

Hot Spots – Five Tests Worth Running in that First Scan of a New Contract

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By Ralph Kroman

Customer review of a technology acquisition contract by a customer can be a daunting task. Not only have technologies become more complex, but many vendors' "standard form" agreements have blossomed into huge documents. It is tough to see the forest because of the trees.

Rather than trying to read every detail, I recommend that each agreement be scouted initially for five "hot spots". Nothing can replace the analysis of an agreement on a line-by-line basis, but I find an initial analysis of hot spots to be very useful in determining if things are on the right track.

Money Matters Most

The first hot spot I look for is whether the agreement clearly calculates the stream of payments to the vendor (including the currency such as U.S. or Canadian dollars). Payment provisions can often be located in places where one least expects them such as in the "fine print" of a schedule that is attached to the agreement.

If I scan the agreement and locate all of the payment provisions but find it unclear regarding how they relate to each other, I know there is a problem. This will require further discussion with the vendor. It is in everyone's interest that the amount of the purchase price be clearly set out so as to avoid disputes and surprises.

While I am going through the contract to determine if the total payment obligations are clear, I also keep a keen eye on the question of when payment is due. Of course, under many situations, it may be appropriate to have milestones at which time part of the purchase price is paid. This is a balancing act. A purchaser wants to ensure that the vendor is keen to deliver as promised in order to get paid, and at the same time the vendor needs to ensure that the purchaser is acting in good faith and will fund the vendor's investment in the project on a reasonable basis.

A very important payment milestone can be the successful acceptance testing of goods or services. It is surprising the number of situations in which acceptance testing is overlooked. Not only can acceptance testing form the basis of a payment, but the ultimate failure of an acceptance test can result in a whole or partial refund of fees. Standard agreements do not always offer a refund process but it is an avenue worth negotiating with a vendor.

Reimbursement of expenses is an issue that comes up when the vendor provides services such as training at the customer's premises. The contract should be reviewed to determine if reimbursement is limited to "reasonable" or "pre-approved" expenses or by an overall cap.

Termination Needs to be Fair

Agreements almost always include provisions that entitle the vendor to terminate the agreement if the purchaser is in default; however, many agreements do not give the purchaser the right to terminate the agreement if the vendor defaults. In my experience,

most vendors will agree to make termination rights reciprocal because it is critical to the customer and reasonable that the customer enjoy termination rights.

Many agreements state that if the customer is in default the vendor may terminate the agreement immediately. It is reasonable for a customer to insert a cure period so that, if the customer is in default, the vendor cannot terminate the agreement unless the customer has been given notice of the default and an opportunity to cure the default.

It is also useful for a customer to negotiate a provision that a vendor cannot terminate the agreement (or charge any interest) if a fee is disputed in good faith by a customer.

Do You Own What You Expect?

The general legal rule is that, unless there is an agreement to the contrary, an independent contractor owns deliverables and other work products that arise due to the performance of services; therefore, the onus is on the customer to insert specific language that the customer owns the work products.

Some vendors are reluctant to give customers outright ownership of all work products (especially code) because they may use some or all of the work products for other customers on other projects. If it is appropriate that the vendor should keep ownership, the agreement could specify that the customer is granted a perpetual license to the work products which survives termination of the agreement. The customer's license may be wholly or partially exclusive. There are many options and the topic should be explored in depth because bad decisions may scare off potential investors and purchasers of the customer's business.

Make Maintenance and Support Meaningful

Many maintenance and support agreements emphasize response times and are silent about resolution or workaround times, but ultimately a resolution or workaround time is most critical to the business.

Although vendors are reluctant to be fully legally liable for damages if they are in default regarding support obligations, they will often agree to remedies such as a full or partial refund of support or other fees if target timelines are not met. Indeed, refunds can often be dependent upon the severity of the default. Purchasers sometimes fail to explore refund possibilities.

In terms of maintenance and support fees, the purchaser should consider the possibility of adding in price protection for future years. For example, fees for future years could be capped at the Canadian consumer price index. A more sophisticated example would be to cap fees at the lesser of Canadian CPI or 4%.

Don't Forget Source Code Escrow

Because the source code for software is a closely-guarded secret of the vendor, vendors do not typically offer source code escrow in their standard form agreements; however, if asked to do so, many vendors are prepared to enter into source code escrow arrangements.

The release conditions for release of the source code to the customer are critical. Sometimes the release condition is simply the bankruptcy of the vendor but this is not good enough. Vendors can go through various types of insolvency proceedings that are not bankruptcies (such as receiverships) but result in the failure to provide maintenance and support. Release conditions should focus on the failure of the vendor to perform critical obligations such as maintenance and support rather than merely on bankruptcy.

The source code escrow provisions should be checked to ensure that the purchaser has the right to verify that the source code deposit (including periodic updates) is complete so that there are not any surprises if there is a release of source code from escrow. Some professional source code escrow providers provide verification services that may be retained by the beneficiary.

The timing of the initial deposit is also important. It is often not feasible for the vendor to deposit the source code with the escrow agent at the precise time that the licence agreement is signed so the agreement may provide a time period within which to deposit the source code into escrow. It is an easy date to miss due to the “hustle and bustle” of the business world. A customer should diarize the date and follow up with the vendor prior to the expiry of that date.

If these hotspots can be assessed on an initial look at an agreement, the review of the remainder of the agreement will usually be easier and more focused.

For more information or inquiries:



Ralph Kroman

Toronto
416.947.5026

Email:
rkroman@weirfoulds.com

Ralph Kroman brings broad experience and high-level expertise to his business law practice with an emphasis upon contract negotiations, intellectual property, information technology and commercial transactions.

WeirFoulds^{LLP}

www.weirfoulds.com

Toronto Office

4100 – 66 Wellington Street West
PO Box 35, TD Bank Tower
Toronto, ON M5K 1B7

Tel: 416.365.1110
Fax: 416.365.1876

Oakville Office

1320 Cornwall Rd., Suite 201
Oakville, ON L6J 7W5

Tel: 416.365.1110
Fax: 905.829.2035