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CONTRACTUAL ISSUES IN THE REMARKETING OF SYSTEMS

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I. INTRODUCTION

Complex commercial transactions involving the distribution of large hardware and software systems raise a myriad of difficult legal and business issues. An understanding of the distribution channels used in the remarketing of these products is a prerequisite to formulating contracts that make business as well as legal sense and that accurately reflect the realities of the competitive world of system remarketing.

One result of the complex array of distribution arrangements has been a wide spectrum of different “standard contracts” that attempt to document the business relationship between and among various parties in the chain of distribution. Most of these agreements share a common thread of major legal and business issues that need to be considered and addressed. This Article will attempt to guide the reader through some of the most important of these issues.

II. AN OVERVIEW OF DISTRIBUTION CHANNELS

A. LARGE MANUFACTURERS

A relatively small number of large manufacturers have design, development, and manufacturing operations that are highly vertically integrated. Such manufacturers may design, develop, and manufacture almost all hardware and software components in a complex system, including CPUs, peripherals, systems software, and applications software. These manufacturers may then sell systems directly to customers through an internal direct sales force and/or utilize a network of conventional wholesale dealers and distributors to market their products.

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B. OEMs

The term Original Equipment Manufacturer (OEM) is loosely applied to a number of different remarketing entities. In many cases, OEMs manufacture and/or assemble substantial portions of a complex system but do not have the resources, expertise, or desire to be vertically integrated with respect to all aspects of the design, development, and manufacture of each and every component in a system.

Thus, for example, some OEMs design and manufacture all, or substantially all, of the hardware components in a system but obtain from third party developers any necessary software to be included in the system. Other OEMs design systems are comprised of off-the-shelf components and sub-assemblies that can be purchased from third party suppliers. Such an OEM can then assemble these components into a system that is shipped out bearing the OEM’s name and trademark, even though substantially all of the component parts comprising the system are manufactured by third parties.

C. VARs and Systems Integrators

Value Added Remarketers (VARs) and Systems Integrators typically acquire hardware and software from other manufacturers and developers and combine that hardware and software into turn-key systems to fulfill the needs of end-user customers. The “added value” they provide is in the integration of components from a number of different sources into a system that will meet the needs of particular customers. VARs and Systems Integrators often specialize in servicing the needs of particular vertical markets, such as the medical and health care field, insurance industry or public and private utilities. In many cases a VAR or System Integrator is the developer of a key component of the turn-key systems it markets, such as a specialized vertical market applications program.

For example, a system sold by a VAR may consist of a central processing unit from one hardware manufacturer, peripheral storage and other devices from a number of other hardware manufacturers, systems software from one software supplier, applications software from one or more software suppliers, and applications software developed by the VAR itself.

D. Conventional Dealers or ISOs

So-called “conventional” dealers and distributors or Independent Sales Organizations (ISOs) acquire hardware and software from a variety of sources and sell these items to end-user customers or other dealers and distributors for resale to end-user customers. In other words, they act as conventional wholesalers and retailers.
With complex and expensive systems, even these conventional ISOs increasingly find themselves playing a role more like that of a VAR or Systems Integrator, providing consulting services and advice to assist customers in finding solutions that will meet their needs. However, conventional ISOs also serve the needs of those customers who know exactly what they want and are looking for a supplier who carries a wide range of merchandise from different manufacturers.

It should be recognized that the categories described above are by no means mutually exclusive. Many companies serve in some or all of these roles in the development, manufacture, and marketing of products. OEMs and VARs may, in turn, market their products through conventional dealers and ISOs, and large manufacturers that have historically been almost entirely vertically integrated are increasingly turning to outside developers or suppliers for certain key components, such as complex software.

III. RELATIONS AMONG PARTIES IN THE CHAIN OF DISTRIBUTION

A. PRODUCT DEVELOPMENT AND CUSTOMIZATION

Often an OEM or VAR that is assembling and remarketing a system will want certain components of the system to be modified or customized by its suppliers. For example, a key piece of software may need to be modified by its developer in order to be fully compatible with the hardware system on which an OEM intends to install it. In other cases, an OEM may have designed a system on paper, and then discovered that a key hardware or software component that will comply with its design simply does not exist. Such an OEM may then wish to contract with a supplier whose component exhibits most of the features and functions the OEM is seeking and have the supplier undertake the necessary enhancements required to meet the OEM’s specifications.

Under these circumstances, a grant of rights from a supplier of hardware or software components to an OEM or VAR may include terms and conditions relating to software or hardware design and development. Such an agreement raises all of the typical development contract issues and requires the parties to agree upon specifications, mechanisms for modifying the specifications, testing and acceptance procedures, timetables for development milestones, remedies for failing to meet those milestones, rights of the OEM or VAR to complete development if the supplier fails to do so in a timely manner, arrangements for loaning or otherwise providing necessary equipment to the developer, and other matters.
1. **Products Definition**

Defining the scope of the products that are subject to a remarketing agreement raises a number of difficult issues.

The rapid pace of technological change can make both hardware and software products obsolete almost overnight. Thus, any remarketer that is seeking to acquire distribution rights for a product (whether for incorporation into a system or for sale on a stand-alone basis) typically seeks to obtain rights, not only to an existing product offered by the manufacturer, but also to future products and enhancements. Ideally, the remarketer will typically want to acquire rights to market *all* present or future products offered by the manufacture, but most manufacturers seek to limit the scope of rights to a more narrowly defined set of products. Clearly defining future products that are within the scope of the rights to be granted poses significant challenges.

If rights are granted with respect to the current product and any enhanced or modified versions of that product, does this include successor products marketed under an entirely different name or trademark? Definitions tied to model numbers or release numbers can provide some precision, but also have the potential for creating mischief, since a manufacturer may be able to avoid supplying new versions of a product under an agreement by changing model or release numbers.

Sometimes definitions of enhanced or successor products are tied to considerations of marketing factors, such as whether the future product is marketed as a replacement for the current product. This may also have room for ambiguity, however, because old product lines are not necessarily discontinued when a new product line is introduced. Instead, a manufacturer may simply change the pricing and/or positioning in the marketplace of the old product. Under these circumstances, negotiating a grant of rights that includes products marketed as a replacement for the current product line may not give the OEM or VAR what it is seeking, which is the right to market the new product line when it is introduced.

Another approach to defining products covered by a remarketing arrangement is to incorporate by reference all products contained from time to time on a specified price list, e.g., a remarketer may be granted rights to acquire and distribute all products identified in a manufacturer's standard VAR price list, as that VAR price list is updated during the term of the agreement. This has the potential for leaving the manufacturer with broad discretion to revamp its distribution practices and channels simply by adding or deleting products from its “standard” VAR price list. Thus, for example, a manufacturer that has such a clause in its standard agreements may avoid granting distribution rights for a particular product to its entire network of VARs by establishing a
new and smaller network of "Super VARs," and including the new product only on the Super VAR price list, not on the standard VAR price list.

2. **Requirements of Incorporation into Systems**

Other difficult definitional issues are raised with respect to limitations on an OEM's or VAR's right to incorporate and market a component as part of a system. It is common for hardware and software suppliers to insist that OEMs and VARs market the supplier's product only as part of a larger system and not on a stand-alone basis.

For instance, Applications Software Incorporated (ASI) may have a thriving business marketing its applications software directly to end-user customers and may not want to cannibalize its own market by permitting remarketers to offer that same software on a stand-alone basis. However, ASI may recognize that it is not reaching many customers who rely on VARs or Systems Integrators to configure a complete system that meets the customers' needs and may be willing to allow its software to be marketed as an integrated part of large systems offered by such VARs and OEMs. Such VARs and OEMs may be able to reach customers that ASI would never be able to reach directly.

Alternatively, an OEM may be seeking some special sales incentive that will help distinguish its hardware products from those of the OEM's competitors and may want to include a "free" copy of ASI's software with every hardware box the OEM sells. The OEM may be willing to pay a substantial up-front cash payment or advance for the right to do this, and ASI may find this impossible to resist, especially if ASI is in need of immediate revenues and cash flow. Again, however, ASI will likely insist that its software be marketed only in conjunction with the OEM's hardware, so that the software does not find its way into conventional retail channels in direct competition with ASI and/or its conventional dealers and distributors.

Careful consideration must be given to formulating these types of restrictions. If a VAR or hardware OEM is required to supply applications or system software only as part of an integrated system comprised of hardware and software, does this permit the VAR or OEM to bundle the software with a single microprocessor chip or a simple add-in board in order to fulfill the hardware requirement? Must the software be included as part of the original system acquisition, or can the OEM or VAR have limited rights to market the software to its installed base?

One approach is to define a system configuration that reflects the minimum acceptable configuration with which a particular component may be marketed by an OEM or VAR. For example, a VAR contract might specify that certain software may only be marketed as part of a
system consisting of a Model 101 or successor CPU and require that the Model 101 or successor CPU be configured in a unit or system containing a minimum number of CRT's and I/O ports and specified minimum capacities of memory storage, either in the CPU box or in one or more peripheral devices. Such restrictions would all be aimed at preventing the marketing of the software with a stripped down system consisting, for example, of a single microprocessor chip.

A vendor might also consider imposing minimum price restrictions, e.g., that the software may only be marketed as part of a system of hardware and software where the total system price equals or exceeds $25,000. Such a provision may raise two concerns, however. First, one needs to be certain to avoid restrictions that might be interpreted as resale price maintenance or price fixing. Second, because hardware prices may drop substantially during the term of a VAR agreement, it is important that any such provisions take into account possible fluctuations in price. A system that sells for $25,000 today may sell for $12,000 a year from now.

A legitimate concern of some resellers, however, is that they be permitted to sell their existing installed base. For example, if a VAR has been granted rights to market certain software as part of a system, the VAR may want the right to provide that software at a later date to customers who do not initially acquire the software with the system but decide to add that functionality later. Software suppliers may want to limit a VAR's rights in this regard by, for example, permitting such marketing only if it occurs within 120 days after the initial system sale, or by requiring that the software be configured so it will not operate on any system other than an authorized system, in order to help prevent the VAR from competing directly with conventional dealers and distributors.

3. Product Exclusivity

It is common for a successful OEM or VAR to seek the exclusive right to market certain key components in conjunction with a particular line of equipment. For example, suppose ASI has a particularly successful application program that is highly respected in a particular vertical market and that runs on a number of different hardware platforms, including minicomputers manufactured by Hye Tech, Inc. Acme VAR, which specializes in marketing systems built around Hye Tech minicomputers, may seek from ASI the exclusive right to distribute that application program on all equipment manufactured by Hye Tech.

Such an arrangement may give Acme VAR a significant competitive advantage, because customers who want to acquire that application program for use on Hi Tech computers will not be able to obtain it from
competing OEMs or VARs. On the other hand, Hye Tech may find it advantageous to enter into such an arrangement in order to encourage Acme VAR to be aggressive in marketing the application and/or in order to prevent Acme VAR from entering into a similar arrangement with a competitor of Hye Tech.

Grants of exclusivity that are defined by reference to a particular manufacturer’s equipment can lead to conflicts and misunderstandings. In an era of increasing consolidation, suppose Hye Tech subsequently acquires XYZ Machines Corporation. Does Application Software Incorporated’s grant of rights to Acme VAR now include exclusive rights to XYZ’s machines as well as Hye Tech machines, since XYZ machines now are Hye Tech machines? Suppose that XYZ Machines Corporation had previously granted another VAR exclusive rights to market its application program on XYZ machines. After XYZ is acquired by Hye Tech, which VAR has what rights to market the application program?

The best solution for a licensor granting exclusive rights with respect to a certain manufacturer’s line of equipment is to be as narrow as possible in defining the relevant equipment. For example, the rights might apply only to equipment which is designed, manufactured, and marketed by the manufacturer under its own name and trademark, in order to prevent the grant from applying to equipment designed and manufactured by an OEM and sold to the manufacturer on a private label basis. Similarly, the rights may be limited so that they do not extend to any equipment marketed by the manufacturer after a merger or acquisition if the equipment was formerly marketed under another name or trademark. Probably the best solution from the licensor’s perspective is to limit any grant of exclusive rights to a specific machine or machines, identified by model number. If the grant of rights applies only to Hye Tech Model 101 machines, there is little room for ambiguity.

B. PRODUCT AVAILABILITY AND DESIGN CHANGES

OEMs and VARs often seek to obtain assurances that all components they incorporate into a system will be available from the manufacturer or supplier for a minimum number of years, and that the design of those components will not be modified without permission. Without such safeguards, an OEM or VAR may have to redesign its large systems to reflect changes in individual components obtained from suppliers.

Design change approval must reflect commercial realities, however. For example, improving speeds or eliminating bugs in software may require substantial redesign of the software, and a software developer may be justifiably reluctant to refrain from changing its software if
such redesign is necessary in order to serve the market adequately. One solution is for the OEM or VAR to require that, upon request, the software developer continue to offer the old version of the software to the OEM or VAR and continue to support the old version of the software even after a new version is introduced. Most software developers, however, are unwilling to commit to supporting and maintaining multiple inconsistent versions of the same product.

Often this dilemma can be solved to the satisfaction of both parties by providing that the design of a component may not be modified in any way that materially and adversely affects its functionality or performance characteristics or, negatively impact form, fit, function, or footprint. In most instances, a VAR's biggest concern is that a component will be modified in ways that adversely affect performance, and a VAR will be willing to accept modifications reflecting improvements.

Another alternative is to grant the VAR the right to manufacture the old version of the component if it does not want to accept an updated version but to terminate all support obligations on the part of the supplier. This gives the VAR the ability to continue to incorporate an earlier version of a component, but lets the supplier escape the burden of supporting multiple inconsistent versions of the same product.

1. Manufacturing Rights and Deliverable Materials

If an OEM is to be granted the right to manufacture hardware or software that has been designed by another party, the OEM must be certain the contract specifies and requires delivery of all materials required for such manufacture.

In the case of hardware this may include schematic drawings, specifications and prototypes. In the case of software, the contract should specify whether an OEM is to receive object code or source code copies of the software and what documentation is to be provided. If source code is to be provided, the contract should specify whether it is to be provided on magnetic media such as tapes or diskettes or in the form of human-readable print-outs of source listings. Normally, one wants to receive source code on magnetic media, because the conversion of human-readable print-outs into a form that can be compiled will require manual inputting and is likely to introduce errors and anomalies. The contract should also specify the exact format of the disk or other magnetic or electronic media, and whether user documentation is to be provided in camera ready form or in a particular word processor or desktop publishing program format.

C. Territorial Allocations

All too often, vendors grant broad, non-exclusive rights to
remarketers to distribute products anywhere in the world, without con-
sidering the potential consequences. Such grants often seem appropri-
ate in the early stages of a vendor's development, but they can wreak
havoc on the company's ability to structure distribution channels intelli-
gently in the future. The existence of any distributor or remarketer
that has broad territorial rights can effectively foreclose the vendor's
ability to grant any truly exclusive rights in the future. If a vendor has
authorized one remarketer to sell vendor's products anywhere in the
world, and the vendor later wishes to grant exclusive territorial rights
for Japan to a Japanese distributor, the vendor will be unable to grant
truly exclusive rights because of the existence of one remarketer who
has the right to sell anywhere it wants to, including in Japan.

Defining precisely what is meant by any grant of territorial exclu-
sivity is critically important. For instance, depending on how an agree-
ment is drafted, a grant of exclusive territorial rights for the State of
New York could mean any one of the following: (i) the remarketer may
sell systems only to customers located in New York and only for instal-
lation in New York; (ii) the remarketer may sell only to customers lo-
cated in New York, but so long as the sale is consummated in New
York, the customer may buy 50 systems, 48 of which are to be installed
at facilities outside of New York; or (iii) no other remarketer located in
New York will be appointed, but remarketers outside New York will be
free to solicit customers in New York. These are by no means the only
variations or possible interpretations of a grant of territorial exclusivity.

Thus, broadly stating that a remarketer is being granted "exclusive
rights" with respect to a territory is not sufficient; the contract must
specify clearly what is meant by exclusive rights.

In order to avoid foreclosing one's ability to sell in a particular geo-
graphic area as a result of a bad choice of remarketers, it is almost al-
ways advisable for a vendor to insist that any territorial exclusivity be
tied to minimum performance goals. If these goals are not achieved, the
contract may either be terminated or rendered non-exclusive, depend-
ing on what the parties agree. From the vendor's perspective, terminat-
ning rights entirely if minimum goals are not met is clearly preferable.
If rights are merely rendered non-exclusive, the vendor is foreclosed
from finding another exclusive remarketer. In many markets, unless
one is willing to grant exclusive rights, a remarketer may be unwilling
to devote the time and resources required to market the product
efficiently.

Generally, however, it is critically important for a vendor to think
through the issues and to adopt at the earliest possible date a coherent
strategy for allocating territories before any broad grants of rights have
been made that may foreclose or limit one's flexibility.
When critical technology is modified and integrated into another party's system, as often happens in OEM and VAR arrangements, disputes over ownership of proprietary rights are common. To the extent software must be modified to make it compatible with a vendor's hardware, the vendor often will maintain that it should own the rights to those modifications, particularly if the hardware vendor either makes the modifications or provides essential specifications for those modifications. The software developer, on the other hand, may feel equally strongly that it should own all rights to any modified versions of its software, no matter who created them.

The tension over proprietary rights ownership often reflects an underlying tension regarding the competitive edge that proprietary rights can provide. Thus, a software vendor may be concerned that if it discloses source code to an OEM, the OEM may have an enhanced ability to develop its own software that can someday be offered as a replacement for the software vendor's product.

Confidentiality restrictions and prohibitions on unauthorized use can be a partial solution to address these concerns. In addition to typical confidentiality restrictions, software vendors may seek to prohibit the OEM from using any employees who had access to the software vendor's source code to develop a product offering similar functionality. Many software vendors remain extremely uneasy about any disclosure of source code, no matter how stringent the contract, because misappropriation or infringement can be difficult and costly to establish. Thus, they may seek a blanket prohibition on any development by the OEM of any competing products or products offering similar functionality or features.

Defining the scope of any such prohibitions on development of similar or competing products raises difficult issues. For example, many features and functions that were once available only in applications software are now being integrated into systems software. Would a prohibition on the development of a competing application program prohibit the development of systems software containing some or all of the same features or functions? Careful consideration should be given to defining what the parties mean by "competitive" products.

In addition, vendors should recognize that although prohibitions on development or marketing of competitive products generally will be enforceable during the term of any remarketing agreement, such prohibitions may not be enforceable in some jurisdictions after the expiration or termination of the remarketing agreement.

Software suppliers must pay particular attention to provisions governing any grant of proprietary rights. If, for example, a software sup-
plier grants all rights or exclusive rights in and to a particular software program to an OEM, the OEM may maintain that the software supplier cannot use subroutines from that program in other products. Most software developers have libraries of subroutines that are used in many products, and they do not assume that a grant of exclusive rights to a product implies an exclusive grant of rights to all subroutines embodied in the product. One solution is to specify in the contract that the developer retains the right to use portions of the code in other products, provided these products do not compete with the product for which exclusive rights were granted to the OEM.

Even this restriction may be hard for a software supplier to accept, however. For example, suppose a software developer grants exclusive rights to an OEM to market certain software for use on medical diagnostic equipment. Such a developer likely has substantial expertise in the development of medical diagnostic software and is unlikely to be willing to agree it will never develop software exhibiting similar functionality for another OEM. Such a developer should make it clear that any grant of exclusive rights does not mean or imply that the developer may not develop functionally similar software for competitors of the OEM. In such cases, the contract might specify that the development of competing products exhibiting some or all of the same functionality would be permissible so long as such competing products are not substantially similar in form of expression to the OEM's product, i.e., a copyright infringement standard.

E. WARRANTIES

1. Warranties and Maintenance Obligations

The scope of warranties provided and responsibilities for maintenance can be particularly critical for systems comprised of components from many different vendors. Manufacturers or suppliers of components to be incorporated into larger systems often seek to limit their exposure and maintenance responsibilities by insisting that any warranties and maintenance obligations run only in favor of the OEM and VAR. Under these arrangements, all responsibility and liability for customer warranties and service falls on the OEM and VAR, not on the manufacturers of component hardware and software. A manufacturer or supplier seeking to so limit its exposure should insist that the OEM or VAR be prohibited from making or passing on any warranties on the manufacturer's behalf, and the manufacturer should insist that the standard end-user contracts used by the OEM or VAR contain appropriate disclaimers sufficient to protect the manufacturer.

Another alternative is for the OEM or VAR to have the right to "pass-on" to its customers a limited warranty from the manufacturer.
The contract should address whether warranty or maintenance service calls are to be “funneled” only through the OEM or VAR, or whether customers are to contact the manufacturer directly to obtain such service.

The designation of when the clock begins to run on a warranty made by a manufacturer can result in considerable shifting of risk. A component supplier may want its warranty to commence upon shipment to the OEM or VAR, e.g., to have a 90-day warranty commencing upon shipment by the component supplier. If it takes time for the OEM or VAR to incorporate the component into a finished system and ship it to a customer, however, the supplier’s warranty may already have expired before a customer ever determines that the component is defective. This can leave the OEM or VAR holding the bag and substantially undermine the value to the OEM or VAR of the manufacturer’s warranty. One solution is to have the warranty run for the longer of 90 days from shipment by the component supplier to the OEM or VAR, or 30 days from shipment to a customer not to exceed one year from shipment by the component supplier. This limits the supplier’s exposure considerably but also provides the OEM or VAR and its customers with a warranty that has some value.

Warranty and maintenance responsibilities also should be allocated fairly to take into account that the source of a problem in a complex system often cannot be quickly identified. For example, if a software vendor spends hours investigating an alleged bug and discovers that the real problem is a hardware defect caused by a product of another vendor, the software vendor should insist that the contract provide for reimbursement for any time spent in diagnosing the problem.

Similarly, if a software developer designs software but permits an OEM to manufacture copies of such software, the contract should distinguish between defects caused by faulty manufacturing, which should be the OEM’s responsibility, and defects caused by faulty design, which should be the developer’s responsibility.

For any software supplier, limitations of remedies are critically important. Blanket assurances that bugs will be fixed pose significant and usually unacceptable risks. Some bugs may be virtually impossible to identify or to fix or may require major architectural changes for successful correction. Normally, a software vendor should seek to provide that the sole remedy for any defect or bug will be diligent efforts to correct the problem. The phrase “best efforts” usually should be avoided, since it may imply a commitment of resources that may be disproportionate in light of a reasonable cost/benefit analysis.

Because of the critical importance of software support, remarketers may seek from software developers a grant of rights that includes the
right to possess and to use source codes for the purposes of maintaining and supporting the software. As discussed previously, software developers typically object strenuously to providing source code to licensees. One concern is the protection of trade secrets and confidential information. Another concern is that most remarketers do not have the skills to provide adequate support and maintenance of software, especially for software developed by someone else. Permitting a remarketer to support and maintain the developer's software may adversely impact the reputation of the developer and its software if the software is not adequately maintained and ultimately my impose greater burdens on the developer if it becomes obligated to try to correct problems arising from bungled attempts at maintenance and support undertaken by the remarketer.

2. Infringement Claims

Warranties of non-infringement are critically important in light of the expense of litigation, and the parties should pay particular attention in the agreement to the interplay between such proprietary rights indemnities and other limitations of liability and exclusions of damages. Often, the indemnities provided under a warranty of non-infringement are subject to the same overall limitations of liability that apply to other contractual remedies. For example, if the contract provides that a supplier's total liability to an OEM may not exceed the amounts actually paid to the supplier under the agreement, and the OEM is sued for proprietary rights infringement arising out of incorporation of the supplier's product into a system, the supplier's indemnity obligation may not even cover the OEM's legal fees if the dispute arises before a significant amount of money has been paid to the supplier. The indemnified party may argue forcefully that limitations of liability that apply to other types of claims should not apply to proprietary rights infringement, and that the supplier should stand behind its ownership of proprietary rights one-hundred percent.

On the other hand, due to the uncertainties inherent in many proprietary rights disputes, many developers and manufacturers are reluctant to accept open-ended liability for infringement claims, particularly in circumstances where the OEM or VAR may be making the lion's share of the profits off the marketing of the system.

Most often, if the issue is pressed, suppliers agree to accept full responsibility for proprietary rights claims. There may be special circumstances, however, where a supplier will not accept any responsibility. For instance, some companies market ROM BIOS software needed to manufacture IBM-compatible microcomputers. Because of the uncertain state of proprietary rights law as it relates to the creation of "com-
patible" software, these companies typically refuse to provide any proprietary rights indemnities to the OEMs to which they market such software. The price paid by the OEMs for such software is relatively low, the potential exposure if a successful claim were litigated would be very high, and these software suppliers have effectively told the OEM market that the OEMs must be willing to take these risks if they want to license their software.

Finally, the precise language of infringement indemnities bears careful scrutiny. Does the indemnity apply to all claims or only to claims that result in a judicial finding of liability?

F. MARKETING OBLIGATIONS

Minimum marketing obligations may be imposed through a number of vehicles. A vendor should consider general language imposing an obligation to use best efforts to market a product to achieve market penetration and to maximize revenue. This language also should specify minimum budgets for advertising and promotion, either in absolute dollars or as a percentage of sales, and require attendance at specified trade shows or advertisements in specified publications.

G. TRADEMARKS

Whether to permit or prohibit the use of one's trademark on products marketed by another is normally determined primarily as a matter of business strategy, but there are legal implications as well. So-called "private label" deals, where a product is manufactured in whole or in substantial part by one party but marketed under the name and trademark of another party may help to insulate the manufacturer from claims from dissatisfied customers.

Alternatively, in order to build good will and reputation in the marketplace, a manufacturer may want to insist that its trademark appear on the product and that its components be prominently identified as having originated with the manufacturer, even if the overall system is identified under the name and trademark of an OEM. Thus, for example, Systems Software Inc. may license its systems software to an OEM for use on the OEM's machines but may insist that the systems software be separately identified under Systems Software Inc.'s name and trademarks.

H. ANTITRUST CONSIDERATIONS

Since the Supreme Court's decision in Continental T.V., Inc. v. GTE Sylvania, Inc.,1 non-price vertical restraints have been tested under the

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rule of reason and not on a per se basis. Thus, in evaluating non-price restraints imposed by a manufacturer on an OEM, VAR or other remarketer, such as geographic limitations, sales quotas or minimum purchase obligations, courts will generally weigh all the facts and circumstances, including economic or business justifications, in determining whether any unreasonable restraint on competition is imposed. In addition, there is a trend by courts and regulators to construe complex commercial relationships as predominantly vertical in nature rather than horizontal and thereby to apply a rule of reason analysis to any restraints.

With respect to restraints that may influence resale pricing in a more indirect fashion, the trend has also been away from an application of the per se rule. Thus, in Montsano Co. v. Spray-Rite Service Corp., the Supreme Court concluded that complaints made by a “full-price” distributor to a manufacturer regarding a competing “discount” distributor were not sufficient to support an inference of concerted action by the manufacturer and the complaining distributor. Rather, the Court concluded that a concerted action could be found only where there is “direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful objective.”

Although the Supreme Court in Montsano found sufficient evidence in the record to affirm the jury’s finding that there was an agreement to terminate the discounting distributor in order to fix resale prices, Montsano does make it clear that termination of a discounting distributor following complaints from a full price competitor is not enough to establish liability under the Sherman Act for a concerted action to fix resale prices. A careful and well-counselled manufacturer will thus have substantial latitude in imposing vertical restraints, even restraints that may appear to have some impact on maintaining resale prices.

This conclusion is also bolstered by Business Electronics Corp. v. Sharp Electronics Corp. In Sharp, one discount reseller of Sharp equipment in Houston was terminated by Sharp after its other reseller in Houston, which normally charged full retail prices, gave Sharp an ultimatum: If Sharp did not terminate the discount reseller within 30 days, the full price reseller would no longer carry Sharp products. In Sharp, the Court concluded that it is inappropriate to apply a per se analysis on a vertical restraint unless the restraint includes some agreement on price or price levels and instead applied a rule of reason analy-

3. Id. at 768.
sis. The Court recognized that manufacturers may be motivated to terminate discount dealers "by a legitimate desire to have dealers provide services, combined with the reality that price cutting is frequently made possible by 'free riding' on the services provided by other dealers." 5

To avoid the appearance of any agreement with one or more distributors to fix resale prices, manufacturers generally should refrain from engaging in discussions with resellers regarding the practices, policies, or pricing of other resellers. If a reseller complains about pricing policies of another reseller, the best response is not to respond; any discussion may be construed as evidence of an agreement or concerted action between the manufacturer and the complaining reseller. Also, if a reseller is to be terminated for violations of vertical restraints (e.g., failing to honor geographical restrictions), it is generally best to be clear and straightforward regarding the grounds for termination. Too often, companies manufacture a false explanation for a termination, making it look like the manufacturer is acting in bad faith or has something to hide, when in fact the real reason for termination is legally defensible.

1. *Robinson-Patman Price Discrimination*

The Robinson-Patman Act 6 prohibits any seller from discriminating in prices for goods of like grade and quality, absent a statutorily permitted "justification" for the discrimination. These prohibitions apply to sales either to resellers or to ultimate customers.

In determining whether Robinson-Patman applies to a particular OEM, VAR, or other reseller arrangement, several factors should be considered.

First, Robinson-Patman only applies to price discrimination in sales of commodities. Thus, if a software developer or publisher is granting an OEM rights to reproduce or distribute copies of its software (as opposed to the developer manufacturing copies and providing the completed packages to the OEM), the transaction will likely be construed as a license that is not even subject to Robinson-Patman. 7 On the other hand, the sale by a supplier of a hardware component normally would be within the scope of Robinson-Patman.

Second, remember that Robinson-Patman applies only to discrimination in pricing with respect to goods of *like grade and quality*. Thus, where components that are supplied to one reseller have been "customized" so that they are materially different from components supplied to

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5. *Id.* at 731.
another reseller, the goods may not be of like kind and quality and thus may be sold at different prices without running afoul of Robinson-Patman. However, the Federal Trade Commission (FTC) and the courts have generally stated that to be a genuine difference, the difference must be bona fide and not merely decorative, artificial, or fanciful and must affect customer use, preference, or marketability. Thus, if components sold to two resellers are functionally interchangeable and the differences between them are relatively minor, the components may be deemed to be of like grade and quality.

In Federal Trade Commission v. Borden Co., the Supreme Court held that two products that are physically or chemically identical will be considered of like grade and quality where one is sold under a nationally recognized trademark and the other is sold on a private label basis. Thus, for example, the sale by a manufacturer to a reseller of one name brand system at a premium price, and a simultaneous sale of the same system to another reseller at a reduced price on a private label basis, probably would violate Robinson-Patman.

2. EEC Antitrust Considerations: Article 85

Article 85 of the Treaty of Rome contains prohibitions on various agreements which may prevent, restrict, or distort competition within the European Economic Community (EEC). Many of the prohibited practices parallel, to a substantial extent, practices prohibited under U.S. antitrust law, such as horizontal price-fixing and resale price maintenance.

Among the most important and troublesome restrictions imposed by Article 85 are the limitations it imposes on a manufacturer's ability to grant geographic or territorial exclusivity to a reseller. Generally, a manufacturer cannot prohibit a reseller located in one EEC country from exporting goods into another EEC country. This has two practical ramifications for the manufacturer seeking to establish an exclusive distributor to handle a member country. First, the manufacturer cannot prohibit that reseller from exporting goods into another member country. Second, the manufacturer cannot guarantee that reseller "true" exclusivity within its own country, because the manufacturer cannot prohibit resellers in other member countries from shipping into that reseller's country.

Although one cannot enter into agreements containing these types of territorial restrictions in the EEC, there are ways that a manufacturer may be able to offer significant incentives for a reseller to concen-

trate on its own territory and not to export into other territories within the EEC.

For example, the reseller agreement might specify that all inventory must be maintained within the country where the reseller is located and prohibit any inventory from being maintained in depots located in other countries. In addition, the reseller agreement might specify that all advertisements and promotional materials must be in the language of the reseller's country. Further, the agreement might prohibit the reseller from advertising in certain specified publications outside its country or might set forth an exhaustive list of the publication in which the reseller is permitted to advertise.

III. CONCLUSION

The above discussion has focused on some of the views and concerns pertaining to contractual issues in the remarketing of systems. It is the author's goal to bring an awareness of the complexity of some of these views and concerns from the perspective of both the vendor and remarketer as an aid in analysis. The foregoing includes a myriad of issues both common and specific. It is meant to be a simple tool in the complex area of contractual issues and is not intended to address all aspects of all terms and conditions, but rather attempts to sensitize the reader to some of the details that must be addressed.