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SPECIAL ALERT!

Technology, Media & Telecommunications (TMT)

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Safeguarding IT Service Providers: Addressing Breach of Payment Terms in IT Contracts

Breach of payment terms is a prevalent issue in IT contracts, where customers withhold payment, alleging issues with deliverables or compliance. This situation can severely impact IT service providers' cash flow and project timelines. To effectively mitigate these risks, IT service providers can employ various contractual mechanisms to protect their interests:

Payment Milestones

Structured payment milestones tied to project progress are often advisable over lump-sum payments upon project completion. This approach reduces the risk of non-payment after project completion. Milestones should be clearly defined in the agreement, for example: 10% upon contract execution, 30% upon design confirmation, 40% upon acceptance tests completion, and 20% upon project Go-live. Each milestone's completion should be objectively verifiable to minimise ambiguity.

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Certificates of Acceptance (COA)

Depending on the project, it may be wise for IT service providers to require customers to sign a certificate of acceptance (COA) upon completion of each individual project milestone. The agreement should stipulate that signing the COA signifies customer's acceptance that the milestone has been fully achieved in accordance with contract specifications. This approach minimises opportunities for customers to dispute the quality of deliverables well after their delivery.

Time Limit to Dispute Invoice

IT agreements should include a clause specifying a fixed period for customers to dispute an invoice and the proper procedure to do so. For example:

> *"Notice of disputes on the charges of any invoice must be made by the [Customer] in writing, within 30 days from the date of receipt of the invoice. Failure to do so will result in the [Customer] waiving their objections on the said charges. The [Customer's] Notice of Dispute should: (a) state the reasons as to why the particular invoice is disputed; (b) set out the precise amount in dispute; and (c) be accompanied by any supporting documents"*

Such a clause aims to prevent customers from raising disputes at a later stage in their attempt to avoid payment.

Late Payment Charges

Late payment charges serve as an effective deterrent against customers defaulting on their payment obligations. An example of such a clause is provided below:

“Any sums payable under this agreement that remain unpaid after their due date shall incur late payment charges at a rate of 6% per annum, calculated on a daily basis.”

However, it is important to note that clauses regarding late payment charges are governed by Section 75 of the Contracts Act 1950 and case law concerning the said provision, such as the case of ***Cubic Electronics Sdn Bhd (in liquidation) v Mars Telecommunications Sdn Bhd***. Under these laws, if the IT agreement specifies a particular late payment charge, the IT service provider is entitled to enforce these charges unless the customer can prove that the charges are ‘unreasonable’. Late payment charges are considered unreasonable if they are “extravagant and unconscionable” in comparison to the highest conceivable losses that may arise from the breach.

It is important to recognise that the determination of reasonableness varies from case to case, and there is no fixed formula for this assessment. Therefore, service providers are advised to exercise caution and avoid setting excessively high late payment charges.

Prohibition Against Set-Off Clause

IT service providers should also consider including a clause in the agreement that prevents customers from setting off or withholding sums due in an invoice unless they are properly disputed in accordance with the agreement. For example:

“Parties hereby agree that [Customer] shall have no right to withhold, deduct, or set off any sums due in the invoices for any reasons whatsoever, unless they are properly disputed in accordance with the procedure set out in Clause X above.”

Suspension & Termination

Another powerful tool at the disposal of IT service providers is the ability to suspend contract performance or terminate the contract entirely in response to the customer's breach of payment terms. However, it is crucial that the rights and procedures for suspension and termination are clearly defined within the agreement. Failure by the IT service provider to adhere to these prescribed procedures could render any suspension or termination unlawful, potentially resulting in the IT service provider being in breach of contract instead.

Deposits & Guarantees

IT service providers may also request advance payments or deposits at the project's outset to mitigate the risks associated with non-payment or late payment. Alternatively, they can seek a personal guarantee, particularly from corporate clients with uncertain financial standing.

These are just a few examples of the many mechanisms available to protect IT service providers against payment issues. However, addressing non-payment is not a one-size-fits-all approach. IT service providers are encouraged to seek legal advice to determine the most effective approach based on the specific circumstances of their projects.

If you have any queries, please contact Associate, **James Lau Jian Hui** (ljh@lh-ag.com), or his team Partner, **Chan Mun Yew** (myc@lh-ag.com). They have notable experience in handling disputes relating to the Technology, Media & Telecommunication (TMT) industry.

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