

Understanding the Software Contracts Process

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More and more often, companies are purchasing supply chain software from commercial software vendors rather than developing it themselves. Even after you've selected the product, the process of actually purchasing the software—from the initial RFP to contract negotiations to the final software contract—can be complex and frustrating. Perhaps the most frustrating aspect is defining and negotiating the actual contract. Understanding the software contracts process and the risks associated is what truly makes an informed, knowledgeable buyer, and results in the buyer getting the best solution for the minimal investment. This article is not legal advice—rather just an effort to create awareness of potential issues as you enter the negotiation process.

The Contracts Process

As part of the purchase process, a vendor generally submits a software license agreement as an appendix to the proposal that was based on criteria from the prospective purchaser's request for proposal (RFP). Many buyers assume they need to accept the vendor's standard terms and conditions as part of this process. While software contracts can be complex and confusing, there is an opportunity for the buyer to negotiate to protect their best interests. These contracts are vital to the user since contracted software will require a significant investment of both capital and resources. It is very important to understand even such fundamental items as who owns the source code and whether there are any restrictions, limits or future payments on use.

If software users are not up to speed on these items or take themselves out of the process early, they can find themselves in trouble later. In fact, the user's role in the contract negotiation process is critical. For example, they may not realize that they may make changes to the vendor agreement or prepare an addendum containing provisions that will take precedence. The final agreement or contract should be the result of negotiations between the users and the vendor, with all attachments—including the

original response to the buyer's RFP—agreed upon and signed to become part of the contract.

Contract Provisions from the User's Perspective

During the negotiation process, users will want to consider at least these 17 contract provisions:

1. Specifications and deliverables—spells out software specifications for functions and capabilities and precisely describes deliverables such as software components, documentation, consulting services, etc.
2. Delivery schedule—details the number of days or dates for each deliverable and the vendor's and users' specific responsibilities for installation, conversion, training and acceptance testing. The schedule may include a provision to extend vendor performance based on user-caused delays or penalties for vendor-caused delays.
3. Payment terms—structures payments so that the vendor receives compensation for what is actually delivered, installed and accepted. For example, an initial payment might be 50 percent of the licensing fee, with another payment due upon delivery and installation, another upon testing and acceptance and the final upon acceptance.

Definitions of installation, testing, acceptance and final acceptance are critical.

Vendors will typically ask for 100 percent of the licensing fee and the first year's support payment at contract signing and then distributed payments for professional services (consulting). Consider a hold back percentage on the professional services to maintain leverage throughout the project life cycle. Some clients are even seeking “pay for performance” terms—the dollar value of the contract is defined based on achieved savings amounts. Obviously this dictates that the terms and conditions of

the contract must be clearly articulated to define both the baseline, the performance metrics and achieved gains.

4. Warranties and remedies—states clearly who made the warranty and to whom, what may be excluded and the remedies available and procedures for obtaining them. It also includes a minimum warranty of conformance to stated specifications and documentation for a stated period of time, and specifies time allowed for the vendor to correct breaches of warranty, method of repair, location of warranty services and any warranty extensions due to ongoing error correction. This will also help you understand the minimum and maximum response times for warranty service, the hours of the vendor's support call center, etc. Users should ensure that, if the buyer wants warranty support on-site for start-up, this is also in the contract terms. It is the common practice of software vendors to charge for software modifications, which is fine—what you must be aware of is that most vendors will charge again for support services related to testing and problem resolution of these same modifications! In others words, if the customization doesn't work, you have to pay more for them to fix it. The justification is that the issue resolution process includes a discovery period where the vendor must determine if the issue is the result of a software problem, a configuration problem, a data integrity problem or a user training problem. Not all are areas that are the vendor's responsibility and thus their desire to get paid for their time.
5. Testing and acceptance—specifies the method of testing, test data to be used, where that test data will be sourced and responsibilities of the vendor and user. It should

include a well-defined process for identifying and communicating errors. Explicit acceptance criteria in the agreement are critical.

6. Support and maintenance—specifies the time period for support and maintenance, location of service, hours available and limits on annual fees. You may want to define specific terms based on your potential needs. For example, if a copy of the client’s production system will be maintained at the vendor’s support center, how remote access will be gained to the client environment, skill sets of support personnel, etc.
7. Documentation—explicitly defines documentation with references to versions and future documentation to include electronic and printed documentation. This should include both end user documentation (functional specifications, training materials, etc.) and technical documentation (technical specifications, system configurations, architecture specification, interface specifications, etc.)
8. Software modifications—includes specifications for all customization work. The contract should provide for vendor or user development, user review and approval and should make acceptance of the entire system, including all customization, a condition of final acceptance. Here it is necessary to refine the rate schedule to be used for software modification and other professional services. You should consider the use of fixed fees for pricing of all professional services. Billing rates for services are open to negotiation—consider a blended rate across all resources rather than separate rates for every title in the vendor organization.
9. Source code escrow—protects the user against a vendor unable or unwilling to maintain the software by providing the terms under which source code and

documentation will be released to the user with an independent third party acting as the escrow agent.

10. Scope of license—specifies all rights. This includes the rights to use the software for its intended purpose, keep duplicate copies, modify the source code, use software on a backup or duplicate CPU, make copies for training purposes and assign the contract to a subsidiary or subcontractor. Special consideration should be given if there are any third party logistics operations or other outside warehouse service providers.

Typically the vendors will license by number of users, by each site, or as a corporate license (unlimited users/sites). You will also see a sliding scale—so much per user up to a certain number then another fee level beyond that, etc.

11. Termination of agreement—gives the user and vendor prior notice (specify number of days) of alleged default and allows the opportunity to correct the default condition.

Users should be aware of vendor clauses to reclaim hardware or software or place a lock on the software.

12. Dispute resolution—includes a provision to use the software while a dispute is being resolved and specifies the location (state) of dispute resolution. The user may wish to include a mandatory, non-binding, pre-litigation mediation provision to save parties from unnecessary litigation; this allows parties to retain an arbitrator to assist in resolution.

13. Confidentiality—defines confidential information. Users should attempt to negotiate a provision to protect their own confidential information (“restraint of trade” issues make vendor restrictions difficult) and they should examine language that protects the vendor’s confidential information carefully and trim it down, if possible.

14. Patent and copyright indemnity—indemnifies the user against third party suits related to patent, copyright, trade secret or trademark infringement. This means that the vendor will protect or insure against any user liability stemming from these infringements. Pay special consideration to the issue of intellectual property issues and the recent case history of Lemelson Medical, Education & Research Foundation, L.P. —the whole use of bar-codes issue.
15. Risk of loss—passes the risk from vendor to user after software or hardware is delivered to user premises (not to carrier) and specifies damages if the loss of hardware or software affects or interrupts business.
16. Insurance—define your expectations as to what types of insurance you expect the vendor to carry and request a copy of their certificates of insurance.
17. Solicitation—defines restrictions around solicitations for employment of each parties employees.

It is important for prospective purchasers to remember that a vendor's product may not be a perfect fit and may require customization. Customized software also requires an agreement with user provisions. These provisions are:

- Payment mechanisms
- Changes to scope
- Progress reports
- Project organization
- Ownership of software

These provisions will protect the user's interests and create a fair and equitable agreement.

The Risks

There are risks involved with software licensing. These include non-performance, cost of modification or integration, vendor bankruptcy and infringement. To minimize these risks, a prospective buyer may want to enlist the aid of a third party. The third party should be well versed in supply chain technology and have the business perspective and technical expertise to assist in the contract negotiation process. Once enlisted, the third party can ensure that proper legal assistance is retained and help identify client issues related to contracts; provisions to be changed, deleted or included and risks inherent in the agreement.

Conclusion

Software licensing agreements and contracts are complex. However, if prospective purchasers are prepared and know their rights in the negotiation process, they can arrive at an agreement with provisions that protect their interests without minimizing the vendor's rights. The appropriate legal counsel should review software contracts, like any business contract. Software purchases are very different than other types of business contracts—make sure your attorney has the appropriate experience to support your software purchasing process. Making informed, educated decisions will enable all parties to come away from the table as winners.

About Tompkins Associates

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Tompkins Associates is headquartered in Raleigh, N.C., and has offices throughout the United States and in the UK, Mexico and Australia. Worldwide, Tompkins helps clients succeed through a combination of focused knowledge of best practices and tailored solutions. Tompkins prepares businesses to harness the energy of continuous change to achieve Supply Chain Excellence.

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