



TAB XIV

SOFTWARE LICENSING

Michael E. Bieniek
Partner
Mayer, Brown & Platt
(Chicago)

and

John P. Brockland
Associate
Mayer, Brown & Platt
(Chicago)

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SOFTWARE LICENSING

Michael E. Bieniek
John P. Brockland^{±/}

This paper contains a summary of some of the principal issues that arise in connection with software licenses and other software related agreements. Topics covered include (i) intellectual property protection for computer software products, (ii) protecting and controlling use and distribution of software intellectual property, (iii) ownership issues in software licensing, (iv) considerations relating to license terms other than intellectual property protections, (v) key issues in software development agreements, (vi) key issues in information technology outsourcing agreements and (vii) enforceability of shrinkwrap and online license agreements.

I. Intellectual Property Protection for Computer Software Products

The principal forms of intellectual property rights in software are copyright, trade secret, patent, trademark and mask work. This paper focuses on copyright and trade secret protection for computer software.

A. Copyright.

1. **Source.** Copyrights are granted under federal law and protect expressions of ideas, including computer software programs.^{1/} The Copyright Act provides that rights arise upon creation of a work of original authorship.^{2/} Among other rights, a copyright holder has the exclusive rights to copy the copyrighted work and to make derivative works (such as

^{±/} Mr. Bieniek is a partner and Mr. Brockland is an associate with Mayer, Brown & Platt in Chicago. Both are members of the firm's Information Technology practice group.

^{1/} 17 U.S. C. § 101 et seq.

^{2/} 17 U.S. C. § 302(a).

translations) from the copyrighted work.^{3/} Copyright does not protect the ideas embodied in a particular expression, so if a later programmer achieves the same result as an earlier programmer using a different set of coded instructions, the earlier programmer may have no recourse under the copyright laws.

2. **Obtaining Rights.** Copyright arises automatically when an original work of authorship is fixed in tangible form. It is not necessary that an author register a copyright in order to obtain copyright protection. However, registration with the Copyright Office of the Library of Congress is presently required to enforce those rights.^{4/} Before bringing an action for infringement, the owner must register the copyright and deposit a copy of the copyrighted work with the Copyright Office. Registration of a copyright also provides certain statutory presumptions and benefits, but copyright owners may be wary of placing a printout of their programs in the public record. In some cases, it may be possible to deposit a redacted version of the program or to deposit the object code form of the program.

3. **Infringement.** For a work to infringe upon a copyrighted work, the infringing work must (a) be derived from the original copyrighted work and (b) be substantially similar in expression.^{5/} The copyright owner claiming infringement has the burden to prove that the accused work derives from the original; however, the copyright owner can meet this initial burden of proof by showing that the accused infringer had access to the original and that the

^{3/} 17 U.S. C. § 106.

^{4/} 17 U.S. C. § 411.

^{5/} See, Donald S. Chisum and Michael A. Jacobs, Understanding Intellectual Property Law § 4F (Matthew Bender 1992).

accused work is substantially similar to the original. The law regarding the meaning of “substantial similarity” is a particularly complicated and unpredictable. Essentially, an accused work is substantially similar to an original if an ordinary observer would recognize the accused work as having been appropriated from the original. In practice, this test is very fact-dependent, and the outcome in any particular case is necessarily difficult to predict.

B. Trade Secret.

1. **Source.** State trade secrets law generally protects information (including ideas) that is secret and has commercial value because it is not generally known.^{6/} Even if the ideas embodied in a computer do not meet the statutory requirements for patentability, they may be protected as a trade secret if the party claiming rights in those ideas has used reasonable steps under the circumstances to protect the confidentiality of the ideas.

2. **Obtaining Rights.** To preserve trade secret rights the covered material must be kept secret. Publication of a trade secret without restriction, even if done without the trade secret owner’s permission, can eliminate trade secret protection.^{7/} Therefore, prudent software owners take steps to maintain the confidentiality of their software. Internally, these steps include restricting access to persons with a “need to know,” requiring employees to sign confidentiality agreements and implementing physical security measures such as firewalls and passcodes in computer systems. When technology is licensed to third parties for their use, additional measures are required.

^{6/} See, Chisum and Jacobs at § 3C.

^{7/} Note that depositing copies of source code form of software with the Copyright Office may disclose trade secrets embodied in such software.

One way that software owners can protect their trade secrets in source code is by strictly limiting access to the source code. Software owners also protect the trade secrets in their software by including use and disclosure restrictions in their software license agreements.^{8/} The software licensee has to make sure that the use and disclosure restrictions permit the type of use that the licensee needs.

3. **Misappropriation.** Trade secret misappropriation can include disclosure or use of a trade secret that is discovered by improper means and disclosure or use of a trade secret where the accused person had a duty not to use or disclose the secret information.^{9/} The duty not to use or disclose trade secret information commonly arises by express contract, such as the software license, but also may be implied from the circumstances of a particular case. As in copyright litigation, showing that the defendant had access to trade secret information and that information used by the defendant is similar to the trade secret can help the plaintiff meet its burden of proof. Direct evidence of copying or misuse is not required.

C. **Patent.** An inventor may obtain a United States patent only by applying for the same with the U.S. Patent and Trademark Office and securing approval.^{10/} The federal patent statute sets forth several categories of patentable subject matter and requires that an invention must be useful, novel and non-obvious to be patentable. Computer programs can be patented, but the process is often expensive and uncertain. Also, obtaining a patent for an invention can be a lengthy process, and the computer software market is fast-changing. Patenting software also

^{8/} See Section III(C) below.

^{9/} See, generally, Chisum and Jacobs at § 3D.

^{10/} 35 U.S.C. § 101 et seq.; See, generally, Chisum and Jacobs at § 2A.

requires that the developer publicly disclose the software. For these reasons, patenting of software programs is not the most common method of protection.

D. Trademark. Trademarks protect the name used in connection with software in the market place. Under state common law, ownership of a trademark arises through adoption of the mark and its use on goods and services. The Federal trademark law, the Lanham Act,^{11/} does not create trademark rights, but federal registration of a mark provides constructive notice of the registrant's claim of rights in the mark as well as other benefits and protections.^{12/}

E. Mask Work. Mask Work protection applies to the stencils or "masks" used in production of semiconductor chip products.^{13/} Mask work protection arises upon the first commercial exploitation of a mask work, and extends for ten years, so long as the mask work is registered within two years of first exploitation. Mask works give the owner certain exclusive rights to reproduce the mask work and to import or distribute semiconductor chip products embodying the mask work.

II. Protecting and Controlling Use and Distribution of Software Intellectual Property

A license is a promise by the licensor not to sue the licensee if the licensee uses the licensed material within the scope of the license. Typically, licensors do not intend to convey ownership in granting a license. In some cases, however, the parties may agree that a licensee obtains ownership in modifications to the basic software licensed. Such ownership by licensee is

^{11/} 15 U.S.C. § 1051 et seq.

^{12/} 15 U.S.C. § 1022; 2 J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 19.01[3] (Clark Boardman 3d. ed. 1996).

^{13/} See 17 U.S.C. § 901 et seq. See, generally, Chisum and Jacobs § 6D.

unusual except where the licensor is hired as a consultant to develop modifications specifically for the licensee. Licensed software may also contain software owned by third parties, and the license agreement should include terms and conditions related to issues that may arise in connection with such third party ownership of the software.

A. **General License Considerations.** License rights may be:

1. exclusive, sole or nonexclusive;
2. perpetual or for a limited term;
3. terminable or irrevocable;
4. limited to a specific field of use or unlimited;
5. worldwide or of limited geographic scope;
6. limited to a specified computer or computers; and
7. limited to a specified number of concurrent users, or to specified users.

Each form of intellectual property includes different types of rights that may be licensed:

a. **Copyright.** Rights granted under copyright licenses and sublicenses commonly include the right to use, copy, display, create derivative works of, and distribute copies of, the copyrighted work.

b. **Trade Secret.** Rights granted under licenses and sublicenses to trade secret, confidential information and know-how are often tailored to fact-specific requirements.

c. **Patent.** Rights granted under patent licenses and sublicenses may include the right to make, have made, import, use and sell devices, methods, processes and apparatus covered by claims in the subject patent.

B. **Particular License Terms--Restrictions and Scope of Use.** Licensors attempt to limit the scope of the license to protect their intellectual property rights and their market advantage. Licensees should ensure that the license permits the licensee to use the software as required for the licensee's business.

1. **Licensor Considerations.** To protect their intellectual property rights,

licensors often require in their license agreements terms such as the following:

- a. a confidentiality provision that prohibits licensee from disclosing or allowing others to access the software;
- b. a covenant that the licensee will not reverse engineer or decompile (derive source code from object code) the software;
- c. if source code is licensed, a provision restricting access to selected licensee personnel, and a requirement that those personnel sign separate nondisclosure agreements;
- d. a restriction on the number of copies that licensee may make of the software and associated documentation, the number of simultaneous users of the software, or the number of computers upon which the software may be used;
- e. a requirement that the licensee reproduce the licensor's copyright and confidentiality notices on any copies made;
- f. a requirement that the licensee return or destroy all copies of the software and documentation (including the copies resident on the licensee's computer systems) and certify in writing such return or destruction if the license ever terminates; and
- g. an express provision that the licensor retains all rights in the software that are not expressly granted to the licensee and that the license conveys no ownership interest in the software.

2. **Licensee Considerations.** Licensees should ensure that they have

obtained accurate answers to the following questions from the licensee's end users and technical team, and should ensure that the answers are properly reflected in the license agreement.

- a. Who will exercise the rights? (For example, will licensee's corporate affiliates, outsourcing services providers or other contractors exercise the rights?)
- b. What rights does the business require?
 - (1) use (to run executable code programs)

- (2) create derivative works (to modify source code or documentation)
 - (3) reproduce (for program development and distribution)
 - (4) make archival copies
 - (5) grant to third parties sublicenses to do any of the above.
- c. How long should the license last? Should it be perpetual or for a fixed term? Should licensee have the option to renew?
 - d. Can licensee transfer the license? Note that this provision can be important in connection with corporate restructuring, mergers and the sale of assets.
 - e. Is the license limited to a specific number of simultaneous users, or to a specific territory, site or computer? If the licensor offers different prices for different platforms, licensee may want the right to upgrade automatically upon payment of the difference in price.

III. Ownership Issues in Software Licensing

A. Allocation of Ownership in Developments.

1. Clear Contract Provisions are Important. The parties' agreement should specify expressly which party will own any intellectual property in the software and in any other work product that may be developed by the licensor. The work product may be defined to include, without limitation, memoranda containing performance analysis requirements, the specifications for any developments, flow charts and other design documents, ideas, inventions (regardless of whether such inventions are patentable or reduced to practice), and manufacturing and production processes and techniques that licensor may develop for the licensee (collectively, the "**Work Product**").
2. Unintended Consequences. In the absence of such express allocation of ownership of the intellectual property rights, default rules that may not reflect the intentions of the parties will govern ownership. The rules regarding ownership of intellectual property vary

with each type of intellectual property. For example, even if the licensee developed the specifications for the modifications with no assistance from the licensor, the licensor may still own the copyright in the software developed by the licensor to conform to those specifications in the absence of an express assignment to the licensee of such copyrights.^{14/} Additionally, in the absence of a series of express assignments from the employees of the licensor to the licensor and from the licensor to the licensee, the licensor's employees may own any patents in the Work Product (subject to shop rights and certain exceptions for employees hired to invent).^{15/} If the Work Product is very costly and ownership by the licensee is very important, the licensee may consider reviewing the licensor's agreements with its employees.

3. **Equivalent Rights.** With the exception of the right to grant exclusive licenses to the intellectual property, it is possible that each of the licensor of a software program and the licensee can have substantially equivalent rights in the intellectual property, either: (i) as joint owners of an undivided interest in the whole, or (ii) as an owner of the intellectual property, on the one hand, and as the recipient of a perpetual, irrevocable, worldwide, sole license to all rights in the intellectual property, on the other hand. Consequently, determining which party will have rights in the intellectual property that differ from the rights of the other party depends on determining which party will gain a competitive advantage in relationship to the other party and to third parties to which the other party might otherwise provide all or a portion of the Work Product.

^{14/} Ownership "vests initially in the author or authors of the work." 17 U.S.C. § 201(a). With the exception of "works made for hire," discussed below, the author is the human person who created the work.

^{15/} 35 U.S.C. § 262. See, generally, Chisum and Jacobs at § 2G.

4. **Determining Rights.** The licensee and licensor will negotiate the terms of ownership in the Work Product based on their respective objectives and needs.

a. **Licensee's Objectives.** The licensee's objectives in obtaining rights in the intellectual property will depend on whether the licensee will use the software: (i) solely to process the data of licensee ("**Internal Use**"); or (ii) as a product or component of a product that licensee either provides to third parties directly or uses to provide to third parties services relating to processing the data of such third parties ("**Commercial Use**").

If the licensee will use the software solely for Internal Use, it may be beneficial for the licensee to forego any ownership claims in the software and require the licensor to provide the software to third parties as often as is commercially possible. By requiring this wide distribution, the licensee can expand the number of users of the software and accelerate the process of locating errors and deficiencies in the software. Consequently, the licensee will want to ensure that the licensor has broad rights in the intellectual property to enable the licensor to distribute the software. For example, a violin repair store can discover and have corrected the bugs in its inventory control program if the inventory control program is provided to other violin repair stores.

If, however, the licensee will use the software for Commercial Use, the licensee may want to restrict the right of the licensor to compete with the licensee or to enable others to compete with the licensee using the software or to provide the software to competitors of the licensee. The licensee may achieve such objective either by obtaining ownership of, or an exclusive license to, the intellectual property and granting to the licensor a license limited to those rights necessary to perform the licensor's obligations under the agreement between the

licensor and the licensee, or by requiring the licensor to enter into non-compete clauses designed to protect the confidential information of the licensee or another protectable business interest. For example, a violin repair store might want to prevent other violin repair stores from obtaining software used to perform spectral analysis on the varnish used by Stradivarius.

b. **Licensor's Objectives**. The licensor's objectives in obtaining rights in the intellectual property will depend on how the licensor generally provides its services. The licensor may provide services (i) to develop and distribute software that performs specific business functions, such as inventory control (an "**Application Specific Developer**"); or (ii) to develop and distribute software in accordance with specifications provided by its customers, without reference to other applications software previously developed by the licensor (a "**General Software Developer**").

If the licensor is an Application Specific Developer, the licensor will want to retain broad rights in the Work Product to enable the licensor to incorporate portions of the Work Product directly into the products that the licensor will provide to third parties. For example, a licensor whose business is to provide products and services related to inventory control will want to obtain broad rights in the inventory control applications developed for the violin store to provide the same to other violin makers and third parties in other businesses.

If the licensor is a General Software Developer, the licensor may be less concerned about obtaining broad rights in the Work Product. However, in all cases the licensor will want to include a "residuals" clause specifying that the licensor may use the general skills and techniques developed while performing the licensor's obligations to the licensee for the benefit of third parties. In addition, even a General Software Developer will likely bring similar tools

and methods to each engagement, and the licensor should include a clause specifying that the Developer retain all rights in such tools and methods.

5. **Development Software Tools.** The licensee should also consider the extent to which the licensee may control the use by the licensor of compilers, linkers and other software development tools that are not generally available to the public. For example, even if the licensee owns all right, title and interest in the source code form of the Software, such ownership may be of little value if the source code is written in a language that can only be compiled using a compiler that is proprietary to the Developer and not generally available.

B. **Third Party Elements in the Software.** The license agreement should specify whether the licensor will incorporate software in which the intellectual property is owned by a third party (“**Third Party Software**”) into the software and any restrictions that may apply to the licensor’s or licensee’s use of such Third Party Software.

1. **Licensee’s Objectives.** The licensee’s objectives regarding Third Party Software are to ensure: (i) that limitations on the licensor’s rights in the Third Party Software do not function as a de facto limitation on the licensee’s rights in the software, (ii) that the licensee may obtain maintenance services for such Third Party Software similar to the maintenance services that the licensor will provide for the licensor’s own software; and (iii) that there is no possibility of “finger-pointing” between the licensor and the third party that owns the Third Party Software if the software is not in compliance with any warranties or specifications.

Consequently, the licensee should consider requiring: (i) that the licensor refrain from including in the software licensed or conveyed by the licensor any Third Party Software without

the prior written consent of the licensee; (ii) that the licensee be entitled to review all agreements between the licensor and each third party that provides any Third Party Software; (iii) that the licensee be named as a third party beneficiary with the right to enforce such agreement directly against such third party; and (iv) that the licensor pass through to the licensee all warranties contained in each such agreement.

2. **Licensor's Objectives.** The licensor may want to use Third Party Software to avoid "re-inventing the wheel." The Licensor's objective with respect to Third Party Software is to avoid liability for failures of such Third Party Software to perform in accordance with the specifications for same. The licensor will also want to be careful to ensure that the rights licensor is granting to the licensee are consistent with the licensor's agreements with the third party that owns the Third Party Software.

IV. **Additional Considerations in Negotiated Licenses for Software**

A. **Defining the Software and Specifications.** One key definition in any license agreement is the definition of the materials being licensed. This definition comprises two components: the definition of the software that will be licensed and maintained, and the description of the performance and operational characteristics of such software (the "**Specifications**").

The parties should consider whether any or all of the following should be included in the definition of materials to be licensed: source code, object code, software tools for use in creating executable code from source code, programming, systems and user documentation, modifications made in the future by the licensor and provided to third parties, and new versions provided to third parties in the future by the licensor.

During the initial stages of the licensee's evaluation of the software of various vendors, the vendors will provide to the licensee written and oral information about the software and its performance. This information is often provided in sales brochures and other materials, not in legal contract language. The licensor will want to carefully control how much information is included in the contract and in what format. In contrast, the licensee will want to make sure that the Specifications that are included in the final agreement accurately reflect all the important promises made during the evaluation.

Specifications play an important role in defining the rights of the parties. For example, license agreements often include a warranty that the software will conform to the Specifications. Additionally, virtually every agreement also contains a merger clause and a disclaimer of warranty clause. The merger clause specifies that all previous communications between the parties relating to the subject of the agreement are superseded by the document containing the agreement, and the disclaimer of warranty clause specifies that the licensor makes no warranties other than the warranties expressly contained in the license agreement. One effect of the merger clause and the disclaimer of warranty clause can be to eliminate or limit the effect of any promises regarding the performance of the software that the licensor's sales personnel may have made to the licensee during the initial evaluation. Consequently, only performance and operational characteristics of the Assets that are expressly included in the final agreement will be used to evaluate whether the software performs as promised.

1. **Licensee's Objectives.** The Licensee should ensure that the Specifications describe in detail all aspects of the software that are important to the licensee. For example, the licensee should consider whether the Specifications should include programming, user and system documentation, responses to any Request for Proposal that may have been issued by the licensee and letters and other communications from the licensor during the qualification process. Further, the licensee should ensure that the Specifications include objective criteria by which the performance of the software may be measured. Examples of quantifiable objective criteria include response times, required minimum and maximum storage capacities for files and data contained therein, records processed per second, and performance degradation relating to system load.

2. **Licensor's Objectives.** The Licensor should ensure that the Specifications are limited solely to that which is attached to the agreement. The licensor can achieve this objective through merger clauses and disclaimers of warranty. Further, the licensor should include terms and conditions relating to events or conditions that are not in the control of the licensor but that may affect whether the software complies with the Specifications, including, without limitation, terms and conditions specifying:

- a. the computer hardware and operating systems upon which the software will be used (the "**Environment**") and that the licensee will operate the Environment in accordance with the instructions from the manufacturer;
- b. any restrictions on other software that may be resident on the Environment; and
- c. any representations by the licensee about the performance of software not provided by the licensor, to the extent that such software will be used by the licensor.

B. **Installation Terms.** The licensor may offer, for a fee, to install the software at the licensee's site. This is particularly important to the licensee if installation of the software is complex or necessary for the licensee's testing. For complicated or lengthy installation or rollouts of software, the licensee should consider including timing and scheduling terms setting forth the licensor's commitment to perform the project in accordance with a detailed time line and work plan.

C. **Acceptance Terms.** Many software licenses provide for a period of acceptance testing by the licensee to ensure that the software conforms to its Specifications.

1. **Why Acceptance Terms are Important.** The licensee's remedies for breach of the license agreement prior to acceptance are broader and more flexible than the licensee's remedies after acceptance. For this reason, the licensee has more leverage to cause the licensor to fix problems with the software before the licensee accepts the software. Although the U.C.C. provides general guidelines regarding that which constitutes acceptance, the licensee will want to specify expressly the licensee's right to test the software and require an affirmative act by the licensee to indicate the licensee's acceptance because such terms eliminate ambiguities in the U.C.C. and because the rights and obligations of the parties at each point in performance will be certain.

2. **Objective Criteria.** The licensor will want to ensure that whether the licensee accepts the software depends solely on whether the software conforms to objective standards included in the Specifications. Consequently, the licensee will want to ensure that the Specifications include as many objective criteria for evaluating the software as possible.

Objective criteria are performance measures that can be quantified (e.g., response times, records processed per second and performance degradation relating to increasing system load).

3. **Phased Delivery.** If the software will be delivered in phases, the licensee will want to withhold final acceptance of the software until all phases have been delivered and tested together. Any intermediate approvals should be expressly subject to rejection if the final acceptance requirements are unfulfilled.

4. **Parallel and Operational Testing.** The best test of any software is use in the operation of the licensee's business. Where new software interfaces with the licensee's then-installed software, after data conversion is complete the licensee should consider using its then-installed software, if any, and its replacement for a period to ensure that the new software performs in accordance with the licensee's needs. Even if parallel use of the old software is not possible, the licensee should try to reserve final acceptance until after some period of operational use.

5. **Fixing Bugs before Acceptance.** As part of the acceptance testing provisions, the licensee should request that the licensor correct any failures of the software to conform to the Specifications by providing all services necessary to make the software so conform. The licensee should ensure that the licensee has ample time to re-test any modified code. Although the licensor may agree to make the software conform to the Specifications, the licensor may balk when the licensee imposes a schedule for making the software conform. If the timing of the licensor's performance is important, it should be expressly specified.

6. **Reasonable Efforts.** The licensee should be wary of "reasonable efforts" obligations by licensors. Licensors often offer to use their "reasonable efforts" to make the

software perform. The licensee should always remember that a licensor can use its reasonable efforts to fix software and satisfy its contractual obligation without actually fixing the software.

D. Warranty. A warranty is a promise that a statement of fact is or will be correct at a specified time. There are three types of warranties: express, statutory and implied. Generally, license agreements contain express warranties regarding the performance of the software and the right of the licensor to grant any licenses. Additionally, warranties of merchantability, fitness for a particular purpose and non-infringement may be included unless the licensor disclaims the same. If the software was developed especially for the licensee, or if the licensee selected the software because of the licensor's assertion that the software is fit for a particular purpose, this disclaimer may be inappropriate. However, rather than accept the uncertainty of implied warranties, licensors would more likely include additional appropriate language in the express performance warranty or in the Specifications than eliminate the disclaimer.

Generally, software is licensed in connection with performance warranties that last for a limited term. If the licensee wants to ensure that the software will continue to conform to the Specifications after the term or the warranty expires, the licensee must enter into a maintenance agreement with the licensor.

E. Maintenance Agreements. Maintenance agreements are extensions to, and more formal elaborations of, the types of services that the licensor will provide to the licensee to ensure that the software continues to conform to the Specifications. Generally, the licensee will pay a maintenance fee of between ten percent and twenty percent of the license fee for each year of maintenance provided under the maintenance agreement. There is no requirement that the

maintenance agreement be contained in a document separate from the license agreement, although it may be to the licensee's benefit to include the maintenance provisions in the license agreement. Maintenance agreements also typically provide that the licensee will receive updates and revisions to the software that the licensor makes generally available during the term of maintenance.

Because the licensee loses virtually all of its negotiating leverage upon executing the license agreement, the licensee should not sign the license agreement until the maintenance agreement is in place.

Structurally, maintenance agreements are a series of promises on the part of the licensor relating to what the licensor will do if everything the licensor has done up to that point has failed to make the software conform to the Specifications. Such promises are typically related to permissible response times and the consequences of failing to perform in accordance with such response times. Further, the level of effort required will vary with the severity of the problem. For example, if the software is not fixed after the first week, the licensor will send representatives to the licensee's location; if the software is not fixed after the second week, the licensor will dedicate more staff, including overtime; if the software is not fixed after the third week, etc. Consequently, it is very important for both parties to ensure that maintenance agreements specify what levels of support will be provided under what circumstances. The licensor will prefer to make more limited promises, such as using "reasonable efforts" to fix the software.

F. **Confidentiality--Licensee's Information.** As discussed above, the licensor will want to include confidentiality restrictions on the software itself to protect the licensor's trade

secrets. If the licensor will receive access to licensee or supplier lists, forecasts, management plans or other data relating to the business of the licensee, the licensee may want to impose a reciprocal obligation on the licensor.

G. Termination/Expiration/Breach. The end of the agreement can be difficult for the licensee unless the termination provisions specify in detail the consequences of such termination or expiration. For example, the licensee should take care that the licensee does not lose the licensee's license to the software if the license agreement is terminated for the licensor's material breach.

The licensee should consider specifying different consequences for different types of failures to perform and whether all material breaches should result in the right to terminate the license agreement. Further, the licensee should consider whether different types of failure to perform merit cure periods of different lengths before termination. Finally, if the parties' agreement comprises more than one contract, each contract should specify the effect of breach of such contract on the other contracts.

H. Indemnification. The parties may want to allocate liability for claims by third parties relating to the subject matter of the license agreement. Note that by expressly including limitations on the licensor's obligation to indemnify the licensee for infringement actions, the licensor may be able to limit an otherwise broad obligation with respect to infringement. It should be noted that indemnification obligations may be very specific to the facts and circumstances relating to each individual license agreement. Typical subject matter includes infringement by the software of third party intellectual property rights and personal injury, death and damage to property arising out of the licensor's performance.

I. **Limitation on Liability and Remedy.** One of the most important provisions for the licensor is a limitation on liability. Software license agreements typically include an exclusion of certain types of damages and a limitation on maximum liability for direct damages. Consequential, incidental and punitive damages are typically excluded. The licensor will want a reasonably low limit on direct damages, and the licensee will want to ensure that the limit bears a reasonable relation to the foreseeable harm from the licensor's breach. The licensee will want these terms to be reciprocal and should consider excluding from such limitation indemnities that should logically be the responsibility of the licensor (e.g., infringement of proprietary rights, personal injury and property damage).

J. **Separating Licenses to Source Code and Object Code--Escrow Agreements.** Software licenses often distinguish between licenses granted for source code and licenses granted for object code. If the licensee intends only to use the software, but will not maintain or enhance the software, the licensee may require only the right to use the object code form of the software. Further, the licensee may require the right to use and copy user documentation, but not programming or systems documentation, related to such software. In protecting its trade secrets in the software, the owner of the software will want to restrict access to the source code and the related programming and systems documentation. However, the licensee may want to acquire the right to obtain possession of the source code form of the software and the related programming and systems documentation and to modify and create derivative works of such source code upon the failure of the licensor to perform maintenance obligations.

Escrow Agreements are often used to strike a balance between the licensor's need to restrict access to source code and the licensee's need to obtain access to source code under certain conditions. The escrow agent keeps the source code and related documentation and is permitted to release it to the licensee only upon the occurrence of specified events--such as the insolvency of the owner of the software or the material breach of maintenance obligations. The events, or "release conditions," that permit the licensee to take possession of the source code are often highly negotiated. Licensees may also require that they be permitted to have another third party verify periodically the contents of the escrow, to ensure that it contains the relevant source code and documentation.

If the licensee has the right to obtain possession of the source code form of the software under an escrow arrangement, the licensee should obtain the present right to copy and create derivative works of the source code form of the software and all associated programming and systems documentation to avoid rejection by a debtor-in-possession or trustee in bankruptcy of an executory obligation to grant such a license. If the licensee needs to maintain or enhance the software from the outset of the license, the licensee should obtain the right to use, copy, and create derivative works of the source code form of the software and related user, programming, and systems documentation.

V. Key Issues in Software Development Agreements

A. Introduction. This section summarizes certain issues related to agreements pursuant to which the developer develops specifically for the licensee software, databases and the documentation (the "**Development Agreement**"). Of course, every transaction is different, and this section does not list all of the issues that can arise in connection with such transactions,

nor does this section contain resolutions to such issues that will be appropriate in all transactions. Additionally, issues discussed in this outline may not apply to all transactions that involve developing software.

B. Structure of Development Agreement. The Development Agreement is an agreement between the developer and the licensee pursuant to which the developer covenants to develop software to conform to certain performance and operational characteristics (the “Specifications”). Additionally, the Development Agreement may require the developer to develop detailed Specifications based on performance and operational characteristics provided by the licensee. Further, Development Agreements often include a schedule for performance of the obligations of the developer and the licensee (the “Project Work Plan”). Finally, the Development Agreement may contain terms and conditions pursuant to which the developer provides training to the licensee.

In connection with the Development Agreement, the parties may enter into certain collateral agreements, such as software license agreements for pre-existing software, maintenance agreements and escrow agreements for source code. The issues discussed in other sections of this paper with respect to such agreements will come into play when they are used with a Development Agreement.

C. Principal Issues and Terms and Conditions related to the Development Agreement.

1. Handling Licensee’s Lack of Flexibility in Changing Developers. The licensee should consider performing due diligence to confirm that the developer will be able to perform its obligations under the Development Agreement because, after the developer begins to perform services for the licensee to develop Software, the licensee may become dependent on

continued performance by the same developer. The licensee may become dependent because the developer:

- a. will be in the best position to respond efficiently to changes in the Specifications because of such developer's knowledge of the structure and design decisions that resulted in such Software;
- b. may own intellectual property rights in the software that the developer is unwilling to grant to a third party; and
- c. may have contractual protections in the Development Agreement that prohibit the use of third parties to modify the Software.

As with other software-related agreements discussed above, after the licensee enters into the Development Agreement, the licensee loses its leverage to negotiate favorable terms in any other collateral agreements. The licensee should resist the temptation to enter into the Development Agreement until all terms in each of the collateral agreements are finalized. Alternatively, the licensee should negotiate to include in the Development Agreement the right to terminate the same if the parties do not enter into any of the collateral agreements within a specified period of time.

2. **Defining the Developer's Performance Obligations and Evaluating the**

Developer's Performance. Although the Development Agreement may include terms and conditions relating to training, support services, project management and other goods and services that developer will provide to the licensee, the principal measure of the developer's performance under the Development Agreement is whether the developer develops the software to be in Compliance (see Section 4a, below) in accordance with the Project Work Plan.

3. **Defining the Specifications.** In addition to the issues discussed regarding

Specifications above, it may not be possible to specify all performance and operational characteristics of the software on the date of execution of the Development Agreement. For example, it may be necessary for the developer, licensee or a third party consultant to perform a

requirements analysis of the licensee's needs before completing the Specifications.

Alternatively, the licensee may not have decided on the Environment for the software.

a. **Licensee Objectives.** If it is not possible to define the Specifications on the date of execution, the licensee should negotiate to include terms and conditions in the Development Agreement that enable the licensee to terminate the Development Agreement if the Specifications developed after the date of execution are not satisfactory to the licensee, or if such Specifications are not complete by a certain date. Further, the licensee should require that any Specifications developed after the date of execution must be signed by an authorized representative of the licensee if such Specifications are to be deemed part of the overall Specifications. Finally, any compensation that may be due to the developer for performing services to develop Specifications that are not satisfactory to the licensee should be expressly specified in the Development Agreement.

b. **Developer Objectives.** The developer should attempt to limit the discretion of the licensee to reject Specifications developed after the date of execution. For example, the licensee may be required to accept any such Specification that is "consistent with the Specifications as such Specifications exist on the Effective Date, or in addition to such Specifications but consistent with the licensee's goals [which may be specified in an Exhibit]." Further, if the licensee has narrowed its choice of Environment to several alternatives, the developer should consider including alternative Specifications for each such alternative before the Effective Date.

4. **Evaluating the Developer's Performance.**

a. **Defining Compliance.** Evaluating whether the developer has performed its obligations to develop the Software as specified in the Specifications requires a definition of the standard to which the Software must conform ("**Compliance**"). Generally, the licensee will take the position that Compliance means that the Software conforms to the Specifications in the opinion of the licensee. In contrast, the developer will request that Compliance means that the Software "substantially conforms to the Specifications in all material respects." The developer may further temper its obligations by using a "best efforts" clause.

5. **Acceptance Testing.** The acceptance testing issues discussed in Section IV C above with respect to license agreements arise also in Development Agreements. The licensee's interest in providing for strong acceptance and remediation provisions may be even stronger in the Development Agreement context, where the licensee is paying the developer specifically to create software in accordance with the licensee's Specifications.

6. **Mode of Payment and Schedule for Payment.**

a. **Modes of Payment.** Modes of payment allocate the risk of unforeseen complexities between the developer and the licensee. Compensation schemes include, but are not limited to:

1. fixed price;
2. period of service payments, with payments based on a fixed rate per calendar period for specified services;
3. payments per milestone;
4. time and materials;
5. time and materials, with level of effort not to exceed a cap;

6. cost or cost-plus; and

7. other metrics.

b. **Developer's Objectives.** The developer will favor modes of payment that link payment to the developer's actual costs and that require that the licensee pay the developer at regular intervals. Note that, from the licensee's perspective, these payment terms may diminish the developer's incentive to develop the software efficiently and to make the software conform to the Specifications.

c. **Licensee's Objectives.** The licensee will favor payment terms that link the developer's performance to logically significant performance obligations ("**Milestones**") that the developer performs in accordance with the Development Agreement. For example, the licensee will prefer to pay the developer amounts associated with Milestones specified in the Development Agreement at the time that the licensee determines that the developer has performed all tasks associated with such Milestones fully and completely.

Note, however, that it may be impossible to define all Milestones on the date of execution of the Development Agreement if the Specifications are not complete by then. If the Specifications are not complete, the licensee may propose that the parties must agree to the Milestones at the time that Specifications are completed. If this method is incorporated into the Development Agreement, the developer may require the right to terminate the Development Agreement if the developer does not agree with the proposed Milestones.

In addition, from time to time during the performance of the Development Agreement, the licensee may desire to modify or increase the scope of the Specifications. If the payment

mode is a fixed fee paid upon completion of Milestones, the Development Agreement should include terms and conditions governing changes to such fixed fee based on such change orders.

7. **Project Management.** If the Development Agreement contemplates an extended relationship between the developer and the licensee, or if the Specifications and other measures of each party's performance are not completely defined on the Effective Date, the developer and the licensee should consider including in the Development Agreement terms and conditions relating to project management.

a. **Role of Expertise.** Appropriate allocations of responsibility for project management may depend on the relative levels of technical expertise of the developer and the licensee. For example, if the licensee has limited technical the skills, the licensee may choose to delegate to the developer responsibility for technical decisions or to a third-party consultant with the requisite level of expertise. If the licensee uses a third-party consultant, the Development Agreement should expressly specify the scope of the authority of such consultant.

b. **Reporting.** Even if the licensee delegates to the developer responsibility for technical problem management, the licensee can retain a measure of control over the developer by requiring the developer to provide reports relating to significant events in the development of the software and any failures to perform in accordance with the Project Work Plan that may affect timely completion of the Software.

c. **Key Personnel.** The licensee may also want to control the performance of the developer's obligations by specifying certain personnel ("**Key Personnel**") of the developer that must perform services for the developer exclusively to perform the obligations of the developer under the Development Agreement until the tasks associated with

such Key Personnel in the Development Agreement have been performed fully and completely. The licensee should consider whether liquidated damages are appropriate if the developer fails to so assign such personnel. The developer will want to limit restrictions on Key Personnel so that the developer is not unduly limited in running its business.

d. **All Personnel.** The licensee will likely want to retain the right to require the developer to replace personnel that are unacceptable to the licensee with personnel acceptable to the licensee. Further, the licensee should require that all personnel of the developer that perform work on the licensee's premises comply with the licensee's policies and procedures while on such premises. Developer will want to limit the licensee's right to require personnel replacement so that the developer is not left without the developer's key resources to complete a job. The developer may propose that the parties will discuss and agree on appropriate resolution of any personnel problems. The developer will also want the licensee's policies and rules specified ahead of time and attached to the Development Agreement.

8. **Confidentiality.** Each of the licensee and the developer may disclose to the other confidential information. Each party should obtain assurances from the other party that the other party will maintain the confidentiality of any confidential information so disclosed: (a) to avoid the damages incurred by such disclosure; and (b) to ensure that such party has taken reasonable steps under the circumstances to maintain the confidentiality of its confidential information. A party claiming rights in information may have difficulty enforcing such rights if the party against whom enforcement is sought can prove that the party claiming such rights has disclosed such information to third parties other than pursuant to obligations of confidentiality.

VI. Other Software Related Agreements--A Word about Outsourcing

While the subject of outsourcing is too large to cover in this short paper, a few comments are warranted. At its most basic level, outsourcing involves the taking-over by a service company of functions previously performed by the customer. Information technology functions are frequently outsourced by companies whose "core competencies" are in other fields such as insurance, banking or manufacturing. Transactions labeled as "outsourcing" transactions range from the very large to the very small. Outsourcing transactions may include the complete transfer of the information technology function, including managing and maintaining mainframes and networks, desktop computer support, procurement and maintenance, applications design and development and other functions, or the transfer of only one or a few of those information technology functions.

As with other transactions discussed in this paper, every transaction is different and raises its own unique issues. Not all of the issues listed here will apply to all transactions, and there are many more issues to be dealt with in outsourcing transactions than can be listed.

Many of the biggest issues in outsourcing transactions derive from the fact that the customer is giving up day-to-day control of functions that are critical to its operation. Also, outsourcing transactions typically last for several years, so that when the outsourcing is over, the customer will no longer have the expertise, infrastructure or even hardware and software assets to perform the function for itself without considerable time and investment.

Key issues in outsourcing transactions often include (i) ensuring an adequate description of the services to be provided, (ii) determining whether the arrangement will be exclusive or non-exclusive on the customer's part, (iii) determining a pricing structure that gives customer the

flexibility it needs as its business changes but permits the vendor to cover its fixed costs and make a reasonable profit, (iv) determining service levels to be provided and the consequences of failure to meet service levels, (v) establishing terms for the transfer of employees from the customer to the vendor, (vi) establishing the customer's rights with respect to controlling the makeup of the vendor's account team and with respect to hiring members of the team when the outsourcing is over, (vii) establishing the terms on which the vendor will use, or in some cases acquire, customer assets, (viii) establishing the software that the vendor will use to perform the services and terms for controlling change, (ix) determining the parties' respective rights in intellectual property created during the transaction, (x) establishing a term of the agreement, any options for extension, and determining each party's right to terminate the agreement early, (xi) establishing the vendor's warranties for its services and work products, (xii) establishing the parties' limitations of liability, (xiii) providing a mechanism for resolving disputes, (xiv) providing a mechanism and allocation of responsibility for changes in law and regulation during the term, (xv) providing for disaster recovery if applicable, (xvi) allocating responsibility for taxes and (xvii) establishing confidentiality and data security terms.

VII. Enforceability Issues with Mass-Market Software Licenses--Shrinkwrap and Electronic Contracts

Many software licenses for "mass market" software are included in the packaging for the software or presented on-line if the software is to be downloaded by the licensee from the Internet. These licenses are not negotiated by the parties. Instead, the licenses contain terms that purport to be accepted when the licensee takes some action. Shrinkwrap agreements generally are unsigned agreements (i) distributed with physical copies of software, (ii) placed on the

outside or within a sealed package containing the software and (iii) that state that the opening of the package or use of the software constitutes acceptance of the license terms. Online contracts are similar to shrinkwrap contracts, but online contracts are presented to the licensee over the Internet or in a “splash screen” and typically require that the licensee take an action such as clicking a button before using software. Shrinkwrap licenses are most likely enforceable if properly drafted and, although there is no controlling law that clearly holds that online contracts will be enforceable, recent case law and pending revisions to the Uniform Commercial Code make it likely that online contracts will be enforced if carefully prepared and presented. Several steps that licensors can take to help ensure that shrinkwrap and online licenses are enforceable include ensuring that:

- the licensee has a chance to review the conditions before using the software;
- the licensee has a way of rejecting the terms and declining the offer;
- the licensee has to take an affirmative step to manifest assent to the terms;
- the terms are clear and are not unconscionable;
- there is some way of identifying the licensee; and
- a record is kept of the licensee’s identification and the customer’s assent (e.g., through return-registration cards or tracking online users).

A. **Contract Formation Principles.**^{16/} The traditional concepts of offer and acceptance in oral or written contracts should apply equally to the formation of shrinkwrap and online contracts.^{17/}

1. **Offer.** Under traditional rules, valid offers must communicate to the receiver that a contract will be formed upon acceptance of the offer.^{18/} Shrinkwrap licenses create an offer by instructing the licensee to read the license terms, visible through the clear packaging of the software, and indicating a method for acceptance. An online licensor may create an offer by instructing interested potential customers to complete an online order form and clearly indicating that a contract will be formed upon the completion of such form. Shrinkwrap and online licenses should also clearly indicate that the licensee has the opportunity to reject the offer. In shrinkwrap licenses, where the offer may be accepted or rejected after the customer has

^{16/} Several references herein are made to certain proposed draft revisions to the Uniform Commercial Code (the “draft U.C.C. revisions”), which may represent a departure from traditional contract law. Currently, the draft revisions are not settled and are subject to change, have not been adopted by any state and have not been interpreted by any court. Significant opposition exists to the proposed Draft. See Timothy G. Westman, Update on Revision of UCC Article 2, Metropolitan Corporate Counsel, Sept. 1997, at 22. Therefore, the purpose of such references is to provide a partial summary of certain draft sections that may be appropriate guidelines for future regulation of the issues discussed.

^{17/} Under the draft U.C.C. revisions, a contract may be formed in “electronic transactions” where an electronic message sent by one party (the “**offeror**”) evokes a response from the other party (the “**offeree**”) and (1) the response is received by the offeror and provides information (i.e., an acceptance) to the offeror that was not precluded by the offer; or (2) the offeror receives notice signifying acceptance. See Draft U.C.C. revisions §§ 2B-204 and 2B-205 (July 1996).

^{18/} See Restatement (Second) of Contracts § 24 (1979). Under the draft revisions an “offer to make a contract invites acceptance in any manner and by any medium reasonable under the circumstances”. Draft U.C.C. revisions § 2B-204(a) (July 1996).

already paid a third-party retailer, the license should expressly permit the licensee to return the software for a refund if the license terms are rejected.

2. **Acceptance.** The acceptance of a shrinkwrap or online offer is made by the licensee taking the invited action. Shrinkwrap licensees accept by opening the package and using the software, online licensees accept by sending an electronic message to the licensor or through other invited conduct, such as keyboard inputs, mouse clicks or the downloading of certain data from a Web site. Under traditional rules, an offer may be accepted “in any manner and by any medium reasonable in the circumstances.”^{19/} Contracts can also be created and accepted by conduct, if reasonable under the circumstances.^{20/} As discussed below, however, the enforceability of specific contract terms may depend on the manner in which the transaction is structured. For example, courts generally will not enforce terms that the offeror presents after contract formation occurs unless the offeree has manifested assent to such terms. Moreover, where acceptance occurs by conduct, a court may review the conspicuousness of the stated consequences of such conduct.

While a potential licensee may argue that, notwithstanding the use of the software, a finding that opening a package, loading software or keyboard or other responses constitute “reasonable conduct” would be tantamount to finding that it accepted the licensor’s offer through silence or inaction. However, where an offeree “takes the benefit of offered services [or receives products] with reasonable opportunity to reject them and reason to know that they were offered

^{19/} U.C.C. 2-206(1)(a); see also Restatement (Second) of Contracts § 50 (1979) (an offer may be accepted by “a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer”).

^{20/} See U.C.C. §§ 2-203; Restatement (Second) of Contracts § 19 (1979).

with the expectation of compensation,” the general rule against acceptance by silence should not apply.^{21/} Therefore, a potential licensee would have to overcome the argument that opening the package, using software, clicking software buttons, entering codes or downloading data constitutes more than mere silence. This potential argument illustrates the importance of providing potential licensees with the opportunity to escape the acceptance process or reject the software.

It should be noted that if the online items offered by a licensor are deemed to constitute the sale of goods over \$500, then the Statute of Frauds may apply and the developer may be required to provide for some writing indicating that a contract has been made and signed by the licensee. Although less likely in the case of shrinkwrap licenses, it at least appears plausible that electronic means of providing a “signature” could be devised.

B. Case Law. Several courts have dealt with the enforceability of non-negotiated, shrinkwrap agreements. Until the Seventh Circuit’s decision in ProCD, Inc. v. Zeiderberg,^{22/} the majority of courts held these agreements unenforceable.^{23/} Courts reasoned that the agreement was not presented prior to the licensee’s entering into a contract to purchase the software from the (usually third party) vendor and the terms of the shrinkwrap agreement therefore constituted an unenforceable attempt to modify the contract already in place.^{24/} Unlike in previous cases, the

^{21/} Restatement (Second) of Contracts § 69(1)(a) (1979).

^{22/} 26 F.3d 1447 (7th Cir. 1996).

^{23/} See, e.g., Step-Saver Data Systems, Inc. v. Wyse Technology, 939 F.2d 91 (ed Cir. 1991); Hill v. Wyandotte Corp., 696 F. 2d 287 (4th Cir. 1982).

^{24/} See, e.g., Hill, 696 F. 2d at 290-91.

court in ProCD held that acceptance did not occur until the customer used the software after having an opportunity to read the terms. The contract was not formed when the customer paid for the software, but, rather, when he took it home, had an opportunity to review the terms, and chose to use the software. If the customer did not like the terms, the Court wrote, he could return the software. The court emphasized that the software included the terms of the license in a “splash screen” that forced the customer to indicate acceptance before proceeding.^{25/}

There are few cases discussing the enforceability of specific terms in online contracts. However, the few cases that have reviewed such forms have enforced them provided that the customer knew of the license and knew that he was assenting those restrictions by his actions.^{26/} Provided the developer makes the license terms conspicuous, requires affirmative conduct, and allows customers to reject terms before entering into the contract, online contracts are likely to be enforced. The trend in the law after ProCD and the proposed U.C.C. Article 2B support this conclusion. For example, proposed Article 2B includes detailed provisions on electronic contracts. The provisions ensure that most electronic contracts are enforceable.^{27/}

^{25/} ProCD, 86 F.3d at 1452.

^{26/} See, e.g., Microstar v. Fomger, Inc., 942 F.Supp. 1312 (S.D. Cal. 1996).

^{27/} See, Joseph P. Verdon, Article 2B: Transaction In Software and Information, N.Y. L.J., Aug. 13, 1997, at 1.