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COMPUTER LAW

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Principal Issues Involved in Negotiating Large System Software Licensing Deals

THIS ARTICLE addresses the principal issues encountered in negotiating business-to-business large system software licenses. Typically, these agreements are characterized by a complex package of software components and have significant installation related issues. Maintenance requirements are frequently a component of these agreements generally averaging 15 percent of the initial license fee on an annual basis. Many of the issues discussed in this article are common in various intellectual property transfer contexts not involving software. In contrast, this article does not address the typical "shrink wrap" software license principally found in consumer-oriented software sold at the retail level.

A. Characterizing the License. The license agreement should designate certain essential terms up front, such as exclusivity, transferability, whether the license is "fully paid up," geographic limitations and the length of the term. The opening paragraph should simply characterize the license with these descriptive terms and then expand on them later in the agreement. The opening paragraph should also identify the software subject to the license, usually by reference to an appendix, which specifies the various components of the software program under license.

B. Scope of Rights. This is one of the critical elements of the license agreement. In this paragraph, the parties must articulate with precision exactly what the licensee is permitted to do with the licensed software. Restrictions should generally fall into categories such as:

- internal use for the licensee's business.
- internal use, plus some sublicensing components.
- use only to support sublicensing (sometimes referred to as a reseller).
- use in connection with a bundling of other products or services (provided by licensee or others) for sublicensing or co-marketing or joint development of combined product (through a joint venture or otherwise).

Whatever the restrictions on use, some specificity as to the logistics of use should be provided. For example, the agreement may provide that the software can only be installed on certain computers identified by a registration number; or that the software may be utilized only by a limited number of users. If sublicensing is permitted (usually in a reseller or co-marketing context), the agreement should provide that no access to the software by sublicensees will be permitted, except pursuant to a sublicense agreement in a form agreed to between the parties, which usually is set forth as an appendix to the license agreement.

Various restrictions are usually set forth which fall under the category of "anti-copying." These provisions state that only "object code" is being provided and that no transfer, assignment or other encumbrance of the software or licensee's rights therein is permitted. It further provides that licensee will not copy, modify or distribute the software (electronically or otherwise), reverse assemble, reverse compile or otherwise translate the object code. The agreement should further restrict multiple users, time sharing or any other use, except as expressly provided.

C. Fees. This section generally should set forth the fees for the license, terms of payment, maintenance fees and any other additional fees. Maintenance fees are usually subject to prospective adjustment on a short-notice basis. This section should also address the obligations for payment of any sales or use taxes.

D. Maintenance and Support. This section should address the licensor's maintenance obligations. It will generally provide that licensor supports only the most current version of the software and imposes upon the licensee the obligation to obtain and substitute all new releases and fixes issued by licensor pursuant to its warranty and support programs. Manufacturers should set forth the terms of maintenance coverage with specificity (e.g., regular business hours or 24 x 7 coverage).

This section should also address licensor's obligations, if any, with respect to providing updates and enhancements to the licensed program. Licensor will also want the agreement to provide that if the licensee fails to pay any fees due under any provisions of the agreement, including maintenance fees, licensor will be entitled to terminate maintenance and support services.

This provision will also set forth the responsibilities of the licensee with respect to the peripheral equipment that must be used in connection with the licensed program. It should impose upon the licensee the responsibility for ensuring a proper environment and proper utilities for the computer system on which the licensed program will operate, including an uninterrupted power supply.

This section should also impose upon the licensee the obligation to select and train (sometimes with licensor's assistance) personnel who are sufficiently qualified to operate the licensed program and who are familiar with the information, calculations and reports that may serve as input and output of the licensed program. It should also allow licensor to charge additional fees over and above monthly maintenance charges if the licensee does not have sufficiently trained personnel operating the equipment.

E. Proprietary Protection. This section generally establishes licensor's sole title, right and interest in and to the licensed program and all modifications and enhancements of the program, including ownership of all trade secrets and copyrights, subject only to the rights and privileges expressly granted to licensee.

This section should also set forth the licensee's restrictions with respect to assignment of the license and will also generally provide that a change of control of the licensee should be deemed equivalent to an assignment. This way, for example, if licensee is sold as a going concern through a stock acquisition, and therefore no assignment of the license occurs, the licensor will be in a position to determine whether to permit the new entity to enjoy the benefits of the agreement or permit licensor to terminate the agreement.

This is especially important if the licensee is sold to a party in an adverse competitive position to licensor. The "change of control" provision is usually the subject of spirited negotiation. This is due to licensee's desire to obtain the economic utility of the license as an attractive asset in the event the licensee company is sold, or to attract investors.

Licensor, however, has a strong interest in determining with whom it will do business, and to obtain the economic benefits of a new license fee. A typical compromise is that the license will be transferable to licensee's successor by merger or sale of assets, provided the successor is not in a competitive position to licensor.

F. Intellectual Property Indemnification. A significant provision for licensee is the licensor's undertaking to indemnify and hold harmless licensee if licensee is sued because a third party claims that the licensed program infringes its patent, copyright or trade secrets. These provisions typically provide that licensor will indemnify licensee for any damages licensee is required to pay (possibly subject to a cap) as long as licensor is permitted to control the litigation.

Another issue arises if the third party is successful in obtaining an injunction preventing further use of the licensed program by any party (including licensor and licensee). In this event, licensor should first be obligated to attempt to produce a non-infringing version of the software. If licensor is unable to do so, it will generally be obligated to give a pro-rata refund to licensee based on the amount paid up front for the license, reduced by the percentage of the term of the license that has already passed (this should be licensee's sole remedy against licensor). Licensor should not have to comply with these provisions to the extent the infringement was caused by licensee combining its use of the licensed program with any other product.

G. Confidentiality. In large software installations, there is a substantial amount of confidential information which must be exchanged in order for the venture to go forward. The parties will typically provide for designating as confidential all of the intellectual property disclosed to the other in carrying out the agreement. The confidential information clause is usually comprehensive and excludes information in the public domain or otherwise lawfully acquired by the recipient. These provisions generally permit the aggrieved party to obtain injunctive relief for a breach or threatened breach of these provisions.

H. Virus and Y2K Certification. Licensee may request that licensor agree to ensure adequate protection against the introduction, via the licensed program, of viruses into licensee's computer systems. These provisions will require licensor to perform prescribed procedures on any software it furnishes to licensee.

Licensee will also generally obtain indemnification from licensor for any violation of this provision. Licensor will try to limit its exposure to actual out-of-pocket damages and require that licensee make adequate provisions for backup of its data to minimize licensor's financial exposure for corrupting, via an introduced virus, licensee's data files.

In addition, licensee will ask for Year 2000 certification and licensor will generally be required to so certify (in the current commercial climate), and to indemnify licensee accordingly.

I. Warranty and Limitations of Liability. Typically, licensor warrants conformity in material respects to specifications of the software set forth in an appendix to the agreement. The warranty will generally be in effect for one year, after which the warranty claims should be handled under the maintenance agreement. This is because any problems with the software will generally show up shortly after installation and certainly in less than one year.

If licensor is unable to correct a material defect in the software affecting principal functionality requirements for which it is responsible under its warranty within a reasonable period, licensee will usually have the right to cancel the license agreement and receive a full refund of the amount paid.

If the defect relates to only a non-critical portion of the software, the termination right will usually not be present and only a pro-rata refund should be provided. The warranty clause should also limit licensor's damages to the total amount of all prior fees paid to licensor. Licensor will want to limit any liability for loss of data or documentation and exclude liability for lost profits or special, exemplary (punitive) or consequential damages. This provision could also contain a short-term period to bring any claim arising out of the license agreement (e.g., 2 years from accrual of the claim).

J. Acceptance and Termination. In a typical "large system" license, a testing period is provided. This testing period will be constructed to defer "acceptance" of the licensed program until licensee certifies that it finds the software compliant with the agreed to specifications. If acceptance does not occur within a period of perhaps 60 days, then the parties should generally be able to terminate the agreement without further liability.

Detailed acceptance testing procedures are specified in an appendix to the agreement. Sometimes if a significant amount of work is required prior to acceptance testing, the parties may agree that licensor will be entitled to retain some dollar amount even if licensee does not accept the licensed program.

Once the acceptance testing is completed and licensee has accepted the software, the warranty provisions go into effect and the license agreement will generally be effective for a multi-year period, subject to early termination upon certain material breaches.

Typically, these are (i) failure to pay fees[1], (ii) violation of confidentiality provisions, (iii) violation of restrictions on use, and (iv) bankruptcy of licensee (there are various complicated provisions that will be required to permit a termination in a bankruptcy context that are beyond the scope of this article; however, if performance of the agreement is to be effected by the trustee in bankruptcy, licensor will generally *not* be permitted to terminate the agreement).

Note that a fully paid up license may still be terminated and no refund will generally be due licensee in the event of such termination. While this is a harsh result, it is in accord with contract law and most licenses do not give licensee relief from this provision. Typically, licensor's interest in protecting its intellectual property can only be served by a license termination (actual or threatened).

Further, in most cases, licensee will not accidentally breach the restrictions on use or confidentiality provisions of a license agreement. Some softening of this provision can be negotiated. For example, the parties can agree that termination will not be available if the confidentiality provisions are breached in an immaterial fashion and the breach is cured.

Sometimes, it is licensee which must be concerned about the economic viability of licensor. In the event of *licensor's* bankruptcy, licensee will generally be protected under the Bankruptcy Code from any "disaffirmance" or rejection of the license agreement by the licensor's bankruptcy trustee. As further protection to licensee, the parties sometimes enter into a "source code" escrow agreement.

These type of agreements are necessary in the event licensor goes out of business and is unable to make necessary modifications or enhancements to the software or continue its maintenance obligations. In these cases, a third party is appointed as a software source code escrow agent and the licensee will be entitled to break escrow and obtain the source code, solely to implement the terms of the license, in the event licensor goes out of business or is otherwise unable to perform the terms of the license agreement.

Numerous variations to the above general parameters will be required based upon the unique circumstances of each situation. Counsel for licensee and licensor will be required to negotiate the nuances of each party's position to achieve the parties' mutual business goals.

(1) These would typically be license fees, maintenance fees and/or royalty fees from sublicensing. Licensor should also provide for audit rights to make certain licensee is reporting properly all royalty producing transactions.