Negotiating Software Contract Risks – The Three Riskiest Provisions

By Stephen Pinson

Software and service contracts come with many potential risks, and businesses should be mindful when initiating a new contract or a renewal. It's considered a best business practice to negotiate the terms in a software or service contract before agreeing to the initial terms a vendor provides in the contract. There are many contract provisions that can be negotiated, but the major risk provisions found in most contracts are the following: (1) Limitation of Liability, (2) Indemnification, and (3) Warranty. These contract provisions must be considered in conjunction with one another because they cannot be effectively negotiated without determining how they affect each other.

Limitation of Liability ranks as one of the top contract provisions negotiated in a software contract. The limitation of liability limits each party's liability for breach of contract or list of damages for all sorts of harm. A software publisher's liability is usually limited to the amount of fees paid to the vendor or a fraction thereof. The risk in not negotiating these terms is that the licensee is capped at the amount of damages. This cap may not equate to the actual amount of harm. The best way to negotiate these contract provisions is to write the provision in such a way as to: (1) increase the damage cap, (2) negotiate insurance coverage, or (3) negotiate a limitation carve-out that excludes certain type of claims from the limitation of liability.

An indemnity clause requires one party to bear the monetary and defense costs, either directly or by reimbursement, for losses incurred by a second party. It shifts potential costs from one party to another. One potential claim is an intellectual property ("IP") infringement claim. The licensee may seek reimbursement for costs incurred in defending a claim by a third party that the licensed software infringes on the third party's IP rights. For this reason, licensees should be careful to negotiate appropriate protections for third-party claims.

The best way to negotiate this contract provision is to include indemnification provisions that the software or service provider will be responsible if the licensed software infringes the IP of a third party by requiring the software or service provider to do the following: (1) purchase a license to the infringing code in order to be able to legitimately provide it to you; (2) modify the infringing code so that it no longer infringes the third party's IP rights; (3) replace the infringing code with code that does not infringe the third party's IP; or, if none of the above solutions are possible, (4) the software vendor will refund the license fees (but be careful, the license fee rarely will be enough to compensate for losses suffered if the software vendor has infringed a third party's intellectual property). There are also indemnification provisions that can be negotiated for harm that is suffered from a service provider that provides services on business property, such as bodily injury, death, or damage to real or tangible, personal property resulting from the negligent or willful acts or omissions. These also need to be carefully negotiated to avoid any potential risk.

A warranty in a software or service contract is (1) a formal promise by a vendor that the product is defect free or that the service will be performed in a workmanlike manner, and that if it fails to do so, (2) how the vendor will go about rectifying the defects in the product or service. The best way to negotiate this contract provision is to include warranties that promise to protect the licensee from failures of warranty. The warranty section should include some of the following warranties: (1) the software or service provider has necessary equipment and trained personnel to perform

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the services consistent with industry standards, (2) the services will be performed in workmanlike manner (3) the software or service provider will comply with all applicable laws (4) the software or service provider warrants that it maintains an information security process with physical safeguards appropriate for the sensitivity of customer information (5) warrants that the software will perform its functions and (6) warrant the software shall be free of material or hidden defects.

Remember, it is always important to seek advice from experienced counsel in order to understand all the risks involved when negotiating software and service contracts.

About the author Stephen Pinson:

Stephen represents clients involved with intellectual property and technology disputes. Specifically, he defends clients in software licensing and copyright infringement matters. Prior to joining the firm, Stephen practiced in high-stakes securities litigation, regulation, and enforcement actions. He spent the majority of his time prosecuting and defending large corporate clients, institutional investors, and Wall Street firms.

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