Be Wary of Certain ISV and Embedded Software Agreements

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It is common for software solution providers to use third-party products to support the functionalities those providers have developed for their solutions. For example, a network-monitoring solution may incorporate IBM Cognos functionality, or an accounting solution may incorporate a Microsoft SQL Server database. Increasingly, in today's market, those solutions are hosted over the Internet, and many software publishers maintain licensing models targeted to solution providers operating in that space (such as Microsoft's Services Provider License Agreement, or SPLA). However, many businesses still prefer on-premises solutions for their business-critical IT solutions, and vendors of those solutions need to be able to accommodate those preferences.

The two principal options for those vendors are:

1. Reselling or otherwise separately procuring on their customers' behalf the appropriate kind and quantity of licenses to support the third-party software components incorporated in their solutions, and then deploying the solutions and all required third-party components on the customers' networks, OR

2. Shipping a complete solution to their customers, with all required third-party components embedded at the factory.

In most cases, the first option is relatively simple to incorporate into the procurement process. However, it often may entail more up-front labor and service charges, since the vendor typically will need to support intensively (if not manage) the implementation of all solution components at customers' locations. For that reason, many vendors are understandably interested in a more turn-key approach, where they can simply ship a packaged product to their customers and then support the implementation remotely. Unfortunately, most off-the-shelf license agreements pertaining to those third-party software components do not allow a solution provider to redistribute the software to end users for a fee. For that, it usually is necessary to enter into a market-specific ISV or royalty agreement.

Under that kind of an agreement, the vendor obtains the right to embed and redistribute specified software components for use in connection with specified solutions, in return for a fee that is typically calculated based on the number of units shipped or the number of users provisioned to use the solution. In theory, that kind of an agreement seems to be reasonable and appropriate, but, as so often is the case, the Devil lurks in the details:

• Narrow Usage Restrictions – In most cases, software licensed under an embedding agreement may be used exclusively in connection with the vendor's solution and for no other purposes whatsoever. In practice, this may mean that the vendor needs to build its solution to prevent non-compliant usage, which in some cases may be incompatible with how the solution is designed. If that is the case, then the vendor would need to include similarly narrow usage restrictions in its agreements with its customers, and those terms may not be warmly received by prospective customers' legal departments.

• Defined User Agreements – On that point, the embedding agreements also may include a laundry list of terms that the vendor is required to include in its customer agreements. Those terms almost always are written to be maximally protective of the software publishers' interests and almost never are particularly palatable to end users. However, absent an amendment to the embedding agreement, the vendors must consider them to be non-negotiable when discussing transactions with new customers.

• Audit Nightmares – Worst of all, many embedding agreements contain audit-rights clauses that give the software publishers not only the right to conduct audits of vendors' records and facilities, but also the right to audit the vendors' customers' compliance with the license terms. Some of those agreements also give the publishers the right to extract licensing fees and audit costs from those customers in the event that non-compliant usage is discovered. In practice, this means that vendors must draft their customer agreements to permit similarly broad and far-reaching audit activity. However, effectively preventing serious or perhaps irreparable damage that could result to the vendor-customer relationship following such an audit is an extremely difficult goal to achieve in any customer agreement.

For all of the above reasons, vendors considering any kind of royalty ISV or other embedding agreement need to carefully scrutinize the terms of such agreements and then carefully consider whether they are willing and capable of satisfying all of the obligations those agreements typically entail. If there is any doubt, it may be far more sensible to undertake a more labor-intensive licensing strategy than to invite the sort of lost business and licensing exposure that can result from non-compliance with controlling agreements.