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Understanding and Drafting Technology Contracts: Avoiding Common Pitfalls

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Overview

- Important industry trends
- Collecting Basic Deal Information
- Pre and Post Contract Diligence
- The “Big” Four
- Key Contract Provisions
- Questions

Important Industry Trends

Recent Adverse Trends - General

- Failure to align expectations - Historically
  - Vendor – Customer
  - Within Customer's own organization
- "Contract float" – not only is data in the cloud, but also key contract terms. Mitigating factors:
  - Don't go negative
  - Lock as exhibit
  - Can't discriminate
  - Termination rights (but what about go-live fees?)

Recent Adverse Trends

- Liability and performance
  - Cybersecurity commitments without liability
  - Customer providing broad warranties and non-fault-based indemnities.
- The dawn of the as-is technology agreement
- Knowing where your data is
  - Shifting compliance obligations to customer
  - Impossible compliance obligation for customer

Recent Adverse Trends

- Cloud: Commodity services/pricing = inflexibility on contract terms
  - "*For the typical subscriber, however, a cloud's pricing policy and SLA are nonnegotiable*." NIST Draft Cloud Computing Synopsis and Recommendations
- More cost overruns and project failures in the last 2-3 years than in the preceding twenty years.
- Impossible to budget
  - Multiple revenue streams
  - Pass through costs of compliance

Recent Adverse Trends

- Virtual cloud providers
  - Flow through terms
  - Treat as a subcontractor?
- Disclaim liability for all subcontractors
- Encryption
  - Who chooses the methodology?
  - Who manages the keys?
  - In motion, at rest, **in use**
  - Foreign governmental access

Recent Adverse Trends

- Feedback clauses
  - Hidden exclusivity
  - Creation of customer liability
- Aggregated data provisions
  - Improperly written, non-compliant with HIPAA
  - Creation of customer liability

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**: Marketing, Purchase, License, SaaS, ASP, Cloud, Service, Support, Hosting, etc.

Basic Information (cont'd.)

- **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.)?

Basic Information (cont'd.)

- **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.

Fees and Costs

- Identify all revenue streams
  - Collect all costs and expenses in a single exhibit
- Warranty against “other” fees and costs
- Beware open-ended T&M provisions
- Beware undefined third party pass-through fees
- Cap fee increases in future years
  - Avoid mutual non-renewal

Diligence

Pre-Agreement Provider Due Diligence

- Pre-agreement provider due diligence
  - can provide valuable insight as to whether the provider can meet the customer's expectations
- Consider using a provider questionnaire
  - Examples of the items to cover in a due diligence questionnaire:
    - provider's financial condition
    - insurance
    - existing service levels
    - capacity
    - physical and logical security
    - disaster recovery and business continuity

Post-Execution – Ongoing Provider Assessment

- Establish a regular program of evaluating the provider's performance
  - Provider would be required to
    - supply the required information to assess the services,
    - notify the customer of any changes, and
    - provide any recommendations to improve the services
  - Allows the customer to
    - perform ongoing risk assessments during the term of the agreement, and
    - determine whether to continue the provider relationship

The Big Four

The Big Four

- **Trial**
  - Best way to undermine leverage
  - Test environment/unimplemented
  - Remedy: termination
- **Acceptance**
  - Implemented/Ready for Production
  - Structured approach
  - Remedies: remediate, terminate, refund

The Big Four, cont'd

- **Warranty**
  - Time limited (compare cloud)
  - Cure, termination, potential litigation
- **Support**
  - Kicks-in after warranty period expires
  - Goals, targets
  - Remedies limited
  - SLAs difficult

Key Contract Provisions

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Parties to the Agreement

- Customer Side:
  - Rights of affiliates under the agreement
  - Ability of affiliates to execute SOWs and order documents
  - Ability of affiliates to assist the primary entity in the performance of the agreement
  - Responsibility for affiliates and agents
  - Assignment, divestitures, acquisitions

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Parties to the Agreement

- Vendor Side:
  - Use of affiliates. Geographic issues.
  - Subcontracting
    - Knowing who you are contracting with/due diligence issues
    - Primary responsibility for performance
    - Critical v. generic services
  - Responsibility
  - Assignment

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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

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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

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Specifications (cont'd.)

- Do not accept the vendor's standard statement of work
- Your organization should obtain sufficient detail in the statement of work to enable the project manager to meaningfully monitor and measure performance and to facilitate contract enforcement and dispute resolution
- Establish clear delivery milestones and completion criteria

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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

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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

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License Grant: Vendor Example

- *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.*

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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*.

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License Fees

- Link to milestones in the implementation
- Significant holdback until “live”/Accepted
- Beware of hidden third party license fees
  - Related issue: third party license terms and conditions
- Escalation caps on recurring / renewal fees
- “Excess Use” provision

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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

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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

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Warranties (cont'd.)

- 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

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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

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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)

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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

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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

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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

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Indemnities (cont'd.)

- 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.

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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

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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

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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.

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Limitation of Liability: Suggestion Revision

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.

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Limitation of Liability: Further Example

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.

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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.

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Assignment

- Technology agreements, particularly license agreements, represent valuable assets of the company. Without the ability to assign those assets, at least in narrow circumstances, their value will be substantially reduced
- Ability for transitioned entities to continue to use software and services for a limited time following transition

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Assignment (cont'd.)

- Critical right, particularly in this age of bankruptcies and acquisitions
- Re-licensing could be very costly
- If it is not possible to negotiate a broad assignment right, limit to affiliates and in the event of a merger, acquisition, or sale of all or substantially all of the business' assets

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Assignment (cont'd.)

- Typical vendor provision: *Customer may not assign any of its rights or obligations hereunder without the prior written consent of vendor.*
- Suggested revision: *The rights and obligations of Customer may be, in whole or in part, exercised or fulfilled by its parent and their respective affiliates, joint venturers, and subsidiaries. Customer reserves the right to assign its rights and obligations hereunder, as it deems appropriate.*
- For all other circumstances, consent not to be unreasonably withheld

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Audit Rights

- Customer-Oriented: confirm fees and expenses, compliance with regulatory requirements, information security, etc.
- Vendor-Oriented:
  - Avoid broad, undefined audit rights
  - Preference is to reject on-site and remote access rights in favor of documentation
  - Limit use of third party auditors
  - Audit rights are not a fishing expedition.

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Term

- Corporate preference: *evergreen v. affirmative renewal*
- Evergreen provisions:
  - Term automatically renews for additional periods of time (usually one year).
  - Who has the ability to elect not to renew?
    - Either party can elect not to renew.
    - Only customer has right to terminate for defined period of years. Thereafter, either party can elect not to renew.

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Term (cont'd.)

- Evergreen provisions:
  - Avoid vendor termination rights during the useful life of the service/software. Loss of price protection/forced renegotiation.
  - Benefit: No inadvertent termination of agreement.
  - Risk: Automatic renewal for another year.

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Term (cont'd.)

- Affirmative Renewal Provisions:
  - Initial term, plus defined number of renewal terms. Following last unilateral renewal, both parties can elect to renew.
  - Requires affirmative action to renew. Else, remaining renewal terms lapse.
  - Benefit: No possibility of inadvertent renewal.
  - Risk: Inadvertent termination. Can be mitigated by vendor notice requirements and careful calendaring.

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Questions?

Thank you.



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