

L E G A L P E R S P E C T I V E

Everything You Always Wanted to Know About Software Escrow Agreements—and Then Some!

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Although the U.S. economy has improved in recent months, the risks associated with bankruptcies, mergers, and other market forces remain, and may adversely impact a software owner's ability or willingness to continue supporting its software.

Without ongoing support, the benefits that customers expect to derive from their investment in the software almost certainly will be substantially reduced or eliminated entirely. Worse yet, a software owner's failure to support a product ultimately may lead to software performance failure, bringing customers' critical business processes to a grinding halt.

Fortunately, customers can mitigate these risks with a robust software escrow agreement that ensures access to the software's source code and other supporting materials if any number of conditions adversely affect the owner, thereby enabling the customer to take control of the support function.

The Parties

Software escrow agreements typically involve either two or three principle parties. In the case of a two-party escrow agreement, the software owner enters an agreement with a third-party escrow agent and then

offers customers the opportunity to sign up as beneficiaries to that agreement by paying a relatively modest annual fee. Because two-party escrow agreements involve several beneficiaries, they usually can be changed only through a customer-specific amendment, which both the owner and escrow agent may resist as administratively burdensome.

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A three-party escrow agreement involves the owner, escrow agent, and one specific customer and therefore, can be changed with relative ease to reflect specifically negotiated terms. A three-party agreement may be a better choice because a customer is likely to secure better contractual protection if the software is critical to the customer's operations.

Under both two- and three-party escrow agreements, the owner promises to deposit various items,

including the source code for its software, with the escrow agent for safekeeping and possible release to customers that have opted to participate in the escrow arrangement, whether as a beneficiary or as a direct party to the escrow agreement. An escrow agreement's potential value will be substantially diminished if the deposits are not complete, current, and verifiable.

A complete set of deposits minimally should include:

- All source code for the software, including interfaces and any customizations, in both human-readable and machine-readable form.
- Load instructions for the software that are sufficient to enable the customer to load, execute, and compile the source code into machine-readable object code.
- Copies of all owner-developed software tools and utilities used by the owner to load, execute, and compile the source code and to support and maintain the software.
- A list of commercially available, and copies of any non-commercially available, third-party software tools and utilities that a customer would need to load, execute, and compile the

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source code and to support and maintain the software.

- A copy of all documentation and specifications for the software.
- Any relevant encryption keys and passwords.
- Any other information reasonably required that would enable the customer to use, support, and maintain the software.

To ensure that the deposits are current, the escrow agreement should require the owner to periodically update the deposits by making supplemental deposits with the escrow agent. Supplemental deposits should include a full updated set of the original deposits. They should be made within a certain time after the owner issues a major new release of the software. Additionally, if the software has matured and the time between releases is lengthy, supplemental deposits should occur at periodic calendar-based intervals, such as semi-annually. Unless the customer agrees otherwise, supplemental deposits should supplement the existing deposits, particularly if the customer has gone to the trouble and expense of verifying the deposits.

Although most owners will take their obligation seriously to ensure that escrowed deposits comply with all escrow requirements, the agreement nonetheless should include procedures that enable a customer or its third party representative, which may include the escrow agent, to verify the accuracy and completeness of the deposits.

The verification procedures should require the owner to make knowledgeable resources available to provide technical assistance during the verification process. The owner also should be required to provide, on a loaner basis, any commercially available third-party software tools and

utilities that are not required to be deposited in the escrow account but are necessary to load, execute, and compile the source code into object code and otherwise confirm that the deposits are complete.

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If any deficiencies in the deposits are discovered during the verification process, the owner should be required to promptly correct them. If the deficiencies indicate substantial non-compliance with the escrow agreement's requirements, the owner should be required to bear all or a portion of the costs and expenses incurred by the customer to conduct the verification.

Releasing the Deposits

In escrow agreement negotiations, two of the most hotly debated topics are identifying the triggering events that enable the customer to initiate a release of the deposits and specifying the release mechanisms and procedures themselves.

While the owner's bankruptcy and business discontinuity are perhaps the best-known triggering events, others include:

- The owner's uncured material

breach of its software support obligations.

- The owner's general discontinuation of support for the software, commonly referred to as “sunsetting.”
- The owner's uncured failure to maintain the currency and accuracy of the deposits.
- The owner's assignment of its support obligations to a third party without prior written consent of the customer.

After a triggering event occurs, the customer has the right to demand that the escrow agent release the deposits. Unfortunately for the unsuspecting customer, the typical escrow agreement allows the owner to stop the release process dead in its tracks by issuing “contrary instructions” to the escrow agent. If that happens, the owner and the customer probably will have to resolve their dispute over whether the deposits should be released through a potentially lengthy court battle or protracted arbitration proceeding. Meanwhile, back at the ranch, the customer may be left with substantially diminished, or even no, software support—a condition that almost certainly will be exacerbated by the existence of the escrow dispute.

The wise customer that has remembered the primary reason for requiring an escrow agreement—to enable it to mitigate the adverse business and operational effects of an owner who's unable or unwilling to support the software—will not settle for the typical contrary instructions approach. A customer should insist on a fast, time-bounded dispute-resolution process, which may take the form of an accelerated arbitration proceeding.

Such a process may require the escrow agent to release the deposits to the customer if the arbitrator has

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not rendered a decision within a certain time period, such as within 10 days after the customer's demand that the deposits be released. Alternatively, to prevent the escrow agent from releasing the deposits, the owner may be required to secure a court-ordered temporary restraining order within a fixed time period and to prove that a triggering event did not occur. For either scenario, the objective is the same—speedy resolution of the dispute.

Is an Escrow Agreement Necessary?

As an alternative to an escrow arrangement, some owners offer to include in the underlying software license agreement a commitment to deliver the source code, and possibly other materials, to the customer if certain triggering events occur. Although superficially appealing, this approach will not provide the same level of protection as an escrow arrangement.

First, without the benefit of an impartial third party, the customer

may be forced to pursue a lawsuit against the owner to enforce the contractual obligation. Unfortunately, lawsuits can take years to wind their way through the court system.

Meanwhile, the customer—who presumably had a good reason for wanting to enforce the contractual obligation in the first place—doesn't have access to the source code and other materials and potentially is left adrift without support.

Second, if the owner files for bankruptcy protection, the customer will have limited rights to enforce the owner's contractual obligations and will be required to work within the confines of the bankruptcy code in order to do so. Although the bankruptcy code does include some important protections for licensees of "intellectual property," it is impossible to know with certainty that a court will enforce the owner's source code delivery obligation quickly, if at all.

Conclusion

An escrow agreement is a critically important risk mitigation technique

that should be considered when any major software investment is made. However, the mere existence of an escrow arrangement is not enough to protect the customer's interests. Instead, the customer must ensure that the agreement appropriately addresses several important issues, including identifying the deposits, the triggering events and the release mechanisms and procedures.

About the Author

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