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CONTRACTING FOR TELEPHONE SYSTEM ACQUISITIONS

Michele C. Kane*

During the first year of deregulation, which commenced January 1, 1984, the telephone industry shipped key telephone system equipment and private branch exchange ("PBX") equipment valued at over two billion dollars to the United States market.¹ Shipments of PBX equipment are expected to increase at the rate of 10 to 15 percent per year² as users increasingly perceive PBX's as tools to enhance office productivity by providing access to data bases and mainframe computers and networking of desktop computers and workstations. Many companies embarking upon the initial acquisition or replacement of existing telephone systems will seek legal assistance in the negotiation and documentation of these acquisitions. In order to sufficiently protect his or her client's interests, the user's attorney must fashion a contract that addresses, at minimum, four essential issues: the telephone system specifications, acceptance testing by the user, warranties, and maintenance services.

Typically, none of these issues is addressed adequately in the standard telephone system vendor's acquisition agreement. In this and several other respects, contracting for the acquisition of a telephone system bears certain disquieting similarities to contracting for the acquisition of a mainframe computer system during the

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1. NORTH AMERICAN TELECOMMUNICATIONS ASSOCIATION, 1985 TELECOMMUNICATIONS SOURCE BOOK 72, 77 (1984).

A key system consists of voice stations with buttons for each office and intercom lines. A distinguishing characteristic of a key system is that the path of the external communications network to the central office, WATS lines and other trunk lines is controlled by the user, who selects from among the paths terminating at his telephone by depressing the button that activates a particular path. A PBX system, by contrast, is a switching machine that automatically selects from a pool of paths. In a PBX system, internal communications do not require a separate system, as they do in a key system, since they are incorporated into the switching machine. P.Hoffman & J. Mills, COMMUNICATIONS HANDBOOK FOR ATTORNEYS 17 (1978). Unlike a key system, a post first generation PBX system can accommodate both voice and data communications.

2. PRUDENTIAL-BACHE SECURITIES, "ROLM CORPORATION COMPANY UPDATE," April 4, 1983 at 2.

1960's. Both markets are dominated by relatively few vendors³ and most customers are unsophisticated with respect to the complex and rapidly advancing technology. More often than not, the vendor selection process is haphazard and customers do not employ a contracting process that includes a request for proposal or request for quotation in which the customer sets forth its requirements (both technical and contractual) prior to the evaluation and selection of a telephone system vendor.

At, or subsequent to, the conclusion of the vendor selection process, or even later, shortly before the completion of the equipment configuration, the user is presented with the vendor's one-to-two page form acquisition agreement for execution. This agreement typically provides that the vendor will use its best efforts to complete installation of the equipment and software by a designated cut-over date (the date on which the user's system is connected to the local telephone company's lines) and that most or all of the purchase price will be paid in installments on or before delivery of the equipment. The agreement includes a limited warranty against defective parts and workmanship, but provides that substantially all risks are borne by the user. Such contracts give little or no protection to the user by failing to articulate many of the user's significant risks, by allocating those risks that are articulated to the user rather than to the vendor and by failing to provide meaningful user remedies or incentives for vendor performance.

The experience gained by attorneys representing users in acquisitions of computer goods and services can be valuable in rendering assistance to users acquiring telephone systems. In both types of acquisitions, whether by way of an addendum to the vendor agreement or in some other manner acceptable to the parties, the user's attorney must strive to address the above-mentioned key issues: specifications, acceptance testing, warranties and maintenance.

I. SPECIFICATIONS

In the selection of a particular telephone system, the user typically relies on the vendor's promotional materials describing the features and capabilities of the system, the proposal submitted by the vendor which has been tailored to the customer's needs as defined by or with the assistance of the vendor, and the oral and writ-

3. The top three suppliers of PBX systems, AT&T, Northern Telecom, Inc. and Rolm Corporation account for more than half of the revenues, and much of the growth in the PBX market. Bertolik, *PBX The Changing Landscape*, COMPUTERWORLD, December 31, 1984/January 7, 1985 at 52.

ten representations of vendor representatives concerning existing and future products. The typical vendor form agreement, however, describes the system only to the extent that it lists equipment and optional software features and indicates that a basic software package is included. All other understandings of the parties, whether oral or written, are excluded by the vendor's merger clause.

The user's primary concerns in such an acquisition, other than lifetime system costs, are whether the system will perform the functions as represented and whether timely service will be provided in the event that the system fails to so perform. If the agreement describes the functions of the system only to the extent that it lists equipment and software, the customer will have virtually no recourse against the vendor if the system does not perform as anticipated. Counsel's first step, therefore, should be to define the functional specifications of the system, perhaps with the assistance of a technical consultant engaged by the user. The functional specifications should include all specifications and descriptions contained in those materials that formed the basis for the user's selection of the system, including the vendor's proposal, and all specifications and descriptions published or disseminated by the vendor describing any portion of the system.

In configuring the user's telephone system, the vendor makes certain determinations with respect to (1) the current capacity of the system (the number of trunks, lines and stations for which the system is equipped) and its ability to accommodate user growth (the number of trunks, lines and stations that can be used with the system as configured without adding additional switching equipment) and (2) the ability of the system to accommodate present and anticipated future user demand. The vendor's determinations in each of these areas should be incorporated into the agreement as part of the functional specifications. Such functional specifications can take the form of representations of (1) the maximum number of ports (trunks and voice and data stations) the system can use and their interchangeability; (2) the CCS rating⁴ for certain equipment components and for all the equipment as configured and as fully utilized; (3) if appropriate, that the system will be totally non-blocking⁵; (4) if appropriate, that all inward trunks can be used si-

4. In telephone terminology, the components of load are calling rate and duration of calls. When the unit for holding time is 100 seconds and the calling rate is expressed as calls/hour, the product gives the traffic load in CCS (hundreds of call seconds per hour). J. McDONALD, *FUNDAMENTALS OF DIGITAL SWITCHING* 42 (1983).

5. A PBX is non-blocking when it provides a line for each user all the time. In a

multaneously; and, (5) the number of internal and external calls that can be handled simultaneously by the system, as configured and as fully utilized, without generating busy signals. Performance criteria meeting or exceeding the vendor's published practices which establish transmission and reliability objectives should also be incorporated into the specifications.

II. ACCEPTANCE TESTING

Once comprehensive specifications are made part of the contract, they can form a basis for acceptance testing, warranty service and ongoing maintenance. An acceptance test consisting of a period (e.g., 60 days) during which the user can determine, under day-to-day operating conditions, whether the system performs in accordance with the specifications provides an opportunity to identify software bugs and equipment defects that are not discovered in the vendor's pre-cutover or immediate post-cutover diagnostic testing. Given the magnitude of the user's capital expenditure for the system and the potential disaster to the user's business if the system fails to operate for any length of time, such an acceptance test period and the holdback of a significant percentage of the purchase price until final acceptance are reasonable and necessary user protections. The user should be certain that the system is performing properly before accepting the system, for a buyer's pre-acceptance remedies are superior to those remedies available to it once acceptance has occurred.⁶ Counsel should be aware that most⁷ standard vendor form contracts provide for no such user acceptance testing.

III. WARRANTIES

As suggested above, comprehensive specifications incorporated into the acquisition agreement can provide a standard against which to measure both the performance of the system and the vendor's warranty service during the warranty period. The establishment of a performance standard, however, is only the first step. The crucial

totally non-blocking system, every telephone in the system could be off hook all the time and no busy signals would be generated.

6. See CAL. COM. CODE §§ 2711, 14 (1963).

7. Unlike contracts of certain of its competitors which provide for no user acceptance test, Northern Telecom Inc.'s Purchase Agreement provides that within 10 days after cutover, the customer shall either accept the system or notify NTI of failures of the system to materially conform with the agreement. The customer's failure to either accept or provide notice of nonconformance within the prescribed time constitutes final acceptance of the system. No meaningful standards for system performance, however, are set forth in the agreement.

second step is to articulate the response required from the vendor if the system fails to perform in accordance with the specifications. The required response may include remote testing and correction, the arrival of vendor repair personnel at the user's site, repair or replacement of the failed component, or some combination of the foregoing. The time frames in which such responses are required should also be stated.

While it is not reasonable to expect a vendor to guarantee a two hour response time for every failure of the system to perform in accordance with the specifications, it is not unreasonable to specify in the agreement which failures are critical to the user's operation, or to provide for a procedure whereby certain failures can be designated as critical, thus requiring a prompt vendor response. A less rapid response would be required for all other failures which can be designated as noncritical. Further, in the event that the vendor is unable to repair within a certain period a system component which has caused a critical failure, the vendor, within a specified period thereafter, should be required to replace the defective component with a new component meeting the contract specifications.

In order to provide an incentive for prompt vendor performance meeting the requirements of the warranty section, user's counsel may seek to include as part of the agreement a provision requiring the vendor to pay the user liquidated damages for each increment of delay in the required vendor response. Such provisions can be expected to be hotly negotiated.

In addition to performance warranties, certain additional warranties should be made part of the agreement. A configuration warranty should be included indicating that no function or feature to be performed by or contained in the system pursuant to the specifications will require the user to add any additional line cards, trunk cards or other additional equipment. A warranty that the system does not infringe upon any third party's patent, copyright, mask work, trade secret or other proprietary rights, and an indemnification by the vendor against any such infringement also should be a part of the agreement. Further, the vendor should warrant that the equipment constitutes "new equipment" (as that term is defined in Section 48(b) of the Internal Revenue Code of 1954, as amended) to assure the user that an investment tax credit will be available to it or its lessor.⁸

8. For financial reasons, many users elect to lease the system rather than purchase it, often with the option or requirement to purchase it at the end of the lease term from a third

IV. MAINTENANCE

Upon expiration of the warranty period, the vendor should be obligated, for the period that the user anticipates using the system (e.g. 10 years), to continue in the manner provided in the warranty section to correct failures of the system to conform to specifications. At the user's option, this continuing obligation can be performed on either a time and materials basis or pursuant to an annual maintenance contract, subject in each case to most favored customer provisions. This obligation is broader than the obligation to repair or replace defective equipment stated in the typical vendor warranty provision and maintenance agreement.

V. OTHER ISSUES

In addition to the foregoing primary issues, the contract should contain delivery, installation and cutover date commitments to facilitate user planning; provide a certain period of price protection on additional equipment ordered by the user; include environmental specifications and a requirement for vendor certification of environmental compliance prior to equipment installation; and describe training to be provided for user console attendants and station users. User's counsel also should consider the desirability of limiting the vendor's remedies for alleged default, to prohibit the vendor from terminating warranty or maintenance service obligations or from disabling or taking any part of the system without a judicial determination of user default.

The ability of a user acquiring a telephone system to negotiate a balanced agreement that satisfactorily addresses the user's primary concerns undoubtedly will vary depending upon the vendor, the bargaining power of the user, the price of the proposed system and the user's willingness to devote the resources of its own personnel to the acquisition process and to effectively utilize technical consultants and informed counsel.

party, such as an affiliate of the vendor. The lease rate charged by the lessor varies depending upon the allocation of the investment tax credit between the parties.

If the system is to be leased, certain modifications may be required to the financing documents to ensure that the user retains the protections it has obtained in the acquisition agreement.