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NEGOTIATING A SOFTWARE LICENSE AGREEMENT FROM THE LICENSEE'S PERSPECTIVE

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Sze-Mei Yeung

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Software plays an increasingly critical role in business. The selection and maintenance of the appropriate software is an essential means of operating a seamless and efficient organisation. A thorough and well-negotiated license agreement is an effective means of risk management, and should also maximise the benefits that the software provides for the licensee. This article highlights some of the key negotiating issues from the perspective of the licensee in the licensing of software.

Scope of License A software license agreement is a grant by a licensor to a licensee of rights to use the software on certain terms and conditions. The scope of the license grant is one of the most crucial clauses and should describe, in sufficient detail, the bundle of rights that is being granted to the licensee during the term of the agreement. The licensee should consider what the intended uses of the software will be, and ensure that the scope of the license grant is wide enough to encompass all these uses. Once the parties have agreed on the scope of the license, this sets the scene for the balance of the agreement.

Installation and Customization For certain software licenses, substantial installation and customization services may be required from the licensor before the software can be deployed and used by the licensee. The licensee will need to have detailed discussions with the licensor to clearly define the scope of work, services, required time frame, and associated costs. If it is possible to negotiate a fixed costs implementation, this will decrease the likelihood of the implementation significantly exceeding budgeted costs. It is also useful for the licensee to negotiate a favourable labour rate for additional services that may be required from the licensor's team. For example, the licensee can request a discounted hourly rate to be used by the licensor for the duration of the implementation project, or alternatively, for a set period of time, such as twelve or eighteen months following the date of the agreement.

The licensee should also ensure that key technical personnel are made available by the licensor during the implementation period, and have such key personnel specified in the agreements as necessary. Often such



key personnel are the most qualified and skilled individuals, and therefore in high demand on other projects. The replacement of such key personnel with other less effective personnel may add to the licensee's overall implementation costs if the services are being performed on a time and materials basis. Another method of managing costs for the licensee is to establish mutually acceptable travel and living policies for the licensor's integration team, and have significant expenses pre-approved by the licensee.

The licensee should ensure that the warranty period on the software set out in the license agreement does not commence until the successful completion of acceptance testing of the software. This is particularly important in the case of software that needs to be customized by the licensor, as the customization process can often consume a significant amount of time. The acceptance testing clause should be comprehensive enough to provide the licensee with a means of termination if the licensee has significant concerns with the software. A typical acceptance testing clause, in favour of the licensee, would include the following:

- acceptance test criteria that are determined by the parties in a schedule to the agreement;
- a time period within which acceptance tests are to be conducted by the licensee;
- an opportunity for the licensor to remedy any deficiencies that are identified by the licensee if the acceptance test is not passed;
- the successful acceptance test as a condition precedent to final payment by the licensee (the licensee should hold back some amounts under the license agreement and/or the professional services agreement to provide for this); and
- if the deficiencies persist, the licensee may opt to terminate the license agreement in which case, licensor will promptly refund some or all amounts that have been paid by the licensee.

Maintenance and Support As annual maintenance and support costs are often calculated by the licensor as a percentage of the net license price, the final negotiated license price that the parties agree to is important from the licensee's perspective. If the licensee and/or its affiliates or subsidiaries requires additional licenses in the future, the licensee may also wish to negotiate a fixed license price, to apply to the licensee and its affiliates or subsidiaries, for a certain period of time after the initial license commences. This preserves any special pricing, and saves the licensee the time and resources required for renegotiation at a later date.

Support and maintenance typically commences after expiration of the warranty period. Prior to committing



to support and maintenance, the licensee should ask for a detailed description of the terms and conditions for the provision of such services, for example, whether support will be provided by telephone, facsimile, remote on-line support or email; whether there are specified response times depending on the level of severity of the problem; and business hours and days during which support is provided. It is also useful to do some due diligence using colleagues and associates in the relevant industry with respect to the company's software and support reputation. It is ideal to source information about the reliability and stability of the software from existing end users.

If the license agreement permits sub-licensing, the parties need to consider whether it will be the licensee or the licensor that provides front line support to end users. This will also determine whether the end users enter into support and maintenance agreements with the licensee or the licensor.

The licensee should also consider if any of the following are required:

- an escrow agreement for access to the source code, if the licensor becomes bankrupt, insolvent, or ceases to support the software;

pre-deployment training from the licensor and a refresher training option afterwards, specifying where the training will take place;

- preferred labour rates for extended on-site support, post-implementation; or
- if the software is integral to the licensee's business, the licensee should ensure that there are transition provisions on termination that extend the license until the completion of a successful transition to other equivalent software, to minimize business interruption for the licensee.

Representations, Warranties and Indemnification The basic representations and warranties that a licensee should require from a licensor, are that:

- the licensor owns, or has the rights to license, the software;
- the software, and license grant, do not infringe any third party rights; and
- a limited time warranty that the software will perform in accordance with its published specifications.

It is also useful to require that if the licensor cannot repair or replace the software in accordance with the warranty terms during the warranty period, that the licensee shall receive a refund of the license fees paid.



It is appropriate to request a full refund of the entire license fees, given the significant investment of time and resources that may be required to implement the licensed software within a business.

The licensee should also expect the licensor to defend and indemnify the licensee against any claims that the licensed software infringes any third party intellectual property rights, and claims arising from any breach of contract and/or negligence of the licensor.

If a licensee can no longer continue using particular software due to an infringement claim, this may materially impact its business, as it would need to seek alternative software and will likely suffer business interruption as a result of such infringement. It is important to ensure that any limitations of liability, e.g. monetary damages caps and exclusion of indirect damages, are excluded from the indemnification obligations, particularly in the case of intellectual property infringement.

Most Favoured Nations Clauses If a licensee has sufficient bargaining power in a non-exclusive license, it may request a provision stating that such licensee will be paying license fees at least as favourable as any other licensee will pay to the software licensor during the course of the license term. This is often referred to as a “most favoured nations clause.”

These clauses are strongly resisted by licensors as they limit the licensor’s flexibility in negotiations with other licensees. Also, future licensees may consider their deal to be confidential and not want it disclosed to the licensee with most favoured nations status, particularly if that licensee is a competitor. One method of making the clause more acceptable to a licensor is limiting the protection to other licenses “on substantially the same terms and conditions” or under “substantially similar circumstances.” This permits the licensor to negotiate lower license fees in other licenses without breaching the most favoured nations clause if the circumstances of the other licensees are very different, for example, providing volume-based discounts or specialised fields of use.

Audit Rights Regular audits of the licensee by the licensor pursuant to a license agreement can be obtrusive and demanding on the licensee’s time and resources. The licensee should make efforts to resist onerous audit clauses from the licensor. This is particularly the case if there are no royalties being paid to the licensor under the license. However, the licensor may still wish to inspect the licensee’s systems or records to verify that the licensee’s use of software is consistent with the license grant. This should be limited as much as possible by the licensee. If the licensor insists on very frequent audits, the licensee should attempt to have the licensor bear any and all costs of such audits, including reasonable amounts to compensate for the use of the licensee’s internal resources, personnel and time.