Software Development Agreements: Negotiating and Drafting Key Provisions
Structuring Contracts to Allocate Risk, Avoid Legal Pitfalls, and Minimize Liability

TUESDAY, JANUARY 21, 2014

1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

Today’s faculty features:

Michael R. Overly, Partner, Foley & Lardner, Los Angeles
Daniel C. Glazer, Partner, Fried Frank Harris Shriver & Jacobson LLP, New York

The audio portion of the conference may be accessed via the telephone or by using your computer’s speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.
Tips for Optimal Quality

**Sound Quality**
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-888-601-3873 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Continuing Education Credits

For CLE purposes, please let us know how many people are listening at your location by completing each of the following steps:

- In the chat box, type (1) your company name and (2) the number of attendees at your location
- Click the word balloon button to send
Software Development Agreements: Negotiating And Drafting Key Provisions

Presented By:
Michael Overly & Daniel Glazer
Overview

- Collecting Basic Deal Information
- Key Contract Provisions
- Questions
COLLECTING BASIC DEAL INFORMATION
Basic Information

- Before any new contract can be reviewed, certain basic information must be marshaled.

- **Executive Description of Engagement:** A paragraph or two describing in plain, non-technical English what the deal is about, including a clear statement establishing the business advantage to be gained by entering into the contract.
Basic Information (cont’d.)

- **Useful Life:** Anticipated duration of engagement, including desired renewal terms.

- **Expected Fees:** Description of fees over contract term, including a breakdown of all first year fees (e.g., license, professional services, implementation, customization, hardware, and telecommunications fees).

- **Type of Agreement:** License, SaaS, ASP, Cloud, Service, Support, Hosting, etc.
Performance:
- How critical is this service or product?
- Is this a customer-facing application?
- Where will the services be performed?
- Is the vendor located offshore?
- Will the vendor use offshore partners or affiliates?
- Will the vendor be performing services onsite or at its own facilities?
- Will the vendor be providing hosting services of any kind (e.g., SaaS, ASP, etc.)?
- **Intellectual Property Issues:** Will the vendor be rendering any development or customization services resulting in intellectual property that the company will want to own? Will the vendor have access to any highly sensitive company intellectual property?

- **Other Unique Issues:** Identify information security issues, unique business risks, unusual performance constraints, regulatory issues, etc.
KEY CONTRACT PROVISIONS
Essential Considerations

1. Specifications
2. License grant
3. License fees
4. Acceptance testing
5. Intellectual property
6. Warranties
7. Indemnities
8. Limitation of liability
9. Confidentiality
Specifications

- Most vendors warrant to the “documentation”
  - Vendor controls the documentation
  - Can change at any time. Functionality “creep”
- Is specific functionality/interoperability required?
- RFP and response
Specifications (cont’d.)

- Tie-in warranties and other performance requirements
- Consider a warranty that precludes any material reduction in functionality without a comparable replacement, unless reduction is mandated by law or agreed upon by the parties
License Grant

- Key term in any license agreement
- Types of licenses:
  - Enterprise
  - Named user, concurrent user
  - Location
  - Hardware specific (Server ID)
- In general, the broadest license is preferred
License Grant

- Focus on who is the “licensee”
- Definition of “Licensed Software,” include updates, bug fixes, etc.
- Use of outsourcers and contractors
- Transferability
- Use in backup, disaster recovery, testing environments
Subject to the terms and conditions of this Agreement, Vendor grants Customer a non-transferable, non-exclusive license to use the Software for its internal purposes.
License Grant: Suggested Revision

Subject to the terms and conditions of this Agreement, Vendor grants to Customer a perpetual, non-exclusive license to use the Software for its business activities. Such business activities include, but are not limited to, the right of Customer’s parents and their respective affiliates, subsidiaries, and joint venturers to access and use the Software. In addition, Customer may serve as a service bureau for the foregoing entities.
License Fees

- Link to milestones in the implementation
- Minimum 20% holdback until “live”
- Beware of hidden third party license fees
  - Related issue: third party license terms and conditions
- Escalation caps on recurring / renewal fees
- “Excess Use” provision
License Fees (cont’d.)

- Always think of future uses
  - Will I need more seats?
  - Suppose I want to make this available in other offices?
  - What is the cost to expand use?
  - New affiliates

- Negotiate pricing when leverage is strongest
Acceptance Testing

- Insist on some form of testing
- Consider pilot/test period
- Main agreement has structure for acceptance. SOWs and Exhibits have criteria for acceptance.
- Define acceptance criteria – not just the documentation
- What will be tested?
  - Software
  - Services
  - Deliverables
  - “As implemented”
Acceptance Testing (cont’d.)

- Acceptance is **not** the same as warranty coverage.
- Avoid automatic acceptance provisions: *Customer shall have five days to evaluate the software. If Customer fails to provide written notice of a defect within the five days, the software shall be deemed irrevocably accepted.*
- Link payments to acceptance
- Provide a remedy. What fees will be refunded?
Intellectual Property Ownership

- Mixed IP environment
- Types of intellectual property at issue:
  - Vendor pre-existing (background) intellectual property
  - Customer pre-existing intellectual property
  - Intellectual property developed during the engagement
  - Third party intellectual property
    - Commercially licensed intellectual property
    - Open source software
    - Freeware
Avoid vague grants or assignments of intellectual property rights

Feedback clause
- No transfer of Customer rights, limited, as-is license
- Must be knowing
- Mutual

Residual Rights
- Information retained in unaided memories
- Mutual
- Residual rights must protect confidential information and intellectual property rights
Preexisting intellectual property:

- Vendor grants customer a broad, perpetual license to use preexisting vendor intellectual property delivered to customer in connection with the agreement. Ensure scope of license encompasses all intended uses.

- Customer grants vendor limited license to use Customer preexisting intellectual property for Customer's benefit in connection with the services. Terminable at-will.
Engagements where no development work is anticipated
- Warranty against prohibited services
- Potential “penalty” clause for breach

Developed intellectual property possibilities:
- Vendor owns, license-back to customer
- Customer owns, no license-back to vendor
- Customer owns, license-back to vendor
- Joint ownership

License-back – Consider cooling off period before vendor can exploit for other customers, including your competitors
Third party intellectual property

- Require disclosure (exception in software license agreements for embedded software)
- Understand which third party licenses apply
- Additional third party royalties/license fees
- Vendor responsibility for third party intellectual property
- Ensure scope of third party licenses matches that of the underlying vendor license
Warranties

- Avoid stock warranties of performance in accordance with the “published documentation”
  - “Published documentation” is a moving target over which the vendor has complete, unilateral control

- What does the warranty really cover?
  - Frequently overlooked issue
  - Make sure the warranties cover all of the following:
    - Licensed Software
    - Enhancements, releases, and new versions
    - Documentation
    - Support and other professional services
What is the warranty period? What triggers the start? How long does it run?

- Sixty days from initial delivery
- Greater of one year from Acceptance or the period in which support is purchased.

Exclusive remedies should be avoided

- Time period for fix
- Tolling of other remedies, but no waiver
Warranties (cont'd.)

- Types of warranties
  - Performance (Specifications, Service Levels)
  - Intellectual Property Infringement
  - Services
  - Legal compliance
  - Privacy Laws and Regulations
  - Viruses and Disabling Mechanisms
  - Offshoring of data
  - Open source
  - Pass through of third party warranties
Warranties (cont’d.)

- Be mindful of broad disclaimers that could override specific warranties (“as-is”; no liability for errors; not interrupted or error-free)
- Beware of extensive customer warranties
- Disclaim all other warranties of the customer
  - Where appropriate, disclaim representations, warranties, and guarantees as to vendor revenue (e.g., in processing agreements)
Indemnities

- What is an indemnity? Think third party claims
- Compare warranties
- Common law right to seek indemnity Why is a contractual indemnity so important?
- Exclude from limitation of liability
Indemnities (cont’d.)

- Key terms: hold harmless, defend, and indemnify; all types of damages and costs, including attorney’s fees and expert costs
- Who is indemnified?
  - Licensee and ????
- What is indemnified?
  - Breach of confidentiality, warranty, infringement of intellectual property rights, injury to persons and damage to tangible and intangible property, negligence and willful misconduct
- Beware of indemnities that are subject to the limitations of liability
Indemnities (cont’d.)

- In addition to indemnity for intellectual property infringement, also need remedy in the event of a claim:
  - Modify the services or software to be non-infringing, while still conforming to all requirements of the Agreement, including those relating to functionality and performance;
  - Obtain license permitting continued use; or
  - As a last resort, terminate and refund

- Timing of remedy is key

- What fees are refunded?
  - License, professional services, pre-paid support, one-time fees, etc.
    - Compare transaction fees or recurring fees
  - Prorated over useful life of services/software
Carefully review all exclusions from the indemnification obligation:

- **Common:** combinations with third party products not provided or authorized by vendor; modifications made to the customer’s specifications; failure to implement an update (provided at not charge and vendor has provided notice implementation would avoid the infringement).

- **Beware:** exclusions of third party software and other intellectual property embedded in the licensed software; new carve-outs for business method patents; other broad exclusions.

- **Notice and cooperation – relieves obligation only to extent vendor prejudiced.**
Vendor warrants to Customer that the Services and Information as and when delivered by Vendor, will not infringe upon any United States copyright, trademark, or trade secret of any third party (collectively, an “Infringement”), unless such Services or Information are (i) provided or performed to meet any specific requirement and agreed by Vendor in writing provided by Customer, or (ii) altered, modified, or revised from the form originally provided by Vendor. Subject to the terms and conditions contained herein, Vendor will indemnify Customer from and against any costs, damages, and judgments finally awarded against Customer in any suit or action brought by any third party based on a breach of the foregoing warranty.
Knowledge-Based Non-Infringement Warranty: Vendor represents and warrants that, to the best of its knowledge as of the Effective Date, Customer’s authorized use of the Software and Services will not infringe the intellectual property rights of any third party.
**Intellectual Property Indemnity:** Licensor shall defend, indemnify, and hold harmless Customer and its officers, directors, employees, agents and Affiliates from and against any claim, action, liability, loss, damage, cost, or expense, including, without limitation, attorneys' fees, experts' fees and court costs, arising out of any claim by a third party that Customer’s authorized use of the Software and/or Services infringes that third party’s intellectual property rights. Customer shall: (i) give Licensor prompt written notice of such claim; and (ii) allow Licensor to control, and fully cooperate with Licensor (at Licensor’s sole expense) in, the defense and all related negotiations. **Licensor shall not** enter into any stipulated judgment or settlement that purports to bind Customer without Customer’s express written authorization, which shall not be unreasonably withheld or delayed.
**Infringement Additional Remedy:** If the Software or Service becomes or is likely to become the subject of an infringement claim, then, in addition to defending the claim and paying any damages and attorneys' fees as required above, Licensor shall, at its option and in its sole discretion, either (a) immediately replace or modify the Software or Service, without loss of material functionality or performance, to make it non-infringing or (b) immediately procure for Customer the right to continue using the Software or Services pursuant to this Agreement. Any costs associated with implementing either of the above alternatives will be borne by Licensor. If Licensor fails to provide one of the foregoing remedies within forty-five (45) days of notice of the claim, this Agreement shall terminate and Licensor shall refund to Customer all sums paid by Customer hereunder, pro rated over five (5) years.
Limitation of Liability

- Types of damages
  - Direct (actual; compensatory): losses stemming directly from the breach
  - Consequential (special): caused by breach, but not necessarily resulting from the breach. Lost profits, damage to business reputation
  - Exemplary/Punitive: In excess of actual damages. Generally only awarded for willful or malicious conduct
Limitation of Liability (cont’d.)

- Two parts to every limitation of liability:
  - Exclusion of consequential damages
  - Cap on direct damages

- What is the liability cap?
  - Multiple of contract price
  - “Stair step” caps
  - Multiple caps for different types of damages

- Who is protected by the limitation of liability?

- Carve-outs: confidentiality, indemnity obligations, intellectual property infringement, gross negligence and willful misconduct
Limitation of Liability: Vendor Example

EXCEPT FOR DAMAGES ARISING FROM BODILY INJURY, VENDOR SHALL NOT BE LIABLE OR OBLIGATED TO CUSTOMER IN CONTRACT, TORT, STRICT LIABILITY, OR UNDER ANY OTHER LEGAL OR EQUITABLE THEORY, FOR ANY INDIRECT, EXEMPLARY, PUNITIVE, INCIDENTAL, SPECIAL, OR CONSEQUENTIAL DAMAGES (INCLUDING DAMAGES FOR LOST PROFITS, LOST REVENUES, LOST GOODWILL, LOST DATA, LOST BUSINESS OPPORTUNITIES, LOST CUSTOMERS, OR LOSS OF USE), WHETHER INCURRED BY CUSTOMER OR ANY THIRD PARTY.
EXCEPT FOR EACH PARTY’S INDEMNITY OBLIGATIONS HEREUNDER, FOR BREACH OF SECTION 6 (CONFIDENTIALITY), AND DAMAGES ARISING FROM BODILY INJURY, NEITHER PARTY SHALL BE LIABLE OR OBLIGATED TO THE OTHER PARTY IN CONTRACT, TORT, STRICT LIABILITY, OR UNDER ANY OTHER LEGAL OR EQUITABLE THEORY, FOR ANY INDIRECT, EXEMPLARY, PUNITIVE, INCIDENTAL, SPECIAL, OR CONSEQUENTIAL DAMAGES (INCLUDING DAMAGES FOR LOST PROFITS, LOST REVENUES, LOST GOODWILL, LOST DATA, LOST BUSINESS OPPORTUNITIES, LOST CUSTOMERS, OR LOSS OF USE), WHETHER INCURRED BY THE OTHER PARTY OR ANY THIRD PARTY.
EXCEPT FOR THE INDEMNITY OBLIGATIONS UNDER THIS AGREEMENT, EITHER PARTY'S INFRINGEMENT OF THE OTHER PARTY'S INTELLECTUAL PROPERTY RIGHTS, AND FOR BREACH OF SECTION 6 (CONFIDENTIALITY), (A) NEITHER PARTY SHALL BE LIABLE TO THE OTHER PARTY OR TO ANY THIRD PARTY FOR ANY INCIDENTAL, CONSEQUENTIAL, OR PUNITIVE DAMAGES ARISING OUT OF OR RELATED TO THIS AGREEMENT, EVEN IF THE PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES, AND (B) EACH PARTY'S AGGREGATE LIABILITY TO THE OTHER PARTY FOR ALL DAMAGES, LOSSES, AND CAUSES OF ACTION (WHETHER IN CONTRACT, TORT (INCLUDING NEGLIGENCE), OR OTHERWISE) SHALL NOT EXCEED THE GREATER OF $100,000 OR TWO (2) TIMES THE TOTAL FEES PAID HEREUNDER BY LICENSEE DURING THE TWELVE MONTHS PRECEDING THE INITIAL EVENT GIVING RISE TO SUCH LIABILITY.
Limitation of Liability: Further Vendor Example

Neither Licensor nor its suppliers shall be liable for any indirect, punitive, special, incidental or consequential, direct, or other damages in connection with or arising out of this Agreement, including loss of business, revenue, profits, use, data or other economic advantage, however it arises, whether in contract or tort, even if that party has been previously advised of the possibility of such damage. IN ANY EVENT, LICENSOR'S ENTIRE LIABILITY TO LICENSEE ARISING OUT OF OR IN ANY WAY CONNECTED WITH THIS AGREEMENT SHALL NOT EXCEED THE LICENSE FEES PAID HEREUNDER IN THE THREE MONTHS IMMEDIATELY PRECEDING THE EVENT GIVING RISE TO LIABILITY.
Confidentiality and Security

- Pre-contract
  - NDA
  - Vendor due diligence
  - Use of diligence questionnaire

- Contractual Protections
  - Confidentiality Clause
  - General security obligations
  - Security and data warranties
  - Use of subcontractors/offshore entities
  - Personnel controls, diligence
  - Breach notification and responsibility for notice costs
Confidentiality and Security (cont’d.)

- Post-contract execution
  - Monitoring and reporting
  - Audit rights
  - Coordinated testing of security measures
Contacts and Questions

Michael R. Overly, Esq.
Foley & Lardner LLP
Tel: (213) 972-4533
moverly@foley.com

Daniel C. Glazer, Esq.
Fried, Frank, Harris, Shriver & Jacobson LLP
Tel: (212) 859-8674 (NYC)
Tel: +44.20.7972.9159 (London)
daniel.glazer@friedfrank.com