

## ITAPS State IT Terms and Conditions Best Practices

ITAPS<sup>1</sup> believes it is in the mutual interest of the public sector purchaser and the IT vendor community to narrow the differences between commercial contracting practices and a state's required terms and conditions. Reforming standard IT terms and conditions and building smarter IT procurement processes enables states to fully recognize the benefits of innovation and products offered by the IT sector. Not only can these products offer widespread system flexibility and cost savings, but they can also be leveraged to make certain that taxpayers and state agencies receive the highest possible outcomes in project and system deliverables. Inflexible terms and conditions that disproportionately shift risk onto the vendor hinder efforts to engender competition among top technology providers and ultimately lead to higher costs for the State and its taxpayers. By narrowing the difference between commercial contracting practices and a state's required terms and conditions, states will not only improve competition among vendors but also build a procurement process that operates more efficiently with fewer issues to negotiate. Following is a list of commercially acceptable best practices around state IT terms and conditions that will grant states the flexibility to efficiently acquire innovative technologies while also maximizing cost savings and reducing the time to purchase.

- 1. A liability cap that is rationally related to the revenue opportunity should be used in contracts, subject to reasonable exclusions such as bodily injury and death.** Unlimited liability has been, and continues to be, a major concern for the IT sector. Higher limitations of vendor liability, or in some cases uncapped liability, creates an unreasonably high risk for vendors and leads to higher costs for products and services— not only for the purchasing agency, but also for state taxpayers. High liability limits can also skew the request for proposal (RFP) process by reducing the number of competitive bids by high performing vendors who are unwilling and unable to underwrite extraordinary risk with no rational relation to incoming revenue. Vendors who choose to participate in these procurement opportunities often seek to mitigate the increased risk by building a larger margin into their prices. Additionally, there is significant risk in these situations that the state will receive bids only from fly-by-night companies that have insufficient or no assets available to protect the state from damages and will disappear at the first sign of trouble. Reasonable limitations on liability would help support the inclusion of qualified vendors in state solicitations for bids that have the requisite accountability for their actions while fostering greater competition and permitting lower pricing. ITAPS proposes that a rational limitation on direct damages should be no more than the amounts paid by the state for the product or service that is the subject of the claim, and if such charges are recurring or pay-as-you-go charges, then no greater than trailing 12 months' spend. The necessary disclaimer for special, incidental, exemplary, indirect, economic consequential damages or costs, loss of or damage to data, lost revenue or profits, and anticipated savings should also be included as part of a damage exclusion term consistent with commercial best practices. The National Association of Chief Information Officers (NASCIO) has indicated that the trend among states is recognition that states benefit from a willingness to agree to limit the nature of damages available for recovery and to commit to limits of liability that closely relate to contract value.
- 2. Carve-outs in the limitation of liability should be limited.** Of the contracts that do contain capped liability, the limitation of liability provision typically carves out damages related to bodily injury or death. The state

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<sup>1</sup> **About ITAPS.** ITAPS, a division of the Information Technology Industry Council (ITI), is an alliance of leading technology [companies](#) building and integrating the latest innovative technologies for the public sector market. With a focus on the federal, state, and local levels of government, as well as on educational institutions, ITAPS advocates for improved procurement policies and practices, while identifying business development opportunities and sharing market intelligence with our industry participants. Visit [itaps.itic.org](https://itaps.itic.org) to learn more. Follow us on Twitter [@ITAlliancePS](#).

provisions often also contain a carve-out for liability for damages caused by ordinary negligence on the part of the vendor or for anything for which the vendor has offered indemnification. Such terms are problematic because they potentially implicate vendors for any deviation, however small, from the terms of the contract. It does not take long before the exception renders the limitation of liability ineffective, and vendors will be forced to increase costs as a way to offset the inordinate risk. Another frequently encountered carve-out term is one that holds the vendor responsible for all breaches of security or data privacy, without any financial or fault-based limitations. Many states are attempting to shift the entire burden for privacy and security to the vendor while failing to take reasonable and important measures (e.g., encryption, physical security, virtual private networks) to secure the data while in the state's control. Worse yet, the state can specify the security method that must be used regardless whether that is the most appropriate method available to the vendor. Vendors are willing to be accountable for their own performance but should not have to bear all of the risks inherent in the solution or shoulder the state's responsibility for protecting its own data. Such burden shifting may also increase vendors' costs—and ultimately the prices vendors offer to states. States must consider shared responsibilities and security when developing these carve-outs to make sure risk is balanced between the two parties. By including reasonable security measures, a state will achieve its goal of protection while more proportionately balancing risk. With risk more proportionally balanced, states will likely see responses to its RFPs from high performing vendors who can offer quality services that are favorable for taxpayers.

- 3. States should not include Most Favored Customer (MFC) clauses as a way to secure best pricing on products and services.** It is difficult for vendors to agree to “Most Favored Customer” language in which they are committed to always provide a particular state customer with the best price offered for a product or service. The IT industry is a thriving market sector competing globally to provide customers with a multitude of products under a variety of conditions. While commercial IT companies produce a wide array of products globally, each product frequently comes with client requests for accompanying services of various complexities and scope, different volumes and configurations, unique specifications, and often very specific requirements based on unique state needs. Further complicating the issue is the fast paced and quickly evolving nature of the IT industry. Because new generations of products replace others as they mature, pricing strategies in the market can vary widely based on a variety of factors such as the time of adoption of the new generation of products and specific terms contained in maintenance agreements. This makes it difficult to apply MFC treatment. It is also nearly impossible for a vendor to comply with a broadly written MFC clause due to variations in IT products, client contract terms and conditions, conditions in the private versus public sector, and large-volume discounts. MFC clauses also represent a significant risk to the vendor community, and it is less likely that bidders will accept the state's terms and conditions without negotiations. An increase in the time it takes to negotiate each and every contract will result in less efficient procurement and extend the procurement cycle. At the pace at which technology changes, this places states at a disadvantage in being able to procure the right goods at the right time. The most effective way to secure the best pricing for the state is through the adoption of commercially reasonable procurement practices.
- 4. A state's right to terminate should be limited to a material breach.** Many state IT contracts contain a combination of broad, unbounded, and unilateral termination rights on the part of states and no rights for the vendor. Such unbalanced provisions are unjustified and ignore valid scenarios under which the vendor should have the right to end the contract (e.g., the state's material failure to pay the vendor) or where the vendor requires significant upfront investment. A more equitable approach, which affords both parties' protection, is to (a) allow the state to suspend or terminate if the vendor defaults with respect to a material

obligation and fails to cure the default within a reasonable period of time after being given notice; and (b) allow the vendor to terminate under specified material circumstances and only after the state is given notice and a reasonable opportunity to cure. States may, of course, retain their right to terminate for non-appropriation, as discussed in the next section.

5. **If a vendor agrees that the state has the right to terminate for its convenience, the vendor should be made whole if that right is exercised.** Vendors understand that funds must normally be appropriated by the state's legislative body and that the state may require a termination for non-appropriation provision in its contracts. Vendors also understand that other circumstances may necessitate early termination of contracts. However, in the event of a termination for convenience, the state should be required to provide some notice (e.g., 30 days) and pay the vendor for all services performed and deliverables delivered through the effective date of the termination plus costs and expenses that are actually and reasonably incurred by the vendor as a result of the unplanned termination. As a type of termination for convenience, the state should be obligated to provide notice if a non-appropriation occurs and the vendor should be made whole to the extent funds have been appropriated.
6. **Intellectual property (IP) provisions should be tailored to the actual solution involved and grant ownership rights to the state with respect to deliverables specifically created for the solution only where necessary.** Many state IT contracts contain language that results in an extremely broad grant of intellectual property from the vendor to the state. Such clauses frequently lack any relation to the solution provided and to the state's actual needs. These provisions can also increase the cost of the solution, as the vendor loses the ability to modify and reuse the IP and must cover all of its costs directly from the state in the initial development. Moreover, it is improper to require vendors to transfer ownership rights in their pre-existing or proprietary IP—especially when the same IP is essential to the vendor's provision of services to other states. These provisions discourage innovation and deter vendors from participating in procurement opportunities. Recently, the Centers for Medicare & Medicaid Services (CMS) issued [guidance](#) on IP ownership for commercial off-the-shelf (COTS) products and Software as a Service (SaaS) solutions, stating that they are “designed, developed, and licensed by the vendor, so the state is not entitled to ownership rights to the core program.” The guidance specified that the state is only granted ownership to the software separate of the core product that is related to the customization and configuration of the COTS products. Rather than requiring that the vendor relinquish all rights in all documents and materials, a better approach would be to establish a framework of IP rights so that the parties can select the appropriate category for each item (e.g., state owns and vendor receives license; vendor owns and state receives broad license; vendor owns and state receives license under separate license agreement ...).
7. **Indemnity risk should be fault based to the extent caused by the negligence or intentional misconduct of the vendor or its subcontractors.** Indemnification provisions can present an excess exposure to a vendor when the provisions are overly broad and present risks that are not insurable or may not be within a vendor's ability to control such as intangible personal injury. The vendor's indemnification obligation should be based on, and limited to, the vendor's negligence or fault. If both the vendor and the state are concurrently at fault, the indemnity should be allocated proportionately between the parties based on their respective percentage of fault. Further, a contract should include a provision that clarifies that a vendor shall have no obligation to indemnify the state from any claim attributable to the acts or omissions of the state and its officers, employees or agents.

- 8. Milestones should be clearly defined and not left for interpretation.** Withholding payment until a set of deliverables are accepted by the state is a poor model unless the acceptance criteria are clearly defined and objective. Subjective terms that require criteria such as “satisfactory” for payment result in an increased perception of risk for the vendor due to ambiguity and uncertainty. In addition, it is unreasonable to withhold 10% of a multimillion-dollar contract until the last year of the multiyear contract. Due to cash flow issues that may be created when withholding is used, the withholding should be limited in amount to no more than 10% of the deliverable charge, and payment of the withheld amount should correspond in time with the development, delivery, and acceptance of the specific deliverable. Clearly defining and articulating the intended outcome and milestones for deliverables as they relate to vendor payment will better balance each party’s interest and expectations.
- 9. A state should use a competitive bidding process focused on obtaining the best value for the taxpayer rather than issuing requests for the lowest price.** Information technology products and solutions are complex and ever-changing, and more often than not cannot be evaluated by price alone. Using an evaluation model focused on the price of a product limits competition among vendors and increases the probability that solutions may not reflect the best value option for taxpayers. To generate robust competition among capable IT vendors and provide the taxpayers with the highest quality product and solution, a state must focus on obtaining the best value.
- 10. The vendor should be granted the ability to make exceptions to the requested terms and conditions without the fear of rejection or disqualification, and subsequently to negotiate such exceptions.** If a state evaluates, discounts, or disqualifies a vendor’s bid based on the exceptions it raises to the bid terms and conditions, IT companies will be forced to either undertake unreasonable risk or not bid on the project at all, as this approach does not allow vendors and states the opportunity to balance terms and conditions risk with pricing and delivery. It also reinforces ambiguous provisions that lead to poor contracting results and thereby does not provide a state with the best value for taxpayers. Finally, this approach decreases the state’s ability to contract with the most qualified bidder.

While each state may have other items that deviate from the IT vendor’s commercial practices, resolution of these major issues will have a significant impact on the state’s ability to capture the best value for taxpayers, reduce IT budgets, and speed up the contract process within state procurement. If you are interested in hearing from the IT vendor community on how the state’s purchasing process and terms and conditions can be improved, please feel free to contact Jordan Kroll at [jkroll@itic.org](mailto:jkroll@itic.org) or 202-524-5546.