

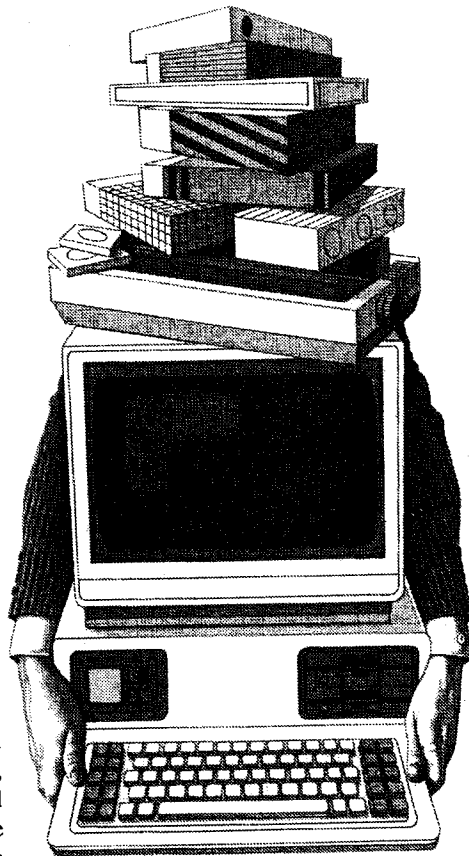
# Contracting for Computer Equipment, Software and Services

In today's business and professional world, the computer is everywhere. Lawyers use computers; clients use computers; and in order to acquire the necessary equipment, software, and services, they all have to enter into contractual relationships.

The decision to acquire a new computer, or upgrade an existing system or software, is one fraught with technological complexity, economic analysis and legal considerations. In order to evaluate the legal aspects of the transaction, and properly counsel clients, the attorney must be thoroughly familiar with the contractual areas involved. In this article, I will discuss from my own personal viewpoint some of the legal and practical considerations that should be addressed by the prospective user who is ready to take the step to acquire computer equipment, software and services.

In more than a dozen years in practice representing computer vendors and users, I have seen many contented vendors and many satisfied users. On the other hand, I have also seen many irate vendors and many disgruntled, disappointed users. The single biggest source of problems between the buyer and seller is simple misunderstanding between the parties. However, misunderstandings are not inevitable; they can be prevented if the parties are properly prepared.

The purpose of contracts and contract law is to reach a meeting of the minds between the parties. So many of the problems commonly encountered by the computer buyer, particularly the inexperienced user, can be eliminated if only he knows what questions to ask, takes the time to obtain satisfactory answers, and acts intelligently upon his newly gained knowledge. This article will provide some helpful information that can be used by the customer when first approaching a vendor about buying or leasing a computer system.



by David Ellis

## Preliminary Matters

From the first, every potential buyer should heed the Latin phrase "caveat emptor," or buyer beware. The vendor is not in business to protect the customer; he is in business to sell computers. Often the seller's interests coincide with the buyer's, in which case both parties are satisfied (or sometimes dissatisfied). At other times, however, there is an adversarial relationship; thus, it is up to the buyer to induce the seller to share his interests and his risks in order to provide an incentive for the vendor to do everything in his power to make the newly acquired computer system work.

In the prepurchase period, the buyer should attempt to find out all he can about the seller's products. A reputable seller will likewise attempt to find out a great deal about his customer's business in order to fashion a suitable system. Once the hardware has been configured and the software chosen, a period of negotiation will follow regarding price, delivery and terms and conditions of sale. These terms constitute the contract regardless of whether they are concluded by handshake, letter, purchase order, single page fine print sales order, or 40-page single-spaced contract with multiple exhibits.

The buyer, if smart, and the vendor, if reputable, will enter into a written contract for the purchase of the system. Everything relating to the purchase should be set forth in writing, including terms of payment, delivery schedules, and warranties and service obligations of the seller. The specific equipment, with model numbers and unit prices, should be stated, as well as accurate descriptions of the software, including pertinent modules, type and size of media, and documentation.

I recommend that the parties attach all requests for proposal, proposals, brochures, data sheets, specifications, descriptive literature, letters and memos relating to the purchase of the system to the contract, or to incorporate specifically and accurately these documents into the contract by reference. Often the buyer is, or believes he has been, promised that the system will perform certain specific functions or that peripheral equipment will run at particular speeds or data throughput. Later the seller says that he never said it, or that he qualified or conditioned it, or that his salesman was unauthorized to make the representations.

The buyer should ask as many questions as he can think of and insist on

answers he can understand. The time to clarify any misapprehensions is before the system is installed and the buyer finds that it does not work the way he thought it would. He should not let the vendor snow him with buzz words—if he does not understand the vendor, he should say so and ask him to explain it again slowly.

### Specific Provisions

A number of specific provisions should be examined carefully and understood by the buyer before proceeding. Among the most important are the seller's warranties. For example, the buyer should determine what warranties the seller is providing, whether they are his alone, or whether he is simply passing through warranties of the manufacturer.

What is the duration of the warranties? When do they begin? What do they cover? Some warranties cover parts and labor, while others cover only parts. Some cover on-site service without charge, while others require the buyer to ship or carry in the unit for repair. Are loaner units available to minimize downtime? What are the seller's policies and charges for providing maintenance service after expiration of the initial warranties?

Another critical point to consider is the payment schedule. Generally, I advise the buyer to pay in installments with as little up front as possible, and to hold something in reserve until the end. Most vendors will ask for a substantial down payment, usually upon placing the order and signing the contract to cover equipment acquisition costs. This practice is normally quite legitimate. By the same token, there is no reason the seller should get full payment in advance, particularly for a computer system that may need a certain amount of testing, adjusting and even modification after installation.

In structuring a payment schedule, some portion of the price should be paid when the system is ordered, more when it is delivered and/or installed, and the balance paid upon system acceptance. Acceptance does not occur when the vendor delivers the box, plugs it in, and lights start flashing. Acceptance means that the system is operating when it is processing the customer's data the way it was represented by the seller.

Before the system is delivered, even before the contract is signed if possible, the parties should sit down and establish acceptance criteria, *i.e.*, a detailed specifica-

tion of what the system should be able to do and the functions it will perform. A reasonable period of time after installation should constitute the acceptance test period, during which time the system will be tested against the acceptance criteria to determine whether it meets the specification.

Typically, the buyer will operate a new computer system in parallel with his current system, be it manual, time sharing/service bureau, or existing computer. Only after he establishes that the new system functions without error during the entire acceptance test period, say 30 or 60 days, and that it is capable of replacing the current system, should the buyer pay the final installment. The reason

(to honor his warranties and provide service). Furthermore, there will often be a "hell or highwater" clause under which the third party's right to receive payment is transferred to him free of all defenses, setoffs, or counterclaims that the customer may have against the vendor for failure to provide service under the contract. The customer is thus required to pay every month come "hell or highwater" which means, in effect, that even if the computer system is completely inoperative the customer is still obligated to make payments every month.

Anyone who is thinking of leasing or buying a computer on an installment basis should read the contract carefully for assignment clauses containing such lan-

**Before the system is delivered, even  
before the contract is signed if possible,  
the parties should sit down and establish  
acceptance criteria**

is obvious—until final payment, the seller shares the buyer's interest in having a properly functioning system, since not until then will he get paid.

Sometimes a customer finds it advantageous to lease a computer system or buy it on an installment basis instead of buying it outright. One common arrangement is called a full payback lease or lease/purchase by which the customer makes monthly payments and takes title at the end of the term, sometimes with a relatively small additional final payment. This type of arrangement is not a true lease, but rather an installment sale. With either the standard operating lease or the full payback lease, there is at least one potential pitfall of which the customer should be aware.

Frequently in a lease or installment sale, the vendor transfers his ownership interest in the equipment and software to a third party, usually a financial institution such as a bank or an independent leasing company. Typically, there will be language in the contract permitting the vendor to assign his rights (to receive lease payments) but not his obligations

guage. Contracts are not cast in concrete, and a vendor may be willing to strike the language and retain the lease himself in order to make the deal. Here, as in many other areas of law and life, it does not hurt, nor cost anything, to ask.

### Software Acquisition

Software acquisition is essentially similar to hardware acquisition but with certain additional areas of concern that must be considered. Software is usually not purchased outright, except in the limited case of custom programming which is discussed later in this article. Instead software is licensed to the user by the owner, who is usually the author and developer of the software and may be a one-man programmer writing on a microcomputer in his garage, or a large corporate software house employing platoons of programmers on large scale computer mainframes.

Licensing means that the software owner retains all ownership rights to the programs, and only gives the user, or licensee, the right to use it on his computer, usually on a nonexclusive and

nontransferable basis. The typical license agreement restricts the user from disclosing the programs to other persons, using it on more than one computer without paying additional fees, or making copies, except perhaps one copy for archival purposes as a backup in the event of loss or damage to the disc or tape. (For a discussion of the legal basis for licensing and protecting software, see "Computer Law— A Primer on the Law of Software Protection," 60 *Florida Bar Journal*, No. 4, pp 81-84 (April 1986).)

Before signing a license agreement to obtain a particular set of programs, the potential licensee should determine needs very carefully. He should view the software in action, on the vendor's machine if possible, and better yet, at the site of a satisfied user who is actually running real data through the system. One of the problems with simply viewing a demonstration package at the vendor's facility is that often the demo data base is very limited and does not necessarily give a valid picture of the speed and efficiency of the software when all of the user's customers, suppliers, and employees are up and running on the system. If the vendor's references are checked closely, these potential deficiencies may be identified in advance, as well as the vendor's abilities regarding technical assistance, software support and general customer relations.

In acquiring software, the potential licensee should understand precisely what he is obtaining. At the minimum he will be getting object code, the machine language processed by the computer from the disc or tape supplied by the vendor. Object code is necessary to run the computer system, but it may not be sufficient, at least not for very long. The user may also require source code, *i.e.*, human readable code which the programmer uses to write the program and from which the object code is derived. Common languages which programmers use to develop source code are BASIC, COBOL and FORTRAN.

The reason for the necessity of source code is that a user's needs change over time but computer programs do not. A particular program may be satisfactory today to process all of a business' payroll, accounts receivable and general ledger, but may not be adequate in six months when the business has grown. If the user has only object code, he cannot expand his system with his business, but is at the mercy of the owner of the source

code to modify the software for him. Therefore, it is advisable for the licensee to ask for source code with the object code, and to pay extra for it if necessary, in order to have the ability to modify the software or have a qualified programmer do so to meet the changing needs of the business.

Not every software vendor will willingly part with his source code, since to do so makes available to others what he may regard as a valuable trade secret. As noted above, some vendors charge extra for the source code, and include very restrictive conditions and penalties for disclosure in the license agreement. Others refuse to make it available at all to users, in which case it is recommended that the licensee require the owner to place the source code in escrow.

In an escrow arrangement, the software owner deposits the source code (and regular updates) with a bank or other reputable third party who acts as escrow agent with instructions to release the code to the user in the event the owner goes out of business or otherwise fails or refuses to support or modify the software. In this way, the licensee is assured of access to the current version of the source code in the event the owner is unable or unwilling to modify the software.

#### **Custom Software**

Custom software consists of specialized programs and modifications and enhancements to existing programs, written by a programmer to perform a particular application on a one-time "custom" basis. Before a prospective user proceeds to negotiate with a programmer to write a custom package, he should first step back and ask a very basic question—is

a custom program really necessary to accomplish the task at hand?

These days, with a variety of off-the-shelf packages available for a host of different applications, the user should undertake a diligent search to determine whether existing programs can be obtained to fulfill his requirements. The advantages of "ready-made" are obvious—as a rule they are less expensive, better documented, pretested and debugged and, of course, immediately available. Sometimes, a canned package comes close to meeting the user's needs, but requires certain changes to satisfy his requirements fully.

In such a case the best course of action might be for the user to contract directly with the software developer to write the modifications or enhancements—after all, it is the developer who is most familiar with the package and is in the best position to make the desired changes efficiently and expeditiously. However, when the software developer is in a distant city, it might be desirable to have a local programmer familiar with the user's business make the changes or extensions to the software. In the latter case, the user must obtain from the owner of the software the source code and the right to have an outside programmer modify or enhance the program.

Once custom programming is determined necessary, the user and the programmer should get together to write a clear and comprehensive contract, statement of work and specification. Among the areas they should address are hardware requirements (type of computer system and peripherals), operating system and programming language, input requirements (format, speed and error detection),

### ***The Journal Invites Manuscripts***

The Florida Bar *Journal* Editorial Board encourages Bar members to submit articles on evolving issues in Florida law for possible publication.

Analysis, opinion, and criticism of the present state of the law are also encouraged as long as such analysis is accompanied by sufficient legal authority on all sides to enable the reader to assess the validity of the opinion.

Articles should be typed on eight and one-half by 11 inch paper, double-spaced with one-inch margins. Citations should be consistent with the Uniform System of Citations. Articles should be no longer than 18 pages, including footnotes, and will be reviewed by members of The Florida Bar *Journal* Editorial Board.

Manuscripts may be submitted to Managing Editor, The Florida Bar *Journal*, Tallahassee, FL 32301.

operational performance (run time, response time), output requirements (format and content of video displays and screens and reports generated), and documentation (instructional manuals—are they “user friendly?”).

Structuring the contract in two phases is one approach to consider. In the first phase, the programmer develops an outline of the project, analyzing the user's need and providing logic diagrams, flow charts and subsystems. Once these are agreed upon by the user, they would be incorporated into the contract specification, and the programmer would proceed to the second phase in which the actual programming and documentation would be generated.

As the programmer proceeds with the project, the user should have the ability to monitor his progress, including the right to inspect his work at specified intervals. In the event the programmer abandons the project or is performing unsatisfactorily for a period of time, the user should have the right to terminate the contract for default, and take over the work, including hiring a new programmer to complete the project. For this reason, it is critical for the user to remain close to the project and have the right to obtain all source and object

code, flow charts and logic diagrams, and documentation generated up to the time of default.

A payment schedule should be established by which an overall contract price is agreed upon, with the programmer receiving payments in installments upon the completion of specified milestones. The final installment of the project should be paid, not just when the code and documentation are delivered, but when the software has been accepted by the user as meeting all requirements of the contract.

A comprehensive acceptance test plan should be agreed to by the parties in advance of the project and made a part of the contract. Test and live data should then be run through the system in accordance with the test plan for an acceptance period running at least 30 days and as many as 90 days or more. If the system continually meets the requirements of the plan for the specified test period, the system is deemed accepted, and the final payment is made.

Once the software is accepted, the programmer's obligations are not necessarily at an end. A warranty should be included in the contract by which the programmer agrees to assist the user for a specified period, say 90 days, six months, or a

year, in debugging the program and correcting errors or other deficiencies that arise during the operation of the system. Consideration should be given to an extended warranty or service contract under which the programmer, for a fee, would agree to be available for continued error correction, program enhancement, modification and support.

A final consideration to be addressed in the contract is the ownership of the software. Ideally, if the user is funding the project, he should require the programmer to assign to him all rights in the programs, documentation and source material, including the right to copyright the software in the user's name. For this purpose, the contract should make it clear that the software is a “work made for hire,” title to which rests with the user. In some instances it might be appropriate for the user to grant the programmer a license to use the programs for other projects, or to market it, with the user sharing in the proceeds of each sale on a royalty basis as a means of recovering all or part of his costs in the project. □

## FLORIDA BAR JOURNAL ON MICROFILM

Save Space  
Save Money

Volume 1-57 (1927-1983)

\$440.00

16mm, Negative, Diazo Film

*William S. Hein & Co., Inc.*

HEIN BUILDING  
1285 MAIN STREET  
BUFFALO, N.Y. 14209



*David Ellis, Largo, practices computer law, corporations, contracts, and copyrights, trademarks and trade secrets. A graduate of M.I.T. and Harvard Law School, he is a member of the Florida and New York bars and the American Bar Association's sections on Science and Technology and Patents, Trademarks and Copyrights. He is also a member of the Computer Law Association, the Data Processing Management Association, Association for Computing Machinery, and Tau Beta Pi. Mr. Ellis has spoken on computer law, contracting, and the protection of proprietary software to various groups throughout Florida. His new book, A Computer Law Primer, (from which this article is excerpted) was recently published by Sudavel Publishing, Largo.*