

Negotiating the Software License: Eight Tips for the Licensee

Brian B. Gilbert¹

A software failure can hamstring your client's business. Be sure to build the solutions into the licensing agreement.

WITH INCREASING COMPETITION and rapidly changing technologies, software has become the lifeblood of business. Acquiring or upgrading software and computer systems is like getting a blood transfusion. A successful transfusion will improve the business's health by making it more efficient and competitive. An unsuccessful one will have an unhealthy effects, like failing to obtain significant benefits, diverting valuable management and operational manpower, and substantially increasing costs of operation. This article will offer some insights into the acquisition of commercial software with its main focus on the negotiation of key provisions in license agreement.

1. PAY ATTENTION TO THE LICENSING AGREEMENT

In many software acquisitions the execution of the license agreement is an afterthought. After the painstaking process of selecting the appropriate software vendor, the required add-ons and options, training and maintenance services, and so on, the urge is to execute the preprinted form and get to the installation process as quickly as possible. The impulse is natural, because the preprinted forms are usually long, technical, and printed in minuscule type visible only under a high-powered magnifying glass. Nevertheless, this cavalier approach could result in the loss of many important benefits and remedies that a fully negotiated license agreement can provide.

2. GET VENDOR AGREEMENTS IN WRITING

A separate topic that is beyond the scope of this article is the art of dealing with the consultants who will procure software, customize it as necessary, and set up the related hardware. In any event, it is worth mentioning that the management and negotiation of agreements with these vendors is a crucial component of the acquisition process. Without getting into the nuances of these relationships, one rule of thumb should be kept in mind: Get it in writing!

Vendor's commitments regarding the capabilities of software, the timing of installation and customization, training personnel, and the support of software should all be memorialized in a written agreement with appropriate penalties, termination rights, and remedies in the event that

¹ Brian B. Gilbert is the Chairman of the Corporate/Commercial Department of Gould & Ratner, in Chicago.

these commitments are breached. The license agreement is an important document to be negotiated in connection with any software acquisition. But it is by no means the only one.

3. GET THE RIGHT KIND OF LICENSE GRANT

The heart of any software license agreement is the provision granting the licensee the right to use the software. This license grant is always modified by qualifiers (often many of them) that serve either to limit or increase the scope of the license. Words such as "non-transferable," "transferable," "fully-paid," "royalty-free," non-exclusive," "exclusive," "limited," unlimited," "perpetual," or "terminable" have a substantial effect on the licensee's rights to the software.

Transferable and Nontransferable Licenses

A license that is fully transferable allows a licensee not only to sell and transfer the license to non-affiliates as part of a sale of all or a portion of its business, but also allows the licensee to reorganize its operations or transfer the rights to use the software to other affiliates at the licensee's discretion.

A nontransferable license forces the licensee to obtain the consent of the licensor in any of these situations. This gives the licensor the opportunity to renegotiate terms of the license and/or extract additional fees from the licensee. Note that even a transferable license may contain other terms and conditions that restrict the licensee's use of the software. For example, a license may prevent the licensee from using the software as part of a service bureau. This could restrict the ability of a licensee to allow affiliates or other third parties to use the software, even though the licensee has technically not transferred the actual license.

Typical License Is Nonexclusive

Generally, licenses for commercial software will be nonexclusive. Licensors desire to market their software and services to numerous users and thus will not want to restrict their ability in this area. Nevertheless, to the extent that a licensee has contracted for custom software and wants to prevent its competitors from obtaining the same operational advantages that it has contracted for, the licensee may consider requesting an exclusive license. Although this may cost more, the competitive edge may be worth it.

Typical License Is Perpetual

Licenses will most likely be perpetual, with termination rights in the licensor made only upon a breach of the license agreement by the licensee. Nevertheless, it is important to focus on these provisions to be sure that the licensee is receiving all of the intended benefits. The licensee certainly does not want to be faced with a situation in which it finds that its rights have expired when its business is increasingly reliant on the same.

License Will Indicate Permitted Use

Finally, the license grant will indicate how the licensee may use the licensed software. A license grant may simply indicate that the licensee is entitled to "use," "distribute," "reproduce," "sell" or "sub-license" the software. Licensees should be aware that other provisions of the license agreement might have limiting language regarding the licensee's use of the software even though the license grant language appears to be broad. For example, the license grant may

indicate that it is an "unlimited" license to "use" the software. Nevertheless, later provisions may restrict the ability to reproduce the software, allow others (even affiliates) to use the software or to sell or transfer the software or the license. Licensees should clearly define their desired uses and rights to the software before the negotiation of the license agreement and make sure that all provisions of the license agreement are consistent with such desired uses and rights.

4. ESCROW SOURCE CODES

Consultants and software vendors typically make most of their profit and continuing maintenance contracts rather than on the base license fees. It follows that vendors have a vested interest in making sure that the licensee is reliant on the vendor for years to come in connection with the provision of maintenance services. As a result, many commercial software licenses provide only for a license of object code (the machine-readable language) and not a license of source code (code that can be deciphered and read by humans). Consultants and vendors will obtain source code licenses from the software developer to be able to maintain the same for their clients. These same developers may be unwilling to license the source code to all users to limit the proliferation of the software and the risk of reverse engineering.

The Risk

The risk for the licensee in this situation has several sources. Vendors or consultants may not be in existence years down the road when maintenance may be required as a result of bankruptcies or business terminations. In addition, vendors may be in breach of their license or maintenance agreements by failing to respond to maintenance concerns in accordance with the negotiated agreements. Without access to the source code, a licensee would have no way of maintaining its valuable system and would be virtually paralyzed.

Why an Escrow Is a Good Idea

A source code escrow can solve these problems and should be negotiated whenever the licensor is unwilling to provide the source code as part of the license. A source code escrow refers to the deposit of the code with a third-party escrow agent that is directed to release the code to the licensee only upon the occurrence of certain events.

Licensee Should Seek To Broaden the Scope of Release Events

Many source code escrows strictly limit the release event to the situation in which the licensor has increased doing business and is thus unable to maintain the software. The licensee should attempt to procure additional release events tied to the licensor's failure to perform its maintenance obligations in a timely or effective manner (consistent failure to respond to, or correct, documented errors within a specified number of days of their report by the licensee to the licensor). Finally, the licensee should consider other release events tied to the practicality of using the vendor for continuing maintenance services. For example, the licensee may consider doing this if the licensor wants to increase maintenance costs beyond a specified limit set in the maintenance contract or the licensee moves its corporate headquarters and it is no longer practical to use the licensor or the particular vendor for ongoing maintenance.

Practical Points

Other points to consider in connection with a source code escrow are the identity of the escrow agent and the nature and mechanics of deposits. Make sure that the agent is an

independent third party unaffiliated with the licensor and has experience in administering source code escrows. Also, make sure that the licensor is obligated to update its source code deposits with all-new versions, updated, and new releases of the subject software. This obligation for additional deposits should be satisfied within a short time period (30 days) after the initial distribution of such new version, update, or release.

Escrow Source Codes for Modifications, Too

Finally, if you employ a vendor to make modifications to canned software, make sure the source code for the modification is either delivered to you or placed in an escrow as described above. A failure to procure these options could leave a licensee without the customized features that it contracted for in the event of a release event as described above.

5. NEGOTIATE FAVORABLE PAYMENT TERMS

The terms of payment are perhaps the most important provisions in a license agreement. The structuring of payment terms can spell the difference between obtaining the software and customized modifications bargained for, or ending up with an expensive failure.

Licensee Should Negotiate Extended Payment Terms

Licensors will attempt to front load payments (90 per cent or more of the total license fees due upon delivery of the base software or even as early as the execution of the license agreement). Despite this initial position, the terms of payment are probably the most negotiable part of a license agreement, and the licensors can be very flexible in structuring terms to fit the customer's needs. Licensees should attempt to structure payment terms with as much of the fees payable after, delivery and installation and acceptance testing (see discussion below) as possible.

Defer Payment Until After Installation and Testing

When software is delivered with little or no modification needed, the licensee should try to have the majority of the payment deferred until after the software has been installed and the licensor/vendor demonstrates that the software runs in accordance with its specifications. In this situation, a larger up-front payment may be more appropriate. The licensee should consider negotiating for a deferral of a small portion of the license fee until after the expiration of the warranty period. This will provide some security that the licensee will not be stuck with a lemon. Consider also the right to return the software before the end of the warranty period for a full refund in the event that the software does not meet the needs of the licensee or does not operate error-free and in accordance with its specifications.

Payment Milestones for Modified Software

When the vendor of the software is making sufficient modifications to the software to meet the licensee's needs, payment terms should be structured around milestones in the completion of the required modifications. Once the vendor has demonstrated to the licensee that a particular modification works in accordance with the desired specifications, another milestone payment will be due to the vendor/licensor. In these situations, a greater percentage of the license fee should be withheld until final completion. The milestones should be clearly set forth in the license agreement. Consider including penalties and/or discounts to the license fee in the event that milestones are not accomplished in accordance with a set timetable through no fault of the licensee.

6. INSIST ON ACCEPTANCE TESTING

Unlike in the acquisition of many other business assets, the licensee of software can usually negotiate for the ability to test the software and related modifications before final purchase to ensure that the same meets the licensee's requirements. Acceptance testing is a very common practice at the conclusion of delivery And installation of software.

Licensee Must Define Requirements and Expectations

The key to effectively negotiating and implementing acceptance testing is to clearly define, at the contract stage, the licensee's requirements and expectations for the software, as well as the specifications for the software and modifications to be delivered. This is seldom an easy process. it can be time-consuming and it usually occurs when the licensee is anxious to begin the acquisition process and execute necessary documentation.

Structuring the Acceptance Testing

The acceptance testing should demonstrate all facets of the software's operation. Complications and timing concerns may arise when key functions can be performed only at certain times (such as monthly closeouts or quarterly or year-end reporting in connection with accounting software). Nevertheless, the licensee should insist that a dummy system be set up to demonstrate these functions or that final payment shall not be forthcoming until the licensee has an opportunity to use the software for a full cycle to demonstrate these functions.

7. GET USEFUL WARRANTIES

Warranties—and exclusions from warranties—are often the trickiest parts of the software license and, in the final analysis, may be the least useful. In the technological marketplace, it is becoming increasingly difficult to find a software developer or vendor willing to stand behind its product for any length of time. A typical warranty will last 90 days from the date of delivery and provide for the correction of documented errors during that time period., If the licensee has done its job in negotiating other types of provisions discussed above (such as extended payment terms, return and termination provisions, acceptance testing, escrows, and other protections) the warranties may not be as important as they first appear.

User Requirements and Extended Warranty Periods

As with acceptance testing, the key to negotiations an effective warranty provision is defining the specifications for the software and the requirements of the licensee. Licensors are usually unwilling to warrant that the software will meet user requirements; however, if the transaction is a large one, it may be possible to negotiate such a concession. Warranty periods beyond 90 days are also uncommon, but can be extended in larger transactions.

Infringing Software: a Special Concern

A common but often overlooked part of a license agreement is the warranty against infringement. The licensee wants the assurance that it will not be exposed to an infringement claim by using software that has a feature that may infringe on any patents, copyrights, or other intellectual property rights. The licensee should insist on such a provision in the agreement. Additionally the licensor should conduct a limited due diligence on the licensor or vendor to

determine how the software was developed and by whom, as well as how the licensor or vendor gained its rights in and to the software.

Licensor's Remedies for Infringing Software

Typical license agreements provide for two rather unsatisfactory remedies if the software is infringing:

- The licensor may terminate the license and refund the license fees; or
- The licensor may replace the infringing portion of the software with non-infringing software.

These provisions don't do much good for licensees. The termination of the license may halt continuing infringement, but it will have a disastrous effect on the licensee's business if the licensee has become reliant on the software. And a refund will almost certainly be much less than the actual damage to the licensee's business.

Aim for Unlimited Remedies

As a result, it is important to ensure that the licensee's remedies are unlimited in the event of an infringement (see discussion on limitation on damages below). In the alternative, a liquidated damages provision may be negotiated that attempts to approximate the licensee's damages in the event of such a breach.

Replacements Should Fulfill Licensee's Requirement

With respect to a licensor's right to replace infringing software, licensees should insist that replacement software be able to perform all functions of the original software that the licensee contracted for in the first place. In addition, the license agreement should provide that the replacement software be delivered promptly after the licensee is required to discontinue use of the original software. If the licensor cannot deliver the replacement software promptly, the licensee should be entitled to a refund as well as to pursue all of its remedies for damages against the licensor.

8. NEGOTIATE LESS RESTRICTIVE DAMAGE LIMITATIONS

Typical damage limitations provide that the damages required to be paid by the licensor in the event of a breach will not exceed a specified amount (typically, the amount of license fees paid by the licensee). In addition, the license agreement will normally require the licensee to waive its right to incidental or consequential damages.

Negotiating a Larger Cap on Damages

Though it is generally difficult to remove damage limitations, it is sometimes possible to negotiate for a larger cap, such as a multiple, of the license fees paid by the licensee. In addition, in certain circumstances (such as patent and copyright indemnifications discussed above) these limitations, along with waivers of consequential and incidental damages, should specifically be inapplicable.

Damages for Customized Software Failures

Licensors often justify strict limitations on damages by arguing that their software is more or less an off-the-shelf item available to a wide range of business customers, and that it makes no sense for the licensor to have any exposure beyond what the licensee has contracted for. Highly customized software, however, the licensor has gained intimate knowledge of the licensee's business, its needs, and the disruptions that a failure can produce. In this type of relationship, it should be possible to negotiate for the elimination of the caps or, at least, a substantially higher limit.

CONCLUSION—In the course of negotiating software license agreements, the licensee will tend to focus on the features of the software that will make it work. To some extent, the purpose of the licensing agreement is to address what will happen if things don't work. These factors can be very difficult to identify, and differ from business to business. Nevertheless, it is safe to say that the topics discussed above will most certainly need to be addressed in almost every software acquisition. Addressing these issues, and not merely executing the pre-printed forms, could make the difference between a successful software acquisition and a failed attempt to inject new life into an outdated system.

PRACTICE CHECKLIST FOR

Negotiating the Software License: Eight Tips for the Licensee

For your client's business to thrive in the current competitive environment, it needs software that works. The first step in making this happen is negotiating a favorable licensing agreement.

- Pay attention to the licensing agreement. Explain that the agreement is negotiable, and that it can be modified to provide important remedies that the client will need if anything goes wrong with the software.
- Get vendor agreements in writing. Do not leave the details of timing, installation, and customization (if any) to chance, and provide for appropriate penalties and termination rights.
- Get the right kind of license grant:
 - Transferable licenses give the licensee more flexibility if it needs to reorganize and transfer the license to other affiliates;
 - The typical license is nonexclusive. If your client has contracted for customized software, it should consider bargaining for an exclusive license to protect the competitive advantage of its customized software; and
 - Check to see whether the license expires after a stated term. Most licenses are perpetual, but not all.

- Escrow source codes. Licensors do not usually want licensees to know source codes. This can be a problem if the licensor goes out of business a few years down the road, so a practical solution is to escrow the source codes.
- Negotiate favorable payment terms Licensors want to front load payments. The licensor should negotiate to have payments deferred until after installation and testing.
- Insist on acceptance testing. The nature of the testing depends on the client's business. But if the function to be tested is something that occurs only at certain times, the licensor should set up a dummy system to test that function.
- Get useful warranties. Typical warranties for infringement are seldom useful to licensees. Aim for unlimited remedies for infringement.
- Negotiate less restrictive damages limitations. It may not be possible to get the licensor to agree to unlimited damages, but it is usually possible to get a larger damages cap (especially with a customized product).