Licensing agreements dictate how companies can use and distribute software to staff, as **Ray Murphy** explains in part four of our series

Licensed to bill

Anyone who uses a computer is party to a licensing agreement for the software installed on it, and for individual consumers it is a subject that evokes minimal consideration. Most people buy the software, install it and, when the licensing agreement appears on screen, press the "accept" button without giving too much thought to the specifics.

For large organisations, however, software licensing is a hugely important area that carries significant obligations – and a resultant potential for liabilities. In a corporate licensing agreement, for example, software "use" may be defined in any number of different ways. The usage rights may range from "restrictive" (say, the software may only be used on a specific computer identified by its unique serial number) to "broad" (for example, every employee, every desktop or every customer of the organisation may be allowed use the software in one form or another).

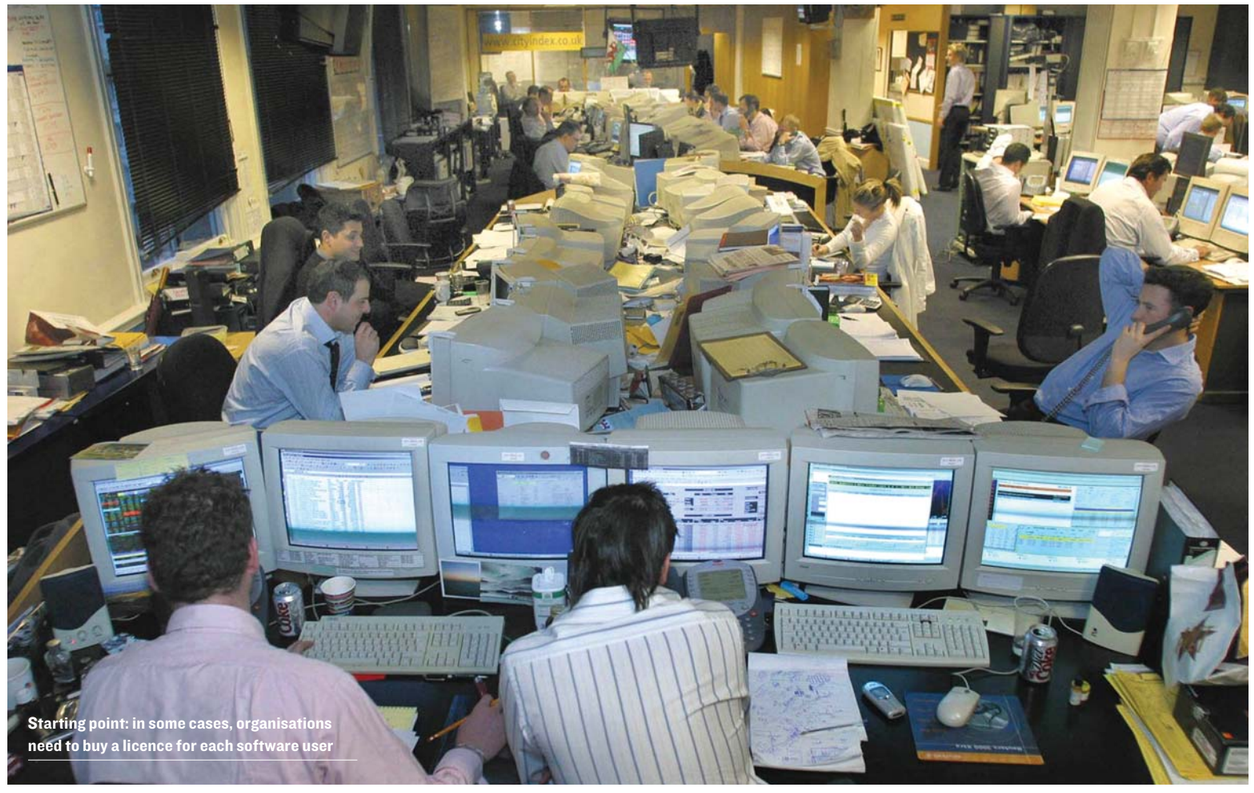
No matter how the usage rights to the software are defined, the obligation to comply with its obligations under the licensing agreement rests with the customer, and any deviation can result in significant liabilities.

Unlike any other product or service that an organisation may buy, the software customer does not have unrestricted rights to the software use. The customer is generally granted a specific and restricted licence to use the software.

This licence may be for a limited term (say, five years), for use within a specific business, on a specific computer, or for a limited number of users or volume of transactions.

Alternatively, the buying organisation may have a perpetual licence for an unlimited number of users, with full assignment rights in the event of a merger, divestment or outsourcing.

What distinguishes one licensing agreement from another generally comes down to a few fundamental issues: the customer's clarity of requirements, the supplier's willingness to negotiate the licence terms, and the timing and positioning of the negotiation.



Starting point: in some cases, organisations need to buy a licence for each software user

For example, most US software companies are listed with the Securities and Exchange Commission (SEC) and are measured, to a large extent, on the basis of their most recent quarterly performance, which essentially comes down to revenues and profits. SEC-listed software companies are constrained in how they may recognise revenue and must meet stringent criteria before they may recognise a sale. Therefore, it is important for such companies to close large software deals before the end of the quarter, while at the same time ensuring that the key revenue-recognition criteria are met.

If the SEC becomes aware of non-compliance, it invariably raises large red flags for investors and Wall Street; the resulting damage to company image alone can be very significant, largely by diminishing company credibility and investor confidence.

Contractual concessions

Software buyers need to have a good awareness of these constraints as they negotiate software licensing agreements. If an agreement is being negotiated at the end of a supplier's quarter, half-year or year-end as part of a competitive bid process, then the customer would likely be in a better position to win significant commercial and contractual concessions than would otherwise be the case.

From a commercial perspective, there is also a need to be careful when agreeing commercial terms to keep these fundamentals in mind. You should ensure you fully understand the supplier's licensing model – there is no such thing as a "standard" licensing model and most suppliers prize their regimes as means of sustaining revenue generation.

Therefore, you should have a clear understanding of how the software is likely to be used within your organisation in both the short and long terms. Attention must be paid to the licence agreement terms: the licence grant and term of licence; scope of use; usage flexibility or constraints (for example, if a licence agreement is not explicit on outsourcing rights, then assume they do not exist and seek to include them); group assignment, divestment and merger rights; usage rights post-termination; the supplier's rights to audit your use of the software; escrow provisions; and any other relevant features.

Some software licence agreements also include support and maintenance terms. If you want the right to stop paying support and maintenance fees but continue to use the software, ensure this is stated explicitly. Many software agreements impose an obligation to have a current support and maintenance agreement in effect – if the agreement is terminated, the right to use the software terminates with it.

While software rental regimes have been in place (particularly in the mainframe software arena) for many years, recently they have become popular for servers and desktops too. Many software suppliers offer both perpetual and term-limited versions of their software licenses, and the customer will decide which option best meets its particular requirements.

Some software rental agreements include support and maintenance as part of the rental process while others keep it separate. In the application service provider model, the software is hosted by the supplier and the customer pays for access to the application (generally based on the number of users, although transaction-based metrics are also used) and both fixed (for the monthly or quarterly rental) and variable (for access to and use of the software) charging may apply.

Whichever licensing model or business arrangement is considered, it is vital to do preparatory work before making an agreement. You should build a licensing checklist and use this to maintain focus as you work through the supplier selection, negotiation and agreement implementation.

Effort spent in the early stages is never wasted. However, lack of clarity, poor attention to detail and insufficient preparation will inevitably result in software-licensing agreements that are costly and a burden to maintain over time.

● NEXT ISSUE: requests for information and proposals in software projects

■ Ray Murphy is a specialist consultant in software sourcing and procurement (www.strategiccomputing.ie). For more information, call +1 289 2522 or e-mail murphyr@indigo.ie

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Six tips for negotiating licences

1. **Do your homework.** Build a licensing checklist to maintain focus as you work through the supplier selection, negotiation and agreement implementation stages. Determine the current and likely future product, volume, geographic and other related requirements. These include the operating system platform, number of internal users, number of customers, transactions and so on.
2. **Seek** as flexible a licence grant as is commercially reasonable. For example, if you are likely to require wider business use in time, you may be wise to seek group-wide usage rights up front. Ensure the licence agreement allows the software to be transferred without any additional cost in the event of a business divestment, merger or outsourcing arrangement. Brainstorm all the possible scenarios under which the software might be used and include them in your licensing checklist.
3. **Be aware** of the software supplier's revenue recognition requirements – and use them to your commercial advantage. In the US, Securities and Exchange Commission-listed software companies face stringent revenue recognition regulations.
4. **Ensure** that what you are buying will meet your needs before you pay the supplier; ensure you adequately acceptance-test the software before you pay large licence fees.
5. **Don't** let price alone be the major factor in influencing your selection criteria. And be wary of special offers. While low initial prices may appear attractive, the switching costs (cost of re-training users, agreement termination penalties) may be high if you make a mistake and want to change to a different software supplier at a later stage.
6. **Ensure** you have the means to track software usage within your organisation. Increasingly, software usage audits are being invoked by large software suppliers, and costs of non-compliance can be severe.