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19 Software Licensing

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I. [19.1] INTRODUCTION

The purpose of this chapter is to introduce the reader to software and software licensing. Software, in its millions of manifestations, is a technology. It is not an intangible like a patent, copyright, or trademark. Those intangibles may inhere in software, or in a particular technology manifestation, but software is in some sense “a thing.” This chapter will cover the basics of software, the business drivers of a software licensing deal, the key points of negotiation, and the basic agreements involved in a typical software licensing deal. A checklist summary is provided in §19.38 below.

A. [19.2] Software and Its Unique Features

Software provides functionality that allows a digital processor to accomplish certain tasks. According to the Copyright Act, a “computer program” is “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.” 17 U.S.C. §101.

The unique architecture of software technology is determinative of typical revenue models and how licensors protect their intellectual property. Software involves two types of languages (or code) for the instructions that ultimately cause the performance of certain tasks. One code is called “source code.” Source code (*e.g.,* a program written in Java, C++, Perl) is the human readable program code that programmers use to write computer programs. The other code is “object” or “machine” code. Object code is the millions of 0s and 1s that sit on a disk and that the computer reads. Humans cannot read object code. The human readable source code is translated through “compilers” into 0s and 1s (object code) for reading by the computer.

Source code is the “crown jewel.” Why? Because it is readable by humans. If you had the Microsoft human readable source programming code to Microsoft’s Windows operating system, you could theoretically rewrite the Windows system, modify it, and offer maintenance and support services. You might be violating a host of copyright, trade secret, patent, and other laws by copying the code. Or maybe you could figure out how to write around the code so that you are not violating copyright. The important point is that Microsoft does not want you to have the source code.

Source code is critical to the rights protection mechanism for software and also to its revenue model. One thing is certain, just like your car, most software will need regular repair and updating. “Maintenance and support” is the chief revenue driver of major software procurement deals and generally accounts annually for as much as 20 percent of the original purchase price of the software. Here is at least one of the key takeaways in software licensing: because the vendor has the crown jewels and because of the nature of the license agreement, the licensee is stuck with that vendor. In effect, the licensee is married to the vendor/licensor. Remember, most of what you pay for comes after you pay for the license.

B. [19.3] Software Transactions: Why License?

The pliability of software should not make us think software itself is an intangible or an intellectual property. Books are a kind of technology, but books with their hard covers and paper pages, arguably, are not as physically pliable and generative as software; software can be manipulated into infinite uses. The uses of books are more limited — just as a toaster may have fewer uses than an oven. An e-book, without technological protection measures (locks and keys that prevent you from digitally moving text around), is more pliable than paper and hard cover but less pliable than the program that is used to compile an e-book that presumably can be used to generate many e-books. See Jonathan Zittrain, THE FUTURE OF THE INTERNET--AND HOW TO STOP IT (2008). The pliability or generativity of a thing does not make that "thing" an intellectual property.

It is helpful to talk about books and software together because it helps to define the legal context of software. When you buy a book, at least two bodies of law are relevant: (1) the law of sales and contracts and (2) the laws of intellectual property, particularly copyright. The law of sales covers the rights to the thing. Your rights to the thing — the physical book in hard copy form or e-book form — are governed by mutuality, assent, consideration, acceptance, rejection, implied warranties, and all the familiar contract concepts governing the sale of any good. (It should be noted that two states, Maryland and Virginia, have adopted the Uniform Computer Information Transactions Act (UCITA) (www.uniformlaws.org/shared/docs/computer_information_transactions/ucita_final_02.pdf), which in those states governs software licensing transactions.)

At the same time, while the law of sales governs your rights and remedies as to the rest, your rights in and to the content of the book — the right to copy the content, the right to display the content, the right to perform the content, the right to create derivative works of the content, and the right to sell and distribute the content — are governed by intellectual property laws, particularly the copyright law, and perhaps others such as laws governing rights to publicity and privacy relative to certain facts or images that may appear in the book.

Generally, software developers and vendors monetize transfer of the object code and preserve the secrecy of the source code for the reasons discussed in §19.2 above. Software may be transferred by sale but more often by license. In cases controlled by Illinois law, Article 2 of the Uniform Commercial Code (UCC), 810 ILCS 5/2-101, *et seq.*, or the common law of contracts will by default fill the gap in any contract. Determining whether the UCC or common law applies is a fact-intensive inquiry into the predominant nature and purpose of the transaction and may be important for statute of limitations purposes. *See, e.g., Bruel & Kjaer v. Village of Bensenville,* 2102 IL App (2d) 110500, 969 N.E.2d 445, 360 Ill.Dec. 635; *Dealer Management Systems, Inc. v. Design Automotive Group, Inc.,* 355 Ill.App.3d 416, 822 N.E.2d 556, 290 Ill.Dec. 971 (2d Dist. 2005); *Allstate Life Insurance Co. v. Peoplesoft, Inc.,* No. 03 C 7025, 2004 WL 1375383 (N.D.Ill. 2004).

Software providers could sell software in the same way that publishers and book dealers sell books. The buyer would "own" the thing (*e.g.,* the software disc) in the same way that the buyer would own the copy of a Harry Potter book that he or she buys in a bookstore. The licensee would be prohibited under the copyright law from copying, making derivative works, performing, displaying, and distributing the software (except for selling the disc that he or she bought).

So why do software developers not simply sell the software? Why license? The answer is that licensing offers the opportunity to impose contractual protections and restrictions that go beyond the laws of intellectual property. A license by itself is a permission; the owner of rights to software could simply grant a permission — limited or expansive — through a conveyance. However, a license, coupled with conditions imposed through a contract, allows licensors to enforce restrictions, limitations, and covenants in tandem with the permissions associated with the use of the software. Intellectual property law, coupled with a contract, permits the licensor to granulate the opportunity to monetize the use of the software. A licensing model allows, for example, the licensor to restrict the term, the right to reverse engineer, the ability of the licensee to disclose information about the software, and the ability of the licensee to assign the license. Again, by example, licensors can use a license agreement to control venue and choice of law and to control risk; licensors can disclaim implied warranties, limit damages, and condition licensee's use on purchase of maintenance and support.

C. [19.4] Summary of Protections and Vendor Lockdown

The discussion in §19.3 above presents a host of protections for the vendor/licensor, sometimes referred to collectively as "vendor lockdown." Joseph R. Mangan, Jr. and John H. Hines, Jr., *Beating Vendor Lockdown: Negotiating Software Licenses for Your Organization*, 24 ACC Docket 2, 45 (2006); J.T. Westermeier, *Open Source Software*, Practicing Law Institute 421 (Sept. 2004). First, the vendor typically controls the source code, which is essential to any development of the software. Second, software is protected by a number of intellectual property laws including copyright, trade secret, and, in some cases, software can receive patent protection. Third, through licenses, the licensor/vendor often imposes severe contractual restrictions on the buyer. These tools gives the licensor lots of control over the unwary licensee and the continued ability to extract additional revenues for any desired freedom from the restrictions imposed by the license.

The key to licensing is control. This is doubly true in software licenses because of vendor lockdown. Remember, you are stuck with the vendor. The licensor has reciprocal concerns: whereas the licensee wants to maximize existing and future rights to the software and fix (and minimize) costs, the licensor's goal is to control the licensee's use and maximize revenue opportunities. When negotiating a software license, both licensor and licensee should keep in mind "who, what, where, when, why, and how." Who can use the software? What can the licensee do with the software? Where can the licensee use the software? When can the licensee use the software? Why will the licensee use the software? How can the licensee use the software?

II. [19.5] SUITE OF SOFTWARE LICENSE AGREEMENTS

There are essentially four agreements in a typical software licensing deal. These four agreements are discussed in §§19.6 –19.29 below.

A. [19.6] License Agreement

The first agreement in a typical software licensing deal is the license agreement itself. The license agreement controls rights to use the licensed software and answers the "who, what, where, when, why, and how" questions in §19.4 above, as well as imposing a host of restrictions such as those discussed in §19.3 above.

B. [19.7] Maintenance Agreement

Maintenance is the service in which the licensor provides all the "new and improved" versions for which the licensee paid. If the licensor adds an insubstantial enhancer, that addition likely comes with maintenance. If the enhancer is substantial and outside the scope of the basic functionality, it may fall outside the scope of maintenance and the licensee may have to pay for it.

C. [19.8] Support Agreement

A licensee will require what is referred to as "support." Think of support as, "I've got a problem, who do I call?" Support consists of the help desk and the people who "fix things" when the licensee has a problem. ("My system is crashing — HELP!"). Maintenance and support are better thought of as two separate agreements, but they usually are lumped into one maintenance and support agreement. As noted in §19.2 above, a maintenance and support agreement may run about 20 percent of the cost of the license. Licensors may well offer a perpetual term for the license, but typically will offer only a fixed and relatively short (renewable) term for maintenance and support.

D. [19.9] Escrow Agreement

Licensees of software should be concerned about the possibility that a licensor will not be able to provide maintenance and support in the future. One risk management tool to minimize the consequences of this possibility is the escrow agreement. A software escrow agreement is a three-way agreement between the licensor, the licensee, and a third-party escrow company under the terms of which the licensor deposits the source code into escrow with the escrow company. Under the typical escrow agreement, the source code of the software is released to the licensee if the licensor is no longer able to provide maintenance and support services, but the terms of the actual release events are typically heavily negotiated.

III. LICENSE AGREEMENT

A. [19.10] Key Negotiation Points

Where do the parties spend time negotiating? How do the licensee and licensor allocate control? Key provisions include: (1) the grant; (2) the acceptance provision, including technical specifications; (3) the warranties; (4) the timing of payments; (5) confidentiality; (6) termination; (7) the assignment; and (8) risk allocation provisions.

B. [19.11] License Grant

The license grant defines the scope of how the licensee can use the software — the who, what, where, when, why, and how. Licensees need to be concerned that they obtain all the rights they need. For example, can all of your corporate divisions and/or affiliates use the software? Can subcontractors? Are there territorial limits? Are there limits on the number of central processing units (CPUs)? On the number of users? Does the license limit the CPUs by serial number? What do you expect for the future? Will existing limits be satisfactory next year or years after? Do you anticipate a need for an increase in the scope of the grant? Licensees need to anticipate and contractually fix the cost of anticipated needs in the license agreement. One thing is certain, once a dependency is created, licensors will be in a stronger position to exact a heavier toll on licensees if the price is not fixed ab initio. Licensors, on the other hand, need to be careful that they are not "giving away the store" now and that they have the opportunity to exploit the full value of their intellectual property in the future — by closely restricting, for example, the term, rights to expand usage, and price.

C. [19.12] Acceptance — Generally

In most cases, the licensee will not simply be able to install the software and start using it. Most licenses involve some customization. There typically is integration, some further development, and other customization. Acceptance provisions become an important tool for the licensee to assure that the licensee is getting what it has paid for. The basic idea of the acceptance provision is that, if after testing the software does not conform to specifications, the licensee can terminate the license and get a refund of any monies paid.

1. [19.13] Specifications

A robust set of specifications are critical (at least from the licensee's perspective) to a meaningful acceptance and warranty process. Specifications are the documents that describe the technical and functional features of the software — most importantly what the software does and what functions it performs. The licensee needs to engage its technical team to read the specifications and assure that they provide a complete description of what the licensee expects the software to do. The specifications are important because they provide the criteria for acceptance and the performance warranty.

2. [19.14] Acceptance Testing

Typically, acceptance involves testing and a test period that may be 21 days or more, depending on the software. If the licensee notes material deficiencies, the licensor will have a period of time to repair. If the licensor fails to repair, the licensee will seek to have the right to terminate or perhaps cycle the software through another test. Licensees want as much discretion as possible in the acceptance provision to accept or reject the software. Licensees should also seek to preserve their right to claim a defect under the warranty, even if they fail to raise the defect in testing. Licensors will resist that type of provision as "two bites at the apple." Moreover, if the contract is to contain a testing provision, the licensor/vendor will seek to impose a narrow and objective standard for testing. Licensors often try to exclude acceptance provisions altogether. One option that licensors may prefer is to give the licensee a precontract beta test opportunity.

D. [19.15] Performance Warranty

Just like the acceptance provision, the performance warranty is tied to the technical and functional specifications. A typical performance warranty provides that the software will conform to the specifications for a certain period, frequently 90 to 120 days or more. Some additional issues giving rise to negotiation of the performance warranty include the following:

1. Licensees also like to add as "belt and suspenders" that the software will be substantially free of defects (which provides the licensee a little protection beyond the specifications themselves). Licensors typically push back at the "free of defects" clause as being vague and straying too far from the specifications.

2. The key difference between acceptance and warranty lies in the remedy. The licensor will try to limit the warranty remedy to repair or replace. The licensee should push for refund and termination; however, that may be a challenge if there is an acceptance clause providing the same right.

3. With respect to any refund for warranty failure, the licensor will try to limit the licensee's refund to the component of the software (to the extent isolable) that is not working; the licensee will resist this kind of divisibility, but at a minimum will ask for a refund for the defective component and any aspect and use of the software that is affected.

E. [19.16] Limitation of Remedy

Licensors may want to consider limiting the licensee's remedy on a performance warranty to repair and replace the defective software. Any exclusive remedy should be in bold print. Exclusive remedies may be subject to attack as being unconscionable or causing the transaction to fail of its essential purpose. To avoid any such claim, licensors are well-advised to offer a "refund" as an option in the event that the licensor is unable to repair the software.

F. [19.17] Other Warranties

In addition to performance warranties, the licensee should consider negotiating for a variety of other warranties, which may include that:

1. no viruses will be injected into the system or software;

2. the licensor has complied with applicable laws in developing the software and that the software is not in violation of any such laws;

3. all services have been and will be performed in accordance with "best practices" industry standards;

4. the licensor is not aware of any pending claims that the software violates the rights of others or any circumstances that would give rise to such claims, including but not limited to claims for intellectual property infringement;

5. the software contains no open source applications (software that is developed in a nonproprietary environment, software that is freely distributed, and software in which the source code is open and developed on a freely accessible basis);

6. documentation, specifications, and manuals will be reasonably complete and accurate, including but not limited to describing all hardware, operational, interoperability, interface, functional, and technical specifications and requirements;

7. licensor will not use any license key or other devices to programmatically suspend or terminate licensee usage absent order of a court of law; and

8. there are no other licenses required to operate the software other than those that are granted in the agreement.

NOTE: A licensee should seek to avoid subjecting the above listed additional warranties to the performance warranty period (described in §19.15 above). Licensors should be careful to insert a bold disclaimer that all warranties not expressly granted are disclaimed, including implied warranties of noninfringement, merchantability, and fitness for a particular purpose. Also, disclaimers that are inconsistent with express warranties will not be enforced. This poses a special hazard because it is possible that, under certain circumstances, representations made outside the four corners of the document (a hard sales pitch) could be construed as an express warranty. Licensors should train their sales people to avoid any statements beyond the performance capabilities of the software. This is a good reason for an integration clause (that the contract includes no statements outside the four corners) and for a representation by the licensee that there has been no reliance on any statement outside the contract.

G. [19.18] Timing of Payment

How do you time payments? The main pinch points of the deal are execution of the contract, installation, acceptance testing, acceptance, productive use, warranty period, maintenance, and support. See the software transaction timeline in §19.39 below. The licensee should seek to gain as much performance as possible relative to any payments. The licensor will try to obtain as much of the payment as possible up front and/or early. Licensees may try to push for some percentage of payment on signing (*e.g.,* 25 percent), some at installation, some at acceptance, and perhaps some at expiration of warranty. The software transaction timeline also contains a chart that diagrams the likelihood of the licensee gaining certain concessions. As a general rule, the more “off the shelf” and less customized the software is, the less likely it is that the licensee will gain concessions.

H. [19.19] Confidentiality

Licensees should require confidentiality from the licensor when there is any kind of disclosure, particularly if there has been development and customization conducted by the licensor and the licensor has the opportunity to obtain information about the licensee. On the other hand, licensors often seek to impose strong confidentiality provisions that prohibit licensees from talking about their technology. Counsel should be careful of these provisions. Licensees do not want to create restrictions that prevent them from being able to talk about the technology when it is essential in the context of migrating to new vendors or integrating various technologies with other third-party providers. Additionally, the terms of the license should be capable of being disclosed in connection with due diligence involved in any strategic investment of a party, as long as the potential investor is under confidentiality restrictions.

I. [19.20] Termination and Wind Down

Frequently licensors will have provisions in the agreement that state that if the licensee breaches, the licensee will have 30 days to cure or the license terminates. Licensees should be alert to these provisions. A termination could be disastrous, particularly if the licensed technology represents critical technology that is core to internal operations or to the assembly of a product or service. If the technology would not be readily replaceable, the licensee should resist allowing the remedy of termination. In effect the licensee should say, "Come sue me for money if I breach, but you are not terminating my rights. Take my company, execute on my property, but you cannot recall the license." If the licensee is not able to negotiate a prohibition on termination, the licensee should consider how long it takes to exhaust its inventory containing the licensed software or to replace critical operations technology that contains the software. What if the buyers of hardware or software solutions, incorporating the terminated technology, need maintenance and support of the terminated incorporated technology? Even if the licensee obtains extended wind-down rights on termination, the licensee may still need to negotiate some kind of termination assistance incorporating those services for some period of time.

J. [19.21] Termination — Another Strategy

Another strategy is to soften the termination provision. Licensees may attempt negotiating a provision such that if the licensee is exercising diligence to fix the alleged breach and mitigates the harm, the licensor cannot terminate. For example, if the licensee inadvertently breaches confidentiality, the licensor cannot terminate if the licensee puts in place processes that minimize the chance of any such future breaches and takes steps to mitigate dispersion of any information disclosed. Large deals involving, for example, seat licenses, run the risk of inadvertent excessive use by licensee. The licensee should consider provisions that automatically liquidate inadvertent license violations with payments tiered to excessive use and avoid such missteps as becoming grounds for termination.

K. [19.22] Assignment

Licenses will often form a major component of the value of the company — operationally and financially. If a technology company, for example, earns most of its revenue from licensing and cannot assign its licenses to a buyer of its assets, it will not be able sell the business. Likewise, a company that licenses in critical technologies related to products and services needs to know that it can assign the licenses when it sells its business. Restrictions on assignments can cause all kinds of pricing and logistical impairments to the smooth exit strategy of a company. Accordingly, it is not uncommon to see provisions that restrict assignment with a carveout for assignment to the purchaser of the company's stock or substantially all of its assets. Licensors should be aware of "giving away the store." If, for example, the licensor has granted an enterprise license to a start-up, the licensor should be wary of that license being transferred, by virtue of an assignment provision, to a large company upon sale of the start-up to the larger company. Licensors should control the scope of the assignment so that (depending on the nature of the license and the proposed assignee) the licensor is not unduly prejudiced in its ability to exploit the value of its intellectual property. Likewise, licensees should be wary of the licensor having unfettered right to assign the licensor's interest in the license, particularly when the licensee relies on some special skill of the licensor in the provision of maintenance and support. The licensee in these cases should attempt to restrict the licensor's right to transfer to parties that at least have the technical and financial competence of the licensor. When appropriate, both parties may consider a provision that allows assignment of the other party with approval by the non-assigning party "not to be unreasonably withheld or delayed"; the parties may delineate examples of criteria for considering the reasonableness of the assignment.

L. [19.23] Outsourcing

Additionally, licensees should anticipate the possibility of future outsourcing of hosted solutions, especially in instances in which the proposed license contains site restrictions and restrictions on subcontractors. Licensees should add carveouts for the possibility of outsourcing and third-party hosts. Failure to carve out their positions ab initio may result in paying for the right to do so if the licensee requests it later.

IV. MAINTENANCE AND SUPPORT

A. [19.24] Maintenance

Under a typical maintenance agreement, licensors will be required to provide licensees with updates (1) that are generally provided to the licensor's customers, (2) for which the licensor generally does not separately charge, and (3) that do not add substantially new functionality. Licensors tend to push for a narrow definition of maintenance releases, because if a development is out of the scope of a maintenance release, the licensee will be required to pay for the development. The licensee wants as broad a definition as possible of what constitutes a new maintenance release. To assure a reasonably robust maintenance program, licensees should seek assurances that the licensor is committed to a maintenance program and continued improvement of the software.

B. [19.25] Other Maintenance Considerations

A licensee may be concerned that it cannot afford maintenance for a year or two and, therefore, wants the option of not having to buy maintenance and support for some period of time. From the licensor's perspective, the licensee's election to come back to the maintenance fold two or three years later should not give the licensee the right to obtain cumulative developments made during the maintenance suspension period. The licensor may want to accommodate the licensee's desire to interupt maintenance, but the licensor should demand some kind of backpay when the licensee "hops back on" — especially since the new versions of the software will incorporate corrections made during the period when the licensee is "off." Frequently, licensors do allow licensees to hop off maintenance but require full back payment if they hop back on. Finally, licensees may have no problem paying for maintenance and support, but they may want the option not to install new releases of the software. They may demand backwards compatibility of support services to versions prior to the current version — assurances that the licensor will provide error correction and other services for such earlier versions. Licensors usually push back on such requests and the parties may settle on some specific period (*e.g.,* one year of backwards compatibility). NOTE: Licensees should resist any condition of continued right to use the software on the purchase of maintenance and support. The licensee should argue the two are independent.

C. [19.26] Support

"Support" refers to the bundle of services that the licensor provides when the software is not working properly. A key point of negotiation arises over various obligations associated with "severity levels." Support agreements will define a problem with the software according to the "severity" of the problem, usually something like "severity 1" (when there is a total shutdown of the application), "severity 2" (when there is something less than a total shutdown, but critical functions of the application are severely impaired), etc. Often the severity levels and associated required responses are built into a chart in the support agreement. Licensees will typically want control over defining the severity level of the problem (severity 1 will place more demands on the licensor than a severity 2 problem) and will seek a representation of quick response and resolution times. Licensees will seek objective metrics built into the severity response chart that clearly define when the licensor is in breach. The licensor will argue that it cannot predict with precision when or even if it will be able solve a problem and that it is unfair to tie the licensor to objective criteria (such as that licensor will achieve a work within eight hours, etc.). Accordingly, licensors will try to maintain control over the severity level definition and will seek to build flexibility into the response requirements. At a minimum, the licensee should obtain (1) a chart with specific initial response, escalation, and target resolution times; (2) a representation that the resolution times have been established based on the licensor's experience and are reasonable; (3) a representation that the licensor will at all times maintain resources designed to achieve the target responses and response times; and (4) a representation that the licensor will at all times use commercially reasonable efforts to achieve the target responses and target response times. The parties will have to reach a compromise on how to decide the severity level of an incident. They might, for example, agree that the licensor has the power to make the ultimate determination but that it has to give reasonable deference to the determination of the licensee and the impact of the incident on licensee's business.

D. [19.27] Maintenance and Support Renewals

Maintenance and support may account for about 18 – 20 percent per year of the cost of the original license. The licensor's "lockdown" of the licensee is going to tie the licensee into renewals and that dependency will give the licensor the opportunity to raise prices over time with the prospect of termination if the licensee does not agree to price increases. Accordingly, the licensee needs to secure automatic renewals at capped increased rates. The licensee may try to negotiate a provision that maintenance and support will renew annually unless either party gives 45 days' notice of nonrenewal — except that the licensee should attempt to extract a concession that the licensor will not exercise its right of nonrenewal unless the licensee is in material default at the time for renewal or the licensor is no longer generally offering maintenance and support to its customers. Under this type of provision, the licensee should also seek to require that any price increase is noticed to the licensee 60 days prior to the end of the term (15 days prior to the licensee's required election not to renew), and such price increase is to be capped at the lesser of, for example, five percent or the annual increase in the Consumer Price Index (or some other reliable index).

V. SOURCE CODE ESCROW AGREEMENT

A. [19.28] Deposit

As discussed in §19.2 above, source code is the human readable blueprint for the design of the software. This blueprint is necessary to maintain and support the software. A source code escrow agreement is a three-party agreement between the licensee, licensor, and escrow agent, under which the licensor agrees to deposit the source code with the escrow agent with the understanding that it will be released to the licensee under certain conditions. The key issues turn on the definition of the deposited source code, on the conditions that will give rise to the release, and on the frequency of updates. Licensees need to make sure that the definition of "source code" is broad and that it includes, for example, all the accompanying documentation relating to the development environment and commentary so that the licensee's programmers can interpret and make use of the source code. Licensees also want frequent updates to the escrow as the code is updated. Licensors frequently push for a narrow deposit of the source code itself and less frequent updates. Licensees should also ask for release of any restrictive covenants on former licensor employees so that they can be free to help interpret the source code if need be.

B. [19.29] Triggers for Release

The most highly negotiated provision in the escrow agreement is usually the trigger for release. Licensors, understandably, are reluctant to turn over the source code — their "crown jewels" — under any circumstances; therefore, they usually try to limit release conditions to bankruptcy, insolvency, ceasing to do business, and other conditions approximating "going out of business." Licensees may argue that the purpose of an escrow agreement is to assure competent maintenance and support. Accordingly, licensees argue that any circumstance that impairs the competent rendering of support and maintenance over some negotiated period of time should give rise to a release of the source code to the licensee.

VI. REGULATORY CONCERNS: EXPORT, GOVERNMENT CONTRACTS, AND TAXES

A. [19.30] Export Control

The export of technology, including software, is tightly controlled by the Department of Commerce, the Bureau of Industry and Security, and the Directorate of Defense Trade Controls. The applicable regulatory scheme includes the Export Administration Regulations (EAR). See 15 C.F.R. pt. 730. If a licensor is planning on exporting to a foreign country, it is important to be familiar with the regulatory scheme. Information about the various rules and regulations are discussed at the U.S. Department of Commerce Bureau of Industry and Security. www.bis.doc.gov. The top items on the list for licensors to consider are that: (1) export of the software may require a government license, if, for example, the license contains certain levels of encryption; (2) it is important for the licensor and the licensor's licensees to observe any restrictions on transfers to certain countries that have embargoes against them; and (3) the license should contain an appropriate paragraph that requires the licensee to observe export laws and transfer restrictions.

B. [19.31] Government Contracts

Government contracting is a highly specialized area of practice with its own set of regulations. Licensors should be very careful if they plan to license software to the government. A contract with the government without appropriate protective language may inadvertently confer rights that are not intended to be transferred by the licensor. Accordingly, it is important to draft a provision that makes appropriate reference to the applicable regulations (the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFAR)) and provides that that the license is to be governed by the terms of the license agreement. With respect to export and government contracts, the parties are well-advised to talk to advisors with specialized experience in these matters.

C. [19.32] Taxes

Licensors are well-advised to consult tax advisors on the ramifications of state and federal taxation regulations on any proposed license transaction. For license transactions controlled by Illinois law, licensors and licensees should be aware of 86 Ill.Admin. Code §130.1935. Parties to license transactions should review the entire provision, but certain license transactions may be carved out of the domain of taxable retail sales if (1) there is a written agreement signed by the parties; (2) the licensee's right to copy and use the software is restricted; (3) further licensing, sublicensing, or transferring of the software to a third party is restricted without the permission and continued control of the licensor; (4) the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software or of allowing the licensee to keep an archival copy (and such policy is stated in the license or notarized statement by license made under penalty of perjury); and (5) there is a requirement that the licensee destroy or return copies of the software at the end of the license period (unless the license is perpetual, in which case the provision is deemed met). *Id.* The parties should review carefully the text of the regulation and include such language in their agreement as may be appropriate under the circumstances of the transaction. Additionally, custom computer programs prepared at the special order of the customer, and otherwise meeting the specific requirements of the regulation, may not be taxable. Again, the parties are well-advised to consult the specific text of the regulation.

VII. [19.33] RISK ALLOCATION

In examining the risk allocation, the parties need to focus on the suite of provisions governing the warranties; disclaimers; limitations of remedies, liability, and damages; indemnification; escrow; and insurance.

A. [19.34] Limitations on Damages and Liability

Typically, the licensor attempts to limit its exposure to direct damages and cap the exposure to the amount paid by the licensee over some period of time. Licensees generally try to expand the period and argue for some multiple of the amount paid or payable. Licensees often agree to limit the licensor's exposure to direct, non-consequential damages but attempt to create carveouts from the limitation. First, licensees may attempt to define certain types of damages that will be considered direct and non-consequential (*e.g.,* cover, cost of substituted goods, restoration of data). Second, licensees may attempt to carve out from both the cap on damages and the limitation on consequential damages certain classes of activities (*e.g.*, fraud, willful misconduct, gross negligence, indemnified claims under the indemnification provision, violation of law, failure to adhere to certain key representations and warranties that are central to the deal, etc.).

B. [19.35] Indemnification

Licensors typically are willing to provide an indemnification for third-party claims but want to limit the indemnification to intellectual property infringement only. Sometimes licensors want to limit the infringement indemnity to the United States. Licensees may consider compromising with respect to a U.S. limitation on patent infringement; a patent infringer does not necessarily know that it is infringing and so it is understandable that the licensor would want to limit its risk through a territorial limitation. On the other hand, other types of infringement require knowing activity — for example, copyright infringement. In those types of cases, the licensee should reject the territorial restriction on indemnification.

Although licensors are very reluctant to extend indemnification beyond intellectual property infringement, licensees may want to seek indemnification for other third-party claims. For example, the licensee may ask for indemnification for third-party claims arising out of the licensor's violation of law, breach of confidentiality, breach of data security covenants, willful misconduct, gross negligence, or breach of other key representations/warranties that are unique to the particular transaction.

C. [19.36] Insurance

Licensees need to be sure that the licensor is properly insured to cover the risks associated with the deal. For example, licensees should seek a provision that covers contractual indemnity to cover the obligation to indemnify. Generally speaking, licensors offer some combination of commercial general liability, error and omissions, and employer and/or workers' compensation liability insurance. Licensees should be sure that the limits of liability are sufficient for the transaction. Licensees are well-advised to consult with a risk management professional relative to insurance coverage.

VIII. [19.37] OPEN SOURCE SOFTWARE

Historically, most individuals and businesses have been accustomed to software distributed on a proprietary basis in which the source code is not disclosed. Open source or "free" software is software in which the source code (the human readable code) is distributed or made available along with the executable object code. Often the code is available for download at no charge from the Internet. There are a number of risks in using open source software, particularly for software developers. First, the code is developed by freelancers and others who contribute back to the source — not in the kind of controlled environment associated with proprietary software. The lack of control over the development environment presents the risk that the code, as used in the open source solution, might violate the intellectual property rights of third parties. The rigorous documentation and other processes associated with proprietary development minimize these risks. Second, the terms of the open source license may present certain risks. Open source licenses contain no warranties or indemnities and are full of disclaimers. The licensee essentially takes it "as is." Moreover, certain open source licenses contain strong "copyleft" provisions that pose special dangers to developers and others incorporating the open source code into their solutions. The copyleft provisions are "viral" in the sense that they require the licensee not only to keep the source code of the open source application "open" but also the source code of any work that is based on or derived from the open source application. Famously, the highly prevalent general public license (GPL) (in its various versions) requires this sort of disclosure, which threatens to taint the portion of the solution that the developer intends to maintain as a trade secret — depending on how the open source application is used. Furthermore, some open source licenses effectively require the licensee to release patent claims that are embraced by the open source technology. Finally, using multiple open source applications may present license compatibility issues; the licenses vary in what is or is not tolerated with respect to use and the incompatibility of the licenses may have implications on whether the applications can be incorporated successfully into the same solution.

In light of the risks associated with open source software, companies acquiring software solutions, particularly technology driven companies, need to be very cautious in their acquisition of software in their licensing practices and mergers and acquisitions activity. Companies that are engaged in software development or that are otherwise software driven need to maintain careful logs of their software inventory, the applicable licenses, and how the software is being used so that they do not inadvertently violate the open source license provisions. Careful attention to this sort of process will help to assure that the company does the required diligence up front rather than facing a problem later. It will also facilitate sale transactions in which prospective buyers are likely to be especially aggressive in seeking information about the company's historic acquisition and use of software.

IX. APPENDIX

A. [19.38] Software License Checklist

[DISCLAIMER: This checklist is somewhat oriented to licensees and purchasers of software technology, but it is designed to be helpful to "both sides of the table." NOTE: This checklist does not purport to be exhaustive, authoritative, or in any way customized to particular circumstances. Please review applicable law and consult with an experienced contract professional as necessary.]

I. Software license suite of agreements

   A. License agreement

   B. Support agreement

   C. Maintenance agreement

   D. Escrow agreement

II. Software License Agreement — License Grant

A. Clear definition of software

1. Exhibit/Attachment with functional and technical specifications

2. NOTE: warranties and acceptance clauses are tied to these specifications.

B. Grant clause answers: who, what, where, when, why, how; *e.g.:*

1. Enterprise

2. Divisions

3. Territorial

4. Affiliates

5. Subcontractors

6. Seat restriction

7. Number of computers

8. Specific computers/serial numbers

C. Adding users

1. Right to add users in future?

2. Cost fixed for additions? Avoid future negotiation

D. Prepare for outsourcing

1. Licensee may decide to outsource its IT

2. If so, licensee may want the right to load the software on third-party hosted servers

III. Term

A. Perpetual or fixed term

B. If fixed term, is it renewable?

1. Typically, there is an automatic renewal, except if notice within 30 days of termination prior to expiration of then existing term

2. However, the licensee should try to limit the licensor's ability to exercise right of nonrenewal and the right to exercise on if:

    a. Licensee is in default, or

    b. Licensor is generally not offering the solution/has terminated the solution as a product offering

IV. Fees — Timing of Payments

A. Licensor tries for payment up front; licensee tries to keep a "carrot" of future payments out there, especially if customization

B. Payments may be tied to milestones, *e.g.,* installation, acceptance, etc.

V. Acceptance testing

A. Test tied to technical and functional specifications

1. Basic: material compliance with specifications

2. Licensee may seek to add: not otherwise defective in materials and workmanship

B. Length of test period, length of remediation period; *e.g.,* 30 days

C. Number of rounds, *e.g.,* three

D. Licensee discretion to return and refund if failure on last round

E. Licensee should draft in that acceptance is without prejudice to claims on warranty

VI. Warranty

A. Performance

1. Material compliance with specifications

2. Not otherwise defective in materials and work

3. Warranty period: 90 to 180 days, typical

4. Remedy

    a. Repair, replace

b. If defect, licensee should seek option to return and refund

c. Licensor should try for "exclusive remedy"; licensee should seek to retain other contract remedies

B. Licensor seeks to restrict warranty to performance; licensee might seek other possible warranties, *e.g.:*

1. The licensor's software documentation and manuals shall be reasonably complete and accurate, including but not limited to describing all hardware, operational, interoperability, interface, functional, and technical specifications and requirements

2. No open source licenses are used in the software [NOTE: If so, such licenses must be separately scheduled and appropriate due diligence done on licenses and code]

3. No viruses

4. Technical, administrative, human resources are sufficient to meet maintenance/support obligations

5. Compliance with laws

6. Non-infringement (at least no knowledge)

7. Pending claims

8. The software has been developed in a professional manner in accordance with generally accepted industry standards

9. Licensor's services under the agreement will be carried out in a timely and professional manner for work generally accepted in the industry

10. Licensor shall not use any license key or other devices to programmatically suspend or terminate licensee usage absent order of a court of law

11. Use of the software in accordance with the rights granted in the agreement will not infringe any third-party intellectual property rights and licensor has not been threatened with nor does there exist any actual litigation alleging third-party intellectual property infringement

12. There are no other licenses required to operate the software other than those that are granted in the agreement

C. Licensee should seek express statements that period of performance warranty and exclusive remedy are limited to performance warranty (See item VI.A. above), not applicable to other warranties, such as in item VI.B. above

VII. Confidentiality

A. Licensor wants confidentiality regarding technology; licensee with respect to business and use of technology

B. Licensee should not let licensor's demand of confidentiality be so broad that provision taints ability to transition or coordinate with licensee's other vendors

C. Carveouts

1. Standard carveouts

a. Information known prior to deal

b. Disclosed by third party not bound

c. Independently developed

d. To the extent disclosure required by law

2. Additional Carveouts

a. Freedom to disclose in event of strategic investment (potential merger, due diligence, etc.)

b. Licensee's ability to disclose as necessary to other provider or in case of transition

VIII. Termination

A. *E.g.,* licensee can terminate on 30 days' notice of material breach (or perhaps shorter in case of key support breaches, etc.), licensor failure to cure

B. *E.g.,* licensee can terminate immediately on notice after repeated material breaches

C. Licensee can argue for restrictions on licensor's right to terminate for material breach

1. Breach is inadvertent

2. Licensee is using diligent efforts to remediate

3. Preventing future breaches

D. If licensor can terminate, licensee should negotiate for long period after notice of termination. Licensee needs time to exhaust inventory and inventory in field

IX. Risk Transfer and Allocation

A. Limitation of liability

1. Generally, expect liability to be limited to direct damages, *i.e.*, no consequential damages

2. Licensee seeks multiple of software costs, *e.g.*, 2 – 5 times

3. Licensee should try to define what direct is, *e.g.*, licensee to argue that “cover” and “substituted goods” are “direct”

4. Possible carveouts

a. Indemnification

b. Breach of confidentiality

c. Willful misconduct

d. Gross negligence

e. Breach of certain warranties

(1) *E.g.*, open source

(2) Not having resources designed to meet maintenance and support obligations

(3) Compliance with laws

5. Licensee shall argue for limitations on its liability

B. Indemnification

1. Defend, indemnify, and hold harmless

a. Unlimited from the vendor on IP

b. Other possible indemnifiable risks:

(1) Compliance with laws, or data security laws

(2) Breach of confidentiality

(3) Willful misconduct, intentional conduct, gross negligence

(4) Failure to maintain resources designed to meet maintenance and support targets

2. Vendor controls settlement

a. But reasonable approval by licensee; or

b. Settlement must be only for money damages for which licensee is fully indemnified; no admission of liability; no effect on other claims that licensee may have and no injunctive relief beyond cessation of use in cases of IP infringement

3. Vendor chooses lawyer

a. Reasonable approval by licensee

b. In cases of potential business/legal counsel, licensee can have own lawyer and licensor pays

c. Licensee can participate with lawyer otherwise, but pays

C. Escrow — independent third party holds source code in the event that licensor fails in obligations to maintain and support software

1. There will be a three-party agreement between escrow provider, licensor, and licensee

2. But key provisions should be in license

a. Licensee seeks broad definition of source code deposit that includes documentation sufficient for reasonably trained programmer to use the software and maintain and support it

b. Frequent updates to deposit when there are corrections and updates to software

c. Events that trigger release of source code:

(1) Licensor seeks to restrict release of “crown jewels” to business termination events, *e.g.*, bankruptcy

(2) Licensee focus on broader definitions related to failure of maintenance and support:

(i) Breach of maintenance and support agreement

(ii) Breach of warranty regarding maintenance and support resources

(iii) Bankruptcy and the like

(iv) Ceasing to do business in the ordinary course

D. Insurance demanded of licensor

1. Licensee should consult with risk management professional; insurance depends on risks/deal

2. Seek from licensor coverage of contractual indemnity provisions

3. General policies

a. Commercial general liability

b. Employer/workers' compensation

c. Errors and omissions

d. Auto

X. Assignment

A. Both parties seek for themselves the right to assign agreement to any entity purchasing all or substantially all of stock or assets or to a reorganized entity, etc.

B. Licensor makes sure to restrict assignment so that it does not gut the ability of licensor to exploit value (*e.g.,* assignment to much bigger entity)

C. Licensee will try to restrict licensor's right to assign in the event assignment threatens performance of services, *e.g.,* obtain right of termination if licensor assignee is not technically or financially competent to extent of licensor

XI. Jurisdiction and governing law

A. Licensors usually push for home territory

B. New York as governing law is sometimes good compromise

C. Silence on jurisdiction is sometimes a compromise to licensor's venue or provision that says, "If you sue, you come to my venue; if I sue, I go to yours"

XII. Maintenance — the right to have new and improved versions as they are rolled out

A. Licensor may seek narrow definition of maintenance versions so that it can exploit revenue for versions "outside" the maintenance program

B. Licensee should try for broad definition of what is included in maintenance (new versions) at no extra cost

C. Standard enhancements of existing functionality generally part of maintenance; new "bells and whistles" may not fall within maintenance

D. Licensee should obtain a commitment that the vendor invests in making new improvements; that they maintain active efforts to product improvement

E. Licensee may decide it cannot afford maintenance and/or support for a year or two — and then decide it wants to hop on again (Obtain the right to hop off and on — may have to pay back maintenance)

F. Licensee should obtain the right not to update with new versions for some period of time; updating may present internal costs for licensee; licensee should try to retain the right to receive software support (help desk, etc.) even if licensee is some number of versions behind

XIII. Support — *I.e.,* the obligation of the vendor to help licensee when licensee has problems

A. The key area of contention here are what are called severity levels; severity levels begin with characterizing and defining the severity level (business stopped, high impact, low impact, etc.) and then asking:

1. How fast fill the vendor respond?

2. How will the vendor escalate the problem?

3. How soon will the problem be solved?

B. Parties to compromise on who retains control on defining severity; *e.g.,* licensor has ultimate control with deference to licensee determination

C. Establish some objectivity in the metrics in performance of support to define whether licensor is in breach

1. Licensor will seek to resist clear definition and objective standards relative to its obligation to meet target times

2. Licensee should at the *very minimum* impose commercially reasonable standard on efforts and representations that standards have been set with a view that licensor can meet those standards based on licensor's professional judgment and experience

3. Other layers of objectivity that licensee may seek to add:

   a. *E.g.,* warranty that the licensor has resources — technical, administrative, and human — reasonably designed to meet the targets

   b. Right to audit

D. Backwards compatibility of support to apply to older version of software for some period of time (discussed above in item XII — Maintenance)

XIV. Renewal of maintenance and support

A. Price often 18 – 20 percent of license cost per year

B. Terms for maintenance and support tend to be anywhere from annual to three to four years

C. There will always be problems with software — just like your car — so licensee needs to obtain some protection that licensor does not gouge licensee for pricing when it comes time for renewal

D. Licensee should seek automatic renewals and fixed prices

1. *E.g.,* maintenance and support will automatically renew annually unless either party notifies other party 60 days in advance of intent to terminate; price will not increase by more, *e.g.,* than lower of five percent or CPI index

2. Key for licensee: restrict licensor's discretion to terminate, *e.g.,* licensor will not exercise right of nonrenewal for given number of years (*e.g.,* five) or unless licensee is in material breach or licensor is no longer generally offering maintenance and support to customers. Point is that if licensor has right to exercise nonrenewal, pricing is back on the table, to detriment of licensee

XV. Taxes

A. Map tax exposure to 86 Ill.Admin. Code §130.1935

B. Limit exposure when possible

XVI. Thumbnail summary of key negotiation points:

A. Collaborate with your organization's IT staff — consider having non-stakeholder negotiate, *i.e.,* a person who will not simply "push" to close the deal at the expense of prudent protections

B. Identify potential needs, liquidate value of those needs and provide for them in contract so that you do not have to negotiate in the future

C. Tight acceptance/performance warranties, tied to specifications

D. Additional key warranties; open source, compliance with laws, sufficiency of resources regarding maintenance and support

E. Granulate/time payments to vendor tasks

F. Perpetual license, automatic renewals of maintenance and support — price increases tied to price index

G. Tailored confidentiality; licensee should be careful that confidentiality provision does not restrict licensee in operation of its business

H. Broad definition of in-scope support and maintenance; fixed fees for out-of-scope work

I. Tight specifications on support: severity levels, time of response, escalations

J. Backwards compatibility of updates with legacy versions/system

K. Assignment/outsourcing; negotiating restrictions on licensor and licensee

L. Termination wind-down considerations relative to inventory, etc.

M. Strong source code escrow; licensee seek to tie release to failure of maintenance and support

N. Risk allocation/Indemnifications

B. [19.39] Software Transaction Timeline

Attachment 2