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IT Governance & Disputes—How to Survive Problematic Audits and Third Party Licenses?

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Introduction

In this article we will provide experiences from recent IT disputes and tools for handling various technology licensing claims related to breaches of contract and copyright infringements after license audits. We also focus on negotiation points regarding third party and standard software licenses that could be used to prevent any problems in advance.

We also look at these issues from the perspective of a listed company and provide guidance when an IT dispute could “materially affect” the value of the company's securities and try to provide assistance when an IT dispute would have Securities Law consequences.

In summary, we claim that it is possible to save significant amounts of money in IT disputes by proper preparation and preliminary measures taken into account in the drafting phase. Finally, we provide a list of key recommendations for IT audit-specific cases to help you navigate through the main risks.

Industry Trends affecting Technology Licensing

There are several reasons why IT vendors have recently been more aggressive in enforcing their licensing policies. Naturally, the economic situation is one of the most significant factors. Also several studies suggest that requests from IT vendors to perform audits are likely to increase in 2011-2012.

It should also be noted that one general industry trend seems to be that there is less room for negotiating standard software licenses, and it is more or less a question for a customer whether to choose a specific software component for a project or not. In this new paradigm, the license terms are merely one factor affecting the final decision rather than a standard starting point for negotiations. This development seems to increase licensing deficit risks as it is just these negotiations that ensure that actual commercial licensing matrix is in compliance with the technicalities of the business case.

Also organizational restructurings, mergers and acquisitions, as well as trends regarding multi-sourcing, the use of private clouds or centralization of IT assets and personnel to separate legal entities for the purposes of providing group-wide IT services (service bureau; SaaS) may have resulted that old license agreements might not be in compliance with the actual legal organization, there might be too few licenses in terms of user amount or licenses are otherwise correct but for a wrong purpose (e.g. limiting possibilities to use licenses for service bureau). These situations we call here license breaches or license deficits.

The Typical Story after License Audits

One hypothetical case could be that after an audit, the IT vendor claims that the back-up environment of Customer Ltd, a publicly listed Finnish company, that was used in connection with environment transition work was not properly licensed and due to such license deficit, the IT vendor requires customer to pay, e.g. X k€ for the lack of appropriate licenses and Y k€ for the unpaid maintenance. We can also normally assume that at least in the first proposal these payment obligations are calculated retrospectively making the total sum exceptionally high.

If this case does not sound familiar, we can easily adapt these facts to a case where additional software components were found from the servers of the Customer Ltd which were not originally purchased (or even wanted) by the customer, or there might be a situation that Customer Ltd's own supplier that provides SaaS-based services does not seem to have valid third party licenses for its operations.

If we return to our hypothetical case, the other facts of this case could be, for example, the following:

- During 2008, both the IT vendor and Customer Ltd were engaged in negotiations concerning licenses that the customer needs to acquire for its IT environment.
- Based on these negotiations, Customer Ltd acquired licenses after having received a license recommendation from the IT vendor's sales manager.
- We can establish that there have been discussions in 2008 on the back-up environment, but we are not able to show evidence as to how long such back-up environment would be operational or as to whether it has been the intent that no separate payment should be accrued. However, this transition work or failover was known by the IT vendor at the time when the IT vendor gave its license recommendations.
- The agreement contains an express provision on failover environment (back-up environment) stating that any use of failover environment exceeding twenty (20) days must be separately licensed.
- We can assume that disputes will be finally resolved in the District Court of Helsinki and the governing law is Finnish law and that agreement contains a limitation of indirect damages for the benefit of customer.

Specific Issues in Transitional Work

One important issue that seems to be missing from many even large-scale IT procurement agreements is a clause that makes it possible for the customer to temporarily exceed the agreed license amount for the purposes of performing, e.g., transitional work regarding changes in IT environment. Another typically problematic clause is limitation to specific hardware or platform, but this is not discussed here further.

Partly this can be solved by choosing a licensing matrix based on user amounts as the number of effective users still naturally remains at the same level despite such transitional work. It should also be noted that even in this case there might be so-called "fail-over clauses" addressing or limiting the customer's possibilities to use back-up environments, like, transitional periods requiring payment of additional license fees after a specific number of days.

When does an IT Dispute Have Securities Law Consequences?

An IT dispute can have securities law consequences either (i) as a litigation that has to be disclosed or (ii) another matter that has a material impact on the company, its cash flow or prospects. As a general rule, all circumstances and decisions that may have material impact on the value of the Company's securities need to be disclosed without undue delay. Breach of the disclosure rules may lead to damages liability, official warning, fines or imprisonment as the worst case scenario.

The evaluation of the significance of the matter is always made beforehand. Therefore, the company needs to have a strategy or a disclosure policy how to administer disclosure e.g. in relation to IT disputes and claims. As securities law issues need to be resolved on a case-by-case-basis, only some general rules can be given to aid the decision-making.

First, the company's disclosure policy needs to be consistent; if you have disclosed similar matters previously, you must also disclose them now. Second, if the IT system is critical to the company's operations, the monetary value of the dispute may not be the real concern but, instead, the disruption to the company's on-going operations. Third, you should not disclose too early on. A potential dispute does not normally have to be disclosed prior to actual filing of the case – in uncertain situations disclosure may create more confusion than clarify issues. Fourth, the company should note how the investors have reacted to previously disclosed information and how they will likely react considering the business that the company is in. Fifth, if payment liability is likely, it may affect the company's profits and cash flow. This may require issuance of a revised profit forecast. However, this route is not often advisable, as it might be construed as admittance of the potential liability.

If the potential impact is material, and the issues are being negotiated prior to the settlement or filing of the case, the parties should ensure the confidentiality of the matter and the negotiations. This should preferably be structured as a "transaction-specific insider register". However, it should be noted that the disclosure should be made at the latest if the official procedure is commenced.

Customer Toolbox for Solving Audit-related IT Disputes

In our hypothetical case, the IT vendor who has performed the audit could have two possible avenues for remedies. The IT vendor could argue that Customer Ltd has committed a breach of contract and is therefore liable for damages, or it could argue that there is merely an infringement of IT vendor's copyrights as the additional use was unlicensed and therefore the IT vendor would be entitled to compensation under the relevant sections of the Copyright Act. We look at these two cases separately.

Breach of Contract

If you face a breach of contract claim from your IT vendor, then, for example, the following arguments could be used to support Customer Ltd's case:

- Interpretation of the agreement under Finnish law is also subject to general contractual principles and in one form these are illustrated in the Finnish Sale of Goods Act, which is not, however, directly applicable to licensing.

Despite the exact wording of the agreement, the intent of the parties is the most relevant factor.

- It could be conceivable to argue that it was the intent of the parties that the agreed price already included the transitional period and utilization of back-up environment during such time as this transition work or failover was known by IT vendor as outlined above and the sales manager gave their license recommendations accordingly.
- In the Sale of Goods Act, the seller (in this case the IT Vendor) has notification obligation to the buyer (in this case Customer Ltd) on issues that may affect the trade and this obligation is actually legally "stronger" than Customer Ltd's obligation to investigate whether there this situation is properly covered by a license or not. Therefore, we could also argue that if any separate payments concern such transition or failover, such terms should have been brought expressly to the attention of customer especially if the Customer Ltd put an emphasis on that in the negotiation phase.
- Under Finnish law, it is widely held that the parties can create an "implied agreement" by their conduct and business practice (e.g. clarifying the content of the original agreement). Therefore, there might be such a term implied into a contract that there is no payments arising out of transition work.
- The actual sizes and negotiation position of the companies are not specified, but in some cases it could be possible to argue that if these sums are exceptionally high that these additional payment terms for fail-over are onerous and strict provisions in standard terms and that Finnish law requires that such terms be separately notified to the contracting party in order to incorporate such terms as part of the agreement or it could be argued that additional payment terms are unreasonable under the Contracts Act S.36.
- Under Finnish law, all claims must be made within a "reasonable time," and therefore, even if this claim would be valid, IT vendor itself should have notified Customer Ltd on any payments regarding transition work or failover. IT vendor has not done so within a reasonable time, and therefore it has lost its right to claim compensation as outlined in your Report.
- However, when lost profits are excluded from liability, IT vendor has to limit its damages claim to direct damages and naturally this is something significantly less than "list fees" for missing licenses.

In a real life situation, we also need to take into account the arguments that weaken our case, such as express wording of the agreement and the fact that both parties may be in equal position in this case as to size and legal competence resulting in that courts are hesitant to apply reasonableness argumentation in a business-to-business environment.

Copyright Infringement:

If you face a copyright infringement claim from your IT vendor, then, for example, the following arguments could be used to support Customer Ltd's case:

- If the case would go to the court, it may be difficult to say in advance whether an issue is classified as a contractual matter or as copyright infringement. This issue is relevant as it determines also the available remedies that an IT vendor can actually claim form the Customer Ltd.
- While this is an open legal issue, our standpoint is that this case should most probably be classified as a contractual matter, and therefore there is an increased litigation cost risk for the IT vendor (this is also reflected in Swedish case law, see for example, T-21342-02). Moreover, while this issue is open it is also possible to argue that copyright issue is not relevant at all as this is a contractual matter (i.e. whether Customer Ltd has committed a breach of the original agreement).
- On the basis of copyright infringement, IT vendor could be entitled to "reasonable compensation" and other damages if it can prove negligence or

intent. The amount of reasonable compensation could be significantly lower than the amount of payments required by the IT vendor (excluding maintenance as there is not breach of copyright, for example). In other words, in many cases it is possible to argue that if there is deemed to be a copyright infringement, then IT vendor's requirements for monetary compensation are incorrect and too high as those monetary requirements are typically not based on Copyright Act.

Legal Drafting Points for 3rd Party Software

Consider the differences between the following clauses from liability and agreement's interpretation preference clause's perspective:

"If the delivery contains Software owned by the Supplier or a third party, and the terms of license differ from those specified in Section [X], such Software and the terms of license shall be specified in Annex X."

"If the delivery contains Software owned by a third party, terms and conditions solely applicable for such Software shall be specified in Annex X."

"If the delivery contains Software owned by a third party, such Software and the terms of license shall be specified in Annex X. Notwithstanding the fact that such terms are attached to this Agreement, the Supplier shall ensure that the Customer shall have the right to use such Software for the intended purposes of the System and that the Software …"

** The main issues relate to supplier's overall liability whether it is governed by the main agreement (e.g., warranties, indemnities and only license terms are different) or whether the supplier completely "washes his hands" from any issues relating to third party software. In some cases it may be necessary that the supplier does not take any liability for third party products, but it is often forgotten point that then it requires license agreement audit from the customer to ensure that such third party products can be used, e.g., for the customer's business purposes as part of the larger IT system.*

Some Conclusive Remarks

- It is possible to argue that the risk that IT vendor will raise an official claim against customer in Finland is in practice relatively low (as generally IT vendors have not been very aggressive in the implementation of their licensing policy in the Finnish markets in the past). Of course this is not to say that this could not happen.
- However, if such claim is raised and an IT vendor is able to present convincing calculation of damages, then the customer must reconsider its position. According to our experience, in many cases these "post-audit notifications" are merely presented to gain additional revenues without actual legal justifications.
- If there is a real claim, of course Customer Ltd should pay as it is a reputable company and this is also a good argument to use in real negotiations, but at this stage, we would be inclined to recommend that Customer Ltd continues to contest both the grounds and amounts presented by IT vendor to be paid for the back-up environment of customer.
- Even if additional payment requirements are not fully waived by IT vendor, arguments supporting the reduction of fees are outlined above, which at least hopefully enable you to reach a reasonable compromise.
- Do you have any questions, comments or objections?

Checklist for Avoiding Pitfalls in Advance

Appropriate contract clauses covering third party software (consider different options above).

If third party components are licensed "under the applicable terms" or similar, ensure compatibility of these license terms with the purposes of the system subject to procurement and also consider liability issues in worst case scenarios (so-called "Customer License Audit").

Ensure the IT vendor's knowledge and understanding of IT architecture keeping in mind that the sales person may not have sufficient technical background.

Try to get express contract clause that the vendor has reviewed your IT environment and allocated the licenses accordingly.

Even an e-mail confirmation that vendor's licensing model corresponds to your IT architecture may prove to be very valuable as under Finnish law it is the intent of the parties that is relevant in case of interpretation of the agreements.

Ensure free allocation of licenses within the group if this can be done with reasonable costs as licenses tend to be forgotten in corporate restructurings.

Pay attention to limitations for hosting, outsourcing, service bureau and M&A situations and need for notifications and try to get a waiver for additional payments.

Save all e-mails and file these so that despite the employee changes, such documents can be easily retrieved.

If you must pay, ensure written settlement agreement for all these cases before making any payments or otherwise you may soon face the same case again.

Settlement agreements are in these cases typically pro-competitive, but as always, limitations imposed by competition law should always be taken into account.

**** JL