

# Bridging the Great Divide

State governments continue to lag behind in their willingness to take advantage of streamlined commercial contracting initiatives.

BY ALLEN SAMELSON AND AARON P. SILBERMAN

Since Congress enacted the Federal Acquisition Streamlining Act of 1994<sup>1</sup> (FASA), the federal government has moved toward terms and conditions in its procurement contracts that are more consistent with those used in the commercial marketplace. More recently, the Department of Defense (DOD) published training guidance to refine its approach to negotiating its contracts' intellectual property rights and to more closely align its practices with commercial transactions.<sup>2</sup> The DOD recognizes that its ability to attract technology development and products from a wider variety of companies depends heavily on its ability and willingness to use commercially-oriented contractual terms and conditions.

In contrast, few state governments have moved toward "commerciality" in contract terms and conditions.

Taking as a benchmark the terms and conditions used by the state of California for acquiring software products, this article compares that state's terms and conditions with those typically used by commercial vendors and those prescribed by the *Federal Acquisition Regulation (FAR)*.

### Commercial Items under FAR

Implementing FASA, FAR 12.301 requires that contracts for the acquisition of commercial items include, to the maximum extent practicable, only those clauses which are consistent with "customary commercial practice" and those required to implement laws and executive orders specifically applicable to acquiring commercial items. FAR 52.212-4 sets forth the contract terms and conditions to be used in commercial item acquisitions.

Because those clauses constitute the baseline terms and conditions for a wide range of different commercial products, FAR 12.302 directs contracting officers to tailor these provisions "to adapt to the market conditions for each acquisition." The provision recognizes that terms and conditions in the commercial marketplace vary significantly depending on

#### About the Authors

**ALLEN SAMELSON** is a shareholder in the San Francisco law firm of Rogers, Joseph, O'Donnell & Phillips, where he specializes in information technology contracts. He is a member of the Silicon Valley Chapter. **AARON P. SILBERMAN** is an associate in the Government Contracts Practice Group of the same firm. Send comments on this article to [cm@ncmahq.org](mailto:cm@ncmahq.org).

the commercial item being acquired.

FAR 12.302(b) sets aside six specific clauses that implement statutory requirements and therefore may not be tailored. Apart from these six clauses, contracting officers are permitted to tailor remaining contract terms used in commercial item contracts. Indeed, in three important areas, namely, the acceptance, warranty, and termination clauses, FAR 12.401 specifically directs contracting officers to determine whether the government's standard terms reflect "the customary practice for a particular market."

There is no standard clause in the FAR itself that mandates specific rights in commercial computer software supplied under federal contracts. While FAR Part 27 directs agencies to develop contract coverage for software rights, the federal agency that makes the majority of the government's software purchases—the General Service Administration (GSA)—has not promulgated standard terms and conditions for software purchase contracts, apart from those purchases made under the GSA Federal Supply and Multiple Award Schedule programs. As a result, unless the purchase is made under a multiple award schedule program, federal contracting officers are left with the general guidance of FAR Part 12 for commercial items acquisitions and FAR Part 27.<sup>3</sup> The extent to which they will actually follow that direction in the context of software acquisitions remains to be seen.

### Comparison of Federal, State, and Commercial Terms

Most commercial software license agreements (SLAs) do not contain specific acceptance or acceptance test procedures. Typically, a commercial SLA will provide that payment is due when the customer or licensee accepts the software or a purchase order for the software, without defining how or when acceptance is to occur. Under the common law of most states, acceptance occurs when the licensee uses the product.

Unlike typical commercial SLAs, the California Model Information Technology Contract has detailed provisions governing software acceptance procedures. Paragraph 17 of the state's General Provisions, titled, "Inspection, Acceptance and Rejection," requires the contractor to employ a quality assurance system acceptable to the state for goods delivered under the contract. The clause further provides that the state will inspect the goods and notify the contractor of rejection within a "reasonable time."

In addition, the contract states that all software—including software initially installed, updated, altered,

plishment of the work for which the equipment was acquired," terminate the contract for default.

The state will not accept software or pay charges associated with it until the software passes the acceptance tests.

According to Paragraph 5 of the California IT Software Special Provisions, the state will be deemed to have accepted the software unless it notifies the contractor in writing within 30 days that the software "fails to conform to the functional and performance specifications" of the contract. Upon receiving such a

**There is no standard clause in the FAR itself that mandates specific rights in commercial computer software supplied under federal contracts.**



or substituted by the contractor for the state under the contract—will be subject to acceptance tests "to ensure that the software operates in substantial accord with the Contractor's technical specifications and meets the state's performance specifications." Unless the statement of work (SOW) says otherwise, the state must perform acceptance testing of software on the first business day after the contractor delivers the software and notifies the state in writing that it is ready for use. If the software does not pass these tests within the time frame specified in the SOW, the state may:

- request substitute software;
- cancel the contract part relating to the unaccepted software;
- continue acceptance testing; or
- if the software is identified in the SOW as "crucial for the accom-

notice, the contractor must investigate the reported deficiencies in the software. The contractor must remedy the nonconformance within the timeframe identified in the SOW. If the contractor does not, the state will return the delivered software and may accept substitute software or terminate all or part of the contract. If the contractor remedies the nonconformance, the state must accept the software. If the state notifies the contractor of a nonconformance when in fact the software does comply with contract requirements, the state must reimburse the contractor for investigation time and material costs.

The federal acceptance clause in commercial contracts is much more streamlined than its California counterpart. While the federal clause reserves the government's right to inspect or test the items, there is no particular requirement for acceptance testing for ordinary commercial products. Thus, the standard FAR inspection/acceptance clause simply directs

the contractor to tender for acceptance items that conform to contract requirements and permits the government to require repair or replacement of nonconforming supplies.<sup>4</sup> The government must exercise its post-acceptance rights within a reasonable time after the defect was or should have been discovered and before any substantial change occurs in the item's condition (unless the change is due to the defect).<sup>5</sup>

While California may not always implement all acceptance procedures included in its Model IT Contract, a contractor will face substantial risks under the state's standard acceptance clauses, none of which are found in the common law or federal clauses. These risks are present even when the state purchases commercial-off-the-shelf and shrinkwrap software under the California Multiple Award Schedule (CMAS) contract. A software manufacturer or re-seller will not encounter similar hurdles under a typical commercial SLA. Consequently, a state contractor's costs in California are certainly higher than a software vendor's in the federal or commercial markets.

### Warranty

Under the standard warranty provision in FAR 52.212-4, the contractor warrants that items delivered are "merchantable and fit for use for the particular purpose described in the contract." These are the standard warranties implied by the common law in the sale of goods. Recognizing that standard commercial practice for the past 40 years has been to disclaim all implied warranties in favor of express warranties, FAR 12.404(b) directs contracting officers to require vendors to offer the government at least the same warranty terms offered to the general public, to the maximum extent practicable. FAR 12.404(b)(2) expressly recognizes that in some markets, it is customary commercial practice for contractors to exclude or limit the implied warranties contained in FAR 52.212-4.

The California Model IT Contract and the CMAS contract require

contractors to provide a much broader warranty. Under both contracts' warranty clause, the contractor warrants that the goods it delivers:

- meet the contract requirements, "including all descriptions, specifications and drawings" incorporated into the contract;
- are free from all defects in materials and workmanship;
- are free from design defects, to the extent they are not manufactured to detailed designs furnished by the state;
- are merchantable; and
- are fit for their intended purposes.

Almost universally, warranty clauses in commercial SLAs are much more limited. They typically provide that the software vendor (licensor) warrants only that 1) the software will perform substantially in accordance with the manufacturer's documentation (as opposed to all contract requirements); and 2) that the *media* on which the software is recorded (as opposed to the software itself) is free from *material* defects in materials and workmanship under normal use. Moreover, it is common for software vendors to specifically disclaim any warranty that the software will operate "error free," that it will run uninterrupted, or that all errors can or will be corrected.

Commercial warranties are also subject to a number of specified conditions, such as: the software was installed on a computer in good operating condition, the defect is reproducible by the licensor, and the defect was not caused by the licensee. The licensee is also required to notify the licensor of the defect within a specified time limit. Finally, commercial SLAs invariably include a disclaimer of all other express and any implied warranties, including the warranties of merchantability and

fitness for a particular purpose.

Obviously, the California State's Model IT and CMAS contracts' warranties are inconsistent with normal commercial practice. Unfortunately for contractors, there is no provision in California state law similar to FASA, which directs state contracting officials to tailor the standard state warranty terms to reflect those customarily found in the commercial marketplace.

### Intellectual Property

Commercial SLAs almost always include several restrictions on the scope of the license granted to the purchaser. These limitations typically include prohibitions against reverse engineering, disassembly, attempts to determine the software's source code, distribution, disclosure, sub-licensing, or transferring any portion of the license to a third party. Commercial SLAs also usually include restrictions against creating derivative works from the software. Moreover, SLAs universally include a clause that 1) recognizes that ownership of all the licensed

**K-Census™**  
**Contract Manager**  
 Contract Management Software

**Fast - Tested - Attractive - Light Load**  
**Reliable - Easy to Use - Customizable**

- Generate reports - Track Vendors
- Automatic Notification of expirations and due dates with advanced tickler system
- Automatic storage of follow-up email
- Encoded data and front-end security system allows *only* authorized access from anywhere
- Store scanned contracts, spreadsheets, anything!

**Before...**



**After...**



Contact: **Griffon Consulting Group, LTD.**  
 520-907-8398

www.k-census.com

rights remains with the software manufacturer, and 2) requires the licensee to ensure that all software copies made under the license will contain the same proprietary notices that describe such ownership rights.

Federal software contracts expressly acknowledge the importance of the licensor's terms in this regard. FAR 12.212(a) requires that the federal government acquire commercial software "under licenses customarily provided to the public" to the extent consistent with federal law and the government's needs. It also provides that the government will not generally require contractors to furnish technical information to the government or provide it with rights "not customarily provided to the public." FAR 12.212(b) further states that the government will only acquire those rights in commercial software that are "specified in the license contained in any addendum to the contract." While federal contracting officers may be reluctant to incorporate an entire commercial SLA due to provisions inconsistent with federal law, on the key terms of the license grant, the FAR defers to the software manufacturer's customary terms.

The California IT model does not take the same approach to these critically important intellectual property ownership provisions. Paragraph 1 of the software special provisions states that the contractor grants the state a non-exclusive, non-transferrable license to use the software products listed in the SOW. The license authorizes the state to use the software "on the computer system located at the site(s) specified in the SOW." Paragraph 6(c), "Right to Copy or Modify," expressly permits the state to modify any "non-personal computer software product, in machine-readable form, for its own use and merge it into any other program material." This clause does restrict the use of any such merged program material to the computers designated in the SOW. But no term in the state's IT contract expressly references the manufacturer's SLA.

### Limitation of Liability

Standard limitation of liability clauses in commercial SLAs provide that the licensee's sole remedy for defective software is to return it to the licensor for replacement or refund if the licensor cannot remedy the problem within a reasonable time. The licensee's recoverable damages are limited to the contract price without exceptions, except as required by law. Some SLAs also provide that the licensor is not liable for the licensee's costs of procuring substitute goods or the costs of cover.

A software licensor's potential liability under a federal contract should be similar to that of a licensor under a commercial SLA. FAR 12.212 provides that the government's rights will be limited to those specified in the license attached to the contract, and FAR 12.301(b)(3) provides that the limitation of liability term in FAR 52.212-4(p) should be tailored and applied in a manner "consistent with customary commercial practice."

The potential liability of a contractor under the California's Model IT Contract, on the other hand, is much broader. Although the contract's "Limitation of Liability" provision states that a contractor's liability is limited to \$200,000 or the contract price (whichever is greater), this limitation is subject to several important exceptions. The limitation does not include:

- indemnity for payments on claims for personal injuries or property damage caused by the contractor's negligence; and
  - damages subject to different limits than those specified.
- The first "cost of cover" exception effectively removes any limitation on the supplier's liability for a contract breach, since it makes the supplier responsible for the state's replacement costs in obtaining substitute software. This is fundamentally inconsistent with the "money-back" remedy provided under the limitation of liability clauses found in most commercial SLAs.
- The other exceptions in the California terms exacerbate the issue for software suppliers. First, the contractor's liability to the state could exceed the contract price; if the contractor fails to deliver the software or a suitable substitute on time, it could be responsible for liquidated damages for each calendar day after the delivery date (up to 180 days). Second, there is no cap on the contractor's liability when the SOW provides for a different damages limitation or where the state law imposes a different limitation or no limitation. Third, the exception for indemnity for costs and damage awards for violations of intellectual property rights will apply under paragraph 36 of the contract's General Provisions if a third party claims that the contractor's goods or software infringes a patent or copyright or violates a trade secret.
- Thus, the potential liability of a contractor under the state's Model IT Contract will be significantly greater than that of a software licensor under a typical commercial SLA or contract with the federal government. For contracts priced at less than \$200,000, the contractor's liability will be "capped" under state contracts at \$200,000, whereas under most commercial SLAs and federal contracts, the cap would be the lower contract price. And, under all Model IT Contracts with the state, regardless of size, there are many
- the state's "cost of cover," i.e., the difference between the contractor's bid price (what the state would have paid had there been no breach) and the state's costs of procuring a substitute for equipment and software the contractor fails to deliver;
  - indemnity for costs and damage awards for violations of a third party's intellectual property rights;
  - claims under any contract provisions that provide for liquidated damages;

potential state claims not subject to any limitation on recoverable damages.

The state's potential liability to the contractor under the state's Model IT Contract is only slightly broader than that of a licensee under a typical commercial SLA or in a federal acquisition. The state is potentially liable up to \$200,000 or the contract price, whichever is greater. This limitation of liability is not subject to any of the exceptions to the limitation applicable to a contractor's liability. The only exception is for claims based on the state's own negligence.

### Consequential Damages

Finally, there may be certain types of damages that either the state or a contractor might be able to recover from the other party under the state's Model IT Contract that a licensee could not recover from a licensor under a typical commercial SLA or federal contract. Under the California contract's terms and conditions, both the contractor and the state are precluded from recovering "consequential damages." Consistent with this clause, the contractor's indemnification obligation does not include consequential damages.

In contrast, a standard limitation of liability clause in a commercial SLA is phrased much more broadly to bar recovery of not only consequential damages but also other types such as indirect, incidental, and special damages. Commercial SLAs typically specify that damages for lost data, lost revenues or profits, loss of goodwill, business interruption, and the like are not recoverable and provide that this disclaimer applies regardless of the legal or equitable theory asserted. Finally, commercial SLAs typically state that this limitation is effective even if the party being sued under the SLA was advised of the possibility of these damages.

While the standard limitation of liability clause for federal commercial item acquisitions in FAR 52.212-4 is worded similarly to the state provision, the federal clause may be tailored in software contracts to

match the more detailed damages disclaimer contained in virtually all commercial SLAs.<sup>7</sup>

It is unclear whether the clause precluding recovery of consequential damages in the California Model IT Contract would be interpreted as broadly as the more detailed and comprehensive disclaimer of indirect damages found in typical commercial SLAs or federal contracts. As a result, there is a risk that the state or its contractors could be subject to greater liability under the state contract than under typical commercial SLAs or federal contracts.

### IP Indemnity

Under the California Model IT Contract, a contractor has a duty to indemnify the state for intellectual property infringement claims for which a licensor would have no duty to indemnify a licensee under a typical commercial SLA or federal contract.

The state's General Provisions paragraph 28 and the General Terms and Conditions paragraph 4 both generally provide that the contractor will indemnify the state from all claims and losses, except for consequential damages, incurred by anyone as a result of the contractor's performance. With regard to intellectual property claims, General Provisions paragraph 36, titled "Patent, Copyright and Trade Secret Indemnity," specifically provides that the contractor

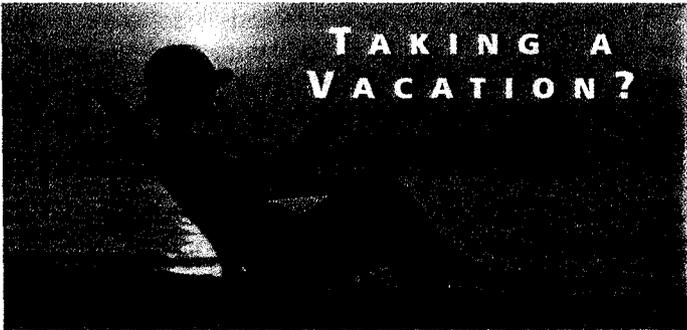
- will indemnify the state from liability, including costs and expenses, for "infringement or use of any copyrighted or uncopyrighted composition, secret process, patented or unpatented invention, article or appliance furnished or used in connection with the contract;"
- may be required to furnish the state with a bond against such liability; and
- will defend any action against the state "based upon a claim

that the goods or software supplied by the contractor or the operation of such goods pursuant to a current version of contractor supplied operating software infringes a United States patent or copyright or violates a trade secret" and will pay any costs or damages awarded in such an action.

The contract further states that in the event that the contractor determines the goods or software it has provided under the contract "are likely to become the subject to a claim of infringement of a United States patent or copyright or a trade secret," the contractor can either procure for the state the right to continue using the goods or software or replace or modify the goods or software so they are non-infringing.

Even though some subparts of General Provisions paragraph 36 are limited to violations of United States patent and copyright laws, other parts of that paragraph are not. Consequently, it is unclear whether a contractor would be required to defend and indemnify the state against actions for alleged violations of other countries' intellectual property laws. Of course, it is virtually impossible for a contractor to monitor or effectively protect against IP infringement claims on a worldwide basis.

In contrast, typical intellectual property indemnity clauses in commercial SLAs provide that the licensor will indemnify the licensee only for claims of infringement of United States intellectual property laws. And, while FAR 52.212-4(h) contains a clause stating that a contractor will indemnify the federal government for infringement of "any United States or foreign patent, trademark or copyright" arising out of the contract work, this clause is only to be incorporated into federal contracts to the extent that it is "consistent with customary commercial practices." This clause also may be tailored by the contracting officer under FAR 12.301(b)(3). In a



## TAKING A VACATION?

BE SURE TO TAKE ALONG NCMA'S

### BOOK OF THE MONTH

FOR EASY ORDERING, VISIT NCMA'S WEB SITE, [WWW.NCMAHQ.ORG](http://WWW.NCMAHQ.ORG), AND CLICK ON THE [AMAZON.COM](http://AMAZON.COM) LINK IN THE LOWER RIGHT-HAND CORNER. WHY GO THROUGH OUR WEB SITE? BY ACCESSING [AMAZON.COM](http://AMAZON.COM) THROUGH OUR SITE, YOU GIVE NCMA UP TO 15 PERCENT OF REFERRAL FEES PLUS NEW CUSTOMER BONUSSES! THIS MEANS MORE SCHOLARSHIPS, SEMINARS, AND MEMBER SERVICES FOR YOU! FOR MILLIONS OF BOOKS, CDs, VIDEOS, KITCHEN AND GARDEN ITEMS, TOYS, GAMES, AND ELECTRONICS, VISIT [WWW.NCMAHQ.ORG](http://WWW.NCMAHQ.ORG), AND CLICK ON THE LINK TO [AMAZON.COM](http://AMAZON.COM). IT'S AS EASY AS THAT!



#### RECOMMENDED READING



**LIGHTNING IN A BOTTLE:**  
**PROVEN LESSONS FOR LEADING CHANGE**  
BY DAVID H. BAUM



**PERSUASIVE BUSINESS PROPOSALS:**  
**WRITING TO WIN CUSTOMERS, CLIENTS,**  
**AND CONTRACTS** BY TOM SANT



**INFORMATION TECHNOLOGY OUTSOURCING**  
**TRANSACTIONS: PROCESS, STRATEGIES,**  
**AND CONTRACTS** BY JOHN K. HALVEY, ET AL



**PROJECT & PROGRAM RISK MANAGEMENT: A**  
**GUIDE TO MANAGING PROJECT RISKS AND**  
**OPPORTUNITIES** BY R. MAX WIDEMAN (EDITOR),  
RODNEY J. DAWSON

commercial software acquisition, this should result in a modification of the intellectual property indemnity clause limiting it to infringement claims under United States intellectual property laws.

In addition, the contractor's indemnity obligation under General Provisions paragraph 36 of the California Model IT Contract is not limited to claims involving the contractor's own products. Rather, the contractor has a duty to indemnify the state against infringement claims against *any products* it provides under the contract, such as in a large-scale system integration contract where many software products manufactured by third parties are used. In contrast, under most commercial SLAs, the licensor has no duty to indemnify the licensee if the alleged infringement arises from the use of third party software. Again, under FAR 52.212-4 and 12.301(b)(3), a federal contractor's duty will be similarly limited if the contracting officer tailors the contract clauses consistently with the general mandate of FAR Part 12.

So unlike a licensor under a typical commercial SLA or a contractor under a typical federal government software contract, a contractor in California may be required to indemnify the state for infringement claims of IP rights under the laws of other countries. The contractor must also indemnify the state if a third party's software infringes IP rights, a responsibility it would not have under a commercial or federal contract.

#### Missed Flexibility and Competition

The tidal wave movement toward commerciality in government procurements that appeared in Washington D.C. in 1994 has not yet surfaced in many state procurements. The California Model Contract terms do not reflect the flexibility found in the FAR for adopting commercial contract terms where appropriate. It remains to be seen whether California will enjoy the benefits of increased competition recently experienced in the federal marketplace due to the elimination of restrictive contract terms and conditions. *CM*

#### Endnotes

1. 41 U.S.C. § 251, et seq.
2. See "Intellectual Property: Navigating Through Commercial Waters," issued January 8, 2001, by the Under Secretary of Defense for Acquisition, Technology & Logistics, U.S. Department of Defense.
3. See FAR 27.405 (b)(2), Acquisition of existing computer software.
4. FAR 12.402(b) suggests that other acceptance procedures may be more appropriate when "complex commercial items" or commercial items used in "critical applications" are being acquired.
5. FAR 52.212-4(a).
6. For example, a commercial SLA may contain payment provisions that are inconsistent with the federal Prompt Payment Act.
7. FAR 12.301(b)(3).