Chapter 1

Software License Agreements

Mark G. Malven*

---

* The author would like to thank colleagues Richard M. Bendix, Darrell W. Pierce, Jeanne M. Whalen, Danielle F. Bass, Candice C. Moore, and Sungjin Yoo for their valuable assistance in the preparation of this chapter.

§ 1:1 Introduction

This chapter addresses the drafting, review, and negotiation of traditional software license agreements. In the view of the author, the traditional software license—unlike some of the other forms of technology transaction agreement—has evolved into some relatively standard forms. There are, of course, many important elements that remain subject to the negotiations of the parties. These are addressed below.

A vendor-oriented form of a Software License Agreement follows this chapter as Appendix 1A, and a form of a Product Evaluation Agreement follows as Appendix 1B.

§ 1:2 Scope of License Rights

§ 1:2.1 License Grant

As with all licenses of intellectual property, the scope of the license grant language is critical and a good place for practitioners to start their review. The language should address clearly the following three questions:

- *Who can use the software?* In particular, the parties should consider and address as appropriate the rights of the customer's affiliates, present and future, as well as customer entities that may be sold and cease to be affiliates. Customers will also want to include language permitting their consultants and the personnel of outsourced services providers to use the software as if they were customer employees. Negotiations are sometimes required to address the legitimate concerns a vendor may have regarding access to nonpublic aspects of the software by competitor employees.
- *How can the software be used?* Are there restrictions on the customer's use, such as number of concurrent users, number of named users, limitations to specific hardware or software, specific locations, or number of servers, etc.? These restrictions are all potential components of a vendor's licensing structure and business model. It is therefore incumbent upon the customer to understand the full impact of these limitations on the customer's intended use of the software. The customer's failure to understand and comply is likely to have significant, and unexpected, financial consequences if the vendor performs an audit.
- *Does the customer have the right to modify the software?* In many cases, the question of whether the customer has the right to modify the software is tied to whether the customer is getting source code.

§ 1:2.2 Limitations on the License Grant

The parties should note the difference between words that define the scope of the license or create conditions regarding the exercise of the customer's rights, and words that are merely contractual covenants. This distinction is important because action outside the scope of a license (if within the vendor's IP rights) is infringement of the vendor's IP, and the vendor will have access to the many owner-favorable statutory provisions under the IP laws.

Software Audit War Story

The author was once engaged to assist a client in a dispute over the meaning of the licensing terms for a software product embedded into the client's hardware products. The software vendor, after an audit, claimed the nature of the hardware maker's use did not qualify under the "Bronze" licensing package (as they were told by the vendor's salesman), but was instead subject to the "Gold" package. The difference involved millions of dollars. And the Gold licensing fee per customer's hardware product was, in fact, greater than the price for the whole product!

In contrast, a breach of a contractual covenant may lead only to a breach of contract claim with the need to prove, among other things, vendor's damages. Also, a breach of a contractual covenant may not necessarily give the vendor the right to terminate the license grant and prevent the customer's continuing use of the technology.

Drafting Tip for Vendors

Try to incorporate all significant limitations on the customer's license rights into the license grant provisions themselves.

§ 1:2.3 Use of Functional Language

Nearly all software vendors use functional language such as "use" or "modify" in their license grant language, rather than the formal words set forth in the U.S. Copyright Act describing the exclusive rights of a copyright holder (for example, "reproduce," "make derivative works," or "distribute").[1] This may seem puzzling to those more familiar with traditional copyright licenses, but it is a standard practice and has withstood the test of time.[2]

---

1. *See* 17 U.S.C. § 106. The term "use" is, in fact, a patent term. *See* 35 U.S.C. § 154(d). Note that the granting of a right to "use" the software in this context carries with it a license to utilize the grantor's intellectual property rights as needed for such use.
2. There may be, of course, the rare exception from time to time where the rights may need to be defined differently.

§ 1:2.4 Commonly Understood Terms (That Really Are Not)

Be careful about relying solely on the typical licensing terms such as "exclusive" or "sublicensable," as they can be the subject of varying expectations or interpretations. The best practice is to explain the parties' intentions in more detail. For example, if the parties intend the license grant to be exclusive or sublicensable, then the license grant section might have a subsection addressing each of these important concepts.

§ 1:2.5 Backup Copies

The customer should normally have the right to make a reasonable number of backup copies of the software. Furthermore, a customer obligation to return or destroy the software upon termination should probably have an exception permitting the customer to retain backup media in accordance with its standard retention policies.

§ 1:2.6 Defined Terms

Pay close attention to the defined terms in the agreement, particularly as they may impact the scope of the rights granted. Given the complexity of the underlying subject matter, license agreements frequently have many defined terms that are often interrelated or overlapping. To avoid misunderstandings or unintended outcomes, these need to be tightly drafted and made as simple as possible under the circumstances.

§ 1:2.7 Subsequent Refinements

Take care when the parties agree to additional refinements or limitations to their respective rights, whether during the initial negotiations or subsequently as amendments to the agreement. The best practice is to carefully review the core license grant provisions and revise them as necessary to integrate the new concepts. A common mistake is to tack on additional provisions reflecting the new concepts without reconciling them with the existing framework. In the author's experience, this is very likely to lead to a license agreement that fails to meet the basic goal of any contract: to clearly define the intended rights and obligations of the parties.

§ 1:3 Protection of Intellectual Property Rights

The prudent software vendor will include a section describing the limitations and obligations of the customer related to the protection of vendor's intellectual property rights in the software. Customer's counsel should read these provisions carefully and confirm they are appropriate for customer's intended use. If properly drafted by the vendor's counsel, these provisions should not require much negotiation for off-the-shelf or otherwise preexisting software.

§ 1:3.1 Vendor Ownership of Off-the-Shelf Software

For preexisting software, the vendor nearly always will retain all intellectual property rights. The ownership section often starts out with a recitation that the copyright, trade secret, and other proprietary rights in the software will remain with the vendor and that the customer will not acquire any rights other than those specifically granted in the license agreement. This provision often will explicitly exclude any implied licenses in favor of the customer.

The vendor will want to state that it retains ownership of all translations, modifications, adaptations, or derivative works of its software. This provision should also include a presently effective[3] assignment from the customer to the vendor of any customer rights it may have in any of the foregoing.

§ 1:3.2 Customer Ownership of Data

If the software vendor will have access to the customer's data entered into the software, then the customer will want a clear provision stating that the customer owns all data that is entered into the vendor's systems or systems of a third-party hosting entity under vendor's control, plus any modifications to that data. The provision should clarify whether the vendor has any rights to use the data other than in performance of its obligations under the agreement. In some cases, vendors may desire to use the data (usually on an anonymous basis) for system optimization or for other analytical purposes. The provisions should also clarify customer's rights to require return and/or destruction of any customer data and the format of the data being returned.

§ 1:3.3 Reverse-Engineering

Most software licenses contain a standard provision prohibiting the customer from attempting to decompile, reverse-engineer, disassemble, or otherwise attempt to obtain or create source code for the software. Copyright laws may not always prohibit these activities,[4]

---

3. *See infra* section 10:3.4.
4. 4 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 13.05 (Matthew Bender, rev. ed.).

and the prudent vendor will therefore want to prohibit them by contract.[5]

Notwithstanding a contract prohibition to the contrary, in certain jurisdictions decompiling the software will be permitted so that a party may obtain information necessary to render the software interoperable with other software.[6]

§ 1:4 Taxes

The tax treatment of software and related services will vary by state and local jurisdictions (this topic is discussed in detail in chapter 19). Absent the rare agreement to the contrary, the license agreement should include a provision stating that the software pricing does not include local, state, or federal sales, use, value-added, or other taxes based on the licenses or services provided under the agreement or the customer's use. The vendor will also want the tax provision to include an affirmative statement that the customer will pay all taxes that may be imposed upon the vendor or the customer, except for income or similar taxes imposed on the vendor. This provision should further state that the customer will be invoiced for, and the customer will pay, any such taxes if the vendor is required to pay them on the customer's behalf.

§ 1:5 Certification and Audit Rights

The prudent software vendor often will include a requirement that the customer provide a signed certification (1) verifying the software

---

5. Note, however, that a contractual prohibition may not be effective if the customer is found to be the purchaser of a copy of the program rather than simply a nonexclusive licensee. While historically courts have honored the characterization of the distribution of software as a license transaction, more recently some courts have concluded that the economic realities of the transaction make it actually a sale of a copy of the software. *See, e.g.*, Softman Prods. Co. v. Adobe Sys., Inc., 171 F. Supp. 2d 1075 (C.D. Cal. 2001). The owner of a copy of the software has broader rights than a licensee, including under the first sale doctrine embodied in section 109 of the Copyright Act, which would provide the customer with the right to sell or otherwise dispose of possession of that copy. For an in-depth treatment of this topic, see 2 NIMMER ON COPYRIGHT §§ 8.12, 8.13; Raymond T. Nimmer, *Copyright First Sale and the Overriding Role of Contract*, 51 SANTA CLARA L. REV. 1311 (2011).
6. *See, e.g.*, Directive 2009/24/EC of the European Parliament and of the Council on Legal Protection of Computer Programs, 2009 O.J. (L 111) 16 (permitting the observation, study, or test of program functionality to determine underlying ideas of a program in article 5 and granting a legitimate user the ability to decompile a work by law when necessary to achieve interoperability in article 6).

is being used in accordance with the terms of the agreement; and (2) providing other information such as the locations in which the software is run, number of users, or number of CPUs. The prudent vendor will often also include the right to conduct an audit of the customer's use of the software and compliance with the agreement. This provision usually will include some protections for the customer, such as notice periods or commitments that the audit will be conducted during business hours and will not unreasonably interfere with the customer's business activities. A typical audit provision should require the customer to provide reasonable information and assistance (including copies of related software applications and other software) necessary to enable the vendor to determine whether the customer is in compliance. The audit section often also includes a provision to shift the cost of the audit from the vendor to the customer if a substantial noncompliance is found. The threshold for fee-shifting is typically between 5% and 10% of the applicable fees, which could be based on an annual amount or the total fees subject to the audit. The prudent vendor will also include interest on any amounts found to be owed and unpaid.

§ 1:6 Warranties

§ 1:6.1 Software Performance

The most common performance warranty in software license agreements is conformance with either (1) the applicable software documentation (generally for preexisting or off-the-shelf software programs) or (2) the specifications (generally for more custom products or for very large implementations). One of the negotiable points will be whether the applicable standard will be "conformance" or "substantial conformance." Another negotiable point will be the length of the warranty period—these typically range from sixty days to twelve months.

Practice Tip for Customers

Customer counsel should review carefully the provisions describing the software performance. Some vendor agreements are surprisingly weak in this area and may provide few contractual remedies for software that does not perform as expected.

A common vendor complaint is that some customers expect unreasonably long or even perpetual warranties regarding software performance. As noted above, this is not the industry standard. In addition, many vendor business models include the provision of software maintenance for a fee. The best practice is therefore to have the end of a warranty period be coincident with the commencement of any maintenance period.

The customer should pay particular attention to the specifics of the software performance warranties, as they will be the primary focus if the software does not perform as expected and customer desires to terminate the agreement, get a refund, or the like.

§ 1:6.2 System Warranties

If the customer is purchasing an integrated software system, it should seek a warranty that the system as a whole will conform to the applicable specifications and service levels. If there are multiple vendors supplying components, the parties may need to carefully negotiate the allocations of responsibilities. The customer may desire to have one vendor responsible for integration and ultimate performance of the system, perhaps through a prime/subcontractor structure.

§ 1:6.3 Quality of Services

If the vendor will be providing services, the customer will want a warranty regarding the quality of those services. The most common standard is that the vendor will perform the services in a professional and workmanlike manner. The customer may also want a warranty that each member of the vendor's project team has the required skill, training, and experience to perform the services that such member is responsible for performing, and that standards and quality of the vendor's work will be consistent with generally accepted (or highest) industry standards.

§ 1:6.4 Viruses and Limiting Routines

In many circumstances, the customer will desire a warranty that the software will be free from all computer viruses at the time of delivery. The prudent customer also may seek a warranty that the software will not include any code that could be invoked to disable or otherwise shut down the software, including keys that make the software stop functioning at the end of a term.

§ 1:6.5 Compliance with Laws

Both customers and vendors should review carefully whether or not a software license agreement should contain contractual obligations regarding compliance with applicable laws. If compliance is a material element, the typical boilerplate provision stating that each party will comply with applicable laws may prove insufficient. This is particularly true for public company compliance requirements (for example, Sarbanes-Oxley), highly regulated industries (such as healthcare and financial services), and compliance with data security and privacy requirements. The best practice is for the parties to discuss and address in detail (1) who will be responsible for which compliance-related activities, and (2) how the parties will address compliance-related obligations arising after the effective date, including any impact on the fees.

§ 1:6.6 Data Security and Privacy

Given the continuing expansion of privacy law regimes, combined with the unfortunate frequency of high-profile security breaches, applicable agreements should contain detailed warranties regarding security and privacy law compliance.[7] One common mistake is over-reliance on boilerplate confidentiality provisions, which are generally designed to protect trade secrets and other proprietary business information, but not personally identifiable information (PII). For one of the more obvious examples, consider that much PII fits within the standard confidentiality exception for publicly available information. Under such a provision, the vendor would be free to publish, for example, end user home addresses, which are usually available to the public at county clerk offices and other similar sources.

§ 1:6.7 Free and Open Source Software

Free and open source software (FOSS), which has become a hot topic in recent years, has had a revolutionary effect on many aspects of the software industry (this topic is discussed in detail in chapter 11). Most of these effects have been positive, and customers should avoid unreasonably fearful responses.

The use of open source has grown to the point that it is often not reasonable to warrant that a product contains no open source materials. Instead, the prudent customer should make sure that the open source code is delivered in a compliant fashion and that it is aware of what restrictions may accompany the product it is receiving.[8] In the context of software licensing between customers and vendors, there are two important elements to understand. First, the main legal risks for noncomplying parties arise under what are called the "copyleft" licenses, and not all FOSS software is provided subject to a copyleft

7. See chapters 14–18 for a discussion of potentially applicable privacy laws.
8. https://opensource.org/ (last checked Jan. 25, 2018).

license. Second, the risk for customer users—sometimes called the "viral effect"—would arise if a customer made a proprietary modification to copyleft-licensed software or combined it with other customer proprietary software.[9] The terms of a copyleft license would then require that this modified or combined software also be provided subject to the copyleft license. The customer would therefore lose the ability to keep the source code confidential and otherwise maintain the new software's proprietary status.

It is important to note that the term "open source" is a term of art, with a definition and certification process controlled by the Open Source Initiative. Because the scope of licenses included in the term "open source" can change over time, best practice is not to include a list of specific licenses, but instead to defer to the canonical list of licenses accepted as open source by the Open Source Initiative.

The following is a sample provision the customer may wish to include:

> Open Source Materials. The Software does not contain (i) "Open Source" software constituting "Copyleft Materials," or (ii) any other Open Source software not in compliance with the applicable licensing requirements. "Open Source" means any copyrightable material distributed under a license accepted by the Open Source Initiative as an Open Source license. "Copyleft Materials" means materials subject to any license that, as a condition of distribution: (A) requires the distribution of complete corresponding source code to any recipient of the materials, or (B) requires that any distributed derivative work of the Open Source materials be subject to the same Open Source license.

§ 1:6.8 Other Warranties

In larger transactions, or if the circumstances otherwise dictate, one may also see warranties related to sufficiency of documentation, interface functionality/compatibility with other products, commitment to future updates, maintenance of releases for a specified minimum period, quality certifications or other compliance requirements, no pending or threatened litigation, or vendor representations made in RFP responses.

9. Generally, distribution or conveyance of the new software is also required to trigger the copyleft or viral provisions. But these terms are broadly defined under most copyleft licenses, so a customer would generally be unwise to rely solely on the fact that its planned use is expected to be internal only.

§ 1:6.9 Remedies

It is common for software licenses to contain specified (and often exclusive) remedies for failure of software performance warranties. They typically state that the vendor must attempt (for example, by exercising commercially reasonable efforts) to correct the nonconforming software. If the vendor is unable to do so, then frequently the next step is a refund. Negotiable aspects include who makes the determination that the software cannot be fixed, and whether the refund is limited to the nonconforming software only.

§ 1:6.10 Disclaimers

[A] Generally

Although not an entirely settled question, courts generally treat software as a good that is subject to the Uniform Commercial Code.[10] Therefore, vendors should include U.C.C.-type warranty disclaimers. Customer's counsel should read these carefully and confirm they are appropriate for customer's intended use. If properly drafted by the vendor's counsel, these provisions should not require much negotiation.

The following is language from a vendor form:

> EXCEPT FOR THE WARRANTIES SET FORTH IN SECTION [ ], WHICH ARE LIMITED WARRANTIES AND THE ONLY WARRANTIES PROVIDED TO CUSTOMER, THE SOFTWARE AND ANY SERVICES ARE PROVIDED "AS IS," AND NEITHER VENDOR NOR ITS LICENSORS MAKE ANY ADDITIONAL WARRANTIES, EXPRESS, IMPLIED, ARISING FROM COURSE OF DEALING OR USAGE OF TRADE, OR STATUTORY, AS TO ANY SOFTWARE OR SERVICES PROVIDED HEREUNDER. THE PARTIES HEREBY DISCLAIM ALL IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, SATISFACTORY QUALITY, TITLE, AND NON-INFRINGEMENT.
>
> NEITHER VENDOR NOR ITS LICENSORS WARRANT THAT THE SOFTWARE OR ANY SERVICES WILL MEET ANY CUSTOMER REQUIREMENTS NOT SET FORTH HEREIN, THAT THE SOFTWARE WILL OPERATE IN THE COMBINATIONS THAT CUSTOMER MAY SELECT FOR USE, THAT THE OPERATION OF THE SOFTWARE WILL BE UNINTERRUPTED OR ERROR-FREE, OR THAT ALL ERRORS WILL BE CORRECTED. IF CUSTOMER REQUESTS PREPRODUCTION (E.G., "ALPHA" OR "BETA")

---

10. *See* 1 JAMES J. WHITE, ROBERT S. SUMMERS & ROBERT A. HILLMAN, UNIFORM COMMERCIAL CODE: PRACTITIONER TREATISE SERIES § 2:2 (6th ed. 2012); *see also* 1 RAYMOND T. NIMMER, LAW OF COMPUTER TECHNOLOGY § 6:4 (4th ed. 2009).

RELEASES OF SOFTWARE, SUCH COPIES ARE PROVIDED "AS-IS" WITHOUT WARRANTY OF ANY KIND.

[B] Title and Noninfringement

In addition to disclaiming the implied warranties of merchantability and fitness for a particular purpose,[11] the prudent vendor should include in its disclaimers the implied warranties of title and non-infringement that arise under U.C.C. section 2-312.[12] This disclaimer is particularly appropriate when the agreement already contains a negotiated provision addressing liability for intellectual property infringement. The vendor will not want to have a second, and possibly different, remedy for intellectual property infringement. Of particular note, possible remedies for a breach of section 2-312 may include rescission or revocation of acceptance.[13]

§ 1:6.11 Magnuson-Moss Warranty Act

The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act[14] is a federal consumer protection statute that applies when software is licensed or sold to consumers and the software is "normally used for personal, family or household purposes."[15] Vendors subject to the act need to review it carefully and will need much more information than is provided here.[16] It is noted here only to explain two types of language typically seen in warranty disclaimers. First, section 102 of the act requires inclusion of the "some states do not allow ______" language frequently seen in warranty disclaimers.[17] Second, section 103 dictates titling a warranty as "full" or "limited."[18] If the act does not apply because the transaction is not with a consumer, then this language is not needed.

---

11. For more information on these implied warranties, see U.C.C. §§ 2-314 and 2-315, and WHITE & SUMMERS, *supra* note 10, § 10.
12. *See* WHITE & SUMMERS, *supra* note 10, § 10:43.
13. *Id*. § 10:45.
14. Pub. L. No. 93-637, 88 Stat. 2183 (1975) (codified at 15 U.S.C. § 2301 *et seq*.).
15. *Id*. § 2301(1).
16. A good place to start would be the Bureau of Consumer Protection Business Center's website. *See Businessperson's Guide to Federal Warranty Law*, FTC (Dec. 2006), www.business.ftc.gov/documents/bus01-businesspersons-guide-federal-warranty-law.
17. *See* WHITE & SUMMERS, *supra* note 10, § 10:47.
18. *See id*. § 10:48.

§ 1:7 Implementation and Acceptance

If the vendor is providing implementation services or if there will be custom software created, the parties will be best served by an acceptance process that is clear and objective (that is, tied to compliance with the specifications, rather than just customer satisfaction).

The following is sample language that has worked well for both customers and vendors:

> Acceptance Process for Deliverables. Customer will have [fifteen (15)] calendar days, or any different period specified in the applicable SOW, after notice from Vendor of a completed Deliverable (the "Acceptance Period") to either (a) notify Vendor in writing of its acceptance of the Deliverable ("Acceptance"), or (b) if Customer reasonably believes that any Deliverable fails to conform [substantially] to the requirements set forth in the applicable SOW, notify Vendor in writing specifying in reasonable detail such nonconformance ("Rejection"). Any failure by Customer to notify Vendor in writing of its Acceptance or Rejection of a Deliverable within the Acceptance Period will be treated as Acceptance of such Deliverable. Upon receipt of a written notice of Rejection specifying the nonconformance, Vendor will attempt to [substantially] conform the Deliverable to the applicable requirements. If Vendor concludes that such conformance is impracticable, then Vendor shall refund the fees paid by Customer to Vendor hereunder [allocable to the nonconforming Deliverable], provided that Customer first returns to Vendor all copies of such Deliverable.

Practitioners should note the distinction between a substantial conformance standard in the context of an acceptance provision and in the context of a performance warranty. There is good reason to consider these contexts separately and perhaps require strict conformance of developed software at the acceptance stage. From a customer's perspective, it would seem odd to require acceptance of nonconforming developed software based on a claim that the nonconformance is not substantial.

§ 1:8 Indemnification for Infringement or Misappropriation of Intellectual Property

It is generally the industry standard for software vendors to provide some form of indemnity for the infringement of third-party intellectual property rights. The provisions can be drafted narrowly or broadly, and the range of coverage can vary fairly widely.

Drafting Tip

Indemnity language in the context of a software license agreement is usually quite different from indemnity in other contexts, such as acquisitions (where the indemnity provision may be the primary means of compensation between the parties for breach of contract) or construction (where the parties are focused on allocating responsibility for personal injury or property damage, and an important consideration is the treatment of a party's own negligence).

§ 1:8.1 Scope

The scope of this indemnity is frequently the subject of negotiation. The customer will want coverage for all types of intellectual property and without geographic limitation. From the vendor's perspective, this may seem unfair, since one may infringe patents "innocently"—that is, without knowledge and without the vendor taking any wrongful actions. Independent development is not a defense to patent infringement. Patent infringement is distinguishable from copyright infringement or trade secret misappropriation because the latter cannot occur without wrongful actions. Common compromises include limiting patent coverage to U.S. patents only or including a knowledge qualifier.

With the proliferation of nonpracticing entities (sometimes called "patent trolls"), vendors are understandably concerned about the possibility of unexpected claims of patent infringement. Some vendors now seek further limits or exclusion of patent claim indemnity altogether.

For purposes of clarity, the parties should include a list of the types of costs that will be subject to the indemnity. The language should also state that the provision only applies to third-party claims (as contrasted with claims between the parties for breach of contract).

§ 1:8.2 Exclusions/Limitations

A standard practice is for vendors to include specific exclusions along the lines of the following:

> VENDOR IP INDEMNITY LIMITATIONS. THE RIGHTS GRANTED TO CUSTOMER UNDER SECTION [ ] ARE CUSTOMER'S SOLE AND EXCLUSIVE REMEDY AND VENDOR'S SOLE OBLIGATION FOR ANY ALLEGED INFRINGEMENT OF ANY PATENT, COPYRIGHT, TRADEMARK, OR OTHER PROPRIETARY RIGHT. VENDOR WILL HAVE NO LIABILITY, INCLUDING UNDER SECTION [ ], OR UNDER ANY APPLICABLE STATE CODIFICATION OF U.C.C.

SECTION 2-312, FOR ANY CLAIM OF INFRINGEMENT OR MISAPPROPRIATION BASED UPON OR ARISING OUT OF: (A) ANY SOFTWARE MODIFIED WITHOUT THE APPROVAL OF VENDOR; (B) ANY CUSTOMER OR THIRD-PARTY APPLICATION OR OTHER TECHNOLOGY; (C) USE OF THE SOFTWARE IN CONNECTION OR IN COMBINATION WITH EQUIPMENT, DEVICES, OR SOFTWARE NOT PROVIDED BY VENDOR (BUT ONLY TO THE EXTENT THAT THE SOFTWARE ALONE WOULD NOT HAVE INFRINGED); (D) COMPLIANCE WITH CUSTOMER'S DESIGN REQUIREMENTS OR SPECIFICATIONS; (E) THE USE OF SOFTWARE OTHER THAN AS PERMITTED UNDER THIS AGREEMENT, OR IN A MANNER FOR WHICH IT WAS NOT INTENDED; OR (F) USE OR DISTRIBUTION OF OTHER THAN THE MOST CURRENT RELEASE OR VERSION OF THE SOFTWARE (IF SUCH INFRINGEMENT OR CLAIM WOULD HAVE BEEN PREVENTED BY THE USE OF SUCH RELEASE OR VERSION).

§ 1:8.3 Terminology: "Indemnify," "Defend," and "Hold Harmless"

Many courts and most scholars consider the terms "indemnify" and "hold harmless" to be synonymous. Others believe the obligation to "hold harmless" is somehow broader than the obligation to indemnify—perhaps by also including an obligation to protect or defend against the risk of loss and not just the actual loss. Note also that still others believe an obligation to "hold harmless" means the obligor is not permitted to seek damages from the other party for the actions of that other party.[19]

The author agrees with the majority view that "indemnify" and "hold harmless" should be considered synonyms, and that use of the words "hold harmless" should therefore be avoided. To keep them both "just to be safe" is actually quite the opposite since, as the well-regarded legal lexicographer Bryan Garner puts it:

> There has been a welter of needless litigation over the doublet [indemnify and hold harmless] as litigants have wasted countless dollars fighting over imaginary differences between the words—differences that have no historical justification. . . . There's an object lesson for all of us . . . make considered drafting decisions that avoid extra words that don't convey extra meaning—because some court, somewhere, some day will find extra meaning where there isn't any.[20]

19. *See, e.g.*, GARNER'S DICTIONARY OF LEGAL USAGE 443 (3d ed. 2011); BLACK'S LAW DICTIONARY 800, 837; MELLINKOFF'S DICTIONARY OF AMERICAN LEGAL USAGE 286 (1992).
20. GARNER'S at 445. See also the discussion therein of the bad law in certain jurisdictions that has arisen.

The problem, of course, arises from the rule of contract interpretation about reading nothing in a contract as "mere surplusage" and giving effect to every word. However, in Garner's words:

> That's not a bad rule when legal drafters abstain from larding their contracts with surplusage, but it's a horrible rule when they do.[21]

Drafting Tip

To avoid unnecessary risk of litigation over its meaning, avoid the use of "hold harmless" in your drafting.

To the extent one is using the "hold harmless" to mean "defend," then the latter term should be used and the obligation fleshed out as described below.

An obligation to "defend" means that the vendor will undertake the defense of third-party claims. This is obviously distinct from an obligation to provide compensation for the specified losses, and both parties should be clear that they want the vendor to be engaging the counsel, managing the defense, and so forth. If the vendor is expected to conduct the defense of third-party claims, then the agreement should include language specifying the procedures applicable to both parties. These may include the customer providing notice of the claim within a reasonable time and tendering control of the defense to the vendor. The customer may want to retain a right to participate in the defense with counsel of its own choosing at its own expense, and the right to approve settlements.

Finally, the words "indemnify" and "indemnity" are themselves not as precise as many think—being the subject of varying interpretations.[22] Therefore, to avoid ambiguity in a particularly important contract provision, the best approach would be to replace the term "indemnify" with more precise language. The intended meaning in the context of IP infringement expenses, for example, is most likely "pay for" or perhaps "reimburse." The author does recognize, however, that this may not always be a battle worth fighting.

21. *Id.* at 444.
22. *Id.* at 443–45; BLACK'S LAW DICTIONARY 837; MELLINKOFF'S 286.

§ 1:9 Limitations of Liability

§ 1:9.1 Dollar Cap

It is commercially standard practice for software licenses to contain a specified limit on vendor's aggregate monetary liability under the agreement, subject to certain exceptions. The amount of the dollar cap is often expressed in relation to amounts paid under the agreement (for example, amounts paid under the previous twelve months, or all fees paid under the agreement), or perhaps a multiple of such amounts. The final dollar value of the cap is often correlated to the respective negotiating leverage of the parties.

The parties should also pay particular attention to the exceptions to the cap, which historically have included indemnity obligations, gross negligence, willful misconduct, and breaches of confidentiality. In recent years, compliance with law and data breach liabilities have also become part of these negotiations. Depending on the circumstances, certain liabilities (such as for data breach) may be subject to a "super cap"—which might be a multiple of the dollar cap for other liabilities.

Practice Tip for Customers

Seek to have the negotiated exceptions to the dollar cap apply also to any exclusion of consequential or other types of damages.

§ 1:9.2 Exclusion of Consequential and Other Types of Damages

It is a common practice for vendors to include provisions that distinguish between "direct" or "general" damages on the one hand (usually allowed), and "consequential" or "special" damages on the other hand (frequently excluded).[23] It is the author's belief, however, that this practice frequently flows from common misunderstandings

23. *See generally* 1 JAMES J. WHITE, ROBERT S. SUMMERS & ROBERT A. HILLMAN, UNIFORM COMMERCIAL CODE: PRACTITIONER TREATISE SERIES §§ 7:21, 11:7 (6th ed. 2012); *see also* Glenn D. West & Sara G. Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 BUS. LAW. 777, 791 (2008) (providing an illuminating discussion of these waivers in the context of acquisition agreements).

regarding the meaning of the applicable terms. These misunderstandings are evident both in written agreements between contracting parties and in court opinions interpreting those agreements.[24]

Some seem to think that consequential damages are those damages that are so vague, speculative, or loosely related to the contract that no fair-minded person should think they are appropriate. This is a misperception of contract law. Just like direct damages, consequential damages for breach of contract are not available unless the aggrieved party shows the damages were actually caused by the failure to perform in accordance with the contract[25] and were foreseeable,[26] and that the aggrieved party attempted appropriate mitigation.[27] In addition, no contract damages are recoverable beyond the amounts that are proven with reasonable certainty.[28]

The distinction between direct and consequential damages flows from the foreseeability requirement, which was articulated in the seminal case of *Hadley v. Baxendale*.[29] As subsequently stated in section 351(1) of the *Restatement (Second) of Contracts*:

> (1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.

Hadley set forth two branches for the evaluation of whether losses were foreseeable and therefore allowable. As stated in section 351(2) of the *Restatement (Second) of Contracts*:

---

24. *See, e.g.*, DaimlerChrysler Motors Co. v. Manuel, 362 S.W.3d 160, 181–82 (Tex. App. Fort Worth 2012) (resolving two sophisticated parties' contractual conflict wherein they concurrently limit out-of-pocket expenses and agree to liability for any actual damages); AM/PM Franchise Ass'n v. Atl. Richfield Co., 584 A.2d 915, 919 (Pa. 1990) (declaring "[t]here has been substantial confusion in the courts and among litigants about what consequential damages actually are and what types of consequential damages are available"); Applied Data Processing, Inc. v. Burroughs Corp., 394 F. Supp. 504, 508 (D. Conn. 1975) (stating "neither in Michigan nor elsewhere does the term 'consequential damages' have a clearly established meaning"); Gregory K. Morgan & Albert E. Phillips, *Design Professional Contract Risk Allocation: The Impact of Waivers of Consequential Damages and Other Limitations of Liabilities on Traditional Owner Rights and Remedies*, 33 J.C. & U.L. 1, 13 (2006) (stating that "no one knows what consequential damages are or may be, at least not with predictability or uniformity").
25. RESTATEMENT (SECOND) OF CONTRACTS §§ 346, 347 (1981).
26. *Id*. § 351.
27. *Id*. § 350.
28. *Id*. § 352.
29. Hadley & Anor v Baxendale & Ors, [1854] EWHC (Exch) J70; 156 Eng. Rep. 145; 9 Ex. Ch. 341.

(2) Loss may be foreseeable as a probable result of a breach because it follows from the breach
   (a) in the ordinary course of events, or
   (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach has reason to know.

In the first branch of foreseeable damages (in section 2(a) above) are the general or direct damages—sometimes called the "natural" result of the breach, in the sense that its occurrence accords with the common experience of ordinary persons.[30] In the second branch of foreseeable damages (in section 2(b) above) are the special or consequential damages—losses that are a result of special circumstances—as long as the breaching party knew or had reason to know of those special circumstances at the time it entered into the contract.[31]

Practice Tip

Boilerplate consequential damages waivers often include a laundry list of excluded damages, such as lost profits, that are written as additional to the exclusion of consequential damages. This has the potential to go beyond the intentions of the parties, as lost profits in some circumstances qualify as the proper measure of direct damages. An easy fix is to reference lost profits, etc. as a parenthetical subset of consequential damages.

The drafters of the Uniform Commercial Code generally followed the framework from *Hadley*[32] and added extensions and refinements that are beyond the scope of this discussion. Of particular note, however, is the following, per White & Summers: "[W]henever a defective component part causes an accident that damages an entire product, a large part of the total damage may be consequential."[33] In addition, some commentators believe (and the author agrees) that a significant portion of the damages that flow from a breach of confidentiality is likely to be consequential.[34]

---

30. RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b; *see also* U.C.C. § 2-714(1).
31. RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b; *see also* U.C.C. § 2-715(2)(a).
32. WHITE & SUMMERS, *supra* note 10, § 11:7.
33. *Id.* § 11:8, at 989 n.7.
34. MICHAEL A. EPSTEIN ET AL., DRAFTING LICENSING AGREEMENTS § 8.09 (2014); Scott M. Kline & Matthew C. Floyd, *Managing Confidential*

It is important to note that not all courts would agree with the foregoing framework. Some courts seem to be moving away from the *Hadley* approach and have stated, for example, that market-measured damages (that is, the difference between the value of the thing as promised and the value of the thing as actually provided) are the proper measure of direct damages and everything else is either consequential or indirect damages.[35]

Seen in light of the foregoing definitions, an exclusion of consequential damages may seem unfair to the aggrieved party—quite possibly leaving it without compensation for a significant portion of its losses caused by the breach, and notwithstanding the fact that the losses were foreseeable by the parties at the time of the contract. The exclusion is also likely to increase the costs of dispute resolution, as the parties will have a strong incentive to battle over the categories of damages, and there are inherent difficulties in separating these categories.[36]

The same can be said of "incidental" damages—which can be described generally as reasonable costs and expenses actually incurred by the nonbreaching party in an attempt to avoid other direct or consequential losses caused by the breach.[37] As such, it would seem inappropriate for a party to waive its right to recover these costs in the context of a software license agreement.

From a vendor's perspective, the possibility of paying to a customer its consequential damages—with such damages potentially being much greater than the purchase price—may not have been factored into vendor's pricing. This is a strong argument and may carry the day in cases where there is no dollar cap on the allowable damages. Where

---

Relationships in Intellectual Property Transactions: Use Restrictions, Residual Knowledge Clauses, and Trade Secrets, 25 REV. LITIG. 311, 342 (2006).

35. *See, e.g.*, Schonfeld v. Hilliard, 218 F.3d 164, 175 (2d Cir. 2000) (stating that general damages are measured by the "difference in contract price and market value at the time of the breach" and consequential damages include any loss outside that value); R.B. Matthews, Inc. v. Transamerica Transp. Serv., Inc., 945 F.2d 269, 274 (9th Cir. 1991) (defining consequential damages as any foreseeable loss incurred by a breach without a normal or special occurrence distinction); Schubert v. Lucent Techs., Inc. (*In re* Winstar Commc'ns, Inc.), 2003 Bankr. LEXIS 766, at *8–11 (Bankr. D. Del. May 29, 2003) (determining foreseeable damages are broad enough to constitute both direct and consequential damages); *Envtl. Sys. Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26, ¶ 93 (Austl.) (declaring that anything beyond market-measured damages is consequential loss).

36. WHITE & SUMMERS, *supra* note 10, § 7:21.

37. RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. c; *see also* U.C.C. § 2-715(1); WHITE & SUMMERS, *supra* note 10, §§ 7:21–7:23.

there is a dollar cap, however, it is the author's view that excluding consequential damages is often not appropriate.[38]

Practice Tip

When faced with an opposing party insisting on an inappropriate exclusion, try to change the language so that only damages that should not be recoverable anyway under contract are being excluded—such as punitive or non-foreseeable damages, or damages that cannot be proven with reasonable certainty.

§ 1:10 Termination

It is fairly common practice for software licenses to be subject to termination upon a material breach by the other party. Both customers and vendors should take care, however, in defining the parties' respective rights to terminate the software license agreement. In particular, parties should avoid unexamined use of boilerplate termination provisions. For example, it is likely not appropriate for a customer's insolvency or bankruptcy to be a cause for termination. As long as the customer has paid and is continuing to pay for its license, its rights probably should continue. Similarly, in most cases a customer should not have the right to terminate a software license merely because the vendor is experiencing financial issues.

If the customer has paid most or all of its fees up front, or if the software is mission-critical, the prudent customer will often seek to limit the vendor's termination right—even for cause. In such a case, the customer may seek to limit vendor's right to terminate to circumstances where customer has failed to pay undisputed amounts for a significant period of time and after written notice. The vendor would, however, still have the right to contract damages for any customer breach of the agreement. In some circumstances, this may prove insufficient, and the vendor will insist on an additional right to terminate if customer is misusing the vendor's IP or taking other continuing actions that have the potential to cause vendor harm.

The parties should also include appropriate provisions describing the effects of any termination, such as return or destruction of the software and the return of customer's data.

---

38. The back-and-forth equities between customers and vendors may be further complicated if there is a dollar cap, but the cap has exceptions.

§ 1:11 Licensee Transferability Rights

Most contract rights are transferable, absent an express anti-transfer prohibition in the agreement (or if the transfer would materially burden the other party or if public policy dictates otherwise).[39] Additionally, in a statutory merger, the contract rights of the parties generally are deemed automatically vested in the surviving entity without the need for an assignment. Inbound IP license rights, however, are sometimes treated differently under the applicable federal (U.S.) common law.[39.1]

The first difference is that the federal courts have consistently held that the licensee position in a nonexclusive patent or copyright license is by default (that is, when silent as to transferability) *not* transferable by the licensee.[39.2] This would, of course, also be the result if the agreement contained an anti-transfer or anti-assignment provision.[40]

The second difference, and probably the more significant for practitioners, is that an inbound nonexclusive license agreement (unlike most other contracts) might be deemed transferred pursuant to a merger in a manner that *would* trigger applicable anti-transfer restrictions (either explicit restrictions in the agreement or the default prohibition when the agreement is silent). The licensee, therefore, would need permission from its licensor prior to the consummation of a merger to avoid an impermissible transfer of the license.

A recent Sixth Circuit case provides a good illustration. In *Cincom Systems, Inc. v. Novelis Corp.*,[41] the technology vendor, Cincom Systems, licensed its software to Alcan Rolled Products Division ("Alcan Ohio") in 1989. In 2003, Alcan Ohio was merged into an affiliate, and after further internal corporate restructuring, the surviving entity became known as Novelis. Throughout these transactions, the software remained on the same computers in the same physical location. Once Cincom Systems learned of these corporate changes, it sued for breach and copyright infringement. Novelis responded, in part, by asserting there was no transfer of the license because the applicable merger statute provided that "the surviving or new entity

---

39. *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 316–43 (1981); U.C.C. § 2-210.

39.1. Litigation involving transferability often has complicated fact patterns, and the perceived harm to a particular party seems to have a significant influence on the ultimate finding of whether a transfer is permissible.

39.2. *See, e.g.*, Unarco Indus., Inc. v. Kelley Co., 465 F.2d 1303 (7th Cir. 1972).

40. Note, however, that the result is reversed if the subject transaction is instead characterized as the sale of a copy of the software (rather than as a nonexclusive license). *See* discussion *supra* note 5.

41. Cincom Sys., Inc. v. Novelis Corp., 581 F.3d 431 (6th Cir. 2009).

possesses all assets and property . . . all of which are vested in the surviving or new entity without further act or deed."[42]

The Sixth Circuit disagreed:

> "A transfer is no less a transfer because it takes place by operation of law. . . ." Federal common law, and the actual language of the license in this case is clear: the only legal entity that can hold a license from Cincom is Alcan Ohio. If any other legal entity holds the license without Cincom's prior approval, that entity has infringed Cincom's copyright because a transfer has occurred.[43]

The *Cincom* case has been criticized, including in the preeminent treatise on copyright law, *Nimmer on Copyright*.[44]

Practice Tip for Customers

Seek a broad right to transfer that includes successors pursuant to acquisition by stock or asset sale, merger, consolidation, or other corporate restructurings or reorganizations.

Practice Tip for Vendors

Since the transfer of nonexclusive license rights can sometimes lead to significant unintended consequences (such as transfer to a competitor), consider a broad "deemed transfer" clause that would require your permission prior to any transfer by change of control of the customer by stock sale, merger, or the like.

Unlike the licensee position, for the licensor position there is no presumption that the licensor may not transfer the license agreement. For this reason, and others, the prudent vendor should consider resisting mutuality in the transferability provisions.

---

42. *Id.* at 439 (quoting OHIO REV. CODE ANN. § 1701.82(A)(3)).
43. *Id.* at 438.
44. 3 NIMMER ON COPYRIGHT, *supra* note 4, § 10.02.

§ 1:12 Bankruptcy-Related Issues

The bankruptcy of a party to a license agreement can have a profound impact on the parties to that agreement. Counsel need to have a basic understanding of how license agreements are treated in bankruptcy and to draft accordingly.

The discussion that follows is only a summary of selected bankruptcy-related issues, and one should always consult bankruptcy practitioners whenever appropriate. It is safe to say, however, that in general vendors will tend to want to prohibit the customer's assignment in a bankruptcy and should therefore draft to emphasize the personal nature of the license agreement and (if possible) the unique aspects of the licensee. Customers will generally want the right to assign (or at least assume) in a bankruptcy and should therefore try to include explicit permissions in the agreement.

§ 1:12.1 Applicable Bankruptcy Principles

[A] Unenforceability of Ipso Facto Clauses

In general, a clause that purports to terminate the agreement or otherwise change a party's rights automatically upon the filing of a bankruptcy petition (called an "ipso facto" clause) is not enforceable pursuant to section 365(e)(1) of the U.S. Bankruptcy Code.[45] A license agreement could, however, contain a valid right to terminate prior to bankruptcy based on likely bankruptcy precursors such as performance or payment delays or poor financial results.

[B] Assignment and Assumption of Executory Contracts

Under section 365 of the Bankruptcy Code, the trustee or debtor-in-possession has the right to either *assume* or *reject* any executory contract. A contract is generally found to be executory if both parties have material obligations still to be performed, and as a practical matter, most (but not necessarily all) licenses will be considered executory. Upon assumption, a trustee or debtor-in-possession has the further right to choose retaining the contract or assigning it to a third party for value (regardless of any anti-assignment provision in the contract).

---

45. 11 U.S.C. § 365(e)(2)(A), however, may cast doubt on this outcome in some circumstances.

[C] Unenforceability of Anti-Assignment Language

In furtherance of the policy in favor of maximizing the value of the debtors assets, section 365(f) of the Bankruptcy Code renders unenforceable anti-assignment language in an executory contract.

[D] Avoidance of Transfers

If a party enters bankruptcy, certain licenses or other transfers might be set aside under section 547, as a preferential transfer, or under section 548, as a fraudulent transfer.

> **Practice Tip for Customers**
>
> The prudent customer should consult bankruptcy counsel early in the process if licensing critical software from a financially distressed vendor.

§ 1:12.2 Bankruptcy of the Customer

[A] Protections for Vendors

Under Bankruptcy Code section 365(c)(1), the debtor's general right to assume and assign executory contracts (and to ignore contractual nonassignment provisions) does not apply when "applicable [nonbankruptcy] law" excuses the nondebtor party from "accepting performance from or rendering performance to" a new party. Therefore, since the federal (U.S.) common law is clear that the licensee position in a nonexclusive license cannot be assigned by the licensee without the consent of the licensor, this provision leads to preventing the customer from unilaterally assuming and assigning the agreement to a third party.

> **Practice Tip for Vendors**
>
> Be careful using "consent not to be unreasonably withheld" in your standard assignment clause. Some courts have held this to change the default common law rule of no assignment by the licensee, and therefore give the trustee or debtor-in-possession the right to assign.

[B] Potential Consequences for the Customer

The statutory language and case law regarding section 365(c), however, can go even further and lead to what some might consider a perverse result for the customer. Depending on whether the applicable court follows the "actual" or "hypothetical" test for evaluating the right to assume a nonexclusive license, a debtor-in-possession customer may be blocked, not only from assigning to a third party, but also from assuming and continuing its own operations under its nonexclusive licenses. This problem follows generally from the theory that the debtor-in-possession is considered to be a separate legal entity from the pre-petition debtor.

Practice Tip for Customers

Try, at a minimum, to get the right to assign to a successor in a corporate restructuring or reorganization situation and, if possible, the right to assign to a successor pursuant to an acquisition.

§ 1:12.3 Bankruptcy of the Vendor

[A] Protections for Customers

If a vendor files for bankruptcy and rejects a license, this could have catastrophic results for a customer that is dependent on that license. To address this problem, Congress in 1988 added section 365(n) to the Bankruptcy Code.

Section 365(n) states that if a license agreement is rejected by the licensor, the licensee has two basic choices: (1) treating the rejection as a breach and seeking damages through the bankruptcy court (by filing a proof of claim as an unsecured, pre-petition creditor), or (2) continuing to use the IP as permitted under the agreement and continuing to pay the applicable royalties (if any).

[B] Limitations of Bankruptcy Code Section 365(n)

While section 365(n) was a big improvement in the law for licensees, there are some important limitations regarding section 365(n). First, it does not apply to trademarks or to non-U.S. intellectual property. Second, upon rejection, all of the vendor's future obligations will cease and a customer will not be getting any contracted-for technical support or future IP developed by the vendor.

§ 1:12.4 Technology Escrow Agreements

There are unique concerns for existing technology escrow agreements when the vendor files for bankruptcy. These are discussed further in chapter 7.[46]

§ 1:13 Secured Creditors

§ 1:13.1 Security Interests in Licensed IP

Under revised article 9 of the Uniform Commercial Code, the rights of a customer under a software license agreement will be subject to any prior, perfected security interests in the vendor's software, unless an exception applies.[47] Having the license agreement rights subject to such a security interest means that the vendor's secured lender could foreclose, terminate the license as a junior interest in the vendor's software, and sell the software free and clear of the customer's rights.

§ 1:13.2 Nonexclusive Licensees in the Ordinary Course

Fortunately, U.C.C. section 9-321 contains an exception that will apply to many software licenses—for nonexclusive licenses granted in the ordinary course by a party in the business of software licensing. Under U.C.C. section 9-321, a "licensee in the ordinary course" takes free and clear of a security interest created by its licensor, just as a buyer of goods in the ordinary course of business takes free and clear of security interests created by its seller.[48]

Prudent counsel should be familiar with the specifics of section 9-321(a), which defines a licensee in the ordinary course of business as:

> a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind. A person becomes a licensee in the ordinary course if the license to the person comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary practices.

---

46. *See infra* section 7:5.
47. U.C.C. §§ 9-201, 9-203, 9-315(a). All U.C.C. references herein are to the model act, so counsel should review the actual state implementations as appropriate. Note, for example, California's adoption of a nonstandard section 9-321.1 modifying the rights of licensees of nonexclusive rights in motion pictures produced pursuant to collective bargaining agreements.
48. *Id.* § 9-320.

§ 1:13.3 Mitigating Secured Creditor Risks

If either (1) a license is exclusive, or (2) the licensee is not a licensee in the ordinary course of business as described in U.C.C. section 9-321, then prior to execution of the license, the licensee should conduct a search for any perfected security interests in the software. While a complete discussion of search procedures is beyond the scope of this chapter, in general the licensee should search in the central filing office in the state where the licensor is organized or has its chief executive office, using the name of the licensor as determined from its organic documents.

If a prior, perfected security interest is found, the customer will need to seek a release from the prior, perfected lien holders. The author has found lenders amenable to this request when the release is narrowly tailored to the specific license agreement at issue.

Whether or not a prior security interest is found, the exclusive or non-ordinary-course licensee should consider filing a U.C.C. financing statement against the licensor describing the licensed software and checking the "Licensee/Licensor" box to indicate the nature of the transaction. After the filing of such a financing statement, any subsequently perfected security interests would clearly not take precedence over the software license agreement. If no such financing statement is filed by the licensee, the licensee would usually prevail anyway over the vendor's subsequent secured lender on the theory that the vendor's rights in the underlying software were encumbered by the license prior to the time the secured lender's security interest attached. However, in certain cases arguments could be made that the licensee's right should be recharacterized and treated as merely a security interest, and since that interest would otherwise be unperfected, a filing would be necessary for the licensee to have priority.

In some circumstances, it may make sense for a customer to obtain a security interest to secure the obligation of the vendor to perform under the contract.[49] If the licensee perfects its security interest and obtains first priority, it will have rights over all other creditors.[50] Hence, if the licensee is first to file or perfect its interest and later a different creditor attempts to foreclose on the asset, the junior creditor's rights to foreclose will be subject to the licensee's rights in the collateral. Additionally, because article 9 allows the parties to define what "default" means,[51] the security agreement may allow default upon any rejection of the license and provide the customer with additional remedies to pursue if its use is interrupted in any way. There is always some difficulty in

---

49. *Id*. § 9-109.
50. *See generally id*. §§ 9-317, 9-322.
51. *Id*. § 9-601 cmt. 3.

securing a nonmonetary obligation, because a court generally is not required to award specific performance and damages may be difficult to determine. However, that problem exists whether or not the license obligations are secured and a security interest affords significant protections should the vendor become bankrupt.

§ 1:14 Other Provisions

§ 1:14.1 Force Majeure/Disaster Recovery

Force majeure provisions should be combined and coordinated with disaster recovery obligations to ensure the customer is getting the disaster recovery or business continuity services it is expecting. Furthermore, even customers not purchasing business continuity services would be wise to pay attention to the boilerplate language of the force majeure clause. The clauses are frequently overbroad and should be tailored as appropriate. Additionally, customers will often want an exception stating that the clause will not excuse a failure of a service provider's own backup plans.

§ 1:14.2 Price Protection

If the relationship involves periodic payments over an extended period of time, the vendor will want the freedom to raise prices in the future rather than be locked in to the current pricing indefinitely. The customer in this circumstance will want to seek some form of price protection, such as a period for which no increases are permitted and thereafter that increases may be made only annually, and then only up to a maximum amount. These limiting amounts can be based on a percentage of the current pricing, COLA-type external percentages, or a combination of both (and either the greater or lesser of these percentages).

§ 1:14.3 Export Regulations

The export of computer hardware, software, and technical data is generally subject to the export laws of the United States and other countries. Prudent vendors frequently include in their standard forms a provision requiring the customer to comply with all applicable export laws. These provisions are generally fairly comprehensive, and the following is a sample:

> <u>Export Regulations</u>. Customer must fully comply with all applicable export laws, including U.S. law, and must not directly or indirectly export any computer hardware, software, technical data, or derivatives of such hardware, software, or technical data ("HSoTD") or re-export or permit the shipment or transfer of

> same: (i) into (or to a national or resident of) Cuba, Iran, Iraq, Libya, North Korea, Sudan, Syria, or any other country, destination, or person to which HSoTD would be prohibited by the United States, such as but not limited to anyone on the U.S. Treasury Department's List of Specially Designated Nationals, List of Specially Designated Terrorists, or List of Specially Designated Narcotics Traffickers, or the U.S. Commerce Department's Denied Parties List; or (ii) to any country or destination for which the United States requires an export license or other approval for export without first having obtained such license or other approval. The provisions of this Section will survive the expiration or termination of this Agreement for any reason.

These provisions may or may not be appropriate under the circumstances, and customer counsel should review them carefully for compliance risks.