



A checklist of major issues relevant to System Acquisition Agreements

The First Annual Western Spring Training Program--Vancouver
May 15-17, 2002
The Fairmont Waterfront Hotel

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Session Objective:

This session will describe the most important aspects of a system acquisition agreement with a view to ensuring that when the transaction has been completed the expectations of both the customer and the supplier have been met.

The goal of the attached paper is to set out the major issues I feel should be addressed in a system acquisition agreement. I make no pretensions to having identified all issues that could possibly arise from such a transaction. That is simply beyond the scope of this paper. At the conclusion of this paper I outline trends in the industry relevant to a lawyer's considerations of how to negotiate a system acquisitions agreement.



A checklist of major issues relevant to System Acquisition Agreements

1. The courtship

1.1. Preliminary documents - Request for Proposal (RFPs)

The goal of a RFP is to document the expectations of a Customer, regardless of whether or not such expectations are realistic.

(Roger M. Tolbert, "*Contract Issues and Strategies: Focus on System Acquisitions*". 1984 Pacific Rim Computer Law Institute", at p. 8A-9)

"Simply stated, after evaluating its needs for a computer system ("do I need it?"), the Customer's major contractual concerns will be the specification of the capabilities of the system ("what is it?"); the definition of acceptance criteria and testing procedures ("how do I know when I've got it"); the establishment of a schedule of performance ("when will I get it?") and for payment ("I won't pay until I get it"); the provision for as unrestricted a right as possible to use the system whenever and for whom-ever the Customer desires ("what may I do with it"); receiving assurances that the vendor, or someone, will maintain and upgrade the system and correct errors ("how long will it be useful?"); and receiving assurances that the system does not infringe the rights of others ("may I keep it?")."

- (a) Description of hardware requirements
- (b) Description of software requirements
- (c) Describes overall functionality of hardware and software as an integrated system
- (d) Describes overall performance of the system eg. specify desired response times
- (e) May ask for references
- (f) May ask for Suppliers' position on key legal issues such as their "prime contractor" role; warranties, limitations on liability, future facilities management role etc.
- (g) May form basis of Suppliers' representations that delivered system will conform to specifications and functionality
- (h) Set out a time for response
- (i) Set out an administrative process for negotiation
- (j) Set out a general timetable

- (k) Attach the Customer's standard form contract and state Customer's expectations that certain portions or all or substantially the same format will be used

1.2 Response to RFPs

The goal of the Supplier's Response to RFP is to document how the Supplier will deliver what the Customer wants. A cynical commentator might say that this document is a stage for a Supplier to promise to deliver whatever the Customer wants, and hope that they don't get held to *all* their promises.

Since the Response to the RFP is a response to an agenda of issues and concerns raised by the Customer, this document should consist largely of responses line item by line item to the Customer's requirements which responses are usually, substantive, and (hopefully) specific to the Customer's concerns. The document may also include:

- (a) Sales brochures and puffery
- (b) Recommendations and testimonials
- (c) Supplier's standard forms
- (d) Supplier's financials – if they are a public company

2. The engagement

2.1 Preliminary understandings - Letters of Intent/Memoranda of Understanding

System acquisition agreements are complicated beasts. I can conceive of almost no situation where a Customer and a Supplier will wait for definitive agreements to be concluded before commencing work. Most parties will agree to some form of preliminary document to flesh out their understanding of how initial work should be undertaken. This preliminary document can be thought of as guidelines and a table of contents for the definitive agreements.

The goal should be to set out a detailed charter for the establishment of what (hopefully) will be a long-term relationship between the Customer and Supplier. In some respects, this usually short and brief document is the most important document in the relationship. Once the parties start work on a large systems projects, for various reasons inherent to implementing big IT systems, it is incredibly costly to withdraw from a project further down the road. If the parties can not come to an agreement on fundamental business issues, it is far far better to learn that **now** and not three or six months, or a year later.

From the Customer's perspective; it will never have as much negotiating leverage as against the Supplier as it does just before a binding agreement is signed. The Customer usually wants their RFP and a Supplier's Response to RFP to be incorporated by reference. From the Supplier's perspective, it wants to not overpromise and later, underdeliver and to not be overly specific in its commitments when so little is know about the project at such an early stage. Usually, but not always, the Supplier also wants to recognize as much revenue as possible up-front.

Some issues which should be addressed in this preliminary document are as follows:

- (a) Will the RFP and Response to RFP be referentially incorporated?
- (b) Will the preliminary document be binding or not binding?
- (c) Can the parties issue press releases? If so, what they can say? Will it be a joint release?
- (d) Is the initial work on a time and materials basis or is it for a fixed fee?
- (e) Who owns the initial work?
- (f) How will the initial work be administered?
- (g) What are cost estimates for the project? Are these estimates binding?
- (h) What is the payment schedule?
- (i) How and when will this initial arrangement terminate?
- (j) What happens if this initial arrangement terminates?
- (k) Non-solicitation of employees.

3. The marriage - the Definitive Agreements

3.1 What you get

An IT system consists of software and hardware (*products*) which are integrated (*services*) in such a way so that they function as a system. An appropriately drafted systems acquisitions agreement should identify what a Customer expects to receive (and what a Supplier should deliver) by way of software, hardware and integration services.

It is worthwhile noting that services can be a larger component than hardware and software combined. For illustration, in 2001, IBM's services revenues of \$ 35 billion were larger than IBM's hardware revenues, for the first time in that company's history.

Some issues are common to both software and hardware; invariably the checklist of items and issues one should address are therefor similar. These items and issues are addressed below.

3.1.1 Software

- (a) Is it off-the-shelf? Then define the functionality. May refer to existing documentation.
- (b) Is it custom? Then define with requirements specification and subsequent documentation and right to reproduce, if applicable.
- (c) Who owns the software?
 - i. Customer owns the software?
 - ii. Exclusive license in a geographic area or defined market?
 - iii. Non – exclusive license?

- (d) If the software is provided under license then what are the license terms?
- i. unrestricted right to use internally
 - ii. rights to use source code
 - iii. terms in the license agreement
 - iv. terms in an escrow agreement
 - v. right to copy and use in multiple computer centers
 - vi. right to sublicense or assign
 - vii. restricted to certain hardware? Specify a unique identifier: serial numbers or locations or IP addresses? Anyway to audit use?
 - viii. Restriction against using in a service bureau environment?
 - ix. Restriction against using in an ASP environment?

3.1.2 Hardware

- (a) Who specifies the hardware? Supplier or Customer or is it a joint responsibility?
- (b) What is the hardware?
- (c) Is there any hardware documentation? Does the Customer have the right to reproduce the documentation?
- (d) What is the nature of the property interest in the hardware? Purchase or lease?
- (e) If lease, what are purchase and cancellation options?
- (f) If the hardware is used who is the manufacturer, what is the model and what are the serial numbers?
- (g) What are the Customer's rights to acquire replacement parts and components?
- (h) What is the manufacturer's timeline for expected life of equipment and availability of parts?
- (i) Is there a guaranteed price for the hardware, the parts and what is the time period for the guarantee?

3.1.3 Integration service – Tying the Software and the Hardware together.

Project management

- (a) What is the development methodology of Supplier? Usually integration services are delivered in phases and set out in a separate technical document commonly known as a Statement of Work (SOW). An example of a fairly complicated SOW may be as follows:
 - i. First phase – defining requirements (or what the Customer wants).

- ii. Second phase – development path (or how to build what the Customer wants).
- iii. Third phase – testing in a controlled environment and fixing any problems that arise (or how to test your first try at building what the Customer wants)
- iv. Fourth phase – limited production use and testing and fixing any problems that arise (or how to really test what you have built).
- v. Fifth phase – Go-live.

- (b) What is the schedule for delivery of software, hardware and services?
- (c) How can this schedule be adjusted?
- (d) What is the approximate skill level of staff? If possible name key personnel.
- (e) Who provides project management? Name key persons
- (f) Will there be periodic meetings? Set out an administrative process.
- (g) Identify Supplier's responsibilities
- (h) Identify Customers's responsibilities

Delivery and associated services

- (a) Responsibility for delivery and insurance; allocation of costs
- (b) For software, what is to be delivered? Source, object, firmware and documentation; using a specified form and format.
- (c) For hardware, what is to be delivered? Specify by make and model and if unique, by unique identifier such as serial number.
- (d) Committed delivery date; liquidated damage assessment if delayed
- (e) Changing delivery dates; notice periods
- (f) Right to reject and time periods
- (g) Specific penalties for failure to meet delivery schedule
- (h) Where is the designated site for delivery?
- (i) Specify that the software or hardware order is not complete until delivered to designated site
- (j) Specify conditions and rights to delay
- (k) Specify if a certain amount of delay gives rise to right to cancel
- (l) Specify if there is a right to cancel if full configuration not delivered
- (m) Security interest till paid

Installation services

- (a) May install in segregated development or test or pilot environment.
- (b) Site preparation

- (c) Computing environment description and layout of installation site.
- (d) Specifications for installation
- (e) Upon completion of installation, provide for Customer testing and test protocol using hardware manufacturer or software developer testing protocol

Conversion of legacy data and associated services

- (a) Test protocol
- (b) Interim system
- (c) Right to delay (or cancel) if conversion proves impractical
- (d) Conversion assistance from Customer

Training services

- (a) Training materials. Right to reproduce and to "train the trainer"
- (b) Continuing availability
- (c) Manuals and documentation. Rights to reproduce, rights to updates, new documentation
- (d) Availability of free copies of software purely for training practice
- (e) Supplier provision of a "hot-line" to answer questions and trouble-shoot
- (f) Separate training environment segregated from development and production environments

Acceptance testing; quality assurance and service levels and associated services

- (a) Timeline for acceptance
- (b) Deemed acceptance if go-live
- (c) Who tests?
- (d) What tests are used? Are the tests objective (e.g. an industry benchmark) or subjective (eg. Customer's satisfaction?)
- (e) Component – by – component test
- (f) System-wide test
- (g) Scaling to test system as used by all expected users and expected load placed on system by software, hardware and interaction with legacy systems
- (h) Test all expected peripheral hardware
- (i) Test all interfaced software
- (j) Test all legacy systems
- (k) Time to cure if acceptance test fails?

- (l) How many failures allowed?
- (m) Consequences of single failure?
- (n) Consequences of multiple failures?
- (o) Test descriptions can be appended
- (p) If appropriate, provide for tests by auditor

Support and Maintenance

- (a) Quality of service generally
- (b) Service levels; calls returned within certain time; errors fixed within a certain time etc.
- (c) Access for Customer's premises for services provided by Supplier by Customer
- (d) Periodic reports
- (e) Services not provided for certain events (ie. Hardware fixed by an unauthorized third party, hardware used outside of specifications; software modified by Customer etc.)
- (f) Type and Extent of maintenance. When are periodic improvements expected and how will they be delivered and installed?
- (g) Right to supplier-prepared enhancements and documentation revision
- (h) Availability of source code; source code escrow with a third party
- (i) Regulatory-mandated changes
- (j) Right for Customer to receive standard software changes developed by software developer and additional cost if any
- (k) Right for Customer to provide input and/or influence into standard software development path
- (l) Right for Customer to contract with others for services
- (m) Supplier or manufacturer to fix hardware
- (n) Hardware backup if hardware cannot be fixed in a timely manner; timeline for quick interim hardware replacement
- (o) Spare part availability
- (p) Preventive hardware maintenance
- (q) Right to schedule hardware-maintenance related visits
- (r) Hardware upgrades and trade-in allowances
- (s) Right to contract with others
- (t) Commitment to maintain parts
- (u) "Lemon clause" ie replace hardware completely if too many failures
- (v) Renewal of services and rates
- (w) Price protection for changes in service rates

- (x) Graduated pricing for better service (eg. 24/7 support)

Customization: is any required

- (a) If any required; specify in SOW or some form of follow-on agreement eg. change request process
- (b) Are customizations included in contract price?
- (c) Provide for feature – creep (ie added customizations and functions) through change request process
- (d) What is extent of Supplier commitment to provide customizations? Limited to availability of Supplier resources
- (e) Price break for Customer if a requested customization is subsequently included in standard software or hardware upgrade or development path

Change Requests

- (a) What is the process?
- (b) All requests must be written
- (c) Documented acceptance
- (d) Cost and cost overruns
- (e) Charge to Customer for answering change request
- (f) Mandatory for Supplier to address change request or at Supplier's discretion whether or not to address?

3.2 What you pay

- (a) Fixed fee?
- (b) Time and material?
- (c) Possible combination of fixed fee and time and materials?
- (d) Progress payments for work completed and products and services delivered?
- (e) “Most favoured nation” clause
- (f) Tax considerations for payments
- (g) Additional payments for training, installation, maintenance or other follow-on services
- (h) Interest on late payments
- (i) Conditions for complete or partial refund (getting rare)
- (j) Milestone-based payments; milestones may include acceptance tests
- (k) Penalties for missing milestones

- (i) Monetary penalties (eg. reduce amount payable by x% for every week late)
 - (ii) Escalation to senior management
 - (iii) Supplier or Customer or third party hardware manufacturer or software developer to dedicate more resources
 - (iv) Credit for future services (eg. one month's free maintenance)
- (l) Holdbacks at contract end; amount of holdback; conditions of release.

3.3 Who bears the risk

3.3.1 Warranties

- (a) Ownership by Supplier or right to license or provide deliverables
- (b) Copyright and trade secret infringement
- (c) Documentation describes use and operation of software
- (d) Hardware is sufficient for needs of Customer
- (e) Compatible with legacy systems; both data and applications are compatible
- (f) Compatible with third party systems
- (g) Software will meet design and performance specifications
- (h) Repair of defects (“bugs”) under warranty for duration of licence
- (i) Compliance with minimum objectively-defined standards (ANSI, CAS, IEEE)
- (j) Compatibility with hardware and other software products
- (k) Y2K
- (l) No disabling code
- (m) For hardware
 - (i) standard asset acquisition warranties
 - (ii) Hardware new
 - (iii) Hardware will meet operating characteristics and specifications
 - (iv) free maintenance period common
 - (v) devices comprising configuration are compatible
 - (vi) reliability
 - (vii) % downtime
 - (viii) MTBF (Mean Time Between Failures)
 - (ix) Assignment of manufacturer or third party warranties

3.3.2 Limitations on warranties and of liability

- (a) Disclaim sales of goods or UCC warranties, representations and conditions
- (b) Limit to direct damages only
- (c) Limit direct damages to a certain sum; eg, contract price or support fee paid in one year or price of equipment or insurance carried by Supplier
- (d) Supplier-favourable limitations of liability
 - (i) Exclude consequential damages
 - (ii) Exclude indirect damages
 - (iii) Exclude economic damages
 - (iv) Exclude loss of use
 - (v) Exclude lost profits
 - (vi) Exclude tort or product liability
 - (vii) Exclude claims by third parties
 - (viii) Consider whether to make exclusions apply or not to apply to damages for intellectual property infringement or breach of confidentiality

3.3.3 Remedies for breach of an obligation (including warranties)

- (a) Total or partial refund
- (b) Repair or replace
- (c) Tie a remedy to service levels
- (d) Liquidated damages; subject only to parties' imagination (eg. Dollar sum penalty for each day late).
- (e) Some situations where a remedy may be provided include:
 - (i) Remedy for failure to agree on specifications
 - (ii) Remedy for late delivery or non-delivery of partial or entire software system
 - (iii) Remedy for failure of software to pass acceptance test for either each phase checkpoint or the total installation
 - (iv) Remedy for on-going performance criteria not met
 - (v) Remedy for unresponsive maintenance
 - (vi) Remedy for disclosure of confidential information
 - (vii) Remedy for bankruptcy or insolvency of Supplier

3.4 General provisions

3.4.1 Confidentiality

- (a) mutual
- (b) detailed or general
- (c) control procedures on confidential information
- (d) special attention to source code
- (e) limit to certain people or locations

3.4.2 Ownership

3.4.3 Insurance; CGI or E&O

3.4.4 Performance bonds

3.4.5 Integration or Whole Agreement clause

3.4.6 Assignment

3.4.7 Force Majeure Clause

- (a) Consider excluding disasters for which Disaster Recovery can be provided by Supplier or by a third party (eg. Sungard)
- (b) Consider excluding events for which using an Uninterruptible Power Supply (UPS) can avoid.

4. If all fails, the divorce

- 4.1 Escalation process
- 4.2 Choice of governing law
- 4.3 Venue for resolving disputes
- 4.4 Attorneys fees
- 4.5 Arbitration or litigation
- 4.6 Conversion away from failed system

5. Trends

A. Systems are getting more complicated or the more things change, the more they remain the same.

Tolbert at p. 8A-1.

"Ten years ago, a computer acquisition generally involved the purchase of a large, expensive hardware configuration from a major manufacturer and the development of extensive custom software designed for the user. Although such large-system acquisitions still occur, they are today outnumbered by sales of smaller, less expensive and easier – to – maintain systems of minicomputers or microcomputers together with industry-specific software packages developed by the most part in advance by independent OEMs or value-added remarketers."

B. Revenue recognition and FASB (Financial Accounting Standards Board) rules or the quarter-end game

(Susan Pullman, "SEC broadens accounting inquiries" From Wall Street Journal Online; Updated April 3, 2002).

"The Securities and Exchange Commission is looking into accounting methods at some of the nation's largest companies, broadening the scope of its inquiry beyond the accounting issues raised by the collapse of Enron Corp. to include a laundry list of other potential accounting abuses.

.....

*The number of companies being examined by the SEC in the technology and telecommunications area shows that at least one of the areas the SEC is emphasizing involves the use -- particularly by formerly highflying technology companies -- of newfangled **revenue recognition** gimmicks.*

*"Our No. 1 problem has always been **revenue recognition** ," he says."*

C. Customers are getting much more demanding or the reluctant prime contractor

(Louis Gerstner, "Chairman's Letter" 2001 IBM Annual Report, p. 1).

"Customers have put on their walking shoes. They've made it emphatically clear to this industry that they will no longer cede control to the makers of the technology.

That means customers are demanding integration, and refusing to accept piece parts that aren't designed and delivered to work together. It means they are demanding solutions, not "speed and feeds". And it means they insist that the technology adapt itself to the needs of their businesses and help them gain some tangible competitive advantage"

D. Consolidation in the industry – large system integrators dictate the terms of the playing field or the uniformity of terms.

(Alex Gove, "Integrating the Internet", Redherring Online, August 1998)

"There are three major parts to Web systems integration (strategic, creative, and technical). Few companies provide end-to-end integration, but they are moving in this direction, often through acquisition. The industry is thus ripe for consolidation."

Seneca Completes Organic Acquisition

SAN FRANCISCO, Jan 14, 2002 (BUSINESS WIRE) -- Organic, Inc. (Nasdaq:OGNC), a technology-enabled marketing partner to Global 1000 companies announced today that a merger between Organic, Inc. and a subsidiary of Seneca Investments LLC has been completed.

Novell Completes Acquisition of Cambridge Technology Partners Jack Messman Becomes President and CEO

PROVO, UT — July 10, 2001 — Novell, Inc. today announced it has completed the acquisition of Cambridge Technology Partners (Massachusetts), Inc.,

DIAMOND TECHNOLOGY PARTNERS TO COMBINE WITH LEADING PAN-EUROPEAN DIGITAL STRATEGY CONSULTING FIRM CLUSTER CONSULTING

\$930 Million Combination to Create the World's Premier Digital Strategy and Solutions Delivery Firm Company Will See Attractive Cash Flows, High Margins

9.11.00

6. Precedents

<http://www.quickforms.net/> Pay database

<http://www.10kwizard.com/> Pay database

http://www.wedge.com/articles_resources.htm - Sample precedents extracted from 10Kwizard and this paper.