Negotiation Strategies For Technology Acquisition Contracts

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Introduction

For companies involved in the business of providing satellite, broadcasting or telecommunications services in Asia, the effective negotiation of technology acquisition contracts is a critical activity. Technology acquisition is a capital-intensive activity, and in many instances the selection of a particular technology and / or technology vendor results in the purchaser being 'locked–in' to a technology and / or vendor for system expansion, maintenance and support for years to come. Examples of critical technology acquisitions in the mobile telecom area include the purchase of radio base stations, switches and supporting software; in the satellite business the selection and purchase of a satellite and contracting with a launch service provider; for digital pay television broadcasters, the selection of a conditional access system and set-top box manufacturer; and for an electronic assembly manufacturer, the purchase of automated manufacturing equipment.

General Rule

Over the years, and in each respective industry, various practices have developed for the negotiation and closing of key technology purchase contracts. As each company has its own history, corporate personality and manner of doing business, the process for making technology acquisition decisions differs. In general, a company seeking to acquire technology will first have its in-house team identify potential vendors that may provide the required systems, and then prepare a 'Request For Proposal' (RFP). The RFP typically includes a general description of the purpose of the request, a scope of work (SOW), technical specifications and draft terms and conditions for the technology acquisition contract. On receipt of the RFP, interested vendors prepare a response that should include a detailed compliance matrix identifying which points in the RFP the vendor's proposal is, or is not, in compliance with (e.g. compliance with the system's technical requirements, the vendor's willingness to 'comply' with the purchaser's requirement for certain legal and commercial terms in the contract, etc.). The purchaser then reviews the potential vendors' responses and short lists those vendors coming closest to meeting its overall requirements as set forth in the RFP. After the short list is agreed internally, in major acquisitions it is common for the purchaser to enter into negotiations with the top two or three potential vendors to narrow the issues and attempt to obtain the best deal possible. Ultimately, the purchaser selects one of the candidate vendors to proceed to final contract negotiations and closing.

The Asian Situation

While the process outlined above is common to most major technology acquisition exercises around the world, there are a number of issues that companies in Asia frequently encounter but do not always negotiate as rigorously as they should to protect their rights and ensuing capital investment. In many instances where technology is sought for deployment, the vendor or its sub-contractors must develop new software and / or hardware for the purchaser's system. These new features, functions or systems may have application to other future customers of the vendor and may later be included in the vendor's overall product line. An example of this in the telecom area is where a vendor is required to develop enhanced functionality for a mobile switch or a new customer care graphic user interface. In the pay television business a vendor of a traffic and control system for channel scheduling and play out may be required to develop a more advanced air-time sales module or interface functionality to a subscriber management system with which it has never before interfaced. Even in the satellite business, an operator may request that certain technology be adapted and integrated into a satellite design requiring new development. The common point in all of these examples is that the purchaser is requiring the vendor to do something that the vendor has not previously done, thereby requiring development of new software, technology and / or interfaces (collectively described in this article as 'new functionality') for the purchaser's particular project.

Ownership of Rights to New Functionality

A key issue that is frequently overlooked in negotiations by the purchaser is how much of the development cost for the new functionality the purchaser should pay for if the new function has utility and may be offered by the vendor to its current or future customers. Vendors never raise this issue in negotiations because it is in their interest to have the first customer requesting the development to pay for the costs, and then for them to have the ability to offer it to other customers in the future. It is up to

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the purchaser to identify and to raise the issue and to use it as leverage in the negotiations. In essence, the point that the purchaser must make is that it will not agree to pay for either all, or even a majority, of the development cost for the new functionality unless the purchaser owns the intellectual property rights to such new functionality. To put it succinctly, if the purchaser is gong to be required to pay for the bulk of the development of a new functionality then it should be owned by the purchaser. Accordingly, the argument goes, the intellectual property rights for the new functionality should be transferred to the purchaser on acceptance. The purchaser may, as part of its strategy in the negotiations, offer to license the vendor the right to include the new functionality into its product line for a royalty, but refuse to pay for what should be carried on the vendor's books as a non-recurring investment in technology to enhance the vendor's product line.

Vendors in many major technology acquisitions in Asia will not anticipate a purchaser raising this point in the negotiations because the purchaser is a buyer and user of technology, and not in the business of owning and licensing features of the vendor's technology. The business concerns of the purchaser are to acquire the technology and deploy it as quickly as possible to allow the purchaser to get on with its business (for example as a mobile operator, television broadcaster or satellite service provider), not own and exploit intellectual property to a system that may have limited application to a single vendor. The leverage, of course, is that for the vendor the ownership of the new functionalities to its base product is very important.

By raising the issue in the negotiations the purchaser may then try to compel the potential vendor either to disclose the details of the development and its costs, what should be considered pre-existing technology owned by the vendor versus new development, and discuss the logistics of a grant back license from the purchaser to the vendor – or to cut the purchaser a better deal. If a new functionality has potential value in the product line of the vendor, most vendors will prefer to negotiate a lower price for the development work to ensure that it maintains all ownership rights to intellectual property for the new function. As a rough general rule, the purchaser should not pay for more than 20–30% of the total development costs for new functionality that the vendor can incorporate into its product offering.

The potential leverage a purchaser has in raising the issue of technology development and intellectual property ownership is highest where the purchaser still has the ability to go to another vendor. If the purchaser is already locked into the vendor's technology, the vendor may insist on its price and to maintain ownership of the intellectual property, thereby forcing the purchaser to capitulate; forgo the new functionality; or proceed through what may be an expensive process of replacing the vendor's products in the purchaser's system to escape technology lock-in.

Source Code Control a Key Issue

In addition to the issue of ownership of technology specifically developed for the purchaser under a technology acquisition contract, a related issue is the requirement by the purchaser that the vendor place all critical software in a source code escrow.[1] A source code escrow is an accepted structure whereby a vendor places its source code into an 'escrow' with an established source code escrow agent under pre-defined and agreed release conditions. In the event that any one of the release events occurs, the source code is released to the purchaser for use in maintaining and supporting the purchaser's system. Most release conditions relate to the situation where the vendor either goes out of business, or is unable or refuses to support its service and maintenance obligations under the contract with the purchaser. Source code escrows are common practice in the United States and Europe and there are established source code escrow companies that provide professional and reliable service to licensees and vendors of software. However, in South East Asia source code escrows are not yet that common and many Asian technology purchasers do not include source code escrows as a contract requirement in negotiations. While the negotiation issues and strategy for putting a source code escrow in place are beyond the scope of this article, it is useful to note that the concept of a source code escrow can be used in conjunction with negotiations for the development of new functionalities in a technology acquisition contract.

Conclusion

Purchasers negotiating with potential vendors should consider (i) what new functionality must be developed by the vendor for the contract being negotiated, and (ii) what software owned by the vendor will be critical to keep the system up and running if the vendor defaults on its obligations to support the software or goes out of business. Following the discussion above with regard to negotiation of new functionalities, the purchaser should insist that so long as it is the owner of the new functionalities all source code comprising the new functionalities should be delivered to it on acceptance of the system (even if the vendor as part of its maintenance contract agrees to maintain and support the new functionalities). With regard to other software that the vendor will provide but is critical to the continued operation of the system in the event that the vendor goes out of business or in breach of its contractual obligations to support and maintain, the source code of such software should be depos-

1. Computer programs are written by programmers in what is called 'source code' but licensed to customers in machine executable code referred to as 'object code'. The source code is kept confidential by the vendor and not released to customers or otherwise made public. However, to maintain, support and enhance the program access to the source code is usually required.

ited with a reputable source code escrow agent. Vendors will predictably resist transferring ownership of new functionalities to the purchaser and will attempt to limit the scope of the code required to be deposited in a source code escrow. Knowing this, purchasers may use this to their own advantage in negotiating a lower price and better terms in the acquisition contract, but must be careful that they remain protected and have adequate recourse in the event that the vendor breaches its support or maintenance obligations.