Technology Contracting in Turbulent Times

by Brad Peterson

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We live in turbulent times. The dot-com wave. The tech wreck. September 11. Recession. Venture funding in gushers or trickles.

Turbulence makes technology contracting risky. The companies you rely on for key technology and services may not perform. Worse, they may pull you into the legal morass of bankruptcy. If they fail, you might miss your commitments to your customers, suppliers and investors.

This article guides you in reducing those risks in your key technology contracts. These include, for example, ASP deals, licenses, outsourcing, alliances and service contracts. There's no silver bullet, because turbulence is chaotic. However, these ideas can reduce your risk.

#1 – Due Diligence

Due diligence means assessing the other company's ability to deliver on the commitments that it makes to you. Due diligence should cover financials, operations and people. Here are some sample questions:

- Financials. Do the financial statements and credit history show adequate financial strength? Do you believe that this company will get funded before it burns through its cash balance?
- Operations. Is the company ready for turbulent times? What are the single points of failure? Is its contingency and recovery plans? Are those plans on the PDAs and other devices that the employees carry with them, or will the plans burn with the office?
- People. Does the other company do the same background checks that you do? Does the other company restrict access to sensitive information and facilities as much as you do? Are its people reliable and capable.

#2 – Agility

Agile companies thrive in turbulent times. Your contracting should increase, not reduce, your flexibility and the options that will be open to you when the world changes.

It is better to have two suppliers than one. If you have two, and one fails, you're still in business. If you have one supplier, it's best to have a contingency plan. Don't have single points of failure.

Build flexibility into your contracts. Secure the right to increase or decrease volume, change objectives, assign the contract, or modify the relationship. Watch out for restrictions, such as exclusivity, requirements contracts and take-or-pay contracts.

#3 – Balance

In turbulent times, your contracts need to be balanced.

One type of balance is the flow of benefits. As an example, a one-year arrangement where one party pays the other monthly for services in the prior month is close to balanced. The same deal would be unbalanced if the payment was made up-front and the services are to be provided over a year. You don't want to give more than you receive because, if the other party fails, you may never get that value back.

Another type of balance is fairness. "Winning" the negotiation can mean losing the deal, because companies can use turbulence to get out of bad deals. Make sure that the deal makes sense for both parties.

#4 – Control

In turbulent times, it's not enough to have a partner who controls key assets and processes. You need control.

The best way to control assets is to possess and own them. Your contractual rights to use may or may not get you what you expect when your partner fails. If your partner goes bankrupt, your new partner is a bankruptcy judge. Bankruptcy judges aren't known to be quick about turning things over. If your partner implodes, you may have no one to talk to about even getting copies of key technology. Remember to get lien waivers.

Beyond that, control is about who, what, where and when:

- Who. You want the other party to perform its obligations using its employees who have signed confidentiality and IP agreements. Otherwise, you'll need additional protections against subcontractors and employees failing to perform or claiming that they own work product.
- What. Your technology contracts should define exactly what the other company will do. It's worth having overlapping protections, such as contracting for both the process and the result.
- Where. If your ASP runs out of a hosting center, both the ASP and its hosting center must be working for you to have service. Be careful with possible subcontract relationships. In particular, make sure that subcontractors are reliable and can not get liens on the work.
- When. In this New Economy, there's little time to wait for a partner to perform. Contract for delivery at a specific time.

#5 – Watchfulness

You want to know when something is going to go wrong before it happens. Your business partners don't want to tell you when they're in trouble, because you'll stop working with them. Thus, you need contract rights, such as:

- Periodic financial statements
- Notice of key employee or officer departures
- Notice of termination of major contracts

Of course, the right to get information is only a start. You'll need to monitor what you learn. Also, you'll need to follow up on concerns, asking questions and analyzing responses. This contract management function allows you act quickly to resolve new issues.

#6 – A Safe Exit

Even if you have information, agility, balance and control, at some point you may need to get out. You don't want the end of the deal to mean the end of your business. Here are some contractual rights that may help:

- Exit Rights. It's not enough to be able to exit on a default not timely cured. By then, the damage is done. Secure rights to exit on change of control, loss of key people, degradation in service or financial deterioration.
- Transition Services. Secure a right to whatever assets, services, and IP rights you'll need to make a smooth transition to the next solution.
- Source Code Escrow. If you will rely on the other party's software during the contract or to make a smooth exit, get the source code in escrow. Not all source code escrow agreements are created equal, though, and a weak one can create a false sense of security.
- End of Restrictions. Consider whether no-hire provisions, exclusivity clauses and similar restrictions need to end to allow you a successful transition.

Bottom Line

Technology contracting is harder in turbulent times. You need a contract that works in many possible futures. It's not as easy as it was in simpler times, but by using the right tools you can manage the risk in technology contracts.

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