.
- The consequences of failing to pass an acceptance test are usually serious for the supplier.
- Acceptance usually triggers a substantial milestone payment, or payment of the total fee.
- The acceptance test process and the details of what is being accepted is one of the key factors that effects how a supplier can recognize the revenue associated with the delivery of the product or service under Australian and US accounting rules.

### What to look for in Acceptance Testing Clauses

#### *What is being Acceptance Tested?*

Each different type of deliverable usually has a different type of acceptance test process, and/or criteria. It is critical to fully describe the subject matter that is to be tested to ensure that the acceptance tests are applicable to that subject matter. For example, for off the shelf software, the full product name, and version number together with the operating environment on which it runs should be specified, (it is industry standard for off-the-shelf software

packages to be deemed accepted on delivery, without any acceptance testing). For hardware, the full configuration should be described, together with any operating software (including the version number) and any functional, operational and resilience measures. For custom built software, the full functionality and performance criteria of the software should be described. For systems integration work the full system, including how the component parts integrate with each other, and its performance characteristics, should be fully described.

***Particular care should be made when describing the following items:***

- The functionality of the product needs to be described in sufficient detail so as to enable an independent third party to assess whether the deliverable has that functionality.
- Any performance characteristics; how will these be measured, over what period are there any external factors which will effect performance?
- Documentation is usually visually tested for completeness, accuracy and format.
- If there is phased delivery of components, which items of functionality are accepted at which times and what are the consequences of previously accepted components if the system is rejected later?
- The supplier should not be responsible for any components of any system or solution that are not provided by the supplier (e.g. hardware, software, networks or coding that have been provided by the client or items which are acquired by the supplier as agent for the customer.) The supplier should be aware of any mismatches in warranties between the warranties that the supplier obtains from subcontractors, and warranties given to the client by the supplier for the same products or services. In particular, in systems integration work it is essential that both the subcontractor and the prime contractor understand

    - when the subcontractor's products and services are to be accepted;
    - whether they are to be accepted at the same time as the system, or whether they are on delivery to the prime contractor; and
    - what happens to the subcontractor's products and services if the client rejects the system. Does the prime contractor bear the risk of irrevocably accepting a subcontractor's product during the system build at the same time as bearing the risk that the client can reject the system (and all the component parts, including the subcontractor's product or service), if the prime contractor cannot get the system to pass the system acceptance test for any reason (including a failure of the subcontractor's product or service)?

- Interfaces with the clients existing IT systems.
- Ensuring that any changes to the contract specifications or deliverables are reflected in updated Acceptance Test criteria.

The tests need to be carefully designed so that they accurately test against only the contract requirements and that they are to be repeatable so that an independent third party could objectively determine whether the deliverable meets the requirements of

the contract. *If the specifications for the deliverables in the contract are not sufficiently detailed to allow an objective assessment of whether the deliverable has meet the contract requirements then the parties run a significant risk of dispute. The size of the exposure to both parties may be many times the size of the fees for the original contract.*

**What standard of testing is being used?**

The standard to which the deliverables are tested should be an objective one. To the extent that a subjective test is used, i.e. "the reasonable satisfaction of the client", then the supplier runs the risk of not being able to pass the acceptance tests. In particular, there are significant risks with certain types of "user" acceptance testing, as the "users" have no understanding of what the contract requires the supplier to deliver, and therefore they may provide many objections to the deliverables which were not based on the obligations under the contract.

As software and associated documentation inevitably contain some errors, the "materiality" of these errors is important. It is advisable to have errors categorised by their impact on the overall deliverable and have different consequences depending on the number and severity of the errors. It is suggested that if there are errors that are "material" (i.e. they substantially effect the overall use of the deliverable) then the test result is a fail, however if there are only immaterial errors then these can be remedied within a warranty service and the deliverable should be conditionally accepted (and trigger payment for acceptance). Any errors that are only superficial should be corrected only if it is reasonable to require the supplier to remedy them. Alternatively the clause can specify that the test be passed when the deliverables are in "substantial conformity" with the contract requirements.

**How is Acceptance Testing being conducted?**

A good acceptance test clause will set out the exact process for acceptance testing and will cover the following issues:

- Who is responsible for the creation and approval of the test scripts and for recording the expected results?
- Who is responsible for running the test, who is providing the test environment, and what is the period during which the tests will be run?
- Is live or representative data to be used?
- Will there be component or unit testing prior to systems testing?
- Will there be performance or stress testing and how will it be conducted?
- What is the timetable for each stage of the testing process and for issuing the results. Payment usually depends on the issue of an Acceptance Test Certificate.
- How is the associated documentation going to be tested and when?


**Acceptance Tests Results**

If there are any errors found during acceptance testing then it is essential that the client gives the supplier sufficient detail of the error to enable correction. This means that the client should provide an accurate description of the error (including the expected test result and the actual test result), how that error

means that a specific contract requirement has not been met, and the impact of the error on the overall usability of the deliverable. It would be unreasonable to require the client to have to state the cause of the error, as it is the supplier's responsibility to diagnose the cause.

If the client fails to run acceptance tests (where it is the client's responsibility to do so) or having run the tests does not issue a notice specifying that the tests were failed, then the supplier should be entitled to assume that the deliverable is accepted. This is usually dealt with by included in a contract a deemed acceptance clause that states that if there has been no notice of failure of the test within a prescribed time frame then the deliverable is deemed accepted.

Further, if the client puts the deliverable into production the contract should expressly state that the deliverable be deemed to be accepted and that the client accepts the risk of not putting the deliverable through the testing process. *There are significant risks to both the client and supplier of allowing a client to run live data in a production environment without going through thorough acceptance testing.*

**What are the consequences of failing to pass Acceptance Tests?**

The contract should set out the remedies for failing to pass the acceptance test. These remedies usually include some or all of the following:

- Rejection of the product, service or system and a refund of all fees paid. (As it is likely that all products or services will contain some errors upon initial delivery it is recommended that rejection is only available after the supplier has been given an opportunity to remedy the errors and resubmit the product or service for testing and the subsequent test has also been failed).
- Termination of the contract ( this right should only be available when the client is entitled to reject the product, service or system and has exercised that right).
- A requirement to remedy the errors within a specified period at no cost.
- The client being able to remedy the errors themselves, or through using third parties, at the supplier's expense.

In addition the supplier will be liable for damages for breach of contract, and in many cases, will be liable for liquidated damages for failing to deliver on time.


**If the Acceptance Test has been passed has the liability for delivery finished?**

Generally, the parties will be free to specify in the contract what the consequences of acceptance will be and will be bound by their agreement. For instance, provided the contract is clearly drafted to require the client to accept a deliverable which passes testing and to pay the purchase price, the client cannot then avoid these consequences simply because it still has some dissatisfaction with the deliverable.

However, there are a few qualifications to this:

- the client may still have a claim in damages notwithstanding acceptance where the deliverable does not comply with the contract specifications;
- the Trade Practices Act will imply non-excludable conditions and warranties (for instance, that services are performed with due care and skill or that goods are of merchantable quality) into some contracts (generally those for a value less than $40,000). These may entitle the client to a remedy notwithstanding acceptance;
- there may be separate liability under the Trade Practices Act for statements and representations made about the deliverables:
- the acceptance tests themselves must comply with the requirements of the contract - for instance, if the supplier was required to develop tests which "ensure" that the system meets the requirements of the contract, the client might be able to require new tests to be developed and performed if the tests were incomplete, inappropriate or inaccurate and did not test the system properly.

**Concluding Comments/Recommendations**

- It is essential that the parties have a common understanding of how any product or service is to be accepted as this defines the core delivery obligation of the supplier. Ask the client how they see the deliverables being accepted. Test the level of detail that the client will use to determine whether the product or services will be accepted.

- The acceptance test process or criteria can significantly affect the method used to record the transaction in the supplier's accounts, and the timing of revenue recognition for the "sale" of the deliverable. This may be a deal breaker.

- It is essential to understand all the consequences, including the impact on the project, legal and accounting consequences, of failing to obtain acceptance.

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# AIIA Contract Negotiation Guide

## Topic: Contractual Insurance Obligations

### Overview

This issue of the Guide addresses the following FAQ's:

- What insurance obligations should I agree to in a contract with a customer?
- What insurance do I need?

This Guide should be read in conjunction with the AIIA Guides on:

- Risk Management; and
- Insurance.

### Introduction

It is common for contractors to be required to effect and maintain various insurances as a term of supply and maintenance contracts. Reasonable insurance requirements can successfully transfer contract risks from the contracting parties to a third party insurer, providing benefits to both the contractor and the customer to the contract. On the other hand, insurance obligations which do not accurately reflect the risks retained by the contractor can expose the contractor to unnecessary expense and potential breaches of contract.

The main reasons for requiring a contractor to effect insurance are:

- to give the customer comfort that should the contractor be liable to the customer for a loss or liability suffered by the customer, the contractor will be able to meet its liability to the customer; and

- to ensure that the contractor will not suffer a loss which prevents it from performing the contract (particularly where the contractor cannot easily be substituted).

We discuss below some of the issues to consider when negotiating contractual insurance requirements.

### What are the risks and who is to bear them?

Consider what the contractor is promising to do. Is software to be provided? If so, is it to be specifically written or is it an off the shelf product? Is the contractor also to maintain the software? Will the contractor work on the customer's premises? Are motor vehicles to be used in performing the contract? And so on. The answers to these questions will determine what types of risks are involved in performing the contract and hence what types of insurances should be considered.

Before insurance obligations are discussed, the allocation of risks under the contract should be settled as far as possible. For example, will the contractor be responsible for consequential or economic losses flowing from the contractor's failure to perform? Will the contractor's liability to the customer be capped to certain amount? Even if there is a liability cap, does it apply to all kinds of liability, or do some kinds of liability remain uncapped? The extent to which the contractor is potentially liable to the customer will partly determine what insurance obligations on a contractor are reasonable.

Usually the general provisions on risk allocation will also determine who is responsible for any excess or deductible payable in the event of a claim.

**What types of Insurance are required and how much?**

Some of the types of insurances which the contractor may be required to effect and maintain include:

- **Property**
- **Contract Works**
- **Public and products liability**
- **Workers Compensation**
- **Professional Indemnity**
- **Computer Crime**
- **IT liability**

These and other insurances are further explained in the Insurance Topic of the Guide.

**How much of the risk is insurable?**

Not all risks are capable of being insured. For example, the risk of deliberate non performance usually not insurable. Some risks will be acceptable to some insurers and not to others. Other risks will be insurable but only at significant cost.

All insurance policies will have a limit to the amount of cover provided for each claim and also possibly for all claims under the policy (an aggregate limit). There will also be exclusions to the cover provided.

Accordingly, regardless of the insurances effected by the parties to the contract, some risks will remain with contracting parties.

**Who should be insured?**

The party who may suffer the loss or incur the liability covered by the policy should be the insured. This may include the contractor, subcontractors, agents and consultants and the customer. It will not always be possible to have all these parties insured under one policy. For example, it is

increasingly hard to have customers added as insureds under contractors public liability policies. Each employer will need to effect its own workers

compensation insurance. Professional indemnity policies usually need to be effected separately.

Where there is more than one insured, try to obtain the insurer's consent:

- to insure claims by one insured against another;

- to waive its rights to recover the cost of a claim paid to one insured from another named insured (ie to waive its rights of subrogation against named insureds); and

- not to impute the acts, omissions or non-disclosures of one insured to another.

**How long is the insurance needed?**

This will depend on whether the insurance is written on a claims made or occurrence basis. The distinction is explained in the topic on Insurance.

**Who is best to effect the insurance?**

Even if the contractor bears a particular risk under the contract, consideration should be given as to whether the customer is in a better position to effect certain insurances. For example, the customer may be able to effect public liability insurance on better terms (including price) through an extension to its existing policy to cover contractors and subcontractors.
The question of who is to pay for the insurances can be separated from the question of who is to procure the insurances. For example, the contractor could reimburse the customer for any additional premium costs it incurs in effecting insurance for the benefit of the contractor. Alternatively, the contractor may be entitled to recover the costs of effecting insurance as a contract cost.

**Project or Contract Specific Insurance?**

If the contract involves unique risks or the customer wants to ensure that, for policies with an aggregate limit for all claims under the policy (eg usually professional indemnity policies), the full limit of cover under the policy is available for claims arising from the performance of the contract, the customer may require that contract specific insurances be purchased. These insurances will cover claims arising from the specified contract only. Effecting such insurance will involve additional costs.

**Beware of contractually assumed risks and waivers of the insurer's rights of subrogation**

Many contracts of liability insurance do not insure contractually assumed risks. For example, if the contractor agrees to a mutual cap on the liability of

the parties to each other and, the contractor incurs a loss which but for the cap it would be entitled to recover from the customer, this loss may not be

insured. If the contract alters the liabilities of the parties to each other, insurances should be carefully checked. Extensions insurance to cover such risks may be possible, but this should not be assumed.

Be careful also of agreeing not to seek to recover losses from specified persons as this may constitute a waiver of the insurer's rights of subrogation. You are giving away rights the insurer would otherwise have to step into your shoes and recover the cost of the insurance claim from that person. This waiver may entitle the insurer to deny your insurance claim. On request, insurers may allow waivers of their rights of subrogation in certain specified instances (for example, in favour of other named insureds). This may incur an additional premium.

**Back to Back Contractual Obligations**

If you agree to insurance obligations consider the extent to which those obligations should be passed through to your subcontractors, suppliers and agents. In particular consider:

- Professional Indemnity
- Product Liability
- Workers Compensation

Consider carefully your potential liability to customers and the public where you use or supply third party products. What guarantees and indemnities do you have from the supplier? What liability are you prepared to accept if these products do not perform? Read your contracts with your suppliers and customers carefully to determine your exposure. Use insurance obligations on suppliers to minimise the risk that suppliers will not be able to make good any liability they have to you.

Also ensure that your contracts with suppliers, subcontractors and agents give you the rights you need in order to fulfil your obligations to your insurers in relation to notifications of changes to the risk, notification of claims and cooperation with insurers in the defence and settlement of claims.

Remember to check compliance by subcontractors, suppliers and agents with their obligations to insure. You may be liable to the customer for uninsured losses or in breach of contract in the event subcontractors, suppliers or agents do not effect required insurances.

**Concluding comments/recommendations**

Insurance obligations in contracts should be given thorough consideration early in the negotiation process. Only too often these provisions are left until very late in negotiations to be given proper attention leading to inappropriate terms being agreed to (with parties often being in breach of contract from day one or not being properly protected) or negotiations reaching an unexpected

impasse to the frustration of all concerned. Seek advice early on from your insurance advisers as to the appropriateness of draft insurance obligations

and the commerciality of suggested terms and amounts. Remember that some policies (particularly contract specific policies) may take some time to place with an insurer.

## Useful Resources

Refer to the Insurance topic in the Guide.

This topic kindly prepared for the AIIA Legal Forum (http://www.aiia.com.au/) by Rehana Box, Partner and Ian Oi, Special Counsel of Blake Dawson Waldron, Lawyers (http://www.bdw.com/), with the assistance of Kevin Stevens, Practice Leader Information and Network Technology Insurance of Chubb Insurance Company of Australia (http://www.chubb.com/).

**Other topics available in the AIIA Contract Negotiation Guide series:**

Pre-contract Issues

Intellectual Property Rights

Risk Management

Acceptance Testing

Insurance

# AIIA Contract Negotiation Guide

Topic: Insurance

## Overview

This topic of the Guide addresses the following FAQ's:

- What insurance do I need?
- What issues do I need to consider?
- How do I obtain insurance?

This Guide should be read in conjunction with the AIIA Guides on

- Risk Management; and
- Contractual Insurance Obligations

## Introduction

Insurance should be a fundamental part of your risk management strategy. Insurance allows you to transfer some of the risks to which your business is exposed to an insurer in return for a premium. But, not all risks can be insured. Nor will it be commercially sensible to insure all insurable risks. Some risks will always be retained by you. Those risks must be managed by other complementary risk management strategies. Refer to the Guide on Risk Management for further information.

In this Guide we introduce some common types of insurance which you may require, explain some of the issues to consider in buying insurance and discuss how to purchase insurance.

## What insurance do I need?

As a member of the information industry you will need to consider not only the regular types of insurances maintained by businesses but also specific insurances which cater for the unique risks associated with delivering IT products and services. If you have an insurance broker you should ask your broker to advise which policies you require given the specific nature of your business activities. You should ensure that your broker understands exactly what products and services you provide and how and where you provide them as this may change the broker's advice. For example, do you provide software services (such as installation, maintenance and support) as well as supply software licences? Do you customise software code for clients rather than supply off the shelf solutions? Do you advise on the suitability of systems for particular applications? Do you provide non technology related services? Are your products distributed or used in the USA or Canada?

## What types of Insurance are required?

### *General insurance types*

There are various insurances which any prudent business should consider. Below is a brief description of some of the more common types of insurance (there are many more). Similar insurances are often referred to by different names and we have mentioned some of these below. Insurers also often package different insurances together and offer them as a set under a particular name eg "Business Pack", “General Liability” or “IT Liability”. What is important is not the name of the policy but what it covers. Two policies from different insurers with the same name will not necessarily cover the same risks. It is very important to read the policy and ensure you are comfortable with what it covers and what it does not. Pay particular attention to the schedule, insuring clauses, exclusions and definitions in the policy. If in doubt, seek advice from your broker and/or lawyer as to the adequacy of the policy to meet your requirements.

In considering insurance it is important to distinguish between policies which will cover you for your own losses (for example, a property policy or a fidelity policy) and those that will cover you for your liability to others for loss they have suffered (for example, a public liability or professional indemnity policy).

**Business Interruption or Consequential Loss** – the insurer agrees to indemnify your firm for economic loss resulting from the disruption of its business following damage caused by an insured peril (this cover is often combined with a property damage policy to form an Industrial Special Risks Policy – see below).

**Computer Crime** – covers your firm’s liability for computer crimes committed by its employees.

**Computer and Electronic Equipment** – covers loss of damage to or theft of computer hardware and associated software. May include data recreation costs and related business interruption. May include cover for virus damage and damage or loss due to power failure.

**Contract Works** – covers a building or other structure during the course of its construction or erection. It may extend to cover the contractor's plant and equipment on site and may include public liability cover (if it includes the latter it is often called Contractors All Risks Insurance).

**Directors and Officers Liability** – covers directors and officers for their liability to third parties for breach of their director's duties or duties as officers and will often include legal expenses cover for the defence of litigation. The policy is often divided into two sections, the first covering the director or officer directly and the second providing company reimbursement cover where the company has indemnified the director or officer. It will usually exclude (with some exceptions) liability by the directors or officers to the company itself.

**Fidelity Guarantee** – provides cover against losses suffered by an employer due to a fraudulent misappropriation or embezzlement by employees.

**Industrial Special Risks** –provides a combined property damage policy (Section 1) and business interruption or consequential loss policy (Section 2). Such a policy will usually cover:

- Property loss or damage caused by fire and extraneous perils such as lightening, storm and tempest, earthquake, aircraft damage, explosion and water damage (usually excluding flood);
- burglary and theft;
- breakage of plate glass;
- loss of money;
- fusion;
- accidental damage to the insured property;
- consequential loss of profits for a specific period following insured loss or damage to property resulting in interruption to the business.

**Motor Vehicle – Compulsory Third Party** – this is a compulsory insurance which must be effected as part of the registration of road vehicles in Australia. The insurance covers liability incurred in respect of the death or bodily injury to persons caused or arising out of the use of the vehicle.

**Motor Vehicle Property (Comprehensive Insurance)** – this policy covers claims by third parties with respect to property damage as well as accidental loss or damage, including by theft and fire, to your firm's vehicles.

**Product Liability** – provides cover with respect to third party property damage or bodily injury losses arising out of the defective nature of goods manufactured, altered or supplied by your firm. Additional policies are required to cover the costs of product recall or product tampering.

**Property** – provides cover for loss of or damage to specified property by specified perils, accident and theft. It can extend to property owned by the insured or for which the insured is responsible.

**Professional Indemnity or Professional Liability (sometimes called Errors and Omissions to cater for where the insured person is not in a "profession")** – covers your firm's liability to third parties for professional negligence or, an error or omission in judgement. This type of policy will be relevant wherever professional advice may be given or professional services provided. For example, in a design and construct contract, professional advice will be given with respect of the design of the thing to be constructed. The policy often covers breaches of intellectual property rights (eg trademarks, copyright or patents), breaches of trade practices legislation and document recreation.

**Public Liability** – covers your firm's legal liability to the public (including customers) for bodily injury or property damage arising out of its business. It may also cover your firm's liability for loss of or damage to property in its care. This policy is often sold as a package with a product liability policy and called a **General Liability policy**.

**Workers Compensation** – it is compulsory in Australia for employers to take out Workers' Compensation Insurance covering their statutory liability to workers suffering an injury or disease arising out of or in the course of their employment. The terms of these policies are prescribed by statute.

***IT industry specific insurances***

The policies described above were developed before the information technology industry and as a result they do not always cover the unique risks faced by IT product and service providers. For example, the definition of "product" in traditional product liability policies may not include software. Or, the policy may require tangible loss or damage to occur, whereas the most likely risk may be a corruption of data or a financial loss from failure of the product to function or perform the service. To address these insufficiencies, some insurers now offer professional indemnity, public liability and product liability policies specifically for the IT industry. These policies are often sold as a package under names such as "**IT Liability**", "**Electronic and IT Liability**" or "**Internet Liability**" policies. IT Liability policies can provide benefits including:

- key liability policies are with one insurer avoiding possible disputes as to which policy should cover a particular claim;
- broad definitions of "product" to cover computer related services;
- cover for infringements of trademarks, copyright and possibly patents;
- wide professional indemnity coverage which covers the advice given by "non-professionals";
- cover for pure economic loss where there is no physical damage to property;
- cover for hacker attacks and viruses;
- world wide cover;
- cover for contractually assumed risks.

See, for example, policies offered via AIIAs Discounted Insurance offering with Chubb/I.T.I.S

**Other issues to consider in effecting insurance**

***Who should be the insured person?***

Ensure that the entity or person carrying the risk is the insured person. Make sure all relevant companies in a group of companies are insured. Consider whether subcontractors, agents and consultants should be covered on your public and products liability policies, if available or should they have their own. For property policies, consider who owns or has an interest in the property insured.

***How much cover should I buy?***

Insurance costs money. At some point you will have to weigh up the cost of insurance as opposed to the risks being insured. Higher levels of cover will cost more. You may be able to significantly reduce insurance costs by accepting a higher excess or deductible ie by not insuring smaller claims and having insurance only for large claims which could significantly affect (and possibly destroy) your business.

You should seek advice from your insurance broker and consider cost against risk. Consider whether the limits in the policy apply separately to each claim or to all claims under the policy. Look to see if sub limits apply to particular types of claims eg for document recreation or each location. For property insurances, check to see if the insurer has a right to reduce its pay out on a claim if the property is underinsured (known as an "average provision"). Also look at how much of each claim you must fund yourself (know as the excess or deductible) and consider its appropriateness.

***How long do I need cover?***

Some liability polices cover all claims arising from an occurrence during the policy period (known as "occurrence policies"). For example, most public and products liability policies are written on this basis. These types of polices should be maintained for the period during which occurrences may happen which may lead to a claim against the insured persons. Other polices cover claims made against the insured persons during the policy period (known as "claims made policies"). For example, all professional indemnity and IT Liability policies are written on this basis. These types of polices need to be maintained for the period during which claims could be brought against the insured persons arising out of their business activities. It is generally considered prudent to maintain these insurances for at least 7 years after the last event which could give rise to a claim against persons insured under the policy (to allow for the usual limitation periods for the bringing and serving of claims). All professional indemnity and IT Liability policies will contain a retroactive date. The policy will only cover you for losses that arise out of activities performed or products supplied after the retroactive date. If you require cover for prior acts of the company you will need to make sure the retroactive date extends back in time to cover such acts.

***Read the policy***

Make sure you understand what the policy covers and what it does not. Especially read the exclusions. For example, a liability policy may not cover risks you take on under a contract unless you would have been liable at law in the absence of the contract provision. Look at the geographical coverage of the policy. It is not unusual for policies to exclude cover for claims made or arising from occurrences in the USA or Canada – is this appropriate given the nature of your business? Make sure you understand what events need to be advised to insurers (eg possibly new business assets or activities, changes in control, outside directorships).


***Follow the procedures for making claims***

Make sure you notify claims promptly and follow the rules of the policy. While it may be possible to get around policy breaches at law, it is far simpler to abide by the contract. In particular do not admit liability without your insurers consent and get your insurers consent to the incurring of defence costs. If having your own lawyers act for you is important, ensure you have that right under the policy (otherwise insurers may appoint there own preferred lawyers).

***If you make a claim on the policy and it is rejected?***

Consider seeking legal advice as the insurer may not be justified in rejecting your claim. Not all terms in insurance contracts are necessarily enforceable as they read. Breaches of the policy may not entitle an insurer to reject a claim.

**Buying Insurance**

Some of the insurances you require may be capable of being purchased directly from insurers. Alternatively, you will need to appoint an insurance broker as your agent to negotiate and purchase the insurances for you. Given the nature of the risks which you will need to insure it is recommended that you seek the advice of a broker and possibly, an insurance lawyer to assist you in placing your insurance program. They can advise you on the differences between alternative policies, amounts of recommended cover and which policy best fits your requirements.

**Concluding comments/recommendations**

Insurance should be a fundamental part of your risk management strategy but it is not a replacement for good overall risk management. The better you are at managing risk, the better you will look to insurers and this should be reflected in premiums for insurances. Insurance is there for when, despite your best efforts, you suffer a loss or incur a liability. Refer to the *Risk Management Topic* in this Guide for further details.

Use your broker and your insurance lawyer to help ensure your insurance cover is appropriate to your needs. Most importantly, make sure that you understand what losses will and what losses will not be covered by your chosen insurance program.

## Useful Resources

Information Technology Insurance Services (I.T.I.S.) is the endorsed insurance broker for AIIA members. Discounts are available to members who use I.T.I.S. to purchase insurances from Chubb Insurance Company of Australia Limited. Visit www.aiia.com.au for contact details.

The names of other brokers can be obtained from:

- The National Insurance Brokers Association

  1800 252 558 or (02) 9964 9400

- Insurance Council of Australia

  1300 728 228 or (02) 9253 5100

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| This topic kindly prepared for the AIIA Legal Forum (http://www.aiia.com.au/) by Rehana Box, Partner and Ian Oi, Special Counsel of Blake Dawson Waldron, Lawyers (http://www.bdw.com/), with assistance from Kevin Stevens, Practice Leader Information and Network Technology Insurance of Chubb Insurance Company of Australia (http://www.chubb.com/). | **Other topics available in the AIIA Contract Negotiation Guide series:**<br>Pre-contract Issues<br>Intellectual Property Rights<br>Risk Management<br>Acceptance Testing<br>Contractual Insurance Obligations |
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# AIIA Contract Negotiation Guide

Topic: Intellectual Property Rights (IPR)

## Overview / Introduction

This topic of the Guide considers IPR ownership issues frequently raised during negotiations. It does not consider associated liability or warranty issues.

## What are the consequences of a supplier assigning ownership of IPR?

A supplier's IPR form the 'tools' of the supplier's trade. By assigning ownership of IPR, a supplier limits its ability to (re)use the IPR and build on the work done to date for the benefit of its business and its future customers. If there is, therefore, any possibility that a supplier will want to reuse all or part of the IPR, it is important that the supplier retain ownership of the IPR.

## What alternatives to ownership can suppliers offer customers?

A supplier can offer a customer a licence to the relevant IPR instead of assigning the IPR to the customer. The scope of the licence will depend on each of the parties' requirements. The licence may be restricted to a simple use licence or may extend, for example, to include rights to reproduce, modify or distribute the relevant IPR. If a supplier is concerned about the customer's ability to commercialise the IPR, the licence should be limited for use for the customer's internal purposes. The supplier should also consider what rights of access its competitors will have for example if the customer is allowed to sublicense the IPR to its contractors.

## What IPR can suppliers consider assigning to customers?

A supplier may be prepared to assign to the customer any IPR that the customer has paid for and is specifically developed for the customer. In which case, it is important for the supplier to carve out from the assignment, and instead license, any pre-existing IPR that may be incorporated in any such work including any IPR developed during the course of the project but which was not developed specifically for the customer and any third party IPR that may subsist in any such work. The supplier should also consider carving out of the assignment any modifications to any such pre-existing or third party IPR.

In granting rights to a customer in any third party IPR, a supplier needs to take great care to ensure that it has all the rights necessary to do so. Further, in respect of any pre-existing and/or third party IPR subsisting in the assigned IPR, the supplier should consider limiting the licence granted to the customer to

a right to use such IPR only for so long and to the extent that the pre-existing and/or third party IPR forms part of the total deliverables so as to prevent the

customer from being able to use the pre-existing and/or third party IPR independently from the deliverables.

## How can the supplier retain commercial advantage if it does assign ownership?

In the event that the supplier agrees to assign any IPR to the customer, the supplier should consider whether a licence back of the IPR is required to enable the supplier to continue to use the relevant IPR in its business. In such a case, the customer will have ownership of the IPR and will therefore be free to use, sell or distribute the IPR (potentially in competition with the supplier) in any way it choses but the supplier will, depending on the terms of the licence, also have the right to use the IPR for the benefit of its business and future customers. From the supplier's perspective obviously, the broader the licence is the better.

Depending on the supplier's concerns, a supplier may also consider requesting that the licence back be a sole or exclusive licence to commercialise the IPR. A sole licence will prevent the customer licensing third parties to commercialise the IPR but will enable the customer to do so itself. An exclusive licence will restrict the customer from commercialising the IPR whilst retaining the rights to use the IPR internally. A customer may request a royalty for the grant of a licence-back.

## Licence to use the customer's pre-existing IPR

Irrespective of the outcome of ownership negotiations, if, during a project, a supplier will be using, modifying or amending IPR owned by the customer or licensed by the customer from a third party, the supplier will need a licence from the customer to allow the supplier to perform all the work contemplated under the project. Although such a licence may be implied from the circumstances, it is best to provide for it expressly to ensure the scope of the supplier's rights are clear.

## Concluding Comments/Recommendations

The important thing suppliers must always consider in any negotiation around IPR is what rights, if any, does the supplier ultimately require in the IPR to allow it to conduct its business (always remembering that IPR is an area where there are a multitude of options for finding a satisfactory resolution for both parties).

## Useful Resources

http://www.ipaustralia.gov.au/ip/W_home.htm

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| This topic kindly prepared by Dominic Instone of Baker & McKenzie (http://www.bakernet.com/) for the AIIA Legal Forum (http://www.aiia.com.au/). | **Other topics available in the AIIA Contract Negotiation Guide series:**<br>Pre-contract Issues<br>Insurance<br>Risk Management<br>Acceptance Testing<br>Contractual Insurance Obligations |
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# AIIA Contract Negotiation Guide

Topic: Pre-contract Issues

## Overview

This topic of the Guide addresses the following FAQs –

- What constitutes a binding contract?
- What is the effect of letters of intent/heads of agreement/ tenders?
- Can we be liable for statements made before the contract is signed?
- How can I protect my confidential information during pre-contractual negotiations?
- What are some tips from experience?

## What constitutes a binding contract?

***Offer and acceptance***

The essential elements of a binding contract are an offer and unqualified acceptance of that offer which is communicated to the offering party. Each party must also offer something (known as "consideration") in return for the performance of promises by the other party; it may be money or a promise to do something else.

***Oral and written contracts***

A contract does not have to be set out in writing to be binding. A contract may be agreed orally, it may be set out in a series of e-mails or facsimiles, or it can be a mixture of both. But it must be clear, from the words used, what the parties intended.

Therefore, in pre-contractual negotiations it is important for each party to be clear when an agreement is reached and which of the issues discussed actually form part of the contract.

## Letters of Intent

Letters of intent, or letters of comfort, are often requested before contract details are finalised, setting out the principal elements of the contract. Usually there is some deadline driving the request, such as a need to arrange finance, order hardware or avoid a proposed price increase.

**Tip**

Letters of intent should be reviewed, preferably by a lawyer, to ensure that there is no binding obligation imposed on either party under the letter, such as to perform some preliminary work before the main project begins, order equipment or arrange finance, in order to avoid the costs of this work being claimed if the contract does not proceed.

**Heads of Agreement**

Contrary to popular belief, heads of agreement are usually binding. A heads of agreement document is often used as an initial step to negotiating the "formal" contract.

**Tip**
Heads of agreement should either be expressed to be non binding, like a letter of intent, or provide for what is to happen if the contract is not completed by a certain time: the arrangement could be terminated, some payment made for work done and materials kept or returned. The safest option is to take the time to negotiate the contract properly or have a briefer, but fully negotiated, contract covering any initial works.

**Tenders**

A call for tenders by a potential customer is not an "offer". It is an invitation to make an offer. By submitting the tender, the tenderer is making the offer which the customer may or may not accept.

It is essential that the tenderer ensures it can perform all promises and representations in the tender documentation and that there are no misleading or deceptive statements. You should not rely on qualifying the tender later. The customer will be relying on its contents to decide who wins the tender. If it later pulls out because you have changed a representation, the customer may claim losses for the delay in its project and any additional costs of bringing in another supplier. Also, the customer will rely on the contents of the tender in negotiations and it may form part of the final contract.

**Can we be liable for statements made before the contract is signed?**

Don't make promises that you can't keep in pre-contractual negotiations! Even if the promises are not repeated in the contract, such conduct which is misleading or deceptive or likely to mislead or deceive the other party or which is false may breach sections 52 or 53 of the Commonwealth *Trade Practices Act 1974*.

***Misleading and deceptive conduct - section 52***
A statement about a future matter will be misleading if, when the statement was made, there were no reasonable grounds to make it. Unrealistic promises by sales personnel are a continual source of problems.

In *RACV Insurance v Unisys Australia Ltd*, the Victorial Supreme Court awarded RACV $3 million in damages when RACV claimed that software

Unisys supplied did not function as represented in pre-contractual discussions.

***False representations - section 53***
Making certain false representations is an offence under the *Trade Practices Act*. Some examples of particular types of false representations which are prohibited are as to: the standard and quality of goods or services; sponsorships and affiliations the corporation has; the need for the goods or services.

Breaches of section 53 can lead to fines and liability in damages for the both company and those individuals involved in the breach.

**How to protect confidential information during pre-contractual negotiations.**

During the negotiation stages of a contract, your business will reveal valuable company information, such as financial information (pricing), product specifications, alliances and other material which you would want to keep from competitors and, sometimes, other customers.

***Use of confidentiality notices and undertakings***
In order to protect any confidential information in tenders and other documents, display a prominent notice that the contents are confidential on the relevant parts of document. This will be effective in precontractual negotiations if the information is really confidential. However, if confidentiality is a major concern, a confidentiality undertaking or agreement has the advantage of setting out specific obligations as to use, disclosure and return of the information. These agreements are often mutual and cover both parties' information that is shared in the pre-contractual stage.

***Keeping patentable material confidential***
If an unregistered invention is disclosed without any clear obligation to maintain the confidentiality of the invention, then the invention may be refused registration.

**Practical Recommendations**

***Retaining records of pre-contractual negotiations***
Ensure that both parties to the contract have a clear understanding of each other's goals and expectations and that there is a "meeting of the minds".

To make the final contract stage simpler:

- Keep a file, Print out emails, Keep written file notes of meetings and conversations;

- Confirm important points with suppliers and customers clearly in writing (by e-mail is easy) to ensure any misunderstandings are ironed out early.

- Save time and money through strategic planning of the contracting process:

- Involve lawyers and business procurement personnel early in negotiations as well as technical personnel. This will prove a timesaver in the long run, by setting the main issues in place for negotiating.

- Standardise procedures in your company for negotiating contracts (decide policies for intellectual property, limitations on liability, insurance levels) to streamline the pre-contractual and contractual stages.

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| This topic kindly prepared for the AIIA Legal Forum (http://www.aiia.com.au/) by Bob Jordan, Partner and Catriona Graham, Lawyer at Henry Davis York (http://www.hdy.com.au/) | **Other topics available in the AIIA Contract Negotiation Guide series:**<br>Risk Management<br>Intellectual Property Rights<br>Insurance<br>Acceptance Testing<br>Contractual Insurance Obligations |
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# AIIA Contract Negotiation Guide

## Topic: Risk Management

### Overview

This topic of the Guide addresses the following FAQ's:

- Helping you avoid or mitigate exposure to litigation and disputes.
- An understanding of the risks associated with your business

This Guide should be read in conjunction with the AIIA Guides on:

- Insurance; and
- Contractual Insurance Obligations

### Introduction

Both the number and cost of information technology and communications (IT&C) disputes have been steadily rising. At the source of increasing litigation are a number of factors, including the following.

- An increase in business partner litigation, arising from customers' increased willingness to sue long established business partners for performance failure problems.
- Dramatic increases in average contract values, increasing the likelihood that a performance failure will be "worth the fight" and increase in average contract length, causing changes in contract specifications to be more likely to dramatically affect the ongoing business of the customer.
- Greater competitive pressure on the IT "provider side," increasing the chances that marketing and sales pressure will invite over-promising of supplier capabilities.
- Greater dependence on information technology solutions, increasing the likelihood that software solutions will be core business solutions.
- An increase in the likelihood that customers will allege a Trade Practices Act breach and seek extra-contractual remedies that can compromise the waiver of consequential loss or contractually agreed limitation of liability.
- An increase in the number of companies "going global," resulting in a host of new exposures arising from foreign laws and regulations.

This guide, which is aimed at helping you avoid disputes and litigation by gaining a better understanding of the risks associated with your business, will discuss in detail areas of potential exposure for the IT&C industry.

### Contracts and Agreements

***Legal review of contracts and agreements***

Have legal counsel review all contracts, purchase orders, license agreements, and service agreements, including those with subcontractors.


***Standardising contracts***
Whenever possible, use standard contracts that set out risk positions you are comfortable with and that you are familiar with. If you must use customized agreements, ensure you understand all the implications of the changes. For example, use boilerplate amendments that have become "standard exceptions," or make sure your legal counsel reviews the deviations from standard.

***Limitations of liability***
Whenever possible, take advantage of contract language measures that enable you to allocate risks and responsibilities, and to manage your liability risks. A good starting point is to consider what you might be willing to accept unlimited liability for, what liabilities you might want to totally exclude, and what liabilities you might be willing to accept on the basis of capped exposure (eg, the value of the contract, or a multiple of that value). In particular, you should understand and manage your exposure to claims of loss of revenue, profits or savings, and indirect, consequential and similar damages (for instance, by excluding or capping them).

***Warranties***
You should only give warranties that you understand and accept the performance risk on, and that you will able to meet. Make the warranties appropriate and as specific as possible. For instance, if you are willing to give a warranty that products or services are fit for the customer's purposes, you should always try to specify in the document what those particular purposes are, and limit your warranty to those identified purposes. Also include disclaimers of warranties other than those that you expressly give in the document, but make sure that these disclaimers conform to the requirements of the Trade Practices Act 1974 (Cth) regarding what can and cannot be disclaimed. There may also be other regulatory requirements that are relevant to the particular transaction and that should be complied with.

***Indemnities***
If you are willing to give an indemnity, also include the procedures, terms and conditions that you want to follow if the indemnity is invoked by the customer. You should also consider what indemnities you wish the customer to give to you. In many cases, asking for a reciprocal indemnity is not unreasonable and will result in the customer withdrawing or moderating its request.

***Force majeure***
Force majeure clauses limit your liability for losses or breaches resulting from external forces such as earthquakes, storms or other natural events, as well as events such as war. Sometimes, they can also be extended to other things that are beyond your reasonable control. For a supplier, it is important to not only include a force majeure clause in the supply contract, but to also specifically include in it any thing that is a particular risk in this area.

***Performance specifications***
When negotiating contracts, ensure that all parties document ahead of time the agreed specific expectations, promises and contingencies regarding the

performance of the contract. Too often contracts are not specific enough in this area and leave you open to potential litigation. Key factors also beneficial to include in your contracts are: agreed upon definitions, performance specifications, time tables, measures for dealing with contract and performance changes, and the processes and procedures to be used in dispute resolution.

***Amendments and modifications***
Specify the procedures for making amendments and modifications to your contracts. All such changes should be required to be made in writing. Where possible, standardise the documentation for requesting and agreeing to contract changes. Document any changes made to product and service specifications and deliverables.

**Quality and Support of Products and Services**

***Quality control***
Implement quality control systems at every phase of production. At a minimum, standards for acceptable levels of reliability, performance measures, functionality and scalability, compatibility with integral systems, product life span, the time it takes for deployment, and on-going support and service. Your checklist for the development of a quality product or service should include the following:

- Alpha & Beta Testing
- Formal customer acceptance procedures
- Prototype Development
- Statistical Process Control
- Vendor Certification Process
- Total Quality Management
- A formal product recall plan
- Products or services produced to widely accepted standards
- Retention of critical contracts, documents and records for clearly defined time standards
- Written and Formalized Quality Control Program

***Discontinued products or services***
Openly communicate to your customers any plans you may have to discontinue producing a product or to discontinue a service. Give them sufficient advance notice of the phase-outs and, if possible, a migration path to some other suitable product or services.

***Outsourcing and resellers of services***
Include in your contracts language that limits your liability in the event one of your outsourced suppliers fails to deliver as promised. If you are unable to fulfill your contractual obligations due to the failure of an outsourced vendor or supplier, you could have significant exposure created by a breach of contract.


***Merger or acquisition activities***
Carefully review prior liabilities and loss experience generated by the organisations being considered for merger or acquisition. Only purchase the assets of an organisation having a history of litigation problems or difficulty with managing or completing projects.

**Operational Controls**

***Legal review of advertising materials and product brochures***
Ensure legal counsel review all advertising and marketing materials with regard to the promises explicitly made or implied to customers. Set realistic expectations and avoid absolutes (eg. the best, the most comprehensive, 100% fool proof) in marketing materials. Product and promotional literature may develop expressed or implied warranties not contemplated in the contracts that are being used. A thorough legal review can reduce potential unintentional warranties from being enforced during litigation.

***Accounts receivable collection procedures***
Be cautious of changing your accounts receivable collection procedures. For example, if you have not been aggressively closing out accounts be wary of doing so. Changing such practices often lead to counterclaims from customers who allege that your products or services did not perform as intended. Your customers could make these allegations in an effort to evade their payment obligations.

***Sales and marketing training***
Seek legal counsel's assistance in developing sales and marketing training programs that control product oversell and puffery. If any confusion exists between what the salesperson told the customer and what the contract says, a claim may be made for misrepresentation or fraudulent inducement to contract.

***Certificates of insurance***
Make it a standard to obtain certificates of insurance from subcontractors and vendors as evidence that they have complied with your requirements. The certificates should specify effective dates, limits, and coverage afforded.

**Network Issues**

A company connected to the Internet should have in place a formal security program and communicate its specifics to all employees. Ensure that the program is updated, documented and adhered to by all your staff. The following risk management recommendations apply to external and internal networks.

***Network Security Manager***
Assign an individual or team with responsibility to closely review your encryption, firewalls, virus protection, security protocols and intrusion detection used to protect the data of others stored on your networks and servers.

***Testing and validation***
Invest in regular, frequent network vulnerability scanning by an outside vendor to validate that your security program is being adhered to. If holes or weaknesses are found in the network, take immediate steps to fix the problems.

***Formalized disaster recovery program and Crisis Management***
Develop a formal disaster recovery plan. The absence of a formalized program may be construed as gross negligence by the courts. Be prepared to quickly convey accurate information regarding security threats and incidents to all appropriate parties.

***Access authorisation/revocation***
Establish access authorisation procedures for all your systems. Prevent former employees from accessing your systems by revoking their access codes.

***Reliability, Redundancy and Network Availability***
The reliability of your systems is the result of good architecture design, use of high quality software, hardware and out source service vendors, and on-going maintenance and upgrades. The availability of your systems is a function of your system architecture and network management. Your network should be designed to allow for load balancing in times of peak capacity. Redundancy is an architecture issue as well. Your network should be built in such a way that traffic cannot be interrupted, and your service provider should be able to back up data or mirror data on another part of the network.

**Disputes and Allegations of Non-Performance**

***Loss History***
Carefully analyze all non-performance losses, claims and litigation as well as their causes. Include in your review all suits, potential suits, complaint letters, disputes or any other circumstances alleging non-performance of your product or services. A thorough loss history can be a window on future litigation problems and should be used to help identify and eliminate potential sources of loss, claims and litigation.

***Product rollbacks or recalls***
If you have had product recalls in the past, document why they occurred and the remedies used for resolving customer loss of use.

***Contract delays***
Examine the causes of any contract delays you have experienced. If the delays arose from promising unrealistic deadlines or agreeing to unrealistic customer expectations, address the issue with your sales force and customers and negotiate reasonable contract terms.

***Contract disputes/non-payment***
Once a contract is in dispute or a customer is withholding payment, you should strive to work with that customer to resolve the dispute and avoid

litigation. Aggressive attempts to get paid for a project that remains in dispute tend to invite breach of contract claims. Instead, positive dialogue and frequent, open discussion concerning the viability of any project as it progresses enables both parties to resolve disputes before they get out of hand and take action when a project hits a snag. Projects can proceed, be cancelled or be redirected by scaling them back or changing the requirements, thereby resulting in a win-win for both parties.

**Concluding comments/recommendations**

This guide is advisory in nature. It is offered as a resource in developing or maintaining a loss prevention/risk management program. The guide is necessarily general in content and intended to give an overview of certain aspects of IT&C liability. It should not be relied on as legal advice or a definitive statement of the law in any jurisdiction. For such advice, readers should consult their own legal counsel.

This topic kindly prepared for the AIIA Legal Forum (http://www.aiia.com.au/) by Kevin Stevens, Practice Leader Information and Network Technology Insurance of Chubb Insurance Company of Australia (http://www.chubb.com/), with the assistance of Rehana Box, Partner and Ian Oi, Special Counsel of Blake Dawson Waldron, Lawyers (www.bdw.com).

**Other topics available in the AIIA Contract Negotiation Guide series:**

Pre-contract Issues

Intellectual Property Rights

Insurance

Acceptance Testing

Contractual Insurance Obligations