

It's Better Than You Think:

Why Software Companies Should Consider The Government Market

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This three-part paper discusses why more software companies should consider selling to local, state, and federal governments. Part I identifies the government as a potentially lucrative market for software companies—a market that too often is neglected for reasons having more to do with myth than reality. Part II briefly outlines the process of finding and winning a government contract. Part III touches on specific rules for licensing software to the U.S. Government.

Part I.

Government: A Neglected Market

Software companies typically sell to other companies and individual consumers. Left out of this mix is another very large potential market: local, state, and federal governments. Yet by most accounts the U.S. government is the world's largest consumer of goods and services, and the aggregate spending of the 50 states is not far behind.¹

Some small software companies—Arxan and Spyrus for example—focus substantial resources on the government marketplace. But they are in the minority. Most businesses focus on the more familiar world of business-to-business and business-to-consumer transactions. Why is this so? The failure of software companies—particularly smaller software ventures—to take advantage of the government market springs primarily from three related factors: difficulties in accessing the market, the complexity of the government procurement process, and risks to intellectual property rights. But the benefits of contracting with the government may outweigh those risks—especially when some persistent myths are dispelled. Consider the facts:

It is *not* that hard to contract with the government. It is true that public contracting is subject to some arcane rules, mostly embodied in the Federal Acquisition Regulations (the FAR)². But the Office of Federal Procurement Policy has helped streamline government contracts, creating standard contract terms and regulations. As a consequence, there are relaxed

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¹ See, e.g., *Federal Government – The World's Biggest Customer*, <http://government.onvia.com/?p=15> (visited June 13, 2006).

² The Federal Acquisition Regulations are codified at Chapter 1 of Title 48 of the Code of Federal Regulations, with agency-specific supplements being in the remaining Chapters.

and simplified rules for acquiring commercial software of a type “customarily used” by non-government consumers.³

Governments have come a long way in improving access to contract opportunities. Traditionally, companies interested in contracting with the government had to peruse a wide range of official publications. Federal government contract opportunities were published in the Commerce Business Daily, and each state (plus many municipalities) had similar paper-publication systems. Though it remains true that connecting buyer and seller is harder in the government market than in the private sector, the internet has made bidding much easier than in years past. The Commerce Business Daily and its state and local counterparts now can be searched online.

Moreover, governments are actively trying to make the process easier. For example, all Federal government procurement opportunities over \$25,000 are now posted online, in searchable form, at <http://fedbizopps.gov>: “Through one portal - FedBizOpps (FBO) - commercial vendors seeking Federal markets for their products and services can search, monitor and retrieve opportunities solicited by the entire Federal contracting community.” Many states—including North Carolina,⁴ South Carolina,⁵ and Texas⁶—and forward-looking foreign countries like Australia⁷ have followed suit and partially or fully enabled e-procurement systems. Some agencies go further still, circulating requests for proposals and invitations to bid via email to interested subscribers, free of charge, based on user-defined profiles.

That said, there are certainly some drawbacks to the process. For example, companies may need to “qualify” before becoming eligible for certain government contracts. Some foreign companies may be excluded from contracts relating to national security. Advertising is less effective when directed to a governmental agency. And client-development is more difficult in an environment where a business lunch or a round of golf could be interpreted as a bribe or kickback. Lastly, there is the ever-present need to understand that the government, generally, cannot participate in a “battle of the forms,” and is required by law to stipulate to certain processes.

The government is *not* going to steal your intellectual property (if you’re careful).

For years, private contractors were wary of dealing with the government because they were afraid the government would take or compromise the company’s intellectual property rights. This was a legitimate—if sometimes overstated—concern. Modern government procurement law developed chiefly in the Department of Defense. But the Department of Defense primarily purchased goods for which there was no “civilian” uses, and needed the ability to second-source replacement parts. So the general rule was that the government would acquire all rights (including all intellectual property rights) in goods or services purchased under a government contract. Companies interested in pursuing commercial opportunities could not

³ See Federal Acquisition Regulations (FAR) Part 12 and 2.101.

⁴ <http://www.ncgov.com/asp/subpages/intention.asp?P=1&I=90> (visited June 13, 2006).

⁵ <http://www.state.sc.us/Requisition> (visited June 13, 2006).

⁶ <http://www.state.tx.us/category.jsp?language=eng&categoryId=2.9> (visited June 13, 2006).

⁷ <https://www.tenders.gov.au/federal/index.cfm> (visited June 13, 2006).

risk losing their intellectual property to the government, and understandably stayed away from the field.

That all changed with the passage of the Bayh-Dole Act during the Reagan Administration. In the wake of Bayh-Dole, the Competition In Contracting Act, and various other contracting innovations over the last 20 years, the government now has the flexibility to contract (almost) like a commercial consumer. And this shift in rules has been accompanied by an increased awareness and recognition of the need to keep intellectual property rights with their developers. Thus, the government now only seeks intellectual property rights consistent with its actual needs. If a company has appropriate protections and good legal counsel, it usually can deal with the government just as it would with any private customer—preserving in full the company’s intellectual property rights.

But there are still some technical traps for the unwary, and a company should be careful when entering a deal with the government involving intellectual property. For example, where non-commercial software is being provided, there are extensive notice and reporting provisions. Certain of these notices must be made prior to contracting, and for non-Department of Defense contracts, care must be taken to ensure that the proper clauses are used to allow delivery of trade secret-protected software. All intellectual property must be prominently marked, and the government needs to know precisely what materials the company considers proprietary. If a company does not follow these provisions, it runs the risk of losing title or rights to its intellectual property, whether existing or developed after contract. By way of example, in *Campbell Plastics Engineering & Mfg., Inc. v. Army*, 389 F.3d 1243 (Fed. Cir. 2004), the U.S. Army took title to a patent for an invention created by Campbell Plastics Engineering during the research conducted under a government contract precisely because Campbell failed to comply with notice-and-reporting rules.

In summary, the government sector is a very large consumer of goods and services, including software, software modifications, and customized applications. Though some barriers remain, it is increasingly easy to find and enter government contracts. Thus, government is a potentially lucrative market that is often overlooked by software companies.

Part II.

An Overview Of The Process Of Government Contracting

In Part I, “Government: A Neglected Market,” we discussed the reasons that software companies should consider marketing to local, state, and federal governments. Despite the unusual nature of the government market, there are several good reasons for companies—especially emerging ones—to take advantage of the possibilities offered by contracting with the government. Assuming we have persuaded the reader to consider entering the market, in this section we outline the process of obtaining a government contract.

The process of winning a government contract or subcontract is very different from entering into a private-sector contract. A company often must go through a complex process of bidding before being awarded a contract; or else it will need to wait while the government seeks an authorization for “sole source” procurement. These rules vary depending on if the contract is

local, state, or federal in nature. We will focus here on the Federal system, which has the best-developed body of procurement law and serves generally as a model for public contracting at the state and local levels.

Registering with the government. Before a company can contract with the government, it needs to become part of the procurement system. This entails registering with various governmental bodies. For Federal contractors, a company needs to obtain its DUNS number from Dun & Bradstreet, and typically also must obtain a Commercial And Government Entity (CAGE) number from the Defense Logistics Agency. These numbers plug into the government's accounting and oversight system, allowing companies to get paid for contracts they win.

Though registration may involve a non-trivial up-front investment of time and resources, it can clear the path to lucrative future contracts. And the government is doing a decent job of standardizing and streamlining the process. For example, the Department of Defense's Central Contractor Registration program allows a company to complete a single registration form in order to contract with any organization falling under the Department's aegis.

Finding contracts. As we discussed in Part I, the process of finding a government contract to bid on has never been easier. All federal contract opportunities—plus a broad spectrum of local, state, and international requests for proposal—are available online in searchable form, free of charge. And companies geared toward facilitating business-to-government transactions have also sprung up. For example, companies like B2GMarket (<http://www.b2gmarket.com>) and Onvia (<http://www.onvia.com>) operate subscriber-based internet clearinghouses of international and domestic government-contracting opportunities. Moreover, the variety of contract types available can allow for substantial flexibility, depending on the work requested. For instance, while generally the government is constrained to follow general procurement rules, certain contract types allow for substantial deviations. Commercial item procurement allows for the purchase of commercial software, even with minor modifications, under the greatly simplified regulations of FARs Part 12. Additionally, the entire structure of the Federal Acquisition Regulation is not applicable to Other Transactions,⁸ venture funding,⁹ and some other special types of research and prototyping agreements that can be used as vehicles for software development or sales.

Small software companies should also bear in mind their potential advantages in seeking government work. In addition to policies favoring competition, most governments have affirmative-action and small-business mandates or set-asides. Companies that are minority- or woman-owned, or that satisfy Small Business Administration guidelines for size,¹⁰ may have an advantage when competing for government work with software giants like Microsoft or Oracle under such programs as the Small Business Innovative Research (SBIR) program.

⁸ 10 U.S.C. § 2371 (DOD, DHS); 42 U.S.C. § 2451(c)(5) (NASA).

⁹ One example of venture funding is funding available from the CIA through In-Q-Tel, a description of which can be found at <http://www.in-q-tel.com/about/index.htm>.

¹⁰ A software company with less than \$18 to \$21 million in annual revenues generally will qualify for small-business set-asides. *See generally* <http://www.sba.gov/size/guide.html> (visited June 14, 2006). Computer hardware companies typically need to have fewer than 1000 employees.

Additionally, even where software giants are awarded contracts, these giants are often required to subcontract and team with smaller contractors, such that substantial sub-contract opportunities typically exist that are not always immediately apparent. One advantage of these sub-contracting opportunities is that the procurement laws and regulations often provide protections not normally provided to a subcontractor in the commercial context.¹¹

Winning contracts. Unlike in the commercial context, the government is required by law to competitively bid most of its contracts. This means that the government must first issue a Request for Proposals or an Invitation to Bid, setting forth both the government’s requirements and the criteria by which the government will evaluate submissions. Submissions are judged by a Contracting Officer, who later will bear the responsibility for administering the contract with the winning bidder. In all of these areas, the government’s behavior is noticeably different from that of commercial companies. It is in some ways easier to understand, as the government buyer is limited in its evaluation to the specific factors set forth in the invitation or request. But it also can be frustrating, in that virtually all contracts must be “competed”—regardless of the performance of the incumbent contractor.

That said, the decision-making process is not that different from a commercial bid: companies submit information (including, where necessary, confidential information protected by bidding laws or nondisclosure agreements) for evaluation, make presentations, and then wait for the buyer to decide. On sufficiently large contracts, unsuccessful bidders can challenge the award (a “bid protest”), claiming that the winning bidder failed to satisfy the pre-set criteria or engaged in misconduct. A bid protest goes first to the Contracting Officer, then through his administrative superiors and a Board of Contract Appeals before finally reaching the court system. But though the bid protest process seems convoluted to outsiders, it is in fact not substantially different from the litigation disgruntled bidders sometimes bring in commercial competition.

With competent legal counsel, navigating from beginning to end of the government contracts process can be a relatively straightforward and painless task.

Part III. Licensing Software To The Government

In Part II, “An Overview of the Process of Government Contracting,” we discussed in general terms the process of finding and bidding on a government contracting opportunity. In this final section, we highlight issues specific to software companies entering Federal contracts.

As discussed above, for the last 20 years or more the Federal government has taken the position that intellectual property can be exploited more effectively by private contractors than by government agencies. Accordingly, the default rule is that government agencies do not seek

¹¹ For example, subcontractor patent rights may bypass the prime contractor and exist only between the government and the subcontractor. See FAR 52.227-11 or 52.227-12. Additionally, 10 U.S.C. § 2320 requires prime contractors to Defense contracts include clauses to flow down protections for technical data, and the Defense computer software clauses mirror this technical data requirement.

and will not acquire the intellectual property rights of contractors. Technically, this rule can be bent in the case of patents, where the government still is willing to assert ownership of contractor assets and where the latent threat of “march-in” rights has kept contractors in check.¹² But for a software company whose primary intellectual property asset is copyrights (source and object code), not patents (business methods and the like), the risk of the government seeking to repossess company resources is remote. Moreover, the government has never actually asserted these march-in rights, which only apply to patents developed under the contract as opposed to pre-existing intellectual property. The government generally understands and respects the need of the contractor to protect its intellectual property rights.

The government typically licenses software on a per-seat basis. Thus, rights are limited to the number of software copies sold; the Federal government operates in this respect just like any over-the-counter purchaser. There are exceptions, however, when it comes to technical data—particularly in defense-related contracts. In the case of software developed in part or in full with government funds, the government often will seek to acquire a broader “government-purposes” license, and also will seek databases and accompanying documentation. Thus, it is critically important for companies doing business with the U.S. government to document all sources of funds used to develop the software being sold. Government rights in software can fall into four categories:

Restricted Rights. The “Restricted Rights” designation is preferred by software companies. Restricted Rights software has been developed at private expense and may also include trade secrets. A Restricted Rights designation prevents the government from making copies of copyrighted programs, except to switch computers or perform software maintenance. Restricted Rights software code cannot be released under the Freedom Of Information Act (FOIA) or disclosed for competitive bidding purposes.

Government Purpose Rights. Government Purpose Rights limit the government’s ability to distribute software outside the government. Generally, Government Purpose Rights convert to Unlimited Rights after five years, unless the parties agree otherwise (as very often they do). Software subject to Government Purpose Rights usually has been developed in part with government funds under a particular contract. Software subject to Government Purpose Rights cannot be released pursuant to a FOIA request, but may be disclosed for competitive bidding purposes. Government Purpose Rights are most commonly sought in Department of Defense contracts.

Small Business Innovation Research (SBIR) Rights. For software developed under SBIR grants, the government is limited in its ability to distribute the software and in the number of copies it can use. The duration and nature of this limitation varies with the SBIR contract under which the software was created. During the limitation period, SBIR software cannot be released under FOIA or disclosed for competitive bidding purposes. After the limitation period expires, however, the government’s rights become unlimited.

¹² March in rights generally refer to the Federal Government's right to take title to subject inventions under certain circumstances. Subject inventions are inventions first conceived or actually reduced to practice under a Federal Government contract. The conditions for march in are contained in 35 U.S.C. § 203, as well as in the patent rights clauses found at FAR 52.227-11 through 52.227-12.

Unlimited Rights. As the name implies, the government has no limitations on distribution or the number of copies it uses of “Unlimited Rights” software. Unlimited Rights software has been developed wholly at public expense and can be released both under FOIA and disclosed for competitive-bidding purposes.

The regulations governing the procurement process offer surprising flexibility in terms of software licenses. For commercial software, Part 12 of the FAR allows delivery using standard commercial terms—the same shrink-wrap license that applies to an over-the-counter buyer at Fry’s Electronics could well apply to the Federal government. FAR and various agency-level elaborations like the Defense Federal Acquisition Regulations allow delivery of non-commercial software under a Restricted Rights designation if (a) the protected status of the software was identified in the contractor’s proposal or bid, (b) the software and documentation is properly marked, and (c) the company maintains records supporting the Restricted Rights classification in the event of a challenge. The real problem is finding a Contracting Officer with the confidence to use this regulatory flexibility, or to insert the right alternate clause in the case of non-Defense contracts.¹³

And in the event of a breach of the government’s license, software companies are able to sue for redress in the Court of Federal Claims, or use a form of binding arbitration through Agency Boards of Contract Appeals set up under the Contract Disputes Act (CDA) and specializing in resolving contract disputes. As an alternative, software companies can sue for copyright and/or patent infringement. However, under 28 U.S.C. § 1498(a) & (b), the exclusive action for an owner of a patent or copyright that is infringed by the government is in the Court of Federal Claims, rather than in a company’s local Federal district court. Nevertheless, a successful plaintiff is entitled to actual damages and profits, and also can seek statutory damages under section 504(c) of the Copyright Act.

Software companies thus enjoy substantial legal protections—commensurate with what they enjoy in the private sector—and tangible advantages in contracting with the Federal government. As we said at the outset: It’s better than you think.

¹³ Unlike Defense contracts, which are governed by the Defense Federal Acquisition Regulations (often referred to as the DFARS), civilian agencies generally follow the FAR when purchasing software. In the context of software, only FAR 52.227-19 (Commercial Computer Software), FAR 52.227-20 (SBIR program software) and FAR 52.227-14 (Alt. III) allow delivery of software with restrictions. Otherwise, FAR 52.227-14 specifically *prohibits* delivery of software with restrictions.