

Caveat Emptor: Seven Terms to Avoid in Contracts

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Abstract

Caveat emptor is Latin for “Let the buyer beware” (Garner, 2009), and in seller’s contracts the buyer needs to beware of seven contract terms that sellers often insert into their standard contracts. These contract terms could cost your organization substantial fees or dramatically increase your organization’s risk. This paper will cover the seven contract terms, their potential pitfalls, and suggest alternative terms. Project Managers need to actively work with their legal counsel to ensure these terms are not included in the contracts governing their projects. This paper will present ideas on how to proactively negotiate these contract terms to reduce your project’s risk and overall procurement costs.

Disclaimer

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Introduction

A Guide to the Project Management Book of Knowledge (PMBOK® Guide) defines a contract as “a mutually binding agreement that obligates the seller to provide the specified products, services, or results, and obligates the buyer to provide monetary or other valuable consideration” (PMI, 2008, p 429). *Black’s Law Dictionary* defines a contract as “An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law.” (Garner, 2009, p 367) A contract has often been referred to as a “meeting of the minds” on a specific subject. (*Carlill v Carbolic Smoke Ball Company*, 1893) Whatever your definition of a contract, contracts are an important part of every major project. According to the *PMBOK® Guide*, “The legal nature of the contractual relationship makes it imperative that the project management team is aware of the legal implications of actions taken when administering any procurement.” (PMI, 2008, p 335) Most projects are governed by software, hardware, consulting, services, maintenance or other legal contracts that require the project manager to perform certain duties or refrain from certain activities. However, many project managers are not aware of those legal documents or the terms that may cause them significant issues in the future.

“Evergreen” Renewal Terms

Many sellers’ contracts today contain a contract term where the contract renews itself from one term to the next (usually annually) in the absence of a contrary notice by one of the parties (usually the buyer). This automatic renewing provision for annual maintenance is often referred to as an “Evergreen” clause (Garner, 2009, p 369). This contract term locks the buyer into automatically renewing their annual fees unless the buyer expresses in writing that they decline to renew within a prescribed period (usually between thirty to ninety days) of the annual renewal date.

Evergreen Clause – “Seller Example”

The term of this contract shall be one (1) year and shall automatically renew without any further documentation or agreements for successive terms of the same duration, unless a party gives written notice to the other party ninety (90) days prior to the expiration of this term or any successive term of this contract.

Evergreen is an appropriate description for these clauses, not because they keep a contract alive for a long period of time, but because these terms provide substantial amounts of green cash (US Dollars) to the seller. Unless your company has an excellent contract management system and dedicated contract management team, these automatic renewals are often overlooked and lock your company into paying annual fees for substantial periods of time. There have even been instances where a buyer was paying for annual maintenance on hardware or software that they no longer used or owned!

A better approach is to eliminate the “Evergreen” nature of renewal altogether from your contracts and place the burden of renewal on the seller, by requiring them to send the buyer an annual invoice for fees or renewal at least 60 days prior to previous contract term’s expiration date. The buyer can then make a proactive decision on each annual term on whether to renew or not. This provides the buyer with the flexibility to determine if they are going to continue to use the seller’s goods or implement a new product/service to replace an existing one.

Recommended Non Renewing Clause

The term of this contract shall be one (1) year. Any subsequent renewal requires the seller to send the buyer an invoice for the next term’s annual maintenance fee or other renewal fees, sixty (60) days prior to the expiration of the original or subsequent contract term. The buyer’s payment of the invoice shall constitute renewal of the contract for the subsequent period.

Limitation of Liability Terms

A Limitation of Liability clause is “a contractual provision by which the parties agree on a maximum amount of damages recoverable for a future breach of the agreement.” (Garner, 2009, p 270) Ever since the landmark case of Markborough v. Superior Court, 1991, many U.S jurisdictions have recognized a seller or buyer’s right to limit their liability through contract provisions. Sellers often include these clauses in their sales and services contracts to mitigate THEIR liability, if the buyer experiences a negative impact through the use of the seller’s product or services.

Limitation of Liability Clause – “Seller Example”

THE SELLER SHALL NOT BE LIABLE TO THE BUYER FOR ANY DAMAGES OF ANY TYPE, INCLUDING BUT NOT LIMITED TO, ANY LOST PROFITS, LOSS OF ANTICIPATED BENEFITS, OR FOR SPECIAL, INCIDENTAL, INDIRECT, PUNITIVE, CONSEQUENTIAL, OR EXEMPLARY DAMAGES ARISING OUT OF OR IN ANY MANNER CONNECTED WITH THIS AGREEMENT OR THE SUBJECT MATTER HEREOF, REGARDLESS OF THE FORM OF LEGAL ACTION INCLUDING CONTRACT, NEGLIGENCE, TORT OR UNDER ANY WARRANTY. BUYER’S SOLE REMEDY FOR BREACH OF THIS CONTRACT IS THE REMAINING FEES TO BE PAID OR FIVE HUNDRED DOLLARS, WHICHEVER IS LESS.

These clauses are usually drafted broadly to limit ALL seller liability even for intentional torts or other outrageous misconduct. For example, if the seller offers on-site services and the seller provides a person who embezzles money from your organization, this contract clause could protect the seller from any legal action. Many jurisdictions require that the Limitations of Liability clause be negotiated between equal parties, clearly conspicuous in the contract and not void as against public policy in their jurisdiction. (Smith and Maxwell, 2007) One method that parties use to make these clauses clearly conspicuous is to place them in bold capital letters.

A better approach is to first make the Limitation of Liability clause mutual so it applies to both the seller and buyer. Both parties agree to hold each other harmless for any liability beyond the contract terms. However, the clause should be strengthened so that both parties to a contract are liable for intentional torts (e.g., theft, battery, murder) and gross negligence caused by their employees, contractors, or other representatives.

Recommended Limitation of Liability Clause

EXCEPT TO THE EXTENT OTHERWISE EXPRESSLY AGREED TO IN THIS AGREEMENT, NEITHER PARTY SHALL BE LIABLE TO THE OTHER PARTY FOR LOST PROFITS, OR FOR SPECIAL, INCIDENTAL, INDIRECT, PUNITIVE, CONSEQUENTIAL, OR EXEMPLARY DAMAGES ARISING OUT OF OR IN ANY MANNER CONNECTED WITH THIS AGREEMENT OR THE SUBJECT MATTER HEREOF, REGARDLESS OF THE FORM OF ACTION AND WHETHER OR NOT SUCH PARTY HAS BEEN INFORMED OF, OR OTHERWISE MIGHT HAVE ANTICIPATED, THE POSSIBILITY OF SUCH DAMAGES. THIS LIMITATION OF LIABILITY SHALL NOT APPLY TO DAMAGES: (I) ARISING OUT OF INDEMNIFICATION CLAIMS UNDER THIS AGREEMENT; (II) ARISING OUT OF SELLER’S WARRANTIES; (III) RESULTING FROM THE GROSS NEGLIGENCE OR THE WILLFUL OR INTENTIONAL MISCONDUCT OF A PARTY OR ITS PERSONNEL; OR (IV) STEMMING FROM PERSONAL INJURY, DEATH, OR PROPERTY DAMAGE CAUSED BY A PARTY OR ITS PERSONNEL.

Annual Maintenance Fee Increase Terms

A seller’s contract may contain annual maintenance fee increase provisions or may be totally silent on the issue of how the seller will calculate the increase in annual maintenance fees. These provisions or lack thereof enable the seller to pass along annual maintenance fee increases without having to negotiate the fee increase each year.

Annual Maintenance Fee Increase – “Seller Example”

The buyer agrees that the seller, in its sole discretion may increase the annual maintenance fee for each subsequent term of this contract (or contract contains no provision on maintenance increases).

These clauses usually do not provide a cap on the amount of an increase the seller can charge. Sellers typically charge between 17 – 22% of list price of the initial purchase for annual maintenance. (Weier, 2009) One major software manufacturer charged 29% for annual maintenance, which means that buyers are totally repurchasing this seller’s product every 3 ½ years! If you do not include objective measures to determine the annual maintenance fee increase, you are at the mercy of the seller and whatever they decide is an appropriate increase for the next year or contract term.

A better approach for the buyer is to negotiate with the seller an objective measure for the fee increase. If the buyer has a strong bargaining position, they should even try to negotiate no fee increase for the first two or three years of the contract, since it is unlikely the buyer will be upgrading or using a significant amount of the seller’s maintenance services on a new product or service. A buyer should include in their contract either a hard cap (no more than 3% per year) or a cap tied to an objective index (U.S Consumer Price Index – Urban for all US Cities, unadjusted). If the buyer wants to be extremely aggressive they can do both, “no more than 3% or the U.S. CPI-U for last year WHICHEVER IS LESS”. The initial annual maintenance fee should be based on what the buyer actually paid for the product or service, not the listed price. If the buyer has negotiated an appropriate reduction from the listed price, basing the maintenance on the actual sales price will save the buyer’s organization fees over the term of the contract. Finally, the buyer should try to negotiate the initial percentage of annual maintenance fees down several percentage points, to provide savings over the lifetime of the contract.

Recommended Annual Maintenance Fee Increase Clause

Maintenance Fees shall be fixed for thirty-six (36) months from the effective date of this contract. Thereafter, Maintenance Fees for any subsequent annual Maintenance Term shall not increase over the amounts charged for the immediately preceding Maintenance Term by more than: (a) 3% (three percent), (b) the rate of inflation as reflected by the Consumer Price Index - Urban for all US Cities, unadjusted (“CPI-U”), or (c) the rate increase seller charges to the general customer base, whichever is less.

Disaster Recovery/Test System Usage Terms

An important component of a software contract is the ability to maintain disaster recovery, development, and test environments. It is important that the rights and responsibilities of the parties be clearly documented in the initial software contract to avoid potential misunderstandings or additional fees in the future.

Disaster Recovery/Test System Usage – “Seller Example”

Buyer may implement one (1) copy of the Licensed Software product.

If a software contract does not specify the rights to development, testing or disaster recovery sites, it may cost the buyer a significant amount of money later to “purchase” these rights. A buyer can not automatically obtain the rights to these additional environments unless it is clearly stated in the buyer’s contract with the seller. In one instance, because the original software contract was silent on the rights to development, testing and disaster recovery environments; one buyer had to pay a seller several hundred thousand dollars more for these rights.

A better approach is to include, in clear language, the buyer’s right to copy the software to multiple environments for development, testing and disaster recovery without any additional charges. In addition, the right to use the software should not be limited to a particular operating system or hardware platform. A seller will sometimes limit the hardware or operating system that their software may be licensed on; so that when technology changes, the seller may charge additional fees to migrate to the new technology. A buyer should not want to be run their critical application on an IBM PC (1981) forever, just to avoid paying the upgrade fee.

Recommended New Disaster Recovery/Test System Usage Clause

The buyer may, at no additional cost, make a reasonable number of copies of the Licensed Program(s) for production, development, testing, quality assurance, staging, high availability, disaster recovery, backup, archival purposes, and other environments for the buyer’s internal use. Also, buyer may at no additional cost, transfer the Licensed Program(s) to new hardware, operating system, site or location, owned or leased by the buyer. Buyer can also use the software on an outsourced or hosted environment within the territories where buyer conducts business.

Contract Termination Terms

A contract termination clause should specifically inform both parties as to when a contract may terminate and the reasons for the termination. From a seller’s perspective, they would be happy if the contract never terminated and the buyer kept providing them an annual annuity (annual maintenance fee) forever. Unfortunately, all good things must come to an end and the buyer needs to ensure that their business with the seller is wrapped up appropriately.

Contract Termination Clause – “Seller Example”

The seller may immediately terminate this Agreement or a particular order if the buyer: (a) commits a material breach and fails to cure such breach within thirty (30) days after having received written notice of such breach; (b) files any voluntary petition in bankruptcy, has an involuntary petition in bankruptcy filed against it, which is not dismissed within sixty (60) days or becomes the subject of any petition or proceeding under any statute of any state or country relating to insolvency, liquidation, or the protection of rights of creditors, or becomes insolvent or has a receivership for substantially all of its assets.

“Early termination of a contract is a special case of procurement closure that can result from a mutual agreement of both parties, from the default of one party, or for the convenience of the buyer, if provided for in the terminations clause of the contract” (PMI, 2009, p 342). Contracts may offer a termination clause for “cause” or breach of contract or for convenience of either party. Many contracts end when a buyer decides to use different software, hardware products or services and wants to terminate the contract for their convenience. Sellers are reluctant to include termination for convenience clauses, as they almost always are exercised by the buyers at the detriment of the seller. Many contracts for software also contain rights for the seller to “turn off” or otherwise remove the software that the buyer has purchased, if the buyer terminates for convenience or fails to pay the annual maintenance fee.

A better approach is to negotiate a termination clause that protects both parties, but enables the buyer to terminate the contract for convenience. The clause should clearly state that the buyer may continue to use the hardware or software products without incurring additional charges, but will not be entitled to upgrades or product support.

Recommended Contract Termination Clause

Either party may immediately terminate this Agreement or a particular order if the other party: (a) commits a material breach and fails to cure such breach within thirty (30) days after having received written notice of such breach; (b) files any voluntary petition in bankruptcy, has an involuntary petition in bankruptcy filed against it, which is not dismissed within sixty (60) days or becomes the subject of any petition or proceeding under any statute of any state or country relating to insolvency, liquidation, or the protection of rights of creditors, or becomes insolvent or has a receivership for substantially all of its assets.

A buyer may upon thirty (30) days prior written notice, at its sole discretion, terminate for convenience (i.e. without cause) the services provided under this Agreement and shall only be liable for the applicable termination fees. The termination fees shall not exceed lesser than twenty-five percent (25%) of the remaining service fees. Any pre-paid and unearned Service Fees paid by buyer, prior to such termination for convenience, will be applied (i.e. credited) to the termination fees. The buyer may continue to use the licensed software or hardware after termination, but will not be allowed to install upgrades, patches, or be entitled to customer support services.

Indemnification Terms

An Indemnification term is “a provision in a contract under which one party or both parties commit to compensate the other for any harm, liability, or loss arising out of the contract. The formula to compute the amount of compensation is usually included in the contract.” (Garner, 2009, p. 370) It is meant to usually protect only the seller for third party damages that arise from the buyer’s use of the seller’s product or service.

Indemnification Clause – “Seller Example”

Buyer agrees to indemnify and hold harmless seller against any claims by third parties arising under this agreement.

These clauses often only protect the seller from damages that arise out of the use of their product or service. More buyers are now being sued directly or indirectly by third parties claiming that the software/hardware products that the buyer purchased from a seller violates an existing patent or license owned by a third party.

Indemnification clauses are important given the significant patent infringement cases that have been litigated recently. One major software seller paid \$200 million (USD) to settle a patent infringement case. (CNET News, 2010) Another seller’s entire network was threatened with a total shutdown until they finally agreed to pay over \$600 million (USD) to settle a patent infringement claim. (CNNMoney.com, 2006)

A good indemnification clause should protect the buyer, as the infringement claim is normally due to a patent infringement or other negative actions by the seller. It should spell out who will be the primary defender of any lawsuit brought against both parties and how each party will participate in any damages.

Recommended Indemnification Clause

Seller agrees to indemnify, defend, and hold harmless the buyer from and against any losses, liabilities, damages, claims, and all related costs and expenses (including reasonable attorneys’ fees and expenses) resulting from or arising out of any third party claim, action, suit, proceeding arising from or relating to: (1) a claim that any software or hardware that infringes, misappropriates, or violates any patent, trademark, trade secret, copyright, or any other proprietary or intellectual property right of a third party.

The above indemnity is contingent upon (i) buyer providing prompt notice to seller of any known claim and reasonable assistance (at seller’s sole expense and) in the defense thereof, (ii) seller’s sole right to control the defense or settlement of any such claim, provided that the settlement does not require payment or admission of liability on the part of buyer, and (iii) buyer shall not take any actions or omit to take actions that hinder the defense or settlement process as reasonably directed by seller.

Seller shall have no liability under this Section if: (i) the allegation of infringement was the result of a modification of the Software not performed by the seller or specified in the Documentation, (ii) the allegation of infringement caused by the Software not being used in accordance with the Documentation, (iii) if the alleged infringement could be avoided or otherwise eliminated by use of a seller's published update or patch, or (iv) if the alleged infringement was the result of use of the Software with any non-seller supplied third party product.

Additional Terms at Seller's Website

An evolving trend in contract drafting is the appearance of a clause that enables sellers to unilaterally change the terms and conditions of contracts. The additional terms clause will refer to the seller's website where additional terms may be posted in the future without notice to the buyer.

Additional Terms Clause – “Seller Example”

Buyer agrees that this contract may be modified by the seller, by posting additional terms and conditions on the seller's website in the future. Buyer will be bound by these additional terms and conditions as if they were part of the original contract between the parties.

A majority of U.S. jurisdictions have found “click wrap” and “shrink wrap” agreements enforceable. (ProCD, Inc. v. Zeldenberg, 1996) The two reasons used for enforcing these agreements are that either the buyer affirmatively accepted by clicking on a “I Agree” type button when installing the software or by continuing to use the software product beyond a certain time period. The minority view has found a seller's “click wrap” and “shrink wrap” agreements to be not enforceable, if the buyer is deemed to have accepted by merely downloading the software. (Step-Saver Data Systems, Inc. v. Wyse Technology, 1991) In either case, a buyer should carefully read these “click wrap” agreements to ensure they agree to the terms. On April 1, 2010 over 7,500 online shoppers unknowingly sold their souls to a computer game retailer, they probably should have read the “click wrap” agreement. (FOXNEWS, 2010)

While there appears to be no direct case law of the validity of these additional terms posted on websites, these additional terms are probably unenforceable. While a recent case from Washington State did not rule directly on the validity of these extra terms posted on a seller's website, the court indicated in dicta that they might find these extra terms to be “procedural unconscionable” (McKee v. AT&T Corp., 2008). In another jurisdiction, the court again did not rule directly on these website terms, but stated that they would be unenforceable as an “illusory” contract term (DeFontes v. Dell, Inc., 2009). In addition, since a contract generally involves a “meeting of the minds”, it's hard to imagine how the buyer and seller's minds have met, when the seller unilaterally posts changes to a contract on their website. At a minimum a seller should affirmatively notify the buyer of the contract changes and give the buyer an opportunity to affirmatively accept or reject the contract modifications.

A buyer should NEVER agree to include this additional language in their contracts. If the buyer does not have a strong bargaining position and the seller insists on this clause; at a minimum, the contract should include an Order of Precedence clause. This clause would ensure that all hard negotiations the buyer has done is not overridden by additional terms posted on a seller's website. The Order of Precedence clause should clearly indicate that the original written contract and any officially approved amendments and exhibits, take precedence over any terms posted on the seller's website.

Recommended Order of Precedence Clause

In the event of any ambiguity, inconsistency or conflict between applicable documents within this contract, the following Order of Precedence shall apply: (i) the Master Agreement including any bilateral amendments thereto; (ii) attachments including any bilateral amendments thereto; (iii) Purchase Orders; provided that if a Purchase Order term conflicts with the Master Agreement, the Master Agreement shall control, unless the parties express in writing an agreement that the Purchase Order terms shall control each modification and will only be valid for each individual Purchase Order, and (iv) other terms posted on the seller's website that the seller has communicated to the buyer and the buyer has accepted as valid modifications to this contract.

Conclusion

The previous seven contract terms are key terms that a buyer should negotiate with any seller. Buyer's need to mitigate or transfer their risks using the recommended contract terms in this paper. A project manager needs to ensure that they have read the legal documents that apply to their project and understand the contract terms. Project managers should seek out competent legal advice when negotiating a contract to ensure that the contract protects the buyer's rights. While the above contract terms are important, the entire contract should be reviewed to ensure favourable terms for the buyer.

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