

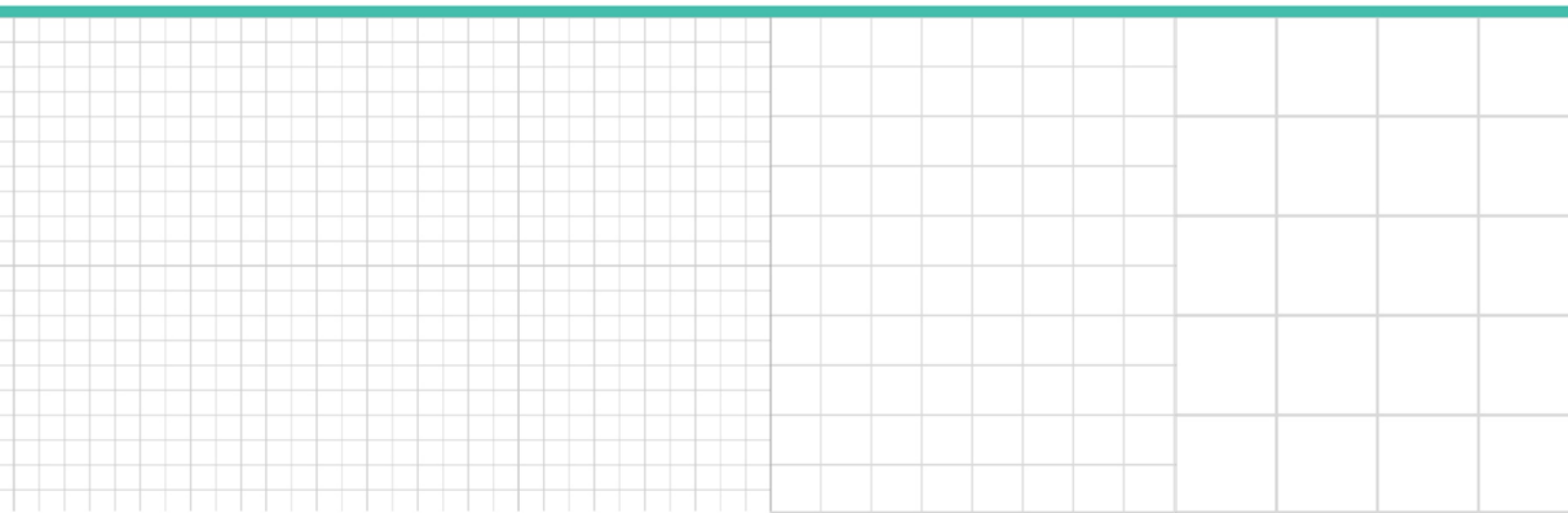


Overview

Preparing for Software License Audits

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Preparing for Software License Audits

Contributed by *John Gary Maynard, Andrew Geyer, and Matthew J. Ricciardi, Hunton Andrews Kurth*

Organizations that license enterprise software will, sooner or later, be the target of a software license audit. Audit rights are usually baked into enterprise software license agreements, and audits are often the only way software vendors can verify compliance. It is reasonable to expect customers to purchase licenses commensurate with their actual usage, but audits have also become revenue drivers, often concluding with allegations of massive shortfalls and eye-popping demands for millions, or tens of millions, in back fees, penalties, and interest. This article presents several issues to consider before an organization receives an audit demand letter.

Audit Triggers

Enterprise software license agreements often allow vendors to conduct audits annually, but audits are usually less frequent and driven by significant events rather than the calendar. Three of the most common triggers are:

Corporate Restructurings. Licenses are usually tied to a specific legal entity and sometimes flow down to wholly owned subsidiaries or defined affiliates. Vendors often audit the post-restructuring licensee to confirm that the resulting corporate structure strictly complies with the specified subsidiary and affiliate entitlements. If it does not, new or relocated entities need to purchase their own entitlements.

Rapid Growth. Most license metrics are, directly or indirectly, tied to the size of the licensee, for example, by the number of users, number of processors, or even revenue. When vendors become aware (e.g., through Securities and Exchange Commission filings or press releases) that licensees have grown substantially since last purchasing entitlements, they often assume that usage has also grown and conduct an audit to identify (and seek payment for) license shortfalls.

Non-Renewal. Conversely, failing to purchase routine version upgrades, extend support contracts, or renew term licenses may be seen as indicating a migration to a competing product. Vendors often conduct close-out audits to extract final value from an ending customer relationship.

Common Causes of Alleged Shortfalls

Audits sometimes identify legitimate (and usually inadvertent) entitlement shortfalls, often due to IT personnel misunderstanding the applicable license metrics or insufficient internal deployment controls. Alleged shortfalls can (and often do) also result from vendors' counterintuitive interpretations of license metrics. Three of the leading culprits are:

Virtualization. Over the past decade, virtualization—running several virtual servers on one physical server—has become the norm in most data centers. Software license agreements with a processor-based license metric are often either ambiguous or explicitly unfavorable (to the licensee) about how to count processors (or cores) in a virtualized environment. IT personnel usually assume licenses are based on the number of processors allocated to the virtual server running the licensed software, while vendors often insist, at least initially, that a license is required for every processor in the underlying hardware, including those not allocated to the relevant virtual server, which can (and often does) lead to allegations of staggering license shortfalls.

Sub-Capacity Licensing. Similar to virtualization, sub-capacity licensing schemes entitle software to run on something less than the entire “capacity” of the underlying hardware. Particularly for mainframe applications, “capacity” is often measured in MIPS (millions of instructions per second) or IBM's proprietary PVUs (Processor Value Units), both of which relate to processing power but not necessarily to the number of underlying physical cores.

Ensuring that license agreements recognize sub-capacity installations and staying within capacity entitlements requires vigilance when negotiating purchases, during initial deployment, and through system upgrades and migrations. Moving to a server with faster processors can require more MIPS or PVU entitlements, for example, even if the number of cores running the software remains the same.

User-Based Licensing. Another popular licensing metric measures entitlements by users, typically either the number of concurrent users (i.e., the maximum number of individuals permitted to access the software at any one time) or the number of named users (i.e., the number of specific or “named” individuals with accounts to access the software). Conflating concurrent- and named-user entitlements can be costly—having six distinct users would exceed a five named-user license, for example, even if they only used the software one at a time.

Dubious vendor assumptions, particularly that every installation instance is used by the full number of licensed users, can also lead to substantial shortfall allegations. For example, if an organization installs software licensed for five named users on five laptops, a vendor might assume five different users are using each laptop, leading to a 20 named-user shortfall when, in fact, only one person ever uses each laptop, so there is no shortfall.

Although vendors will not typically agree to contractual limits on shortfall exposure, some vendors will allow licensees to true-up at the end of each contract year without penalty.

Which License Agreement Governs

Vendors regularly revise license agreements, so organizations that purchase entitlements and upgrades over a period of years can find themselves subject to overlapping and even contradictory license terms. Establishing an internal process to track license agreements, and which agreement is applicable to which entitlements, can be critical during an audit. Vendors often point to the most favorable language across agreements without clearly establishing which agreement, and therefore which terms, are applicable to each alleged shortfall.

License terms can change substantially over time, particularly in evolving technology areas (e.g., how to count processing cores in virtualized environments), so pressing vendors to migrate old entitlements to newer, more favorable license terms should be a routine part of purchase negotiations.

How Audits Are Typically Resolved

After an initial investigation, where the vendor typically runs scripts or requests certifications to determine usage, the vendor will provide a report showing entitlements, usage, and shortfalls for each licensed product, along with amounts due to true-up the shortfalls, often with interest, penalties, and retroactive support. The licensee and vendor then engage in a back-and-forth and, in most cases, reach agreement on an aggregate dollar amount to be paid, sometimes for a combination of true-up entitlements and additional upgrades that the licensor needs to purchase anyway.

Timing can be a critical pressure point in negotiations. Vendors typically prefer to resolve audits before the end of fiscal years and may settle for less in exchange for a quick payment to hit revenue targets. Likewise, vendors are understandably eager to close sales and so are often willing to temper audit, licensing metrics, and other terms going forward, particularly in connection with a large purchase.

Litigation is rare, but does happen when business discussions fail, and can lead to staggering money damages claims. For example, within just the past two years, SAP pursued breach of license claims for £55 million and \$600 million, settling the latter for an undisclosed sum and securing a favorable judgment on liability from the High Court in London, lending at least some credence to the former.

Advance Internal Investigations

Organizations can (and often should) conduct internal investigations to confirm license compliance before receiving an audit demand. Licensees often employ software asset management tools to help monitor use and compliance. There are, however, several important issues to consider.

First, to the extent an organization employs an outside expert to assess use and compliance, the organization should confirm that any scripts run by the expert do not themselves run afoul of the vendor's copyrights or other intellectual property rights. Any script run by the expert should be proprietary to the expert and not derivative of any scripts created by the vendor or a third party.

Second, the organization should review its license agreements to confirm its record keeping obligations. Some licenses require robust maintenance of records. Companies should take care to avoid inadvertently violating these provisions, particularly when potentially creating new usage and compliance records during an internal investigation.

Third, some aspects of an internal investigation may be shielded by the attorney-client or work-product privilege, and therefore not discoverable by the vendor, with careful planning and execution. While it is axiomatic that underlying facts are not privileged, a confidential attorney-client communication that includes or discusses facts may be privileged under certain circumstances. See *United States v. Davita, Inc.*, [301 F.R.D. 676](#), 683 (N.D. Ga. 2014).

Attorney-Client Privilege. The privilege analysis focuses on whether a communication was primarily for the purpose of securing a legal opinion or assistance in some legal proceeding. See, e.g., *In Re Grand Jury*, [475 F.3d 1299](#), 1304 (D.C. Cir. 2007). Investigations into what are primarily business matters or to assist with business decisions are usually not afforded the privilege. As such, “much depends on how the investigation is structured before it is even begun, what the employees are told is the purpose of the interview and how the facts are cast.” *United States v. ISS Marine Servs., Inc.*, [905 F. Supp. 2d 121](#), 128 (D.D.C. 2012).

Outside counsel should conduct and manage any investigation, and the purpose of that investigation, such as determining exactly how an organization employs the relevant software so as to evaluate its compliance with its legal obligations, should be clearly articulated from the beginning and repeated to those witnesses involved in the fact finding process. See *Upjohn Co. v. United States*, [449 U.S. 383](#), 394 (1981).

Work-Product Privilege. Similar to the business matters exclusion applicable to attorney-client privilege, “Documents prepared in the ordinary course of business” that “would have been created essentially in the same form irrespective of [anticipated] litigation are not protected by the work product doctrine.” See *United States v. Mount Sinai Hosp.*, [185 F. Supp. 3d 383](#), 390 (S.D.N.Y. 2016). Especially careful consideration is necessary if an outside expert will be employed to assist counsel in identifying how an organization employs the software, particularly the technical details of how virtualization, sub-capacity, cloud computing, or other installation methods are implemented, so counsel can then evaluate the organization's compliance with licensing obligations.

See *Cicel (Beijing) Science & Tech. Co., Ltd. v. Misonix, Inc.*, [331 F.R.D. 218](#), 232-234 (E.D.N.Y. 2019). An expert should conduct the investigation under the direction of counsel. And, counsel should control the communications between the organization and the expert, with an emphasis on addressing the legal terms of use, not the business ones.

How to Avoid an Audit

Vendors are unlikely to waive audit rights entirely, but organizations can seek to limit the scope and frequency of audits when negotiating new entitlement purchases. For example, if the standard license agreement terms include an annual audit right, an organization might consider pressing for a 24-month audit-free period followed by at most biennial audits. Vendors are understandably eager to close sales and so are often willing to temper audit, licensing metric, and other terms, particularly in connection with large purchases.

Licensees should always consider how to leverage entitlement purchases that they need to make anyway to gain more favorable terms across the board. Careful consideration needs to be paid not only to the audit provision itself but also to the licensing metrics and corresponding definitions, which often underpin the aggressive audit positions and tactics commonly advanced by vendors to establish unlicensed use.

When to Involve Counsel

Experienced counsel, whether in-house or external, need to be involved throughout the software licensing process, before an audit notice arrives. As described above, leveraging purchases to negotiate favorable terms and diligently keeping track of applicable license agreements and associated deployments is a critical preparation and an ongoing process. When a corporate restructuring or major IT realignment occurs, counsel need to be involved to identify and get ahead of potential license assignments and shortfalls.

When an audit notice arrives, counsel must guide responses and participate in internal strategy discussions from the outset, not only in an effort to cloak internal investigations and strategy deliberations in privilege, but also to prevent unwitting IT staff from making admissions that, true or not, will be used to justify excessive true-up demands. Experienced counsel and, for particularly complicated licensing regimes, a consultant with vendor-specific expertise are crucial and usually pay for themselves many times over in license shortfall savings.