

Managing Risk II: Litigation Prophylaxis in High-Tech Agreements By Ronald D. Coleman¹

Introduction

It is an axiom of practical lawyering that the best high-tech procurement agreements, like any other commercial transactions, are only as good as they are enforceable, regardless of how elegantly structured. Naturally the more sophisticated such an agreement is, and the more closely it is tailored to achieving a specific strategic business goal, the more important issues such as exit strategy, identification of deliverables and dispute resolution become. It is a mistake to push the consideration of these and other litigation issues to the back end of the drafting process, where crucial protections for the client may be sacrificed to preserve a well-crafted technology solution or where boilerplate provisions bearing only a passing relationship to the transaction at hand are merely tacked on as window dressing.

The tolerances in high technology transactions can be fine indeed. Outsourcing, licenses and ASP's are typically chosen precisely because the organization itself cannot provide a critical missing piece to succeed. Because of the organizational "leverage" one mission-critical vendor relationship can have on a high-tech organization, the risks to the client in failing properly to manage dispute resolution or even friendly termination contingencies may far outweigh the dollar value of a particular contract itself.

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Contracts Issues

Representations and Warranties

These frame the factual world in which all parties understand they are operating. That is why they are at the beginning. Obviously these need to be negotiated and drafted with great care, and reps and warranties are a lawyer's meat. Less obviously, during due diligence, counsel needs to think

less like a lawyer and more like a client. Good draftsmanship may not provide a safety net where it can be shown that one party ignored a red flag on reps and warranties and pushed ahead to closing anyway. It is the law in most states that, in a business sale (stay with me here), where the party alleged to have breached a rep or warranty can be shown to have been aware of that breach, a claim for breach of warranty will lie unless there has been reliance on the representation itself. But California appears to hold to the contrary, i.e., that a party claiming breach of a contractual warranty (in the context of the sale of a business) needs to show reliance on the representation to succeed – a tough road to hoe if the adversary can demonstrate that you or your client knew the rep was false but decided to take your chances and bank on the contractual language if things went sour. The Second Circuit has also ruled that where the source of the information contradicting the rep or warranty is the other party itself (also in the context of a business sale), the other party has waived the breach.¹

Technology Contracts

Obviously reps and warranties, and deep due diligence, are critical in a business sale situation. How do these principles apply in a technology contract? If it is a joint venture, they may apply with at least equal force, depending on the structure of the deal, for reasons that should be fairly obvious. Your client is "getting into bed" with another entity in a joint venture, and these terms can be critical, depending on the structure of the transaction and the cap on your client's exposure.

Yet in some technology joint ventures, they are not a significant terms in the contract at all. One recent technology joint venture whose documents are available on the Internet contains the following as its sole rep and warranty: "The parties hereby represent and warrant to and hereby covenant with each other that they have the right and authority to enter into this agreement and to perform the obligations on their respective parts under this Agreement."² I welcome comments from the panel and attendees as to what value, as a representation or warranty, they believe this adds to the contract. It may well be that reps and warranties were not an important part of that transaction because it was essentially built around a license – and contractual reps and warranties (as opposed to standard product "warranties") are not a key feature of licenses, ASP's or outsourcing agreements, where the focus is on progress reporting, benchmarking and auditing.

Yet even in these situations it may be appropriate for counsel to consider whether warranties or their cousins, covenants, are appropriate. For example, it may appropriate to require a warranty regarding the other side's financial wherewithal, for example, so that your client need not wait until a struggling ASP or outsourcing provider actually files for or is forced into bankruptcy, defaults or is legally determined to be insolvent – often a challenging proof to make – in order to trigger a termination clause on its own terms. A number of major technology companies have turned out to be built on no more than creative accounting. An appropriate rep and warranty may avoid the long slow death of the technology relationship, or at least permit your client to stage its alternative on its own terms, once the economic bona fides of your client's partner or supplier are shown to have been illusory.³

Choice of Law

Choice of law clauses are nearly always enforced in technology and other arms'-length commercial contracts, and they are not to be taken likely in high technology agreements where so much can be at stake for your client. The rare cases where they are not enforced are where they have no "reasonable relation"⁴ to the transaction. If you do not choose the applicable law at all, the court, depending on the jurisdiction will typically use the "place of contracting" – whatever that means in the year 2003, unless there is another forum that, based on the facts of the case, has a "dominant relationship with the parties and issues." This is the law in New Jersey,⁵ though other states use other tests such as the "grouping of interests" test.⁶

New York as Fair Broker; New Jersey as Heartbreaker

Oddly enough, New York State invites⁷ parties involved in transactions involving \$250,000 or more to utilize the substantive law of the State of New York even if the transaction bears no

reasonable relation to the Empire State. You may ask what good this statute does if you are outside of New York State, considering that it does not control what the courts of other states, bound by their states' versions of the UCC, will decide; whereas if you are already in New York State, you have a good shot at meeting the reasonable relationship test. But of course, New York has already thought of that. It also authorizes New York courts as a forum, though the trigger for this "Full Employment for New York Attorneys Act"⁸ is \$1 million. This is not merely an aside. The choice of New York law, and even forum (see below), may be a good one for parties in far-flung states. The substantive law of that State is, of course, very well developed in commercial matters, even if certain states out west have the lead in technology cases.

New Jersey's law in commercial litigation is certainly well developed, of course; but parties foreign to our courts and gardens may be biased, for various reasons, against our state as a compromise. Some of these reasons are cultural; New York is considered a center of commerce, while New Jersey is not. Some of them are, however, well grounded in business and legal judgment, for our courts are arguably inclined to favor – and, if necessary, to craft – remedies to protect consumers, or even businesspeople reckoned by courts as their functional equivalents.⁹ This sort of judicial creativity, not to say activism, may intimidate some businesses; how it cuts for your client will, of course, depend on its profile and the facts of the situation.

Familiarity and Predictability

Of course, the axiom is that the right choice of law depends on how you think a given jurisdiction's law will work for your client if things go awry. New York offers predictability both because its courts are more conservative (with a "small c") and because it has such a vast body of decisional law. Yet as often as not the choice of law of choice is the home state of the drafting party, or the party with the bargaining power to get its way on this issue. This has the advantage of familiarity to home-state counsel, but, depending on the local issues as they may play out in the contract, it may not be the right choice.

Whether an ASP, an outsourcing or a license, whether you can negotiate the choice of law will depend on who is in the driver's seat during negotiations. But if this clause is not "negotiable," counsel may want to look at how the choice of law clause it is stuck with may affect the substantive terms in the contract. For example, if the choice of law clause grants certain protections to certain classes of contracting parties, you may be able, elsewhere in the contract, to either define the parties in a functionally different way or to explicitly waive the benefit of those protections. This may be more likely to be negotiable, because home-state counsel is not likely to be focusing on that particular issue so much as, again, retreating to familiarity.

Drafting Issues

Use a good forms resource, whether your firm's or a commercially published one, to choose your choice of law clause. Many choice of law clauses state that the parties agree to a given state's substantive law, "except with respect to choice of law." This is a useful phrase, because otherwise – at least in theory – you may end up getting a New Jersey court to agree to apply the law of the State of New Jersey to the question of which state's law applies – and end up litigating your dispute in a forum you, or even the adversary, never dreamed of, based on New Jersey's own criteria for choosing which state's substantive law applies. In general, choice of law clauses should be very explicit.

Choice of Venue

Choice of venue is the happy twin of choice of law. All things being equal, a litigator scanning a contract on the eve of litigation looks to see if there is a choice of forum clause or an arbitration clause (see below), as soon as the contract in dispute comes off the fax machine from the nervous client in the midst of a dispute. This has become more important than ever as business has become more international, and certainly is almost always done across state lines. The odds of the ASP, joint venturer or other high-tech solutions provider that can provide what your client needs being located in the same state as your client are overwhelmingly low. Forum clauses are

routinely enforced.

Home Court Advantage

Venue selection has several aspects. The party that succeeds in defining the home "court" has the home court advantage. If your client is on the losing end of that bargain, this means that, in most cases, you and your client do not know the rules of procedure where your dispute will be litigated; do not know the judge who will decide it; do not know if these courts are suited to adjudicating heavily technical substantive issues or if they always root for the home team. The other side does.

In all but the largest transactions, this advantage is frequently outcome-determinative, especially if the party that defines the forum succeeds in defining one that is "out there." Your programmer in Paramus just may be willing to slug it out with Microsoft "on the principle of the thing," but he is not likely to be prepared to go through with its flush of outrage and make its point once you explain that to do so he will have to set up siege in the State of Washington. The financial and practical burdens of doing so, for most companies, almost dictate a "beg for mercy" strategy.

It is bad enough if the biggest technology company in the world sticks you with a choice of forum clause that makes it utterly impractical and uneconomical for your client to defend its legal rights, but many otherwise sophisticated contracts leave the choice of forum on the table. Fight for the forum, for no forum clause at all if you cannot get your choice of forum, or, alternatively, for an acknowledgment by each party that it agrees to be subject to the jurisdiction of the other's home state (or a specific state in which it does business) in the event of litigation.

Drafting and Technical Issues

Forum selection clauses must be clear. If you win concessions on the forum (or choice of law) issue, be sure they are adequately secured by good draftsmanship. A clause such as "The parties acknowledge that this is a New Jersey contract" may be construed as a choice of law clause; less likely as a choice of forum clause; possibly as a statement of karmic reality with no enforceable legal meaning at all.

Keep in mind that a forum selection clause can never create jurisdiction. Most courts will not enforce a forum selection clause involving a state that has nothing to do with the parties or the transaction, though you can certainly choose to arbitrate in such a state by way of geographical compromise. Also, as mentioned above, New York is an exception to this general rule, and considering the success of the Commercial Part of the New York Supreme Court (is plenary trial court, equivalent to our Superior Court), some practitioners consider this a viable option. Also remember that agreement to a forum selection clause does not create subject matter jurisdiction. This is particularly important in federal court, which will only hear a contract dispute without any federal question (i.e., no copyright or other federal statutory issue) jurisdiction if there are valid grounds under the statute governing diversity jurisdiction. If these (e.g., complete diversity, and the jurisdictional minimum) are absent, a forum selection clause will not create jurisdiction.

Alternative Dispute Resolution Clauses

Arbitration and mediation clauses are typical features of high tech contracts. One text makes the following powerful point:

Many arbitration clauses are inadequate, or even defective, because parties fail to consult standard forms and then, abandoning the caution used for drafting other contractual provisions, fail to assure that they are using terms that have been tested at lat and developed by those experienced in the application and enforcement of arbitration clauses.

At the same time, many arbitration clauses are inadequate precisely because they fail to go beyond standard forms. By not considering the options available for arbitration clauses, parties squander the flexibility and party control over the process that are

potentially key advantages of arbitration over litigation. It is inexcusable not to consider how an arbitration clause can be drawn to accommodate a particular contractual relationship.¹⁰

Sort of a certificate of merit in a box.

It is sort of an open secret that arbitration is not necessarily simpler, cheaper or faster than litigation, although because appeal from an arbitration decision is so limited, it tends to be more final. It is beyond our scope to consider the arbitration versus litigation issues here, but one point that applies both to arbitration and to mediation (binding or otherwise) is that, when it comes to technology issues, the parties' ability to have a significant amount of control over the neutral or neutrals who will consider their case is substantial. This is only true, on the other hand, if the arbitral panel defined by the party has access to technologically sophisticated neutrals. If your neutrals are merely yesterday's judges, as is the case with many ADR providers, you are likely to end up with experienced, seasoned jurists who are in fact less likely to understand your technical issues than the younger judges who have taken their place.

ADR Issues

Another advantage of ADR over litigation is that, as mentioned above, parties can fine tune the place of arbitration. In the almost inevitably interstate or international market for high-tech commercial solutions, this can be a great advantage, and may also assuage a foreign provider or joint venture partner concerned about being subject to the perceived biases of local courts and juries.

Sophisticated outsourcing, ASP or joint venture agreements are typically governed by more than one operative document. There may be an operating agreement plus a license, for example. So a key issue to watch out for in arbitration clauses is to make sure they show up in all the relevant documents, and, of course, that they say the same thing, or that they all cross reference a master agreement or other central governing document that is the sole source of all dispute resolution provisions.¹¹

Software Escrow

This is also an increasingly important issue, and can be so important to a technology agreement that failure to plan properly can not only undermine the value your client bargained for, it can leave the client far worse off than if it had never gone into the relationship if it is botched. The heart of the escrow issue is that it is the only hard solution to the distinct possibility that your supplier may go out of business, regardless of how hearty it looked when the original agreement was inked. That escrow is a life preserver.

Ironically, some lawyers representing software providers seeking to save some inconvenience, and a few of their clients' dollars in the short run, have been known to lash that life preserver to themselves, and throw in an anvil for good measure by naming themselves as escrow agents. This is a huge mistake. An escrow agent is a fiduciary to the beneficiary. The beneficiary is your client's customer. The client is . . . your client, to whom you owe a completely different set of duties. Law firms that get caught in the middle of software escrow battles not only risk their client relationships. They risk being found both in derogation of their fiduciary obligations and possibly their legal ethics obligations. Find an escrow agent.

Escrow requirements should be worked out as part of the overall software outsourcing agreement. The escrow agreement should not merely be a clause in the main document; it should be a self-standing agreement that gets proper attention and is appropriately integrated into the deal. It is critical that the terms of the escrow spell out what will be deposited in escrow, how often, and what the auditing provisions are. One authority suggests the following standard deposit ¹²:

- Two copies of the source code for each version of the software on magnetic media
- All manuals not provided to the licensee
- Maintenance tools and third-party systems
- Names and addresses of key technical employees that a licensee may hire as a subcontractor in the event the developer ceases to exist
- Compilation instructions in written format or recorded on video format

The technical people on both sides must have input into these specifications during the negotiation process. You also may want to discuss with your client having some legal staff, either in-house or otherwise, be part of the ongoing monitoring or auditing function.

Exit Strategy

That the exit strategy or end-game in a technology outsourcing contract of any source needs to be thoroughly thought through is a commonplace. Yet it seems almost inevitable that at some rocky point on, shortly before, or shortly after a contractual termination date – or a desired one – a litigator is combing through a set of documents looking for a way out. This is not a litigation prophylaxis issue. Rather, it goes to the heart of the transaction itself. Short of an acquisition – not your typically way to acquire a technology solution, though not unheard of – there will be the end of the road some day. Counsel's failure to work out all the likely scenarios, as many unlikely ones as possible, and to do appropriate contingency planning is simply unacceptable. The above issues are among the easiest to address when considering exit strategy, but the end of the relationship, its restructuring or its adaptation must be considered holistically throughout the structuring of the arrangement.

This presents a challenge to you transactional attorneys, and meeting it may result in higher fees for drafting and negotiation than your client would like to spend. If she needs convincing, however, introduce you to your litigation partners and ask her how many hours of free technology blowup war stories she wants to hear from your trial group. Tell her it's on the house.

¹ M. Moskin, ed., 1 Commercial Contracts: Strategies for Drafting and Negotiating § 3.02 at 3-4–3.6 (Supp. 2003).

² Available [here](#).

³ See B. Peterson, "Seven Key Questions for Drafting Effective Exit Provisions," available at <http://outsourcing-journal.com/issues/aug2002/legal.html>.

⁴ See U.C.C. § 1-105 (1).

⁵ *NL Indus. v. Commercial Union Ins. Co.*, 65 F.3d 314 (3 rd Cir. 1995).

⁶ New York courts apply a "center of gravity" or "grouping of contacts" approach to choice of law questions in contract cases, including insurance cases. *Zurich Ins. Co. v. Shearson Lehman Hutton, Inc.*, 642 N.E.2d 1065, 1068 (N.Y. 1994).

⁷ N.Y. Gen. Oblig. L. § 5-1401.

⁸ N.Y. Gen. Oblig. L. § 5-1402.

⁹ A good recent example is the Appellate Division's decision in *Kavky v. Herbalife Int'l of America*, 359 N.J.Super. 497 (App. Div. 2003).

¹⁰ M. Moskin, 1 Commercial Contracts § 5.01 at 5-5.

¹¹ See, e.g., *United Kingdom v. Boeing Co.*, 998 F.2d 68 (2d Cir. 1993) (refusing to consolidate related agreements in a single arbitration where each agreement did not contain an arbitration clause).

¹² K. Mobley, "Keys to a Reliable Software Escrow Agreement," available at <http://www.gigalaw.com/articles/2000-all/mobley-2000-12-all.html>.