Contracts for Accessing Enterprise Software Applications

Typical Really Bad Terms

And how to avoid them.

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INTRODUCTION

Most ERP access contracts provided by sellers are simply awful. Awful for buyers, but quite stellar for sellers. However, buyers have options to achieve a balanced status in such contracts and the resultant commercial relationship. The information below shows how. The advice in this document is a result of years of arranging balanced terms for those wanting to access ERP, both in a subscription model or purchased perpetual ERP licenses.

Before we go further, it’s important to acknowledge that ERP sellers, whether subscription ERP or purchased licenses, have solid reasons to protect their intellectual property, revenue stream, and other reasonable business interests in granting access to users of their ERP. This is largely because buyers create many problems for themselves, and they often blame the ERP application or the ERP implementer. Commercial relationship suggestions in this paper have nothing to do with the legitimate terms an ERP seller should want.

FIRST SOME HISTORY ON CONTRACTS FOR ACCESSING ERP

In years past nearly all ERP access contracts were somewhat typical to what one might expect in such legal documents. There were some differences with upper-tier ERP compared to mid-market ERP, and there were some style differences with some ERP sellers. Beyond these, the documents were reasonably consistent and the items needed to be fixed or added for the buyer were fairly typical. This status changed in recent years due to the following developments:

<u>Click-through Agreements</u>: ERP seller’s contracts increasingly included language found in shrink-wrap software contracts. Such contract terms are acceptable when purchasing a $39 drawing program that can be easily replaced with little cost. ‘Click-through' or 'shrink-wrap' software access contract terms are highly unsuited for governing access to enterprise software that involves large dollar amounts and is a high-risk and expensive effort to replace.

<u>Cloud ERP</u>: Cloud ERP is considered a service with all the physical hardware and software handled by the service provider. Cloud ERP sellers tend to have an attitude as though they are selling a monthly high-tech service such as internet access or web hosting. Many Cloud ERP Cloud service provider’s contracts reflect this with a stunning disconnect from the realities of the commercial relationship and the critical commercial controls a buyer should legitimately possess when accessing ERP. Most key contracts terms that buyers should secure (shown later in this document) are not in native Cloud ERP contract terms.

<u>Complexity and confusion rising</u>: Before the ERP contract problem became so bad in recent years, most relevant mid- and upper-market ERP sellers had one key ERP license contract (usually about 6 pages) and one for ERP support/maintenance (about 3 to 4 pages). In a subscription they typically have one contract (around 10 to 15 pages).

There may be other documents, but they're usually specific and don't try to compete with or confuse the primary contracts. This has deteriorated, with some ERP sellers wanting buyers to endure two or three times the normal amount of contract documents with vague and conflicting language, and references to many other documents and URLs that are subject to change. This increasing expansion of confusion only benefits the seller.

KEY CONTRACT OBJECTIVE TO ACHIEVE

The buyer should insist on certain high-value items in order to have reasonable commercial controls and options. It's important to know these items can be acquired, regardless of the excuses of those selling access to ERP. Many other items not listed in this document should be tuned and contained, but these are not usually as important as items listed below and are dealt with on a case-by-case situation.

The key contract objectives are greatly influenced by the fact that this commercial relationship is far more risky for the buyer seeking to access an ERP application. The reason is simple. If there's a commercial disagreement that appears to be unresolvable, the seller only has the potential to lose some potentially disputed revenue and the ongoing revenue that would have been earned. For most relevant ERP sellers, this is hardly noticed. It's very different for the buyer. In an intractable commercial dispute the buyer faces the specter of extreme risk and cost, as they have to contemplate the effort to locate, purchase, and implement a new ERP. The extreme disparity of risk in this type of commercial relationship should be contained. The following contract objectives are key items to balance matters.

<u>Costs that are predictable over time</u>: ERP sellers know quite well that once a buyer is using their ERP it's very difficult to change to another. This is the basis for easily raising costs on customers, especially for customers that arranged lower initial costs to access the ERP. Further, the ERP sellers are usually reluctant to offer control terms going forward—again especially for buyers that arranged superior initial ERP access pricing. For ERP sellers, every dollar of future revenue they can defensibly project has a multiplier effect to their company valuation. In general, the ERP sales culture aggressively protects their options for open-ended cost increases, especially in the subscription model for ERP access.

Notwithstanding this, the buyer can arrange excellent original ERP access costs and still arrange contract terms to stop opportunistic price increases for as long as they use the ERP. These terms typically give seller the option to raise cost each year based on some not-to-exceed percentage or inflation rate metric, with rules on which to use. These escalation terms are especially important when the buyer arranges excellent original ERP access costs (1) in a subscription model, or (2) when perpetual ERP license maintenance is charged based on a percentage of negotiated pricing.

Never forget the irony when seeking these cost-control terms. The sellers will often claim they cannot offer ongoing price-control terms because they cannot predict their costs. So the ERP seller's solution to solve their faux problem is to give the buyer nearly zero predictability on its future costs. A proper cost increase term will give the seller proper protection—so do not accept any seller's excuses for why they cannot provide permanent cost escalation terms. To underscore this point, it’s rare our clients ever accept a contract for ERP access without firm cost escalation terms.

<u>Bulletproof termination terms</u>: Termination means 'stop using the ERP'. Obviously the rules for triggering such a radical action need to be carefully designed and only be triggered for serious beaches and after a period of time to attempt to cure the alleged material breach. This is especially true in an ERP lease arrangement where the seller effectively has a switch to shut off the buyer. Notwithstanding this, the termination terms in most ERP access agreements enable the seller to terminate rather quickly for almost any alleged breach. Practically, the ERP sellers would not tend to do this, but such terms create the intimidating environment the sellers want. That is, a commercial agreement in which the buyer has no effective options but to bow to the will of the seller. Any ERP termination statement should have provisions to access the ERP for an amount of time necessary for an orderly migration to another ERP. The most egregious breaches should be excepted, which can only be confirmed by an independent third party, for which immediate termination would be understandable. The seller has no risk to offer this balance—however, they lose the dictatorial control they desire in a normal contract.

<u>Contract ambiguity and instability</u>: Commercial terms for confidently accessing critical enterprise business applications should obviously be precise on material terms and not broadly ambiguous, which can confound such material terms. Examples of these terms are: ERP access rights, termination, ERP license/subscription ownership transfers, and cost escalation, to name a few. Today many ERP access contracts are loaded with imprecise language on key items, make references to other voluminous documents/URLs with more potential material terms that are subject to change, and in the worst case with some subscription providers, have provisions that the negotiated terms lapse upon the next renewal. Some vendors have multilayer contracts that often conflict and for which priority is cloudy. As noted earlier, much of this broad ambiguity and instability increased in recent years is somewhat tied to subscription access ERP. The sellers have canned reasons and excuses for the general status of these contracts, as described below. These excuses should be rejected entirely. Once the native contract issues are fixed, the buyer should obtain a guarantee that the documents and URLs ‘incorporated by reference’ in the one or more foundation contracts will not weaken the fundamental strength of the initial commercial relationship established, as these documents and URLs may change over time.

<u>ERP transfer rights</u>: Whether an ERP access subscription or perpetual licenses, there should be rights to transfer this asset to a future potential buyer of the company using the ERP. However, nearly all ERP access contracts state that access to the ERP is nontransferable. In addition to arranging transfer rights, there should be no requirement to have the seller approve such a transfer. The sellers can place reasonable conditions on the transfer, such as the transfer can be valid if 50% plus of assets are sold to the

acquirer, that the acquirer be subject to the agreement, the acquirer cannot be a competitor, and other potential conditions.

Subscription term: Subscription access ERP vendors will often want the buyer to commit to a multiyear contract in general, or as a condition for contract and cost discount concessions. Since the seller is primarily selling access to intellectual property and infrastructure that already exist, the costs of the new sale is some increment for the impact to existing application delivery infrastructure/support and the cost of sales. Usually it would take the ERP vendor 2 to 6 months of subscription fees to recover these costs. The customer account would tend to be highly profitable after that. These sellers want multiyear contracts because they simply look great on their books and positively affect valuations. It's not really to 'lock down' the buyer, as once a buyer has implemented a new ERP, they're effectively 'locked-down' anyway. Buyers can agree to a 24 to 36 month initial term, but this is giving the seller a gift. The buyer should receive something significant in return and include exceptions for which the subscription could be stopped before the term with little no financial penalty. In renewals, never agree to more than a year term unless further discounts are offered and similar exceptions are arranged.

TACTICS TO EXPECT FROM THE ERP SELLER

Two key background factor that support all the tactics below are: (1) The ERP industry general sale techniques and culture seeks to sell to buyer's emotions, and (2) the buyer is at a disadvantage, since the ERP software salespeople and their sales managers and executives are selling ERP software full time, while the buyers enter into this complex search and purchase every 8 to 20 years. The following are tactics continually seen from ERP sellers when processing commercials terms in contracts.

Process contracts after buying decision: Default ERP access contracts contain many unfavorable terms and the sellers understandably prefer to discuss contracts and potential changes once the buyer has revealed that the seller is the winner and is probably too exhausted to consider changing to another vendor. The correct approach is to take possession of proposed contracts when there are two or three finalist ERPs and tell the sellers that their willingness to fix contracts will materially influence which ERP seller is selected. Even if the buyer arranged to review contracts earlier, many sellers will use delay tactics to drag out the adjudication of the material terms until the seller hopes to have more knowledge of its status. If the seller's sales team believes they are winning, they usually presume the buyer is exhausted with the selection process and less able to fight for appropriate contract changes.

Buy now or lose the offer: ERP salespeople and sale executives usually benefit from placing calendar deadline pressure on buyers to help close deals. These are usually quarterly time frames with the fiscal year-end being the most important. These are real in the sense the seller would like to close business, but the premise that the better offer cannot be received if the calendar deadline is missed is not real if the buyer plays its cards right. A buyer should tell the sellers early in a selection process that they will try to respect quarterly sale close periods, but never at the expense of being rushed.

The 'Contracts expert': The ERP sales teams will often have a 'contracts expert' get involved in the discussion of the buyer's contract objectives. These 'contracts experts' are nearly always useless for buyers seeking the type of terms described earlier in this document. They're trained to protect the interests of the seller including the illegitimate ones described earlier in the 'Key Contract Objectives to Achieve' section. If pushed to respectfully discuss the key objectives, these experts will usually be unable to, as they seem to read from a script of weak excuses for not wanting to meet the key terms. The buyer needs to work with a sales executive and explain that they want to avoid this manipulative and time-wasting process and that the discussion will require someone with authority and situational awareness be involved. Competent ERP reseller can often be a guide to help locate a person at the ERP vendor who can facilitate having the key terms reviewed and materially met.

Can't change the contracts - too hard to manage: This excuse has only come up in the ERP subscription environment and relates to sellers claiming with thousands of customers they cannot deal with differences in contracts. This significantly relates to the previous comments in this document on ERP sellers acting like they're selling the $39 drawing program. This excuse for not addressing the buyer's concerns with default contacts could not be more specious. These sellers will usually follow-up such statements by saying that thousands of buyers have accepted these terms, implying the prospective buyer is unreasonable. It's hard to imagine any buyer being compelled by this sort of facile argument for such an important purchase. Certain buyer controls are critical in ERP purchases, and the buyer has literally no effective control on serious matters in most default ERP contracts.

TACTICS FOR ERP BUYERS

Below are key tactics to help the buyer achieve key ERP access contract objectives and many other specific contract objectives associated with the specific buyer and issues with particular sellers.

The buyer is serious and reasonable: Since few buyers recognize the terrible commercial terms normally offered, and fewer know how to defend themselves, the sellers aren't expecting effective pushback. An ERP sales executive needs to be informed early in an ERP selection that there will be significant changes needed to the terms typically offered. Use examples from the list above on key items to achieve in ERP contracts in this discussion. Emphasize that these are contract objectives any rational company would seek in such a commercial relationship. The right people at the ERP vendor know this to be true. Then when there are two or three finalist ERP, the contracts should be requested for review and the key items identified, discussed, and contained as a condition to being selected. The ERP seller will probably still try many tactics listed in the prior section, but they'll be seen as disrespectful and counterproductive if the buyer has followed the guidance in this paragraph.

Decisions are made on the buyer's timetable: As noted in the seller tactic above on 'buy now or lose the offer' the buyer should inform all relevant candidate ERP sellers that they cannot be rushed at the end of a sales cycle if questions and actions remain open. Tell ERP sellers proactively that you can respect a sales timetable, but will never be rushed for any reason. Remember, sellers look for prospects who are tired and are up against an apparent deadline. If the seller sees this and believes they're in the 'current favored status' they'll nearly always drag their feet on the better cost discounts or contract fixes while stating the deal must be closed by the end of the quarter for the current offer to survive.

Purposeful contract discussion: In contract discussions the sellers will likely try to manipulate the buyer who seeks the contract objectives described earlier in this document. Tell the finalists when requesting contracts that (1) the level that contract objectives are met will be influential to the final ERP selection and (2) you need to avoid typical contract discussion tactics from the ERP industry. This must be conveyed to a sales VP and not the sales facilitator. If a sales VP does not acknowledge the problem and commits to a different path to discuss reasonable contract adjustments, then it likely won't happen—but at least the buyer can reference this discussion when issues come up later. Finally, as mentioned earlier, a competent reseller's leadership can usually find a path to the right people at the ERP company who are reasonable and have situational awareness.

Keep it competitive to the end: This may seem easy, but it's not. The buyer's teams usually telegraph the ERP sellers' status, even when we work closely with them to not do so. It's just human nature and the ERP seller's emotion-based sales process is keen to detect these signals and use them to its advantage. For the finalist ERP and especially the apparent winner, the ERP sellers needs to believe they are close, but apparently not winning. This is typically what they believe if the buyer is doing a good job at not sending the 'buy signals' the seller expects to see. Further if an ERP seller thinks they are winning, they need to believe the buyer knows it has fine alternate ERP options. Finally, 'keeping it competitive' is helped by continuing to emphasize that all key ERP selection factors of functionality, ERP access costs, commercial terms, and aspects of implementation will be carefully reviewed before a final selection decision is made.

THE CONTRACT REVIEW PROCESS

The process to fix ERP access contracts for the list of objectives shown above is involved. As noted earlier in this document, the sellers will often use this complexity to justify delays, hoping to reach a time they know more about their status. Based on this complexity and seller's tactics, it's important to have an organized and efficient contract review process. The process we advocate is:

1. Get contracts: Take possession of the default contracts for ERP access, maintenance/support, and implementation services when two or three finalist are chosen. Make a PDF copy, if it wasn't provided that way.

2. Review contracts: Someone with the right experience should review the contracts, with a focus on achieving the objectives listed earlier, as well as noting other issues detected. When the reviewer finds issues, questions, or missing items, highlight related text with the PDF highlighter, then use the PDF comment function to describe the issue, question, or missing item. Create a color code system to show an item's initial severity and use the comment bubble's 'color control' to show the right level.
3. Present to ERP vendor: Locate a person at the ERP application firm per suggestions in the tactics section above. Turn over the draft contracts with color-coded comments. Confirm they understand the color coding technique on the comment bubbles and if they have further thoughts on any comment, they'll use the comment bubble's 'reply' feature if available. This keeps their inputs in the related comment bubble, but separate and automates a date stamp and usually who commented.
4. Contracts processed with ERP vendor: Review and discuss the contract items with the contracts point-of-contact. Note that some concerns and questions will be resolved from the discussion and these results entered into the PDF contracts comment bubble. Others will take the form of changes to the commercial agreement, which, again, is noted in a comment bubble. As the items in the comment bubbles are resolved or mitigated, the severity color-coding should be changed.
5. Update contracts: Agreed-upon changes may go into an amendment or a changed original contract.
6. Discussion history: The original contracts with the record of discussions by comment can be useful later in further purchases or if there is a good-faith disagreement. The history of the concern and comments by the sellers may be able to help solve a disagreement.

CONCLUSION

As shown in this document, the typical contract terms to access ERP are terrible for buyers. This situation with enterprise software sellers is expected to stay the same or even get worse for the indefinite future as there's too much money and control in the balance. Further the typical dictatorial culture in place isn't seen by the ERP industry as unfair. It's the culture, and many of the players will double down on it before admitting a problem exists.

Over time this devolving and one-sided commercial relationship situation will eventually lead to an industry-wide crisis. More and more buyers will not play along and at some point what is happening will become common knowledge, and pushback and disgust will accelerate. We see this happening with projects at Engleman Associates, Inc. Very few clients are so timid that they don't see a problem or are afraid to push back.

The opportunity here is for reasonable ERP sellers to promote fairness and innovate in providing ERP access that isn't abusive to buyers but still protects the business model of the seller. ERP sellers would impress prospects and win business if they successfully showed their proactive fairness and showed how most major ERP sellers don’t provide for the key objectives listed early and worse actively oppose them.

For now, what should a buyer of ERP do? If a buyer is educated and not in a rush, they emphatically don’t need to put up with this worsening ERP industry situation with abusive commercial terms. The benefits to the buyer have been noted here, but they may be even greater when one considers and understands the intangible value of real control and real options in such a complex and important commercial relationship. This sort of thing may not be noticeable until it’s used. However, its very presence may be the reason the future potential problems are avoided. Another version of peace through strength.